**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of:<br><br>**K. ZARRINNAM AND**<br>**S. ZARRINNAM** | OTA Case No. 18124035 |

## OPINION

Representing the Parties:

For Appellants: K. Zarrinnam

For Respondent: Eric R. Brown, Tax Counsel III
Eric A. Yadao, Tax Counsel IV[1]

For the Office of Tax Appeals: Neha Garner, Tax Counsel III

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, K. Zarrinnam and S. Zarrinnam (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $26,865, an accuracy-related penalty of $5,373, and applicable interest, for the 2013 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Kenneth Gast, Asaf Kletter, and Suzanne B. Brown held an oral hearing for this matter in Cerritos, California, on July 11, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

## ISSUES

1. Whether appellants have shown error in FTB's proposed assessment of additional tax, which is based on a final federal determination.
2. Whether the accuracy-related penalty should be abated.
3. Whether interest should be abated.

[1] David Kowalczyk prepared the opening brief for the Franchise Tax Board (FTB), but he is no longer employed with FTB. He is currently employed with the Office of Tax Appeals (OTA) as a Tax Counsel, but he has had no involvement with this appeal while at OTA.

## FACTUAL FINDINGS

1. Appellants filed a joint 2013 California resident income tax return.
2. FTB subsequently received information from the IRS indicating it examined appellants' 2013 federal income tax return and made several adjustments that increased their taxable income. As relevant here, the IRS disallowed a Schedule E[2] mortgage interest deduction of $8,522, increased Schedule E pass-through entity income by $279,668, and disallowed a portion of claimed itemized deductions based on adjusted gross income (AGI) and other limitations. On June 6, 2016, the IRS closed its examination and assessed additional tax, an accuracy-related penalty based on negligence, and applicable interest.[3]
3. Based on the IRS's adjustments, FTB made conforming changes that increased appellants' California taxable income. On July 20, 2017, about a year after the IRS concluded its examination of appellants' 2013 federal tax return, FTB issued a Notice of Proposed Assessment (NPA) for the 2013 tax year. The NPA proposed to assess additional tax of $26,865, an accuracy-related penalty of $5,373 that was also based on negligence, and applicable interest.[4]
4. On July 24, 2017, appellants protested the NPA,[5] and over a month later, on September 8, 2017, FTB acknowledged appellants' protest. Then, on June 5, 2018, FTB notified appellants that its position had not changed but they could submit additional evidence. On June 19, 2018, appellants replied, and four months later, on

[2] Federal Schedule E is used to report, among other items, income or loss from rental real estate, royalties, partnerships, S corporations, estates, and trusts.

[3] This is based on appellants' most recent 2013 tax year federal account transcript contained in the record, which has a request and response date of May 19, 2022. The federal account transcript, which shows appellants' revised AGI and taxable income, is consistent with appellants' FEDSTAR IRS Data Sheet, which contains a summary of the IRS's adjustments and has an "FTB Received Date" of June 7, 2016.

[4] Specifically, FTB increased appellants' 2013 California taxable income by disallowing the Schedule E mortgage interest deduction of $8,522 and increasing Schedule E pass-through entity income by $276,088 (i.e., the IRS adjustment of $279,668, reduced by $3,580 of Schedule E income reported by appellants on their 2013 California tax return). FTB also disallowed the following claimed itemized deductions based on AGI and other limitations: $14,765 in medical expenses; $5,763 of miscellaneous deductions; and $7,781 of overall itemized deductions.

[5] Appellants included a $10,000 payment with their protest, which FTB is holding in suspense until its proposed assessment is final.

October 26, 2018, FTB issued a Notice of Action (NOA) that affirmed its NPA.[6] This timely appeal followed.

## DISCUSSION

Issue 1: Whether appellants have shown error in FTB's proposed assessment of additional tax, which is based on a final federal determination.

R&TC section 18622(a) requires a taxpayer to concede the accuracy of a federal determination or state where it is erroneous. It is well settled that FTB's proposed assessment based on a final federal determination is presumptively correct and the taxpayer bears the burden of proving the determination is erroneous. (*Appeal of Gorin*, 2020-OTA-018P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof with respect to an assessment based on a federal action. (*Ibid*.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Chen and Chi*, 2020-OTA-021P.)

Here, FTB proposed an assessment of additional tax based on a final federal determination that, among other adjustments, disallowed a Schedule E mortgage interest deduction, increased Schedule E pass-through entity income, and disallowed a portion of claimed itemized deductions. As California generally conforms to these changes, FTB's proposed assessment is presumptively correct. (See R&TC, §§ 17071, 17076, 17077, 17087.5, 17201.)

Appellants argue they only agreed to the IRS's computation of additional tax as reflected on federal Form 4549, Income Tax Examination Changes, which they and the IRS examiner signed in 2015, and FTB's proposed adjustments to their California taxable income are incorrect because they do not match the IRS adjustments on that form.[7] On appeal, appellants submit their signed Form 4549, which shows they handwrote that they only agreed to the tax balance due and not the accuracy-related penalty or interest. However, even though this document is based on adjustments different from those FTB proposes, it is not the IRS's final assessment. Rather, Form 4549 summarizes the results of the audit, memorializes appellants' consent to not exercise

[6] According to its NOA, FTB suspended interest from June 7, 2017, to August 3, 2017, under R&TC section 19116.

[7] For example, appellants claim the IRS, as shown on Form 4549, did not disallow a Schedule E mortgage interest deduction, and while the IRS did increase their Schedule E pass-through entity income, FTB's conforming adjustment is greater.

their appeal rights so the IRS can immediately assess tax and begin collection action, and explains it is subject to further IRS review. (See *Evans v. Commissioner*, T.C. Memo. 1999-66 [Form 4549 is not a final and conclusive closing agreement under Internal Revenue Code (IRC) section 7121 and does not preclude the IRS from later determining an additional deficiency].)

Appellants' federal account transcript, dated May 19, 2022, indicates the IRS closed its examination and assessed additional tax on June 6, 2016, which was over a year after appellants signed Form 4549 in 2015. The federal account transcript, which shows appellants' revised AGI and taxable income, is consistent with their FEDSTAR IRS Data Sheet. FTB received that IRS data sheet in 2016, also a year after appellants signed Form 4549, and it contains a summary of the relevant final IRS adjustments that differ from those on Form 4549. FTB thus properly based its proposed assessment on these federal documents and not on Form 4549. Although appellants requested IRS audit reconsideration, there is no evidence the IRS reduced or revised its assessment. Accordingly, appellants have not shown error in FTB's proposed assessment.

Issue 2: Whether the accuracy-related penalty should be abated.

R&TC section 19164 generally incorporates the provisions of IRC section 6662 and imposes an accuracy-related penalty of 20 percent of the applicable underpayment of tax. As relevant here, the penalty applies to any portion of an underpayment attributable to negligence or disregard of rules and regulations. (IRC, § 6662(b)(1).) "Negligence" includes "any failure to make a reasonable attempt to comply" with the provisions of the code, and "disregard" includes "any careless, reckless, or intentional disregard." (IRC, § 6662(c); see also Treas. Reg. § 1.6662-3(b)(1) ["'Negligence' also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly"].)

Here, the IRS imposed an accuracy-related penalty based on negligence. Thus, FTB's imposition of an accuracy-related penalty also based on negligence is presumptively correct. (See *Appeal of Abney* (82-SBE-104) 1982 WL 11781 [when FTB proposes a penalty based on a federal penalty determination, FTB's determination is presumptively correct].) Appellants argue the IRS erroneously imposed the penalty because although they signed Form 4549 stating they agreed to the tax balance due, they indicated disagreement with the accuracy-related penalty by crossing it out and inserting their initials. However, there is no evidence the IRS reduced or cancelled this penalty, and appellants do not otherwise argue the penalty was improperly imposed.

An accuracy-related penalty based on negligence can be abated upon a showing of reasonable cause and good faith. (IRC, § 6664(c)(1); Treas. Reg. §§ 1.6664-1(b)(2), 1.6664-4.) Taxpayers bear the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc., et al. v. Commissioner*, T.C. Memo. 2010-76.) Appellants contend the penalty should be "abated due to the lengthy time period the FTB/IRS has taken to inform [them] of this additional tax." However, this does not explain why appellants underreported their tax, which led to FTB's imposition of the accuracy-related penalty.[8] For example, appellants have not shown the extent of their efforts to assess their proper tax liability. (See Treas. Reg. § 1.6664-4(b)(1).) Accordingly, appellants are not entitled to abatement of the accuracy-related penalty.[9]

Issue 3: Whether interest should be abated.

If any amount of tax is not paid by the due date, interest is required to be imposed from the due date until the date the taxes are paid. (R&TC, § 19101(a).) Interest is not a penalty but is compensation for the taxpayer's use of money that should have been paid to the state. (*Appeal of Balch*, 2018-OTA-159P.) Imposition of interest is mandatory, and it can only be abated in certain limited situations when authorized by law. (R&TC, § 19101(a); *Appeal of Balch*, *supra*.)

As with the federal accuracy-related penalty, appellants assert they did not agree to interest when they signed Form 4549. However, appellants' focus on the IRS's imposition of interest is improper because the IRS and FTB are two separate tax agencies. By statute, FTB separately calculates interest on unpaid amounts of state income tax and penalties and is therefore not bound by IRS interest determinations. (See R&TC, § 19101.)

Appellants also assert the IRS, and presumably FTB, took more than two years to assess additional tax and therefore unreasonably delayed in notifying them of their deficiency.[10] R&TC

[8] Appellants also argue abatement is appropriate because this is the first time they received a notice from FTB that additional tax was owed. However, there is no provision in California tax law allowing the accuracy-related penalty to be abated under these circumstances. (But see R&TC, § 19132.5 [allowing first-time abatement of timeliness penalties for good filing and payment history for the 2022 and subsequent tax years].)

[9] FTB alternatively asserts its imposition of the accuracy-related penalty is proper based a substantial understatement of tax. (IRC, § 6662(b)(2).) However, since OTA finds appellants are liable for the penalty based on negligence, OTA need not separately determine whether they are liable for the penalty based on this alternative ground for affirmance.

[10] To the extent appellants assert a reasonable cause-type argument, there is no such exception to the imposition of interest. (*Appeal of Moy*, 2019-OTA-057P.)

section 19104 authorizes FTB to abate interest if there has been an unreasonable error or delay in the performance of a ministerial or managerial act by an officer or employee of FTB. OTA has jurisdiction to determine whether a failure by FTB to abate interest was an abuse of discretion and may order an abatement in such cases. (R&TC, § 19104(b)(2)(B).) To show an abuse of discretion, a taxpayer must establish that, in refusing to abate interest, FTB exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. (*Appeal of Gorin*, *supra*.) Appellants, however, have not made such a showing.

As a threshold matter, appellants are not entitled to interest abatement prior to July 20, 2017, because that is when FTB issued its NPA first contacting appellants in writing about the underlying deficiency. (R&TC, § 19104(b)(1).) Thereafter, on July 24, 2017, appellants protested the NPA, and over a month later, on September 8, 2017, FTB acknowledged appellants' protest. Then, nine months later, on June 5, 2018, FTB notified appellants that its position had not changed, but provided them an opportunity to submit additional evidence. On June 19, 2018, appellants replied, and four months later, on October 26, 2018, FTB issued its NOA that affirmed its NPA. In total, FTB took less than a year and a half to issue its NPA and affirm it with the NOA. FTB was thus working on appellants' protest after the NPA was issued and there is no evidence to indicate it failed to do so during the nine-month time period between acknowledging the protest and communicating its position.[11] Accordingly, appellants are not entitled to interest abatement.[12]

[11] Appellants also argue FTB's imposition of interest is "both illegal and usury" under the California Constitution because, in their view, FTB charged 12 percent interest (i.e., $3,251.11 of interest per the NPA divided by additional tax of $26,865.00), instead of the allowable 3 percent based on FTB's website. However, appellants' calculation of interest appears to be based on simple interest, which is incorrect because FTB is required by statute to compound interest daily. (R&TC, § 19521(b)(1).) In any event, under Article III, section 3.5 of the California Constitution, OTA lacks jurisdiction to determine whether a California statute is invalid or unenforceable under the California Constitution, unless a federal or California appellate court has already made such a determination. (Cal. Code Regs., tit. 18, § 30104(a).)

[12] However, as noted above, FTB suspended interest from June 7, 2017, to August 3, 2017, under R&TC section 19116. Therefore, appellants are not liable for interest during that time period, and as FTB acknowledged at the oral hearing, appellants' $10,000 payment being held in suspense will also reduce the interest owed. (See R&TC, § 19041.5.)

## HOLDINGS

1. Appellants have not shown error in FTB's proposed assessment of additional tax, which is based on a final federal determination.
2. The accuracy-related penalty should not be abated.
3. Interest should not be abated.

## DISPOSITION

FTB's action is sustained in full.[13]

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Kenneth Gast
Administrative Law Judge

We concur:

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Asaf Kletter
Administrative Law Judge

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Suzanne B. Brown
Administrative Law Judge

Date Issued: 8/15/2023

[13] In their appeal letter, appellants request that OTA accept their $10,000 payment to settle the proposed assessment. However, OTA lacks authority to make discretionary adjustments to the amount of a tax assessment based on a taxpayer's willingness to settle. (*Appeal of Robinson*, 2018-OTA-059P.) Instead, FTB, and not OTA, has statutory authority to settle disputed liabilities with the taxpayer and to compromise certain final liabilities. (R&TC, §§ 19442, 19443.)