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9 **BOARD OF EQUALIZATION**
 10 **STATE OF CALIFORNIA**

11 In the Matter of the Appeal of:) **REHEARING SUMMARY¹**
 12) **PERSONAL INCOME TAX APPEAL**
 13) **MYLES D. HUBERS AND**) Case No. 534595
 14) **MICHELLE HUBERS**)

15 Deficiency

16 <u>Year</u>	17 <u>Amount</u>	18 <u>Penalty²</u>
19 2001	20 \$192,637.00	21 \$153,366.32
22 2002	23 \$208,177.00	24 \$148,244.64
25 2003	26 \$298,861.00	27 \$192,885.33

28 Representing the Parties:

29 For Appellants: Marc S. Schechter, Butterfield Schechter LLP
 30 Paul D. Woodard, Butterfield Schechter LLP

31 For Franchise Tax Board: Roman D. Johnston, Tax Counsel III

32 ¹ The Board held an oral hearing on this matter on July 17, 2013 and sustained respondent's determination. Following the Board's adoption of a Summary Decision, appellants filed a timely petition for rehearing. On April 22, 2014, the Board granted a rehearing to consider whether appellants have met their burden of proving error in respondent's imposition of the interest-based penalty. Following the resolution of this issue, the Appeals Division will prepare a proposed Summary Decision which will be submitted for the Board's approval on a later calendar.

33 ² As noted above, this rehearing was granted to reconsider the interest-based penalty. The interest-based penalty is \$76,311.32 for 2001, \$64,973.64 for 2002, and \$73,341.00 for 2003. The remaining penalty amounts consist of a noneconomic substance transaction penalty.

1 QUESTION: Whether appellants have shown error in respondent's imposition of the interest-
2 based penalty under former Revenue and Taxation Code (R&TC) section 19777.
3

4 REHEARING SUMMARY

5 Section 40 Appeal

6 This is an appeal in which R&TC section (Section) 40 applies. Therefore, within
7 120 days of the date the Board renders its decision in this matter, a written opinion must be published
8 on the Board's website. Please see Staff Comments for a discussion of Section 40.

9 Background

10 The relevant facts are described more fully in the original hearing summary for the prior
11 Board hearing.³ In brief, appellants were the owners of Mortgage Loan Specialists (MLS), a California
12 corporation that specialized in originating home mortgages. Appellant-husband purchased
13 Shawn Christopher, Ltd., dba Money Matters Management, a Nevada corporation (MMM). MMM was
14 an "S corporation."⁴ During the years at issue, MLS paid MMM fees pursuant to a management
15 agreement, and MMM established a nonqualified deferred compensation plan for the benefit of
16 appellant-husband which accrued liabilities of \$3,899,797. In addition, MMM formed an employee
17 stock ownership plan (ESOP). Appellant-husband sold MMM to the ESOP in 2001 and then
18 reacquired sole ownership of MMM in 2003. During each of the years at issue, MLS deducted the fees
19 paid to MMM, which eliminated the taxable income of MLS. As an S corporation, MMM paid a
20 reduced rate of California income tax, and the ESOP, as a tax-exempt entity, paid no tax on MMM's
21 earnings. (See Original Hearing Summary, pp. 2 – 4, 48 – 49.)

22 On audit, respondent determined that the transaction was an abusive tax avoidance
23 transaction and reallocated MMM's income to appellant-husband. Respondent issued a Notice of
24 Proposed Assessment (NPA) in which it assessed additional tax, as well as the NEST penalty and the
25

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27 ³ This hearing summary can be found at:
www.boe.ca.gov/meetings/pdf/hearingsummaries/B_Hubers_Myles_D_and_Michelle_534595_Sum_071713.pdf.

28 ⁴ "S corporations" are subject to subchapter S of the Internal Revenue Code (IRC). They are subject to a reduced rate of California income tax and generally not subject to federal income tax. Shareholders of an S corporation are taxable on their pro rata share of the S corporation's income.

1 interest-based penalty. Following protest, respondent affirmed the NPA in a Notice of Action (NOA).
2 Appellants then filed this timely appeal. (*Id.*; see also Resp. Op. Br., p. 7.)

3 As noted previously, the Board previously heard the appeal and sustained respondent's
4 NOA. The Board subsequently granted this rehearing to consider whether appellants have met their
5 burden of proving error in respondent's imposition of the interest-based penalty.

6 As discussed more fully below, in order to determine whether the interest-based penalty
7 was properly imposed, it must be determined under former R&TC section 19777 whether the
8 transaction at issue was of a type that had been "determine[d] by regulations as having a potential for
9 tax avoidance or evasion." Respondent argues that this requirement of R&TC section 19777 is satisfied
10 here by former Treasury Regulation section 1.6011-4T(b)(4). In that regulation, the IRS determined in
11 relevant part that a transaction was reportable if it had two of certain characteristics listed by the
12 regulation and met a projected tax effect test. One of the characteristics identified by the regulation
13 was that the taxpayer participated in the transaction under "conditions of confidentiality" as that phrase
14 is defined by law and regulation. The parties dispute two issues: first, whether appellants participated
15 in the transaction here under "conditions of confidentiality," and, second, whether the projected tax
16 effect test must be met in order for the transaction to have been identified by regulation as having the
17 potential for tax avoidance and, if so, whether the test was met.

18 Contentions

19 Appellants' Opening Brief⁵

20 Appellants note that the interest-based penalty is at issue. Appellants state that the
21 sub-issues are as follows: "(1) 'What is required to establish that a taxpayer participated in a
22 transaction under conditions of confidentiality?'; and (2) Whether the projected tax effect test under
23 former Treasury regulation section 1.6011-4T(b)(4) is applicable" (App. Op. Br., p. 1.)

24 Appellants note that "conditions of confidentiality" is defined in Treasury Regulation
25 section 301.6111-2T(c) and requires an analysis of all the facts and circumstances. Appellants note that
26 the confidentiality provision in the management agreement provided as follows:
27 _____

28 ⁵ All references to briefs herein refer to the briefing on rehearing.

1 [Confidentiality of Transaction.] Except insofar as data and information may be required
2 by law to be disclosed, each party agrees that following the execution of this Agreement
3 it will (i) preserve the confidentiality of the terms of the Agreement and refrain from
4 discussing the Agreement with any person or entity except for discussion held on a
5 confidential basis with persons or entities affiliated with [MMM] or MLS or interested in
acquiring an ownership interest therein, and (ii) continue to coordinate with the other
party any announcements or public discussion of the Agreement.

6 Appellants contend that the Board erroneously found that the “entire transaction, including the purchase
7 and sale [by] the ESOP and related management agreement were offered under conditions of
8 confidentiality based on the above-referenced provision.” (App. Op. Br., p. 2.)

9 Appellants argue that, in order for a transaction to be considered to be offered under
10 conditions of confidentiality, the statute requires that “the offeree’s disclosure of the **tax treatment** or
11 **tax structure** of the transaction is limited in any manner by an express or implied understanding or
12 agreement with or for the **benefit of any tax shelter promoter**. [appellants’ emphasis]”⁶ Appellants
13 contend that the provision therefore requires the involvement of a promoter and confidentiality
14 conditions limiting the disclosure of the tax treatment or tax structure. Appellants contend that neither
15 of these conditions is satisfied. Appellants assert that the management agreement is “completely
16 unrelated to the tax treatment or tax structure of the transaction” and “does not even reference the tax
17 structure . . . nor does it restrict the disclosure of the involvement of the ESOP.” Appellants contend
18 that the provision was standard language intended to keep “business practices” confidential and further
19 contend that “no evidence” was presented showing that the transaction involved a promoter. (App.
20 Op. Br., pp. 2 - 3.)

21 Appellants state that Treasury Regulation section 301.6111-2T(c)(1) provided that “an
22 offer will also be considered made under conditions of confidentiality in the absence of such
23 understanding or agreement if any tax shelter promoter knows or has reason to know that the offeree’s
24 use or disclosure of information relating to the **structure or tax aspects** of the transaction is limited for
25

26 ⁶ Appellants indicate that they are quoting former IRC section 6111(d)(2)(A), however it does not appear to staff that this
27 statutory provision included the above language. Appellants appear to be quoting from Treasury Regulation section
28 301.6111-2. It appears to staff, and the parties appear to agree that, an earlier temporary version of the regulation, Treasury
Regulation section 301.6111-2T, provides the relevant definition for purposes of this appeal. This earlier version of the
regulation, which is quoted below by both parties and in Applicable Law, is similar to the above language, but refers to “the
structure or tax aspects of the transaction” rather than the “tax treatment or tax structure of the transaction.”

1 the **benefit of any person other than the offeree** in any other manner, such as where the transaction is
2 claimed to be **proprietary or exclusive** to the **tax shelter promoter** or any party other than the
3 offeree.” Appellants argue that the confidentiality provision here was not designed to benefit a third
4 party or tax shelter promoter and further argue that it did not benefit appellant’s counsel,
5 Butterfield Schechter. Appellants contend that the provision was for the benefit of the parties to the
6 agreement. Appellants argue that former Treasury Regulation section 1.6011-4T(b)(3) “ was adopted
7 to prevent professionals from promising tax advantages in secret and preventing their clients from
8 disclosing the tax advantages to any third party.” Thus, appellants argue, in order to be “confidential”
9 under the regulation, a promoter or other professional must have required that the client not disclose the
10 arrangement. (App. Op. Br., p. 3.)

11 With regard to the projected tax effect test, appellants note that the test “will be satisfied
12 if the taxpayer reasonably expects the transaction to reduce Federal income tax by more than \$5 million
13 in any single taxable year or by a total of more than \$10 million in any combination of years in which
14 the transaction reduces tax.” Appellants argue that this threshold is not met here because the income
15 tax deficiency amounts were \$192,637, \$208,177, and \$298,861 for tax years 2001, 2002, and 2003,
16 respectively (totaling \$699,675). (App. Op. Br., p. 4.)

17 Respondent’s Opening Brief

18 Respondent notes that, under former IRC section 6111(d)(2)(A), “conditions of
19 confidentiality” only requires an understanding or agreement with or for the benefit of the promoter
20 preventing “disclosure of the tax shelter or any significant features of the tax shelter.” Respondent
21 emphasizes that the agreement does not have to be with the promoter as the agreement may simply
22 benefit the promoter. Respondent further notes that former Treasury Regulation section 301.6111-
23 2T(c)(1) provides that “if an offeree’s disclosure of the structure or tax aspects of the transaction is
24 limited in any way by any express or implied understanding or agreement with or for the benefit of any
25 tax shelter promoter, an offer is considered made under conditions of confidentiality. [respondent’s
26 emphasis]” (Resp. Op. Br., pp. 1 – 2.)

27 Respondent notes that former Treasury Regulation section 301.6111-2T(c)(1) does not
28 reference “tax treatment or tax structure of the transaction.” Respondent states that appellants quote

1 language from final treasury regulations when in fact the temporary regulations issued before
2 February 28, 2003 apply. Respondent argues that appellants recognize this because, later in their brief,
3 they quote the following language from the temporary regulation: “an offer will also be considered
4 made under conditions of confidentiality in the absence of any such understanding or agreement if any
5 tax shelter promoter knows or has reason to know that that the offeree’s use or disclosure of
6 information relating to the *structure or tax aspects* of the transaction is limited for the *benefit of any*
7 *person other than the offeree* in any other manner, such as where the transaction is claimed to be
8 *proprietary or exclusive* to the *tax shelter promoter* or any party other than the offeree. [emphasis
9 added by appellants and reflected in respondent’s quotation]” (Resp. Op. Br., pp. 2 – 3.)

10 Respondent argues that four factors demonstrate that appellants participated in the
11 transaction under conditions of confidentiality. First, respondent argues, Butterfield Schechter prepared
12 a 2002 Confidential Memorandum outlining the mechanics of the transaction and the structure.
13 Respondent contends that the memorandum demonstrates “an understanding between
14 Butterfield Schechter and potential participants and their representatives that the tax shelter aspect of
15 the arrangement must not be disclosed[,]” quoting the following language from the memorandum in
16 support:

17 The conceptual design of the model is as follows. The key management group and their
18 support staff are transferred to a newly created Subchapter S Management Corporation
19 (SMC). The purpose for the creation of the Management Corporation must be to achieve
20 specific and definable business objectives other than merely to achieve tax efficiencies.
21 Business reasons for creating a Management Corporation include increased operating
22 efficiencies and better security for deferred compensation obligations. [respondent’s
23 emphasis]

22 Respondent asserts that the foregoing quote reflects that “Butterfield Schechter and the participants
23 have an understanding that, in order to conceal the tax shelter aspect of the transaction, their purpose
24 ‘must’ be to achieve business objectives, like ‘increased operating efficiencies and better security for
25 deferred compensation obligations.’” (Resp. Op. Br., p. 3 and Ex. A.)

26 Respondent further asserts that appellants have “complied with this understanding
27 between themselves and Butterfield Schechter throughout audit, protest, and [the Board’s] appeal
28 process[,]” quoting the following language from a letter submitted by appellants to the FTB at protest:

1 The management company permitted these entities to consolidate their employee
2 workforce, consolidate benefit planning, and isolate employment related liability to the
3 management company level As a result, the management company was
4 implemented to provide the ability for the key employees to defer compensation in an
entity which would have some level of protection from claims against the higher risk
operating companies.

5 (Resp. Op. Br., p. 3 and Ex. B [appellants' protest letter])

6 Respondent contends that the second factor showing conditions of confidentiality is the
7 management agreement. Respondent asserts that “[t]he management agreement contained a restriction
8 on disclosure in favor of Butterfield Schechter” and that the significance of the provision “cannot be
9 overstated.” Respondent further contends that the management agreement is a “significant
10 component’ of the abusive tax avoidance transaction.” Respondent notes that the management
11 agreement enabled the transfer of funds from MLS to MMM “under the guise of tax-deductible
12 management fees.” Respondent contends that if this transfer of money was not tax-deductible, “the
13 structure would be an instant failure for tax avoidance purposes[,]” and notes in support that the
14 Confidential Memorandum identifies the adoption of a management contract as “distinct steps for the
15 success of the arrangement.” (Resp. Op. Br., p. 4.)

16 Respondent further provides three factors (or sub-factors) that it contends demonstrate
17 that the confidentiality provision was for the benefit of Butterfield Schechter. First, respondent notes
18 that Butterfield Schechter drafted the agreement, and argues that Butterfield Schechter therefore “was
19 able to insert the Confidentiality of Transaction provision without entering into an explicit agreement
20 with the participant that the transaction was confidential.” Second, respondent notes that appellant-
21 husband signed the agreement for MMM and also signed it for MLS, so, “[u]nlike arm’s length
22 transactions between unrelated parties, there was little benefit to Myles Hubers by having a provision
23 that the transaction between one of his corporations and another one of his corporations was
24 confidential.” Respondent asserts that “[t]he benefit was to Butterfield Schechter.” Third, respondent
25 notes that the confidentiality provision protected “the terms of the Agreement from disclosure.
26 [respondent’s emphasis].” Respondent argues that appellants incorrectly argue that the provision
27 protected “business practices.” Respondent contends that Provision 7.1 (not Provision 7.2) of the
28 management agreement kept confidential information “which relates to the business of the other party.

1 [quoting the provision]” Respondent argues that Provision 7.2 of the agreement covered the
2 confidentiality of the agreement and notes that required that the parties “continue to coordinate with the
3 other party any announcements or public discussion of the Agreement.” Thus, respondent contends,
4 “[t]he entities could not even discuss the Agreement in public.” (Resp. Op. Br., pp. 4 – 5.)

5 Respondent cites appellant-husband’s resume as the third factor showing the presence of
6 conditions of confidentiality. Respondent observes that appellant-husband “purportedly performed
7 significant amounts of work for [MMM], yet his resume completely omits this employment.” (*Id.*,
8 p. 5.)

9 As the fourth factor showing conditions of confidentiality, respondent cites “the negative
10 consequences to Butterfield Schechter should it become known that they were materially involved in
11 the promotion or structuring of the transaction.” Respondent argues that the confidentiality provision
12 benefited Butterfield Schechter because in 2005 Butterfield Schechter “publicly called a substantially
13 similar transaction a ‘sham’ and implied it would fail the ‘substance over form’ test.” Respondent
14 contends that Butterfield Schechter “made additional points, which demonstrated the need to keep
15 Butterfield Schechter’s involvement in the implementation of the structure concealed[.]” In support,
16 respondent provides the following quotation from the 2005 presentation made by Butterfield Schechter:

17 Don’t you think if this (sic) is really worked, that everyone would be doing it? Would
18 not we be reading about it in Forbes, the Wall Street Journal, Professional Seminars, etc.?
19 Want to have clients under IRS investigation (possible tax fraud allegations) and face
20 lawsuits for malpractice? If so, those of you doing this keep doing it. There are those of
us who know its wrong and will continue to speak against it.

21 Based on the foregoing, respondent argues that Butterfield Schechter “would not want it to become
22 publicly known that it was involved in the preparation of the transactions.” (Resp. Op. Br., pp. 5 – 6
23 and Ex. C [update from Butterfield Schechter].)

24 Respondent further notes that, in *United States v. A. Blair Stover* (W.D. Mo. 2010)
25 710 F.Supp.2d 887, the court “enjoined an attorney from the promotion and sale of abusive tax
26 avoidance transactions involving S corporations, ESOPs, and management companies.” Respondent
27 observes that the attorney was required to obtain the prior approval of the IRS for any such
28 transactions, was required to notify the IRS of new clients, and was required to provide current and new

1 clients with a copy of the court order. Respondent argues that these types of court orders “are not
2 beneficial for practicing attorneys” and that “[a]ttorneys looking to maintain or expand their business
3 cringe at the thought of constant contact with the IRS” (Resp. Op. Br., pp. 6 – 7.)

4 With regard to the projected tax effects test under former Treasury Regulation section
5 1.6011-4T(b)(4), respondent argues that appellants “misunderstand” the test “and, instead of looking at
6 projections of federal income tax reductions, they mistakenly referred to actual state income tax
7 assessments.” (*Id.*, p. 7.)

8 Respondent further argues that the projected tax effects test “does not apply for [the]
9 purpose of the interest-based penalty under former [R&TC] section 19777.” Respondent notes that
10 former section 19777 applied to a potentially abusive tax avoidance transaction which was defined as
11 “[a]ny entity, investment plan or arrangement, or other plan or arrangement which is of a type that the
12 Secretary of the Treasury or the [FTB] determines by regulations as having a potential for tax
13 avoidance or evasion.” Respondent contends that, “. . . there is a significant distinction between a
14 transaction carrying the potential for tax avoidance or evasion (as required under former [R&TC]
15 section 19777) and the requirement for such transaction to be reportable.” Respondent observes that,
16 “[i]n addition to listed transactions, transactions can carry the potential for tax avoidance or evasion if
17 they have two of the six characteristics set forth in Regulation section 1.6011-4T(b)(3).” As applicable
18 here, respondent asserts, these characteristics include “the taxpayer participating under conditions of
19 confidentiality and the use of a person in a more favorable tax position.” Respondent contends that the
20 projected tax effects test “is not a characteristic that carries the potential for tax avoidance or evasion”
21 and is “irrelevant.” (Resp. Op. Br., pp. 7 – 8.)

22 As further support, respondent states that listed transactions are transactions that the IRS
23 has determined are tax avoidance transactions and has identified in published guidance. However,
24 respondent observes, a listed transaction “is not a reportable transaction unless the taxpayer meets the
25 projected tax effects test set forth in [the regulation].” Similarly, respondent argues, “for transactions
26 meeting two of the six characteristics, the potential for tax avoidance or evasion lies in the transaction
27 having two of the six characteristics, not in whether the taxpayer met the projected tax effects test.”
28 (Resp. Op. Br., p. 8.)

1 In the alternative, respondent argues that, even if the projected tax effects test applied, it
2 would be satisfied here. Respondent states that appellants have asserted that the transaction “was not
3 expected to last only three years, but instead that, ‘Hubers fully intended to have the ESOP own all of
4 the stock for years into the future.’” Respondent argues that in briefing, appellants asserted that the
5 Board “should look at the structure over a time period of at least ten years.” In support of this
6 contention, respondent quotes language from appellants’ briefing in which they stated that “[t]his
7 structure had objective economic substance because over the course of ten years (from 2001 to 2011)
8 MLS has been exposed to over twenty lawsuits” Respondent also quotes in support appellants’
9 argument that the transaction at issue began in 2001 and “continues to the current day” through the
10 maintenance of a profit sharing plan. (Resp. Op. Br., p. 8.)

11 Respondent states that it “does not have appellants’ projections of federal tax savings,
12 but notes that appellants transferred almost \$1 million in a nonqualified deferred compensation plan
13 from Execupro to MLS and MLS transferred \$2 million to MMM in 2001.”⁷ Respondent asserts that
14 “[p]ursuant to the terms of the management agreement, MLS should have transferred \$6.5 million to
15 MMM in 2002 and \$8 million to MMM in 2003[.]” citing a statement in appellants’ briefing prior to
16 the oral hearing. Respondent further asserts that, while appellants list the assessments in the NOAs,
17 “they failed to consider the projected federal tax savings at the time they implemented the structure or
18 at any time subsequent to it.” Respondent states that “[i]n appellants’ own words, they ‘fully intended
19 to have the ESOP own all of the stock for years into the future[.]’” quoting a statement by appellants in
20 prior briefing. Quoting *Appeal of Don A. Cookston*, 83-SBE-048, decided January 3, 1983, respondent
21 states that the failure of a party to produce evidence within the party’s control “gives rise to the
22 presumption that, if provided, it would be unfavorable.” Respondent contends that “[a]ppellants’
23 failure to provide relevant information in its control and relying on inapplicable figures to argue that
24 they are not subject to the interest-based penalty is thwarting the process and improper.” (Resp.
25 Op. Br., p. 9.)

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28 ⁷ ExecuPro is described as an “Irish deferred compensation plan.”

1 Appellants' Reply Brief

2 Appellants agree that former IRC section 6111(d)(2)(A) applies the correct standard for
3 analysis. Appellants state that, under former IRC section 6111(d)(1)(B), “[t]he registration of corporate
4 tax shelters under former IRC section 6111(d) is limited to transactions that are offered to any potential
5 participant under ‘conditions of confidentiality.’” Appellants observe that, under “the facts-and-
6 circumstances test in the temporary regulations, an offer is considered made under conditions of
7 confidentiality ‘if an offeree’s disclosure of the structure or tax aspects of the transaction is limited in
8 any way by an express or implied understanding or agreement with or for the benefit of any tax shelter
9 promoter . . . whether or not such understanding or agreement is legally binding[,]” citing former
10 Treasury Regulation section 301.6111-2T(c)(1). Thus, appellants contend, the former regulation
11 requires two separate findings: (1) that “the offeree’s disclosure of the structure or tax aspects of the
12 transaction is limited by an express or implied understanding or agreement; and (2) [that] the express or
13 implied understanding or agreement is with or for the benefit of a tax shelter promoter.” Appellants
14 argue that neither requirement is met. (App. Reply Br., pp. 1 – 2.)

15 With regard to the first requirement, appellants assert that the confidentiality provision
16 in the management agreement (set forth above page 3 of this Hearing Summary) “does not restrict
17 MMM or MLS from disclosing the structure or tax aspects off the ESOP transaction.” Appellants note
18 that the management agreement does not reference the ESOP and state that “[i]n fact, the existence of
19 the ESOP is a matter of public record due to the annual filing of IRS Form 5500 which is available
20 online to the public” Appellants assert that the provision is “completely unrelated to the structure
21 or tax aspects of the ESOP transaction” and further that “[r]espondent is attempting to mislead [the]
22 Board by misconstruing the intent and language of temporary Treasury Regulation 1.6011-4T(b)(3) to
23 apply to a standard management agreement paragraph between MMM and MLS rather than an
24 agreement that benefits a tax shelter promoter.” (App. Reply Br., pp. 2 – 3.)

25 With regard to the second requirement listed by appellants (i.e., that the express or
26 implied understanding be for the benefit of a tax shelter promoter), appellants argue that respondent
27 incorrectly asserts that three factors provide evidence of a benefit for Butterfield Schechter. First,
28 appellants argue that “. . . the mere fact that Butterfield Schechter drafted the management agreement

1 which included the paragraph does not mean that Butterfield Schechter somehow benefited from the
2 provision.” Appellants assert that “[t]he parties could have easily amended the management agreement
3 to eliminate this paragraph without involving Butterfield Schechter.” (App. Reply Br., p. 3.)

4 Second, appellants contend that respondent incorrectly argues that MMM and MLS did
5 not benefit from the paragraph. Appellants argue that “[t]he fact that Myles Hubers signed on behalf of
6 both MMM and MLS does not discount the benefit of having the business affairs of the entities kept
7 confidential.” Appellants assert that “[o]ther individuals worked for MMM and MLS . . . and the
8 paragraph was intended to apply prospectively to future operations.” (App. Reply Br., p. 3.)

9 Third, appellants argue that the “Internal Memorandum” of Butterfield Schechter does
10 not support respondent’s argument because “[r]espondent has no evidence as to whether this
11 memorandum was distributed to the taxpayers in this case and, to the contrary, the fact that it is listed
12 as an ‘Internal Memorandum’ and does not have Myles Hubers, MLS, or MMM written on it shows it
13 is completely irrelevant.” Appellants object that they are first learning of respondent’s reliance on this
14 document during rehearing. Appellants argue that, contrary to respondent’s assertion that the
15 memorandum “contains an understanding between Butterfield Schechter and potential
16 participants . . . ,” appellant-husband “never even received the memorandum” and, moreover, “. . . there
17 is nothing in the memorandum that implies that the structure must be kept confidential or prevented
18 from being disclosed.” Appellants conclude that “. . . there is nothing in the memorandum that tells
19 taxpayers to keep the ESOP ‘confidential’ and/or to prevent ‘disclosure.’” (App. Reply Br., pp. 3 – 4.)

20 Applicable Law

21 Under former R&TC section 19777, as in effect for the years at issue in this appeal, a
22 penalty in the amount of 100 percent of the interest accrued prior to the date of the mailing of the NPA
23 was imposed on a deficiency if respondent had contacted the taxpayer regarding the use of a potentially
24 abusive tax shelter. Subdivision (b)(2) of R&TC section 19777 defined a potentially abusive tax shelter
25 to include an arrangement “which is of a type that the Secretary of the Treasury or [respondent]
26 determines by regulations as having a potential for tax avoidance or evasion.”

27 Former Treasury Regulation section 1.6011-4T(b), as in effect for the years on appeal,
28 defined a reportable transaction, in part, as a “listed transaction” (identified by the IRS as a tax

1 avoidance transaction) or an “other reportable transaction.” An “other reportable transaction” was
2 identified in relevant part by whether it met two of the following characteristics: (1) conditions of
3 confidentiality (as defined), (2) contractual protection of tax benefits, (3) more than \$100,000 in fees
4 contingent on participation in the transaction, (4) a book-tax difference of at least \$5 million in any tax
5 year, and (5) participation of a tax-exempt entity or other person with different tax treatment (where
6 that tax status provides the taxpayer with more favorable income tax treatment).⁸

7 Former Treasury Regulation section 1.6011-4T(b) set forth the “conditions of
8 confidentiality” characteristic as follows: “The taxpayer has participated in the transaction under
9 conditions of confidentiality (as defined in § 301.6111-2T(c)).” Former Treasury Regulation section
10 301.6111-2T(c) then provided as follows:

11 All the facts and circumstances relating to the transaction will be considered when
12 determining whether an offer is made under conditions of confidentiality as described in
13 section 6111(d)(2), including prior conduct of the parties. Pursuant to section
14 6111(d)(2)(A), *if an offeree’s disclosure of the structure or tax aspects of the transaction*
15 *is limited in any way by an express or implied understanding or agreement with or for the*
16 *benefit of any tax shelter promoter, an offer is considered made under conditions of*
17 *confidentiality, whether or not such understanding or agreement is legally binding.*
18 *Pursuant to section 6111(d)(2)(B), an offer will also be considered made under*
19 *conditions of confidentiality in the absence of any such understanding or agreement if*
20 *any tax shelter promoter knows or has reason to know that the transaction is protected*
21 *from disclosure or use in any other manner, such as where the transaction is claimed to*
22 *be proprietary to the tax shelter promoter or any party other than the offeree. An*
23 *offeree’s privilege to maintain the confidentiality of a communication relating to a tax*
24 *shelter in which the taxpayer might participate or has agreed to participate, including an*
25 *offeree’s confidential communication with the offeree’s attorney, is not itself a condition*
26 *of confidentiality. [emphasis added]*

27 As indicated in the quote above, former Treasury Regulation section 301.6111-2T(c)
28 referenced former IRC section 6111(d)(2)(A) and (B). Under these provisions of IRC section 6111, an
offer was considered made under conditions of confidentiality if:

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⁸ See Treasury Decision (T.D.) 9000, June 11, 2002. The temporary regulation initially listed six characteristics, but one characteristic not relevant to this appeal, regarding foreign tax treatment, was removed. (See T.D. 8961, Aug. 7, 2001.)

1 (A) the potential participant to whom the offer is made (or any other person acting on
2 behalf of such participant) has an understanding or agreement with or for the benefit of
3 any promoter of the tax shelter that such participant (or such other person) will limit
disclosure of the tax shelter or any significant features of the tax shelter, or

4 (B) any promoter of the tax shelter –

5 (i) claims, knows or has reason to know,

6 (ii) knows or has reason to know that any other person (other than the potential
participant) claims, or

7 (iii) causes another person to claim,

8 that the tax shelter (or any aspect thereof) is proprietary to any person other than the
potential participant or is otherwise protected from disclosure to or use by others.

9 In order to constitute an “other reportable transaction,” Former Treas. Reg. sec. 1.6011-
10 4T also required, in addition to requiring that two of the listed characteristics be present, that the
11 transaction meet “the projected tax effect test[.]” which was set forth in paragraph (b)(4). The
12 projected tax effect test was satisfied if, at the time the taxpayer entered into the transaction or at any
13 time thereafter, the taxpayer reasonably estimated that the transaction will reduce the taxpayer's federal
14 income tax liability by more than \$5 million in any single taxable year or by a total of more than
15 \$10 million for any combination of taxable years in which the transaction is expected to have the effect
16 of reducing the taxpayer's Federal income tax liability.

17 STAFF COMMENTS

18 As a threshold matter, staff requests that respondent confirm at the hearing, or clarify as
19 necessary, whether it agrees that at least two of the characteristics listed in former Treasury Regulation
20 section 1.6011-4T must be present in order for a transaction to have been identified by that regulation
21 as having a potential for tax avoidance.

22 The parties appear to agree that appellants’ transaction involved the following
23 characteristic under the temporary regulation: participation of a tax-exempt entity or other person with
24 different tax treatment (where that tax status provides the taxpayer with more favorable income tax
25 treatment). However, the parties dispute two issues: (1) whether the “conditions of confidentiality”
26 characteristic is also present, and (2) whether the projected tax effect test is relevant, and, if so, whether
27 it was satisfied.

28 With regard to the first issue, the parties agree that former Treasury Regulation

1 section 6011-4T(b)(3)(i)(A), quoted above in Applicable Law, provides the relevant test. The former
2 regulation also refers to IRC section 6111(d)(2)(A) and (B), which provisions are also set forth above
3 in Applicable Law. Accordingly, the parties should focus their discussion on whether the evidentiary
4 record shows that appellants participated in the transaction under “conditions of confidentiality” as that
5 phrase is defined in these statutory and regulatory provisions.

6 As noted above, respondent argues that four factors support its determination appellants
7 participated in the transaction under conditions of confidentiality: (1) the confidentiality provision in
8 the management agreement, (2) a 2002 Confidential Memorandum of Butterfield Schechter,
9 (3) appellant-husband’s resume (which does not list MMM) and (4) a 2005 Butterfield Schechter
10 statement that similar transactions were a sham. Staff offers the following comments with regard to
11 each factor.

12 Confidentiality Provision. Appellants argue that the agreement does not cover the
13 ESOP, which was a crucial part of the transaction. Appellants should be prepared to address
14 respondent’s point that the language of IRC section 6111(d) states that confidentiality may be found if a
15 “significant feature” of the transaction is confidential.

16 Respondent should address appellants’ argument that the clause was standard language
17 that was not intended to benefit Butterfield Schechter or any other third party. Respondent should be
18 prepared to discuss whether the interest-based penalty would be potentially applicable to many
19 transactions if and to the extent contract language similar to the language here demonstrates the
20 presence of conditions of confidentiality.

21 The parties may wish to discuss whether, if Butterfield Schechter or others intended or
22 expected that the transaction would be kept confidential, such expectation would have been reflected in
23 other documents, such as its engagement letter or other correspondence with appellants. Appellants
24 should be prepared to persuade the Board that all such documents have been provided. To the extent
25 any such documents have been provided (at audit or protest) or are otherwise available, the parties
26 should provide them prior to the hearing and be prepared to discuss at the hearing whether those

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1 documents indicate any understanding or agreement with regard to confidentiality.⁹

2 2002 Confidential Memorandum. At the hearing, respondent should be prepared to
3 address the fact that this memorandum is not addressed to appellants and there is no evidence it was
4 provided to appellants. Also, it is marked as a memorandum “For Internal Use Only” (apparently
5 referring to use within the law firm), and it is dated May, 2002, while appellants entered into the
6 transaction in 2001. Further, respondent should be prepared to explain further how the fact that the
7 memorandum states that a business purpose must be present demonstrates a condition of
8 confidentiality.

9 Mr. Hubers’ Resume. Appellants did not address this argument in their briefing on
10 rehearing. At the hearing, they should be prepared to explain why Mr. Hubers’ resume did not list
11 MMM as an employer. Staff notes the resume listed MLS as Mr. Hubers’ employer from 1994 through
12 2008.¹⁰ Respondent should be prepared to discuss further the inferences that might be drawn from, and
13 its view of the weight to be given to, the fact that Mr. Hubers’ resume did not list MMM.

14 Butterfield Schechter’s 2005 Statements. Butterfield Schechter should be prepared to
15 address why it made statements in 2005 suggesting that such transactions would be treated as shams but
16 apparently helped appellants set up a similar transaction in 2001. Respondent should be prepared to
17 address how much weight, if any, should be given to statements made in 2005, after the tax years at
18 issue and more than three years after appellants entered into the transaction. Both parties should be
19 prepared to discuss whether and when such transactions (i.e., transactions involving the use of
20 management company S corporations and ESOPs) became well known, with supporting evidence if
21 possible. Appellants should be prepared to explain, with supporting evidence, how they learned of the
22 transaction and whether they understood or agreed that the transaction would be confidential.

23 Appellants have the burden of proof in this matter. In addition, if the Board determines
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26 ⁹ Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any additional evidence to present, it
27 should provide the evidence to the Board Proceedings Division at least 14 days prior to the oral hearing. Evidence exhibits
28 should be sent, with a copy to the other party, to: Khaaliq Abd’Allah, Appeals Analyst, Board Proceedings Division, State
Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.

¹⁰ The resume can be found as Exhibit B of respondent’s additional reply brief filed prior to the original oral hearing, which
is available to Board Members and staff on the Board drive for the July 17, 2013 oral hearing.

1 that appellants are withholding evidence relevant to the issue of confidentiality, such evidence would
2 be assumed to be adverse to appellants' position under the *Appeal of Don A. Cookston, supra*. For
3 these reasons, appellants should be prepared to identify any evidence in the record that they believe
4 shows, or provide any evidence showing, that the transaction was not subject to conditions of
5 confidentiality (e.g., evidence indicating that the transaction was or could be disclosed to third parties).
6 Staff notes that appellants have pointed out that the ESOP's existence and some of its tax filings were
7 public, but staff further notes that such disclosures presumably would not have disclosed the payment
8 of the management fee and the use of deferred compensation arrangements. As noted above, in order to
9 show whether the transaction was subject to conditions of confidentiality, appellants will also want to
10 provide all relevant correspondence from Butterfield Schechter or other parties regarding the
11 transaction, such as Butterfield Schechter's engagement letter and any correspondence offering or
12 describing the transaction, or persuade the Board that no such correspondence exists.

13 With regard to the second disputed issue (i.e., the projected tax effect test), the parties
14 should be prepared to discuss whether the requirement of having two of the listed characteristics
15 establishes the character of the transaction (i.e., as one having the potential for tax avoidance), while
16 the projected tax effect test only relates to the amount of potential tax avoidance and whether the
17 transaction is reportable. Consider a transaction that clearly had two or more of the listed
18 characteristics (for example, the promoter would receive more than \$100,000 in fees contingent on the
19 offeree's participation in the transaction, conditions of confidentiality, and participation of tax-exempt
20 entity) but for which the projected tax effect was \$2 million (i.e., less than \$5 million). It appears to
21 staff that the Board might find that, while the transaction would not be reportable, the temporary
22 regulation would determine that the transaction had the potential for tax avoidance.

23 Section 40

24 As noted above, this matter is subject to Revenue and Taxation Code section 40.
25 Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written
26 opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website. (Cal.
27 Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become final
28 30 days following the date of the Board's vote. (Cal. Code Regs., tit. 18, § 5465, subd. (b).) No

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petition for rehearing may be filed following the Board’s vote to determine the appeal after the rehearing. (Cal. Code Regs., tit. 18, § 5460, subd. (c)(2).)

Following the conclusion of this rehearing, if the Board votes to decide the appeal, but does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board directs otherwise, the proposed Summary Decision would not be confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the Summary Decision. If it wishes, the Board may hold its vote in abeyance until it has the opportunity to review the proposed Summary Decision. If the vote is held in abeyance, the proposed Summary Decision will be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).)

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