OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **DAVID LINDSEY AND LORYN LINDSEY**	) OTA Case No. 18012098)))))

OPINION

Representing the Parties:

For Appellants: Hector C. Perez, Attorney
William K. Shipley, Attorney

For Respondent: Sonia D. Woodruff, Tax Counsel IV

For Office of Tax Appeals: Josh Lambert, Tax Counsel

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellants David Lindsey and Loryn Lindsey appeal an action by respondent Franchise Tax Board in proposing: (1) an assessment of additional tax of $157,709, a late-filing penalty of $38,885.75, an accuracy-related penalty of $30,176.20, plus interest, for the 2003 tax year; (2) an assessment of additional tax of $6,175, plus interest, for the 2004 tax year; and (3) an assessment of additional tax of $1,302, plus interest, for the 2005 tax year.[1]

Office of Tax Appeals Administrative Law Judges John O. Johnson, Kenneth Gast, and Richard I. Tay held an oral hearing for this matter in Van Nuys, California, on October 28, 2019. At the conclusion of the hearing, this matter was submitted for decision.

[1] These are revised tax amounts after concessions by respondent. Respondent abated failure-to-furnish-information penalties for 2003, 2004 and 2005. Appellants have not raised arguments with respect to the casualty loss deduction, relating to tax year 2004, and investment interest expense deductions, relating to all years, that are at issue in this appeal. Therefore, these issues will not be discussed herein. Respondent also will allow home mortgage interest deductions of: (1) $76,046 for 2003; (2) $42,650 for 2004; and (3) $50,724 for 2005. Appellant agrees with these amounts. The parties indicate that the above concessions effectively mean that the proposed assessments for 2004 and 2005 are no longer at issue on appeal, and therefore will not be discussed herein.

ISSUE

Whether appellants have shown error in respondent's proposed assessment for the 2003 tax year, based on the calculation of gain from the sale of residential property in 2003.[2]

FACTUAL FINDINGS

Sale of La Caminita Residence

1. In 1990, appellants purchased a principal residence at an address on La Caminita, in Lafayette, California (La Caminita or the residence) for $1.2 million.
2. Appellants made various improvements to the property. Appellants provide a "Job Cost Analysis Detailed" from 1992 from Young & Burton, Inc. (YB), the contractor, that states the projected job cost total was $1,586,816, and a 1991 invoice from Mr. Harmon, an architect, for $62,236. The "Job Cost Analysis Detailed" also shows a handwritten note from the president of YB stating that the schedule accurately shows the "total job costs [and] monies received from David [and] Loryn Lindsey per work performed . . . during 1991 [and] 1992." Appellants also provide correspondence from YB and Mr. Harmon describing the jobs, and a 1995 appraisal describing improvements and valuing the residence at $2.8 million. Appellants also provide a letter from YB dated July 5, 2011, stating that it was paid monthly for the work that was conducted around 1990 to 1991.
3. Appellants provide financial records to show that they obtained bank loans and refinanced the property in 1993.
4. In 1996, appellants entered into a purchase agreement to sell one-half of their interest in La Caminita to Marbel Holdings, Inc. (Marbel), a Nevada corporation owned by an offshore entity. Marbel was created as part of appellants' Income Stabilization Plan, discussed below. Documentation of the transaction includes the purchase agreement, a promissory note (Note), and a conveyed deed.
5. In the transaction, Marbel was represented by appellants' accountant. Pursuant to the sale agreement, Marbel agreed to pay appellants a total of $1.05 million for the one-half

[2] Appellants do not provide separate arguments as to the late-filing and accuracy-related penalties, but request recomputation of the penalties to the extent the underlying assessment is reduced. Therefore, the penalties will not separately be addressed herein.

interest. Of this total purchase price, Marbel paid $23,872 by the closing date of December 3, 1996, and was to pay the balance over a 30-year period pursuant to the terms of the Note, secured by a Deed of Trust.

6. The Note reflected a principal amount of $1,026,128 with a variable annual interest rate accruing at seven percent.[3] Marbel's monthly Note payments to appellants began in January 1997. The ultimate amount of payments made on the Note is not known.

7. According to the terms of the purchase agreement, upon the subsequent sale of La Caminita, the profits of the sale were to be split by first providing Marbel payment of $23,872 (i.e., same amount as its initial payment under the purchase agreement), plus 6 percent interest from the date of Marbel's one-half interest acquisition. Second, appellants would receive $1,026,128 (i.e., same amount as total purchase price for the one-half interest), and, third, the remainder would be split equally between the two owners.

8. Appellants apparently reported the sale of the one-half interest to Marbel on their personal tax returns, when they reported the sale of a home for $1.05 million but did not list an address or specify that it was a one-half interest. Appellants reported a basis of $1.4 million, and therefore reported no taxable gain on the sale. Marble reported its one-half ownership of the property on its returns and records.

9. On May 16, 2003, appellants sold their interest in the residence to third-party individual purchasers for $3.6 million. Neither appellants nor Marbel reported any gain from the sale on their 2003 tax returns. The Seller Final Closing Statement dated May 16, 2003, does not mentioned Marbel. The statement indicates that appellants are the only seller and that they will receive the proceeds of $3.6 million.

<u>"Income Stabilization Plan"</u>

10. Under a plan created by appellants' accountant in the mid-1990s, Mr. David Lindsey (appellant-husband) began using offshore entities to export his medical corporation's untaxed receivables offshore. Then, upon request, he would repatriate the funds through Marbel as reimbursement payments for expenses relating to La Caminita and personal

[3] Assuming the interest rate remained constant, Marbel was to pay appellants interest income of $6,785,020 over the 30-year installment period.

expenses. These payments were characterized as Marbel's one-half ownership obligation on expenses and otherwise as payments on the Note.[4]

Tax Returns

11. Appellants filed California income tax returns claiming married filing joint status for the 2003, 2004, and 2005 tax years. Appellants' 2003 tax return was untimely filed on January 31, 2005, but the 2004 and 2005 tax returns were timely filed within the extended filing period. In 2007, appellants filed an amended 2004 tax return reporting a reduced tax liability to include an amended federal Form K-1 issued by appellant-husband's incorporated medical practice (David E. Lindsey, M.D., Professional Corporation). Respondent accepted the 2003-2005 tax returns as filed and issued refunds accordingly.

Audit

12. Respondent then received information reported on federal Form 1099-S that appellants sold La Caminita in 2003. Respondent audited appellants' 2003-2005 tax years.[5]

13. On June 4, 2008, respondent issued Notices of Proposed Assessment (NPAs) for the 2003, 2004, and 2005 tax years. For 2003, respondent proposed to include the sale price of La Caminita in appellants' gross income. For the 2003 tax year, respondent also proposed to assess an accuracy-related penalty due to a substantial understatement of income tax, as well as a late-filing penalty.

14. The Internal Revenue Service (IRS) audited appellants for 2002 and 2003 and took the position that funds disbursed by Marbel were disbursed according to the Income

[4] Appellants' original position appears to have claimed some of these Marbel payments as increasing appellants' basis in La Caminita. On appeal, appellants revised their position and assert that the only adjustment to basis for construction costs being sought by appellants in this appeal are payments made for improvements during 1991 and 1992.

[5] With regard to the one-half interest sale to Marbel, respondent determined at audit that the transaction was not valid because there was no deed of trust filed with the county recorder and Marbel did not have a legal claim to the sales proceeds. As discussed below, respondent reversed this position on appeal, and now says that the sale to Marbel was valid.

Stabilization Plan.[6] The matter was ultimately resolved with no additional tax assessed from the examination.

Protest

15. Appellant filed a timely protest of the NPAs. At protest, appellants asserted that the cost basis of La Caminita was $1.2 million, and they had made various capital expenditures totaling approximately $2 million. Appellants stated that, of the $2 million, approximately $1.586 million represented alleged payments to the contracting company, YB for work done in 1991 and 1992, and that the remaining amount was for various other capital and non-capital expenses.

16. During protest, respondent allowed appellants: (1) a cost basis of $1.2 million (representing the purchase price); (2) an exclusion of home sale gain in the maximum amount of $500,000 pursuant to Internal Revenue Code (IRC) section 121; (3) substantiated capital improvement expenses of $59,346; and (4) capital selling expenses of $216,249, consisting of commission fees, escrow charges, and a recording fee. Respondent calculated the gain from the sale of the residence as $1,624,405. For the 2003 tax year, respondent reduced the proposed additional tax to $160,128, and made corresponding reductions to the penalty amounts. Respondent determined that appellants did not substantiate the remaining items and made no further adjustments.

17. On September 8, 2011, respondent issued a Notice of Action (NOA) for the 2003 tax year, revising appellants' 2003 tax liability, and NOAs for the 2004 and 2005 tax years, affirming the 2004 and 2005 NPAs. Appellants subsequently filed this timely appeal.

DISCUSSION

Respondent's determination is presumed correct and a taxpayer has the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S.

[6] When asked about the ownership of Marbel at the oral hearing, appellants began to discuss the IRS investigation, noting the involvement of an offshore entity with Marbel, but asserted that, at that time, the "offshore planning" (presumably discussing the Income Stabilization Plan) was legal and proper until the law was changed sometime after 2003.

435; *Appeal of Myers, supra*.) Unsupported assertions are not sufficient to carry a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

IRC section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis as defined in IRC section 1011.[7] IRC section 1011 provides that the adjusted basis for determining the gain from the sale of property shall be the property's initial basis (determined under IRC section 1012 or other applicable sections of that subchapter) with adjustments as provided in IRC section 1016.

Under IRC section 1016, the property's initial basis must be adjusted for capital expenses and capital recoveries. Capital expenses increase the initial basis and capital recoveries decrease the initial basis so that on the date of disposition the adjusted basis reflects the unrecovered cost or other basis of the property. Capital expenses, such as the cost of capital improvements made to the property by the taxpayer, increase the initial basis.

Appellants contend that their gain from the 2003 sale is $267,350, which is below the $500,000 exclusion amount pursuant to IRC section 121 and therefore, they are allowed to exclude the entire gain from gross income.[8] Appellants divided their amount realized and basis by two to reflect the sale of one-half the interest of the property. Appellants' calculation of the gain is as follows:

$3,600,000	Sales proceeds
-$216,249	Selling expenses
$3,383,751	Total amount realized
x 50%	Half interest in the residence
$1,691,876	Share of the amount realized
-$1,424,526	Adjusted basis ($1.2 million + $1,649,052)/2)
$267,350	Appellants' gain

Respondent contends that appellants' gain from the 2003 sale is $1,622,380. Respondent reduced the sales proceeds of $3.6 million by the cost basis of $1.2 million, selling expenses of $216,249, and capital improvements of $61,371. Respondent does not divide the amount

[7] California generally conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

[8] IRC section 121 allows taxpayers, in certain circumstances, to exclude up to $500,000 of gain from the sale of a residence of a married couple filing a joint return.

realized or the basis by two. Respondent allowed an exclusion of $500,000 from gain pursuant to IRC section 121. Respondent's calculation of the gain is as follows:

$3,600,000	Sales proceeds
-$1,200,000	Cost basis
-$216,249	Selling expenses
-$61,371	Capital improvements
-$500,000	IRC section 121 home sale gain exclusion
$1,622,380	Appellants' gain

Appellants initially claimed adjustments to basis for improvements of more than $2.1 million. Appellants now only claim the payments to YB and Mr. Harmon, their architect, totaling $1,649,052. Appellants concede the remaining claimed amounts. To support their claimed basis of $1,649,052, appellants provide a YB "Job Cost Analysis Detailed" from 1992 that states the projected job cost total was $1,586,816, and a 1991 invoice from Mr. Harmon for $62,236. The "Job Cost Analysis Detailed" also shows a handwritten note from the president of YB stating that the schedule accurately shows the "total job costs [and] monies received from David [and] Loryn Lindsey per work performed . . . during 1991 [and] 1992." Appellants also provide correspondence from YB and Mr. Harmon describing the jobs, and a 1995 appraisal describing improvements and valuing the residence at $2.8 million. Appellants also provide a letter from YB dated July 5, 2011, stating that it was paid monthly for the work that was conducted around 1990 to 1991.

Respondent does not dispute that improvements were made to the residence. Instead, respondent contends that appellants have not shown that the improvements were paid with personal funds. Respondent argues that, in some circumstances, appellant-husband requested Marbel reimbursement years after expenses were incurred. Respondent also asserts that the only documented payment to YB occurred in 2003, after implementation of the Marbel arrangement.

However, appellants are only claiming costs that appear to originate from 1990 to 1991, based on the invoices described above, and the evidence provided in the form of invoices and declarations support a finding that payments were made during the years the work was performed. To show they had personal funds to pay for the improvements, appellants provide financial records to show that they obtained bank loans and refinanced the property. If appellants personally funded the improvements, whether through personal loans or otherwise, and were then "reimbursed" years later through loan repayments by a third party, it is unclear whether this would indeed reduce appellants' basis, as asserted by respondent. Rather, it appears that appellants would have an increase in basis, and then the receipt of third-party funds to pay off personal debts would be a subsequent and separate transaction. The tax effect of that second transaction in the subsequent year is unclear, but persuasive arguments have not been provided to suggest it would reduce appellants' basis in the property.

Furthermore, while appellants were provided certain reimbursements according to the Income Stabilization Plan for prior expenditures, the evidence in the record is not sufficient to conclude that the improvements at issue were reimbursed. Although respondent is correct in noting that financial records from the early 1990s were not provided on appeal to trace the source of the payments at issue, reliable and contemporaneous documentation discussed above between appellants and the companies performing the work, as well as the 1995 appraisal value, support appellants' position that they personally made payments toward the improvements claimed. As a result, we conclude that appellants are allowed a basis of $1,649,052.

Pursuant to the 1996 purchase agreement, Marbel became a one-half owner of La Caminita in that year.[9] Accordingly, in computing the gain for the sale of the property in 2003 to a third party, we will first divide the basis of the property in half to reflect that one-half of the property was sold to Marbel. As a result, appellants' basis in the property at the time of the sale in 2003 is $1,424,526, which is the original purchase price of $1.2 million, plus the allowed improvements of $1,649,052, divided by two.

As mentioned above, the property was sold in 2003 for $3.6 million. Appellants argue that the proceeds should be divided in two because one-half of the property was owned by Marbel. However, the Seller Final Closing Statement dated May 16, 2003, does not mention Marbel. The statement indicates that appellants are the only seller and that they alone will be receiving the proceeds of $3.6 million. Therefore, there is no evidence that Marbel was involved in the sale or received any funds.

Furthermore, while appellants assert that the amount realized from the sale must be split evenly between Marbel and appellants, pursuant to the 1996 purchase by Marbel of one-half

[9] Respondent no longer refutes this assertion, and no longer contends that appellants' basis should be adjusted by the $1,050,000 received in that sale.

interest and regardless of how the profits of the sale were actually allocated, appellants ignore the specific profit allocation terms of the 1996 purchase agreement. In that agreement, profits were to be allocated by first paying $23,872 to Marbel, then $1,026,128 to appellants, and then splitting the remainder evenly between the two. Therefore, by the terms of the purchase agreement, appellants were to receive an additional million dollars of the profits over Marbel, and a true fifty-fifty split was never contemplated. Regardless, there is no evidence that these guidelines were followed, and it is necessary to look at the facts of what happened to determine how to allocate the gain from the sale.

The facts show that 100 percent of the proceeds from the sale went to appellants. When asked at the oral hearing about any evidence showing that any payments went to Marbel, appellants indicated that no such documents likely exist, but did refer to the possibility that gain from the sale was allocated to Marbel but then used to pay off appellants' indebtedness pursuant to a preexisting obligation. The only evidence appellants could point to in support of this theory was the 1996 purchase agreement; however, as discussed directly above, the profit allocation terms of that agreement run contrary to appellants' position.

Therefore, appellants' gain from the sale may not be divided in two, as the evidence indicates they received the full amount. Appellants have not met their burden to show that the full sales price was not received and retained by them. As such, we compute appellants' gain as follows:

$3,600,000	Sales proceeds
-$216,249	Selling expenses
$3,383,751	Amount realized
-$1,424,526	Adjusted basis ($1.2 million + $1,649,052)/2)
-$500,000	IRC section 121 home sale gain exclusion
$1,459,225	Appellants' gain

Based on the foregoing, we conclude that appellants' gain is $1,459,225, which is less than respondent's calculation of gain of $1,622,380.

<u>HOLDING</u>

Appellants' gain is revised to $1,459,225, and the proposed assessment and penalties on appeal for 2003 shall be recomputed accordingly.

<u>DISPOSITION</u>

Appellants' gain on the sale of La Caminita in 2003 is revised to $1,459,225. Accordingly, the affected tax and penalties assessed shall be revised to reflect this recomputed gain. Respondent's action is further modified, as conceded on appeal, to abate the failure-to-furnish-information penalties and to allow home mortgage interest deductions of $76,046 for 2003, $42,650 for 2004, and $50,724 for 2005. Respondent's action is otherwise sustained.

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John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
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Richard I. Tay
Administrative Law Judge

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