OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **W. STEFFIER**	) OTA Case No. 20076326)))))

OPINION

Representing the Parties:

For Appellant: W. Steffier

For Respondent: Eric A. Yadao, Attorney

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

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, W. Steffier (appellant)[1] appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $731,500, an accuracy-related penalty of $146,300, and applicable interest for the 2013 tax year.[2]

Office of Tax Appeals (OTA) Administrative Law Judges Cheryl L. Akin, Kenneth Gast, and Sara A. Hosey 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.

ISSUE

Whether the accuracy-related penalty imposed for the 2013 tax year should be abated.

[1] Although appellant and his spouse filed a joint 2013 California income tax return, only appellant signed the appeal letter. Thus, appellant's spouse is not included as a party to this appeal.

[2] Appellant concedes the proposed additional tax of $731,500 and related interest.

FACTUAL FINDINGS

General Background and Appellant's Sale of Stock

1. Appellant was president and a 45 percent shareholder of Hyper-Therm Temperature Composites, Inc., a California S corporation (Hyper-Therm).
2. In April 2013, appellant sold his shares in Hyper-Therm to a third party pursuant to a stock purchase agreement. In return for his shares, appellant received consideration exceeding $17 million. The purchaser elected to treat the stock purchase as an asset acquisition for income tax purposes pursuant to Internal Revenue Code (IRC) section 338.

Appellant's Engagement of Mr. A. Cohen, Transfer of Funds to Lorax, LLC, and Reporting on his 2013 California Income Tax Return

3. At the oral hearing for this appeal, appellant testified that his previous CPA, who had prepared his taxes for more than 20 years, was unable to prepare appellant's 2013 federal and California income tax returns due to the technical complexities of the Hyper-Therm sale and IRC section 338 election. Appellant further testified that he received a cost estimate exceeding $10,000 from another CPA firm for the preparation of his 2013 personal tax returns. Believing this cost to be too high, appellant began searching for another qualified CPA to prepare his 2013 personal tax returns.
4. Appellant and appellant's witness testified that appellant was referred and introduced to Mr. A. Cohen (Mr. Cohen), a New York CPA.[3] Appellant's witness testified that Mr. Cohen was personally recommended to the witness by a friend who was a very successful businessperson. The witness indicated that she researched Mr. Cohen and found that Mr. Cohen had been a CPA since the 1960s, had no disciplinary record for more than 50 years, had no lawsuits against him, and had great clients who operated successful businesses. The witness further testified that she met with a few of Mr. Cohen's clients and there was nothing to indicate that Mr. Cohen was providing tax-avoidance schemes.

[3] Appellant provides evidence showing that Mr. Cohen was a licensed CPA in the state of New York, from May 25, 1966, through September 30, 2014.

5. Mr. Cohen flew to California sometime in 2013 to meet and discuss his services with appellant.[4] Appellant testified that during a day-long meeting and presentation, Mr. Cohen represented to appellant that he could minimize appellant's tax liability from the sale of his Hyper-Therm stock by forming a separate company, Lorax LLC (Lorax), which in turn would purchase several outside companies that had sustained capital "paper" losses. The purchased companies with capital losses would be "folded into" Lorax and the capital losses from these acquired companies would be used to offset appellant's capital gain from the sale of his Hyper-Therm stock. In order to accomplish this transaction, appellant testified that he was required to contribute $550,000 to Lorax, which would be used by Lorax to purchase the loss companies. Appellant further testified that he also paid $150,000 to a company called CA Consulting Services, which was owned by Mr. Cohen's wife, for the management and operation of Lorax, and that at some point in the future, Lorax (or the purchased loss companies) would be sold so that appellant could recover his initial investment. Appellant testified that Mr. Cohen represented to appellant that the suggested transaction was completely legitimate, legal, and consistent with generally accepted accounting principles (GAAP); that Mr. Cohen "does [this] all the time" and had successfully used similar tax structures for numerous other clients; and that accounting practices like this are regularly used by large companies to minimize tax.
6. Appellant was impressed by his meeting with Mr. Cohen and hired Mr. Cohen to prepare his 2013 personal income tax returns.[5]
7. On April 14, 2014, appellant transferred $550,000 to Lorax in exchange for a 50 percent membership interest in Lorax.[6]

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[4] The exact date of this meeting with Mr. Cohen is not in the appeal record. At the hearing, appellant testified that Mr. Cohen "flew out at his expense back in 2013 to basically introduce himself and tell us what he could do for me, with regard to my taxes." The declaration from appellant's witness similarly states, "[Mr.] Cohen followed up sometime in March or early April of 2013, and volunteered to fly out to California to personally meet with [appellant] and [the other former shareholder in Hyper-Therm] to discuss his services ....."

[5] Appellant testified that he signed an agreement retaining Mr. Cohen to prepare his 2013 personal tax returns for $1,200 or $2,500 (appellant was uncertain of the exact amount), and that no other written agreements were executed by appellant and Mr. Cohen relating to the Lorax transaction. The written agreement wherein appellant agreed to retain Mr. Cohen to prepare his 2013 personal income tax returns is not in the appeal record.

[6] The other 50 percent membership interest in Lorax was purportedly owned by appellant's brother-in-law (or former brother-in-law) who also sold his stock in Hyper-Term during the 2013 tax year.

8. Appellant also paid $150,000 to CA Consulting Services.[7]

9. Appellant filed a timely 2013 California income tax return in October 2014, which was prepared by Mr. Cohen.[8] With respect to the sale of appellant's stock in Hyper-Therm, the return reported total proceeds from the sale of $8,696,293, a cost basis of $14,848,183, and a resulting capital loss of $6,151,890, which was offset against appellant's additional $8,696,293 of net IRC section 1231 capital gain from Hyper-Therm.

FTB's Audit of Appellant's 2013 Tax Return

10. FTB began an examination of appellant's 2013 tax return in August 2016. Appellant authorized Mr. Cohen to represent him during the audit.

11. During the audit, FTB requested substantiation for the reported $14,848,183 stock cost basis in Hyper-Therm. In October 2016, Mr. Cohen responded in a letter stating that appellant's cost basis in Hyper-Therm consisted of the following:

Appellant's basis in Hyper-Therm per the Schedule K-1	$9,348,183
Appellant's capital contribution to Lorax	$5,500,000[9]
Total cost basis	$14,848,183

12. FTB determined that appellant had properly substantiated basis of $9,348,183 and requested an additional explanation of and substantiation for the reported $5,500,000 cost basis associated with Lorax.

13. Mr. Cohen responded in a letter received by FTB in May 2017, stating that appellant was a partner in Lorax which rendered ongoing financial consulting and investment banking services in connection with appellant's sale of his stock in Hyper-Therm; there was an agreement between the shareholders and Lorax which called for an initial payment of $550,000 and a note payable; and the agreed upon compensation was based on the agreement between the parties. The letter stated that both the Lorax bank statement

[7] Evidence of this payment and the date it was made are not in the appeal record; however, both parties agree that this payment was made by appellant.

[8] Appellant testified that he did not "open up" or review his 2013 tax return at the time it was prepared or filed.

[9] Mr. Cohen stated in the letter to FTB that appellant "invested $5,500,000 in Lorax [], which investment resulted in a loss of $5,500,000 for 2013."

showing receipt of $550,000 from appellant on April 14, 2014, and the note payable from appellant to Lorax was attached. The bank statement was attached, but the promissory note was not.

14. On appeal, appellant provides an incomplete and unsigned subscription agreement and promissory note which appellant indicates may have been provided to FTB by Mr. Cohen during the audit and/or protest.[10] Appellant testified that the subscription agreement and promissory note were inconsistent with what he and Mr. Cohen previously discussed and agreed to, and as a result, he refused to sign these documents when Mr. Cohen presented these documents to him during the FTB audit and/or protest.

15. On December 8, 2017, FTB issued a Notice of Proposed Assessment (NPA), disallowing the reported $5,500,000 basis associated with Lorax. The NPA increased appellant's income by $5,500,000, and proposed additional tax of $731,500, an accuracy-related penalty of $146,300, and applicable interest.[11]

Appellant's Protest with FTB and Appeal to OTA

16. On January 25, 2018, appellant protested the NPA. Appellant's protest letter noted that appellant was drafting his own response because he feared that Mr. Cohen may fail to respond.

17. On May 11, 2020, FTB issued a Notice of Action affirming its NPA.

18. Appellant timely appealed to OTA, contesting the accuracy-related penalty only.

[10] Both documents are not specific to appellant or Lorax. For example, the subscription agreement appears to be related to an unrelated LLC, and the promissory note does not contain the party names or the loan amount.

[11] The auditor's supervisor approved the auditor's imposition of the accuracy-related penalty, which, according to the Audit Issue Presentation Sheet, was imposed based on a substantial understatement of income tax. (See R&TC, § 19187(b)(1) [requiring written approval of the supervisor for imposition of certain penalties such as the accuracy-related penalty].)

Texts, Emails, Letters, and Meetings Between Appellant and Mr. Cohen

19. On appeal, appellant provides screenshots of text messages he exchanged with Mr. Cohen during the FTB audit and protest.[12] In the text messages, appellant repeatedly asked Mr. Cohen to provide him with supporting documentation for his 2013 taxes; repeatedly asked Mr. Cohen to resolve the issue with FTB by providing FTB with the information and documentation FTB requested; repeatedly followed up with Mr. Cohen regarding whether he will be timely filing a protest of the NPA with FTB; asked Mr. Cohen whether he will be providing FTB with "legitimate support" for appellant's 2013 taxes; requested to meet with Mr. Cohen; requested that Mr. Cohen assure appellant that the methods Mr. Cohen used in preparing his 2013 taxes were completely legal and legitimate;[13] asked whether Mr. Cohen continued to stand behind appellant's 2013 taxes;[14] asked Mr. Cohen whether the Lorax transaction was a tax shelter scheme;[15] asked Mr. Cohen for documentation relating to Lorax, including financial records and information showing how his initial investment in Lorax was disbursed; and asked Mr. Cohen if he will be attending the protest hearing. Mr. Cohen frequently delayed responding to appellant or providing appellant with the requested information by indicating that either he and/or his wife were sick, in the hospital, or dealing with various medical issues.

20. Appellant also provides various email correspondence with Mr. Cohen between August 2016, when FTB began its examination of appellant's 2013 return, and November 5, 2019. These emails include the following relevant exchanges:[16]

    a. In an email dated December 19, 2017, appellant questioned Mr. Cohen regarding how the 2013 tax return supported the loss claimed and how the basis was calculated to

[12] Some of the text messages contain the month and day the message was sent, but not the year. Other text messages are undated. However, the text messages appear to contemporaneously discuss the FTB audit and protest. As the text messages are voluminous, this Opinion will only discuss those which OTA finds to be most relevant and applicable to the accuracy-related penalty at issue in this appeal.

[13] Mr. Cohen responded, "Yes."

[14] Mr. Cohen again responded, "Yes."

[15] Mr. Cohen responded by first stating that he did not know what "son of boss" was, and later responded by stating, "The 2013 tax return is legal and legit."

[16] The email exchanges provided by appellant are voluminous. As such, this Opinion only includes and discusses the emails which OTA finds to be most relevant to the accuracy-related penalty at issue in this appeal.

reconcile the loss. Mr. Cohen responded the same day stating that there were other pages which he would send later.

b. In an email dated January 7, 2018, appellant asked Mr. Cohen for the Lorax schedule K-1, articles of incorporation, profit and loss statements, and "all signed documents," so that he could "better understand the investment of which [he] owns 50 [percent]."[17]

c. In a letter sent to appellant via email on June 11, 2018, Mr. Cohen's attorney stated, "Mr. Cohen advises that in order for him to properly represent you in connection with this audit, he needs copies of the executed Lorax [] Subscription Agreement and related note payable. Without these documents Mr. Cohen will not be able to properly represent you in this matter." Appellant responded via email on June 15, 2018, stating that he was confused as to what the subscription agreement was, and asked Mr. Cohen's attorney to please define what this document was and how it worked to resolve his tax matter. On the same day, Mr. Cohen's attorney responded by stating that appellant should address that with Mr. Cohen.

d. In an email to Mr. Cohen's attorney dated June 15, 2018, appellant again requested documents relating to Lorax, including articles of incorporation, organizational documents outlining the officers, and bank records or other information showing where appellant's investment in Lorax was or who it was disbursed to. Appellant also stated that the "Subscription Agreement" previously provided to him for signature was nothing more than an "IOU," that "[s]uch IOU-based tax evasion scams are illegal," and that he wanted all of his money back immediately.

21. Appellant also provides audio recordings of an in-person meeting appellant had with Mr. Cohen in January 2018, and a telephone conversation appellant had with Mr. Cohen in June 2018.[18]

a. At the meeting in January 2018, appellant and Mr. Cohen discussed the FTB audit and appellant's protest which was required to be filed with FTB by February 6, 2018. Appellant repeatedly noted that he did not understand the transaction or what happened, asked Mr. Cohen to explain what happened to the $700,000 that he had

[17] Mr. Cohen's response, if any, is not in the record.

[18] The audio recordings provided by appellant are lengthy. As such, this Opinion only includes and discusses the exchanges which OTA finds to be most relevant to the accuracy-related penalty at issue in this appeal.

paid to Lorax and CA Consulting Services, and asked how Lorax acquired and folded in losses from other entities. Mr. Cohen attempted to explain the Lorax transaction to appellant, and stated Lorax purchased losses for "10 cents on the dollar" which would be used to offset appellant's capital gain. Mr. Cohen attempted to explain the need for the subscription agreement and promissory note to Lorax, and repeatedly assured appellant that the 2013 tax reporting was "legitimate" and "legal," and stated that appellant was "getting legitimate losses" and they would ultimately "prevail" with FTB.

b. In the June 2018 telephone call, appellant told Mr. Cohen that "what you're doing is not legal," that a subscription or an IOU was "not going to work," and that Mr. Cohen was going to have to use the money appellant previously paid to "find some losses" and "provide [FTB] with legitimate losses, not an IOU."

22. On December 20, 2019, appellant's attorney sent Mr. Cohen a Demand for Payment and Production of Documents (Demand Letter). The Demand Letter asserted that Mr. Cohen engaged in a fraudulent scheme and described in detail Mr. Cohen's conduct. The Demand Letter demanded return of $700,000 to appellant and documents such as: copies of all correspondence Mr. Cohen had with FTB relating to appellant; documentation identifying individuals or entities that may have received any portion of the $700,000 paid by appellant and contact information for those individuals or entities; and information and documentation relating to Lorax, including records of the transactions whereby losses were purchased and folded into Lorax.

23. On June 20, 2020, appellant filed a Securities and Exchange Commission complaint against Mr. Cohen alleging that Mr. Cohen committed fraud, securities violations, and tax evasion.

24. On appeal, appellant also provides an unsigned, undated copy of a 2013 Form 1065, U.S. Return of Partnership Income, for Lorax.[19] On the return, Lorax reported zero gross receipts and "other deductions" of $11,000,000 described as a "financial management fee," resulting in a net loss of $11,000,000 for the 2013 tax year. The Schedule K-1, Partner's Share of Income, Deductions, Credits, etc., reflected that appellant was a

[19] Because the return is unsigned and undated, it is unclear whether it was ever filed with the IRS. Appellant indicated that he received this return in 2017 after the FTB auditor had requested it from Mr. Cohen.

50 percent member of Lorax, appellant made a capital contribution of $5,500,000 during 2013, and appellant's share of Lorax's ordinary business loss was $5,500,000.

DISCUSSION

Applicable Law – Accuracy-Related Penalty Generally

At issue in this appeal is the $146,300 accuracy-related penalty imposed by FTB for appellant's 2013 tax year. When FTB imposes a penalty, it is presumed to have been imposed correctly. (*Appeal of Xie*, 2018-OTA-076P.) R&TC section 19164 generally incorporates the provisions of IRC section 6662, which provides for an accuracy-related penalty of 20 percent of the applicable underpayment of tax. (See also *Appeal of Daneshgar*, 2021-OTA-210P.) As relevant here, the penalty applies to any portion of an underpayment attributable to a substantial understatement of income tax. (IRC, § 6662(b)(2).)

An "understatement" of tax is defined as the excess of the amount of tax required to be shown on the tax return for the tax year, over the amount of tax that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A)(i)-(ii).) For individual taxpayers, an "understatement" constitutes a "substantial understatement" if the amount of the understatement for the tax year exceeds the greater of $5,000, or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A)(i)-(ii).) Here, appellant was required to report total tax of $1,136,727 on his 2013 return; however, appellant only reported tax of $405,227. Appellant's understatement of $731,500 ($1,136,727 - $405,227) is substantial because it exceeds $113,673, 10 percent of the tax required to be reported on the return ($1,136,727 x 10 percent), which is greater than $5,000. As such, FTB properly imposed the 20 percent accuracy-related penalty based on a substantial understatement of income tax. (IRC, § 6662(b)(2) & (d)(1).) However, even if an understatement is found to be substantial, the penalty shall not be imposed to the extent the taxpayer can show reasonable cause for the underpayment and the taxpayer acted in good faith with respect to that underpayment.[20] (R&TC, § 19164(d); IRC, § 6664(c)(1).)

[20] While IRC section 6662(d) provides other exceptions or defenses to the accuracy-related penalty (such as substantial authority and adequate disclosure), only the reasonable cause exception is relevant to this appeal.

FTB's Argument that the Reasonable Cause Exception Does Not Apply to Transactions Lacking Economic Substance

FTB argues that the reasonable cause exception does not apply if the underlying transaction has no economic substance. As support, FTB cites to the Internal Revenue Manual (IRM) section 20.1.5.7.1(1), which states, "[t]he reasonable cause exception in IRC section 6664(c) applies to all of the components of the accuracy-related penalty on underpayments . . . except for any portion of an underpayment that is attributable to one or more transactions lacking in economic substance as described in IRC section 6662(b)(6)."[21] It appears that IRM section 20.1.5.7.1(1) is referencing the current version of IRC section 6664(c)(2), which states that the reasonable cause exception "shall not apply to any portion of an underpayment which is attributable to one or more transactions described in [IRC] section 6662(b)(6) ....."

However, for the 2013 tax year at issue in this appeal, California conformed to the version of the IRC as of January 1, 2009. (See R&TC, § 17024.5(a)(1)(O).) The version of the IRC in effect on January 1, 2009, does not contain this language or other language providing that the reasonable cause exception does not apply to transactions lacking economic substance. FTB does not provide any other support or authority for its statement that the reasonable cause exception does not apply if the underlying transaction has no economic substance. As such, for purposes of this appeal, OTA finds the reasonable cause exception applies to the accuracy-related penalty (regardless of whether the transaction had or lacked economic substance) and will evaluate and consider whether appellant has established reasonable cause for the underpayment and whether he acted with good faith. (See R&TC, § 19164(d); IRC, § 6664(c)(1).)

Appellant's Reasonable Cause Arguments

Appellant asserts that the accuracy-related penalty should be abated due to reasonable cause because of his reliance on Mr. Cohen, a tax professional, who represented to appellant that the Lorax transaction and tax reporting were legal and legitimate. FTB contends that based on all the facts and circumstances, appellant's reliance on Mr. Cohen fails to establish reasonable cause.

[21] The IRM is available at: https://www.irs.gov/irm/part20/irm_20-001-005#idm140411598714448.

A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on all the pertinent facts and circumstances, including the extent of the taxpayer's efforts to assess the proper tax liability, the taxpayer's knowledge, education, and experience, and the extent to which the taxpayer reasonably relied in good faith on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1) & (c)(1).) A taxpayer claiming reliance on a professional must show: (1) the advisor was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the tax advisor; and (3) the taxpayer actually relied in good faith on the advice. (*Neufeld v. Commissioner*, T.C. Memo. 2008-79 (*Neufeld*), citing *Neonatology Associates P.A. v. Commissioner* (2000) 115 T.C. 43, 99, affd. (3d Cir. 2002) 299 F.3d 221 (*Neonatology*).)

However, unconditional reliance on a preparer or adviser, by itself, does not always constitute reasonable reliance. (*Neufeld*, *supra*; *Van Scoten v. Commissioner* (10th Cir. 2006) 439 F.3d 1243, 1253 (*Van Scoten*).) The taxpayer must also exercise "diligence and prudence" (*Neufeld*, *supra*) and the reliance must be reasonable (*Van Scoten*, *supra*, at p. 1253). To be objectively reasonable, the advice must generally be from a "competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment." (*Mortensen v. Commissioner* (6th Cir. 2006) 440 F.3d 375, 387 (*Mortensen*); see also *Van Scoten*, *supra*, at p. 1253.)

Appellant's witness described the general research she did before appellant met with and ultimately hired Mr. Cohen. She states that she found that Mr. Cohen had been a CPA since the 1960s, had no disciplinary record, and no record of any lawsuits against him. She also states that she met with a few of his clients and did not find anything to suggest that Mr. Cohen was providing tax-avoidance schemes. Similarly, appellant testified that after the day-long meeting with Mr. Cohen, appellant was very impressed and decided to hire him. Appellant credibly testified that both before he hired Mr. Cohen, and throughout the FTB audit and protest, Mr. Cohen continually assured appellant that the Lorax transaction was legitimate, legal, and in accordance with GAAP, and represented to appellant that he had successfully completed numerous similar transactions for other clients in the past.

Appellant also credibly testified that he believed he had been defrauded by Mr. Cohen and that the transaction Mr. Cohen ultimately engaged in on his behalf and reported on appellant's 2013 return, and to FTB during the audit, was not what the parties had previously

agreed to and discussed. Appellant credibly testified that Lorax was to use his $550,000 initial capital contribution to purchase other legitimate companies that had sustained capital losses. The losses would be acquired for "10 cents on the dollar" and "folded into" (i.e., owned by) Lorax and used to offset a portion of the capital gain from appellant's stock sale of Hyper-Therm. However, appellant's 2013 return reported $5,500,000 in additional stock basis in Hyper-Therm, instead of an offsetting pass-through capital loss from Lorax in that amount, which suggests that Lorax may never have acquired interests in any other companies. Similarly, Lorax's unsigned and undated 2013 return reported only that Lorax incurred $11,000,000 in "financial management fee" expenses, resulting in an $11,000,000 net ordinary loss for the 2013 tax year, with $5,500,000 attributed to appellant. It does not reflect any purchases of other loss companies. Additionally, during the audit, Mr. Cohen told FTB that appellant was a partner in Lorax which rendered ongoing financial consulting and investment banking services in connection with appellant's sale of his stock in Hyper-Therm. Appellant testified that he did not provide such services, and that the money contributed to Lorax was not for services that Lorax provided, but again, was intended for the purchase of other loss companies that were to be folded into (i.e., owned by) Lorax.

While OTA finds appellant's testimony and statements that he relied upon and believed Mr. Cohen's assurances that the Lorax transaction was legitimate, legal, and in accordance with GAAP to be credible, and acknowledges appellant's sincere belief he had been defrauded by Mr. Cohen, this does not end OTA's inquiry. Appellant's reliance on Mr. Cohen must also be objectively reasonable. (*Van Scoten*, *supra*, at pp. 1252-1253.) Appellant's conduct is to be compared to that of a "reasonable and ordinarily prudent person." (*Mortensen*, *supra*, at p. 385.) In *Van Scoten* and *Mortensen*, both the Tenth and Sixth Circuit Courts of Appeal found that the taxpayers had failed to establish reasonable reliance on their tax advisor, an enrolled agent, despite the advisor's conviction for fraud in connection with the transactions at issue in the cases.[22]

In *Van Scoten*, the Tenth Circuit Court of Appeals expressly noted that the tax advisor had been convicted of 52 criminal counts including fraud and conspiracy and was ordered to pay restitution of $102 million – the amount that was paid by investors to the various organizations created by the tax advisor. (*Van Scoten*, *supra*, at p. 1246.) Despite this, the Tenth Circuit

[22] The tax advisor in both *Van Scoten* and *Mortensen* was the same individual.

upheld the tax court's determination that the taxpayers had failed to establish reasonable cause based on their reliance on the tax advisor because the taxpayers' "actions in relation to their investment and the tax claims were objectively unreasonable." (*Id.*, at p. 1260.) In *Mortensen*, the Sixth Circuit Court of Appeals acknowledged the taxpayer's argument that an "average" taxpayer would have been unable to uncover the fraud perpetrated by the tax preparer, but agreed with the tax court's conclusion that "the issue is not whether [the taxpayer] could or should have uncovered the fraud, but whether [the taxpayer] was negligent in 'not adequately investigating the partnership and/or seeking qualified independent advice concerning it.'" (*Mortensen*, *supra,* at p. 389.)

Thus, despite appellant's credible testimony that he was misled (and potentially defrauded) by Mr. Cohen, appellant must still establish that his reliance on Mr. Cohen was objectively reasonable based on all of the facts and circumstances.[23] OTA notes that even if Mr. Cohen had structured the Lorax transaction as the parties had discussed and agreed, appellant still would not have been entitled to the tax benefit promised by Mr. Cohen and reported on appellant's 2013 return.

Even assuming Mr. Cohen had done as promised and Lorax had used appellant's $550,000 initial contribution to purchase other companies which generated large losses during the 2013 tax year, appellant still would not be entitled to a $5,500,000 capital loss. Generally, a partner's share of partnership loss (including capital loss) is only allowed to the extent of the partner's adjusted basis in the partnership at the end of the year in which the loss occurred. (IRC, § 704.)[24] Appellant contributed $550,000 to Lorax, and his basis in Lorax would not have

[23] In determining whether appellant's reliance on Mr. Cohen was reasonable based on the facts and circumstances, OTA evaluates the Lorax transaction as understood by appellant, and the facts know to appellant at the time he entered into the transaction and filed his 2013 return.

[24] California incorporates IRC sections 701 through 761, relating to partnerships and partners with certain exceptions. (R&TC, § 17851.) Lorax was an LLC taxed as a partnership as evidenced by its 2013 Form 1065, U.S. Return of Partnership Income.

exceeded this amount.[25] While appellant testified that this money was to be used by Lorax to acquire other loss companies for "10 cents on the dollar," appellant has failed to provide any explanation for why he believed he would be entitled to a $5,500,000 loss when he had only paid $550,000 to acquire his partnership interest in Lorax. Appellant has testified that he is not an accountant; however, OTA concludes that a reasonable and ordinarily prudent person would have inquired as to why he or she would be entitled to a $5,500,000 loss when he or she only paid, invested, or contributed $550,000 to acquire such loss. Appellant did not provide any testimony or other evidence establishing that he ever asked Mr. Cohen how or why he would be entitled to a $5,500,000 loss given his $550,000 capital contribution to Lorax.

Critically, appellant's $550,000 capital contribution to Lorax also was not made during the 2013 tax year. Rather, appellant transferred $550,000 to Lorax on April 14, 2014. When asked whether Mr. Cohen had provided any explanation of how a purchase of a membership interest in Lorax in 2014 could generate a loss for the earlier 2013 tax year, appellant stated, "There was no explanation for that." OTA similarly concludes that a reasonable and ordinarily prudent person would have inquired as to how an investment made in 2014 could result in a deductible loss for the prior 2013 tax year.

Of additional concern is Mr. Cohen's failure to provide, and appellant's failure to require, any written documentation relating to the Lorax transaction. Appellant did not receive any written contract for the Lorax transaction or other documentation confirming each parties' obligations with respect to the transaction, or detailing how the Lorax transaction was to be structured and executed. Appellant also did not receive a written analysis of the tax benefits anticipated to result from the transaction or the legal basis for Mr. Cohen's conclusions as to those tax benefits. Appellant testified that he entered into a written contract with Mr. Cohen for the preparation of his 2013 tax return for a fee of $1,200 or $2,500, but that for the Lorax transaction, "[i]t was basically both verbal and visual documents that were provided to [him],

[25] IRC section 722 generally provides that the basis of an interest in a partnership acquired by a contribution of property, including money to the partnership, shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution. While it appears that Mr. Cohen may have attempted to create additional basis through a subscription agreement and promissory note for the remaining $4,950,000 ($5,500,000 - $550,000), appellant testified that the subscription agreement and note were inconsistent with what he and Mr. Cohen previously agreed to and discussed, and as a result, he refused to sign these documents when Mr. Cohen presented them to appellant during the FTB audit and/or protest. However, even if appellant had executed these documents, "the contribution of a partner's own note to his partnership [is not] equivalent to a contribution of cash, and without more, it will not increase [the partner's] basis in [the] partnership interest." (*VisionMonitor Software, LLC v. Commissioner*, T.C. Memo. 2014-182.)

nothing in writing." Additionally, while appellant was to become a 50 percent member in Lorax as a result of the $550,000 capital contribution made on April 14, 2014, appellant never received the LLC operating agreement, or other documentation evidencing his ownership. Further, while appellant paid $150,000 to CA Consulting Services, which was purportedly for the ongoing management and operation of Lorax, appellant did not receive a contract detailing the services CA Consulting Services was to perform in exchange for that payment. Again, OTA concludes that a reasonably prudent person in these circumstances would not have relied solely on Mr. Cohen's presentation during the one-day meeting in 2013, and Mr. Cohen's verbal assurances, especially given the magnitude of appellant's contribution to Lorax ($550,000), the management fee ($150,000), and the anticipated tax benefit (a $5,500,000 capital loss).

Finally, appellant testified that he did not "open up" or review his 2013 tax return, which was prepared by Mr. Cohen and filed with FTB, at the time it was prepared and filed. However, taxpayers have a duty to read their tax returns and ensure that all income items are included. (*Neufeld*, *supra*.) When appellant subsequently reviewed his 2013 California return in December 2017, appellant questioned Mr. Cohen as to how the 2013 return supported the claimed loss. Had appellant reviewed his return before it was filed with FTB and discussed it with Mr. Cohen, he may have identified some of the inconsistencies between what Mr. Cohen reported versus what he had promised appellant.

The most important factor in determining whether a taxpayer acted with reasonable cause and in good faith is the extent of the taxpayer's efforts to ascertain his or her proper tax liability. (*Mortensen*, *supra*, at p. 387.) Here, appellant does not meet this standard because he did not diligently attempt to correctly determine his tax liability regarding the claimed $5,500,000 loss from Lorax. Specifically, he failed to ask relevant questions regarding the Lorax transaction (including why he would be entitled to a $5,500,000 loss when he only invested $550,000, and why he would be entitled to a loss in 2013 when the investment was not made until 2014); he failed to request or require that Mr. Cohen provide him with written documents evidencing the Lorax transaction, the anticipated tax benefits of the transaction, and the legal basis for such tax benefits; and he failed to review his 2013 tax return prepared by Mr. Cohen.

Additionally, appellant did not just hire Mr. Cohen to correctly compute his income from the Hyper-Therm sale and prepare appellant's 2013 return, but also to structure a transaction

which Mr. Cohen asserted would significantly reduce appellant's tax on such sale.[26] Appellant testified that he does not usually seek second opinions for the professionals he hires (including physicians and lawyers), and trusts the licensed professionals he hires to be professional and ethical. However, given the tax-motivated nature of the transaction, and Mr. Cohen's financial interest in it,[27] appellant's reliance solely on Mr. Cohen's representations here is not sufficient to establish reasonable cause and good faith.

While a taxpayer generally need not challenge an independent competent adviser, confirm that the advice is correct, or seek a second opinion, a taxpayer is not reasonable in relying on an advisor burdened with an inherent conflict of interest about which the taxpayer knew or should have known. (*American Boat Co., LLC v. U.S.* (7th Cir. 2009) 583 F.3d 471, 481; see also *Neonatology*, *supra*, at p. 98.) To be objectively reasonable, the advice must generally be from a "competent and independent advisor unburdened with a conflict of interest and not from promoters of the investment." (*Mortensen*, *supra*, at p. 387; see also *Van Scoten*, *supra*, at pp. 1253, 1259.) Here, Mr. Cohen both promoted the transaction in question and had a financial interest in it. Appellant knew or should have known that Mr. Cohen had an inherent conflict of interest. As such, appellant's failure to seek advice from an independent accountant or attorney as to the propriety of the Lorax transaction and the claimed tax benefits, and reliance exclusively on Mr. Cohen's verbal assurances, was not objectively reasonable. Appellant, therefore, has not established reasonable cause for the abatement of the accuracy-related penalty.

[26] Appellant's only stated purpose in engaging in the Lorax transaction was to offset his capital gain from the Hyper-Therm sale by $5,500,000, and thereby reduce his taxes. While appellant testified that Mr. Cohen represented that at some point in the future the purchased loss companies and/or Lorax would be sold so that appellant could recoup his initial $550,000 investment in Lorax, appellant does not assert that Mr. Cohen ever represented to appellant that he would earn income from the operation of Lorax or the acquired companies or that appellant would realize a gain or profit on the sale of the loss companies or Lorax.

[27] In addition to the $1,200 or $2,500 paid to Mr. Cohen for the preparation of appellant's 2013 returns, Mr. Cohen also had unfettered access to and control over appellant's $550,000 capital contribution to Lorax and was paid (indirectly through CA Consulting Services) $150,000 for ongoing "management and operation" of Lorax.

HOLDING

The accuracy-related penalty imposed for the 2013 tax year should not be abated.

DISPOSITION

FTB's action is affirmed.

DocuSigned by:
Cheryl Akin
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Cheryl L. Akin
Administrative Law Judge

We concur:

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

Date Issued: 10/16/2023