OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011731
GRIGORY SHENKMAN AND YELENA SHENKMAN	) Date Issued: November 6, 2019

OPINION

Representing the Parties:

For Appellants: Brian Rowbotham, Crowe Horwath LLP

For Respondent: Sonia D. Woodruff, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Grigory Shenkman and Yelena Shenkman (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing to assess: (1) additional tax of $183,874 and an accuracy-related penalty of $36,775, plus interest, for the 2003 tax year;[1] (2) additional tax of $526,392 and an accuracy-related penalty of $43,824, plus interest, for the 2004 tax year; (3) additional tax of $134,132 and an accuracy-related penalty of $10,800, plus interest, for the 2006 tax year; and (4) additional tax of $113,940 and an accuracy-related penalty of $9,281, plus interest, for the 2007 tax year.

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

ISSUES

1. Whether appellants have shown error in FTB's disallowance of capital loss carryovers related to the sale of stock.
2. Whether appellants have shown that the accuracy-related penalties should be abated.

[1] Appellants do not dispute the portion of the 2003 tax and penalties that are related to the adjustment to appellants' basis in the stock of EHI.

FACTUAL FINDINGS

1. Trans Eurasia Networks Ltd. (TEN) is a Bermuda corporation doing business in Europe, Asia, and Russia. TEN was incorporated in Bermuda on May 4, 2000.
2. Appellant Grigory Shenkman acted in some capacity as an owner or chairman of TEN since at least July 28, 2000. Mr. Shenkman was formally named as the chairman of TEN in November 2001.
3. On their 2002 California and federal income tax returns, appellants reported a loss from the sale of stock in TEN. Appellants listed the dates of acquisition and sale as "various" on their return, but subsequently indicated to FTB that they acquired the TEN stock on June 14, 2001, for $7,591,137, and sold it for $100,000 six months later, on December 21, 2001, to Kristor, Ltd., generating a loss of $7,491,137.[2] Appellants carried the loss over to their 2003, 2004, 2006, and 2007 income tax returns.
4. During an FTB audit, appellants stated that they were revising their claimed basis in TEN to $6,563,186.35. According to appellants, this amount included a claimed payment of $6,200,000 to exercise an option to purchase 2,400 shares of TEN stock for $2,400. Appellants also claimed that they paid additional expenses of $360,786.35 on behalf of TEN, which they argued should increase their stock basis.
5. Appellants contend that they exercised the option to purchase the TEN stock in April 2001. In support, appellants provide an option agreement dated December 1, 2000, which granted them an option to purchase TEN stock from LV Finance Group Limited (LV Finance), a British Virgin Islands company. LV Finance owned 50 percent of the 12,000 outstanding ordinary shares of TEN. According to the Option Agreement, Mr. Shenkman was granted the right to pay $6,200,000 to purchase 2,400 shares of TEN stock for $2,400. The Option Agreement provided that the payment was to be made by wire transfer to two specific listed bank accounts (First Union National Bank and Raiffaisen Bank Austria, under the Account Name of "Transcontinental Mobile Investment Limited").[3]

[2] The Bermuda Monetary Authority approved the transfer of the shares to appellants by letter dated September 17, 2002, and approved the transfer of the shares from appellants to Kristor, by letter dated October 17, 2002.

[3] Appellants purchased the stock from LV Finance and sold the stock to Kristor. We note that the CEO of LV Finance is the same individual, Mr. Rozhetskin, who controls Kristor.

6. In further support, appellants provided a copy of written correspondence addressed to PricewaterhouseCoopers in Russia, dated April 23, 2001. In that document, Mr. Shenkman stated his intent to exercise the option by August 31, 2001.

7. Appellants also offered a copy of a "Payment Notice" dated April 20, 2001, from Mr. Rozhetskin on behalf of LV Finance. The Payment Notice is addressed to Mr. Shenkman requesting payment of the Option Price no later than three business days from the date of the letter.

8. They also provided a letter addressed to Mr. Shenkman dated April 30, 2001, from the Chief Executive Officer of LV Finance, confirming the receipt of $6,200,000 from appellants as payment for the exercise of the option to purchase TEN stock.

9. Appellants provided a written resolution of the directors of TEN reflecting an assignment of 2,400 shares of TEN stock to appellant.

10. Appellants submitted copies of documents reflecting four withdrawals totaling $3,060,000 from various banks in 1998 and 1999. These documents include: (1) a document from Provident Credit Union stating: "Wire Chase NYC" for $150,000 on September 2, 1998; (2) a document stating: "Bank of New York" reflecting a transfer or withdrawal of $160,000 on October 6, 1998; (3) a document stating: "Bank of America, NT & SA, MRITFIHH, MERITA BANK LTD., ALEXKSANTERINKATU 30, HELSINKI, FED FUNDS" reflecting a transfer or withdrawal of $250,000 on November 9, 1998; and (4) a document from Goldman Sachs with a memo stating "Bankers Trust Company, Optiva Bank Tallinn, Estonian, Robeco Limited Fed Funds per your request," reflecting a withdrawal or transfer of $2,500,000.

11. FTB allowed a basis of $38,756.70, which included the stock purchase price of $2,400 and additional expenses for consulting fees that appellants were able to substantiate.[4]

12. FTB issued Notices of Action dated June 16, 2016, proposing to assess: (1) additional tax of $183,874 and an accuracy-related penalty of $36,775, plus interest, for the 2003 tax year; (2) additional tax of $526,392 and an accuracy-related penalty of $43,824, plus interest, for the 2004 tax year; (3) additional tax of $134,132 and an accuracy-related penalty of $10,800, plus interest, for the 2006 tax year; and (4) additional tax of $113,940

[4] During the FTB audit, appellants asserted that there was a side agreement under which they would satisfy their commitments to pay the $6,200,000 through reimbursement of expenditures incurred on behalf of TEN. However, such an agreement was never produced.

and an accuracy-related penalty of $9,281, plus interest, for the 2007 tax year.[5] This timely appeal followed.

DISCUSSION

Issue 1: Whether appellants have shown error in FTB's disallowance of capital loss carryovers related to the sale of stock

FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Aaron and Eloise Magidow* (82-SBE-274) 1982 WL 11930.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow, supra.*) FTB's determinations cannot be successfully rebutted when the taxpayer fails to provide credible, competent, and relevant evidence as to the issues in dispute.[6] (*Appeal of Oscar D. and Agatha E. Seltzer* (80-SBE-154) 1980 WL 5068.)

Income tax deductions are a matter of legislative grace, and the taxpayer bears the burden of establishing entitlement to the deductions claimed. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) To meet this burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Robert R. Telles* (86-SBE-061) 1986 WL 22792.)

Internal Revenue Code (IRC) section 165(a) generally permits taxpayers to claim as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. (IRC, § 165; R&TC, § 17201.) Loss is computed by determining the excess of the adjusted basis over the amount realized from the sale of an asset. (IRC, § 1001.) Losses from sales or exchanges of capital assets are allowed only to the extent prescribed by IRC sections 1211 and 1212. (IRC, § 165(f).) As relevant here, those sections generally provide that capital losses shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of: (1) $3,000 ($1,500 in the case of a married individual filing a separate return); or (2) the excess of such losses over such gains. (IRC, § 1211(b).) Capital losses exceeding this limitation may be carried forward to subsequent tax years. (IRC,

[5] The Notices of Action affirmed or revised previously issued Notices of Proposed Assessment for the years at issue. The parties have not, however, provided us with copies of the Notices of Proposed Assessment.

[6] Appellants argue that the burden of proof should shift to FTB, pursuant to section 7491 of the Internal Revenue Code. However, California does not conform to that section of the Internal Revenue Code.

§ 1212(b).) In order to carry forward a capital loss from one year to another, a taxpayer must keep records substantiating: (1) that the taxpayer incurred a loss; (2) that the taxpayer is entitled to deduct the loss; (3) the character of the loss; and (4) the amounts of any capital gain offset during any subsequent years. (*Wang v. Commissioner*, T.C. Memo. 2017-81; *Wideman v. Commissioner*, T.C. Memo. 2004-162.)

The basis of property is its cost, including the initial acquisition cost as well as expenses properly chargeable to capital account. (IRC, §§ 1012, 1016(a).) Items properly chargeable to capital account include improvements and betterments to the property. (Treas. Reg. § 1.1016-2(a).) Basis is not adjusted for any items that are allowable as a deduction in computing net or taxable income for the taxable year. (Treas. Reg. § 1.1016-2(a).)

Where, as here, a taxpayer is claiming losses from foreign transactions, the Internal Revenue Service (IRS) has ruled that losses from foreign investments are subject to a higher level of scrutiny because foreign transactions are not subject to the regulatory supervision equal to that provided in the United States. For example, in Revenue Ruling 80-324, 1980-2 C.B. 340, the IRS determined that it was not required to assume the existence of foreign futures transactions merely because the taxpayer produced some documentation purporting to evince such transactions, such as a prospectus, cancelled checks, and confirmation statements. Rather, the IRS stated that: "a taxpayer can be required to supply sufficient information to permit the Service to determine the bona fides of any claimed deduction or credit." In *Appeal of William C. and Sandra M. Scott* (86-SBE-168) 1986 WL 22842, the Board of Equalization (board) reviewed a taxpayer's claims of sustaining losses on the London Metal Exchange, a private metal commodity market not subject to regulation by the United States. The brokerage firm employed by the taxpayers was in Switzerland, and the records were not subject to scrutiny by any United States regulatory authority. The board found that confirmation certificates from the brokerage firm were not sufficient, by themselves, to establish that the taxpayers had sustained a bona fide loss. The board noted that the taxpayers had refused to supply additional documents requested, such as copies of their contracts with the brokerage firm, proof of money paid to or received from the brokerage firm, and monthly statements from the brokerage firm, and information regarding the trading rules governing the transactions.

In the present case, appellants have failed to substantiate their claimed purchase price (i.e., basis) in the TEN stock and instead rely on statements issued by foreign persons regarding

Russian transactions occurring through a Bermuda corporation. Appellants argue that "in Russia, business transactions may be carried out without certain of the formalities that exist in this country." However, these foreign persons are not subject to review or regulation by U.S. regulatory agencies and accordingly should be subject to a higher requirement of proof. Appellants provide correspondence in support of their contention that they paid $6,200,000 for the TEN stock between April 20, 2001, and April 24, 2001. However, appellants have not provided proof of the transferring funds to pay for the stock, by providing bank statements indicating a transfer of that amount during the relevant period. Withdrawal documents provided by appellants reflect transfers totaling less than half of $6,200,000. Furthermore, the documents do not evidence transfers of funds into the specified bank accounts into which funds were required to be deposited under the Option Agreement. Furthermore, the transfers occurred a year or more *before* the execution of the Option Agreement. There is no evidence that these transfers were related to the TEN stock, or that the amounts are expenses that may be capitalized into the TEN stock. Therefore, appellants have not substantiated their claimed purchase price of $6,200,000 for the TEN stock.

Appellants also contend that they paid expenses on behalf of TEN. Appellants submitted a summary of expenses they claim to have paid or transferred to TEN. The summarized expenses amount to $1,391,139.55. Appellants also allege that they transferred $207,763.15 to TEN from another wholly owned company, Software AG. Finally, appellants listed an additional $645,427.82 of additional expenses they claim to have paid that allegedly are includible in their basis in TEN stock.

Appellants' listed expenses consist of travel, marketing and consultant fees, and expenses for travel, airfare, travel agency fees, lodging, meals and other miscellaneous costs associated with international travel. The following is a sampling of some these costs from appellants' summary of expenses: (1) 5/21/00 $1,116.95 Cafe Pushkin; (2) 5/21/00 $843.18 Bochka; (3) 5/22/00 $1,756.12 AirFloat: (4) 5/24/00 $525.25 Uzbekistan Restaurant; (5) 5/24/00 $464.29 Restaurant; (6) 7/27/00 $1,315.19 Veika; (7) 7/28/00 $6,619.00 Alitalia; (8) 9/1/00 $1,079.20 Slavyanskaya; (9) 9/24/00 $6,194.86 Claridge's. Appellants have failed to produce evidence showing a clear business purpose for the expenses. There is no identification of the parties incurring these charges, or explanation why they were necessary. Nor do they indicate what

business activities, if any, occurring during these meals or trips, and why these expenses constitute expenses properly chargeable to appellants' capital account for TEN.

Appellants also attempt to claim capital expenses paid by other entities. The expense list includes several payments by "Software AG," "Shenkman Ptnrs" and "Nikita Trust." However, appellants may not increase their basis by amounts paid by other entities. Appellants also claimed $575,000 in payments to Textar Marketing. Appellants provide a letter from Mr. Ir Sek Den of Textar Marketing explaining some of these costs. The letter does not support increases to appellants' basis in TEN. Mr. Ir Sek Den writes that, while he does not possess any records nor any exact figures, he received approximately $500,000 from appellants between 1999-2001 for the payment of various expenses on behalf of TEN. This correspondence does not prove that these transfers occurred, in what amount, by whom (appellants or a related entity) or the purpose of these purported payments. The letter does not substantiate the amount claimed by appellants. Furthermore, there is no formal written agreement pertaining to Textar's services, nor actual invoices for such amounts. The owner of Textar was a personal friend of appellants, who allegedly paid business expenses in Russia on TEN's behalf pursuant to instructions from the appellant-husband or other members of TEN management. Apart from the basic lack of documentation for the claimed $575,000, it is impossible to determine whether appellants or TEN actually incurred and paid these costs.

Appellants provided a few records reflecting wire transfers and check payments. However, many of the cancelled checks provided do not reflect the name of the account holder and, accordingly, it is impossible to tell if they may be attributed to appellants or to one of appellants' many other business holdings or family trusts.[7] Based on the above, appellants have not substantiated that any of their claimed expenses may increase their basis in TEN stock.

Issue 2: Whether appellants have shown that the accuracy-related penalties should be abated

R&TC section 19164, which incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of any portion of an underpayment of tax required to be shown on a return that is attributable to negligence or the disregard of rules and regulations.

[7] Appellants argue that their stock basis should be estimated using the *Cohan* Rule, which is where expenses may be approximated if the taxpayer establishes that it paid or incurred reasonable business expenses. (See *Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 840.) However, this rule does not apply here, where the taxpayer has not established that payments or expenditures have been made or the business purpose of the purported payments.

(IRC, § 6662(b)(1).) FTB's determination of negligence is presumed to be correct, and the taxpayer has the burden of proving the contrary, or any other defense in order to abate the penalty. (*Neely v. Commissioner* (1985) 85 T.C. 934, 947.)

IRC section 6662(c) defines "negligence" as any failure to make a reasonable attempt to comply with the provisions of the IRC and the term "disregard" as including any careless, reckless, or intentional disregard. Negligence is the lack of due care or the failure to do what a reasonable and ordinarily prudent person would do under the circumstances. (*Neely v. Commissioner, supra,* 85 T.C. 934, 947.)

For purposes of this appeal, the accuracy-related penalty will not be imposed to the extent that appellants show that a portion of the underpayment was due to reasonable cause and that they acted in good faith with respect to such portion of the underpayment. (IRC, § 6664(c)(1); Treas. Reg. §§ 1.6664-1(b)(2) & 1.6664-4.) An accuracy-related penalty applicable to the portion related to negligence applies if the taxpayer fails to keep adequate books and records. (Treas. Reg. § 1.6662-3(b)(1).) A determination of whether or not a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including the taxpayer's efforts to assess the proper tax liability, the taxpayer's knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).)

FTB imposed accuracy-related penalties due to negligence for the entire underpayment for the 2003 tax year, and for the portions of the underpayments for the 2004, 2006, and 2007 tax years that are attributable to the losses and carryovers appellant claimed with respect to their TEN stock.[8] Under IRC section 6662(a), negligence is defined as a lack of due care or failure to do what a reasonable and prudent person would do under like circumstances. Appellants reported a basis of over $7,500,000 in the TEN stock. Their failure to substantiate a significant portion of their basis and the failure to maintain adequate records for purposes of determining the correct tax basis are evidence of negligence. Appellants have failed to demonstrate that there was reasonable cause for the underpayment and that they acted in good faith with respect to the underpayment. In this case, appellants have asserted no facts or legal authority to establish any of the other potentially applicable defenses, nor have they otherwise satisfied their burden of

[8] The portion of the 2003 underpayment that is not related to the TEN stock is related to a separate issue involving the basis of EHI stock. However, appellants do not dispute this issue or the related penalty.

proving error in FTB's imposition of the accuracy-related penalties. Therefore, the penalties were properly imposed and cannot be abated.

HOLDINGS

1. Appellants have not shown error in FTB's disallowance of capital loss carryovers related to the sale of stock.
2. Appellants have not shown that the accuracy-related penalties should be abated.

DISPOSITION

FTB's action is sustained.

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Joczielle Cruz
Senior Legal Typist, on behalf of
Josh Lambert
Administrative Law Judge

We concur:

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John O Johnson
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John O. Johnson
Administrative Law Judge

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