OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **A. KASSEL**	OTA Case No. 18010965

OPINION

Representing the Parties:

For Appellant:	Mortimer Laski, Attorney Anthony Glass, Attorney
For Respondent:	David Hunter, Tax Counsel IV
For Office of Tax Appeals:	Linda Franklak, Tax Counsel V

C. AKIN, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, A. Kassel (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $223,119, and applicable interest, for the 2007 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Cheryl L. Akin, Sara A. Hosey, and Kenneth Gast held an oral hearing for this matter in Cerritos, California, on February 14, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

ISSUES

1. Whether appellant's reported sale of stock in Flexiciser, Inc. (Flexiciser) during the 2007 tax year had economic substance beyond tax considerations.

2. If the reported sale had economic substance, whether appellant is entitled to the reported capital loss in the amount of $2,228,000.[1]

FACTUAL FINDINGS

Flexiciser's Background and Events Prior to its Reported Sale in 2007

1. In October 2002, appellant co-founded and incorporated Flexiciser, a privately held California corporation that was taxed as a C corporation for federal and California income tax purposes. Flexiciser manufactured and sold physical movement therapy devises to be used by mobility challenged and bariatric customers. At all relevant times leading up to the reported sale in December 2007, appellant was the owner of the majority of Flexiciser's outstanding shares of common stock and served as Flexiciser's chairman and CEO.
2. During the 2004, 2005, and 2006 tax years, Flexiciser reported net losses of $647,140, $598,547, and $943,606, respectively, according to its California Corporation Franchise or Income Tax Returns (Forms 100).[2]
3. Between June 4, 2003, and December 20, 2007, appellant made numerous transfers or advances of funds to Flexiciser in amounts ranging from $2,500 to $300,000. These transfers or advances totaled at least $1,784,500.[3] The nature of these transfers or advances (as loans or contributions of capital/equity, etc.) is not clear from the evidence in the record.

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[1] This second issue includes the sub-issues of: (a) whether appellant has substantiated his reported basis (in full or in part) in Flexiciser; and (b) whether appellant is entitled to any loss or deduction during the 2007 tax year for loans or advances appellant made to Flexiciser prior to the reported sale (appellant contends these loans totaled $809,937 at the end of 2007 and were extinguished as a result of the sale). On appeal, appellant concedes that the capital loss should be reduced to $1,984,500 ($100,000 less revised basis of $2,084,500). As discussed below, OTA finds Issue 1 to be dispositive, and therefore, does not need to reach Issue 2.

[2] Flexiciser's Forms 100 for the 2002 and 2003 tax years or other information indicating Flexiciser's net income or losses for these years were not provided by the parties.

[3] On appeal, appellant contends that these transfers total $2,084,500. While appellant provided various documents such as check copies, deposit slips, wire transfer documentation, etc., to substantiate transfers totaling $2,084,500, OTA was only able to verify $1,784,500 based on the evidence provided by appellant. Several of the claimed transfers from appellant to Flexiciser were, in fact, transfers from one Flexiciser account to another, such as, for example, the claimed transfers of $20,000 on June 2, 2005, June 24, 2005, July 11, 2005, and July 26, 2005. Additionally, for certain other claimed transfers, incomplete documentation was provided, such as, for example, the claimed transfers of $25,000 on January 3, 2006, February 1, 2006, March 2, 2006, and April 1, 2006. Only deposit slips were provided and there is no evidence establishing appellant was the source of these transferred funds.

4. In 2006, Flexiciser held "general discussions" with an unrelated third party called Apria Healthcare Group, Inc. (Apria) regarding the potential sale of Flexiciser to Apria. The content of these discussions is not in the record and the sale to Apria was not ultimately consummated.

5. On November 22, 2007, Flexicisor held a Joint Special meeting of the Shareholders and Board of Directors (Special Meeting). Only appellant and D. Lafaille were present at the Special Meeting.[4] The Minutes of the Special Meeting (Minutes) indicate that appellant owned 564,376 shares and D. Lafaille owned 11,968 shares of Flexiciser stock. Together, this amounted to 52.7 percent of the 1,093,511 issued and outstanding shares of Flexiciser stock as of November 22, 2007.[5] Per the Minutes, the shareholders resolved to authorize the issuance to appellant of an additional 2,130,000 shares in Flexiciser in exchange for the cancellation of "the notes to [appellant] in the amount of $1,065,000."[6] The shareholders also authorized "any director or shareholder of [Flexiciser to] invest in 1,200,000 shares of newly issued [Flexiciser] voting common stock at the price of 50-cents per share . . . and a five year term, on a first come first served basis until the shares are sold."[7]

6. A stock certificate (certificate no. 26) was issued to appellant on December 1, 2007, reflecting the issuance of 2,130,000 shares of Flexiciser stock to appellant's trust. Similarly, a handwritten Stock Transfer Ledger indicates that appellant's trust was issued 2,130,000 shares of stock on December 1, 2007.

[4] D. Lafaille is described as Flexiciser's corporate attorney and Secretary. The Minutes of the Special Meeting indicate that the four remaining unrelated shareholders in Flexiciser were not present at the meeting.

[5] The Minutes indicate that there are 1,093,511 issued and outstanding shares of Flexiciser stock; however, the Minutes further reflect that the present shareholders held a total of 576,344 shares while the absent shareholders held a total of 508,167 shares. This totals 1,084,511 shares (576,344 + 508,167 = 1,084,511) which does not reconcile to the 1,093,511 total shares reflected in the Minutes. This discrepancy has not been explained by appellant.

[6] Following the cancellation of the notes to appellant in exchange for the issuance of the additional shares, appellant owned 2,694,376 (2,130,000 + 564,376 = 2,694,376) of the now 3,223,511 (2,130,000 + 1,093,511 = 3,223,511) total issued and outstanding shares. Appellant thus owed approximately 83.6 percent of Flexiciser.

[7] There is no evidence in the record indicating that appellant or any other director or shareholder of Flexiciser opted to purchase any of the additional 1,200,000 authorized shares of Flexiciser stock at the stated 50-cents per share purchase price.

Sale of Appellant's Flexiciser Stock and Flexiciser's 2007 Tax Year

7. Appellant's trust and G. Wallace executed a document entitled "Purchase Agreement" as of December 26, 2007.[8] The Purchase Agreement lists appellant's trust as seller and G. Wallace as buyer and provides, "[Appellant's trust] shall sell and deliver to [G. Wallace] one hundred percent (100 percent) of the issued and outstanding common stock of Flexicisor [*sic*] owned by [appellant's trust], which consists of 2,694,376 shares in a form enabling [G. Wallace], then and there, to become the record and beneficial owner of said common stock which represents approximately 83.7 percent of the issued and outstanding common stock of Flexicisor [*sic*]." The consideration was set at $100,000 and the closing date per the Purchase Agreement was set as "2:00 p.m., local time, December 27, 2007[,] at Beverly Hills, California."[9]

8. A stock certificate and/or updated Stock Transfer Ledger reflecting G. Wallace as owner of 2,694,376 shares of Flexiciser stock as of December 27, 2007, has not been provided by the parties.[10]

9. According to its 2007 Form 100, Flexiciser reported a net loss of $638,957 for the 2007 tax year and loans from shareholder and capital stock balances of $809,387 and $2,827,035, respectively, as of December 31, 2007. On Question J1 on Side 2 of the Form 100, Flexiciser answered "no" to the question, "For this taxable year, was there a change in control or majority ownership for this corporation ....."

[8] G. Wallace is described by appellant as appellant's "long time personal accountant" and as Flexiciser's accountant who "ran the day to day operations" of Flexiciser.

[9] Evidence of G. Wallace's payment of the $100,000 purchase price to appellant or appellant's trust on or about December 26 or 27, 2007, is not in the appeal record. However, there does not appear to be any dispute that this amount was in fact paid to appellant or his trust by G. Wallace. FTB specifically states in its Protest Determination Letter dated September 11, 2015, "The taxpayer provided a copy of a check for $100,000 from [G.] Wallace dated December 26, 2007."

[10] FTB's Protest Determination Letter dated September 11, 2015, indicates, "During protest, [G.] Wallace provided stock certificate #27 to support that [G. Wallace] was the registered holder of 2,694,376 shares of Flexiciser, Inc." However, this stock certificate has not been provided by the parties as evidence in this appeal. The Protest Determination Letter also indicated that appellant provided FTB with an updated or revised Stock Transfer Ledger reflecting the issuance of certificate #27 to G. Wallace during the protest. FTB noted various inconsistencies with this updated or revised Stock Transfer Ledger and the Stock Transfer Ledger that appellant previously provided to FTB during the audit. A copy of the updated or revised Stock Transfer Ledger, reflecting the issuance of certificate #27 to G. Wallace, has not been provided by either party as evidence in this appeal and the copy of the Stock Transfer Ledger in the appeal record does not reflect G. Wallace as an owner of stock in Flexiciser.

10. On January 15, 2008, G. Wallace transferred $50,000 from his personal bank account to Flexiciser, which G. Wallace described as a loan.[11]

Appellant's Repurchase of the Flexiciser Stock in 2008

11. Sometime in early 2008, appellant repurchased the Flexiciser stock from G. Wallace. The details of appellant's repurchase of the Flexiciser stock from G. Wallace, including the date, terms, purchase price, etc., are not in the appeal record.[12]

Events Subsequent to Appellant's Repurchase of the Flexiciser Stock in 2008

12. After repurchasing the Flexiciser stock, appellant continued to make significant transfers to Flexiciser. Appellant states that these transfers totaled $1,188,000, $638,000, $535,500, and $295,000 in 2008, 2009, 2010, and 2011, respectively.

13. In 2008, Flexiciser drafted a document entitled "Flexiciser International Private Placement Memorandum" (Private Placement Memo). The Private Placement Memo is dated May 1, 2008, and notes that Flexiciser was seeking to generate between $7 million and $7.5 million from the sale of "Units" with each "Unit" consisting of 250,000 shares of Flexiciser common stock. The Private Placement Memo further indicates that the offering consists of one million shares of common stock currently owned by appellant and 1.5 million shares of newly issued common stock and that each share of common stock shall have a price of $3.

14. According to its 2008 Form 100, Flexiciser reported a net loss of $1,488,486 for the 2008 tax year and loans from shareholder and capital stock balances of $2,132,351 and $2,827,035, respectively, as of December 31, 2008. On Question J1 on Side 2 of the Form 100, Flexiciser again answered "no" to the question, "For this taxable year, was there a change in control or majority ownership for this corporation..... "

[11] Appellant contends that G. Wallace has not received any part of these funds back.

[12] Presumably the repurchase occurred sometime after G. Wallace's transfer of $50,000 to Flexiciser on January 15, 2008, and sometime before appellant's first reported transfer of funds to Flexiciser during the 2008 tax year on February 12, 2008. At the hearing, appellant stated that the repurchase occurred only a couple of days after the sale; however, this is inconsistent with G. Wallace's purported loan to Flexiciser on January 15, 2008, which appellant asserts was made by G. Wallace as the majority shareholder in Flexiciser at that time.

15. Flexiciser's Forms 100 report net losses of $851,956 for 2009; $1,119,374 for 2010; $1,154,298 for 2011; $152,362 for 2013; and $363,719 for 2014; net income of $5,755 for 2016; and a net loss of $6,009 for 2017.[13]

16. Flexiciser's Forms 100 also report loans from shareholder balances of $2,545,028 at December 31, 2009; $3,066,407 at December 31, 2010; $2,639,455 at December 31, 2011; $3,352,903 at December 31, 2013; and $3,704,283 at December 31, 2014.[14]

Appellant's Reporting of the Sale According to his Individual Tax Return and FTB's Audit

17. Schedule D, Capital Gains and Losses, of appellant's 2007 California Resident Income Tax Return, reports a capital loss of $2,228,000 ($100,000 sales price less reported basis of $2,328,000) from the purported sale of his Flexiciser stock. This $2,228,000 capital loss partially offset appellant's capital gain of more than $7.5 million from the sale of a commercial real property during the 2007 tax year, which is not at issue in this appeal.

18. FTB audited appellant's 2007 return and disallowed the reported capital loss of $2,228,000. FTB issued a Notice of Proposed Assessment (NPA) for 2007, proposing additional tax of $223,119, plus interest. Appellant protested the NPA, and FTB issued a Notice of Action affirming it. This timely appeal followed.

DISCUSSION

Burden of Proof

FTB's determination is generally presumed to be correct, and a taxpayer bears the burden of proving otherwise. (*Appeal of GEF Operating, Inc*., 2020-OTA-057P.) Except as otherwise provided by law, the burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) A preponderance of the evidence means the taxpayer must establish by documentation or other evidence that the circumstances the taxpayer asserts are more likely than not to be correct. (*Appeal of Carr*, 2022-OTA-157P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Morosky*, 2019-OTA-312P.)

[13] Flexiciser's Forms 100 for the 2012, 2015, 2018, and subsequent tax years are not in the appeal record.

[14] As previously noted, Flexiciser's Forms 100 for the 2012, 2015, 2018, and subsequent tax years are not in the appeal record. Additionally, the Schedule L, Balance Sheets, of the 2016 and 2017 Forms 100 are blank.

In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid*.)

Gain or Loss on the Sale of Property

Internal Revenue Code (IRC) section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis of the property, and the loss shall be the excess of the adjusted basis of the property over the amount realized.[15] IRC section 1011 provides that the adjusted basis for determining the gain or loss from the sale of property shall be the property's initial basis determined under IRC section 1012 or other applicable statutes in that subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships) and P (relating to capital gains and losses), adjusted as provided for in IRC section 1016. IRC section 1012 provides that the basis of property generally shall be the cost of such property.

Sham Transaction Doctrine

The sham transaction doctrine is a judicial doctrine developed to prevent a taxpayer from reaping tax benefits from a transaction that lacks economic substance. (*Appeal of La Rosa Capital Resources, Inc.*, 2020-OTA-220P, citing *Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360.) The basic rule of law is that taxation is based on substance, not form. (*DeMarino v. Commissioner* (2nd Cir. 1988) 862 F.2d 400, citing *Gregory v. Helvering* (1935) 293 U.S. 465, 469-470.) Only a bona fide loss is allowable, and the substance (not mere form) shall govern in determining a deductible loss. (*DeMarino v. Commissioner*, *supra*.) Losses resulting from sham transactions, therefore, are not deductible. (*Ibid*.)

When examining whether a particular transaction may be disregarded, courts have examined two related factors: (1) whether, from a subjective standpoint, the transaction was motivated by a business purpose other than tax avoidance that is sufficient to justify the form of the transaction; and (2) whether the transaction had economic substance beyond tax avoidance. (*Bail Bonds by Marvin Nelson, Inc. v. Commissioner* (9th Cir. 1987) 820 F.2d 1543, 1549; *Levy v. Commissioner* (1988) 91 T.C. 838, 853-856; see also *Appeal of La Rosa Capital Resources, Inc.*, *supra*, citing *Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1363.) The application of the business purpose prong is a subjective test, whereas the application of the economic

[15] California conforms to IRC sections 1001 and 1011 through 1016 at R&TC section 18031.

substance prong is an objective test. (*Sochin v. Commissioner* (9th Cir. 1988) 843 F.2d 351, 354.) This two-part analysis is not a conjunctive test or "rigid two-step analysis" but rather "more precise factors" that need to be weighed to determine whether the transaction had any practical economic effects other than the creation of tax losses. (*Appeal of La Rosa Capital Resources, Inc.*, *supra*; *Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1363.)

The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. (*Appeal of La Rosa Capital Resources, Inc.*, *supra*; *Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1364.) The economic substance factor includes an examination of whether the substance of the transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax benefit. (*Casebeer v. Commissioner*, *supra*, 909 F.2d at p. 1364; *Bail Bonds by Marvin Nelson, Inc. v. Commissioner*, *supra*, 820 F.2d at p. 1549.) The transaction to be analyzed is the one that gave rise to the alleged tax benefit. (*Appeal of La Rosa Capital Resources, Inc.*, *supra*, citing *Coltec Industries, Inc. v. U.S.* (Fed. Cir. 2006) 454 F.3d 1340, 1356.) The taxpayer bears the burden of proving that the transaction has economic substance. (*Coltec Industries, Inc. v. U.S.*, *supra*, 454 F.3d at p. 1355.)

The Parties' Contentions Regarding Appellant's Reported Sale of Flexiciser Stock

Appellant contends that the sale of his Flexiciser stock in December 2007 to his long-time accountant was a bona fide sale with a valid business purpose beyond just tax considerations. Appellant asserts that he had both personal and business reasons for the sale and subsequent repurchase of the stock. Appellant contends that he both wanted to stop incurring losses and wanted the equipment to continue to be available to those who needed it. Appellant asserts that he sold Flexiciser to G. Wallace, who in turn, intended to sell Flexiciser to a third-party, who had the financial means to continue the business of Flexiciser and was knowledgeable in the fields of health and medical care.

In contrast, FTB contends that appellant has not shown a legitimate business purpose for the sale of his stock in Flexiciser to his long-time accountant for the low price of $100,000. FTB notes that just a month prior to the claimed sale, appellant was issued an additional 2,130,000 shares of Flexiciser at 50 cents per share, which indicates the value of the stock at the time of sale was over $1.3 million, not $100,000. FTB further notes that G. Wallace purchased the stock at 3.71 cents per share, when it was valued a month earlier by the Board Directors of Flexiciser

at 50 cents per share per the Special Meeting on November 22, 2007. FTB contends that appellant has failed to point to any material changes in the operations of Flexiciser and failed to explain this significant decline in stock price. FTB asserts that the primary, if not sole, purpose of the transaction was to create a significant $2.2 million loss for appellant, which offset appellant's other capital gains during the tax year, and the transaction had no valid business purpose beyond this tax benefit to appellant. For the reasons discussed below, OTA finds in favor of FTB.

Business Purpose Factor

Appellant contends he was highly motivated to sell his stock to his long-time accountant, G. Wallace, for "both a strong non-business personal reason and a business reason." As to the non-business personal reason, appellant notes that he was very devoted to his wife (now deceased) who was stricken with Parkinson's disease and sought ways to ease her symptoms, such as rigidity or stiffness of the limbs, trunk and postural instability, and impaired balance and coordination. Appellant notes that he came across the work of an inventor who had developed equipment to assist with these types of problems and ultimately obtained the rights to work with the equipment. Appellant asserts that he had a strong desire to see that this equipment would benefit all those in need of it, and as a result, in 2002, he cofounded Flexiciser with the inventor of that equipment. Appellant states that after his wife's death in 2004, he devoted himself to improving the equipment, which he believes was a valuable resource for mobility challenged persons with a disease or injury condition. Appellant indicates that he was committed to helping those who would benefit from the equipment, despite suffering financial losses year-after-year.

Regarding the reason for the sale, appellant asserts that he both: (1) wanted to stop incurring losses; and (2) wanted the equipment to continue to be available to those who needed it. Appellant contends that he decided to sell the stock to G. Wallace, his "long-time personal accountant," because G. Wallace was also CFO of an unrelated fitness healthcare club for individuals over the age of 50 and "was involved in the buying and selling of many businesses." Appellant asserts that G. Wallace was interested in purchasing Flexiciser because he believed he could sell it to Dr. Z, one of the founders and owners of the fitness healthcare club.[16] Appellant contends, however, that Dr. Z did not want to work with appellant, and to work around this

[16] Because this individual is not a party to this appeal, his full name will not be used in this Opinion. Instead, he will be referred to as Dr. Z throughout the Opinion.

problem, G. Wallace allegedly stated that he would buy Flexiciser and present it to his partner Dr. Z without appellant's involvement.

Appellant states that once G. Wallace owned the Flexiciser stock, he tried to complete the deal by conveying the company to Dr. Z, but that Dr. Z, "after due deliberation and review of Flexiciser's financial losses to date, decided against the purchase." Appellant contends that G. Wallace wanted to avoid further financial losses and therefore G. Wallace "convinced [appellant] to reacquire the stock." Appellant explains that he "was concerned that [G. Wallace] would shut down the company if [appellant] did not buy back the stock" and "that those who needed the equipment would otherwise not have it." Thus, appellant contends that "[G.] Wallace had a business purpose in purchasing Flexiciser – to sell Flexiciser to [Dr. Z] and make a profit."

While appellant provides several explanations of the business and personal reasons for the sale of the Flexiciser stock to G. Wallace and the subsequent repurchase of the stock by appellant, these explanations are unsupported assertions which have not been substantiated and are not supported by any evidence in the record. These unsupported assertions regarding the business purpose of the sale are insufficient to carry appellant's burden of proof. (*Appeal of Morosky*, *supra*.)

Appellant asserts that he sold the Flexiciser stock to G. Wallace because G. Wallace hoped in turn to sell the stock to his business partner, Dr. Z, who did not want to deal directly with appellant. However, these statements are unsupported assertions only. Appellant provides no evidence to support his statements regarding the anticipated sale to Dr. Z. Neither G. Wallace nor Dr. Z provided any witness testimony or statements under penalty of perjury in this appeal, and appellant provides no evidence of the negotiations between G. Wallace and Dr. Z for the purchase of Flexiciser, such as letters of intent, draft sales agreements, term sheets, financial disclosures, etc.

Further, appellant's statements regarding the potential sale are vague and lacking in detail. While appellant explains that Dr. Z, "after due deliberation and review of Flexiciser's financial losses to date, decided against the purchase," appellant fails to explain when G. Wallace first contacted Dr. Z regarding Dr. Z's potential purchase of Flexiciser, when Dr. Z was first presented with Flexiciser's financial information, and whether this was before or after G. Wallace agreed to purchase Flexiciser from appellant. Appellant also fails to describe the negotiations engaged in by G. Wallace and Dr. Z, the status of those negotiations at the time of

the sale of the Flexiciser stock to G. Wallace in late December 2007, or when and how the negotiations with Dr. Z deteriorated such that it was clear that the anticipated sale to Dr. Z would not occur. Appellant does not explain whether Dr. Z would be purchasing all the shares in Flexiciser or only appellant's interest in Flexiciser (approximately 83.6 percent), or whether the other shareholders in Flexiciser were informed of the potential sale to Dr. Z. Appellant also does not explain whether at the time of the sale of the Flexiciser stock in December 2007, appellant and G. Wallace discussed the possibility that G. Wallace may be unable to sell Flexiciser to Dr. Z and what would happen with Flexiciser in such an event. Appellant fails to explain why G. Wallace felt compelled to purchase the stock from appellant without first consulting with Dr. Z or why G. Wallace did not wait to purchase the stock from appellant until after he was certain that Dr. Z would in fact purchase the Flexiciser stock from him.

Given appellant's stated desire and commitment to making Flexiciser's equipment available to those who needed it, it seems unlikely that appellant would have been willing to permanently relinquish all interest in and control of the company he co-founded and was passionate about unless he was relatively certain that the anticipated sale to Dr. Z, who would continue to operate the business, would actually occur.[17] Despite this, appellant provides no evidence of the negotiations between G. Wallace and Dr. Z concerning the potential sale of Flexiciser to Dr. Z, no explanation why in December 2007, appellant and G. Wallace were confident that G. Wallace would be able to sell Flexiciser to Dr. Z, or how and why the sale to Dr. Z. subsequently fell through only a month later in January or February 2008.

Additionally, appellant's contentions regarding the business purpose of the sale also appear to be inconsistent with appellant's subsequent actions in 2008 and later years after he reacquired the Flexiciser stock from G. Wallace. Appellant asserts that he decided to sell his Flexiciser stock to G. Wallace in order to stop incurring financial losses. However, this stated intent is contradicted by appellant's repurchase of the Flexiciser stock only about a month later in January or February 2008, and continued infusions of large amounts of cash into Flexiciser for years following this reacquisition. In fact, while appellant states that he had advanced funds totaling $2,228,000 to Flexiciser between 2003 and 2007, appellant's post-reacquisition advances to Flexiciser actually exceed this amount, totaling $2,656,000 during the four-year

[17] Appellant does not assert that G. Wallace had either the intent or financial ability continue to fund and operate Flexiciser absent a sale to Dr. Z.

period between 2008 and 2011.[18] Appellant's advances to Flexiciser in 2008 alone totaled $1,188,000. Thus, it appears that appellant's primary motivation here was to continue to develop and improve Flexiciser's products, and to ensure that these products remained available to those who needed it. While appellant may have been willing to sell Flexiciser, the evidence in the record suggests that he was only willing to sell it to a buyer who would continue to operate Flexiciser and even then, only at a price that would either generate a profit or at least allow appellant to recover a large amount of his investment in and advances to Flexiciser.[19]

OTA also notes that appellant has not adequately explained why he was willing to sell Flexiciser to G. Wallace for $100,000. Appellant has failed to establish the fair market value of his Flexiciser shares in December 2007, or how the $100,000 purchase price was negotiated and agreed upon by him and G. Wallace. Appellant does not disclose the anticipated price for the sale to Dr. Z, and whether the $100,000 purchase price agreed to by appellant and G. Wallace is reasonable in light of that price.[20] Additionally, OTA notes that appellant advanced more than $1.2 million to Flexiciser in 2007 in the months leading up to the sale to G. Wallace in December 2007, and continued to advance $1,188,000 to Flexiciser in 2008 immediately after reacquiring the Flexiciser stock from G. Wallace. These advances to Flexiciser both immediately before the sale and immediately after the reacquisition suggest that appellant believed Flexiciser was worth much more than the $100,000 sales price appellant agreed to with G. Wallace in December 2007. Additionally, the $100,000 sales price is also inconsistent with the attempt to sell Flexiciser to Apria for an undisclosed price in 2006, and the subsequent attempt to make a private sale of Flexiciser's stock in May 2008, at $3 per share. Per the Private Placement Memo, the sale would have included one million shares of Flexiciser stock currently owned by appellant (assuming maximum subscription was received) and would have generated $3 million in proceeds for appellant at the stated $3 per share price. Appellant has not explained why he was willing to sell all 2,694,376 shares of his Flexiciser stock for $100,000 in December 2007, when only months

[18] This amount does not include any advances appellant may have made to Flexiciser after the 2011 tax year. OTA notes that the loans from shareholders balance per Flexiciser's Forms 100 continued to increase from $2,639,455 at December 31, 2011, to $3,352,903 at December 31, 2013, and $3,704,283 at December 31, 2014, suggesting that appellant continued to advance significant amounts of money to Flexiciser after the 2011 tax year.

[19] See the Private Placement Memo, wherein appellant agreed to sell up to 1 million shares of Flexiciser stock for $3 per share.

[20] At the hearing, appellant contends that he was taken advantage of by G. Wallace, who represented appellant during the FTB audit and protest, but did not provide any evidence to support this assertion.

later he was seeking $3 million for the sale of only 37 percent (1,000,000 divided by 2,694,376) of his Flexiciser stock.

Ultimately, appellant's unsupported assertions regarding the business purpose of the sale of his Flexiciser stock to his long-time accountant G. Wallace, and the subsequent repurchase of that stock from G. Wallace, are insufficient to satisfy appellant's burden of proof. (*Appeal of Morosky*, *supra*.)

Economic Substance Factor

The transaction that gave rise to the tax benefit here (the capital loss at issue) is appellant's sale of his Flexiciser stock to G. Wallace in December 2007. The facts and circumstances surrounding this sale suggest that the sale may have been motivated primarily by tax considerations and may lack economic substance beyond those tax considerations. These facts and circumstances include: the timing of the sale at the very end of the 2007 tax year (i.e., as of December 27, 2007); the fact that the sale generated a significant $2.2 million capital loss, which appellant was able to use to offset an unrelated capital gain of more than $7.5 million realized in that same tax year; the low $100,000 sales price compared to appellant's advances to Flexiciser both immediately before and after the sale; the fact that the sale was made to appellant's long-time accountant and business associate rather than an independent third party purchaser; and the fact that appellant repurchased the stock from G. Wallace only about a month later in January or February 2008.[21] Ultimately, appellant received a significant tax benefit (i.e., the $2.2 million capital loss, which offset the capital gain realized on an unrelated sale of real property during the same tax year), while in the end, still effectively retaining his majority ownership interest in and control of Flexiciser both before and after the sale in question.

Given these facts and circumstances, OTA notes that appellant provides very little evidence to substantiate the claimed sale of his Flexiciser stock and to establish that this was a bona fide sale with economic substance. The only evidence provided to substantiate the sale is:

[21] As previously noted, OTA presumes that the repurchase occurred sometime after the January 15, 2008 transfer of $50,000 to Flexiciser by G. Wallace and sometime before appellant's first reported transfer to Flexiciser during the 2008 tax year on February 12, 2008. If appellant repurchased the Flexiciser stock on or before January 26, 2008 (i.e., within 30 days of the sale on December 26, 2007), the wash sale rules contained in IRC section 1091 (for personal income tax purposes, California conforms under R&TC section 18031), may apply to disallow appellant's loss on the sale of his Flexiciser stock. Because FTB does not argue that the wash sale rules apply here, OTA will presume that appellant repurchased the Flexiciser stock sometime after the 30 day period noted in IRC section 1091(a) had elapsed.

(1) the Sales Agreement between appellant's trust and G. Wallace; and (2) G. Wallace's subsequent transfer of $50,000 to Flexiciser on January 15, 2008. No other evidence (documentary or testimonial) substantiating this sale has been provided by appellant.[22] Given that appellant was the cofounder, majority owner (owning 83.6 percent of Flexiciser's stock), CEO, and chairman of Flexiciser, OTA would expect that the other shareholders, officers, and Board of Directors of Flexiciser would have been promptly notified of appellant's sale of his controlling interest in Flexiciser to G. Wallace. Despite this, appellant fails to provide any evidence showing that any third parties, beyond appellant and G. Wallace, were ever informed or notified of the sale. For example, appellant has failed to provide relevant evidence, such as contemporaneous letters or emails notifying others of the sale, or Minutes from Board of Directors or Shareholder meetings reflecting the change in ownership or replacing appellant as chairman and CEO of Flexiciser. OTA also notes that the changes in control resulting from appellant's sale of his Flexiciser stock to G. Wallace in December 2007, and reacquisition of the same stock from G. Wallace in January or February 2008, were not reported on Flexiciser's 2007 or 2008 Forms 100.[23]

Appellant also fails to provide any details regarding his reacquisition of the Flexiciser stock from G. Wallace in January or February 2008. For example, appellant has not disclosed the exact date, the purchase price, or any of the terms of the reacquisition. Because appellant has failed to provide any evidence or information regarding his reacquisition of the Flexiciser stock, OTA is unable to determine whether there was any change in economic or financial position for either appellant or G. Wallace as a result of the sale and subsequent repurchase of Flexiciser stock by appellant. (See, e.g., *Stein v. Commissioner*, T.C. Memo. 1977-241 [A taxpayer's sale of stock to a friend generating a tax loss and subsequent reacquisition of the same stock from that friend 33 days later found to be a sham transaction where there was no change in financial or economic position for either party to the transactions].) Appellant's failure to produce evidence

[22] While it appears that evidence of G. Wallace's payment of the $100,000 purchase price and a stock certificate reflecting G. Wallace as owner of 2,694,376 shares of Flexiciser stock were provided to FTB during the audit and/or protest, these documents have not been provided to OTA in this appeal. This documentation, if provided, would not change the outcome of this appeal.

[23] Flexiciser answered "no" to the question of whether there was a change in control or majority ownership for the corporation on both its 2007 and 2008 Forms 100. Since appellant owned more than 83.6 percent of the stock in Flexiciser, this sale and repurchase resulted in a change in control and majority ownership, which should have been disclosed on the Forms 100 for the 2007 and 2008 tax years.

that is within his or her control gives rise to a presumption that such evidence, if provided, would have been unfavorable to the taxpayer's case. (*Appeal of Bindley*, 2019-OTA-179P.)

In conclusion, appellant has failed to establish by the preponderance of the evidence that the December 2007 sale of his Flexiciser stock to his long-time accountant, G. Wallace, and the subsequent repurchase of this stock from G. Wallace in January or February 2008, had economic substance beyond tax considerations. As previously noted, only a bona fide loss is allowable, and the substance (not mere form) shall govern in determining a deductible loss. (*DeMarino v. Commissioner*, *supra*.) Losses resulting from sham transactions, therefore, are not deductible. (*Ibid*.) Because appellant has failed to establish the reported sale had economic substance beyond tax considerations, appellant is not entitled to the reported capital loss in the amount of $2,228,000. (See also *Stein v. Commissioner*, *supra*.) As the above findings are dispositive of this appeal, OTA does not reach the second issue.

HOLDING

Appellant has failed to establish that the reported sale of his stock in Flexiciser during the 2007 tax year had economic substance beyond tax considerations. As a result, appellant is not entitled to the reported capital loss in the amount of $2,228,000.

DISPOSITION

FTB's action is affirmed.

DocuSigned by:
Cheryl L. Akin
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Cheryl L. Akin
Administrative Law Judge

We concur:

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Sara A. Hosey
Administrative Law Judge

DocuSigned by:
Kenneth Gast
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Date Issued: 3/30/2023