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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**
9

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **JUDITH RICH**¹) Case No. 505587
13

	<u>Years</u>	<u>Proposed Assessments</u> ²
14	2002	\$1,722.19
15	2003	\$240.27
16	2004	\$290.36

17
18 Representing the Parties:

19 For Appellant: Noel Benton, TAAP³

20 For Franchise Tax Board: Anne Mazur, Specialist
21

22 **QUESTIONS:** (1) Whether appellant has shown the accuracy-related penalties should be abated.
23 (2) Whether this Board has jurisdiction to consider the post-amnesty penalty.
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25 ¹ Appellant resides in El Cerrito, California.

26 ² These amounts consist of accuracy-related penalties in the following amounts: \$1,472.40 for 2002, \$240.27 for 2003, and
27 \$290.36 for 2004. There is also a \$249.79 post-amnesty penalty proposed for 2002. Respondent has stated it will reduce the
accuracy-related penalty for 2002 to \$677.30. (Resp. Op. Br., p. 1, fn. 1.)

28 ³ Appellant filed an appeal letter on her own behalf. Mr. Benton, from the Tax Appeals Assistance Program (TAAP),
submitted appellant's reply brief.

1 HEARING SUMMARY

2 Background

3 Appellant timely filed California income tax returns for 2002, 2003, and 2004. Appellant
4 reported a 2002 taxable income amount of zero and a tax liability of zero. Appellant indicated that she
5 wanted the resulting overpayment of \$1,050 applied to her 2003 estimated tax. (Resp. Op. Br., exhibit
6 A.) Appellant's 2003 tax return reported taxable income of \$66,445, a total tax liability of \$4,177,
7 payments of \$6,050, and a resulting overpayment of \$1,873 which appellant requested be applied to her
8 2004 estimated tax. (*Id.* at exhibit B.) Appellant's 2004 tax return reported a taxable income of \$4,964,
9 a total tax liability of zero, and an overpayment of \$2,873. Appellant requested \$2,673 to be refunded to
10 her and \$200 to be applied to her 2005 estimated tax. (*Id.* at exhibit C.)

11 Subsequently, based on information respondent received from the Internal Revenue
12 Service (IRS), respondent issued Notices of Proposed Assessment (NPAs) on March 23, 2009, for each
13 of the three years at issue. (Appeal Letter, exhibits.) The 2002 NPA revised appellant's taxable income
14 to \$60,557.00, and proposed additional tax of \$3,681.00, an accuracy-related penalty of \$1,472.40, an
15 estimated post-amnesty penalty of \$249.79, and applicable interest. The 2003 NPA revised appellant's
16 taxable income to \$132,647.00, and proposed additional tax of \$6,167.00, an accuracy-related penalty of
17 \$1,233.40, and applicable interest. The 2004 NPA revised appellant's taxable income to \$42,533.00,
18 and proposed additional tax of \$1,892.00, an accuracy-related penalty of \$378.40, and applicable
19 interest.

20 Appellant timely protested the NPAs by letter on April 15, 2009. (Resp. Op. Br., exhibit
21 D.) Appellant did not contest the additional tax due, but requested respondent reduce the accuracy-
22 related penalties in the same manner as the IRS. Appellant provided a copy of the IRS appeals officer's
23 report, showing that the IRS reduced the penalties by 54 percent, 81 percent, and 23 percent for 2002,
24 2003, and 2004, respectively. (*Id.* at exhibit E.)

25 Respondent issued a letter acknowledging the protest on June 5, 2009. Respondent
26 indicated it would revise the accuracy-related penalties for 2003 and 2004 based on the IRS adjustments,
27 but that the accuracy-related penalty for the 2002 year was computed at a rate of 40 percent because it
28 was a year for which amnesty was available but appellant did not participate, and that it would not be

1 revised. (Resp. Op. Br., exhibit F.) Appellant replied by letter, requesting further explanation regarding
2 the 2002 accuracy-related penalty, and again requesting that the penalty be revised in accordance with
3 the IRS settlement. (Resp. Op. Br., exhibit G.)

4 Respondent issued Notices of Action (NOAs) for each of the three years on July 9, 2009.
5 The NOAs affirmed the 2002 NPA, reduced the accuracy-related penalty for 2003 to \$240.27, and
6 reduced the 2004 accuracy-related penalty to \$290.36. (Appeal Letter, exhibits.) This timely appeal
7 followed.

8 Contentions

9 Appellant asserts that for each year at issue she had her tax returns prepared and she
10 relied on her tax preparer to apply the proper deductions pursuant to her business structure.⁴ (App.
11 Reply Br., p. 1.) Appellant contends that the accuracy-related penalties should be abated based on her
12 reasonable reliance on tax professionals. (*Id.* at p. 2.) Appellants states respondent conceded in its brief
13 that she was "likely reasonable in her reliance on the organizational business structure that her tax
14 professionals created for her," but subsequently decided it was not reasonable.⁵ (*Ibid.*) Appellant states
15 she has no experience in tax law or accounting, and that courts have held even intelligent investors hire
16 independent, educated experts to advise them. (*Id.* at pp. 2-3; citing *Mauerman v. Commissioner* (1994)
17 22 F.3d 1001 (*Mauerman*.) Appellant contends respondent recognizes that the organizational structure
18 that appellant relied on was not "obviously unreasonable", and appellant should not be expected to know
19 that the resulting tax benefits from this complex structure were unreasonable. (App. Reply Br., p. 3.)

20 Appellant contends the post-amnesty penalty should not be applied because it is an
21 unconstitutional retroactive levy. Appellant notes that she puts forth this contention in order to preserve
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24 ⁴ Appellant asserts one of the tax professionals she entrusted to complete her tax returns was a certified public accountant,
25 and the other was a tax attorney. (App. Reply Br., p. 2.) The exhibit provided by appellant lists one of the two professionals
as being a certified financial planner. (*Id.* at exhibit A, p. 1)

26 ⁵ Staff does not see this concession in respondent's brief; appellant should clarify her contentions in this regard. It appears
27 appellant may have attempted to paraphrase the following statements in respondent's brief: "Respondent agrees that it is not
28 only reasonable, but prudent, to seek the advice of professionals for business organization and tax planning. However, in this
case it appears that appellant should have known, not necessarily that there was a problem with the organizational structure,
but that the deduction of personal living expenses therein was contrary to the law. It is therefore not reasonable for appellant
to have relied on professionals to claim personal expenses as deductions that are commonly understood by reasonably
educated laypeople not to be deductible." (See ROB, p.5, para. 4.)

1 her appeal rights, and concedes the Board lacks jurisdiction to determine whether the post-amnesty
2 penalty is constitutional.

3 Respondent notes that the IRS imposed the accuracy-related penalties in regard to
4 appellant's federal returns for the years at issue based on negligence, and that respondent followed the
5 federal action. (Resp. Op. Br., p. 3.) Respondent followed the IRS action in reducing the penalty
6 amounts for the 2003 and 2004 years, as described above. On appeal, respondent also concedes that it
7 will reduce the 2002 accuracy-related penalty from \$1,472.40 down to \$677.30. (*Id.* at p. 4.)
8 Respondent contends the Board does not have jurisdiction over the estimated post-amnesty penalty. (*Id.*
9 at pp. 6-7.)

10 Respondent contends the accuracy-related penalties can not be abated in this appeal based
11 on appellant's claim of reasonable reliance on tax preparers. Respondent asserts appellant should have
12 known the deduction of personal living expenses is contrary to law, and therefore it is not reasonable for
13 her to rely on professionals to claim personal expenses as deductions when they are "commonly
14 understood by reasonably educated laypeople not to be deductible." (Resp. Op. Br., p. 5, emphasis in
15 original.) Respondent notes that the IRS appeals officer report shows appellant deducted virtually all
16 her personal living expenses as business deductions for the three years at issue, including home
17 landscaping, groceries, personal travel, and other similar expenses. (*Id.* at p. 5 & exhibit E, p. 4.)
18 Respondent notes that appellant has a Ph.D. in psychology and works with business executives and other
19 professionals, giving her a higher level of education, sophistication, and experience as a businesswoman.
20 (*Id.* at pp. 5-6 & exhibit I.) Therefore, respondent contends, the facts and circumstances of appellant,
21 viewed as directed by Treasury Regulation section 1.6664-4(c)(1), show it is not reasonable for her to
22 rely on tax advisors to deduct personal expenses, which appellant should know are not deductible
23 business expenses, even if she is not sophisticated in tax matters. (Resp. Op. Br., p. 6.) Respondent
24 asserts that appellant's negligence, defined under the appropriate Treasury Regulations below, prevents
25 her from claiming reasonable reliance and the penalties are therefore appropriately applied.

26 Applicable Law

27 Accuracy-Related Penalty

28 Revenue and Taxation Code (R&TC) section 19164 provides for an accuracy-related

1 penalty determined in accordance with Internal Revenue Code (IRC) section 6662. R&TC section
2 19164, which incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty
3 of 20 percent of the applicable underpayment. The penalty applies to the portion of the underpayment
4 attributable to negligence or disregard of rules and regulations or to any substantial understatement of
5 income tax. (Int.Rev. Code, § 6662(b).) The IRC defines “negligence” to include “any failure to make
6 a reasonable attempt to comply” with the provisions of the code. (Int.Rev. Code, § 6662(c).) The term
7 “disregard” is defined to include any “careless, reckless, or intentional disregard.” (*Ibid.*) There is a
8 “substantial understatement of income tax” when the amount of the understatement for a taxable year
9 exceeds the greater of ten percent of the tax required to be shown on the return, or \$5,000. (Int.Rev.
10 Code, § 6662(d)(1).) Respondent’s imposition of a penalty for negligence is presumed correct. (*Appeal*
11 *of Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.)

12 An accuracy-related penalty shall not be imposed as to any portion of an underpayment
13 as to which appellants show there is reasonable cause and they acted in good faith. (Rev. & Tax. Code,
14 § 19164, subd. (d); Int.Rev. Code, § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164, subd. (a).) Treasury
15 Regulation 1.6664-4(b)(1) provides in relevant part that:

16 The determination of whether a taxpayer acted with reasonable cause and in good faith is
17 made on a case-by-case basis, taking into account all pertinent facts and circumstances.
18 Generally, the most important factor is the extent of the taxpayer’s effort to assess the
19 taxpayer’s proper tax liability. Circumstances that may indicate reasonable cause and
20 good faith include an honest misunderstanding of fact or law that is reasonable in light of
21 all of the facts and circumstances, including the experience, knowledge, and education of
22 the taxpayer.

23 With respect to an underpayment attributable to reliance by the taxpayer on professional
24 advice, Treasury Regulation 1.6664-4(c)(1)(ii) provides the advice must not be based on unreasonable
25 factual or legal assumptions (including assumptions regarding future events) and must not unreasonably
26 rely on the representations, statements, findings, or agreements of the taxpayer or any other person.

27 That provision further states, as an example, the advice must not be based on a representation or
28 assumption that the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate
representation or assumption regarding the taxpayer’s purposes for entering into a transaction or for
structuring a transaction in a particular manner.

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1 Post-Amnesty Penalty

2 California imposes a post-amnesty penalty under R&TC section 19777.5, subdivision
3 (a)(2), for any underpayment of an eligible tax year beginning before January 1, 2003, that became final
4 after the end of the amnesty period (March 31, 2005).⁶ The amnesty provisions give respondent no
5 discretion to determine whether the amnesty penalty should be imposed and provide no exceptions for
6 taxpayers who may have acted in good faith or had reasonable cause for failing to participate in the
7 amnesty program. In addition, the amnesty provisions strictly limit the Board's ability to review
8 respondent's imposition of the amnesty penalty.

9 This Board's jurisdiction to review the amnesty penalty is limited. For example, a
10 taxpayer has no right to an administrative protest or appeal of an unpaid amnesty penalty. (*Id.* subd.
11 (d).) A taxpayer also has no right to file an administrative claim for refund of a paid amnesty penalty,
12 except upon the basis that the penalty was not properly computed. (*Id.* subd. (e).) Therefore, the
13 Board's jurisdiction to review the amnesty penalty is limited to situations where the penalty is assessed
14 and paid, the taxpayer files a timely appeal from a denial of a refund claim, and the taxpayer attempts to
15 show a computational error in the penalty.

16 STAFF COMMENTS

17 Respondent on appeal concedes a reduction in the 2002 accuracy-related penalty amount
18 from \$1,472.40 down to \$677.30, in accordance with the IRS reduction to the penalty for this year.

19 Accuracy-Related Penalty

20 The parties dispute whether the accuracy-related penalties should be abated on a basis of
21 reasonable reliance by appellant on her tax preparers. Both parties cite to the relevant R&TC, IRC, and
22 Treasury Regulation sections, and do not appear to argue the applicable law. Treasury Regulation
23 1.6664-4 notes that when determining whether an appellant has reasonably relied in good faith on advice
24 to establish reasonable cause for the abatement of an accuracy-related penalty, all facts and
25 circumstances must be taken into account. The regulation notes that "[g]enerally, the most important
26 factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability," and
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28 _____
⁶ The amount of the penalty is 50 percent of the interest on the tax underpayment from the original due date of the tax to the end of the amnesty period.

1 "[c]ircumstances that may indicate reasonable cause and good faith include an honest misunderstanding
2 of fact or law that is reasonable in light of all of the facts and circumstances, including the experience,
3 knowledge, and education of the taxpayer." (Treas. Reg., § 1.6664-4(b)(1).)

4 Appellant admittedly is highly educated and has had business professionals as her clients,
5 but states she has no experience in tax law or accounting. The parties should be prepared to discuss how
6 appellant's experience, knowledge, and education affect her ability to claim reasonable reliance in this
7 situation, and whether it is reasonable to rely on tax preparers that deduct virtually all of her personal
8 expenses as business deductions. Board staff notes that the taxpayer in *Mauerman* (in which the
9 accuracy related penalty was abated) was a doctor without legal, tax, or insurance experience; his
10 underpayment arose from deductions for payments he made to Pre-Paid Legal services to participate in
11 their reinsurance program (which payments should have been capitalized.) Mauerman relied on advice
12 from his attorneys. That advice pertained to a timing difference; i.e., whether the payments were
13 currently deductible (instead of amortized). The parties should discuss whether Mauerman is
14 distinguishable based on the type of advice sought (the timing/treatment of reinsurance program
15 payments versus the deductibility of personal living expenses) and the qualifications of appellant's tax
16 preparer. The parties should also be prepared to discuss any possible negligence that would contradict a
17 claim of reasonable reliance, including what steps appellant took to make a reasonable attempt to
18 ascertain the correctness of her returns prior to filing, including reviewing any deductions that would
19 seem to a reasonable and prudent person to be too good to be true under the circumstances. (See Treas.
20 Reg., § 4.6662-3(b).)

21 Post-Amnesty Penalty

22 It does not appear this appeal meets the criteria for the Board to consider the post-
23 amnesty penalty; the penalty is not yet assessed or paid, further, there is no claim for refund here
24 asserting a computational error in the penalty.

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