

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 21057805
D. MITCHELL AND)
D. BOUCHER)
_____)

OPINION

Representing the Parties:

For Appellants: D. Mitchell
D. Boucher

For Respondent: Leoangelo C. Cristobal, Tax Counsel
Maria Brosterhous, Tax Counsel IV

H. LE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, D. Mitchell and D. Boucher (appellants) appeal an action by the Franchise Tax Board (respondent) denying appellants’ claim for refund of \$7,531.51 for the 2017 tax year.

Office of Tax Appeals Administrative Law Judges Huy “Mike” Le, Eddy Y.H. Lam, and Amanda Vassigh held an electronic oral hearing for this matter on March 22, 2022. After the hearing, we closed the record and submitted this matter for an opinion.

ISSUES

1. Whether gain deferred under Internal Revenue Code (IRC) section 1033 should be reported for the year the gain was realized or for the year the IRC section 1033 transaction failed when appellants acquired a dissimilar property.
2. Whether appellants have established any basis to abate interest.

FACTUAL FINDINGS

1. Appellants timely filed a 2017 California income tax return, indicating that rental property destroyed by fire would be replaced with similar property under IRC section 1033 and, accordingly, deferred recognizing the gain from their insurance proceeds.
2. In 2019, appellants filed an amended 2017 California income tax return, requesting to withdraw the deferral of gain because they used their insurance proceeds to purchase a dissimilar property. Appellants reported an \$848,225 gain from the insurance proceeds. Appellants self-assessed a tax amount owed of \$84,803 and paid this amount.
3. Subsequently, because appellants did not pay the total tax owed for the 2017 taxable year by the original April 17, 2018 due date, respondent sent a State Income Tax Balance Due Notice, imposing interest of \$7,509.93.
4. Then, appellants requested a waiver of the balance due. Respondent denied the request and provided an updated balance due of \$7,531.51.
5. Appellants made a \$7,531.51 payment, but since it was untimely, respondent sent another State Income Tax Balance Due Notice, imposing additional interest of \$12.42.
6. Appellants paid the remaining balance and filed a claim for refund for \$7,531.51.
7. Respondent denied appellants' claim for refund, and then appellants filed this timely appeal.

DISCUSSION

Issue 1: Whether gain deferred under IRC section 1033 should be reported for the year the gain was realized or for the year the IRC section 1033 transaction failed when appellants acquired a dissimilar property.

IRC section 1033(a) generally provides for the nonrecognition of gain where a property has been involuntarily converted (as a result of its destruction in whole or in part or other transactions) into money or unrelated property, and the taxpayer, within two years after the close of the first taxable year in which any part of the gain upon conversion is realized, acquires replacement property that is similar or related in service or use to the property so converted.¹

¹ Under R&TC section 18031, California law generally incorporates IRC section 1033.

Here, appellants state a fire destroyed their rental property in October 2017, and they received insurance proceeds for their rental property. On their 2017 California income tax return, appellants deferred recognizing the gain from the insurance proceeds and stated their intent to reinvest the insurance proceeds in property similar to their destroyed rental property. However, appellants failed to reinvest the insurance proceeds in similar property because they allegedly were unable to agree with a builder. In 2019, appellants submitted an amended 2017 California income tax return, requesting to withdraw their original gain deferral because they used the insurance proceeds to acquire a dissimilar property. Accordingly, on their amended 2017 California income tax return, appellants reported the \$848,225 gain due to the insurance proceeds² and self-assessed additional tax of \$84,803. Despite this amended return, appellants now argue that appellants incorrectly recognized the gain from the insurance proceeds in the 2017 tax year, and instead argue this gain should have been recognized for the 2019 tax year because that is the year appellants were unable to obtain a contract to rebuild their rental property.

However, Treasury Regulation section 1.1033(a)-2(c)(2) provides that if, after electing IRC section 1033 treatment, a taxpayer decides not to replace the converted property with similar property, the gain from the conversion is to be reported on the return for the taxable year in which gain was realized, and the tax liability for that year is to be recomputed. This recomputation should be in the form of an “amended return.” (Treas. Reg. § 1.1033(a)-2(c)(2).) Stated differently, “[i]f a taxpayer elects deferral but thereafter fails to make a qualifying investment in property of like kind within that two-year period, he or she must recognize the gain *retroactively* to the year in which it was realized.” (*Suffness v. U.S.* (5th Cir. 1992) 974 F.2d 608, 609–610, italics added.) Thus, although appellants deferred gain under IRC section 1033 in 2017, they were required to recognize gain retroactively to 2017 after they acquired a dissimilar property in 2019.

² We found no evidence in the record that shows appellants realized gain in a year other than 2017. For this case, realization occurs in the year in which a taxpayer receives insurance proceeds in exchange for the destroyed property. (See Treas. Reg. § 1.1001-1(a).)

Issue 2: Whether appellants have established any basis to abate interest.

Interest must be assessed from the date a tax payment is due through the date that it is paid. (R&TC, § 19101.) Imposition of interest is mandatory; it is not a penalty but is compensation for a taxpayer's use of money after it should have been paid to the state. (*Appeal of Moy*, 2019-OTA-057P.) There is no reasonable cause exception to the imposition of interest. (*Ibid.*)

Although we understand appellants' argument that they should not be required to pay interest while their gain was deferred under IRC section 1033 because they intended to rebuild their property, there is no exception under the R&TC for a situation in which the tax that is being paid was previously deferred pending possible reinvestment of the proceeds of involuntary conversion. (See R&TC, § 19101.)

To obtain relief from interest, a taxpayer must qualify under the waiver provisions of R&TC sections 19104, 19112, or 21012. Here, R&TC section 19104 is inapplicable because interest was assessed based on appellants' amended 2017 California income tax return reporting additional gain and not due to an unreasonable error or delay by respondent. Under R&TC section 19112, respondent may grant a waiver of interest when it "determines that an individual or fiduciary demonstrates inability to pay that interest solely because of extreme financial hardship caused by significant disability or other catastrophic circumstance." Under this section, only respondent may determine when a waiver of interest is warranted upon a showing of extreme financial hardship. (*Appeal of Moy*, 2019-OTA-057P.) Finally, R&TC section 21012 is not relevant here because respondent did not provide appellants with any written advice. Accordingly, appellants have not established a basis to abate interest.

HOLDINGS

1. Gain deferred under IRC section 1033 must be reported for the year the gain was realized, which, based on the record, is the 2017 tax year.
2. Appellants have not established a basis to abate interest.

DISPOSITION


We sustain respondent’s denial of appellants’ claim for refund.

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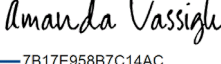
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 Huy “Mike” Le
 Administrative Law Judge

We concur:

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 Eddy Y.H. Lam
 Administrative Law Judge

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 Amanda Vassigh
 Administrative Law Judge

Date Issued: 5/16/2022