BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	
D. GOTTLIEB and S. GOTTLIEB,	OTA NO. 20056185
APPELLANT.	

TRANSCRIPT OF VIRTUAL PROCEEDINGS

State of California

Tuesday, September 28, 2021

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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IN THE MATTER OF THE APPEAL OF, D. GOTTLIEB and S. GOTTLIEB, APPELLANT.	OTA NO. 20056185

Transcript of Virtual Proceedings, taken in the State of California, commencing at 1:03 p.m. and concluding at 2:03 p.m. on Tuesday, September 28, 2021, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ JOHN JOHNSON
Panel Members:	ALJ CHERYL AKIN ALJ JOSHUA ALDRICH
For the Appellant:	PHILIP PANITZ
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD BRIAN MILLER SONIA WOODRUFF

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-11 were received at page 9.)

(Department's Exhibits A-U were received at page 9.)

(Joint Stipulation Exhibit JS-1 was received at page 9.)

PRESENTATION

CLOSING STATEMENT

California; Tuesday, September 28, 2021

1:03 p.m.

JUDGE JOHNSON: We're now on the record in OTA Appeal of Gottlieb. This is OTA Case Number 20056185. It is 1:03 p.m. on September 28th, 2021. This appeal is being conducted electronically, led by myself Judge John Johnson here in Sacramento, California. While I am lead ALJ for purposes of conducting this hearing, it will be the panel of three ALJs before you that will decide this matter.

At this point let me say good afternoon to my fellow co-panelists today.

Good afternoon, Judge Akin.

JUDGE AKIN: Good afternoon. Judge Akin speaking here. I look forward to the parties' presentation today. Thank you.

JUDGE JOHNSON: Thank you.

Judge Johnson, again. And good afternoon, Judge Aldrich.

JUDGE ALDRICH: Good afternoon. This is Judge Aldrich. Welcome, parties.

JUDGE JOHNSON: Thank you.

Judge Johnson, again. I'll remind the participants and viewers that the Office of Tax Appeals is

not a court but an independent appeals body. The office is staffed by tax experts and is independent of the State's tax agencies. We do not engage in ex parte communications with either party, and our decision will be based on the arguments and evidence provided by the parties on appeal in conjunction with an appropriate application of the law.

We have read the briefs and examined the submitted exhibits and are looking forward to your arguments today. I know it has taken many steps to get to this point, so I appreciate the parties' efforts. And we fully respect the importance of the decision to be made on this appeal.

Let me have the parties' representatives introduce themselves, and I'll start with the Appellant's side.

MR. PANITZ: Phillip Garrett Panitz on behalf of the Appellants.

JUDGE JOHNSON: Thank you.

And Respondent Franchise Tax Board.

MR. MILLER: Brian Miller for Respondent Franchise Tax Board.

MS. WOODRUFF: And I'm Sonia Woodruff also for the Respondent Franchise Tax Board.

JUDGE JOHNSON: This is Judge Johnson. Thank

you.

The first issue identified on appeal is whether Appellants are entitled to deduct the gallery's losses from their gross income for the tax years at issue. Following the prehearing conference, the second issue was identified as potentially for discussion today, and that is whether Appellants are entitled to net losses relating to DGBM Business Management company for the tax years at issue.

Let me first ask Appellant, do those issue statements properly reflect what is at issue today?

MR. PANITZ: Well, we object to DGBM even being considered today. We believe that the Franchise Tax Board has waived that issue.

JUDGE JOHNSON: Okay. This is Judge Johnson, again. We'll leave it on the table for now. And definitely during the presentations, the parties can discuss whether or not that is an item before us and will consider that once we close the hearing and get into the opinion writing process.

Let me turn to Respondent Franchise Tax Board. Do the two issue statements accurately reflect what you believe is at issue in this appeal?

MR. MILLER: Yes, I do.

JUDGE JOHNSON: Judge Johnson. Thank you.

At the prehearing conference we discussed the exhibits that are provided by the parties with their briefs. That's Appellant's Exhibits 1 through 9 and Respondent's A through Q. Some duplication was noted, but no objections to the exhibits being admitted into the record were stated at the prehearing conference.

After the prehearing conference at OTA's request, Appellant provided a memorandum and attached Exhibits 10 and 11. Respondent replied with exhibit -- their own memorandum and also Exhibits R through U. Respondent also provided a joint stipulation, which we labeled as JS-1.

Appellant, are there any objections to the exhibits provided by Respondent after the prehearing conference?

MR. PANITZ: No, Your Honor.

JUDGE JOHNSON: Thank you.

And, Respondent, any objections to the exhibits provided by Appellant?

MR. MILLER: Brian Miller for Franchise Tax Board. We do not object to any of them. But I would like to point out on the record Exhibit 10, the September 15th letter from Alec Cast to the extent this is a declaration. It was not signed under penalty of perjury, and it was submitted fewer than 15 days before this oral hearing. With that said, we do not object to its admittance.

JUDGE JOHNSON: This is Judge Johnson. Thank you and noted.

So then Appellant's Exhibits 1 through 11, Respondents Exhibits A through U, and the joint stipulation JS-1 will all be admitted as evidence into the record.

(Appellant's Exhibits 1-11 were received in evidence by the Administrative Law Judge.)

(Department's Exhibits A-U were received in evidence by the Administrative Law Judge.)

(Joint Stipulation Exhibit JS-1 was received in evidence by the Administrative Law Judge.)

At this point, we are ready to hear the parties' presentation. Before we begin, Appellant will be going first.

Let me ask Franchise Tax Board, any other questions or things that we need to address before we get into the parties' arguments?

MR. MILLER: Yes, please. On Issue No. 2, the business management DGBM, for the record and as I stated in my writing, we do not concede that issue. We never waived it. And number two, I'm asking, if we are going to orally argue it today, which Respondent is ready to do, we would request a few more minutes than the current 20 minutes allotted.

JUDGE JOHNSON: This is Judge Johnson. Thank you, Mr. Miller. We're the only hearing for this afternoon, so we should be able to allow that. Once we get to that point, if you feel that you are running toward the end of your 20 minutes, just let us know if you need extra time for that second issue, and we should be able to grant it at that time.

MR. MILLER: And then -- sorry. Brian Miller again. Then to confirm, when we go into our 20-minute presentations, Appellant first, Respondent next, just go ahead and argue that DGBM matter. Is that how we're going to proceed?

JUDGE JOHNSON: This is Judge Johnson. Yeah. You can wrap all of your arguments into that 20-minute time or if to be expanded. We don't need to separate out the second issue. You can cover them both at once.

MR. MILLER: Very good. Thank you.

JUDGE JOHNSON: Judge Johnson, again. Appellant any questions before we go into your arguments on appeal?

MR. PANITZ: No, Your Honor.

JUDGE JOHNSON: Thank you. This is Judge Johnson. Then please, Mr. Panitz, whenever you are ready, please again.

MR. PANITZ: Okay. Thank you.

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PRESENTATION

MR. PANITZ: Good afternoon, Your Honors. I represent Daniel Gottlieb, and this case involves hobby loss issues and Section 183 of the Internal Revenue Code. The interpretation of Section 183 is done by Treasury Regulation, which is 1.183-1. And that's the governing statute and authority with regard to the hobby loss issue.

G2 Gallery, the Gottliebs bought a building with the intent of making a profit. They bought the building and sold the building 11 years later. They did make a profit. When they bought the building, their intention was to make the building as good as it possibly could be in relation to the area, an area called Abbott Kinney, which is a very trendy area now in Los Angeles. But at the time that they bought, it just starting gentrification.

They bought the building. They fixed it up, and they put an art gallery inside it in keeping with what was going on in the area. Art galleries, pubs, dining restaurants, with the intent of making the building as valuable as possible so they could ultimately sell it.

I reference Treasury Regulation 1.183 because the treasury specifically states with regard to whether or not an activity should be considered as a separate activity or a single activity. And 1.183-1(d), d as in dog,

specifically states generally the commissioner, meaning the commissioner of internal revenue, will accept the characterization by the taxpayer of several undertakings, either as a single activity or as separate activities. That's the general rule.

The taxpayer's characterization will you not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. So that's the exception to the rule. In order to show that the taxpayer's intent should not be respected, then the taxpayer's characterization of the transaction must be deemed artificial. That's the legal term.

The cases that were cited by the Respondent in their briefs, almost every single case had to do -- almost every single case had to do with horse breeding activities. And in every single case the court had the hindsight to see that there never was a profit made on the activity. You know, it takes a while to get to court, and the court had the benefit of the future information.

This is the case where we have the benefit of hindsight, and we know that the taxpayers did, in fact, make a profit. Their intent to buy a building, fix it up in a gentrified area of Los Angeles, put in an upscale art gallery, and then sell the building for a profit, turned

out to be exactly right. They did exactly what their intent was, which was to make a profit. And it was a tremendous profit. It was almost $8 million of profit.

There aren't any cases that we can look at that where the Tax Court -- the United States Tax Court said the taxpayers made a profit, and we determined that their intent was not to make a profit. In all the cases cited by Respondent, the taxpayers failed to make a profit. And we had to look back and say, well what was their intent? Were they at least intending to make a profit? And the analysis started from there.

We have never had a case where the taxpayers made a profit and the IRS then challenged it and said, well, they didn't intend to make a profit. Because we know that they did make a profit, which is almost absurd. A lot of the cases that are also cited by the Respondents misuse the language of the Treasury Regulation, a couple of the cases they cited. And let me give you an exact example.

The specific language of the Treasury Regulation states that, "The taxpayer's characterization will not be accepted when it appears that its characterization is artificial and cannot be reasonably supported under the facts and circumstances." That word "and" means that both findings need to be met. Yet, the cases where Respondent cites to this particular Treasury Regulation, the United

States Tax Court memorandum decision, which is a one-judge decision. It's not by the full body of the tax court.

The tax court got it wrong because they cited to this Treasury Regulation and used the word "or", as if the single activity had to be either artificial or not reasonably supported under the facts and circumstances. The reason why this is important is because the Respondent's entire argument in this case seems to rely on the second prong of the test, attempting to argue that it's just facts and circumstances involved in this case and that each case should be looked at from an individual basis.

We argue that the taxpayer's characterization of this building was not artificial by the location of the building. The art gallery was in the building. The gentrification of the neighborhood was all part and parcel of their profit motive. Their intent was to make a profit, and we're focusing on the taxpayer's intent. And we have the objective proof that they did, in fact, make a profit which, you know, buttresses the argument that they had intent to make a profit because they did make a profit.

There was no -- the Respondent argues and attempts to show also, on one of their side arguments, that the gallery itself was purely used for charitable

purposes. And to prove that up, in one of their exhibits, they show flyers that were handed out to potential patrons of the gallery showing that large amounts of donations were made, and those donations were made to charity. And that is true.

However, what they don't say is that when you hand out literature to potential buyers of art, and you're saying that a portion of what you pay for a painting or a photograph at the gallery is going to be donated to charity, that's actually an incentive to the buyer to purchase the art. In other words, it's good marketing to say, hey, a percentage of everything you contribute and buy here today is going to charity. That is actually part of the profit motive to get people to want to buy the artwork.

Also, there's a mischaracterization in the Respondent's briefs because they seem to imply that these charitable donations were part of the losses that the gallery was accumulating during the time of its operation. That is not the case. The gallery was on the Schedule C of the taxpayers on their 1040. The charitable donations were on Schedule A. Meaning that the donations that they made as individuals were their own charitable donations from the proceeds that came through to them from the gallery.

It didn't effect the bottom line of the gallery itself on the Schedule C showing what income came in and what the expenses of the gallery were. Also, as Mr. Cast pointed out, he's the CPA who was the CPA for all of the activities of Daniel Gottlieb. He pointed out that the employees of the gallery were employees of the real estate development company. Even the director of the art gallery was an employee of the real estate development.

And although the art gallery had its own director and its own bookkeeper, they reported up the line to both Mr. Gottlieb and to Mr. Cast as the CFO who was doing all the tax returns. So all of the activities that were done by Daniel Gottlieb and all the LLCs that he had, would flow through to his tax return and they were all part of one enterprise.

Some of the cases talked about that. Whether the activities were in the same location? They were here. Whether the employees were from different companies? No, they were all employees of the real estate company, including the art gallery employees. And everything flowed through to the taxpayers through the LLCs to their 1040 tax returns, and for the purpose of the State, their 540 tax returns.

The taxpayers' groupings of these activities should be respected. They should be respected because

they're not artificial. They were all part of the same profit motive, which was to enhance the value of the building to ultimately sell the building for a profit. And they accomplished that when they sold the building.

We rest our case, Your Honor.

JUDGE JOHNSON: This is Judge Johnson. Thank you, Mr. Panitz.

Now we'll turn it over to the Respondent Franchise Tax Board, and you have 20 minutes. And let us know if you need more beyond that. You may begin.

MR. MILLER: Okay. One second please. All right. Brian Miller here. I'm ready to start.

JUDGE JOHNSON: Judge Johnson. Please start when you're ready.

PRESENTATION

MR. MILLER: Okay. Good afternoon, judges.

The facts of this case when applied to the law should lead us to conclude that Appellants' gallery activity was separate from the real estate investment. The evidence shows that Appellants did not engage in this separate gallery activity for profit. And, therefore, under the law they are not entitled to deduct the gallery's losses from their income. Appellants are entitled to deduct, and we allowed, the gallery's expenses

only to the extent of gallery income.

But first, as a threshold matter, I will explain that under the facts of this case the law does not allow Appellants to combine their gallery and real estate undertakings into a single activity. Then I'll explain why we determine that the separate gallery activity was not an activity engaged in for profit. And finally, in the concluding portion of my presentation, I will separately explain that we disallowed Appellants' claimed losses of their Dan Gottlieb Business Management activity because it was on an activity engaged in for profit.

Now, when deciding cases before it, the OTA has consistently ruled, including in its precedential Dandridge Opinion, that Appellants bear the burden to prove an entitlement to a deduction. OTA also ruled in its precedential GEF Operating that FTB's determination of tax is presumed to be correct. And under the rules for tax appeals, the burden is on Appellants to prove by preponderance of the evidence all issues of fact.

Our legal analysis begins with ascertaining whether Appellants' gallery and real estate investment were two separate undertakings or a single activity. The most important facts and circumstances in determining whether multiple undertakings are a single activity, are the degree of organizational and economic

interrelationship between the undertakings, whether there's a common business purpose and the similarity of various undertakings.

The facts demonstrate that there was a low degree of organizational and economic interrelationship between the gallery and real estate investment. The gallery had an operations employee, as described by Appellants in Exhibit E, who did the gallery's bookkeeping. The gallery bookkeeper maintained the gallery's accounts, including managing Form 1099s. The gallery director, meanwhile, according to the job description, oversaw the gallery's bookkeeping. Appellants' accountant, Mr. Cast, tells us in his September 15th, 2021, letter -- which is Appellant's Exhibit 10 -- that there was a gallery bookkeeper and there was a real estate company bookkeeper.

The separate books and separate bookkeepers demonstrate a low degree of organizational interrelationship between the gallery and the real estate investment. Mr. Cast's letter tells us that he then prepared the income tax returns for all the branches of Appellants' various companies. Exhibit 10 demonstrates that the gallery with its own books and the real estate investment with its own books were separate branches with a common tax preparer. Merely sharing a tax preparer is a low degree of shared organizational interrelationship

between the gallery and the real estate investment.

In addition to a low degree of organizational interrelationship, the gallery's economic drag on the real estate investment demonstrates a low degree of economic interrelationship. Treasury Regulations tell us that when a taxpayer farms land that it is held for its appreciation, the farming undertaking and the real estate undertaking are its single activity only -- only if the farming activity reduces the net cost of carrying the land for its appreciation and value.

The gallery's expenses exceeded its income in each and every year. The income derived from the gallery did not exceed the deductions attributable to the gallery activity. So the gallery did not reduce the net cost of carrying the real estate investment. This demonstrates a low degree of economic interrelationship between the gallery and the real estate investment.

Now, another element in analyzing whether multiple undertakings are a single activity is whether there was a common business purpose among the undertakings. Appellants contend the gallery's purpose was to improve the real estate investment's value and that there was a common business purpose. They point to the fact that the real estate investment did appreciate and contend that this proves that the gallery's purpose was to

increase the real estate investment's value.

However, Appellants provided two separate professional analyses for the real estate investment's value. These professional analysis attribute the property's appreciation to its Venice location, not to the existence of the gallery. Appellant's Exhibit 3, a professional -- in Exhibit 3 a professional describes the property's increased value without referring to Appellants' art gallery. The property's value is based on the building's condition and, importantly, its location in a popular Venice neighborhood.

In Appellant's Exhibit 5, a different professional describes the property's value based on its location in Venice where commercial property values were, quote, "Skyrocketing and the supply and demand feature is very much in play." These professional evaluations demonstrate that the real estate investment could have appreciated regardless of whether Appellants operated an art gallery. The gallery -- the property real estate investment did not need the gallery to appreciate. In addition to being an economic burden, the gallery was unnecessary. This does not demonstrate common business purpose between the real estate investment and the gallery.

And finally, it is significant that there is no

similarity between the gallery undertaking and the real estate undertaking. Appellants told Respondents that the gallery undertaking involved the buying, displaying, and selling art for the purpose of an income stream for Appellants to contribute to conservation organizations. The gallery website told the public that net proceeds from sales were contributed to conservation organizations, which is not the same as contributing profits from sales. And this is -- this is from Appellants' gallery's website, which is now closed. It was not a flyer that was distributed to the public. It is a website. Meanwhile, the real estate investment's purpose was to profit from holding real estate. These two undertakings, the gallery and the real estate investment, had no similarities.

Now, in summary, the lack of organizational and economic interrelationship, the business purpose served by the undertakings and the dissimilarity of the undertakings does not support Appellant's contention that the gallery and real estate investment were a single activity. Now, Appellants contended earlier today that the regulation state that a taxing agency will generally accept the taxpayer's characterization of several undertakings as a single activity and that the taxing agency will not accept the taxpayer's characterization when it appears to be artificial and cannot be supported under the facts and

circumstances.

Now, this language does not, as Appellants contend, does not mean that Respondent bears the burden to prove that Appellants' characterizations of its gallery and real estate investments as a single activity is an artificial and not reasonably supported by the facts. The plain language of the regulation states that a taxing agency will generally accept the taxpayer's characterizations. Regulation then provides two circumstances when the characterization will be rejected. The regulation does not command Respondent to accept Appellants' characterization of its gallery and real estate investment as a single activity, unless Respondent proves that the characterization is artificial and not reasonably supported by fact.

In fact, Tax Courts have inconsistently interpreted and applied this regulation by asking if the taxpayer's characterization of its undertakings as a single activity is reasonably or unreasonable -- is reasonable or unreasonable based on the facts and circumstances of the case. The taxpayer was still required to meet the burden of proving that its characterization of its undertakings is a single activity was reasonable.

In this case, Respondent gave due consideration

of all substantiated facts and circumstances and determined that Appellants' characterization of its gallery and real estate undertaking is a single activity is not reasonable.

So now that we've identified that Appellants' gallery undertaking is a separate activity, we turn to the question of whether the gallery was an activity engaged in for profit. Respondent FTB determined that the gallery undertaking was not an activity engaged in for profit and disallowed the claimed losses. All the facts and circumstances with respect to the activity are taken into account in determining whether an activity is engaged in for profit. In Appellants' case, the evidence does not demonstrate that they engaged in the gallery activity for profit.

Appellants told us during the audit, see Exhibit F, that the purpose of the gallery was to provide a stream of income for Appellants to donate to conversation organizations. The gallery website told the public that all the net proceeds of our sales and other revenue were donated to environmental organizations and boasted that the gallery donated more than $1 million during its 11-year run. These contentions do not demonstrate the gallery was an activity engaged in for profit.

Now, to the extent the gallery produced a revenue stream for Appellants to donate to charity, they would have reported them as itemized deductions on Schedule A. It appears from accounting records that at least a portion of the gallery's donations were a donation of the use of the gallery's space for events, catering, valet service, and the like, not cash. It appears these noncash donations were treated as expenses and claimed on the gallery's Schedule C as other expenses.

In most years these expenses exceed gross income. These cash and in-kind contributions at least contributed to expense exceeding income in each and every year that the gallery was operated. It demonstrates that the gallery, as Appellants tell us, was operated to generate a revenue stream for contributions to conservation groups and other charitable causes. Now, certainly, operating a gallery that generates funds and other contributions for conservation, it may be judged as a social good, but it's not an activity engaged in for profit and does not, under the tax law, entitle a taxpayer to tax deductions.

Now, Appellants also told us during the examination in Exhibit F, that another purpose of the gallery was to develop its reputation as a premiere and respected private art gallery. This appears to be a personal motive as the owners of a premiere and respected

art gallery would enjoy at least a measure of social status and personal satisfaction.

The Treasury Regulations in case law provide a set of factors to consider when analyzing an activity, whether an activity was engaged in for profit. The presence of personal motives in carrying on an activity is a factor that may indicate that the activity is not engaged in for profit, especially, when there are personal elements involved. Now, another fact in the Regulations is the history of the activities' income and losses. Losses sustained beyond the period, which is customarily necessary to bring the operation to profitable status may indicate the activity is not engaged in for profit.

Now, the gallery business plan in Exhibit 7, reports that galleries typically take five years to break even. In each of the 11 years the gallery was open, income never exceeded expenses. There is no indication that Appellants considered or attempted to modify gallery operations in any way that would demonstrate an intention to reverse losses. And yet another factor is the manner in which the activity is carried on, including keeping books and altering business operations in a manner consistent with an intent to improve profitability.

The gallery had a bookkeeper to track the gallery's expenses and income, issue Form 1099s, among

other administrative tasks. It appears the gallery was operated in a businesslike fashion as far as keeping records goes. However, as I discussed a minute ago, there's no indication that the gallery ever altered its operations or abandoned unprofitable methods in an attempt to become profitable.

This inaction in the face of more than a decade of losses demonstrates the opposite of operating in a businesslike fashion. Another factor -- another factor is the taxpayer's expertise -- expertise in and their preparation for the activity. Appellants do not contend that they had any experience operating an art gallery, and they provided no evidence of preparation by, for example, consulting with experts in the field or researching and studying standard practices of successful gallery businesses.

We're not saying that the taxpayer with no experience in a particular activity could not engage in a new activity intending to profit. But the regulation asks us to consider that a person with no expertise in an activity would be expected to prepare by extensive study of accepted business practices or at least consult with experts. Such study or engagement of experts can demonstrate that a new activity was engaged in for profit.

Now, Appellants did hire a director with some

experience in gallery management. His job description included working with gallery owners to maintain the mission and evolve direction of the gallery. The rest of the of the director's job description was about handling the day-to-day operations of the gallery under the direction of Appellants. Nothing indicates that the manager was hired to provide expert -- Appellants with expertise in operating a gallery for profit.

Now, another factor is the time and effort expended by Appellants in carrying on the activity. Appellants contend that they devoted combined several days per week to the gallery undertaking, working with their hired managers and staff. Respondent acknowledges that Appellant spent at least some time on the gallery undertaking, but their facts do not demonstrate either a profit motive or a lack of profit motive.

And then finally, an expectation that assets used in an activity may appreciate in value can't demonstrate an activity's profit motive. However, the regulation refers us to the previous Section 181-1, which is an analysis of whether multiple undertakings are a single activity. In order to apply the factor that their appreciation of land in excess of losses shows that it was an activity for profit, in order to apply that, one must find that it is a single activity. We would have to

determine that the gallery and the real estate investment were a single activity, which the evidence shows they were not.

Now, because the gallery is a separate activity, income and deductions cannot be aggregated with the real estate investment. Thus, the appreciation of the real estate investment is not taken into account in determining whether the gallery activity was engaged in it for profit. In conclusion, Appellants' gallery undertaking was separate from Appellants' real estate investment undertaking. There was little economic interrelationship between the undertakings. There was no common business purpose, and the real estate undertaking was not at all similar to the gallery undertaking.

Appellants did not engage in the gallery activity for profit. They tell us it was intended to generate funds for conversation groups, and the website tells us that proceeds were donated. When the gallery sustained year after year of losses, there was no change in operations. Appellants also enjoy the personal satisfaction of trying to build the gallery's reputation. The gallery is not an activity engaged in for profit. Appellants are not entitled to deduct losses claimed by the gallery.

Now, referring to the second, I'm referring to

the issue of whether Dan Gottlieb Business Management was an undertaking for profit during these appraisal years -- appeal years 2011 through 2015, I point out the Respondent FTB disallowed Appellants' claimed loss because the total of all evidence Appellants provided does not demonstrate this undertaking was intended for profit.

The only information Appellants provided is in their Exhibit 11, which they provided to our auditor. We asked for additional basic documentation, such as the management agreement with their remaining client, in order to understand what the undertaking involved, but there was no response. The tax returns reported employee expenses. So we asked for documentation of Appellant-husband's hours spent on the undertaking during the appeal years and a schedule of employee hours on the undertaking, but there was no response.

The evidence does not indicate that Appellants engaged in the Daniel Gottlieb Business Management activity with the objective of making a profit. Appellants did not carry out this activity in a businesslike manner by, for example, abandoning unprofitable methods in a manner consistent with an intent to improve profitability. In our case, Appellants did not abandon unprofitable methods during any of the appeal years. Appellants tell us that there is a single

remaining client, and serving this client alone is not profitable.

Appellants did not abandon their own profitable method or demonstrate any changes that would make it profitable such as attempting to gain new clients, attempting new business areas. In this case, it appears Appellants' objective was to continue serving the longtime client, not to make a profit. The amount of time a taxpayer spends on an undertaking is another factor. In this case our auditor requested documentation from Appellants in this case on this element, but to date has not been produced.

When information under the exclusive control of a taxpayer is not produced, it is presumed that the information does not support its case. So there's no indication that Appellant spent any time on this undertaking, which indicates that it was not intended for profit. History of losses in this undertaking also indicates that it was not engaged in for profit.

Now a series of years in which net income was realized would be a strong evidence for Appellants.

And just two more minutes, please.

Now a series of years in which net income was realized would be strong evidence for Appellants. That, however, is not the case here. In each appeal year the

undertaking claimed expenses in excess of income. Respondent's available records indicate that the last time DGBM reported income exceeding expenses was in 2006. The undertaking consistently reports -- reports expenses exceeding income.

Appellants have made no operational changes that would demonstrate an intent to profit, such as seeking new clients or trimming costs. And Appellants' substantial income from other sources is a factor indicating that they did not engage in the management undertaking for a profit. The regulation includes a parenthetical that particularly if the loss generated substantial tax benefits, it may indicate the activity is not for profit. In that case Appellants appear to deduct expenses from income while not engaging trying to make a profit.

And finally, there appear to be a personal element in carrying on the business management activity. Appellants said income from clients used to range up to half-a-million dollars a year during some unspecified era. Those days appear to be in the past. In each and every year from 2008 to 2019 -- given this unbroken pattern of losses, this undertaking appears to be more for personal gain serving its remaining client, rather than the undertaking for a profit.

In conclusion, Respondent FTB determined, based

on all the available evidence, the Appellants did not engage in the DGBM undertaking for a profit. The undertaking is not actively engaged in seeking profit, and operations were not changed to reverse the pattern of losses.

Further, Appellants appear to maintain this undertaking for personal reasons, maintaining a relationship with the remaining client. Appellants provide no additional facts or evidence contrary to this determination. Respondent's determination should be sustained.

Thank you.

JUDGE JOHNSON: This is Judge Johnson. Thank you.

Mr. Panitz, you'll have 10 minutes for rebuttal. If you need any additional time to also discuss DGBM, just let us know, and we can allow you a couple of minutes over 10 minutes as well. Whenever you're ready, you can begin your 10-minute rebuttal.

MR. PANITZ: Thank you, Your Honor.

CLOSING STATEMENT

MR. PANITZ: I'm going to start with a rebuttal on the primary issue in the case, the G2 Gallery, but I will make some procedural objections with regard to DGBM

at the conclusion.

Our arguments that we've advanced today, both Respondent and the Appellants, are pretty much the same arguments we've been saying all along in our briefs. And so there is sort of a repetitiveness to our arguments. I'm going to, therefore, leave my rebuttal just simply to what Mr. Miller said in oral arguments today with regard to some of the points that he made.

He stated and he quoted from 1.183-1 the language that's what I call in the second page of the Treasure Regulation. And that language, which he referenced, had to do with farming activities and owning land for appreciation. That specifically pertains to farming activities. And unless Mr. Miller is arguing that somehow running an art gallery is akin to farming activities, I think that that argument is irrelevant because it's specifically designed for farming activities.

More relevant in the Treasury Regulation is some of the preamble language which specifically states, "Generally, the most significant facts and circumstances in making this determination" -- and the determination they're referring to is separate activity versus one activity -- "the most significant is the degree of organizational and economic interrelationship of various undertakings. The business purpose, which is or might be

served by carrying on the various undertakings separately or together in a trade or business or in an investment setting and the similarity of various undertakings."

I emphasize in an investment setting because this was, in fact, an investment of the taxpayers. And their intent with their investment was to increase the value of their investment. And it was their subjective intent that to increase the value of their investment was to make it as attractive as possible. I find it a little bit incredulous that the Franchise Tax Board is in essence arguing that what was inside the building is completely irrelevant to the value of the building.

Would it be true -- would it be reasonable to assume that if the interior of the building was completely vacated and empty, that that somehow wouldn't affect the value of the building itself. There had to be some business inside this building to make it attractive. Whether it was a restaurant, whether it was boutique, whether it was an art gallery. Whatever it was in keeping with the spirit of the neighborhood, it had to be occupied with something and not left vacant. And to say whatever was inside contributed nothing to the value is -- it's strange credibility.

The taxpayers did provide an exhibit, Exhibit H. And on page 3 out of 4 of that exhibit as part of their

business plan, and that's what Exhibit H is. It's the business plan for the gallery itself. They do indicate that the gallery will sometimes take five years to break even.

Now, with regard to, you know, DGBM, I'm going to make a quick analogy to the federal system. Because when the IRS conducts an audit and they issue a document called a "Notice of Deficiency" -- euphemistically referred to as a 90-day letter -- it allows the taxpayer to petition the United States Tax Court within 90 days or forever hold their peace. In the Notice of Deficiency, the IRS must put down all those items that they are disputing, all the items that they are adjusting so that the taxpayers know what they're being held accountable for and what their arguments must be to the Tax Court to rebut.

I would make the analogy that the Notice of Proposed Assessment, which the Franchise Tax Board issues, has the same exact rationale. It is there to show, here is what we are adjusting. Here is what we are disputing. And in the petition that we then file in response to that Notice of Proposed Assessment, it is to contradict, deny, to point out the facts that are contra to those proposed assessments made in the NPA.

To support the argument, now by the Franchise Tax Board, that somehow the DGBM issue is in play after it was

not addressed in the Notice of Proposed Assessment and simply saying the Schedule C adjustments of G2 Gallery and DGBM, when, in fact, it then goes onto discuss what the issues were. And all of the issues in the NPAs, every single one of them, had to do with G2 Gallery and whether or not hobby loss applied.

Never once was it amplified or would put any counsel on notice that, in fact, there was some issue with regarded to management fees involving a celebrity who happened to be Ann-Margret, and that those are being contested. It wasn't ever discussed in anybody's brief. When the Franchise Tax Board characterized the issue in this case in two briefs, their opening brief and in their reply brief, they frame the issue involving hobby loss and the G2 Galleries.

Never once did they bring up anything about Ann-Margret or expenses related to her career and the management of her career by Daniel Gottlieb. Never once putting us on notice that there was even an issue with regard to that, not in the NPAs and not in the briefs. We argue the issues that were presented to us by the Franchise Tax Board. Therefore, we are taking the legal position that they waive their right to assert this.

When I talked to Mr. Cast -- and this is hearsay because he's not here to testify. But I'm just going to

tell you that he discussed these issues with the auditor. He presented evidence to the auditor and never hearing again about it and -- and Mr. Black went on and on for several months about G2 Gallery. He made an assumption that what he had presented to the auditor had satisfied the auditor. They now present evidence -- I believe it's their Exhibit R, which is a letter from Mr. Black to Mr. Cast regarding the DGBM issues.

A letter, by the way, which I have never seen until they put that into evidence here in this case. That letter predated the Notice of Proposed Assessments. It was part of the audit process. It was part of the audit settlement discussions, but it had nothing to do with the actual legal document that was issued by the Department when the Franchise Tax Board put the taxpayers on notice that they were going to be objecting to the G2 Gallery expenses in the Notice of Proposed Assessment.

Therefore, I think that exhibit is completely irrelevant as much as settlement discussion are irrelevant before, you know, a litigation occurs. It was simply audit -- audit discussions that didn't make its way into the actual legal document that framed the issues of this case. We were never put on notice that this was an issue. And for us to be informed that this was a legal issue in a telephone conference with Judge Johnson basically within

two weeks of this hearing, I think is appalling.

It needed to be in the Notice of Proposed Assessment. We needed to be able to respond to it. Because back five-and-a-half years ago when Daniel Gottlieb -- unfortunately, who is suffering from advance dementia right now and could not even participate in this hearing.

But back five-and-a-half years ago, if that was an issue and we were aware of it, we could have presented evidence to the fact that Mr. Gottlieb managed a tremendous amount of celebrities' careers and that Ann-Margret was simply the last one of all the celebrities that he managed and was winding down her career at the very end. But he made a tremendous profit in that area for many, many, many years prior to the last few years of managing her career.

So, therefore, we strenuously object on the record that the Franchise Tax Board has any right now, having brought this up for the first time two weeks ago, to argue that the DGBM issue is even before this court.

Thank you, Your Honors.

JUDGE JOHNSON: This is Judge Johnson. Thank you, Mr. Panitz.

We'll turn to panel questions. I'll turn to my co-panelists in just a moment, but I do want to address

Mr. Panitz' last arguments there regarding notice. And going through the briefing, I noticed that -- maybe I'll turn to Franchise Tax Board if they want to kind of flush this issue out -- that on Respondent's opening brief, page 2, they mentioned, Respondent disallowed Appellants' DGBM losses.

Appellants do not protest or appeal the adjustments disallowing the losses. They are included in the table to document how the additional amount of tax is calculated. And as far as being mentioned in the brief, that's where I primarily saw it come up, and it seems like Franchise Tax Board, again, I'll turn to you in a second. Seems like you're considering it not to be at issue. But also, on the Notice of Proposed Assessment, I do see that it says the examination determined that Schedule C, G2 Gallery, and DGBM were not actually engaged for profit per IRC 183. As such, the losses for those entities are disallowed.

So I do see on the NPA, Mr. Panitz, where it is mentioned. I agree that it didn't come out into full force from the documents that we have in record post NPA. But let me turn to Franchise Tax Board.

Is there anything we're missing as far as the discussion of DGBM up to the point that we were at in the conference and the hearing?

MR. MILLER: So I guess I would begin with the audit examination, at the conclusion of the audit examination as your standard procedure. Audit issue presentation sheets are issued. We issued AIPS Number 2. Sent it to the taxpayer's representative at the time, Alex Cast informing him that we were going to disallow the losses from the DGBM. We did not get a response to that. He never necessarily -- there was never a challenge articulating any challenge to that.

Number two, we issued Notice of Proposed Assessment, as you just mentioned, Judge, where the first sentence does say the two names, G2 Gallery and DGBM. And then the second sentence uses the plural as such losses from those entities, plural, are disallowed. Therefore, with the conclusion of the audit, both in the AIPS from the auditor and the Notice of Proposed Assessment, we informed the taxpayers that we were disallowing losses from DGBM.

Now, turning to my brief, I mentioned the fact that they did not protest or appeal it because that was a fact. Now, we made an adjustment. In their protest they only address the G2 issue. They did not address the second issue. On appeal it was the same thing. They only addressed the first issue. Therefore, I put in my brief that we made the adjustments.

So at that point, if they had not been on notice from the conclusion of the audit from the AIPS, from the NPA, the protest, then they would have then in the second sentence of my opening brief be put on notice that, yes, this adjustment was made.

And then number two, I included the DGBM losses in the table in order to show how we calculated it. But that was also almost putting in blinding lights that, hey, there were some adjustments made here, and the Appellants had not addressed them. And that's -- so this is not a surprise. The first time this came up was during the audit. The most recent time yes was at the prehearing conference. However, it's been brought up on numerous other occasions.

JUDGE JOHNSON: This is Judge Johnson. Thank you.

And it is an important issue as far as notice and the parties knowing what's going on at issue. So I'll turn back to Mr. Panitz.

If you had anything else that you wanted to kind of reply to or speak further on to that subject?

MR. PANITZ: The DGBM reference in the Notice of Proposed Assessment was in the context of Section 183. And because we were never notified that there were some issue, I didn't even know about Ann-Margret or anything

having to do with that issue from the accountant. I would have been put on notice from the actual Notice of Proposed Assessment.

And the assumption was made that the DGBM had to do with managing the gallery without anybody telling me otherwise. And there should be something in the Notice of Proposed Assessment that would at least alert somebody that this was a completely separate issue that had nothing to do with G2 Gallery.

JUDGE JOHNSON: This is Judge Johnson. Thank you.

And now I'd like to turn it over to my panel members if they have any questions for the parties.

I'll start with Judge Akin. Any questions?

JUDGE AKIN: Yes. Thank you, Judge Johnson. I do have one clarifying questions for Appellants. I guess I'm a little curious whether all of the net proceeds from art sales or only a part of proceeds from art sales were contributed to charities. I know that would be reflected on Schedule A and not Schedule C, but I'm just wondering if it was, you know, 100 percent of the net proceeds or just a portion.

MR. PANITZ: My understanding was -- and of course, you know, without the ability to go back and ask Mr. Gottlieb, you know, more recent questions because of

his unfortunate dementia. But my understanding from Mr. Cast, who was the accountant, was that not all of the proceeds went to charitable causes just -- they flowed through to Mr. And Mrs. Gottlieb, the income from the gallery. And then they would make charitable deductions.

And I believe some of the tax year in question there were over $3 million of charitable contributions, but that wasn't just from the gallery. That was from all their charitable contributions from all their sources of revenue. So it's hard for us now to look back and say specifically what it traced to because it was on a Schedule A, and it was from income they received from all different sources.

JUDGE AKIN: Understood. Thank you. And I had one additional question. I'm just wondering if Appellants undertook any efforts to kind of change the business model or business plans or operations of the gallery in an attempt to make it more profitable, you know, as the business went on over the course of it's, I think, 10 to 11-year history.

MR. PANITZ: My understanding was that they were trying to build a reputation and bring in the best photographers. That was really the work that was going on at the gallery was a photographic art exhibit. And as their reputation grew, the more famous photographers were

being brought in to display their works, which would have led, of course, to more revenue.

JUDGE AKIN: Okay. Thank you. That's all the questions I have at this time.

JUDGE JOHNSON: Judge Johnson. Thank you, Judge Akin.

I'll turn to Judge Aldrich. Do you have any questions?

JUDGE ALDRICH: Hi. This is Judge Aldrich. I don't have any questions at this moment. Thank you.

JUDGE JOHNSON: This is Judge Johnson. Thank you.

And with that, we have the evidence that's been admitted into the record, and we have your arguments and your briefs, as well as your oral arguments presented here today. We have a complete record from which to base our decision. But let me turn to the parties to see if there's any final questions before we conclude today.

I'll start with Mr. Panitz for Appellants. Any questions?

MR. PANITZ: No, Your Honor.

JUDGE JOHNSON: Thank you.

And Respondent Franchise Tax Board, any questions before we conclude?

MR. MILLER: I guess I'm just wondering about

what happens on procedural motion that he made -- that Appellants made? Is that something that's dealt with today, or is that something in the written opinion that's coming up?

JUDGE JOHNSON: This is Judge Johnson. And that's referring to the question as to whether or not DGBM issue is before us?

MR. MILLER: Affirmative. Yes. And the ultimate decision of the underlying matter, not just the motion.

JUDGE JOHNSON: Thank you.

The panel -- this is Judge Johnson, again. The panel will go back and take a look at the issue based on the amount that was claimed in the appeal that was submitted before the OTA. Comparing that to the Notice of Action from which the appeal came will determine whether or not that issue is before us, and we will include it as an issue in our opinion.

And part of that issue may be whether or not there's jurisdiction for it. If there is jurisdiction, we will decide the issue as to whether to sustain Franchise Tax Board or reverse in favor of the Appellant.

That answers your question?

MR. MILLER: Very good. This is Mr. Miller. Yes. Thank you, Judge.

JUDGE JOHNSON: Thank you. Judge Johnson.

I wish to thank both parties, again. Thank you for your efforts in this matter. This will conclude the hearing for this Appeal of Gottlieb. Parties should expect a written opinion no later than 100 days from today.

With that, we are off the record.

(Proceedings adjourned at 2:03 p.m.)

HEARING REPORTER'S CERTIFICATE

I, Ernalyn M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 15th day of October, 2021.

_____
ERNALYN M. ALONZO
HEARING REPORTER