OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **K. BABAOFF AND** **S. BABAOFF**	) OTA Case No. 19125534)))))

OPINION

Representing the Parties:

For Appellants:	Robert M. Corbin, CPA Eric Blau, CPA
For Respondent:[1]	David Hunter, Tax Counsel IV Marguerite Mosnier, Tax Counsel V
For Office of Tax Appeals:	Grant S. Thompson, Tax Counsel IV

A. VASSIGH, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, K. Babaoff and S. Babaoff (appellants) appeal an action by the respondent Franchise Tax Board (FTB) proposing $334,750 of additional tax, an accuracy-related penalty of $66,950, and applicable interest, for the 2011 tax year.

Office of Tax Appeals Administrative Law Judges Josh Lambert, Richard Tay, and Amanda Vassigh, held an electronic hearing for this matter on January 25, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUES

1. Whether appellants have shown they are entitled to a claimed capital loss of $3,250,000.
2. Whether appellants are liable for the accuracy-related penalty.

[1] David Gemmingen, Tax Counsel IV, wrote FTB's opening and additional briefs.

FACTUAL FINDINGS

1. Appellant-husband was born in Iran and came to California in 1976 as a university student. When the Iranian revolution took place in 1979 and the Islamic Republic of Iran was created, appellant-husband's family had to flee the country.
2. Prior to the revolution, appellant-husband inherited one-fourth ownership of a family property (the property) in Shemiran that was then on the outskirts of Tehran, Iran. Over the years, the location of the property became zoned for development. Appellant-husband and his family planned to eventually sell the property.
3. When appellant-husband's uncle returned to Iran in 2008 or 2009 to look into selling the property, the Islamic Republic put a hold or lien on the title of the property and began a legal process to confiscate the property. Appellants sought relief through administrative channels until they received a Notice of Confiscation from the Iranian government in 2011.
4. Appellants sought tax advice and provided their tax advisors with the information they had.
5. For the 2011 tax year, appellants reported a $3,250,000 capital loss due to the confiscation of investment property. They attached a federal Form 8886 stating that, on September 7, 2011, they received the English translation of a document informing appellant-husband of the confiscation of investment property in a foreign country (Iran). Appellants further stated that the amount was "being used in 2011 to offset capital gains from the sale of other investment properties..... "
6. FTB audited appellants' tax return.
7. On September 13, 2017, FTB issued a Notice of Proposed Assessment (NPA) proposing to disallow the claimed loss. The NPA stated that the total tax owed was $616,091, and therefore proposed $334,750 of additional tax (as reduced by the amount originally reported), an accuracy-related penalty of $66,950, plus applicable interest.
8. Appellants protested the NPA, and following the protest, FTB issued a Notice of Action affirming the NPA.
9. Appellants then filed this timely appeal.
10. A translation of a May 27, 2010 letter (Letter) from M. Kouhi, at the "Department of Registration of Documents and Properties in Shemiran," includes the following language:

> With regards to the letter number 89/2/6-151/117/89 it is hereby declared that the six shares of the landed property with an area of 1927.50 square meters, subdivision registration number 670, subdivided from property number 3467, located in Dareh Gheshlagh in Shemiran, District 11 of Tehran belongs to the following people according to its ownership document . . . . Mr. [Owner #1], holding three fourth of the shares, Ms. [Owner #2], holding three fourth of the shares, [appellant-husband], holding 1.5 of the shares, Mr. [Owner #3], holding three fourth of the shares, Mr. [Owner #4], holding three fourth of the shares and Mr. [Owner #5], holding three fourth of the shares. The grant deed is issued and delivered. The shares of [appellant-husband] and [Owner #3] which was equal to two and one quarter of the shares was later on confiscated according to order number 251/324 issued on May 10, 1983, by the Revolutionary Court, and it now belongs to the Office of the Prime Minister. . . .

11. The official translation of an undated appraisal (Appraisal) prepared by an individual described as an Official Expert of the Department of Justice, Field of Civil Engineering and Topography, indicates the total value of the property to have been worth 13,000,000,000 *tomans* at some point.

12. Appellants provide an official translation of a Declaration Letter (Declaration) pertaining to the court order by the Revolution Court of [the] Islamic Republic of Iran Particulars. The Declaration by S. H. Zandi, who is listed as "Head of Legal Office," states:

> Reference to the request received from [M. Soltanpour], the attorney designated by [appellant-husband] , and the documents received from of [sic] chamber Justice Administration of the Islamic Republic of Iran on the return and confiscation of the entire movable and immovable properties of [appellant-husband] (through verdict number 251/324 dated May 31, 2011 by Headquarter for enforcing principle 49 and the Commands of Supreme Leader) in favor of [the] Prime Ministry Office, this is to provide explanations on the client's property in exchange rate of Rials currency . . . and dollars to appraise damages incurred by him.
>
> One and a half portion out of [the] total [of] six portions of a plot of land with trading usage in Mirdamad Boulevard, registered plot 670 in Shemiran, district 11 of Tehran, measuring [1,927.50 square meters], has been transferred to [appellant-husband] irrevocably [52,000,000 rials] equivalent to [$753,600] through deed 25641 dated October 6, 1976 . . . . By virtue of the mentioned order, the share of the above-mentioned person [appellant-husband] in the property was confiscated in favor of the Prime Ministry of [the] Islamic Republic of Iran and the title deed was issued in their names and submitted accordingly.

13. Appellants' calculation of the fair market value of the property as of the date of inheritance is provided in a schedule (Schedule).[2] The Schedule states a "current" value of $11,818,182 for the entire property. The Schedule then appears to apply a discount rate of one percent[3] over 34 years (apparently calculating back to 1977 which is when appellant-husband states he inherited the property) to estimate the value of the inherited property (as of 1977) as $8,426,049 based on a "[p]resent value of future payment calculation." It also states a value of inherited property of $13,000,000 and claims that appellant-husband's share of the property is 25 percent.[4] It notes that the loss claimed was $3,250,000, which is 25 percent of $13,000,000.[5] It further states as follows:

    a. "This is to confirm that the exchange rate in [the month of] Khordad [in Persian calendar year] 1389 was 1100 Toman for each US Dollar[;]"
    b. "Current value is taken from 2011 appraisal. Toman to USD conversion is taken from valuation expert[;]"
    c. "The property was inherited in 1977 and confiscated in 2011."
    d. "The property appreciated at 1% per year, at the most."

DISCUSSION

Issue 1: Whether appellants have shown they are entitled to a claimed capital loss of $3,250,000.

Deductions from gross income are a matter of legislative grace and a taxpayer has the burden of proving entitlement to the deductions claimed. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; *Appeal of Dandridge*, 2019-OTA-458P.) To carry his or her burden of proof, a taxpayer must point to an applicable statute and show by credible evidence

[2] The fair market value on the date of inheritance is potentially relevant because the amount of any loss depends on appellant-husband's adjusted basis in the property at the time of the loss, and the basis of inherited real property is generally "stepped up" to fair market value as of the date of the benefactor's death. (See Internal Revenue Code (IRC), § 1014(a).) As relevant here, California conforms to IRC section 1014 pursuant to R&TC section 18031. The basis would then have to adjusted to reflect any depreciation or other adjustments. (See IRC, § 167; R&TC, § 17250.5.)

[3] In an email dated February 14, 2017, FTB asked appellants' representative for the source of the one-percent assumption, and appellants' representative stated that it was an estimate that appellant-husband recommended.

[4] It is not clear how this $13,000,000 value relates to the "current" value listed of $11,818,182.

[5] It is not clear why appellants used the $13,000,000 value to calculate the claimed $3.25 million loss, rather than the claimed $8,426,049 value of the property at the time appellant-husband inherited his portion of the property.

that the deductions claimed come within its terms. (*Appeal of Telles* (86-SBE-061) 1986 WL 22792.) A taxpayer must retain sufficient records to substantiate claimed deductions. (*Sparkman v. Commissioner* (9th Cir. 2007) 509 F.3d 1149, 1159.)

The relevant law we look to in this matter is Internal Revenue Code (IRC) section 165, as incorporated into California law by R&TC section 17201. IRC section 165 allows a deduction for a loss sustained during a tax year that is not compensated for by insurance or otherwise. The amount of the loss is based on the adjusted basis of the property. (IRC, § 165(b).) For individuals, any such loss is limited to losses incurred in a trade or business or in a transaction entered into for profit, or certain losses arising from fires, storms, or other casualties, or theft. (IRC, § 165(c).)

A loss due to expropriation or confiscation of property by a government does not constitute a theft for purposes of IRC section 165(c). (*Powers v. Commissioner* (1961) 36 T.C. 1191; *Moshrefzadeh-Sani v. Commissioner* T.C. Memo. 1992-592 (*Moshrefzadah-Sani*).) Therefore, appellants must show that they incurred the claimed loss, in 2011, in a trade or business or in a transaction entered into for profit.[6] (See IRC, § 165(c)(1) & (2).)

A loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. (Treas. Reg. § 1.165-1(d)(1); *Moshrefzadeh-Sani, supra*.) The determination of whether a loss is sustained during a particular taxable year is purely one of fact and the taxpayer bears the burden of proof in establishing that a loss is sustained in the year reported. (*Moshrefzadeh-Sani, supra*.) For loss purposes, the timing of a foreign expropriation is the year the taxpayer loses control and possession of the property at issue. (*Makouipour v. Commissioner*, T.C. Memo. 1988-363.) An act of expropriation occurs when the taxpayer has been deprived of ownership of property or the normal attributes of ownership, such as receipt of income and control over the operation or use of the property, with little or no chance of compensation. (*Appeal of Soulkanian* (87-SBE-077), citing Rev. Rul. 62–197, 1962–2 C.B. 66, 69; see also *United States v. S.S. White Dental Mfg. Co.* (1927) 274 U.S. 398, 402-403.)

A taxpayer "may be deprived of 'ownership' for purposes of [IRC] section 165 and yet retain legal title. It is the loss of control over and possession of the property which constitutes

[6] We focus on this aspect of IRC 165 since the loss in this case did not arise from a fire, storm, or other casualty.

the expropriation loss for income tax purposes." (*Korn v. Commissioner* T.C. Memo. 1973-258, affd. (9th Cir. 1975) 524 F.2d 888.) "An important indication of the year of the loss is the year that the taxpayer loses control and possession of the property." (*Elghanian v. Commissioner* T.C. Memo. 2005-37 (*Elghanian*).) A taxpayer's subjective opinion that the loss occurred in the year claimed is not decisive in determining whether a loss was in fact sustained in a particular year for purposes of IRC section 165. (*Boehm v. Commissioner* (1945) 326 U.S. 287, 292-293.) Even if a taxpayer's belief that he or she was the record owner of the property is justified, the actual retention of legal title in the face of signs of practical dispossession is not persuasive. (*Korn v. Commissioner, supra,* 524 F.2d 888, 890; see *Benichou v. Commissioner,* T.C. Memo. 1970-263 ["property may be expropriated by actual seizure before the effective date of an official decree"].) Furthermore, courts have rejected assertions that the effective date of an expropriation is the date of a subsequent settlement or other final act that occurred after the taxpayer's loss of control and possession of the property at issue. (See *Estate of Fuchs v. Commissioner* (2d Cir. 1969) 413 F.2d 503; *Colish v. Commissioner* (1967) 48 T.C. 711.)

We sympathize with appellants' situation, and found appellant-husband's testimony earnest and credible. It is undisputed that the property was confiscated without compensation. However, appellants have not carried their burden of establishing that the expropriation loss occurred in 2011.[7] The record contains conflicting evidence regarding the date of the actual confiscation of the property. The Letter states that appellant-husband's property interest was confiscated pursuant to order number 251/324 issued by the Revolutionary Court on May 10, 1983, which conflicts with appellants' assertion that they are entitled to the claimed $3,250,000 deduction for the 2011 tax year. The Declaration, on the other hand, states that the verdict confiscating the land was dated May 31, 2011.[8] Unfortunately, the translation of the Declaration is difficult to follow and appears to be of poor quality, which does raise questions about how much we can rely on it. (Cf. *Moshrefzadeh-Sani*, *supra* [finding a translation of a purported certificate of confiscation to be unreliable].)

[7] As a result, it is not necessary to determine whether the loss was incurred in a trade or business or in a transaction entered into for profit. (IRC, § 165(c)(1) & (2).)

[8] We also note that appellants' tax return states that they were "informed" of the loss in 2011, rather than stating that they incurred the loss in 2011. This comports with appellant-husband's testimony that the legal process to finalize the confiscation of the property was a drawn-out process, which was finalized when appellants received a Notice of Confiscation.

Appellant-husband testified that the process of confiscation took place over years, as the property was portioned out and assigned to various government agencies. Appellant-husband also testified that there was a drawn-out legal process to confiscate the property, which took up to two years to finalize. However, as explained above, it is the loss of control over and possession of the property which constitutes the expropriation loss for income tax purposes. (*Korn v. Commissioner*, *supra*.) The record indicates that appellant-husband lost control and possession of the property. Appellant-husband testified that he still owned the property during the legal process to confiscate it. Yet even if he technically retained title, for all practical purposes, the record indicates that he lost control and possession of the property before 2011. Appellant-husband was deprived of the use of the property by order number 251/324 of the Revolutionary Court, in 1983. Even if appellant-husband did not lose control over and use of the property in 1983, he testified that a lien or hold was placed on the property in 2008 or 2009 when his uncle returned to Iran to attempt to sell the property. The inability to sell the property at that time is also an indication that appellant-husband was deprived of control and use of the property prior to 2011. Ultimately, there is insufficient evidence to show that the confiscation occurred in 2011.

Even if we were to conclude that the confiscation did occur in 2011, we have no evidence by which to determine appellant-husband's adjusted basis in the property. The Schedule prepared by appellants asserts values of both $11.8 million and $13 million for the property in 2011 and applies a one percent discount rate to arrive at an estimated value at the time of inheritance of $8,426,049. However, there is no evidence in the record to support an $11.8 million or $13 million value in 2011, or the one percent discount rate used to estimate the value at the time of inheritance. The Appraisal claimed a value of 13 billion *tomans* but does not provide a valuation methodology. If we were to assume the valuation was correct, since the

Appraisal is undated, we do not know when the property was so valued.[9] Furthermore, there are no depreciation calculations or other evidence from which one could determine the adjusted basis of the property as of 2011.[10]

In sum, appellants have not provided, and the evidentiary record does not include, sufficient evidence to carry appellants' burden of showing that they suffered a loss of $3.25 million in 2011 under IRC section 165.

Issue 2: Whether appellants are liable for the accuracy-related penalty.

R&TC section 19164, which incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of any portion of an underpayment of tax required to be shown on a return. As relevant here, the penalty applies to the portion of the underpayment attributable to: (1) negligence or disregard of rules and regulations; or (2) any substantial understatement of income tax. (IRC, § 6662(b)(1), (2).) For individual taxpayers, there is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of 10 percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1)(A).)

Appellants' understatement of tax is $334,750. This $334,750 understatement is greater than 10 percent of the tax required to be shown on the return (10 percent of $616,091 is $61,609), which is greater than $5,000. Accordingly, appellants' understatement of tax is a substantial understatement under IRC section 6662(d)(1)(A).

There are exceptions to the imposition of the accuracy-related penalty. The accuracy-related penalty shall be reduced by the portion of the understatement attributable to a tax

[9] The Declaration states in part that its purpose is "to provide explanation on the client's property . . . to appraise damages incurred by him . . . [,]" and it goes on to state that a portion of the land had been transferred to appellant-husband "irrevocably [52,000 rials] equivalent to [$753,600] through deed 25641 dated October 6, 1976 . . . ." This language is unclear and could be read to mean that the land had this value when it was received by appellant-husband, or it could be read to suggest that this is the value of the land when it was confiscated and the measure of his damages. FTB argues that the language suggests that appellants may have received some type of reimbursement or compensation for the property. Appellant-husband testified that this language reflected the value of the property at the time he inherited it. We find appellant-husband's testimony reliable and accept as true that this language was referring to the value of the land when it was received by appellant-husband. Still, we have no way of determining the basis for such $753,600 valuation, on October 6, 1976, and such a valuation would be dramatically inconsistent with appellants' claim of a $3,250,000 loss.

[10] IRC section 1016(a)(2), which California conforms to per R&TC section 18031, requires taxpayers to adjust their basis in property by the greater of the amount allowed or allowable as depreciation deductions in prior tax years.

treatment of any item if the relevant facts affecting the item's tax treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item. (IRC, § 6662(d)(2)(B)(ii).) And the accuracy-related penalty will not be imposed to the extent that a taxpayer shows that a portion of the underpayment was due to reasonable cause and that the taxpayer acted in good faith with respect to such portion of the underpayment. (IRC, § 6664(c)(1); Treas. Reg. §§ 1.6664-1(b)(2) & 1.6664-4.) The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.)

The reasonable basis standard is a "relatively high standard of tax reporting" and is "not satisfied by a return position that is merely arguable or that is merely a colorable claim." (*Planty v. Commissioner*, T.C. Memo 2017-240 (*Planty*), quoting Treas. Reg. § 1.6662–3(b)(3).) A return position reasonably based on the authorities that would satisfy the substantial authority standard generally will satisfy the reasonable basis standard. (Treas. Reg. § 1.6662-3(b)(3).) A few examples of the types of authorities a taxpayer could rely on include applicable provisions of the Internal Revenue Code, revenue rulings and procedures, and court cases. (Treas. Reg. § 1.6662-4(d)(iii).) However, taxpayers must take into account the relevance of the authorities and any subsequent developments. (Treas. Reg. § 1.6662-3(b)(3).)

A determination of whether or not a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including the taxpayer's efforts to assess the proper tax liability, the taxpayer's knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).) Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. (*Ibid*.) Generally, the most important factor is the extent of the taxpayer's effort to assess her proper tax liability. (*Ibid*; *Goode v. Commissioner*, T.C. Memo. 2006-48.) The kinds of activities that show a reasonable attempt to comply with the tax laws are maintaining records sufficient to support an entitlement to claimed deductions, conducting tax research, and discussing the situation with the IRS, FTB, or tax advisors. (*Goode v. Commissioner, supra; Gomez v. Commissioner*, T.C. Memo. 1999-94.) Reliance on professional advice may constitute

reasonable cause and good faith if, under all the circumstances, such advice was reasonable and the taxpayer acted in good faith. (*Planty*, *supra*.)

In this case, appellants formally disclosed their loss position on IRS Form 8886, *Reportable Transaction Disclosure Statement*, and by doing so, apprised FTB that the deduction was for an expropriation loss, its amount, and the potential controversy thereby satisfying the disclosure requirement under IRC section 6662(d)(2)(B). (See *Elghanian, supra*.) Though we conclude that the seizure occurred when appellants lost control over the property, which was prior to 2011, it was reasonable for appellants to believe, especially since their tax advisors agreed, that they were entitled to claim a capital loss in 2011, when the final Notice of Confiscation was issued. However, a reasonable belief or even a colorable argument is not enough to find that there was a reasonable *basis* for the tax treatment of an item. (See *Planty*, *supra*.).) The position taken on appellants' 2011 return does not satisfy the reasonable basis standard because the law is clear that for income tax purposes, an expropriation loss occurs in the year the taxpayer loses control over and possession of the property. The evidence in this case shows that the loss of control and possession of the property occurred quite a bit earlier than 2011.

However, we do find that appellants acted with reasonable cause and in good faith. They sought tax advice, provided their accountants with the information they had, and they relied in good faith on their tax advisor's professional judgment.

For the foregoing reasons, we conclude that appellants are not liable for the accuracy-related penalty.

HOLDINGS

1. Appellants have not shown they are entitled to a claimed capital loss of $3,250,000.
2. Appellants are not liable for the accuracy-related penalty.

DISPOSITION

FTB's action is sustained as to the claimed capital loss and reversed as to the accuracy-related penalty.

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Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

We concur:

DocuSigned by:
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Richard Tay
Administrative Law Judge

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

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