OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. ORTIZ AND** **C. ORTIZ**	OTA Case No. 19034479

OPINION

Representing the Parties:

For Appellants: Gary M. Slavett, Attorney

For Respondent: Leoangelo C. Cristobal, Tax Counsel

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Ortiz and C. Ortiz (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing $229,014 of additional tax, and applicable interest, for the 2010 taxable year.

Appellants waived the right to an oral hearing; therefore, the Office of Tax Appeals (OTA) decides the matter based on the written record.

ISSUE

Have appellants shown error in FTB's proposed assessment, which is based on a federal determination?

FACTUAL FINDINGS

1. Appellants filed a 2010 California income tax return, claiming an overpayment of $3,211. FTB processed the return and issued a refund on April 15, 2011.
2. The IRS provided information to FTB indicating it had made changes to appellants' 2010 federal income tax return following an audit. The IRS reduced appellants' Schedule A itemized deductions by $6,899, increased appellants' Schedule D long-term capital gain by $1,531,486, and increased appellants' Schedule E income by $687,398, resulting in an

increase to appellants' taxable income of $2,225,783.[1] The IRS imposed additional tax, plus penalties and interest.

3. Many of the adjustments the IRS made to appellants' 2010 taxable year were made pursuant to a federal closing agreement (closing agreement) between appellants and the IRS.[2] Specifically, as part of the closing agreement, appellants agreed, for federal tax purposes, to recognize as taxable income for the 2010 taxable year three transactions from taxable years prior to 2010: (1) capital gain in the amount of $362,500 from the sale of a 50 percent ownership interest in Los Rancheros Properties, LLC (Los Rancheros), which occurred on January 1, 2004;[3] (2) capital gain of $225,000 from the sale of a 50 percent ownership in El Pescador #6, Inc. (El Pescador), which occurred on January 1, 2004;[4] and (3) capital gain of $944,508[5] from the sale by CCC&J Properties, LLC (CCC&J Properties), an S corporation, of a 49 percent interest in real property to Angel 9, LLC, in a related-party transaction on April 23, 2007.[6] Based on these three

[1] Federal Schedule E is where taxpayers report supplemental income and loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, etc.

[2] OTA's record includes only excerpts of the closing agreement and federal audit working papers. It is not clear whether all the IRS adjustments reported to FTB were included in the closing agreement.

[3] The closing agreement reflects a sales price of $362,500. The LLC membership interest purchase agreement provided by appellants on appeal shows the sale price to be $300,000. The difference is irrelevant to the outcome of this appeal. Additionally, per IRS audit workpapers, the IRS did not allow a reduction for appellants' basis in Los Rancheros because appellants did not provide source documents showing the source of the funds used to fund or acquire Los Rancheros.

[4] The closing agreement reflects a sales price of $450,000; however, the IRS audit workpapers reflect appellants' share of the sales price as $225,000 (50 percent of $450,000 reflected in the closing agreement). The stock purchase agreement provided by appellants on appeal shows the sale price to be $150,000. The difference is irrelevant to the outcome of this appeal. Additionally, per the IRS audit workpapers, the IRS did not allow a reduction for appellants' basis in El Pescador because appellants did not provide source documents showing the source of the funds used to fund or acquire El Pescador.

[5] The closing agreement reflects total consideration of $1,968,393; however, the IRS audit workpapers reflect a total sales price of $1,437,467. The difference is not explained by the parties and is irrelevant to the outcome of this appeal. The IRS audit workpapers calculate appellants' share of the unreported capital gain to be $944,508 after subtracting basis of $488,073 and capital gain already reported by appellants in the amount $4,886 (instead of the reported capital gain of $2,443 as indicated in the closing agreement). The difference is also irrelevant to the outcome of this appeal.

[6] Appellants owned a 50 percent interest in CCC&J Properties.

transactions, the IRS adjusted appellants' Schedule D long-term capital gains by $1,531,486 for the 2010 taxable year.[7]

4. In the closing agreement appellants agreed that: (1) income from El Pescador #12, an S Corporation wholly owned by appellants, was understated for the 2010 taxable year, and agreed to a gross sales adjustment, and (2) certain adjustments to CCC&J Properties' income and expense deductions for the 2010 taxable year were proper. Based on these agreements reached in the closing agreement, the IRS increased appellants' Schedule E income by $437,168 of unreported sales income from El Pescador #12 and $223,754[8] of additional passive income from CCC&J Properties.
5. To the extent applicable under California law, FTB adjusted appellants' California taxable income by following the federal changes reflected in information the IRS provided to FTB.[9] On June 17, 2016, FTB issued a Notice of Proposed Assessment (NPA) which increased appellants' California taxable income by $2,281,012 and proposed additional tax of $229,014, plus applicable interest.
6. Appellants did not enter into a California closing agreement with FTB.
7. At a protest hearing with FTB, held on June 26, 2018, appellants informed FTB that some of the IRS audit adjustments to their 2010 taxable year were based on a closing agreement with the IRS and occurred as the result of prior years' transactions. Specifically, appellants reiterated that they did not have Schedule D long-term capital gains of $1,531,483 in the 2010 taxable year (which is made up of the IRS adjustments to capital gain from Los Rancheros, El Pescador, and CCC&J Properties).
8. After appellants protested the NPA, FTB issued a Notice of Action affirming the NPA. This timely appeal followed.

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[7] The total capital gain for all three transactions totaled $1,532,008 ($362,500 + $225,000 + $944,508). The IRS audit workpapers indicate that appellants reported $522 per their original federal return, resulting in a total Schedule D long-term capital gain adjustment of $1,531,486 ($1,532,008 - $522).

[8] The amount of the federal adjustment to appellants' passive income in CCC&J Properties of $223,754 is not mentioned in the excerpts of the audit working papers or closing agreement. The total is calculated by subtracting the unreported El Pescador #12 income of $437,168 from the total Schedule E adjustments reported to FTB on the Fedstar Data Sheet of $678,398 ($678,398 - $437,168 = $223,754. The number was also used in appellants' briefing and is not disputed by FTB.

[9] In addition to following the federal adjustments related to Schedule A medical and dental expense deductions, Schedule D long-term capital gain, and Schedule E income, FTB limited appellants' overall itemized deductions due to the limitation based on appellants' revised federal adjusted gross income.

DISCUSSION

R&TC section 18622(a) provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. FTB's deficiency determination based on a federal audit report is presumptively correct, and appellants bear the burden of proving error in FTB's determination. (*Appeal of Gorin*, 2020-OTA-018P; *Todd v. McColgan* (1949) 89 Cal.App.2d 509.) In the absence of credible evidence showing that FTB's determinations are incorrect, they must be upheld. (*Appeal of Valenti*, 2021-OTA-093P.) Unsupported assertions are not sufficient to satisfy appellants' burden of proof. (*Appeal of Gorin*, *supra*.)

The burden on appeal does not require that appellants prove error in the final federal determination. Rather, appellants' burden is to show error in FTB's proposed assessment based on that final federal determination. One way in which error may be shown is by demonstrating that the federal adjustment was modified or canceled. However, that is not the only means by which error may be shown. Appellants may overcome the presumption of correctness by showing error in the federal determination upon which FTB based its proposed assessment or by showing on appeal that FTB's determination is incorrect.

Here, FTB based its proposed assessment of additional tax on a final federal determination which was based upon a closing agreement signed by appellants and the IRS. Internal Revenue Code (IRC) section 7121 provides that a final federal determination made pursuant to a closing agreement is an irrevocable determination or adjustment of taxpayers' federal tax liability. Absent a showing of fraud or malfeasance, or misrepresentation of a material fact, there exists no further right of appeal, either administrative or judicial. (IRC, § 7121(b).)

Appellants contend that FTB incorrectly included taxable transactions which occurred prior to the 2010 taxable year at issue. More specifically, appellants assert that FTB cannot include the capital gain transactions at issue that occurred in 2004 and 2007 in their 2010 taxable year. Appellants further assert that they do not owe taxes for Schedule E income included in

their closing agreement because they do not know how the IRS calculated the liability and do not believe it is correct.

FTB does not appear to dispute that the federal assessment for the 2010 taxable year based on the closing agreement included taxable capital gains that should have been reported and recognized as taxable income in prior taxable years. Rather, FTB asserts that the closing agreement "is considered final, and accordingly, [FTB] can follow the IRS' assessment" for the 2010 taxable year.

Schedule D Long-Term Capital Gains

The IRS is authorized to enter into an agreement in respect of any internal revenue tax, and the closing agreement is final and conclusive, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact. (IRC, § 7121.) A federal closing agreement may be entered into for any taxable period occurring prior to or subsequent to the date of the agreement. (Treas. Reg. § 301.7121-1(a).)

At protest with FTB, appellants claimed that they did not have a good understanding of written English and that they did not know how the IRS computed their tax liability. FTB asserts in response that regardless of their level of understanding, because appellants have not shown error in the final determination in the closing agreement, its proposed assessment must be upheld. At protest, appellants also asserted that capital gains occurred in years prior to 2010, and they did not agree with those changes. FTB responded that the federal adjustment was not changed, and therefore, FTB could not make the change.

To the extent appellants argue that the closing agreement is not a final federal determination because of their misunderstanding of the document, OTA agrees with FTB. Appellants' alleged misunderstanding and lack of competent representation do not constitute fraud, malfeasance, or misrepresentation of a material fact, as required by law to disregard a closing agreement. (IRC, § 7121; Cal. Code Regs., tit. 18, § 19059(e).)

On appeal, appellants do not assert that the closing agreement is void or should be disregarded. Rather, appellants primarily assert that the capital gain adjustments in the closing

agreement occurred in taxable years prior to 2010, and therefore, FTB cannot include those transactions in an NPA issued for the 2010 taxable year. In support of that assertion, appellants provide copies of documents, including pages of the closing agreement and some audit workpapers.[10] As relevant here, the closing agreement reflects that appellants' interest in Los Rancheros was sold in 2004, which is further supported by an LLC Membership Interest Purchase Agreement dated January 1, 2004. The closing agreement also reflects that appellants received a pro rata share of a sale in 2007, by CCC&J, Properties, of 49 percent of a building, which is further supported by audit workpapers indicating a "[s]ale to Angel 9, LLC on 4/23/07." The closing agreement reflects that appellants' interest in El Pescador was sold in 2004, which is further supported by a Stock Purchase Agreement dated January 1, 2004, and by stock certificates with the same date. The IRS audit report page submitted by appellants reflects that "The sale of one of the commercial properties and the restaurant were not reported in their year of occurrence nor subsequently." The auditor notes that "[a]lthough neither of the sales occurred in 2007,[11] the [t]axpayers have agreed to report the adjustment to [c]apital [g]ains on the earliest year under examination, 2010."

FTB counters that appellants are bound by the closing agreement. FTB further asserts that appellants have not shown error in FTB's proposed assessment based on the federal adjustments to their 2010 tax liability. Finally, FTB contends that appellants' documentation is insufficient to show error in FTB's determination.

Appellants' burden is to show that FTB's determination is erroneous, as discussed above. Appellants may do this in one of three ways: (1) by showing that the federal determination was canceled, withdrawn, or revised by the IRS; (2) by showing error in the federal determination, or (3) by showing error in FTB's determination independent of whether error in the final federal determination is shown. (See *Appeal of Surrey House, Inc.* (80-SBE-047) 1980 WL 4975

[10] FTB asserts that appellants did not submit all pages of the closing agreement, which raises the presumption that the missing information would be unfavorable to them. (See *Appeal of Vardell*, 2020-OTA-190P.) However, FTB does not appear to dispute the relevant transactions at issue occurred prior to 2010 so the missing pages do not appear to change the outcome of this appeal, and OTA declines to speculate as to the contents of the missing information.

[11] It appears the auditor meant 2010 as taxable year 2007 was not under audit by the IRS.

[holding that where appellant submitted documentary evidence on appeal showing that the federal determination was incorrect, appellant overcame the presumption of correctness in FTB's determination which was based on a federal determination even though appellants did not seek a cancelation or modification at the federal level].) Appellants did not enter into a closing agreement with FTB. Just as FTB is not bound to follow the federal determination (see *Appeal of Der Wienerschnitzel International, Inc.*, *supra*), appellants may show on appeal that a proposed assessment based on a final federal determination is incorrect. (See *Appeal of Surrey House*, *Inc*. *supra*.)

Although a presumption of correctness attends FTB's 2010 proposed assessment, it is a rebuttable presumption, and appellants have presented sufficient evidence to rebut that presumption, including sales agreements, stock certificates, IRS auditor's workpapers, and the pages of the closing agreement that reflect transactions which occurred in prior years. FTB has not shown that the documentation related to capital gains submitted by appellants on appeal is inaccurate in any respect.

Gain or loss from the sale of property must generally be recognized in the year the sale occurs (IRC, § 1001(a), (c);[12] *Appeals of Lovinck Investments, N.V., et al.*, 2021-OTA-294P), or in the case of an installment sale, in the year the installment payments are received. (IRC, § 453; R&TC § 17551(a);)[13] FTB does not dispute that the capital gain transactions were realized and should have been recognized prior to 2010. Thus, appellants were required to recognize capital gain in 2004 and in 2007, not in 2010. The NPA and Notice of Action at issue here were issued only for the 2010 taxable year, and OTA only has authority to address that taxable year.[14] (See

[12] California conforms to IRC section 1001, et seq. through R&TC section 18031.

[13] Nothing in OTA's record suggests that the El Pescador and CCC&J Properties transactions were installment sales. Additionally, while the LLC Membership Purchase Agreement for the Los Rancheros sale dated January 1, 2004, indicates that the purchase price was to be paid in 12 monthly installments, presumably the 12 monthly installments would have been paid in 2004 (or 2005 at the latest).

[14] OTA expresses no opinion on whether or when the statute of limitations for 2004 and 2007 has expired. The record is unclear as to when FTB had sufficient information to allow it to calculate taxes and issue NPAs for taxable years prior to 2010. (See R&TC, § 18622(c) [notification of a change must be sufficiently detailed to allow computation of the resulting California change]; see also Cal. Code Regs., tit. 18, § 19059(a) [notification shall be made by mailing to the FTB "the original or a copy of the final determination . . . as well as any other data upon which such final determination . . . is claimed"].)

Appeal of Liljestrand Irrevocable Trust, 2019-OTA-012P.) Appellants' taxable transactions from prior years which were included in appellants' federal taxable income for 2010 pursuant to the closing agreement cannot be taxed by California in their 2010 taxable year and were improperly included in FTB's 2010 NPA.

Schedule E Supplemental Income and Loss

Appellants' closing agreement includes additional tax based on underreported income from a restaurant referred to as El Pescador #12. The closing agreement thus increased appellants' 2010 taxable income by $437,168, which amount is also recorded on Form 886-X (Shareholders' Share of Income, Deductions, and Credits).[15] In addition, the IRS increased appellants' passive income from CCC&J Properties by $223,754 for 2010.

Appellants' only argument with respect to their increased Schedule E income is that they do not understand why the IRS made the adjustments, and they "do not believe it to be correct."[16] FTB did not expressly address this argument but instead relied on the presumption of correctness that applies to its proposed assessment made pursuant to a final federal determination.

The Schedule E adjustments increased appellants' 2010 federal tax liability. FTB correctly followed those adjustments and increased appellants' California taxable income for the 2010 taxable year. Because the presumption of correctness applies to FTB's determinations based on federal adjustments, appellants have the burden of proving that the Schedule E adjustments were erroneous. Appellants' unsupported assertions with respect to the Schedule E income are insufficient to overcome the presumption. (*Appeal of Gorin*, *supra*.) Thus, appellants have not met their burden of proof with respect to the increase in appellants' Schedule E income.

[15] Form 886-X is a federal form used to notify shareholders of adjustments the IRS made based on its examination of the corporation.

[16] OTA notes that the IRS audit methodology is clearly set forth in the closing agreement, so appellants' claim that they do not understand why the IRS made the adjustments is unconvincing.

Adjustments to Itemized Deductions

Appellants do not provide any specific arguments with respect to FTB's corresponding adjustment of $6,899 for disallowed medical and dental expenses; therefore, they have not met their burden to show error in this adjustment.

HOLDING

Appellants have shown error in the portion of FTB's determination that relates to the increase of their taxable income for capital gains of $1,531,486 which were realized prior to 2010. Appellants have not otherwise established error in FTB's proposed assessment.

DISPOSITION

FTB's action with respect to the inclusion in appellants' taxable income of capital gains (i.e., $1,531,486) realized prior to 2010 is reversed. FTB shall modify its proposed assessment consistent with the holding on appeal. Otherwise, FTB's action is sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

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Kenneth Gast
Administrative Law Judge

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John O. Johnson
Administrative Law Judge

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