

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

**J. ZHAO &**  
**Y. LIU**

) OTA Case No. 21057711  
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**OPINION**

Representing the Parties:

For Appellants: Cindy L. Ho, Attorney

For Respondent: Desiree Macedo, Tax Counsel

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Zhao and Y. Liu (appellants) appeal an action by the Franchise Tax Board (respondent) proposing additional tax of \$9,980, and applicable interest, for the 2012 tax year.

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

**ISSUE**

Whether appellants are entitled to a charitable contribution deduction for payments made to the Lotus Creek Foundation (Foundation).

**FACTUAL FINDINGS**

1. Appellants established the Foundation,<sup>1</sup> a nonprofit public benefit organization. In 2011, the Foundation requested a private foundation exemption from tax, which respondent granted under R&TC section 23701d, effective December 22, 2010.
2. On May 29, 2012, the Foundation registered with the California Secretary of State and filed its Articles of Incorporation. The Articles state that the purpose of the Foundation was to donate available fund assets to certain academic institutions for their research and

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<sup>1</sup> The Foundation is not a taxpayer in this appeal.

- development activity uses; to advocate for community benefits; and to develop and expand its various philanthropic missions.
3. In 2013, appellants filed a timely personal income tax return (Form 540). On appellants' federal income tax return (Form 1040), Schedule A, appellants claimed a charitable contributions deduction of \$107,316.
  4. In 2016, respondent examined the Foundation's exempt status to determine whether the Foundation's activities were confined to those permitted under R&TC section 23701d. Respondent conducted the examination after receiving information from the Santa Clara District Attorney's office that the Foundation's CPA had been charged with tax evasion relating to his own private foundation. The charges indicated that the CPA facilitated the organization of several other private foundations that may be operating similar to his, including the Foundation.
  5. Based on the examination, respondent determined that the Foundation failed to meet the requirements of R&TC section 23701d, which, among others, prohibits net earnings of which inures to the benefit of private shareholders or individuals. Respondent determined that the Foundation purchased and paid for the expenses of a BMW, which was exclusively used by appellant-Zhao; paid the personal expenses of appellant-Zhao to renew his driver license; purchased investment property and paid for the expenses incurred for renovating and landscaping the property; among others. The Foundation purchased a rental property as an investment asset, which the Foundation believed would ensure that the Foundation had funds "to sustain the longevity to the Foundation through regular investment income and appreciation of the capital asset." Respondent concluded that "[a]lthough investment activity can be acceptable as long as there is also substantial charitable activity, ... the Foundation has only minimally engaged in charitable activities." As such, respondent revoked the Foundation's tax-exempt status effective May 29, 2012, and the Foundation became a taxable C-Corporation with appellants' previous contributions to the Foundation recharacterized as capital contributions. Respondent issued Notices of Proposed Assessment (NPAs) for the 2013, 2014, 2015, and 2016 tax years.
  6. In the interim, respondent issued a protective NPA, due to the pending statute of limitations for the 2012 tax year, disallowing appellants' 2012 charitable contribution

deduction. Appellants protested the NPA, which was deferred pending the completion of respondent's examination of the Foundation. After respondent completed the Foundation's examination, respondent issued appellants a Notice of Action, affirming the 2012 NPA. This timely appeal followed.

### DISCUSSION

Income tax deductions are a matter of legislative grace, and taxpayers bear the burden of establishing an entitlement to the claimed deduction. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440.) To carry that burden, taxpayers must point to an applicable statute and show by credible evidence that they come within its terms. (*Appeal of Vardell*, 2020-OTA-190P.) Taxpayers' unsubstantiated assertions are insufficient to satisfy the burden of proof. (*Ibid.*) Further, 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.)

R&TC section 17201(a) incorporates by reference Internal Revenue Code (IRC) section 170. IRC section 170(a)(1) allows a deduction for any charitable contribution made in compliance with the statute. A "charitable contribution" is a contribution to or for the use of, among others, a corporation or foundation: (1) created or organized in the United States; (2) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes; (3) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and (4) which is not disqualified for tax exemption under IRC section 501(c)(3) for attempting to influence legislation, and which does not participate in any political campaign on behalf of any candidate for public office. (IRC, § 170(c)(2)(A)-(D).) Even if the benefit inuring to the individual is small, it is still impermissible. (*McGahen v. Commissioner* (1981) 76 T.C. 468, 482.) The term "charitable contribution" is also synonymous with the word "gift." (*DeJong v. Commissioner* (1961) 36 T.C. 896, 899 affd. (9th Cir. 1962) 309 F.2d 373.) "A gift is generally defined as a voluntary transfer of property by the owner to another without consideration therefore. If a payment proceeds primarily from the incentive of anticipated benefit to the payor beyond the satisfaction which flows from the performance of a generous act, it is not a gift." (*Ibid.*)

Appellants have not provided any evidence to rebut respondent's findings of inurement. Instead, appellants argue that respondent's decision to revoke the Foundation's tax-exempt status based on its finding that the Foundation was "only minimally engaged in charitable activities" is

unfounded. Appellants argue that the Foundation's decision to purchase investment real estate to grow the Foundation's assets, which would allow the Foundation to make larger charitable donations in the future, was not a speculative investment. Appellants contend that the Foundation intended to increase its charitable giving over the years as the rental property became more profitable.

An organization organized and operated for nonprofit purposes in accordance with R&TC section 23701d may qualify for tax exemption, upon meeting certain requirements, for California purposes. The language describing a qualifying organization in R&TC section 23701d is very similar to that described in IRC section 501(c)(3). Similarly, the organizations listed in IRC section 170(c)(2) are also virtually identical to those described in IRC section 501(c)(3). (See *Variety Club Tent No. 6 Charities, Inc. v. Commissioner*, T.C. Memo. 1997-575.) Consequently, courts have applied many of the same standards in interpreting IRC sections 107(c)(2) and 501(c)(3). (See *Bob Jones University v. U.S.* (1983) 461 U.S. 574, 586-587.)


Although we do not have jurisdiction in this appeal to review whether respondent's revocation of the Foundation's tax-exempt status was proper, as the Foundation is not an appealing taxpayer in this appeal, the bases for respondent's revocation are nevertheless relevant to this appeal because both R&TC section 23701d and IRC section 170(c)(2) require that no net earnings inure to the benefit of private shareholders or individuals. Here, one of the reasons appellants' Foundation lost its tax-exempt status was because respondent determined that more than an insubstantial amount of the Foundation's net earnings inured to the benefit of appellants. For example, the Foundation purchased a luxury vehicle with Foundation funds that was also used for private purposes; the Foundation used its assets to pay appellants' personal expenses; and the Foundation transferred its assets directly to appellants' bank account. Appellants have not met their burden of providing evidence that there was no private inurement. As such, the charitable contribution deduction was properly denied.

HOLDING


Appellants are not entitled to a charitable contribution deduction for payments made to the Foundation.


DISPOSITION

Respondent’s action is sustained.

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Andrea L.H. Long  
Administrative Law Judge

We concur:

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Sheriene Anne Ridenour  
Administrative Law Judge

Date Issued: 12/1/2021