OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011368
E. MILLER AND	)
C. MILLER	)
	)
	)

OPINION

Representing the Parties:

For Appellants: Ellis G. Wasson

For Respondent: David Gemmingen, Tax Counsel IV[1]

For Office of Tax Appeals: Linda Frenklak, Tax Counsel V

P. KUSIAK, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, E. Miller and C. Miller (appellants) appeal the actions taken by the Franchise Tax Board (FTB) proposing: (1) additional tax of $560,443.00, a late-filing penalty of $137,227.50 and an accuracy-related penalty of $112,088.60 plus interest, for the 2007 tax year; (2) additional tax of $77,026.00, a late-filing penalty of $19,256.50 and an accuracy-related penalty of $15,405.20 plus interest, for the 2007 tax year; [2] and (3) additional tax of $64,400 and an accuracy-related penalty of $12,880.00 plus interest, for the 2008 tax year. On appeal, the FTB withdrew the proposed assessment for the 2008 tax year.

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

[1] Andrea Long, who is currently employed as an administrative law judge with the Office of Tax Appeals (OTA), previously represented the Franchise Tax Board in this case while she was employed with that agency. Ms. Long was not involved in any aspect of the OTA's consideration of this matter.

[2] As discussed below, the FTB issued appellants two separate proposed assessments for the 2007 tax year and made adjustments on appeal to the second proposed assessment that reduced the additional tax proposed in that notice to $29,251.00, the late-filing penalty to $7,312.75, and the accuracy-related penalty to $5,850.20. The adjustments proposed in the second notice for 2007 are *in addition to* (and not in lieu of) the adjustments made in the first proposed assessment for the 2007 tax year.

ISSUES

1. Whether appellants have shown that the FTB improperly disallowed their claimed net operating loss (NOL) deduction for the 2007 tax year.
2. Whether appellants have shown that the FTB improperly increased their reported taxable flow-through income and eliminated their reported flow-through loss for the 2007 tax year.
3. Whether appellants have shown that they timely filed their 2007 return or, alternatively, that the late filing of their 2007 return was due to reasonable cause and not willful neglect.
4. Whether appellants have shown that the accuracy-related penalties proposed for the 2007 tax year should be abated.

FACTUAL FINDINGS

Factual Background

1. In 2007, appellant-husband and J. Guarrasi were the sole members of Gardena Village, LLC (Gardena Village), which was classified as a partnership for income tax purposes. Appellant-husband had an 80-percent interest in Gardena Village and Mr. Guarrasi had a 20-percent interest. During 2007, Gardena Village developed a residential real estate project for the construction of 55 condominiums on Lot 6 of property located on Artesia Boulevard in Gardena, California, that it acquired in 2006 with a loan from East West Bank (EWB).
2. Lot 6 was originally part of a larger parcel of land owned by Honeywell International, Inc. (Honeywell), consisting of Lots 1 through 6. Apart from condominium units 1 through 55 of Lot 6, the Honeywell property eventually was redeveloped for commercial use.
3. From 1953 through 1991, Honeywell operated a facility on this property that manufactured gas furnace control valves. Honeywell incurred expenses for cleaning up contamination at the facility site before and after it sold the property. Beginning in the 1980s, Honeywell conducted environmental tests that revealed the soil and groundwater were contaminated with volatile organic compounds (VOCs). In 1990, Honeywell built a groundwater treatment system to address the VOCs in the groundwater.

In 1992, Honeywell demolished its buildings and structures on the property, and excavated approximately 28,000 tons of VOC-contaminated soil for offsite disposal.

4. Jetco (aka Albertsons) acquired Lot 1, and Gardena Marketplace, LLC (Gardena Marketplace) subsequently acquired Lots 2 through 6. Gardena Marketplace developed a shopping center on Lots 2 through 5 and began a residential project to construct 59 condominium (units 1 through 59) on Lot 6.

5. Gardena Marketplace executed a Construction Loan Agreement dated August 17, 2000, with Chinatrust Bank to borrow a maximum of $11.5 million for the purchase of Lot 6 and to finance the construction of 59 condominium units on the property. Four of the units on Lot 6 (units 56 through 59) were later rezoned for commercial use after soil contamination was discovered on them, which left the residential project with 55 planned units. Initially, Gardena Marketplace borrowed $2,746,661 from Chinatrust Bank to purchase Lot 6. Gardena Marketplace took many draws on this loan to pay for the construction costs associated with the condominium project. Gardena Marketplace was not related to Gardena Village, except that appellant-husband was a member of both LLCs.

6. After Honeywell sold the property, it continued to perform routine environmental testing under the direction of the Regional Water Quality Control Board. In April 2002, Honeywell discovered that the upper levels of soil on Lot 6 contained detectable levels of polychlorinated biphenyls (PCBs). The contaminated soil was landfill that was brought onto the property during the construction process. Gardena Marketplace suspended the construction of the condominiums while remediation measures were taken to clean up the PCB-contaminated soil.

7. After making further draws on the loan, Garden Marketplace owed Chinatrust Bank more than $7 million when it defaulted on the loan in 2006 and Chinatrust foreclosed on the property. During the 2006 foreclosure proceedings, Gardena Marketplace sold the uncontaminated portion of Lot 6 (units 1 through 55) to Gardena Village with the approval of Chinatrust Bank. Under the terms of the loan and security interest between Gardena Marketplace and Chinatrust Bank, Gardena Village, as the purchaser, was required to pay off Gardena Marketplace's loan balance of $7,235,000.

8. In April 2006, Gardena Village took out a loan from EWB that allowed it to purchase units 1 through 55 of Lot 6. Under the terms of its loan, Gardena Village could borrow up to $24,500,000. Gardena Village never owned the four commercial units of Lot 6 (units 56 through 59) and the purchase cost of the commercial units was not a part of Gardena Village's construction loan with EWB. Gardena Village initially took a draw of $7,235,000 for the purchase of Lot 6, which paid off Gardena Marketplace's loan with Chinatrust Bank. Gardena Village also paid a total of $442,460 of closing costs, including title, tax and escrow charges.
9. Due to the collapse of the real estate market, Gardena Village only sold a total of 30 condominiums: (1) five condominiums in 2007; (2) 24 condominiums in 2008; and (3) one condominium in 2009. Other than installing the concrete foundations, Gardena Village never completed construction of the remaining 25 condominiums. Gardena Village executed an auction agreement in November 2007 with a proposed auction date of December 15, 2007, for the sale of the remaining completed units. However, no sale of those completed units occurred in 2007. They were sold in 2008 and 2009.
10. On January 5, 2009, Gardena Village defaulted on its loan with EWB. At the time of default, the loan had a balance of $9,588,960. On February 12, 2009, EWB recorded a Notice of Default and began foreclosure proceedings on Lot 6. Gardena Village subsequently conveyed the 25 uncompleted units to EWB in satisfaction of its outstanding debt. On January 5, 2010, EWB sold the property for $4,095,524.02 to Gardena Rock, LLC, which was not related to Gardena Village. The Trustee's Deed Upon Sale shows the amount of unpaid debt together with costs was $9,588,960 and the amount paid by Gardena Rock, LLC at the Trustee's sale was $4,095,624.
11. Gardena Village's loan with EWB was a recourse loan as evidenced by the terms of the construction loan agreement, which provided nine enumerated remedies for EWB to pursue if Gardena Village defaulted on the loan. Also, appellants produced a document entitled "Summary of Debt & Foreclosure Restructure," which indicated that EWB forgave the outstanding balance of $5,493,336 that remained after it completed the foreclosure of Lot 6.

2007 Returns

12. Gardena Village filed a California Limited Liability Company tax return (FTB Form 568) for the 2007 tax year, reporting gross income of $3,435,000 and total deductions of $3,634,803, resulting in an ordinary loss of $199,803. Gardena Village self-assessed a tax and fee liability of $6,000. It claimed the following deductions: (1) legal and professional costs of $1,500; (2) cost of construction of $3,400,005; (3) concession and commission costs of $197,513; and (4) title, escrow, and closing costs of $35,785. On the 2007 Schedules K-1 (FTB Forms 568), Gardena Village reported a California flow-through loss to appellant-husband in the amount of $197,805 and a California flow-through loss to Mr. Guarrasi in the amount of $1,998. Appellant-husband's Schedule K-1 erroneously[3] increased his capital account at the beginning of the year of $2,703,776 by a federal loss of $198,597, resulting in a capital account at the end of the year of $2,902,373. Mr. Guarrasi's Schedule K-1 increased his capital account at the beginning of the year of $0 by his capital contribution of $150,000 and, erroneously[4], by a federal loss of $2,006, resulting in a capital account at the end of the year of $152,006.

13. On October 27, 2008, appellants filed a California individual income tax return (FTB Form 540) for the 2007 tax year. They reported federal adjusted gross income (AGI) of -$337,414. After applying California adjustments, appellants reported California AGI of $10,811. After applying itemized deductions of $103,092, they reported taxable income of -$92,281. On their Schedule CA (540), appellants reported capital gains of $5,306,735, which they offset by a claimed NOL deduction of $5,680,709.[5] Appellants reported a zero tax liability and claimed a refund of $11,533.

[3] Under federal law, which is applicable for California purposes pursuant to R&TC section 17851, a partner's distributive share of partnership losses reduces the partner's capital account. (IRC, § 704(b); Treas. Reg. §1.704-1(b)(2(iv).)

[4] See footnote 3.

[5] The NOL deduction was a carryforward of unused NOL deduction(s) allegedly generated in the early 1990s.

Audits and Proposed Assessments

14. In 2010, the FTB audited appellants' 2007 return. In an Audit Issue Presentation Sheet dated February 10, 2011, the auditor determined that appellants were not entitled to an NOL deduction of $5,680,709 in tax year 2007 because this NOL had been generated in the 1990s and any deduction had expired prior to 2007. The auditor recommended increasing appellants' reported 2007 taxable income by $5,680,709, from -$92,281 to $5,588,428, to eliminate the claimed NOL deduction. The auditor also recommended the imposition of a mental health services tax of $45,884, which is one percent of the amount of appellants' revised taxable income in excess of $1 million. The auditor found that an accuracy-related penalty of $112,088 was applicable because: (1) appellants were negligent and disregarded the rules concerning when an NOL deduction may be claimed for California purposes; and (2) there was a substantial understatement of tax because the understatement was $560,443, which exceeded ten percent of the tax required to be shown on the return.

15. In a letter to the auditor dated March 16, 2011, appellants' representative stated that appellant agreed with the proposed adjustments to the net operating loss deduction. The representative contended, however, that appellants were entitled to offset the proposed assessment for the disallowed NOL deduction by claiming additional flow-through deductions for capitalized expenses (i.e., cost of construction) and an abandonment loss from Gardena Village. The representative asserted that, although Gardena Village poured the foundations and completed the site work for units 1 through 55, only 30 of those units were completed and sold before Gardena Village abandoned the project due to the collapse of the real estate market without completing the remaining 25 units. The representative stated, "[a]ccordingly, except for the costs of the vertical construction,[6] Gardena Village had incurred all construction costs for the twenty[-]five abandoned units."

16. Gardena Village submitted to the auditor a revised 2007 return that increased its reported construction costs of $3,400,005 to $6,241,013 and reported that appellant-husband was its sole member instead of its majority member. Gardena Village subsequently submitted

[6] Although never defined by appellants or the FTB, the phrase "vertical construction" appears to refer to construction of a building up from its foundation.

to the auditor a second revised 2007 return and a supporting project cost schedule to document their revised expenses.

17. Gardena Village's second revised 2007 return reported gross income of $3,465,000, total deductions of $11,167,561, and a loss of $7,702,561. On Schedule B of this return, Gardena Village listed the following deductions: (1) cost of construction of $2,649,580; (2) concession and commission costs of $197,513; (3) title, escrow, and closing costs of $35,785; (4) environmental remediation expense of $5,059,686; and (5) cost of abandonment of $3,224,997. On the Schedule K-1 (FTB Form 568), Gardena Village reported a flow-through loss for the entire revised loss amount of $7,702,561 to appellant-husband as the sole member of the LLC.

18. The auditor opened an examination of Gardena Village's 2007 return so that the positions taken by appellants at audit could be addressed. Appellants revised their 2007 return to conform with Gardena Village's second revised 2007 return. The auditor retained Gardena Village's first and second revised 2007 returns as part of the audit file without accepting or filing either one of them.

19. The FTB issued appellants a Notice of Proposed Assessment (NPA) for 2007 dated May 3, 2011, which increased their reported taxable income by $5,680,709, from -$92,281 to $5,588,428, due to the disallowance of the claimed NOL deduction of $5,680,709. After applying adjusted exemption credits of $776, the NPA proposed additional tax of $560,443, including a mental health services tax of $45,884. The NPA imposed a late-filing penalty of $137,227.50 and an accuracy-related penalty of $112,088.60 plus interest. The NPA stated that appellants did not have an NOL deduction available in the 2007 tax year because the NOL had been generated in the 1991 through 1993 tax years and those NOLs had expired.

20. In an Audit Issue Presentation Sheet issued to Garden Village dated May 24, 2011, the auditor recommended disallowing the total expense deductions of $3,634,803, which Gardena Village claimed on its original 2007 return, due to a lack of substantiation. The auditor found errors on the Schedules K-1 Garden Village had issued to appellant-husband and Mr. Guarrasi, because they improperly increased both members' beginning capital accounts by federal losses and the federal amounts were erroneously used on these Schedules K-1 to compute the California capital accounts. The auditor asserted that

Mr. Guarrasi stated in an April 20, 2011 telephone conference that Honeywell had paid for all of the contamination cleanup expenses at the project site. The auditor also found that Gardena Village's 2007 revised returns contained errors. Due to the disallowance of all the claimed expense deductions of $3,634,803, the auditor adjusted Gardena Village's California net loss of $199,803 reported on the original return by $3,634,803, resulting in a revised net income of $3,435,000. The auditor allocated $2,748,000 and $687,000 of Gardena Village's adjusted income of $3,435,000 to appellant-husband and Mr. Guarrasi, respectively, based on their respective ownership interests as reported on the original 2007 Schedules K-1.

21. In an email sent to the auditor on September 19, 2011, Mr. Guarrasi stated, "[a]s to collecting expenses related to cleanup and contaminated land, this was all paid for by Honeywell … pursuant to our indemnity agreement with them. We did not incur any such costs and have not reported or deducted any costs related to cleanup or contamination."

22. In an Audit Issue Presentation Sheet issued to Garden Village dated November 22, 2011, the auditor allowed $2,729,478 of Gardena Village's claimed expense deductions after reviewing documents that appellants produced in support of their position, including a "Cost of Construction – Project Development Cost Recap," updated October 4, 2011. Based on the closing statements, the auditor found that the correct amount of the gross receipts Gardena Village received from the sale of five units during 2007 amounted to $3,465,000; this is the amount of gross receipts listed on Gardena Village's second revised 2007 return, rather than $3,435,000 -- the amount of gross receipts listed on its 2007 original return. The auditor disallowed Gardena Village's abandonment loss deduction claimed on its 2007 second revised return due to a lack of substantiation. The auditor rejected Gardena Village's position that, although it purchased the property for $2,746,661, a separate draw from EWB for $9,000,000 is allocable to the property and generates a step-up in basis. The auditor concluded that Gardena Village paid off the Chinatrust loan through a loan from EWB for a total of $7,235,000 and the costs of the four commercial lots were not part of the construction loan with EWB. The auditor found that Gardena Village had a total of $20,901,864 of construction costs consisting of the following: (1) Chinatrust Bank loan construction costs of $7,235,000; (2) EWB loan

construction costs of $11,370,033; and (3) EWB loan interest cost of $2,296,831. The auditor determined that the construction costs for the five units sold in 2007 was $2,494,680 based on a per unit cost of $498,936. The auditor allowed Gardena Village to deduct a total of $2,729,478 of claimed deductions consisting of the following: (1) legal and professional costs of $1,500; (2) cost of construction, land and interest for five sold units of $2,494,680; (3) concession and commission costs of $197,513; and (4) title, escrow and closing costs of $35,785. The auditor determined that, after subtracting a total of $2,729,478 of expense deductions from Gardena Village's revised gross receipts of $3,465,000, it realized ordinary income of $735,522 instead of a loss of $199,803. The auditor allocated $588,418 of Gardena Village's adjusted income of $735,522 to appellant-husband and $147,104 to Mr. Guarrasi based on their respective ownership interests as reported on the original 2007 Schedules K-1.

23. In a letter to the auditor dated December 16, 2011, Mr. Guarrasi replied to the November 22, 2011 Audit Issue Presentation Sheet. He stated that Gardena Village disagrees with the auditor's denial of its abandonment loss claim for 2007 and the auditor's adjustment to its gross receipts. Mr. Guarrasi asserted that Gardena Village had a land allocation of $9,000,000 consisting of the Chinatrust Bank loan payoff of $7,235,000, a payoff of $1,275,000 to Gaudenti and Sons, a payoff of $62,500 to Hall and Foreman, property taxes of $421,000, and allocated closing costs of $6,500. He indicated that Gardena Village was contemplating an abandonment of the project due to the anticipated housing recession, as reflected in auction correspondence dated as early as February 2007. He asserts that the City of Gardena ceased inspecting the project in April 2007, as reflected in City of Gardena Inspection Cards. He submitted a graph, as well as a newspaper article dated October 27, 2006, regarding the real estate decline. Attached to Mr. Guarrasi's December 16, 2011 letter is a second version of the "Cost of Construction – Project Development Cost Recap," updated December 14, 2011. With respect to the EWB loan, this revised schedule lists total costs of $23,458,685 that Gardena Village incurred during this project consisting of the following: (1) land of $9,000,000; (2) interest of $2,296,831; and (3) construction costs of $12,161,854. The revised schedule states in footnote 1, "Chinatrust loan incurred PCB soil environmental problems in 2002 causing the entire project to shut down and undertake remediation and

the demolition of all improvements, taking several years to complete and a brand new operation." The revised schedule also lists total costs incurred by Gardena Marketplace under the Chinatrust loan.

24. The FTB issued appellants a document entitled "Audit Determination from Gardena Village, LLC," dated January 20, 2012, which increased the amount of allowed claimed deductions to $2,790,423 and decreased Gardena Village's ordinary income to $674,577. The FTB subtracted the adjusted deductions of $2,790,423 from Gardena Village's gross income of $3,465,000. Based on this latest calculation, the FTB determined that appellant-husband had flow-through income of $539,662, which is an allocation to him of 80 percent of Gardena Village's adjusted ordinary income of $674,577.

25. The FTB issued appellants a second NPA for the 2007 tax year dated June 14, 2012, which increased their taxable income by $742,820 (from the adjusted amount of $5,588,428, as set forth in the first NPA for the 2007 tax year dated May 3, 2011, to $6,331,248), consisting of additional flow-through income of $539,662 from Gardena Village, the elimination of a claimed flow-through loss of $197,805 from Gardena Village, and claimed itemized deductions of $5,353. The NPA proposed additional tax of $77,130, a late-filing penalty of $19,282.50, an accuracy-related penalty of $15,426, plus interest.

Appellants' Protests

26. Appellants protested both NPAs for the 2007 tax year. In a letter dated August 9, 2012, appellants' representative argued that appellants produced supporting documents that substantiated the flow-through loss from Gardena Village that appellants reported on their 2007 return. He contended that the FTB incorrectly calculated Gardena Village's capitalized cost of construction, erroneously denied its abandonment loss deduction, and improperly reduced appellants' claimed deductions. He also contended that, because appellants were not liable for any additional tax, the FTB improperly imposed penalties and interest. Appellants' representative also claimed that appellants had timely filed their 2007 return.

27. In appellants' representative's letter to the protest hearing officer dated July 24, 2014, appellants' representative stated that during 2007, Gardena Village "expended approximately $31,367,176 (comprising of bank draws in the amount of $7,908,491 from

Chinatrust Bank and $23,458,684 from EWB, on a real estate development project in Gardena, California." He submitted to the auditor a Chinatrust Bank statement issued to Gardena Marketplace dated March 13, 2006, concerning a real estate loan's final payment notice with a total balance due of $7,908,491.28.

28. In a letter dated October 3, 2014, the protest hearing officer indicated that during a June 17, 2014 protest hearing conference, appellants conceded that the FTB properly disallowed the claimed NOL deduction of $5,680,709. The protest hearing officer also asserted that appellants indicated during the June 17, 2014 protest hearing conference that they may have some additional documents to submit to support their position with respect to the Gardena Village flow-through income issues. The protest hearing officer provided appellants 30 days to locate, organize and submit all information concerning the protested issues.

29. In a protest position letter issued to Gardena Village dated April 23, 2015, the protest hearing officer calculated that Gardena Village had substantiated Gardena Village's costs of land, construction and interest of $15,333,750 for the 30 units that were completed and sold between 2007 and 2009. The protest hearing officer calculated the per unit cost of the 30 sold units at $511,125 by dividing $15,333,750, the costs allocated to the 30 sold units, by 30. Consequently, the protest hearing officer allowed cost of $2,555,625 ($511,125 x 5) for the 5 units sold in 2007. The protest hearing officer also allowed for 2007 deductions, as claimed, for legal expenses ($1,500), concessions and commissions ($197,513) and title, escrow and closing costs ($35,785), for total adjusted deductions of $2,790,423. The protest hearing officer thus calculated Gardena Village's adjusted ordinary income for 2007 as $674,577 by subtracting the total adjusted deductions of $2,790,423 from the gross receipts of $3,465,000. The protest hearing officer rejected the deductions claimed on the second revised return for 2007 of $3,224,997 for abandonment loss and $5,059,686 for remediation costs.

30. The protest hearing officer issued appellants a protest position letter dated April 23, 2015, which states that appellants agreed to the disallowance of the NOL deduction but that they submitted a revised 2007 return to claim additional capitalized expenses and an abandonment loss to offset the proposed assessment. The protest hearing officer made the recommendation to affirm the June 14, 2012 NPA, which increased appellants'

reported flow-through income from Gardena Village by $539,662, which is 80 percent of Gardena Village's revised ordinary income of $674,577, and eliminated appellants' claimed flow-through loss of $197,805 and their claimed itemized deductions of $5,353 due to income limitations. The protest hearing officer concluded that the June 14, 2012 NPA properly imposed a late-filing penalty and an accuracy-related penalty.

31. In a letter dated June 3, 2015, appellants informed the protest hearing officer that they would not be submitting any further documents in response to the April 23, 2015 protest position letter.

32. The FTB issued appellants a Notice of Action (NOA) dated July 7, 2015, for the 2007 tax year, affirming the first 2007 NPA. The NOA states that the NOL providing the basis for the NOL deduction claimed in 2007 was generated in tax years 1992 and 1993 and was not available as a deduction for the 2007 tax year.

33. The FTB issued appellants a separate NOA dated July 7, 2015, for the 2007 tax year, affirming the second 2007 NPA.

34. Appellants filed a timely appeal of both NOAs for the 2007 tax year.

35. On appeal, appellants argue that the FTB incorrectly calculated their basis and disregarded their supporting evidence.[7] They also contend that the proper computation of their basis is provided in the third version of the Cost of Construction – Project Development Cost Recap updated May 20, 2016, which lists revised costs incurred in the project. According to appellants, the FTB incorrectly contends that they are inflating Gardena Village's adjusted basis by counting twice the amounts attributable to the Chinatrust Bank loan. Appellants contend that the remediation expenses provided in their basis computations were incurred by Gardena Village and appellants, rather than by Honeywell. Appellants also contend that under IRC section 165(a), they are entitled to claim "abandonment losses from Gardena Village for the construction costs attributable to the 25 incomplete and abandoned units" in 2007 because "Gardena Village and [a]ppellants ceased all vertical construction on the 25 abandoned units in 2007 when it became economically impracticable, due to the rapid collapse of the housing market, to

[7] Although the FTB made initial adjustments in its opening brief, there is no reason to discuss those adjustments because the FTB revised those adjustments in its supplemental information brief, which are discussed in detail below. Appellants did not discuss the revised adjustments in their reply brief and they did not file any brief after the FTB filed its supplemental information brief.

complete the units and placed the 30 completed units up for auction in 2007." Appellants argue that there is no merit to the FTB's position that no abandonment occurred in 2007, because Gardena Village continued to hold title to the project until it was foreclosed upon in 2010. Appellants state that "ownership of title and subsequent events should not be the applicable standard here," because "Gardena Village and [a]ppellants had the intent to abandon the units and made a positive act of abandonment in 2007." Appellants briefs on appeal do not discuss the issue of whether the FTB improperly disallowed their NOL deduction for the 2007 tax year.

36. In its supplemental information brief, the FTB adjusts Gardena Village's original basis, i.e., purchase price, for the 55 units to $7,677,460, consisting of Gardena Village's purchase price of $7,235,000 and its closing costs of $442,460, consisting of title, tax and escrow charges. By dividing the adjusted purchase price of $7,677,460 by 55, the FTB determines that the purchase price of each of the 55 units was $139,590.

37. In its supplemental information brief, the FTB concedes that appellants have substantiated all of Gardena Village's construction costs of $12,161,854 listed on the December 14, 2011 Cost of Construction – Project Development Cost Recap. The FTB asserts, however, that the December 14, 2011 schedule omitted an additional EWB loan draw, Draw No. 12 – Itemized Reimbursement, dated February 25, 2007, which lists a grand total reimbursement of $97,387.30, which should be included in Gardena Village's allowed construction costs. The FTB thus determines on appeal that appellants have substantiated a total of $12,259,241 of construction costs incurred by Gardena Village under the EWB loan ($12,161,854 + $97,387), as well as interest costs of $2,296,831 attributable to the EWB loan.

38. In its supplemental information brief, the FTB determines that Gardena Village's proportionate purchase price, i.e., original basis, for the 30 units is $4,187,705 based on the total purchase price of $7,667,460 for 55 units ($7,667,460 x 30/55). Similarly, the FTB determines that Gardena Village's proportionate purchase price, i.e., original basis, for the 25 unsold units was $3,489,755 based on the total purchase price of $7,667,460 for 55 units ($7,667,460 x 25/55). The FTB also revises the adjusted basis allocated to the 30 completed units to $18,743,777 by adding the proportional purchase price of the 30 completed units of $4,187,705, the revised construction costs of $12,259,241, and the

claimed interest costs of $2,296,831 that Gardena Village incurred under the EWB loan. The FTB next calculates the revised per unit adjusted basis for each of the 30 completed units at $624,793 by dividing $18,743,777, the adjusted basis allocated to the 30 completed units, by 30. Similarly, the FTB calculates the revised total adjusted basis for the five units sold in 2007 at $3,123,965 ($624,793 x 5). In addition, the FTB disallows the claimed deductions for environmental remediation and abandoned construction costs. The FTB allows deductions of $3,357,263, consisting of the revised adjusted basis for the five units sold in 2007 of $3,123,965, plus the concession and commissions cost of $197,513, and title, escrow and closing costs of $35,785 that were claimed on Gardena Village's second 2007 revised return. The FTB thus recalculates Gardena Village's 2007 ordinary income as $107,737, by subtracting the revised allowed deductions of $3,357,263 from the gross receipts of $3,465,000.

39. After allocating 80 percent of Gardena Village's revised ordinary income of $107,737 to appellant-husband, the FTB calculates appellants' additional taxable income from Gardena Village for 2007 as $86,190. The FTB thus reduces appellants' proposed additional tax for 2007 from $77,130, the amount set forth in the June 14, 2012 NPA, to $29,251. The FTB also reduces the amount of the late-filing penalty from the $19,282.50 amount set forth in the June 14, 2012 NPA to $7,312.75. The FTB further reduces the amount of the accuracy-related penalty from the $15,426 amount set forth in the June 14, 2012 NPA to $5,850.20.

40. In their reply brief, appellants do not discuss the specific adjustments that the FTB made to the second proposed assessment for 2007 in its supplemental information brief or otherwise refer to the FTB's supplemental information brief.

41. To further develop the issues, OTA requested additional briefing from the parties in a letter dated February 15, 2018. Appellant was requested to respond to the contentions that the FTB made in its reply brief and provide any additional evidence that supports their position. They were also asked to clarify whether they concede on appeal that the FTB properly disallowed their claimed NOL deduction and imposed the late-filing penalty. Appellants were asked numerous questions concerning their position with respect to the adjustments proposed to their reported flow-through income and loss and were requested to substantiate their position. Lastly, appellants were requested to clarify

whether they contend that the accuracy-related penalties should be abated on the grounds of reasonable cause and good faith. The FTB also was requested to respond to appellants' additional brief. Appellants did not submit a responsive brief. The FTB did.

42. To further develop the issues, the OTA requested additional briefing from the parties in an email dated October 4, 2018. In this email, the OTA requested that the FTB produce copies of any relevant internal records reflecting the date when appellants filed their 2007 return. The FTB provided three separate documents that indicate that appellants filed their 2007 return on October 27, 2008. The first document consists of the first two pages of appellants' 2007 return. The FTB states that, pursuant to its normal business practices, it "serial stamped" the bottom of the first page of appellants' 2007 "return with a unique number (DLN) [D8 10259507M], which was followed by a date stamp that is given on the first day of FTB's receipt and reflects the filing date of the return, which in this matter is October 27, 2008, as represented by the date stamp of '10/27/08' on the return." The second document is a copy of computer records from the FTB's taxpayer information account records that shows that the return-filed date for appellants' 2007 return was October 27, 2008. The FTB states that, because it maintains this document within its business records and government records, the date stamp "satisfies the business records and official records exceptions found in California Evidence Code section[s] 1271 and 1280, respectively, and provide[s] the basis upon which [the OTA] can find that [a]ppellants[']' return was filed delinquently." The third document is a copy of appellants' 2007 federal account transcript, which is maintained by the Internal Revenue Service (IRS) in the normal course of business. The FTB asserts that appellant's 2007 federal account transcript reveals that October 28, 2008, was the "[r]eturn due date or return received date ([w]hichever is [l]ater)." The FTB states, "[t]his October 28, 2008, federal income tax return received date corresponds and directly supports the October 27, 2008, filing and received date of [a]ppellants' California tax return by FTB." The FTB asserts that just because appellants' 2007 return is dated October 14, 2008, this does not establish that appellants' 2007 return was filed on October 14, 2008, citing *Appeal of La Salle Hotel Co*. (66-SBE-071) 1966 WL 1412. The FTB states, "[a]s the Internal Revenue Service did not receive [a]ppellants' 2007 return until October 28, 2008, the delinquency of filing their federal return indicates a corresponding

> delay in its preparation, a precondition to the preparation of [a]ppellants' California return, which further supports the delinquent filing of [a]ppellants' return with the Franchise Tax Board."

43. Appellants were provided an opportunity to file a response to FTB's submission, but did not do so.

DISCUSSION

Issue 1: Whether appellants have shown that the FTB improperly disallowed their claimed NOL deduction for the 2007 tax year.

Deductions are strictly a matter of legislative grace and the taxpayer bears the burden of establishing an entitlement to the claimed deduction. (*INDOPCO, Inc. v. Comm'r* (1992) 503 U.S. 79, 84; *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; see also *OMJ Pharms., Inc. v. United States* (1st Cir. 2014) 753 F.3d 333, 336; *Appeal of Telles* (86-SBE-061) 1986 WL 22792.) To carry that burden, the taxpayer must point to an applicable statute and show by credible evidence that he or she comes within its terms. (*Appeal of Telles, supra*.)

California generally conforms to IRC section 172 pursuant to R&TC section 17201. IRC section 172 provides that, for federal purposes, an NOL may be carried forward to each tax year following the tax year of the loss. Former R&TC section 17276(d)(l)(A),[8] as in effect for the 2007 tax year, modified IRC section 172 with respect to NOL carryforwards as follows:

> For a net operating loss for any taxable year beginning on or after January 1, 1987, and before January 1, 2000, [s]ection 172(b)(1)(A)(ii) of the Internal Revenue Code, relating to years to which net operating losses may be carried, is modified to substitute "five taxable years" in lieu of "20 taxable years" except as otherwise provided in paragraphs (2) and (3).

Appellants have presented no factual or legal basis in support of their position that the NOL deducted on their 2007 return was allowable. In fact, appellants advised the auditor that they were conceding this issue during the audit, although they have contested the disallowance in this appeal. In any event, the evidence shows that the NOL deduction of $5,680,709 claimed on appellants' 2007 return was for NOLs generated in tax years 1991, 1992, and 1993. Pursuant to

[8] R&TC section 17276 was repealed by Senate Bill 858 in 2010. However, because former R&TC section 17276 was in effect during the 2007 tax year at issue, the former statute is controlling for this appeal.

former R&TC section 17276(d)(1)(A), the FTB properly determined that the claimed NOL had expired and disallowed NOL deduction claimed for the 2007 tax year.

Issue 2: Whether appellants have shown that the FTB improperly increased their reported taxable flow-through income and improperly eliminated their reported flow-through loss for the 2007 tax year.

Burden of Proof

The question of a taxpayer's basis is an issue of fact. (*Vaira v. Commissioner* (3d Cir. 1971) 444 F.2d 770, 774; *Appeal of Giesea* (86-SBE-016) 1986 WL 22687.) "It is well established that a presumption of correctness attends respondent's determinations as to issues of fact and that appellant has the burden of proving such determinations erroneous." (*Appeal of Seltzer* (80-SBE-154) 1980 WL 5068.) This is a rebuttable presumption, however, that will only support a finding if there is insufficient evidence to the contrary. (*Ibid.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930; *Appeal of Kamrany* (72-SBE-006) 1972 WL 2640; *Appeal of Walshe* (75-SBE 073) 1975 WL 3557.) A taxpayer's failure to introduce evidence that is within his or her control gives rise to the presumption that the evidence, if provided, would be unfavorable to his or her position. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15434.) A taxpayer's burden of proof is not relieved merely because it may be difficult or impossible to substantiate his or her position. (*Appeal of Giesea*, *supra*; *Appeal of Bedford* (82-SBE-110) 1982 WL 11787; *Appeal of Eastman* (78-SBE-031) 1978 WL 3944; *Appeal of Lew* (73-SBE-053) 1973 WL 2786.) The fact that basis may be difficult to establish does not relieve a taxpayer from this burden. (*Coloman v. Commissioner* (9th Cir. 1976) 540 F.2d 427, 430, citing *O'Neill v. Commissioner* (9th Cir. 1959) 271 F.2d 44.)

Determination of Gain or Loss

California conforms to IRC section 61, except as otherwise provided. (R&TC, § 17071.) IRC section 61, in defining gross income, includes income from gains derived from dealings in property. R&TC section 18031 provides for the determination of the amount of gain and loss on disposition of property by reference to Subchapter O of Chapter 1 of Subtitle A of the IRC, which commences with IRC section 1001. IRC section 1001 provides that gain from the sale of property shall be the excess of the amount realized over the adjusted basis provided in

section 1011 for determining gain, and the loss from a sale shall be the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized. IRC section 1011(a) provides that "the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under section 1012." IRC section 1012 provides that the basis shall be the cost of the property, except as otherwise provided. IRC section 1016 further provides that proper adjustment shall in all cases be made for expenditures or other items properly chargeable to capital accounts. Allowable adjustments to basis for items chargeable to capital accounts include the cost of improvements and betterments made to the property and carrying charges such as taxes and interest which the taxpayer elects to treat as chargeable to capital account under IRC section 266. (Treas. Reg. § 1.1016-2.)

As discussed in detail above, the FTB disallowed the claimed deductions for abandoned construction costs and environmental remediation expenses. However, in its supplemental brief, the FTB increased the cost of construction of the units sold in 2007 to $3,123,965 ($624,793 per unit), and allowed the concession and commissions cost of $197,513 and title, escrow and closing costs of $35,785, as claimed on Gardena Village's second 2007 revised return, thereby reducing the additional tax for the second NPA for 2007 from $77,130 to $29,251. The FTB reduced the late-filing penalty and the accuracy-related penalty accordingly.

Abandonment Costs

IRC section 165(a) allows a taxpayer to deduct any loss that is sustained during the tax year that is not compensated for by insurance or otherwise. To qualify for the deduction, the loss must be "evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year." (Treas. Reg. § 1.165–1(b).) Determining the tax year for which a taxpayer can claim a loss deduction evidenced by a closed and completed transaction is a question of fact. (*Boehm v. Comm'r* (1945) 326 U.S. 287, 293.)

A taxpayer may claim a loss deduction under IRC section 165(a) if during the tax year the taxpayer abandons an asset or, alternatively, the asset becomes worthless. (See *Tucker v. Comm'r,* T.C. Memo. 2015-185, affd. (11th Cir. 2016) 841 F.3d 1241 (citations omitted).) "Worthlessness and abandonment are separate and distinct concepts. (*Echols v. Comm'r* (5th Cir. 1991) 935 F.2d 703, 707.) The test for abandonment is objective in that "the abandoning party must manifest an intent to abandon by some overt act or statement reasonably calculated to

give a third party notice of the abandonment." (*Ibid*.) In contrast, "the test for worthlessness is a mixed question of objective and subjective indicia." (*Ibid*.)

"When a taxpayer's real property is secured by a recourse obligation, the taxpayer is not entitled to a loss deduction until the year of the foreclosure sale, regardless of whether the taxpayer claims to have abandoned the property in a prior year or claims the property became worthless in a prior year." (*Tucker v. Comm'r, supra*, T.C. Memo. 2015-185 (citations omitted). See also *Evans v. Comm'r*, T.C. Memo. 2016-7.) A foreclosure is a sale or exchange for federal tax purposes from which a taxpayer realizes a gain or a loss. (See *Helvering v. Hammel* (1941) 311 U.S. 504, 512; *Aizawa v. Comm'r* (1992) 99 T.C. 197, 201-212.) "[A] taxpayer's equity in mortgaged property for which the taxpayer is personally liable is not worthless before a foreclosure sale because "the property continues … to have some value which, when determined by the sale, bears directly upon the extent of the owner's liability for a deficiency judgment." (*Tucker v. Comm'r, supra*, T.C. Memo. 2015-185 (citations omitted).) "A loss resulting from a foreclosure sale is typically sustained in the year in which the property is disposed of and the debt is discharged (the debt being the debt secured by the property and satisfied—in full or in part—from the proceeds of the foreclosure sale)." (*Evans v. Comm'r*, T.C. Memo. 2016-7.)

Appellants claim an abandonment loss deduction under IRC section 165(a) for the 2007 tax year for a portion of Lot 6 based on the downturn in the real estate market. They contend that Gardena Village manifested an intent to abandon the 25 uncompleted units in 2007 by ceasing the vertical construction of those units and scheduling a December 2007 auction of the 30 completed units (although there was no evidence that the auction ever took place). Appellants assert that Gardena Village only completed and sold 30 units before it abandoned the remaining units due to the collapse of the real estate market without completing the remaining 25 units. Yet, Gardena Village sold all but five of the 30 completed units *after* 2007, which undermines appellants' position that the 25 uncompleted units were worthless in 2007. A loss deduction under IRC section 165(a) must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year. (Treas. Reg. § 1.165–1(b).) An affirmative act of abandonment is missing under these facts and circumstances.

Furthermore, there is no dispute that Gardena Village continued to hold title to the 25 unsold units, which were encumbered by a recourse loan, until EWB foreclosed on them in 2009. Without providing any legal authority, appellants state in their reply brief that ownership of title

and subsequent events should not be the applicable standard for determining when there is an abandonment of property. We disagree. Even assuming that Gardena Village abandoned a portion of Lot 6 in 2007, Gardena Village was not entitled to claim an abandonment loss deduction under IRC section 165(a) in 2007 because Lot 6 continued to be secured by a recourse obligation. The lender did not execute a foreclosure sale on the property until 2009. (*Tucker v. Comm'r, supra*.) Accordingly, we find the FTB properly disallowed the claimed deduction for abandoned construction costs.

Remediation Costs

With respect to the claimed environmental remediation deduction for the 2007 tax year, appellants have not substantiated that Gardena Village incurred the cost of cleaning up the contamination on any portion of Lot 6. In fact, Mr. Guarrasi, the minority member of Gardena Village in 2007, told the auditor that Honeywell paid for all of the contamination cleanup expenses. Furthermore, Gardena Village never owned any of the contaminated portion of Lot 6. The contaminated portion of Lot 6 (units 56 through 59) was carved out of Gardena Marketplace's April 2006 sale of Lot 6 (units 1 through 55) to Gardena Village. Accordingly, we find that the FTB properly disallowed the claimed deduction for environmental remediation for the 2007 tax year, and that appellants have failed to establish error in FTB's revised determination of their gain.

Issue 3: Whether appellants have shown that they timely filed their 2007 return or, alternatively, that the late filing of their 2007 return was due to reasonable cause and not willful neglect.

R&TC section 19131 provides that a late-filing penalty shall be imposed when a taxpayer fails to file a tax return on or before its due date or extended due date unless the taxpayer establishes that the late filing was due to reasonable cause and not willful neglect. The penalty is computed at five percent of the amount of tax required to be shown on the return for every month or fraction of the month that the return is late, without any regard to an extended due date, up to a maximum of 25 percent. (R&TC, § 19131(a).) Reasonable cause means such cause as would prompt an ordinarily intelligent and prudent businessperson to have so acted under similar circumstances. (*Appeal of Curry* (86-SBE-048) 1986 WL 22783.)

When the FTB imposes a penalty, the law presumes that the penalty was imposed correctly. (*Appeal of Myers* (2001-SBE-001) 2001 WL 5626976.) The burden of proof is on the

taxpayer to show that reasonable cause exists to support an abatement of the penalty. (*Appeal of Beadling* (77-SBE-021) 1977 WL 3831.) To overcome the presumption of correctness attached to the penalty, appellant must provide credible and competent evidence supporting a claim of reasonable cause; otherwise, the penalty cannot be abated. (*Appeal of Walshe*, *supra*.)

Appellants assert that the late-filing penalty was improperly imposed because their 2007 return was timely filed. However, appellants offered no evidence to corroborate when the return was filed.

FTB provided a copy of the return for 2007 with a signing date of October 14, 2008. However, the return also reflected October 27, 2008, as the date the return was filed. In addition, FTB offered its records reflecting October 27, 2008, as the date appellants' 2007 state return was filed and federal records show October 28, 2008, as the date appellants' 2007 federal return was received. As the Board of Equalization pointed out in *Appeal of La Salle Hotel Co.*, *supra*, when the timeliness of a California return is at issue, the date a taxpayer's federal return was received is a strong indication that the state return was not filed before that date.

Appellants have failed to establish that the penalty for a delinquent return for 2007 was not properly imposed. Accordingly, we find the FTB properly imposed a late-filing penalty with respect to the first proposed assessment and the revised second proposed assessment for the 2007 tax year. Appellants do not contend that the FTB improperly calculated either of these late-filing penalties or that reasonable cause prevented them from timely filing their 2007 return. Appellants are therefore liable for the 2007 late-filing penalties.

Issue 4: Whether appellants have shown that the accuracy-related penalties for the 2007 tax year should be abated.

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. As relevant here, the penalty applies to the portion of the underpayment attributable to: (1) negligence or disregard of rules and regulations; or (2) any substantial understatement of income tax. (IRC, § 6662(b).) For an individual, there is a "substantial understatement of income tax" when the amount of the understatement for a tax year exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. (IRC, § 6662(d)(1).) In determining whether there is a substantial understatement, the taxpayer excludes any portion of the understatement for which: (1) there is substantial authority for the treatment of the position;

or (2) the position was adequately disclosed in the tax return (or in a statement attached to the return) and there is a reasonable basis for the treatment of the item. (IRC, § 6662(d)(2)(B).) To qualify as an adequate disclosure, Treasury Regulations generally require that the taxpayer disclose the details of his or her position on a federal Form 8275, a Form 8275-R, or a qualified amended return. (Treas. Reg. § 1.6662-4(f).) Even if an understatement is found to be substantial, the penalty shall not be imposed to the extent the taxpayer can show reasonable cause and good faith. (R&TC, § 19164(d); IRC, § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164(a).) The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Comm'r*, T.C. Memo. 2010-76.)

A determination of whether 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. (Treas. Reg. § 1.6664-4(b)(1).) Generally, the most important factor is the taxpayer's effort to assess his or her proper tax liability. (*Ibid.*) Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. (*Goode v. Comm'r*, T.C. Memo. 2006-48.) The types of activities that show a reasonable attempt to comply with the tax law include maintaining records sufficient to support an entitlement to claimed deductions, conducting tax research, and discussing the situation with the IRS, the FTB, or tax advisors. (*Ibid.*)

The total correct tax liability for the first proposed assessment is $560,443 and appellants reported a zero tax liability on their 2007 return. The total correct tax liability for the second proposed assessment (as revised on appeal) is $29,251 and appellants reported a zero tax liability on their 2007 return. Hence the understatements are "substantial understatements" within the meaning of IRC section 6662(d)(1).

Appellants do not address the accuracy-related penalties other than to state that they were improperly imposed because appellants are not liable for any additional taxes. They do not allege that they qualify for any other defenses to the penalty. Accordingly, appellants have not met their burden of establishing a basis for an abatement of the accuracy-related penalties proposed for their 2007 tax year.

HOLDINGS

1. Appellants have not shown that the FTB improperly disallowed their claimed NOL deduction for the 2007 tax year.
2. Appellants have not shown that the FTB improperly increased their reported taxable flow-through income and eliminated their reported flow-through loss for the 2007 tax year.
3. Appellants have not shown that they timely filed their 2007 return or, alternatively, that the late filing of their 2007 return was due to reasonable cause and not willful neglect.
4. Appellants have not shown that either of the accuracy-related penalties for the 2007 tax year should be abated.

DISPOSITION

The FTB's action with respect to the first proposed assessment for the 2007 tax year is sustained. The FTB's action with respect to the second proposed assessment for the 2007 tax year is modified, as conceded by the FTB on appeal, to reduce the additional tax to $29,251.00, the late-filing penalty to $7,312.75, and the accuracy-related penalty to $5,850.20. As conceded by the FTB on appeal, the proposed assessment for the 2008 tax year is withdrawn.

DocuSigned by:
Patrick J. Kusiak
8E20179F0CB743E...
Patrick J. Kusiak
Administrative Law Judge

We concur:

DocuSigned by:
Douglas Bramhall
CA2E033C0906484...
Douglas Bramhall
Administrative Law Judge

DocuSigned by:
Nguyen Dang
4D465973FB44469...
Nguyen Dang
Administrative Law Judge

Date Issued: 4/9/2020