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2022 – OTA – 049
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **G. SHAANAN AND** **S. SHAANAN**	) OTA CaseNo. 20076364

OPINION

Representing the Parties:

For Appellants: Mark E. Leinenweber, CPA

For Franchise Tax Board: D'Arcy Dewey, Tax Counsel III

For Office of Tax Appeals: Grant S. Thompson, Tax Counsel IV

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, G. Shaanan (appellant-husband) and S. Shaanan (collectively, appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing $73,066 and $30,328 of additional tax, plus applicable interest, for the 2012 and 2013 tax years, respectively.

Appellants waived their right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether appellant-husband's basis in stock of an S corporation is increased by his pro rata share of guaranteed payments which were received by the S corporation but not includable in his income and the income of the S corporation until the following tax year.
2. Whether appellants' carryover deductions are reduced by deductions erroneously taken in prior tax years that have been closed by the statute of limitations.

FACTUAL FINDINGS

1. Appellant-husband is the sole shareholder of Gadlight, Inc. (Gadlight), an S corporation. During the years at issue, Gadlight used the accrual method of accounting, reported its taxes on a calendar year basis, and had no accumulated earnings and profits.

2. In 2010 and 2011, appellants erroneously deducted, on their California personal income tax returns, $146,394 in charitable and Internal Revenue Code (IRC) section 179 deductions that they claimed passed through to them from Gadlight.[1]
3. In August 2011, Gadlight formed Yofimeter, LLC (Yofimeter), and like Gadlight, Yofimeter used the accrual method of accounting and had a calendar year end. Gadlight provided services to Yofimeter and, in return, received guaranteed payments from Yofimeter.
4. In November 2011, Yofimeter admitted a C corporation as a 50 percent member. Following the admission of the C corporation member, Yofimeter was treated as a partnership for income tax purposes.
5. The C corporation's tax year ended September 30. Due to the admission of the C corporation as a member, Yofimeter's tax year end also changed from the calendar year end to a fiscal year ending September 30.[2]
6. During Yofimeter's *fiscal* tax year ending September 2012 (which began on October 1, 2011, and ended on September 30, 2012) Yofimeter paid Gadlight guaranteed payments for services totaling $1,391,111. Similarly, for Yofimeter's *fiscal* tax year ending September 2013 (which began on October1, 2012, and ended on September 30, 2013), Yofimeter paid Gadlight guaranteed payments for servies totaling $1,915,000. Yofimeter issued Schedule K-1s to Gadlight reporting the $1,391,111 and $1,915,000 it paid to Gadlight during its *fiscal* tax years ending September 2012 and

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[1] The record contains no evidence or allegation that FTB examined or proposed adjustments to appellants' 2010 or 2011 tax returns, and it is undisputed that the deductions shown in the 2010 and 2011 tax returns were erroneous. For the 2010 tax year, the erroneously deducted amounts consisted of $23,002 in charitable contributions and $13,453 in IRC section 179 deductions. For the 2011 tax year, the erroneously deducted amounts consisted of $87,151 in charitable contributions and $22,788 in IRC section 179 deductions. The parties agree that the amounts were erroneously deducted during these years.

[2] Where no single partner owns a majority interest in a partnership, Treasury Regulation section 1.706-1(b)(3) generally requires the partnership to adopt a tax year that results in the least aggregate deferral of income. Under this rule, where a partnership has two 50-percent partners with different tax years, the partnership generally must adopt the tax year of the partner with the tax year that ends earliest. This rule required Yofimeter to change its calendar tax year to a fiscal year ending September 30. As relevant to the issues on appeal, California conforms to the IRC provisions referenced herein. (See R&TC, §§ 17087.5, 17851.) Also, and again as relevant to the issues on appeal, federal regulations pertaining to IRC provisions referenced herein apply for California purposes. (See R&TC, § 17024.5(d).)

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2013, respectively. Gadlight and appellants included these *fiscal* year guaranteed payments as income in their 2012 and 2013 *calendar* year end tax returns.[3]

7. However, during the 2012 *calendar* year (which began on January 1, 2012, and ended on December 31, 2012), Gadlight received guaranteed payments from Yofimeter totaling $1,886,667, which is $495,556 more than $1,391,111 guaranteed payments Gadlight received from Yofimeter during Yofimeters's *fiscal* tax year ending September 2012 (covering October 1, 2011, through September 30, 2012). Similarly, during the 2013 *calendar* year (which began on January 1, 2013, and ended on December 31, 2013), Gadlight received guaranteed payments from Yofimeter totaling $2,039,444, which is $124,444 more than the $1,915,000 guaranteed payments Gadlight received from Yofimeter during Yofimeter's *fiscal* tax year ending September 30, 2013 (covering October 1, 2012, through September 30, 2013). (Collectively, these differences will be referred to as Excess Calendar Year Payments.)

8. As noted above, for the 2012 and 2013 *calendar* tax years, Gadlight and appellants included in income only those guaranteed payments shown on the Schedule K-1s issued to Gadlight by Yofimeter for the relevant *fiscal* tax year. Gadlight and appellants did not include the $495,556 and $124,444 Excess Calendar Year Payments in income for their 2012 and 2013 *calendar* tax year returns.

9. During the 2012 and 2013 calendar years, Gadlight distributed $821,974 and $1,553,149, respectively, to appellant-husband.

10. Appellants filed timely joint California income tax returns for 2012 and 2013.[4] Appellants did not report any taxable distributions from Gadlight and reported pass-through charitable and IRC section 179 deductions from Gadlight that were carried over from prior tax years.

11. FTB audited appellants' 2012 and 2013 tax returns. As relevant to the issues on appeal,

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[3] As discussed later in this opinion, IRC section 706(a) and Treasury Regulation section 1.706-1(a)(1) required Gadlight to match its reporting of guaranteed payments to the tax year in which Yofimeter reported the guaranteed payments. Gadlight therefore properly included these fiscal year guaranteed payments in its income for its 2012 and 2013 calendar year end tax years.

[4] Appellants later filed an amended California tax return to claim a refund for the 2013 tax year. According to FTB, the return claimed research credits which FTB allowed. FTB's Notice of Action for the 2013 tax year allows research credits of $24,519. The research credits are not at issue on appeal.

FTB determined that appellant-husband received taxable distributions in excess of his stock basis for both tax years.[5] As a result of its determination that appellant-husband's basis in Gadlight was exhausted, FTB also disallowed pass-through deductions claimed by appellants.[6] FTB further determined that appellants erroneously carried over deductions that they erroneously took in 2010 and 2011, years that were closed by the statute of limitations.[7]

12. On December 28, 2016, FTB issued Notices of Proposed Assessment (NPAs) proposing $73,066 and $54,728 of additional tax, and applicable interest, for the 2012 and 2013 tax years, respectively.[8]
13. Following protest proceedings, FTB issued Notices of Action (NOAs) affirming its NPA for the 2012 tax year and revising the additional tax proposed per its NPA for the 2013 tax year from $54,728 to $30,328.[9]
14. Appellants then filed this timely appeal.

DISCUSSION

Issue 1: Whether appellant-husband's basis in stock of an S corporation is increased by his pro rata share of guaranteed payments which were received by the S corporation but not includable in his income and the income of the S corporation until the following tax year.

A shareholder of an S corporation must include the shareholder's pro rata share of the S corporation's income. (IRC, § 1366(a)(1).) Specifically, under subparagraph (A) of IRC

[5] Under IRC section 1368(b)(2), for S corporations with no accumulated earnings and profits, distributions in excess of stock basis are treated as gain from the sale or exchange of property.

[6] While a shareholder may also have basis in the indebtedness of the S corporation and may utilize such debt basis to allow the deduction of additional pass-through losses and deductions from the S corporation (see IRC, § 1367(b)(2)), debt basis is not at issue in this appeal.

[7] There is no dispute that, when FTB discovered the erroneous deductions taken by appellants in the 2010 and 2011 tax years, the statute of limitations barred it from proposing assessments for those tax years.

[8] The proposed assessment for the 2012 tax year allowed a $37,745 adjustment to account for a capital loss carryover from 2010. Appellants have not raised any issues or concerns regarding the amount of the capital loss carryover allowed by FTB.

[9] The 2013 NPA was revised to allow the $24,519 research credit appellants claimed on their amended return. The NOA also made a slight adjustment to appellants' itemized deductions adjustment from $139,031 per the NPA to $139,931 per the NOA.

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section 1366(a)(1), the shareholder must take into account the shareholder's pro rata share of the S corporation's "items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder . . . ."[10] Under subparagraph (B) of IRC section 1366(a)(1), the shareholder must take into account the shareholder's pro rata share of the S corporation's "nonseparately computed income or loss," which generally refers to all other items of gross income less deductions allowed to the S corporation. (IRC, §§ 1366(a)(1)(B), 1366(a)(2).)

Pursuant to IRC section 706(a) and Treasury Regulation section 1.706-1(a)(1), Gadlight only included in its income for each tax year those guaranteed payments which were made within Yofimeter's fiscal tax year (i.e., as relevant here, Gadlight excluded from its 2012 and 2013 calendar tax year returns the $495,556 and $124,444 Excess Calendar Year Payments). Under these provisions, a partner (here, Gadlight) only includes in its income those items of income or loss, or guaranteed payments, which were paid or accrued by the partnership (here, Yofimeter) for that taxable year under the partnership's method of accounting. Thus, IRC section 706(a) and Treasury Regulation section 1.706-1(a)(1) provide that the timing of Gadlight's reporting of income, loss and guaranteed payments from Yofimeter is consistent with the timing of Yofimeter's reporting of such items. As a result of these provisions, it is undisputed that Gadlight reported the guaranteed payments correctly.

To determine appellant-husband's pro rata share of Gadlight's income under IRC section 1366(a)(1), Gadlight correctly passed through only appellant-husband's pro rata share of the guaranteed payments Gadlight reported as income for each tax year. Appellant-husband did not include the Excess Calendar Year Payments as income because those payments were not included in Gadlight's income for that year (due to IRC section 706(a) and regulations thereunder). It is undisputed that appellants reported appellant-husband's pro rata share of Gadlight's income correctly.

However, when it comes to the calculation of appellant-husband's basis in Gadlight for the 2012 and 2013 tax years, the parties' positions diverge. Appellants argue that appellant-husband's basis should be increased by his pro rata share of the Excess Calendar Year Payments,

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[10] A separately stated item is an item of income, loss, deduction, or credit that might be treated differently by the shareholder than if the shareholder did not take into account the income separately. So, for example, an S corporation's capital gain or loss might be treated differently by a shareholder of the S corporation depending on the shareholder's own tax situation. (See Treas. Reg. § 1.1366-1(a)(2)(i).)

even though the payments were not included in either Gadlight's or appellants' income for the relevant tax years. FTB disagrees, arguing that appellant-husband only obtains an increase in basis for his pro rata share of Gadlight's income for the tax years at issue. For the reasons discussed below, we find FTB's position is correct.

Appellants' interpretation of IRC section 1367(a)(1) is erroneous because it divorces the basis calculation under IRC section 1367(a)(1) from the determination of the shareholder's pro rata share of income under IRC section 1366(a)(1). IRC section 1367(a)(1) increases a shareholder's basis in the S corporation by the income determined under subparagraphs (A) and (B) of IRC section 1366(a)(1). Specifically, it provides that the basis of a shareholder's stock "for any period" is increased by the sum of the income determined under subparagraphs (A) and (B) of IRC section 1366 (i.e., by the shareholder's pro rata share of the S corporation's income) for "such period." (IRC, §1366(a)(1)(A) & (B).)

For example, if a shareholder taxpayer's pro rata share of an S corporation's income under subparagraphs (A) and (B) of IRC section 1366 for a tax year is $100, the taxpayer obtains a corresponding basis increase of $100 for that tax year. If this were not the case, the shareholder would be taxed twice on the same income: first on his or her pro rata share of the income under IRC section 1366 and again when this income is later distributed to the shareholder.[11] Thus, the basis increase provided by IRC section 1367(a)(1) refers to, and mirrors, the determination of the shareholder's pro rata share of income under subparagraphs (A) and (B) of IRC section 1366(a)(1).

Appellants' interpretation would require us to find that, when IRC section 1367(a)(1) references subparagraphs (A) and (B) of IRC section 1366(a)(1), the meaning of the subparagraphs is different from their meaning in IRC section 1366. Specifically, appellants' interpretation would require us to find that, for the same tax year, subparagraphs (A) and (B) of IRC section 1366(a)(1) *include* Excess Calendar Year Payments for purposes of calculating appellant-husband's basis under IRC section 1367 but *exclude* those same payments for purposes of determining appellant-husband's pro rata share of Gadlight's income under IRC section 1366. We do not find this interpretation persuasive.

The basis increase provided by IRC section 1367(a) is tied to the pass through of a shareholder's pro rata share of income under IRC section 1366. In the tax year when income is

[11] As noted previously, distributions in excess of basis are taxable. (IRC, § 1368(b)(2).)

passed through to the shareholder under IRC section 1366(a)(1), the shareholder obtains a basis increase for the income that passed through to the shareholder.[12]

Appellants contend that *Gitlitz v. Commissioner* (2001) 531 U.S. 206 (*Gitlitz*), supports their position by showing that income may increase basis even if it does not result in taxable income in the year at issue. In *Gitlitz*, the U.S. Supreme Court held that S corporation shareholders could increase their basis by the amount of cancellation of debt (COD) income realized by the S corporation, even though that COD income was not taxable pursuant to IRC section 108.[13] Congress later amended IRC section 108 to close this "loophole." (*Ball ex rel. Ball v. Commissioner* (3d Cir. 2014) 742 F.3d 552, 562 (*Ball*);[14] see also *Powers v. Commissioner*, T.C. Memo. 2013-134, fn. 19 [stating that Congress "effectively abrogated" *Gitlitz*].)

In *Gitlitz*, the Court addressed two questions: first, whether taxpayers may increase their bases in S corporation stock by the amount of an S corporation's COD income that is excluded from gross income under IRC section 108, and second, if so, "whether the increase [in basis] occurs before or after taxpayers are required to reduce the S corporation's tax attributes." (*Gitlitz*, *supra*, at pp. 208-209.) The Court's resolution of these issues does not support appellants' position.

As to the first issue, the Court found that the shareholders' pro rata shares of the COD income passed through to them under IRC section 1366 and therefore increased their tax bases under IRC section 1367. (*Gitlitz*, *supra*, p. 216.) The Court thus linked the inclusion of the taxpayer's pro rata share of S corporation income under IRC section 1366 with the basis increase provided by IRC section 1367. In contrast, appellants' position would break this link and

[12] For this purpose, it does not matter whether the income is tax-exempt income. If an S corporation receives tax-exempt income, the income will increase the taxpayer's basis, even if it is not taxable. (IRC, §§ 1366(a)(1)(A), 1367(a)(1)(A).) If this were not the case, the tax-exempt income would effectively be taxed when it was ultimately distributed to the shareholder.

[13] IRC section 108(a)(1)(B) allows a taxpayer to exclude COD income from gross income to the extent of the taxpayer's insolvency. However, IRC section 108(b) imposes a cost for that exclusion: under IRC section 108(b), the taxpayer's tax attributes, such as net operating losses, are reduced by the amount of the exclusion.

[14] In *Ball*, *supra*, the court declined to extend the reasoning of *Gitlitz* to gain realized from the deemed liquidation of a qualified subchapter S subsidiary.

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provide a basis increase under IRC section 1367 for income that, as confirmed by appellants' own tax reporting, had not yet passed through to appellant-husband under IRC section 1366.[15]

The second issue was a specific statutory sequencing question: whether IRC section 108(b)(4)(A) required a reduction in net operating losses by the amount of excluded COD income before or after IRC section 1367 increases the shareholders' bases by the amount of the excluded income. (*Gitlitz*, *supra*, at pp. 208-209, 218.) As this appeal does not involve IRC section 108 or COD income, this aspect of the Court's decision is not relevant or applicable to this appeal.

Here, IRC section 706(a) and Treasury Regulation section 1.706-1(a)(1) required Gadlight to include guaranteed payments in its income in the same tax year in which the payments were reported by Yofimeter. Pursuant to IRC section 1366(a)(1), appellant-husband took into account his pro rata share of this income in the same year it was included in Gadlight's income, and, pursuant to IRC section 1367, his basis increased during this same tax year. *Gitlitz* did not involve the application of IRC section 706(a) and regulations thereunder, and it does not support appellants' position that appellant-husband obtains a basis increase for income that has not yet passed through to him under IRC section 1366(a)(1).

Appellants also argue that only allowing a basis increase for income that passed through to appellant-husband during the tax year under IRC section 1366 causes double taxation. Specifically, appellants contend that FTB's determination will cause them to be taxed first on the distribution of the Excess Calendar Year Payments in the tax year of the distribution (as those payments will exceed appellant-husband's basis) and then again when the Excess Calendar Year Payments pass through to appellant-husband as income in the following tax year.

We understand appellants' concern but disagree that FTB's determination causes double taxation. When the Excess Calendar Year Payments passed through to appellant-husband as income in the following tax year, appellant-husband obtained a basis increase that was available to: be applied against future distributions such that the distributions would be nontaxable to appellant-husband; allow the pass-through of additional losses or deductions in that tax year or future tax years; or allow a deductible loss on the disposition of his investment in Gadlight.

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[15] In *Gitlitz*, the Court rejected an "implicit" IRS argument that "tax-deferred" income did not pass through to shareholders under IRC section 1366. (*Gitlitz*, *supra*, p. 216.) Here, both parties agree that the Excess Calenar Year Payments did not pass through to appellant-husband under IRC section 1366 until the following year.

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It is true that if appellant-husband had waited to receive a distribution until after the income passed through to him under IRC section 1366, he would have deferred the incurrence of tax. For example, if Gadlight had distributed the 2012 Excess Calendar Year Payments in 2013, rather than in 2012, appellant-husband would not have received a taxable distribution in the 2012 tax year.[16] Instead, he would have incurred tax on the pass through of that income in 2013 and a corresponding basis increase that he could then have immediately used to absorb the distribution of the payments. Thus, he could have taken full advantage of the basis increase in 2013, resulting in tax only on the income in the 2013 tax year.

However, Gadlight distributed the 2012 Excess Calendar Year Payments in 2012, before these payments were recognized as income by Gadlight in its 2013 calendar tax year and before the income passed through to appellant-husband in 2013 under IRC section 1366. As a result, the distribution of the 2012 Excess Calendar Year payments exceeded his 2012 basis and was therefore taxable in the 2012 tax year. Then, in 2013, the income passed through to him and was taxed in the 2013 tax year. If one stopped the analysis here, it might appear that appellants were taxed twice on the same income. However, stopping the analysis at that point would disregard the fact that, when the income passed through to appellant-husband in 2013, he obtained a basis increase that offset distributions made during the 2013 tax year.

By having the 2012 Excess Calendar Year Payments distributed in 2012, rather than in 2013 or a later tax year, appellant-husband accelerated his tax bill, causing tax to be due for the 2012 tax year rather than the 2013 tax year or a later tax year.[17] However, he received the distribution in 2012, not 2013, so it is not surprising that the distribution caused additional tax in the 2012 tax year, rather than in the 2013 or later tax year.[18] Moreover, to the extent that appellants did not obtain an immediate tax benefit from the inclusion of the Excess Calendar Year Payments as income in a tax year, the increase in basis is available to offset distributions or increase deductions and deductible losses in later tax years.

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[16] While we use only the 2012 Excess Calendar Year Payments and the 2012 distribution as an example here, we note that the analysis in this example is equally applicable to the 2013 Excess Calendar Year Payments and the 2013 distributions.

[17] Again, we note that this analysis would be equally applicable to the 2013 Excess Calendar Year Payments which were distributed in 2013, rather than in 2014 or a later tax year.

[18] While taxpayers may organize their affairs as they choose, they must accept the tax consequences resulting from their choices. (*Higgins v. Smith* (1940) 308 U.S. 473, 477.)

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For the foregoing reasons, FTB correctly determined that the Excess Calendar Year Payments did not increase appellant-husband's basis until the tax year when Gadlight recognized such payments as income and appellant's pro rata share of the income passed through to him under IRC section 1366(a)(1)(A).

Issue 2: Whether appellants' carryover deductions are reduced by deductions erroneously taken in prior tax years that have been closed by the statute of limitations.

To prevent double deductions, IRC section 1367(a)(2)(B) reduces the basis of S corporation shareholders by the amount of the S corporation's losses and deductions that pass through to the shareholders under IRC section 1366(a)(1). (*Nathel v. Commissioner* (2d Cir. 2010) 615 F.3d 83, 85.)[19] IRC section 1366(d) provides that an S corporation shareholder's losses and deductions cannot exceed the shareholder's adjusted basis in the S corporation's stock and any debt owed to the shareholder by the S corporation. IRC section 1366(d)(2)(A) generally allows S corporation shareholders to carryforward disallowed losses (due to the basis limitation) to subsequent tax years.

Here, in the 2012 and 2013 tax years, appellants reported and utilized carryover deductions from prior tax years. It is undisputed that these claimed carryover deductions included deductions appellants erroneously took on their 2010 and 2011 tax returns because they exceeded appellant-husband's adjusted basis in Gadlight as of the 2010 and 2011 tax years. Therefore, appellants were not entitled to the $146,394 of deductions. Nevertheless, appellants took the erroneous deductions in the 2010 and 2011 tax years and obtained a tax benefit from them.

After the statute of limitations passed for the 2010 and 2011 tax years, FTB discovered that appellants' claimed carryover deductions included the erroneous deductions that appellants had previously taken in the 2010 and 2011 tax years. On appeal, FTB argues that appellants' attempt to carry over deductions that they previously claimed and deducted in prior tax years is barred by the duty of consistency and the doctrine against double deductions.

[19] Federal cases interpreting S corporation provisions are persuasive where, as is the case with respect to the provisions at issue here, California law conforms to the federal statute. (See *Meanley v. McColgan* (1942) 49 Cal.App.2d 203, 209; *Andrews v. Franchise Tax Bd.* (1969) 275 Cal.App.2d 653, 658.)

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Duty of Consistency

The duty of consistency "precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position." (*Appeal of Davis*, 2020-OTA-182P (*Davis*).) The duty of consistency requires: (1) a representation or report by the taxpayer; (2) on which FTB relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm FTB. (*Davis*, *supra*; *Appeal of Chen and Chi*, 2020-OTA-021P (*Chen*); *Estate of Ashman v. Commissioner*, T.C. Memo. 1998-145 (*Ashman I*), affd. (9th Cir. 2000) 231 F.3d 541 (*Ashman II*).) The second requirement, reliance, is present if FTB accepts the tax return containing the representation or report. (*Ashman II*, *supra*, 231 F.3d 541, 546.) If these requirements are met, the government may act as if the taxpayer's prior representation were true, even if was not. (*Herrington v. Commissioner* (5th Cir. 1988) 854 F.2d 755, 758 (*Herrington*).)

Here, a preponderance of the evidence indicates that appellants' attempt to carry over and deduct amounts previously deducted in prior tax years is barred by the duty of consistency.[20] Appellants claimed the deductions in their 2010 and 2011 tax returns and FTB accepted the returns and thereby relied on appellants' representation that they were entitled to the deductions. Now, after the statute of limitations passed for FTB to adjust appellants' 2010 and 2011 tax returns, appellants attempt to disavow their prior representations that they were entitled to the claimed deductions in 2010 and 2011 and argue that they can, instead, carry over the deductions. The duty of consistency applies to treat appellants' prior representations as if they were true.[21]

[20] As we find that a preponderance of the evidence shows that the duty of consistency applies, the burden of proof is irrelevant. (See *Williams v. Commissioner*, T.C. Memo. 2018-48.) We note that *Ashman I*, *supra*, indicates that the party asserting the duty of consistency has the burden of showing that it is applicable. However, *Chen*, *supra*, and *Davis*, *supra*, state the standard burden of proof, which places the burden of proving factual issues on the taxpayer, in cases that involved the duty of consistency. As applied to the duty of consistency, these statements may be dicta, as *Chen* and *Davis* appear to decide the duty of consistency issue based on the preponderance of the evidence rather than relying on the burden of proof. We further note that *Chen* cites *Ashman I*, *supra*, which, as noted above, states that the party asserting the duty of consistency has the burden of showing that it applies, and *Davis* cites *Ashman II*, which affirmed *Ashman I*.

[21] See *Herrington*, *supra*; *Coldiron v. Commissioner*, T.C. Memo. 1987-569 [applying the duty of consistency to bar S corporation shareholders from obtaining an additional loss from deductions they had erroneously taken in prior tax years]; *Stoecklin v. Commissioner*, T.C. Memo. 1987-453 [applying the duty of consistency to prevent an S corporation shareholder from disavowing a prior representation to claim short-term capital losses].

Therefore, appellants are treated as if they were, in fact, entitled to the deductions in 2010 and 2011. As a result, they cannot carry over and apply the deductions in later tax years.

Appellants argue that their 2010 and 2011 tax returns contained "self-evident errors," that an inspection of the returns would have revealed the errors and inconsistencies, and that the returns "do not rise to the level of a report upon which the FTB relied for the purposes of the duty of consistency." In this respect, appellants note that their 2010 federal return was attached to their 2010 state return and that their federal Schedule D listed "DISTRIBUTIONS IN EXCESS OF BASIS – GADLIGHT, INC." totaling $37,745.[22] Appellants further note that an S corporation shareholder may not claim deductions in excess of basis and contend that it was evident from the return alone that if the basis in the S corporation was exhausted by reductions for distributions to the shareholder, there would not be sufficient basis for the pass through deductions claimed on the return.

However, by claiming the deductions at issue, appellants represented that they were entitled to the deductions, even if an examination of the schedules attached to appellants' 2010 federal returns might have cast doubt on that representation. (*Ashman II*, *supra*, at p. 546.) Therefore, we find appellants represented that they were entitled to the claimed deductions.

A review of the returns might have caused FTB to question whether appellants correctly stated in their 2010 federal return that they had received distributions in excess of basis, and whether they were entitled to the claimed deductions. However, the duty of consistency does not require that FTB have reviewed or examined the returns in order to have relied on the returns. (*Ashman II*, *supra*, at p. 546; *Herrington*, *supra*, at p. 758; *Arberg v. Commissioner*, T.C. Memo. 2007-244.) It is sufficient that appellants claimed the deductions on the prior returns and FTB accepted the returns and allowed the claimed deductions. (*Ibid*.) [23]

[22] Appellants also note that a statement attached to their 2010 federal return lists charitable contribution of $42,577 as being "FROM K-1 – GADLIGHT, INC" and that their 2010 federal Form 4562 shows a total allowable pass-through of IRC section 179 expense in the amount of $24,902. Appellants do not provide any documentation for their 2011 tax return. They instead state that "[t]he tax preparer did not have sufficient information to complete an analysis of basis for preparation and timely filing of the 2011 return."

[23] FTB also argues that the doctrine against double deductions bars appellants from deducting in the 2012 and 2013 tax years those pass-through expenses from Gadlight they previously and erroneously deducted in the 2010 and 2011 tax years. However, because we have already concluded that these deductions are barred by the duty of consistency, we do not need to reach the issue of whether they are also barred by the double deduction doctrine.

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Appellants Net Operating Loss Carryover (NOL) Argument

Appellants also argue that we should apply authorities requiring that NOL carryovers and credit carryovers be calculated based on the actual amount of income and losses in closed years rather than reported amounts. (See, e.g., *State Farming Co., Inc. v. Commissioner* (1963) 40 T.C. 774, 781 (*State Farming*); *Hill v. Commissioner* (1990) 95 T.C. 437, 445 – 446 (*Hill*).) However, as FTB points out, the authorities cited by appellants regarding NOL and credit carryovers do not entitle taxpayers to obtain a double tax benefit by claiming the same deductions twice.[24] Therefore, appellants' attempt to carry over deductions they previously (but erroneously) used in a prior tax year is not supported by the NOL and credit carryover authorities that appellants cite as support for their position.

For the foregoing reasons, appellants are not entitled to carryover deductions that they erroneously claimed in 2010 and 2011.

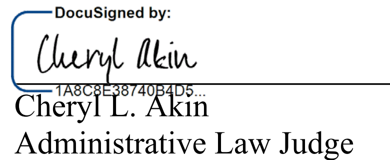
[24] If a taxpayer omitted taxable income in a closed year, the taxpayer generally may not again benefit from that error by claiming NOLs that would have been absorbed if the taxpayer had reported all its taxable income. (See, e.g., *State Farming*, *supra*, at pp. 780–782; *Hill*, *supra*, at p. 445.)

HOLDINGS

1. Appellant-husband's basis in stock of an S corporation is not increased by his pro rata share of guaranteed payments which were received by the S corporation but not includable in his income and the income of the S corporation until the following tax year.
2. Appellants' carryover deductions are reduced by deductions erroneously taken in prior tax years that have been closed by the statute of limitations.

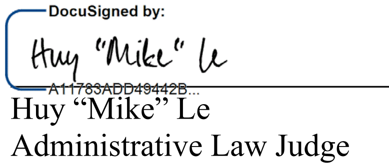
DISPOSITION

FTB's actions are sustained.

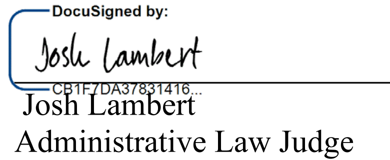


Cheryl L. Akin
Administrative Law Judge

We concur:



Huy "Mike" Le
Administrative Law Judge



Josh Lambert
Administrative Law Judge

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