

1 Steven Mark Kamp
Tax Counsel III
2 Board of Equalization, Appeals Division
450 N Street, MIC:85
3 PO Box 942879
Sacramento CA 95814
4 Tel: (916) 322-8525/203-5661
Fax: (916) 324-2618
5

6 Attorney for the Appeals Division

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 **DONALD G. NORTHRUP and DACREY**) Case No. 467011
13 **NORTHRUP¹**)
14 _____)

	<u>Year</u>	<u>Proposed</u>
	2002	<u>Assessment Tax</u>
		\$ 26,946 ²

18 Representing the Parties:

19 For Appellants: David B. Porter, Attorney
20 For Franchise Tax Board: Jenna Mayfield, Tax Counsel
21

22 **QUESTIONS:** (1) Whether amounts received by appellants from an arbitration award may be treated
23 as gain from the sale of a capital asset rather than as ordinary income.
24 (2) Whether the Board has jurisdiction to consider respondent's estimated post-
25

26 ¹ Appellants' address is in Newport Beach, Orange County, California.

27 ² Responded also included an estimated post-amnesty penalty of \$1,306.12. Respondent should be prepared to provide the
28 accrued interest amount as of the date of the oral hearing (November 17, 2009.).

1 amnesty penalty before appellants have paid the penalty.

2 (3) Whether appellants are entitled to an abatement of interest.

3 HEARING SUMMARY

4 Background

5 This case presents the question of whether appellants may characterize a \$607,239
6 employment termination arbitration award as a capital asset, and treat the \$353,126 in legal fees paid as
7 the “asset.”³

8 Appellants Donald and Dacrey Northrup, husband and wife, timely filed their 2002
9 California joint filing status 540 return on the extension due date of October 15, 2003. On their federal
10 1040, line 21, appellants reported as “other income” a “court settlement” of \$295,775, which appellants
11 reduced by \$62,000 in expenses purportedly incurred in obtaining the settlement, as stated on a “Federal
12 Statements Page 1” attached to their return.⁴ A form 1099-MISC provided by BKM Enterprises (BKM)
13 to appellants and the Franchise Tax Board (FTB) states that BKM in 2002 paid to appellants
14 \$295,774.80 in “non-employee compensation.”⁵ In June of 2005, respondent’s auditors reviewed a jury
15 verdicts publication and discovered that on May 21, 2002, appellant-husband (“Mr. Northrup”) received
16 a \$690,573 arbitration award against BKM.⁶ According to the article discovered by respondent’s
17 auditors, the award to Mr. Northrup was for “his right to receive severance payments under the terms of
18 the contract”; that the arbitrator (retired California Supreme Court Justice Edward Panelli) found for
19 BKM “on the breach of contract, wrongful termination, fraud and defamation claims” and awarded
20 BKM “an offset of \$83,333 to the defendant after finding that the plaintiff breached his fiduciary duty to
21 [BKM] when he provided services to a competitor while still employed by [BKM].” The article also
22

23 ³ If this characterization is accepted, the parties agree that appellants may offset against \$254,113 in purported gain, \$72,765
24 in capital losses (\$66,563 carried over from 2001), further offset the resulting \$181,348 in “gain” against \$183,123 in
25 Schedule E rental real estate losses, add \$7,539 in taxable interest and dividends, and add \$25,660 in California addition
26 adjustments. The parties agree that this would result in appellants having California adjusted gross income of \$31,424, and
that from such amount, respondent would subtract \$40,489 in California itemized deductions, allowing appellants to report
zero in California taxable income and zero California tax for 2002.

27 ⁴ Respondent’s Opening Brief, Exhibits A (California return), B (federal 1040 return) and C (“Federal Statements Page 1”).

28 ⁵ Respondent’s Opening Brief, Exhibit D.

⁶ Respondent’s Opening Brief, page 1: 19-20; Exhibit E (“Jury Verdicts Weekly, June 18, 2002”).

1 states as follows:

2 “plaintiff’s counsel reported that, under the terms of the ownership
3 purchase agreement...the plaintiff was an at-will employee and had not
4 achieved the goals required to purchase the California portion of BKM”

5 The civil action filed by Mr. Northrup contained five causes of action: (1) breach of oral contract to sell
6 him the California BKM dealership; (2) breach of written agreement; (3) wrongful termination; (4)
7 defamation; and (5) discrimination/retaliation in violation of fundamental public policy/ fraud. The
8 arbitration award decision ruled against Mr. Northrup on all claims except the one for termination
9 benefits under the Ownership Purchase Agreement (OPA), where Mr. Northrup prevailed in the amount
10 of \$690,573 minus the \$83,333 he earned while working for a competitor. The arbitrator ruled against
11 Mr. Northrup on all other claims, including the claim that BKM had breached the OPA provision
12 requiring it to sell to him an ownership interest in BKM, because:

13 “...there were not five years of a six year period in which the [net profit] targets were
14 achieved. As a result of this failure, [appellant’s] rights to purchase BKM were lost.
15 Since [appellant] lost any rights to purchase BKM he cannot recover damages from BKM
16 for breach of the OPA as it relates to the purchase and sale of the business.”⁷

17 On August 23, 2005, respondent informed appellants that their 2002 return was under
18 audit, and requested information regarding the arbitration award. Appellants provided a “Statement of
19 Decision Pursuant to Order of Reference” (the award) (Resp. Opening Brief, exhibit H), which indicates
20 that Mr. Northrup received \$607,239.67, and that he instructed the other arbitration party (BKM) to pay
21 \$295,774.80 directly to him and to pay the remaining amount (\$311,464.87) to his arbitration attorneys.
22 After reviewing the arbitration decision and related documents, respondent determined that the award
23 was based on the termination provision in the OPA that gave Mr. Northrup a termination benefit of
24 \$690,573, minus \$83,333 in salary appellant received from another company while employed by BKM.⁸

25 On May 26, 2006, respondent issued a Notice of Proposed Assessment (NPA) to
26 appellants, proposing to increase appellants’ gross income by \$373,465 to reflect the arbitration award

27 ⁷ Respondent’s Opening Brief, Exhibit H, page 5: 5-10. Appellants in their Appeal Letter (page 3, paragraph 2) acknowledge
28 the existence of the five year net profits target requirement in the OPA, but do not say whether or not Mr. Northrup met it.
The arbitrator found that he did not.

⁸ Respondent’s Opening Brief, Exhibit H, pages 5: 11 through 6:1 and 6: 25-26.

1 amount not reported on their 2002 federal 1040 line 21 and California 540. The NPA allowed an
2 additional itemized miscellaneous deduction of \$335,276 for legal fees appellants incurred in obtaining
3 the award, and increased appellants' regular California personal income tax by \$2,949. However,
4 because appellants' income placed them within the California Alternative Minimum Tax (AMT), where
5 the itemized miscellaneous deduction is an add-back preference item, the NPA added another \$24,240 in
6 tax under the AMT, minus \$243 "previously assessed."⁹ There are no other issues regarding appellants'
7 return for 2002.¹⁰ After respondent issued the Notice of Action (NOA) affirming its proposed
8 assessment, this timely appeal followed.

9 Question (1): Whether amounts received by appellants from an arbitration award may be treated as
10 gain from the sale of a capital asset rather than as ordinary income, and, if so, whether
11 attorney's fees received by appellant-husband's arbitration attorney may be added to
12 the basis of the claimed capital asset arbitration award, or must instead be reported as
13 an itemized miscellaneous deduction.

14 Contentions

15 Appellants' Contentions

16 Appellants contend that the arbitration award amount is income from a capital
17 transaction, and that the legal fees should be added to the unspecified basis of the capital asset.¹¹ In
18

19 ⁹ Respondent's Opening Brief, Exhibit I. There is no discussion anywhere regarding this \$243, so it appears that appellants
20 are not including this amount in this appeal.

21 ¹⁰ Respondent did not question the \$183,123 in federal line 17 Schedule E losses claimed by appellants, which appellants
22 adjusted upward by \$12,475 in Schedule CA, line 17, column C, and wrote off against the entire reported arbitration award
23 amount of \$233,775, and which respondent has effectively permitted them to write off against \$607,240 that respondent
24 believes is the total amount of the arbitration award. See Respondent's Opening Brief, Exhibit A, page 3. The Schedule E in
25 the federal return is not included with Respondent's Opening Brief or Appellant's Appeal Letter, nor has it been otherwise
26 provided, and in any event the four year limitations period for 2002 returns due on April 15, 2003, has now passed.

27 ¹¹ On their only 2002 return, appellants claimed a \$3,000 capital loss from all Schedule D transactions, which in the original
28 return did not include the BKM award. On the 2002 federal and California Schedule D documents provided by both parties
in response to the Appeals Division request for supplemental briefing, appellants reported a net short-term capital loss for
2002 of (\$2,255), and a net long-term capital loss for 2002 of (\$69,765). These amounts resulted from three separate short-
term sales involving "Nortel", "Travelers" and "Travelers", and three separate long-term transactions involving "MGM
Mirage", "Worldcom" and "Worldcom." Appellants on their 2002 Schedule D Line 17 list a total capital loss from 2002 of
(\$72,020) and on Form 1040 Line 13 ("Capital Gain or Loss") reported the maximum \$3,000 loss, and apparently carried
over the remaining (\$69,020) to 2003 and future years. At no point on the 2002 return Schedule D did appellants list sales of
any "BKM" asset.

1 their Appeal Letter, appellants argued that the NOA should be withdrawn, notwithstanding appellants’
2 failure to report \$373,465 in income from the arbitration award, based on appellants’ assertion that Mr.
3 Northrup’s recovery from BKM was an Internal Revenue Code (IRC) section 1221 and section 1234A
4 capital asset.¹² The Appeals Division requested that appellants and respondent explain the basis, net
5 gain, and other aspects of the 2002 return that impact the purported treatment of the BKM award as a
6 capital asset. In their Supplemental Brief, appellants argue that the BKM “settlement recovery should
7 also be reported on Schedule D since the damages were in substitution for a capital asset.” In Exhibit B
8 to their Supplemental Brief, appellants create a hypothetical revised Schedule D that lists “BKM CA”
9 with an acquisition date of January 1, 1995; a sell date of May 21, 2002; a sales price of \$607,239; a cost
10 basis of \$353,126; and a resulting gain of \$254,114, which, when added to the amounts reviewed above,
11 results in a net long-term capital gain for 2002 of \$184,349.

12 As can be seen from appellants’ 2002 federal 1040 return, substitution of \$184,349 on
13 Line 13 for the loss of (\$3,000), together with removal of the \$233,775 on line 22 (“other income”),
14 results in positive income amounts of \$192,812, from which appellants can subtract (\$7,262) in line 12
15 Schedule C losses and (\$183,123) in Line 17 Schedule E losses, leaving \$2,427 in Line 35 federal
16 adjusted gross income. On the California 540 return, two adjustments from the original return remain:
17 \$996 from line 10 (state income tax refund) would be removed, and \$25,722 in California addition
18 adjustments would be added, resulting in \$27,153; after California itemized deductions of \$40,489 are
19 subtracted, appellants new California taxable income would be zero. In addition, appellants would not
20 be subject to the AMT for 2002.¹³

21 Appellants in their Appeal Letter argue that the arbitration award “is based on [Mr.
22 Northrup’s] claim for an ownership interest in BKM California”, which “arose from a claim based on
23 his property rights and the recovery compensated him for shares of BKM California stock”. The award
24 “was actually a payment in substitution for his right to purchase all or part of BKM California” and “was
25 actually a payment in substitution for his right to purchase an ownership percentage in BKM
26

27 ¹² Appeal Letter, pages 3-4.

28 ¹³ Appellants’ Supplemental Brief, page 7.

1 California.”¹⁴ Therefore, appellants argue that the award is a “capital asset” under IRC sections 1221
2 (defining “capital asset”) and 1234A (“[g]ains or losses from certain terminations.”). Appellants argue
3 that the entire arbitration award is a “capital asset” in the form of an ownership interest in BKM and that
4 there was a “cancellation, lapse, expiration or other termination” of a right or obligation to a capital
5 asset, as these terms are used in IRC sections 1221 (defining capital assets), 1222 (capital gains and
6 losses) and 1234A (gains or losses attributable to cancellations, lapses, expirations and terminations).
7 Therefore, according to appellants “[IRC] Section 1243A should apply to Mr. Northrup’s recovery and it
8 should be treated as capital gain” because “the recovery received by Mr. Northrup was actually a
9 payment in substitution for his right to purchase an ownership interest in BKM California and should
10 have been reported on his individual income tax return as a capital gain with legal fees added to basis.”¹⁵
11 In their Supplemental Brief Exhibit B, appellants provide a new Schedule D that lists the acquisition
12 date, sale date, basis, sales price and gain from the sale of the BKM “asset.”

13 Respondent’s Contentions

14 Respondent in its Opening Brief, its reply to the Appeals Division letter (July 2, 2009),
15 and its Reply to Appellants’ Supplemental Brief, argues that the arbitration award was issued in lieu of
16 termination payments and does not represent any ownership interest in BKM. Respondent, quoting from
17 the arbitration award, ¹⁶ notes that the award expressly denied Mr. Northrup’s claim that he was entitled
18 to purchase BKM, because the profit target requirements in the OPA were not met. Respondent, further
19 quoting from the arbitration award, notes that the award determined that Mr. Northrup was entitled to
20 damages under the OPA termination clause after finding that he had no right to purchase BKM.¹⁷
21 Therefore, respondent argues that the arbitration award is ordinary income, not a capital asset.
22 Respondent further noted that IRC section 83, incorporated into Revenue and Taxation Code (R&TC)
23 section 17081, requires ordinary income treatment of “[p]roperty transferred in connection with
24

25 ¹⁴ Appellants’ Appeal Letter, page 4, topic 6.

26 ¹⁵ Appellant’s Appeal Letter, pages 5-6, topics 5 and 6.

27 ¹⁶ Respondent’s Opening Brief, Exhibit H.

28 ¹⁷ Respondent’s Opening Brief, pages 2: 13 through 3: 3, and 4 13 through 5:2.

1 performance of services” where the property “is transferred to any person other than the person for
2 whom such services are performed.” Therefore, respondent treats the unreported \$373,465 as California
3 gross income, with a pre-AMT miscellaneous itemized deduction for \$335,276 in legal fees that is added
4 back under the AMT.

5 Respondent also argues that appellants’ purported acquisition date of the BKM asset
6 cannot be 1995, because “under the OPA, any right to purchase BKM was contingent upon Mr.
7 Northrup meeting the net profits target for at least five years”, whereas the arbitration award found that
8 he never met the target, and under IRC section 83(f), “the holding period for restricted property does not
9 begin until the property is transferable or no longer subject to a substantial risk of forfeiture.”¹⁸

10 Applicable Law

11 Under the California Personal Income Tax Law (unlike the IRC) the same tax rates
12 (between 1 per cent and 9.3 per cent) apply to both ordinary income and capital gain income.

13 IRC section 1221 defines “capital asset” as “property held by the taxpayer” subject to
14 several exceptions, including depreciable property, inventory, or copyrights. IRC section 1234A states
15 that “[g]ain or loss attributable to the cancellation, lapse, expiration or other termination” of “a right or
16 obligation. ... which is... a capital asset in the hands of a taxpayer... shall be treated as gain or loss from
17 the sale of a capital asset.” (Int. Rev. Code, § 1234A, subd.(1).) In addition “[i]t has long been
18 recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are
19 to be treated as capital expenditures” and that “legal, brokerage, accounting, and similar costs incurred
20 in the acquisition or disposition of such property are capital expenditures. (*Woodward v. Commissioner*
21 (1970) 397 U.S. 572, 575-576.) R&TC section 18151 incorporates the IRC treatment of capital
22 transactions as income by incorporating “Subchapter P of Chapter 1 of Subtitle A of the Internal
23 Revenue Code, relating to capital gains and losses” and declaring that these provisions “shall apply,
24 except as otherwise provided.”

25 IRC section 64 states as follows:

26 “For purposes of this subtitle, the term ‘ordinary income’ includes any gain from the sale
27 or exchange of property which is neither a capital asset nor property described in section
28

¹⁸ Respondent’s Reply to Appellants’ Supplemental Brief, page 4: 18-22.

1 1231(b).”¹⁹

2 R&TC section 17074 incorporates IRC section 64 into California law. In IRC Subchapter B, Part II,
3 entitled “Items Specifically Included in Gross Income”, IRC section 83 states that, for “[p]roperty
4 transferred in connection with the performance of services”, the excess of the fair market value at the
5 time of the transfer over the amount paid for such property “shall be included in the gross income of the
6 person who performed such services.” R&TC section 17081 incorporates IRC sections 71 through 90
7 into California law.

8 In *Furrer v. C.I.R.* (9th Cir. 1977), 566 F.2d 1115, 1117, *cert. denied*, (1978) 437 U.S.
9 903, the court explained as follows:

10 “If all contracts granting rights could be considered capital assets, without inquiry into
11 the nature of the rights granted, almost all ordinary income from salaries, wages or
12 commissions could be transformed into capital gain.”

13 Therefore, the court rejected the taxpayer’s contention that “the damages taxpayer received for breach of
14 his agency contract with an insurance company are taxable as ordinary income and not as capital gain.”
15 (*Id.*, at p. 1116.) The court did so after analyzing the final judgment, pleadings, and proof at trial, and
16 found that they “simply contain no evidence that ‘the entire insurance business’ amounted to anything
17 more than the right to earn commissions.” (*Id.*, at p. 1116-1117.) Instead, the court concluded as
18 follows, at 566 F.2d 1117:

19 “a lump sum payment for the termination of an agency relationship is ordinary income ...
20 even though the contract be nonterminable and exclusive. The fact that others are
21 excluded from the sources available to [taxpayer] for earning income *in no way changes*
22 *the fact that his income derived from personal services and that what he lost through*
23 *termination was the right to earn future income.*” (Emphasis added.)

24 The court noted: “This attempted transubstantiation of income into capital must fail because the essential
25 element – the capital asset, tangible or intangible – is not present.” (*Ibid.*) Finally, the court rejected the
26 taxpayer’s argument that the award “was, at least in part, in compensation for” “capital assets” in the
27 form of “valuable good will and files of documents and information” because the Oregon state court
28 judgment did not contain any indicia that plaintiff’s award was compensation for the alleged destruction
of such capital assets. (*Ibid.*)

In *Basle v. Commissioner*, T.C. Memo. 1957-169 (Aug. 30, 1957) the Tax Court held

¹⁹ IRC section 1231(b) covers “property used in trade or business.”

1 that the entire amount of an antitrust settlement received by a theater owner from film companies (for
2 refusing to send him first-run films) was ordinary income, notwithstanding the owner's contention that it
3 represented "a long-term capital gain attributable to the loss of partnership goodwill" as well as a
4 settlement agreement that allocated 75 percent to loss of goodwill and 25 percent to lost profits.²⁰

5 In *Turzillo v. C.I.R.* (6th Cir. 1965) 346 F.2d 884, 885, 888-889, the court held that
6 capital gains treatment applied to the "rights acquired by [the taxpayer] through the execution of the five
7 contracts on September 21, 1954" and money received for the release of all rights thereunder, because
8 they "were property rights, the essential nature of which was not merely to obtain periodic receipts of
9 income for services rendered, but to afford [the taxpayer] an opportunity to acquire an interest in
10 property, which if itself held, would be a capital asset." The court noted that the taxpayer's "amended
11 petition did not seek recovery of future income from any loss of employment, but sought damages for
12 the illegal termination by Intrusion of [the taxpayer's] option to acquire an interest in the company."

13 Respondent notes in its Reply to appellants' Supplemental Brief²¹ that *Turzillo* was decided in 1965, and
14 involved the 1954 tax year, both of which are years that predate the 1969 addition of IRC section 83 in
15 Public Law 91-172, the Tax Reform Act of 1969. As discussed above, IRC section 83 expressly
16 includes in gross income compensation received for property transferred in connection with the
17 performance of services, and does not extend capital asset treatment to this income. However, none of
18 the several post-1969 cases citing *Turzillo* refer to its holding as being subsumed by the enactment of

19 ///

20 ///

21 ///

22 ///

23 ///

24
25 ²⁰ This case is cited in appellants' Supplemental Brief (pages 5-6) for the proposition that "[w]hen a settlement relates to a
26 capital asset, it is necessary to refer to the basis of the asset to determine what portion of the recovery, if any, ought to be
27 taxed as capital. If no basis is demonstrable, the entire amount is treated as capital gain." Respondent argues in its Reply to
28 Appellants' Supplemental Brief (page 4: 11-13) that "[r]ather than support an argument for capital gain, this reinforces the
fact that a settlement recovery for termination payments will be characterized as ordinary income."

²¹ Page 3: 5-7. The legislative history quoted above comes from IRC section 83 annotations in the Thomson Reuters edition
of The Complete Internal Revenue Code.

1 IRC section 83.²²

2 Staff Comments

3 Here, it appears that the BKM award expressly distinguished between the right to
4 purchase BKM after five years of meeting profit targets (which the arbitration award decision expressly
5 found had not been met) and payments the arbitrator awarded under the separate termination provision
6 of the OPA, which were offset by the \$83,333 appellant earned while working for a competitor. Thus,
7 even if *Turzillo* is still valid after the addition of IRC section 83, appellants' facts appear to be
8 distinguishable from the facts of *Turzillo*. Appellants' arbitration award appears to be no different than
9 any other form of severance payment, which, because it is compensation for lost wages, is quintessential
10 ordinary income.

11 Unlike the famous case of *C.I.R. v. Ferrer* (2d. Cir. 1962) 304 F.2d 125, this appeal does
12 not involve a contract which resulted in simultaneous and commingled payment for both the surrender
13 by actor Jose Ferrer of the rights to theatre production of the film *Moulin Rouge*, and the receipt by the
14 taxpayer of motion picture proceeds for the same work. In *Ferrer*, the court concluded, contrary to the
15 positions of both the taxpayer and the IRS, that the surrender of the theatre rights was a capital asset, and

17
18 ²² See, e.g.,
19 *Fox v. United States*, 1974 U.S. Dist. LEXIS 9360, 33 A.F.T.R.2d (RIA) 1118, 74-1 U.S. Tax Cas. (CCH) P9358 (E.D. Pa.
1974);

20 *Cline v. Commissioner*, 617 F.2d 192, 195, 1980 U.S. App. LEXIS 19266, 45 A.F.T.R.2d (RIA) 1093, 80-1 U.S. Tax Cas.
(CCH) P9315 (6th Cir. 1980)

21 *Bankers Life & Cas. Co. v. United States*, 1996 U.S. Dist. LEXIS 3534, 79 A.F.T.R.2d (RIA) 1726, 1729, 97-2 U.S. Tax Cas.
22 (CCH) P50722 (N.D. Ill. 1996);

23 *Wachner v. Commissioner*, T.C. Memo 1995-88, 1995 Tax Ct. Memo LEXIS 88, 69 T.C.M. (CCH) 1982, 95 TNT 48-18
(T.C. 1995);

24 *Rothstein v. Commissioner*, 90 T.C. 488, 494, 1988 U.S. Tax Ct. LEXIS 34, 90 T.C. No. 34 (1988)

25 *Belz Inv. Co. v. Commissioner*, 72 T.C. 1209, 1230, 1979 U.S. Tax Ct. LEXIS 46 (1979);

26 *Denison v. Commissioner*, T.C. Memo 1977-430, 1977 Tax Ct. Memo LEXIS 13, 36 T.C.M. (CCH) 1759, T.C.M. (RIA)
27 P77430, T.C.M. (RIA) P770430 (T.C. 1977)

28 *Putchat v. Commissioner*, 52 T.C. 470, 476, 1969 U.S. Tax Ct. LEXIS 109 (1969)
e.g.,

1 that the motion picture proceeds were ordinary income, with the case remanded to the Tax Court to
2 perform an allocation. (id. at pp. 132-136.) In contrast, it appears here that the only income received by
3 Mr. Northrup came from the termination provision of the OPA and not from any ownership interest in
4 BKM.

5 It also appears to staff that appellants' position is contrary to the statement by the Court
6 of Appeal in *Furrer v. C.I.R.*, *supra*, that care should be taken to avoid characterizing contract-based
7 wages as capital assets. In the similar case of *Banks v. Commissioner* (1995) 543 U.S. 426, 437, the
8 U.S. Supreme Court extensively discussed the multiple tax theory arguments for excluding attorney-
9 retained portions of lawsuit recoveries from the client's gross income, and rejected all of them.

10 At the hearing, appellants should be prepared to cite additional authority and present
11 argument to support their position that the arbitration award was in settlement of appellant-husband's
12 right to purchase an ownership interest in BKM despite the arbitrator's finding that appellant-husband
13 lost the right to purchase the ownership interest.

14 Appellants fail to note that, if their characterization of the BKM award is accepted, they
15 would also have no capital loss carryforwards from 2002 into future years, nor do they explain whether
16 or not they have claimed such carryforwards on their returns from 2003, 2004, 2005, 2006, 2007, and/or
17 2008, or whether they would file amended returns revoking such claims and paying California tax and
18 interest on any \$3,000 capital loss claims for each of these six years based on such carryforwards.

19 Appellants also do not explain whether or not they have filed amended returns for 2002 with the Internal
20 Revenue Service (IRS) with these characterizations, or whether the IRS accepted them.

21 Question (2): Whether this Board has jurisdiction to consider respondent's estimated post-amnesty
22 penalty.

23 Contentions

24 In their Appeal Letter, appellants generally dispute the estimated post-amnesty penalty
25 and interest, but do not offer any specific arguments regarding these issues.

26 Respondent notes that the \$1,306.12 in post-amnesty penalty shown on the NOA is an
27 estimated amount, is not part of the deficiency amount, "and will be re-computed and imposed if and
28 ///

1 when the proposed deficiency assessment becomes a final assessment.”²³

2 Applicable Law

3 R&TC sections 19730 – 19738 and 19164 establish a tax amnesty program for 2002 and
4 other pre-2003 years for taxpayers who apply and make full payments or enter into installment payment
5 agreements on or before May 31, 2005. Taxpayers who do not apply for amnesty and pay are subject to
6 a 50 percent interest surcharge on the interest that accrued through March 31, 2005. However, R&TC
7 section 19777.5, subdivision (d) provides that Article 3 (relating to deficiency assessments and the
8 protest and appeal thereof) shall not apply with respect to the assessment or collection of the amnesty
9 interest penalty; and subdivision (e) provides that appellant must pay the amnesty interest penalty before
10 filing a claim for refund of its amount, and that the only ground for a claim for refund is a computation
11 error by respondent.

11 Staff Comments

12 It appears that appellants’ contentions with respect to the amnesty penalty are premature
13 (and the Board does not have jurisdiction to consider them) since the penalty remains unpaid and
14 appellant has not filed a claim for refund objecting to the calculation of the penalty.

15 Question (3): Whether appellants are entitled to interest abatement.

16 Contentions

17 In their Appeal Letter, appellants generally dispute the assessment of interest in the NOA, but do
18 not offer any specific arguments for interest abatement. Respondent argues that interest on unpaid tax is
19 mandatory unless appellants attempt to demonstrate specific facts entitling them to interest abatement
20 under R&TC section 19104, which respondent argues appellants have not done.

21 Applicable Law

22 The assessment of interest on unpaid tax is mandatory; interest is not a penalty but is
23 merely compensation for the taxpayer’s use of the money. (Rev. & Tax. Code, § 19101, subd. (a);
24 *Appeal of Amy M. Yamachi*, 77-SBE-095, June 28, 1977; *Appeal of Audrey C. Jaegle*, 76-SBE-070,
25 June 22, 1976.) R&TC section 19104, subdivision (b)(1) expressly states that interest cannot be abated
26 before any period prior to August 23, 2005, the day the FTB first contacted appellants in writing by
27

28 ²³ Respondent’s Opening Brief, page 1, footnote 1.

1 informing them that their 2002 return was under audit.²⁴ For the period beginning on August 24, 2005,
2 R&TC section 19104 permits respondent to abate interest only when the aggrieved taxpayer identifies an
3 unreasonable error or delay which (1) occurred after respondent contacted the taxpayer in writing about
4 the particular deficiency or overpayment underlying the disputed interest; (2) is not significantly
5 attributable to the taxpayer; and (3) is attributable to a ministerial or managerial²⁵ act performed by
6 respondent. (*Appeal of Michael and Sonia Kishner*, 99-SBE-007, Sept. 29, 1999; see also Rev. & Tax.
7 Code, § 19104, subds. (a)(1) & (b)(1).)

8 Respondent's determination not to abate interest is presumed correct, and the burden is
9 on appellant to prove error. (*Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.) The R&TC
10 grants the Board jurisdiction to review respondent's refusal to abate interest for abuse of discretion and
11 to order an abatement of interest if it determines that such an abuse occurred. (R&TC § 19104, subd.
12 (b)(2)(B); *Appeal of Ernest J. Teichert*, 99-SBE-006, Sept. 29, 1999.) In order to show an abuse of
13 discretion, appellant must establish that the FTB exercised its discretion arbitrarily, capriciously, or
14 without sound basis in fact or law by refusing to abate interest. (*Woodral v. Commissioner* (1999) 112
15 T.C. 19, 23.) Interest abatement provisions are not intended to be routinely used to avoid the payment of
16 interest, thus abatement should be ordered only "where failure to abate interest would be widely
17 perceived as grossly unfair." (*Lee v. Commissioner* (1999) 113 T.C. 145, 149.).

18 _____
19 ²⁴ Respondent's Opening Brief, page 2: 20-22.

20 ²⁵ In the *Appeal of Michael and Sonia Kishner* (99-SBE-007), decided September 29, 1999, this Board adopted the language
21 from Treasury Regulation section 301.6404-2 (b)(2), which defines a "ministerial act" as:

22 A procedural or mechanical act that does not involve the exercise of judgment or discretion, and that occurs
23 during the processing of a taxpayer's case after all prerequisites to the act, such as conferences and review
24 by supervisors, have taken place. A decision concerning the proper application of federal law (or other
25 federal or state law) is not a ministerial act.

26 Further, as we did in the *Appeal of Michael and Sonia Kishner*, we turn to Treasury Regulation section 301.6404-2 (b)(1) for
27 the definition of a "managerial" act. The regulation defines a managerial act as:

28 [A]n administrative act that occurs during the processing of a taxpayer's case involving the temporary or
permanent loss of records or the exercise of judgment or discretion relating to management of personnel. A
decision concerning the proper application of federal tax law (or other federal or state law) is not a
managerial act. Further, a general administrative decision, such as the IRS's decision on how to organize
the processing of tax returns or its delay in implementing an improved computer system, is not a
managerial act for which interest can be abated

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

Staff Comments

As noted above, appellants have not yet demonstrated any basis for interest abatement under R&TC section 19104.

///
///
///

Northrup_smk