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**BOARD OF EQUALIZATION**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) **HEARING SUMMARY**  
) **PERSONAL INCOME TAX APPEAL**  
**EUGENE MIDLOCK AND** ) Case No. 484989  
**PENELOPE MIDLOCK<sup>1</sup>** )

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	<u>Year</u>	<u>Refund</u>
	2001	Amount
		\$48,566.65 <sup>2</sup>

Representing the Parties:

For Appellant: Edwin P. Antolin, Silverstein & Pomerantz LLP  
For Franchise Tax Board: Craig L. Scott, Tax Counsel IV

QUESTIONS: (1) Whether respondent properly imposed an accuracy-related penalty pursuant to Revenue and Taxation Code (R&TC) section 19752, subdivision (b)(5)(A)(ii).  
(2) Whether the penalty under R&TC section 19752, subdivision (b)(5) should be imposed pursuant to deficiency procedures or by a Notice of State Income Tax Due

<sup>1</sup> This matter was originally scheduled for oral hearing at the March 23, 2010 Board meeting. The matter was subsequently rescheduled to the May 25-27 Board meeting at the appellant's representative's request.

<sup>2</sup> This is the amount stated in Appellants' Opening Brief, which represents the accuracy-related penalty of \$34,821.00 and interest of \$13,745.5, plus any additional interest as provided by law.

1 used by respondent to assess the accuracy-related penalty.

2 (3) Whether this Board has authority to hear and decide appellants' request for  
3 attorney's fees pursuant to R&TC section 19717.

4 HEARING SUMMARY

5 Factual and Procedural Background

6 Appellant filed a timely 2001 California income tax return (Form 540) on October 1,  
7 2002, and reported taxable income of \$788,259 and a total tax liability of \$11,280. In March 2004,  
8 respondent sent two letters to appellant-husband at an address on Farmingham Way in Cupertino, CA  
9 notifying him about the Voluntary Compliance Initiative (VCI) program. The letters stated that new  
10 California law authorized respondent to aggressively combat abusive tax shelters and transactions by  
11 adding substantial penalties and other provisions. The letters also stated that the VCI program allowed  
12 taxpayers who underreported their income or tax liability due to abusive tax shelters and transactions to  
13 amend their returns and limit the risk of incurring penalties. (Resp. Open. Br., pp 1-2.)

14 Appellants filed an amended 2001 return on March 30, 2004, and elected to participate in  
15 the VCI program under option 2. By choosing this option, all penalties except the accuracy-related  
16 penalty were waived, and appellants retained their rights of appeal. On the amended return, appellants  
17 eliminated a capital loss of \$1,845,019 resulting from the sale of foreign currency option contracts and  
18 self-assessed additional tax of \$186,312. Appellants submitted a payment of \$195,003 with the  
19 amended return. (Resp. Open. Br., p. 2.)

20 Appellants also filed an amended 2001 federal return in March 2004, reporting changes  
21 increasing their adjusted gross income by \$1,845,019 and decreasing their itemized deductions by  
22 \$55,050<sup>3</sup>, and self-assessed additional federal tax of \$391,219. Appellants provided an explanation of  
23 the changes which states, in part, that “[a]t the time the original return was filed, and all times thereafter,  
24 [appellants] believed that substantial authority exists for the manner in which the transaction was  
25 reflected in the tax return.” The explanation also states that the subject transaction is not a “listed  
26 transaction” or an “abusive tax shelter”. Finally, appellants state that they believe their treatment of the  
27

28 <sup>3</sup> Respondent refers to this amount as \$55,050, whereas appellants refer to this amount as \$55,350; the parties should clarify the correct amount at the oral hearing.

1 item would be allowed by the IRS upon review but they amended the return to remove the loss in light  
2 of recent rulings in order to avoid potentially costly administrative and legal proceedings. The Internal  
3 Revenue Service (IRS) subsequently notified appellants in April 2005, of the IRS's intent to audit  
4 appellants' 2001, 2002 and 2003 returns. (App. Open. Br., p. 4 and exhibits B and H.)

5 In Announcement 2005-80, dated November 14, 2005, the IRS announced a settlement  
6 initiative for taxpayers who had claimed tax benefits from one of the transactions described in the  
7 announcement. Taxpayers who participated in the settlement initiative were required to submit a  
8 completed Form 13750 to the IRS prior to January 23, 2006, and upon receipt of all required  
9 information, the IRS would prepare a closing agreement stating the terms of the settlement. Taxpayers  
10 were then required to pay in full, the tax, interest and an accuracy-related penalty, which was a stated  
11 percentage based on the type of transaction.

12 Appellants and the IRS entered into a "Closing Agreement on Final Determination  
13 Covering Specific Matters, Form 906" (Closing Agreement), in which appellants conceded all tax  
14 benefits in the amount of \$2,000,000, from a transaction involving offsetting foreign currency options  
15 contracts for which appellants claimed an ordinary loss in 2001. The Closing Agreement allowed a  
16 \$10,000 capital loss deduction for transaction costs and imposed an accuracy-related penalty of \$77,820.  
17 (Resp. Open. Br., pp. 2-3 and App. Open. Br., exhibit D.)

18 A federal Form 4549-A, titled "Income Tax Discrepancy Adjustments", dated March 15,  
19 2007, lists an accuracy-related penalty for 2001 pursuant to IRC section 6662 in the amount of \$77,820  
20 and a balance due of tax of \$389,101. A detail sheet shows that the adjustment subject to the 20 percent  
21 accuracy-related penalty was a Schedule D – Short Term Gain/Loss of \$2,000,000. A second Form  
22 4549-A, dated April 9, 2007, makes two additional adjustments to income of \$10,000 and \$300 and a  
23 decrease in tax of \$2,118. This Form 4549-A also lists an accuracy-related penalty for 2001 pursuant to  
24 IRC section 6662 in the amount of \$77,820. A federal Form 886-A, titled "Explanation of Items", states  
25 that the accuracy-related penalty was imposed on the \$2,000,000 transaction amount of the net short-  
26 term capital loss reported on the original 2001 return. (Resp. Open. Br., exhibit I, pp. 1-2, 5, 23-24, 39.)

27 Respondent subsequently notified appellants that it received copies of the Forms 4549-A  
28 and advised appellants that certain federal adjustments applicable to California resulted in an

1 overpayment of \$930. The letter also states that respondent would assess an accuracy-related penalty in  
2 the amount of \$34,821 issued on a Notice of Tax Due (NTD), which is not protestable but that  
3 appellants may file a claim for refund of the penalty after it is paid. (App. Open. Br., exhibit E.) In  
4 response to the NTD issued on June 10, 2008, appellants made a payment of \$47,481.65 and filed a  
5 timely claim for refund. Respondent denied the claim and this timely appeal followed. (Resp. Open. Br.,  
6 pp. 4-5.)

7 **Issue 1: Whether respondent properly imposed an accuracy-related penalty pursuant to Revenue**  
8 **and Taxation Code (R&TC) section 19752, subdivision (b)(5)(A)(ii).**

9 Contentions

10 Appellants' Contentions

11 Appellants contend that respondent improperly imposed the accuracy-related penalty for  
12 two reasons: (1) the statutory requirements under R&TC section 19752, subdivision (b) were not met,  
13 and (2) respondent failed to impose the penalty within the applicable statute of limitations period.  
14 Under the circumstances presented in this appeal, appellants state that R&TC section 19752, subdivision  
15 (b)(5), provides that a taxpayer who chooses Option 2 may be subject to the accuracy-related penalty  
16 when "a federal determination becomes final for the same issue, in which case the penalty shall be  
17 assessed (and may not be abated) if the penalty was assessed at the federal level." Appellants contend  
18 that the penalty may not be imposed because there has not been a federal determination for the same  
19 issue. Appellants' cite California Code of Regulations section (Regulation) 19059, subdivision (e)(1)  
20 providing that a final federal determination "is an irrevocable determination or adjustment of a  
21 taxpayer's federal tax liability from which there exists no further right of appeal either administrative or  
22 judicial" which includes "a closing agreement made under Section 7121 of the Internal Revenue Code of  
23 1986 finally and irrevocably adjusting and settling a taxpayer's tax liability." Appellants also cite  
24 R&TC section 18622, subdivision (d) which provides that the date of a final federal determination "shall  
25 be the date on which each adjustment or resolution resulting from an Internal Revenue Service  
26 examination is assessed pursuant to Section 6203 of the Internal Revenue Code." (App. Open. Br., p. 7.)

27 Appellants contend that the federal closing agreement did not adjust or settle the capital  
28 loss transaction because they already made the adjustment by reversing the transaction in the amended

1 return prior to contact by the IRS. In addition, appellants contend that the closing agreement did not  
2 adjust and settle their federal tax liability with respect to the loss transaction because that transaction had  
3 already been reported on the amended return. According to appellants, the Closing Agreement merely  
4 confirmed the treatment of the capital loss reported on the amended return and the only adjustment made  
5 by the agreement was the allowance of additional deductions. (App. Open. Br., pp. 7-8.) Appellants  
6 argue that respondent acknowledges in its opening brief that the Closing Agreement “described the  
7 capital loss transaction” but did not adjust and settle it. (App. Reply Br., p. 4.)

8 Furthermore, appellants assert that the only federal determination in the Closing  
9 Agreement were the adjustments allowing additional deductions and imposing the accuracy-related  
10 penalty. Therefore, appellants contend, neither of those adjustments was the “same issue” as the loss  
11 transaction triggering the accuracy-related penalty at issue here as required by R&TC section 19752,  
12 subdivision (b)(5). Appellants assert that respondent’s position construes the “same issue” requirement  
13 to mean “related issue” which is contrary to the express language of the provision. (App. Reply Br., p.  
14 5.)

15 Appellants dispute respondent’s position that their amended return constitutes a final  
16 federal determination for purposes of R&TC section 19752, subdivision (b)(5)(A)(ii). Appellants  
17 contend that respondent’s position conflicts with R&TC section 18622, subdivisions (a) and (b), and  
18 renders subdivision (b) superfluous. Specifically, appellants assert that subdivision (a) requires that the  
19 taxpayer report federal audit adjustments within six months “after the date of each final federal  
20 determination” and concede the accuracy of the determination or state why it is erroneous. Subdivision  
21 (b) provides that a taxpayer who files an amended federal return is required to file an amended  
22 California return within six months after the federal return is filed. If, as respondent contends, an  
23 amended return constitutes a final federal determination, appellants argue that subdivision (b) would  
24 have been unnecessary. Thus, appellants conclude that construction of the statute indicates that a federal  
25 determination and federal amended return are not the same. (App. Open. Br., p. 8.)

26 Appellants also contend that respondent’s interpretation of a federal determination  
27 conflicts with R&TC section 18622, subdivision (d) which provides that the date of a final federal  
28 determination is the date “on which each adjustment or resolution resulting from an Internal Revenue

1 Service examination is assessed pursuant to Section 6203 of the Internal Revenue Code.” Appellants  
2 assert that this provision makes clear that a final determination results from an IRS examination and not  
3 an amended return. (App. Open. Br., pp. 8-9.)

4 Appellants further contend that the purpose of R&TC section 19752, subdivision (b), is to  
5 impose the accuracy-related penalty on “taxpayers who, after filing a VCI Option II amended return,  
6 continue to contest the merits of the disputed transaction with the FTB or the IRS and do not prevail.”  
7 Because appellants did not contest respondent’s treatment of the transaction, they argue that the  
8 Legislature did not intend the accuracy-related penalty to be imposed. Otherwise, appellants argue, the  
9 Legislature would have imposed the penalty on all taxpayers who reported a questionable transaction on  
10 their original return regardless of the final federal determination. (App. Open. Br., p. 9.) Appellants  
11 explain that the penalty is designed to discourage taxpayers from defending questionable transactions  
12 and is imposed as the cost to the taxpayer of exercising his or her right to defend the original reporting  
13 position. Appellants maintain that there is no reasonable ground for treating taxpayers who concede  
14 their reporting position the same as those who defend that position. (App. Reply Br., p. 7.)

15 Appellants contend that respondent’s interpretation of “federal determination” is contrary  
16 to rules of judicial construction and leads to absurd consequences. Specifically, appellants assert  
17 respondent’s position, that entering into a federal closing agreement triggers the accuracy-related  
18 penalty, would result in imposition of the penalty on all taxpayers who participated in the IRS settlement  
19 program. Such an interpretation, appellants argue, would discourage participation in the program and  
20 would create a trap for taxpayers who are trying to comply with the tax laws. Appellants contend that  
21 this Board should reject respondent’s interpretation of a federal determination in the context of R&TC  
22 section 19752, subdivision (b), based on the legal principle that penalty provisions must be strictly  
23 construed in favor of the taxpayer. (App. Open. Br., pp. 9-10.)

#### 24 Respondent’s Contentions

25 Respondent contends that the accuracy-related penalty was properly imposed and  
26 summarizes the requirements of R&TC section 19752, subdivision (b)(5)(A)(ii) as follows: “(1) there  
27 has been a final federal determination, (2) the determination was for the same issue, and (3) there has  
28 been the imposition by the IRS of an accuracy-related penalty.” Respondent states that each of these

1 requirements has been met in this case. (Resp. Open. Br., p. 5.) Respondent asserts that the opening of  
2 the IRS examination and the adjustment of appellants' 2001 tax year liabilities constituted a federal  
3 determination within the meaning of R&TC section 18622, which appellants were required to report to  
4 respondent under that section. Citing R&TC section 18622, subdivision (d) and Treasury Regulation  
5 section 301.6203-1 for support, respondent states that (1) a federal determination is final on the date on  
6 which the adjustment resulting from the IRS examination is assessed and (2) recording the liability in  
7 accordance with federal rules and regulations constitutes an assessment. Respondent asserts that  
8 appellants' Individual Master File Transcript (IMF), which indicates assessment of a federal accuracy-  
9 related penalty and the abatement of federal income tax for tax year 2001, satisfies the definition of a  
10 final federal determination. Respondent also notes that appellants conceded all claimed tax benefits by  
11 executing the Closing Agreement which resulted in a final IRS determination as reflected on the IMF.  
12 (Resp. Open. Br., p. 6.)

13           Respondent also disputes appellants' argument that there was no final determination "for  
14 the same issue" because the examination and Closing Agreement did not adjust or settle the capital loss  
15 transaction that appellants reported on the amended federal return. Respondent points out that the  
16 Closing Agreement described the capital loss transaction and provided for a deduction of costs directly  
17 related to that transaction and an accuracy-related penalty for the understatement on the original return.  
18 Respondent argues that the IRS made the additional adjustments to appellants' 2001 liabilities based on  
19 the capital loss transaction that appellants' removed on the amended return. Thus, respondent concludes  
20 that these adjustments were for the same issue and this requirement of R&TC section 19752, subdivision  
21 (b)(5)(A)(ii) was satisfied. In addition, respondent also states that the IRS assessed an accuracy-related  
22 penalty which satisfies the third requirement of R&TC section 19752, subdivision (b)(5)(A)(ii). (Resp.  
23 Open. Br., p. 7.)

24           Respondent rejects appellants' contention that the purpose of R&TC section 19752,  
25 subdivision (b), is to impose the accuracy-related penalty only on taxpayers who file a VCI Option II  
26 amended return and continue to contest the merits of the disputed transaction with the FTB or the IRS  
27 but do not prevail. Respondent asserts that a plain language reading of that provision, which is the  
28 controlling rule of statutory construction here, refutes appellants' contention that contesting the

1 transaction is a precondition for imposing the penalty. Respondent also points out that appellants could  
2 have avoided the penalty altogether by electing Option I but they chose to assume the risk of penalty  
3 imposition by choosing Option II. Canceling the penalty on this basis, respondent argues, would  
4 effectively allow appellants to choose Option I retroactively which would be unfair to other taxpayers  
5 who elected Option I and thereby waived their appeal rights. (Resp. Open. Br., pp. 7-8.)

6 Applicable Law

7 Voluntary Compliance Initiative

8 In 2003, the California Legislature enacted the “Voluntary Compliance Initiative,” which  
9 allowed taxpayers to file amended returns, disclose potentially abusive tax shelter transactions, pay the  
10 resulting tax and interest, and avoid the application of penalties. (Rev. & Tax. Code, § 19751 et seq.)  
11 Taxpayers were allowed to file amended VCI returns during the period from January 1, 2004, through  
12 April 15, 2004, inclusive. (Rev. & Tax. Code, § 19751, subd. (b).)

13 Taxpayers who participated in the VCI could elect either of two options. Under the first  
14 VCI option:

- 15 • The state would waive all penalties attributable to the abusive transactions (Rev. &  
16 Tax. Code, § 19752, subd. (a)(1));
- 17 • The taxpayer would be immune from criminal prosecution in connection with the  
18 abusive transactions (*Id.*, subd. (a)(2)); and
- 19 • The taxpayer would give up the right to “file a claim for refund for the amounts paid  
20 in connection with” the abusive transactions. (*Id.*, subd. (a)(4).)

21 Under the second VCI option:

- 22 • The state would waive all penalties attributable to the abusive transactions except the  
23 accuracy-related penalty under R&TC section 19164. (Rev. & Tax. Code, § 19752,  
24 subd. (b)(1));
- 25 • The taxpayer would be immune to criminal prosecution in connection with the  
26 abusive transactions (*Id.*, subd. (b)(2)); and
- 27 • The taxpayer would retain the right to file a claim for refund. (*Id.*, subd. (b)(4).)

28 In addition, subdivision (b)(5) provides that the taxpayer **shall be subject to the**

1 **accuracy-related penalty** under Section 19164; further, subdivision (b)(5)(A) provides that **the penalty**  
2 **may be assessed:**

- 3 (i) When the Franchise Tax Board takes action on the claim for refund.
- 4 (ii) When a federal determination becomes final for the same issue, in which case the  
5 penalty shall be assessed (and may not be abated) if the penalty was assessed at the  
6 federal level.

7 (Emphasis added.)

8 Federal Determination

9 R&TC section 18622, subdivisions (a) provides, in part, that

10 “[i]f any item required to be shown on a federal tax return, including any gross income,  
11 deduction, penalty, credit, or tax for any year of any taxpayer is changed or corrected by  
12 the Commissioner of Internal Revenue. . . , that taxpayer shall report each change or  
13 correction . . . , within six months after the date of each final federal determination of the  
14 change or correction or renegotiation . . . For any individual subject to tax under Part 10  
(commencing with Section 17001), changes or corrections need not be reported unless  
they increase the amount of tax payable under Part 10 (commencing with Section 17001)  
for any year.”

15 Subdivision (b) of that section provides that a taxpayer who files an amended federal return shall also  
16 file within six months thereafter an amended California return. However, for a taxpayer subject to  
17 California personal income tax, “an amended return need not be filed unless the change therein would  
18 increase the amount of tax payable.” Subdivision (d) of that section provides that “[f]or purposes of this  
19 part, the date of each final federal determination shall be the date on which each adjustment or resolution  
20 resulting from an Internal Revenue Service examination is assessed pursuant to Section 6203 of the  
21 Internal Revenue Code.”

22 California Code of Regulations, title 18, section (Regulation) 19059, subdivision (e)  
23 defines a “final determination” as “an irrevocable determination or adjustment of a taxpayer’s federal  
24 tax liability from which there exists no further right of appeal either administrative or judicial.”  
25 Subdivision (e)(1) provides the following as an example of a final determination: “(1) a closing  
26 agreement made under Section 7121 of the Internal Revenue Code of 1986 finally and irrevocably  
27 adjusting and settling a taxpayer’s tax liability.” Under Section 7121 of the Internal Revenue Code, the  
28 IRS is authorized to enter into a closing agreement regarding the tax liability of any person which, when

1 approved, is final and conclusive. (*Gen. Split Corp. v. United States* (7th Cir. 1974) 500 F.2d 998, 1000-  
2 01.)

### 3 Accuracy-Related Penalty

4 R&TC section 19164 provides for an accuracy-related penalty determined in accordance  
5 with IRC section 6662. R&TC section 19164, which incorporates the provisions of Internal Revenue  
6 Code (IRC) section 6662, provides for an accuracy-related penalty of 20 percent of the applicable  
7 underpayment. The penalty applies to the portion of the underpayment attributable to negligence or  
8 disregard of rules and regulations or to any substantial understatement of income tax. (Int.Rev. Code,  
9 § 6662(b).) The IRC defines “negligence” to include “any failure to make a reasonable attempt to  
10 comply” with the provisions of the code. (Int. Rev. Code, § 6662(c).) The term “disregard” is defined  
11 to include any “careless, reckless, or intentional disregard.” (Ibid.) There is a “substantial  
12 understatement of income tax” when the amount of the understatement for a taxable year exceeds the  
13 greater of ten percent of the tax required to be shown on the return, or \$5,000. (Int. Rev. Code,  
14 § 6662(d)(1).) Respondent’s imposition of a penalty for negligence is presumed correct. (*Appeal of*  
15 *Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.) An accuracy-related penalty shall not be  
16 imposed as to any portion of an underpayment as to which appellants show there is reasonable cause and  
17 they acted in good faith. (Rev. & Tax. Code, § 19164, subd. (d); Int.Rev. Code, § 6664(c)(1); Cal. Code  
18 Regs., tit. 18, § 19164, subd. (a).)

### 19 STAFF COMMENTS

20 Appellants contend that the Closing Agreement does not constitute a final federal  
21 determination for purposes of R&TC section 19752, subdivision (b)(5)(A)(ii) because their 2001 tax  
22 liability was not “adjusted” by the IRS. However, the Appeals Division notes that the provisions cited  
23 by appellants state the federal determination is “an irrevocable determination or adjustment” (Cal. Code  
24 Regs., § 19059, subd. (d)) and an “adjustment or resolution” resulting from an IRS examination of a  
25 taxpayer’s federal tax liability. (Rev. & Tax. Code, § 18622, subd. (d).) Thus, the type of action that  
26 results in a final determination is described in the disjunctive as *either* an adjustment *or* a determination  
27 or resolution. Here, appellants filed an amended 2001 federal return that was subsequently the subject  
28 of an IRS examination and the results of that examination were set forth in the “Closing Agreement on

1 Final Determination Covering Specific Matters, Form 906”. In the view of the Appeals Division, and as  
2 the name of the form suggests, it appears that the Closing Agreement is the final federal determination  
3 for purposes of California tax law regardless of whether appellants filed an amended return that was  
4 accepted by the IRS upon examination.

5 It thus appears that the closing agreement, which appears to be the final federal  
6 determination for 2001, became “final for the same issue” – the loss transaction – that triggered the  
7 accuracy-related penalty at issue here as required by R&TC section 19752, subdivision (b)(5). The  
8 Closing Agreement in paragraph b describes the foreign currency options contracts as the transaction for  
9 which appellants conceded all tax benefits as the subject of the agreement.

10 At the hearing, appellants should be prepared to cite any legal authority to support their  
11 interpretation of a final federal determination.

12 With respect to appellants’ position as to the purpose of the accuracy-related penalty,  
13 staff notes that there are only two conditions for when the penalty (which shall be imposed), may be  
14 assessed pursuant to R&TC section 19752, subdivision (b)(5)(A): (1) respondent takes action on the  
15 claim for refund; (2) a federal determination becomes final for the same issue and the penalty was  
16 assessed at the federal level. There is no language to indicate that the penalty is appropriately imposed  
17 only if the taxpayer contests the treatment of the underlying transaction that gave rise to the penalty. At  
18 the hearing, appellants should provide any information such as legislative history to support their  
19 interpretation.

20 **Issue 2: Whether the penalty under R&TC section 19752, subdivision (b)(5) should be imposed**  
21 **pursuant to deficiency procedures or by a Notice of State Income Tax Due used by**  
22 **respondent to assess the accuracy-related penalty.**

23 Contentions

24 Appellants’ Contentions

25 Appellants contend that respondent did not assess the accuracy-related penalty within the  
26 applicable limitations period. Appellants take the position that respondent was required to provide  
27 notice of the penalty under the deficiency assessment provisions of the R&TC, which provide for a  
28 general four-year statute of limitations under R&TC sections 19036 and 19057. Appellants assert that

1 under the four-year limitations period, the last day on which to issue a timely notice was March 29,  
2 2008, and that respondent's notice was dated June 10, 2008. (App. Open. Br., p. 10.)

3 Appellants also assert that the statutory exceptions extending the foregoing four-year  
4 limitations period are not applicable. Appellants state that the four-year limitations period is extended  
5 by R&TC section 19059 and 19060 under the following circumstances: If there is a federal  
6 determination for the same tax year which the taxpayer is required to report to respondent, then  
7 respondent may issue a notice of proposed deficiency within two years after the taxpayer reports it or if  
8 the taxpayer fails to report it, then respondent may issue the notice of proposed deficiency at any time.  
9 However, appellants contend that they were not required to report the federal adjustments described in  
10 the Closing Agreement because appellants filed a California 2001 amended return prior to the federal  
11 examination and the execution of the Closing Agreement and the Closing Agreement did not increase  
12 the amount of tax payable by appellants. In addition, appellants contend that the limitations period may  
13 be extended for six months under R&TC section 19065 if a taxpayer agrees to a waiver of the federal  
14 statute of limitations. In this case, appellants executed a waiver until October 31, 2007, so the extended  
15 limitations period expired on March 30, 2008<sup>4</sup>, and respondent notice dated June 10, 2008, was  
16 untimely. (App. Open. Br., pp. 10-11.)

17 Appellants dispute respondent's position that the deficiency assessment provisions are  
18 not applicable here. Appellants point to R&TC section 19752, subdivision (b)(5)(A)(ii) which provides  
19 that an accuracy-related penalty "shall be assessed" as evidence that the Legislature intended that  
20 respondent must "assess" the penalty pursuant to the deficiency assessment procedures. Appellants  
21 contend that if the Legislature had not intended that respondent comply with the deficiency assessment  
22 procedures, R&TC section 19752 would have included express language to that effect similar to R&TC  
23 section 19777.5. Appellants also point to the language of R&TC section 19752, subdivision (b)(5)(A)(i)  
24 which provides that "the penalty is due and payable upon notice and demand pursuant to Section  
25 19049." Pursuant to R&TC section 19049, appellants contend, the VCI penalty is not due and payable  
26 until a "deficiency is determined and the assessment becomes final." Therefore, appellants contend that  
27

28 <sup>4</sup>It appears the six months would have expired on April 30, 2008; this appears to have no impact on appellants' contention.

1 respondent may not collect an accuracy-related penalty without making such an assessment. (App.  
2 Reply Br., pp. 7-8.)

3 Appellants take issue with respondent's argument that the late filing and late payment  
4 penalty provisions of R&TC sections 19131 and 19132 support respondent's position that the accuracy-  
5 related penalty may be assessed at any time. In addition to respondent's failure to cite any supporting  
6 authority, appellants point out that those sections do not provide that those penalties are "due and  
7 payable upon notice and demand pursuant to Section 19049." Therefore, appellants assert, even if the  
8 late filing and late payment penalties could be imposed without following the deficiency assessment  
9 procedures, those provisions are clearly distinguishable from R&TC section 19752.

10 Appellants also contend that respondent misconstrues R&TC section 19752, subdivision  
11 (b)(5)(C) to mean that the Legislature intended to bar any prepayment challenge of the VCI penalty and,  
12 consequently, that the deficiency assessment procedures would not apply. Appellants contend that  
13 subdivision (b)(5)(C) only provides that a taxpayer may not appeal the imposition of the penalty to this  
14 Board unless the taxpayer first pays the tax and files a claim for refund. However, appellants contend  
15 that provision does not bar a taxpayer from protesting a proposed assessment of the penalty and it does  
16 not state that the normal limitations period for making an assessment does not apply. (App. Reply Br., p.  
17 8.)

18 Appellants also reject respondent's statement that appellants' position leads to the absurd  
19 result that a taxpayer would have prepayment protest rights but would also be required to pay the  
20 penalty amount and file a refund claim in order to appeal to this board. Appellants contends that a  
21 prepayment protest right is not at issue here because appellants paid the penalty. Appellants argue that  
22 the statutory scheme allows a taxpayer to protest the penalty but if the taxpayer is unsuccessful, he or  
23 she may still appeal to this Board after paying the penalty and filing a refund claim. Appellants claim  
24 that such a procedure is common in California law. (App. Reply Br., p. 9.)

25 Finally, appellants request that this Board reject respondent's position based on the  
26 general rule of statutory construction that penalty provisions must be strictly construed. (App. Open. Br.,  
27 pp. 11-12.)

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1                   Respondent’s Contentions

2                   Respondent argues that there are two ways in which tax and other amounts become final  
3 liabilities. After tax and other amounts that constitute “deficiencies” under R&TC section 19041  
4 become final under the deficiency assessment provisions, R&TC section 19049 provides the method for  
5 issuing a notice and demand to the taxpayer which becomes payable at the expiration of 15 days from  
6 the date of that notice and demand. When tax and other amounts that are not “deficiencies” within the  
7 meaning of R&TC section 19041 become final liabilities, respondent states, such amounts are  
8 “immediately due and payable” and assessed by notice and demand. Respondent notes the late filing  
9 and late payment penalties under R&TC sections 19131 and 19132, respectively, as two examples of  
10 penalties that are immediately due and payable. Respondent states that these penalties are not assessed  
11 as a proposed deficiency assessment for that reason. (Resp. Open. Br., pp. 8-9.)

12                   Respondent explains that taxpayers who participated in the VCI program self-assessed  
13 additional tax and interest and the accuracy-related penalty was calculated based on that self-assessed  
14 amount. Like the late filing and late payment penalties, respondent asserts, the VCI Option 2 accuracy-  
15 related penalty was intended to be issued on a bill, immediately payable upon notice and demand under  
16 R&TC section 19049. Because the accuracy-related penalty is not assessed as a deficiency under R&TC  
17 section 19057, respondent argues that appellants’ claim that the notice and demand was untimely has no  
18 merit. (Resp. Open. Br, p. 9.)

19                   Respondent also disagrees with appellants that the use of the word “assessed” in R&TC  
20 section 19752, subdivision (b)(5), indicates that the Legislature intended to require that respondent  
21 follow the deficiency assessment procedures in the imposition of the accuracy-related penalty. If that  
22 had been the Legislature’s intention, respondent argues, R&TC section 19752 would have referenced  
23 R&TC section 19033 or 19036 rather than R&TC section 19049. Even though R&TC section 19752  
24 does not expressly provide that the deficiency assessment procedures are not applicable as does R&TC  
25 section 19777.5, respondent notes that section 19752 does expressly provide that a taxpayer may seek  
26 relief from the penalty only by first making payment and filing a claim for refund. Based on that  
27 limitation, respondent contends that the Legislature could not have intended the penalty to be imposed  
28 by the deficiency assessment procedures which allow for prepayment protest. Thus, respondent

1 concludes that appellants' position directly conflicts with R&TC section 19752, subdivision (b)(5) and  
2 leads to an absurd result in violation of fundamental rules of statutory construction. (Resp. Open. Br.,  
3 pp. 9-10.)

#### 4 Applicable Law

5 For a taxpayer who elects Option 2 of the VCI program, R&TC section 19752,  
6 subdivision (b)(5) provides, in part, that a taxpayer shall be subject to the accuracy-related penalty under  
7 Section 19164 and that "[t]he penalty may be assessed" when specified conditions occur. R&TC section  
8 19752, subdivision (b)(5)(C) further provides that the accuracy-related penalty "is due and payable upon  
9 notice and demand pursuant to Section 19049. Only after the taxpayer has paid all amounts due,  
10 including the penalty, and the claim is denied in whole or in part, may the taxpayer file an appeal under  
11 Chapter 6 (commencing with Section 19301), of this part in conjunction with the appeal filed under  
12 paragraph (4)."

13 R&TC section 19049, subdivision (a) provides that "[w]hen a deficiency is determined  
14 and the assessment becomes final, the Franchise Tax Board shall mail notice and demand to the taxpayer  
15 for the payment thereof. The deficiency assessed is due and payable at the expiration of 15 days from  
16 the date of the notice and demand."

#### 17 STAFF COMMENTS

18 Here, the parties dispute the meaning of the term "assessed" under subparagraph (A) of  
19 subdivision (b)(5) of R&TC section 19752 and the meaning of the phrase "due and payable upon notice  
20 and demand pursuant to Section 19049." Appellants contend that the use of that language is a reference  
21 to the deficiency assessment procedures. Respondent contends that the language should not be given  
22 such a narrow interpretation that, in this case, leads to an absurd result.

23 In order to determine the Legislature's intent so as "to effectuate the purpose of the law",  
24 one must "first look to the words of the statute themselves, giving to the language its usual, ordinary  
25 import and according significance, if possible, to every word, phrase and sentence". In doing so, the  
26 language "must be construed in context, keeping in mind the statutory purpose, and statutes or statutory  
27 sections relating to the same subject must be harmonized, both internally and with each other, to the  
28 extent possible. Where uncertainty exists consideration should be given to the consequences that will

1 flow from a particular interpretation.” (*Dyna-Med, Inc. v. Fair Employment & Housing Com.* (1987) 43  
2 Cal.3d 1379, 1386-87.)

3           The word “assess” is defined as “to impose an amount”. (*Webster’s New World*  
4 *Dictionary*, 3rd College Edition, p.82 (1991).) In addition to the deficiency assessment provisions under  
5 R&TC sections 19031 through 19067, the word “assess”, or some variant thereof, is used in the jeopardy  
6 assessment provisions under R&TC section 19081 through 19093, the interest provisions under R&TC  
7 section 19101 through 19120 (e.g., Rev. & Tax. Code, §§19101, subd.(c)(1) & (c)(2)), 19104, subd. (c)  
8 and 19105), and the provisions for penalties and additions to tax under R&TC section 19131 through  
9 19187 (e.g. Rev. & Tax. Code, § 19132, subd. (b).) In view of its relatively common use, it appears the  
10 Legislature did not intend to limit the use of the word “assess” (or other variants of that word) to apply  
11 only to procedures related to deficiency assessments. Thus, it is conceivable that the Legislature would  
12 not have considered it necessary to include an express provision in R&TC section 19752, subdivision  
13 (b)(5) that the deficiency assessment procedures are not applicable.

14           The Appeals Division also notes that R&TC section 19049 appears to be incorporated by  
15 reference specifically with respect to when the penalty “is due and payable” and not as the statutory  
16 trigger for assessment of the penalty as appellants suggest. That is, the assessment of the penalty is  
17 prescribed by R&TC section 19752, subdivision (b) as one consequence of electing VCI Option 2, and  
18 not when “a deficiency is determined and the assessment becomes final” under R&TC section 19049.  
19 At the hearing, the parties should be prepared to discuss whether the statutory purpose of subparagraph  
20 (b)(5)(C) of R&TC section 19752 is to prescribe the procedure for imposing the penalty or to prescribe  
21 the due date for payment and the method by which the taxpayer may seek relief.

22           According to respondent, appellants’ interpretation of R&TC section 19752, subdivision  
23 (b)(5), is inconsistent because the deficiency assessment procedures allows for prepayment protest and  
24 appeal while the VCI program does not so provide. At the hearing, appellants should be prepared to  
25 explain how their interpretation complies with the rule of statutory construction that “statutes or  
26 statutory sections relating to the same subject must be harmonized, both internally and with each other,  
27 to the extent possible.” (*Dyna-Med, Inc. v. Fair Employment & Housing Com., supra.*)

28 **Issue 3: Whether this Board has authority to hear and decide appellants’ request for attorney’s**

1 **fees pursuant to R&TC section 19717.**

2 Contentions

3 Appellants' Contentions

4 Appellants request reasonable attorney's fees pursuant to R&TC section 19717 on the  
5 ground that respondent's position is not "substantially justified". Appellants contend that respondent's  
6 position is directly contradicted by statutory and regulatory provisions and that respondent does not  
7 provide any supporting legal authority.

8 Respondent's Contentions

9 Respondent contends that R&TC section 19717 allows for reimbursement of attorney's  
10 fees incurred in civil court proceedings and because this matter is the subject of an administrative  
11 proceeding, appellants' claim is premature. In addition, respondent states that it is premature to seek  
12 attorney's fees reimbursement under R&TC section 21013, which allows for reimbursement of fees and  
13 expenses for an appeal before this Board, because such a request may be made only after a decision on  
14 the appeal has become final.

15 Applicable Law

16 R&TC section 19717 generally provides that the prevailing party in "a civil proceeding  
17 brought by or against the State of California in a court of record" in connection with a state franchise or  
18 income tax matter may be awarded a court judgment for reasonable litigation costs incurred. Under  
19 R&TC section 21013, every taxpayer is entitled to be reimbursed for any reasonable fees and expenses  
20 related to an appeal before the State Board of Equalization under specified conditions. The Rules for  
21 Tax Appeals (RTA), section 5603, subdivision (b) (Cal. Code Regs., § 5603, subd. (b)), provides that the  
22 claim form must be filed within one year after the decision of the Board become final. Subdivision (c) of  
23 RTA section 5603 provides that a claim is ineligible and must be dismissed "when the Board previously  
24 disposed of the case at hearing without granting the petition for redetermination or claim for refund."

25 STAFF COMMENTS

26 Because this appeal is the subject of an administrative proceeding, rather than a civil  
27 court proceeding, R&TC section 19717 does not appear to be applicable for the relief that appellants  
28 seek. With respect to R&TC section 21013, RTA section 5603, subdivisions (b) and (c), indicate that a

1 claim for reasonable attorney's fees may be made only after a decision on the appeal has become final.  
2 At the hearing, appellants should be prepared to discuss why their claim for attorney's fees is not  
3 premature pursuant to RTA section 5603.

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