OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011178
J. BOODAIE AND	)
M. BOODAIE	)
	)
	)

OPINION

Representing the Parties:

For Appellants:	Walter Weiss, Attorney
For Respondent:	David Hunter, Tax Counsel IV Peter Kwok, Tax Counsel IV
For Office of Tax Appeals:	Mai Tran, Tax Counsel IV

K. GAST, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Boodaie and M. Boodaie (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $197,768 and an accuracy-related penalty of $39,553.60, plus interest, for the 2008 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Kenneth Gast, Jeffrey I. Margolis, and Richard Tay held an oral hearing for this matter in Cerritos, California, on December 18, 2019. At the conclusion of the hearing, the record was closed and this matter was submitted for a decision.

ISSUES

1. Whether appellants must include in their gross income $3,256,232 of ordinary pass-through income from All Century Incorporated (All Century).
2. Whether appellants are entitled to deduct $25,000 of passive rental real estate activity losses against their ordinary income.
3. Whether appellants are liable for the accuracy-related penalty.

FACTUAL FINDINGS

General Background

1. J. Boodaie (appellant-husband) is the sole shareholder of All Century, which is taxed as a Subchapter S corporation. All Century is in the business of lending money and serving as an accommodator for tax-deferred exchanges under Internal Revenue Code (IRC) section 1031. Both appellants and All Century are cash method taxpayers.
2. In September 2008, F. Rashti and M. Rashti (the Rashtis) and M. Rostami (Mr. Rostami) (collectively, the Clients) sold certain real properties located in Buena Park, California.[1] The total proceeds realized was $3,564,573 (rounded), with the Rashtis receiving $1,419,685 (rounded), and Mr. Rostami receiving the remaining $2,144,888 (rounded). The Rashtis' accountant advised they could reduce income taxes on the sale by completing an IRC section 1031 exchange and recommended the services of appellant-husband and his company, All Century.
3. On or about September 12, 2008, the Rashtis, through their revocable trust, and Mr. Rostami entered into separate exchange agreements with All Century. The purpose of the exchange agreements was for All Century to facilitate an IRC section 1031 exchange of the Client's Buena Park properties for replacement properties. In connection with the exchange agreements, in September 2008, the Clients transferred their total proceeds of $3,564,573 to All Century to hold the funds in trust for a later purchase of replacement property.
4. After a series of meetings, the Clients and appellant-husband could not agree on which replacement properties to purchase. Also, between September 22, 2008 and October 22, 2008, appellant-husband failed to comply with several requests by the Clients for documentation concerning where All Century had deposited their funds. Accordingly, on October 22, 2008, the Clients requested that All Century relinquish its position as the accommodator and transfer the Clients' funds to a new accommodator of their choosing. All Century refused the Clients' request.
5. On January 25, 2009, the Clients requested that All Century return the funds that they had entrusted to it. All Century refused.

[1] The Rashtis and Mr. Rostami are related to each other, with Mr. Rostami being the brother of Mrs. Rashtis. They are not related to appellants.

6. From March 2009 through April 2009, All Century returned only a small portion to the Rashtis and Mr. Rostami.[2]

7. In or shortly after April 2009, allegedly to repay the Clients' funds, All Century assigned to them its interests in two loans made to third parties. The first, with a purported face amount of $3,092,002.70, related to a deed of trust secured by real property located in Nevada. The second, with a purported face amount of $2.1 million, related to a blanket mortgage secured by real properties located in New York.

Lawsuit and Bankruptcy Proceedings

8. On May 7, 2009, the Clients sued appellant-husband and All Century in California superior court for, among other things, misappropriating their funds. After appellant-husband failed to respond to the third amended complaint, the court, on May 27, 2010, entered a default judgment (default judgment) against appellant-husband personally in the principal sum of $1,154,685[3] for the Rashtis and $1,844,573[4] for Mr. Rostami.

9. On September 23, 2009, M. Boodaie (appellant-wife) filed a voluntary petition for Chapter 7 bankruptcy. Appellant-husband did not file as a joint debtor.

10. On November 20, 2015, the Rashtis filed a complaint against appellant-husband in the United States Bankruptcy Court (Bankruptcy Court). They sought a determination that their default judgment would be nondischargeable as to appellant-husband, a non-debtor spouse, in a hypothetical Chapter 7 case. Such a determination would enable the Rashtis to enforce the default judgment against appellants' community property.

[2] According to the third amended complaint, discussed below, the total amount returned to the Rashtis and Mr. Rostami was $265,000 and $300,000, respectively.

[3] According to the third amended complaint, this amount is the $1,419,685 the Rashtis entrusted with All Century for the IRC section 1031 exchange, less $265,000 returned to them in 2009.

[4] It appears this amount is derived primarily from the $2,144,888 of funds entrusted with All Century, less $300,000 returned to Mr. Rostami in 2009. The discrepancy of $315 is de minimis and has not been explained by either party.

11. On October 18, 2016, the Bankruptcy Court ordered the default judgment[5] excepted from discharge on two of three grounds asserted by the Rashtis.[6] The court concluded the state court complaint filed by the Rashtis contained "allegations sufficient to satisfy all the required elements" of both Bankruptcy Code section 523(a)(2)(A), which excepts from discharge any debt "to the extent obtained by false pretenses, a false representation, or actual fraud," and section 523(a)(4), which excepts from discharge any debt for "embezzlement." The court determined these issues were "actually litigated in the State Court," were "necessarily decided in the State Court," "[t]he decision of the State Court was final and on the merits," and "[d]efendant [appellant-husband] was the same party to both proceedings."[7]

12. The Bankruptcy Court determined it was "appropriate to give preclusive effect to" the default judgment to establish the following relevant facts to support its order:

    a. "All representations made by [appellant-husband] to induce the Rashtis to enter into [the exchange agreement in 2008] were all false."
    b. Appellant-husband "falsely represented that he would facilitate the Rashtis' [IRC section] 1031 exchange if they deposited profits from the sale of the Property with him."
    c. Appellant-husband "knew these representations were false at the time [he] made them, as he had no intent of facilitating the Rashtis' [IRC section] 1031 exchange, but instead intended to convert the Rashtis' funds to his own use."
    d. The Rashtis and appellant-husband met several times towards the end of 2008, during which they asked him to complete an IRC section 1031

[5] The Bankruptcy Court described the amounts in the excepted default judgment as "the principal amount of $1,157,908.00, plus accrued interest as of May 27, 2016, in the amount of $577,342.50, and continuing to accrue at a rate of 10% per annum." It is unclear why this principal amount is more than the $1,154,685 noted above, but this difference does not appear to be relevant to the resolution of this case.

[6] The order was set forth in a document filed and entered by the Bankruptcy Court entitled, "Findings of Fact, Conclusions of Law, and Order Granting In Part And Denying In Part [the Rashtis'] Motion for Summary Judgment Filed August 22, 2016." Appellant-husband represented himself before the Bankruptcy Court and contested the Rashtis' motion for summary judgment.

[7] However, on the third ground, the Bankruptcy Court found against the Rashtis, concluding the default judgment was not excepted from discharge under Bankruptcy Code section 523(a)(4) on the grounds of fraud or defalcation while acting in a fiduciary capacity in a hypothetical Chapter 7 case filed by appellant-husband.

exchange, but he refused to do so, at one point recommending they purchase two properties from him that they later discovered had no equity.

e. On January 25, 2009, the Rashtis demanded their funds be returned, but appellant-husband refused to return the funds. Between January 25, 2009, and February 10, 2009, the Rashtis and appellant-husband met several times, and at each meeting, appellant-husband assured them that their funds were safe and they should continue to allow him to hold their funds to complete an IRC section 1031 exchange.

f. "In April 2009, [appellant-husband] returned $265,000.00 of the funds the Rashtis had deposited with him, but did not return the remaining $1,154,685.00 ..... Instead, [appellant-husband] converted the funds for his own benefit."

13. The trustee's final report in appellant-wife's bankruptcy case indicates the Rashtis' default judgment was allowed as a general (unsecured) claim in the full amount of $1,154,685.

Procedural History

14. FTB audited All Century's 2008 tax return and issued a Notice of Proposed Assessment (NPA). The NPA, among other adjustments, included the $3,564,573 of entrusted funds in All Century's gross income. On protest, FTB reduced this amount to $3,256,232 based on its determination that All Century could deduct repayments it had made to the Clients of $308,341.[8] FTB then issued a Notice of Action (NOA), proposing additional tax and penalties, plus interest. All Century filed an appeal with the Board of Equalization, but because it was suspended with the California Secretary of State, it did not have the right to prosecute that appeal and the NOA went final.

15. FTB also audited appellants' joint 2008 tax return and issued an NPA followed by an NOA, which proposed additional tax of $197,768 and an accuracy-related penalty of $39,553.60, plus interest. The NOA, among other things, reflected the same adjustment asserted in the NOA issued to All Century, thereby increasing appellants' as-filed

[8] FTB asserts that, of this amount, $8,341 was repaid to the Rashtis and $300,000 was repaid to Mr. Rostami. FTB has not shown that these repayments were made during the 2008 year at issue (in fact, the state court complaint, which FTB relies on as the primary basis for its position, indicates that no repayments were made until 2009), but we accept FTB's reduction of appellants' income determination for these repayments.

negative taxable income by $3,256,232 of ordinary pass-through income from All Century. The NOA also disallowed a pass-through real estate rental loss of $473,314 from All Century that FTB recharacterized as passive from nonpassive. Appellants filed this timely appeal.

DISCUSSION

Issue 1 – Whether appellants must include in their gross income $3,256,232 of ordinary pass-through income from All Century.[9]

FTB has the initial burden of showing that its action is reasonable and rational, and only then does the burden shift to appellants to prove the proposed assessment is wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) California generally conforms to the federal income tax treatment of S corporations and their shareholders. (See R&TC, §§ 17087.5, 23800.) An S corporation is essentially taxed as a pass-through entity, which means its items of income, loss, deduction, or credit are passed through on a pro rata basis to its shareholders, who report and paid tax on such items on their personal income tax returns. (See IRC, § 1366.) Therefore, if the $3,256,232 at issue is properly treated as gross income to All Century, an S corporation, it will be treated and taxed as such to appellants.

Gross income is broadly defined as "all income from whatever source derived." (R&TC, §§ 17071, 17087.5; IRC, § 61.) But not every remittance of funds is income to the recipient. For example, "[b]ank deposits are not income to the bank; … and funds received in trust by a trustee are excludible from gross income when those funds are subject to a restriction that they be expended for a specific purpose, and the taxpayer does not profit, gain, or benefit in spending the funds for the stated purpose." (*Bailey v. Commissioner*, T.C. Memo. 2012-96, 2012 WL 1082928 at p. *21 (*Bailey*), affd. (1st Cir. Mar. 14, 2014, No. 13-1455) 2014 WL 1422580.) However, it is well settled that gross income includes funds acquired through embezzlement or misappropriation. (*James v. United States* (1961) 366 U.S. 213, 219 (*James*).) Whether income has been misappropriated is a question of fact. (*Bailey*, *supra*, T.C. Memo. 2012-96, 2012 WL 1082928 at p. *22.)

[9] FTB contends that, as a jurisdictional matter, appellants are bound by this adjustment and cannot contest it here since it stems from the NOA issued to All Century that went final. We disagree. FTB has not provided legal authority to support this contention and we are aware of none. Our jurisdiction is based on the separate NOA issued to appellants, which they have timely appealed to OTA. (See R&TC, § 19045; see also Cal. Code Regs., tit. 18, § 30103(a)(1).) We therefore conclude appellants can contest this adjustment before OTA.

FTB has shown a reasonable and rational basis for its proposed assessment by producing evidence that establishes the following relevant facts. On May 7, 2009, the Clients jointly sued appellant-husband and All Century in state court for misappropriating their funds. When appellant-husband did not defend his case, the court, on May 27, 2010, entered a default judgment against him personally in the principal sum of $1,154,685 for the Rashtis and $1,844,573 for Mr. Rostami. After appellant-wife filed for Chapter 7 bankruptcy, the Rashtis filed a complaint against appellant-husband in the Bankruptcy Court, seeking a determination that their default judgment would be nondischargeable as to appellant-husband, a non-debtor spouse, in a hypothetical Chapter 7 case. The Rashtis then filed a motion for summary judgment in the Bankruptcy Court, which appellant-husband, representing himself, contested. On October 18, 2016, the Bankruptcy Court partially granted the Rashtis' motion, ordering the default judgment excepted from discharge. In doing so, it gave "preclusive effect to" the default judgment because the misappropriation issue was litigated in state court, was necessarily decided in state court, the decision of the state court was final and on the merits, and appellant-husband was the same party to both proceedings.[10] Consequently, to support its order, the Bankruptcy Court concluded appellant-husband obtained the Rashtis' funds "by false pretenses, a false representation, or actual fraud" and through "embezzlement."[11]

FTB's evidence further establishes that All Century misappropriated total funds of at least $3,256,232 from the Clients in 2008. That is the year the Clients entrusted their funds with All Century and when, according to their state court complaint and the Bankruptcy Court's order, appellant-husband had no intention of using the funds to facilitate an IRC section 1031 exchange.[12] Rather, he intended to, and did in fact, convert the funds for his own use. In short, FTB has made an initial showing that All Century had dominion and control over the Clients'

[10] The Bankruptcy Court determined "[a] default judgment is considered a final judgment on the merits and is thus effective for the purposes of claim preclusion. *Howard v. Lewis* (9th Cir. 2001) 905 F.2d [1318], 1323." We believe the Bankruptcy Court is correct on this point.

[11] In its tentative ruling, which was adopted as its final ruling, the Bankruptcy Court concluded the three elements of embezzlement—(1) property rightfully in the possession of a nonowner, (2) nonowner's appropriation of the property to a use other than which it was entrusted, and (3) circumstances indicating fraud—were met because the state court could not have entered a default judgment "unless it found that [appellant-husband] had misappropriated the funds to a use other than that for which the funds were entrusted."

[12] Although Mr. Rostami was not a party to the Bankruptcy Court proceedings, there is nothing to suggest the findings of facts in the Bankruptcy Court's order should not be applicable to Mr. Rostami. This is because Mr. Rostami was a party to the suit against appellant-husband and All Century as well as the resulting default judgment against appellant-husband on which the Bankruptcy Court's order was based.

funds in 2008, such that those funds became gross income to it and appellants during that year. (See *James, supra,* 366 U.S. at p. 219.)

The burden now shifts to appellants to prove FTB's proposed assessment is wrong.[13] Appellants, however, do not specifically address whether All Century misappropriated the Clients' funds. Rather, in their brief, they contend it is "unknown" why the Rashtis sued appellant-husband, who "did not appear [to make] any substantial efforts to defend in the case and a default judgment was entered." At the hearing, appellant-husband testified that he did not defend against the lawsuit because he thought he had paid the Clients back and, in any event, did not have the financial resources to hire an attorney. He also testified that Mr. Rostami withdrew as a party from the lawsuit after he was paid back.

However, FTB's proffered evidence, which we find convincing, more likely than not establishes that All Century misappropriated the Clients' funds. Indeed, appellant-husband testified he commingled the Clients' funds with his own personal funds and those of his other clients and lent a portion of the funds to third parties. Appellant-husband's testimony shows he did not actually use the funds for their intended purpose, which supports the Clients' allegations in their complaint that he never intended to assist with an IRC section 1031 exchange.

Appellant-husband also testified that he "invested" some of the Clients' funds during the 45-day time limit imposed by IRC section 1031 (requiring the Clients to identify replacement property, which they did not), he paid the Clients a rate of return on the investments, and the Clients knew about this arrangement, which was permitted by section 5.1 of the exchange agreements.[14] He further testified that it is customary for accommodators, such as All Century, to hold onto a client's funds and pay interest for up to 180 days (the time limit imposed by IRC section 1031 to acquire replacement property if one is identified within 45 days), and that after the 180 days expired here, he was experiencing cash liquidity problems due to the real estate crisis and consequently assigned the Clients two loans, in April 2009, in full satisfaction of the funds they entrusted with All Century. But the fact remains appellant-husband did not, and

[13] Generally, the applicable burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) That is, the taxpayer must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of Estate of Gillespie*, 2018-OTA-052P, fn. 6.)

[14] Section 5.1 of the exchange agreements states in full: "Exchanger [the Clients] agree[] that intermediary [All Century] has the right to invest their funds at discretion." Appellant-husband, however, has not provided any documentation showing what was done with the funds All Century received from the Clients.

could not, return those same entrusted funds back to the Clients because, as the Bankruptcy Court found, he had already spent them for purposes entirely unrelated to a tax-deferred exchange. This undisputed fact, at the very least, supports FTB's determination that All Century had the requisite dominion and control over the funds such that they constituted gross income to All Century and appellants in 2008. In addition, as noted above and contrary to appellant-husband's testimony, Mr. Rostami did not withdraw from the lawsuit against appellant-husband and All Century, but instead he obtained a default judgment.

Appellants nonetheless largely contend that All Century fully repaid the Clients by assigning them, in April 2009, its interests in two loans—one related to a deed of trust secured by real property located in Nevada, and the other related to a blanket mortgage secured by real properties located in New York. Therefore, they argue that since All Century allegedly repaid the Clients' funds in 2009, it is entitled to fully offset its additional 2008 income of $3,256,232 with that repayment.

Appellants' contention, however, is misplaced. Even assuming, without concluding, All Century repaid the Clients, it is only entitled to a deduction in the year of repayment, which here is no earlier than 2009—not 2008, the year on appeal.[15] (*James, supra,* 366 U.S. at p. 220; *Taylor v. Commissioner*, T. C. Memo. 1997-513, 1997 WL 739055 at p. *7; see also *Burnett v. Sanford & Brooks Co.* (1931) 282 U.S. 359, 365-366 [it is a well-settled principle in tax law that each tax year stands on its own and must be reviewed separately].)[16] Accordingly, pass-through income of $3,256,232 from All Century's misappropriation of the Client's funds was properly included in appellants' gross income for 2008, without offset for amounts that were allegedly repaid in subsequent years (other than those offsets already allowed by FTB).

[15] For this reason, none of the alleged repayments identified by appellants can be deducted in 2008 because those undisputedly occurred after that tax year. For example, appellants submitted a document signed by the Clients on November 12, 2010, wherein the Clients certify the blanket mortgage was fully repaid. FTB counters this only netted the Clients a recovery of approximately $200,000 in 2010. But we need not decide how much, if any, the Clients were repaid with respect to this mortgage because the repayment occurred in 2010, which is after the 2008 tax year in dispute.

[16] And even assuming, without concluding, All Century intended to repay the misappropriated funds, the funds are still includable in gross income in the year they are misappropriated, which here was 2008. (See *Bailey, supra,* T.C. Memo. 2012-96, 2012 WL 1082928 at p. *21.)

Issue 2 – Whether appellants are entitled to deduct $25,000 of passive rental real estate losses against their ordinary income.

California generally conforms to IRC section 469. (R&TC, §§ 17551(a), 17561.) That section essentially prohibits the use of passive activity losses to reduce nonpassive activity income (e.g., wages). In general, a taxpayer's passive losses may be deducted only to the extent of income from passive activities, and any unused passive losses are suspended and carried forward to future years to offset passive income generated in those years. (See *Lowe v. Commissioner*, T.C. Memo. 2008-298, 2008 WL 5396602 at p. *3.)

California does not conform to IRC section 469(c)(7), which allows taxpayers who materially participate in the real property business to treat rental real estate activity losses as nonpassive losses for federal purposes. (See R&TC, § 17561(a).) Thus, for California purposes, rental real estate activities are considered passive activities, and any losses from such activities can only be used to offset passive activity income. However, California does conform to IRC section 469(i), which permits an offset of up to $25,000 of rental real estate losses against ordinary income for individuals who actively participate in rental real estate activities. (See R&TC, §§ 17551(a), 17561(d).) The offset phases out (but not below zero) by 50 percent of the amount by which the taxpayer's adjusted gross income (AGI) exceeds $100,000, with a complete phase-out if AGI exceeds $150,000.[17] (See IRC, § 469(i)(3)(A).)

Here, FTB disallowed a claimed pass-through rental real estate loss of $473,314 from All Century that it recharacterized as passive from nonpassive. Appellants do not disagree with this recharacterization. Rather, they contend they are entitled to deduct $25,000 of the disallowed amount against their ordinary income under IRC section 469(i) because they reported negative AGI on their California tax return.[18] However, since we conclude above that appellants failed to report additional income of $3,256,232, their recomputed AGI well exceeds $150,000. Accordingly, appellants are not allowed any offset against their ordinary income.

[17] For purposes of the offset, a taxpayer's AGI is modified by certain adjustments not relevant here. (See IRC, § 469(i)(3)(F).)

[18] FTB does not appear to dispute that appellant-husband actively participated in rental real estate activities within the meaning of IRC section 469(i).

Issue 3 – Whether appellants are liable for the accuracy-related penalty.

R&TC section 19164, which generally incorporates 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 any underpayment attributable to any substantial understatement of income tax. (IRC, § 6662(b)(2).) For individuals, such as appellants, there is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1)(A).) Appellants do not dispute the imposition of the penalty or its computation, but rather contend there is reasonable cause and good faith to abate it.

The penalty shall not be imposed with respect to any portion of an underpayment if it is shown there was reasonable cause and the taxpayer acted in good faith with respect to such portion. (R&TC, § 19164(d); IRC, § 6664(c)(1); Treas. Reg. § 1.6664-4(a).) A determination of whether the 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, taking into consideration 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).) "Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." (*Ibid.*) The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity. (Treas. Reg. § 1.6664-4(e).)

Appellants have not alleged—much less shown—they took any steps to assess the proper tax implications of All Century's retention and spending of the Clients' funds. For example, the record does not show they inquired with a tax professional whether the funds may have constituted gross income in 2008. Accordingly, appellants are liable for the accuracy-related penalty.

HOLDINGS

1. Appellants must include in their gross income $3,256,232 of ordinary pass-through income from All Century.
2. Appellants are not entitled to deduct $25,000 of passive rental real estate losses against their ordinary income.
3. Appellants are liable for the accuracy-related penalty.

DISPOSITION

FTB's action is sustained.

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

We concur:

DocuSigned by:
Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

DocuSigned by:
F8E81582226F448...
Richard Tay
Administrative Law Judge

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