

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

**W. MCWETHY**

) OTA Case Number 220510377  
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**OPINION**

Representing the Parties:

For Appellant:

Andrew S. Robinson, CPA

For Respondent:

Parviz T. Iranpour, Tax Counsel

For the Office of Tax Appeals:

Tom Hudson, Tax Counsel III

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, W. McWethy (appellant) appeals from the action of respondent Franchise Tax Board (FTB) proposing to assess additional tax of \$220,392, and applicable interest, for the 2016 taxable year.

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

**ISSUE**

Did FTB properly disallow a portion of appellant’s claimed net loss?<sup>1</sup>

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<sup>1</sup> Prior to this appeal, the parties’ sole disagreement was the value of the two boats appellant purchased from his wholly owned S corporation. On appeal, FTB asserts a new theory—that the entire loss could have been disallowed pursuant to Internal Revenue Code (IRC) section 267, as a disallowed sale between related parties. FTB states that “[a]lthough IRC section 267 technically bars Appellant from recognizing any of the \$13.6 million loss reported, FTB will not pursue additional tax beyond the original \$220,392 tax assessment reflected in its Notice of Action due to the timing of its discovery.” When FTB abandons its original position or introduces a “new matter” that alters the original deficiency asserted against the taxpayer, such as increasing the amount of the deficiency, or which requires the presentation of different evidence, the burden of proof shifts to FTB. (See *Appeal of Praxair*, 2019-OTA-301P, citing *Appeal of Mendelsohn* (85-SBE-141) 1985 WL 15923.) However, OTA need not decide who has the burden of proof regarding IRC section 267 because OTA finds that the loss is disallowed under IRC section 267, and appellant is liable for the tax as proposed, regardless of who has the burden.

### FACTUAL FINDINGS

1. During the 2016 taxable year, appellant, a California resident, was the sole owner and president of Titan Marine (TM), a California-based S corporation that developed and manufactured custom boats.
2. In 2016, prior to dissolving, TM sold to appellant two boats from its inventory in exchange for a reduction of TM's debt owed to appellant. Prior to that sale, TM owed \$22,208,195 to appellant. After the sale of the boats from TM to appellant, TM reduced its debt principal by the reported sales price for the two boats, resulting in debt principal of \$18,508,195 (\$22,208,195 - \$3,700,000).
3. On its 2016 California S corporation tax return, TM reported an ordinary business loss (i.e., NOL) of \$13,938,950, which it passed through to appellant. This loss was largely based on the \$13.7 million loss it generated from the sale of the two boats to appellant. Appellant claimed the entire \$13,938,950 as an ordinary loss on his individual California tax return, which appellant used to offset other income. TM reported on the return that it dissolved on December 31, 2016.
4. FTB audited appellant and disallowed part of appellant's claimed loss after adjusting the sales prices for the boats to reflect their fair market value as appraised by a third party, Maritime Consultants. FTB increased the total sales price for both boats by \$1.625 million. As a result, FTB disallowed \$1.625 million of appellant's claimed net loss for the 2016 taxable year.
5. On January 28, 2021, FTB issued a Notice of Proposed Assessment (NPA) to appellant that proposed to assess additional tax of \$220,392, plus applicable interest, based, in part, on FTB's disallowance of \$1.625 million of TM's net loss that flowed through to appellant.<sup>2</sup>
6. FTB affirmed the NPA in a Notice of Action (NOA). This timely appeal followed.

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<sup>2</sup> The details of FTB's adjustments and determinations, reflected on the NPA, are not discussed here because FTB changed its position on appeal. As further explained below, the dispute in this appeal no longer involves the fair market value of the boats, so the corresponding adjustments in the NPA are no longer at issue. Consequently, OTA expresses no opinion on the boat valuation issue. The issue is, therefore, whether losses on the sale of these boats must be disallowed as related-party transactions under IRC section 267.

7. On appeal, FTB changed its position and now asserts that no deduction can be allowed for losses from the sale of the two boats as the sale was completed by related parties (i.e., appellant is the sole owner of TM and therefore they are related parties).
8. FTB will not pursue additional tax based on its new position beyond the original \$220,392 proposed tax assessment reflected in its NOA.

### DISCUSSION

Internal Revenue Code (IRC) section 267 is incorporated into California law by R&TC sections 17201(c) and 24427.<sup>3</sup> IRC section 267(a)(1) provides, in relevant part, that “[n]o deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b).” IRC section 267(b)(2) in turn refers to “[a]n individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual[.]”

In this appeal, there is no dispute that (1) appellant owned all of the outstanding stock of TM, and (2) TM sold two boats to appellant, a related party under IRC section 267(b)(2), before TM dissolved on December 31, 2016, which generated the disallowed losses at issue. Therefore, since TM was entirely owned by appellant, TM is not entitled to a deduction for losses, resulting from the sale of the boats from TM to appellant, under IRC section 267(a)(1). Because TM’s losses on the sales of these boats are disallowed, they are not passed through to appellant as the 100 percent shareholder of TM. Accordingly, FTB’s proposed assessment must be sustained, even though FTB changed its position to uphold its NOA on appeal to OTA. Appellant does not dispute this conclusion since he solely contends that he does not agree with FTB’s valuation of the boats, a position that FTB has abandoned on appeal.

An exception exists in IRC section 267(a)(1), which allows any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation. However, that exception does not apply here. Both parties considered the transaction at issue as the sale of inventory from TM to appellant. While TM liquidated thereafter, it first sold the boats and, at the same time, reduced the debt owed by TM to appellant by the sales price of the boats. Appellant has not provided evidence that the liquidation was concurrent with the distribution of

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<sup>3</sup> California also generally conforms to Subchapter S of Chapter 1 of Subtitle A of the IRC relating to tax treatment of “S corporations” and their shareholders. (R&TC, §§ 17087.5, 23800.)

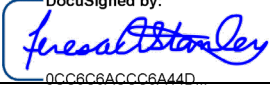
inventory, or that the other requirements of the corporate liquidation exception have been met. Therefore, the exception does not apply.

HOLDING

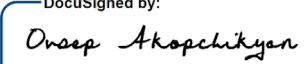
FTB properly disallowed part of appellant’s claimed net loss.

DISPOSITION

FTB’s action is sustained.

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Teresa A. Stanley  
Administrative Law Judge

We concur:

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Ovsep Akopchikyan  
Administrative Law Judge

DocuSigned by:  
  
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Kenneth Gast  
Administrative Law Judge

Date Issued: 8/14/2023