

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 18042892
G. RIOS)
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OPINION

Representing the Parties:

For Appellant: Steven Toscher, Esq.
Lacey Strachan, Esq.

For Respondent: Bradley W. Kragel, Tax Counsel III

For Office of Tax Appeals: Matthew D. Miller, Tax Counsel III

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, G. Rios (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing \$273,317 of additional tax and applicable interest for the 2012 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Sara A. Hosey, Alberto T. Rosas, and Suzanne B. Brown held a virtual hearing for this matter on May 19, 2021.¹ At the conclusion of the hearing, the record remained open for the parties to provide post-hearing briefing. After each party submitted its post-hearing brief, the record was closed on July 20, 2021, and this matter was submitted for decision.

ISSUE²

Whether appellant has demonstrated that she is entitled to recognize a claimed long-term capital loss in the 2012 tax year.

¹ Although noticed for Sacramento, California, OTA conducted this hearing electronically due to COVID-19.

² Appellant is appealing the entire proposed assessment, including interest. However, appellant has not provided a specific contention regarding interest abatement for the tax year at issue, and we find no apparent grounds for interest relief under the facts.

FACTUAL FINDINGS

1. In 2002, Agua Mansa Lot 23 Investors LLC (Agua LLC) was organized as a limited liability company (LLC) in California. The members of Agua LLC included appellant as trustee of The Rios Family Trust.
2. According to its Articles of Organization, the purpose of Agua LLC was “to engage in any lawful act or activity for which a limited liability company may be organized under the Beverly-Killea limited liability company act.”³ Agua LLC’s Operating Agreement stated that it was formed for the purpose of “acquiring, owning and managing the Property.”
3. In 2002, Agua LLC purchased real property in Riverside, California (the Property) for \$5,850,000.
4. At various times during its ownership, Agua LLC leased portions of the Property to corporations owned by appellant’s children.
5. In 2011, a third party offered to purchase the Property. A majority of Agua LLC’s members voted to sell, but one member, The Rios Family Trust, opposed the sale. In July 2011, the members of Agua LLC entered into a settlement agreement whereby they agreed that a majority of the membership was sufficient to sell the property, and all leases would terminate with the property’s sale.
6. In March 2012, another third party offered to purchase the Property for \$11,000,000, but members of the Rios family objected. In June 2012, Agua LLC filed a complaint in Riverside County Superior Court against The Rios Family Trust, the lessees, and members of the Rios family; the complaint sought to terminate the leases and permit the sale of the property to move forward.
7. On November 14, 2012, Agua LLC sold the Property for \$11,000,000.
8. On February 6, 2013, Agua LLC and the defendants named in the complaint entered into a settlement agreement which stipulated that Agua LLC would distribute \$2,690,000 to The Rios Family Trust no later than February 8, 2013, with the balance of the funds being distributed to Agua LLC’s other members. Additionally, Agua LLC agreed to take all necessary steps to wind up and dissolve the entity as soon as practicable.

³ Former Corp. Code, § 17000, et. seq.

9. On April 10, 2013, Agua LLC filed a Certificate of Cancellation with the California Secretary of State.⁴
10. Agua LLC liquidated appellant's entire interest in the LLC when it issued a check to the Rios Family Trust for \$2,690,000 on February 13, 2013. Agua LLC properly reported this distribution on its 2013 LLC tax return. Agua LLC reported the sale of the Property on its 2012 LLC tax return, and reported cash assets of \$6,662,842, interest income of \$735, and deductions totaling \$24,743 on its 2013 LLC tax return.
11. On October 13, 2013, appellant filed her 2012 personal income tax return, reporting zero taxable income. Regarding Agua LLC, appellant reported zero in ordinary income and a long-term capital loss of \$985,510. Appellant also filed a Notice of Inconsistent Treatment or Administrative Adjustment Request (Form 8082).
12. On April 11, 2014, appellant filed her 2013 personal income tax return, reporting zero taxable income. Regarding Agua LLC, appellant reported a rental loss of \$10,545.
13. FTB audited appellant's 2012 personal tax return and determined that the loss occurred in 2013, when the LLC was terminated.
14. In June 2015, the FTB sent an Information Document Request to appellant asking her to explain the adjustments reported for tax year 2012 on Form 8082. Appellant responded and contended that the loss should be recognized in 2012.
15. FTB issued a Notice of Action (NOA) on January 4, 2018, which disallowed appellant's claimed recognition of her long-term capital loss relating to Agua LLC. The NOA proposed an assessment of \$273,317 in tax and applicable interest. This timely appeal followed.

DISCUSSION

FTB's determinations are presumed correct and a taxpayer has the burden of proving it to be wrong. (*Appeal of Davis and Hunter-Davis*, 2020-OTA-182P (*Davis*)). Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) In the absence of credible, competent, and relevant evidence showing an error in FTB's determinations, FTB's determinations will be upheld. (*Ibid.*) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).)

⁴ Upon filing the Certificate of Cancellation (Form LLC-4/7), an LLC will be cancelled, and its powers, rights and privileges will cease in California. (Corp. Code, § 17707.08(c).)

California incorporates Internal Revenue Code (IRC) sections 701-761 relating to partners and partnerships with certain exceptions. (R&TC, § 17851.) When applying the IRC, California also incorporates Treasury Regulations to the extent that they do not conflict with regulations promulgated by FTB. (R&TC, § 17024.5(d).) The IRS treats multi-member LLCs as partnerships for tax purposes. (Treas. Reg. §§ 301.7701-2(c), 301.7701-3(b)(1)(i).) Multi-member LLCs do not pay taxes on business income; instead, the LLC members each pay taxes on their distributive share of the profits from the LLC on their personal income tax returns. (IRC, § 702.)

IRC section 731 prescribes the treatment for recognition of gains and losses resulting from partnership distributions. It provides:

- (A) Partners.--In the case of a distribution by a partnership to a partner--
- (1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution, and
 - (2) loss shall not be recognized to such partner, except that upon a *distribution in liquidation of a partner's interest* in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of--
 - (a) any money distributed, and
 - (b) the basis to the distributee, as determined under section 732, of any unrealized receivables (as defined in section 751(c)) and inventory (as defined in section 751(d)).

Any gain or loss recognized under this subsection shall be considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.

(IRC, § 731(a), italics added.)

“Liquidation of a partner's interest” is defined as “the termination of a partner's entire interest in a partnership by means of a distribution, or a series of distributions, to the partner by the partnership.” (IRC, § 761(d).) Therefore, a partner may only recognize a partnership (or LLC) loss upon liquidation of her entire interest in the partnership through distributions by the partnership in the form of money, unrealized receivables, and inventory. (Treas. Reg. § 1.731-1(a)(2).)

Here, Agua LLC liquidated appellant's entire interest in the LLC when it issued a check to the Rios Family Trust for \$2,690,000 on February 13, 2013. Agua LLC properly reported this distribution on its 2013 LLC tax return. Under IRC 731, appellant should have reported and

recognized any loss from liquidation of her interest in Agua LLC on her 2013 personal tax return. However, instead appellant reported and recognized the LLC loss on her 2012 personal tax return.

Appellant contends that Agua LLC's sale of the Property on November 14, 2012 triggered a "constructive final liquidating distribution" under IRC section 708(b)(1)(A), as operative during the tax year at issue.⁵ IRC section 708(b)(1)(A), as operative during the tax year at issue, stated, "a partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership." (Former IRC, § 708(b)(1)(A).) Appellant cites a treatise for the proposition: "If a partnership terminates under [IRC section] 708(b)(1)(A) because it ceases to carry on any business, financial operation, or venture, its taxable year closes with respect to all partners and all partnership assets are treated as distributed to the partners." (McKee et. al, *Federal Taxation of Partnerships & Partners (WG&L)*, ¶ 13.05 *Tax Consequences of a Partnership's Termination*.) Appellant contends that after the sale of the Property in 2012, Agua LLC did not retain any partnership business or investment assets; it retained only cash in its bank account. Appellant contends that cash is neither a business asset nor an investment asset, and therefore it is insufficient to prevent a partnership from terminating. However, the treatise also explains:

Generally, however, the activity necessary to prevent a partnership's termination under [IRC section] 708(b)(1)(A) is so minimal that the retention of any partnership business or investment assets is sufficient to keep the partnership alive. Therefore, instead of a [IRC section] 708(b)(1)(A) termination triggering a constructive final liquidating distribution of significant proportions, it is more common for an actual final liquidating distribution to cause a termination under [IRC section] 708(b)(1)(A). Thus, the most significant tax consequence of a [IRC section] 708(b)(1)(A) termination may be the closing of the partnership's taxable year.

(Ibid.)

The relevant case law indicates that a nominal amount of continuing business or financial activity prevents a partnership from terminating under former IRC section 708(b)(1)(A), even

⁵ IRC section 708(b)(1)(A), enacted in 1954, was repealed in 2017 and replaced by a new IRC section 708(b)(1) addressing the same subject matter. (2017 Tax Cuts and Job Act (Pub. Law. No. 115-97), § 13504(a).)

though its primary business activity has ended. In *Baker Commodities, Inc. v. Commissioner* (9th Cir. 1969) 415 F.2d 519, 526-527 (*Baker*), the Ninth Circuit Court of Appeals held that a California partnership did not terminate until all assets of the partnership were distributed to the partners, and all partnership activity ended. In *Baker*, a limited partnership was formed in 1958 for the sole purpose of constructing, owning, and operating a convalescent hospital. The partnership closed the hospital in July 1960, and subsequently sold all assets of the partnership in March 1961. The purchaser gave a promissory note for the purchase price, which was secured by a chattel mortgage and deed of trust. The partnership reported the sale of its assets on its 1961 return, and it reported collections on the installment sale and an asset with an amount due on its 1962 return. (*Id.* at p. 523.) The taxpayer argued that the partnership ceased to exist under IRC section 708(b)(1)(A) when it sold its only asset in March 1961. The court determined that the partnership “did not terminate in March 1961 due to a sale of partnership interests; the sale was of assets and not a going business.” (*Id.* at p. 526, citing *Foxman v. Commissioner* (1964) 41 T.C. 535, 557, *affd.* on other grounds 522 F.2d 466 (3rd Cir. 1965).)

Similarly, in *Harbor Cove Marina Partners Partnership v. Commissioner* (2004) 123 T.C. 64, 83 (*Harbor Cove*), the tax court held that a California partnership did not terminate where its managing general partner failed to wind up its business operation in accordance with the procedures set forth in the partnership agreement. The court noted that a “partnership continues to exist even when its operations are substantially changed or reduced in a period of winding up, and even when its sole asset during that period is cash.” (*Id.* at p. 81, citing Treas. Reg. § 1.708-1(b)(1), (3)(i).) The court relied on an extensive discussion of *Baker*, holding “a partnership’s termination under [IRC] section 708(b)(1)(A) does not occur until the winding up of its business operations is completed.” (*Id.* at p. 84.) And in *7050, Ltd. v. Commissioner*, (2008) 95 T.C.M (CCH) 1413, p. 4 (*7050, Ltd.*), the tax court held that no termination occurred where a Colorado partnership continued to hold foreign currency in an inactive bank account. Citing *Harbor Cove*, the tax court found “Holding Canadian currency in a bank account is quite similar to the kinds of minimal activity that we’ve already found were enough to keep a partnership unterminated. . . [therefore the] partnership interest was not liquidated through 7050’s termination in 2001.” (*Id.* at p. 5.)

In *Davis*, OTA found that after an LLC distributed income following the sale of its interest in another LLC, an individual could not claim a loss because the distribution was not a

“distribution in liquidation” of the taxpayer’s interest under IRC section 731(a). (*Davis, supra*, at pp. 11-18.) OTA determined that because the partnership continued to exist in anticipation of the receipt of funds dependent on the conclusion of litigation, the taxpayer had not established that the partnership terminated. (*Ibid.*) OTA held that a nominal amount of continuing business financial activity precludes a partnership from termination for federal tax purposes. (*Ibid.*)

Apart from the treatise, the only legal authority that appellant cites in support of her position is an unpublished opinion from the Sixth Circuit Court of Appeals, *Goulder v. U.S.*, No. 93-3832, 1995 WL 478595 (6th Cir. Aug. 9, 1995) (*Goulder*). In *Goulder*, a partnership’s apartment building was foreclosed in 1980. The partnership distributed all partnership assets in 1980, except for those retained as representing tenants’ security deposits, which were distributed in 1981. The IRS disallowed the taxpayer’s claimed loss in 1980. The parties filed a joint stipulation of facts with the court which included the following paragraph: “During 1981 the Partnership neither operated or [sic] carried on any business, financial operation, or venture, having ceased any such activity prior to the beginning of such year.” (*Id.* at p. 4.) Noting that the stipulation tracked the language of IRC section 708(b)(1), the court determined that the stipulation was unequivocal, and both the district court and the court of appeals were bound by its terms. (*Id.* at pp. 6-7.) The court acknowledged that public policy and legal precedent required enforcement of the parties’ stipulation: “If a trial judge can, as here, ignore a clear stipulation of the parties, the incentive to enter stipulations is eliminated.” (*Id.* at pp. 7-8.) There is no such stipulation in the case before us. Neither do the facts before us resemble those in *Goulder*, and we do not find it applicable to this case.

Instead, the facts in this case mirror the facts of the controlling Ninth Circuit and tax court precedents, as well as the facts in *Davis*. Agua LLC sold all of its assets in 2012, but it did not distribute in liquidation appellant’s interest in the LLC until 2013, the following taxable year. Agua LLC reported the sale of the Property on its 2012 LLC tax return, and reported cash assets of \$6,662,842, interest income of \$735, and deductions totaling \$24,743 on its 2013 LLC tax return. (See *Baker, supra*, 415 F.2d at p. 523 [partnership reported the sale of property in 1961, and reported cash assets and income on its 1961 tax return].) In 2012, Agua LLC filed a complaint against The Rios Family Trust, the lessee of the property, and members of the Rios family. In 2013, the parties entered into a settlement agreement whereby Agua LLC agreed to take all necessary steps to wind up and dissolve the entity as soon as practicable. (See *Harbor*

Cove, supra, 123 T.C. at p. 83 [partnership did not terminate where the managing general partner failed to wind up its business operation in accordance with the procedures set forth in the partnership agreement – partnership continued to exist until wound up in accordance with agreement]; see *Davis, supra* [partnership did not terminate where it retained assets and had pending litigation].) After Agua LLC sold its primary business asset in 2012, its only asset was currency in its bank account until it distributed the funds in liquidation to the partners in 2013. (See *7050, Ltd., supra*, T.C.M 112, p. 5 [holding currency in a bank account is sufficient minimal activity to keep a partnership unterminated].)


Appellant cites no controlling or persuasive authority to support her contention that Agua LLC’s sale of the Property triggered a “constructive final liquidating distribution” under IRC section 708(b)(1)(A), as operative during the tax year at issue. Accordingly, we find that appellant has not satisfied her burden of showing error in FTB’s determination that appellant should have reported and recognized any loss from liquidation of her interest in Agua LLC on her 2013 personal tax return.

HOLDING

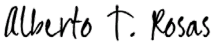
Appellant has failed to demonstrate that she is entitled to recognize a claimed long-term capital loss in the 2012 tax year.


DISPOSITION

FTB’s action is sustained.

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Sara A. Hosey
Administrative Law Judge

We concur:

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Alberto T. Rosas
Administrative Law Judge

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Suzanne B. Brown
Administrative Law Judge

Date Issued: 10/27/2021