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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	CORPORATION FRANCHISE TAX APPEAL
STATE-OF-THE-ART TECHNOLOGIES, INC.[1]	Case No. 521969

Years	Proposed Assessment Penalty
12/31/2002	$2,973.49
12/31/2003	$3,765.50

Representing the Parties:

For Appellant: Barry Moser, CPA

For Franchise Tax Board: Diane L. Ewing, Tax Counsel IV

QUESTION: Whether appellant has shown reasonable cause for abatement of the accuracy-related penalties.

HEARING SUMMARY

Factual Background

On April 15, 2007, appellant filed amended corporation franchise or income tax returns

[1] Appellant's headquarters is located in Los Angeles County, California.

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(Form 100X) for tax years ending on December 31, 2002 (2002) and December 31, 2003 (2003). (Resp. Opening Br., p. 1, exhibits A-B.) On the amended 2002 return, appellant reported additional net income of $168,184 and additional tax of $14,867. On line 19 of the 2002 amended return, Penalties and Interest, appellant reported net changes of $4,242 of penalties in column (a) and $3,797 of interest in column (b). On Statement 5 of the 2002 amended return, appellant lists a self-assessed late payment and/or late filing penalties of $3,696 and an underpayment penalty of $688, and late payment interest of $3,797.[2] In Part V of the 2002 amended return, appellant reported that the changes were made due to an audit by the Internal Revenue Service (IRS). Appellant reported an extension payment of $3,978, a return payment of $142 and an "other" payment of $15,000 amounting to total payments of $19,120. Appellant claimed an amount due of $7,823. (*Id*., exhibit A.)

On the amended 2003 return, appellant reported additional net income of $212,981 and additional tax of $18,828. (Resp. Opening Br., exhibit B.) On line 19 of the 2003 amended return, Penalties and Interest, appellant reported net changes of $4,917 of penalties in column (a) and $3,660 of interest in column (b). (*Id*.) Respondent no longer has a full copy of appellant's 2003 amended return and therefore is unable to ascertain the type of penalties appellant self-assessed, but respondent assumes based on appellant's 2002 amended return that appellant self-assessed a late payment and an underpayment of estimated tax penalty for a total amount of $4,917. (Resp. Opening Br., pp. 1-2, n. 1.) In Part V of the 2003 amended return, appellant reported that the changes were made due to an audit by the IRS. (*Id*., exhibit B.) Appellant reported estimated tax payments of $2,799 and an "other" payment of $20,000 amounting to total payments of $22,799. (*Id*.) Appellant claimed an amount due of $7,405. (*Id*.)

Respondent reviewed the 2002 and 2003 amended returns and other account information, including copies of appellant's business master file transcripts (BMFs) from the IRS. (Resp. Opening Br., p. 2.) Respondent determined that the late payment penalties and underpayment of estimated tax

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[2] Respondent similarly asserts that appellant self-assessed a late payment penalty of $3,696 and an underpayment of estimated tax penalty of $688 plus $3,797 of interest. (Resp. Opening Br., p. 1, 3.) Staff notes, however, that the sum of these two penalty amounts equals $4,384 whereas the penalty amount listed on line 19, column b, is $4,242. The difference amounts to $142, which is the return payment amount appellant reported on its 2002 amended return. Staff also notes that respondent's records show that on June 19, 2008, it refunded $4,332.76 to appellant. (*Id*., exhibit C.)

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penalties appellant self-assessed on the 2002 and 2003 amended returns were not applicable and respondent therefore refunded these amounts to appellant. (*Ibid*.) According to the BMFs, the IRS audited appellant's 2002 and 2003 federal returns and assessed accuracy related penalties for both tax years due to substantial understatements of tax. (*Ibid*.) Based on the federal assessments, respondent issued penalty only Notices of Proposed Assessments (NPAs) dated December 30, 2008 for 2002 and 2003, which imposed an accuracy related penalty of $2,973.49 for 2002 and an accuracy related penalty of $3,765.50 for 2003.[3] (*Id*., exhibits D-F.) Respondent calculated each of the accuracy related penalties by multiplying the additional tax liability reported on each amended return by 20 percent. (*Id*.)

Appellant timely protested the 2002 and 2003 NPAs. Respondent sent appellant a letter dated October 2, 2009, acknowledging appellant's protest, explaining the assessment of the penalties, and requesting additional information or documentation showing that the IRS reduced or reversed the penalties. (Appeal Letter, Attachment, Resp. Opening Br., p. 2.) After not receiving any additional information from appellant, respondent issued Notices of Action (NOA) affirming the 2002 and 2003 NPAs. (Appeal Letter, Attachment; Resp. Opening Br., p. 3.) Appellant filed this timely appeal.

Contentions

Appellant's Contentions

In the appeal letter, Sota Omoigui, M.D., appellant's president and sole shareholder, contends that respondent issued a new bill for accuracy-related penalties three years after appellant paid all the taxes, penalties and interest due for 2002 and 2003. (Appeal Letter, p. 2.) Dr. Omoigui also contends that the IRS did not impose an accuracy-related penalty on appellant's federal account for 2002 or 2003. He points out that respondent stated in its letter dated October 2, 2009, that it would reduce or withdraw the accuracy-related penalty if the IRS did the same. Dr. Omoigui asserts that the attached copy of the IRS Form 5278, Statement-Income Tax Changes, does not show a federal accuracy-related penalty for 2002 or 2003. Attached to the appeal letter are copies of a letter dated October 19, 2009, from appellant's representative to respondent concerning a federal audit report that he claims "provides

[3] The December 30, 2008 NPA for 2003 incorrectly indicates that it is for taxable year 12/31/2002. (Resp. Opening Br., exhibit E.) Consequently, respondent issued a second NPA dated March 30, 2009, for 2003, which merely corrects the taxable year. (*Id*., exhibit F.)

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information that the IRS did not impose any penalty on the tax return in 2002," and a one-page federal Form 5278, Statement-Income Tax Changes.[4] (Appeal Letter, p.2, Attachment.)

In appellant's reply brief, appellant argues that the penalties should be abated pursuant to Internal Revenue Code (IRC) section 6664(c) because appellant had reasonable cause and acted in good faith. According to appellant, an accountant who prepared the 2002 and 2003 original returns made errors on them due to his failure to prepare properly the books. (App. Reply Br, p. 1.) Appellant contends that another firm was hired to complete the audit after it was discovered that appellant's books did not correspond with the original returns. Appellant also contends that the IRS accepted the new records without additional audit procedures. He contends that reasonable cause and good faith is established by the fact that appellant filed the 2002 and 2003 amended tax returns on April 15, 2007, when it realized there were errors in the original returns, and the IRS did not close out the federal audit until June 4, 2007, at which time the IRS imposed the federal accuracy- related penalties. (*Id*., pp. 1-2.) Appellant argues that he "could have waited and taken the chance that the Franchise Tax Board would never have billed him." (*Id*., p. 2.)

According to appellant, respondent incorrectly asserts that the IRS imposed the accuracy-related penalties on March 15, 2003 and September 15, 2004. (App. Reply Br, p. 2-3.) Appellant contends these two dates are listed for the penalties on the 2002 and 2003 federal account transcripts because they are the dates when appellant filed the 2002 and 2003 federal returns. (*Ibid*.; Resp. Opening Br., exhibits J, p. 2, K, p. 2.) He argues the facts surrounding the federal audit are different and appellant could not use the same defense with respect to the federal accuracy-related penalties because appellant did not pay the federal additional tax due until after the IRS notified it of an audit. Appellant asserts that in the case of the accuracy-related penalties imposed by respondent, however, "[t]he Franchise Tax Board never notified the taxpayer of an audit and voluntarily paid the additional tax when he noticed the error." Appellant also argues that the cases cited in respondent's opening brief are factually distinguishable from the present appeal and are not controlling because they were decided prior

[4] Dr. Omoigui also references an appeal before the California Unemployment Insurance Appeals Board, which he has apparently confused with the present appeal before the Board. He also attached to the appeal letter copies of documents concerning this unrelated petition. (Appeal Letter, p. 2.)

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to the current IRC section 6664(c), which allows for abatement of the accuracy-related penalty due to reasonable cause and good faith, and the taxpayers did not file returns until notified by respondent. (App. Reply Br., pp. 2-3.)

Respondent's Contentions

Respondent contends that it properly refunded the amounts appellant paid for self-assessed late payment penalties because it does not impose this penalty for additional tax reported on an amended return and it properly refunded the amounts appellant paid for self-assessed underpayment of estimated tax penalties because it does not impose this penalty on amounts shown on an amended return. (Resp. Opening Br., p. 3, exhibit C.) Respondent contends that appellant did not self-assess an accuracy-related penalty on the 2002 amended return or the 2003 amended return and it properly imposed the accuracy-related penalties for both tax years based upon the IRS's imposition of the federal accuracy-related penalty for both tax years. Respondent asserts that the accuracy-related penalty would be listed on the *second* page of the federal Form 5278, which appellant did not attach to its appeal letter. Respondent submitted copies of the IRS's account transcripts for 2002 and 2003, which respondent asserts show that for tax year 2002, the IRS assessed an accuracy-related penalty of $11,733.00 on March 15, 2003, and for tax year 2003, the IRS assessed an accuracy-related penalty of $14,908.60 on September 15, 2004. (Resp. Opening Br., pp. 3-4, exhibits C, J and K.) According to respondent, the federal account transcripts do not indicate the IRS abated the accuracy-related penalty for either tax year at issue, and appellant has not submitted any other arguments that would show reasonable cause for the substantial understatements that were the basis for the imposition of the penalties. (Resp. Opening Br., p. 4, n. 5.)[5]

In its reply brief, respondent argues that appellant fails to establish reasonable cause for the abatement of the accuracy-related penalties. Respondent asserts that the understated amount of tax for 2002 and 2003 exceeds the floor of $10,000 set forth in IRC section 6662(d), as in effect for these tax years. Respondent also asserts that Treasury Regulations section 1.6664-4(c) provides that the

[5] Respondent also argues in its opening brief but not in its reply brief that the Board does not have jurisdiction to resolve constitutional issues, presumably because the appeal letter asserts that Dr. Omoigui was never provided the hearing he requested in his letter dated November 12, 2009, to another agency. As discussed in footnote 4, supra, this concerns a petition that is unrelated to the present appeal before the Board.

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determination of whether a taxpayer acted with reasonable cause and in good faith should be made on a case-by-case basis. (Resp. Reply Br., pp. 1-2.)

With respect to appellant's argument that the penalties should be abated because it amended its 2002 and 2003 returns prior to the close out of the federal audit, respondent argues as follows:

> The reasonable cause defense is based on the reasons for underreporting the income and not on what the taxpayer subsequently did after he was notified of a federal audit, such as filing an amended return later. The fact that appellant filed an amended return prior to the end of the federal audit does not show that [sic] reasonable cause for underreporting its income in the first instance. The most important factor is appellant's efforts to assess the proper tax liability on its original return, not that appellant acted reasonably in filing an amended return with the respondent after or during an audit.

(Resp. Reply Br., p. 2, fn. 1.)

Respondent asserts that a taxpayer's reliance on professional advice constitutes reasonable cause only if, under all of the circumstances, the taxpayer's reliance was reasonable and he or she acted in good faith. Respondent asserts, "There is simply not enough information to make a determination that appellants [sic] reasonably relied on a tax advisor and acted in good faith." According to respondent, appellant must provide specific details of the facts surrounding the substantial understatements before it can be determined whether abatement of the penalties is warranted. Respondent contends that the only evidence appellant produced in support of its contention that it reasonably relied in good faith on advice from its accountant are unsubstantiated statements by Dr. Omoigui, who is a medical doctor and the sole shareholder of appellant. Respondent asserts that lack of oversight on the part of Dr. Omoigui with his level of knowledge, education and experience does not constitute reasonable cause and good faith. (Resp. Reply Br., pp. 2-4.)

According to respondent, appellant asserts in its reply brief that it had reasonable cause because its "prior accountant did not properly prepare the books and therefore made errors in preparing the return." Respondent contends that appellant's purported reliance on a tax professional's advice thus appears to be in the nature of a computation type error, rather than a substantive matter of tax law. Citing *United States v. Boyle* (1985) 469 U.S. 242, respondent argues that reasonable cause can be demonstrated when a taxpayer shows that it relied on a tax professional's advice concerning a substantive matter of tax law, which does not appear to be the case in the present appeal. (Resp. Reply

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Br., p. 4.)

Respondent asserts that the factual differences between the cases it cited in its opening brief and the present appeal are not relevant to the principle for which they were cited, namely, that the taxpayer bears the burden of demonstrating with credible and competent evidence that he or she exercised ordinary business care and prudence. (Resp. Reply Br., pp. 4-5.) Moreover, respondent contends that all of the cases it cited in its opening brief have been discussed in decisions that, although they may not be cited as precedents, addressed accuracy-related penalties, and those decisions were issued subsequent to the enactment of the current federal statutes. (*Id*., fn. 2.)

Lastly, respondent argues that it is not relevant when the IRS assessed the accuracy-related penalties for 2002 and 2003. (Resp. Reply Br., p. 5.) Respondent contends the relevant fact is that the IRS assessed the penalties for both tax years at issue and, as evident from appellant's federal account transcripts, has not subsequently revised or abated them. (Id., exhibit L, M.)

Applicable Law

R&TC section 18622 requires the taxpayer to report federal changes in income or deductions to respondent and to concede the accuracy of the federal changes or state wherein they are erroneous. A deficiency assessment based upon a federal change is presumed to be correct and the taxpayer bears the burden of proving the determination erroneous. (*Appeal of Sheldon I. and Helen R. Brockett*, 86-SBE-109, June 18, 1986; *Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) When based on a federal action, respondent's assessment of an accuracy-related penalty is presumptively correct. (*Appeal of Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.)

R&TC section 19164, subdivision (a), as in effect for tax years 2002 and 2003, imposed an accuracy-related penalty in accordance with IRC section 6662. The accuracy-related penalty is calculated to equal 20 percent of the portion of the underpayment to which IRC section 6662 applies. (Int.Rev. Code, § 6662, subd. (a).) This penalty is imposed where the underpayment of tax is due to negligence or disregard of the rules or regulations or to any substantial understatement of income tax. (Int.Rev. Code, § 6662, subd. (b).) For tax year 2002 and 2003, IRC section 6662(d)(1)(B) provided that in the case of a corporation other than an S corporation or a personal holding company there was a substantial understatement of income tax for any taxable year if the amount of the understatement for the

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taxable year exceeds the greater of 10 percent of the required tax to be shown on the return for the taxable year or $10,000.[6] The taxpayer bears the burden of showing there was reasonable cause for, and that he or she acted in good faith with respect to, a portion of an underpayment. (*Remy v. Commissioner* (1997) T.C. Memo 1997-72.)

IRC section 6664(c) (1) provides:

> No penalty shall be imposed under this part with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all of the relevant facts and circumstances. (Treas. Reg., § 1.6664- 4(b)(1).) The most important factor is the extent of the taxpayer's effort to assess his proper tax liability. (See *id*.) An honest misunderstanding of fact or law that is reasonable in light of the experience, knowledge, and education of the taxpayer may indicate reasonable cause and good faith. (*Remy v. Commissioner, supra*.) Further, reliance by the taxpayer on the advice of a qualified adviser constitutes reasonable cause and good faith, if, under all of the facts and circumstances, the reliance by the taxpayer was reasonable and the taxpayer acted in good faith. (Treas. Reg., § 1.6664-4(b)(1).)

For purposes of the accuracy-related penalty, Treasury Regulation section 1.664-4(c)(1) defines advice as follows:

> Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

STAFF COMMENTS

Appellant argues it is entitled to abatement of the accuracy-related penalties for 2002 and 2003 because it acted in good faith and established reasonable cause by filing amended returns upon determining that it underreported its tax liabilities as a result of the federal audit. It is undisputed that the IRS imposed the federal accuracy-related penalty for both 2002 and 2003, even though appellant presumably relied upon the same tax professional to prepare both the federal and California income tax

[6] In 2004, Congress amended IRC section 6662(d)(1)(B) effective for tax years beginning after October 22, 2004. (P.L. 108-357, § 819(a).)

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returns for the tax years at issue. It also is undisputed that the IRS did not revise or abate the federal accuracy-related penalties for either tax year at issue. At the hearing, appellant should be prepared to discuss and to cite any legal authority to support its position that filing amended returns for 2002 and 2003 subsequent to the commencement of the federal audit satisfies the requirements of IRC section 6664(c)(1).

Appellant should also clarify at the oral hearing whether it is arguing that it acted with reasonable cause and in good faith with respect to any portion of an underpayment because it relied on the advice of its tax professional when filing the original returns. If so, appellant should be prepared to discuss at the oral hearing the facts and circumstances surrounding its reliance on the advice of its tax professional that would establish it acted with reasonable cause and in good faith. Appellant has the burden of proving with credible and competent evidence that it informed the tax professional who prepared its 2002 and 2003 returns of all pertinent facts and circumstances, exercised ordinary business care and prudence, and read the returns to ensure all items were included. (Treas. Reg. § 1.6664-4(c)(1).).

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