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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

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10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **CORPORATION FRANCHISE TAX APPEAL**
12 **SITE MANAGEMENT SERVICES, INC.**) Case No. 713613

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	<u>Year</u>	<u>Proposed</u>
	08/31/2003 ²	<u>Assessment</u> ¹
		\$22,633

15
16 Representing the Parties:

17 For Appellant: Ronald A. Mollis, Attorney at Law

18 For Franchise Tax Board: Anne Mazur, Specialist

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20 **QUESTION:** Whether appellant has shown that the determination by the Franchise Tax Board
21 (respondent or the FTB) to impose an accuracy-related penalty based on a federal
22 audit report is incorrect.

23 **HEARING SUMMARY**

24 Background

25 Appellant, a C corporation, filed a late California tax return for the tax year ending
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27 ¹ The assessed amount of \$22,633 represents an accuracy-related penalty imposed by respondent.

28 ² Respondent states that the length of time between the appeal year and the filing of the appeal in this matter is attributable to a federal audit and a federal administrative appeal. (Resp. Op. Br., p. 1, fn. 1.)

1 August 31, 2003 (2003), on July 6, 2004. The return showed total tax of \$800. Appellant filed an
2 amended return on October 15, 2004, which showed a revised total tax of \$2,898. (Resp. Op. Br., p. 1.)

3 On December 27, 2010, appellant filed a second amended return on which it reported
4 federal adjustments of \$1,280,178, along with other adjustments, such as a self-assessed estimated tax
5 penalty adjustment of \$3,445, additional tax of \$113,167, and an amount due of \$174,892, which was
6 remitted with the return. Attached to the second amended return was a federal audit report (Internal
7 Revenue Service (IRS) Form 5278 (Statement-Income Tax Changes)) showing an adjustment described
8 as "Other Deductions-Defined Benefit Pension Plan" amount of \$1,280,178.00, a balance due exclusive
9 of interest and penalties of \$441,282.00, and a federal accuracy-related penalty of \$88,256.40. On
10 May 13, 2011, respondent mailed to appellant an Amended Return Bill, which imposed a late filing
11 penalty of \$28,541.25 and a post-amnesty penalty of \$4,509.72.³ (Resp. Op. Br., 1-2, Exh. A; Appeal
12 Letter, Atths.)

13 In a Notice of Proposed Assessment (NPA) dated June 1, 2011, respondent proposed the
14 assessment of an accuracy-related penalty of \$22,633. The NPA stated that "[a] twenty percent
15 accuracy-related penalty has been imposed on the portion of any underpayment attributed to one or more
16 of the following: (1) negligence or disregard of rules or regulations, (2) substantial understatement of
17 income tax, (3) substantial valuation overstatement or (4) overstatement of pension liabilities."
18 Furthermore, the NPA states that "[t]he above penalty is based on the additional tax of \$113,167
19 reported on the amended return filed to report the federal audit adjustments." (Resp. Op. Br., 1-2; App.
20 Op. Br, Atths.)

21 In a protest letter dated July 25, 2011, appellant argued that the accuracy-related penalty
22 should be waived for reasonable cause because it had relied upon the opinion of a tax attorney, that the
23 deduction taken on its original return for a retirement plan, that it had adopted under Internal Revenue

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27 ³ Respondent states that appellant's account shows a post-amnesty penalty of \$4,768.72. Respondent also states that
28 appellant's account shows an estimated tax penalty of \$27.99, rather than an estimated tax penalty of \$3,445.00 that appellant
self-assessed on the amended return of December 27, 2010. Respondent states that neither the post-amnesty penalty nor the
estimated tax penalty are at issue in this appeal. (Resp. Op. Br., p. 2, fn. 5.)

1 Code (IRC) section 412(i)⁴ (the 412(i) Plan), was proper. Appellant attached a copy of a memo (the
2 Memo) from the attorney.⁵ In a Notice of Action (NOA) dated January 4, 2013, respondent affirmed its
3 NPA on the basis that the information appellant provided does not establish that its assessment is
4 incorrect. Respondent indicated in the NOA that it based its NPA on information received from the IRS.
5 This timely appeal followed. (Resp. Op. Br., p. 2, Exh. B; App. Op. Br, Atths.)

6 Contentions

7 Appellant's Opening Brief

8 Appellant contends that the accuracy-related penalty should be abated due to reasonable
9 cause. Appellant states that its original return for 2003 included a deduction for a 412(i) retirement plan
10 but that, after filing the return, it converted the 412(i) Plan into a standard defined benefit plan.

11 Appellant states that the IRS audited its 2003 federal return and determined that the deduction related to
12 the 412(i) Plan was improper. Appellant alleges that, as part of its settlement with the IRS, it agreed to
13 remove the deduction from its 2003 federal return and to pay any tax and interest due. Appellant alleges
14 that, once the settlement was reached, it filed an amended California return and paid the tax and interest
15 due, but not the penalty. (App. Op. Br., pp. 1-2.)

16 Appellant states that “[it] acknowledges the amount of tax and interest due which has
17 been paid, and is requesting the twenty percent (20%) accuracy related penalty be abated.” Appellant
18 states that, during the analysis of the proposed 412(i) Plan, it received a written opinion from a reputable
19 tax attorney stating that the Plan was proper and deductible.⁶ (App. Op. Br., p. 2, Atth.)

20 Although appellant acknowledges that R&TC section 19164 provides for a 20 percent
21 penalty for a substantial underpayment of tax, it states that there are exceptions to this penalty for
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24 ⁴ Two commentators describe plans under IRC section 412(i) as defined benefit pension plans that are funded solely with
25 level premium life insurance and annuity contracts. They state that one attraction of those plans is that they permit much
26 greater contributions to the plan than might otherwise be permitted because the insurance premiums are calculated using the
27 low interest guarantees specified in the contract. (Van Brunt and Griffin, 529 T.M., *Income Taxation of Life Insurance and*
28 *Annuity Contracts*, pp. 125-126.) Staff notes that former IRC section 412(i) was renumbered as IRC section 412(e)(3) in
2006. For ease of reference, this hearing summary will refer to IRC section 412(i) instead of IRC section (e)(3).

⁵ Respondent states that the IRS determined that appellant's 412(i) Plan was the same or substantially similar to transactions
described in IRS Revenue Ruling 2004-20, *Abusive Transactions Involving Insurance Policies in IRC 412(i) Retirement*
Plans, published on February 13, 2004.

⁶ Appellant has attached that document (the Memo) to its opening brief.

1 substantial authority, proper disclosure, and reasonable belief. Appellant emphasizes that the
2 regulations indicate that the most important factor to consider is the extent of the taxpayer's effort to
3 report the proper tax liability and whether the taxpayer acted with reasonable cause or in good faith.
4 Appellant states that an honest interpretation of fact or law is a reasonable cause/good faith exception.
5 Appellant argues that reliance on an exception is permissible if such reliance was reasonable under the
6 circumstances. Appellant alleges that it relied upon an independent tax attorney to research the validity
7 of the 412(i) Plan and to give a written recommendation as to the tax treatment. Appellant also alleges
8 that, once it received the Memo from the tax attorney and had several meetings, the decision was made
9 to proceed with the 412(i) Plan. Appellant argues that it proceeded with all due care and believed in the
10 deductibility of the 412(i) Plan, based on the professional advice received.⁷ (App. Op. Br., pp. 2-3.)

11 Respondent's Opening Brief

12 Respondent contends that the accuracy-related penalty cannot be abated because
13 appellant has not established any of the statutory defenses to waive the penalty. Respondent states that,
14 according to IRS Form 886-A (Explanation of Items) (the 886-A), the IRS assessed the accuracy-related
15 penalty under IRC section 6662 based on a substantial understatement of income tax or, in the
16 alternative, negligence or disregard of rules and regulations.⁸ Respondent states that it followed the
17 federal accuracy-related penalty of \$88,256.40 in assessing its accuracy-related penalty of \$22,633.00.
18 (Resp. Op. Br., p. 3, Exhibit C; App. Op. Br., Atth.)

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20 ⁷ The attached letter from Keith A. Rosenbaum of Spectrum Law Group, LLP addressed to appellant's former CPA is dated
21 October 28, 2010. Mr. Rosenbaum indicated that this letter was drafted in connection to the federal audit regarding
22 appellant's 412(i) Plan and discusses the activities that took place on or about December 2002 in relation to the 412(i) Plan.
23 Mr. Rosenbaum indicated that his firm was engaged to review the tax aspects of the 412(i) Plan and to provide a
24 recommendation on the adoption of the 412(i) Plan. The letter indicated that there were three Exhibits attached to the letter,
including the Memo. Mr. Rosenbaum further indicated that the Memo was intended to provide a reasonable basis for the
adoption of the 412(i) Plan. Mr. Rosenbaum indicated that, at the time the Memo was issued, Circular 230 was not yet issued
or revised to the extent of its current requirements and there was no consideration of any compliance with Circular 230.

25 The Exhibits included: Exhibit A, an email addressing certain actuarial and funding issues related to the 412(i) Plan;
26 Exhibit B, an opinion letter originally issued to AIG, addressing the AIG policy used to fund the 412(i) Plan; and Exhibit C, a
27 memorandum dated December 19, 2002, a quick summary of Spectrum Law Group's review and recommendation as to
whether to adopt the 412(i) Plan. Appellant only submitted Exhibit C. (App. Op. Br., Atths.)

28 ⁸ Respondent asserts that the threshold for a substantial understatement is met for California purposes in this case.
Respondent argues that because the understatement of \$113,167 (required tax of \$116,065 less reported tax of \$2,898)
exceeds the lesser of \$11,607 (10 percent of \$116,065) or \$10,000, there is a substantial understatement of income tax.
(Resp. Op. Br., p. 3, fn. 13.)

1 Citing Revenue and Taxation Code (R&TC) section 18622, respondent states that the law
2 requires taxpayers to concede the accuracy of the federal changes or to state where in such changes are
3 erroneous. Respondent states that if the taxpayer challenges the validity of the accuracy-related penalty,
4 it has the burden of proving that it is in error. Citing the *Appeal of Frank J. and Barbara D. Burgett*
5 (83-SBE-127), decided by the Board on June 21, 1983, and other cases, respondent asserts that the
6 Board has consistently held that respondent's determination is presumed correct when it is based upon a
7 federal audit. Respondent argues that it is also a firmly-established rule that the burden is on the
8 taxpayer to overcome the presumption of correctness that attaches to a federal determination.
9 Respondent argues that, as a result, unless a taxpayer can provide documentation to the contrary, its
10 actions are presumed correct. Citing the *Appeal of David A. and Barbara L. Beadling* (77-SBE-021),
11 decided by the Board on February 3, 1977, and other authority, respondent asserts that this rule applies
12 to a California penalty that is based on a federal audit. (Resp. Op. Br., p. 3.)

13 Respondent states that, consistent with the federal audit report, its Business Master File
14 (BMF) for 2003 indicates that a penalty of \$88,256.40 was assessed on February 15, 2011. Respondent
15 alleges that appellant is not disputing that the IRS assessed the accuracy-related penalty and also states
16 that there is no indication in its BMF that the IRS reduced or abated the penalty. Respondent asserts
17 that, because appellant has not offered any evidence that it is further appealing the IRS determination,
18 respondent's action in assessing the accuracy-related penalty is presumed correct. (Resp. Op. Br.,
19 pp. 3-4, Exh. D.)

20 Respondent argues that, unless appellant establishes the existence of a valid defense to
21 the accuracy-related penalty, the penalty was properly imposed and must not be abated. Citing IRC
22 sections 6662(d)(2)(B) and 6664(c), respondent states that, generally, an accuracy-related penalty based
23 upon a substantial understatement of income tax can be abated upon a showing of (1) substantial
24 authority or adequate disclosure with reasonable basis for the position taken or (2) reasonable cause and
25 good faith. However, respondent also states that special rules apply to a substantial understatement
26 attributable to tax shelter items of corporations. Respondent asserts that, based on the 886-A, the IRS
27 applied these rules in this matter when considering defenses to the accuracy-related penalty.
28 Respondent also asserts that, because it appears that appellant's understatement is attributable to a tax

1 shelter, special rules apply to appellant. Respondent states that, under Treasury Regulation section
2 1.6664-4(f), the determination of whether a corporation acted with reasonable cause and in good faith in
3 its treatment of a tax shelter item (as defined in Treasury Regulation section 1.6662-4(g)(3)), is based on
4 all pertinent facts and circumstances. Respondent asserts that reasonable cause must be based on a
5 “legal justification.” However, respondent states that Treasury Regulation section 1.6664-4(f) also
6 provides that the facts and circumstances other than legal justification may be taken into account as
7 appropriate, regardless of whether the minimum requirements of legal justification (as discussed below)
8 have been satisfied. (Resp. Op. Br., p. 4.)

9 Respondent states that, in order to demonstrate reasonable cause based on a “legal
10 justification,” the taxpayer must demonstrate both of the following to defend against the
11 accuracy-related penalty on tax shelter items: (1) the taxpayer must establish substantial authority for
12 the return position at the time the return was filed (as provided in Treasury Regulation section
13 1.6662-4(d)) and (2) the taxpayer must establish that it reasonably believed at the time the return was
14 filed that the tax treatment was more likely than not proper. Respondent argues that, to show a taxpayer
15 reasonably believed that the tax treatment was more likely than not the proper tax treatment, it must be
16 shown that (without taking into account the possibility that a return will not be audited, that an issue will
17 not be raised on audit, or that an issue will be settled): (1) the taxpayer analyzed the pertinent facts and
18 authorities and reasonably concluded that there was a greater than 50 percent likelihood that the tax
19 treatment would be upheld or (2) the taxpayer reasonably relied upon the opinion of a professional tax
20 advisor, if the opinion was based on the pertinent facts and authorities and “unambiguously” stated that
21 the tax advisor concluded that there was a greater than 50 percent likelihood that the tax treatment would
22 be upheld if challenged by the IRS. Respondent states, with regard to the second alternative, that all of
23 the requirements of Treasury Regulation section 6664-4(c)(1), relating to reliance on an opinion or
24 advice, must be satisfied. (Resp. Op. Br., p. 4.)

25 Respondent states that Treasury Regulation section 6664-4(c)(1) provides that all facts
26 and circumstances must be taken into account in determining whether a taxpayer has reasonably relied
27 in good faith on advice (including the opinion of a professional tax advisor) regarding the treatment of
28 the taxpayer (or any entity, plan, or arrangement) under federal law. Furthermore, respondent states that

1 the regulation also provides that the taxpayer's education, sophistication, and business experience are
2 relevant in determining whether the reliance on the opinion of the tax professional was reasonable and in
3 good faith. (Resp. Op. Br., p. 5.)

4 Respondent states Treasury Regulation section 6664-4(c)(1) also provides that such a
5 determination must include an examination of the facts and circumstances and the law relating to them,
6 including the following:

- 7 • The taxpayer's purpose for entering into the transaction must be considered.
- 8 • The taxpayer cannot have failed to disclose a fact that the taxpayer knows or
9 should have known to be relevant to the proper tax treatment of the item.
- 10 • The advice cannot be based on any unreasonable factual or legal assumptions.
- 11 • The advice cannot unreasonably rely on the representations, statements, findings,
12 or agreements of the taxpayer or any other person, including representations or
13 assumptions that the taxpayer knows or has reason to know are unlikely to be
14 true.

15 Respondent also states that a taxpayer cannot rely on an opinion or advice to show that the taxpayer
16 acted with reasonable cause and good faith unless the taxpayer adequately disclosed the position that the
17 regulation at issue is invalid, in accordance with Treasury Regulation section 1.6662-3(c)(2). (Resp. Op.
18 Br., p. 5.)

19 In addition, respondent states that if any portion of an underpayment is attributable to a
20 reportable transaction (which includes a listed transaction), the failure by the taxpayer to disclose the
21 transaction pursuant to the requirements found in Treasury Regulation section 1.6011-4 (or Treasury
22 Regulation section 1.6011-4T, as applicable) is a strong indication that the taxpayer did not act in good
23 faith to establish reasonable cause. Respondent argues that, in this matter, there is absolutely no
24 evidence to show that the IRS determined that the accuracy-related penalty should be waived on the
25 basis of the foregoing defenses, including a reasonable and good faith reliance on the advice of a tax
26 professional. (Resp. Op. Br., p. 5.)

27 Respondent asserts that appellant has not expressly raised the defense of reasonable cause
28 based on a legal justification. However, respondent states that appellant appears to make reasonable

1 cause-type arguments by asserting it “relied upon his independent tax attorney to research the validity of
2 the plan and give a written recommendation as to the tax treatment.” Respondent also states that
3 appellant asserted as well that it “proceeded with all due care and believed in the deductibility of the
4 plan, based on the professional advice received.” (Resp. Op. Br., p. 5.)

5 Respondent states that appellant provided a copy of a letter, dated October 28, 2010, from
6 the attorney who wrote the Memo to appellant’s CPA.⁹ Respondent states that the letter was apparently
7 written in response to the IRS audit. Respondent states that the attorney listed in the letter various steps
8 taken and people consulted in order to arrive at the conclusion and recommendations described in the
9 Memo.¹⁰ (Resp. Op. Br., p. 5; App. Op. Br., Atths.)

10 Respondent states that, while the attorney concluded that the 412(i) Plan should be
11 implemented, he included numerous disclaimers in the Memo. Respondent asserts, as an example, that
12 the attorney stated in the Memo: “[a]s of the date of this memorandum, we have not had an opportunity
13 to review the insurance policy illustrations, the insurance contract terms, or the provisions of the defined
14 benefit plan. Therefore, we cannot comment on the adequacy of the insurance policies or the plan
15 provisions.” Respondent states that appellant also cautioned that various unanswered issues “must be
16 addressed to Mr. Harstein and/or the plan actuary.” (Resp. Op. Br., pp. 5-6.)

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25 ⁹ Respondent notes that the letter of October 28, 2010, makes reference to a number of exhibits that were not provided with
26 the appeal. Respondent states that it is unclear whether those exhibits would have any bearing on its reasonable cause
determination but argues that their absence suggests its determination would be unfavorable.

27 ¹⁰ Respondent notes that the attorney analyzed another potential planning idea in the Memo, the Supporting Organization
28 Plan, but, in dismissing it, stated: “[t]he Supporting Organization Plan is an aggressive plan which would likely be attacked
by the [S]ervice if the transactions were ever audited.”

1 Respondent discusses Mr. Harstein further in footnote 23 of its opening brief:

2 In 1999, Kenneth Harstein and his company, Economic Concepts, Inc. designed and
3 developed what appears to be a similar 412(i) plan called the “Pendulum Plan.” This
4 plan was designed to maximize tax deductions and was funded exclusively with life
5 insurance. However, the IRS began to question such plans. During an October 28, 2002
6 conference held by the American Society of Pension Actuaries, the IRS’s chief actuary
7 addressed Section 412(i) plans and identified innovative practices that the IRS would
8 scrutinize as “abusive.” (*Drilling Consultants, Inc. v. First Montauk Sec. Corp.*, 2012
9 U.S. Dist. Lexis 114250, 4-5 (M.D. Fla. Aug. 14, 2012).) Later, the IRS issued Revenue
10 Ruling 2004-20 on February 13, 2004, that designated certain abusive 412(i) plans as
11 listed transactions.¹¹ (Resp. Op. Br., p. 6, fn. 23.)

12 Respondent argues that, as a result, it is clear appellant failed to disclose to the attorney
13 who wrote the Memo all of the information relevant to determining the validity of the proposed plan.
14 Respondent states that, as described above, Treasury Regulation section 6664-4(c)(1) prohibits a finding
15 of reasonable cause and good faith reliance when a taxpayer fails to disclose a fact that it knows or
16 reasonably should know to be relevant to the proper tax treatment of an item. Furthermore, respondent
17 states that the advice also cannot unreasonably rely on the representations, statements, findings, or
18 agreements of the taxpayer or any other person, including representations or assumptions that the
19 taxpayer knows or has reason to know is unlikely to be true. (Resp. Op. Br., p. 6.)

20 Respondent alleges that, in this matter, appellant failed to disclose the plan and policy
21 information critical to a complete analysis of the validity and tax treatment of the 412(i) Plan.

22 ¹¹ The court in *Drilling Consultants* quotes from an IRS document explaining the details of an “abusive” 412(i) plan as
23 follows:

24 An abusive Section 412(i) plan involves the employer’s contributing abnormally large and
25 tax-deductible amounts of cash to the trust, while claiming an income tax deduction for each contribution.
26 The trustee uses the cash to pay a high premium on an insurance policy. As a consequence of the
27 employer’s large cash contribution and resulting payment of the high insurance premium, the policy
28 accumulates over a few years an impermissibly large cash reserve. However, as sold, the policy carries a
high “surrender charge,” the amount forfeited in the trust pre-maturely “cashes out” of the policy. The
surrender charge disguises and suppresses the value of the policy’s cash reserve, and after five to seven
years a participant may purchase the policy from the trust for the “surrender value”-the value of the
policy’s cash reserve reduced by the surrender charge

The purchase is tax-free, and the surrender charge gradually decreases to zero within a few years.
Therefore, a so-called “springing” cash value policy increases dramatically in value, which allows the
purchaser to obtain a tax-free loan against the increased cash value of the insurance policy. The high cash
contribution and the high surrender charge-which results in a “disconnection between the benefit[] provided
by the insurance [Policy] and the benefit [] promised under the defined benefit pension plan being funded
by the [policy]” distinguishes an abusive Section 412(i) plan from a traditional Section 412(i) plan.

(*Drilling Consultants, Inc. v. First Montauk Securities Corp.*, 2012 U.S. Dist. LEXIS 114250, p. 5, fn. 4.)

1 Respondent states that, without knowing the terms of the policy or the plan, the attorney who wrote the
2 Memo was limited to providing a speculative rather than a full and detailed conclusion and
3 recommendation. Respondent argues that, although the attorney indicated in his letter of
4 October 28, 2010, that he and firm “established the relevant facts, including an evaluation of the
5 reasonableness of any assumptions or representations,” this assertion directly contradicts the disclaimers
6 in the Memo that he had not seen insurance policy illustrations, insurance contract terms, or provisions
7 of the Plan. (Resp. Op. Br., p. 6.)

8 Finally, respondent states that Treasury Regulation section 6664-4(c)(1) requires a
9 reasonable cause determination to consider, among other aspects, a taxpayer’s purpose for entering into
10 the transaction. Respondent argues that it is clear that appellant’s purpose was to reduce substantially its
11 tax burden, allegedly without regard to the aggressive and/or abusive nature of the plan. (Resp. Op. Br.,
12 pp. 6-7.)

13 Appellant’s Reply Brief

14 Appellant states that it disputes specifically, but not by limitation, the position taken by
15 respondent that appellant conceded the IRS adjustments of tax, interest, and penalty. Appellant alleges
16 that it vigorously defended its deduction for 2003 during the eight-year period from 2004 through 2012.
17 (App. Reply Br., p. 1.)

18 Appellant asserts that the 412(i) Plan, in which it allegedly invested \$1,330,337.01 (paid
19 in four installments) to American General Life Insurance Co. (AGLI) ¹² in 2003, was for retirement
20 planning and life insurance and was business-motive driven. Appellant argues that respondent’s
21 opening brief incorrectly presumes, allegedly without legal authority, that the IRS determination is
22 presumptively correct. Appellant asserts that respondent’s reliance is incorrect. Appellant states that its
23 opening brief includes a copy of a signed, legal tax opinion (the Memo) signed by a tax attorney that
24 resulted in significant expense, time, and effort to appellant. Appellant argues that the written tax
25 opinion is unequivocal. (App. Reply Br., p. 1.)

26 Furthermore, appellant alleges that it relied upon the tax attorney and Economic
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28 ¹² AGLI is apparently part of American Insurance Group, Inc. (AIG).

1 Concepts, Inc., in addition to advice and counsel by its accountants/tax preparers before investing in the
2 412(i) Plan and the legal opinion issued to AIG (an international insurance company) and ALGI, the
3 recipient of the \$1,330,227.01. Appellant argues that it has provided substantial authority and a
4 reasonable basis for its position under IRC section 6662(d)(2)(B) and reasonable cause and good faith
5 under IRC section 6664(c). (App. Reply Br., p. 2.)

6 Appellant argues that, at the time it invested in the 412(i) Plan, no IRS authority existed
7 precluding its purchase or deduction. Appellant states that respondent has provided no authority
8 precluding deductibility that is dated at or near the 2003 investment time period. Citing Treasury
9 Regulation section 1.6662-4(d), appellant argues that it justifiably relied upon AIG representatives, its
10 accountant/tax preparation firm, AGLI representatives, and a “top-to-bottom” due diligence that
11 reflected no IRS or FTB prohibitions on the 412(i) Plan. (App. Reply Br., p. 2.)

12 Appellant argues that respondent again, incorrectly and without any facts, assumed
13 appellant’s investment was a tax shelter. Appellant assert that it was not. Appellant alleges that it did
14 not invest \$1.3 million only to have it disallowed and that the investment was intended to be its
15 retirement. (App. Reply Br., p. 2.)

16 Appellant argues that respondent’s own opening brief, at the bottom of page four, admits
17 that:

18 (1) Taxpayer analyzed the pertinent facts and authorities and reasonably concluded
19 that there was a greater than 50 percent likelihood that the tax treatment would be
upheld, or

20 (2) Taxpayer reasonably relied in good faith on the opinion of a professional tax
21 advisor, if the opinion was based on the pertinent facts and authorities and
22 “unambiguously” states that the tax advisor concluded there was a greater than
23 50 percent likelihood that the treatment of the item would be upheld if challenged by
the IRS. All of the requirements of Treasury Regulation section 1.6664-4(c)(1)
relating to reliance on opinion or advice must be satisfied.

24 (App. Reply Br., pp. 2-3.)

25 Appellant alleges that its key shareholder is educated, business savvy, and experienced,
26 and a relatively-successful businessman who sought out and received tax, accounting, investment, and
27 legal professionals’ opinions before investing \$1,330,227.01 in the 412(i) Plan. Appellant argues that its
28 reliance on qualified and well-established officials of AGLI and on industry professionals was done in

1 good faith. Citing Treasury Regulation section 1.6662-4(d), appellant asserts that respondent has not
2 cited any authority on or about 2003 that precluded a deduction of a legitimate retirement plan
3 purchased through AGLI. (App. Reply Br., p. 3.)

4 Respondent's Reply Brief

5 Respondent addresses appellant's argument that, at the time it invested in the 412(i) Plan,
6 no IRS authority existed precluding its purchase or deduction. Respondent states that it appears that
7 appellant is arguing it had substantial authority for the position taken on its return. However, citing
8 Treasury Regulation section 1.6662-4(d)(3)(iv)(C), respondent argues that the crucial date is not the date
9 appellant invested in the 412(i) Plan but, rather, the date appellant took the disapproved position on its
10 tax return. Respondent states that Revenue Ruling 2004-20 was issued on February 13, 2004, almost
11 five months before appellant filed the return on June 6, 2004, on which it claimed the disallowed
12 deduction. (Resp. Reply Br., pp. 1-2.)

13 Respondent also states that, for the first time, appellant asserts as a basis for relief from
14 the accuracy-related penalty a reliance on the legal opinion issued to AIG and on the advice of
15 representatives from AIG, AGLI, and Economic Concepts, Inc. Respondent asserts that appellant has
16 not provided any documentation demonstrating that it reasonably and in good faith relied on those
17 entities and persons for the position taken on its return, as required by Treasury Regulation section
18 1.6664-4(c). Respondent notes again the absence in the record of Exhibits A and B referenced in the
19 letter of October 28, 2010, by the attorney who wrote the Memo. In addition to reiterating that it is
20 unclear whether those exhibits would have any bearing on its reasonable cause determination,
21 respondent argues that, because Exhibit B was identified by the attorney as an opinion letter that was
22 apparently issued to AIG and not to appellant, it is impermissible for that opinion letter to be the basis
23 for reliance for the position taken on its return. Respondent also argues that, if the insurance companies
24 precluded any reliance by appellant on representations by the companies as tax or legal advice, appellant

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Appeal of Site Management Services, Inc.

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1 knew or should have known it could not rely on such advice.¹³ Therefore, in respondent's view, any
2 alleged reliance by appellant on the opinions issued to the insurance companies, rather than to appellant,
3 would not be in good faith. (Resp. Reply Br., p. 2.)

4 In reference to appellant's disagreement with an alleged statement in respondent's
5 opening brief that "[a]ppellant conceded the IRS adjustments of tax, interest, and penalty." Respondent
6 asserts that it did not make that statement but did state the following: "[a]ppellant is not disputing that
7 the IRS assessed the accuracy-related penalty, nor is there any indication in appellant's BMF that the
8 IRS reduced or abated the penalty. Appellant has not offered any evidence that it is further appealing
9 the IRS determination. Absent such evidence, respondent's action in assessing the accuracy-related
10 penalty is presumed correct." (Resp. Reply Br., p. 2.)

11 Respondent asserts that appellant then erroneously states that respondent cites no
12 authority for this presumption. Referring to the last full paragraph in its opening brief and the
13 authorities cited in footnotes 15 and 16 of that brief, respondent states that the Board and the courts have
14 consistently held that respondent's determination is presumed correct when it is based on a federal audit.
15 Respondent states that it is also firmly established that the burden is on the taxpayer to overcome the
16 presumption of correctness that attaches to a federal determination. Respondent argues that, as a result,
17 unless a taxpayer can provide documentation to the contrary, respondent's actions are presumed correct.
18 (Resp. Reply Br., p. 3.)

19 Finally, respondent argues that appellant also misrepresents respondent's opening brief
20 by stating that respondent made a concession on the bottom of page four of the brief. Respondent
21 contends that, to the contrary, it was describing the requirements for reasonable cause based on legal
22 justification, as provided in Treasury Regulation section 1.6664-4(f). Respondent asserts that it did not
23 and does not now concede that appellant satisfied those requirements. (Resp. Reply Br., p. 3.)

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27 ¹³ In footnote five of its reply brief, respondent states that it is not clear whether AGLI, which sold the insurance policy at
28 issue to appellant, provided appellant with such a disclaimer. Quoting language from *Dameware Development, LLC v. American General Life Insurance Company* (5th Cir. 2012) 688 F3d 203, 206, respondent asserts that it appears AGLI provided the disclaimer to other policy purchasers in similar circumstances during the same time period. (Resp. Reply Br., p. 2, fn. 5.)

1 Applicable Law

2 Presumptions

3 R&TC section 18622, subdivision (a), provides that a taxpayer shall either concede the
4 accuracy of a federal determination or state wherein it is erroneous. It is well-settled that a deficiency
5 assessment based on a federal audit report is presumptively correct and the appellant bears the burden of
6 proving that the determination is erroneous. (*Appeal of Frank J. and Barbara D. Burgett, supra; Appeal*
7 *of Sheldon I. and Helen E. Brockett, 86-SBE-109, June 18, 1986; Todd v. McColgan (1949) 89*
8 *Cal.App.2d 509.*) When respondent assesses an accuracy-related penalty based on a federal action, the
9 assessment of the penalty is presumptively correct. (*Appeal of Robert and Bonnie Abney, 82-SBE-104,*
10 *June 29, 1982.*) It is also well settled that the failure of a party to introduce evidence within his control
11 gives rise to the presumption that, if provided, the evidence would be unfavorable. (*Appeal of*
12 *Dan A. Cookston, 83-SBE-048, Jan. 3, 1983.*)

13 Accuracy-Related Penalty

14 R&TC section 19164, subdivision (a)(1)(A), provides that an accuracy-related penalty
15 shall be imposed under that part and shall be determined in accordance with IRC section 6662, except as
16 otherwise provided. IRC section 6662(a) provides that if that section applies to any portion of an
17 underpayment of tax required to be shown on a return, there shall be added to the tax an amount equal to
18 20 percent of the portion of the underpayment to which it applies. IRC section 6662(b) provides, in part,
19 that the section will apply to any portion of the underpayment that is attributable to (1) negligence or
20 disregard of rules or regulation or (2) any substantial understatement of income tax. IRC section
21 6662(c) provides that, for purposes of the section, “negligence” includes any failure to make a
22 reasonable attempt to comply with the provisions of the Internal Revenue Code. The term “disregard” is
23 defined to include any “careless, reckless, or intentional disregard.” (*Id.*)

24 IRC section 6662(d)(1)(B) provides, in part, that, in the case of a corporation other than
25 an S corporation or a personal holding company, there is a substantial understatement of income tax for
26 any taxable year if the amount of the understatement for the taxable year exceeds the lesser of
27 (i) 10 percent of the tax required to be shown on the return for the taxable year (or, if greater, \$10,000)
28 or (ii) \$10,000,000. IRC section 6662(d)(2)(A) provides that the term “understatement” means the

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1 excess of (i) the amount of tax required to be shown on the return for the taxable year over (ii) the
2 amount of tax imposed which is shown on the return.

3 There are three exceptions to the imposition of the accuracy-related penalty. The
4 taxpayer bears the burden of proving the following defenses to the imposition of the accuracy-related
5 penalty. (*Recovery Group, Inc. v. Comm’r*, T.C. Memo 2010-76.)

6 Substantial Authority Exception

7 Under the first exception, the accuracy-related penalty shall be reduced by the portion of
8 the understatement attributable to a tax treatment of any item if there is substantial authority for such
9 treatment. (Int.Rev. Code, § 6662(d)(2)(B).) Treasury Regulation section 1.6662-4 discusses the
10 substantial authority exception in greater detail.¹⁴ The substantial authority standard is defined as an
11 objective standard involving an analysis of the law and the application of the law to relevant facts.
12 (Treas. Reg. §1.6662-4(d)(2).) The substantial authority standard is less stringent than the more likely
13 than not standard,¹⁵ but more stringent than the reasonable basis standard used for analyzing whether an
14 underpayment is due to negligence or to the disregard of rules or regulation. (*Id.*)

15 There is substantial authority for the tax treatment of an item only if the weight of the
16 authorities supporting the treatment is substantial in relation to the weight of the authorities supporting a
17 contrary treatment. (Treas. Reg. §1.6662-4(d)(3)(i).) The weight of the authorities is evaluated in light
18 of all the facts and circumstances based on Treasury Regulation section 1.6662-4(d)(3)(ii). (*Id.*)
19 Treasury Regulation section 1.6662-4(d)(3)(ii) provides that the weight accorded to an authority
20 depends on its relevance and persuasiveness, and the type of document providing the authority.
21 Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax
22 professionals are not authority. (Treas. Reg. §1.6662-4(d)(3)(iii).) The authorities underlying such
23 expressions of opinion where applicable to the facts of a particular case, however, may give rise to
24 substantial authority for the tax treatment of an item. (*Id.*) In addition, substantial authority for the tax
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27 ¹⁴ In the absence of regulations by the FTB and, unless otherwise provided, in instances where the Personal Income Tax Law
28 or the Corporation Tax Law conform to the Internal Revenue Code, regulations under the Internal Revenue Code shall, if
possible, govern the interpretation of conforming California statutes. (Cal. Code. Regs., tit. 18, § 19503.)

¹⁵ The “more likely than not” standard is met when there is a greater than 50-percent likelihood of the position being upheld.
(Treas. Reg., § 1.6662-4(d)(2).)

1 treatment of an item is determined at the time the return containing the item is filed, or on the last day of
2 the taxable year to which the return relates. (Treas. Reg. §1.6662-4(d)(3)(iv)(C).)

3 Adequate Disclosure Exception

4 Under the second exception, the accuracy-related penalty shall be reduced by the portion
5 of the understatement attributable to a tax treatment of any item if the relevant facts affecting the item's
6 tax treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item.
7 (Int.Rev. Code, § 6662(d)(2)(B).) Treasury Regulation section 1.6662-4(e)(1) provides that, if there is
8 adequate disclosure of the item, then the tax attributable to that item will not be part of the
9 understatement subject to the accuracy-related penalty. However, the adequate disclosure exception will
10 not apply where the item or position made on the return: (1) has no reasonable basis; (2) is attributable
11 to a tax shelter; or (3) is not properly substantiated. (Treas. Reg. § 1-6662-4(e)(2).)

12 "Reasonable basis" standard is defined as a relatively high standard of tax reporting that
13 is significantly higher than not frivolous or not patently improper. (Treas. Reg. § 1.6662-3(b)(3).) The
14 reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a
15 colorable claim. (*Id.*) If the return position is reasonably based on one or more of the authorities (as
16 permitted for the substantial authority exception), the return position will generally satisfy the
17 reasonable basis standard even though it may not satisfy the substantial authority standard. (*Id.*)

18 Exclusion for Tax Shelters

19 The substantial authority and adequate disclosure exceptions to the application of the
20 accuracy-related penalty do not apply to any item attributable to tax shelters. (Int.Rev. Code,
21 § 6662(d)(2)(C)(i).) "Tax shelter" is defined as a partnership or other entity, any investment plan or
22 arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan,
23 or arrangement is the avoidance or evasion of federal income tax. (Int.Rev. Code, § 6662(d)(2)(C)(ii);
24 Treas. Reg. § 1.6662-4(g)(2).)¹⁶ Treasury Regulation section 1.6662-4(g)(1)(ii) provides that, in cases

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27 ¹⁶ Staff notes that Treasury Regulation section 1.6662-4(g)(2) uses the term, "principal purpose," in contrast to the IRC
28 section 6662(d)(2)(C)(ii), which uses the term, "significant purpose." Treasury Regulation section 1.6662-4(g)(2)(ii)
provides that the principal purpose of an entity, plan, or arrangement is not to avoid or evade federal income tax if the entity,
plan, or arrangement has as its purpose the claiming of exclusions from income, accelerated deductions, or other tax benefits
in a manner consistent with the statute and Congressional purpose.

1 of corporate taxpayers, all tax shelter items of a corporation are taken into account in computing the
2 amount of any understatement. Disclosure made with respect to a tax shelter item of a corporate
3 taxpayer does not affect the amount of an understatement. (Treas. Reg. § 1.6662-4(g)(1)(iii).) An item
4 of income, gain, loss, deduction, or credit is a “tax shelter item” if the item is directly or indirectly
5 attributable to the principal purpose of a tax shelter to avoid or evade federal income tax. (Treas. Reg.
6 § 1.6662-4(g)(3).) A corporate taxpayer may seek relief from the accuracy-related penalty based on the
7 reasonable cause exception for understatements arising from a tax shelter item pursuant to Treasury
8 Regulation section 1.6664-4(f), which is discussed below. (Treas. Reg. § 1.6662-4(g)(1)(iv).)

9 Reasonable Cause Exception

10 Under the third exception, the accuracy-related penalty will not be imposed to the extent
11 that a taxpayer shows a portion of the underpayment was due to reasonable cause and that it acted in
12 good faith with respect to such portion of the underpayment. (Int.Rev. Code, § 6664(c)(1); Treas. Reg.
13 §§ 1.6664-1(b)(2) & 1.6664-4.)

14 A determination of whether a taxpayer acted with reasonable cause and in good faith is
15 made on a case-by-case basis and depends on the pertinent facts and circumstances, including its efforts
16 to assess the proper tax liability, its knowledge and experience, and the extent to which it relied on the
17 advice of a tax professional. (Treas. Reg. § 1.6664-4(b).) Generally, the most important factor is the
18 extent of the taxpayer’s effort to assess its proper tax liability. (*Id.*) Reliance on the advice of a
19 professional tax advisor does not necessarily demonstrate reasonable cause and good faith. (*Id.*)
20 However, reliance on professional advice constituted reasonable cause and good faith if, under all the
21 circumstances, such reliance was reasonable and the taxpayer acted in good faith. (*Id.*)

22 All of the facts and circumstances must be taken into account in determining whether a
23 taxpayer has reasonably relied in good faith on advice, including the opinion of a professional tax
24 advisor, as to the treatment of the taxpayer (or any entity, plan, or arrangement) under federal tax law.
25 (Treas. Reg. § 1.6664-4(c)(1).) The advice must be based on all pertinent facts and circumstances and
26 the law as it is related to those facts and circumstances. (Treas. Reg. § 1.6664-4(c)(1)(i).) The advice
27 must not be based on a representation or assumption which the taxpayer knows or has reason to know is
28 unlikely to be true. (Treas. Reg. § 1.6664-4(c)(1)(ii).) “Advice” is any communication, including the

1 opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the
2 taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or
3 indirectly, and does not have to be in any particular form. (Treas. Reg. §1-6664-4(c)(2).)

4 Reliance on advice of an expert tax preparer may, but does not necessarily, demonstrate
5 reasonable cause and good faith. (*Stolz v. Comm'r*, T.C. Memo 1999-404.) Such reliance is not an
6 absolute defense, but is a factor to be considered. (*Id.*) A taxpayer claiming reliance on a professional
7 must show that (1) the tax preparer was a competent professional who had sufficient expertise to justify
8 reliance; (2) the tax preparer was supplied with necessary and accurate information; and (3) the taxpayer
9 actually relied in good faith on the advice. (*Neufeld v. Comm'r*, T.C. Memo 2008-79, citing
10 *Neonatology Assocs., P.A. v. Comm'r* (2000) 115 T.C. 43, 99.)

11 Special Rules for Tax Shelters

12 Treasury Regulation section 1.6664-4(f) provides special rules for the imposition of the
13 accuracy-related penalty due to a substantial understatement attributable to tax shelter items of a
14 corporate taxpayer. The determination of whether a corporation acted with reasonable cause and good
15 faith in its treatment of a tax shelter item is based on all pertinent facts and circumstances. (Treas. Reg.
16 § 1.6664-4(f)(1).) To show reasonable cause based on legal justification,¹⁷ the minimum requirements
17 that a corporate taxpayer must satisfy include the following: (a) there was substantial authority¹⁸ for the
18 treatment of the tax shelter item; and (b) the corporation reasonably believed at the time the return was
19 filed, based on all the facts and circumstances, that the tax treatment of the item was more likely than
20 not the proper treatment. (Treas. Reg. § 1.6664-4(f)(2).)

21 A corporation is considered to reasonably believe that the tax treatment of an item is
22 more likely than not the proper tax treatment if (1) the corporation analyzes the pertinent facts and
23 authorities and reasonably concludes in good faith that there is a greater than 50-percent likelihood that
24 the tax treatment would be upheld if challenged by the IRS; or (2) the corporation reasonably relies in
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26 ¹⁷“Legal justification” is defined as any justification relating to the treatment or characterization under federal tax law of the
27 tax shelter item or of the entity, plan, or arrangement that gave rise to the item. (Treas. Reg., § 1.6664-4(f)(2)(ii).)

28 ¹⁸ Treasury Regulation section 1.6664-4(f)(2)(1)(A) cross references the standard of substantial authority found in Treasury
Regulation section 1.6662-4(d), which was discussed above under the section titled, “Substantial Authority Exception.”

1 good faith on the opinion of a professional tax advisor, if the opinion is based on the pertinent facts and
2 authorities and unambiguously states that the tax advisor concludes that there is a greater than
3 50-percent likelihood that the tax treatment will be upheld if challenged by the IRS.¹⁹ (Treas. Reg.
4 § 1.6664-4(f)(2)(i)(B).) Satisfaction of the minimum requirements is an important factor to be
5 considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith,
6 but is not necessarily dispositive. (Treas. Reg. § 1.6664-4(f)(3).) Other facts and circumstances may be
7 taken into account, as appropriate, in determining whether a corporation acted with reasonable cause and
8 good faith with respect to a tax shelter item. (Treas. Reg. § 1.6664-4(f)(4).)

9 412(i) Plan

10 IRC section 412 sets forth minimum funding requirements for certain
11 employer-sponsored pension plans. Former IRC section 412(i) provides that certain insurance contract
12 plans are exempt under former IRC section 412(h)(2) from the minimum funding requirements.²⁰ To
13 qualify as a 412(i) Plan, the plan must meet the six requirements pursuant to former IRC section
14 412(i).²¹ As relevant to this appeal, the benefits provided by the plan must be equal to the benefits
15 provided under each contract at normal retirement age under the plan and are guaranteed by an insurance
16 carrier to the extent premiums have been paid. (Former Int.Rev. Code, §412(i)(3).)

17 Revenue Ruling 2004-20 (2004-1 C.B. 546), issued on March 8, 2004

18 Revenue Ruling 2004-20 provides an example where a qualified pension plan cannot be
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20 ¹⁹ The requirements of Treasury Regulation section 1.6664-4(c) must be met with respect to the opinion of a professional tax
21 advisor. That provision is discussed above under the section titled, "Reasonable Cause Exception."

22 ²⁰ Staff notes that a 412(i) Plan is an employer-sponsored defined-benefit pension plan that provides a retirement and death
23 benefit to participants. Generally, a small business creates a trust to hold the plan's assets which consist of life insurance and
24 annuity policies and the trust uses tax-deductible employer premiums to purchase the policies for the plan. IRC section
25 412(i) exempts a qualified plan from requirements typically imposed on defined benefit plans, such as quarterly
26 contributions, minimum capitalization, and IRS actuarial assumptions.

27 ²¹ The requirements include: (1) the plan is funded exclusively by the purchase of individual insurance contracts; (2) such
28 contracts provide for legal annual premium payments to be paid commencing with the date the individual became a
participant in the plan (or in the case of an increase of benefits, commencing at the time such increase becomes effective) and
extending not later than the retirement age for each individual participating in the plan; (3) the benefits provided by the plan
are equal to the benefits provided under each contract at normal retirement age under the plan and are guaranteed by an
insurance carrier to the extent premiums have been paid; (4) the premiums payable for the plan, and all the prior plan years,
under such contracts have been paid before lapse or there is a reinstatement of the policy; (5) no rights under such contracts
have been subject to a security interest at any time during the plan year; and (6) no policy loans are outstanding at any time
during the plan year.

1 an IRC section 412(i) Plan if the plan holds life insurance contracts and annuity contracts for the benefit
2 of a participant that provide for benefits at normal retirement age in excess of the participant's benefits
3 at normal retirement age under the terms of the plan. The ruling also addresses when certain employer
4 contributions to purchase life insurance coverage for a participant in a defined benefit plan are
5 deductible and whether those transactions are "listed transactions." Revenue Ruling 2004-20 considers
6 the following two factual situations:

7 Situation 1

8 Employer M maintains Plan A, a defined benefit plan that is funded for each
9 participant commencing with the date the individual becomes a participant in the plan (or,
10 in the case of an increase in benefits, commencing at the time the increase becomes
11 effective) and ending with the individual's attainment of normal retirement age. Plan A
12 is intended to be a plan described in § 412 (i). The amounts that will be accumulated
13 under the insurance contracts and annuity contracts for the benefit of a participant at
14 normal retirement age, assuming premiums are paid and determined by applying annuity
15 purchase rates guaranteed under the contracts, will provide for benefits in excess of the
16 participant's benefits at normal retirement age under the terms of the plan.

13 Situation 2

14 Employee N maintains Plan B. With respect to Participant P, Plan B provides a
15 death benefit that meets the definition of an incidental death benefit under
16 § 1.401-1 (b) (1) (i) of the Income Tax regulations. The assets of Plan B include life
17 insurance contracts on the life of Participant P. with a face amount in excess of
18 Participant P's death benefit under Plan B. Premiums with respect to Participant P
19 include an annual premium for the waiver of the entire premium payment if Participant P
20 becomes disabled. Upon the death of a covered employee, the portion of the proceeds of
21 the life insurance contract that exceeds the death benefit payable to participant P's
22 beneficiary under the plan is applied to the payment of premiums under the plan with
23 respect to other participants.

19 Revenue Ruling 2004-20 holds, that in Situation 1, a pension plan fails to satisfy IRC
20 section 412(i) where amounts accumulated under life insurance contracts and annuities held by the plan
21 exceed benefits payable under the plan's terms. In addition, in Situation 2, employer contributions to a
22 pension plan are not fully deductible when those contributions are used to pay premiums on life
23 insurance contracts that provide for death benefits in excess of the participant's death benefit under the
24 terms of the plan.

25 Revenue Ruling 2004-20 further provides that transactions that are the same as, or
26 substantially similar to, the transaction in Situation 2, are identified as "listed transactions" for purposes

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1 of Treasury Regulation section 1.6011-4(b)(2)²² and the identification of these listed transactions is
2 effective as of February 13, 2004, provided that the employer has deducted amounts used to pay
3 premiums on a life insurance contract for a participant with a death benefit under the contract that
4 exceeds the participant's death benefit under the plan by more than \$100,000. Revenue Ruling 2004-20
5 also provides that arrangements that are the same as, or substantially similar to, the arrangements
6 described in Revenue Ruling 2004-20 may already be subject to disclosure requirements, tax shelter
7 registration requirements, or list maintenance requirements. The IRS also indicated that it may impose
8 the federal accuracy-related penalty on participants in these arrangements or substantially-similar
9 arrangements.

10 STAFF COMMENTS

11 Appellant claimed a deduction for amounts paid into a retirement plan for which
12 appellant intended to be treated as a 412(i) Plan. The IRS determined that appellant's plan did not
13 qualify for IRC section 412(i) treatment and the IRS disallowed that deduction and imposed a federal
14 accuracy-related penalty based on the resulting understatement of tax. Respondent imposed the state
15 accuracy-related penalty based on the federal audit report imposing the federal accuracy-related penalty.
16 As such, respondent's action is presumed correct and appellant bears the burden to show that the
17 accuracy-related penalty was incorrectly imposed. (*Appeal of Robert and Bonnie Abney, supra.*) Staff
18 notes that, based on appellant's federal BMF, there was no indication that the IRS removed the federal
19 accuracy-related penalty. (Resp. Op. Br., Exh. D.) Appellant will want to clarify whether it provided
20 the October 28, 2010 letter and its exhibits, including the Memo, to the IRS during the federal appeals
21 process.

22 Both parties should be prepared to discuss whether any of the following exceptions to the
23 accuracy-related penalty applies to appellant's circumstances: (1) there was substantial authority for the
24 tax treatment; (2) there was adequate disclosure of the relevant facts affecting the item's tax treatment in
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26 ²² A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the
27 IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published
28 guidance as listed transaction. (Treas. Reg. § 1.6011-4(b)(2).) If any portion of an underpayment of tax is due to a reportable
transaction as defined in Treasury Regulation section 1.6011-4(b), then the failure by a taxpayer to disclose the transaction is
a strong indication that the taxpayer did not act in good faith with respect to the portion of the underpayment attributable to
the reported transaction. (Treas. Reg. § 1.6664-4(d).)

1 the return and there is a reasonable basis for that tax treatment; or (3) whether there was reasonable
2 cause for the underpayment and appellant acted in good faith with regard to that underpayment.

3 The Board will first need to determine whether the item at issue, the disallowed
4 deduction, is attributable to a tax shelter. The disallowed deduction was related to appellant's
5 412(i) Plan. If the Board determines that appellant's 412(i) Plan is a tax shelter and the disallowed
6 deduction is a tax shelter item, then the substantial authority and adequate disclosure exceptions cannot
7 apply in this appeal, and appellant may only seek relief from the accuracy-related penalty through the
8 reasonable cause exception pursuant to Treasury Regulation section 1.6664-4(f). If the Board
9 determines that appellant's 412(i) Plan is not a tax shelter and the corresponding disallowed deduction is
10 not attributable to a tax shelter, then appellant may seek relief of the accuracy-related penalty pursuant
11 to all three exceptions (substantial authority, adequate disclosure, and reasonable cause). With regard to
12 the reasonable cause exception, if the Board determines that the item is not attributable to a tax shelter,
13 then appellant may seek relief pursuant to Treasury Regulation section 1.6664-4(c).

14 With regard to determining whether appellant's 412(i) Plan is a tax shelter, staff notes
15 that, according to the 886-A, the IRS determined that appellant's plan failed to meet the requirements to
16 be a qualified pension plan described in IRC section 412(i) because the benefits provided by appellant's
17 Insurance policy do not equal the benefits provided by appellant's pension plan.²³ Accordingly, the IRS

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19 ²³ Staff notes that, according to the 886-A, appellant's plan had two participants: Michael Flynn and Deena Flynn. Under the
20 plan, Michael Flynn would be eligible for retirement at 55 with 19 years of participation with a monthly benefit equal to
21 \$8,575. Under the plan, Deena Flynn would be eligible for retirement at 55 with 25 years of participation with a monthly
22 benefit equal to \$9,027. The benefit for each participant was funded using life insurance policies provided by AIG. The
23 effective date of each policy was December 20, 2002. For Michael Flynn, the face amount of the policy was \$8,064,428 and
24 the annual premium was \$347,093. For Deena Flynn, the face amount of the policy was \$7,619,500 and the annual premium
25 was \$266,054. Using the guaranteed cash values stated in the insurance policies, the equivalent monthly benefit for Michael
26 Flynn was \$5,500. For Deena Flynn, the equivalent monthly benefit was undeterminable. The face amount of the policy for
27 Michael Flynn was \$8,064,428. The pre-retirement death benefit under the plan for him was \$857,750 and the excess death
28 benefit was \$7,206,678 (i.e., \$8,064,428 - \$857,750). The face amount of the policy for Deena Flynn was \$7,619,499.72.
The pre-retirement death benefit under the plan was \$902,700.00 and the excess death benefit was \$6,716,799.72 (i.e.,
\$7,619,499.72 - \$902,700.00).

26 The IRS determined that the cumulative value of the premiums paid under the insurance policy for Michael Flynn after five
27 years was \$1,735,465, but the guaranteed cash value was only \$192,256 and, after five years, the accumulative value is no
28 less than 85.10 percent of the premiums paid. The cumulative value of the premiums paid under the insurance policy for
Deena Flynn after five years was \$1,340,270, but the guaranteed cash value was only \$122,445 and, after five years, the
accumulated value is no less than 82.81 percent of the premiums paid. As such, the accumulated value of the policies for
both participants exceeded the amount necessary to provide the benefit under the plan and the lump sum provided under the
plan.

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1 concluded that appellant's plan was subject to the minimum funding requirements of IRC section 412.
2 (Resp. Op. Br., Exh. C.) Furthermore, staff notes that, in the 886-A, the IRS states that "[t]he Marketing
3 Materials (including the Policy Illustration and Contract) contemplate that the ownership of the policy
4 will be transferred to the individuals as part of their distribution. Thus, the individual can receive the
5 policy as part of a lump sum, hold it for 5 (five) years until the surrender charges are "0" and effectively
6 receive the accumulated value." (*Id.*) The parties should be prepared to address whether either
7 Situation 1 or Situation 2 of Revenue Ruling 2004-20, or both of those situations, is applicable to the
8 facts discussed and conclusions reached by the IRS in the 886-A. It appears that the IRS, in its analysis
9 of whether to impose the federal accuracy-related penalty, used the special rules for tax shelters pursuant
10 to Treasury Regulation section 1.6664-4(f) and determined that appellant had not shown that it had
11 reasonable cause and acted in good faith with respect to the underpayment of the tax and appellant had
12 not shown that any exceptions to the federal accuracy-related penalty applied.

13 As noted above, IRC section 6662(d)(2)(C)(i) precludes the reduction of the
14 understatement of tax related to any item attributable to a tax shelter pursuant to the substantial authority
15 and the adequate disclosure exceptions. Staff notes that Treasury Regulation section 1.6664-4(f)
16 provides special rules for a substantial understatement penalty attributable to tax shelter items of a
17 corporation. Respondent should be prepared to discuss, if Situation 1 discussed in Revenue Ruling
18 2004-20 is applicable here, (1) whether the 412(i) Plan should be treated as a tax shelter and (2) whether
19 the item whose deduction was disallowed by the IRS and respondent is a tax shelter item.

20 As noted above, if the Board determines that the disallowed deduction is attributable to a
21 tax shelter, then the Board must determine, based on all the pertinent facts and circumstances, whether
22 appellant acted with reasonable cause and good faith in its treatment of the tax shelter item. (Treas. Reg.
23 §1.6664-4(f)(1).) Appellant should be prepared to discuss whether it has satisfied the minimum
24 requirements provided in Treasury Regulation section 1.6664-4(f)(2). With regard to whether the belief
25 requirement pursuant to Treasury Regulation section 1.6664-4(f)(2) was satisfied, staff observes that the
26 Memo indicates that the attorney who drafted it thought he had insufficient information regarding the
27 412(i) Plan and the related insurance policies to comment on the adequacy of the insurance policies or
28 the plan provisions and that he also had reservations regarding the viability of appellant's 412(i) Plan for

1 tax purposes if the insurance policies did not remain permanently in the 412(i) Plan and actually fund
2 retirement benefits. Appellant should provide Exhibits A and B of the October 28, 2010 letter and be
3 prepared to discuss their impact, if any, on its “reasonable cause” arguments. Staff also notes that
4 Revenue Ruling 2004-20 was issued on March 8, 2004, and effective as of February 13, 2004, prior to
5 appellant filing its return on July 6, 2004. Accordingly, the parties should be prepared to discuss how
6 this fact affects the Board’s determination on whether appellant reasonably believed at the time the
7 return was filed that that the tax treatment of the disallowed deduction was more likely than not the
8 proper treatment. (Treas. Reg. §1.6664-4(f)(2)(i)(B).)

9 Staff notes that the satisfaction of these minimum requirements is an important factor in
10 considering whether appellant acted with reasonable cause and in good faith, but it is not necessarily
11 dispositive and other facts and circumstances may be taken into account if appropriate. (Treas. Reg.
12 §§ 1.6664-4(f)(3) & (4).) Appellant will want to provide any other evidence and legal arguments it
13 wishes the Board to consider regarding this issue. (Appeal Letter, Atths.)

14 As noted above, if the Board determines that the disallowed deduction is not attributable
15 to a tax shelter, then appellant should be prepared to demonstrate that it meets the requirements of any of
16 the three exceptions to the accuracy-related penalty. With regard to the substantial authority exception,
17 appellant will need to discuss the relationship between the information it relied on in claiming the
18 disallowed deduction and Revenue Ruling 2004-20. With regard to the adequate disclosure exception,
19 appellant will want to discuss and substantiate that it adequately disclosed the facts relating to the tax
20 treatment of the deduction on the return and that there was a reasonable basis for the tax treatment.
21 With regard to the reasonable cause exception, appellant will want to discuss and substantiate whether it
22 meets the requirements pursuant to Treasury Regulation section 1.6664-4(c). In that regard, appellant
23 will want to discuss whether its reliance on the Memo is appropriate in light of the tax attorney’s lack of
24 review of the pertinent insurance policy that appellant purchased for its 412(i) Plan.

25 Additional Evidence

26 Pursuant to California Code of Regulations, title 18, section 5523.6, each party should
27 provide any additional documentary evidence it has been requested to present, or otherwise wishes to
28

1 present, to the Board Proceedings Division (with copies to the other party) at least 14 days prior to the
2 oral hearing.²⁴

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6 Sitemanagementservice,Inc.rv1.doc

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²⁴ Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

Appeal of Site Management Services, Inc.

NOT TO BE CITED AS PRECEDENT - Document prepared for Board review. It does not represent the Board's decision or opinion.

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