OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. BLAU**	) OTA Case No. 21088383)))

OPINION

Representing the Parties:

For Appellant: Harold Hecht, CPA

For Respondent: Cheyanna L. Jaffke, Tax Counsel III

For Office of Tax Appeals: William J. Stafford, Tax Counsel III

E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Blau (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing an additional tax of $650,369, plus applicable interest, for the 2011 tax year.

Appellant waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides this matter based on the written record.

ISSUES[1]

1. Whether appellant has demonstrated that FTB's apportionment of business income to appellant for the 2011 tax year is erroneous.
2. Whether appellant has established that interest should be abated.

FACTUAL FINDINGS

1. During the 2011 tax year, appellant was a nonresident individual taxpayer. Appellant was also the sole member of Yukon Holdings, LLC, a limited liability company classified as a disregarded entity for federal and California income tax purposes (Yukon).

[1] Appellant's appeal letter requests abatement of penalties. However, FTB has not assessed any penalties against appellant for the 2011 tax year according to the Notice of Action dated July 13, 2021.

2. In the 2011 tax year, Yukon had an ownership interest of about 11.5794 percent in The Related Companies, L.P., a limited partnership (TRC LP). TRC LP generated pass-through income directly and indirectly from other partnerships, one of which is Related General IV L.P., a limited partnership (RG IV LP). TRC LP is a 99.99 percent limited partner in RG IV LP.

3. Appellant received a 2011 federal Schedule K-1 from Yukon, which reported a pass-through Internal Revenue Code (IRC) section 1231 net gain (1231 net gain) in the total amount of $85,503,375.[2] Yukon reported a California apportionment percentage of 10.064 percent. Appellant did not report any amount of the 1231 net gain as California source income.

4. During audit, FTB determined that $80,331,367 of the $85,503,375 total 1231 net gain was business income subject to apportionment. Based on the 10.0640 California apportionment percentage reported by Yukon, FTB determined that appellant had additional California source income of $8,084,549 ($80,331,367 x 10.0640 percent = $8,084,549) for the 2011 tax year. As a result, FTB issued a Notice of Proposed Assessment (NPA), which increased appellant's 2011 California taxable income and proposed additional tax of $650,369, plus applicable interest.[3]

5. In response to the NPA, appellant timely filed a protest. Appellant stated Yukon's originally filed return did not reflect the 1231 net gain as part of the sales factor and contended that if 1231 net gain is business income subject to apportionment, appellant should also be permitted to include the 1231 net gain in the sales factor. Appellant proposed taking the California apportionment information from TRC LP and modifying it to include the 1231 net gain (not gross receipts from the 1231 net gain transactions) to apportion the business income of $80,331,367, instead of using Yukon's apportionment factors.

6. As relevant to this appeal, TRC LP reported a California apportionment percentage of 12.1215 for the 2011 tax year. A federal 2011 Schedule K-1 issued by RG IV LP indicates TRC LP's distributive share of the 1231 net gain was $13,032,092, with an

[2] A copy of the Schedule K-1 issued to appellant was not provided to OTA.

[3] A copy of the NPA is not in the appeal record, but a copy of the Notice of Action affirmed the additional tax amount of $650,369.

attached footnote stating that all income indicated on the federal Schedule K-1 is entirely from California sources.[4] TRC LP's 2011 federal Form 4797, Sales of Business Property, reported a total 1231 net gain of $424,468,549.[5]

7. FTB affirmed the NPA in a Notice of Action (NOA).
8. This timely appeal followed.
9. On appeal, appellant concedes that the $80,331,367 of 1231 net gain was business income subject to apportionment.
10. FTB concedes that it made interest abatement determinations attributable to the time periods from February 25, 2018, through February 9, 2021; and from April 11, 2021, through July 13, 2021.

DISCUSSION

Issue 1: Whether appellant has demonstrated that FTB's apportionment of business income to appellant for the 2011 tax year is erroneous.

I. Burden of Proof

FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) The applicable burden of proof standard is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) To meet this evidentiary standard, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of Belcher*, 2021-OTA-284P.) In other words, the preponderance of the evidence standard means more than 50 percent. (*Ibid*.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeals of Amarr Company and Amarr Company (C SGNF)*, 2022-OTA-041P (*Amarr*).) FTB's determinations cannot be successfully rebutted when the taxpayer fails to provide credible, competent, and relevant evidence as to the issues in dispute. (*Ibid*.)

[4] A copy of the California Schedule K-1 was not provided to OTA.

[5] The entire copy of TRC LP's federal and California tax returns were not provided to OTA.

II. IRC section 1231

The computation of a gain or loss from the disposition of property is generally the *amount realized* less the taxpayer's adjusted basis. (IRC, § 1001(a), italics added.)[6] IRC section 1231 generally allows a taxpayer to treat 1231 net gains from the sale of certain property as a capital gain and 1231 net losses from such a sale as an ordinary loss. IRC section 1231(a)(2) provides that a loss on the sale of property used in a trade or business shall be treated as an ordinary loss if the IRC section 1231 gains for the tax year do not exceed the IRC section 1231 losses for such taxable year. IRC section 1231 is generally incorporated into California law. (R&TC, § 18151.)

III. General Rules on California Apportionment

Apportionment is the process by which business income is divided among the states according to a formula. (See *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 756.) In general, for the 2011 tax year an apportioning trade or business could apportion business income to California by the use of a three-factor formula composed of a property factor, a payroll factor, and a double-weighted sales factor.[7] (R&TC, § 25128(a).) Only the sales factor is at issue in this appeal.

As relevant to this appeal, the sales factor is "a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." (R&TC, § 25134.) The term "sales" is defined as "all gross receipts of the taxpayer not allocated under [R&TC] [s]ections 25123 to 25127, inclusive." (R&TC, § 25120(f)(1).) In relevant part, the term "[g]ross receipts" means "*the gross amounts realized* (the sum of money and the fair market value of other property or services received) on the sale or exchange of property . . . in a transaction that produces business income, in which the income, gain, or loss is recognized . . . under the [IRC] . . . ." (R&TC, § 25120(f)(2); see also *Amarr*, *supra*, italics added.) "Amounts realized on the sale or exchange of property *shall not be reduced by the cost of goods sold or the*

[6] California conforms to IRC section 1001 pursuant to R&TC section 18031.

[7] For tax years beginning on or after January 1, 2011, but before January 1, 2013, taxpayers were permitted make an annual irrevocable election to apportion their business income to California using a single-sales formula. (See R&TC, § 25128.5(a), effective November 7, 2012, to November 30, 2013.) Here, Yukon and TRC LP did not make such an election and therefore the business income for those entities were apportioned to California using a three-factor formula with double-weighted sales for the 2011 tax year.

basis of property sold." (R&TC, § 25120(f)(2), italics added.) Furthermore, California Code of Regulations, title 18, (Regulation) section 25136(d)(2) provides that "[g]*ross receipts* from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state." (Italics added.)

There are certain instances where gross receipts may be excluded from the sales factor even though the transaction generates business income. (See e.g., R&TC, § 25120(f)(2)(A)-(L) and Cal. Code Regs., tit. 18, § 25137(c)(1).) One such example is where the gross receipts are derived from a substantial and occasional sale. (Cal. Code Regs., tit. 18, § 25137(c)(1)(A).) In relevant part, Regulation section 25137(c)(1)(A) provides that substantial amounts of gross receipts derived from an occasional sale of fixed assets or other property (including intangible property) held or used in the regular course of taxpayer's trade or business, are excluded from the sales factor.

IV. Analysis

Appellant contends that his 1231 net gain income from Yukon originates from TRC LP, an entity that invests directly and indirectly in other pass-through entities, one of which is RG IV LP. Here, appellant disputes FTB's determination that the California source income from the 1231 net gain is $8,084,549 ($80,331,367 x 10.0640 percent) because it is calculated based on Yukon's 10.0640 California apportionment percentage. Appellant contends that Yukon did not include gross receipts from the 1231 net gain transactions in its California sales factor. Appellant further contends that he does not have any information with regards to those gross receipts from the underlying pass-through entities. As such, appellant proposes that FTB should use the reported apportionment factors from TRC LP and add the 1231 net gain (not gross receipts from the 1231 net gain transactions) to TRC LP's reported sales factor to source the 1231 net gain business income.

In summary, appellant purports that the 1231 net gain business income of $80,331,367 should be apportioned by a California apportionment percentage of 9.2511, using TRC LP's reported apportionment factors and modifying it as noted above. Appellant supports his California apportionment percentage calculation by providing two documents. First, appellant provides a 2011 federal Schedule K-1 issued from RG IV LP to TRC LP, reporting TRC LP's distributive share of RG IV LP's 1231 net gain as $13,032,092, together with an attached footnote stating that all income indicated on that federal Schedule K-1 is entirely from California

sources. Second, appellant provides TRC LP's Form 4797, which reported a total 1231 net gain of $424,468,549. Together, appellant proposes to modify TRC LP's reported sales factor from California Schedule R by adding on $13,032,092 net gain to the total within California numerator and $424,468,549 net gain to the total everywhere denominator, resulting in a 9.2511 California apportionment percent. TRC LP originally reported a 12.1215 California apportionment percent for the 2011 tax year.

However, appellant fails to provide credible, competent, and relevant evidence to successfully rebut FTB's determinations for three reasons. First, R&TC section 25120(f)(1) and Regulation section 25136(d)(2)(A), as applicable for the 2011 tax year, provides for the inclusion of "gross receipts," not net gain in the calculation of the California sales factor. Furthermore, appellant does not contend and has not established that the standard allocation and apportionment provisions (requiring the use of gross receipts) do not fairly represent his, Yukon's or TRC LP's activities in California. (See R&TC, § 25137.) Therefore, appellant's proposal of including net gains with gross receipts to compute the sales factor is inconsistent with the relevant California apportionment rules in this appeal.

Second, evidence in the record does not provide details as to the composition of TRC LP's sales factor computation to support appellant's assertion that TRC LP indeed excluded the gross receipts from the 1231 net gain transactions from its sales factor as originally reported. However, even if appellant's assertion were true, appellant fails to discuss and provide evidence showing that the gross receipts from the 1231 net gain were wrongfully excluded from the apportionment factors by TRC LP or the other underlying pass-through entities. For example, appellant did not provide evidence to show whether the gross receipts from each of the specific 1231 net gain transactions should be excluded from TRC LP's (or the other underlying entities') sales factor based on the substantial and occasional sale rule provided in Regulation section 25137(c)(1)(A).

Third, appellant can only use TRC LP's apportionment percentage instead of Yukon's apportionment percentage to apportion the 1231 net gain if Yukon and TRC LP are not unitary.[8] Regulation section 17951-4 contains income sourcing provisions applicable to a nonresident's business, trade, or profession and generally incorporates the apportionment rules of the Uniform Division of Income Tax Purposes Act contained in R&TC sections 25120 to 25139, including Regulation section 25137-1. (See e.g., R&TC, § 17951-4(c), (d), (e); see also *Appeal of Smith*, 2023-OTA-069P.) A taxpayer's distributive share of partnership business income is generally apportioned by the formula set forth in Regulation section 25137-1(f) or (g), whichever is applicable. (Cal. Code Regs., tit. 18, § 25137-1(a).) Generally, if a partner's or member's activities are *unitary* (disregarding ownership requirements) with the partnership's or LLC's activities, the partner or member shall *combine* its share of the partnership's or LLC's apportionment factors with the partner or member's own apportionment factors to apportion the combined income. (See Cal. Code Regs., tit. 18, § 25137-1(f); *Appeal of Smith, supra*.) By contrast, if a partner's or member's activities are *not unitary* (disregarding ownership requirements) with the partnership's or LLC's activities, the partnership or LLC apportions its business income separately and its factors are *not combined* with the partner or member's own apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(g); *Appeal of Smith, supra*.)

Appellant contends that the "TRC LP apportionment factor should flow[-]through to [appellant];" therefore, FTB should use the California apportionment percentage of 9.2511 from TRC LP, as modified by appellant, to source the 1231 net gain business income. However, appellant has not provided any details as to the composition of the apportionment factors for Yukon and TRC LP. Also, appellant did not explain the discrepancy between the California apportionment percentages originally reported by Yukon, 10.0640 percent, and TRC LP, 12.1215 percent. In sum, appellant fails to show potentially relevant facts of how income and

[8] While not discussed in either party's briefing it appears that FTB's proposed assessment uses Yukon's apportionment percentage of 10.064 percent to apportion the 1231 net gain generated by the underlying pass-through entities on the basis that Yukon is unitary with TRC LP, and Yukon's apportionment factors incorporate its share of TRC LP's apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(f); see also Cal. Code Regs., tit. 18, § 17951-4(d)(2).) It is unclear whether FTB determined these entities were unitary based on the entities.' California returns, appellant's statements or representations during audit, an audit of the issue, or if FTB assumed that these entities were unitary. It appears that both parties are treating the underlying pass-through entities where the 1231 net gain transactions originated as unitary with TRC LP. Otherwise, the California source income determination would have been made at each of the underlying pass-through entities' level using that pass-through entities' California apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(g); see also Cal. Code Regs., tit. 18, § 17951-4(d)(1).)

apportionment factors should flow-through from the various underlying pass-through entities to TRC LP and from TRC LP to Yukon. For example, appellant did not establish whether some or all of the underlying pass-through entities (where the various 1231 net gain transactions originated) were unitary with TRC LP and whether Yukon was unitary with TRC LP. As such, appellant has not shown the 1231 net gain (generated by the various underlying pass-through entities) is properly apportioned using TRC LP's apportionment factors (modified to include the 1231 net gain transactions generated by the various underlying pass-through entities) without regard to Yukon's apportionment factors. (See Cal. Code Regs., tit. 18, § 25137-1(f) and (g).) Therefore, appellant has not established any basis to rebut FTB's determination which used the reported California apportionment percentage from Yukon to source the 1231 net gain business income to California.

As noted above, appellant's unsupported assertions are insufficient to satisfy his burden of proof. (*Amarr*, *supra*.) Here, appellant has not demonstrated by a preponderance of the evidence that FTB's apportionment of business income to appellant for the 2011 tax year is erroneous.

Issue 2: Whether appellant has established that interest should be abated.

R&TC section 19101(a) provides that interest shall be paid upon any portion of the tax not paid on or before the date prescribed for payment. The imposition of interest is mandatory. (R&TC, § 19101(a); *Appeal of Balch*, 2018-OTA-159P.) Interest is not a penalty, but rather, it is compensation for the taxpayer's use of money from the time it was required to be paid to the state, to the actual date of payment. (*Ibid*.)

As relevant to this appeal, under R&TC section 19104(a)(1), FTB may abate interest related to a proposed deficiency to the extent the interest is attributable in whole or in part to: (1) an unreasonable error or delay; (2) by an officer or employee of FTB acting in his or her official capacity; (3) in performing a ministerial or managerial act; and (4) which occurred after FTB contacted the taxpayer in writing regarding the proposed deficiency, provided no significant aspect of that error or delay can be attributable to the taxpayer. (R&TC, § 19104(a)(1), (2), (b)(1); *Appeal of Gorin*, 2020-OTA-018P.)

However, OTA's jurisdiction in an interest abatement case is limited. OTA only reviews FTB's failure to abate interest for abuse of discretion. (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*.) Interest abatement provisions are not intended to be routinely used to avoid the payment of interest; thus, abatement should be ordered only where failure to abate interest would be widely perceived as grossly unfair. (*Ibid*.)

In this appeal, the NOA assessed interest for two periods. For the first period, FTB assessed interest in the amount of $73,310.07 for the period April 15, 2012, through October 12, 2015. As for the second period, FTB assessed interest in the amount of $163,772.86 for the period November 24, 2016, through July 13, 2021. At appeal, FTB exercised its discretion and determined to abate interest attributable to the second period from February 25, 2018, through February 9, 2021, and from April 11, 2021, through July 13, 2021. In summary, FTB has determined to abate interest for a total of three years, two months, and 17 days.

Here, appellant asserts, in a general manner, that interest should be abated entirely due to reasonable cause because appellant did not willfully avoid his California tax liability. However, there is no reasonable cause exception to the imposition of interest. (*Appeal of Gorin*, *supra*.) Furthermore, appellant has not identified and evidence in the record does not reveal any other time periods for which there was an unreasonable error or delay by FTB. Therefore, appellant has not shown that FTB abused its discretion in failing to abate interest for the other time periods. Therefore, appellant has not established any basis for additional abatement of interest.

HOLDINGS

1. Appellant has not demonstrated that FTB's apportionment of business income to appellant for the 2011 tax year was erroneous.
2. Interest is abated, as conceded by FTB on appeal, from February 25, 2018, through February 9, 2021, and from April 11, 2021, through July 13, 2021.

DISPOSITION

The NOA is modified, as conceded by FTB on appeal, to abate interest from February 25, 2018, through February 9, 2021, and from April 11, 2021, through July 13, 2021. Otherwise, the NOA is sustained in full.

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Eddy Y.H. Lam
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Eddy Y.H. Lam
Administrative Law Judge

We concur:

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Cheryl L. Akin
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Cheryl L. Akin
Administrative Law Judge

DocuSigned by:
Teresa A. Stanley
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Teresa A. Stanley
Administrative Law Judge

Dated: 7/7/2023