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2023 – OTA – 268
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 21067910

F. GOLSHANI

OPINION

Representing the Parties:

For Appellant: F. Golshani and R. Golshani

For Respondent: Parviz Iranpour, Tax Counsel
David Hunter, Tax Counsel IV

For Office of Tax Appeals: William J. Stafford, Tax Counsel III

A. KLETTER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, F. Golshani (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of $5,479, $5,437, and $10,320, and applicable interest, for the 2015 through 2017 tax years (Tax Years at Issue), respectively.[1]

The Office of Tax Appeals (OTA) Administrative Law Judges Asaf Kletter, Huy "Mike" Le, and Eddy Y.H. Lam 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 OTA has jurisdiction to consider appellant's constitutional, due process, and hardship claims for the Tax Years at Issue.
2. Whether appellant has shown error in FTB's proposed assessments of additional tax for the Tax Years at Issue.

[1] Appellant and his spouse filed joint returns for the Tax Years at Issue. Although appellant's spouse appeared for appellant at the hearing, she did not join in this appeal, and this Opinion will refer to F. Golshani as the sole appellant.

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FACTUAL FINDINGS

1. In 1995, appellant purchased a home in Paradise Valley, Arizona, for $332,000 (Arizona Property), and used it as his personal residence. Appellant made various improvements to the Arizona Property.
2. In 2008, appellant moved to California to work as a college dean and rented a home in Rancho Palos Verdes, California (Palos Verdes Property), where he resided. Appellant attempted to sell the Arizona Property around that time without success.
3. Thereafter, appellant rented the Arizona Property from time to time between 2009 and 2017. Appellant reported rental income, expenses, and depreciation for the Arizona Property on his California income tax returns from the 2011 tax year through the Tax Years at Issue.
4. On December 28, 2017, appellant sold the Arizona Property. On April 10, 2018, appellant purchased a home in Rolling Hills, California (Rolling Hills Property).
5. On his 2017 California Resident Income Tax Return (return), appellant reported the Arizona Property's sales price of $1,720,000, its adjusted basis of $1,381,974, and a $338,026 subtraction under Internal Revenue Code (IRC) section 121. Appellant reported zero gain on the Arizona Property sale.
6. FTB audited the returns for the Tax Years at Issue. FTB determined that rental losses incurred in the 2015 and 2016 tax years on the Arizona Property were unavailable in those years and were deductible only in the 2017 tax year. FTB disallowed the IRC section 121 subtraction on the Arizona Property sale. FTB increased the Arizona Property's adjusted basis for selling expenses appellant had not claimed.
7. At audit, appellant claimed that the rental payments for the Palos Verdes Property were deductible business expenses incurred to subsidize the Arizona Property rental. Appellant also argued that he made a like-kind exchange of the Arizona Property for the Rolling Hills Property pursuant to IRC section 1031.
8. FTB rejected appellant's arguments and issued him Notices of Proposed Assessment for the Tax Years at Issue. Appellant timely protested.
9. FTB affirmed its position. On April 30, 2021, FTB issued appellant Notices of Action (NOAs) for the Tax Years at Issue.
10. Appellant timely appealed.

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DISCUSSION

Issue 1: Whether OTA has jurisdiction to consider appellant's constitutional, due process, and hardship claims for the Tax Years at Issue.

This appeal arises from FTB's NOAs sustaining its deficiency determinations. As relevant here, OTA's jurisdiction over proposed tax deficiencies is limited to hearing and deciding appeals from FTB notices of action. (Cal. Code Regs., tit. 18, § 30103(a).) An administrative agency's authority to act is of limited jurisdiction and it "has no powers except such as the law of its creation has given it." (*Appeal of Moy*, 2019-OTA-057P; *Ferdig v. State Personnel Board* (1969) 71 Cal.2d 96, 105.) OTA has no jurisdiction over (1) "[w]hether a California statute is invalid or unenforceable under the United States or California Constitutions . . . " or (2) "[w]hether the appellant is entitled to a remedy for an Agency's actual or alleged violation of any substantive or procedural right to due process under the law, unless the violation affects the adequacy of a notice, the validity of an action from which a timely appeal was made, or the amount at issue in the appeal." (Cal. Code Regs., tit. 18, § 30104.)

Appellant contends that FTB's determinations under the tax code ignore or violate his alleged basic right to housing and that FTB violated his procedural rights when it allegedly failed to engage in settlement negotiations with him. However, OTA has no jurisdiction over constitutional or substantive due process right claims. (See Cal. Code Regs., tit. 18, § 30104(b), (d).) Further, even if it FTB failed to engage in settlement negotiations with him, appellant does not claim that the alleged violation affected the adequacy of FTB's NOA, the validity of an action from which a timely appeal was made, or the amount at issue on appeal. Accordingly, OTA has no jurisdiction to review FTB's actions or failures to act. (See Cal. Code Regs., tit. 18, § 30104(d).)

In addition, appellant raises the issue of financial hardship due to his job loss in 2020, stating that he will not be able to pay the deficiencies if they are upheld. Although FTB in certain instances may consider appellant's inability to pay,[2] as applicable here, no statute or provision authorizes OTA to take any action based on appellant's assertion of financial hardship. (See *Appeal of Robinson*, 2018-OTA-059P.)

[2] FTB may consider appellant's inability to pay under its payment arrangement or offer-in-compromise programs. If appellant is experiencing difficulties in paying his liabilities once the decision in this appeal is final, he may contact FTB to discuss payment options. (See https://www.ftb.ca.gov/pay/if-you-cant-pay/index.html.)

Issue 2: Whether appellant has shown error in FTB's proposed assessments of additional tax for the Tax Years at Issue.

FTB's determinations are presumed correct, and a taxpayer has the burden of proving otherwise. (*Appeal of Rios*, 2021-OTA-341P.) Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (*Appeal of Silver*, 2022-OTA-408P.) To meet that burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Ibid.*) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) In the absence of credible, competent, and relevant evidence showing an error in FTB's determinations, it must be upheld. (*Appeal of Crocker*, 2022-OTA-137P.) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(c).) To meet this evidentiary standard, a party must establish by documentation or other evidence that the circumstances it asserts are more likely than not to be correct. (*Appeal of Crocker*, *supra*.)

Passive Activity Rules

California generally incorporates IRC section 469, which prohibits the use of "passive activity" losses to reduce non-passive activity income. (IRC, § 469(a);[3] R&TC, §§ 17551, 17561.) The term "passive activity" means any activity (1) which involves the conduct of any trade or business, and which the taxpayer does not materially participate, and (2) any rental activity. (IRC, § 469(c)(1), (2), (4); see R&TC, § 17561(a) [decoupling from federal exclusion from passive activity treatment for rental activity performed by qualified real estate professionals].) Thus, the R&TC generally characterizes rental activity as a passive activity.

Under the passive activity rules, an individual allowed up to $25,000 in passive activity losses, subject to a 50 percent reduction for the amount by which the individual's modified adjusted gross income (MAGI) exceeds $100,000. (IRC, § 469(i).) A taxpayer whose MAGI exceeds $150,000 is not allowed any passive activity losses. (See IRC, § 469(i)(3).) Any unused passive activity losses are suspended and carried forward to offset future passive activity income, or to the tax year in which the taxpayer disposes of his or her entire interest in the passive

[3] For the Tax Years at Issue, R&TC section 17024.5(a)(1)(P) provides that for Personal Income Tax Law purposes, California conforms to the January 1, 2015 version of the IRC. References to the IRC are therefore to the January 1, 2015 version.

activity in a fully taxable transaction to an unrelated party. (IRC, § 469(b), (d), (g); R&TC, § 17561(c).)

Here, FTB determined that appellant's 2015 and 2016 rental losses on the Arizona Property were passive activity losses which should be suspended and carried forward because appellant's MAGI exceeded $150,000 in those years. FTB applied appellant's rental losses to the year when he disposed of his entire interest in the property, i.e., 2017.[4]

Rental Losses

California incorporates IRC section 261 (which disallows deductions specified in IRC sections 262 through 280H) and IRC sections 262 through 280H. (See generally R&TC, §§ 17201, 17222.) IRC section 262 provides, "[e]xcept as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." Treasury Regulation 1.262-1(b)(3) clarifies that the "[e]xpenses of maintaining a household, including amounts paid for rent, water, utilities, domestic service, and the like, are not deductible."[5]

Here, appellant asserts that the rental losses were business expenses which must be allowed. It is undisputed that appellant was employed as a college dean.[6] Nonetheless, appellant claims he incurred business expenses due to the circumstances of the 2008 recession, during which the Arizona Property could not be sold. He alleges that he was forced to rent out the Arizona Property until market conditions improved and it could be sold. He claims that rental payments for the Palos Verdes Property were "an additional cost of doing business, namely, acquisition of an alternative place to live." Appellant also contends that market conditions forced him to rent the Arizona Property cheaply when the mortgage on the property was significantly higher (presumably creating a net rental loss). Appellant alleges that under these circumstances, the rental payments should be deductible in the 2015 and 2016 tax years.

As noted above, expenses for maintaining a household cannot be deducted as expenses incurred for a trade or business. Rent for the Palos Verdes Property, where appellant resided,

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[4] Appellant did not specifically address the passive activity rules in briefing.

[5] When applying the IRC, California also incorporates Treasury Regulations to the extent that they do not conflict with regulations promulgated by FTB. (R&TC, § 17024.5(d).)

[6] During the Tax Years at Issue, appellant also reported interest and dividend income.

was such an expense.[7] Appellant has the burden to establish entitlement to the business expense deductions. (*Appeal of Silver*, *supra*.) However, he provides no authority for his assertion that rental expenses for the Palos Verdes Property are business expenses. Nor did appellant provide any documentation. Thus, appellant fails to demonstrate error in FTB's determination that such rental expenses were not deductible as business expenses.

A taxpayer claiming an income tax deduction has the burden to prove by competent evidence that he or she is entitled to that deduction. (*Appeal of Silver*, *supra*.) Here, appellant has not argued or otherwise shown by credible or competent evidence that the net rental losses he alleges were incurred on the Arizona Property were business expenses.[8] Thus, appellant has not shown error in FTB's determination that the 2015 and 2016 rental losses on the Arizona Property were not deductible in the respective tax years incurred.

Gain from the 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, including, but not limited to, "[g]ains derived from dealings in property." (IRC, § 61(a), (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; R&TC, § 18031.)

Principal Residence Exclusion

Gross include excludes gain from the sale or exchange of property, if during the five-year period ending on the date of the sale or exchange, such property has been owned and used by the

[7] The IRC contains a limited exception whereby rental payments for a personal residence can be treated as deductible business expenses when the taxpayer exclusively uses on a regular basis a portion of the residence as a principal place of business for a trade or business. (IRC, § 280A(c)(1)(A).) This exception is inapplicable here. Appellant does not allege, nor does a review of the record indicate, that he used the Palos Verdes Property in such a manner.

[8] Appellant also fails to address the application of the passive activity rules to the net rental losses. OTA is not aware of any authority for the proposition that passive activity rules do not apply to net rental losses.

taxpayer as the taxpayer's principal residence for periods aggregating two years or more. (IRC, § 121; R&TC, § 17152.) Taxpayers filing joint returns may exclude up to $500,000 of gain from the sale of a principal residence. (IRC, § 121(b).) Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. (Treas. Reg. § 1.121(b).)[9]

Here, the facts are not in dispute. After 2008, appellant moved to California and resided in the Palos Verdes Property. Appellant sold the Arizona Property on December 28, 2017. Appellant has not alleged or shown with credible evidence that he used the Arizona Property as his residence for any period during the five-year period ending on the date of its sale such that it was his principal residence. Appellant merely alleges that the Arizona Property was his principal residence "as [he] did not have any other residential property," and that FTB has not shown otherwise. His unsupported assertions are insufficient to satisfy his burden of proof. (*Appeal of Silver*, *supra*.) He also contends that the term "primary" [sic] is relevant only if a taxpayer owns a "secondary" home that can be his or her residence. IRC section 121 provides otherwise.

Appellant has the burden of proving by competent evidence that he is entitled to the principal residence subtraction. (*Appeal of Silver*, *supra*.) However, appellant has not shown by credible evidence that he qualifies for the principal residence exclusion and is entitled to make the $338,026 subtraction from his gain on the sale of the Arizona Property.

<u>IRC Section 1031</u>

California law generally conforms to IRC section 1031, which is an exception to the general rule requiring recognition of gain or loss upon the sale or exchange of property. (See IRC, § 1001(c); Treas. Reg. § 1002.1(a); R&TC, §§ 18031, 24902, 24941.) To qualify for nonrecognition treatment under IRC section 1031, three general requirements must be satisfied: (1) the transaction must be an exchange (exchange requirement); (2) the exchange must involve like-kind properties (like-kind requirement); and (3) both the property transferred (the

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[9] In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends on all the facts and circumstances. If a taxpayer alternates between two properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. (Treas. Reg. § 1.121(b).)

Other factors in determining a taxpayer's principal residence include his or her place of employment; the principal place of abode of the taxpayer's family members; the address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card; the taxpayer's mailing address for bills and correspondence; and the location of religious organizations and recreational clubs with which the taxpayer is affiliated. (Treas. Reg. § 1.121(b)(2).)

relinquished property) and the property received (the replacement property) must be held for a qualified purpose (holding requirement). (IRC, § 1031(a)(1)-(3).) If IRC section 1031 is inapplicable, the general recognition rule under IRC section 1001(c) is triggered. (*Appeal of Lovinck Investments N.V.*, 2021-OTA-294P.)

It is well-established that a transaction in which a taxpayer receives – or controls – cash proceeds from the sale of real property does not meet the exchange requirement and is not entitled to nonrecognition treatment. (See *Klein v. Commissioner* (1993) T.C. Memo. 1993-491; *Nixon v. Commissioner* (1987) T.C. Memo. 1987-318.) Under the IRC section 1031 rules, a taxpayer generally has actual receipt of money when the taxpayer receives the money or property or its benefit. (Treas. Reg. § 1.1031(k)-1(f)(2).) A taxpayer has constructive receipt of money when the money or property is credited to the taxpayer's account, set aside for the taxpayer, or made available so that the taxpayer can draw on it with notice. (*Ibid.*) Actual or constructive receipt by the taxpayer's agent is imputed to the taxpayer. (*Ibid.*) The Treasury Regulations provide a safe harbor for Qualified Intermediaries. (Treas. Reg. § 1.1031(k)-1(g)(4).)

IRC section 1031 specifies that where the exchange is not simultaneous, the like-kind requirement is not met where taxpayers do not identify the replacement property within 45 days of the sale of the relinquished property and acquire the replacement property within 180 days after the sale. (IRC, § 1031(a)(3)(A); Treas. Reg. § 1.1031(k)-1.) In addition, case law provides that the holding requirement is a question of fact that must be determined at the time of the exchange. (*Bolker v. Commissioner*, (1983) 81 T.C. 782, 804 (*Bolker*), *aff'd*, (9th Cir. 1985) 760 F.2d 1039; *Click v. Commissioner*, (1982) 78 T.C. 225, 231.) The taxpayer bears the burden of proving that he or she had the requisite intent. (*Click v. Commissioner*, *supra*.)

Here, the general facts are not in dispute. Appellant sold the Arizona Property on December 28, 2017. Appellant purchased the Rolling Hills Property on April 10, 2018. Appellant concedes that he did not use a Qualified Intermediary. Appellant thus directly and received the actual cash proceeds from the Arizona Property, which was used to purchase the Rolling Hills Property. Therefore, the exchange requirement is not met. Appellant concedes that there was no paperwork which followed the requirements of a deferred exchange, such as identification of the replacement property within 45 days of selling the relinquished property. (Treas. Reg. § 1.1031(k)-1.) Therefore, the like-kind requirement is not met.

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Concerning the holding requirement, only the replacement property at issue. Appellant asserts that the Rolling Hills Property was intended to be a rental property, but that no prospective tenants could be found. Appellant contends that the Rolling Hills Property was later converted to a personal residence after a period of six months. The holding requirement is determined at the time of the exchange. (*Bolker*, *supra*.) However, appellant provides no evidence to support his assertions. Mere assertions are insufficient to meet his burden of proof. (*Appeal of Silver*, *supra*.)

IRC section 1031 is an exception to the general recognition rule. Appellant has the burden to show by credible evidence that the purported exchange comes within its terms. (See *Appeal of Silver*, *supra*.) However, appellant's mere assertion that the legal requirements were successfully executed is insufficient to meet his burden of proof. (*Ibid*.)

Adjusted Basis in the Arizona Property and Capital Gain

As mentioned above, the gain from the sale of property is generally the amount realized over the taxpayer's adjusted basis. (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; R&TC, § 18031.)

Here, the amount realized ($1,7200,000 in gross proceeds on the Arizona Property) is not in dispute. Rather, appellant claims that FTB improperly disallowed adjustments to basis to the Arizona Property exceeding $100,000. However, the record shows that FTB accepted the Arizona Property's reported basis of $1,381,974 from appellant's 2017 return. FTB subsequently adjusted the reported basis to $1,491,658 to include $109,684 in commission and other selling expenses.

Nonetheless, Appellant asserts that his initial investment of $332,000, plus approximately $1.4 million in capital expenditures and the commission and other selling expenses, results in a "sheer loss of nearly $150,000." Appellant appears not to account for, nor address the depreciation deductions he took on the Arizona Property, which significantly reduced its adjusted basis. (IRC, §§ 1011, 1012, 1016; R&TC, § 18031.)[10] Appellant has not provided credible, competent, and relevant evidence showing an error in FTB's determination of the gain on the sale of the Arizona Property. Therefore, FTB's determination must be upheld.

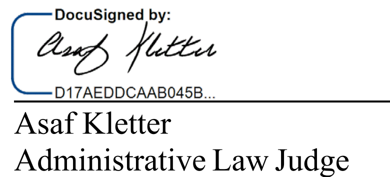
[10] During the Tax Years at Issue, depreciation deductions totaled $133,678. In prior tax years, additional depreciation totaling $174,528 was also taken, but those returns are not in the record.

HOLDINGS

1. OTA lacks jurisdiction to consider appellant's constitutional, due process, and hardship claims for the Tax Years at Issue.
2. Appellant has not shown error in FTB's proposed assessments of additional tax for the Tax Years at Issue.

DISPOSITION

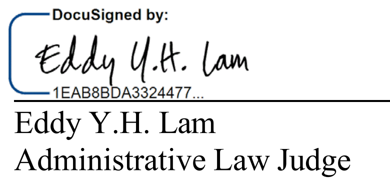
FTB's actions are sustained.



Asaf Kletter
Administrative Law Judge

We concur:

Huy "Mike" Le
Administrative Law Judge



Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 4/3/2023