OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 20056185
D. GOTTLIEB AND	)
S. GOTTLIEB	)
	)
	)

OPINION

Representing the Parties:

For Appellants:	Philip Garrett Panitz, Esq.
For Respondent:	Brian Miller, Tax Counsel III Sonia Woodruff, Tax Counsel IV
For Office of Tax Appeals:	Linda Frenklak, Tax Counsel V

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellants D. Gottlieb and S. Gottlieb appeal actions by respondent Franchise Tax Board proposing additional tax of $133,198, plus interest, for the 2011 tax year, additional tax of $124,727.17, plus interest, for the 2012 tax year, additional tax of $113,059, plus interest, for the 2013 tax year, additional tax of $132,664, plus interest, for the 2014 tax year, and additional tax of $129,616, plus interest, for the 2015 tax year.[1]

Office of Tax Appeals Administrative Law Judges John O. Johnson, Cheryl L. Akin, and Josh Aldrich held an electronic oral hearing for this matter on September 28, 2021. At the conclusion of the hearing, the record was thereafter closed on October 5, 2021, and this matter was submitted for decision.

[1] Included in these proposed additional tax amounts is the mental health services tax, calculated at the rate of one percent on the portion of taxable income in excess of one million dollars. (R&TC, § 17043.)

ISSUES

1. Whether appellants are entitled to deduct their gallery's losses from their gross income for any of the tax years at issue.
2. Whether appellants are entitled to deduct losses from Daniel Gottlieb Business Management (DGBM) from their gross income for any of the tax years at issue.[2]

FACTUAL FINDINGS

1. Appellants owned a single member limited liability company (LLC) treated as a disregarded entity for tax purposes, G2 Gallery LLC, which purchased commercial property (AKB)[3] located on Abbott Kinney Boulevard in Venice, California, on October 2, 2007, for $4,536,000. On March 20, 2018, G2 Gallery LLC sold AKB for $12,250,000. In 2018, appellants reported a gain of $7,524,139 from their sale of AKB on line 6 of their 2018 federal Form 4797.
2. On March 8, 2008, appellants began operating their solely owned gallery, G2 Gallery (the gallery), in the building on AKB. Appellants' gallery displayed and sold photography, as well as jewelry and other items made by artists, and books. The gallery ceased operations when appellants sold AKB in 2018.
3. During the tax years at issue, appellant-husband was also the sole proprietor of DGBM, which managed the finances and affairs of clients in the entertainment industry.[4]
4. Appellants filed joint federal income tax returns (i.e., Form 1040s) for 2011, 2012, 2013, 2014, and 2015. On the couple's 2011-2015 federal returns, appellant-husband reported his occupation as real estate development[5] and appellant-wife reported her occupation as nurse. Appellants calculated and reported their taxable income for California purposes

[2] Included in this issue is appellants' preliminary argument that the issue of DGBM losses was conceded by respondent prior to the filing of this appeal.

[3] The commercial property consists of a building, referred to as the Abbot Kinney Building or AKB by the parties, as well as the land on which the building sits. Both the land and building were bought and sold together and are treated as a single property for purposes of this appeal.

[4] Based on appellants' arguments provided at the hearing and in a prehearing memorandum, it appears that DGBM had one client during the years at issue.

[5] Relying on a Bloomberg printout, a copy of which was provided on appeal, respondent states that appellant-husband "was a board member of G&L Realty Corporation, which offers real estate trust services" and "invested in medical office buildings, and other retail sectors."

based on their 2011-2015 federal returns, on which appellants reported the following amounts of DGBM losses and gallery losses:[6]

Tax year	DGBM Losses	Gallery Losses
2011	$113,822	$1,184,676
2012	$110,394	$827,550
2013	$153,601	$693,462
2014	$176,262	$764,746
2015	$192,046	$782,508

5. Respondent audited appellants' California returns for the years at issue and sent appellants an Information Document Request (IDR) dated May 12, 2015.[7] This IDR requested information and documents concerning the gallery, including a detailed written description of the gallery's business operations, books and records, all operating budgets from its inception, a detailed written explanation of appellants' role in its business operations, a detailed schedule listing its business activities that involved appellants, including the total annual hours worked in each activity, and copies of cancelled checks, invoices, wire transfer receipts and any other documents that substantiated the gross receipts and cost of goods sold that the gallery reported.

6. In response to the IDR, appellants' tax preparer provided the auditor with a document that describes the gallery, which is entitled "G2 Gallery LLC (G2)."[8] This document explains that appellants have operated the gallery through a single member LLC since it was established in early 2008. The document states, "The purpose of the gallery is to provide a stream of income to be donated by [appellants] to various wildlife and environmental causes while at the same time they are building a reputation as one of the

[6] During the years at issue, appellants reported income and expenses for both the gallery and the AKB real estate activity on Schedule Cs for G2 Gallery LLC. DGBM information was listed on separate Schedule Cs.

[7] The audit was originally opened for tax years 2011, 2012, and 2013, and the remaining two years at issue were timely added to the audit in December 2016. Respondent indicated that appellants' federal returns were not audited.

[8] Appellants challenge the source of this document, i.e., Exhibit F, stating, "There is no indication on Exhibit F who prepared this exhibit." In response, respondent clarified the source of the document by noting that this document was sent via facsimile on June 15, 2015, from the facsimile number which is the same number listed on appellants' FTB Form 3520, Power of Attorney. We note that appellants were represented by their tax preparer during the audit, and have different representation on appeal.

premier and respected private art galleries in California." The document asserts that the gallery's profit motive consists of the artwork sales and the appreciation of AKB. The document states that the gallery's unnamed manager and other employees "are experienced professionals in the art world," appellant-wife works at the gallery "between two and three days per week," and she "works closely" with the gallery's unnamed "Art Director/Manager to determine the direction and artist for each of the numerous shows and each year." The document states that appellant-husband "concentrates on the financial side of the business and meets with the Art Director/Manager weekly to review the financial affairs of the business."

7. The auditor determined that appellants were not entitled to deduct losses for the gallery or DGBM for 2011-2015 because neither of these two activities were operated for profit during these years.[9] After disallowing all the claimed losses listed on the Schedule C for DGBM and the Schedule C for G2 Gallery LLC, the auditor adjusted the itemized deductions and revised appellants' California taxable income, resulting in proposed additional tax in the amounts at issue on appeal, and a mental health services tax for each of the years at issue.

8. Respondent issued appellants Notices of Proposed Assessment (NPAs) for each tax year at issue on April 5, 2017.

   a. The NPA for 2011 increased appellants' reported taxable income as a result of disallowed Schedule C deductions of $1,298,498 and allowed itemized deductions of $5,322. The NPA proposed a mental health services tax of $68,691 and additional tax of $133,198, plus interest.

   b. The NPA for 2012 increased appellants' reported taxable income as a result of disallowed Schedule C deductions of $937,944 and allowed itemized deductions of $147. The NPA proposed a mental health services tax of $227,106 and additional tax of $124,727.17, plus interest.

[9] This determination did not deny that any expenses were incurred, but rather limited any such expenses to be offset only against any income attributable to gallery and DGBM activities, and disallowed the claim deduction of these losses against ordinary income appellants' earned from other activities and sources.

c. The NPA for 2013 increased appellants' reported taxable income as a result of disallowed Schedule C deductions of $850,063.[10] The NPA proposed a mental health services tax of $52,389 and additional tax of $113,059, plus interest.

d. The NPA for 2014 increased appellants' reported taxable income as a result of disallowed Schedule C deductions of $941,008 and disallowed itemized deductions of $56,460. The NPA proposed a mental health services tax of $330,313 and additional tax of $132,664, plus interest.

e. The NPA for 2015 increased appellants' reported taxable income as a result of disallowed Schedule C deductions of $974,554. The NPA proposed a mental health services tax of $269,029 and additional tax of $129,616, plus interest.

9. Appellants protested the 2011-2015 NPAs with respect to the disallowed gallery losses. During protest, appellants provided a letter stating, "The taxpayer and his financial advisors did extensive research on the operations of an art gallery and had created a business plan in advance of the original acquisition." The letter states that the taxpayer and his financial advisors interviewed several people and chose an individual (Ms. Hansen) "to run the art gallery." The letter does not indicate the dates of Ms. Hansen's employment at the gallery. With respect to the gallery's lack of profits, the letter states:

> While [the gallery] was not profitable on a current cash basis for its entire existence, the appreciation of the building was the greatest profit motive for continuing in spite of annual operating shortfalls. As seen from the historical sales figures, nearly each year the retail sales amounts increased on a year over year basis and thereby reduced the reported losses. Certain expenses were reduced, particularly payroll. Expenses and costs were continually reviewed and reduced as necessary which also reduce cash losses.

The letter describes appellant-husband as a successful real estate professional with extensive experience in real estate development and redevelopment who "has never lost

[10] We note that the amount of disallowed Schedule C deductions listed for the 2013 tax year on respondent's NPA is $3,000 greater than the aggregate of the disallowed DGBM and gallery losses. However, as this difference is not contested or argued by the parties and we do not have complete returns to analyze, coupled with the fact that it represents a de minimis amount in relation to the appeal (i.e., 0.3 percent of the disallowed deductions for one of the years at issue), we do not further address this distinction other than to request that respondent verify the calculations are correct and to take any appropriate action should a miscalculation exist.

money on a real estate deal." The letter indicates that, after offsetting the losses from the gallery from 2008 through 2018, G2 Gallery LLC sold AKB on March 20, 2018, for a net gain of $776,481. Lastly, the letter states:

> In summation, [appellant-husband] purchased this building to make a profit, and did in fact make a profit even after the losses that were incurred through the operations of [the gallery] were offset. In order to have the building appreciate, it was his opinion that operating a business in keeping with the type of businesses in the trendy, bohemian, chic area known as "Abbott Kinney" (due to its location on or around Abbott Kinney Boulevard) would further that objective. Abbott Kinney is an area where there are numerous art galleries, clothing boutiques, chic and trendy eateries, and pubs. His decision to operate the [gallery] did in fact lead to the overall profit of the *collective enterprise*, namely that the real estate would appreciate and the entire endeavor taken as a whole would lead to a profit. It did.[11] (original italics.)

10. Appellants provided respondent a document entitled, "Original 2008 Business Plan and Projections." The business plan states that the gallery "will be a leader in nature exhibition, charitable giving and environmental education." The business plan provides that the gallery's mission "is to support and promote an active participation in the conservation of our earth through the exhibition of some of today's most recognized wildlife and landscape photographers." It states that additional clientele will be achieved by offering the building "rent free to environmental non profit [*sic*] organizations to host events and fundraisers." According to the business plan, it typically requires galleries "five years to break even." Attached to the business plan submitted with appellants' reply brief is an eight-page 2008 budget, which lists total building improvements of $218,000, total expenses of $716,300 and total income of $139,000.

11. Appellants provided respondent three documents that provide job descriptions and salaries for the gallery's director, marketing employee, and operations employee. One document shows that the director's assigned duties included working "with gallery owners to maintain mission and evolve direction of gallery," and included tasks related

[11] Listed as attachments to the letter were copies of the Original 2008 Business Plan and Projections, Ms. Hansen's resume, a Schedule of Loss History of G2 Compared to Gain on Sale of Building, closing escrow statements for the sale of AKB, and documents that substantiate the charitable contributions for 2011-2014.

to hiring and managing staff, maintaining exhibits and events schedule, and overseeing inventory and bookkeeping. The second document shows that the marketing employee's assigned duties included various public relations tasks, and the third document shows that the operations employee's assigned duties included bookkeeping and inventory tasks.

12. Appellants provided respondent a document entitled, "Loss History of G2 Gallery LLC," which lists total accumulated cash losses of $6,265,087 for 2008 through 2016 (net of depreciation claimed). It also shows a gain on the sale of AKB of $7,042,568 consisting of the sale price of $12,250,000 less the original cost of $5,207,432. The document states that there is an excess of gain of $776,481 based on the "sale over accumulated [cash] losses."[12]

13. Appellants provided respondent with a letter dated October 13, 2015, from an executive managing director of Jones Lang LaSalle, a commercial real estate services company. This letter provides the following "Broker's Opinion of Value" concerning AKB, "Given [AKB]'s condition, the lack of available product in the market, and the exceptionally strong capital markets environment for retail properties in Abbot Kinney, we estimate that [AKB] would trade for a price of approximately $14,500,000 or $2,300 per square foot."

14. Appellants provided respondent a letter dated August 19, 2016, from an assistant manager of John Aaroe Group, a real estate brokerage company. This letter states that AKB's estimated value was approximately $18,500,000 "[b]ased on the recent values in Venice and all of the upgrades that are happening now."

15. Respondent issued Notices of Action for all tax years at issue, affirming each of the NPAs. This timely appeal followed.

16. On appeal, respondent produced a printout from the gallery's website[13] that lists the non-governmental organizations (NGOs), i.e., charities, that the gallery supported with total monetary contributions of $1,200,000 since its opening on March 8, 2008.

[12] When the listed cash losses amount of $6,265,087 are applied against the gain from the sale in the amount of $7,042,568, it results in $777,481, or $1,000 more than appellants' calculation of sale over accumulated cash losses. This difference does not impact our analysis herein.

[13] The top of this document shows the following: "Past Nonprofits - G2 Gallery" and "https://www.theg2gallery.com/we-support/past-nonprofits/".

17. In their reply brief, appellants state that "[t]hey hired a manager for [the gallery] with extensive experience in the art gallery field," and provided copies of Ms. Hansen's resume and application for the position of gallery director dated November 13, 2007.

DISCUSSION

Gross income means all income from whatever source derived, unless specifically excluded. (R&TC, §§ 17071, 17085; Internal Revenue Code (IRC), §§ 61(a)(8)-(10), 72, 408(d).) The taxpayer bears the burden of establishing entitlement to any deductions claimed through credible evidence, other than mere assertions, showing that the deduction claimed falls within the scope of a statute authorizing the deduction. (*Appeal of Robinson*, 2018-OTA-059P.) A taxpayer's failure to introduce evidence that is within his or her control gives rise to the presumption that the evidence, if provided, would be unfavorable to his or her position. (*Appeal of Bindley*, 2019-OTA-179P.) There is a presumption of correctness as to respondent's denial of deductions. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Janke* (80-SBE-059) 1980 WL 4988.)

IRC section 162(a) allows a taxpayer to deduct all the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business.[14] An activity is a trade or business that qualifies for a deduction under IRC section 162 "only if the taxpayer's 'predominant, primary or principal objective' for engaging in it is to make an economic profit independent of tax savings." (*McMillan v. Commissioner,* T.C. Memo. 2019-108, quoting *Wolf v. Commissioner* (9th Cir. 1993) 4 F.3d 709, 713, affg. T.C. Memo. 1991-212; see also *U.S. v. Am. Bar Endowment* (1986) 477 U.S. 105, 110, fn.1 [the standard test for the existence of a trade or business is whether the activity was entered into with the dominant hope and intent of realizing a profit].)

IRC section 183 provides that a taxpayer is generally not allowed to deduct expenses incurred in connection with an activity not engaged in for profit (i.e., "hobby losses"), to offset taxable income from other sources. (IRC, § 183(a)-(b); Treas. Reg. § 1.183-2(a); see also IRS FS-2008-23 (June 2008), Is Your Hobby a For-Profit Endeavor?) Rather, IRC section 183 "permits a taxpayer to offset expenses incurred in a not-for-profit activity against income from that activity up to the amount of the income." (*Portland Gold Club v. Commissioner* (1990)

[14] Federal rules regarding itemized deductions, including those referenced herein, are generally adopted into California law, with some exceptions not applicable to this appeal, pursuant to R&TC section 17201.

497 U.S. 154, 164, fn. 15; see also *Vest v. Commissioner*, T.C. Memo. 2016-187.) IRC section 183(c) defines the term, "activity not engaged in for profit" as any activity other than one for which deductions are allowable under IRC sections 162 or 212(1) or (2).

Issue 1: Whether appellants are entitled to deduct their gallery's losses from their gross income for any of the tax years at issue.

Whether the gallery and real estate activity constitute a single activity[15]

When a taxpayer is engaged in more than one activity, each of the activities may be a separate activity, or the activities may constitute a single activity. (Treas. Reg. § 1.183-1(d)(1).) When a taxpayer engages in two or more separate activities, the deductions and income attributed to each separate activity may not be aggregated when determining whether a particular activity is engaged in for profit or in applying IRC section 183. (*Ibid*.)[16] Treasury Regulation section 1.183-1(d)(1) provides that, when determining whether and to what extent IRC section 183 and its regulations apply to an activity, we must first address the threshold issue of the scope of the activity under review, and, specifically, whether appellants' two undertakings discussed here constitute a single activity. (*Crile v. Commissioner*, T.C. Memo. 2014-202; see also *Toppings v. Commissioner*, T.C. Memo. 2007-92.)

"In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account." (Treas. Reg. § 1.183-1(d)(1).) Significant facts and circumstances include: (1) the degree of organizational and economic interrelationship of various undertakings; (2) the business purpose which is (or might be) served by carrying on the various undertakings separately or together; and (3) the similarity of various undertakings. (*Ibid*.)

[15] There is no contention that the activities of DGBM were in any way involved with either the gallery or the real estate activity.

[16] When two activities are treated as a single activity that results in a net profit in at least three of the last five consecutive tax years, there is a general presumption under IRC section 183(d) that the taxpayer operated the loss-generating activity with the intent to make a profit. The general presumption set forth in IRC section 183(d) does not apply in this appeal, because the gallery activity did not produce income in excess of deductions for any of the years of its operations. (See *Mitchell v. Commissioner*, T.C. Memo. 2006-145.)

The taxpayer's characterization of various undertakings as a single activity or as separate activities will generally be accepted unless it appears that the taxpayer's "characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case."[17] (*Ibid*.)

Here, the parties dispute whether the activity to be considered under IRC section 183 encompasses the AKB real estate activity and the gallery activity or, alternatively, only the gallery activity. Appellants argue that the AKB real estate activity and the gallery activity constitute a single activity for purposes of determining whether they operated the gallery for profit. Appellants state that buying AKB and operating a gallery inside the building "was all part of an integrated plan to make a profit by increasing the value of the building and then selling it." They state that "as part of the integrated plan to make a profit, the building had to be consistent with the upscale gentrification of the neighborhood known as Abbott Kinney," which they describe as a redeveloped neighborhood that includes "numerous art galleries, boutique clothing stores, quaint restaurants, bars and pubs." According to appellants, "they had to maintain the building as an integral part of the Abbott Kinney neighborhood by operating a gallery inside the building" if they were to increase the value of the building to sell it at a profit. Appellants state that "the art gallery improved the building's net worth."

Respondent argues that pursuant to Treasury Regulation section 1.183-1(d)(1), appellants' characterization of the AKB real estate activity and the gallery activity as one activity is artificial and is not reasonably supported by the facts and circumstances. Respondent contends that the gallery activity was not economically interrelated with the AKB real estate activity and these two undertakings cannot be aggregated for purposes of determining whether appellants operated the gallery for profit. Respondent states that "third-party real estate valuations made while [a]ppellants owned the building did not cite the gallery as a factor in the building's rising market value." Respondent also states that the "valuations cite to the real

[17] For example, the U.S. Tax Court has held that reporting two activities separately on federal returns constitutes an admission by a taxpayer that the two activities are separate activities. (See *Den Besten v. Commissioner*, T.C. Memo. 2019-154; *Topping v. Commissioner*, *supra*.) Here, appellants may have listed depreciation or IRC section 179 expense deductions relating to the real estate activity on the same Schedule C as the expenses for the gallery, but the record is unclear. Furthermore, appellants have not provided any evidence or arguments establishing which of the disallowed deductions may be related to the real estate activity rather than the gallery, and thus no adjustments to respondent's proposed assessments are warranted in that regard.

estate's location as the reason for appreciation" and they "make no mention of [a]ppellants' contention that a specific kind of business made any difference in the building's appreciation."

Treasury Regulation section 1.183-1(d)(1) addresses the issue of whether a taxpayer's acquisition or holding of land should be considered part of another activity, farming, for purposes of IRC section 183.[18] This provision states that when land is purchased or primarily held with the intent to profit from an increase in the land's value and the taxpayer engages in farming on the land, "the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value." Under this rule, farming and holding land is considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity that are not directly attributable to the holding of land, such as interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land. (Treas. Reg. § 1.183-1(d)(1).)

In *Purdey v. Commissioner*, T.C. Memo. 1989-657, the taxpayer conducted a thoroughbred horse breeding and racing activity at his ranch, where he kept horses of racing age. Applying Treasury Regulation section 1.183-1(d)(1), the tax court held that the value of the ranch was not relevant to the issue of whether the taxpayer engaged in the horse breeding and racing activity for a profit. Quoting this provision, the tax court stated, "even assuming that the [land] was 'purchased or held primarily with the intent to profit from increase in its value,' [the taxpayer] has not met the second requirement of the regulation, namely, that the activity [at issue] 'reduces the net cost of carrying the land for its appreciation in value.' " The tax court found that the taxpayer's thoroughbred breeding and racing activity did not produce income in excess of deductions, even after disregarding deductions "attributable to the holding of the land." The tax court also found that the taxpayer's land would have increased in value regardless of whether or not the taxpayer conducted his thoroughbred breeding and racing activity on the land.

Respondent contends that the gallery activity is analogous to the farming activity described in Treasury Regulation section 1.183-1(d)(1). Respondent thus argues that the gallery

[18] Appellants argued at the oral hearing that reliance on this regulatory section is incorrect since it is specifically designed for farming, not for running an art gallery. However, as shown in *Purdey v. Commissioner*, T.C. Memo. 1989-657, the regulation is persuasive to analyzing the scope of an activity alongside land ownership for activities beyond simply farming.

activity and the AKB real estate activity could only be considered a single activity if the gallery's income reduced the net cost of carrying AKB for its appreciation value. Respondent also contends that the facts in this appeal are similar to the facts in *Purdey v. Commissioner*, *supra*. Respondent thus argues that the gallery was a separate activity from the AKB real estate activity because the gallery activity sustained losses in excess of deductions, even after disregarding deductions attributable to the holding of AKB.

Appellants, conversely, argue that the grouping of the real estate activity and the gallery should be respected and is not artificial. Appellants asserted at the oral hearing that both activities were "part of the same profit motive, which was to enhance the value of the building to ultimately sell the building for a profit," which was accomplished when they sold the building. Appellants also refer to the fact that, while the gallery had its own employees, they ultimately reported up the line to appellants' CFO who completed their tax returns, and all amounts flowed to appellants through their various LLCs. Appellants also emphasized that both activities operated at the same physical location of AKB.

Applying the requirements of Treasury Regulation section 1.183-1(d)(1), we conclude that the AKB real estate activity and the gallery activity are not entitled to be characterized as a single activity for purposes of IRC section 183. Most importantly, appellants have not established that the gallery activity reduced the net cost of holding AKB. The gallery's Schedules C for the tax years at issue show that the gallery failed to produce income in excess of deductions, even after disregarding deductions attributable to the holding of AKB. (See Treas. Reg. § 1.183-1(d)(1); *Purdey v. Commissioner*, *supra*.) Furthermore, the other criteria identified in Treasury Regulation section 1.183-1(d)(1) do not support a finding that these two activities constituted a single activity. Although the gallery was located inside the building, there is no organizational and economic interrelationship between the AKB real estate activity, which involved purchasing, holding, and selling real estate for profit, and the gallery activity, which involved operating a gallery that primarily exhibited and sold the photographs of wildlife and landscape photographers. These two activities had independent business purposes. The AKB real estate activity's business purpose was to invest in real estate for profit. As stated in the gallery's business plan, the gallery's mission was "to support and promote an active participation in the conservation of our earth[.]" Similarly, the document entitled "G2 Gallery LLC (G2)" states, "The purpose of the gallery is to provide a stream of income to be donated by

[appellants] to various wildlife and environmental causes while at the same time they are building a reputation as one of the premier and respected private art galleries in California." In addition, there is no similarity in the various undertakings of the AKB real estate activity and the gallery activity for the reasons stated above. (See Treas. Reg. § 1.183-1(d)(1); *Crile v. Commissioner*, *supra*.)

Although appellants argue that the operation of the gallery increased the value of AKB, they have produced no independent evidence that supports this self-serving statement. The two appraisals that appellants submitted concerning AKB's value in 2015 and 2016 make no reference whatsoever to the presence of the gallery in the building. In addition, the gallery apparently ceased operations when appellants sold AKB. Accordingly, we conclude that for purposes of applying IRC section 183 with respect to the disallowed gallery losses for the tax years at issue, the AKB real estate activity and the gallery activity are separate activities.[19]

Whether the Gallery Was Engaged in for Profit

Now that it is determined that the gallery and real estate activities were separate activities, it must be determined whether the gallery, on a standalone basis, was engaged in for profit or if its expenses constitute hobby losses. Treasury Regulation section 1.183-2(a) provides, "Although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the objective of making a profit." This provision also states that "[t]he determination whether an activity is engaged in for profit is to be made by reference to objective standards, taking into account all of the facts and circumstances of each case" and "greater weight is given to objective facts than to the taxpayer's mere statement of his [or her] intent." (Treas. Reg. § 1.183-2(a); See also *Nix v. Commissioner*, T.C. Memo. 2018-116.)

Treasury Regulation section 1.183-2(b) sets forth the following factors to be considered in determining whether an activity is engaged in for profit:

(1) manner in which the taxpayer carries on the activity;
(2) the expertise of the taxpayer or his or her advisors;
(3) the time and effort expended by the taxpayer in carrying on the activity;
(4) expectation that assets used in the activity may appreciate in value;
(5) the success of the taxpayer in carrying on other similar or dissimilar activities;
(6) the taxpayer's history of income or losses with respect to the activity;

[19] It is therefore unnecessary for us to analyze whether the AKB real estate activity was operated for profit, and our analysis turns only to the question of whether the gallery activity was operated for profit.

(7) the amount of occasional profits, if any, which are earned;
(8) the financial status of the taxpayer; and
(9) elements of personal pleasure or recreation.

Under Treasury Regulation section 1.183-2(b), no single factor is determinative, the list is not intended to be exclusive, and a determination is not "to be made on the basis that the number of factors . . . indicating a lack of profit objective exceeds the number of factors indicating a profit objective, or vice versa." In relevant cases, the tax court "regularly analyzes the foregoing facts, among other facts and circumstances," and the Ninth Circuit Court of Appeals "has approved [the] application of the factors." (*Strode v. Commissioner*, T.C. Memo. 2015-117, citations omitted.) "Certain factors may be accorded more weight in a particular case because they have greater salience or persuasive value as applied to its facts." (*Vest v. Commissioner*, *supra*.)

We apply the factors solely to the gallery activity based on our finding that the scope of the activity to be considered under IRC section 183 is the gallery activity without regard to the AKB real estate activity. We examine each of these factors to determine whether appellants have met their burden of showing that during any of the tax years at issue, they were engaged in the gallery activity for profit within the meaning of Treasury Regulation section 1.183-2(b).

(1) Manner in which appellants carried on the gallery activity

The fact that the taxpayer carries on an activity in a businesslike manner may indicate a profit motive. (Treas. Reg. § 1.183-2(b)(1).) An activity is operated in a businesslike manner if appellants: (1) maintained complete and accurate books and records for the activity; *(2)* conducted the activity in a manner substantially similar to those of other activities of the same nature that were profitable; (3) changed operating methods, adopted new techniques, or abandoned unprofitable methods in a manner consistent with an intent to improve profitability; and (4) prepared a business plan. (*Ibid*.; see also *Judah v. Commissioner*, T.C. Memo. 2015-243.) "Perhaps the most important indication of whether or not an activity is being performed in a businesslike manner is whether or not the taxpayer implements some method for controlling losses." (*Nix v. Commissioner*, *supra*, quoting *Dodge v. Commissioner*, T.C. Memo. 1998-89.)

Although appellants created an original 2008 business plan and budget, reportedly advertised the gallery,[20] and maintained a formal recordkeeping system for the gallery, appellants have failed to show that they ever changed operating methods, adopted new techniques, or abandoned unprofitable methods in a manner that would be consistent with an intent to convert the gallery's losses to profits after failing to make a profit throughout the years of the gallery's operation. There is no evidence that substantiates appellants' representative's statement in his May 21, 2018 letter that "[c]ertain expenses were reduced, particularly payroll." Appellants present no evidence showing that they operated the gallery in a manner substantially like profitable galleries. (See Treas. Reg. § 1.183-2(b)(1).)

Additionally, while appellants assert that appellant-husband and his financial advisors did extensive research on the operations of an art gallery and created a business plan, appellants have not provided any evidence to support this assertion and have not identified the individuals they consulted with, their expertise and experience in operating profitable art galleries, or explained how this consultation helped to shape or form their original 2008 business plan. Appellants' original 2008 business plan included a 2008 budget, which indicates that appellants intended or projected that the gallery would lose money; it lists total building improvements of $218,000, total expenses of $716,300 and total income of $139,000. Appellants do not contend, and the evidence does not show, that the gallery's 2008 business plan and 2008 business budget were revised or updated for subsequent years. We are not persuaded by appellants' argument that the 2008 business plan substantiates their profit motive merely because it states that it typically requires galleries "five years to break even." In fact, the gallery never broke even. Appellants, who concede they are not gallery experts, fail to explain the basis for this statement or support it with any authority.

When questioned at the oral hearing as to whether they ever undertook any efforts to change the business model or operations of the gallery in an attempt to make it more profitable, the response was that the goal was to build a reputation, which was expected to bring in more famous photographers and then lead to more revenue. Appellants did not provide evidence or

[20] On the G2 Gallery LLC's Schedule C, appellants reported advertising expenses of $1,770, $1,412, $10,312, $1,770, and $2,218 in 2011, 2012, 2013, 2014, and 2015, respectively. A legacy copy of the gallery's website was provided on appeal, and appellants mentioned flyers that were used to advertise, but no other evidence of advertising was provided.

assertions that show any adjustments were made to the gallery's operations in an effort to create a profitable venture, in spite of years of consistent losses.

The exhibit entitled "G2 Gallery LLC (G2)" states that the gallery's purpose was "to provide a stream of income to be donated by [appellants] to various wildlife and environmental causes while at the same they are building a reputation as one of the premier and respected private art galleries in California." Appellants do not explain how they calculated how many charitable contributions the gallery could afford to make in any given year after taking into account the gallery's annual revenue and costs. If appellants intended to operate the gallery activity in a businesslike manner, the gallery would not have made charitable contributions that caused it to incur further losses.[21] Based on these facts and circumstances, we find that appellants operated the gallery without regard to cost or profit.

This factor weighs against appellants.

(2) The expertise of appellants or their advisors

The fact that a taxpayer developed his or her own expertise and consulted with experts concerning the accepted business, economic, and scientific practices of an activity may indicate that the taxpayer has a profit motive. (Treas. Reg. § 1.183-2(b)(2).) There is no dispute that appellants lacked expertise in art gallery ownership. Appellants' assertion that they employed a gallery manager with extensive experience in the art gallery field is not sufficiently substantiated by their submission of staff job descriptions and a gallery manager applicant's resume and application. There is no other evidence, such as an affidavit signed by the gallery manager under penalty of perjury, that indicates that appellants employed the applicant or any experts during the tax years at issue, or that they consulted with any business experts about ways to make the gallery profitable.

This factor weighs against appellants.

[21] At the oral hearing, appellants clarified that charitable cash contributions "didn't affect the bottom line of the gallery itself on the Schedule C" reporting of income and expenses because, as respondent also noted, appellants "would have reported them as itemized deductions on Schedule A." However, respondent added at the oral hearing that the gallery also provided donations that were noncash in nature, such as use of the gallery space for events, catering, and valet service. Respondent asserts that these noncash charitable donations would factor into the expenses listed on the Schedule C as other expenses.

(3) The time and effort used by appellants in carrying on the gallery activity

The fact that a taxpayer expends time and effort in carrying on an activity, especially where the activity does not have substantial personal or recreational aspects, may indicate a profit motive. (Treas. Reg. § 1.183-2(b)(3).) Appellants produced a document at audit that states that appellant-husband "concentrates on the financial side of the business and meets with the gallery's unnamed "Art Director/Manager weekly to review the financial affairs of the business," and appellant-wife works two or three days each week at the gallery and meets with the gallery's unnamed "Art Director/Manager to determine the direction and artist for each of the numerous shows and each year." There is no independent evidence, such as an affidavit signed by the "Art Director/Manager" under penalty of perjury or contemporaneous documents, that establishes that appellants spent any substantial time and effort to make the gallery profitable during the tax years at issue.

This factor weighs against appellants.

(4) Expectation that assets used in the activity may appreciate in value

The fact that a taxpayer expects that assets used in the activity will appreciate in value may indicate a profit motive, even if the taxpayer derives no operational profit. (Treas. Reg. § 1.183-2(b)(4).)[22] "[A] profit objective may be inferred from the expected appreciation of assets only where the appreciation exceeds operating expenses and would be sufficient to recoup accumulated losses of prior years." (*Donoghue v. Commissioner*, T.C. Memo. 2019-71, citations omitted.) This factor, however, is subject to the provisions of Treasury Regulation section 1.183-1(d). As discussed above, we find that the AKB real estate activity is separate from the gallery activity pursuant to Treasury Regulation section 1.183-1(d). Accordingly, we apply this factor solely to the gallery activity.

Appellants' only potential appreciable assets in the separate gallery activity were the gallery's inventory of photographs, other artwork, and books. Appellants do not contend, and the evidence does not indicate, that appellants owned assets in the gallery with the expectation that they would appreciate in value. It appears that appellants displayed for sale at least some of

[22] Pursuant to Treasury Regulation section 1.183-2(b)(4), "profit" includes "appreciation in the value of assets, such as land, used in the activity." This provision explains that, in addition to deriving a profit from the operation of the activity, a taxpayer may also intend an overall profit from appreciation in the value of land used in the activity because "income from the activity together with the appreciation of land will exceed expenses of operation."

the photographs and other artwork on a consignment basis, which would mean that appellants did not own them. Furthermore, G2 Gallery LLC's Schedules C show that the amounts of beginning and ending inventory for each of the years at issue was never higher than the beginning inventory of $125,212 in 2011, and in the years at issue the ending inventory for each year was less than $37,500, which is far less than the actual cash operational losses appellants reported incurring each year.[23] We therefore find that appellants did not have a bona fide expectation that the appreciation of assets used in the gallery activity would offset past and future gallery losses.

This factor weighs against appellants.

(5) Appellants' success in carrying on other similar or dissimilar activities

The fact that the taxpayer previously engaged in similar activities and converted them from unprofitable to profitable enterprises may indicate that an activity is engaged in for profit, even if the activity is presently unprofitable. (Treas. Reg. § 1.183-2(b)(5).) There is no dispute that appellants had no prior experience with gallery activities. The lack of prior experience, however, does not necessarily indicate that the taxpayer did not engage in the activity with the intent of making a profit. (*Pirnia v. Commissioner*, T.C. Memo. 1989-627.)

This factor is neutral.

(6) Appellants' history of income or loss with respect to the activity

The fact that the taxpayer sustained continued losses beyond the period customarily necessary to make the activity profitable, "if not explainable," may indicate that the activity is not engaged in for profit. (Treas. Reg. § 1.183-2(b)(6).) There is no dispute that appellants continuously reported substantial losses from 2008 through 2018 on the gallery's Schedules C. Assuming a gallery "typically take[s] five years to break even," as stated in appellants' business plan, appellants fail to explain the series of losses the gallery continued to sustain from 2013 through 2018, the six-year period following the first five years. There is persuasive evidence that the taxpayer did not expect to make a profit when an activity produces substantial losses

[23] The gallery used an accrual accounting method. In 2011, it reported a loss of $1,184,676, a beginning inventory of $125,212, and an ending inventory of $0. In 2012, the gallery reported a loss of $827,550, a beginning inventory of $0, and an ending inventory of $0. In 2013, the gallery reported a loss of $693,462, a beginning inventory of $0, and an ending inventory of $22,310. In 2014, the gallery reported a loss of $764,746, a beginning inventory of $22,310, and an ending inventory of $29,030. In 2015, the gallery reported a loss of $782,508, a beginning inventory of $29,030, and an ending inventory of $37,445.

over many years without the likelihood of reaching a profitable operation. (*Purdey v. Commissioner*, *supra*.) Appellants do not contend, and there is no evidence indicating, that the gallery's substantial losses were due to any unforeseen or fortuitous circumstances that were beyond appellants' control. (See Treas. Reg. § 1.183-2(b)(6).)

This factor weighs against appellants.

(7) The amount of occasional profits, if any, which are earned

The amount of profits the taxpayer received in relation to the amount of incurred losses, the amount of the taxpayer's investment, and the value of the assets the taxpayer used in the activity may be useful criteria in determining whether the taxpayer had a profit objective. (Treas. Reg, § 1.183–2(b)(7).) There is no dispute that the gallery did not earn any profits during any of its operational years.

This factor weighs against appellants.

(8) Appellants' financial status

Substantial income or capital from sources other than the activity, especially where losses from the activity generate substantial tax benefits, may indicate that the taxpayer did not engage in the activity for profit, "especially if there are personal or recreational elements involved." (Treas. Reg. § 1.183-2(b)(8).) In his May 21, 2018 letter to the protest hearing officer, appellants' representative stated that appellant-husband was a successful real estate professional who "has never lost money on a real estate deal." During the tax years at issue, appellants' reported gross income from appellant-husband's real estate business was substantial and appellants obtained significant tax benefits by deducting the gallery losses on their 2011, 2012, 2013, 2014, and 2015 returns. "The tax benefits [the taxpayer] sought to derive suggest the absence of a true profit motive." (*Nix v. Commissioner*, *supra*; see also *Mitchell v. Commissioner*, T.C. Memo. 2016-145 ["taxpayers with substantial income from other sources have a greater tax incentive to incur large expenditures in a hobby type of activity"].)

This factor weighs against appellants.

(9) Elements of personal pleasure or recreation

The fact that the taxpayer derives personal pleasure or recreation related to the activity may indicate that the activity is not engaged in for profit. (Treas. Reg. § 1.183-2(b)(9).)

Conversely, the fact that an activity lacks any appeal other than profit may indicate a profit motive. (*Ibid*.) Appellants stated in a document they submitted at audit that the gallery's purpose "is to provide a stream of income to be donated by [appellants] to various wildlife and environmental causes while at the same time they are building a reputation as one of the premier and respected private art galleries in California." Appellants also provided respondent with a document listing the "well-known national and respected local charities" that received contributions from the gallery. Without considering any personal benefits derived from gallery events, the gallery activity provided appellants elements of personal pleasure based on their contributions to charitable causes of their choosing and their desire to create a premier and respected private art gallery.

This factor weighs against appellants.

In sum, considering the nine factors set forth in Treasury Regulation section 1.183-2(b), eight factors weigh against appellants and one factor is neutral. After weighing these factors and considering the facts and circumstances of this appeal, we conclude that appellants have failed to meet their burden of proving that they engaged in the gallery activity with an actual and honest objective to make a profit. We thus conclude that respondent properly determined that appellants' claimed gallery activity was an activity "not engaged in for profit" pursuant to IRC section 183.

Issue 2: Whether appellants are entitled to deduct losses from DGBM from their gross income for any of the tax years at issue.

The issue of the disallowed losses relating to DGBM was raised at the prehearing conference, when it was noted that it had not been addressed by appellants' briefing. In a post-conference memorandum, appellants asserted for the first time their position that respondent had conceded this issue at audit. This assertion is based on an assumption from appellants' tax preparer when respondent did not continue to request information related to this issue after receiving some information from the tax preparer.

Appellants concede that the DGBM losses were included on the NPAs but assert there was "no amplification" of DGBM in those notices.[24]

At the oral hearing, appellants made an analogy to federal rules, noting that the taxing agency needs to list all the items it is adjusting so that the taxpayers know what they are being held accountable for and what to argue in court. Appellants asserted that respondent failed to provide similar notice to appellants as to what was at issue with its NPAs since the details of the issues provided on those notices only pertained to the gallery activity, and similarly framed the issues on appeal in its briefs as only involving the gallery. Respondent contended at the oral hearing that appellants have been on notice that the DGBM losses were being denied since the audit, and that specific references to DGBM in both the NPAs and respondent's opening brief continued to inform appellants that those losses are at issue.

The appeal before us is an appeal of proposed assessments of additional tax based on disallowed deductions pertaining to both the gallery activity and the DGBM activity. This is stated clearly in the NPAs for each year at issue, and in respondent's opening brief on appeal. Respondent's opening brief includes the specific amounts relating to DGBM losses disallowed as deductions, which are listed separately from the gallery losses, and states that "[a]ppellants did not protest or appeal [r]espondent's adjustments disallowing DGBM losses . . . [r]espondent includes those adjustments in the table below to document how [r]espondent determined the amount of additional tax." Regardless of whether appellants' representative mistakenly believed DGBM losses were not at issue, they are clearly part of the NPAs and at issue on appeal. Accordingly, appellants bear the burden of establishing entitlement to the claimed deductions through credible evidence, other than mere assertions, by showing that the deductions claimed fall within the scope of a statute authorizing the deduction. (*Appeal of Robinson*, *supra*.)

Respondent's position with regard to the DGBM losses is that appellants have not established that they were entitled to the related deductions. Respondent refers to the evidence in the record of what was provided at audit, and the conclusion reached by respondent that

[24] Appellants' memorandum then states that this led to a reasonable assumption that DGBM was included in the notices simply as the name of the company that managed the gallery and real estate ventures, and also notes that DGBM was not mentioned when the matter was passed from appellants' tax preparer to their representative on appeal. It seems as though these arguments go toward whether appellants' representative on appeal was made aware of the DGBM component of the adjustments, but the misunderstanding or incorrect assumptions of appellants' representative does not control whether certain disallowed deductions are at issue on appeal.

DGBM was not engaged in the DGBM activity with the objective of making a profit for the tax years at issue. Respondent indicates that appellants' objective was to continue serving the last remaining longtime client, and not to make a profit (noting the last year in which DGBM reported income exceeding expenses was 2006). Appellants' position on appeal consists only of procedural objections and assertions that respondent conceded this issue prior to this appeal.

We find that respondent provided appellants with sufficient notice as supported by the NPAs and the briefing. We are unpersuaded by appellants' procedural objections and assertions that respondent conceded the issue. Appellants have not provided sufficient evidence to support the claimed DGBM deductions, and therefore have not met their burden to show error in respondent's denial of the claimed deductions relating to the DGBM losses.

HOLDING

Appellants are not entitled to deduct their losses from the gallery activity or DGBM's activity from their gross income for any of the tax years at issue.

DISPOSITION

Respondent's actions are sustained.

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

DocuSigned by:
Cheryl L. Akin
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Cheryl L. Akin
Administrative Law Judge

DocuSigned by:
Josh Aldrich
48745BB80B914B4...
Josh Aldrich
Administrative Law Judge

Date Issued: 1/6/2022