OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011703
E. MALM AND	)
E. MALM	)
	)
	)

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Timothy Mulgrew, EA CDFA ABFA

For Respondent: David Hunter, Tax Counsel IV

A. ROSAS, Administrative Law Judge: On April 30, 2019, the Office of Tax Appeals (OTA) held an oral hearing in this matter. In July 2019, OTA reopened the record, vacated the original submission date, and requested post-hearing briefs. The parties filed post-hearing briefs, and, in September 2019, OTA closed the record and submitted this matter for decision. OTA's December 24, 2019 opinion held in favor of respondent, sustaining its proposed assessment.[1] Appellants timely filed a petition for rehearing (PFR) under Revenue and Taxation Code (R&TC) section 19048.

A rehearing may be granted where one of the following grounds exists, and the substantial rights of the complaining party are materially affected: (a) an irregularity in the appeal proceedings which occurred prior to the issuance of the written opinion and prevented fair consideration of the appeal; (b) an accident or surprise which occurred during the appeal proceedings and prior to the issuance of the written opinion, which ordinary caution could not have prevented; (c) newly discovered, relevant evidence, which the party could not have

[1] In the December 2019 opinion, OTA held: (1) as to the corporation's claimed ordinary losses, appellants did not prove material participation in any activity; as to the corporation's rental activities, California law bars NVMLI, Inc., from applying net real estate losses to nonpassive income; thus, appellants were not entitled to deduct the claimed ordinary losses or the claimed net real estate losses against their nonpassive income; and (2) appellants did not show that respondent improperly imposed the accuracy-related penalties or that any of these penalties should be abated.

reasonably discovered and provided prior to the issuance of the written opinion; (d) insufficient evidence to justify the written opinion or the opinion is contrary to law; or (e) an error in law. (Cal. Code Regs., tit. 18, § 30604(a)-(e); see also *Appeal of Do*, 18-OTA-002P; *Appeal of Wilson Development, Inc*. (94-SBE-007) 1994 WL 580654.)

Appellants base their PFR on the first, fourth and fifth grounds. Upon due consideration, we conclude that the grounds set forth in the PFR do not constitute good cause for a rehearing.

A. An Irregularity in the Appeal Proceedings which Occurred Prior to the Issuance of the Written Opinion and Prevented Fair Consideration of the Appeal

"Courts have defined an irregularity in the proceedings as 'any departure by the court from the due and orderly method of disposition of an action by which the substantial rights of a party have been materially affected ….' " (*Appeal of Graham and Smith*, 2018-OTA-154P at pp. 6-7 (*Graham & Smith*), quoting *Gay v. Torrance* (1904) 145 Cal. 144, 149 (*Gay*).) "An 'irregularity in the proceedings' is a catchall phrase referring to any act that (1) violates the right of a party to a fair trial and (2) which a party 'cannot fully present by exceptions taken during the progress of the trial ….' " (*Montoya v. Barragan* (2013) 220 Cal.App.4th 1215, 1229-1230, quoting *Gay*, *supra*, at p. 149.)

Although it is unclear from the PFR, it seems appellants contend that there were two distinct irregularities in the appeal proceeding: (1) OTA relied on untrue statements; and (2) the oral hearing transcript contained significant errors.

First, appellants take issue with the factual finding that Mr. Malm "may have been physically present at the bank for 40 to 50 hours per week during 2010 and 2011 ..... " Appellants argue that this statement is based on assumptions made by respondent, and that "this was never submitted into evidence, never determined, and remains categorically untrue." Actually, this statement comes from Mr. Malm's sworn testimony:

> Mr. Malm: Typically I would report into work at normal time, 8, 9 o'clock in the morning. Typically I would leave at 5 o'clock, 5, 6 o'clock. So I was working a full 40-hour week you could say.
>
> Mr. Hunter: For 2010, 2011?
>
> Mr. Malm: Yes. What I would say is that I was there for 40 hours a week.

Mr. Malm also testified that "there's 168 hours in the week, 40 to 50 of them could be spent at a job." Thus, Mr. Malm's own testimony contradicts appellants' argument about this finding.

Second, appellants argue that the oral hearing transcript contained "significant errors in some wording that could mislead the reader, therefore relying on the transcript more than 8 months after the hearing could have led to an outcome other than what both sides anticipated." Appellants, however, did not identify the "significant errors." Moreover, on July 9, 2019, OTA emailed to the parties a courtesy copy of the Reporter's Transcript of Proceedings. Appellants did not raise allegations of "significant errors" in the transcript until filing their PFR on January 22, 2020. Although OTA's regulations are silent as to any deadline for a party to make corrections to a transcript, we believe that raising this allegation over six months after their receipt of the transcript was unreasonable. Thus, appellants failed to identify any "significant errors" in the transcript, and their objection was untimely.

Overall, we cannot find any support for appellants' argument that "an irregularity in the appeal proceedings . . . prevented fair consideration of the appeal." (Cal. Code Regs., tit. 18, § 30604(a).) Appellants did not show how such alleged irregularities violated their right to a fair hearing, or how their substantial rights were materially affected.

B. Insufficient Evidence to Justify the Written Opinion or the Opinion is Contrary to Law

This ground for a rehearing consists of two separate, distinct grounds: on the one hand, whether there is insufficient evidence to justify a written opinion; or, on the other hand, whether an opinion is contrary to law. Requesting a rehearing based on insufficiency of the evidence requires "weighing the evidence." (Code Civ. Proc. (CCP), § 657.) This includes the power to consider the credibility of witnesses and to draw reasonable inferences from the evidence. (*Valdez v. J. D. Diffenbaugh Co.* (1975) 51 Cal.App.3d 494, 512 (*Valdez*).) In contrast, we do not weigh the evidence when determining whether an opinion is contrary to law. (*Graham & Smith, supra,* 2018-OTA-154 at p. 6, citing *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906 (*Sanchez-Corea*).) Appellants seem to argue that a rehearing is warranted under both of these separate and distinct grounds; thus, we will discuss both below.

Insufficiency of the Evidence

"To find that there is an insufficiency of evidence to justify the opinion, we must find that, after weighing the evidence in the record, including reasonable inferences based on that evidence, the panel clearly should have reached a different opinion." (*Appeal of Swat-Fame, Inc.*, 2020-OTA-045P at p. 3 (*Swat-Fame*).) "In weighing and evaluating the evidence, the court

is a trier-of-fact . . . . The court may grant a new trial . . . so long as the court determines the weight of the evidence is against the verdict." (*Candido v. Huitt* (1984) 151 Cal.App.3d 918, 923.) It is not only the right but the duty of the judge to grant a new trial when he or she believes the weight of the evidence to be contrary to the prior decision. (*Tice v. Kaiser Co., Inc.* (1951) 102 Cal.App.2d 44, 46.)

In weighing and evaluating the evidence, the applicable standard is a preponderance of the evidence. (Evid. Code, § 115.) 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.) 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 Cal., Inc. v. Construction Laborers Pension Trust for So. Cal.* (1993) 508 U.S. 602, 622.) Appellants had the burden of proving their material participation. Material participation, as defined in Internal Revenue Code section 469(h)(1), requires involvement in the operations of an activity that is regular, continuous and substantial. We considered the testimony and evidence to determine whether appellants proved material participation by satisfying either the "500-hour test" or the "five-year test." (Temp. Treas. Reg. § 1.469-5T(a)(1), (5).) After reviewing the testimony and admitted exhibits and considering the lack of records and corroboration for appellants' position, we concluded that appellants did not meet their burden of proving that they satisfied either of these material participation tests.

Appellants contend that during a prehearing conference on the day of the hearing, it was purportedly stated that OTA "would allow and accept Mr. Malm's testimony under oath as evidence of his participation." Appellants argue that despite this assurance, "the panel did not accept any testimony under oath by Mr. Malm, even though the questions were promulgated by the panel itself." OTA accepted Mr. Malm's testimony into evidence, but the issue is how much credibility we attributed to his uncorroborated testimony.

Appellants argue that "Mr. Malm provided extensive testimony that seemed more than satisfactory to the panel and more than answered all concerns raised by the panel." Appellants suggest that because Mr. Malm's testimony may have "seemed more than satisfactory," OTA should have attributed a higher degree of credibility to the testimony. But the power to consider

the credibility of witnesses rests with judges, not the parties. (*Valdez, supra*, 51 Cal.App.3d at p. 512.)[2]

We reexamined Mr. Malm's testimony for purposes of this PFR. But we do not look at his testimony in a vacuum; rather, we also considered the admitted exhibits and the lack of corroborating records. Appellants claim that "Mr. Malm's under oath testimony is corroborated . . . ." We disagree. Appellants claim that they proved Mr. Malm's material participation not just via his testimony, but also through receipts of expenditures, construction logs, activities, photographs, etc. Although photographs were not admitted into evidence, some photographs were used as demonstrative aids during the hearing. The admitted exhibits, however, did not include any receipts of expenditures or construction logs.[3]

Appellants' PFR contains speculation about what the contents of evidence that is not before us might have established had it been presented. But such evidence was not presented. A weighing of evidence requires just that—evidence—not speculation; and we cannot weigh evidence that is not before us. In reweighing and reevaluating the testimony and admitted evidence, we are confident that OTA's initial conclusion is correct: appellants did not meet their burden of proving material participation in any NVMLI, Inc. (NVMLI), activity.

Against (or Contrary to) Law

To find that an opinion is against (or contrary to) law, we do not weigh the evidence; instead, we must determine whether that opinion is "unsupported by any substantial evidence." (*Graham & Smith, supra,* 2018-OTA-154P.) This requires reviewing an opinion "and indulging in all legitimate and reasonable inferences" to uphold that opinion. (*Sanchez-Corea*, *supra,* at p. 907.) "The relevant question is not over the quality or nature of the reasoning behind the opinion, but whether the opinion can or cannot be valid according to the law." (*Swat-Fame*, *supra*, 2020-OTA-045P at p. 3.)

[2] As explained in the December 2019 opinion, we found the testimony as to the hours spent on 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 rightin the first instance to reject the testimony as incredible." (*Blodgett v. Commissioner* (8th Cir. 2005) 394 F.3d 1030, 1036, citing *Marcella v. Commissioner* (8th Cir. 1955) 222 F.2d 878, 883 [stating a trial 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"].)

[3] Appellants claim that "Mr. Malm did not bring old calendars from 5 years back because the State already conceded to his list of activities that were verified at the time of examination." Respondent denies this claim.

In reviewing the December 2019 opinion, we looked at whether it was unsupported by any substantial evidence. In *Sanchez-Corea*, the California Supreme Court held that a verdict (or, for our purposes, an opinion) "was 'against law' only if it was 'unsupported by any substantial evidence, i.e., [if] the entire evidence [was] such as would justify a directed verdict against the part[ies] in whose favor the verdict [was] returned.' " (*Sanchez-Corea*, *supra*, 38 Cal.3d at p. 906, quoting *Kralyevich v. Magrini* (1959) 172 Cal.App.2d 784, 789.) CCP section 630 governs motions for a directed verdict. In determining whether the December 2019 opinion was against (or contrary to) law—and similarly, whether the entire evidence was such as would justify a directed verdict against respondent—we indulged "in all legitimate and reasonable inferences" to uphold the opinion. (*Sanchez-Corea, supra,* at p. 907.) "In our review, we consider the evidence in the light most favorable to the prevailing party ....." (*Swat-Fame, supra,* 2020-OTA-045P at p. 3, citing *Sanchez-Corea, supra,* at p. 907.) Considering the evidence in such light, we note that, under CCP section 630, when a party has the burden of proof on a material point, "unless some such evidence is produced [the opposing party] is entitled to a directed verdict." (*Garber v. Prudential Ins. Co. of America* (1962) 203 Cal.App.2d 693, 707.)

The December 2019 opinion held that appellants did not meet their burden of proving material participation in any NVMLI activity; our conclusion was based, in part, on the lack of corroborating records. Under these circumstances, in theory, respondent would have been entitled to a directed verdict in its favor under CCP section 630. As such, when a party fails to meet its burden of proof based on a lack of evidence, that party has an uphill battle when arguing for a rehearing under the "contrary to law" ground.

Next, in reviewing the December 2019 opinion, we also looked at whether it can or cannot be valid according to the law. (*Swat-Fame, supra,* 2020-OTA-045P at p. 3, citing *Appeal of NASSCO Holdings, Inc*. (2010-SBE-001) 2010 WL 5626976 (*NASSCO*).) Appellants argue that OTA applied the incorrect law.[4] We disagree. We previously considered and discussed the applicable law, and we will not repeat our detailed analysis and legal conclusions. Suffice it to say that, on review, we agree with our prior application of the law.

[4] Specifically, appellants make the following arguments: (1) the law on the issue of material participation was incorrect, and OTA should have applied a reasonable person standard to the material participation tests; (2) the law applicable to the accuracy-related penalty must be based on proving an intentional or malicious act; (3) OTA's refusal to believe Mr. Malm's testimony about material participation is contrary to the law; and (4) when dealing with a trade or business, its activities are per se nonpassive, even when one of its activities includes rental property.

Furthermore, appellants' contentions do not show that the December 2019 opinion created an "injustice based on a mistake of law or misunderstanding of facts." (*NASSCO, supra*, 2010-SBE-001.) Overall, in considering the evidence in the light most favorable to respondent, we conclude that appellants have not demonstrated that there was insufficient evidence to justify the opinion, nor did appellants demonstrate that the opinion was against (or contrary to) law.

C. An Error in Law

"Courts have found that a new trial may be granted based on an error in law if its original ruling as a matter of law was erroneous." (*Swat-Fame, supra*, 2020-OTA-045P at p. 2, fn. 2, citing *Collins v. Sutter Memorial Hospital* (2011) 196 Cal.App.4th 1, 17-18.) "A claim on a petition for rehearing that there was an error in law is a claim of procedural wrong." (*Swat-Fame, supra*, at p. 2, fn. 2.) "For example, courts have found an error in law occurred when there was . . . an erroneous ruling on the admission or rejection of evidence …." (*Ibid*., citing *Nakamura v. Los Angeles Gas & Elec. Corp*. (1934) 137 Cal.App. 487.) However, when the error in law is based on improper admission or exclusion of evidence, the evidence in question needs to be identified. (*Treber v. Sup.Ct. (The Recorder Printing & Publishing Co.)* (1968) 68 Cal.2d 128, 131.) Appellants' contentions are based on four allegations of improper admission or exclusion of evidence.

First, appellants take issue with the fact that although one of their pleadings included attached exhibits of NVMLI's federal income tax returns for the 2004, 2005 and 2006 tax years, these exhibits were not introduced into evidence and, hence, not considered as evidence. "Statements in briefs and exhibits attached to briefs are not evidence." (*Allen v. Commissioner*, T.C. Memo. 2006-11.) While each party has the right "to introduce exhibits," only "admitted evidence" constitutes the type of evidence that makes it into an "oral hearing record." (Cal. Code Regs., tit. 18, §§ 30102(p), 30410.) Appellants failed to request that OTA admit these tax returns into evidence.[5]

[5] Specifically, appellants did not submit any exhibits with their prehearing conference statement; instead, their statement indicated, "Appellant will refer to Exhibits submitted by Respondent, but reserves the right to offer additional documents as the hearing progresses." However, respondent's exhibits did not include NVMLI's federal income tax returns for the 2004, 2005 or 2006 tax years. Nevertheless, even if OTA had admitted these tax returns into evidence, these returns in and of themselves would "not establish the facts contained therein. [Citations.] The tax return signed under penalties of perjury is merely a statement of the petitioner's claim [citation]; it is not presumed to be correct." (*Roberts v. Commissioner* (1974) 62 T.C. 834, 837.)

Second, appellants take issue with OTA admitting into evidence Mr. Malm's Forms W-2s for tax years 2010, 2011 and 2012 (portions of Exhibits C, D and E, respectively) as well as the Internal Revenue Service's "Passive Activity Loss ATG – Chapter 4, Material Participation" (Exhibit AA). Appellants argue that admission of the Forms W-2s was prejudicial. Exhibit AA includes a list of several factors that may indicate a taxpayer did not materially participate. Appellants argue that Exhibit AA "does not constitute law it merely guides an examiner on the facts that may lead them to a passive determination." However, appellants failed to timely object to the admission of this evidence.[6] (*Bell v. American Title Ins. Co.* (1991) 226 Cal.App.3d 1589, 1602 ["Failure to register a proper and timely objection to a ruling or proceeding in the trial court waives the issue on appeal"].) Thus, the objections to Exhibits C, D, E and AA are untimely.

Third, appellants take issue with the admission into evidence of Mr. Malm's employment background. Appellants argue that their prehearing conference statement included a motion to suppress this employment information and to suppress the Forms W-2s discussed above. It is correct that appellants' prehearing conference statement included objections to some of respondent's exhibits, but appellants objected to two exhibits only, Exhibits A and B, arguing that both exhibits were irrelevant and prejudicial. OTA agreed, sustained appellants' objections, and neither Exhibit A nor B were admitted into evidence. But appellants did not object to any other exhibits, nor did appellants object to any employment background information that may have been contained within Exhibits C though VV. Moreover, on direct examination, appellants' representative asked about Mr. Malm's employment background. When respondent followed up on cross examination and asked Mr. Malm additional questions about his employment background, appellants did not voice any objections about this line of inquiry. Thus, as to OTA's reliance on any employment background information admitted into evidence through exhibits or testimony, the objections raised in the PFR are untimely.

Lastly, as to a discussion about appellants' "activity summaries" during the prehearing conference on April 30, 2019, appellants argue that, because respondent had purportedly agreed to accept this activity summary during the audit examination, "it remains unfair to disallow evidence when no reasonable expectation or provision exists." Appellants argue that OTA

[6] During the telephonic prehearing conference on April 11, 2019, appellants did not object to the admission of Exhibits C, D, E or AA. The prehearing conference orders indicated that respondent's Exhibits C through VV were admitted into evidence. During the oral hearing, we summarized the prehearing conference orders, including the order indicating respondent's Exhibits C through VV were admitted into evidence; and when asked whether this was an accurate summary of the prehearing conference orders, appellants said yes.

agreed to accept Mr. Malm's testimony under oath, in lieu of these "activity summaries," in what appellants describe "as a means of trial expedience to which all parties were interested in expedience." We disagree with appellants' recollection of this discussion from the April 30, 2019 in-person prehearing conference; fortunately, we summarized this discussion on the record.[7] Appellants did not object to the "activity summaries" (Exhibit 4) being admitted into evidence subject to limitations. Appellants did not argue that Exhibit 4 should be admitted for the truth of the matter stated therein. Thus, the objection raised in the PFR is untimely.

However, even if the four objections raised in the PFR had been made timely, appellants would still lose on the merits. When discussing an error in law, the error must be prejudicial; that is, the error must likely have affected the outcome: "If it clearly appears that the error could not have affected the result of the trial, the court is bound to deny the motion." (*Bristow v. Ferguson* (1981) 121 Cal.App.3d 823, 826.) " 'Prejudice from error is never presumed but must be affirmatively demonstrated by the appellant. [Citations.]' " (*Hernandez v. County of Los Angeles* (2014) 226 Cal.App.4th 1599, 1616.) Thus, appellants' request for a rehearing based on error in law also fails because appellants did not affirmatively demonstrate prejudice from the alleged errors. In other words, of the four allegations of improper admission or exclusion of evidence, appellants did not demonstrate that any of these admissions or exclusions of evidence affected the result of the April 30, 2019 hearing.

To summarize, when an error in law is based on improper admission or exclusion of evidence, (1) the evidence in question needs to be identified, (2) any objection must be made timely, and (3) prejudice from error must be affirmatively demonstrated. While appellants identified the evidence in question, their objections were untimely, and they did not affirmatively demonstrate any prejudice resulting from the alleged errors.

D. Settlement Offer and Holding

As an alternative option, appellants attached a settlement offer to their PFR. OTA cannot consider a settlement or compromise of an appeal. An administrative agency's authority to act is limited and it "has no powers except such as the law of its creation has given it." (*Ferdig v. State*

[7] The lead Administrative Law Judge stated as follows: "And as Exhibit 4, . . . a summary or narrative of some of the hours that were purportedly worked by Mr. Malm during the tax years at issue. As was discussed, Exhibit 4 is not coming in for to prove those exact hours, is not coming in for the truth of the matter stated in those -- in that exhibit. We are just bringing it in for the purposes of avoiding an undue consumption of time to prevent having to have Mr. Malm read line by line those three pages into the record."

Personnel Bd. (1969) 71 Cal.2d 96, 105, quoting *Conover v. Bd. of Equalization* (1941) 44 Cal.App.2d 283, 287.) As to the power to settle an appeal, that power vests with respondent and the California Attorney General. (R&TC, § 19442.) As to the power to compromise a final tax liability, that power vests solely with respondent. (R&TC, § 19443.) There is no statutory authority that grants these powers to OTA.

Although appellants included additional arguments in support of their PFR, to the extent not discussed herein, we find such arguments to be irrelevant and without merit. As to the legal grounds discussed above, we find that appellants have not shown grounds exist for a rehearing, and we deny their PFR.

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Alberto T. Rosas
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Alberto T. Rosas
Administrative Law Judge

We concur:

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Date Issued: 8/18/2020