CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of: **MYLES D. HUBERS AND** **MICHELLE R. HUBERS**	Case No. 534595 Oral hearing date: July 17, 2013 Oral rehearing date: February 24, 2015 Decision rendered: March 26, 2015 Publication due by: July 24, 2015

Representing the Parties:

For Appellants: Elizabeth Van Clief, Butterfield Schechter LLP

For Respondent: Roman Johnston, Tax Counsel III

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

LEGAL ISSUE (1)

Whether appellants have shown that the Franchise Tax Board (hereafter FTB or respondent) erred by disregarding appellant-husband's purchase of Money Matters Management (MMM), a Management Agreement (Management Agreement) between MMM and Mortgage Loan Specialists (MLS), and MMM's adoption of an Employee Stock Ownership Program and Trust Agreement (ESOP) with a related nonqualified deferred compensation plan as lacking business purpose and economic substance.

FINDINGS OF FACT

This appeal is made pursuant to section 19045 of the Revenue and Taxation Code (R&TC)[1] from the action of respondent on appellants' protest against proposed assessments of tax in the amount of $192,637.00 and penalties in the amount of $153,366.32 for tax year 2001, tax in the amount of $208,177.00 and penalties in the amount of $148,244.64 for tax year 2002, and tax in the amount of $298,861.00 and penalties in the amount of $192,885.33 for tax year 2003.

Appellants were the owners of MLS, a California subchapter C corporation that specialized in

[1] References to the R&TC provisions refer to provisions in effect for the years on appeal.

originating home mortgages. On December 5, 2001, appellant-husband purchased Shawn Christopher, Ltd., dba Money Matters Management, a Nevada subchapter S corporation (hereinafter MMM), and MMM and MLS entered into a Management Agreement under which MMM was to provide management and consulting services "to assist MLS in its day-to-day business operations in an efficient and cost-effective manner" for an initial term of five years. The documentation for the stock purchase stated that it was effective August 15, 2001, but the purchase did not occur until December 5, 2001. The Management Agreement provided that MLS would pay MMM an annual management services fee as follows: A flat fee of $2 million for the period from August 15, 2001, to December 31, 2001, and, thereafter, 22 percent per year of the gross annual receipts of MLS.

MMM adopted an ESOP on December 17, 2001, purportedly for the benefit of MLS and MMM employees. Appellant-husband sold 100 percent of his shares in MMM to the ESOP, making the ESOP the sole shareholder in MMM. MMM also adopted a nonqualified deferred compensation plan for the benefit of appellant-husband. For the 2001 tax year, MLS paid MMM $2 million, purportedly for management services provided by appellant-husband and two others, and MLS deducted the $2 million as an ordinary and reasonable business expense. MMM allocated the $2 million to the ESOP, and reported a liability of $2 million for the nonqualified deferred compensation plan established for the benefit of appellant-husband. For the 2001 plan year, MLS contributed $5,928 to the ESOP and MMM made no contributions and distributed no dividends to the ESOP. MMM's 2001 state and federal tax returns show no expenses for 2001, and show no income other than the $2 million received from MLS and $189 of interest income. The payment of the purported management fee, together with other deductions, eliminated any taxable income that MLS otherwise would have had and, together with other deductions, caused MLS to report a loss of $85,434 on total revenue of approximately $30 million. Appellants assert that, starting on August 15, 2001, MMM managed complaints and customer relations, purchased supplies, equipment, materials and goods, and provided accounting, bookkeeping and other services. However, MMM was owned by a third party on August 15, 2001, and was not acquired by appellants until December 5, 2001, and there is no contemporaneous documentation showing that MMM provided any of these services to MLS.

During the 2002 tax year, appellant-husband transferred approximately $791,000 of securities from an ExecuPro[2] nonqualified deferred compensation plan to MMM's nonqualified deferred compensation plan. MMM's liability for nonqualified deferred compensation plans increased from $2 million to $3,899,797. Also during 2002, MLS paid MMM $2.4 million, purportedly for management services, which constituted all of MMM's reported gross receipts for that year. Under the terms of the Management Agreement, the fee would have been $6.5 million. In 2003, MLS paid MMM a purported management fee of $2.4 million, although the fee would have been $8 million pursuant to the terms of the Management Agreement. MMM paid no dividends to the ESOP during any of the years at issue, and the ESOP did not make any distributions during the years at issue.

The assets in the ESOP were appraised as of September 12, 2003, at a value of $5,146,000.00, including Deferred Compensation in the amount of $4,302,894.50, but appellants subsequently had another appraisal prepared which valued the MMM stock at $50,000. Effective September 30, 2003, appellant-husband purchased 20 percent of the MMM stock from the ESOP, and MMM redeemed the remaining 80 percent of the MMM stock from the ESOP; in exchange, the ESOP received $10,000 in cash from appellant-husband and a promissory note for $40,000 from MMM.

On its 2003 return, MMM reported $3,500,000 in gross receipts and, pursuant to IRC section 1377(a)(1), elected to have its tax year treated as though it were two separate tax years. MMM allocated $3,160,017 of ordinary income to the ESOP for the initial short-year tax return, and a loss of $186,116 to appellant-husband for the later short-year return.

On audit, respondent determined that the transaction was an abusive tax avoidance transaction and reallocated MMM's income to appellant-husband. Respondent issued Notices of Proposed Assessment (NPAs) dated December 26, 2007, for each of the tax years 2001, 2002, and 2003, assessing additional tax, noneconomic substance transaction (NEST) penalties, and interest-based penalties. Appellants requested that the Chief Counsel of the FTB waive the NEST penalty, and FTB's Chief Counsel denied the request. Following the protest, respondent affirmed the NPAs in Notices of Action. Appellants then filed this timely appeal.

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[2] ExecuPro is described as an "Irish deferred compensation plan."

APPLICABLE LAW

United States v. A. Blair Stover, Jr. (W.D. Mo. 2010) 731 F.Supp. 2d 887, aff'd (8th Cir. 2011) 650 F.3d 1099 (*Stover*)

In *Stover*, the federal district court held that an accountant was enjoined from promoting and selling a certain tax structure involving an operating company that formed an S corporation management company, which, in turn, created an ESOP that owned the management company's stock. The same person or persons who owned the operating and managing companies were also the only beneficiaries of the ESOP. The operating company deducted the management fees paid to the management S corporation as expenses and those fees were not taxable as income to the management company that was owned by the tax-exempt ESOP. On appeal, the United States Court of Appeals for the Eighth Circuit affirmed, finding that the record demonstrated that the structures constituted abusive tax shelters.

Casebeer v. Comm'r (9th Cir. 1990) 909 F.2d 1360 (*Casebeer*)

In *Casebeer*, the taxpayers deducted depreciation and interest expenses on their federal income tax returns based on a series of transactions involving the leasing, sale, and financing of computer equipment, which the Internal Revenue Service (IRS) determined were sham transactions. The court articulated the two-prong sham transaction test as: (1) whether the taxpayer has shown a subjective intent evidencing a business purpose for engaging in the transaction other than tax avoidance; and (2) whether the taxpayer has shown by objective evidence that the transaction had economic substance beyond the creation of tax benefits. The court rejected the taxpayers' argument that both prongs must be satisfied and held that "the consideration of business purpose and economic substance are simply more precise factors to consider in the application of [the] traditional sham analysis; that is, whether the transaction had any practical economic effects other than the creation of income tax losses." The Court of Appeals upheld the Tax Court's findings that the taxpayers failed to show a subjective business purpose apart from the tax considerations and that the transaction lacked economic substance.

Appeal of James A. Alyn and Lisa E. Alyn (2009-SBE-001) May 27, 2009 (*Alyn*)

In *Alyn*, this Board adopted the test for sham transactions set forth by *Casebeer* and found that the taxpayers failed to establish a business purpose because they did not provide objective evidence that they had a business purpose for engaging in the transaction other than tax avoidance. With respect to the economic substance, this Board found that the transactions at issue would not produce economic benefits aside from tax benefits and therefore the transactions lacked economic substance.

Weekend Warrior Trailers, Inc. v. Comm'r of the Internal Revenue, T.C. Memo 2011-105 (*Weekend Warrior*)

In *Weekend Warrior*, the taxpayer was an operating corporation that formed an S corporation management company and entered into an agreement under which the management company was to provide design, personnel, and management services to the operating corporation. The management company established a deferred compensation plan and also adopted a retirement plan composed of an ESOP and an IRC section 401(k) profit-sharing plan, which covered all employees of the management company under stated conditions.

The court found that the management company was not formed for a valid business purpose and noted that the deferred compensation plan solely benefited the president of the corporation, which indicated minimal benefits for rank-and-file employees. The court also found no credible evidence that the new structure allowed the operating corporation to achieve cost savings or efficiencies or that it resulted in any meaningful changes in business operations. The court found no credible evidence to support the taxpayers' argument that the management company was needed for reasons of liability protection and noted that the taxpayers did not claim they considered additional liability insurance or that they evaluated whether the management company's "corporate shield" would have practical significance in case of a lawsuit.

Although the court found no business purpose for the transaction, it held that the management company engaged in business activity and must be respected as a separate entity on that basis. However, for purposes of determining whether the management fees were deductible as reasonable and necessary expenses of the operating company, the court found that the record provided few details as to the parties' relationship. The court found little evidence as to the identity of the persons who allegedly provided services under the management agreement and determined that the taxpayers failed to present any credible evidence of the services performed. The court therefore concluded that the taxpayers did not establish that the fees were deductible as necessary or reasonable expenses.

Love v. Comm'r, T.C. Memo 2012-166 (*Love*)

In *Love*, the taxpayers restructured their business of owning and operating multiple chain restaurants by forming an operating company, a management company, and a profit-sharing plan (PSP) for the benefit of the management company's employees. The taxpayers later decided to establish an ESOP to replace the PSP, formed an S corporation as the new management company, and issued the stock in the new management company to the ESOP. The taxpayers and approximately 275 other employees of the former management company became participants in and beneficiaries of the ESOP, the financial assets of the PSP were transferred into the ESOP, and the PSP was terminated. The new management company also established a nonqualified deferred compensation plan (NQDCP) for the benefit of its senior officers and employees, and significant portions of the new management company's income were deferred compensation under the NQDCP. Thus, those amounts were not available for distribution to the ESOP employee-beneficiaries.

In response to perceived abuses under statutory provisions allowing ESOPs to own stock in S corporations, the IRS promulgated temporary regulations that would have negatively impacted the taxpayers. To avoid these negative consequences, the taxpayers sold the management company stock to themselves at fair market value as determined by an independent appraisal, caused the management company to pay them $3,066,000 in deferred compensation, and terminated the ESOP. The taxpayers then contributed $2,965,000 to the management company as a capital contribution, which increased their tax basis in the management company. As a result of the increase in tax basis achieved through the contribution of capital, the taxpayers were able to use the management company's $2,969,000 net operating loss deduction (arising from the payment of the deferred compensation) to offset the tax effect of most of the $3,066,000 deferred compensation paid to them.

The IRS determined that the taxpayers acquired the stock from the ESOP for the principal purpose of tax avoidance and disallowed the claimed loss deduction under IRC section 269. The court held that IRC section 269 applies only if tax evasion or avoidance is the principal purpose for the acquisition and such a determination is a question of fact that depends upon the subjective intent of those who acquire control at the time of acquisition. The court found that the taxpayers determined that the new management structure had become more complicated and costly and less effective than they had anticipated, and the temporary regulations further complicated that management structure. As a result, the court concluded that they reverted to the prior management structure in which the taxpayers' acquisition of the stock was a key feature of that restructuring and, thus, did not occur principally for tax avoidance purposes. The court also found that the temporary regulations and deferred compensation required the taxpayers to take some action and that the taxpayers' capital contribution was a real economic outlay that increased the taxpayers' tax basis in their management company stock.

ANALYSIS AND DISPOSITION

We apply the two-prong test of *Alyn*, *supra*, and *Casebeer*, *supra*, to determine whether the stated form of appellants' transaction reflects economic substance. Therefore, we consider whether appellants have shown (1) a subjective business purpose for paying the purported fees at issue and allocating them to the ESOP and (2) the objective economic substance of the transaction.

Business Purpose

Appellants assert that the use of MMM as a management company had valid business purposes of providing management services to MLS and other businesses, thereby increasing profits, and of providing liability protection. However, there is no credible evidence that MMM provided management services or that MMM was intended to increase the profits of MLS. On the contrary, it appears that the purported management fee was set at a level that would eliminate any taxable income of MLS rather than provide compensation for any services rendered. Although appellants assert that the use of MMM served a liability protection purpose, in fact the structure created a substantial and current annual cash expense for MLS with no apparent economic benefit other than the structure's purported tax benefits. There is no evidence that appellant-husband held himself out as an employee of MMM, and his resume indicates he provided his services directly to MLS as the branch manager during the years on appeal.

Appellants initially maintained that MMM provided consulting services for several companies owned by third parties so that MMM would recognize income from the other companies even if MLS was unprofitable. However, during the briefing process, appellants conceded that MMM had only one Management Agreement with MLS, and there is no evidence in the record indicating that MMM sought to provide management services to any other companies.

According to appellants, the management structure “provided protection beyond insurance coverage” and was “set up to provide protection to MMM from the liability exposure of the business operations of MLS” by insulating MMM from the day-to-day transactions of MLS, which was the target of multiple lawsuits. However, the evidence undermines appellants’ assertion that the structure was formed to provide protection beyond insurance coverage. If appellants were concerned with liability protection for MMM, they would have carried basic insurance coverage, and there is no evidence that MMM carried insurance coverage of any kind. By contrast, MLS carried errors and omissions insurance, a commercial umbrella package, life insurance, and California workers’ compensation insurance in 2001, 2002, and 2003. In addition, the Management Agreement provided that MMM would assist MLS in its “day-to-day business operations,” which contradicts appellants’ assertion that the structure was designed to insulate MMM from the day-to-day transactions of MLS. We also note that transferring the stock of MMM to an ESOP provided no liability protection to MMM, or its assets, because MMM made no distributions to the ESOP.

Appellants have not shown their asserted business purpose of providing employees with significant retirement benefits because the ESOP apparently received only $10,000 in cash from appellant-husband and a promissory note from MMM for $40,000 for the sale of its MMM shares in 2004 while, in contrast, MMM had income of over $2 million a year for the preceding 3 years. Appellants state that another business purpose of the ESOP was to hold retirement assets safe from creditors until the participants retire but, as noted above, the evidence shows that substantially all the money remained in MMM. Accordingly, the ESOP could provide no such asset protection. No distributions were made from MMM to the ESOP during any of the years at issue.

Although appellants rely on *Love*, *supra*, as support for their position that there existed nontax reasons for acquiring stock in MMM and for the ESOP ownership structure, *Love* is distinguishable because in case that there was credible evidence that the management company services were actually provided. Also, the issue in *Love* was the application of IRC section 269, which is not at issue in this appeal.

<u>Economic Substance</u>

Under the Management Agreement, MMM was to provide management and consulting services to MLS relating to MLS's business operations, but appellants have not shown that MMM provided services to MLS. Specifically, there is no credible evidence to support their contention that MMM managed complaints and customer relations, purchased supplies, equipment, materials and goods, or provided any other services. Like the court in *Weekend Warrior*, we find that the evidence does not support appellants' contention that the management company actually provided the stated services to the operating company.

The Management Agreement states that MLS was required to pay a management fee in the amount of $2 million for the period from August 15, 2001, to December 31, 2001, even though appellant-husband did not purchase MMM until December 5, 2001. The timing of the purchase suggests that appellant-husband was not employed by MMM as of August 15, 2001, and undermines the assertion that MMM provided management services for the $2 million fee. We further note that MMM's 2001 state and federal tax returns showed no employee expenses or other expenses. In addition, appellant-husband was employed by ExecuPro Management Services in 2001, which purportedly leased appellant-husband's services to MLS for $50,000 per month, thereby calling into question whether MLS would have paid $2 million to MMM for management services when appellant-husband was already providing services to MLS.

For years after 2001, the Management Agreement provided for the payment of a fee of 22 percent of the annual gross receipts of MLS, but, rather than complying with that fee provision, MMM and MLS agreed to substantially reduced fees that eliminated any net profit that MLS would have recognized for each year. Appellants offer varying explanations for the modification of the fee arrangement that are not supported by any independent evidence. The modification of the fee amounts appears to have been designed to eliminate the taxable income of MMM rather than being based upon the amount or nature of the services allegedly provided by MMM. Thus, it appears that MMM was merely a conduit for transferring profits from MLS to the ESOP, which was not subject to tax on the profits.

We note that the court in *Weekend Warrior* determined that the evidence did not establish that the management company provided any services to the operating company, and, on that basis, the court disallowed the deduction of the management fees as neither necessary nor reasonable expenses.

Similarly, we find that MMM did not establish that it provided the stated management services to MLS.

In view of the foregoing, we find that appellants have not shown error in respondent's determination that the transactions at issue lacked economic substance.

LEGAL ISSUE (2)

Whether appellants have shown that the NEST penalty should be abated.

APPLICABLE LAW

R&TC section 19774, subdivision (a) imposes a penalty for a noneconomic substance transaction understatement for any taxable year, in an amount equal to 40 percent of the amount of the understatement. A "noneconomic substance transaction" includes:

> . . . [t]he disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance. A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.

(Rev. & Tax. Code, § 19774, subd. (c)(2)(A).)

FINDINGS OF FACT

As determined under Legal Issue (1), the evidence shows that the transactions in issue had no economic substance as there was no valid nontax California business purpose for entering into those transactions. In this regard, we find that MMM did not provide management services and that the fee was not based on an arms' length transaction but rather on the amount necessary to eliminate the taxable income of MLS.

ANALYSIS AND DISPOSITION

For the reasons stated above, we find that the subject transaction lacked economic substance and that appellants did not have a valid nontax California business purpose for entering into the transaction. Thus, the NEST penalty is applicable. We further note that subdivision (d)(3) of R&TC section 19774 precludes this Board from reviewing respondent's Chief Counsel denial of appellants' request for relief from the imposition of the penalty.

LEGAL ISSUE (3)

Whether appellants have shown that the interest-based penalty should be abated.

APPLICABLE LAW

Under former R&TC section 19777, a penalty in the amount of 100 percent of the interest accrued prior to the date of the mailing of the NPA was imposed on a deficiency if respondent had contacted the taxpayer regarding the use of a potentially abusive tax shelter. Subdivision (b)(2) of R&TC section 19777 defined a potentially abusive tax shelter to include an arrangement "which is of a type that the Secretary of the Treasury or [respondent] determines by regulations as having a potential for tax avoidance or evasion."

Former Treasury Regulation section 1.6011-4T(b), as in effect for the years on appeal, defined a reportable transaction, in part, as a "listed transaction" (identified by the IRS as a tax avoidance transaction) or an "other reportable transaction." An "other reportable transaction" was identified in relevant part by whether it met at least two of the following characteristics: (1) conditions of confidentiality (as defined); (2) contractual protection of tax benefits; (3) more than $100,000 in fees contingent on participation in the transaction; (4) a book-tax difference of at least $5 million in any tax year; and (5) participation of a tax-exempt entity or other person with different tax treatment (where that tax status provides the taxpayer with more favorable income tax treatment).[3]

Former Treasury Regulation section 1.6011-4T(b) set forth the "conditions of confidentiality" characteristic as follows: "The taxpayer has participated in the transaction under conditions of confidentiality (as defined in § 301.6111-2T(c))." Former Treasury Regulation section 301.6111-2T(c) then provided, in part, as follows:

> All the facts and circumstances relating to the transaction will be considered when determining whether an offer is made under conditions of confidentiality as described in section 6111(d)(2), including prior conduct of the parties. Pursuant to section 6111(d)(2)(A), *if an offeree's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any tax shelter promoter, an offer is considered made under conditions of confidentiality, whether or not such understanding or agreement is legally binding. Pursuant to section 6111(d)(2)(B), an offer will also be considered made under conditions of confidentiality in the absence of any such understanding or agreement if any tax shelter promoter knows or has reason to know that the transaction is protected from disclosure or use in any other manner, such as where the transaction is claimed to be proprietary to the tax shelter promoter or any party other than the offeree.*

[3] See Treasury Decision (T.D.) 9000, June 11, 2002. The temporary regulation initially listed six characteristics, but one characteristic not relevant to this appeal, regarding foreign tax treatment, was removed. (See T.D. 8961, Aug. 7, 2001.)

[emphasis added]

As indicated in the quote above, former Treasury Regulation section 301.6111-2T(c) referenced former IRC section 6111(d)(2)(A) and (B). Under these provisions of IRC section 6111, an offer was considered made under conditions of confidentiality if:

> (A) the potential participant to whom the offer is made (or any other person acting on behalf of such participant) has an understanding or agreement with or for the benefit of any promoter of the tax shelter that such participant (or such other person) will limit disclosure of the tax shelter or any significant features of the tax shelter, or
> (B) any promoter of the tax shelter –
> (i) claims, knows or has reason to know,
> (ii) knows or has reason to know that any other person (other than the potential participant) claims, or
> (iii) causes another person to claim,
> that the tax shelter (or any aspect thereof) is proprietary to any person other than the potential participant or is otherwise protected from disclosure to or use by others.

FINDINGS OF FACT AND RELATED CONTENTIONS

Respondent imposed the interest-based penalty based on a determination that the subject transaction met two of the characteristics set forth in Treasury Regulation section 1.6011-4T, as described above. As one characteristic, respondent found that the transaction was subject to conditions of confidentiality. As to the second characteristic, respondent found that the transaction included the participation of a tax-exempt entity where that entity's tax position enabled the transaction to be structured on favorable terms. Only respondent's first finding, that the transaction was subject to conditions of confidentiality, is disputed by the parties.

In support of its determination that conditions of confidentiality were present, respondent provides the following four pieces of evidence.

First, respondent points to the following language in the Management Agreement:

> [Confidentiality of Transaction.] Except insofar as data and information may be required by law to be disclosed, each party agrees that following the execution of this Agreement it will (i) preserve the confidentiality of the terms of the Agreement and refrain from discussing the Agreement with any person or entity except for discussion held on a confidential basis with persons or entities affiliated with [MMM] or MLS or interested in acquiring an ownership interest therein, and (ii) continue to coordinate with the other party any announcements or public discussion of the Agreement.

Second, respondent provides a 2002 Confidential Memorandum prepared by Butterfield

Schechter LLP (Butterfield Schechter) which described the "conceptual design of the model" as follows:

> The key management group and their support staff are transferred to a newly created Subchapter S Management Corporation (SMC). The purpose for the creation of the Management Corporation must be to achieve specific and definable business objectives other than merely to achieve tax efficiencies. Business reasons for creating a Management Corporation include increased operating efficiencies and better security for deferred compensation obligations.

Third, respondent provides appellant-husband's resume to support its contention that appellants were bound by confidentiality. Respondent notes that the resume does not list MMM as an employer although, under the stated form of the transaction, appellant performed work for MMM.

Fourth, respondent points to statements made in a 2005 presentation by Butterfield Schechter that certain management company structures involving the purported provision of services to an operating company and the use of a defined benefit plan would not be respected for tax purposes.

Appellants provide a copy of their engagement letter and agreement with Butterfield Schechter confirming the parties' understanding that appellants would hire Butterfield Schechter to draft and implement an ESOP, to obtain tax qualification for the ESOP, and to draft the documentation for the ESOP's stock purchase. Appellants also provide additional letters and related email correspondence from Butterfield Schechter describing various aspects of the transactions, including the adoption of the ESOP, the Management Agreement, and the NQDCP and ESOP stock purchase, as well as the effect of Treasury Regulation provisions which impose an excise tax on the ESOP and the proposed actions to avoid the tax. Neither the engagement letter and agreement nor any of the other letters or email correspondence suggests that appellants agreed to keep the transaction or structure confidential for the benefit of Butterfield Schechter or another third party.

<u>ANALYSIS AND DISPOSITION</u>

As noted above, respondent based its imposition of the interest-based penalty on its finding that the transaction had been identified as having the potential for tax avoidance or evasion by former Treasury Regulation section 1.6011-4T(b). Under the relevant portion of that regulation, at least two of certain identified characteristics must be present. As noted above, the parties agree that one characteristic was present (regarding the participation of a tax-exempt entity), but the parties disagree as to whether the transaction was subject to "conditions of confidentiality," as defined by the law and regulations described above.

Here, we find that the subject transaction was not offered under conditions of confidentiality. Specifically, the Management Agreement provision cited by respondent does not address the disclosure of the ESOP ownership structure or appear to be designed to limit the disclosure of the transaction for the benefit of a tax shelter or other third party promoter.

The 2002 Confidential Memorandum was not sent to appellants prior to being provided by respondent on appeal, and it is dated after appellants entered into the transaction. Therefore, it does not show that, as a condition of receiving an offer to participate in the transaction, appellants agreed with Butterfield Schechter that appellants would not disclose the structure or tax aspects of the transaction in order to protect Butterfield Schechter or another third party. Additionally, the memorandum does not reflect any understanding or agreement that any limitations were placed on participants in the transaction with respect to the disclosure of the structure or tax aspects of the transaction described.

As noted above, the omission of MMM as an employer on appellant-husband's resume supports our finding that the transaction had no business purpose but it does not support an inference that the omission was intended as part of a plan or agreement to keep the transaction confidential for the benefit of Butterfield Schechter or any other promoter or third party. Likewise, the statements made in the 2005 Butterfield Schechter presentation do not support an inference that this transaction was subject to conditions of confidentiality. Finally, the engagement letter and other documentation which describes the detailed steps of the transaction and the legal requirements and tax consequences appear to support appellants' argument that the transaction was not subject to conditions of confidentiality, as the documentation does not include any provisions indicating that the transaction was offered under conditions of confidentiality.

For the foregoing reasons, we find that the transaction was not subject to conditions of confidentiality. As a result, only one of the characteristics set forth in former Treasury Regulation section 1.6011-4T(b)(3) was present. As noted above and relevant here, the regulation requires that at least two characteristics be present. Therefore, the transaction here was not identified by regulation as having the potential for abuse or tax avoidance, and the interest-based penalty is inapplicable.

LEGAL ISSUE (4)

Whether the NPAs were issued within the applicable limitations period.

FINDINGS OF FACT, APPLICABLE LAW AND ANALYSIS

Appellants contend that the NPAs were not issued within the four-year limitations period prescribed by R&TC section 19057 and that the eight-year statute of limitations provided by R&TC section 19755 is inapplicable. As stated above, the NPAs for tax years 2001, 2002 and 2003 were issued on December 26, 2007, and revised California taxable income from the reported amount of $215,238 to $2,282,425 for 2001, from $294,509 to $2,532,735 for 2002 and from $416,268 to $3,629,830 for 2003. R&TC section 19058 provides for a six-year limitations period from the date of filing of the return for issuance of an NPA if the taxpayer has omitted from gross income a properly includable amount in excess of 25 percent of gross income stated in the return. Here, all the returns were timely filed and the return for the earliest tax year, 2001, was filed on or about April 15, 2002 so the NPA for 2001, which was issued on December 26, 2007, was issued within six years of the filing date of the return. In addition, appellants omitted from gross income for each tax year a properly includable amount far in excess of 25 percent of gross income.

DISPOSITION

Therefore, the NPAs were all timely pursuant to R&TC section 19058, and this Board therefore does not consider the applicability of the eight-year statute of limitations provided by R&TC section 19755.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

ORDER

Pursuant to the analysis of law and facts above, the Board ordered that the interest-based penalties be removed, and that the action of the FTB on appellants' protest against the proposed assessments for 2001, 2002 and 2003 otherwise be sustained. Adopted at Sacramento, California, on this 28th day of May, 2015.

Jerome E. Horton, Chairman

George Runner, Member

Fiona Ma, Member

Diane L. Harkey, Member

Yvette Stowers, Member*

*For Betty Yee, pursuant to Government Code section 7.9.