BOARD OF EQUALIZATION STATE OF CALIFORNIA

In the Matter of the Appeal of: RAVINDRANATH PATEL, MD AND NAINA PATEL

SUMMARY DECISION[*]

PERSONAL INCOME TAX APPEAL

Case No. 467727

Adopted: September 14, 2010

Representing the Parties:

For Appellants: Edward O.C. Ord, Esq.

For Franchise Tax Board: Michael C. Hamersley, Tax Specialist III

Counsel for the Board of Equalization: Louis A. Ambrose, Tax Counsel IV

This appeal is made pursuant to section 19324 of the Revenue and Taxation Code (R&TC) from the action of the Franchise Tax Board (FTB or respondent) in denying appellants' claim for refund in the amount of $483,687 [1] for 2002. The issues presented in this appeal are (1) whether appellants "perfected" their appeal as required by the Board's Rules for Tax Appeals and (2) whether appellants have demonstrated that respondent erred by denying their claim for refund of self-reported additional tax on their 2002 amended Voluntary Compliance Initiative (VCI) return.

FINDINGS AND DISCUSSION

Background

Appellants filed their original 2002 income tax return on October 14, 2003, reporting taxable income of $2,129,369 and total tax liability of $194,281. On April 7, 2004, appellants filed their 2002 VCI Amended Return (VCI return) reporting additional taxable income of $5,200,931, and additional tax liability of $483,687. In a statement attached to the VCI return, appellants state that their 2002 return was amended based on an amended K-1 received from Centercal Management Services, Inc. to reflect "the elimination of certain deductions related to an investment in a pass through entity named LDORAD, LLC." Appellants also state that the return was amended "pursuant to the California Voluntary Compliance Initiative" but that "[t]axpayer does not concede that the tax treatment of the items, as originally reported, was legally incorrect." Appellants also attached a VCI Participation Agreement Form on which appellants chose Option 2B, by which appellants notified respondent that their election to participate in the VCI program should not be treated as a claim for refund but that they want to maintain their appeal rights.

On April 7, 2004, appellants also filed an amended 2002 federal tax return on which they reported additional taxable income of $5,200,931, and additional federal income tax liability of $2,036,755. On July 12, 2004, appellants filed a second federal amended return and claim for refund of the additional tax reported on the first amended 2002 federal return. The Internal Revenue Service (IRS) denied the claim for refund. On October 15, 2007, appellants filed a second 2002 amended California return and claim for refund of the self-assessed additional tax on the VCI return. Respondent notified appellants in a letter dated June 3, 2008, that the claim was denied in accordance with R&TC section 18622, based on the IRS's disallowance of appellants' refund claim for similar reasons for the same transaction. By letter dated September 2, 2008, appellants appealed respondent's denial and attached to the letter the refund claim and a legal opinion letter. In the appeal letter, appellants state the IRS has "refused to provide any details on its positions" so that appellants are unable "to protest what we do not know." Appellants state that they will amend their appeal after respondent "provides us with its positions."

By letter dated November 18, 2008, Board staff accepted appellants' letter as a valid appeal and requested that respondent file an opening brief by February 16, 2009. By letter dated November 26, 2008, appellants requested that the appeal be stayed because respondent never conducted "any audit, investigation or provided any facts or evidence or details" and, as a result, appellants "had no records to give to the Board". Appellants also requested that their letter be forwarded to legal counsel to compel respondent to conduct an investigation. Appellants made a second request for deferral and audit in a letter dated January 27, 2009. Appellants' requests were denied.

Contentions

Appellants' Contentions

In their reply brief, appellants contend that respondent never made "any factual investigations, obtained documents, or conducted interviews to support the factual allegations in its opening brief" to support respondent's legal positions. Appellants also state that respondent admits the IRS never investigated and issued a report with respect to appellants' investment motivations. On that basis, appellants contend that respondent summarily denied appellants' "protest and sworn statements in their refund claim." Furthermore, appellants contend respondent in its opening brief made "inadmissible, abstract, hearsay opinions and charts, speculations and conclusions that are not supported by any admissible foundation or evidence." Specifically, appellants assert that respondent's position is based on the IRS's Coordinated Issue Paper on Distressed Asset/Debt (DAD) abusive tax shelters and that respondent provides no direct evidence of their investments and the arguments made in the Coordinated Issue Paper.

Appellants conclude that respondent's position is that the particular facts and circumstances of their activities are irrelevant and any losses from a DAD tax shelter may not be allowed. Appellants further assert that respondent takes the position that "all investments with tax aspects are bad unless the taxpayer makes a gain so that the [respondent] can tax and obtain revenue." In addition, appellants assert that respondent's position reflects the view that a DAD investment can never be profitable and, as a result, respondent makes no particularized findings that appellants' specific transactions and investments were not motivated by profit. Appellants contend that respondent has not met its burden of proof by producing admissible evidence. For that reason, appellants assert that this Board is required to remand the matter to respondent for a full field investigation.

In the absence of an investigation, appellants contend that respondent's assessment has no reasonable basis and, therefore, should not be accorded the presumption of correctness. On the other hand, appellants argue that they have provided evidence in the form of sworn statements supporting their claim for refund. Because respondent has not presented any evidence, appellants argue, respondent has not met its burden of establishing a rational basis for the determination and, therefore, the claim for refund should be granted.

Appellants further argue that respondent's failure to provide particularized findings and evidence violates due process and fundamental fairness. In addition, the absence of a detailed report with facts, analysis and evidence violates the provisions of the Administrative Procedures Act and the R&TC which set forth procedures to guarantee due process rights. Because those procedures have not been followed, appellants contend this Board cannot make a final decision and must remand the matter to respondent.

Appellants also cite Internal Revenue Code (IRC) section 704 and the interpretive Treasury Regulation which governs the distribution of partnership income and losses from contributed property among the partners, including the recognition of a partnership's built-in gain or loss. Appellants state that when a partnership interest is transferred from the partner who has contributed property, any built-in gain or loss must be allocated to the transferee partner just as it would have been allocated to the transferor partner. Appellants contend that by enacting IRC section 704 in 1954 and in view of the legislative history, Congress expressly intended the tax consequences at issue in this appeal. By changing that law in 2004 as part of the American Jobs Creation Act (AJCA), appellants contend, “Congress effectively acknowledged” that appellants correctly allocated their built-in losses in 2002.

Appellants argue that the AJCA is operative as of January 1, 2004, and thus the application of that Act to appellants' transaction would violate “ex post facto, due process, and fundamental fairness clauses.”

Appellants further assert that respondent has made unsupported conclusions regarding the contribution of the DAD to the partnership. Specifically, respondent states that the asset was worthless and had no carryover basis at the time it was contributed to the partnership and the purpose of the transaction was manipulation of the tax rules. Appellants contend that manipulation of tax rules is legitimate tax planning and is not a basis for disallowance. Appellants dispute respondent's position that all DADs are worthless. In support of their contention, appellants state that the United States has a long history of profiting from distressed debt and cite the examples of speculators who bought U.S. Treasury Bonds that fell in value after the Revolutionary War and a recent former Secretary of the Treasury who made a fortune from acquiring distressed debts during the savings and loan crisis.

Appellants also cite case law for the proposition that a debt is worthless only when it loses all intrinsic or potential value. Appellants state that so-called “vulture investors” make a practice of buying DADs at low prices and reaping large profits when those investments perform. In view of that practice, appellants maintain that DADs clearly have value because there is a market for distressed debt. Based on the foregoing and respondent's failure to make specific findings, appellants argue respondent's conclusion that the DAD was worthless is baseless and must be denied. Appellants further contend that respondent may not recast the transaction by disregarding either the partnership or the transferor partner because respondent has not made any finding of the facts and circumstances that would permit such recasting.

With respect to the provision of IRC section 165(c)(2) that limits deductions to losses incurred in transactions entered into for profit, appellants assert that the term “for profit” has been construed by federal courts to mean “primarily for profit.” In order to determine a taxpayer's primary purpose for entering into a transaction, appellants further assert, the courts have held that such a determination must be conducted from the taxpayer's point of view at the time the transaction occurred. Instead, appellants contend that respondent disallowed the losses based on hindsight as to appellants' primary purpose for the investments. Appellants contend that they demonstrated in the claim for refund that they engaged in the transactions primarily to make a profit and appellant-husband was advised by independent tax attorneys that he would make a substantial return.

Finally, appellants object to respondent's contention that the appeal should be denied because the appeal letter does not comply with the requirements under the Rules for Tax Appeals. Appellants argue that they were unable to present a statement of grounds for their appeal because respondent failed to investigate or issue a report. Appellants contend that respondent's conduct violates due process and is fundamentally unfair.

Respondent's Contentions

Respondent first contends that the appeal letter does not comply with Rules for Tax Appeals (RTA) section 5420 (Cal. Code Regs., tit. 18, § 5420), subdivision (b)(7) which requires every appeal to contain the facts involved and legal authorities upon which appellants rely. Thus, respondent argues that the appeal letter must be “perfected” before the briefing and resolution of the appeal may begin. If the Board is in agreement, respondent states that it has no objection to a deferral of the matter to allow appellants an opportunity to perfect.

Regardless of whether the appeal letter complies with the RTA, respondent contends that the subject series of transactions can be identified as a DAD abusive tax shelter publicly identified by the IRS in 2007 in the Coordinated Issue Paper and federal tax shelter anti-abuse legislation based on the following facts:

- Key transactional elements relating to the abusive tax shelter and the names of the abusive tax shelter and the names of the abusive tax shelter promoters provided by appellants in attachment to the claim for refund.
- Positive identification of appellants as having purchased the “cookie cutter” DAD abusive tax shelter in 2002 provided by DAD tax shelter promoters
- Substantial transactional documentation and information regarding the mechanics and marketing of cookie cutter DAD abusive tax shelters provided by the DAD tax shelter promoters.

Respondent also contends that the Coordinated Issue Paper clearly explains the reason the IRS denied appellants' federal refund claim and, therefore, appellants should understand why respondent also denied appellants' claim for refund. Specifically, respondent asserts that the transaction is an abusive tax shelter motivated solely by tax savings wholly lacking in economic substance as completely laid out in the Coordinated Issue Paper.

Respondent also states that appellants' claim for refund identifies as their tax advisors the same parties who have promoted “cookie cutter” abusive tax shelters. Respondent states that these parties, KPMG LLP (KPMG), Carl Hastings, a former KPMG partner, Gramercy Advisors LLC (Gramercy) and the law firm of De Castro, West, Chodorow, Glickfield & Nass (Nass law firm), provided respondent with DAD abusive tax shelter client lists that include appellants as having consummated a DAD abusive tax shelter in 2002. Despite their assertion that they have no records of the transaction, respondent points out in the claim for refund that appellants state that they received and signed an engagement letter with KPMG and Carl Hastings and the Nass law firm provided tax advice and an opinion letter regarding their distressed asset investment. In addition, respondent asserts the promoters have stated that each purchaser of a DAD tax shelter was provided with numerous documents by the promoters. However, respondent states that appellants have not disclosed those documents to respondent even though such disclosure was a condition of the VCI Participation Agreement.

Respondent contends that the Coordinated Issue Paper provides detailed descriptions of the precise structure of abusive tax shelters, explains how they are abusive and sets forth the legal grounds for disallowing the losses resulting from these tax shelters. Respondent also cites the following relevant points made by the Coordinated Issue Paper with respect to the examination of an abusive tax shelter transaction under applicable tax law requirements and procedures:

- A partnership has the burden of establishing the partners' bases in contributed assets at the time of contribution.
- The contribution of a worthless asset to a partnership does not give rise to carryover basis in that asset under IRC section 723 because, in effect, no property has been contributed within the meaning of IRC section 721.
- The IRS may recast a DAD transaction involving a partnership formed for a purpose inconsistent with the intent of Subchapter K by disregarding the partnership or disregarding the partner pursuant to Treas. Reg. section 1.701-2(b).
- Judicial doctrines holding that a transaction that lacks economic substance should not be given effect are applicable to the abusive tax shelter transactions. Respondent provides an explanation of the application of each of those doctrines and the types of evidence suggesting that such application is appropriate.
- Any loss purportedly realized in connection with the investments should be disallowed under IRC section 165(c)(2) because the primary purpose of the investments was tax avoidance and the transactions were not entered into for profit.

Respondent also contends that the AJCA amended IRC sections 704, 734 and 743 by requiring that only the partner who contributed the property may account for a built-in loss and by making basis adjustment rules mandatory in cases with a substantial basis reduction or substantial built-in loss. These amendments were made to curtail the promotion of the abusive nature of DAD tax shelters like the one appellants purportedly entered into.

Respondent also argues that appellants have failed to meet their burden of proof with respect to substantiating the loss deduction by failing to provide any evidence to support the claim for refund. Respondent contends that appellants are disingenuous and engaging in gamesmanship when they claim the IRS and respondent failed to provide them with information about their own transactions. Respondent asserts that appellants have been provided with several documents related to the DAD tax shelter and should be required to produce those documents to meet their burden. Moreover, respondent points out that appellants have a legal obligation to disclose all material facts relevant to the items reported on their 2002 federal and state income tax returns, which are signed under penalty of perjury. Respondent contends that appellants failed to comply with these legal obligations under Treas. Reg. section 1.6011-4 (which is incorporated by reference in R&TC section 18407) as a "reportable transaction", under R&TC section 19754, subdivision (d) as a condition of participation in the VCI program and under R&TC section 18622 which requires appellants to report the substance of a change or correction made by the IRS.

In a reply brief, respondent argues that there is no legal authority for this Board to remand an appeal to respondent. Respondent speculates that appellants may have intended to argue that this Board should dismiss the appeal to allow for further investigation of appellants' claims. However, according to respondent, a dismissal would have the effect of finalizing the denial of the claim and would possibly leave appellants without further administrative or judicial recourse.

With respect to appellants' argument that respondent has no rational basis for the assessment, respondent contends that the amount at issue was self-assessed by appellants on their VCI return. For that reason, respondent was entitled to accept that return as filed and was not obligated to conduct an audit. Furthermore, respondent states that R&TC section 19322 requires a refund claim "to state the specific grounds upon which it is founded" and Code of California Regulations, title 18, section 19322 is to the same effect. In addition, respondent cites Board precedent decisions for the proposition that a taxpayer bears the burden of proof with respect to an appeal from a denial of a claim for refund. In addition, respondent contends that appellants' claim for refund involved the same facts as their federal refund claim that was denied. Appellants acknowledged the IRS denial in their claim for refund by stating that they assumed that respondent would follow the IRS positions.

Respondent also rejects appellants' claim of due process violations, stating that this appeal process affords appellants notice and opportunity to be heard on the validity of the tax. Respondent also points out that this Board has a long-standing position that due process is satisfied as long as the taxpayer has an opportunity to question the validity of the tax at some stage in the proceedings. Thus, respondent argues that appellants have the burden of going forward and demonstrating their transactions differed from the DAD abusive tax shelter transactions.

DISCUSSION

VCI Provisions

In 2003, the California Legislature enacted the VCI which provided taxpayers with the opportunity to file amended returns, disclose potentially abusive tax shelter transactions, pay the resulting tax and interest, and avoid the application of penalties. (Rev. & Tax. Code, § 19751 et seq.) Taxpayers were allowed to file amended VCI returns during the period from

January 1, 2004, through April 15, 2004, inclusive. (Rev. & Tax. Code, § 19751, subd. (b).)

Taxpayers who participated in the VCI could elect either of two options. Under the first VCI option, the state would waive all penalties attributable to the abusive transactions (Rev. & Tax. Code, § 19752, subd. (a)(1)); the taxpayer would be immune from criminal prosecution in connection with the abusive transactions (*Id*., subd. (a)(2)); and, the taxpayer would give up the right to "file a claim for refund for the amounts paid in connection with" the abusive transactions. (*Id.* subd. (a)(4).) Under the second VCI option, the state would waive all penalties attributable to the abusive transactions except the accuracy-related penalty (*Id.* subd. (b)(1)); the taxpayer would be immune from criminal prosecution in connection with the abusive transactions (*Id.* subd. (b)(2)); and, the taxpayer would retain the right to file a claim for refund. (*Id.* subd. (b)(4).)

Here, there is no dispute that appellants entered into the VCI Participation Agreement, filed an amended return reversing the loss deductions from the DAD tax shelter transactions and paid the additional tax. Because appellants chose Option 2, they were entitled to file a claim for refund of the additional tax amount paid. As discussed below, the Board's authority to hear and decide this appeal is limited to determining whether respondent erred by denying appellants' claim.

Jurisdiction of Board

RTA section 5412 specifically provides that this Board has jurisdiction to hear and decide issues involving disputes over the correct amount of tax, penalties, fees and interest on respondent's determinations of proposed assessment and carryover adjustment; cancellation, credit or refund; abatement of interest or disallowance of interest on a refund; innocent spouse relief; jeopardy assessment; and claims for Homeowners' and Renters' Assistance. (Cal. Code Regs., tit. 18, § 5412, subd. (a) (1) - (10).) However, RTA section 5412 also expressly provides that the Board has no jurisdiction to hear and decide issues involving the validity or enforceability of a California constitutional provision, statute or regulation (absent a California appellate court decision); whether a liability has been or should have been discharged in bankruptcy; whether respondent violated the Information Practices Act, the Public Records Act or similar provision; and whether appellant is entitled to a remedy for respondent's violation of any procedural or substantive right, unless that violation relates to the adequacy of notice, the validity of respondent's action, or the amount at issue. (Cal. Code Regs., tit. 18, § 5412, subd. (b)(1) - (5).) Clearly, the specific provisions of RTA section 5412 do not grant this Board authority to remand this matter to respondent for further investigation and audit as appellants request. Hence, our action on this appeal will be limited to an examination of whether respondent's determination to deny appellants' claim for refund was erroneous.

Due Process Violations

This Board has held that "due process is satisfied with respect to tax matters so long as an opportunity is given to question the validity of a tax at some stage of the proceedings." (*Appeals of Walter R. Bailey,* 92-SBE-001, Feb. 20, 1992.) Because appellants have been provided with the right to file a claim for refund and to file an appeal from respondent's denial of their claim, appellants have been afforded due process by this opportunity to present their position and have it fully considered. (*Appeal of Michael E. Myers,* 2001-SBE-001, May 31, 2001.)

Presumption of Correctness and Burden of Proof

It is well-settled that tax deductions are a matter of legislative grace and the taxpayer bears the burden of proving that he is entitled to deductions claimed. Respondent's determination that a deduction should be disallowed is presumed correct. (*Appeal of Henry and Jeannette Stumpf*, 87-SBE-022, Mar. 3, 1987.) With respect to an appeal of a refund claim denial, a taxpayer has the burden of proving both that respondent's determination of the tax liability is erroneous and the correct amount of the tax liability. (*Appeal of Omer W. Ross, deceased*, 86-SBE-120, June 10, 1986.) R&TC section 19322 requires that a claim for refund "state the specific grounds upon which it is founded" and Regulation section 19322, subdivision (a) is to the same effect.

Here, appellants have not presented evidence sufficient to prove that respondent erred by denying their claim for refund. In order to show that the transaction was not a sham for the sole purpose of tax avoidance, appellants must produce evidence of the objective economic substance of the transaction. Instead, appellants simply provide statements of facts concerning the transaction, the decision to invest and the reporting position on the original 2002 return as summarized in a legal opinion letter from the Nass law firm. However, those statements of facts are not supported by any written evidence that would corroborate their position that their decision to enter into the transactions was motivated by profit. Thus, we hold that appellants have not met their burden of proof. In so holding, we reject appellants' claim that respondent has made a "naked assessment" and bears the burden of providing a rational basis for the assessment. Clearly, the subject appeal arises out of appellants' claim for refund of a self-assessed tax amount, not an assessment made by respondent.

CONCLUSION

For the foregoing reasons, respondent's action is sustained.

Footnotes

[1]Respondent states that this amount was self-reported by appellants' on their 2002 amended return which was filed pursuant to their Voluntary Compliance Initiative participation agreement.

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[*] California State Board of Equalization Rules for Tax Appeals Section 5451(d) provides that its summary decisions may not be cited as precedent in any appeal or other proceeding before the Board. *See also Appeal of Fowlks*, 88-SBE-023-A (Oct. 31, 1989).