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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**[2]
	PERSONAL INCOME TAX APPEAL
MYLES D. HUBERS AND	Case No. 534595
MICHELLE HUBERS[1]	

Deficiency

Year	Amount	Penalty[3]
2001	$192,637.00	$153,366.32
2002	$208,177.00	$148,244.64
2003	$298,861.00	$192,885.33

Representing the Parties:

For Appellants: Elizabeth Van Clief, Butterfield Schechter LLP

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

[1] Appellants reside in Solana Beach, San Diego County.

[2] This appeal was originally scheduled to be heard on February 26, 2013. Taxpayer's representative requested a postponement from the February 26, 2013 oral hearing calendar due to a scheduling conflict, so it was rescheduled to the April 24, 2013, oral hearing calendar for the Board's next Culver City meeting. Postponement was once again requested by taxpayer's representative, due to scheduling conflict, from the April 24, 2013 oral hearing calendar, Culver City meeting, and placed on the July 17, 2013, Culver City oral hearing calendar.

[3] As stated on the Notices of Action, for tax year 2001, the noneconomic substance transaction (NEST) penalty is $77,055.00 and the interest-based penalty is $76,311.32, for tax year 2002, the NEST penalty is $83,271.00 and the interest-based penalty is $64,973.64, and for tax year 2003, the NEST penalty is $119,544.00 and the interest-based penalty is $73,341.00.

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QUESTIONS: (1) Whether appellants have shown that respondent erred by disregarding appellant-husband's sale of Money Matters Management (MMM) stock to the MMM Employee Stock Ownership Plan (ESOP) as a legal impossibility and sham transaction.

(2) Whether appellants have shown that respondent erred by disregarding appellant-husband's purchase of MMM, the management agreement between MMM and Mortgage Loan Specialists (MLS), and MMM's adoption of the Employee Stock Ownership Program and Trust Agreement and nonqualified deferred compensation plan as lacking business purpose and economic substance.

(3) Whether appellants have shown that the noneconomic substance transaction (NEST) understatement penalty and the interest-based penalty should be abated.

HEARING SUMMARY

Section 40 Appeal

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

Background

Appellants were the owners of MLS, a California subchapter C corporation that specialized in originating home mortgages. On December 5, 2001, appellant-husband purchased Shawn Christopher, Ltd., dba Money Matters Management, a Nevada subchapter S corporation (hereinafter MMM), and MMM and MLS entered into a Management Agreement under which MMM was to provide management and consulting services "to assist MLS in its day-to-day business operations in an efficient and cost-effective manner" for an initial term of five years. The Management Agreement provided that MLS would pay MMM an annual Management Services fee as follows: A flat fee of $2 million for the period from August 15, 2001 to December 31, 2001 and 22 percent per year thereafter of MLS' gross annual receipts. (Appeal Letter, p.2; Resp. Op. Br., exh. S.)

MMM adopted an ESOP on December 17, 2001 for the benefit of MLS and MMM employees and appellant-husband sold 100 percent of his shares in MMM to the ESOP, making the ESOP the sole shareholder in MMM. MMM also adopted a nonqualified deferred compensation plan

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for the benefit of appellant-husband. For the 2001 tax year, MLS paid MMM $2 million for appellant-husband's management services and MLS deducted the $2 million as an ordinary and reasonable business expense. MMM allocated the $2 million to the ESOP, and reported a liability of $2 million for the nonqualified deferred compensation plan established for the benefit of appellant-husband. For the 2001 plan year, MLS contributed $5,928 to the ESOP and MMM made no contributions and distributed no dividends to the ESOP. (Resp. Op. Br., pp. 5-6, Resp. Reply Br., exh. A; App. Letter, pp. 2-3.)

During the 2002 tax year, appellant-husband transferred approximately $791,000 of securities from the ExecuPro[4] nonqualified deferred compensation plan to MMM's nonqualified deferred compensation plan. Also, during that tax year, MLS paid MMM $2.4 million for management services and which constituted all of MMM's reported gross receipts for that year. MMM's liability for nonqualified deferred compensation plans increased from $2 million to $3,899,797.

The trustee of the MMM ESOP trust, appellant-wife, had a report prepared to determine the value of the assets in the ESOP trust based on information dated September 12, 2003. The appraiser determined that the value of the assets as of September 12, 2003, was $5,146,000, with a description of assets and amounts as follows: Cash in bank – Union Bank of CA, $813,977.69; Accounts Receivable, $30,000.00; and Other Current Assets – Deferred Compensation, $4,302,894.50. The report showed no liabilities. (Resp. Op. Br., p. 6; Resp. Reply Br., exh. I.) Appellants assert that the foregoing report did not accurately reflect the value of MMM's assets and that appellant-husband had another independent appraisal performed which valued the MMM stock at $50,000. On or effective as of September 30, 2003, appellant-husband repurchased 20 percent of the MMM stock from the ESOP and MMM redeemed the remaining 80 percent of the MMM stock from the ESOP. In exchange, the ESOP received $10,000 in cash from appellant-husband and a promissory note for $40,000 from MMM. In this way, appellant-husband regained ownership of 100 percent of MMM's stock. The ESOP was subsequently converted to a 401(k) Profit Sharing Plan. On its 2003 return, MMM reported $3,500,000 in gross receipts and, pursuant to IRC section 1377(a)(1), elected to have its tax year treated as though it were

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[4] ExecuPro is described as an "Irish deferred compensation plan" in a memo dated August 11, 2003 describing a meeting with key officers of MLS, including appellant-husband, and their legal and financial advisors to discuss the impact of new IRS regulations on ESOP-owned MMM. (Resp. Reply Br., exh. D, p. 3.)

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two separate tax years. As an S corporation, MMM allocated $3,160,017 of ordinary income to the ESOP and a loss of $186,116 to appellant-husband. (Resp. Op. Br., pp. 6-7, App. Letter, pp. 2-3.)

Respondent subsequently opened an audit of the management and ESOP arrangement between appellants, MMM and MLS, whereupon respondent determined that the transaction was an abusive tax avoidance transaction and reallocated MMM's income to appellant-husband. Respondent issued a Notice of Proposed Assessment (NPA) in which it assessed the NEST penalty and the interest-based penalty. Appellants protested the NPA and requested that the Chief Counsel of the FTB waive the NEST penalty. Respondent affirmed the NPA in a Notice of Action (NOA) and the Chief Counsel denied appellants' request. Appellants then filed this timely appeal. (Resp. Op. Br., p. 7.)

Contentions

Appellants

Appellants assert that respondent relies on the sham transaction doctrine and substance over form doctrine for its determination, as stated in the NOA, that "the ESOP purchase of the MMM stock was a sham in fact". Appellants further assert that these doctrines are case law constructs and that respondent has not cited any federal tax code or state tax code authority for disregarding an ESOP and its management structure (which the Internal Revenue Service (IRS) determined to be a tax qualified plan) as lacking a business purpose. Appellants contend that respondent's conclusion was incorrect because appellants have shown that MMM had a valid business purpose of providing liability protection and management services to MLS and other businesses. Additionally, appellants contend that the business purpose of adopting the ESOP was to provide employees with a means of acquiring retirement benefits as evidenced by the fact that MMM continues to maintain a profit sharing plan. Appellants state that another purpose of the ESOP was to hold retirement assets safe from creditors until the participants retire. (Appeal Ltr., p. 3.)

Appellants further contend that the step transaction doctrine is inapplicable because appellant-husband did not intend at the outset of the transaction to take the final steps of converting the ESOP to a profit sharing plan and have the ESOP sell its MMM shares to appellants. Rather, according to appellants, appellant-husband set up the ESOP for the purpose of protecting retirement benefits from creditors and intended the ESOP to own all of the stock "for years into the future" which is evidenced by

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the current profit sharing plan. However, appellants assert that the ESOP sold the stock back to them because the IRS issued regulations to Internal Revenue Code (IRC) section 409(p) in 2003 that changed the rules for subchapter S corporation ESOPs. (Appeal Ltr., p. 4.)

In a reply brief, appellants assert that respondent's opening brief characterizes the transactions in issue as a scheme by appellants and their accounting firm "to set up fraudulent businesses, contracts and transactions for the sole purpose of avoiding tax." Appellants further assert that the documentation relied upon by respondent is either irrelevant or protected by the attorney-client privilege. Appellants object to and move to strike the following portions of respondent's opening brief and exhibits thereto for the following reasons:

(1) Discussion of the Execupro Tax Strategy on pages 4, 12, and 13 and Exhibit C, page 1 which is an "Account QuickReport of retained earnings for Mortgage Loan Specialists, Inc. for 1999, 2000 and 2001." Appellants contend that tax years 1999 and 2000 were not audited by respondent and an audit is now barred by the statute of limitations.

(2) Exhibit C, pages 3 and 4 which are an ExecuPro Management Services, Inc. (EMS) payment of $50,000 dated December 3, 2001 and "checks for ExecuPro" because EMS was never audited. Appellants state that they consistently maintained that transactions related to ExecuPro were outside the scope of the ESOP audit. Appellants also contend that respondent's allegations "substantially prejudice" them because they do not have documentation to "defend their position" and their current counsel did not represent them with respect to ExecuPro. Appellants further assert that the payments for 1999, 2000 and 2001 were retained earnings and EMS paid the S corporation tax on net income for those years so any contributions to a deferred compensation plan were made from after tax income. (App. Reply Br., pp. 2-3.)

(3) Exhibit G of respondent's opening brief and a portion of page 7 of the brief because it concerns a confidential communication between spouses under California Evidence Code section 980, a confidential communication between parties to this appeal and communication protected by the attorney-client privilege. The exhibit is a series of email messages between appellants and from appellant-husband to counsel regarding a legal issue related to the ESOP during the audit in anticipation of a protest or appeal. Appellants assert that the respondent's possession of the

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email message is a violation of their privacy and privileges. (App. Reply Br., pp. 3-4.)

(4) Respondent's allegations on pages 15 and 16 of the opening brief that appellants' management structure violates California law regulating real estate broker activities such that a real estate salesperson is not permitted to manage a real estate broker. Appellants contend that respondent raises this issue for the first time in its opening brief, not in prior letters or verbal communications, and appellants were not given adequate opportunity to prepare a response. Appellants assert that there is a "potential jurisdiction issue" for the Board to determine a violation of the California Business and Professions Code (B&P Code). Appellants also assert that the Board's Rules for Tax Appeals provide the Board with jurisdiction to determine the adequacy of notice and respondent has not provided adequate notice of this issue. Finally, appellants contend that respondent has presented no evidence to show that appellant-husband, in his capacity as a real estate salesperson, directly managed appellant-wife's duties as a real estate broker or that any management services violated the B&P Code. (App. Reply Br., pp. 4-5.)

Appellants assert that respondent admits that S corporation ESOPs were permitted under the IRC prior to the publication of temporary federal regulations on July 21, 2003 "which generally prevent qualification of most S corporation ESOPs after October 20, 2003." Appellants state that respondent requests that this Board disallow the MMM ESOP, and in effect "re-write the temporary regulations", despite the fact that the ESOP was adopted almost two years prior to the publication of the temporary regulation. Appellants point out that the IRS did not systematically audit and disqualify all S corporation ESOPs adopted before October 20, 2003 because those ESOPs were permitted under the IRC and regulations prior to that date. Appellants contend that respondent disallowed the MMM ESOP based on the economic substance and business purpose doctrines "developed by the district court" but states that no district court or Tax Court decisions have applied either of those doctrines to S corporation ESOPs. Thus, appellants contend that respondent's position is "unsubstantiated". (App. Reply Br., pp. 5-6.)

Appellants take issue with respondent's citation of *United States v. A. Blair Stover, Jr.* (W.D. Mo. 2010) 731 F. Supp. 2d 887 (*A. Blair Stover*), as case law authority for the disallowance of an S corporation ESOP. Appellants argue that *A. Blair Stover* did not involve either the economic

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substance doctrine or the business purpose doctrine, but rather held that an accountant "was enjoined from promoting and selling a certain tax structure that involved an S corporation ESOP." In that case the operating company and the management company were part of a controlled group because a few people owned all the stock of both companies. Appellants contend that the court enjoined the accountant because they were part of a controlled group whereas MMM and MLS were not part of a controlled group. For that reason, appellants conclude that *A. Blair Stover* does not support respondent's position. (App. Reply Br., pp. 6-7.)

Appellants dispute respondent's argument (summarized below) that the MMM stock purchase was a "sham in fact" because appellant-husband completed the purchase of MMM on December 5, 2001 but the documents show that a meeting was held to adopt the ESOP on August 15, 2001. Appellants assert that events delayed the purchase of MMM so that some of the documentation was not complete on August 15, 2001, but that all the parties involved agreed on the effective date of August 15, 2001. Appellants contend that the sale of MMM was an arm's-length transaction and even if this Board finds the ESOP was adopted and the sale of the stock occurred in December 2001 there would be no different tax effect. Appellants state that the stock appraisal was made on August 15, 2001, but assert that there is no evidence to suggest that the stock increased in value from August 15, 2001 to December 2001. For those reasons, appellants contend that the later final purchase date of MMM is not a valid basis for disallowing the tax-qualified status of the ESOP. (App. Reply Br., pp. 7-8.)

Appellants restate their position that the business purpose of the MMM management agreement and adoption of the ESOP was asset protection and accumulating retirement benefits for participants. Appellants argue that the retirement benefits plan continued after the ESOP was terminated and converted to a 401(k) profit sharing plan that had "numerous participants" from 2001 until 2004. Appellants assert that the management structure "provided protection beyond insurance coverage" and was "set up to provide protection to MMM from the liability exposure of the business operations of MLS." Appellants state that MMM could continue to recognize a profit even if MLS did not, because MMM provided consulting services to several different companies. Appellants further state that the management structure insulated MMM from the day-to-day transactions of MLS, which was proven successful in view of the fact that MLS was the target of multiple lawsuits while MMM had no liability

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exposure. (App. Reply Br., pp. 8-9.)

Appellants cite *Compaq Computer Corp. v. Commissioner* (5th Cir. 2001) 277 F.3d 778 (*Compaq*) in which the IRS challenged the taxpayer's stock sale transaction as lacking a business purpose and economic substance. Appellants state that the Court of Appeals ruled in favor of the taxpayer even though the transaction "took less than 24 hours, had significant transaction costs, little to no economic profit from the transaction and there were significant tax savings . . . ." Appellants compare the *Compaq* transaction to their own by stating that:

- The ESOP was adopted in 2001 and the retirement plan purpose continues to the present with the maintenance of the profit sharing plan.
- The costs of adopting the ESOP were relatively small compared to the benefits that have accumulated in the ESOP and profit sharing plan "free from creditors".
- There are strong economic reasons for establishing a retirement plan safe from creditors because a mortgage loan business like MLS has significant liability exposure.

Appellants quote a portion of the holding in *Compaq* which appellants characterize as the court's recognition that minimizing risk is a valid business purpose. Appellants also point out the distinction between the *Compaq* transaction in which the tax was completely avoided and their transaction in which taxation is deferred until the payment of the income to appellant-husband during his retirement. Appellants contend that the facts presented here weigh more heavily in favor of the appellants. (App. Reply Br., p. 9-10.)

In response to respondent's argument that appellant-husband's 2003 purchase of the MMM stock from the ESOP lacked economic substance, appellants contend that appellant-husband obtained an independent appraisal and purchased the stock at the price determined by that appraisal. Appellants also state that the appraisal dated September 12, 2003, which valued MMM at $5,146,000, is irrelevant and was not used for purposes of appellant-husband's repurchase of stock from the ESOP. Appellants explain that the September 12 appraisal contains a "serious error" that overstates the MMM stock value by millions of dollars by classifying deferred compensation of $4,302,984.50 as an asset. Appellants contend that the deferred compensation plan funds are both an asset and a liability because MMM has the contractual obligation to pay future benefits to the employees/participants.

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(App. Reply Br., pp. 10-11.)

Finally, appellants assert that respondent attempts to present appellants in a "bad light" by arguing that appellant-husband "caused substantially all of the cash and property to be set aside in a nonqualified deferred compensation plan for the benefit of appellant-husband and, in subsequent years, two other individuals." Appellants contend that respondent fails to recognize that MMM paid the 1.5 percent S corporation tax on its net income prior to the deferred compensation plan contributions and participants in the deferred compensation plan will pay tax on the distributions as ordinary income. Appellants further contend that respondent mischaracterized a legal deferred compensation program which is a valid retirement planning technique as a tax avoidance scheme. Appellants also state that the IRS determined that the ESOP was a qualified plan. (App. Reply Br., pp. 11-12.)

In response to respondent's reply brief, appellants filed a second reply brief dated February 9, 2011, in which they continue to object to respondent's references to ExecuPro and dispute respondent's position that the ExecuPro transactions are relevant because appellant-husband "rolled over" funds from ExecuPro to the MMM ESOP. Appellants contend that respondent's "reasoning has nothing to do with whether the ESOP transactions had economic substance." Appellants also object to a "press release" relating to a taxpayer who pled guilty to tax evasion involving a company by the name of ExecuPro Medical Corporation. Appellants state that it appears that respondent attached the press release to attempt to influence the Board into believing that appellants are guilty of tax evasion but there is no connection between that taxpayer and appellants. Appellants also assert that they were audited by the IRS for the years involving ExecuPro and with respect to the ExecuPro transaction and the audit was concluded in their favor. (App. 2d Reply Br., p. 2.)

Appellants offer arguments against three arguments made by respondent with regard to whether the email correspondence is subject to attorney-client privilege. First, appellants contend that the disclosure of the email, which was attached to a transmittal letter from CBIZ, a professional services company, to respondent, was inadvertent. Appellants further contend that only the clients can waive the attorney-client privilege and CBIZ's involvement does not waive it. Second, appellants dispute respondent's argument that they had no expectation of privacy because the email messages involved an accounting firm. Appellants contend that Evidence Code section 952 provides that the disclosure of

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information to "those who are present to further the interest of the client in the consultation" does not destroy the attorney-client privilege. Appellants also characterize as "ridiculous" respondent's argument that the disclaimer at the foot of the email correspondence stating that the firm made no guarantees that the correspondence would be properly delivered and read only by the addressee indicates that appellants had no expectation of privacy. Finally, appellants contend that neither they nor their accounting firm realized that the email correspondence had been inadvertently disclosed to respondent. Appellants also state that respondent "hid the ball" during protest and never mentioned that the email correspondence established a significant fact to be considered. (App. 2d Reply Br., p. 3.)

Respondent

Respondent states that prior to 1996, a tax-qualified retirement plan was not allowed to be a shareholder in an S corporation. In 1996, legislation was enacted that allowed organizations that qualified under IRC sections 401(a) or 501(c)(3) and exempt from tax under IRC section 501(a) to be shareholders in S corporations, but the income that passed through to the organization was treated as unrelated business taxable income (UBTI) pursuant to IRC section 512. IRC section 512 was later amended and effective January 1, 1998, ESOPs were no longer required to recognize S corporation income as UBTI, so the S corporation pass through income was nontaxable. With that change in the law, respondent asserts that some abuses occurred which led to the enactment of IRC section 409(p), effective for plan years ending after March 14, 2001, limiting individual stock ownership in an S corporation that adopted an ESOP. (Resp. Op. Br., pp. 2-3.)

Respondent asserts that some tax advisors structured transactions that appeared to satisfy the requirements of IRC section 409(p) but "substantially all of the benefits" went to key executives or the original owners. Respondent states that the IRS recognized that these arrangements were designed to evade IRC section 409(p) by using the ESOP "as part of a structure to shelter profits that would be paid as future compensation for a small group of executives or management employees" such that the rights associated with ownership of the corporation were not transferred to the employees of the corporation. The regulations became effective July 21, 2003 and respondent concludes that they "provide insight into the IRS' view of the abuse of this transaction." Respondent also notes that on August 9, 2010, in *A. Blair Stover, supra*, the district court issued an order against a promoter of tax

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shelters enjoining him from organizing, establishing or selling any structure involving an ESOP-owned S corporation that provided management services to the taxpayer's C corporation. (Resp. Op. Br., pp. 3-4.)

Respondent states that appellant-husband "orchestrated a similar strategy in prior tax years" which is relevant to this appeal because he transferred "nonqualified deferred compensation funds from the prior strategy to MMM's nonqualified deferred compensation plan established on his behalf." Respondent describes the strategy as follows: In the 1999, 2000, and 2001 tax years, appellant-husband was "employed" by ExecuPro which leased his services to MLS. During those years, MLS paid ExecuPro, $850,000, $650,000, and $600,000, respectively, for appellant-husband's services and MLS "referred to" those payments as "retained earnings". Appellants deferred approximately $2 million in a Rabbi Trust during those years, and the trust funds were held in investment accounts at Merrill Lynch. (Resp. Op. Br., p.4.)

Respondent contends that appellants used the management agreement at issue here to strip the profits out of MLS by transferring them to MMM and then used the ESOP to allocate MMM's income to a tax-exempt entity. Respondent concludes that appellants used the nonqualified deferred compensation plan to hold the cash for the benefit of appellant-husband. Respondent describes the arrangement as follows: Appellant-husband is a real estate salesperson and he purchased MMM on December 5, 2001. MMM adopted an ESOP for the benefit of MLS and MMM employees and through a series of transfers the ESOP became MMM's sole shareholder. MMM then adopted a nonqualified deferred compensation plan for the benefit of appellant-husband. Appellant-husband "purportedly" provided management services to his subchapter C corporation, MLS. The minutes of a special meeting of the MMM Board of Directors state that "MMM intended to manage real estate salespersons." Respondent contends that appellant-husband was legally prohibited from managing real estate salespersons or performing real estate brokerage activities because MMM did not employ a real estate broker. (Resp. Op. Br., pp. 5-7.)

Respondent states that a "sham in fact" occurs "when a transaction that purportedly took place never occurred at all." Respondent states that appellants, in their opening brief, state that appellant-husband purchased MMM on December 5, 2001, effective as of July 25, 2001. However,

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according to the minutes of an MMM Director's meeting on August 15, 2001, MMM adopted an ESOP effective August 15, 2001 and the ESOP purportedly purchased appellant-husband's MMM stock on the same day. As evidence of this purchase, appellants provided a one-page undated appraisal of MMM's value as $1,500 as of August 15, 2001. Respondent contends that none of those events occurred in August 2001 and, therefore, were a sham in fact which means that the entire transaction is disallowed. (Resp. Op. Br., p.8.)

Respondent cites the following four reasons for its determination:

(1) Appellant-husband could not have sold his MMM shares to the ESOP on August 15, 2001 because he purchased MMM on December 5, 2001.

(2) Under federal law, an ESOP must be established by written instrument which was actually done on December 17, 2001 so the ESOP was not adopted until that date and, thus, could not have acquired the MMM stock on August 15, 2001.

(3) Under federal law, the parties were required to obtain an independent appraisal for the ESOP's purchase of the MMM stock but the appraisal submitted by appellants valued MMM as of August 15, 2001 when appellant-husband did not own any shares and MMM had not adopted the ESOP.

(4) MMM was an accrual basis taxpayer and in 2001 it had not accrued any ESOP-related expenses, legal fees, start-up costs, appraisal expenses, or miscellaneous expenses.

Even if this Board determines that the ESOP purchased appellant-husband's stock and became MMM's sole shareholder, respondent contends that the transactions in issue lacked economic substance. Respondent asserts that the business purpose doctrine and the economic substance doctrine are intended to ensure that business transactions have "independent substance" apart from tax considerations. The economic substance doctrine requires the taxing authority "to disregard, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality." This doctrine may apply even if a transaction has economic substance "if the taxpayer's sole subjective motivation is tax avoidance." (*Coltec Industries, Inc. v. U.S.* (Fed Cir. 2006) 454 F.3d 1340, 1352, 1355.) Respondent notes that the *Coltec Industries* court emphasized the need to analyze each independent transaction to ensure that each step had a business purpose. (Resp. Op. Br., p. 8-10.)

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Respondent states that the courts make a distinction between legitimately structuring a "real transaction" in a way to provide a tax benefit versus creating a transaction that lacks a business purpose which is not legitimate. Respondent states that the first part of the sham transaction test is determining whether the taxpayer had a business purpose for engaging in the transaction other than tax avoidance. Respondent contends that appellants had no business purpose for appellant-husband to purchase MMM, enter into a management agreement with MLS and for MMM adopt an ESOP and nonqualified deferred compensation plan when MLS retained appellant-wife as a managing broker. As support, respondent asserts that in *A. Blair Stover* the court "analyzed a similar S corporation management company arrangement and determined that it lacked a business purpose and failed to ensure that it satisfied the requirements of an arm's-length transaction. (Resp. Op. Br., p. 10.)

Respondent also cites *Melnik v. Commissioner* (2006) T.C. Memo. 2006-25 in which the Tax Court found that the taxpayers' testimony concerning the business purpose of their transactions was suspect because the transactions entered into for nontax reasons were initiated close in time to the transactions motivated by tax avoidance. Respondent contends that the timing of the transactions in issue "illustrates that appellants' true desire was to implement a structure that ultimately served to abuse the unique tax status of the ESOP." According to respondent, all the relevant transactions occurred in or around December of 2001 which indicates an orchestrated plan to transfer profits from MLS, allocate them to the ESOP and set aside cash for appellant-husband and selected key executives. Respondent further contends that the only individuals who substantially benefitted were the nonqualified deferred compensation plan participants while the MLS rank-and-file employees received de minimis benefits from the ESOP. (Resp. Op. Br., pp. 10-11.)

In response to appellants' argument that MMM was created to protect MLS retirement benefits from MLS creditors, respondent contends that in 2001, 2002, and 2003 MLS carried errors and omissions insurance, a commercial umbrella package, life insurance, and California workers' compensation insurance whereas MMM did not carry any insurance coverage. Thus, respondent concludes that liability protection was not the purpose of the transactions but rather for tax avoidance. Respondent asserts that "even national ESOP trade organizations implicitly refuse to acknowledge the liability protection argument" based on their belief that this structure primarily benefits key

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management. Respondent further asserts that the IRS also implicitly refused to acknowledge this argument as an identical structure was characterized by the IRS as a means of evading the requirements of IRC section 409(p). (Resp. Op. Br., pp. 11-12 and exh. M.)

Respondent states that appellants have not provided any evidence to support their assertion that MMM managed other businesses and only MLS entered into a written agreement with and paid MMM for purported management services. In addition, contrary to appellants' assertion that the business purpose of the ESOP was to provide employees with significant retirement benefits, respondent contends that upon the redemption of its MMM shares in 2004 the ESOP received only $10,000 in cash from appellant-husband and a promissory note from MMM for $40,000. Finally, respondent states that appellant-husband improperly "rolled over" funds from the ExecuPro nonqualified deferred compensation plan into his MMM nonqualified deferred compensation plan. Respondent contends that this improper rollover constituted appellant-husband's constructive receipt of the income which would have made it immediately taxable. However, respondent states that it did not allocate the rollover funds to appellant-husband because those funds were not income to MMM and that amount remains untaxed. Respondent also states that an employer with a nonqualified deferred compensation plan is allowed a deduction for the compensation when the employee recognizes it as income for tax purposes. However, because the funds were rolled over to MMM and MMM did not pay tax on that amount, respondent contends that MMM should not be allowed to utilize the deduction that ExecuPro would have taken when appellant-husband recognizes that amount as taxable income. Respondent also states that the IRS in Notice 2003-22 disallowed the tax benefits from offshore deferred compensation arrangements similar to the ExecuPro transactions. (Resp. Op. Br., pp. 12-13 and exh. N.)

As further support for its position that the transactions had no legitimate business purpose, respondent cites Treasury Decision 9081 (2003-35 I.R.B. 420) in which the IRS rejected such an arrangement and the concerns raised by private practitioners about the "S Management Corporation ESOP structure." (Resp. Op. Br., p. 13 and exhibits A and M.)

Respondent states that the second prong of the test is whether the transaction had "economic reality" apart from the tax consequences. Respondent contends that the management arrangement had no economic substance as evidenced by "the unfettered transfer of profits from MLS to

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MMM." Respondent asserts that appellant-husband's activities in 2001 "highlight" the lack of a connection between the management agreement and the amount of the management fees. Respondent points out that in 2001 MLS paid MMM $2 million for appellant-husband's management services under the management agreement executed in December 2001. Also in 2001 EMS employed appellant-husband and leased him to MLS for $50,000 per month. Respondent contends that "it is highly unrealistic that MLS would have needed to lease one of its owners from two distinct entities." (Resp. Op. Br., pp. 13-14.)

Respondent argues that appellants' arrangement constituted a sham transaction even though it differed from the structure of the arrangement that the court invalidated in *A. Blair Stover*. Specifically, in that case key employees were the only participants in the ESOP and the court held that, in addition to being a sham, the structure violated the Employee Retirement Income Security Act (ERISA). Here, according to respondent, to avoid a conflict with ERISA appellants utilized a nonqualified deferred compensation plan to hold the profits for appellant-husband. However, respondent contends that appellants' structure still fails as a sham transaction involving illusory management services and paper entities. Respondent further argues that MMM's redemption and appellant-husband's purchase of the ESOP's stock effective September 30, 2003 lacked economic reality because MMM was valued at $5,146,000 as of September 12, 2003, a few weeks later MMM was valued both at $10,000 and $50,000 on the same day and by 2004 it had become "a high net worth company." Thus, respondent argues that appellant-husband artificially depressed MMM's value solely for the purpose of redeeming the ESOP's stock. (Resp. Op. Br., pp. 14-15 and exhibits O and P.)

In addition, respondent contends that the structure's lack of economic substance is also demonstrated by the fact that it violates California laws regulating real estate broker activities. Respondent asserts that real estate salespersons are prohibited by law from managing a real estate broker or a broker's salespersons and that case law establishes that salespersons are agents of the broker under whom they are licensed. Here, MLS' corporate license designated appellant-wife as the licensed real estate broker and appellant-husband was a licensed real estate salesperson. Because MMM had no licensed real estate broker, respondent states that appellant-husband was legally prohibited from performing any real estate brokerage activities. Thus, respondent concludes that appellants' structure

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should be disregarded because it lacked legal and economic substance. (Resp. Op. Br., pp. 15-16 and exhibit E.)

Respondent disputes appellants' position that the sham transaction doctrine and substance over form doctrine are inapplicable because the ESOP was a qualified ESOP. Respondent maintains that transactions involving ESOPs may have a business purpose and economic substance but ESOPs may also be used as nominal shareholders for tax avoidance purposes. Respondent repeats that the rank-and-file employees received "pittance" for their participation in the ESOP and were excluded from the nonqualified deferred compensation plan where most of the money was contributed. Respondent cites Notice 2004-30, IRB 2004-17 which identified as abusive a transaction that shifted the incidence of taxation of S corporation income away from taxable shareholders to a tax exempt entity under IRC section 401(a) or 501(c)(3). The exempt entity was allocated a substantially larger amount of S corporation income as compared to the exempt party's share of the total economic benefit of stock ownership. Respondent contends that appellants' transaction had the same abusive result. (Resp. Op. Br., p. 16.)

NEST Penalty and Accuracy-Related Penalty

Respondent summarizes R&TC section 19774 as imposing a penalty of 40 percent of the understatement resulting from a "noneconomic substance transaction" which includes "an arrangement or transaction that lacks economic substance or in which an entity is disregarded as lacking economic substance." Respondent asserts that the evidence shows that there was no valid nontax California business purpose for entering into the transactions in issue. Respondent contends that MLS could have protected its rank-and-file employees' benefits by adopting its own ESOP and making actual distributions into its own ESOP. Respondent further contends that, as the court found in *A. Blair Stover*, MMM did not actually provide management services and the fee was not based on an arms' length transaction but rather on the amount necessary to diminish the other entity's income. (Resp. Op. Br., p.17.)

Respondent also contends that the lack of economic substance is another reason for application of the NEST penalty. Respondent cites the portion of *A. Blair Stover* in which the court held that management fee expenses did not reflect real activities and simply allowed the operating company

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to avoid reporting income "by paying for illusory management services to paper entities that had no economic substance." Respondent contends that MMM was a paper entity as a depository of MLS' profits and that in 2001 all of its "income" was directed to appellant-husband's nonqualified deferred compensation plan. Respondent further contends that the purpose of liability protection "does not justify the transfer of funds in non-arms' length dealings through the guise of management fees." (Resp. Op. Br., pp. 17-18.)

If this Board finds that the NEST penalty was not properly imposed, respondent states that its proposed assessment of the accuracy-related penalty was clearly met in each of the years on appeal. Respondent explains that IRC section 6662 imposes a penalty of 20 percent of any underpayment identified in subdivision (b), which includes underpayments due to negligence or disregard of rules or regulations and any substantial understatement of income tax. A substantial understatement is defined as exceeding the greater of $5,000 or 10 percent of the tax required to be shown on the return. Respondent contends that appellants' understatement meets this threshold and that appellants have not argued any of the defenses to imposition of the penalty. Respondent also contends that appellants' underpayments were due to negligence which includes "any failure to make an attempt to comply with the provisions of the IRC." In this regard, respondent asserts that appellants did not act as reasonable and prudent persons by taking the steps involved in this transaction. Specifically, respondent asserts they failed to act reasonably and prudently when they purchased a Nevada corporation in December, backdated documents to August and rolled over non-qualified deferred compensation funds without first obtaining professional tax advice as to whether the rollover was permitted by law. Respondent also contends that appellants have not established either of the defenses to a penalty based on negligence which is a reasonable basis for taking such a position or reasonable cause for the understatement. (Resp. Op. Br., pp. 18-19.)

Interest-Based Penalty

Respondent states that under R&TC section 19777, a penalty is imposed in circumstances in which respondent has contacted a taxpayer regarding the use of a potentially abusive tax shelter and a deficiency results from the taxpayer's participation in a potentially abusive tax shelter. Respondent notes that a "potentially abusive tax structure" is defined as a tax shelter defined pursuant to IRC section

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6111 for which registration was required or any plan which is of a type that the IRS or the FTB determines by regulations as having a potential for tax avoidance or evasion. With respect to the subject transactions, respondent contends that it meets two of the "six enumerated characteristics" set forth in Treasury Regulation section 1.6011-4T (which addresses reportable transactions) which indicate that a transaction may be abusive. The first characteristic is that appellants' transaction was entered into under terms of confidentiality which respondent asserts is demonstrated by a provision of the management agreement which expressly states that it is to be kept confidential. The second characteristic is that the transaction included "the participation of a person that the taxpayer knows or has reason to know is in a Federal income tax position that differs from that of the taxpayer (such 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 Federal income tax treatment than it could have obtained without the participation of such person." Respondent asserts that appellants adopted an ESOP so that MMM's income could be allocated to a tax-exempt entity. (Resp. Op. Br., pp. 19-20.)

Respondent's Reply Brief

In a reply brief, respondent contends that appellants mischaracterize respondent's arguments and assertions as follows:

(1) Appellants contend that respondent seeks to "disallow the entire ESOP" whereas respondent argues that an ESOP created in December of 2001 could not have purchased stock from appellant-husband in August of 2001, which demonstrates a sham in fact which should be disregarded. Respondent rejects appellants' argument that the "effective date" of the stock purchase was August 15, 2001 because an ESOP has no legal or physical ability to conduct business prior to its existence. Respondent cites *A. Blair Stover* in which the court held that the taxpayer could not "deem" the existence of an ESOP prior to the date of its creation. (Resp. Reply Br., pp. 4-5.)

(2) Appellants assert that respondent ignored an appraisal establishing the value of MMM's stock as $50,000 as of September 30, 2003. Respondent explains that appellants did not provide such an appraisal but instead provided an appraisal valuing the ESOP's assets as $4,302,984.50 as of

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September 12, 2003 and, in reply to respondent's request for information, represented that this appraisal was utilized for the purpose of the September 30, 2003 stock purchase. Thus, respondent contends that rather than ignoring appellants' information, it considered the September 12, 2003 appraisal and concluded that it demonstrates that the redemption and purchase of the ESOP's stock for $50,000 lacked economic substance. Even accounting for appellants' explanation of the errors in that appraisal, respondent contends that MMM and appellant-husband substantially underpaid the ESOP for the stock as MMM had $813,977.69 in cash apart from the nonqualified deferred compensation liability. (Resp. Reply Br., pp. 5-6.)

(3) Appellants argue that this Board should not consider respondent's discussion of the prior ExecuPro transactions because it substantially prejudices appellants but those transactions are relevant because appellant-husband performed a "roll over" of the funds from ExecuPro to MMM and appellant-husband had constructive receipt of the income at that point. Appellants also misconstrue the application of the statute of limitations which bars assessment of additional tax from a prior year but does not bar discussion or inclusion of facts from earlier tax years that have an effect on the year in issue. (Resp. Reply Br., pp. 6-7.)

(4) Appellants' objection to the inclusion of the email correspondence from appellants' accountant but appellants are wrong for the following reasons: The disclosure was intentional and not inadvertent as appellants assert. Appellants had no reasonable expectation of privacy with respect to such email messages and the agreement with their accountants specifically informed them that email was not a secure method of communication. Appellant-husband and his brother were copied on the email correspondence and appellants did not object to the disclosure until they filed their reply brief. (Resp. Reply Br., pp. 7-8.)

(5) Appellants contend that they have not been given an opportunity to reply to respondent's argument that under California law a mortgage salesperson is prohibited from managing a mortgage broker. Appellants cite RTA 5412(b)(5) as authority for this Board to consider the violation of a procedural or substantive right if it affects the adequacy of respondent's notice. Throughout the audit and protest proceedings, respondent states that appellants have been aware that respondent was examining MMM's business purpose and economic substance and the

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related management agreement which included appellant-husband's purported activities while "employed" by MMM. Respondent notes that appellants' representative in November of 2005 issued a publication which discussed concerns about management companies that violate professional rules. Respondent also asserts that appellants were afforded an opportunity to reply to respondent's argument pursuant to RTA 5431(c).[5]

Respondent states that appellants "concede" that there is no evidence appellant-husband directly managed appellant-wife's conduct as a broker and respondent suggests that appellants' concession supports the view that there is no evidence that MMM "did anything" for the $2 million paid by MLS in 2001, the $2.4 million paid in 2002 and the $3.5 million paid in 2003. Respondent concludes that the sole purpose of those payments was tax avoidance rather than management services. Respondent cites *A. Blair Stover* for the court's holding that the management company's activities were relevant to a determination of whether the transaction was a sham.

(6) Respondent also disputes appellants' argument that *A. Blair Stover* is distinguishable from this appeal because in that case the corporations were members of a controlled group. Respondent contends that the controlled group issue was irrelevant to the court's determination that the management agreement was a sham and the management services were illusory. Respondent adds that even if the controlled group issue was relevant to the court's determination, MLS and MMM were members of an affiliated group of corporations and IRC section 414 outlines the rules for both controlled groups and affiliated corporations which treats the employees of either type of organization as though they are employed by a single employer. Respondent contends that regardless of this issue, the transactions between MLS and MMM lacked economic substance. (Resp. Reply Br., pp. 7-10.)

(7) With respect to appellants' argument that all transactions involving the ESOP were valid, respondent contends that the favorable determination letters finding that the ESOP was a qualified plan did not determine that the implementation of this abusive tax shelter was per se

[5] Subdivision (c) provides that an appellant is entitled to file a reply brief as a matter of right.

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valid. Respondent quotes the 2005 publication from the Butterfield Schechter law firm which states that an IRS determination letter refers solely to a pension plan document and not to the operation of the structure under which the plan is implemented. (Resp. Reply Br., pp. 11-12.)

Additional Briefing

In response to a request by the Appeals Division, the parties submitted additional briefing addressing the issues summarized below.

1. Additional Briefing Request. Address case law cited by appellants (*Weekend Warrior Trailers, Inc. v. Comm'r of the Internal Revenue*, T.C. Memo 2011-15 (*Weekend Warrior*)) and other decisions (*Appeal of James A. Alyn and Lisa E. Alyn* (2009-SBE-001), May 27, 2009 and *Casebeer v. CIR* (9th Cir. 1990) 909 F.2d 1360) relevant to the issues presented.

Respondent

Respondent summarizes the facts in *Weekend Warrior*, in which a taxpayer formed a subchapter S corporation to manage his wholly-owned C corporation and the S corporation adopted an ESOP to which the taxpayer contributed 99.9 percent of the stock of the S corporation. The C corporation and the S corporation entered into a agreement whereby the S corporation would manage executive personnel services, fiscal services and purchasing. For the years 2002, 2003, and 2004, the C corporation paid the S corporation over $4.8 million in management fees and accrued a fee liability of almost $2.3 million and in 2004 the S corporation redeemed the ESOP's stock for $150,000. Although the IRS argued that the sale of the S corporation stock to the ESOP lacked a business purpose, the court declined to consider this argument because the IRS raised it for the first time in its briefing. The IRS also argued that the S corporation was a sham entity that should be disregarded for federal income tax purposes. The court rejected this argument because the S corporation provided personnel services which the IRS did not challenge, adopted a retirement plan which the IRS did not timely challenge, paid employees, purchased and sold stock and maintained bank accounts. However, the court agreed with the IRS's third argument that the management fees were not deductible because they were not ordinary or necessary expenses as required by IRC section 162. (Resp. Add'l Br., pp. 1-2.)

Respondent distinguishes *Weekend Warrior* by contending the IRS did not timely assert the sham transaction doctrine while in this appeal respondent argued the transaction was a sham and

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lacked economic substance. As a result, respondent allocated MMM's income to appellant-husband because he received the benefit of the income. Respondent also cites *Appeal of James A. Alyn and Lisa E. Alyn, supra* in which this Board held that, from an objective standpoint, a transaction must be likely to produce economic benefits aside from a tax deduction to satisfy the economic substance test. Respondent contends that the transactions at issue here were only likely to provide a tax deduction as they were intended to "siphon" money from MLS and set it aside for appellant-husband by allocating it to a tax-exempt entity, the ESOP. (Resp. Add'l Br., p. 2.)

Appellants

Appellants state that *Casebeer, supra* involved an examination of the issue of whether certain equipment leaseback transactions had a business purpose and economic substance. The Court of Appeals affirmed the Tax Court which held that the legal standard for determining whether a transaction was a sham "required consideration of both the taxpayer's subjective business motivation and the objective economic substance." Appellants assert that the Tax Court relied on the following two factual findings in its determination that the subject transactions were a sham: (1) the taxpayers were inexperienced with respect to the purchase of equipment and did not investigate the equipment's fair market value and residual value. This fact demonstrated that the taxpayers did not intend to enter into the leaseback transaction for a business purpose and thus did not have a subjective business motivation. (2) The economic return on the leasebacks did not exceed the investment and so there was no economic substance to the transaction. (App. Add'l Br., pp. 1-2.)

Appellants distinguish the facts of this appeal from those of *Casebeer* and contend that their transaction has both subjective business motivation and objective economic substance. Unlike the *Casebeer* leaseback transaction which had no economic return, appellants assert that MMM and MLS were created to reduce potential liabilities while increasing profits. Appellants assert that this arrangement had economic substance in view of the fact that MLS had been "exposed to over twenty lawsuits relating to the administrative aspects of issuing mortgages" over the course of 10 years. Appellants assert that their business motivation for creating MMM was protecting profits from potential liabilities. As compared with the taxpayers in *Casebeer, supra* who had no experience purchasing equipment, appellants state that they had significant experience with mortgages prior to 2001 and

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consulted with attorneys concerning the structure of the transaction and the potential for liability protection. (App. Add'l Br., pp. 2-3.)

Appellants assert that *Weekend Warrior* provides the most current legal authority for the Board's consideration in this appeal. According to appellants, the court held that there exist two alternative requirements - business purpose or business activity - but the court found that the taxpayers failed to prove that the S corporation that adopted an ESOP had a valid business purpose. Despite finding no business purpose, the court held that the S corporation "nevertheless must be respected for tax purposes if it actually engaged in business activity". Appellants contend that *Weekend Warrior* presents an almost identical legal issue to this appeal in that the court held that business activity requires that the business entity be respected and whether an entity carries on a business activity is a question of fact. In that case, the court found that the S corporation carried on sufficient business activity to be recognized for federal income tax purposes. Appellants contend that the facts in this appeal weigh even more in favor of this Board finding that MMM was engaged in business activity. Appellants state that MMM had a bank account, prepared profit and loss sheets for the years in issue, had numerous employees, adopted an ESOP, and conducted other business activities. Thus, appellants contend that MMM should be recognized for federal and state income tax purposes. (App. Add'l Br., pp. 3-5.)

With respect to *Appeal of Alyn, supra*, appellants assert that this Board applied the two *Casebeer* factors to the taxpayers' transactions, trading treasury notes, which produced a substantial benefit to the taxpayers. Appellants state that in applying the first factor the Board found that the taxpayers failed to show subjective business motivation because they had no experience in trading treasury notes and they did not present evidence that they investigated the profitability of the venture. In applying the second factor, the Board found that the taxpayers failed to show economic substance because expert testimony concluded that each transaction would have resulted in a substantial economic loss to the taxpayers after accounting for all transaction costs. Appellants contend that their transaction is distinguishable because they have shown subjective business motivation and economic substance. As to the first factor, appellants state that they had mortgage loan industry experience, an awareness of the inherent business risks and they investigated the effectiveness of creating MMM for liability protection. As to the second factor, appellants state they showed economic substance as the business purpose was

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achieved in that MLS was the subject of over 20 lawsuits which MMM had liability protection. (App. Add'l Br., pp. 5-6.)

Respondent's Reply

In reply to appellants' additional brief and evidence, respondent contends that appellant-husband's resume exemplifies the sham nature of the transaction because it does not list any experience with MMM, where he purportedly managed MLS as stated in the management agreement. Furthermore, respondent notes that the resume does not mention his employment with ExecuPro even though appellants stated at protest that ExecuPro employed appellant-husband and maintained a deferred compensation plan in which he participated as an employee of ExecuPro. On this basis, respondent maintains that the resume supports respondent's position that appellant-husband provided his services directly to MLS as the branch manager during the years on appeal. (Resp. 2d Add'l Br., pp. 2-3.)

Respondent further contends that the lawsuits filed against MLS do not prove the subject transactions had economic substance. Respondent asserts that the *Casebeer* court stated that the "objective substantive 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 a tax deduction." In this regard, respondent argues that the substance did not reflect the form as appellants "essentially concede" the management fees were "mere devices for the siphoning of profits away from MLS and into MMM for liability protection." Respondent also notes that appellants fail to acknowledge that the court in *Weekend Warrior* determined that the "management fees" were neither necessary nor reasonable and, similar to the facts in that case, MMM did not support the operations of MLS. Respondent assert that even if MMM's entity status is respected the structure of the transaction was a sham. Respondent also asserts that the *Weekend Warrior* court did not give much weight to the testimony of the operating company owner because it was not supported by evidence just as appellant-husband's resume does not support his employment at MMM managing MLS. (Resp. 2d Add'l Br., pp. 3-4.)

Respondent contends that appellants have not provided any evidence showing that they inquired of their attorneys as to whether the structure of MMM would adequately protect MMM's profits from potential liabilities of MLS. While appellants imply that they received such assurance,

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respondent points to a statement from their attorney that his firm did not provide any "opinion letters or guarantees." Respondent also notes that appellant-husband's resume states that he maintained top volume production as the branch manager of MLS at the same time appellants claim he was providing substantial services to MLS through MMM. Respondent also states that the Butterfield Schechter law firm has issued guidance in this area which questions the legitimacy of this management structure as potentially abusive and subject to IRS scrutiny. (Resp. 2d Add'l Br., pp. 4-6.)

Respondent argues that "liability protection" does not justify sham transactions. In this regard, respondent contends that the management agreement was for the purpose of creating the façade of a deductible expense. Respondent also maintains that the structure had the effect of increasing, rather than reducing, lawsuits against MLS and thereby increased the liability exposure, which was contrary to appellants' expressed purpose. Respondent takes issue with appellants' assertion that the creation of MMM had "objective substance" that resulted in increased profits and, instead, contends that MLS had reduced profits by paying MMM, which was purportedly owned by the ESOP, over $7 million for "unnecessary management expenses". Respondent further contends that the only way this structure resulted in increased profits is by ignoring the ESOP's ownership of MMM and treating MMM as appellants' corporation. Consequently, respondent concludes that appellants received the benefit of their ownership of MMM through the increased profits and respondent properly allocated the tax liability to appellants. Additionally, respondent contends that appellants' argument that they were seeking to protect profits from liabilities also justifies the allocation of MMM's income to appellants because the structure protected profits from liabilities only if you ignore the ESOP's ownership of MMM and treat MMM as appellants' corporation. Respondent also notes that appellants previously asserted the MMM could recognize a profit even if MLS did not because MMM was providing consulting services to other entities. However, appellants now concede that MMM provided consulting services only to entities controlled by parties related to appellants. Respondent then cites *Lucas v. Earl* (1930) 218 U.S. 111 in which the U.S. Supreme Court held that it was proper to disregard for tax purposes a valid contract under which the taxpayer allocated 50 percent of his income to his spouse for "asset protection". Respondent states that appellants also assert that the ESOP was formed for liability protection but do not establish that it provided such protection or that it increased profits. Thus, respondent concludes that

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appellants have not shown a business purpose. (Resp. 2d Add'l Br., pp. 7-8.)

Appellants' Reply

Appellants maintain that respondent acknowledges in its reply that MMM is a valid entity for federal and state income tax purposes. Appellants assert that respondent's apparent argument is that *Weekend Warrior* does not apply because the IRS did not allege that the sale of the stock to the ESOP in that case lacked business purpose. However, appellants contend that the *Weekend Warrior* decision is applicable despite the court's failure to consider that issue and the court's analysis in its ruling that the S corporation was not a "lifeless façade" should apply to the MMM ESOP. In this regard, appellants assert that the ESOP filed Form 5500s and created an ESOP trust, the ESOP accepted 401(k) deferrals from an average of 27 employees who were employed by either MLS or MMM, and the ESOP had an average of 27 participants who were allocated shares of MMM under the ESOP. The ESOP also had a plan document, a favorable IRS letter ruling determination and a third-party plan administrator. Thus, appellants conclude that the evidence establishes that the ESOP should be recognized for federal income tax purposes just as the court determined for the S corporation in *Weekend Warrior*. (App. 3d Add'l Br., pp. 2-3.)

As a result of applying the *Weekend Warrior* analysis, appellants argue that respondent's only remaining argument is that the sale of the MMM stock to the ESOP should be disregarded for income tax purposes because it lacked economic substance. Appellants contend that this argument is not supported by the evidence in the record. Appellants maintain that the following facts show the stock sale had economic substance: the ESOP signed a promissory note to purchase the stock, stock certificates were issued to the ESOP, MMM's tax returns reflected that the ESOP owned 100 percent of the MMM stock, appellants obtained an appraisal to establish the fair market value for the stock purchase, the ESOP's Form 5500s reflected the ESOP's purchase of the stock, MMM paid the 1.5 percent franchise tax for the income of MMM as a result of the ESOP's stock ownership, and an average of 27 employees received an allocation of the stock in the ESOP. (App. 3d Add'l Reply, p. 3.)

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2. Additional Briefing Request. Address whether appellants still maintain respondent erroneously applied the extended statute of limitations to the issuance of the NPA.

Respondent

Appellants have not recently asserted that respondent wrongly concluded that the extended statute of limitations is applicable. Respondent states that R&TC section 19058 provides for a six-year statute of limitations for an omission of more than 25 percent of the amount of gross income reported on the return and R&TC section 19755 provides for an eight-year statute of limitations for deficiency assessments related to abusive tax avoidance transactions. Respondent contends that both conditions were met. (Resp. Add'l Br., p.3.)

Appellants

Appellants contend that the extended statute of limitations under R&TC section 19755 is inapplicable because appellants have shown that the formation of MMM and adoption of the ESOP was not an abusive tax avoidance transaction. Appellants further contend that under R&TC section 19732, subdivision (c) an S corporation ESOP transaction similar to appellants' transaction is not a listed transaction and the extended statute of limitations only applies if a transaction is designed for the principal purpose of avoiding tax. (App. Add'l Br., p. 6.)

3. Additional Briefing Request. Discuss whether R&TC section 19774, subdivision (d), applies or is relevant to this appeal and, in so doing, you may wish to discuss (i) whether this subdivision is ambiguous, (ii) whether there is any relevant legislative history for this subdivision, and (iii) respondent's prior guidance regarding subdivision (d)(3) of this statute.

Respondent

Respondent contends that R&TC section 19774, subdivision (d) is not ambiguous and provides that respondent's Chief Counsel's determination to compromise all or a portion of a NEST penalty may not be reviewed in any administrative or judicial proceeding. Respondent concludes that a taxpayer has no right to an appeal before this Board or to file an action in court to challenge the Chief Counsel's determination. However, a taxpayer may protest a NEST penalty proposed on a NPA and then appeal a NOA affirming the NPA or may pay the penalty amount and file a claim for refund or refund action in court. (Resp. Add'l Br., pp. 3-4.)

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Respondent states that there is limited legislative history as to the intent and purpose of subdivision (d) and a legislative hearing report merely states that only the Chief Counsel may compromise a NEST penalty which may not be subject to review. Respondent also quotes its analysis of the legislation which is to the same effect. Respondent asserts that subdivision (d)(1) provides for the manner of imposing a NEST penalty on an NPA, and provides the Chief Counsel with authority to reduce or eliminate an otherwise properly imposed NEST penalty. Respondent notes that R&TC section 19774 does not provide equitable standards for the compromise of a penalty but states that the Chief Counsel considers standards used for the compromise of other penalties which include, but are not limited to, a history of tax law compliance, an unintentional mistake of fact, imposition is against equity and good conscience and rescinding the penalty would promote tax law compliance. Finally, respondent asserts that, although the Chief Counsel's determination is not reviewable, a taxpayer who timely appeals or files a court action may present arguments to support a reduction of the penalty from 40 percent to 20 percent. (Resp. Add'l Br., pp. 4-5.)

Respondent asserts that the following language of subdivision (d)(3), "any determination under this subdivision", is a reference to subdivision (d) of section 19774 and the purpose and effect of the language is to limit review of a Chief Counsel's determination to compromise a NEST penalty. Respondent specifies that subdivision (d) does not limit review by this Board or by the courts as to other issues raised by a taxpayer, e.g. the economic substance of the transaction or the computation of the penalty. In addition, the language "notwithstanding any other law or rule of law" means that a taxpayer's right to contest a NEST penalty is "expressly limited" by subdivision (d)(3) which prevents a taxpayer from seeking review of a Chief Counsel's compromise determination. Respondent states that its letter dated March 4, 2009, explained the several methods of challenging a NEST penalty either before payment or after payment of the penalty. (Resp. Add'l Br., pp. 5-6.)

Appellants

Appellants contend that R&TC section 19774 has no application because their transaction had a valid nontax business purpose and, hence, there is no understatement to which the NEST penalty would attach. Appellants also contend that subsection (d) of section 19774 is ambiguous insofar as the Chief Counsel's authority to compromise a penalty seems to be inconsistent with the powers and

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authority vested in this Board and the courts. Appellants assert that the language stating the condition that an NPA has been sent is ambiguous because it appears unnecessary and that the term "compromise" is undefined. Appellants also assert that the phrase "notwithstanding any other law or rule of law" is ambiguous because its scope is not limited and may not legally supersede all other law interpreting economic substance. (App. Add'l Br., pp. 7-8.)

Appellants also repeat their objection to respondent's contention that MMM violated the California Business and Professions Code because appellants were not provided with adequate notice during the audit and appeal process. Appellants request that the Board not admit respondent's evidence on this issue due to its low probative value and its irrelevance to the issue of whether there was a business purpose for the transaction. Appellants also attach additional documentation as evidence to show the number of lawsuits filed against MLS, appellant-husband's mortgage loan industry experience, federal and state tax returns, summary of participant accounts for 19 individuals for the period from August 15, 2001 to December 31, 2001, annual statements for each of those individuals for that period, trust reports for the periods from October 1, 2002 to December 31, 2002 and July 1, 2003 to September 30, 2003 and an allocation of contributions and forfeitures. Additionally, appellants provided various ESOP documents. Appellants also state that MMM only provided consulting services to entities controlled by parties affiliated with appellants and the terms of the fee payment by MLS to MMM set forth in the management agreement, which the parties later agreed to modify.[6] (App. Add'l Br., pp. 8-10.)

Respondent's Reply

Respondent takes issue with appellants' contention that the NEST penalty does not apply and argues that appellants have not shown that the provisions of R&TC section 19774 are ambiguous. Even if the Board disregards subdivision (d) as appellants request, respondent contends that it would have no effect on the percentage of the penalty, the definition of a noneconomic substance transaction and the definition of an understatement based on a noneconomic substance transaction. With respect to the Chief Counsel's authority to "compromise" a penalty provided in subdivision (d), respondent argues

[6] Appellants state that under the agreement the fees would have been $6,500,000 for 2002 and $8,000,000 for 2003 based on gross profits of $30.2 million and $38 million, respectively. However, after taking into consideration MLS' profits which were low compared with the high gross receipts, MMM agreed to reduced management fees of $2.4 million for 2002 and $3.5 million for 2003.

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that judicial and administrative bodies do not compromise penalties, they rule on the applicability or the proper calculation of a penalty, and subdivision (d) does not conflict with that authority. Respondent further argues that the issuance of the NPA language is not ambiguous and only relates to the timing of the Chief Counsel's review of the penalty. Finally, with respect to the "notwithstanding any other law or rule of law" language, respondent argues that appellants fail to understand that language does not affect judicial or administrative review to determine whether the transaction has economic substance or other issues and so does not limit a taxpayer's appeal rights. (Resp. 2d Add'l Br., pp. 8-9.)

4. Additional Briefing Question. Explain whether IRC section 409(p) applies here and state the reasons for this position.

Respondent

Respondent asserts that IRC section 409(p)[7] applies to the structure of the transaction because it was implemented after March 14, 2001. Respondent further asserts that appellants structured the ESOP to cover rank and file employees and thus appeared to comply with section 409(p) but it lacked economic substance because "the ESOP was simply an accommodation party to the tax benefits provided to appellants." Specifically, respondent contends that the ESOP appeared to be the sole shareholder and was allocated 100 percent of MMM's income but the ESOP never received more than a "miniscule" amount of cash and the allocated income was set aside in a nonqualified deferred compensation plain for the benefit of appellant-husband and two other key employees. (Resp. Add'l Br., p. 6.)

Appellants' Reply

Appellants assert that respondent acknowledges in its additional briefing that the ESOP transaction was designed to avoid direction application of IRC section 409(p) and, in so doing, appellants argue that respondent admits that the ESOP did not violate IRC section 409(p). As a consequence, appellants argue that respondent's only legal authority for its position is the "Federal

[7] IRC section 409(p) provides that no assets of an ESOP may be allocated (directly or indirectly) for the benefit of any "disqualified person" if, at any time during the plan year, disqualified persons own in the aggregate 50 percent or more of the equity of an S corporation. A "disqualified person" is defined as a person owning 10 percent or more of the equity in the S corporation. If an S corporation ESOP fails this test then the result is a non-allocation year which means the plan loses its exemption from the unrelated business income tax and amounts allocated to disqualified persons are subjected to one or more 50 percent excise taxes.

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common law doctrine of economic substance" and appellants have established, by citing *Weekend Warrior*, that MMM and the ESOP should not be disregarded on that basis. (App. 3d Add'l Br., p.4.)

5. Additional Briefing Question. Please discuss whether appellants' ESOP arrangement has been identified by the IRS or respondent as having the potential for tax avoidance or evasion under the former version of the regulation that respondent believes is applicable to these facts. Also, discuss whether under former Treasury Regulation section 1.6011-4T the IRS or respondent has made such a determination and discuss the relevance, if any, of the requirement of subdivision (b)(1) of section 1.6011-4T that a nonlisted transaction must meet the "projected tax effect test" to be a reportable transaction.

Respondent

Respondent states that former R&TC section 19777 which was in effect for the years in issue in this appeal provided for a penalty in the amount of 100 percent of the interest imposed on a deficiency if respondent had contacted the taxpayer regarding the use of a potentially abusive tax shelter. Subdivision (b)(2) defined a potentially abusive tax shelter as an arrangement of a type which respondent or the IRS determined by regulation to have a potential for tax avoidance or evasion. Former section 19777 applied to NPAs mailed after January 1, 2004 and for taxable years ending on or before December 31, 2004. Respondent cites R&TC section 18407 which provides that a transaction that has a potential for tax avoidance or evasion includes a reportable transaction. (Resp. Add'l Br., p. 7.)

Respondent also cites the two types of reportable transactions specified by former Treas. Reg. sec. 1.6011-4T, which was in effect for the years on appeal. The first type is a "listed transaction" and the second type is a transaction entered into after February 28, 2000, which had at least two of a specified list of characteristics. Respondent further explains that a transaction that included two or more of those characteristics became reportable if it also meets the projected tax effects test. Respondent states that a transaction may have the potential for tax avoidance or evasion regardless of whether it meets the projected tax effect test. Thus, respondent concludes that whether "the projected tax effects test" is satisfied is irrelevant to a determination that the ESOP transaction warrants imposition of the interest-based penalty. Rather, the penalty is properly imposed if the IRS or respondent determines in a regulation that the arrangement has the potential for tax avoidance or evasion. (Resp. Add'l Br., p. 7.)

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Respondent states that it relied on former Treas. Reg. sec. 1.6011-4T(b)(3) for characteristics of transactions that by regulation were of a type that had the potential for tax avoidance or evasion. As explained in the opening brief, respondent states that appellants' ESOP transaction had two of the characteristics as follows: (1) appellants entered into the transaction under terms of confidentiality and (2) the participation of a person the taxpayer knows or has reason to know is in a federal income tax position that differs from the taxpayer's position and the taxpayer knows or has reason to know that the tax position difference provides the taxpayer with more favorable federal income tax treatment. Respondent states that appellants were notified that the transaction was determined by regulation to have a potential for tax avoidance or evasion and thus was a potentially abusive tax shelter pursuant to former R&TC section 19777(b). (Resp. Add'l Br., pp. 7-8.)

Appellants

Appellants contend that the ESOP transaction did not have the two characteristics identified by respondent as set forth in former Treas. Reg. sec. 1.6011-4T(b)(3). Appellants state that it was a temporary regulation that was modified and the final regulation specifies that for a transaction to be a listed transaction as a result of confidentiality it must be "offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a minimum fee." Here, appellants maintain that respondent has not presented any evidence that Butterfield Schechter LLP requested that appellants keep the ESOP confidential and by law an ESOP may not be kept confidential. Appellants contend that respondent is attempting to mislead this Board by misapplying that regulation to the management agreement between MLS and MMM rather than between a tax shelter promoter and a taxpayer. With respect to the confidentiality provision in the management agreement, appellants argue that it is a standard provision which merely ensures the business practices of both entities are to remain confidential. Appellants also request that this Board take notice that the IRS has not alleged that similar ESOP transactions are reportable transactions under IRC section 6011 during 2001, 2002 and 2003. (App. 3rd Add'l Br., pp. 4-5.)

Love v. Comm'r, T.C. Memo 2012-166

In a 4th Additional Brief, appellants request that this Board take notice of *Love v. Comm'r*, T.C. Memo 2012-166 (*Love et al.*), decided on June 13, 2012, which "discusses the legal

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framework of S corporation ESOP management" and "termination of the S corporation ESOP management structure in 2004 after the temporary regulations were issued." Appellants assert that the U.S. Tax Court concluded that the taxpayers had nontax reasons for acquiring stock in the management company. Appellants explain that in *Love et al.* the taxpayers formed a management company, made an S election and adopted an ESOP and a nonqualified deferred compensation plan in 2002. The taxpayers used the management structure for three years and terminated it in 2004 because it was more complicated and costly and less effective than expected. According to appellants, the Tax Court held that the taxpayers had legitimate nontax reasons, even though the court found in 2002, 2003 and 2004 that large amounts of the taxpayers' compensation allocated to the nonqualified deferred compensation plan resulted in significant portions of the management company's income not being available for distribution to the ESOP and rank-and-file employees. Appellants add that the ruling in favor of the taxpayers was not affected by the court's finding that the ESOP was not taxed on the income. Appellants maintain that the *Love et al.* decision explains that taxpayers like appellants have followed the IRC and relevant regulations and involved facts similar to those in this appeal. (App. 4th Add'l Br., pp. 1-3.)

Respondent's Reply

In reply to appellants' 4th Additional Brief, respondent contends that *Love et al.* is not controlling because the Tax Court "was not asked to rule on the abusive facts present in this matter." Instead, according to respondent, the court held that the IRS could not utilize IRC section 269 to disallow tax benefits when there was a valid non-tax business purpose. Respondent asserts that appellants appear to argue that *Love et al.* "somehow validates sham transactions, transactions lacking economic substance, and transactions lacking business purpose." Respondent further asserts that it has provided Supreme Court case law precedent for the proposition that taxpayers cannot shift their tax liability to other parties through anticipatory contracts. Respondent contends that the evidence shows that appellants improperly assigned income to MMM through the management agreement because appellant-husband performed his management services through MLS. (Resp. 3rd Add'l Br., pp. 3-4.)

Respondent contends that it has presented federal appellate case law decisions affirming the disallowance of transactions that are found to be shams (*Illes v. Commissioner* (6th Cir. 1992) 982

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F.2d 163) and recognizing the long-standing principle that a transaction without a business purpose created to generate a tax benefit is not legitimate (*Coltec Industries, Inc. v. United States* (Fed. Cir. 2006) 454 F.3d 1340). Respondent asserts that the evidence demonstrates the several transactions were shams in fact, such as the impossibility of appellant-husband's sale of the MMM stock to the ESOP on August 15, 2001, when he did not purchase that stock until December 5, 2001 and the ESOP was not adopted until December 17, 2001. Respondent also asserts that the transactions had no business purpose based on evidence showing that, though appellants stated their intention to create a retirement plan to protect those assets from creditors, substantially all the money remained in the S corporation so the ESOP could provide no protection and hence no business purpose. (Resp. 3rd Add'l Br., pp. 4-5.)

Respondent notes that appellants represented that MMM was insulated from the day-to-day transactions of MLS when the management agreement explicitly provided that MMM assisted MLS in its "day-to-day business operations" and, thus, MMM was "entwined" with the liabilities associated with MLS' mortgage operations. Although appellants state they wanted to increase profits, respondent contends that appellants caused MLS to pay exorbitant management fees that resulted in decreased profits when appellant-husband was performing those duties as MLS' branch manager. Respondent also argues that appellants state they sought to reduce potential liabilities but the evidence shows that liabilities increased. Specifically, respondent notes that appellants state they were sued over 20 times from 2001 to 2011 and MMM did not carry workers' compensation insurance while MLS' profits were transferred to MMM where it was unsecured under the terms of the nonqualified deferred compensation plan. (Resp. 3rd Add'l Br., pp. 5-7.)

Respondent distinguishes *Love et al.* by noting that the taxpayers had utilized a management company structure for 8 years prior to the ESOP's ownership of the management corporation while the evidence in this appeal shows that appellant-husband did not provide management services through MMM. Respondent also notes that MMM was not legally allowed to employ individuals without workers' compensation insurance and appellant-husband as a real estate salesperson could not manage a real estate broker or the broker's salespersons. Thus, respondent concludes that MMM lacked economic substance. Respondent also states that it has explained how the transaction was substantially similar to a federal listed transaction as described in Notice 2004-30, IRC 2004-17 and that

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law firms in San Diego have "recognized that abuse can occur during the time the transaction is in place". (Resp. 3rd Add'l Br., pp. 7-8.)

Respondent maintains that the Tax Court in *Love et al.* did not evaluate the economic substance of the transaction whereas the district court in *A. Blair Stover* determined that an S corporation ESOP management structure similar to appellants' lacked economic substance. In *A. Blair Stover* the court concluded that because the management fee expenses did not reflect actual transactions or activities, "the end result [was] the creation of a series of phantom deductions . . ." and, thus, there was no legitimate business purpose. (Resp. 3rd Add'l Br., p.8.)

Applicable Law

Sham Transaction and Economic Substance Doctrines

United States v. A. Blair Stover, Jr. (W.D. Mo. 2010) 731 F. Supp. 2d 887

In *A. Blair Stover*, the federal district court held that an accountant was enjoined from promoting and selling a certain tax structure that involved an invalid S corporation ESOP. According to the court's findings,

- The management company was an S corporation which then formed an ESOP that owned the management company's stock.
- The same person or persons who owned the operating and managing companies were also the only beneficiaries of the ESOP.
- The management fees paid by the operating company obtained an indefinite deferral of income taxation: the income to the management company was not taxed because it made an election under subchapter S, and an ESOP's income is not subject to taxation. Thus, the operating company gains a deduction in the amount of the management fees, and those fees are not taxed until money is distributed from the ESOP.
- In that case the operating company and the management company were part of a controlled group because a few people owned all the stock of both companies. Consequently, for purposes of evaluating the legitimacy of the tax deferral claimed by the ESOP, *all* employees of the operating company were deemed also to be employees of the management company.
- The owners of the corporations were deemed to be key employees within the meaning of IRC

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section 416(i), and the ESOP 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. (*A. Blair Stover, supra* at 895.)

Compaq Computer Corp. v. Commissioner (5th Cir. 2001) 277 F.3d 778

In this case, the taxpayer engaged in a foreign stock transaction involving the purchase and resale of American Depository Receipts (ADRs). The Tax Court held that the ADR transaction lacked economic substance and should be disregarded for federal income tax purposes. On appeal, the Court of Appeal held that the ADR transactions had both economic substance and a business purpose. The Court of Appeal explained the two tests articulated by the federal courts in determining whether a transaction should be treated as a sham as follows:

- The court finds that "the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists." (*Rice's Toyota World, Inc. v. Comm'r* (4th Cir. 1985) 752 F.2d 89, 91.)
- A business purpose and a reasonable possibility of profit are factors to be considered in determining whether a transaction is a sham. These are two distinct aspects of the economic sham inquiry which are not discrete prongs of a "rigid two-step analysis", but are related factors which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes (*See, e.g., ACM Partnership v. Comm'r* (3d Cir. 1998) 157 F.3d 231, 247; *James v. Comm'r* (10th Cir. 1990) 899 F.2d 905, 908-09.)

Coltec Industries, Inc. v. U.S. (Fed Cir. 2006) 454 F.3d 1340

In *Coltec Industries*, the Court of Appeals reviewed case law precedent and summarized the "general principles" of the economic substance doctrine as follows:

- A taxpayer has a right to reduce or avoid taxes by means permitted by law but under the law a taxpayer may not reap tax benefits from a transaction that does not reflect economic reality. Even if the transaction has economic substance, the doctrine may apply if the taxpayer's sole subjective motivation is tax avoidance. However, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance.

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- When claiming a deduction, the taxpayer bears the burden of proving that the transaction has economic substance.
- The economic substance of a transaction must be viewed objectively rather than subjectively. While the taxpayer's subjective motivation may be pertinent to the existence of a tax avoidance purpose, all courts have looked to the objective reality of the transaction in assessing its economic substance.
- The transaction to be analyzed is the one that gave rise to the alleged tax benefit. The courts have recognized that there is a material difference between structuring a real transaction in a particular way to provide a tax benefit (which is legitimate), and creating a transaction, without a business purpose, in order to create a tax benefit (which is illegitimate).
- Arrangements with subsidiaries that do not affect the economic interest of independent third parties deserve particularly close scrutiny.

Illes v. Comm'r (6th Cir. 1992) 982 F.2d 163

The Court of Appeal held that a claimed deduction must satisfy both components of a two-part test with the threshold question being whether the transaction has economic substance. If the court determines that the transaction has economic substance then the court must determine whether the taxpayer was motivated by profit to participate in the transaction. However, if the court determines that the transaction is a sham, the entire transaction is disallowed for federal tax purposes, and the second inquiry is never made. The court explained that first part of the test consists of "an examination of the transaction, not the taxpayer. If the transaction lacks economic substance, then the deduction must be disallowed without regard to the "niceties" of the taxpayer's intent". (*Id.* at p. 165.) In *Illes*, the taxpayer stipulated that the subject transaction lacked economic substance and the court held that the IRS properly disallowed the claimed deduction, regardless of whether the taxpayer was actually motivated by profit.

Casebeer v. CIR (9th Cir. 1990) 909 F.2d 1360

A leasing company purchased computer equipment, leased the equipment to end-users and then sold the equipment to the taxpayers in exchange for recourse and installment nonrecourse notes. The taxpayers also assumed part of the nonrecourse debt owed by the leasing company to the

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banks that financed the original purchases. The taxpayers then leased the equipment back to the leasing company. The amount of monthly rent payment was equal to the taxpayers' payment on the installment nonrecourse notes. The taxpayers also executed remarketing and residual sharing agreements with the leasing company. Based on these transactions, the taxpayers deducted depreciation and interest expenses on their federal income tax returns. The IRS determined that the underlying transactions were sham transactions and disallowed the deductions.

The court articulated the two-prong sham transaction test as follows: (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. The court explained that the application of the "business purpose" prong is a subjective test, whereas the application of the "economic substance" prong is an objective test. In its discussion, the court rejected the taxpayers' position that the court must find both that the taxpayer was motivated by no business purpose other than obtaining tax benefits *and* that the transaction has no economic substance. Rather, the court held that "the consideration of business purpose and economic substance are simply more precise factors to consider in the application of [the] traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses."

By applying that analysis, the Court of Appeal upheld the Tax Court's determination that the taxpayers' failure to investigate independently the equipment's fair market value or its expected residual value was relevant in determining whether they did not manifest a subjective business purpose apart from tax considerations. Furthermore, the court affirmed the Tax Court's consideration of the taxpayers' economic return on their investments, whereby if the return did not exceed the investment, the Tax Court found that the transaction did not have economic substance.

Appeal of James A. Alyn and Lisa E. Alyn, 2009-SBE-001, May 27, 2009

In *Appeal of James A. Alyn and Lisa E. Alyn* (2009-SBE-001), decided May 27, 2009, this Board applied the test for sham transactions set forth by the *Casebeer* court. In *Appeal of Alyn*, the taxpayers entered into "short-sale" transactions in short-term securities whereby they borrowed securities from their stock broker, sold them, and contributed the proceeds to a recently formed partnership. The

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transactions generated losses which were used to offset gains from other transactions. The Board noted that the Ninth Circuit Court of Appeal adopted a "unitary approach" in which it will consider "both the prong of a taxpayer's subjective business motivation in entering into a transaction and the prong of the objective economic substance of the transaction in deciding whether a transaction is a sham, but will not apply those prongs in a 'rigid two-step analysis' but rather as 'precise factors' in determining whether the transaction had any practical economic effects other than the creation of tax losses."

In applying the factors from *Casebeer*, the Board noted that the taxpayers acknowledged they had no particular experience that would enable them to generate profits from the transactions and did not provide evidence that they investigated the economic profitability of the transactions. The Board held that the taxpayers failed to satisfy the business purpose test because they did not provide objective evidence that they had a business purpose for engaging in the transaction other than tax avoidance. With respect to the economic substance, the Board stated that respondent's expert prepared a study evaluating approximately two thousand combinations of possible short-sale transactions which concluded that each of those possible transactions would have resulted in a substantial economic loss to the taxpayers when all transactions costs were taken into account. The Board pointed out that the taxpayers did not provide any information contradicting the expert's study and concluded that the weight of the evidence, viewed from an objective standpoint, showed that the transactions at issue would not produce economic benefits aside from a tax deduction. For that reason, the Board held that the taxpayers did not satisfy the economic substance test.

Weekend Warrior Trailers, Inc. v. Comm'r of the Internal Revenue, T.C. Memo 2011-15

The taxpayer was a corporation that manufactured and sold trailers (operating corporation) and in 2002 formed an S corporation which "established a deferred compensation arrangement (deferred compensation plan) 'for a select group of management or highly-compensated personnel'." The S corporation adopted a retirement plan composed of an ESOP and an IRC section 401(k) profit-sharing plan which covered all employees of the S corporation under stated conditions. Also, in 2002, the operating corporation and the S corporation entered into a management agreement under which the S corporation was to provide design, personnel, and management services to the operating corporation.

The IRS urged the court to disregard the S corporation for Federal income tax purposes

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because it lacked a legitimate business purpose and economic substance and was formed for the sole purpose of obtaining tax benefits. In this regard, the IRS argued that the S corporation was used as an accounting arrangement to funnel taxable income away from the operating company by allowing the operating company to claim management fee expense deductions without incurring real costs because the S corporation then lent money to the operating company. The IRS also argued that the S corporation did not carry on business activity because it had only one client, that the operating corporation's design work did not change when purportedly performed by the S corporation, that the invoices for management services do not describe what work was done or who performed it, and that the S corporation performed no functions that the operating corporation had not performed before the S corporation's creation.

The court found that the S corporation was not formed for a valid business purpose. In response to the taxpayers' argument that a business purpose existed because they sought "to establish an incentive plan for rank-and-file employees", the court noted that the deferred compensation plan solely benefitted the president of the corporation which cast doubt that "the benefits to rank-and-file employees were more than minimal." The court also noted that this asserted business purpose was not credible in the light of the president's testimony that in 2004 the S corporation repurchased the shares from the ESOP because "the Government had changed the law and it was not a good deal anymore."

The taxpayers also argued that "rapid business growth" of the operating corporation made the S corporation necessary but the court found that there were no additional divisions organized in the operating corporation so that there was "no credible evidence in the record that the new structure allowed [the operating corporation] to achieve cost savings or efficiencies or that it resulted in any meaningful changes in business operations. Finally, the court found that "no credible evidence in the record" corroborated the taxpayers' argument that the S corporation was needed for reasons of "manufacturing liability and protecting value". Specifically, the court noted that the taxpayers did not claim they considered additional liability insurance or that they evaluated whether the S corporation's "corporate shield" would have practical significance in case of a lawsuit.

Despite finding no evidence to support a business purpose, the court found that the S corporation engaged in business activity and must be respected as a separate entity on that basis.

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However, for purposes of determining whether the management fees were deductible as reasonable and necessary expenses of the operating company, the court focused its analysis on the services that the S corporation purportedly provided under the management and design portions of the management agreement. The court found that the record provided few details as to the parties' relationship as the S corporation issued no invoices to the operating corporation for 2003 and 2004. Of the four invoices that the S corporation issued for 2002, two predated the S corporation's creation which cast doubt on the other two invoices as well which included only the general description "Management Fee".

The court also found little evidence as to the identity of the persons who allegedly supplied services on behalf of the S corporation under the management agreement. Other than the president, the court found that three top managers could have provided some services that might fall under the management agreement. Although one manager testified at trial, he did not explain how his duties were divided between his employment with the operating corporation and with the S corporation under the management agreement. The court also observed that there was no credible evidence regarding the other top managers' jobs after 2002. In 2003, the court stated that the evidence showed that the other two managers received wages only from the S corporation which indicated that they performed all their work under the management agreement. However, the court was unable to find that they provided any services because the taxpayers failed to present any credible evidence as to those managers' jobs or the actual services they performed. In addition, the record contained no details as to the president's duties under the management agreement and his testimony at trial was not corroborated by other credible evidence regarding "any changes in operations, such as material control, quality control, or product shipment." Because the record was so vague as to the specific services performed by the S corporation and who exactly performed those services, the court could not conclude that the fees were necessary or reasonable.

Love v. Comm'r, T.C. Memo 2012-166

In 1994, the taxpayers restructured their business of owning and operating multiple chain restaurants by forming two corporations – an operating company and a management company. In exchange for fees paid by the operating company, the management company employed and paid all of the employees working in the restaurants and was responsible for, among other things, hiring, training,

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and firing the employees; administering employee health care; and maintaining liability insurance relating to operation of the restaurants. In 1994 the taxpayers formed a profit-sharing plan (PSP) for the benefit of the management company employees but over the years the PSP did not perform as well as expected and in 2002 the taxpayers decided to establish an ESOP to replace the PSP and to own the stock in the management company.

A new S corporation was formed as the new management company and concurrently an ESOP was formed to which the stock in the new management company was issued. The taxpayers and approximately 275 other employees of the former management company became participants in and beneficiaries of the ESOP. The financial assets of the PSP were transferred into the ESOP, and the PSP was terminated. The new management company also established and began sponsoring a nonqualified deferred compensation plan (NQDCP) for the benefit of its senior officers and employees. The taxpayers elected to participate in the NQDCP, and in 2002, 2003, and early 2004 and a total $3,066,000 of the taxpayers' management company salaries were deferred under the NQDCP in exchange for the management company's commitment to pay them the deferred compensation in future years. Because of the large amounts of the taxpayers' compensation that was deferred under the NQDCP, significant portions of the management company's income for 2002, 2003, and 2004 (consisting of the fees it received from the operating company) reflected the deferred compensation and were not made available for distribution to the ESOP and to the rank-and-file employee-beneficiaries of the ESOP.

In response to perceived abuses under statutory provisions allowing ESOPs to own stock in S corporations, Congress enacted IRC section 409(p) in 2001, which in general limits tax benefits available through ESOPs that own S corporations unless the ESOPs actually provide meaningful benefits to rank-and-file employees. The IRS promulgated temporary regulations implementing and interpreting section 409(p) effective July 21, 2003. Under those regulations, after July 21, 2004, absent any payout of their deferred compensation, the taxpayers would have been required to include in their 2004 income their $3,066,000 balance in their NQDCP accounts with the management company, an excise tax equal to percent of the prohibited allocation would have been imposed on the management company, and the ESOP would have lost its tax-exempt status. The taxpayers avoided the negative consequences of the temporary regulations by agreeing to take the following steps before July 21, 2004:

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sell the management company stock to petitioners for fair market value, have the management company pay to petitioners the $3,066,000 deferred compensation, and terminate the ESOP.

On July 13, 2004, the taxpayers (as new owners of the stock in the management company) ceased benefit allocations to the ESOP, established a PSP for the benefit of management company employees, merged the assets of the ESOP into the new PSP, and terminated the ESOP. The new management company paid out to the taxpayers the $3,066,000 it owed to them as deferred compensation under the NQDCP which they recognized as ordinary income on their 2004 joint Federal income tax return. In addition, the taxpayers acquired from the ESOP all of the S corporation stock in the management company for $103,000 which was consistent with an independent appraisal. Because the $3,066,000 deferred compensation was paid during the second of the two 2004 taxable periods (which was elected by the taxpayers) and because they reported the $3,066,000 in their 2004 taxable income, the management company became entitled under IRC section 404(a)(5) to a $3,066,000 deduction with respect thereto at a time when petitioners were its sole shareholders.

Largely as a result of the $3,066,000 deduction, the management company realized a net operating loss of $2,969,000 which was reported in its second taxable period for 2004. This $2,969,000 ordinary loss deduction flowed through to the taxpayers, who claimed it on their 2004 joint Federal income tax return. Between July 14 and November 24, 2004, the taxpayers transferred $2,965,000 to the management company as a capital contribution which increased their bases in their stock in the management company. Petitioners acknowledged that the capital contribution was made for the purpose of increasing their tax bases in the management company and thereby to take full advantage of the net operating loss deduction. As a result of this increase to bases, this $2,969,000 loss deduction offset the tax effect of most of the $3,066,000 deferred compensation paid to petitioners.

On audit, the IRS determined that the taxpayers' July 12, 2004, acquisition of the stock from the ESOP occurred for the principal purpose of avoiding or evading taxes and respondent disallowed under IRC section 269 the claimed loss deduction. IRC section 269 provides, in part, that if a taxpayer acquires control of the stock in a corporation and the principal purpose for the acquisition is the evasion or avoidance of income tax by securing the benefit of a deduction to which the taxpayer would not otherwise be entitled, the IRS may disallow the deduction.

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In its decision, the court held that section 269 applies only if tax evasion or avoidance is the principal purpose for the acquisition and that determination is a question of fact that depends upon the subjective intent of those who acquire control at the time of acquisition. The court noted that facts occurring before and after the acquisition may be considered to the extent they tend to support or negate the proscribed purpose. The court found that by 2004, the taxpayers determined that the management structure they put in place in 2002 had become more complicated and costly and less effective than they had anticipated and the temporary regulations further complicated that management structure. As a result, they eliminated the ESOP ownership of the management company, acquired the stock and terminated the NQDCP, and reverted to the management structure they had used in earlier years. Thus, the court concluded that the taxpayers' acquisition of the stock was a key feature of that management restructuring and did not occur principally for tax avoidance purposes. The court also noted that the temporary regulations and deferred compensation effectively required the taxpayers to take some action and found that:

- The payout of deferred compensation was in direct response to the IRS' notice to such taxpayers under the temporary regulations to make such a payout.
- The payout and the taxpayers' treatment as taxable income in 2004, produced the tax loss deduction for the management company and represented a substantive economic event for both the management company and the taxpayers.
- The taxpayers' split of the management company's 2004 tax year was authorized under the IRS and appropriate in light of the change in ownership of the management company on July 12, 2004.
- The taxpayers' capital contribution to the management company was a real economic outlay that increased the taxpayers' tax bases in their stock in the management company. The fact that the capital contribution was made with the purpose and objective in mind of increasing their stock bases in anticipation of the flowthrough loss deduction from the management company did not affect the economic substance of the capital contribution.

<u>NEST Penalty</u>

R&TC section 19774, subdivision (a) imposes a penalty for a noneconomic substance

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transaction understatement for any taxable year, in an amount equal to 40 percent of the amount of the understatement. Subdivision (b)(1) of section 19774 reduced the penalty to 20 percent with respect to any portion for which the "relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return." The term "noneconomic substance transaction understatement" is defined as "any amount which would be an understatement under Section 6662A(b) of the Internal Revenue Code, as modified by subdivision (b) of Section 19164.5[8] if Section 6662A(b) of the IRC were applied by taking into account items attributable to noneconomic substance transactions rather than items to which Section 6662A(b) applies." (Rev. & Tax. Code, §19774, subd.(c)(1).) A "noneconomic substance transaction" includes:

> The 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.

(Rev. & Tax. Code, §19774, subd.(c)(2)(A).)

Under subdivision (d)(1) of R&TC section 19774, once a penalty is imposed and the NPA has been sent, only respondent's Chief Counsel "may compromise all or any portion of that penalty." Subdivision (d)(3) specifies, "Notwithstanding any other law or rule of law, any determination under this subdivision may not be reviewed in any administrative or judicial proceeding."

Accuracy-Related Penalty

R&TC section 19164, which incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. As relevant to this appeal, the penalty applies to the portion of the underpayment attributable to (1) negligence or a disregard of rules and regulations or (2) any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) The IRC defines "negligence" to include "any failure to make a reasonable attempt to comply" with the provisions of the code. (Int.Rev. Code, § 6662(c).) The term "disregard" is defined to include any "careless, reckless, or intentional disregard." (*Ibid.*) IRC section 6662 provides that a substantial

[8] Subdivision (b) or R&TC section 19164.5 generally provides that the IRC section 6662A penalty and understatement amounts are modified by those amounts as defined in R&TC section 19774.

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understatement of tax exists if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. (Int.Rev. Code, § 6662(d)(1).) The term "understatement" means the excess of the amount required to be shown on the return for the taxable year over the amount of the tax imposed which is shown on the return, reduced by any rebate. (Int.Rev. Code, § 6662(d)(2).)

As potentially relevant to this appeal, there are three exceptions to the imposition of the accuracy-related penalty. Under the first exception, the accuracy-related penalty will be reduced by the portion of the understatement attributable to a tax treatment of any item if there is substantial authority for such treatment. (Int.Rev. Code, § 6662(d)(2)(B).) Under the second exception, the penalty will be reduced by the portion of the understatement attributable to a tax treatment of any item if the relevant facts affecting the item's tax treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item. (Int.Rev. Code, § 6662(d)(2)(B).) Under the third exception, the penalty will not be imposed to the extent that an appellant shows that a portion of the underpayment was due to reasonable cause and that he acted in good faith with respect to such portion of the underpayment. (Int.Rev. Code, § 6664(c)(1); Treas. Regs. §§ 1.6664-1(b)(2) & 1.6664-4.)

A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including his efforts to assess the proper tax liability, his knowledge and experience, and the extent to which he relied on the advice of a tax professional.[9] Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. The reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. However, the reliance on professional advice constitutes reasonable cause and good faith if, under all of the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (Treas. Reg. § 1.6664-4(b)(1).)

With respect to an underpayment attributable to the reliance by the taxpayer on professional advice, the advice must not be based on unreasonable factual or legal assumptions and

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[9] "Advice" is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayers, provided to (or for the benefit of) the taxpayers and on which the taxpayers rely, directly or indirectly, and does not have to be in any particular form. (Treas. Reg. §1-6664-4(c)(2).)

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must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. (Treas. Reg. § 1.6664-4(c)(ii).) For example, the advice must not be based on a representation or assumption which the taxpayer knows or has reason to know is unlikely to be true. (*Id*.) A taxpayer claiming reliance on a professional must show that (1) the tax preparer was a competent professional who had sufficient expertise to justify reliance; (2) the tax preparer was supplied with necessary and accurate information; and (2) the taxpayer actually relied in good faith on the advice. (*Neufeld v. Comm'r*, T.C. Memo 2008-79, citing *Neonatology Assocs., P.A. v. Comm'r* (2000) 115 T.C. 43, 99.) When respondent assesses an accuracy-related penalty based on a federal action, the assessment of the penalty is presumptively correct. (*Appeal of Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.) The taxpayer bears the burden of proving any defenses to abate the penalty. (*Recovery Group, Inc. v. Comm'r*, T.C. Memo 2010-76.)

Interest-Based Penalty

Under former R&TC section 19777 in effect for the years at issue in this appeal, a penalty in the amount of 100 percent of the interest accrued prior to the date of the mailing of the notice of proposed assessment was imposed on a deficiency if respondent had contacted the taxpayer regarding the use of a potentially abusive tax shelter. Subdivision (b)(2) of R&TC section 19777 defined a potentially abusive tax shelter as an arrangement of a type which respondent or the IRS "determines by regulations as having a potential for tax avoidance or evasion." Former section 19777 applied to NPAs mailed after January 1, 2004 and for taxable years ending on or before December 31, 2004.

Former Treas. Reg. sec. 1.6011-4T provided, in part, that every taxpayer who participated, directly or indirectly, in a "reportable transaction" within the meaning of paragraph (b) of that section was required to disclose the transaction. Paragraph (b) defined a reportable transaction as a "listed transaction" (identified by the IRS as a tax avoidance transaction) or an "other reportable transaction" which was identified by whether it met two of the six characteristics presented in the regulation. The transaction also had to meet the "the projected tax effect test" in paragraph (b)(4) in order to be reportable. A transaction described in paragraph (b) met the projected tax effect test if, at the time the taxpayer reasonably estimated that the transaction would reduce the taxpayer's Federal income tax liability by more than a stated amount.

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STAFF COMMENTS

In the view of the Appeals Division, *Weekend Warrior* and *Love et al* appear to be the most relevant case law authority on facts similar to those presented in this appeal. In *Weekend Warrior* the S corporation management company and ESOP were created concurrently after the law allowed tax-exempt ESOPs to hold S corporation stock. The court found that those transactions did not have a valid business purpose but that the S corporation conducted business activity and therefore should be respected for federal income tax purposes. The court then focused on the nature of that business activity and determined that there was no credible evidence in the record to establish that the operating corporation paid the S corporation for management services for which the operating corporation claimed a deduction as necessary and ordinary business expenses. In its examination, the court found that the S corporation did not issue invoices to the operating corporation for 2003 and 2004 and the four invoices that the S corporation issued for 2002 were unreliable because they were issued before the creation of the S corporation or included no detail of the services performed. In addition, there was little evidence as to the identity of the persons who allegedly performed services and the services that they performed.

In *Love et al* the management structure was formed in 1994 and it appears that the IRS did not question that the management company had a valid business purpose of providing management and other services to the operating company. Rather, in that case, the IRS determined that acquisition of the management company's stock from the ESOP (after which the taxpayers claimed the loss deduction) occurred for the principal purpose of avoiding or evading taxes and therefore disallowed the deduction on that basis. However, the court found that the taxpayers' acquisition of the stock was a key feature of the management restructuring and not for the principal purpose of tax avoidance. The court also found that the other steps taken were either authorized by the IRC or had economic substance and a business purpose.

At the hearing, the parties should be prepared to explain how each of these decisions support their respective positions or undercut the other party's position.

Management Services Agreement

Under the terms of the management agreement, MLS agreed to payments for management services of $2 million in 2001 and 22 percent of gross profits in the 2002 and 2003 tax

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years. Thus, the management fees would have been $6,500,000 for 2002 and $8,000,000 for 2003 based on 22 percent of MLS's gross profits of $30.2 million and $38 million for those years, respectively. However, according to appellants, after taking into consideration that MLS's profits were low compared with high gross receipts, MMM agreed to reduced management fees of $2.4 million and $3.5 million for 2002 and 2003, respectively. (App. Add'l Br., p. 10.) The Appeals Division notes that the amount of the management fee appears to have roughly approximated the net profits of MLS, prior to the management fee deduction, with the result that payment of the management fee eliminated any profits in MLS and resulted in a small tax loss for MLS in 2002 and 2003.[10]

Appellants should be prepared to demonstrate that the management fees paid by MLS in fact paid for management services provided by MMM.[11] In this regard, appellants may wish to address the following:

- Appellant-husband purchased MMM December 5, 2001, but the management agreement provides for payment of the management fee for the period from August 15, 2001 to December 31, 2001 in the amount of $2 million. Appellants may wish to provide evidence showing the actual period during which the management services were performed, describing how the amount of the management fee was determined and describing the nature of those services and by whom they were performed.
- Appellants may wish to provide evidence to show the type and extent of the services performed during 2002 and 2003, how the amount of the fee was determined in each year, by whom services were performed and the manner and amount by which those persons were compensated.
- If appellant-husband provided management services, explain whether he managed a real estate broker or a broker's sales agents and, if so, address respondent's argument that he lacked the

[10] MLS' tax returns for 2001, 2002, and 2003 are attached as exhibit D to Appellants' Additional Brief and exhibit I to Appellants' Second Additional Brief.

[11] Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any additional evidence to present, it should be provided to the Board's Board Proceedings Division at least 14 days prior to the oral hearing. Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

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legal authority to provide those services.

NEST Penalty

Respondent imposed the NEST penalty on the basis that "the documents implementing appellants' structure" show that it had no "valid nontax California business purpose" and lacked economic substance as it was undertaken solely for the purpose of tax avoidance by allocating 100 percent of MLS' income to a tax-exempt entity. Respondent also contends that a separate reason for imposition is that MMM, an entity involved in the transaction, should be disregarded as lacking economic substance. In this regard, respondent asserts 100 percent of its income was directed to a nonqualified deferred compensation plan for appellant-husband and MMM did not perform any new services for MLS. Appellants argue that they have shown that the transaction had economic substance and that MMM, as an entity, should not be disregarded as lacking economic substance. If the Board determines that the transaction and MMM had economic substance the NEST penalty would not be applicable.

Interest-Based Penalty

Staff requests that both parties be prepared to address further when a transaction should be considered to have been determined "by regulations" to have the potential for tax avoidance. In relevant part, former R&TC section 19777 defines "potentially abusive tax shelter" as a plan or arrangement "which is of a type that the [IRS or FTB] determines by regulations as having a potential for tax avoidance or evasion." Respondent contends that through former Treas. Reg. sec. 1.6011-4T(b)(3) the IRS determined "by regulations" that this type of transaction has the potential for tax avoidance. This former regulation provided that a transaction was a "reportable transaction" if it had at least two of five[12] characteristics, had a projected tax effect of more than $5 million and certain exceptions (e.g., for ordinary course transactions) did not apply. The five characteristics were: (1) conditions of confidentiality (as defined), (2) contractual protection of tax benefits, (3) more than $100,000 in fees contingent on participation in the transaction, (4) a book-tax difference of at least $5

[12] The temporary regulation initially listed six characteristics, but one characteristic, regarding foreign tax treatment, was removed. (See Treasury Decision (T.D.) 8961, Aug. 7, 2001.) This difference is not relevant to this appeal.

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million in any tax year, and (5) participation of a tax-exempt entity or other person with different tax treatment (where that tax status provides the taxpayer with more favorable income tax treatment). Respondent contends that the transaction in this appeal was offered under conditions of confidentiality and was structured to take advantage of the tax status of an ESOP and therefore has been determined by regulation as having the potential for tax avoidance or evasion.

Appellants contend that the applicable regulatory provision is in the final regulation, Treas. Reg. sec. 1.6011-4(b)(2), which currently defines a "reportable transaction" as a transaction which is offered to a taxpayer under conditions of confidentiality, and for which the taxpayer has paid the advisor a minimum fee. Appellants contend that the agreement provision at issue here is standard language to ensure the business practices of both entities are kept confidential.

The history of Treas. Reg. sec. 1.6011-4 and former temporary regulation Treas. Reg. sec. 1.6011-4T is complex.[13] It appears to staff that the confidentiality and minimum fee portion of the final regulation, which appellants cite, first appeared late in 2003, and was then only applicable to transactions entered into on or after December 29, 2003.[14] It further appears to staff that the temporary regulation cited by respondent was in effect for transactions entered into prior to 2003.[15] If and to the extent that appellants' formation and operation of the ESOP and S corporation is viewed as a transaction that was entered into prior to 2003, it appears to staff that the temporary regulation cited by respondent would be in effect for purposes of the transaction. At the hearing, the parties should be prepared to

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[13] See Treasury Decisions 8877, 8896, 8961, 9000, 9017, and 9046. The timing and effective date of the final regulation are also discussed in *Blak Investments v. Commissioner*, 133 T.C. 431 at pages 448 – 450, which concerned a listed transaction.

[14] In T.D. 9108, the IRS set forth this confidentiality-and-minimum-fee provision. Subsection (h) of this version of the regulation states that in part that subsection (b)(3) applies to transactions entered into on or after December 29, 2003, and subsection (b)(3) set forth the rule regarding confidential transactions.

[15] On February 28, 2003, the IRS issued a final regulation and stated that the rules set forth in the temporary regulation as in effect prior to that date applied to transactions entered into prior to that date, and that paragraphs (a) through (g) of the final regulation applied to transactions entered into on or after that date. (See T.D. 9046.) The final regulation covered any one of six types of transactions: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period. It stated that the term "transaction" included "all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan." A "confidential transaction" was defined in part in paragraph (b)(3) as a transaction where disclosure "of the tax treatment or the tax structure of the transaction" was limited by any understanding with or for the benefit of any person who provided a statement "as to the potential tax consequences that may result from the transaction . . . ."

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provide their own views, with any appropriate supporting exhibits to the extent not already in the record.

As noted above, respondent contends that appellants' transaction satisfies two of the characteristics listed by the temporary regulation, with one of the characteristics being that the transaction was offered under "conditions of confidentiality." Paragraph (c)(1) of Treas. Reg. sec. 301.6111-2T (which is cross-referenced by Treas. Reg. sec. 1.6011-4T(b)(3)(A)) provided in part that "an offer is considered made under conditions of confidentiality . . . if an offeree's disclosure of the tax treatment or tax structure of the transaction is limited in any manner by an express or implied understanding or agreement *with or for the benefit of any tax shelter promoter* . . . whether or not such understanding or agreement is legally binding. [emphasis added]"[16] Thus, the provision appears to require the involvement of a promoter and confidentiality conditions limiting the disclosure of the tax treatment or tax structure of the transaction. At the hearing, the parties should address further where these requirements have been met.

Respondent should be prepared to state at the hearing whether its general position with regard to the interest-based penalty is that, even if a transaction has only one of the characteristics set forth in the temporary regulation, the transaction is still "of a type that the Secretary of the Treasury or the Franchise Tax Board determines by regulations as having a potential for tax avoidance or evasion." In this connection, respondent should be prepared to address whether it contends that the interest-based penalty still applies in this appeal if the Board determines that the "conditions of confidentiality" characteristic is not present. Both parties should be prepared to discuss whether each characteristic listed by the temporary regulation sets forth a type of transaction identified by regulation as having a potential for tax avoidance.

Statute of Limitations

It appears to staff that respondent's proposed assessments were timely under the six-year

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[16] Temporary regulation 301.6111-2T further provided as follows:

> an offer will also be considered made under conditions of confidentiality . . . if any tax shelter promoter . . . has reason to know that the offeree's use or disclosure of information relating to the structure or tax aspects of the transaction is limited for the benefit of any person other than the offeree in any other manner, such as where the transaction is claimed to be proprietary or exclusive to the tax shelter promoter or any party other than the offeree. . . .

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statute of limitations provided by R&TC section 19058 for omissions of more than 25 percent of gross income. Therefore, it does not appear to staff that the Board needs to consider the eight-year statute of limitations provided by R&TC section 19755. To the extent either party has a different view, it should be prepared to provide evidence and argument supporting its view at the hearing.

Section 40

Revenue and Taxation Code section 40 was enacted by Assembly Bill No. 2323 (2011-2012 Reg. Sess.) and provides that the Board will publish on its website a written opinion for each decision rendered by the Board in which the amount in controversy is $500,000 or more. Section 40 does not apply to consent calendar actions. The amount in controversy in this appeal is over $500,000, and it is not a consent item; therefore, Section 40 will apply to the Board's decision in this appeal.

Section 40 requires that the Board publish on its website a Summary Decision or Formal Opinion containing findings of fact, analysis and other required content within 120 days of the date the Board's decision is rendered. Following the conclusion of the hearing, if the Board votes to decide the appeal but does not specify whether a Summary Decision or a Formal Opinion should be prepared or direct preparation of a Formal Opinion, staff will prepare a Summary Decision (which would not be precedential) and submit it to the Board for review and adoption at a later public meeting.

Under California Code of Regulations, title 18, sections (Rules) 5451, subdivision (c), 5452, subdivision (c), and 5460, subdivision (a) of the Rules for Tax Appeals (RTA), the Summary Decision (or Formal Opinion if so directed) will remain confidential unless and until it is adopted by the Board, and the date on which the Board votes to adopt the Summary Decision (or Formal Opinion) will be the date of the Board's decision and the date on which the 30-day period for filing a Petition for Rehearing (PFR) will begin. If no PFR is filed, the decision will be final and rendered at the expiration of that 30-day period, and shortly thereafter published to the Board's website in compliance with Section 40. If a PFR is filed, the Board's determination would not become final, and no decision would be published, until the PFR process is completed. Following the hearing, staff will promptly notify the parties in writing of the following: the Board's vote, whether a Formal Opinion or Summary Decision

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will be prepared, when the decision will become final, and when a PFR may be filed.[17]

Recommendation for Formal Opinion

In the view of the Appeals Division, this appeal raises issues regarding the NEST penalty and the interest-based penalty under former R&TC section 19777 that have not been addressed in any California court decision or prior precedential Board decision, and also involves important issues regarding the scope and application of the economic substance doctrine. As a result, the Board might determine that the appeal raises legal issues of "continuing public interest" under Rule 5452, subdivision (e)(3), or that other factors make it suitable for a precedential decision. The determination of whether to direct preparation of a Formal Opinion for the Board's review is subject to the Board's discretion, and staff will prepare a Summary Decision (which would not be precedential) if the Board does not direct preparation of a Formal Opinion.

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[17] The above process results from the application of Section 40 to the Board's existing income tax rules. In contrast, business tax rules permit a process in which the finality of the Board's decision is not deferred while the decision required by Section 40 is prepared and reviewed by the Board (unless the Board elects to hold its decision in abeyance pending review of the required decision). Pending proposed revisions to the RTA would provide that the Board's vote to resolve the appeal, rather than its later adoption of a Summary Decision, would start the 30-day period for filing a PFR (unless the Board otherwise directs or directs preparation of a Formal Opinion). This would bring the income tax procedures closer to conformity with existing business tax procedures, and in addition is intended to avoid any delay and additional interest accrual that might otherwise be caused by Section 40's requirement that a written opinion be published.