

**OFFICE OF TAX APPEALS
STATE OF CALIFORNIA**

In the Matter of the Appeal of:) OTA Case Number 220911419
F. SEDDIQUI AND)
K. SEDDIQUI)
_____)

OPINION

Representing the Parties:

For Appellants: F. Seddiqui and K. Seddiqui

For Respondent: Sonia D. Woodruff, Attorney

For Office of Tax Appeals: Tom Hudson, Attorney

V. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, F. Seddiqui and K. Seddiqui (appellants) appeal from the action by respondent Franchise Tax Board (FTB) proposing additional tax of \$116,163 and applicable interest for the 2017 tax year.

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

ISSUE

Whether appellants have established entitlement to additional basis in real property in Los Altos, CA (the Residence).

FACTUAL FINDINGS

1. Appellants purchased the original 1,800-square-foot Residence in 1982 for \$375,000. After substantial remodeling, repairing, and new construction, the size of the Residence increased to 4,700 square feet, with many new amenities. Appellants sold the Residence in 2017 for \$4,100,000.
2. On their 2017 California income tax return, appellants reported the Residence’s sale price of \$4,100,000, basis of \$3,178,000, adjustments of \$741,293, and a taxable gain of

\$180,707. These adjustments consisted of the selling expense of \$241,293 and the \$500,000 exclusion from gain provided to married couples filing jointly, in accordance with Internal Revenue Code (IRC) section 121, which concerns capital gains from the sale of a principal residence.

3. FTB audited appellants' 2017 tax return and focused on appellants' construction costs for the improvements and repairs to the Residence. To substantiate their reported basis, appellants provided: lists with general descriptions of improvements and repairs;¹ photographs; copies of correspondence and e-mails concerning construction;² the first page of an undated Design and Purchase Agreement with Alno San Francisco for a total price of \$86,770.12 for materials and services ;the first page of a six-page contract with Art Ruiz of DreamWorks Construction dated January 25, 2009, for \$97,229 for "Home Improvements for Kitchen Remodel/Addition," including demolition and remodeling of the existing kitchen; loan documents from a \$372,000 home loan from Wells Fargo Home Mortgage, Inc. dated June 13, 2003; and a spreadsheet containing check numbers, dates, and amounts for approximately 29 checks totaling \$229,618.29, but no information about the bank(s), the check recipients, the purpose for the payments, whether or not the checks cleared the bank, etc.
4. Because appellants did not have complete records of their expenditures at audit, FTB reduced appellants' basis in the Residence from \$3,178,000 to \$1,244,000. This estimate was comprised of appellants' \$375,000 purchase price for the Residence, plus \$869,000 of improvements. FTB issued a Notice of Proposed Assessment (NPA) on July 16, 2021, that increased appellants' taxable gain by \$1,934,000 and proposed to assess additional tax of \$240,065.³

¹ Significantly, appellants explained that the 1989 Loma Prieta earthquake caused significant damage to the Residence. No detailed information was provided concerning the repair costs or casualty losses that may have been claimed on appellants' tax returns or on insurance claims.

² The documents provided are vague, with few financial details. As an example, an e-mail message from D. Gewargis dated January 20, 2021, states "The construction company that did the work at your house has closed down and [is] no longer in business. I believe the total amount of work for building the deck was over \$105,000 not including any landscaping work and purchasing of any of the lighting fixtures etc. The pictures reminded me little about the work."

³ The NPA dated July 16, 2021, also proposed to reduce appellants' itemized deductions by \$15,383. This amount was affirmed in the Notice of Action. Appellants have not disputed FTB's adjustments to the itemized deductions.

5. Appellants protested the NPA. During the protest process, FTB determined that the value of the demolished original structure should be removed from the purchase price of \$375,000. FTB allocated 43 percent, or \$161,500, of the value of the property to the land based on the allocation used in the 1999 property tax assessment, and disallowed the remaining \$213,500 as allocable to the demolished structure.⁴ Because appellants did not have records of their construction costs, FTB used a software program known as the Marshall & Swift CoreLogic Swift Estimator (“CoreLogic Estimator”) to estimate the construction costs for the various improvements. In addition to estimating the remodeling costs, this software also estimated other construction costs, such as the outdoor pizza oven, wrought iron gates, and other exterior improvements. Using this software, FTB determined that appellants’ basis should be increased from \$1,244,000 to \$2,128,096. This basis included \$161,500 for the land portion of appellants’ purchase of the Residence, plus \$1,966,596 of improvements.
6. FTB incorporated the audited basis calculations reached as a result of the protest process into the Notice of Action (NOA) that was issued to appellants on August 26, 2022. Allowing a basis of \$2,128,096, FTB reduced appellants’ taxable gain from \$1,934,000 to \$1,230,611. As a result, the NOA proposed additional tax of \$116,163 plus interest. This timely appeal followed.

DISCUSSION

FTB’s determination is presumed correct and taxpayers have the burden of proving error. (*Appeal of Johnson*, 2022-OTA-166P.) Except as otherwise provided by law, the applicable standard for the burden of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) Unsupported assertions are insufficient to satisfy the taxpayers’ burden of proof. (*Appeal of Johnson*, *supra*.)

As relevant here, California conforms to federal rules for computing the basis of property to determine the gain on the sale of such property. (R&TC, § 18031.) Gain on the sale of property shall be the excess of the amount realized over the adjusted basis of the property. (IRC, § 1001.) The adjusted basis shall be the cost of property with proper adjustments made for

⁴ This determination was based on a 1999 property tax assessment that valued the land portion of the Residence at 43 percent of the total assessed value, which was \$404,722 at that time. Thus, FTB allowed a basis of \$161,500 for the purchase of the land in 1982 but disallowed the remaining basis of \$213,500 for the original house that was demolished.

various items including the costs of improvements and betterments made to the property. (IRC, §§ 1011(a), 1012(a), 1016(a); Treas. Reg. § 1.1016-2(a).)

If a taxpayer with inadequate records shows that improvements were made to the taxpayer's property, but cannot substantiate the exact amount, the cost of the improvements may be estimated under the rule announced in *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540 (*Cohan*) to determine basis. The *Cohan* rule was adopted when the famous theatrical producer George M. Cohan testified that he had spent substantial sums of money on travel and entertaining actors, employees, and drama critics in furtherance of his theatrical production business. (*Ibid.*) Mr. Cohan could not substantiate his actual expenditures by written records but instead estimated the amounts in his testimony. (*Ibid.*) The court held that, where a taxpayer has established that the taxpayer incurred an expense for which a deduction may properly be claimed but is unable to document the exact amount of the expense, a court may make a reasonable estimate of the deduction in certain circumstances, "bearing heavily" against the taxpayer whose inexactitude is of his or her own making. (*Id.* at pp. 543-544.) The *Cohan* rule has been applied to estimate a taxpayer's basis in property. (See, e.g., *Dockery v Commissioner*, T.C. Memo. 1978-63.) OTA's predecessor, the California State Board of Equalization (SBE), applied the *Cohan* rule, stating "[w]here [FTB] has allowed part of a deduction, [SBE] will not alter [FTB's] determination unless facts appear from which a different approximation can be made." (*Appeal of Swimmer, et. al.* (63-SBE-138) 1963 WL 1744.) Similarly, SBE expressed "reluctance to disturb [FTB's] determinations involving unsubstantiated amounts without independent facts on which to base a different finding." (*Appeal of California Steel Industries, Inc.* (2003-SBE-001) 2003 WL 176962.) A taxpayer must demonstrate some "basis on which an estimate can be made" that goes beyond mere speculation, unsupported allegations, or mere inference. (*Vanicek v. Commissioner* (1985) 85 T.C. 731, 742-743; see also *Appeal of Hakim* (90-SBE-005) 1990 WL 176081.)

This case supports the application of the *Cohan* rule to estimate appellants' basis in the Residence, since detailed financial data is not available, and it is undisputed that appellants made improvements to the Residence. FTB's determination includes total basis of \$2,128,096, comprised of \$161,500 for appellants' purchase of the land for the Residence and \$1,966,596 of capital improvements.

The evidence presented by appellants demonstrates extensive construction and improvements, corroborating FTB's cost estimates. However, appellants' evidence does not demonstrate that appellants are entitled to additional basis beyond the amount estimated by FTB. Appellants have not provided invoices, receipts, credit card statements, bank statements, complete contracts, or other similar documentation showing expenditures in excess of \$2,128,096. The Design and Purchase Agreement with Alno San Francisco for \$86,770.12 does not indicate a date to show that the interior decoration services were provided during the relevant time period or whether they constituted capital improvements such that they should be included in appellants' basis for the Residence. The first page of the contract with Art Ruiz of DreamWorks Construction for \$97,229 in home improvements is relevant, but this sum was included in FTB's estimate. The loan documents from Wells Fargo Home Mortgage, Inc. indicate that appellants borrowed \$372,000, but there is no evidence that this amount was used for home improvements that would increase appellants' basis. Appellants have not shown that FTB's estimate of \$2,128,096 for appellants' cost basis is incorrect. Accordingly, FTB's estimate of \$1,966,596 of capital improvements must be sustained.

The final component of appellants' basis is the purchase price, which was accepted by FTB at audit as \$375,000, and then reduced at protest to \$161,500. FTB's protest determination letter states that it reduced the purchase price of the Residence because improvements that were included in the purchase price were demolished by appellants in 1998, and thus were not part of the improvements sold in 2017. In support of this assertion, FTB's NOA cites *U.S. v. Rogers* (9th Cir. 1941) 120 F.2d 244, 246 (*Rogers*) for the proposition that only improvements that are part of the property when it is sold may be included in basis.

In *Rogers*, the taxpayer paid \$55,000 for land with a residence, made \$48,777 of initial improvements to the residence, and then made \$23,033 in improvements to the grounds, including adding a garage, barn, pool fence, and shrubbery. (*Rogers, supra*, 120 F.2d 244 at p. 245.) It was then discovered that the residence had extensive termite damage and, accordingly, the home was razed. (*Ibid.*) The taxpayer sold the land without rebuilding the home for \$150,000. (*Ibid.*) The taxpayer's asserted basis included the cost of the land and residence, cost of improvements to the residence, and the cost of the improvements to the grounds. (*Ibid.*) The IRS asserted that the cost of improvements to the residence should not be included, but permitted

the cost of the land, residence, and improvements to the grounds.⁵ (*Ibid.*) In sustaining the IRS's position, the court explained that "basis is 'the cost of such property [sold].' [] What property was sold? It was a parcel of land with certain improvements, but without a house." (*Id.* at p. 247.)

The holding in *Rogers* does not support FTB's contention because in *Rogers*, the IRS did not seek to reduce the taxpayer's cost basis by the amount of purchase price allocable to the original residence. (*Rogers, supra.*) Also, in this case appellants' sale included both the land and residence, unlike in *Rogers* where the taxpayer did not replace the demolished residence. Although a taxpayer's cost basis can be increased only by capital improvements that are part of the residence at the time of sale, the starting point is a taxpayer's cost basis, which is the cost of such property. (See *Bayly v. Commissioner*, T.C. Memo. 1981-549; IRS Pub. 523, 2022 WL 19577492; IRC § 1012.) OTA is not aware of statutory or precedential authority that would permit FTB to reduce a taxpayer's cost basis by the value of a demolished structure. (See IRC, §§ 1012-1016.)

Accordingly, FTB's determination to reduce appellants' cost basis by the portion of appellants' purchase price allocable to the original structure that was demolished is reversed.

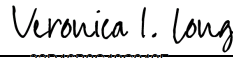
⁵ The IRS asserted that there was \$71,997 of gain, which is equal to the sales price of \$150,000 less the purchase price of \$55,000 and the \$23,033 of improvements made to the grounds. (*Ibid.*)

HOLDING

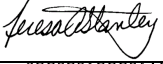
Appellants have established error in FTB’s determination that a portion of the cost basis attributable to a demolished structure should be excluded from appellants’ basis in the Residence. Otherwise, FTB’s disallowance of additional basis for improvements is sustained.


DISPOSITION

FTB’s action is modified to allow appellants’ full purchase price (cost basis) of \$375,500 in their basis. FTB’s action is otherwise sustained.

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Veronica I. Long
Administrative Law Judge

We concur:

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Teresa A. Stanley
Administrative Law Judge

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Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 9/27/2023