OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **SAWTANTRA CHOPRA AND ARUNA CHOPRA**	OTA Case No. 18010805 Date Issued: April 9, 2019

OPINION

Representing the Parties:

For Appellants: Sawtantra Chopra and Aruna Chopra

For Respondent: Carolyn S. Kuduk, Tax Counsel III

For Office of Tax Appeals: Josh Lambert, Tax Counsel

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellants appeal an action by respondent Franchise Tax Board proposing to reduce their net operating loss (NOL) carryover available for the 2008 tax year from $575,914 to $60,302 (a $515,612 reduction) and to increase their capital loss carryover to 2008 from $103,794 to $497,175 (a $393,381 increase).[1]

Appellants waived their right to an oral hearing and therefore the matter is being decided based on the written record.

ISSUE

Whether appellants have shown that respondent erroneously recharacterized appellants' ordinary loss from the sale of real property to a capital loss.

FACTUAL FINDINGS

1. Appellants acquired a 320-acre real property on Black Diamond Way in Pittsburg, California, (Black Diamond property) in 1987 for $1,550,000.

[1] On appeal, respondent has agreed to revise the capital loss carryover amount of $492,960 as determined at audit. Respondent has conceded a $4,215 adjustment, bringing the carryover amount to $497,175 (i.e., $492,960 + $4,215). The difference of $122,231 (i.e., $515,612 - $393,381) between the decrease in NOL carryover and increase in capital loss carryover is due to an overstatement of basis, as conceded by appellants prior to this appeal.

2. Appellants stated at audit that they leased the property back to the seller, who used it to graze livestock, during the twenty years that they owned the land.
3. Appellants participated in a court case in 1993 that granted an easement to them and about twenty other landowners to preserve their ability to use a public road.
4. Appellants entered into a separate easement agreement in 2006 for a neighboring property. The agreement states that the easement is "expressly limited" for agricultural and cattle ranching use and "in the event of residential development" the easement may not be used for more than two residential living units on the property.
5. Appellant-husband does not have a real estate sales or broker license.
6. Appellants entered into a listing agreement with a broker on April 27, 2006, authorizing Colliers International the "Exclusive Authorization to Sell" the Black Diamond property.
7. The Black Diamond property was sold for $1,344,000 in November 2007. Appellants' adjusted basis at the time of sale was $1,737,381, which resulted in a loss of $393,381 ($1,344,000 - $1,737,381).
8. Appellants filed a timely California resident income tax return for the 2007 tax year. On the federal Form 4797 attached to the return, appellants reported a $515,612 ordinary loss from the sale of the Black Diamond property.
9. Appellants did not report any income from the Black Diamond property for 2007 and reported $16,526 in expenses due to real estate taxes.
10. Respondent audited appellants' return as to the sale of the Black Diamond property. Respondent asked for documentation regarding the sale, how appellants determined the cost basis for the property, a description of the property, and how the property was used.
11. In a letter dated April 30, 2011, appellants stated that efforts were made to develop the land into residential units and to change the zoning for future development potential. Appellants also described the property as an "investment property."
12. Appellants stated in a letter dated July 15, 2011, that the loss was characterized as ordinary loss per Internal Revenue Code (IRC) section 1231. Appellants also stated that the property was purchased with intentions to either farm the property or to develop the property and sell it to someone for subdivision land.

13. Respondent subsequently issued a Notice of Proposed Adjusted Carryover Amount (NPACA) on April 13, 2012, recalculating and recharacterizing the reported ordinary loss as a capital loss.
14. Appellants timely protested the NPACA and requested a protest hearing, which took place on December 2, 2013.
15. At the protest hearing, appellant-husband stated that in 2007, he spent 70 percent of his time practicing medicine and 30 percent of his time on real estate activities. Appellant-husband explained that he was initially so involved in his medical practice that he did not have time to work on development of the land.
16. Appellants stated that they owned many apartments and other rental buildings, that these buildings were purchased as already-developed units for which they hired individual local managers, and that they admit that they have not successfully rezoned, developed, and sold a completed project.
17. On July 8, 2014, respondent affirmed its NPACA. This timely appeal followed.

DISCUSSION

IRC section 1221

IRC section 1221 (incorporated by R&TC section 18151) defines capital assets to include property held by the taxpayer, except those specifically listed in the statute. Generally, if property is characterized as a capital asset, any loss from the sale of such property is treated as capital loss and the deduction of the capital loss is limited to the amount of capital gains realized plus $3,000. (IRC, §§ 1221 & 1211(b).) Any capital loss in excess of this amount may be carried forward to subsequent tax years.

Certain types of property are excluded from the definition of capital asset. IRC section 1221(a)(1) excludes "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[2] A loss from the sale of property that falls under this exclusion is treated as an ordinary loss which may be used to offset other ordinary income. (IRC, § 1221.) Courts have developed the following nonexclusive factors in determining whether a property is primarily held for sale in the ordinary course of a taxpayer's business:

[2] IRC section 1221(a)(2) also excludes "real property used in the taxpayer's trade or business" from the definition of capital asset. We note that this exclusion is similar to the definition of property eligible for IRC section 1231 treatment discussed below, and the analysis below applies equally to this exclusion.

(1) the purpose for which the property was initially acquired, subsequently held, and held at the time of the sale; (2) improvements made to the property by the taxpayer; (3) the frequency, number, and continuity of sales; (4) the ordinary business of the taxpayer; (5) the proximity of the sale to the purchase; and (6) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property. (*Hoover v. Commissioner* (1959) 32 T.C. 618; *Oace v. Commissioner* (1963) 39 T.C. 743; *Appeal of Pfau*, 77-SBE-027, Feb. 3, 1977.)[3] Whether a taxpayer held specified property primarily for sale to customers in the ordinary course of the taxpayer's trade or business is a question of fact. (*Fargo v. Commissioner,* T.C. Memo. 2015-96.)

Appellants only assert on appeal that the loss should be treated as ordinary and not capital in nature, without further explanation of their position. While appellants contended that they needed more time to collect and submit additional documentation, appellants failed to provide any additional arguments or evidence despite multiple opportunities provided to them.[4]

From documents provided by respondent on appeal, it appears appellants argued at protest that the property was held primarily for sale to customers in the ordinary course of their trade or business and that, therefore, the loss is ordinary. Appellants stated that efforts were made to develop the land into residential units and to change the zoning for future development potential. However, appellants also described the property as an "investment property" and stated that they intended to farm the property.

That a taxpayer devotes little time or effort to the selling of assets may suggest that the assets are held for investment purposes. (See *Bramblett v. Commissioner* (5th Cir. 1992) 960 F.2d 526.) Appellant-husband stated that in 2007, he spent 70 percent of his time practicing medicine and only 30 percent of his time on real estate activities. Appellant-husband explained that he was initially so involved in his medical practice that he did not have time to work on development of the land. The more time a taxpayer advertises, solicits customers, lists the property, and otherwise promotes the sale of the property is a factor evidencing that the taxpayer may be a developer. (See *Biedenharn Realty Co., Inc. v. U.S.* (1976) 526 F.2d 409.) Other than

[3] State Board of Equalization opinions, designated by "SBE," are generally available for viewing on its website: <http://www.boe.ca.gov/legal/legalopcont.htm#boeopinion>.

[4] Appellants made the same contention that they needed additional time to gather the relevant documents to respondent during their protest of the NPACA prior to this appeal.

the 2006 listing agreement with a third-party broker, appellants have not shown any efforts to promote and sell the Black Diamond property during their 20-year ownership.

The frequency and substantiality of sales are highly probative on the issue of whether one is a dealer because the presence of frequent sales ordinarily evidences that property is not being held for investment. (*Suburban Realty Co. v. United States* (5th Cir. 1980) 615 F.2d 171.) Appellants have not shown that they were engaged in real estate development with continuity and regularity. Appellants, in fact, have only provided evidence that they sold one property, the property at issue. Appellants have not provided any evidence of any other sales. In the twenty years that they held the property, they only leased the property back to the seller who used it to graze livestock. Appellants state that the economy took a turn for the worse in 2006-2007 and they sold the property because they needed funds immediately. This does not indicate that the land was held in the ordinary course of business for sale to customers, but rather that they only decided to sell it because they had financial difficulties resulting from a sudden economic downturn. Furthermore, the fact that appellants owned the land for twenty years indicates that appellants held it for investment. (See *Williford v. Commissioner*, T.C. Memo. 1992-450, cf. *Appeal of Pfau, supra*.) Appellants have not shown that they engaged in sales frequently and substantially enough to qualify as a trade or business, and the length of time between the purchase and sale of the Black Diamond property indicates that it was held for investment.

Where a taxpayer develops land by subdividing, grading, rezoning, or installing roads and utilities, he or she may be deemed a developer. (See *Harder v. Commissioner*, T.C. Memo. 1990-371.) Appellants provide evidence that they participated in a court case in 1993 that allowed them to maintain an easement. However, in this lawsuit, appellants were one of about twenty other landowners who sued to preserve their ability to use a public road. Therefore, the easement was unrelated to personal efforts by appellants to develop their property as a part of a real estate development business. Additionally, this court action occurred 14 years before the sale of their property and appellants provide no other evidence to show development activity until 2006.

Appellants also submit an easement agreement from 2006 showing that they received an easement over a neighboring property. The agreement, however, states that the easement is "expressly limited" for agricultural and cattle ranching use and "in the event of residential development" the easement may not be used for more than two residential living units on the

property. Accordingly, the easement, created 20 years after appellants purchased the property, limited its use in the case of residential development, and allowed appellants to continue to lease the property for grazing purposes, an activity which is not part of a real estate development business. Therefore, appellants have not provided significant evidence of improvements made to the land to sell it as a part of a real estate development business.

In weighing the above factors, we find that appellants did not hold the Black Diamond property primarily for sale to customers in the ordinary course of a trade or business. The evidence shows that purchasing, developing, and selling real estate was not their primary or ordinary business, and, in fact, appellants admit that they had not successfully rezoned, developed, and sold a completed project. Specific to the Black Diamond property, appellants did not make any significant improvements to the land or show efforts made to sell the land during the relatively stagnant 20 years of ownership. Accordingly, the evidence shows that the property was an investment property. Thus, respondent properly recharacterized the Black Diamond property as a capital asset.

IRC section 1231

IRC section 1231 generally allows taxpayers to treat gain from the sale of certain property as a capital gain and a loss from such a sale as an ordinary loss. IRC section 1231 provides that a loss on the sale of property *used in a trade or business* shall be treated as an ordinary loss if the IRC section 1231 gains do not exceed the IRC section 1231 losses for such taxable year. As relevant to this appeal, IRC section 1231(b)(1) provides that "property used in the trade or business" includes real property used in the trade or business, held for more than one year, which is not, among other things, property held by the taxpayer primarily for sale to customers in the ordinary course of his or her trade or business.

Appellants have not argued on appeal, and the evidence does not show, that they were in the trade or business of property rental or property leasing.[5] Documents provided by respondent show that appellants referred to unrelated apartment and rental buildings during the protest period, and pointed to the fact that they leased the Black Diamond property back to the seller

[5] As noted above, appellants assert on appeal that the loss was an ordinary loss and not a capital loss, and requested additional time to provide substantiating documents. Despite multiple extensions and several requests for information from appellants, they did not provide further documentation. Appellants' sole piece of evidence is a letter from respondent detailing extensions and efforts made to provide appellants additional opportunity to provide substantiation prior to affirming the NPACA.

after purchase as evidence of their involvement in real estate activities. However, appellants also admitted that they did not allocate much time to real estate activities due to the demands of appellant-husband's career practicing medicine, that they hired property managers for each of their apartment and rental buildings, and that they never successfully rezoned, developed, and sold a completed real estate project. Accordingly, appellants have failed to show that they were in the trade or business of property rental or property leasing for purposes of IRC section 1231(a)(3)(A)(i).

Specific to the Black Diamond property, the evidence shows that appellants' primary purpose in holding the property was for investment. The casual rental of the land for grazing purposes at a nominal fee does not evidence use of the land in a bona fide rental business. (*Yarbro v. Commissioner* (5th Cir. 1984) 737 F.2d 479.) Furthermore, although appellants claim that they rented the land for grazing, appellants did not report any income produced by the property for the year at issue or for any years prior. Rather than reporting rental income, appellants only reported $16,526 in expenses due to real estate taxes in 2007. Appellants have not provided any support, such as rental agreements or canceled checks, for their assertion that they earned money from leasing the property over the twenty-year span of ownership. Regardless, any such rents appellants may have received from the leasing of the Black Diamond property appear to be incidental to the protection of the investment. These circumstances do not amount to a regular trade or business. (See *Chicago Title & Trust Co. v. United States* (7th Cir. 1954) 209 F.2d 773.) As such, the sale of the Black Diamond property is not eligible for ordinary loss treatment pursuant to IRC section 1231.

HOLDING

Appellants have not shown that respondent erroneously recharacterized appellants' ordinary loss from the sale of real property to a capital loss.

DISPOSITION

Respondent's determination is modified, as conceded on appeal, to revise the capital loss carryover amount at issue to $497,175. Respondent's determination is otherwise sustained.

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John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

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Daniel Cho
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Daniel K. Cho
Administrative Law Judge

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