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7 **BOARD OF EQUALIZATION**  
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **PERSONAL INCOME TAX APPEAL**  
12 **DAVID A. LUBECK AND** ) Case No. 557788  
13 **MABEL C. McNALL-LUBECK<sup>1</sup>** )

	<u>Year</u>	<u>Proposed Assessment</u>	<u>Tax</u>	<u>Penalty</u>
	2008		\$11,386.00	\$2,846.50

18 Representing the Parties:

20 For Appellants: David A. Lubeck and Mabel C. McNall-Lubeck  
21 For Franchise Tax Board: Jeffery Morgan, Graduate Legal Assistant

23 QUESTIONS: (1) Whether appellants have demonstrated any error in the proposed assessment issued  
24 by respondent;  
25 (2) Whether appellants have established reasonable cause to support an abatement of  
26 the notice and demand penalty; and

28 <sup>1</sup> Appellants reside in Santa Clara County.

1 (3) Whether the Board should impose a penalty, for the filing of a frivolous appeal,  
2 under Revenue and Taxation Code (R&TC) section 19714.<sup>2</sup>

3 HEARING SUMMARY

4 Facts

5 Appellants submitted a 2008 California resident return (Form 540) dated February 22,  
6 2009, claiming married filing joint status. Appellants reported \$3,304 in federal adjusted gross income  
7 (AGI) reduced by \$7,384 in standard deductions, zero taxable income and self-assessed tax of zero.  
8 Appellants also reported \$5,422 in withholding credits, which they requested be refunded. (Appellants’  
9 Opening Brief (App. Op. Br.), Doc. 4.)

10 In addition, appellants attached a Substitute for Form W-2, Wage and Tax Statement  
11 (Form 3525) to the return which reflected that appellant-wife was employed by the County of Santa  
12 Clara, earned zero wages, but had state income tax withholding of \$5,421.73 and State Disability  
13 withheld of \$693.58.<sup>3</sup> Appellant-wife made the following statements in response to inquiries printed on  
14 each form, which was signed by her under penalty of perjury:

15 Information from the payer’s records, and corrections made to comply with California  
16 [R&TC] sections 18501, 17071 and 17072 and others, and the statutory language behind  
Internal Revenue Code Sections 3401, 7701, and others.

17 In response to the question “Give the reason why Form W-2, 1099, or W-2c, Statement of Corrected  
18 Income and Tax Amounts, was not furnished by employer or payer, if known. Explain your efforts to  
19 obtain the form,” appellant-wife stated:

20 The original form W-2 issued by the payer contained one or more inaccurate amounts.  
21 No efforts were taken with the payer. Payers are generally unfamiliar with the proper  
application of the income tax laws, and are fearful of the I.R.S. and Franchise Tax Board.

22 (App. Op. Br., Doc. 4.)

23 In addition, appellants provided three corrected Form 1099’s: (1) a Form 1099 which  
24 reflected that it was originally issued by Village Square Realty, reporting \$1,223.06 paid to appellant-  
25 husband in nonemployee compensation; (2) a Form 1099 which reflected that it was originally issued by

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28 <sup>2</sup> This is appellants’ first appeal of this nature before the Board. Respondent’s records indicate that appellants also failed to  
file a 2007 California income tax return.

<sup>3</sup> Appellants also provided the federal counterpart form to this California form indicating the same information.

1 Charles Schwab & Co., reporting a gross distribution to appellant-husband in the amount of \$408.40;  
2 and (3) a Form 1099 which reflected that it was originally issued by Nu Skin United States, reporting  
3 other income paid to appellant-wife in the amount of \$917.76.<sup>4</sup> Each of the reported amounts paid were  
4 lined through and “zero” was placed in each of the boxes that originally reported the income paid to  
5 appellants. The following statement was also added to each of the purported corrected Form 1099’s for  
6 Village Square Realty and Nu Skin United States:

7 Please be advised of the following, and update your records accordingly.

8 This form was filed unnecessarily. No monies or other forms of remuneration were paid  
9 to the “recipient: by the “payer” in the course of a “Trade or Business”, as defined in the  
10 Internal Revenue Code Section 7701(a)(26), or for a any other federally connected  
11 activity.

11 The following statement was added to the purported corrected Form 1099 for Charles Schwab & Co.:

12 Please be advised of the following, and update your records accordingly.

13 The “payer” filed a return when none was required. The account from which monies  
14 were withdrawn does not qualify as an “Individual Retirement Account” as defined by  
15 Internal Revenue Code Sections 408, 3121, and others.

16 Each of these statements was then signed and sworn to by the appellant-spouse to whom the Form 1099  
17 had originally been issued. A federal Form 1040A which reflected zero wages, but included \$1,560 in  
18 federal income tax withheld was also provided with appellants’ Form 540. (App. Op. Br., Doc. 9.)

19 Upon review, respondent determined that appellants’ return was frivolous and issued  
20 letters to appellants on June 16, 2009 and June 24, 2009, informing appellants that the 2008 return they  
21 filed was frivolous and invalid and demanded that appellants file a valid return within 30 days of the  
22 notice date. (App. Op. Br., Docs. 6 and 7.) According to respondent, appellants did not file a valid 2008  
23 return. (Respondent’s Opening Brief (Resp. Op. Br.), p. 2.) On March 29, 2010, respondent issued a  
24 Notice of Proposed Assessment (NPA) based on (1) the Form 1099-MISC issued by Village Square  
25 Realty, Inc. to appellant-husband in the amount of \$1,223; (2) the Form 1099-R issued by Charles  
26 Schwab & Co, Inc. to appellant-husband in the amount of \$408; and (3) income information from the

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28 <sup>4</sup> We note that while appellants discuss the amount received from Nu Skin United Inc., it appears that the Notice of Proposed  
Assessment (NPA) and Notice of Action (NOA) issued by respondent do not include this amount in the adjustments. (App.  
Op. Br., Docs. 1 and 2.)

1 Employment Development Department which indicated that appellant-wife received wages of \$179,885  
2 reported on a W-2 by her employer, the County of Santa Clara.<sup>5</sup> (App. Op. Br., Doc. 2.) Respondent  
3 also imposed a Failure to File Upon Demand penalty of \$3,018.25. (*Id.*)

4 On May 16, 2010, appellants protested the NPA and requested an oral protest hearing.  
5 (App. Op. Br., Doc. 8.) On July 12, 2010, respondent issued a notice to appellants stating that it  
6 determined appellants' protest was a specific frivolous submission and informed appellants that they had  
7 30 days to withdraw their protest or respondent would impose a \$5,000 frivolous submission penalty.  
8 (*Id.*) By letter dated August 11, 2010, appellants informed respondent that they were returning  
9 respondent's July 12, 2010 letter and requested that respondent either admit that appellants' statements  
10 of fact contained in their protest were correct or grant appellants a hearing. (*Id.*) On August 16, 2010,  
11 respondent acknowledged appellants' protest and request for an oral hearing. (App. Op. Br., Doc. 11.)  
12 By letter dated August 26, 2010, respondent notified appellants that it scheduled a protest hearing for  
13 October 7, 2010. (App. Op. Br., Doc. 12.) Respondent's letter explained that any request for a  
14 postponement should be postmarked and received by respondent at least ten days prior to the scheduled  
15 date of hearing and should show sufficient reason for granting the request. (*Id.*)

16 At the October 7, 2010 hearing, appellants provided additional written and oral argument.  
17 (App. Op. Br., Doc. 13.) Respondent states that appellants did not argue against the receipt of the  
18 amounts reported on the Form W-2s and 1099s. (Resp. Op. Br., p.3.) Rather, appellants asserted that  
19 those amounts were not taxable income. (*Id.*) After reviewing the matter, respondent issued a Notice of  
20 Action (NOA) on November 24, 2010, affirming the NPA. (App. Op. Br., Doc. 2.)

21 According to federal records, appellants filed a 2008 federal return reporting a tax  
22 liability of zero. (Resp. Op. Br., Ex. B.) On December 27, 2010, the Internal Revenue Service (IRS)  
23 assessed additional tax of \$34,948 as a result of unreported income and imposed an accuracy-related  
24 penalty of \$6,990. (*Id.*)

25 This timely appeal followed.

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28 <sup>5</sup> Respondent obtained this information as part of its automated annual Integrated Non-Filer Compliance Program. (Resp. Op. Br., p. 3.)

1           Contentions

2                   Appellants

3           Appellants assert that respondent made a number of errors including the assessment of  
4 the incorrect amounts of tax liability, failing to meet statutory requirements, failing to exercise care and  
5 due diligence in the performance of its duties, and improperly rejecting appellants' NPA protest. (App.  
6 Op. Br., p. 1.) Specifically, appellants make the following arguments:

- 7           • Respondent's reliance on unattested third party information is insufficient to support  
8 respondent's proposed assessment. (App. Op. Br., p. 4.)
- 9           • Non-federally-connected private sector remuneration, or pay for work, is not the "gains, profits,  
10 and income" and "wages" that are subject to federal taxes. (App. Op. Br., Doc. 13.)
- 11           • "Wages" are limited to "those receipts that are within the federal government's powers to tax,  
12 such as the pay of federal workers, which necessarily involves the privilege of receiving  
13 remuneration from or on behalf of the federal government." (App. Op. Br., Doc 13.)
- 14           • The Form 1099's and W-2, on which respondent relies, are incorrect because the payers  
15 misapplied the reporting requirements found in the Code of Federal Regulations (CFR) and/or  
16 the definition of "trade or business" as defined in Internal Revenue Code section 7701(a)(26).  
17 (App. Op. Br., Doc. 8.)
- 18           • The W-2 submitted by the County of Santa Clara was issued, and monies were deducted,  
19 withheld and paid over, without legal authority as the relevant tax law and pertinent facts clearly  
20 demonstrate. (Appellants' Reply Brief (App. Reply Br.), p. 1.)
- 21           • The County of Santa Clara, Village Square Realty, Charles Schwab & Co and Nu Skin United  
22 were not "legally authorized to act as a 'Payor' or 'Withholding Agent'." Subsequently, the  
23 original Form 1099's and W-2 must be considered void. (App. Reply Br., p. 4.)
- 24           • Appellants are not considered "*U.S. person[s]*" or "*foreign person[s]*, as defined by statute,  
25 required to provide a Tax Identification Number (TIN) under CFR Title 26, Section 301.6109-  
26 1(b)." (App. Reply Br., Ex. A and B.)
- 27           • By issuing the "Frivolous Return letters" and applying subsequent penalties, respondent ignore  
28 appellants' due process protection under the United States Constitution and the California

1 Constitution. (App. Op. Br., Doc. 8.)

2 Respondent

3 Respondent contends that appellants refuse to file a required valid 2008 return.

4 Respondent further contends appellants attempt to avoid their state income tax responsibilities through  
5 the assertion of frivolous arguments based on respondent's alleged failure to provide an adequate  
6 hearing and alleged miscalculation of income. Respondent notes that the Board, the IRS, respondent,  
7 and the courts consistently and emphatically rejected arguments similar to appellants and have found  
8 these arguments to be frivolous and without any significant merit. Citing Notice 2008-14, I.R.B. 2008-  
9 4, Jan. 28, 2008, and the IRS publication, "The Truth About Frivolous Tax Arguments," section  
10 I(C)(4),<sup>6</sup> respondent asserts that the IRS published, and respondent adopted, a list of positions that are  
11 frivolous, including any argument asserting that wages are not taxable. Respondent further asserts that  
12 no United States court decisions pertaining to income have ever stood for the proposition that wages  
13 received for services performed are not subject to the income tax. (Resp. Op. Br., pp. 4-5.)

14 Respondent also contends that appellants failed to provide any specific, credible, or  
15 relevant information showing respondent's proposed assessment is incorrect. Respondent asserts that  
16 appellants are not in a good position to criticize the NPA because appellants failed to file a valid 2008  
17 return and did not provide any specific income information about their 2008 income. Respondent notes  
18 that appellants did not deny receiving the amounts indicated in the Form W-2 and 1099's on which  
19 respondent based its proposed assessment. (Resp. Op. Br., p. 4.) In the absence of a return providing  
20 the necessary information to determine appellants' tax liability, respondent has great latitude to seek  
21 data and the authority to request and use information. (Resp. Op. Br., p. 6.)

22 Next, respondent contends that appellants' arguments based on alleged violations of  
23 substantive or procedural rights based on law that does not apply to the assessment of tax are beyond the  
24 Board's jurisdiction in this appeal. Respondent states that the facts show respondent scheduled an oral  
25 protest hearing for the purpose of giving appellants an opportunity to demonstrate the factual error in the  
26 NPA. Respondent further states that, as appellants attended the hearing and were given the opportunity  
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<sup>6</sup> See <http://www.irs.gov/taxpros/article/0,,id=159853,00.html>.

1 to dispute the assessment, this Board has previously determined that these conditions do not show a  
2 violation of due process. (Resp. Op. Br., p. 5.)

3 Respondent also contends that the demand penalty was properly imposed and appellants  
4 have not presented evidence of reasonable cause to support an abatement of that penalty. Respondent  
5 notes that it issued a Request for Return to appellants for the 2007 tax year and when appellants failed to  
6 respond, respondent issued an NPA for that tax year. Finally, the FTB contends that appellants are  
7 maintaining a frivolous appeal and requests that this Board impose a frivolous appeal penalty. (Resp.  
8 Op. Br., p. 6-7.)

9 Applicable Law

10 Proposed Assessment

11 R&TC section 17041 imposes a tax “. . . upon the entire taxable income of every resident  
12 of this state . . .” and upon the entire taxable income of every nonresident or part-year resident which is  
13 derived from sources in this state.<sup>7</sup> R&TC section 18501 requires every individual subject to the  
14 Personal Income Tax to make and file a return with the FTB “stating specifically the items of the  
15 individual’s gross income from all sources and the deductions and credits allowable . . . .” R&TC  
16 section 19087, subdivision (a), provides:

17 If any taxpayer fails to file a return, or files a false or fraudulent return with intent to  
18 evade the tax, for any taxable year, the Franchise Tax Board, at any time, may require a  
19 return or an amended return under penalties of perjury or may make an estimate of the net  
interest, and penalties due.

20 If respondent makes a tax assessment based on an estimate of income, respondent’s initial  
21 burden is to show why its assessment is reasonable and rational. (*Todd v. McColgan* (1949) 89  
22 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.) Federal courts have held  
23 that the taxing agency need only introduce some evidence linking the taxpayer with the unreported  
24 income. (See *Rapp v. Commissioner* (9th Cir. 1985) 774 F.2d 932.) When a taxpayer fails to file a valid  
25 return, respondent’s use of income information from various sources to estimate a taxpayer’s taxable  
26 income is a reasonable and rational method of estimating taxable income. (See *Palmer v. Internal*

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28 <sup>7</sup> It appears undisputed that appellants resided in California during the 2008 tax year.

1 *Revenue Service* (9th Cir. 1997) 116 F.3d 1309, 1313; *Andrews v. Commissioner*, T.C. Memo 1998-316;  
2 *Giddio v. Commissioner*, (1970) 54 T.C. 1530, 1533; *Appeals of Walter R. Bailey*, 92-SBE-001, Feb. 20,  
3 1992; *Appeals of R. and Sonja J. Tonsberg*, 85-SBE-034, Apr. 9, 1985.)

4           Once respondent has met its initial burden, the assessment is presumed correct and an  
5 appellant has the burden of proving it to be wrong. (*Todd v. McColgan, supra*; *Appeal of Michael E.*  
6 *Myers, supra*.) Unsupported assertions are not sufficient to satisfy an appellant's burden of proof.  
7 (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In the absence of uncontradicted,  
8 credible, competent, and relevant evidence showing error in respondent's determinations, respondent's  
9 proposed assessments must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov.  
10 18, 1980.) A taxpayer's failure to produce evidence that is within his control gives rise to a presumption  
11 that such evidence is unfavorable to his case. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

#### 12           Constitutional/Due Process Issues

13           The Board is precluded from determining the constitutional validity of California statutes  
14 and has an established policy of declining to consider constitutional issues. (Cal. Const., art III, § 3.5;  
15 *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983; *Appeals of Walter R. Bailey, supra*.) In *Bailey*,  
16 *supra*, the Board stated:

17           [D]ue process is satisfied with respect to tax matters so long as an opportunity is given to  
18 question the validity of a tax at some stage of the proceedings. It has long been held that  
19 more summary proceedings are permitted in the field of taxation because taxes are the  
20 lifeblood of government and their prompt collection is critical.

#### 21           Demand Penalty

22           California imposes a penalty for the failure to file a return or to provide information upon  
23 respondent's demand to do so, unless reasonable cause prevented the taxpayer from responding to the  
24 request. (Rev. & Tax. Code, § 19133.) The burden is on the taxpayer to prove that reasonable cause  
25 prevented him from responding to the demand. (*Appeal of Kerry and Cheryl James*, 83-SBE-009,  
26 Jan. 3, 1983.) Respondent will only impose a demand penalty if the taxpayer fails to respond to a  
27 current Demand for Tax Return and respondent issued an NPA under the authority of R&TC section  
28 19087, subdivision (a), after the taxpayer failed to timely respond to a Request for Tax Return or a  
Demand for Tax Return at any time during the four taxable years preceding the year for which the

1 current Demand for Tax Return is being issued. (Cal. Code Regs., tit. 18, § 19133, subd. (b).)<sup>8</sup>

2 Frivolous Appeal Penalty

3 The Board may impose a penalty of up to \$5,000 whenever it appears to the Board that  
4 proceedings before it have been instituted or maintained primarily for delay or that the position is  
5 frivolous or groundless. (Rev. & Tax. Code, § 19714; Cal. Code Regs., tit., 18, § 5454.) The following  
6 factors are considered in determining whether, and in what amount, to impose the penalty: (1) whether  
7 appellant is making arguments that have been previously rejected by the Board in a Formal Opinion or by  
8 courts, (2) whether appellant is repeating arguments that he or she made in prior appeals, (3) whether  
9 appellant filed the appeal with the intent of delaying legitimate tax proceedings or the legitimate  
10 collection of tax owed, and (4) whether appellant has a history of filing frivolous appeals or failing to  
11 comply with California's tax laws. (Cal. Code Regs., title 18, § 5454.) The Board may consider other  
12 relevant factors in addition to the factors listed above. (*Id.*) The Board has considered arguments similar  
13 to appellants' arguments and rejected each of the contentions as frivolous and without merit. (See  
14 *Appeals of Robert E. Wesley, et al.*, 2005-SBE-002, Nov. 15, 2005; *Appeal of Michael E. Myers, supra.*)

15 STAFF COMMENTS

16 At the hearing, appellants should be prepared to provide evidence that demonstrates  
17 error in respondent's determination and reasonable cause to abate the demand penalty. Additionally,  
18 both parties should be prepared to discuss whether, and in what amount, a frivolous appeal penalty  
19 should be imposed. Staff notes that appellants' argument that their wages are not subject to tax has  
20 been consistently rejected by the IRS, the federal courts, respondent, and the Board, over long periods  
21 of time. Appellants were notified that the Board may impose a frivolous appeal penalty in the NOA  
22 and in a letter from Board staff dated January 7, 2011. Staff notes this is the first appeal of appellants  
23 that the Board has considered, although respondent's records indicate respondent issued a Request for  
24 Tax Return and an NPA against appellants for the 2007 tax year.

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28 <sup>8</sup> Regulation 19133 became operative on December 23, 2004.