

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No. 18010827  
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**SALVACION Y. TORRE** ) Date Issued: June 27, 2019  
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**OPINION**

Representing the Parties:

For Appellant: Lili Sitjar, Representative  
Eli Pairis, Tax Preparer

For Respondent: John Yusin, Tax Counsel IV  
David Gemmingen, Tax Counsel IV

Office of Tax Appeals: William J. Stafford, Tax Counsel III

L. CHENG, Administrative Law Judge: Pursuant to California Revenue and Taxation Code (R&TC) section 19045, Salvacion Y. Torre (appellant) appeals an action of the Franchise Tax Board (FTB) proposing an assessment in the amount of \$1,379 in additional tax, plus applicable interest, for the 2011 tax year; and an assessment in the amount of \$12,128 in additional tax, plus applicable interest, for the 2014 tax year.

Administrative Law Judges Linda C. Cheng, Douglas Bramhall, and Sara A. Hosey held an oral hearing for this matter in Los Angeles, California, on March 19, 2019. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

**ISSUES<sup>1</sup>**

1. Whether appellant has established that she is entitled to deduct a loss pertaining to the short sale of real property for the 2014 tax year.

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<sup>1</sup> Appellant conceded the issue of pension income for the 2011 tax year at the prehearing conference held on March 4, 2019, and confirmed her concession at the oral hearing. Therefore, we will not further address this issue.

2. Whether taxpayer properly reported cancellation of debt (COD) income for the 2014 tax year.<sup>2</sup>
3. Whether taxpayer correctly calculated her basis in the real property at issue.

### FACTUAL FINDINGS

1. During the taxable years at issue, appellant was a California resident and a medical doctor.
2. In 2006, appellant's son, Sean, and his wife, Crisalyn, purchased as their primary residence, a home on Lemongrass Street in Corona, California, (the "Lemongrass Property" or "property") for \$560,500 and financed the purchase with a mortgage of \$476,119.
3. In April of 2007, Sean and Crisalyn transferred as a gift, a one-third interest in the property to appellant, as a joint tenant.
4. In 2007, Sean received a Notice of Default on the mortgage. Subsequently, Sean, Crisalyn, and appellant refinanced the Lemongrass Property in the amount of \$532,800.
5. In September of 2013, Sean and Crisalyn transferred the remaining two-thirds interest in the property, as a gift, to appellant in an intrafamily transfer.
6. The property became vacant during 2013 and remained vacant.
7. In March of 2014, appellant transferred a 5-percent interest in the property to an unrelated individual.
8. In June 2014, appellant received a Notice of Default in relation to the Lemongrass Property. Appellant decided to sell the property via a short sale. The Trustee's Deed Upon Sale states that appellant sold the Lemongrass Property to Flagstar Bank for \$399,000.00 and that the outstanding loan plus costs totaled \$611,218.96.
9. Appellant filed a 2014 California income tax return, reporting the sale of the Lemongrass Property for \$399,000, depreciation of \$19,375, basis in the property of \$548,729, and a business loss on the property in the amount of \$130,354.

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<sup>2</sup> Neither the Notice of Proposed Assessment (NPA) nor the Notice of Action (NOA) proposed to assess tax based on unreported COD income. Accordingly, the parties agreed that the issue of COD income, as well as issue #3 relating to appellant's basis in the real property, would be relevant as potential offset issues only if appellant establishes that she is entitled to deduct a loss under issue #1. As discussed below, because we find that appellant is not entitled to deduct a loss, issues #2 and #3 are moot, and we will not further address them.

10. FTB audited appellant's 2014 California return and denied the business loss of \$130,354 because the property was not reported as a rental nor did appellant report any rental income.<sup>3</sup>
11. Appellant filed a timely protest. During protest, appellant provided a copy of an unsigned rental agreement dated May 1, 2014, between herself and Tess Abraham, purporting to rent the property for \$500 per month.<sup>4</sup>
12. Following the protest, FTB issued a Notice of Action, disallowing the loss of \$130,354. The NOA set forth an additional tax of \$12,128, plus applicable interest.
13. Appellant filed this timely appeal.

### DISCUSSION

Issue 1: Whether appellant has demonstrated that she is entitled to deduct a loss for the 2014 tax year pertaining to a short sale of real property.

A. Internal Revenue Code (IRC) Section 1231<sup>5</sup>

Section 1231 governs the tax treatment of gains and losses of real and depreciable property used in a trade or business and held over one year. (§ 1231(a)(3).)<sup>6</sup> A net Section 1231 loss is fully deductible as an ordinary loss. (§ 1231(a)(2).) “[T]o be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and . . . the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.” (*Commissioner v. Groetzinger* (1987) 480 U.S. 23, 35.)

Here, appellant has not alleged or submitted evidence showing that she was engaged in a “trade or business” other than her medical practice. Furthermore, appellant has not alleged or provided evidence showing that her medical practice was somehow associated with the Lemongrass Property. Moreover, the property was disposed of as a voluntary short sale, not as

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<sup>3</sup>The NOA did not disallow or otherwise address the depreciation of \$19,375 that appellant reported on federal Form 4797 as “allowed or allowable since acquisition” of the property.

<sup>4</sup>A copy of the alleged rental agreement is not located in the appeal record. The details of the unsigned rental agreement are set forth by FTB in a determination letter dated June 30, 2017.

<sup>5</sup>Unless otherwise indicated, all Section references are to the IRC.

<sup>6</sup>Section 1231 is generally incorporated into California law at R&TC section 18151.

an involuntary conversion. Accordingly, appellant has not demonstrated that she is entitled to a business loss under Section 1231 in relation to the short sale of the Lemongrass Property.

**B. Section 165**

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers* (2001-SBE-001) 2019 WL 1187160.)

Section 165(a) provides, in part, that “there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.”<sup>7</sup> Section 165(c) limits an individual’s deduction for losses pursuant to Section 165(a) to: (1) losses incurred in a trade or business;<sup>8</sup> (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.<sup>9</sup> Section 262 provides, in part, that “except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.”<sup>10</sup>

To qualify for a loss deduction under Section 165(a)(2), a taxpayer’s use of a property that was not previously used for profit purposes would have to have shifted from a personal use to a business or profit-oriented purpose permitted under Section 165(c). (*Henry v. Commissioner*, T.C. Memo. 1983-277.) The Tax Court in *McAuley v. Commissioner*, T.C. Memo. 1976-276 (*McAuley*), held that merely offering a house for rent is not enough to establish that the house had been converted for purposes of allowing a loss under Section 165. The Tax Court in *McAuley* noted that Treasury Regulation section 1.165-9(b) provides that if property has been acquired or used as the taxpayer’s personal residence, it must first be “rented or otherwise appropriated to income-producing purposes” in order for the taxpayer to become entitled to deduct a loss under Section 165. Merely listing a property for sale or rent has been held to not

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<sup>7</sup> Section 165 is generally incorporated into California law at R&TC section 17201.

<sup>8</sup> As discussed above, appellant has not shown that the property is related to her occupation as a medical doctor.

<sup>9</sup> Appellant does not claim that the property sustained the loss as a result of fire, storm, shipwreck, or other casualty, or from theft.

<sup>10</sup> Section 262 is generally incorporated into California law at R&TC section 17201.

qualify as “appropriated to income producing purposes” under Section 165. (Treas. Reg. § 1.165-9(b); *Cowles v. Commissioner*, T.C. Memo. 1970-198; *Brinker v. Commissioner*, T.C. Memo. 1975-244.)

Here, appellant has not shown that the Lemongrass Property was rented via a bona fide lease or otherwise “appropriated to income-producing purposes” such that she is entitled to deduct a loss under Section 165. In her appeal letter, appellant contends that she began leasing the Lemongrass Property in 2011. In support, appellant provides a copy of her 2011 California return. Appellant’s 2011 return, however, shows that appellant reported rental income from a different property located in Artesia, California, not the Lemongrass Property.

During protest, appellant provided FTB with a copy of an unsigned rental agreement dated May 1, 2014, for the Lemongrass Property, in which appellant allegedly agreed to rent the property for \$500 per month to an individual named Tess Abraham. This unsigned rental agreement, however, is not part of the appeal record nor has appellant provided a signed copy of the purported rental agreement on appeal. In addition, appellant has not provided any evidence, such as a declaration from Ms. Abraham, substantiating that the property was rented by Ms. Abraham on May 1, 2014, for \$500 per month. On the contrary, appellant states in her appeal brief that “[i]n spite of the improvements, no renters can afford the rental of the whole property to be able to cover the monthly mortgage . . . [t]he property was vacated after 2013.” The appeal brief makes no mention of any renters for the 2014 tax year. We also note that appellant’s 2014 California tax return similarly does not claim that appellant rented the Lemongrass Property during the 2014 tax year.<sup>11</sup> Hence, because the record is devoid of any evidence that appellant leased the Lemongrass Property during the 2014 taxable year, we are unpersuaded that the property was being held for income-producing purposes.

Consequently, appellant has not demonstrated that she is entitled to a loss under Section 165 pertaining to the short sale of the Lemongrass Property.

#### HOLDING


Appellant has not demonstrated that she is entitled to deduct a loss for the 2014 tax year pertaining to a short sale of real property.

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<sup>11</sup> Appellant’s 2014 California Worksheet (FTB Form 3801) lists a rental property located on Meadow Drive, not Lemongrass Street. In addition, the amount of loss claimed for the Meadow property is \$30,612, not \$130,354.

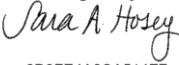
DISPOSITION

FTB's actions for the 2011 and 2014 tax years are sustained.

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Linda C. Cheng  
Administrative Law Judge

We concur:

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Michael F. Geary  
Administrative Law Judge for  
Douglas Bramhall  
Administrative Law Judge

DocuSigned by:  
  
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Sara A. Hosey  
Administrative Law Judge