OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: | OTA Case No. 18042718

S. YARI AND
L. YARI

OPINION

Representing the Parties:

For Appellants: Steven R. Mather, Attorney

For Respondent: D. Todd Watkins, Attorney

For Office of Tax Appeals: William J. Stafford, Attorney

R. TAY, Administrative Law Judge: This appeal is made pursuant to section 19045 of the Revenue and Taxation Code (R&TC) from the action of the Franchise Tax Board (FTB) proposing a deficiency assessment against S. and L. Yari (appellants) for their 2006 tax year consisting of the following: additional tax of $339,966; a noneconomic substance penalty under R&TC section 19774 of $116,490; an interest-based penalty under R&TC 19777 of $147,197.97; plus interest on any unpaid amounts.[1]

Office of Tax Appeals (OTA) Administrative Law Judges Andrea L.H. Long, Amanda Vassigh, and Richard Tay held an oral hearing for this matter in Cerritos, California, on September 12, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

[1] On appeal, FTB withdrew the noneconomic substance penalty and the interest-based penalty. Thus, the penalties are no longer in dispute.

ISSUE[2]

Whether FTB's Notice of Proposed Assessment (NPA) was timely issued for purposes of the statute of limitations for the 2006 tax year.

FACTUAL FINDINGS

Related Entities

1. United Enterprises (United) was formed as a limited partnership, which was in the business of owning, constructing, managing, and maintaining real property in New York City.[3] Prior to January 2, 2002, appellant-husband had been a partner with a 10 percent capital and profits interest in United. As of January 2, 2002, however, appellant-husband's limited liability company (LLC), Topaz Global Holdings, LLC (Topaz), replaced him as a partner in United. According to United's 2006 federal income tax return, United was comprised of 11 partners, one of which was Topaz.[4]
2. In 2006, Topaz was a single-member LLC, and appellant-husband was its sole member/owner. Topaz was a "disregarded entity" for federal and California tax purposes, and in 2006, appellants reported Topaz's income on their federal Schedule C.
3. Supreme Dynamics, Inc., (SDI) was also wholly owned by appellant-husband and domiciled in Nevada in 2006.

United's Sales of Properties in 2006

4. In 2006, United sold various rental real estate properties. The sales produced approximately $30 million in Internal Revenue Code (IRC) section 1231 gains.[5]

[2] During the pre-hearing conference, appellants affirmed they are no longer separately arguing for relief of the interest in dispute, and that any relief would be a consequence of appellants' prevailing on the statute of limitations issue. Thus, OTA limits its discussion accordingly.

[3] Although formed as a limited partnership, United reported that it was a general partnership on its federal tax return for the year at issue.

[4] It is noteworthy that United issued Schedule K-1s to Topaz through 2016.

[5] IRC section 1231 is incorporated into California tax law by R&TC section 18151.

Tax Reporting for the 2006 Tax Year

Schedule K-1 From United

5. United issued a Schedule K-1 to Topaz for 2006 indicating that Topaz held a 10 percent interest in United. Topaz's share of income included $2,995,058 of net IRC section 1231 gain, and $7,000,000 in distributions from United during 2006.

Appellants' 2006 Income Tax Return

6. On appellants' 2006 federal and California income tax returns, appellants reported gross receipts or sales of $191,250 and a net loss of $359,291 from Topaz on Schedule C. The largest deduction claimed on the Schedule C was a $286,000 deduction for "accounting fees." Appellants also reported Schedule D gains from SDI: $1,420 of short-term gain and $27,349 of long-term gain. Appellants also included $136,421 of losses from SDI on their Schedule E.

SDI's 2006 Income Tax Return

7. SDI filed an S corporation federal tax return for 2006 reporting that it was in the business of "real estate." SDI did not file a 2006 California franchise or income tax return.
8. On its 2006 federal income tax return, SDI reported that it received various items of pass-through income from United (short term capital gain of $1,420 and long-term capital gain of $27,349.) A Form 4797 (Sales of Business Property) attached to SDI's return claims a step-up in basis from United that generated a $3,131,479 loss and $2,995,058 of gain, which it offset to generate a $136,421 loss on Form 4797. SDI also reported having received $446,487 of net rental income from United during 2006. SDI issued a Schedule K-1 to appellant-husband reporting gains and losses that allegedly flowed from United, to SDI, to appellant-husband for the 2006 tax year.
9. Despite the tax reporting on SDI's 2006 return, United continued to issue its Schedule K-1s to Topaz after 2006.
10. Appellants contend that although they had discussed with their accountants a plan to transfer the interest Topaz held in United to SDI, which they apparently hoped would justify a step-up in basis, no such transfer ever occurred. However, appellants' tax return

for 2006 was premised on the transaction having occurred, which triggered the step-up in basis in the United partnership interest.

Audit and Procedural History

11. FTB initiated an audit of appellants' 2006 California income tax return in 2011. During audit, FTB determined that SDI's reported transaction involving the basis step-up of $3,131,479 lacked economic substance and that the IRC section 1231 gain of $2,995,058 should be included in appellants' gross income, instead of the loss of $136,421. In addition, FTB determined that by reporting the loss of $136,421, appellants had participated in an "abusive tax avoidance transaction" (ATAT) such that the extended 12-year statute of limitations pursuant to R&TC section 19755(a)(2) was applicable.
12. FTB issued an NPA dated April 6, 2015, which proposed a deficiency tax assessment of $339,966.00, and penalties, plus applicable interest, for the 2006 tax year.[6]
13. At protest, appellants conceded that FTB's deficiency determination of tax was correct but argued that it was not timely made within the applicable limitations period. Appellants asserted, *inter alia*, that FTB's proposed assessment was not related to an ATAT, and thus, the 12-year extended statute of limitations under R&TC section 19755(a)(2) was not applicable.
14. FTB affirmed the NPA in a Notice of Action dated November 21, 2017.
15. Appellants filed this timely appeal.

DISCUSSION

The Applicable Statute of Limitations

The general rule is FTB must mail an NPA within four years after the taxpayer filed the income tax return for the year at issue for the proposed assessment to be considered timely. (R&TC, § 19057(a).) Asserting that an assessment is barred by the statute of limitations is an affirmative defense, and the appellant has the burden of proving that defense. (*Adler v. Commissioner* (1985) 85 T.C. 535, 540; see also *Amesbury Apartments, Ltd. v. Commissioner* (1990) 95 T.C. 227, 240-241; *Heckman v. Commissioner*, T.C. Memo. 2014-131.) Here, it is uncontroverted appellants' 2006 California tax return was filed on October 15, 2007, and FTB's

[6] As a result of the increase to appellants' income, appellants' itemized deductions were adjusted as well. Appellants do not dispute this computational change premised on FTB's proposed assessment of tax.

NPA was issued on April 6, 2015. Hence, appellants argue, FTB did not timely issue the NPA under the general statute of limitations.

Where the party pleading the defense makes such a showing, the burden of going forward with the evidence shifts to respondent who must then introduce evidence to show that the bar of the statute is not applicable. (*Adler v. Commissioner*, *supra* at p. 540.) FTB contends its NPA was timely issued pursuant to an exception to the general statute of limitations, contained in R&TC section 19755. R&TC section 19755(a)(2) provides an NPA is timely if it is issued within 12 years after the return is filed for the period at issue, if it contains a proposed deficiency assessment related to an ATAT. Thus, whether FTB's NPA was timely issued is contingent on whether FTB has shown its deficiency determination is "related to an [ATAT]" within the meaning of R&TC section 19755(a)(2).

The Alleged ATAT Transaction

SDI reported the $2,995,058 gain that flowed from United, but also reported a stepped-up basis (positive adjustment) of $3,131,479. The $3,131,479 step-up in basis offset the gain of $2,995,058, and as a result, SDI reported a loss of $136,421. SDI passed the loss of $136,421 to appellant-husband via a Schedule K-1. Appellants then reported on their individual return the loss of $136,421. This reporting was the result of an alleged transfer of a United partnership interest from Topaz to SDI.

ATAT Analysis

FTB has the burden of showing that an exception to the default statute of limitations applies. (*Adler v. Commissioner*, *supra*, at p. 541.) FTB must show the transfer of a United partnership interest from Topaz to SDI, which resulted in the favorable tax benefits to appellants, was an ATAT.

The definition of an ATAT is contained in R&TC section 19777(b), which provides as follows:

> (b) [An ATAT] means any of the following:
>
> (1) A tax shelter as defined in Section 6662(d)(2)(C) of the Internal Revenue Code . . .
>
> (2) A reportable transaction, as defined in Section 6707A(c)(1) of the Internal Revenue Code, relating to reportable transaction, with respect to which the requirements of Section 6664(d)(3)(A) of the Internal Revenue Code are not met.

> (3) A listed transaction, as defined in Section 6707A(c)(2) of the Internal Revenue Code, relating to listed transaction.
> (4) A gross misstatement, within the meaning of Section 6404(g)(2)(D) of the Internal Revenue Code.
> (5) Any transaction to which [R&TC section] 19774 applies [i.e., a "noneconomic substance transaction"].

(R&TC, § 19777(b).)

Accordingly, to determine whether the extended 12-year statute of limitations of R&TC section 19755(a)(2) applies to appellants' 2006 tax year, the transaction at issue must be classified as one of the above-listed classifications (e.g., a tax shelter, a reportable transaction, a listed transaction, a gross misstatement, or a noneconomic substance transaction). Specifically, FTB argues appellants engaged in a noneconomic substance transaction and tax shelter for purposes of R&TC section 19777(b).[7] OTA agrees.

<u>Noneconomic Substance Transaction</u>

A "noneconomic substance transaction" includes:

> The disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance. A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.

(R&TC, § 19774(c)(2)(A).)

In determining whether a transaction lacks economic substance, courts have generally focused on the following principles: (1) whether the taxpayer has demonstrated a business purpose for engaging in the transaction other than tax avoidance; and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits. (*Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360, 1363 (*Casebeer*); *Appeal of Alyn* (2009-SBE-001) 2009 WL 2340393 (*Alyn*).) The business purpose factor is a subjective analysis

[7] As for the fourth classification (i.e., a "gross misstatement"), FTB contends that the transaction at hand qualifies as a "gross misstatement" in that the applicable overstatement of basis was at least 400 for each of the properties sold in 2006. In response, appellants assert that there was no overstatement of basis on *their* return. OTA need not address this particular issue because, as discussed below, OTA finds that the transaction at hand constituted a "noneconomic substance transaction," as well as a "tax shelter."

of the taxpayer's intent in entering the transaction whereas the economic substance factor is an objective analysis of whether the transaction had any practical economic effects other than the creation of tax losses. (*Casebeer*, *supra*, at p. 1363.) The business purpose prong and the economic substance prong are "precise factors" that need to be weighed to determine whether the transaction had any practical economic effects other than the creation of tax benefits. (*Ibid*.)

The transaction to be analyzed is the one that gave rise to the alleged tax benefit. (*Coltec Industries, Inc. v. U.S.* (Fed.Cir. 2006) 454 F.3d 1340, 1356 (*Coltec*).) A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance. (*Id.* at p. 1355.) Additionally, the taxpayer bears the burden of proving that the transaction has economic substance (*ibid.*), and whether the taxpayer meets the economic substance test is a factual finding. (*Casebeer*, *supra*, 909 F.2d at p. 1365).

The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. (*Casebeer*, *supra*, 909 F.2d at p. 1364; *Bail Bonds by Marvin Nelson, Inc. v. Commissioner* (9th Cir. 1987) 820 F.2d 1543, 1549.)

The economic substance factor looks beyond the form of the transaction to the objective substantive effect of the transaction. The question is not one of whether the taxpayer believed the transaction was capable of creating a profit or affecting the taxpayer's financial situation, but whether the transaction in fact objectively was a transaction capable of either of those two possibilities. (*Jade Trading, LLC v. U.S.* (Fed.Cl. 2007) 80 Fed.Cl. 11, 47-48; *Coltec, supra*, 454 F.3d at p. 1355.) "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of [the legislature]." (*Commissioner v. Court Holding Co*. (1945) 324 U.S. 331, 334.)

OTA applies the two-prong test of *Casebeer*, *supra*, 909 F.2d 1360, and *Alyn*, *supra*, to determine whether the stated form of appellants' transaction reflects economic substance. OTA considers whether appellants have shown: (1) a subjective business purpose for the transaction; and (2) the objective economic substance of the transaction.

Business Purpose

Appellants have not offered any evidence or explanation of a nontax business purpose for the sale, as reported, of Topaz's interest in United to SDI—and OTA finds no such evidence in the appeal record. Appellants have not demonstrated that the transaction was reported for any reason other than to avoid tax on appellants' share of flow-through income from United, and thus, OTA concludes the transaction lacked business purpose.

Economic Substance

Here, appellant-husband was the sole owner of SDI. The transaction, as reported, has not been shown to result in any change in appellant-husband's economic interest in United, as his distributive share of income from United still flowed through to appellants. The only change was to reduce appellants' tax on that income, as appellant-husband had SDI report the basis step-up pursuant to an alleged IRC section 754 election,[8] which reduced appellants' income by approximately $3 million in 2006. The IRS has taken a position that this type of transaction is a sham.[9] Thus, the record shows that appellants engaged in a noneconomic substance transaction.

Tax Shelter

As modified by R&TC section 19777(b)(1), IRC section 6662(d)(2)(C)(ii) provides " . . . the term 'tax shelter' means – (I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of [income or franchise tax]." Typical features of "tax shelters" include "overvalued assets" or "the mischaracterization of the substance of the transaction." (Treas. Reg. § 1.6662-4(g)(2)(i)(C).) "The existence of economic substance does not of itself establish that a transaction is not a tax shelter if the transaction includes other characteristics that indicate it is a tax shelter." (*Ibid.*)

An item of income, gain, loss, deduction, or credit is a "tax shelter item" if the item is

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[8] The appeal record does not indicate that United had made an IRC section 754 election. An IRC section 754 election is an election that can only be made by the partnership, not the partners. (IRC, § 754; Treas. Reg. § 1.754-1.)

[9] In *Bakersfield Energy Partners v. Commissioner* (2007) 128 T.C. 207, affd (9th Cir. 2009) 568 F.3d 767, the IRS argued that an installment sale of a partnership interest to a related entity with an IRC section 754 election to step-up basis prior to the partnership's sale of the property, was a sham that lacked economic substance. The court, however, did not reach the merits of the transaction because the notice of deficiency was not timely under former IRC section 6501(e)(1). (*Id.* at p. 778.)

directly or indirectly attributable to a principal purpose of avoiding or evading income tax. (Treas. Reg. § 1.6662-4(g)(3).) "The definition of a tax shelter thus directs our analysis to the purpose of the 'partnership, entity, plan, or arrangement,' rather than to the subjective motivation of the individual investors." (*Davis v. Commissioner*, T.C. Memo. 1989-607.) Further, even a fictitious plan or arrangement can be a tax shelter. (*Scherping v. Commissioner*, T.C. Memo. 1998-288 [fictitious transfer of farming assets held to be a tax shelter]; see also *U.S. v. Stover* (8th Cir. 2011) 650 F.3d 1099.)

Based on the evidence in the appeal record, OTA finds that the transaction at hand (i.e., the reporting of the sale of appellant-husband's interest in United to SDI, along with the alleged IRC section 754/743 basis adjustment) was: (1) a plan or arrangement, (2) with a significant purpose of avoiding income tax. As discussed above, appellants have not explained what business purpose would have been accomplished by transferring the interest in United to appellant-husband's wholly-owned S corporation. Although appellants argue the transaction did not occur, OTA notes that even if the transaction did *not* occur, the reporting of a fictitious transaction would constitute a tax shelter. (*Scherping v. Commissioner*, *supra*; *U.S. v. Stover,supra*.)

Thus, based on the foregoing, OTA agrees that appellants engaged in an ATAT, and consequently, the 12-year statute of limitations applies.

<u>Appellants' Mistake Argument</u>

Since FTB has shown that an exception to the four-year statute applies, the burden now shifts to appellants "to show that the alleged exception to the expiration of the limitations period is ineffective or otherwise inapplicable." (*Madison Recycling Associates v. Comissioner* (2d Cir. 2002) 295 F.3d 280, 286.) Appellants argue that the 12-year statute is inapplicable because the alleged ATAT transfer did not actually occur. Appellants allege that they "contemplated a transfer of the United interest" from Topaz to SDI, which would have resulted in SDI "claiming a substantial basis in its newly-acquired interest in United." But, according to appellants, they did not make an actual transfer.

Despite their decision to abandon the transfer, SDI and appellants reported their income as if the transaction occurred. By reporting the flow-through income from United on SDI's return and calculating the flow-through income to appellants using an increased basis, SDI reported as if it owned an interest in United and was entitled to an IRC section 754/743 basis adjustment, which results from the sale of a partnership interest. (See IRC, §§ 754, 743.) Appellants do not dispute that their tax reporting and SDI's tax reporting are consistent with the contemplated sale of appellants' United interest; however, appellants contend that the reporting of the sale of his interest in United to SDI, along with the IRC section 754/743 basis adjustment, was a "mistake" by their return preparer. Accordingly, appellants argue that because no transaction actually occurred, they could not have participated in an ATAT.

In support of their argument, appellants contend such a transaction was impermissible according to United's Certificate of Limited Partnership, which did not allow the transfer of a partnership interest except to a partner's heirs or another partner. Moreover, United issued Schedule K-1s for the 2006 through 2016 tax years to Topaz, not SDI, because Topaz was the actual partner of United. Thus, appellants and SDI's return preparer, was not aware that the sale of his ownership interest in United did not occur and erroneously prepared the returns to reflect that the sale did occur.

FTB argues appellants are bound by the transaction as reported on their return, which FTB determined, for the reasons set forth above, is an ATAT. OTA agrees. Appellants have not provided legal authority demonstrating that a reporting of an ATAT by "mistake" (even assuming that such a mistake could be established) should be considered a factor towards *not* applying the extended 12-year statute of limitations set forth in R&TC section 19755(a)(2). Rather, as FTB argues, even if appellants could establish the transaction was reported on their return by mistake by appellants' return preparer, appellants are bound by the representations made on their return. (*Maletis v. U.S.* (9th Cir. 1952) 200 F.2d 97, 98; *McManus v. Commissioner* (9th Cir. 1978) 583 F.2d 443; *Norwest Corp. v. Commissioner* (1998) 111 T.C. 105; *Brennan v. Commissioner*, T.C. Memo. 2012-187.)

In *Maletis,* the Ninth Circuit Court of Appeals held the taxpayer was bound by the form of the entity as reported on the taxpayer's tax return, even if the taxpayer's actions "were so inadequate as to make the form unreal for income tax purposes." The Tax Court also found "when a taxpayer seeks to disavow its own tax return treatment of a transaction by asserting the priority of substance only after the Commissioner raises questions with respect thereto, this Court need not entertain the taxpayer's assertion of the priority of substance." (*Norwest Corp. v. Commissioner*, *supra*, 111 T.C. at p. 145.) The Tax Court further held that it is the government "who should have the sole power to sustain or disregard the effect of the fiction since otherwise the opportunities for manipulation of taxes are practically unchecked." (*Id.* at p. 171, fn. 13.) Similarly, appellants argue that the substance of their transaction should control rather than what was reported on their income tax return. However, OTA is not bound by the fact that a transfer to SDI of appellant-husband's ownership interest in United may not have occurred. To allow appellants to recast the transaction reported on their 2006 return would be to allow for a "manipulation of taxes" the courts have been loath to permit. Appellants and SDI filed income tax returns as if appellant-husband had sold its United partnership interest to SDI, and consequently, received tax benefits of that purported sale. After FTB audited appellants 2006 income tax return, appellants now attempt to recast their transaction, and thereby engage in post-transactional tax planning using the statute of limitations as a shield. (See *In re Steen* (9th Cir. 1975) 509 F.2d 1398, 1402, fn. 4.) Thus, OTA finds appellants is bound by the representations made on their 2006 California income tax return that they transferred their United partnership interest to SDI. Since OTA determined that this transaction was an ATAT, the 12-year statute of limitations applies, and FTB's NPA was timely.

HOLDING

FTB's NPA was timely issued for purposes of the statute of limitations for the 2006 tax year.

DISPOSITION

FTB withdrew the noneconomic substance penalty and the interest-based penalty on appeal. FTB's action is otherwise sustained.

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Richard Tay
Administrative Law Judge

We concur:

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Andrea L.H. Long
Administrative Law Judge

DocuSigned by:
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Amanda Vassigh
Administrative Law Judge

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