OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. LEE AND** **V. LEE**	OTA Case No. 19105396

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: J. Lee and V. Lee

For Respondent: Sarah J. Fassett, Tax Counsel

S. RIDENOUR, Administrative Law Judge: On October 21, 2021, the Office of Tax Appeals (OTA) issued an Opinion modifying an action of respondent Franchise Tax Board (FTB) denying a claim for refund filed by J. Lee and V. Lee (appellants) for the 2016 tax year. Specifically, the Opinion reduced the demand penalty at issue from $7,830.00 to $795.25.

FTB filed a petition for rehearing under Revenue and Taxation Code (R&TC) section 19334 as to the reduced demand penalty based on the ground that the Opinion is contrary to law.[1] OTA concludes that FTB established a basis to grant a new hearing.

OTA may grant a rehearing where one of the following six grounds is met and materially affects the substantial rights of the party seeking a rehearing (here, FTB): (1) an irregularity in the proceedings that occurred prior to the issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise that occurred during the appeals proceeding and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the filing party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the appeals

[1] The October 21, 2021 Opinion also found that appellants did not show that the failure to timely file a 2016 return was due to reasonable cause. Neither party filed a petition for rehearing as to the late filing penalty issue. Therefore, this Opinion on Petition for Rehearing will solely address the demand penalty.

hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6); *Appeal of Do*, 2018-OTA-002P; *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654.)

Newly Submitted Evidence

As a preliminary matter, while FTB only asserts the contrary to law ground in its petition for rehearing, FTB has provided an exhibit (Exhibit T) with its petition for rehearing which was not a part of the original appeal record. In order for OTA to consider newly submitted evidence in a petition for rehearing, the party submitting the evidence needs to show that the documentation submitted is newly discovered, relevant evidence which the party could not have reasonably discovered and provided prior to the issuance of the Opinion. (Cal. Code Regs. tit. 18, § 30604(a)(3).) FTB does not contend that the evidence (notices relating to J. Lee's 2012 tax year issued by FTB in 2014) could not have been discovered by it and provided to appellants and OTA prior to the issuance of the Opinion. As such, the additional evidence (Exhibit T) will not be considered by OTA in determining whether to grant FTB's petition for rehearing and OTA's analysis of the contrary to law ground will be based solely on the record in the original appeal.

Contrary to Law

Under the prior version of OTA's Rules for Tax Appeals, there were five grounds to grant a rehearing, and the insufficient evidence to justify the written opinion ground and the opinion is contrary to law ground were interconnected as a single ground for a rehearing. (See Cal. Code Regs., tit. 18, § 30604(d) [effective January 2, 2019, through February 28, 2021].) The March 1, 2021 revision to OTA's Rules for Tax Appeals separated the insufficient evidence and contrary to law grounds into two separate grounds, and added a new explanation that "the 'contrary to law' standard of review shall involve a review of the Opinion for consistency with the law." (Cal. Code Regs., tit. 18, §§ 30604(a)(4) & (5), 30604(b) [effective March 1, 2021].) The revision serves to make clear that the analysis may now focus solely on insufficiency of the evidence or contrary to law, or both, as relevant. (Cal. Code Regs., tit. 18, § 30604(a)(4)-(5).)

The contrary to law ground "does not import a situation in which the court weighs the evidence and finds a balance against the [holding], as it does in considering the ground of insufficiency of the evidence." (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906

(*Sanchez-Corea*), citing *Musgrove v. Ambrose Properties* (1978) 87 Cal.App.3d 44, 56.)[2] Rather, a holding is contrary to law "only if it was 'unsupported by any substantial evidence, i.e., [if] the entire evidence [was] such as would justify a [holding] against the part[y] in whose favor the [holding was] returned.'" (*Sanchez-Corea, supra,* 38 Cal.3d at p. 907, citing *Kralyevich v. Magrini* (1959) 172 Cal.App.2d 784, 789.) This requires indulging "in all legitimate and reasonable inferences" to uphold the Opinion. (*Sanchez-Corea, supra*, 38 Cal.3d at p. 907; see also *Appeals of Swat-Fame Inc. et al.*, 2020-OTA 045P.) The question does not involve "examining the quality or nature of the reasoning behind [OTA's Opinion], but whether [the Opinion] can or cannot be valid according to the law." (*Appeal of NASSCO Holdings, Inc.* (2010-SBE-001) 2010 WL 5626976, at p. *5.) A rehearing may be granted when, examining the evidence in the light most favorable to the prevailing party (here, appellants), with all legitimate inferences to uphold the Opinion, the petitioning party (here, FTB) establishes that the Opinion incorrectly stated or applied the law and, therefore, is contrary to law. (*Appeal of NASSCO Holdings, Inc., supra*.)

In the instant appeal, FTB filed its petition for rehearing on the ground that the Opinion is contrary to law. Therefore, this appeal turns entirely on a question of law and whether OTA finds that the Opinion is contrary to law. (See Cal. Code Regs., tit. 18, § 30604(a)(5).)

For OTA's administrative proceedings, OTA interprets the contrary to law standard of review as requiring that: (1) the evidence must be examined in the light most favorable to the prevailing party and OTA must indulge all legitimate and reasonable inferences to uphold the Opinion; (2) at least some portion of the Opinion applied the wrong legal standard or interpretation of the law to the evidence; and (3) application of the correct legal standard or interpretation of the law would likely result, in whole or part, in a different holding.

The pertinent evidentiary findings and facts are not in dispute. The relevant facts and findings are as follows:

1. On February 3, 2015, FTB sent V. Lee a Demand for Tax Return (Demand), requiring that she either file a 2013 return, provide evidence that a 2013 return was already filed, or explain why a 2013 return was not required. When V. Lee failed to respond to the

[2] As provided in *Appeal of Wilson Development, Inc., supra*, it is appropriate for OTA to look to Code of Civil Procedure section 657 and applicable caselaw as relevant guidance in determining whether a ground has been met to grant a new hearing.

Demand, FTB issued V. Lee a Notice of Proposed Assessment (NPA), dated April 6, 2015.

2. On March 15, 2018, FTB sent J. Lee a separate Demand, requiring that he either file a 2016 return, provide evidence that a 2016 return was already filed, or explain why a 2016 return was not required.[3] When J. Lee failed to respond to the Demand, FTB issued J. Lee an NPA, dated May 14, 2018, setting forth estimated California taxable income of $370,640.00. The NPA proposed tax (before payments/credits) of $33,393.00, a late filing penalty, a demand penalty of $8,348.25, and a filing enforcement fee, plus applicable interest. J. Lee did not protest the NPA, and it became a final assessment.
3. On April 10, 2018, FTB sent V. Lee a separate Demand, requiring that she either file a 2016 return, provide evidence that a 2016 return was already filed, or explain why a 2016 return was not required. When V. Lee failed to respond to the Demand, FTB issued V. Lee an NPA, dated June 11, 2018, setting forth estimated California taxable income of $63,056.00. The NPA proposed tax (before payments/credits) of $3,181.00, a late filing penalty, a demand penalty of $795.25, and a filing enforcement fee, plus applicable interest. V. Lee did not protest the NPA, and it became a final assessment.
4. On September 6, 2018, appellants untimely filed a joint 2016 California tax return, reporting California taxable income of $395,585.00 and total tax (before payments/ credits) of $31,320.00. FTB accepted the return as filed and reduced the demand penalty to $7,830.00 and imposed a revised late filing penalty.
5. Appellants' outstanding liability was subsequently satisfied, and appellants filed a claim for refund.
6. Appellants are entitled to a refund if FTB improperly imposed the demand penalty, in whole or in part.

If a taxpayer fails or refuses to furnish any information requested in writing by FTB or fails or refuses to make and file a return upon notice and demand by FTB, then, unless the failure is due to reasonable cause and not willful neglect, FTB may add a penalty of 25 percent of the amount of the tax assessed pursuant to R&TC section 19087 or of any deficiency tax assessed by FTB concerning the assessment of which the information or return was required (i.e., the demand

[3] At the oral hearing, FTB stated that it issued an NPA and Demand to J. Lee for the 2012 tax year and offered to provide copies to OTA. OTA did not request a copy of the documents and the record was closed at the conclusion of the hearing.

penalty). (R&TC, § 19133.) With respect to individual taxpayers, FTB will only impose a demand penalty if: (1) the taxpayer fails to respond to a current Demand; and (2) at any time during the preceding four tax years for which the current Demand is issued, FTB issued an NPA following the taxpayer's failure to timely respond to a request or a demand for tax return. (See former Cal. Code Regs., tit. 18, § 19133(b)(1)-(2).)[4] The demand penalty is computed at 25 percent of the amount of the taxpayer's total tax liability, which is determined without regard to tax withholding and other payments. (R&TC, § 19133; *Appeal of Jones*, 2021-OTA-144P.)

The Opinion, finding no evidence in the record establishing that at any time during the preceding four tax years FTB issued an NPA to J. Lee following his failure to timely respond to a request or a demand for tax return (Cal. Code Regs., tit. 18, § 19133(b)(2)), held that the "demand penalty imposed on J. Lee was not properly imposed." The Opinion, therefore, reduced the demand penalty of $7,830.00 to $795.25. The Opinion also found that the "demand penalty imposed on V. Lee in the amount of $795.25" was properly imposed, and that appellants failed to meet their burden of proving reasonable cause to abate the penalty. Therefore, the sole issue in this petition for rehearing involves whether the Opinion's holding reducing the demand penalty to $795.25 is "valid according to the law." (See *Appeal of NASSCO Holdings, Inc.*, *supra*.)

Because there is no evidence in the record establishing that FTB issued a request or demand for tax return and an NPA to J. Lee at any time during the four tax years preceding the 2016 tax year at issue in this appeal, this Opinion on Petition for Rehearing only considers the proper calculation of the demand penalty imposed on V. Lee exclusively.[5] As noted above, the Opinion reduced the demand penalty imposed on V. Lee to $795.25, the amount of the demand penalty reflected on the NPA issued to V. Lee. This demand penalty amount was based on FTB's *estimate* of V. Lee's *separate* net income and resulting tax for the 2016 tax year before appellants untimely filed their joint 2016 return reporting their correct net income and tax, which FTB accepted as filed. At a minimum, OTA concludes that the calculation of the demand penalty imposed on V. Lee should have considered the revised/corrected net income and tax

[4] Regulation section 19133(b)(2) was amended for demand penalties imposed on or after January 1, 2020, which is not applicable in this appeal. (Cal. Code Regs., tit. 18, § 19133(b)(2).)

[5] As noted above, this Opinion on Petition for Rehearing is not considering Exhibit T (the 2012 Demand and NPA issued to J. Lee), which was provided by FTB with its petition for rehearing.

amounts that V. Lee reported with her spouse, J. Lee, on their untimely filed joint tax return for the 2016 tax year.[6]

When a taxpayer fails to file a required return, FTB does not have knowledge of all of the taxpayer's potential income[7] or deduction items, marital status, or dependents for the applicable tax year, nor does FTB know the filing status the taxpayer will utilize on his or her return for the year or if the taxpayer will elect to file a joint return with a spouse or registered domestic partner. The NPA that FTB sent to V. Lee proposing tax (before payments/credits) of $3,181.00 and a demand penalty of $795.25 (i.e., 25 percent of the proposed tax of $3,181.00) was necessarily based on an estimate of V. Lee's net income and resulting tax for the 2016 tax year. For example, while appellants' joint return reported two dependents and itemized deductions exceeding $46,000 for the 2016 tax year, the NPAs separately issued to J. Lee and V. Lee each utilized the single filing status, no dependents, and allowed only the standard deduction. By utilizing the NPA's estimate of V. Lee's net income and resulting tax to compute the demand penalty for the 2016 tax year, the Opinion improperly disregards the corrected items reported by appellants on their joint return, in favor of FTB's estimate of V. Lee's net income and resulting tax, which as noted above was necessarily based on limited and incomplete information.

R&TC section 19133 expressly provides that if a taxpayer fails or refuses to make and file a return upon notice and demand by FTB, then, unless the failure is due to reasonable cause and not willful neglect, FTB may add a penalty of "25 percent of the amount of the tax assessed pursuant to [R&TC] section 19087 *or* of any deficiency tax assessed by [FTB] concerning the assessment of which the . . . return was required." (Italics added.) The "or" in R&TC section 19133 makes clear that the demand penalty may be calculated based on either: (1) the proposed tax based on FTB's estimate of the taxpayer's net income made pursuant to R&TC section 19087 where no return is filed by the taxpayer; or (2) the "deficiency tax assessed" concerning the assessment of which the return was required (i.e., concerning the missing return). Where, as here, the taxpayer subsequently files a missing return after FTB issued an NPA

[6] This Opinion on Petition for Rehearing does not decide whether the Opinion's reduction to the demand penalty imposed on V. Lee to $795.25 is also contrary to joint and several liability law based on appellants' filing of a joint return for the 2016 tax year, as FTB asserts.

[7] FTB would only have knowledge of income items which are reported to it by the IRS or third parties. Taxpayers may have additional income items or sources which are not reported to the IRS or FTB.

estimating the taxpayer's net income and imposing tax and the demand penalty based on that estimate, the second clause in R&TC section 19133 permits FTB to revise its demand penalty based on the subsequently filed, and accepted, return. When a missing return is subsequently accepted as filed by FTB (after FTB initially imposed tax and a demand penalty based on an estimate of the taxpayer's net income pursuant to R&TC section 19087(a)), FTB necessarily corrects the "deficiency tax assessed" concerning that missing return based on the taxpayer's reporting on that return. Since the "deficiency tax assessed" concerning the missing return is revised by FTB, so too is the demand penalty which is computed as 25 percent of the "deficiency tax assessed" concerning that return.

If FTB was not permitted to revise its initial demand penalty computation per its NPA estimating a taxpayer's net income, after a taxpayer either protests the NPA or subsequently files a missing return, the "or" and the last clause in R&TC section 19133 would be unnecessary. Instead, with respect to the failure to file a return upon notice and demand, R&TC section 19133 could simply state FTB may add a penalty of 25 percent of the amount of tax determined pursuant to R&TC section 19087, and stop there.[8] Additionally, OTA and its predecessor the Board of Equalization, have repeatedly upheld FTB's revisions to the demand penalty amount initially imposed in an NPA which estimated the taxpayer's net income, based on the revised total tax subsequently reported by the taxpayer in a late filed return. (See, e.g., *Appeal of Lash* (86-SBE-021) 1986 WL 22692 [demand penalty for the 1980 and 1981 tax years revised after appellant filed joint returns with his spouse for these tax years]; *Appeal of Day* (82-SBE-061) 1982 WL 11739 [demand "penalty was reduced from 25 percent of the tax liability estimated by

[8] Where no return has been filed, the only statute authorizing FTB to estimate income and assess tax based on such estimate is R&TC section 19087(a), which provides that FTB may "make an estimate of the net income, from any available information," and "propose to assess the amount of tax, interest, and penalties due" where a taxpayer "fails to file a return."

[FTB] to 25 percent of the self-assessed tax shown on the return" after appellant filed the missing return for the 1978 tax year].)[9]

Other than stating that the demand penalty was properly imposed as to V. Lee (but not J. Lee), the Opinion provides no analysis, discussion, rationale, or legal authority for why the revised demand penalty imposed on V. Lee should be reduced to $795.25, an amount based on FTB's *estimate* of V. Lee's *separate* net income and resulting tax per the NPA, rather than the net income and resulting tax actually reported by V. Lee (and accepted by FTB) on the joint return she filed with her spouse J. Lee.[10] OTA concludes that the Opinion's failure to provide any rationale for its reduction of the penalty to $795.25, and its failure to consider the actual amount of net income and resulting tax reported by V. Lee in the late filed return (including appellants' proper filing status, tax rate, itemized deductions, dependents, etc.), is contrary to R&TC section 19133, which permits FTB to calculate and impose the demand penalty based on its estimate of a taxpayer's net income pursuant to R&TC section 19087, *or* based on the "deficiency tax assessed" concerning the assessment of which the return was required.

Similarly, the reduction of the demand penalty to $795.25 based on FTB's *estimate* of V. Lee's *separate* net income fails to properly analyze and apply California's community property law. Absent a prior valid transmutation agreement, appellants would be required to follow community property rules for the division of income. (Fam. Code, §§ 760, 852.) Where

[9] OTA notes that this re-computation of the demand penalty, after a taxpayer either protests the NPA or files a missing tax return, is often beneficial to taxpayers since the result is often a *reduction* to the amount of the demand penalty initially imposed per the NPA. This is because the NPA necessarily estimates the taxpayer's net income, only allows the standard deduction, and assumes a filing status of single with no dependents. This was the result in both *Appeal of Lash*, *supra*, and *Appeal of Day*, *supra*, and here. The demand penalties imposed by the separate NPAs issued to J. Lee and L. Lee totaled $9,143.50; however, this amount was reduced to $7,830.00 after appellants filed their joint return. Failing to adjust the demand penalty imposed per the NPA, where the taxpayer subsequently protests the NPA or files a return which is accepted as filed by FTB, would result in situations where taxpayers are improperly penalized based on more tax than they actually owe for the applicable tax year and situations where FTB is improperly limited or prevented from imposing the correct penalty amount where it had incomplete information about the taxpayer's income items for a particular tax year because of the taxpayer's failure to file required returns.

[10] In a situation such as this, where the demand penalty is only properly imposed as to one of the two spouses who subsequently file a joint return, there remains an open question of: (1) whether the revised demand penalty imposed on the nonresponding spouse should be computed based on the total tax reported on the joint return as a result of joint and several liability arising from the filing of a joint return (see Internal Revenue Code section 6013(d)(3) and R&TC section 19006(b)), as FTB asserts in its petition for rehearing; or (2) whether the total tax reported on this joint return should be somehow prorated or bifurcated to determine V. Lee's share of the total tax reported for purposes of computing the revised demand penalty. This Opinion on Petition for Rehearing does not need to address this issue in order to find FTB's petition for rehearing should be granted.

the income in question is community property, one-half of the income is attributable to each spouse and each spouse must report and pay tax on his or her respective one-half community property interest in the income. (*Appeals of Cremel and Koeppel*, 2021-OTA-222P, citing *U.S. v. Mitchell* (1971) 403 U.S. 190; 196-97; *U.S. v Malcom* (1931) 282 U.S. 792; and *Poe v. Seaborn* (1930) 282 U.S. 101.) The NPA also understandably did not take into consideration V. Lee's community property interest in the community's income (including the income earned by J. Lee), as FTB lacked knowledge as to V. Lee's marital status for 2016 at the time the NPA was issued.[11] The Opinion, by reducing the demand penalty to $795.25, an amount based on FTB's estimate of V. Lee's *separate* net income, does not take into consideration V. Lee's community property interest in the community's income (including that earned by J. Lee), which is contrary to California's community property law.

As discussed above, OTA finds a rehearing based on the ground that the Opinion is contrary to law requires a finding that: (1) the evidence must be examined in the light most favorable to the prevailing party and OTA must indulge all legitimate and reasonable inferences to uphold the Opinion; (2) at least some portion of the Opinion applied the wrong legal standard or interpretation of the law to the evidence; and (3) application of the correct legal standard or interpretation of the law would likely result, in whole or part, in a different holding. OTA finds, after examining the evidence in the light most favorable to appellants and indulging all legitimate and reasonable inferences to uphold the Opinion, that the Opinion's reduction of the demand penalty imposed on V. Lee to $795.25, based on FTB's *estimate* of V. Lee's *separate* net income and tax (before payments/credits) for the 2016 tax year, rather than the actual net income and resulting tax reported on the joint return subsequently filed by appellants and accepted as filed by FTB, is contrary to R&TC section 19133 and California's community property law.

[11] Had V. Lee filed a separate return for the 2016 tax year, she would have been required to report one-half of the income she earned during the 2016 tax year and one-half of the income earned by J. Lee during the 2016 tax year, pursuant to California community property law and the authorities noted above. Any proration or bifurcation of the total tax reported on the joint return (if required) would need to consider V. Lee's community property interest in the community's income (including the income earned by J. Lee).

OTA grants FTB's petition for a rehearing as to the issue of the demand penalty, on the basis that the Opinion's holding as to the reduced demand penalty is contrary to law, resulting in an incorrect disposition of the appeal.

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Sheriene Anne Ridenour
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Sheriene Anne Ridenour
Administrative Law Judge

We concur:

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