OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SALOFI TAUTUA'A AND LOVELY TAUTUA'A**	OTA Case No. 18010829 Date Issued: August 15, 2018

OPINION

Representing the Parties:

For Appellant: Salofi and Lovely Tautua'a

For Respondent: Eric R. Brown, Tax Counsel III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (RTC) section 19045, Salofi and Lovely Tautua'a (appellants) appeal a Franchise Tax Board (FTB) determination of additional tax ($7,201), an accuracy-related penalty ($1,440.20), and applicable interest due for the 2007 tax year.

Appellants waived their right to an oral hearing. Therefore, we decide the matter based on the written record.

ISSUES

1. What mortgage interest deductions are appellants entitled to claim for the 2007 tax year?
2. Should the accuracy-related penalty be adjusted or abated?

FACTUAL FINDINGS

1. A copy of appellants' timely filed 2007 California income tax return shows that they reported federal adjusted gross income (AGI) of $127,567, California AGI of $148,097, deductions of $90,860, which included a claimed mortgage deduction of $84,870, and $57,237 in California taxable income. Appellants' return reported tax of $1,626, less

$1,364 in exemption credits, for tax due of $262. After subtracting claimed withholding credits of $8,064, appellants claimed an overpayment of $7,802.

2. On September 29, 2008, FTB refunded to appellants $7,802 tax and $231.44 interest.

3. According to a "FEDSTAR IRS Data Sheet" received by FTB on June 20, 2011, the Internal Revenue Service (IRS) audited appellants' 2007 federal income tax return and, as a result, disallowed appellants' claimed $84,870 mortgage interest deduction. That adjustment caused appellants' federal tax liability to increase by $13,029. The IRS also added an accuracy-related penalty. There is no evidence that the IRS later adjusted the liability. Rather, it appears that appellants made periodic payments on the account beginning in 2012 and continuing through mid-November 2014. Appellants did not report the changes to FTB.

4. On March 16, 2012, FTB issued a Notice of Proposed Assessment (NPA) to appellants. The NPA advised appellants that FTB disallowed their claimed mortgage deduction of $84,870 (based on the federal adjustment), which increased their reported taxable income from $57,237 to $142,107 and increased their tax from $262 to $7,463. The NPA also stated FTB was adding an accuracy-related penalty of $1,440.20, and interest of $1,756.60, for a total due of $10,397.80.

5. By letter dated May 15, 2012, appellants protested the NPA, indicating they had submitted additional evidence to the IRS, which was further reviewing the matter. Appellants asked FTB to delay final consideration of their protest until the IRS finished its review.

6. By letter dated September 27, 2012, sent to appellants' address of record (2080 E. Prescott Pl., Chandler, AZ), FTB acknowledged appellants' protest and request for a delay. The letter informed appellants that the IRS did not say it was still considering appellants' documents and had not informed FTB that there were any changes made to appellants' federal taxes, penalties, or interest. It also said that FTB would affirm the proposed assessment if appellants did not provide some evidence, by October 29, 2012, to show that the IRS was still considering the matter. The United States Postal Service returned the letter to FTB as undeliverable at that address.

7. By letter dated August 29, 2013, FTB sent a second letter with substantially the same content to appellants at a different address (3748 Hoover St., Redwood City, CA), except

that FTB stated that it would affirm the proposed assessment if appellants did not provide the evidence by September 30, 2013.

8. Appellants did not respond to FTB's request. FTB issued a Notice of Action dated December 30, 2013, affirming the assessment. This timely appeal followed.

9. The Office of Tax Appeals' file contains the following:

   a. A substitute Form 1098 issued by Wachovia Mortgage (formerly World Savings) to Salofi Tautua'a at 311 Sheridan Drive, Menlo Park, CA (the Sheridan Drive property) and showing net mortgage interest of $29,476.80 paid (and deferred interest of $29.903.32 added to principal) in 2007 on a conventional residential mortgage with a remaining balance of $748,908.43. The Form 1098 does not show the address of the property securing the debt, but appellants took a deduction for that amount on their 2007 federal return, Schedule E (used to report supplemental income and loss from real estate rentals and other activities), identifying the rental property as the Sheridan Drive property. The IRS and FTB allowed that deduction.

   b. Page 1 (of 4 pages) of a Form 1098 issued by Washington Mutual Bank (WaMu) to Salofi Tautua'a (at the Sheridan Drive property) showing net mortgage interest of $19,714.50 paid in 2007 on a conventional residential mortgage on 40128 Dortha Court, Fremont, CA (the Dortha Court property), which was the residence/mailing address listed on the first page of appellants' 2007 California tax return. (We will refer to this Form 1098 as WaMu 1.)

   c. A substitute Form 1098 issued by WaMu to Salofi Tautua'a at the Dortha Court property, showing mortgage interest of $60,628.44 ($58,280.64 in interest and $2,347.80 in late charges) paid through November 2007 on a conventional residential mortgage with a remaining balance of $834,489.49. It does not indicate the address of the property securing the debt. (We will refer to this Form 1098 as WaMu 2.)

   d. A Form 1098 issued to appellants at 5686 Abington Drive, Newark, CA, which indicates appellants also paid mortgage interest of $7,375 during 2007 to

Financial Integrity Group/Warehouse Capital (Financial Integrity), though the form does not identify the property that secured the debt.

e. At least five IRS letters to appellants dated May 10, 2010, through October 7, 2010, requesting more information from appellants. The first indicates that the IRS determined that appellants may have deducted mortgage interest in excess of the $1,000,000 limitation on loan amounts. The four subsequent letters indicate the IRS's assessment of additional tax ($15,306), penalties ($3,061.20), and interest, and appear to focus primarily on appellants' failure to complete and return a worksheet used to calculate a taxpayer's limit on qualified loan amounts and deductible interest (worksheet).

f. A copy of a May 15, 2006 escrow settlement statement for the Dortha Court property showing total consideration from appellant Salofi Tautua'a of $1,070,000 and copies of two promissory notes totaling $1,050,000 by Long Beach Mortgage Company (Long Beach Mortgage). One was an adjustable-rate loan of $840,000 at a starting rate of 7.5 percent through June 2008, amortized over 40 years. This loan called for monthly payments of $5,589.97 through June 30, 2008. The second was a loan of $210,000 at a fixed rate of 9.85 percent that called for monthly payments of $1,819.67.

g. A copy of a November 3, 2006 escrow settlement statement for the Sheridan Drive property, which shows a total consideration from appellants of $949,999 and two loans totaling $901,749.80.

h. Copies of pages from appellants' 2007 federal and state tax returns, including Schedule E to Form 1040, which shows appellants deducted $29,476 in mortgage interest paid on a loan secured by their rental property on Sheridan Drive.

DISCUSSION

Issue 1 - What mortgage interest deductions are appellants entitled to claim for the 2007 tax year?

RTC section 18622 states a taxpayer shall either concede the accuracy of a federal determination or state how it is wrong. A deficiency assessment based on a federal assessment is presumed to be correct, and a taxpayer bears the burden of proving that the determination is

wrong. (*Appeal of Sheldon I. and Helen E. Brockett*, 86-SBE-109, June 18, 1986; *Appeal of Barbara P. Hutchinson*, 82-SBE-121, June 29, 1982.)[1] California Code of Regulations, title 18, section 30705(c) states that unless there is an exception provided by law, "the burden of proof requires proof by a preponderance of the evidence."[2] Unsupported assertions are not enough to satisfy a taxpayer's burden of proof with respect to an assessment based on a federal action. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

California conforms to Internal Revenue Code (IRC) section 163 regarding the deductibility of mortgage and other interest. (See RTC, § 17201.) The general rule is that individuals may not deduct personal interest. (IRC, § 163(h)(1).) An exception allows individuals to deduct "qualified residence interest." (IRC, § 163(h)(2)(D).) "Qualified residence interest" includes interest paid or accrued during the taxable year on debt incurred to purchase, construct, or substantially improve a qualified residence and which is secured by the residence (acquisition debt), subject to a $1,000,000 limitation ($500,000 for married filers filing separately). (IRC, § 163(h)(3)(B).) It also includes interest paid or accrued during the taxable year on home equity debt secured by a qualified residence of the taxpayer, subject to a $100,000 limitation ($50,000 for married filers filing separately). (IRC, § 163(h)(3)(C).) The $1,000,000 limitation does not apply to qualified residence loans made to the taxpayer on or before October 13, 1987 (grandfathered debt). (IRC, § 163(h)(3)(D)(i)(II).) However, the limitation applicable to debt incurred after that date is reduced by the amount of grandfathered debt. (IRC, §163(h)(3)(D)(ii).)

A qualified residence includes the taxpayer's principal residence and one other residence of the taxpayer or spouse. (IRC, § 163(h)(4).) The principal residence is one that meets the requirements for the nonrecognition of gain upon a sale under IRC section 121. (*Ibid*.) The one other residence, or second residence, refers to one that is used as a residence if not rented or, if rented, meets the requirements for a personal residence under the rental of vacation home rules.

[1] Formal and memorandum opinions issued by the Board of Equalization can be seen on the Board's website at http://www.boe.ca.gov/legal/legalopcont.htm.

[2] A preponderance of evidence means that the taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc., v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.)

(*Ibid.*) A taxpayer who has more than one second residence can make the choice each year of which one is the qualified second residence. (*Ibid.)*

In this case, there are four Forms 1098 showing mortgage interest paid by appellants during 2007 and reported to the IRS: (1) the Wachovia Mortgage Form 1098 showing mortgage interest of $29,476.80; (2) the Financial Integrity Form 1098 showing mortgage interest of $7,375; (3) WaMu 1, showing mortgage interest of $19,714.50; and (4) WaMu 2, showing mortgage interest of $60,628.44. There does not appear to be any dispute that appellants paid this mortgage interest. As already stated, the IRS and FTB allowed appellants' deduction of the interest shown in the Wachovia Mortgage Form 1098 under IRC section 163(d).[3] This allowance for investment interest does not affect appellants' allowable deductions for mortgage interest on their qualified residences under IRC section 163(h). That leaves three Forms 1098 totaling $87,717.94 as possible support for appellants' claimed deduction of $84,870.

The Financial Integrity Form 1098 (item 2, above) is the only evidence we have concerning that mortgage interest. There are no other documents that refer to that mortgage and appellants declined to appear before us at a hearing, where they might have been able to testify about it.[4] Appellants have not established that this interest was included in the claimed $84,870 mortgage interest deduction for qualified residences or that it was paid on a loan secured by a qualified residence. We conclude that the evidence before us does not prove that the interest shown on the Financial Integrity Form 1098 was mortgage interest paid on a qualifying residence. The two WaMu Forms 1098 totaling $80,342.94 remain.

The direct and circumstantial evidence indicates that WaMu 1 refers to the $210,000 loan made by Long Beach Mortgage for the purchase of the Dortha Court property.[5] Appellants continued to receive mail at the Dortha Court address during and after 2007, which is evidence

[3] Appellants claimed this interest as an investment expense on their Schedule E.

[4] We suspected that appellants could have provided additional information through their testimony, sworn written statements, or other evidence that would have helped us to decide whether any part of their claimed mortgage interest deduction should have been allowed. By letter dated June 12, 2018, OTA requested additional information from appellants (copy to FTB), but appellants did not respond.

[5] Facts are established through direct and indirect, or circumstantial, evidence. Direct evidence can be relied upon to conclusively establish a fact, without an inference or presumption. (*Godwin v. Hunt Wesson, Inc.* (9th Cir. 1998) 150 F.3d 1217, 1221.) Indirect or circumstantial evidence tends to establish the fact in dispute by proving another fact which, though true, does not of itself conclusively establish that fact, but which allows an inference or presumption of its existence. (*People v. Goldstein* (1956) 139 Cal.App.2d 146, 152-153.)

they lived there. WaMu 1 states the Dortha Court property secures the loan, but we have no evidence to suggest that appellants borrowed money from WaMu to purchase, construct, or improve that property. Long Beach Mortgage loaned purchase money for that property, but there is no Form 1098 from that lender or other evidence before us to show appellants paid mortgage interest to that lender during 2007. Also, there is nothing in the evidence to suggest appellants paid off those loans, which totaled $1,050,000 on May 15, 2006. All of this indicates that appellants still owed at least most of the $210,000. The monthly payment due on the $210,000 Long Beach Mortgage Dortha Court loan was $1,819.67, the same amount due on the WaMu loan to which WaMu 1 refers. It is common knowledge that lenders often sell mortgage loans to other lenders at a discount, often soon after the lender first loans the money. We find that the evidence supports an inference that Long Beach Mortgage sold this loan prior to 2007 and that WaMu held the loan during 2007, as shown by the WaMu 1, showing $19,714.50 interest paid (item 3, above).[6] We also find that the evidence establishes that appellants paid this interest on a mortgage secured by appellants' qualified residence, and that appellants have shown that FTB's assessment is wrong as far as it disallowed that interest deduction supported by WaMu 1.

We do not have direct evidence that WaMu 2 reported interest paid on the $840,000 Dortha Court purchase money loan from Long Beach Mortgage, but there is credible and persuasive circumstantial evidence that it did. Appellants continued to live at the Dortha Court property and there is nothing in the evidence to suggest that appellants paid mortgage interest to Long Beach Mortgage or that they paid off the loan. WaMu 2 shows interest paid that is at least consistent with that loan amount. It shows appellants paid interest of $58,280.64 through November 2007. According to amortization tables, appellants should have paid about $57,533 in interest through November 2007 on the $840,000 loan from Long Beach Mortgage. Finally, we have already found, above, that the $210,000 Long Beach Mortgage loan was held by WaMu during 2007. This is strong circumstantial evidence that WaMu 2 shows interest paid on the $840,000 loan made by Long Beach Mortgage. We find the evidence is sufficient to establish that WaMu 2 reported mortgage interest paid on the $840,000 purchase-money loan made by Long Beach Mortgage and that appellants paid this interest on a qualified residence. Therefore,

[6] "An inference is a deduction of fact that may logically and reasonably be drawn from another fact or group of facts found or otherwise established in the action." (Cal. Evid. Code, § 600(b).)

appellants have shown that FTB's assessment is wrong as far as it disallowed that interest deduction supported by WaMu 2.

Having found that appellants paid mortgage interest on loans secured by their qualified residence, we must decide whether the IRC section 163(h)(3)(B) limitations come into play.[7] The Long Beach Mortgage loans totaled $1,050,000, $50,000 more that the allowed maximum for deductible interest on mortgage debt. (IRC, § 163(h)(3)(b).) The worksheet that the IRS asked appellants to complete and return is used to calculate a taxpayer's qualified loan limit.[8] Although appellants still have not provided a completed worksheet, we look to the evidence to determine whether the limit can be reasonably determined.

First, the worksheet calls for the average balance of grandfathered debt. There is no evidence appellants had any. Next, the worksheet asks for the balance of all home acquisition debt. WaMu 1 shows payments against principal during 2007 averaging about $106 per month but there is insufficient information for us to determine the average mortgage balance so we will use the total loan amount, $210,000. WaMu 2 shows the highest balance of the loan was $834,489. For the worksheet calculation, we will use the total of those principal balances, $1,044,489. Because appellants paid mortgage interest on more than the maximum allowable debt, we must calculate the ratio of maximum allowed debt ($1,000,000) to total debt ($1,044,489). That ratio is .957 (1,000,000 ÷ 1,044,489 = .957).[9] We then multiply appellants' total interest paid on qualified mortgage debt by the same ratio to calculate appellants' total allowable interest deduction of $76,888 (.957 x $80,343 = $76,888). Based on the evidence, we find that appellants could claim a $76,888 mortgage interest deduction for 2007.

Issue 2 - Should the accuracy-related penalty be adjusted or removed?

The law imposes a 20 percent accuracy-related penalty on any underpayment attributable to, among other things, a substantial understatement of income tax. (§ 19164(a)(1)(A); IRC, § 6662(b)(2).) For individual taxpayers, it is presumed that an understatement is substantial if the amount of the understatement exceeds the greater of $5,000 or 10 percent of the tax. (IRC,

[7] There is no evidence that any of the Forms 1098 were for interest paid on a home equity line of credit under IRC section 163(h)(3)(c).

[8] It appears from the file that the IRS disallowed appellants' entire interest deduction because appellants did not complete this worksheet.

[9] The IRS worksheet instructs us to round the ratio to three decimal places.

§ 6662(d)(1)(A).) Nevertheless, the accuracy-related penalty is reduced to the extent that any part of the understatement is attributable to an item for which the taxpayer has substantial authority for its treatment of that item. (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).) Substantial authority may include both legal authority and factual evidence. (*Estate of Kluener v. Commissioner* (6th Cir. 1998) 154 F.3d 630, 638.)

Appellants claimed a mortgage interest deduction of $84,870. We find, above, that they were entitled to claim a deduction of $76,888. The liability as adjusted does not call for an accuracy-related penalty. Therefore, the penalty should be abated.

HOLDING

Appellants are entitled to claim a $76,888 mortgage interest deduction for the 2007 tax year, and the accuracy-related penalty should be abated.

DISPOSITION

We reverse FTB's assessment of additional personal income tax to the extent it is based on a claimed mortgage interest deduction of $76,888 and imposes an accuracy-related penalty, but we sustain FTB's assessment of additional personal income tax based on appellants' claimed mortgage interest deduction in excess of $76,888.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Amanda Vassigh
Administrative Law Judge

DocuSigned by:
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Neil Robinson
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