OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 18011703
	)	
EARLE A. MALM AND EVELYN A. MALM	)	
	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellants:	Timothy Mulgrew
For Respondent:	David Hunter, Tax Counsel IV David Gemmingen, Tax Counsel IV Michael Cornez, Attorney V
For Office of Tax Appeals (OTA):	Andrea Long, Tax Counsel

A. ROSAS, Administrative Law Judge: Under California Revenue and Taxation Code (R&TC) section 19047, appellants Earl A. Malm and Evelyn A. Malm appeal respondent Franchise Tax Board's action proposing tax deficiencies, penalties, and applicable interest for tax years 2010, 2011, and 2012 (the Tax Period).[1]

OTA Administrative Law Judges Jeffrey I. Margolis, Sara A. Hosey, and Alberto T. Rosas held an oral hearing in this matter in Sacramento, California, on April 30, 2019. At the conclusion of the hearing, we closed the record and submitted this matter for decision.

On July 9, 2019, OTA reopened the record, vacated the original submission date, and requested post-hearing briefs. The parties filed post-hearing briefs and, on September 27, 2019, OTA closed the record and submitted this matter for decision.

[1] Respondent proposed $86,056 of additional tax, an accuracy-related penalty of $17,211.20, and applicable interest for the 2010 tax year; $27,090 of additional tax, an accuracy-related penalty of $5,418, and applicable interest for the 2011 tax year; and $43,095 of additional tax, an accuracy-related penalty of $8,619, and applicable interest for the 2012 tax year.

During the oral hearing and in post-hearing briefing, respondent stated that it conceded appellants are entitled to their reported Internal Revenue Code (IRC) section 1231 loss of $588,490 for tax year 2010.

ISSUES

1. Whether appellants materially participated in the activity conducted by NVMLI, Inc., thus rendering the claimed pass-through losses as nonpassive.
2. Whether the accuracy-related penalties should be abated.

FACTUAL FINDINGS

1. Mr. Malm formed NVMLI, Inc. (NVMLI) in 2002 under Nevada law. NVMLI made an S corporation election. Mr. Malm was the sole shareholder and president of NVMLI. Mrs. Malm and appellants' son made up the remaining directors and officers.
2. From 2009 through 2012, NVMLI reported income and losses from real estate activities.[2] During the Tax Period, no gross income or sales were reported from incubators or consulting.[3]
3. For most of the Tax Period, Mr. Malm was employed as the president of a wholly-owned subsidiary of Union Bank, located in San Francisco, earning wages of over one million dollars each year. Although he may have been physically present at the bank for 40 to 50 hours per week during 2010 and 2011, he was sometimes able to spend his time "involved in other activities as well." From mid-2011, his position was that of an advisor, and then he retired from Union Bank in 2012.
4. NVMLI owned the following three properties in California during the Tax Period:

    - Residential Property in Danville, California: Appellants purchased this property for $691,000 in March 2009 and transferred it to NVMLI in September 2010. Appellants' son lived here rent-free. On its 2012 original California return, NVMLI reported $3,750 of imputed rent.

    - Commercial Property in Oakland, California: NVMLI purchased this commercial property, a warehouse, in February 2011. In it, Mr. Malm stored items used in various real estate projects, including files and tools.

    - Residential Condo in Walnut Creek, California: NVMLI purchased this property in August 2011. Appellants' daughter lived here, and NVMLI reported rent of $10,000 (2011) and $12,000 (2012).

[2] Appellants described NVMLI's real estate business as property development, redevelopment, construction, reconstruction, conversion, rental, operation, management, and leasing.

[3] Appellants argued that NVMLI was also involved in business incubators and consulting during the Tax Period.

5. NVMLI agreed to "adopt . . . as an asset of the corporation" the following properties:

- Residential Property in Henderson, Nevada: This was appellants' personal residence before they moved to California. In August 2009, NVMLI's Board of Directors unanimously voted to "adopt" this Nevada residence as an asset of NVMLI. On its original California returns, NVMLI claimed $57,644 (2011) and $55,401 (2012) as net expenses for this property, and NVMLI reported only $6,800 (2011) and $5,400 (2012) as gross income.[4]

- Three Timeshares in Hawaii:

  Timeshare in Lahaina: In August 2011, NVMLI's Board of Directors unanimously voted to "adopt" this timeshare as a corporate asset. NVMLI reported that it rented this timeshare at fair market value for 30 days in 2011 and reported $8,000 as gross income. NVMLI reported that it rented the timeshare at fair market value for all of 2012 and reported $3,000 as gross income.

  Two Timeshare Units in Princeville: In October 2012, NVMLI's Board of Directors unanimously voted to "adopt" these two separate timeshares as corporate assets. NVMLI did not report any gross income from these timeshares in 2012.

  These three timeshares were available for rent and personal use. They were rented to outsiders 25-percent of the time, they were vacant 25-percent of the time, appellants personally used the timeshares another 25-percent of the time, and the timeshares were used by friends and family the remaining 25-percent of the time.

6. Mr. Malm received K-1 schedules from NVMLI stating he owned 100-percent of the outstanding stock. These schedules reported the following losses:

	Ordinary Losses	Net Real Estate Losses	IRC § 1231 Losses
2010 K-1	$181,439	$120,137	$588,490[5]
2011 K-1	$215,040	$76,253	n/a
2012 K-1	$184,502	$139,517	n/a

7. Appellants filed federal returns for the Tax Period:

- 2010 Federal Return: Appellants reported wages of $1,265,087 ($1,028,335 from Union Bank) and federal adjusted gross income (AGI) of $400,003. In calculating this AGI, appellants deducted, as nonpassive losses, the following: (1) an Internal Revenue Code (IRC) section 1231 loss of $588,490; and (2) the NVMLI total loss of $301,576 ($181,439 + $120,137).

[4] It is unclear whether NVMLI used the Nevada residence in a trade or business, or whether appellants used it as a second home.

[5] As mentioned above, respondent conceded that appellants are entitled to this loss of $588,490 for tax year 2010.

- 2011 Federal Return: Appellants reported Union Bank wages of $1,007,564 and federal AGI of $790,774. In calculating this AGI, appellants deducted, as a nonpassive loss, the NVMLI total loss of $299,760 ($215,040 + $76,253).

- 2012 Federal Return: Appellants reported Union Bank wages of $1,386,303 and federal AGI of $1,453,931. In calculating this AGI, appellants deducted, as a nonpassive loss, the NVMLI total loss of $324,019 ($184,502 + $139,517).

8. Appellants filed California returns for the Tax Period, reporting the federal AGI, including the pass-through losses from NVMLI claimed on their respective federal returns.

9. Respondent audited appellants' California returns for the Tax Period and examined NVMLI's federal returns. At the conclusion of the audit, respondent determined that appellants improperly characterized the pass-through losses from NVMLI as nonpassive losses.

10. Respondent issued a Notice of Proposed Assessment (NPA) for each tax year at issue:

- 2010 NPA: Increased reported taxable income from $215,287 to $1,105,353 due to the disallowance of reported pass-through losses of $890,066, and proposed additional tax of $86,056 and an accuracy-related penalty of $17,211.20 plus interest.

- 2011 NPA: Increased reported taxable income from $648,238 to $939,531 due to the disallowance of reported pass-through losses of $291,293, and proposed additional tax of $27,090 and an accuracy-related penalty of $5,418 plus interest.

- 2012 NPA: Increased reported taxable income from $1,393,267 to $1,717,286 due to the disallowance of reported pass-through losses of $324,019, and proposed additional tax of $43,095 and an accuracy-related penalty of $8,619 plus interest.

11. Appellants protested the NPAs. On May 11, 2016, respondent issued a Notice of Action (NOA) for each tax year at issue, affirming each NPA. This timely appeal followed.

12. During the audit and protest, respondent asked appellants to produce complete copies of NVMLI's returns for the Tax Period. Appellants refused to provide the returns, stating that NVMLI "is a Nevada corporation and generally beyond the jurisdiction of the California Franchise Tax Board."

13. On February 10, 2017—10 days after respondent filed its opening brief—NVMLI filed original California returns for the 2011 and 2012 tax years, but not for the 2010 tax year.

14. In a June 2017 Information Document Request (IDR) issued to NVMLI, respondent stated that NVMLI had a "requirement to file California tax returns during the years the

corporation did business in California including owning and depreciating properties located in California."[6] Although NVMLI provided some minimal information, it never filed a 2010 California return or produced all the documents requested in the June 2017 IDR.

DISCUSSION

Generally, determinations set forth in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving the determinations are erroneous. (*Welch v. Helvering* (1933) 290 U.S. 111, 115; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514.) Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any deduction claimed. (*INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84; *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.)

Taxpayers generally bear the burden of proving entitlement to a claimed deduction by a preponderance of the evidence. (*Griffin v. Commissioner* (8th Cir. 2003) 315 F.3d 1017, 1021.) Taxpayers must identify an applicable statute allowing a deduction and provide credible evidence that their facts are within the terms of the legal authorities. (*Appeal of Telles* (86-SBE-061) 1986 WL 22792.) This burden requires that taxpayers not only demonstrate the claimed deductions are allowable under a statutory provision, but also substantiate their claimed loss deductions by maintaining and producing adequate records. (*Higbee v. Commissioner* (2001) 116 T.C. 438, 440.) That is, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Concrete Pipe and Products of California, Inc. v. Construction Laborers Pension Trust for Southern California* (1993) 508 U.S. 602, 622.)

Issue 1 – Whether appellants materially participated in the activity conducted by NVMLI, thus rendering the claimed pass-through losses as nonpassive.

For both federal and California tax purposes, the S corporation's income and losses are passed through on a pro rata basis to the corporation's shareholders, who must report them on

[6] In this IDR, respondent requested California returns for all tax years that NVMLI was "doing business" in California within the meaning of R&TC section 23101; copies of closing/final escrow and title statements from the purchase and sale of the Danville property and a basis schedule for all capital improvements to the Danville property; and the names and contact information for NVMLI's tenants, copies of deeds, rental agreements, security deposits, correspondences with tenants, and *documents supporting business expenses claimed*.

their individual returns. (IRC, §§ 1363(b) & 1366; R&TC, § 17087.5.) Losses passed through to S corporation shareholders are limited by: (1) the basis limitations of IRC section 1366(d); (2) the at-risk limitations of IRC section 465; and (3) the passive activity loss limitation of IRC section 469. (Temp. Treas. Reg. § 1.469-2T(d)(6).)

At issue in this appeal is the passive activity loss limitation, which prohibits individual taxpayers from currently deducting passive activity losses that exceed passive activity income. (IRC, § 469(a)(1), (d)(1).) Congress designed IRC section 469 to prevent taxpayers from reducing taxable nonpassive income by losses attributable to passive activities. (*See Hillman v. Commissioner* (2002) 118 T.C. 323, 329; *Langille v. Commissioner,* T.C. Memo. 2010–49, affd. (11th Cir. 2011) 447 Fed. Appx. 130.) This general prohibition permits passive losses to offset only passive income. (*Langille*, *supra,* T.C. Memo. 2010–49 (citing *Schwalbach v. Commissioner* (1998) 111 T.C. 215).)

A passive activity generally involves the conduct of a trade or business in which the taxpayer does not materially participate. (IRC, § 469(c)(1).) Material participation (discussed in subsection A below) requires that the taxpayer's involvement in the operations of the activity be regular, continuous, and substantial. (IRC, § 469(h)(1).) However, rental activity (discussed in subsection B below) is treated as a per se passive activity, regardless of whether the taxpayer materially participates. (IRC, § 469(c)(2), (4).)

A: Material Participation.

Of relevance to this material participation discussion, appellants reported ordinary losses of $181,439 for 2010, $215,040 for 2011, and $184,502 for 2012. Although appellants argued that NVMLI was involved in real estate activity, business incubators, and consulting during the Tax Period, appellants did not report any gross income or sales from incubators or consulting. As to NVMLI's real estate activity relevant to this material participation discussion, appellants described the operation of this activity as including property development, redevelopment, construction, reconstruction, conversion, operation, and management.

Material participation is defined as involvement in the operations of an activity that is regular, continuous, and substantial. (IRC, § 469(h)(1).) Taxpayers may satisfy the material participation requirement if they satisfy any one of seven regulatory tests. (Temp. Treas. Reg. § 1.469-5T(a); see also *Lapid v. Commissioner,* T.C. Memo. 2004–222.) Of these, appellants rely on the following two tests: (1) the individual participated in the activity for more than 500

hours during the year (the "500-hour test"), and (2) the individual materially participated in the activity for any five of the previous 10 tax years (the "five-year test"). (Temp. Treas. Reg. § 1.469-5T(a)(1), (5).) We consider each test.

i. The 500-Hour Test.

Appellants contend they satisfy the 500-hour test, which provides that an individual materially participates if he or she "participates in the activity for more than 500 hours during . . . [the] year." (Temp. Treas. Reg. § 1.469-5T(a)(1).) "The extent of an individual's participation in an activity may be established by any reasonable means." (Temp. Treas. Reg. § 1.469-5T(f)(4); see *Shaw v. Commissioner,* T.C. Memo. 2002–35.) But while the regulations allow taxpayers some latitude in establishing the extent of their participation in an activity, "the regulations do not allow a postevent 'ballpark guesstimate.'" (*Moss v. Commissioner* (2010) 135 T.C. 365, 369 (citing *Bailey v. Commissioner*, T.C. Memo. 2001-296; *Goshorn v. Commissioner*, T.C. Memo. 1993-578).)[7] In the absence of "[c]ontemporaneous daily time reports, logs, or similar documents," the extent of a taxpayer's participation may be established by "the identification of services performed over a period of time and the approximate number of hours spent performing such services . . . based on appointment books, calendars, or narrative summaries." (Temp. Treas. Reg. § 1.469-5T(f)(4).)

Appellants did not submit any daily time reports, logs, appointment books, calendars, or narrative summaries. Instead, Appellant's [*sic*] Reply Brief Part Two, dated May 5, 2017, included a list described as "the activity summaries" for tax years 2010, 2011, and 2012. However, statements in briefs are not evidence and cannot supplement the record. (*Niedringhaus v. Commissioner* (1992) 99 T.C. 202, 214, fn. 7; *Kronish v. Commissioner* (1988) 90 T.C. 684.) Thus, "the activity summaries" list in the brief is not evidence.

Mr. Malm testified that "the only thing that [he] would have" to support the hours listed on these "activity summaries" is his "calendar of trips." However, he did not introduce this "calendar of trips" into evidence, and there is no indication that he ever provided this purported calendar to respondent at any time. Taxpayers failure to produce evidence that is within their control gives rise to a presumption that such evidence is unfavorable to their case. (*Appeal of Cookston* (83-SBE-048) 1983 WL 15434.)

[7] See also *Lee v. Commissioner,* T.C. Memo. 2006-193 (non-contemporaneous time logs reconstructed based on the taxpayer's personal experience and limited records are not credible); *Mowafi v. Commissioner,* T.C. Memo. 2001-111 (non-contemporaneous logs prepared for a taxpayer's audit and testimony at trial not credible).

Furthermore, appellants' "lack of records and documentation is not cured by estimates made years after the fact in writing or by testimony." (*Bartlett v. Commissioner*, T.C. Memo. 2013-182.) The "activity summaries" list from the May 5, 2017 brief consisted of mere estimates. "I tried to draw some conclusions," Mr. Malm testified; "And that's how I made my estimates." We give no credence to these post-event estimates.

But despite the absence of contemporaneous records, the extent of a taxpayer's participation may be established by other means, including testimony. However, courts may be skeptical of self-serving testimony that is not sufficiently corroborated by contemporaneous records or otherwise. (*Speer v. Commissioner*, T.C. Memo. 1996-323.) As the sole shareholder and investor, Mr. Malm was the heart and soul of the corporation and was involved in its business activities.[8] But we are not persuaded by his self-serving and uncorroborated oral testimony about the extent of his material participation.[9] Mr. Malm testified that because there are 168 hours in a week, after reducing these hours by 40 to 50 hours for time spent at Union Bank plus 56 hours for sleeping, "there's still another 50 [hours] that I have something to do." However, just because there were enough hours in a week does not mean that appellants established their material participation by a preponderance of the evidence.

The Internal Revenue Service's (IRS) "Passive Activity Loss ATG – Chapter 4, Material Participation" (December 2004) was admitted into the evidentiary record. This audit guideline includes a list of several factors that may indicate a taxpayer did not materially participate, including: the taxpayer was not paid for services, the taxpayer had W-2 employment requiring 40 plus hours per week for which the taxpayer received significant compensation, and there is paid on-site management and/or employees who provide day-to-day oversight and care of the operations. We discuss each of these factors below.

First, the fact that NVMLI did not pay a salary to Mr. Malm is not of great significance to this panel. As the sole shareholder and sole financial backer of NVMLI, Mr. Malm thought it

[8] Mr. Malm testified: "I am NVMLI." And he explained, "I'm basically involved in everything and do almost everything." In terms of how much time he personally participated in the Danville property over the Tax Period, Mr. Malm testified he put in "easily six months of over that three-year period of time." He added, "[a]nd every Saturday I was out there [in Danville] with a level checking to see what was going on "

[9] See *Harrison v. Commissioner*, T.C. Memo. 1996-509 (court persuaded by oral testimony about material participation because it was detailed and to some extent corroborated); *Tolin v. Commissioner*, T.C. Memo. 2014-65 (taxpayer satisfied 500-hour requirement in thoroughbred breeding activity where his narrative summary was supported and corroborated by phone records, third-party witness testimony, the parties' comprehensive stipulations of fact, and other contemporaneous materials).

would be "strange to fund a business . . . and then to draw a salary out of that business and then turn around and refund it again." We agree.

Second, we also agree with Mr. Malm that just because he was the president of a wholly-owned subsidiary of Union Bank doesn't preclude him from participating in NVMLI activities. Although Mr. Malm was busy in another line of work, based on the unique nature of his employment, he was still able to participate in NVMLI activities. However, under the totality of the circumstances, evidence that Mr. Malm worked at Union Bank 40 to 50 hours per week, along with the lack of records and corroboration, makes it less likely that he participated in the rental activity for more than 500 hours each year during the Tax Period.

And third, we find it is significant that NVMLI employed appellants' son (as a manager) and daughter (as an administrator). In 2010, the son was paid $144,000 as management fees, and the daughter was paid $37,000 as administrative fees; in 2011, the son was paid $130,000 as management fees, and the daughter was paid $36,000 as administrative fees; and in 2012, the son and daughter were collectively paid $164,000. These facts, along with the lack of records and corroboration, make it less likely that appellants satisfied the material participation requirement.

Overall, we reject Mr. Malm's testimony as to the hours he spent on his real estate activity as being too incredible to believe. "While a tax court must consider the testimony as 'if no contrary evidence were submitted (without regard to the judicial presumption of IRS correctness),' a tax court has the right in the first instance to reject the testimony as incredible." (*Blodgett v. Commissioner* (8th Cir. 2005) 394 F.3d 1030, 1036, quoting *Marcella v. Commissioner* (8th Cir. 1955) 222 F.2d 878, 883 [stating a tax court "is not compelled to believe evidence which to it seems improbable, or to accept as true uncorroborated evidence of interested witnesses even though uncontradicted"].) Some of appellants' claims simply do not add up. For example, based on the limited evidence, it is not clear how Mr. Malm, while being physically present at Union Bank in San Francisco 40 to 50 hours per week, could work out of the Oakland warehouse where he would await deliveries, how he was able to be present in Danville "every Saturday," all the while being able to visit his former Nevada residence 20 times in 2010 and 2012, and also use the Hawaii timeshares 25-percent of the time. The evidence does not substantiate his claims.

Appellants also ask us to believe Mr. Malm's meetings at the Danville property were identical in duration for three consecutive years.[10] They ask us to believe his construction site maintenance activity at the Danville property was identical in duration for three consecutive years.[11] And they ask us to believe his visits to his former Nevada residence were identical in nature and duration for two consecutive years.[12]

We decline to believe these allegations, particularly in light of the complete lack of corroborating evidence and appellants' use of a manager (their son) and administrator (their daughter). At best, appellants' uncorroborated estimates represent a post-event ballpark guesstimate, the likes of which triers of fact have consistently rejected.

ii. The Five-Year Test.

Appellants contend they satisfy the five-year test, which provides that an individual materially participates if he or she "materially participated in the activity . . . for any five taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year." (Temp. Treas. Reg. § 1.469-5T(a)(5).) Appellants state they meet this requirement because they materially participated in the activity during the 2002, 2004, 2005, 2006, 2007, and 2008 tax years. Appellants assert they worked more than 2,000 hours at NVMLI in 2002, and that there were no other employees at NVMLI. For the 2004 through 2008 tax years, they similarly assert that Mr. Malm worked more than 100 hours for each year and that NVMLI did not use outside services or employ any other person during those tax years. They provided NVMLI's federal income tax returns for the 2004, 2005, and 2006 tax years as proof that NVMLI did not use outside services or had any employees during those years. However, they did not introduce these tax returns into evidence; hence, they are not considered as evidence. Indeed, there is no proof that NVMLI was even engaged in any activity (real estate, business incubators, or consulting) during the years 2002 through 2008, much less that it was involved in the same activity in those years as it was during the Tax Period. Thus, because they

[10] In regard to the Danville property, the activity summaries claim that Mr. Malm attended 40 meetings in 2010, 26 meetings in 2011, and 20 meetings in 2012—and that all 86 meetings lasted exactly three hours.

[11] The activity summaries claim that Mr. Malm provided construction site maintenance in Danville for 6 months in 2010, 12 months in 2011, and 9 months in 2012, at the rate of 6 hours per month for each month.

[12] The activity summaries claim that Mr. Malm made 10 visits to the Nevada residence in 2010 and another 10 visits in 2011, each for maintenance and project coordination, and that each and every visit included exactly 30 hours of work.

have been unable to quantify and corroborate the number of hours performed in any year, appellants have not satisfied the 5-year test for material participation.

Therefore, we find that appellants did not prove that they materially participated in NVMLI, and we find that appellants failed to establish that respondent's recharacterization of these unsubstantiated expenses as passive losses was erroneous.

B: Rental Activities.

Appellants reported net real estate losses of $120,137 for 2010, $76,253 for 2011, and $139,517 for 2012. Rental activity is treated as a per se passive activity, regardless of whether the taxpayer materially participates. (IRC, § 469(c)(2), (4).) A rental activity is any activity where payments are principally for the use of tangible property. (IRC, § 469(j)(8).) There are several exceptions to the definition of "rental activity" (Temp. Treas. Reg. § 1.469–1T(e)(3)(ii)), but appellants do not assert the application of any exception.

While IRC section 469(c)(7) provides an exception to the per se rule for those who qualify as "real estate professionals," R&TC section 17561(a) specifically provides that this subdivision does not apply. Therefore, rental real estate activities are considered passive activities for California purposes and any losses from those activities are suspended until taxpayers have offsetting passive income. (IRC, § 469(b).) Based on this per se rule, appellants have not met their burden of proving that they are entitled to claim rental losses as nonpassive losses for the Tax Period. Accordingly, we sustain respondent's disallowance of these deductions.

C: New Matter.

The parties raised another potential issue: whether respondent's request for substantiation is a "new matter" that shifts the burden of proof to respondent. A new matter is one that is beyond the scope of the deficiency determination. (*Shea v. Commissioner* (1999) 112 T.C. 183, 191.) However, a new position taken by the tax agency is not a "new matter" if it "merely clarifies or develops" the tax agency's "original determination without requiring the presentation of different evidence, being inconsistent with [the] . . . original determination, or increasing the amount of the deficiency." (*Friedman v. Commissioner* (6th Cir. 2000) 216 F.3d 537, 543.)

As stated above, we conclude that (1) appellants did not prove that they materially participated in NVMLI, (2) they failed to establish that respondent's recharacterization of these

unsubstantiated expenses as passive losses was erroneous, and (3) they have not met their burden of proving that they are entitled to claim rental losses as nonpassive losses for the Tax Period. Accordingly, based on these conclusions, and for purposes of adjudicating appellants' appeal of respondent's actions for the Tax Period, we do not believe it necessary to discuss the issue of whether respondent's request for substantiation is a "new matter."

Issue 2 – Whether the accuracy-related penalty should be abated.

IRC section 6662(b) provides, in part, that an accuracy-related penalty applies to the portion of the underpayment attributable to any substantial understatement of income tax. For individual taxpayers, a substantial understatement of tax exists if the amount of the understatement exceeds the greater of 10-percent of the tax required to be shown on the return or $5,000. (IRC, § 6662(d)(1).) IRC section 6662, incorporated by R&TC section 19164, provides for an accuracy-related penalty of 20-percent of the applicable underpayment. At oral argument, respondent clarified that it "mechanically applied" this accuracy-related penalty because there was a substantial understatement of income tax.

Taxpayers bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.) Taxpayers may reduce or eliminate their liability if they successfully demonstrates one of three exceptions: (1) they had substantial authority for their treatment of any item giving rise to the understatement; (2) the relevant facts affecting the item's tax treatment are adequately disclosed and there is or was a reasonable basis for the tax treatment of such item; or (3) the underpayment was due to reasonable cause and the taxpayers acted in good faith with respect to such portion of the underpayment. (IRC, §§ 6662(d)(2)(B) & 6664(c)(1).)

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, 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).) Generally, the most important factor is the extent of the taxpayer's effort to assess the proper tax liability. (*Ibid*.)

Although Mr. Malm testified that "there was never any intention to do anything wrong," appellants do not provide any argument or evidence establishing that they acted reasonably in claiming that the losses at issue were nonpassive losses. They also fail to show either substantial

authority to justify the understatement or adequate disclosure of the understatement specifying a reasonable basis. Accordingly, appellants have failed to establish that respondent improperly imposed an accuracy-related penalty or that the penalty should be abated.[13]

HOLDINGS

1. As to NVMLI's claimed ordinary losses, appellants did not prove material participation in any NVMLI activity. As to NVMLI's rental activities, California law bars NVMLI from applying net real estate losses to nonpassive income. Thus, appellants are not entitled to deduct the claimed ordinary losses or the claimed net real estate losses against their nonpassive income.
2. Appellants did not show that respondent improperly imposed the accuracy-related penalties or that any of these penalties should be abated.

DISPOSITION

Respondent conceded that appellants are entitled to their reported IRC section 1231 loss of $588,490 for tax year 2010; thus, based on this concession, respondent shall adjust the 2010 NOA's additional tax, penalty, and interest, accordingly. In all other respects, we sustain respondent's action.

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Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

We concur:

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Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

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Sara A. Hosey
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Sara A. Hosey
Administrative Law Judge

Date Issued: 12/24/2019

[13] However, because respondent conceded that appellants are entitled to their reported IRC section 1231 loss of $588,490 for tax year 2010, respondent shall adjust the accuracy-related penalty of $17,211.20 for tax year 2010 accordingly.