**OFFICE OF TAX APPEALS**

**STATE OF CALIFORNIA**

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| In the Matter of the Appeal of:<br><br>**S. SADATNEJAD AND**<br>**K. MARCONET** | OTA Case No. 221211991 |

## OPINION

Representing the Parties:

For Appellants: David Browne, Attorney

For Respondent: Brian C. Miller, Attorney

For Office of Tax Appeals: Carl Joseph, Attorney

T. STANLEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S. Sadatnejad and K. Marconet (appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing additional tax of $148,069, and applicable interest, for the 2018 taxable year; and additional tax of $141,980, and applicable interest, for the 2019 taxable year.[1] In addition, pursuant to R&TC section 19324, appellants appeal an action of FTB denying appellants' claim for refund of $70,450 for the 2015 taxable year and appellants' claim for refund of $95,951 for the 2016 taxable year.

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

## ISSUE

Have appellants shown error in FTB's determination that a loss taken on their 2017 tax return was not connected to a trade or business and therefore was ineligible to be carried back to the 2015 and 2016 taxable years and carried over to the 2018 and 2019 taxable years?

[1] FTB also imposed late-filing penalties for the 2018 and 2019 taxable years. Appellants did not provide argument with respect to the penalties or interest, and they are not addressed separately in this Opinion.

## FACTUAL FINDINGS

1. Appellants reported a business loss of $5,373,969 on their original 2017 California Form 540 return.
2. Appellants filed an amended 2017 return that also reported a business loss of $5,373,969. In addition, they attached a California Form 3805V claiming net operating loss (NOL) carrybacks to 2015 and 2016 and an NOL carryover to 2018.
3. Appellants filed an amended 2015 return applying an NOL carryback from the 2017 taxable year and claiming a refund of $70,450. Appellants filed an amended 2016 return applying an NOL carryback from the 2017 taxable year and claiming a refund of $95,951.
4. On their original 2018 and 2019 returns, appellants also reported NOL carryovers from 2017.
5. FTB audited appellants' 2015 and 2016 refund claims and their amended 2017 tax return that claimed an NOL with carrybacks to 2015 and 2016. FTB expanded the audit to appellants' 2018 and 2019 returns to examine appellants' claimed NOL carryovers. FTB allowed appellants' 2017 reported loss of $5,373,969 and did not propose additional tax for 2017. However, FTB denied the refund claims on the ground that the loss reported in 2017 was a nonbusiness deduction that could not be carried back and applied to the 2015 and 2016 taxable years.
6. FTB also issued Notices of Proposed Assessment (NPAs) for the 2018 and 2019 taxable years reflecting its determination that the loss could not be carried over and applied to those years. Following appellants' timely protest of the NPAs, FTB issued Notices of Action (NOAs) affirming the NPAs.
7. Appellants filed this timely appeal from FTB's NOAs for the 2018 and 2019 taxable years and FTB's denial of appellants' refund claims for the 2015 and 2016 taxable years.

### The Loss at Issue

8. During the years at issue, appellant-husband was a partner in the accounting firm of Magidoff, Sadat & Gilmore (MSG).
9. Among the clients of MSG were H. Groff and S. Groff (the Groffs).

10. In addition to MSG, the Groffs also worked with an investment advisor, S. Wilshinsky (Wilshinsky) who was employed by Oppenheimer and Company Inc. (OPCO).
11. OPCO, MSG, and appellant-husband were the subject of a binding arbitration award which determined that appellant-husband failed as a fiduciary to protect the Groffs' investment funds that were under his control, failed to account to the Groffs as to investments made without their knowledge and permission, and failed to disclose conflicts of interest. The arbitrators also found that Wilshinsky acted with intent to deceive and defraud the Groffs, appellant-husband, and OPCO.
12. The arbitrators determined that appellant-husband converted the Groffs' funds by transferring funds to the TOV trust, a trust set up by Wilshinsky and appellant-husband for the benefit of their respective children. Appellant-husband was the sole trustee for the TOV trust. The arbitrators found appellant-husband to be the primary tortfeasor and deemed him to be 75 percent liable for the Groffs' investment losses of $6.3 million.
13. In a Memorandum of Points and Authorities in Opposition to Application for Right to Attach Order (Memorandum), appellants opposed the attachment order sought by OPCO on the basis that the underlying claim at issue in the litigation was not the type of claim that allows the relief requested by OPCO because it was not one arising from the conduct of a trade or business.
14. Appellant-husband signed a settlement agreement with the California Board of Accountancy (Board) wherein he gave up his right to contest the Board's findings that he engaged in self-dealing, embezzled the Groff's funds, and breached his fiduciary duty.

## DISCUSSION

Income tax deductions are a matter of legislative grace, and taxpayers who claim a deduction have the burden of proving by competent evidence that they are entitled to that deduction. (*Appeal of Vardell*, 2020-OTA-190P.) Internal Revenue Code (IRC) section 165(a), as incorporated into California law by R&TC section 17201(a), provides, in part, that "there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." IRC Section 165(c) limits an individual's deduction for losses pursuant to IRC Section 165(a) to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses

of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

For individuals, in calculating whether the taxpayer has an NOL in a given year, and thus a loss that is able to be carried over or back to offset income in other taxable years, any nonbusiness deductions are allowed only to the extent of nonbusiness income. (IRC, § 172(d)(4).)[2] A taxpayer claiming entitlement to deduct an NOL bears the burden of establishing both the existence of the NOL and the amount of any NOL that may be carried over to other taxable years. (*Filler v. Commissioner*, T.C. Memo. 2021-6, citing *U.S. v Olympic Radio & Television, Inc.* (1955) 349 U.S. 232, 235.) If the loss at issue is a nonbusiness loss, no NOL may be used in other taxable years. (IRC, § 172(b)(2), (d)(4); see *Cavaretta v. Commissioner*, T.C. Memo. 2010-4 (*Cavaretta*) [the court's job is to decide whether petitioners' payments were business or nonbusiness expenses].) Like the tax court in *Cavaretta*, OTA's job in this appeal is to determine if the payment made by appellant-husband to settle the dispute with OPCO was a business expense, and thus could give rise to an NOL, or whether it was a nonbusiness expense deductible under IRC section 165(c)(2) but without giving rise to an NOL.[3]

This analysis is aided to a large degree by the Memorandum that was filed by appellants' attorney as part of litigation filed by OPCO against appellant-husband. In this Memorandum, appellant-husband, who is referred to as Sadat, opposed the attachment order on the basis that the underlying claim at issue in the litigation (the litigation that was the subject of the arbitration award and subsequent settlement that gave rise to the loss at issue in this appeal) was not the type of claim that allows the relief requested by OPCO. Significantly, the Memorandum argues that the claim was not one arising from the conduct of a trade or business. Relevant statements in the Memorandum include: (1) "[a]s to Sadat, the underlying dispute arose from conduct by Sadat concerning a trust for which he was trustee, and into which OPCO transferred the Groffs' funds pursuant to its fraud on the Groffs . . . [and] has nothing to do with Sadat's trade, business or profession . . . ."; (2) "[t]he underlying claim was for equitable indemnity - that Sadat should bear some portion of the Groffs' losses due to his own misconduct after he received the funds"; (3) "[t]he key findings concerning his obligation to be responsible was [sic] that he was a

[2] California conforms to IRC section 172 with certain modifications not relevant here. (R&TC, § 17276.)

[3] IRC section 165(2) relates to losses incurred in any transaction entered into for profit, even if not connected with a trade or business.

fiduciary as to the funds received and had the independent obligation to safeguard the funds"; (4) "[t]here is no contention or allegation that Sadat's role as trustee of the trust had anything to do with his trade or business"; (5) "no aspect of the transactions involved his accounting business"; (6) "[t]he requirement that the obligation *arise* from his conduct of his trade, business or profession is not met by this link"; and (7) "[b]eing a trustee of a trust was not part of his activities of his trade or business."

Appellants have not addressed how their position in the Memorandum can be squared with their position in this appeal. Appellants argue that the origin of the claim should control whether the loss could be used in other years. However, it is unclear what appellants believe to be the origin of the claim, nor have appellants set forth any analysis on this issue beyond stating that the "essence" of the claim was that OPCO "sought indemnity from [appellant-husband] based on the $4,000,000 that they paid to the Groffs to settle the claims that the Groffs brought against [OPCO]."

The "origin of the claim" test is not a mechanical search for what occurred first in the chain of events leading to the litigation but is instead based on all the facts and circumstances of the litigation. (*Estate of Kincaid v. Commissioner* (1986) T.C. Memo. 1986-543.) The inquiry is directed to the determination of the "kind of transaction" from which the litigation arose. Consideration is given to "the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertinent to the controversy." (*Ibid.*)

The record reflects that the origin of the claim that led to the loss at issue was the tortious actions of appellant-husband; namely, the conversion of the Groffs' funds as a result of their transfer to the TOV trust, which appellant-husband controlled, and appellant-husband's subsequent failure as a fiduciary to protect the Groffs' investment funds held by the TOV trust. OTA agrees with appellant-husband's and his attorneys' statements that these actions were not connected with appellant-husband's trade or business as a CPA. As such, the loss is a nonbusiness loss and does not give rise to an NOL deductible in other years.[4]

[4] Appellants argue that the decision of the arbitrators was erroneous, and that the ultimate payment to OPCO was based on a settlement agreement. However, as discussed previously, appellants themselves argued that the claim at issue was not related to appellant-husband's trade or business. Even if the arbitrators' decision was erroneous, appellants have not shown that the award was related to appellant-husband's trade or business.

## HOLDING

Appellants have not shown error in FTB's determination that their loss in the 2017 taxable year did not give rise to an NOL that could be carried back to the 2015 and 2016 taxable years and carried over to the 2018 and 2019 taxable years.

## DISPOSITION

FTB's action denying appellants' claims for refund for the 2015 and 2016 taxable years, as well as its actions assessing additional tax for the 2018 and 2019 taxable years, are sustained.

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Teresa A. Stanley
Administrative Law Judge

We concur:

Signed by:
25E8FE08EF56478...
Natasha Ralston
Administrative Law Judge

Signed by:
4E8E740EDB984CD...
Kim Wilson
Hearing Officer

Date Issued: 8/21/2024