

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 20076345
M. JOHNSON AND)
A. JOHNSON)
_____)

OPINION

Representing the Parties:

For Appellants: Anthony Barr, CPA

For Respondent: Matthew D. Miller, Tax Counsel IV

For Office of Tax Appeals: Linda Frenklak, Tax Counsel V

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. Johnson (appellant-husband) and A. Johnson (collectively, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$205,456 and an accuracy-related penalty of \$41,091, plus applicable interest, for the 2012 tax year.¹

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

ISSUE

Whether appellants have established error in FTB’s proposed assessment.

¹ On appeal, FTB concedes to abate the accuracy-related penalty, so we will not address the merits of the penalty.

FACTUAL FINDINGS

General Background and Returns

1. During 2012, appellant-husband was the sole shareholder of an S corporation, EM Johnson Interest, Inc. (EM Johnson), which was a 50 percent member of Leeding Edge Partners, LLC (Leeding Edge Partners).
2. For the 2012 tax year, Leeding Edge Partners was a California limited liability company (LLC) classified as a partnership for tax purposes. During 2012, Leeding Edge Partners was a 99 percent member of SD Mega Block, LLC (SD Mega Block) with a 100 percent profits and loss interest. On its Articles of Organization, which it filed with the California Secretary of State on August 31, 2007, Leeding Edge stated that it would be managed by all its members.
3. For the 2012 tax year, SD Mega Block was a California LLC classified as a partnership for tax purposes. On its California Secretary of State Statement of Information dated October 23, 2009, SD Mega Block described its business as real estate investments and listed Leeding Edge LLC and Telesis CDE One Corp (Telesis CDE One) as its two members.
4. On August 1, 2013, SD Mega Block filed a final California Limited Liability Company Return of Income (Form 568) for the 2012 tax year. The return's Schedule IW, Limited Liability Company Income Worksheet; Schedule K, Members' Shares of Income, Deductions, Credits, etc.; and, a final California Schedule K-1 (568), Member's Share of Income, Deductions, Credits, etc., for Leeding Edge Partners, report total gain under Internal Revenue Code (IRC) section 1231 of \$8,027,522. The return's Schedule D-1, Sales of Business Property, reports a gain of \$8,027,522 from a "deed in lieu property,"² for property acquired on January 1, 2007, and sold on October 1, 2012, for a gross sales price of \$18,639,000 and a basis of \$10,611,478 (hereinafter referred to as the reported property). SD Mega Block's return does not report any cancellation of debt (COD) income. The return has "Leeding Edge Partners LLC/LLC member" printed on the

² In general, a deed in lieu of foreclosure is a voluntary conveyance in which the borrower transfers to the lender title to the real property in full satisfaction of the outstanding debt. (See *Decon Group, Inc. v. Prudential Mortg. Cap. Co., LLC, et al.* (2014) 227 Cal.App.4th 665, 670.)

- signature line without a date, and the tax preparer's name is printed and dated July 23, 2013.
5. On August 1, 2013, Leeding Edge Partners also filed a final Form 568 for the 2012 tax year. Consistent with the final California Schedule K-1 (568) issued by SD Mega Block, Leeding Edge Partners' Schedule IW and Schedule K report California 1231 gains of \$8,027,522 and its Schedule D-1 reports a gain of \$8,027,522 from a "pass through entity (Sch K-1)." Leeding Edge Partners' return includes a final Schedule K-1 (568) for EM Johnson, as a C corporation,³ which reports total gain under IRC section 1231 of \$4,013,761 (i.e., 50 percent of \$8,027,522). Leeding Edge Partners' return does not report any COD income. "Avion Development LLC/LLC member" is printed on the signature line of the return without a date, and the tax preparer's name is printed and dated July 23, 2013.
 6. On October 15, 2013, appellants filed a joint California Resident Income Tax Return (Form 540) for the 2012 tax year. On their 2012 California return, appellants reported taxable income of -\$4,603, zero tax, and an overpayment of \$2,955. Appellants' return does not report any pro rata share of IRC section 1231 gain or COD income.
 7. On February 12, 2014, EM Johnson filed a California S Corporation Franchise or Income Tax Return (Form 100S) for the 2012 tax year. The return reports that EM Johnson has one shareholder, it made a federal S corporation election on March 30, 1998, and it was incorporated in California on February 15, 2012. The return reports net income of \$450,653, a tax due of \$6,760, and an estimated tax penalty of \$136. EM Johnson's return does not report any distributive share of IRC section 1231 gain or COD income. The return has appellant-husband's name printed on the signature line and is dated September 17, 2013.
 8. On March 11, 2014, EM Johnson filed an amended 2012 California return (Form 100X), which states that EM Johnson's original 2012 California return inadvertently identified pass-through income as passive and the amended return corrects this error. The amended return reports a revised amount due of \$824. The amended return does not report any

³ This Schedule K-1 (568) incorrectly identifies EM Johnson as a C corporation. As discussed below, EM Johnson filed a 2012 California S Corporation Franchise or Income Tax Return (Form 100S). Also, on appeal, appellants describe EM Johnson as an S corporation.

distributive share of IRC section 1231 gain or COD income. The amended return is signed with an illegible signature for the president and is dated March 10, 2014.

Audit, Proposed Assessment, and Protest

9. FTB audited appellants' 2012 California return. The auditor sent appellants a letter dated May 5, 2015, stating that FTB received information indicating that on their 2012 return, appellants did not report a capital gain of \$4,013,761 from Leeding Edge Partners, which was reported to EM Johnson on a Schedule K-1. The auditor requested basis schedules for EM Johnson's interest in Leeding Edge Partners and appellants' interest in EM Johnson. After appellants failed to respond to the auditor's May 5, 2015 letter, the auditor sent appellants a second letter dated January 5, 2016, which provided appellants an opportunity to explain why they and EM Johnson failed to report a capital gain of \$4,013,761.
10. After receiving no response, FTB issued appellants a Notice of Proposed Assessment (NPA) dated May 11, 2016, which increased appellants' reported taxable income by \$2,398,518, from -\$4,603 to \$2,393,915, consisting of "unreported income (CODI)" of \$4,013,761 and disallowed itemized deductions of \$39,093, less an allowed capital loss carryover of \$1,654,336. The NPA proposed a mental health services tax of \$13,939.00, additional tax of \$282,597.00, and an accuracy-related penalty of \$53,731.60, plus interest.
11. In a protest letter dated July 11, 2016, appellants' representative asserted that, although his firm prepared appellants' and EM Johnson's 2012 returns, it did not prepare Leeding Edge Partners' 2012 final return and Leeding Edge Partners' tax preparer did not provide his firm with the original 2012 Schedule K-1 from Leeding Edge Partners. He stated that his firm therefore was "not aware of additional income that would have been reported on EM Johnson Interest Inc's [return] and ultimately would have flowed through to [appellants' California return]." He indicated that the additional income is excluded COD income because appellants were insolvent on October 1, 2012. Attached to the protest letter are completed copies of a federal Form 982, Reduction of Tax Attributes

- Due to Discharge of Indebtedness, a Publication 4681 Insolvency Worksheet, and an attachment to the insolvency worksheet.⁴
12. FTB sent appellants an Information Document Request (IDR) dated November 9, 2016, requesting information and documents substantiating appellants' claimed insolvency and proving that the sale of business property reported on SD Mega Block's Schedule D-1 was business property under IRC section 1231 or COD income.
 13. In response to the IDR, appellants sent FTB a letter dated February 28, 2017, stating that they were insolvent as of December 31, 2012, and unable to pay the tax liability that flowed from Leeding Edge Partners' Schedule K-1.
 14. In a determination letter dated March 13, 2020, FTB asserted that appellants' purported insolvency was irrelevant because the NPA incorrectly identified the unreported IRC section 1231 gain as COD income by referring to it as "CODI." FTB noted that COD income would need to be listed on line 11 of a Schedule K-1, whereas the income of \$4,013,761 was listed on line 10 of Leeding Edge Partners' final 2012 Schedule K-1 for EM Johnson, and the auditor reduced the IRC section 1231 gain by appellants' capital loss carryover of \$1,654,336, which would not be allowed if the unreported income was COD income. FTB determined that the proposed assessment was correct.
 15. Appellants subsequently sent a letter to FTB, requesting a redetermination based on the attached copies of Leeding Edge Partners' amended 2012 final return and an amended Schedule K-1 for EM Johnson that reports IRC section 1231 gain of \$1,584,133 in box 10, and COD income of \$2,429,628 in box 11-E. Appellants asserted that the IRC section 1231 gain of \$1,584,133 should be fully wiped out by appellants' capital loss carryforward of \$1,654,336 and the COD income of \$2,429,628 should be excluded from income due to the insolvency of both appellants and EM Johnson, as reflected on the attached balance sheet. In addition, appellants asserted that their 2012 return inadvertently omitted a net operating loss (NOL) carryforward of \$841,339 from 2011 that should be applied against the additional income in 2012.
 16. In a redetermination letter dated June 2, 2020, FTB reiterated that appellants' unreported income of \$4,013,761 is entirely IRC section 1231 gain, as reflected on the original

⁴ Copies of appellants' insolvency worksheet and attachment thereto are attached to the November 9, 2016 IDR. A copy of appellants' Form 982 is not in the appeal record.

Schedules K-1 for Leeding Edge Partners and EM Johnson, which are consistent with SD Mega Block’s reporting of a deed in lieu of foreclosure of its real property on a nonrecourse loan. FTB asserted that there was no cancellation of indebtedness because the realized gain of \$8,027,522 includes the nonrecourse debt for which SD Mega Block was relieved. FTB determined that the submitted amended Schedule K-1 for EM Johnson is unreliable because relief of debt on a nonrecourse loan is not cancellation of indebtedness and based on a review of the documents, the loan was nonrecourse. FTB asserted that “[t]he lender could only look to the real property for repayment of the loan,” because “[e]ven if loan documents specified that the loan was recourse, in reality SD Mega Block had no other assets in which to satisfy the debt.” FTB also asserted that, even if SD Mega Block’s loan was recourse, appellants have failed to show how SD Mega Block determined that its gain should be bifurcated into IRC section 1231 gain of \$3,168,266 and COD income of \$4,859,256 or establish that SD Mega Block’s reported property had a fair market value of \$13,779,744.⁵ FTB adjusted appellants’ revised taxable income and the proposed additional tax and accuracy-related penalty based on an allowed NOL carryover of \$635,987 from 2011, a revised capital loss carryover of \$1,598,942, and a revised itemized deduction phaseout of \$39,680. FTB attached to the redetermination letter an NOL Carryover Schedule and a California Capital Loss Schedule (Revised Capital Loss Carryover).⁶

⁵ FTB determined that appellants would need to establish that the reported property’s fair market value was \$13,779,744, because appellants claim that SD Mega Block realized an IRC section 1231 gain of \$3,168,266 on a recourse debt and SD Mega Block had a basis of \$10,611,478 in the reported property, as reported on Schedule D-1 of its 2012 California return.

⁶ Appellants concede that FTB properly calculated and applied the NOL and capital loss carryforwards, as reflected on the NOL Carryover Schedule and California Capital Loss Schedule (Revised Capital Loss Carryover), and do not dispute the amount of the itemized deduction phaseout. We thus will not discuss these items further.

17. FTB issued a Notice of Action (NOA) dated June 15, 2020, revising the NPA. The NOA increased appellants' taxable income from -\$4,603 to \$1,813,909, consisting of "unreported income (CODI)" of \$4,013,761 and disallowed itemized deductions of \$39,680 less an allowed capital loss carryover of \$1,598,942 and an allowed NOL carryover of \$635,987.⁷ The NOA decreases the proposed additional tax to \$205,456 and the proposed accuracy-related penalty to \$41,091. The NOA states that, pursuant to R&TC section 19104(a), interest was abated from September 22, 2017, to March 10, 2020.
18. This timely appeal followed.
19. On appeal, appellants submitted copies of the following relevant documents:
 - a. 2012 amended final federal return (Form 1065) for SD Mega Block, which includes:
 - 1) an amended federal Schedule K that reports partners' distributive share items of \$8,029,725, including IRC section 1231 gain of \$3,168,266, and COD income of \$4,859,256; 2) an amended federal Schedule K-1 for Leeding Edge Partners, which reports IRC section 1231 gain of \$3,168,266 in box 10 and COD income of \$4,859,256 in box 11-E; and 3) an amended federal Form 4797, Sales of Business Property, which reports a gain of \$3,168,266 from a "deed in lieu property" acquired on January 1, 2007, and sold on October 1, 2012, for a gross sales price of \$13,779,744, with a basis of \$10,611,478. Statement 1 of SD Mega Block's submitted 2012 amended federal return states that the original return was "[a]mended to properly reflect cancellation of debt income and to correct gain on sale in deed in lieu of foreclosure settlement." The submitted return has an illegible signature dated October 8, 2013.
 - b. 2012 amended final California Form 568 for SD Mega Block, which includes: 1) an amended final California Schedule K that reports total distributive income/payment items of \$8,029,725, including IRC section 1231 gain of \$3,168,266 and COD income of \$4,859,256; 2) an amended Schedule IW that reports California 1231 gains

⁷ On appeal, FTB asserts, and appellants do not dispute, that the NPA and NOA incorrectly list the unreported IRC section 1231 gain of \$4,013,761 as COD income by referring to this item as "CODI." We note that the March 13, 2020 Determination Letter advised appellants that the NPA contained this error. Assuming, without deciding, that the NPA and NOA contain a technical defective by listing this item as "CODI," it did not prevent appellants from filing an intelligent protest and appeal. (See *Appeal of Luer* (75-SBE-040) 1975 WL 3524; *Appeal of The First National Bank of Chicago, Trustee* (64-SBE-054) 1964 WL 1459.)

- of \$3,168,266 and COD income of \$4,859,256; 3) an amended California Schedule K-1 (568) for Leeding Edge Partners, which reports IRC section 1231 gain of \$3,168,266 and COD income of \$4,859,256; 4) an amended California Schedule D-1 that reports a gain of \$3,168,266 from a “deed in lieu property” for property that was acquired on January 1, 2007, and sold on October 1, 2012, for a gross sales price of \$13,779,744, with a basis of \$10,611,478. Statement 1 of SD Mega Block’s submitted 2012 amended final California return is identical to Statement 1 of the submitted amended 2012 final federal return. The submitted return has an illegible signature dated October 8, 2013.
- c. 2012 amended final federal Form 1065 for Leeding Edge Partners, which includes: 1) an amended federal Schedule K that reports partners’ distributive share items of \$8,028,925, including IRC section 1231 gain of \$3,168,266 and COD income of \$4,859,256; 2) an amended federal Schedule K-1 for EM Johnson that reports IRC section 1231 gain of \$1,584,133 in box 10 and COD income of \$2,429,628 in box 11-E; and 3) an amended federal Form 4797 that reports a gain of \$3,168,266 from a “pass through entity (Sch K-1).”⁸ Statement 1 of Leeding Edge’s submitted amended 2012 final federal return states that the original return was amended due to receipt of an amended Schedule K-1 from SD Mega Block. The submitted return has an illegible signature for the LLC member manager dated October 9, 2013.⁹
- d. 2012 amended final California Form 568 for Leeding Edge Partners, which includes: 1) an amended California Schedule K that reports IRC section 1231 gain of \$3,168,266 and COD income of \$4,859,256; 2) an amended Schedule IW that reports IRC section 1231 gain of \$3,168,266 and COD income of \$4,859,256; 3) an amended California Schedule K-1 (568) for EM Johnson that reports IRC section 1231 gain of \$1,584,133 and COD income of \$2,429,628; and 4) an amended California Schedule D-1 that reports a gain of

⁸ No information is listed on the amended federal Form 4797 regarding the dates of acquisition and sale, the sale price, or the basis.

⁹ Appellants submitted a second version of a 2012 amended final federal Form 1065 for Leeding Edge Partners, which is not signed or dated, although it shows the tax preparer’s printed name and indicates the tax preparer signed the return on October 9, 2013. This version of the amended return appears to be essentially identical to the first version of the amended return, including identical Schedules K and federal Forms 4797. The second version of the amended return does not include the Schedule K-1 for EM Johnson.

- \$3,168,266 from a “pass through entity (Sch K-1).”¹⁰ Statement 1 of Leeding Edge Partners’ submitted 2012 amended final Form 568 is identical to Statement 1 of its submitted amended 2012 final Form 1065. The return has an illegible signature for the officer dated October 9, 2013.
- e. A loan agreement executed by Telesis CDE One and SD Mega Block on October 26, 2007, which states that SD Mega Block held title to property located on 16th Street in San Diego, California that was to be developed as a mixed-use development consisting of housing units, commercial office space, and retail space, and Telesis CDE One agreed to loan SD Mega Block an aggregate principal amount not to exceed \$17,139,000 evidenced by two promissory notes secured and guaranteed by closing security documents (Loan Agreement).¹¹
 - f. A Continuing Guaranty signed by appellant-husband as president of EM Johnson, which states that Avion Development LLC made and entered into this guaranty as of October 26, 2006, in favor of Telesis CDE One regarding the Loan Agreement.
 - g. An untitled document appellants refer to as “tax preparer’s workpapers,” which calculates SD Mega Block’s COD income of \$4,859,256 and a gain on sale of \$3,168,266.
 - h. A revised balance sheet for EM Johnson as of October 1, 2012, signed by appellant-husband as president of EM Johnson, which shows total insolvency of \$9,883,920.
20. FTB produced copies of FTB’s 2012 return summaries for SD Mega Block and Leeding Edge Partners to substantiate that neither entity filed 2012 amended final California returns with FTB.

¹⁰ No information is listed on the amended Schedule D-1 regarding the dates of acquisition and sale, the sale price, or the basis.

¹¹ A copy of any deed related to the property is not in the appeal record.

DISCUSSION

Burden of Proof

FTB's determination is presumed correct, and a taxpayer has the burden of proving error. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of GEF Operating Inc.*, 2020-OTA-057P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Chen and Chi*, 2020-OTA-021P.) 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 the taxpayer's position. (*Appeal of Bindley*, 2019-OTA-179P.) A taxpayer's burden of proof is not relieved because it may be difficult or impossible to substantiate his or her position. (*Appeal of Giesea* (86-SBE-016) 1986 WL 22687.)

Gain from Sale of Property

Tax shall be imposed on the entire taxable income of every resident of California. (R&TC, § 17041(a).) Gross income means all income from whatever source derived, unless specifically excluded. (IRC, § 61(a); R&TC, § 17071.)¹² Gross income includes “[g]ains derived from dealings in property.” (IRC, § 61(a)(3); R&TC, § 17071.) The specific rules for computing the amount of gain or loss from dealings in property under IRC section 61(a)(3) are contained in IRC section 1001 and the regulations thereunder. (Treas. Reg. § 1.61-6(a).) The gain from the sale or other disposition of property is generally the excess of the amount realized over the taxpayer's adjusted basis, and the loss is the excess of the adjusted basis over the amount realized. (IRC, § 1001(a).) The adjusted basis is generally the cost of the property, plus any capital expenditures made with respect to the property, and less any depreciation taken with respect to the property. (IRC, §§ 1011, 1012, 1016.)¹³

The conveyance of mortgaged property in lieu of foreclosure should be treated as the functional equivalent of a sale or exchange for federal income tax purposes. (*Allen v.*

¹² For the 2012 tax year, R&TC section 17024.5(a)(1)(O) provides that for Personal Income Tax Law purposes, California conforms to the January 1, 2009 version of the IRC. References herein to the IRC are therefore to the January 1, 2009 version.

¹³ California law generally conforms to IRC sections 1001, 1011-1016 pursuant to R&TC section 18031.

Commissioner (1986) 86 T.C. 655, 659, affd. (8th Cir. 1988) 856 F.2d 1169; *Lowry v. Commissioner*, T.C. Memo. 2003-225, affd. (9th Cir. 2006) 171 Fed.Appx. 6; *Appeal of Olson* (94-SBE-005) 1994 WL 395765.) IRC section 1231(a) generally allows a taxpayer to treat a recognized gain from the sale or exchange of property used in the trade or business as a capital gain, and a loss from such a sale or exchange as an ordinary loss.¹⁴

COD Income

Gross income includes “[i]ncome from discharge of indebtedness,” which is also known as COD income. (IRC, § 61(a)(12); R&TC, § 17071.) “A discharge of indebtedness occurs when ‘the debtor is no longer legally required to satisfy his [or her] debt either in part or in full.’ [Citations.]” (*Black v. Commissioner*, T.C. Memo. 2014-27.) The rationale for including discharge of indebtedness in gross income is that, to the extent a taxpayer has been released from indebtedness, the taxpayer has realized additional income because the cancellation of indebtedness effects a freeing of assets previously offset by the liability. (*Jelle v. Commissioner* (2001) 116 T.C. 63, 67; see also *U.S. v. Kirby Lumber Co.* (1931) 284 U.S. 1, 3.) COD income is generally recognized in the year the debt is cancelled. (*Bui v. Commissioner*, T.C. Memo. 2019-54.) Income realized on the discharge of such debt is ordinary income taxed at ordinary rates. (*Callahan v. Commissioner*, T.C. Memo. 2013-131.) The amount of ordinary income realized from the discharge of indebtedness is the difference between the amount of the debt discharged and the fair market value of the property received by the lender. (*Bui v. Commissioner, supra*; see also Treas. Reg. § 1.1001-2(c), Example 8.) The determination of whether a transaction is governed by IRC section 61(a)(3) or IRC section 61(a)(12) “depends on the particular facts of the case.” (*2925 Briarpark, Ltd. v. Commissioner* (5th Cir. 1999) 163 F.3d 313, 319.)

IRC section 108 excludes certain discharges of indebtedness from gross income.¹⁵ Gross income does not include any amount that would otherwise be included in the gross income of a taxpayer if the discharge of indebtedness occurs when the taxpayer is insolvent. (IRC, § 108(a)(1)(B).) The excluded amount cannot exceed the amount by which the taxpayer is

¹⁴ IRC section 1231 is generally incorporated into California law pursuant to R&TC section 18151.

¹⁵ California generally conforms to IRC section 108 pursuant to R&TC section 17131.

insolvent. (IRC, § 108(a)(3).)¹⁶ For purposes of IRC section 108, a taxpayer is insolvent if, immediately before the cancellation of debt, the taxpayer's liabilities exceed the fair market value of the taxpayer's assets. (IRC, § 108(d)(3).) The provisions of IRC section 108(a) concerning excluded COD income shall be applied at the corporate level in the case of an S corporation and at the partnership level in the case of a partnership. (IRC, § 108(d)(6)-(7).)

Recourse and Nonrecourse Debt

A debt is characterized as recourse when the borrower is personally liable for the debt, and a debt is characterized as nonrecourse when the borrower is not personally liable for the debt and the creditor's recourse is limited to the secured asset. (*Simonsen v. Commissioner* (2018) 150 T.C. 201, 206; *Wienke v. Commissioner*, T.C. Memo. 2020-143; see also Treas. Reg. § 1.1001-2(c).) "The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability." (Treas. Reg. § 1.1001-2(a)(4)(i).) When a taxpayer sells or disposes of property encumbered by a nonrecourse loan, the amount realized is the full outstanding amount of the debt, and the amount of gain or loss realized is the difference between the outstanding amount of the debt and the property's adjusted basis. (Treas. Reg. § 1.1001-2(a)(1) & (c), Example 7; *Crane v. Commissioner* (1947) 331 U.S. 1, 12-13.) "The fair market value of the property is irrelevant to this calculation." (*Commissioner v. Tufts* (1983) 461 U.S. 300, 317; see also *Appeal of Olson, supra.*) When determining the amount of gain or loss with respect to a property, "the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject." (IRC, § 7701(g); R&TC, § 17020.5.)

The tax treatment is different when the transferred property is subject to a recourse debt in an amount greater than the fair market value of the property. For tax purposes, such a transaction is bifurcated into an amount realized on the sale or other disposition of property under IRC section 61(a)(3) and an amount of COD income under IRC section 61(a)(12). "The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under [IRC] section 61(a)(12)." (Treas. Reg. § 1.1001-2(a)(2).) Instead, the

¹⁶ A taxpayer who claims excluded COD income due to insolvency under IRC section 108(a) must reduce certain tax attributes (but not below zero) by the amount excluded, including NOL and capital loss carryovers. (IRC, § 108(b); see also IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, Abandonments(2012) pp. 9-10.)

amount realized on the sale or other disposition of the property is the fair market value of the property, and the difference between the property's fair market value and the property's basis is recognized as gain or loss pursuant to IRC section 61(a)(3). Any amount in excess of the cancelled debt over the property's fair market value is COD income pursuant to IRC section 61(a)(12). (Treas. Reg. § 1.1001-2(c), Example 8; Rev. Rul. 90-16, 1990-1 C.B. 12; see also *Frazier v. Commissioner* (1998) 111 T.C. 243, 245; *Aizawa v. Commissioner* (1992) 99 T.C. 197, 200-202; *Appeal of Olson, supra.*)

Pass-Through Entities

An LLC classified as a partnership, such as SD Mega Block and Leeding Edge Partners, is a pass-through entity. R&TC section 17087.6 states, "If [an LLC] is classified as a partnership for California tax purposes, a person with a membership or economic interest shall take into account amounts required to be recognized under Chapter 10 (commencing with [R&TC] Section 17851)." IRC section 702(a) provides that each partner is required to report his or her distributive share of the partnership's taxable income, gain, loss, deductions, or credits.¹⁷ According to FTB's 2012 Members Instructions for Schedule K-1 (568), an LLC that has elected to be treated as a partnership for tax purposes uses Schedule K-1 (Form 568) to report distributive shares of the LLC's income, deductions, credits, etc., and the LLC member should not file the Schedule K-1 with his or her return because the LLC files a copy of it with FTB.

An S corporation, such as EM Johnson, is also a pass-through entity. For both federal and California tax purposes, the S corporation's income and losses are passed through on a pro rata basis to the corporation's shareholders, who must report them on their individual returns. (IRC, §§ 1363(b) & 1366; R&TC, §§ 17087.5, 23800.) The character of a shareholder's pro rata share of S corporation income is determined as if such income was realized directly from the source from which it was realized by the corporation or incurred in the same manner as incurred by the corporation. (IRC, § 1366(b); R&TC, § 23801; see also *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284, 1288.) An S corporation uses California Schedule K-1 (Form 100S) to report the shareholder's pro rata share of the S corporation's income, deductions, credits, etc., and the shareholder uses the information from the California Schedule K-1 to file

¹⁷ R&TC section 17851 generally incorporates the partnership laws provided in IRC section 701 et seq., into California law.

his or her return and is liable for the income tax on his or her share of the S corporation's income. (See FTB's 2012 Shareholder's Instructions for Schedule K-1 (100S).)

Appellants disavow the original 2012 final returns that SD Mega Block and Leeding Edge Partners filed with FTB on August 1, 2013, both of which report IRC section 1231 gain of \$8,027,522 and no COD income. They argue that when SD Mega Block transferred the reported property in lieu of foreclosure on October 1, 2012, the reported property was subject to total debt of \$18,639,000 consisting of: 1) the Loan Agreement for \$17,139,000, which was purportedly a recourse debt; 2) a note executed by Telesis CDE One for \$40,000, which was purportedly a recourse debt; and 3) a note executed by Brown/Clark Trust for \$1,460,000, which was purportedly a nonrecourse debt. Appellants contend that for tax purposes, SD Mega Block is required to bifurcate this reported transaction into COD income of \$4,859,256 and IRC section 1231 gain of \$3,168,266, and these items of income would flow through to Leeding Edge Partners. Appellants also contend that EM Johnson, as a 50 percent member of Leeding Edge Partners, would be required to report its distributive share of flow-through COD income of \$2,429,628 and an IRC section 1231 gain of \$1,584,133. They further contend that appellants, as sole shareholders of EM Johnson, would be required to report 100 percent of EM Johnson's flow-through COD income of \$2,429,628 and an IRC section 1231 gain of \$1,584,133. Lastly, appellants argue that the COD income of \$2,429,628 should be excluded from their gross income pursuant to IRC section 108(a)(1)(B), because, as of October 1, 2012, EM Johnson was insolvent, as reflected on the submitted revised balance sheet.¹⁸

The submitted amended 2012 final California returns for SD Mega Block and Leeding Edge Partners, the submitted amended 2012 Schedules K-1 (568) for Leeding Edge Partners and EM Johnson, the Loan Agreement, the Continuing Guaranty, and the "tax preparer's workpapers" are not sufficient evidence to demonstrate that, contrary to the information reported on SD Mega Block's and Leeding Edge Partners' original 2012 final returns, SD Mega Block realized COD income of \$4,859,256 and an IRC section 1231 gain of \$3,168,266. Appellants have failed to establish that the submitted amended 2012 final returns, which are dated October 8, 2013, and October 9, 2013, were prepared at the behest of SD Mega Block and Leeding Edge Partners. Although they concede that the tax preparer who prepared Leeding Edge

¹⁸ Initially, appellants contended that for purposes of IRC section 108(a)(1)(B), appellants were insolvent, but later conceded that insolvency should be determined at EM Johnson's level pursuant to IRC section 108(d)(7).

Partners' original 2012 final return did not prepare EM Johnson's and appellants' 2012 returns, appellants do not identify the individual who prepared the submitted amended 2012 final returns and Schedules K-1 (568) on behalf of SD Mega Block and Leeding Edge Partners. Appellants also do not describe the facts and circumstances surrounding the preparation (and filing) of these documents or when and how they were able to obtain these documents. Appellants do not explain why EM Johnson's 2012 original and amended returns filed on February 12, 2014, and March 11, 2014, respectively, do not reflect the relevant information included in the submitted amended 2012 final return for Leeding Edge Partners dated October 9, 2013, or why their July 11, 2016 protest letter fails to mention SD Mega Block's and Leeding Edge Partners' amended final returns that were purportedly prepared in October 2013. Based on the evidence in the record, we are not persuaded that SD Mega Block or Leeding Edge Partners amended (or intended to amend) their original reporting of the IRC section 1231 gain of \$8,027,522. Most importantly, FTB has provided copies of its return summaries for SD Mega Block and Leeding Edge Partners for the 2012 tax year, which show that neither entity filed an amended 2012 final return with FTB. We find the submitted amended 2012 final returns for SD Mega Block and Leeding Edge Partners and the submitted amended Schedules K-1 (568) are not credible, which raises the question of whether appellants produced them to support their position at protest and on appeal.

There is no dispute that FTB accepted as filed SD Mega Block's and Leeding Edge Partners' original 2012 final returns. SD Mega Block and Leeding Edge Partners signed their original 2012 final returns under penalty of perjury. "[S]tatements a taxpayer makes on its signed tax return 'are considered binding admissions unless there is 'cogent evidence' that indicates such statements are wrong.'" (*Purple Heart Patient Ctr., Inc. v. Commissioner*, T.C. Memo. 2021-38, citing *Kornhauser v. Commissioner*, T.C. Memo. 2013-230, *affd.* (9th Cir. 2016) 632 Fed.Appx. 421.) Appellants have failed to produce "cogent evidence" that establishes that the relevant information reported in SD Mega Block's and Leeding Edge Partners' filed returns is wrong. We need not accept appellants' self-serving contentions, especially in the absence of reliable corroborating evidence. (*Geiger v. Commissioner* (9th Cir. 1971) 440 F.2d 688, 689-90 (*per curiam*), cert. den. (1971) 404 U.S. 851.)

Appellants rely on the Loan Agreement and two other notes to show that for tax purposes, SD Mega Block's transfer of the reported property should have been bifurcated into

COD income and IRC section 1231 gain. Although appellants produced a copy of the Loan Agreement, they did not produce copies of the two other notes or contemporaneous documents substantiating that SD Mega Block's reported property was subject to two debts of \$40,000 and \$1,460,000, as well as the Loan Agreement. Appellants do not address how they determined that the claimed loan of \$40,000 was a recourse debt and the claimed loan of \$1,460,000 was a nonrecourse debt. Assuming without deciding that the claimed loan of \$40,000 was a recourse loan, appellants have failed to produce any contemporaneous documents that show an outstanding balance due on the claimed loan of \$40,000 after the completion of the reported transfer in lieu of foreclosure. Without substantiating documents to support appellants' position that the \$40,000 loan was a recourse debt and the \$1,460,000 loan was a nonrecourse debt, the record does not support appellants' position in the appeal.

Appellants contend that the Loan Agreement represents a recourse loan of \$17,139,000, even though they concede that paragraph 36 of the Loan Agreement, which is entitled "Non-Recourse Provisions," contains express nonrecourse provisions. They assert, however, that paragraph 36 of the Loan Agreement also contains recourse language by providing, "except as may be set forth in any indemnity or Guaranty executed by Borrower or any Guarantor." In addition, they assert that section 2.1 of Article II of the Continuing Guaranty provides that this guaranty is binding "notwithstanding the non-recourse provision set forth in Section 36 of the Loan Agreement[.]" Assuming without deciding that the Loan Agreement was a recourse loan, appellants have failed to produce any contemporaneous documents that show an outstanding balance due on the Loan Agreement after the completion of the reported transfer in lieu of foreclosure. SD Mega Block was in the best position to know whether the property it owned was subject to nonrecourse or recourse debt. We find that SD Mega Block characterized the Loan Agreement as a nonrecourse debt based on its reporting of the transaction on its original 2012 return as entirely an IRC section 1231 gain of \$8,027,522. Appellants have not proven that SD Mega Block's original characterization of the entire debt that encumbered the reported property as nonrecourse debt was erroneous.

Lastly, we are not persuaded by the calculations set forth in the submitted "tax preparer's workpapers." According to the calculations in this document, SD Mega Block realized IRC section 1231 gain of \$3,168,266 and COD income of 4,859,256 based on the reported property having a basis of \$10,611,478, and a claimed fair market value of \$12,319,744 on

October 1, 2012, and the three claimed debts discussed above. The document lists a basis of \$10,611,478, which is consistent with the amount of basis that SD Mega Block reported on its original Schedule D-1. Appellants, however, fail to address or substantiate how they determined that on October 1, 2012, the reported property had a fair market value of \$12,319,744, as reflected on the “tax preparer’s workpapers.” They do not contend that SD Mega Block reported this item on its original final return. In addition, appellants do not address or substantiate how they determined that as of October 1, 2012, the Loan Agreement’s outstanding balance due was exactly \$17,139,000, the stated maximum amount of the loan, without considering any loan distribution amounts, accrued interest, or fees. It is reasonable to assume that there are documents reflecting the outstanding balances due on this long-standing debt; the Loan Agreement was executed on October 26, 2007. As discussed above, we find that the Loan Agreement represents a nonrecourse debt and appellants did not produce evidence of the two notes that purportedly represent a claimed nonrecourse debt of \$1,460,000 and a claimed recourse debt of \$40,000 that encumbered the reported property on October 1, 2012. The “tax preparer’s workpapers” are no more reliable than the information contained in it.

We conclude that appellants have failed to prove that SD Mega Block and Leeding Edge Partners improperly reported IRC section 1231 gain of \$8,027,522 and no COD income on the 2012 final returns they filed with FTB. Accordingly, EM Johnson, as a 50 percent member of Leeding Edge Partners, was required to report the flow through IRC section 1231 gain of \$4,013,761 and appellants, as the sole shareholders of EM Johnson, were required to report the same flow-through IRC section 1231 gain of \$4,013,761 on their 2012 returns.

HOLDING

Appellants have not established error in FTB’s proposed assessment.

DISPOSITION

FTB’s action is modified to abate the accuracy-related penalty, as conceded by FTB on appeal; otherwise, FTB’s action is sustained.

DocuSigned by:
Sara A. Hosey
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Sara A. Hosey
Administrative Law Judge

We concur:

DocuSigned by:
Kenneth Gast
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Kenneth Gast
Administrative Law Judge

DocuSigned by:
Andrea L.H. Long
272945E7B372445...
Andrea L.H. Long
Administrative Law Judge

Date Issued: 4/8/2022