

In the Matter of the Consolidated Appeals of:

A. VARELA AND

J. VARELA

) OTA Case Nos. 18011376, 18053075
)
)
)
)
)
)

Appellants waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals (OTA) on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUES

1. Whether FTB's issuance of the Notices of Proposed Assessment (NPAs) to appellants for the 1999, 2000, and 2001 tax years was timely because the structure implemented by appellants whereby an S corporation management company adopted an Employee Stock Ownership Plan (ESOP) for the benefit of appellant A. Varela (Mud ESOP Structure), was an abusive tax avoidance transaction (ATAT).
2. Whether the Mud ESOP Structure implemented by appellants lacked economic substance, and if so, whether FTB properly reallocated the ESOP's flow-through income to appellants for the 1999, 2000, and 2001 tax years.
3. Whether FTB properly imposed the NEST penalties for the 1999, 2000, and 2001 tax years.
4. Whether FTB properly imposed the IB penalties for the 1999, 2000, and 2001 tax years.
5. Whether appellants have shown error in FTB's proposed assessments of additional tax for the 2003 and 2004 tax years, which are based on federal determinations.
6. Whether FTB properly imposed the ARPs for the 2003 and 2004 tax years, and if so, whether the penalties may be abated.

FACTUAL FINDINGS

Appellant A. Varela and Proven Management, Inc. (Proven); American Qualified Plans, Inc.'s (AQP's) proposal to appellant A. Varela; appellant A. Varela's incorporation of Mud Management, Inc. (Mud); Mud's adoption of an ESOP (Mud ESOP); and allocation of all of Mud's stock to appellant A. Varela's ESOP account.

1. For the Tax Years at Issue, appellant A. Varela was the sole shareholder and president of Proven, a California C corporation engaged in construction. Proven maintained an Internal Revenue Code (IRC) section 401(k) profit-sharing plan for Proven's employees, with pre-tax salary deferral and discretionary employer matching contributions.
2. On December 3, 1998, AQP sent appellant A. Varela, as president of Proven, a proposal for services if Proven proceeded with the installation of an ESOP.¹ Under the proposal, AQP would complete a limited appraisal of Proven's fair market value (FMV), determine the feasibility of the ESOP and if the ESOP could be structured to accomplish Proven's objectives in consultation with Proven's CPA, and obtain Proven's approval to proceed with the ESOP. AQP would then consult with Proven's management on IRC

¹ AQP's proposal concerned the adoption of an ESOP by Proven; however, a separate company, Mud, ultimately installed an ESOP, as discussed below.

requirements for qualification and other ESOP parameters for an optimal plan design, draft the Plan and Trust document, and review the initial draft with Proven's management. Following Proven's approval of the Plan and Trust document, AQP would apply for a letter of determination from the IRS and provide Proven with a Summary Plan Description employee booklet. AQP would then prepare a final formal appraisal of Proven under the IRS's evaluation criteria. AQP's proposal "guarantees that the final application to the IRS will be approved or all fees will be returned to [Proven]."

3. On April 8, 1999, appellant A. Varela incorporated Mud, a California S corporation.² Appellant A. Varela was Mud's sole Director, president, and employee. On the same day, appellant A. Varela capitalized Mud with \$20,000 in cash, and Mud issued to appellant A. Varela 1,000 shares of no-par common stock of Mud with a FMV of \$20,000. On April 8, 1999, Mud adopted the Mud ESOP, and appellant A. Varela sold all 1,000 shares of Mud stock to the Mud ESOP for \$20,000. The Mud ESOP allocated all 1,000 shares of Mud stock to appellant A. Varela's ESOP account.
4. During the Tax Years at Issue, Mud did not issue any additional stock. The Mud ESOP was Mud's sole shareholder during the Tax Years at Issue.
5. On June 23, 2000, the IRS issued a favorable determination letter to Mud stating that the Mud ESOP qualified under IRC section 401(a) as a tax-exempt entity.
6. Beginning in 2001, Mud employed M. Bradshaw, an individual, who also participated in the Mud ESOP.³ AQP reported in its 2002 annual administration report for the Mud ESOP that only appellant A. Varela held Mud stock in his ESOP account. By

² In a December 31, 2014 declaration, appellant A. Varela declares that "[i]n March 1999, I incorporated [Mud]." However, Mud's federal Forms 1120S, U.S. Income Tax Return for an S Corporation, for the 1999 through 2004 tax years, list April 8, 1999 as the date incorporated and the effective date of election as an S corporation. A printout from the California Secretary of State Business Portal also shows that Mud filed an application for incorporation on April 8, 1999; however, the printout states that the information "is not a complete or certified record of the Corporation."

³ Appellant A. Varela declares that M. Bradshaw participated in the Mud ESOP beginning in mid-2001, which is consistent with the Mud ESOP's federal Form 5500, Annual Return/Report of Employee Benefit Plan, for the 2001 tax year, as well as AQP's 2002 annual administration report for the Mud ESOP, which reports that M. Bradshaw was hired on July 1, 2001.

contrast, M. Bradshaw's participation was limited to cash allocations to his ESOP account.⁴

Proven and Mud's Employee Leasing Agreement; Mud's Employment Agreement with appellant A. Varela; Mud's invoicing for leasing and equipment rental services and pass-through income; Mud's rental real estate and investment activities.

7. Proven and Mud (together, the Entities) entered into an Employee Leasing Agreement effective May 1, 1999, whereby Proven retained Mud to supply it with employees in exchange for \$2,193,922.84 during the first year of the agreement, and at a rate to be agreed upon in writing by the parties each year thereafter. Per an attached 1999 Payment Schedule, Proven would pay Mud a minimum of \$20,000 per month with additional compensation for incentives, bonuses and increased workload as negotiated by the Entities. Appellant A Varela signed the agreement as president of both Entities.
8. Appellant A. Varela and Mud entered into an Employment Agreement effective May 1, 1999, whereby Mud employed appellant A. Varela to provide "management services" to Mud and "management and marketing services or other duties" on behalf of Mud's clients. The Employment Agreement provided that appellant A. Varela would be compensated at a rate to be agreed upon each year by Mud and appellant A. Varela, subject to additional compensation for services rendered as may be determined by Mud's Board of Directors. Appellant A. Varela signed the agreement as Mud's president and as its employee.
9. Proven paid the following amounts to Mud on a calendar-year basis: \$2,183,893 for 1999; \$3,002,287 for 2000; \$1,435,000 for 2001; \$539,449 for 2003; and \$554,270 for 2004. The payments represented the following percentages of Mud's gross income on a calendar-year basis: 101 percent in 1999;⁵ 90.9 percent in 2000; 88.3 percent in 2001; 35.9 percent in 2003; and 14 percent in 2004. Mud reported zero payments from unrelated parties in 1999 and 2000. Between 2001 and 2004, Mud reported receiving

⁴ Per AQP's 2002 annual administration report, appellant A. Varela held a "CSA" and an "OIA" account, while M. Bradshaw only held an "OIA" account. "CSA" apparently refers to a "Company Stock Account," and "OIA" apparently refers to an "Other Investment Account." Appellant A. Varela's "CSA" account had a beginning stock value of \$1,830 per share, and an ending value of \$2,100 per share, which match AQP's 2001 and 2002 valuation reports, respectively. By contrast, the "OIA" accounts had a beginning and ending stock value of \$1 per share.

⁵ Mud's gross income in the 1999 calendar year was \$2,165,859 because Mud reported losses from related entities.

payments from unrelated parties representing between 14.5 percent and 39.7 percent of Mud's gross income.

10. In 2000, 2001, 2002, and 2003, Mud issued Proven invoices for employee leasing costs, expense reimbursement, and accounting services. Each of Mud's invoices to Proven for employee leasing costs was for a set period (e.g., "for the period of March 1, 2001, through March 31, 2001") and for a total amount due (e.g., "\$35,000.00"). Mud did not itemize or indicate on the invoice how it calculated the total amount due.
11. Proven sold equipment for \$285,000 to Mud effective January 1, 2001. Beginning in 2001, Mud invoiced unrelated parties for equipment rental services.⁶
12. During the Tax Years at Issue, Mud was also engaged in rental real estate and investment activities, and held interests in Moon Valley Properties, LLC (Moon Valley), which invested in a rental property in Santa Rosa, California, and Egbert Enterprises, LLC (Egbert), which invested in a commercial property in San Francisco, California. Mud provided invoices for accounting and overhead services to Moon Valley and Egbert. In 2001, Mud owned another rental real estate property in Santa Rosa.

AQP's valuations of Mud stock for 1999, 2001, and 2002.

13. Appellants, as trustees of the Mud ESOP, engaged AQP to determine the FMV of the 1,000 shares of Mud common stock that appellant A. Varela sold to the Mud ESOP. AQP's valuation, dated "as of April 8, 1999" (1999 Valuation Report), concluded that the Mud stock had a FMV of \$20,000, or \$20 per share. AQP stated that in arriving at its FMV conclusion, it considered that:

[T]he income anticipated by the ESO[P] is to be derived from the management services of [appellant A.] Varela as the sole employee of the corporation. The sole employee, moreover, can anticipate as a plan participant an allocation of all of these earnings to his ESOP account. This fact insures [*sic*] that such personal services will continue to be rendered on behalf of [Mud] and, under these circumstances, on behalf of the ESO[P]. It is not reasonable to assume, however, that the sole employee would be motivated to divest himself of some portion of these personal service earnings for the benefit of some third party passive investor in [Mud] On the other hand, the acquisition of these shares by some other unrelated person or business entity would not, per se, entitle such third party to assume that the financial benefits of the personal services of the sole employee of [Mud] would be guaranteed to continue.

⁶ Appellant A. Varela declares that Mud provided a portion of the equipment rental services to Proven but appellants did not provide any invoices to support this contention on appeal.

AQP did not consider including the value of Mud's earnings in the FMV determination "as no permanent or enduring interest in these earnings would be acquired by the acquisition of shares of the common stock of Mud by an independent third party investor."

14. AQP prepared Mud stock valuations as of December 31, 2001, and December 31, 2002. AQP's 2001 valuation report concluded that the value of the stock was \$1,830,000, or \$1,830 per share, and the 2002 valuation report concluded that it was \$2,100,000, or \$2,100 per share. Consistent with AQP's 1999 Valuation Report, AQP's 2001 and 2002 valuation reports state that Mud's income was primarily derived from appellant A. Varela's management services. However, AQP's 2001 and 2002 valuation reports considered Mud's discounted future earnings in determining the Mud stock's FMV.

Proven's 1999, 2000, and 2001 federal and California corporate income tax returns.

15. On a 1999 federal Form 1120, U.S. Corporate Income Tax Return (Form 1120), for the tax year ended (TYE) May 31, 2000, Proven reported gross receipts of \$1,370,515 and cost of goods sold of \$1,649,484. Proven reported total income of \$3,456,269, and total deductions of \$3,348,332, including employee leasing expenses of \$2,802,287. For the 1999 tax year, Proven reported a federal taxable income of \$107,937. Proven filed a 1999 Form 100, California Corporation Franchise or Income Tax Return (Form 100), which incorporated the 1999 Form 1120.
16. On a 2000 Form 1120 for the TYE May 31, 2001, Proven reported gross receipts of \$7,187,738 and cost of goods sold of \$5,603,534. Proven reported total income of \$2,725,641, and total deductions of \$2,484,054, including employee leasing expenses of \$1,390,000. For the 2000 tax year, Proven reported a federal taxable income of \$241,587. Proven filed a 2000 Form 100 which incorporated the 2000 Form 1120.
17. On a 2001 Form 1120 for the TYE May 31, 2002, Proven reported gross receipts of \$6,418,204 and cost of goods sold of \$5,906,782. Proven reported total income of \$640,106, and total deductions of \$1,330,827. For the 2001 tax year, Proven reported a federal taxable loss of \$690,721. Proven filed a 2001 Form 100 which incorporated the 2001 Form 1120.

Mud's 1999, 2000, and 2001 federal and California corporate income tax returns.

18. On a 1999 federal Form 1120S, U.S. Income Tax Return for an S Corporation (Form 1120S), for the short tax year beginning on April 8, 1999, and ending on December 31, 1999, Mud reported gross receipts of \$2,183,893, total income of

\$2,179,090 and total deductions of \$398,945. Mud reported ordinary income of \$1,780,145, a rental activity loss of \$18,736 related to Moon Valley, and investment interest income of \$5,505. A statement attached to the 1999 Form 1120S reported that on April 8, 1999, Mud issued 1,000 shares of no-par common stock of Mud with a FMV of \$20,000 to appellant A. Varela in exchange for \$20,000 in cash. Another statement attached to the 1999 Form 1120S reported that, beginning April 8, 1999, and through the end of the year, the Mud ESOP owned and was allocated 100 percent of Mud's stock. Mud filed a 1999 Form 100S, California S Corporation Tax Return (Form 100S) which incorporated the 1999 Form 1120S.

19. On a 2000 Form 1120S, Mud reported gross receipts of \$3,002,287, total income of \$3,000,897, and total deductions of \$473,663. Mud reported ordinary income of \$2,527,234, a total rental activity loss of \$160,096 related to Moon Valley and Egbert, investment interest income of \$5,222, and a net short-term capital gain of \$457,527. Mud filed a 2000 Form 100S which incorporated the 2000 Form 1120S.
20. On a 2001 Form 1120S, Mud reported gross receipts and total income of \$1,770,586, and total deductions of \$731,586. Mud reported ordinary income of \$1,039,000 and a total rental activity loss of 59,2889 related to Egbert and the rental real estate property in Santa Rosa, interest income of \$5,713, and a net long-term capital loss of \$91,250. Mud filed a 2001 Form 100S which incorporated the 2001 Form 1120S.

Federal and California Schedules K-1 issued to the Mud ESOP by Mud.

21. Mud reported on a 1999 federal Schedule K-1 (Form 1120S), Shareholder's Share of Income, Credits, Deductions, etc. (Schedule K-1) that the Mud ESOP's 100 percent pro rata share of Mud's ordinary income was \$1,780,145. Mud reported on a 1999 California Schedule K-1 (100S), Shareholder's Share of Income, Deductions, Credits, etc. (CA K-1), that the Mud ESOP's 100 percent pro rata share of Mud's income/losses were as follows: California source ordinary business income of \$1,780,945, California source net rental real estate losses of \$18,736, and federal nonbusiness investment interest of \$5,505.
22. Mud reported on a 2000 federal Schedule K-1 that the Mud ESOP's 100 percent pro rata share of Mud's ordinary income was \$2,527,234. Mud reported on a 2000 CA K-1, that the Mud ESOP's 100 percent pro rata share of Mud's income/losses were as follows: California source ordinary business income of \$2,582,091, California-source net rental

real estate losses of \$159,376, federal nonbusiness investment interest of \$5,222, and nonbusiness federal net short-term capital gains of \$457,527.

23. Mud reported on a 2001 federal Schedule K-1 the Mud ESOP's 100 percent pro rata share of Mud's ordinary income was \$1,039,000. Mud reported on a 2001 CA K-1, that the Mud ESOP's 100 percent pro rata share of Mud's income/losses were as follows: California source ordinary business income of \$1,098,682, California source net rental real estate losses of \$58,129, federal nonbusiness investment interest of \$5,713, and federal nonbusiness net long-term capital gain of \$91,250.

The Mud ESOP's 1999, 2000, and 2001 federal employee benefit plan returns.

24. The Mud ESOP's 1999 federal Form 5500, Annual Return/Report of Employee Benefit Plan (Form 5500), was marked "first return/report," and reported that the plan's effective date was April 8, 1999, that it had one active participant, net income of \$3,489,830, and employer securities of \$3,487,960.
25. The Mud ESOP's 2000 Form 5500 reported one active participant, net income of \$1,417,650, and employer securities of \$4,880,017.
26. The Mud ESOP's 2001 Form 5500 reported two active participants, a net loss of \$3,016,818, and employer securities of \$1,830,000.
27. Appellants were reported as the Mud ESOP trustees on the 1999, 2000, and 2001 Forms 5500.

Filing dates of appellants' joint California income tax returns.

28. Appellants filed joint 1999, 2000, and 2001 Forms 540, California Resident Income Tax Returns (Forms 540) on April 15, 2000, April 15, 2001, and July 23, 2002, respectively.⁷ A statement attached to appellants' 1999 federal income tax return reported the April 8, 1999, sale of Mud stock for \$20,000.
29. Appellants filed joint 2003 and 2004 Forms 540 on October 15, 2004, and October 15, 2005, respectively.

⁷ Copies of the returns are not in the record. Appellants state that the 1999, 2000, and 2001 Forms 540 were filed "on a timely basis not later than October 15 of the following calendar year."

Federal audit and assessments, United States Tax Court (Tax Court) proceedings, and IRS closing agreements with the Mud ESOP and appellants.

30. The IRS audited the Mud ESOP's qualified status under IRC section 401(a). On November 12, 2008, the IRS revoked the Mud ESOP's tax-exempt status for plan years ending December 31, 1999, and for all subsequent plan years.
31. The IRS determined that appellant A. Varela was deemed to own 100 percent of Mud because the Mud ESOP owned 100 percent of Mud's stock and appellant A. Varela was the Mud ESOP's sole participant. Appellant A. Varela also owned 100 percent of Proven's stock and therefore owned more than 80 percent of the Entities. The Entities were a brother-sister controlled group under various IRC sections, and therefore, all employees of the Entities were treated as employees of a single employer for purposes of the coverage requirements of IRC section 410(b).⁸ The IRS determined that the Mud ESOP violated the minimum coverage requirements of IRC section 410(b) because appellant A. Varela was a "highly compensated employee" of the Entities, and none of the "non-highly compensated employees" were covered by, or received a benefit of, the Mud ESOP in the 2000, 2001, 2002, 2003, or 2004 tax years.
32. For the 2003 tax year, the IRS proposed to increase appellants' federal taxable income by \$3,438,361, by including other income of \$221,134; the vested accrued benefit of \$2,539,200; \$577,880 of wages; and disallowing itemized deductions of \$100,147. The IRS assessed additional federal tax of \$1,169,160 based on its adjustments and imposed a 20 percent ARP.⁹
33. For the 2004 tax year, the IRS proposed to increase appellants' federal taxable income by \$833,440, by including the vested accrued benefit of \$809,165, and disallowing itemized deductions of \$24,275. The IRS assessed additional federal tax of \$259,627 based on its adjustments and imposed a 20 percent ARP.
34. Appellants petitioned the Tax Court for redetermination of the federal deficiencies for the 2003 and 2004 tax years.

⁸ IRC section 410(b) generally sets forth minimum coverage requirements that ensures that an ESOP sufficiently covers non-highly compensated employees.

⁹ The IRS and appellants later entered into a closing agreement, and the Tax Court subsequently held that appellants had a reduced federal income tax deficiency of \$339,809 and owed a ten percent ARP for the 2003 tax year. Pursuant to the parties' closing agreement, the Tax Court held that appellants had a reduced federal income tax deficiency of \$503,047 and owed a ten percent ARP for the 2004 tax year. See findings of fact 35, 36 and 37.

35. On January 24, 2012, the IRS and the Mud ESOP entered into a closing agreement (Mud Closing Agreement) which states the parties' mutual understandings that: Mud filed a petition for declaratory judgment with the Tax Court opposing the IRS's revocation letter; the IRS and the Mud ESOP ultimately agreed that the Mud ESOP shall not be treated as tax-qualified and agreeing on the tax ramifications thereof to certain interested parties; and the Mud ESOP was not part of a listed transaction, as described in guidance promulgated under Treasury Regulation section 1.6011-4(b)(2). The Mud Closing Agreement provided that the IRS will not assert any income tax adjustments against Mud for failure to qualify as a tax-qualified plan prior to January 1, 2005, and that the Mud ESOP will not knowingly or intentionally engage in any transactions identical to or substantially similar to the Mud ESOP after the Mud Closing Agreement execution date.
36. On January 24, 2012, appellants and the IRS entered into a closing agreement (Varela Closing Agreement) which states the parties' mutual understandings, which were the same as the understandings for the Mud Closing Agreement set forth above. The IRS and appellants agreed in the Varela Closing Agreement that the IRS will not assert any income tax adjustments against appellants under IRC section 402(b) arising out of appellant A. Varela's participation in the Mud ESOP, and that appellants will not knowingly or intentionally engage in any transactions identical to or substantially similar to the Mud ESOP after the Varela Closing Agreement execution date.
37. On January 30, 2012, based on the Varela Closing Agreement, the Tax Court held that for the 2003 tax year, appellants had a federal income tax deficiency of \$339,809 and owed a ten percent ARP. Based on the Varela Closing Agreement, the Tax Court held that for the 2004 tax year, appellants had a federal income tax deficiency of \$503,047 and owed a ten percent ARP.
38. On February 2, 2012, based on the Mud Closing Agreement, the Tax Court held that for the 2003 and 2004 tax years, Mud had no federal income tax deficiencies, overpayments, or penalties.
39. On April 5, 2012, the IRS's deficiency assessments against appellants for the 2003 and 2004 tax years became final federal determinations.

California audit and assessments.

40. On February 20, 2004, FTB opened an audit of Mud's 2000, 2001, and 2002 Form 100S. The audit expanded to include appellants' 1999 through 2002 Forms 540.

41. On January 26, 2007, FTB determined that Mud's implementation of the Mud ESOP was a sham transaction for the sole purpose of tax avoidance. FTB reallocated the Mud ESOP's flow-through income to appellant A. Varela for the 1999, 2000, and 2001 tax years. FTB proposed additional tax for the 1999, 2000, and 2001 tax years.¹⁰ FTB also proposed to apply the IB and NEST penalties because the Mud ESOP transaction was substantially similar to the Management S Corporation ESOP Transaction identified in IRS Announcement 2005-80 as an abusive transaction.¹¹
42. On February 26, 2008, FTB issued NPAs to appellants for the 1999, 2000, and 2001 tax years.¹² For the 1999 tax year, FTB proposed to increase appellants' California taxable income by \$1,783,267. For the 2000 tax year, FTB proposed to increase appellants' California taxable income by \$3,073,776. For the 2001 tax year, FTB proposed to increase appellants' California taxable income by \$1,140,979. FTB also imposed the IB and NEST penalties for each of the 1999, 2000, and 2001 tax years.
43. Appellants protested the 1999, 2000, and 2001 NPAs. At appellants' request, FTB deferred the protest beginning in 2009, pending resolution of the federal proceedings.
44. On June 17, 2014, FTB issued Notices of Action (NOAs) to appellants affirming the NPAs for the 1999, 2000, and 2001 tax years.
45. On June 29, 2015, FTB received information from the IRS indicating that it had audited appellants' federal income tax return for the 2003 and 2004 tax years and increased appellants' federal income. For the 2003 and 2004 tax years, the IRS respectively assessed additional federal tax of \$339,809 and \$503,047. The IRS also imposed ARPs for the 2003 and 2004 tax years. Appellants did not report the federal changes to FTB.
46. To the extent allowable by California law, FTB made comparable adjustments to appellants' 2003 and 2004 Forms 540. On January 19, 2016, FTB issued NPAs to appellants for the 2003 and 2004 tax years. For the 2003 tax year, FTB proposed to

¹⁰ Appellants had a loss in the 2002 tax year after application of FTB's proposed adjustments.

¹¹ In FTB Notice 2006-01 (January 11, 2006), FTB pursued a settlement initiative following IRS Announcement 2005-80. However, appellants determined that they would not participate in the FTB initiative.

¹² FTB's adjustments for the 1999, 2000, and 2001 tax years, besides itemized deduction phase outs, were comprised of Mud's flow-through items reported on the CA K-1, including, where applicable, and subject to applicable limitations: ordinary income, rental activity losses, interest income, short-term capital gains and long-term capital losses.

increase appellants' California taxable income by \$1,010,187¹³ and to impose a 20 percent ARP. For the 2004 tax year, FTB proposed to increase appellants' California taxable income by \$1,469,083¹⁴ and to impose a 20 percent ARP.

47. Appellants protested the 2003 and 2004 NPAs. For the 2003 and 2004 tax years, FTB reduced the ARPs to ten percent, consistent with the federal reduction of the ARPs. FTB issued NOAs to appellants affirming the NPAs for the 2003 and 2004 tax years, as modified for the ARP.
48. Appellants timely appealed the NOAs issued for the Tax Years at Issue.
49. On appeal, FTB provides appellants' 2003 and 2004 federal account transcripts dated May 12, 2022, which show that as of that date, the IRS had not cancelled or reduced its assessment of tax or abated the federal ARP.

DISCUSSION

Issue 1: Whether FTB's issuance of the NPAs to appellants for the 1999, 2000, and 2001 tax years was timely because the Mud ESOP Structure was an ATAT.

For the 1999, 2000, and 2001 tax years, R&TC section 19057(a)¹⁵ provided that, except in the case of a false or fraudulent return and as otherwise expressly provided in Part 10.2 of Division 2 of the R&TC (Part 10.2), every NPA shall be mailed to taxpayers within four years of the date taxpayers file the return. Within Part 10.2, R&TC section 19755(a) stated that, notwithstanding R&TC section 19057, an NPA "related to" an ATAT (as defined in R&TC section 19753(c)) may be mailed to the taxpayer within the later of eight years after the return was filed, or within the period otherwise provided in Part 10.2, Chapter 4, Article 3. R&TC sections 19753 and 19755 were enacted in 2003 and later amended effective March 24, 2011. (Stats. 2011, c. 14 (S.B.86), § 20.) R&TC section 19755(b) applied to returns made under Part 10.2 and filed on or after January 1, 2000.¹⁶

¹³ This figure reflects the difference between the federal adjusted gross income (AGI) of \$1,592,663 shown on appellants' June 5, 2015 federal account transcript for the 2003 tax year, minus the federal AGI of \$582,476 that appellants reported to FTB on their 2003 Form 540.

¹⁴ This figure reflects the difference between the federal AGI of \$2,014,548 shown on appellants' June 5, 2015 federal account transcript for the 2004 tax year, minus the federal AGI of the \$545,465 that appellants reported to FTB on their 2004 Form 540.

¹⁵ All "R&TC" references are to the code as effective for the relevant Tax Years at Issue.

¹⁶ The version of R&TC section 19755(b) effective January 1, 2004 to March 23, 2011, applied to appellants' 1999, 2000, and 2001 returns because it applied to returns made under Part 10.2 and filed on or after January 1, 2000. Appellants' returns were made under Part 10.2 and filed on April 15, 2000, April 15, 2001, and July 23, 2002, respectively.

On February 26, 2008, FTB issued NPAs for the 1999, 2000, and 2001 tax years. It is uncontested that the statute of limitations under R&TC section 19057(a) expired prior to FTB's issuance of the NPAs. However, FTB contends that it timely issued the NPAs under R&TC section 19755(a) related to ATATs.¹⁷ It is well established that a specific statute of limitations controls over a general statute of limitations. (*Ordlock v. Franchise Tax Board* (2006) 38 Cal.4th 897, 902, 910-911.) Thus, if the statute of limitations related to ATATs applies, it controls over the general statute of limitations for assessment under R&TC section 19057(a).

The party asserting a statute of limitations defense has the burden of proving the defense. (*Adler v. Commissioner* (1985) 85 T.C. 535, 540; see also *Amesbury Apartments, Ltd. v. Commissioner* (T.C. 1990) 95 T.C. 227, 240-241; *Heckman v. Commissioner*, T.C. Memo 2014-131.) OTA's regulations provide that the burden of proof is on appellants as to all issues of fact, and that the applicable standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(a-b).) Unsupported assertions are insufficient to satisfy the taxpayer's burden of proof. (*Appeal of Gelpi*, 2024-OTA-072P.) In the absence of credible, competent, and relevant evidence showing error in FTB's determination, FTB's determination will be upheld. (*Ibid.*)

R&TC section 19753(c) defined an ATAT as "a plan or arrangement devised for the principal purpose of avoiding tax" and stated that ATATs "include[d], but [we]re not limited to, 'listed transactions'" as described in R&TC section 18407(a)(4). R&TC section 18407(a)(4) modified IRC section 6011,¹⁸ to provide that "listed transaction" also included:

"any transaction that [wa]s the same as, or substantially similar to, a transaction specifically identified by the Secretary of the Treasury under Section 6011 of the [IRC] for federal income tax purposes or by the [FTB] under this section for California income or franchise tax purposes, as a[n] ATAT] including deductions, basis, credits, entity classification, dividend elimination, or omissions of income

¹⁷ On appeal, FTB argues that the 2001 NPA was timely issued under R&TC section 19058, which provides that, if a "taxpayer omits from gross income an amount properly includable therein which is in excess of 25 percent of the amount of gross income stated in the return, a[n] NPA] may be mailed to the taxpayer within six years after the return was filed." However, the 2001 NPA and FTB's determination dated January 26, 2007, do not reference R&TC section 19058. In any case, because OTA finds that appellants were engaged in an ATAT, further discussion of R&TC section 19058 is unnecessary.

¹⁸ R&TC section 17024.5(a)(1)(L), effective for the 1998 through 2001 tax years, and R&TC section 17024(a)(1)(M), effective for the 2002 through 2004 tax years, provides that for Personal Income Tax Law purposes, California conforms to the IRC as effective on January 1, 1998, and January 1, 2001, respectively. Thus, "IRC" references in this Opinion are to the IRC as effective on January 1, 1998, for the 1998 through 2001 tax years, and January 1, 2001, for the 2002 through 2004 tax years.

It is uncontested that when FTB issued the NPAs for the 1999, 2000, and 2001 tax years, the Mud ESOP Structure was not the same as, or substantially similar to, a listed transaction. Because ATATs were not limited to listed transactions, the issue here is whether the Mud ESOP Structure was a “plan or arrangement devised for the principal purpose of avoiding tax.”

As Issue 2 explains below, OTA finds that appellants have not shown by a preponderance of the evidence that the Mud ESOP Structure had a business purpose or economic substance. Appellants do not show that the Mud ESOP Structure had a valid business purpose; rather, OTA finds the Mud ESOP Structure was like the transactions lacking business purpose identified by the IRS and federal courts and later addressed by IRC section 409(p). Appellants fail to show that the Mud ESOP Structure had economic substance; instead, OTA finds that the Mud ESOP Structure resulted in no operational or ownership change and that the transaction resulted only in the indefinite deferral of taxation. On the record before it, OTA finds that, based on a preponderance of the evidence, the Mud ESOP Structure had the principal purpose of tax avoidance.

Appellants contend that FTB has not demonstrated by clear and convincing evidence that appellants engaged in an ATAT. However, the clear and convincing evidentiary standard applies in any proceeding involving the issue of fraud, which is not at issue in this appeal. (See former Cal. Code Regs., tit. 18, § 5541(b); Cal. Code Regs., tit. 18, §§ 30106, 30219(c); *Neely v. Commissioner* (2011) 116 T.C. 79, 86.) The applicable standard is proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).)

Appellants also cite R&TC section 19180, which provides that FTB bears the burden of proof to impose penalties under R&TC sections 19177, 19178, and 19179. Appellants’ reliance on R&TC section 19180 is misplaced as that provision is limited to the enumerated penalties.¹⁹

¹⁹ Appellants further assert that FTB erred in retroactively applying R&TC section 19755 to the 1999, 2000, and 2001 tax years, citing *Franchise Tax Bd. v. Superior Court of San Francisco County (Quellos Group LLC, Real Party in Interest)* (2013) 221 Cal.App.4th 647 (*Quellos*). In *Quellos*, the court examined an uncoded section of the law enacting increased tax shelter penalties, *in the absence of specific statutory language*, to determine whether the increased promoter penalty could be applied retroactively. (*Id.* at pp. 658-662.) That language provided that the act applied “with respect to any penalty assessed on or after January 1, 2004, *on any return for which the statute of limitations on assessment has not expired.*” (*Id.* at p. 651, italics original.) The court determined that because the promoter penalty is not a penalty assessed on the taxpayer’s return, the increased promoter penalty could not be applied retroactively. (*Ibid.*) In other words, the Legislature did not employ the necessary language to evidence its intent for retroactive application. (*Id.* at p. 671.)

By contrast, R&TC section 19755 specifically provides that deficiency assessments related to ATATs for any return filed on or after January 1, 2000, may be mailed to the taxpayer within the later of eight years after the return was filed, or within the period otherwise provided in Part 10.2, Chapter 4, Article 3. Unlike *Quellos*, R&TC section 19755(b) has specific statutory language which indicates that the eight-year statute of limitations *shall* apply to tax returns filed on or before January 1, 2000.

Here, appellants bear the burden of proof. (Cal. Code Regs., tit. 18, § 30219(a); *Adler v. Commissioner, supra*.)

Appellants timely filed Forms 540 for the 1999, 2000, and 2001 tax years on April 15, 2000, April 15, 2001, and July 23, 2002, respectively. Because OTA finds that appellants engaged in an ATAT, R&TC section 19755 authorized FTB to issue NPAs for the 1999, 2000, and 2001 tax years within eight years from the date appellants filed the return. Here, FTB was authorized to issue NPAs for the 1999, 2000, and 2001 tax years until April 15, 2008, April 15, 2009, and July 23, 2010, respectively. On February 26, 2008, FTB timely issued the NPAs for the 1999, 2000, and 2001 tax years.

Issue 2: Whether the Mud ESOP Structure implemented by appellants lacked economic substance, and if so, whether FTB properly reallocated the ESOP's flow-through income to appellants for the 1999, 2000, and 2001 tax years.

In determining whether a transaction lacks economic substance, courts have generally focused on the following principles: (1) whether the taxpayer has shown that it had 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 at p. *14; *see also Reddam v. Commissioner* (9th Cir. 2014) 755 F.3d 1051, 1059 (*Reddam*).) The application of the business purpose prong is a subjective test whereas the application of the economic substance prong is an objective test. (*Casebeer, supra*, 909 F.2d at p. 1363.) The economic substance doctrine is not a rigid two-step analysis, but instead focuses holistically on “whether the transaction had any practical economic effects other than [tax avoidance].” (*Ibid*; *Reddam, supra*, 755 F.3d at p. 1060.) 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*).)

Business Purpose Factor

The business purpose factor involves an examination of the subjective factors that motivated a taxpayer to engage in the transaction at issue aside from tax avoidance. (See *Casebeer, supra*, 909 F.2d at p. 1364; *Appeal of Alyn, supra*, at p. *14.) The taxpayer has the burden of proof. (*Casebeer, supra*, 909 F.2d at p. 1362, n. 7; *Appeal of Alyn, supra*, at p. *13.)

Whether the taxpayer meets the business purpose test is a factual finding. (*Casebeer, supra*, 909 F.2d at p. 1363; *Appeal of Alyn, supra*, at p. *14.)

Appellants assert the adoption of the Mud ESOP had a business purpose, however, the evidence in the record does not support appellants' assertions.²⁰ First, appellant A. Varela declares that "During 1999, I considered ways in which I might assure the retention of certain key employees who contributed importantly to Pro[v]en's success. . . . [r]etention of key employees [was] critical," and that "as part of my plan to retain key employees, on the advice of competent tax and benefit plan design professionals, I created an [ESOP] for the Mud employees, so they could hold its stock and share in its success."²¹

However, Proven maintained a 401(k) plan for its own employees, with pretax salary deferral and discretionary employer-matching contributions, which appellants argue "provided amply for the employees remaining in Proven." Appellants also explain that all employees other than appellant A. Varela and M. Bradshaw were union employees whose benefits were collectively bargained. Thus, no evidence in the record supports appellants' assertion that the adoption of the Mud ESOP supported the retention of key Proven employees.

Moreover, on April 8, 1999, when the Mud ESOP was effective, appellant A. Varela was the sole participant and all 1,000 shares of Mud stock were allocated to his ESOP account. In 2001, when Mud employed M. Bradshaw, his ESOP account was limited to cash allocations. Appellants assert that ESOP administrators "regularly" reallocate employer stock where a new employee is added. However, evidence in the record shows that, as of 2002, appellant

²⁰ Appellant A. Varela declares that he formed Mud to "perform some, but not all of the services previously performed by Pro[v]en," and explains the advantages of doing so. Even if appellant A. Varela had a business purpose for incorporating Mud, it is not the "transaction to be analyzed" because the incorporation did not "g[i]ve rise to the alleged tax benefit." (*Coltec, supra*, 454 F.3d at p. 1356.) Here, the Mud ESOP Structure gave rise to the alleged tax benefit (adoption of the Mud ESOP, allocation of all Mud stock to appellant A. Varela's ESOP account, and execution of the Employee Leasing Agreement and the Employment Agreement).

²¹ Appellants argue that the separate incorporation of Mud would enable employees to acquire stock in Proven since its value would be less. As described in footnote 20 above, the incorporation of Mud is not the "transaction to be analyzed." (*Coltec, supra*, 454 F.3d at p. 1356.) Even if it were, appellants fail to provide credible evidence that appellant A. Varela intended to offer Proven employees the opportunity to acquire Proven stock during the 1999, 2000, and 2001 tax years. Appellants submitted copies of agreements between appellant A. Varela and W. Gilmartin III in 2014 and 2015, but those agreements are well outside the 1999, 2000, and 2001 tax years, and fail to show that Mud was incorporated to enable Proven employees to acquire Proven stock at a reduced cost. Appellants also assert without evidence that "without Mud's input for Proven . . . [the] compan[y] would have been less successful and less profitable," which contradicts their first argument, as it is more expensive to buy the stock of a successful and profitable company. In any case, evidence in the record shows that the Mud ESOP owned all Mud shares, which were allocated to appellant A. Varela's ESOP account, and therefore, Mud's income accrued to appellant A. Varela's sole benefit.

A. Varela and M. Bradshaw were the only Mud ESOP participants, all Mud stock shares were allocated to appellant A. Varela's ESOP account, and that the value of the Mud shares increased substantially. Mud did not issue any additional stock during the Tax Years at Issue. Therefore, the appreciation in value of the Mud Shares benefitted appellant A. Varela, and M. Bradshaw did not benefit from the appreciation in value of the Mud shares.

Second, appellant A. Varela declares that in establishing the Mud ESOP, tax considerations were "secondary to the need to stabilize and protect the future of Pro[v]en's business." Appellants provide no substantiation for this assertion and no evidence in the record shows that implementation of the Mud ESOP stabilized or protected Proven's business. Instead, Proven's 1999 Form 1120S shows that Proven's net income and profitability were reduced by engaging appellant A. Varela through the Employee Leasing Agreement, the cost of which was more than double Proven's gross receipts from its operating business for the TYE May 31, 2000.²² Based on the foregoing, appellants have not shown that the Mud ESOP had a business purpose.²³

OTA's conclusion is supported by decisions of federal courts, the IRS, and Congress, which concluded that similar transactions, involving S corporation management companies and ESOPs, lack a valid business purpose. In *U.S. v. A. Blair Stover* (W.D. Mo. 2010) 731 F.Supp.2d 887 (*Stover*), *affd.* by *U.S. v. A. Blair Stover* (8th Cir. 2011) 650 F.3d 1099, the federal district court held that a certain tax structure (ESOP/S structure), involving an operating company that formed and paid management fees to an S corporation management company, which, in turn, created an ESOP that owned the management company's stock, lacked a business purpose. (*Stover*, 650 F.Supp.2d 887, 895-896.) The ESOP's sole beneficiary or beneficiaries would be the owner(s) of the operating and management companies. The ESOP/S structure resulted in indefinite deferral of taxation because: (1) the operating company deducts the management fees, (2) as an S corporation, the management company's income is not taxed, and (3) the ESOP's income is not taxed until the ESOP distributes the money. (*Ibid.*) The *Stover* court noted that the operating company and the management company were part of a controlled group because the same people (numbering less than five) owned all the stock of

²² On its 1999 Form 1120, Proven reported gross receipts of \$1,370,515 and "employing leasing expenses" totaling \$2,802,287 for the TYE May 31, 2000. In calendar years 1999 and 2000, Proven's employee leasing payments to Mud were reported to be \$2,183,893 and \$3,002,287, respectively, which comprised 101 and 90.9 percent of Mud's gross receipts for each of these calendar years.

²³ Appellants assert that there was a "subjective business purpose" for the Mud ESOP because appellant A. Varela consulted banks, a surety, and an ESOP consulting company. OTA fails to understand how consultation of advisors, by itself, serves a business purpose. Appellants also assert that they relied upon tax and legal advice in forming the Mud ESOP, which is addressed in Issue 6 below.

both companies. (*Ibid.*) As a result, the owners of the corporations were deemed to be key employees, and the ESOP improperly favored them because the other employees (i.e., the operating company's employees other than the owners) were not permitted to participate in the plan. (*Ibid.*)

Like the *Stover* ESOP/S structure, appellant A. Varela was the sole shareholder of Proven, the operating company, sole shareholder of Mud, the S corporation management company, and sole beneficiary of the Mud ESOP's income.²⁴ As in the *Stover* ESOP/S structure, Proven, the operating company, deducted the cost of the employee leasing services payments to Mud; Mud, the S corporation, was not taxed on the income from the agreement; and the Mud ESOP's income was not subject to taxation until it distributed money. Thus, as with the *Stover* ESOP/S Structure, the Mud ESOP Structure obtained an indefinite deferral of income. Similar to the court's determination for the ESOP in *Stover*, here, the IRS determined that the Mud ESOP violated the minimum coverage requirements of IRC section 410(b) because Proven and Mud were a controlled group, appellant A. Varela was a key employee, and the Mud ESOP improperly favored appellant A. Varela. Thus, *Stover* supports OTA's finding that the Mud ESOP Structure lacked a valid business purpose.²⁵

In 2004, the IRS issued a public announcement entitled "S Corporation ESOP Abuses."²⁶ The guidance explained that because of IRC changes, beginning in 1998, the income of an S corporation could pass through to a tax-exempt ESOP, resulting in the indefinite deferral of income. In abusive transactions, taxpayers attempt to exclude the income of an operating business by using an S corporation in combination with an ESOP. The guidance identified a typical abusive arrangement whereby an individual, Individual A, is an employee and the sole shareholder of a C corporation operating company, Corporation X. In a subsequent year, an S corporation, Corporation Y, is created, and Corporation Y establishes a purported ESOP and enters into an agreement with Corporation X for fees to be paid for management services to be provided by Individual A to the C corporation. As a result, Corporation X deducts the management service fees, which are reported by Corporation Y as income of the

²⁴ Although M. Bradshaw participated in the Mud ESOP beginning in 2001, all Mud stock shares were solely allocated to appellant A. Varela's ESOP account. Therefore, appellant A. Varela was the sole beneficiary of Mud's income.

²⁵ See also *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C. Memo. 2011-105 [finding incorporation of S corporation personnel services company by operating company president lacked credible business purpose, but finding ESOP was not a sham because IRS untimely raised argument].

²⁶ The guidance provides additional detail on the typical abusive arrangement. It is available at: https://www.irs.gov/pub/irs-tege/scorp_esop.pdf.

tax-exempt ESOP. Substituting appellant A. Varela for Individual A, Proven for Corporation X, and the Mud ESOP for Corporation Y, the Mud ESOP Structure followed the typical abusive arrangement. That the IRS has identified transactions like the Mud ESOP Structure to be abusive supports OTA's finding that the Mud ESOP structure lacked a business purpose.

In 2001, Congress enacted IRC section 409(p) to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. (Pub. L. No. 107-16, 115 Stat. 38, § 656(a); Rev. Rul. 2004-4, 2004-1 C.B. 414, (2004) [discussing legislative history and intent].) Appellants concede that appellant A. Varela did not widen Mud's role and function due to "the uncertainty and chilling effect" created by IRC section 409(p), which restricted the use of ESOPs "in situations arguably similar to the [Mud ESOP]." Beginning in 2001, when IRC section 409(p) was enacted, Mud began providing services to third parties, which greatly lowered the amount of Mud's employment leasing service income paid or accrued from Proven and the relative percentage those payments represented of Mud's gross receipts. Also beginning in 2001, equipment rental services were shifted from Proven to Mud, but the shifting of services does not provide the Mud ESOP Structure with a valid business purpose.²⁷ The income attributable to the services shifted from Proven to Mud continues the deferral of tax because Mud, as an S corporation, is not taxed on the income, and the Mud ESOP, a tax-exempt entity, owns Mud. IRC section 409(p) supports OTA's finding that the Mud ESOP Structure lacked a business purpose because that code section was enacted in response to substantially similar structures that lacked a business purpose.²⁸

Based on the foregoing, appellants have not shown that the Mud ESOP had a business purpose, and OTA finds that the Mud ESOP had no business purpose.

Economic Substance Factor

The economic substance factor involves a broader examination of whether the substance of the transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from the creation of tax benefits. (See *Casebeer, supra*, 909 F.2d at p. 1365.) The question is whether the transaction was in fact objectively capable of creating a profit or affecting the taxpayer's financial situation. (*Jade Trading, LLC v. U.S.* (Fed. Cl. 2007) 80 Fed. Cl. 11, 47-48, *affd.* in part and *revd.* on other

²⁷ Effective January 1, 2002, Proven sold equipment for \$285,000 to Mud, and beginning in 2001, Mud invoiced unrelated parties for equipment rental services.

²⁸ Appellants argue that IRC section 409(p) ultimately applied for plan years beginning on or after December 31, 2004, and that it does not show appellants' intent in adopting the Mud ESOP. However, IRC section 409(p) supports the conclusion that the Mud ESOP Structure lacks a business purpose.

grounds (Fed. Cir. 2010) 598 F.3d 1732; *Coltec, supra*, 454 F.3d at p. 1356 n. 16). Whether the taxpayer meets the economic substance test is a factual finding. (*Casebeer, supra*, 909 F.2d at p. 1365.) The taxpayer bears the burden of proving that the transaction has economic substance. (*Coltec, supra*, 454 F.3d at p. 1355.) A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance. (*Ibid.*) 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 Congress. (*Commissioner v. Court Holding Co.* (1945) 324 U.S. 331, 334.)

The Mud ESOP Structure at issue consisted of the establishment of the Mud ESOP, the allocation of all Mud's stock to appellant A. Varela's ESOP account, and the arrangement provided by the Employee Leasing Agreement between the Entities and the Employment Agreement with appellant A. Varela. As described above under business purpose, the record demonstrates that only appellant A. Varela benefitted from the Mud ESOP Structure during the Tax Years at Issue, since the Mud stock was allocated solely to appellant A. Varela's ESOP account, and the limited cash allocations to M. Bradshaw's ESOP account saw no benefit from the appreciation in value of the Mud stock. Only appellant A. Varela benefitted from stock ownership in his ESOP account. The Mud ESOP Structure effected no apparent change in the Entities' operations, as appellant A. Varela remained the sole shareholder of the Entities and still performed services for Proven, but now as an employee of Mud.²⁹ Appellants failed to demonstrate that appellant A. Varela's role changed in any substantive way.

The Mud ESOP Structure resulted solely in the creation of tax benefits. Proven's income was deducted by Proven and pursuant to the Employee Leasing Agreement, the income flowed to the Mud ESOP, a tax-exempt entity. Thus, the Mud ESOP Structure obtained indefinite deferral of taxation. The IRS's determinations that the Mud ESOP's tax-favored status was disqualified from the beginning of the Mud ESOP's existence, and that appellant A. Varela was deemed to be Mud's sole owner further support the finding that the Mud ESOP Structure

²⁹ Prior to the Employee Leasing Agreement and Employment Agreement, Proven paid appellant A. Varela directly, and after the Agreements, Proven paid Mud, which allocated the income to appellant A. Varela's ESOP account. Appellant A. Varela was the beneficial owner of that account.

lacked economic substance.³⁰ Thus, appellants have failed to demonstrate that the Mud ESOP Structure had any economic substance.³¹

Because the Mud ESOP Structure lacked a valid business purpose and economic substance, FTB properly applied the economic substance doctrine to disregard the Mud ESOP.

Tax Consequences – Reallocation

Because FTB found that the Mud ESOP Structure lacked economic substance, FTB disregarded the Mud ESOP Structure and reallocated the flow-through income and losses from the Mud ESOP to appellant A. Varela for the 1999, 2000, and 2001 tax years. Appellants argue that the flow-through income and losses should have instead been reallocated to Proven, which benefited from the deduction for employee leasing services. However, the incorporation of Mud is not the “transaction to be analyzed” because it did not “g[i]ve rise to the alleged tax benefit.” (*Coltec, supra*, 454 F.3d at p. 1356.) Instead, the Mud ESOP Structure, which as described above, had no economic substance and should be disregarded, created the tax benefit.

Appellants’ argument rests on disregarding Mud as a corporate entity. However, Mud engaged in real estate investments, provided accounting and overhead services to Moon Valley and Egbert, and engaged in equipment rental activity with third parties. Appellants have not shown that Mud lacked a business purpose or activity and must be disregarded as an entity. (See *Moline Props., Inc. v. Commissioner* (1943) 319 U.S. 436; *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C. Memo. 2011-105 at *17-*19 [finding separate corporation carried on sufficient business activity and was not a sham entity].)³² Thus, appellants have not shown

³⁰ Moreover, appellants have not shown that AQP’s valuations of the Mud stock reflect economic reality. AQP, who originally marketed the ESOP plan to appellants, initially valued Mud’s 1,000 shares of common stock at a FMV of \$20,000 based solely on the \$20,000 cash appellant A. Varela contributed to Mud in exchange for the stock. The valuation expressly declined to assign any value to appellant A. Varela’s personal services, noting that a third party would not be entitled to “assume that the financial benefits of the personal services of the [appellant A. Varela] would be guaranteed to continue.” Yet the same shares increased in value to \$1,830,000, and \$2,100,000, as of December 31, 2001, and December 31, 2002, respectively. AQP later valued the shares based on Mud’s discounted future earnings, though Mud’s future income was primarily derived from appellant A. Varela’s personal services.

³¹ Appellants argue that Mud had real economic substance because Mud “actively market[ed] and provid[ed] substantial services to unrelated third parties as well as Pro[v]en.” However, the incorporation of Mud is not the transaction to be analyzed. (See footnote 20, *supra*.) Appellants assert that the formation of the Mud ESOP had economic substance but provide no further elaboration. A review of the record does not support that the Mud ESOP Structure had economic substance.

³² Proven is not a party to this appeal and its expense deductions pursuant to the Employee Leasing Agreement are not at issue in this appeal. Appellant A. Varela continued to be Mud’s shareholder in economic substance and therefore, appellants are taxable on appellant A. Varela’s pass-through income as Mud’s shareholder, regardless of whether Proven properly treated the income paid to Mud as deductible business expenses.

error in FTB's reallocation of the Mud ESOP's flow-through income to appellant A. Varela for the 1999, 2000, and 2001 tax years.

Appellants alternatively argue that under IRC section 402(b), the method FTB used to reallocate the Mud ESOP's flow-through income to appellant A. Varela, the reallocation should be limited to the amount of the vested accrued benefit in appellant A. Varela's ESOP account. Appellants rely on OTA's nonprecedential decision in *Appeal of Thompson*, 2020-OTA-075. However, nonprecedential opinions cannot be relied upon by the parties or OTA in an appeal. (Cal. Code Regs., tit. 18, § 30502(b).) Thus, OTA is not precluded from reaching a different result in this appeal. Appellants also rely on *Yarish v. Commissioner* (2012) 139 T.C. 290 (*Yarish*). In *Yarish*, the court described IRC section 402(b)(4)(A) as providing:

“a special rule that applies when the trust tax exemption under [IRC] section 501(a) does not apply due to a plan's failure to meet certain coverage or participation requirements under [IRC] section 410(b) [concerning minimum coverage requirements] The special rule requires a highly compensated employee to include in income ‘an amount equal to the vested accrued benefit of such employee (other than the employee's investment in the contract).’”

However, *Yarish* did not involve an ESOP that lacked economic substance, nor did that case address the tax consequences of disregarding an ESOP based on the economic substance doctrine. The Varela Closing Agreement supports FTB's approach because it states that the Mud ESOP shall not be treated as tax-qualified and that the IRS would not assert IRC section 402(b) income tax adjustments against appellants.

Appellant A. Varela was the sole shareholder of Mud prior to contributing the Mud stock to the Mud ESOP. If the adoption of the Mud ESOP, and appellant A. Varela's transfer of his Mud common stock shares to the Mud ESOP, are disregarded, appellant A. Varela remained Mud's sole shareholder. Therefore, the Mud ESOP's flow-through income (and loss) is properly reallocated to appellant A. Varela. Reallocating the flow-through income to Proven or using IRC section 402(b)'s vested accrued benefit method contradicts OTA's determinations that (1) Mud should be respected as a business entity because appellants have not shown that it lacked a business purpose or activity and must be disregarded as an entity, and (2) the Mud ESOP Structure lacks economic substance and should be disregarded.

For the foregoing reasons, OTA finds that FTB properly reallocated the Mud ESOP's flow-through income to appellant A. Varela for the 1999, 2000, and 2001 tax years. OTA also finds no error in FTB's method of reallocation.

Issue 3: Whether FTB properly imposed the NEST penalties for the 1999, 2000, and 2001 tax years.

R&TC section 19774(a) imposes a penalty for a noneconomic substance transaction understatement for any taxable year, in an amount equal to 40 percent of the amount of the understatement.³³ The NEST penalty is 20 percent with respect to the portion of any noneconomic substance transaction understatement with respect to 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(b)(1).) A “noneconomic substance transaction” includes:

[t]he 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).)

R&TC section 19774(d)(1) provides that if the NPA has been sent with respect to a NEST penalty, only FTB’s Chief Counsel “may compromise all or any portion of that penalty.” R&TC section 19774(d)(3) specifies that “[n]otwithstanding any other law or rule of law, any determination under this subdivision may not be reviewed in any administrative or judicial proceeding.”

As discussed under Issues 1 and 2, above, appellants have not demonstrated that the Mud ESOP Structure had a valid business purpose, and evidence in the record shows that the transaction lacked economic substance, and OTA finds that the principal purpose of the transaction was the indefinite deferral of taxation. Thus, the Mud ESOP Structure lacked a valid nontax California business purpose.

Appellants contend that even if the NEST penalty applies, it must be reduced to 20 percent because the transaction was adequately disclosed on appellants’ Forms 540, in addition to the federal tax returns of Proven, Mud, and the Mud ESOP. A taxpayer is subject to a 20 percent NEST penalty on the portion of the noneconomic substance understatement where 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(b).) Appellants are the taxpayers subject

³³ The NPAs were issued for the 1999, 2000, and 2001 tax years on February 28, 2008. R&TC section 19774 was amended effective March 24, 2011. (Stats. 2011, c. 14 (S.B.86), § 23.) However, the amendments do not affect the instant appeal, and the parties do not argue otherwise.

to the NEST penalties, and they must disclose the relevant facts affecting the tax treatment of the item on their return or a statement attached to their return. Copies of appellants' 1999, 2000, and 2001 Forms 540 are not in the record. While appellants disclosed appellant A. Varela's April 8, 1999 sale of 1,000 shares of Mud stock for \$20,000 on a statement to their 1999 *federal* income tax return, appellants did not adequately disclose the Mud ESOP Structure because, among other things, they did not provide adequate notice to FTB on the Forms 540 that appellant A. Varela sold the Mud stock *to the Mud ESOP*, that the Mud ESOP was Mud's sole shareholder, or that appellant A. Varela was the only ESOP participant and sole beneficiary of the ESOP's stock allocation.

Appellants provide no authority that disclosure by a separate taxpayer, such as Mud or the Mud ESOP, can be attributed to appellants for NEST penalty disclosure purposes. Even considering the information reported on appellants' personal income tax returns, Mud's federal and California Forms 1120S, and the Mud ESOP's Forms 5500s and the federal and CA K-1s issued to appellants for the 1999, 2000, and 2001 tax years, OTA finds that appellants failed to show that they submitted sufficient information to disclose the relevant facts affecting the tax treatment of the Mud ESOP Structure. Thus, the 40 percent NEST penalties were properly imposed.

Issue 4: Whether FTB properly imposed the IB penalties for the 1999, 2000, and 2001 tax years.

Former R&TC section 19777(a) provided that if FTB contacted the taxpayer regarding the use of a potentially abusive tax shelter, a penalty of 100 percent of the interest that accrued prior to the date of the mailing of the NPA was imposed on a deficiency.³⁴ Former R&TC section 19777(b)(2) defined a potentially abusive tax shelter as an arrangement which is "of a type" that FTB or the IRS "determines by regulations as having a potential for tax avoidance or evasion." Former R&TC section 19777(d) states that it shall apply to NPAs mailed after the effective date of the act adding the section, i.e., January 1, 2004.³⁵

Former Treasury Regulation section 1.6011-4T provided, in part, that every taxpayer that has participated, directly or indirectly, in a "reportable transaction" was required to disclose the

³⁴ Effective March 24, 2011, the legislature amended R&TC section 19777 to apply the IB penalty to any transaction to which a NEST penalty applies. (See Stats.2011, c. 14 (S.B. 86), § 24; R&TC, § 19777(b)(5).)

³⁵ The parties do not dispute that Former R&TC section 19777 as in effect on January 1, 2004, is applicable. That version applies for taxable years ending on or before December 31, 2004. (See Former R&TC, § 19777(a).)

transaction.³⁶ A “reportable transaction” was defined as a “listed transaction” or an “other reportable transaction.” (Former Treas. Reg. § 1.6011-4T(b).) “Other reportable transaction” was identified as a transaction: (1) entered into after February 28, 2000; (2) which satisfied at least two of the six characteristics presented in the regulation; and (3) met “the projected tax effect test.”³⁷ As relevant to this appeal, the characteristics included the following:

(B) The taxpayer has obtained or been provided with contractual protection against the possibility that part or all of the intended tax benefits from the transaction will not be sustained, including, but not limited to, rescission rights, the right to a full or partial refund of fees paid to any person, fees that are contingent on the taxpayer’s realization of tax benefits from the transaction, insurance protection with respect to the tax treatment of the transaction, or a tax indemnity or similar agreement (other than a customary indemnity provided by a principal to the transaction that did not participate in the promotion of the transaction to the taxpayer).

(E) The transaction involves the participation of a person that the taxpayer knows or has reason to know is in a [f]ederal income tax position that differs from that of the taxpayer (such as a tax exempt entity or a foreign person), and the taxpayer knows or has reason to know that such difference in tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with more favorable [f]ederal income tax treatment than it could have obtained without the participation of such person (or another person in a similar tax position).

(Former Treas. Reg. § 1.6011-4T(b)(3)(i)(B) & (E).)

The Mud ESOP Structure satisfies the contractual protections characteristic. (Former Treas. Reg. § 1.6011-4T(b)(3)(i)(B).) Pursuant to the AQP proposal dated December 3, 1998, addressed to appellant A. Varela, AQP would complete a limited appraisal, draft the Plan and Trust document, apply for a letter of determination from the IRS, and complete a final formal appraisal of Proven under the IRS’s evaluation criteria. AQP guaranteed that the final application to the IRS will be approved, or it would return all fees to Proven. The AQP proposal

³⁶ Former Treasury Regulation section 1.6011-4T was published on March 2, 2000, but effective for federal corporate income tax returns filed on or after February 28, 2000. (See 65 C.F.R. 11205, 2000 WL 33932824). The IRS issued regulations on August 16, 2000, which modified the earlier regulations. (See 65 C.F.R. 49909, 2000 WL 33932864.)

³⁷ The requirements that the transaction be entered into after February 28, 2000, and the “projected tax effect” only implicated whether timing of the transaction and the amount or magnitude of the tax effect of the transaction were sufficient to require reporting of the transaction. These requirements did not implicate whether the transaction is of a “type” having the “potential” for tax avoidance. A transaction met the projected tax effect test, with respect to “other reportable transactions,” if the taxpayer reasonably estimates the transaction will reduce its federal tax liability by \$5 million in any single year or more than \$10 million for multiple tax years. (Former Treas. Reg. § 1.6011-4T(b)(4).)

indicates that appellant A. Varela was provided with contractual protection against the possibility that part or all the intended tax benefits from the transaction would not be sustained because AQP agreed to return the fees if the IRS did not approve the Mud ESOP.

Additionally, the Mud ESOP Structure involved the participation of an ESOP, a tax-exempt entity. Appellant A. Varela acknowledged that, at the time the Mud ESOP was implemented, he was aware that all other employees' retirement benefits were collectively bargained for and that those employees would be unable to participate in the Mud ESOP. Appellant A. Varela also acknowledged that, at the time the Mud ESOP was adopted, he was the sole ESOP participant and all Mud stock was allocated to his ESOP account. Therefore, appellant A. Varela knew or had reason to know that the Mud ESOP's tax position allowed the Mud ESOP Structure to provide appellant A. Varela with more favorable income tax treatment than he could have obtained without adopting the Mud ESOP.

Based on the foregoing, appellants engaged in an arrangement "of a type" which the IRS determined by regulations "as having a potential for tax avoidance or evasion." On January 26, 2007, FTB contacted appellants regarding this potentially abusive tax shelter. FTB outlined the tax consequences to appellants of the abusive transaction involving Mud and the Mud ESOP. FTB subsequently issued the NPAs for the 1999, 2000, and 2001 tax years on February 26, 2008. Therefore, the IB penalties were properly imposed.

Issue 5: Whether appellants have shown error in FTB's proposed assessments of additional tax for the 2003 and 2004 tax years, which are based on federal determinations.

When the IRS makes a final federal determination, a taxpayer must concede the accuracy of the federal changes to a taxpayer's income or state where the changes are erroneous. (R&TC, § 18622.) It is well settled that a deficiency assessment based on a federal adjustment to income is presumed to be correct and a taxpayer bears the burden of proving that FTB's determination is erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; 514; *Appeal of Valenti*, 2021-OTA-093P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof with respect to an assessment based on a federal action. (*Appeal of Dillahunty*, 2024-OTA-024P.)

On June 29, 2015, FTB received information from the IRS that it had increased appellants' federal income and assessed additional federal income tax for the 2003 and 2004 tax years. FTB made corresponding adjustments. On appeal, FTB provides appellants' 2003 and 2004 federal account transcripts, which show that as of May 22, 2022, the IRS had not cancelled or reduced its assessment of tax. Appellants assert that FTB's NPAs are erroneous

because the Entities' retirement plans did not violate IRC section 409(p)'s non-discrimination provisions. Appellants assert that Proven had only union employees at the time the Mud ESOP was adopted, and that beginning in 2000, non-union employees were hired and eligible for the Entities' retirement plans. However, appellants fail to provide support for their assertions, and these claims are insufficient to satisfy their burden of proof. (*Appeal of Dillahunty, supra.*)

Moreover, appellants' contentions fail to acknowledge the Varela Closing Agreement, which recited the parties' mutual understanding that the IRS issued a Final Revocation letter to the Mud ESOP because the IRS "determined a defect in the [Mud ESOP's] tax-qualified status," i.e., it violated the minimum coverage requirements of IRC section 410(b), and stated the parties' mutual agreement that the Mud ESOP "shall not be treated as tax-qualified" and their agreement "on the tax ramifications thereof" Thus, appellants fail to demonstrate error in the IRS's determination that the minimum coverage requirements were not met.

Because appellants fail to demonstrate error in the final federal determination or in FTB's assessment based on the final federal determination, it must be upheld. (*Appeal of Valenti, supra.*)

Issue 6: Whether FTB properly imposed the ARPs for the 2003 and 2004 tax years, and if so, whether the penalties may be abated.

R&TC section 19164, which generally incorporates IRC section 6662,³⁸ imposed an ARP on an underpayment of tax due to a substantial understatement of income tax or due to negligence or disregard of rules and regulations. (IRC, § 6662(b)(1) & (2).) Individual taxpayers have a "substantial understatement of income tax" if the amount of the understatement for any taxable year exceeds the greater of 10 percent of the tax required to be shown on the return, or \$5,000. (IRC, § 6662(d)(1).) An "understatement" is the excess of the amount of tax required to be shown on the return over the amount of the tax that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2).) When FTB imposes a penalty, such as an ARP, it is presumed to have been imposed correctly. (*Appeal of Steffier, 2024-OTA-017P.*)

Here, FTB determined an understatement of tax of \$93,947 and \$136,624 for the 2003 and 2004 tax years, respectively. Appellants were required to report tax of \$128,579, and \$176,674 for the 2003 and 2004 tax years, respectively. Ten percent of the tax required to be shown on the return for the 2003 and 2004 tax years was \$12,857.90 and \$17,667.40. The understatements for the 2003 and 2004 tax years exceed ten percent of the tax required to be

³⁸ R&TC section 19164 and IRC section 6662 have been modified several times. However, the amendments do not affect the imposition of the ARP, and the parties do not argue otherwise.

shown on Forms 540 for the 2003 and 2004 tax years, and both understatements are greater than \$5,000. Therefore, the ARP was properly imposed for the 2003 and 2004 tax years.

There are various exceptions to the imposition of the ARP. The ARP will not be imposed to the extent that a taxpayer has shown that a portion of the underpayment was due to reasonable cause and the taxpayer acted in good faith with respect to the underpayment. (IRC, § 6664(c)(1); Treas. Reg. § 1.6664-4.) The taxpayer bears the burden of proving any defenses to the imposition of the ARP. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.) Taxpayers' failure to produce evidence that is within their control gives rise to a presumption that such evidence is unfavorable to their case. (*Appeals of Kwon, et al.*, 2021-OTA-296P.)

Taxpayers may demonstrate reasonable cause through reliance on the advice of a professional tax adviser as to the proper treatment of an item. (*Gerdau Macsteel, Inc. v. Commissioner* (2012) 139 T.C. 67, 191.) A professional may render advice that may be relied upon reasonably when [the professional] arrives at that advice independently, taking into account, among other things, the taxpayers' purposes for entering into the underlying transaction. (*Neonatology Associates, P.A. v. Commissioner* (2000) 115 T.C. 43, 98, (*Neonatology*) affd. (3rd Cir. 2002) 299 F.3d 221.) Reliance may be unreasonable when it is placed upon insiders, promoters, or their offering materials, or when the person relied upon has an inherent conflict of interest that the taxpayer knew or should have known about. (*Neonatology, supra*, 115 T.C. at p. 98.)

For a taxpayer to reasonably rely upon advice to abate the ARP, taxpayers must prove by a preponderance of the evidence that they meet each requirement of the following test: (1) the adviser was a competent professional who had sufficient expertise to justify reliance; (2) the taxpayer provided necessary and accurate information to the adviser; and (3) the taxpayer actually relied in good faith on the adviser's judgment. (*Clary Hood, Inc. v. Commissioner*, T.C. Memo. 2022-15, affd. in part & judg. vacated in part and cause remanded on other grounds (4th. Cir 2023) 69 F.4th 168, citing *Neonatology, supra*, 115 T.C. at p. 99.)

Appellants contend they had reasonable cause for the understatement because they relied on professional advice in implementing the Mud ESOP Structure. Appellants contend that they sought advice from their attorneys, accountants, an ESOP consulting company, banks, and a surety. However, appellants have not provided any written documentation of advice from these professionals to support their assertion.³⁹ Thus, appellants have not shown that they acted reasonably and in good faith in relying on their professionals' judgment. (See *Appeal of Alyn*, *supra*, at pp. *19-20.) Therefore, appellants have not shown that the ARPs may be abated for the 2003 and 2004 tax years.

³⁹ Appellant A. Varela declares that his CPA "consulted with an experienced law firm . . . to review the transaction and orally to opine whether it was problematic. [The law firm] registered no objection." Appellants provided no evidence to support this contention. OTA finds this uncorroborated statement unpersuasive and gives it no weight. Appellant A. Varela also declares that "[t]hese events occurred about seventeen years ago . . . running a construction company with numerous work sites throughout the state is a highly paper-intensive endeavor, requiring us to discard documents arising from completed transactions frequently . . . [w]e simply were unable to retain all documents that now, with perfect hindsight, might be considered relevant, in a traditional paper format. In addition, since that time, Pro[v]en and Mud have undergone two substantial moves, further complicating the ability to maintain consistent, old records." Appellants have the burden of proof, and their loss of records does not meet the burden of proof, particularly as appellants were aware that FTB began reviewing the Mud ESOP transaction in February 2004.

HOLDINGS

1. FTB's issuance of the NPAs to appellants for the 1999, 2000, and 2001 tax years was timely because the Mud ESOP Structure was an ATAT.
2. The Mud ESOP Structure implemented by appellants lacked economic substance. FTB properly reallocated the ESOP's flow-through income to appellants for the 1999, 2000, and 2001 tax years.
3. FTB properly imposed the NEST penalties for the 1999, 2000, and 2001 tax years.
4. FTB properly imposed the IB penalties for the 1999, 2000, and 2001 tax years.
5. Appellants have not shown error in FTB's proposed assessments of additional tax for the 2003 and 2004 tax years, which are based on federal determinations.
6. FTB properly imposed the ARPs for the 2003 and 2004 tax years, and the penalties may not be abated.

DISPOSITION

FTB's actions are sustained.

DocuSigned by:



D17AFDDCAAB045B...

Asaf Kletter
Administrative Law Judge

We concur:

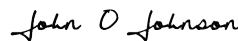
DocuSigned by:



1A3C8E36740B4D5...

Cheryl L. Akin
Administrative Law Judge

DocuSigned by:



073D9797B9E04E1...

John O. Johnson
Administrative Law Judge

Date Issued: 11/4/2025