OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18011162
	)	
AHMAD SKOUTI AND FATEN KOUR	)	Date Issued: May 29, 2018
	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellants: Joseph J. Doerr, Attorney

For Respondent: David Hunter, Tax Counsel IV

KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (RTC) § 19045, Ahmad Skouti (appellant) and his spouse Faten Kour (collectively, appellants) appeal an action by the Franchise Tax Board (FTB or respondent) in denying appellants' protest of a proposed assessment in the amount of $742,648 in additional tax for the 2007 tax year, plus interest, and a 20-percent accuracy-related penalty of $148,529.60.

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Kwee, Jeffrey Margolis, and Michael Geary, held an oral hearing for this matter in Sacramento, California, on February 26, 2018. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

ISSUES

I. Did appellants establish that all or a portion of the amount awarded to appellant in a civil case in 2007 qualifies for nonrecognition treatment under Internal Revenue Code (IRC) § 1033?

II. Did appellants establish a basis for relief from all or any portion of the accuracy-related penalty?

FACTUAL FINDINGS

1. Appellant is a farmer who owns vineyards located near Fresno, California.

2. During the summer of 2002, appellant purchased fertilizer and services related thereto from Britz Fertilizers, Inc. (Britz) for use in his vineyards.

3. Soon after the fertilizer was applied to appellant's vineyards, grapes growing on the vines suffered damage, resulting in reduced crop production for 2002. In addition, the vines suffered physical damage, resulting in reduced crop production during later years.

4. Appellant sued Britz in Fresno County Superior Court (the civil case) on December 18, 2002, for damages caused by the fertilizer.[1] The jury trial in the civil case began in March 2005. At the trial, appellant's expert witness, Dr. Richard Nordstrom, testified that appellant suffered the following losses: (A) damages for reduced crop production from 2002 to 2004; (B) damages for added costs due to working with or around damaged vines from 2002 to 2004, also referred to as "repair costs"; and (C) future damages from 2005 to 2012.[2]

5. Damages for reduced crop production from 2002 to 2004. In the civil case, Dr. Nordstrom testified that appellant suffered damages caused by reduced grape production in the amount of $3,260,166, from 2002 through 2004. Dr. Nordstrom calculated the $3,260,166 amount as follows: for 2002, lost production in the amount of 1,999 tons of grapes, representing a loss of $1,067,106[3]; for 2003, lost production in the amount of 1,079 tons of grapes, representing a loss of $640,710[4]; for 2004, lost production in the amount of 1,185 tons of grapes, representing a loss of $1,552,350.[5]

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[1] Civil Case No. 02-CECG04540.

[2] Appellant also claimed damages for lost profits resulting from appellant's inability to purchase grapes from others, and was awarded $467,629 with respect to this claim. This aspect of the civil case is not relevant to the appeal.

[3] The loss for 2002 was calculated as follows: expected crop value of $2,049,976, less actual crop value of $982,869, equals a loss of $1,067,106. Crop value was determined taking into account the selling price of grapes that year. (The $1 discrepancy was contained in Dr. Nordstrom's calculations.)

[4] The loss for 2003 was calculated as follows: expected crop value of $1,732,190, less actual crop value of $1,091,479, equals a loss of $640,710. (The $1 discrepancy was contained in Dr. Nordstrom's calculations.)

[5] The loss for 2004 was calculated as follows: expected crop value of $4,625,948, less actual crop value of $3,073,598, equals a loss of $1,552,350.

6. Prior to the hearing in this matter (the hearing), the parties submitted a signed stipulation agreeing that nonrecognition of the damage award pursuant to IRC § 1033 would be inapplicable to the extent OTA determines that the judgment was awarded to compensate for crops destroyed by the fertilizer, including crops that were physically attached to the vines at the time the fertilizer was applied.
7. At the hearing, appellant's first witness, Mr. Jim Betts, testified that 100 percent of the $1,067,106 award for damages for 2002 represented damages to crops that were physically attached to the vines at the time the fertilizer was applied. Consistent with Dr. Nordstrom's testimony in the civil case, both witnesses at the hearing, Mr. Jim Betts and Dr. Nordstrom, testified that the $3,260,166 in damages to crops claimed from 2002 to 2004 was measured based entirely on reduced crop production. Further, both witnesses testified that the vines also suffered substantial physical damage.
8. At the hearing, Mr. Jim Betts further testified that appellant did not request damages in the civil case for injury to the vines from 2002 to 2004 because appellant did not start replanting until after 2004. Therefore, Mr. Betts testified that "[an award for damages to the vines] would have no place in [an] itemized jury award for damages in '02. Same for '03, same for '04." Mr. Betts also clarified that appellant sought to recover damages to the vines from 2005 onwards in the civil case.
9. Damages for repair costs from 2002 to 2004. During the civil case, Dr. Nordstrom testified that appellant suffered damages caused by additional costs incurred for working with or around damaged grape vines, referred to during the civil case as "repair costs," in the net amount of $160,933 for 2002 through 2004. Dr. Nordstrom allocated the damages for 2002 to 2004 by year. For 2002, repair costs were in the amount of $265,955. For 2003, repair costs were in the amount of $199,138, less savings from reduced crop harvesting costs in the amount of $234,143. For 2004, repair costs were in the amount of $187,128, less savings from reduced crop harvesting costs in the amount of $257,145. Thus, the $160,933 of net repair costs for 2002 through 2004 consisted of the repair costs for those years, reduced by the savings from reduced crop harvesting costs for 2003 and 2004.
10. Future damages from 2005 to 2013. During the civil case, Dr. Nordstrom testified that appellant would suffer future losses from 2005 through 2013 in the amount of

$10,861,766. The future losses claimed included loss of profits from reduced crop production for 2005 to 2013 (+$10,835,605); less crop harvesting costs saved during those years (- $1,716,323); plus costs to install a new irrigation system in 2005 (+$309,582), costs to replant damaged vines during 2005 to 2008 (+$1,000,652), and other miscellaneous growing and watering costs from 2005 to 2010 (+$432,250). Dr. Nordstrom also testified that the present value of appellant's total future losses of $10,861,766 was $9,339,846.

11. The jury instructions included an instruction as to how the jury should calculate the damages for harm to appellant's crops. This instruction explained that if the vines were destroyed, then the measure of damages may include the costs of replanting.

12. The jury instructions included an instruction as to how the jury should calculate appellant's lost profits. This instruction explained that lost profits are the amount that appellant would have received for his grapes but for the conduct of Britz, less the expenses, including the value of labor, material, expenses, rent, and interest payments, that appellant would have incurred if Britz's fertilizer had not been applied to the vines. The jury instructions for calculating lost profits did not allow the jury to include replanting costs in lost profits because replanting costs would not have been incurred if Britz's fertilizer had not been applied to appellant's vineyards.

13. In summary, appellant's expert, Dr. Nordstrom, testified during the civil case that appellant suffered the following damages:

    (A) $3,260,166 in reduced crop production during 2002 to 2004, excluding replanting costs;

    (B) $160,933 in added repair costs for 2002 through 2004; and

    (C) $10,861,766 in future damages for 2005 onwards, including growing costs, replanting costs, irrigation costs, and lost profits, with a present value of $9,339,846.

14. On April 13, 2005, the jury awarded appellant the following damages, as set forth in a special verdict:

    (A) $3,260,166 for "damage to raisin crop" from 2002 to 2004;[6]

[6] The jury allocated this amount consistent with Dr. Nordstrom's testimony: $1,067,106 for 2002; $640,710 for 2003; and $1,552,350 for 2004.

(B) $160,933 for costs to repair the vines from 2002 to 2004; and

(C) $3,666,505 for "future lost profits."

15. During the hearing, appellants' second witness, Dr. Nordstrom, testified that $160,933 was too small a figure to compensate for the damage appellant sustained due to dead and damaged vines, and that the actual amount of damages suffered was closer to $3.6 million. Dr. Nordstrom further testified at the hearing that the $3,260,166 figure from the civil case represented the amount of income that appellant did not earn from 2002 through 2004 as a result of Britz's actions. Dr. Nordstrom further testified that this was an easy figure to measure because the damages were calculated after-the-fact in 2005.

16. During 2007, appellant received payment of the total amount of the jury award, plus interest.

17. On October 15, 2008, appellants filed a joint California Resident Income Tax Return for the 2007 tax year. Appellants filed using the cash basis method of accounting. Appellants included the $3,666,505 received for future lost profits as gross income from farming on line 10 of Schedule F (Profit or Loss from Farming),[7] and claimed a deduction for "payment of profits" in the amount of $3,950,000 on line 34b of Schedule F (other expenses). FTB disallowed the "payment of profits" deduction in its entirety and appellant does not contest this disallowance. Appellant also does not contest FTB's imposition of an accuracy-related penalty with respect to the disallowance. Appellants did not report the $160,933 portion of the judgment (for costs to repair the vines from 2002 to 2004) as income on their state or federal tax returns. The parties agree, however, that the $160,933 amount does not result in income in the 2007 tax year, and this amount is not at issue in this appeal.

18. With respect to the remaining $3,260,166, appellants claimed this amount as nontaxable during the 2007 tax year. Specifically, on Form 4684 (Casualty and Thefts) of their federal return, which was attached, in part, to their California tax return, appellants reported a casualty or theft loss for property with a basis of $3,260,166, and receipt of a recovery in that same amount. Thus, the net casualty loss deduction appellants claimed

[7] The total amount of income reported on line 10 was $4,134,134. This amount represented the sum of the future lost profits of $3,666,505, plus the $467,629 awarded for the lost opportunity to purchase green grapes from others (see footnote 2, *supra*).

on their Form 4684 was $0. Appellants did not otherwise report the $3,260,166 as income, or provide a disclosure related thereto, on their California tax return.

19. On their federal Form 4684, appellants described the casualty or theft property as "Lawsuit judgment casualty loss see stmt various."

20. Appellants attached the federal Form 4684, but not the statement referenced in Form 4684, to their California tax return at the time it was filed. At the hearing, FTB introduced a copy of what appears to be the "2007 Federal Supplemental Information" statement referenced in appellants' Form 4684.[8] In pertinent part, it stated:

> Ahmad Skouti filed a lawsuit against Britz Fertilizers, Inc. The lawsuit went to trial, and the jury awarded Mr. Skouti a judgment which included $3,260,166 for damage to raisin crops. Mr. Skouti is treating this award as a conversion under IRC Sec. 1033. The award is reported on form 4684 as a casualty loss and reimbursement for the loss. . .

21. On June 14, 2012, FTB completed and mailed an Audit Issue Presentation Sheet (AIPS) to appellants. The AIPS determined that, although appellants purchased seven replacement rental real estate properties at a total cost of $3,963,622, the payment of $3,260,166 received by appellants did not qualify for deferral pursuant to IRC § 1033 because that amount constituted a recovery of lost profits. The AIPS further determined that the $3,260,166 constituted ordinary income.

22. On November 26, 2012, FTB issued appellants a Notice of Proposed Assessment (NPA) for the 2007 tax year, which proposed two income adjustments: (1) FTB determined that appellants had additional income of $3,260,166, described as "SCHEDULE F – OTHER INCOME"; and (2) FTB increased appellants' income by $3,950,000, for "SCHEDULE F – DISALLOWED DEDUCTIONS." Together, these income adjustments resulted in a proposed assessment of $742,648 in additional tax. The FTB also determined that appellants were liable for an accuracy-related penalty of $148,529.60 (20 percent of the entire tax deficiency), plus accrued interest.

[8] Appellants furnished the "2007 Federal Supplemental Information" statement to FTB at an unspecified date. Respondent contends this information was furnished in connection with its audit of appellants' 2007 tax return.

23. On August 29, 2014, FTB issued a Notice of Action (NOA) to appellants, denying appellants' protest of the NPA (protest letter).[9]

24. On September 10, 2014, appellants timely appealed the NOA. In their appeal, appellants dispute the taxes proposed to be assessed on $3,260,166 of the jury award, on the basis that this amount was paid to compensate appellant for damage to the vines, a capital asset. Appellants also dispute the accuracy-related penalty allocable to this adjustment.

DISCUSSION

I. Taxability of the Jury Award

Gross income means all income from whatever source derived, unless specifically excluded. (IRC, § 61; RTC, § 17071.) Ordinary income generally includes any gain from the sale or exchange of property which is neither a capital asset, nor depreciable property used in a trade or business (business property) as described in IRC § 1231. (IRC, § 64; RTC, § 17074.) IRC § 1231 specifically provides for the treatment of gain on the disposition of business property (§ 1231 gain) as ordinary income or capital gains.[10] Section 1231 gain includes any recognized gain from the involuntary conversion (as a result of destruction in whole or in part) of any business property into other property or money.[11] (IRC, § 1231(a)(3)(A)(ii)(I).) Business property does not include inventory or any other property held by a taxpayer primarily for sale to customers in the ordinary course of business. (IRC, § 1231(b)(1)(A).)

The gain from the disposition of property is generally the excess of the amount realized over the taxpayer's adjusted basis. (IRC, § 1001(a).) The adjusted basis is generally the cost of the property, plus any capital expenditures made with respect to the property, and less any depreciation taken with respect to the property. (IRC, §§ 1011, 1012, 1016.) Grape vines are depreciable property and are classified as 10-year property for depreciation purposes. (IRC, § 168(e)(3)(D).)

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[9] Appellants' protest letter is not a part of the evidentiary record.

[10] RTC § 18031 incorporates IRC § 1001 et seq., pertaining to the calculation of gain or loss on the disposition of property.

[11] IRC § 1231 also applies to gain from the disposition of any capital asset which is held for more than one year and is held in connection with a trade or business or a transaction entered into for profit. (IRC, § 1231(a)(3)(A)(ii)(II).) Subject to listed exclusions, a capital asset generally includes property held by a taxpayer, including property held for investment purposes or production of income. (See IRC, § 1221.) Depreciable business property, and real property used in a trade or business, are excluded from the definition of a capital asset. (IRC, § 1221(a)(2).)

Gain realized from the disposition of property generally must be recognized unless it is established that the taxpayer is entitled to nonrecognition treatment. (See IRC, §§ 61(a)(3), 1001(c); *Insurance & Title Guarantee Co. v. Commissioner* (2d Cir. 1929) 36 F.2d 842, 844.) Under certain circumstances, IRC § 1033 allows a taxpayer to defer recognition of gain when property, as a result of its destruction in whole or in part, is involuntarily converted into money. (IRC, § 1033(a).) If the taxpayer timely and for the purpose of replacing property converted into money, purchases other property similar or related in service or use to the property so converted, then at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion exceeds the cost of such other property. (IRC, § 1033(a)(2)(A).) To be timely, the replacement property generally must be purchased no earlier than the date the converted property was destroyed (or threatened with destruction) and no later than two years after the close of the first taxable year in which any part of the gain from destruction of the converted property is realized. (IRC, § 1033(a)(2)(B).) The Treasury regulations provide an example of this scenario: if a taxpayer had $10,000 in adjusted basis in a barn when the taxpayer realizes $22,000 as a result of its complete destruction, and the taxpayer timely purchased a replacement barn for $20,000, the taxpayer would be able to defer recognition of $10,000 out of the $12,000 in gain under IRC § 1033. (Treas. Reg., § 1.1033(b)-1.)

Further, the taxpayer's basis in the replacement property must be reduced by the amount of gain that is not recognized pursuant to IRC § 1033. (IRC, § 1033(b)(2).) Thus, in the above example, the Treasury regulations explain that the taxpayer would have $10,000 in basis in the replacement barn calculated as follows: the $20,000 cost of the replacement barn less the $10,000 in gain for which recognition was deferred under IRC § 1033. (Treas. Reg., § 1.1033(b)-1.)

Neither the IRC nor the Treasury regulations specifically define what constitutes "property" for purposes of IRC § 1033.[12] Instead, IRC § 1033 only requires that the replacement property be "similar or related in service or use" (often referred to as the "like-kind" and the "functional use" tests).

FTB contends, without citing any authority, that inventory does not constitute property for purposes of IRC § 1033. Furthermore, FTB contends that the applicable test to determine if

[12] See Internal Revenue Service Field Service Advisory (IRS FSA) (Oct. 15, 1996) 1996 WL 33320952.

property qualifies for IRC § 1033 treatment is whether the property was subject to an allowance for depreciation under IRC § 167, held for more than one year, and used in a trade or business within the meaning of IRC § 1231(b)(1), which specifically excludes inventory. We do not find any legal support for FTB's arguments and, for the reasons described below, we conclude that inventory does constitute property for purposes of IRC § 1033.

Both the United States Tax Court and the IRS have concluded that inventory is qualifying property within the meaning of IRC § 1033. (*Maloof v. Commissioner* (1975) 65 T.C. 263, 270.) [concluding that a taxpayer who uses proceeds from converted inventory to purchase replacement inventory may defer recognition of gain pursuant to IRC § 1033]; see also, IRS Chief Counsel Advice 200114046 (Apr. 2, 2001) [concluding that a taxpayer who receives proceeds from involuntarily converted inventory may elect to defer recognition of gain as provided in IRC § 1033]; IRS FSA (May 2, 2000) 2000 WL 33119578 [discussing treatment of inventory in the context of IRC § 1033].) In *Maloof,* proceeds from converted inventory were held to be reinvested in property similar or related in service or use to the extent of the taxpayer's reinvestment of the proceeds in new inventory of the same sort of goods. (65 T.C. at p. 272.)

On the other hand, in *Maloof,* additional amounts reinvested in depreciable assets for a manufacturing facility resulted in a substantial change (from inventory to fixed assets) and failed to qualify for nonrecognition under IRC § 1033. (65 T.C. at p. 270.) Similarly, the courts have concluded that converting container-bound citrus trees held for sale into agricultural real property used to grow citrus trees fails the "similar or related in service or use" requirement of IRC § 1033 because inventory is "of a dissimilar character" from real property. (*In re Mahon* (M.D. Fla. 1998) 98-2 USTC ¶ 50,684.) In sum, as a general matter, for purposes of IRC § 1033 inventory may be converted into new inventory of the same type of goods; however, inventory may not be converted into fixed assets or real property.

A recovery for lost profits, including lost profits due to crop damage, is generally taxable as ordinary income. (*Estate of Longino v. Commissioner* (1959) 32 T.C. 904, 905; see IRS FSA (Apr. 26, 2002) 2002 WL 200217001 [settlement proceeds for lost profits not eligible for IRC § 1033 treatment]; IRS FSA (Apr. 15 1994) 1994 WL 1866101 [to same effect]; IRS FSA (Jan. 22, 1997 [jury award for lost wages includible in gross income]; see also, Rev. Rul. 73-408, 1973-2 C.B. 15 [recovery for crop damage]; Rev. Rul. 73-161, 1973-1 C.B. 366 [loss of expected future income]; Rev. Rul. 68-44, 1968-1 C.B. 191 [payments to substitute for farm income must be

reported as ordinary income]; Rev. Rul. 60-32, 1960-1 C.B. 23 [payments to substitute for crop income].) Furthermore, the case law is clear that IRC § 1033 does not apply to compensation for lost profits, which is taxable as ordinary income. (See *Graphic Press, Inc. v. Commissioner* (9th Cir. 1975) 523 F.2d 585, 589 [an award for lost profits "should be currently taxed irrespective of reinvestment"]; see also, *Massillon-Cleveland-Akron Sign Co. v. Commissioner* (1950) 15 T.C. 79, 85.) Similarly, the Treasury regulations provide that proceeds of a use and occupancy insurance contract, which by its terms insured against loss of business net profits, are not proceeds of an involuntary conversion within the meaning of IRC § 1033, but instead constitute income that is taxed in the same manner that the profits it replaces would have been taxed. (Treas. Reg., § 1.1033(a)-2(c)(8).) IRS rulings also conclude that funds received in lieu of expected ordinary income are taxable as ordinary income and ineligible for nonrecognition pursuant to IRC § 1033. (See Rev. Rul. 73-477, 1973-2 C.B. 302; IRS FSA (Jun. 21, 1993) 1993 WL 1468081.)

Sometimes, a question may arise with respect to whether or not a settlement payment or jury award constitutes a recovery of lost profits. The taxability of an amount recovered upon a contested claim depends upon the nature of the claim and the actual basis of recovery. (*Estate of Longino v. Commissioner*, *supra*, 32 T.C. at p. 905 [recovery for crop damage].) Determination of the nature of the claim is factual, and the critical question is: In lieu of what was the amount at issue paid? (*Knightlinger v. Commissioner* (1998) T.C. Memo. 1998-357.) Furthermore, the tax authorities must give "proper regard" to the allocation of an award entered by a court in a bona fide adversarial proceeding. (See *Robinson v. Commissioner* (5th Cir. 1995) 70 F.3d 34, 37.) Where, as here, an amount was awarded as lost profits by a jury in an bona fide adversarial proceeding, there is no reason to look behind the jury's allocation and statements regarding the reasons for the award. (See generally *Rozpad v. Commissioner* (1st Cir. 1998) 154 F.3d 1; *Vincent v. Commissioner*, T.C. Memo. 2005-95.)

In the civil case, the jury awarded appellant $3,260,166 for "damage to raisin crop" from 2002 through 2004. Appellants point out that this language raises an ambiguity because, while it may appear that an award for "damage to raisin crop" is intended to reimburse appellant for damage to existing crops, the 2003 and 2004 crops did not exist at the time the fertilizer was applied. Specifically, appellants argue that the fertilizer was applied in 2002; thus, the crops for future years could not have been physically damaged at the time the fertilizer was applied in

2002. We agree with appellants that, to this extent, there is some ambiguity that requires interpretation. Here, it is necessary to also consider the underlying nature of the award and the basis for how the jury arrived at this award. (*Estate of Longino v. Commissioner, supra,* 32 T.C. at p. 905.)

Appellants' witness, Mr. Betts, testified that the spraying in 2002 destroyed existing growing crops, and this damage represented 100 percent of the damage claimed and awarded for 2002 (i.e., $1,067,106). Mr. Betts further explained that "where the spray hit the grapes [it] fried them." Appellants' witnesses testified that, after 2002, appellant suffered reduced crop production due to damage to the vines. The testimony from Dr. Richard Nordstrom established that the $3,260,166 amount claimed and ultimately awarded was calculated based on the expected crop value for each year from 2002 to 2004, less the actual crop production for those years (see footnotes 3-5, *supra*.) Thus, based on the evidence and testimony we conclude that of the $3,260,166 awarded by the jury for damages to the crops from 2002 to 2004: (1) $1,067,106 was awarded for crop damage in 2002, representing a recovery for physical destruction of growing crops during 2002; and (2) $2,193,060 was awarded for damage to the raisin crops in 2003 and 2004, representing damages *due to a loss in profits from the expected production and sale of crops in those years*.

The 2002 crop damage award

The first issue with respect to the award for 2002 is whether immature crops qualify as property for purposes of IRC § 1033. While the courts have concluded that inventory is qualifying property, inventory is not defined for purposes of IRC § 1033.[13] (See *Maloof, supra,* 65 T.C. at p. 270.) Nevertheless, the United States Supreme Court has concluded that proceeds attributable to growing crops are derived from property held primarily by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business, even though immature crops are not yet severable from the trees upon which they are growing. (*Watson v. Commissioner* (1953) 345 U.S. 544, 551 [proceeds attributable to immature crops determined to be ordinary income and ineligible for capital gains treatment].) Consistent with the United States Supreme Court's analysis, we conclude that qualifying property for purposes of IRC § 1033 includes

[13] FTB acknowledges in its opening brief: "Appellant's grape crops are his inventory. That's what he sold. Appellant's grapes would properly be includible in his inventory at the close of the taxable year, and Appellant held the grapes primarily for sale to customers in the ordinary course of his trade or business."

immature crops growing on depreciable property if the taxpayer primarily holds those crops, when mature, for sale to customers in the ordinary course of business. In the instant case, it is undisputed that appellant sells the mature crops in the regular course of business. Therefore, we conclude that a portion of the total crop damage award; the $1,067,106 awarded for 2002, is a recovery for destroyed "property," within the meaning of IRC § 1033.

To qualify for § 1033 nonrecognition treatment, however, appellants also must establish that appellant purchased replacement property similar or related in service or use to the destroyed grape crops (inventory). Here, appellant replaced the destroyed inventory with rental real estate property in Syria that was purchased for $3,963,622. We concluded above that real estate is dissimilar in character from inventory. Furthermore, appellants stipulated that IRC § 1033 treatment is inapplicable to the extent we concluded that the jury award was for destruction of growing crops. Therefore, we conclude that IRC § 1033 treatment is inapplicable with respect to the $1,067,106 awarded for crop damage during 2002.

The 2003 and 2004 crop damage award

We concluded above that an award for lost profits is ineligible for IRC § 1033 treatment. We further concluded that the jury awarded appellant the amount for "damage to raisin crop" in 2003 and 2004 to compensate him for lost profits from reduced crop production in those years. Therefore, IRC § 1033 treatment is inapplicable with respect to the $2,193,060 balance of the jury award for crop damage.

The damage to the vines

Appellants contend that the $160,933 awarded as repair costs (and allowed as a nontaxable recovery by the FTB) does not fully reflect the actual amount of damage to the vines. We agree that the evidence may reasonably support a finding that the amount of physical damage suffered by the vines exceeded $160,933. Specifically, appellants presented evidence to the jury that $1,000,652 of replanting costs would be incurred as a result of damage to the vines. Nevertheless, the maximum amount of income potentially eligible for nonrecognition under IRC § 1033 is not the amount of damage appellants establish that the vines suffered. Instead, the limit is the amount of income appellants *recovered* for damage to the vines. Accordingly, our focus rests upon the jury award, and we must determine how much of the jury award was

intended to compensate appellant for damages to the vines as opposed to compensation for destroyed crops and lost profits.

Here, the jury awarded appellant exactly the amount of damages he requested for 2002 to 2004: (1) $3,260,166 for "damage to raisin crop" measured by lost crop production, plus (2) $160,933 for the "cost to repair vines." The jury instructions specified that the measure of damages for destruction to the crops could include the costs of replanting. Appellant only asked for and recovered $160,933 for damage to the vines during 2002 through 2004, and FTB agrees that recovery is not taxable. The balance of the recovery for 2002 to 2004, $3,260,166, was for the precise amount of damage to the crops sought by appellant for those years, representing the reduction in the value of the crops that appellant expected to produce and sell (i.e., lost profits). Therefore, no portion of the $3,260,166 qualifies for IRC § 1033 treatment.

The 2005 to 2013 award for future lost profits

We briefly address the balance of the jury award, $3,666,505, for "future lost profits" to ensure that we fully address the issues in this appeal. In the civil case, appellant sought to recover $10,861,766 of damages for the years 2005 through 2013, which included $1,000,652 of replanting costs relative to the damaged vines. Appellant, however, did not receive an award for the entire amount claimed. The jury ultimately awarded appellant $3,666,505, which it characterized as "future lost profits." Furthermore, the jury instructions for calculating "lost profits" prohibited the jury from including replanting costs in the measure of lost profits.[14] Specifically, the jury was instructed that damages for lost profits may only include amounts appellant would have received from selling his grapes but for the application of the fertilizer, less the expenses that appellant saved by not having to harvest the crops. In other words, in calculating lost profits for 2005 through 2013, the jury was required to assume a scenario where no damage to the vines occurred. Therefore, the jury was not allowed to award appellants replanting costs in the measure of damages for future lost profits. Based on the above, we find that no portion of the jury award for "future lost profits" was for damage to the vines.

[14] As noted earlier, the jury instructions expressly permitted replanting costs to be included in the computation of the damage to the raisin crops from 2002 to 2004; however, appellant's expert explained that appellant did not request any such damages from 2002 to 2004 because appellant did not start replanting until after 2004.

Based on the above, we conclude that appellants failed to establish entitlement to IRC § 1033 nonrecognition treatment with respect to any portion of the jury award.[15]

II. The accuracy-related penalty

The law imposes a 20-percent accuracy-related penalty on any underpayment attributable to, among other things, a substantial understatement of income tax. (RTC, § 19164(a)(1)(A); IRC, § 6662(b)(2).) An understatement is substantial if it exceeds the greater of $5,000 or 10 percent of the tax required to be shown on the return. (IRC, § 6662(d)(1)(A).) Nevertheless, the accuracy-related penalty is reduced to the extent that any portion of the understatement is attributable to an item for which the taxpayer has substantial authority for its treatment of that item.[16] (IRC, § 6662(d)(2)(B)(i).) The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. (Treas. Reg., § 1.6662-4(d)(2).) The taxpayer must have substantial authority, both under the facts and the law, to support the taxpayer's treatment of the item in dispute. (*Estate of Kluener v. Commissioner* (1998) 154 F.3d 630, 638.)

The accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was reasonable cause for the underpayment and the taxpayer acted in good faith with respect to the underpayment. (IRC, § 6664(c)(1). Such a determination is made on a case-by-case basis, taking into account all the pertinent facts and circumstances. (Treas. Reg., § 1.6664-4(b).) The relevant factors may include the taxpayer's efforts to assess the proper tax

[15] We note that both parties stipulated that any gain (the amount of which depends on basis) would be eligible for nonrecognition under IRC § 1033 to the extent we "ultimately concluded that all or any part of the disputed $3,260,166 represents a payment to compensate for damage caused to the vines." Thus, at least implicitly, the parties agree that appellants' rental real estate meets the similar or related in service or use requirement of IRC § 1033. The parties were unable to agree on the issue of basis and there is no evidence in the record to indicate whether appellants have any basis in the vines or whether the vines have been fully depreciated. Based on our conclusion that no portion of the $3,260,166 represents an award for damage to the vines, we make no finding with respect to the issue of basis or whether appellants' rental real estate in Syria is similar or related in service or use to the grape vines.

[16] The penalty also will not apply to any portion of an understatement for which the taxpayer had a reasonable basis for the tax treatment of an item, provided that the taxpayer made an adequate disclosure of the relevant facts affecting the item's tax treatment on their return or on a statement attached to the return. (IRC, § 6662(d)(2)(B)(ii).) We do not discuss this provision because appellants failed to attach the "2007 Federal Supplemental Information" statement to their California tax return, and appellants did not otherwise disclose the relevant facts pertaining to the IRC § 1033 issue on their California return. We make no finding on whether the Supplemental Information statement could have qualified as an adequate disclosure within the meaning of IRC section 6662(d)(2)(B)(ii)(I).

liability, including the taxpayer's reasonable and good faith reliance on the advice of a professional such as an accountant. (Treas. Reg., § 1.6664-4(b); *Remy v. Commissioner*, T.C. Memo. 1997–72.)

Appellants do not dispute the amount or calculation of the $148,529.60 accuracy-related penalty.[17] Appellants instead contend that they acted in good faith and they had either substantial authority or reasonable cause for their position with respect to the IRC § 1033 treatment issue.

We do not find substantial authority for appellants' position that all or any portion of the jury award constituted a nontaxable recovery, aside from the $160,933 awarded for repair costs, which amount is not at issue in this appeal. The evidence established that under the facts of this case, from 2002 to 2004, appellant incurred no replanting costs, and requested no replanting costs as damages for those years in the civil case. Instead, appellant requested damages measured by lost grape production during 2002 to 2004 (i.e., lost profits), and the jury awarded appellant exactly the amount he requested as "damage to raisin crop." With respect to the balance of the award, for 2005 onwards, the evidence established that the jury was instructed not to include replanting costs in calculating lost profits, and the jury only awarded appellant damage for lost profits from 2005 onwards. Thus, there is no basis for us to conclude that appellant received an award for injury to the vines.

Nevertheless, considering the unique facts and circumstances of this case, and the complexity of this area of law, we grant relief from a portion of the accuracy-related penalty, applying the reasonable cause and good faith standard. (See Treas. Reg., § 1.6664-4(b).) Both parties agree that grape vines are qualifying property for purposes of IRC § 1033 and that the vines sustained some damage. Both parties further agree that appellant purchased qualifying replacement property to the extent the jury awarded appellant damages for injury caused to the vines. (See footnote 15, *supra.*) Furthermore, it was reasonable for appellants to believe in good faith that the vines sustained damages in excess of the $160,933 amount specifically allocated

[17] The total tax required to be reported was $914,383. The additional tax amount was $742,648, resulting in an 81.2 percent understatement. The accuracy-related penalty is 20 percent of the additional tax amount.

thereto by the jury, and for appellants to have advanced that position in good faith.[18] It was not reasonable, however, for appellants to have concluded that no portion of the $3,260,166 awarded by the jury was for taxable lost profits. Accordingly, we find appellants had reasonable cause for treating the portion of the $3,260,166 recovery described below as a nontaxable damage award.

Appellants provided credible evidence that the vines suffered damage that would require $1,000,652 of replanting costs from 2005 to 2013. This represents 9.2 percent of the total damages appellants claimed for this time period ($1,000,652 divided by $10,861,766). Applying the same ratio to the actual award, we find that appellants had reasonable cause for believing that $337,781 of the damage awarded for this period (i.e., 9.2 percent of the $3,666,505 award) was for damages to the vines. Therefore, we conclude that the accuracy-related penalty is inapplicable to the extent the understatement is attributable to recognizing $337,781 of the jury award as income during the tax year at issue. Our conclusion reduces the $148,529.60 accuracy-related penalty by an amount equal to 20 percent of the tax attributable to recognizing the $337,781 as income in 2007.

In addition to the above, we considered the following factors as relevant in reaching this conclusion: (1) the law in this area is highly complex, as evidenced by the fact that we rejected the FTB's position on appeal with respect to what constitutes qualified property for purposes of IRC § 1033; (2) correctly applying the law to the facts of this case required a factual inquiry into the nature and computation of the jury award, and an examination of the actual jury instructions, which were highly technical in nature; and (3) appellants provided credible evidence that the amount of damage to the vines exceeded the $160,933 amount allowed by FTB and both parties stipulated that any gain would qualify for nonrecognition under IRC § 1033, to the extent appellants were awarded compensation for injury to the vines.

[18] Appellants argued that the jury's award of lost profits was simply a way of measuring the amount of damages to the vines. While this argument has some superficial attraction, it is ultimately untenable in light of the jury's specific allocation of its award between damages for repair costs, reduced crop production, and future lost profits.

HOLDINGS

I. Appellants failed to establish that any portion of the jury award qualifies for nonrecognition under IRC § 1033.

II. The accuracy-related penalty is reduced by an amount equal to 20 percent of the additional tax attributable to recognizing $337,781 as ordinary income in 2007.[19]

DISPOSITION

Respondent's action is sustained with respect to recognition of all of the additional income for 2007, and reversed in part with respect to the accuracy-related penalty.

DocuSigned by:
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Andrew J. Kwee
Administrative Law Judge

We concur:

DocuSigned by:
Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

DocuSigned by:
Michael F. Geary
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Michael F. Geary
Administrative Law Judge

[19] This reduces the accuracy-related penalty by approximately $6,958.29 (i.e., the highest marginal rate of 10.3 percent, inclusive of the mental health services tax, times $337,781, times 20 percent).