

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 19115431
B. MORRIS AND)
D. MORRIS)
_____)

OPINION

Representing the Parties:

For Appellants: Ryan Nowicki, Attorney
D. Morris

For Respondent: James Youn, Attorney
Matthew Miller, Attorney Supervisor

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

A. VASSIGH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, B. Morris and D. Morris (appellants¹) appeal an action by respondent Franchise Tax Board (FTB) proposing a noneconomic substance transaction (NEST) penalty of \$222,153.00, and an interest-based (IB) penalty of \$200,079.01, plus applicable interest, for the 2006 tax year.²

Administrative Law Judges John O. Johnson, Asaf Kletter, and Amanda Vassigh, held an oral hearing for this matter in Cerritos, California, on August 13, 2025. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision pursuant to California Code of Regulations, title 18, section 30209(b).

¹ Appellant-wife D. Morris' arguments at appeal pertain to herself, personally. Therefore, in this Opinion, OTA refers to appellant-wife in the singular, as "appellant" and appellant-husband as "B. Morris." References to "appellants" in this Opinion refer to actions taking solely by B. Morris or actions of the couple. This should not be construed as a finding that appellant was responsible for these actions.

² FTB states that it issued a Notice of Proposed Assessment (NPA) to appellants on August 28, 2012, in reliance on the extended statute of limitations set forth in R&TC section 19755 for deficiencies relating to an abusive tax avoidance transaction. A copy of the NPA has not been provided as part of the appeal record. However, according to the evidentiary record, the NPA also imposed additional tax of \$615,102, which appellant is no longer contesting. Appellant is also not contesting the timeliness of the NPA.

ISSUES

1. Whether the NEST penalty under R&TC section 19774 is applicable.
2. Whether the IB penalty under R&TC section 19777 is applicable.

FACTUAL FINDINGS

1. In 2003, appellants purchased real property (the Property) located in Napa County, California. Appellants subsequently created various legal entities and utilized a series of transactions to dispose of the Property.
2. Appellants first created a children's trust (the Trust), purportedly gifting the Trust \$1 million. The agreement creating the Trust was executed on July 11, 2005. After creating the Trust, appellants then formed a limited partnership (the LP). According to appellants, they then contributed the Property to the LP as a nontaxable capital contribution. Subsequently, on July 15, 2005, appellants reportedly sold 90 percent of their 97 percent LP interest to the Trust.³
3. Next, the LP made an Internal Revenue Code (IRC) section 754 election, which pursuant to IRC section 743(b) increased the Trust's proportionate share of the LP's basis in the LP's assets (i.e., the Trust's "inside basis") to equal the Trust's basis in its 90 percent LP interest.⁴
4. Afterwards, on February 10, 2006, the LP sold the Property to a third-party purchaser under the terms of an installment note. For the 2006 tax year, the Trust reported its share of installment income on that sale, less an IRC section 734(b) basis adjustment (attributable to the IRC section 754 election by the LP).
5. Appellants were contacted by FTB regarding an "abusive tax avoidance transaction" via an audit issue presentation sheet dated June 5, 2012. During the audit, FTB determined that the sale of appellants' 90 percent LP interest to the Trust (along with the IRC section 743(b) basis adjustment) should be disregarded under the economic substance doctrine. Further, FTB determined that the Trust should be disregarded because it lacked economic substance.

³ Ownership of the LP prior to the July 2005 sale was as follows: 97% belonged to appellants, 1 percent belonged to the Trust, and 2 percent belonged to a corporation of which B. Morris was the managing partner.

⁴ IRC sections 743 and 754 are incorporated into California law by R&TC section 17851.

6. On August 28, 2012, FTB issued a Notice of Proposed Assessment (NPA) to appellants revising their 2006 taxable income and proposing additional tax, a NEST penalty, and an IB penalty, plus applicable interest.
7. Appellants filed a timely protest. FTB later affirmed the NPA in a Notice of Action.
8. Appellants then filed this timely appeal.
9. B. Morris passed away in 2021, during the pendency of this appeal. Appellant then took over management of his estate and learned about the transaction and the penalties at issue in this appeal.

DISCUSSION

Issue 1: Whether the NEST penalty under R&TC section 19774 is applicable.

FTB's determination of fact is presumed to be correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Bindley*, 2019-OTA-179P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Bindley*, *supra*.)

The United States Court of Appeals for the Ninth Circuit may apply the economic substance doctrine to determine if a transaction should be disregarded for income tax purposes. (*Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360.) In determining whether a transaction lacks economic substance, the Ninth Circuit applies a two-pronged analysis considering: (1) whether the taxpayer has demonstrated a non-tax business purpose for the transaction (a subjective analysis); and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits (an objective analysis). (*Id.* at pp.1363-1368.) In this case, appellants do not argue that the sale of appellants' 90 percent LP interest to the Trust and the resulting basis adjustment had economic substance and a nontax business purpose. In fact, at the hearing, appellant described the transaction as "bogus" and a "tax shelter," and intimated that the NEST penalty, imposed on any understatement attributable to a "noneconomic substance transaction," would be applicable to B. Morris if he were still alive.⁵

However, appellant argued at the hearing that the penalties should not apply to her because it was B. Morris who entered into the transaction, without her knowledge. Appellant

⁵ A "noneconomic substance transaction" is defined as including, a transaction or arrangement that lacks economic substance, including a transaction or arrangement in which an entity is disregarded as lacking economic substance. (R&TC, § 19774(c)(2)(A).) 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. (*Ibid.*)

presented a reasonable cause argument that she had no reason to know about and in fact did not know about the transaction, and therefore was not able to disclose relevant facts in a return or statement attached to the return.⁶ Appellant described an uneven power structure in a marriage in which financial control and abuse were prevalent. OTA finds appellant's testimony compelling and credible.

However, although OTA is sympathetic to appellant's situation, it can only grant relief where the law specifically allows. (*Appeal of Gillespie*, 2018-OTA-052P.) The record demonstrates, and appellant concedes, that the installment sale of appellants' 90 percent LP interest to the Trust comes within the definition of an "abusive tax avoidance transaction."

As for appellant's contention that the penalty should be abated for reasonable cause⁷ because she was not involved in the transaction and did not know about it until after Mr. Morris had passed away, *there is no reasonable cause exception to the imposition of the NEST penalty*. Based on the foregoing, OTA finds that the NEST penalty of 40 percent is applicable. California law provides that OTA's role is limited to determining whether the penalty was properly imposed in the first place, and OTA has no authority to abate the penalty. (R&TC, § 19774(a), (d)(3); *Appeal of La Rosa Capital Resource, Inc.*, 2020-OTA-220P). Having found that the NEST penalty was properly imposed, only FTB's Chief Counsel may compromise it. (R&TC, § 19774(d)(1).)

Issue 2: Whether the IB penalty under R&TC section 19777 is applicable.

Under R&TC section 19777, a penalty of 100 percent of the interest that accrued prior to the mailing of an NPA is imposed on a deficiency if FTB had contacted the taxpayer regarding an "abusive tax avoidance transaction." For the purposes of R&TC section 19777, an abusive tax avoidance transaction means any transaction to which the NEST penalty applies. (R&TC, § 19777(b)(5).)⁸

⁶ The NEST penalty is equal to 40 percent of the amount of the NEST understatement; however, the penalty is reduced to 20 percent with respect to the portion of the NEST understatement for which the "relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return." (R&TC, § 19774(a) & (b)(1).)

⁷ Appellant was asked at the hearing to present any regulations, cases, or authorities that indicate that a lack of knowledge constitutes reasonable cause, but was unable to do so. Appellant stated that "it's more of a policy argument that these penalties should just not apply to her." Appellant indicated that taxpayers in this situation would ordinarily qualify for relief via innocent spouse relief provisions, but that was not an option here since appellant inherited the estate of B. Morris.

⁸ References to R&TC section 19777 are to the former version of the statute in effect from March 24, 2011, through December 31, 2022, based on the date the NPA was mailed. (R&TC, § 19777(e).)


As discussed above, the installment sale of appellants' 90 percent LP interest to the Trust comes within the definition of an "abusive tax avoidance transaction" and the NEST penalty is applicable. Furthermore, appellants were contacted by FTB regarding an "abusive tax avoidance transaction" via an audit issue presentation sheet dated June 5, 2012, and the NPA on August 28, 2012. OTA finds credible appellant's testimony that she had no knowledge of the transaction nor the tax implications; however, the IB penalty is a strict liability penalty, and no defense to the IB penalty is provided for "reasonable cause." (See R&TC, § 19777(a).) Based on the foregoing, OTA finds that the IB penalty is applicable.

HOLDINGS

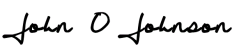
1. The NEST penalty under R&TC section 19774 is applicable.
2. The IB penalty under R&TC section 19777 is applicable.


DISPOSITION

FTB's action is sustained.

DocuSigned by:

 7B17E958B7C14AC...
 Amanda Vassigh
 Administrative Law Judge

We concur:

DocuSigned by:

 873D8797B9E64E1...
 John O. Johnson
 Administrative Law Judge

DocuSigned by:

 D17AEDDCAAB045B...
 Asaf Kletter
 Administrative Law Judge

Dated: 11/5/2025