

**OFFICE OF TAX APPEALS  
STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No. 230212616  
C. CHIEN )  
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**OPINION**

Representing the Parties:

For Appellant: C. Chien  
For Respondent: Carolyn S. Kuduk, Attorney  
For Office of Tax Appeals: Linda Frenklak, Attorney

A. KLETTER, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, C. Chien (appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$361,726, an accuracy-related penalty (ARP) of \$72,345.20, and applicable interest for the 2019 tax year.

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

**ISSUES**

1. Whether appellant has shown error in FTB’s proposed assessment of additional tax for the 2019 tax year.
2. Whether the ARP was properly imposed and may be abated.

**FACTUAL FINDINGS**

1. In 1998, appellant purchased for \$410,000 a commercial property located on Moffett Boulevard in Mountain View, California (the Moffett Property). The Moffett Property was a commercial property which appellant used as her office until she retired in 2000. In 2000, appellant moved to Southern California to care for her mother

- and primarily resided at her mother's house. On occasion, appellant stayed at the Moffett Property.
2. Appellant later used half of the Moffett Property as storage and rented the other half. Appellant reported rental income, expenses, and depreciation for the Moffett Property on her California Resident Income Tax Returns (Forms 540) for the 2014 tax year through the 2019 tax year. Appellant made improvements to the Moffett Property.
  3. In 2004, appellant purchased a residential property on East Evelyn Avenue in Mountain View, California (the East Evelyn Property). The East Evelyn Property is located about 2.1 miles away from the Moffett Property. On Forms 540 for the 2015 and 2016 tax years, appellant listed the East Evelyn Property as her mailing address.
  4. On appellant's 2013 federal Form 4562, Depreciation and Amortization, appellant reported placing a nonresidential real property, i.e., the Moffett Property, into service on July 1, 2013, with a basis for depreciation of \$463,671 and a recovery period of 39 years using the straight-line method.<sup>1</sup> Appellant claimed depreciation of \$10,351 on the 2013 Form 4562.<sup>2</sup> Appellant also claimed depreciation for the Moffett Property totaling \$79,507 for the 2013 tax year through the 2019 tax year on federal Schedules E, which report income or loss from rental real estate.
  5. In 2017, appellant purchased a second residential property in Hacienda Heights, California (the Hacienda Heights Property). Appellant listed the Hacienda Heights Property as her mailing address on her Forms 540 for the 2017, 2018, and 2019 tax years.
  6. The Moffett Property is located in the County of Santa Clara. The County of Santa Clara issued appellant two property tax bills for the Moffett Property, one for the 2017-2018 tax years, and one for the 2019-2020 tax years. Both property tax bills were issued to appellant at her Hacienda Heights Property address. Both property tax bills indicate a homeowner exemption of zero for the Moffett Property.
  7. On September 27, 2019, appellant sold the Moffett Property for \$3,458,000. On her 2019 Form 540, appellant reported the Moffett Property's sales price of \$3,458,000, cost or other basis of \$2,996,158, and pursuant to Internal Revenue Code (IRC) section 121, a subtraction of \$250,000. On appellant's 2019 federal income tax return,

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<sup>1</sup> While not specifically named on Form 4562, it is undisputed that Form 4562 reports the Moffett Property.

<sup>2</sup> FTB's records show that appellant did not file a federal Form 4562 for the 2014 through 2019 tax years.

- she also claimed selling expenses of \$338,369, which increased the Moffett Property's California basis.<sup>3</sup> On appellant's 2019 federal income tax return and 2019 Form 540, she reported a net long term capital gain of \$211,842 on the sale of the Moffett Property.
8. FTB audited appellant's 2019 Form 540. The auditor requested documentation to substantiate appellant's reported cost basis and capital gain computation for the Moffett Property. Appellant reported that she lost the requested documentation.
  9. Concerning the Moffett Property's cost or other basis, FTB determined that appellant overstated the claimed cost basis by \$2,277,004 and failed to account for unrecaptured IRC section 1250 gain of \$257,842.<sup>4</sup> FTB also disallowed the IRC section 121 subtraction of \$250,000 on the gain from the Moffett Property sale. Accordingly, FTB determined that appellant's net gain on the sale of the Moffett Property was \$2,784,846 (\$2,277,004 + \$257,842 + \$250,000). FTB also proposed to assess an ARP because appellant substantially understated the tax for the 2019 tax year.
  10. FTB subsequently issued appellant a Notice of Proposed Assessment (NPA), which proposed to increase appellant's reported taxable income by \$2,795,075, and to assess total tax of \$388,329, additional tax of \$361,726, and an ARP of \$72,345, plus interest.<sup>5</sup>
  11. Appellant timely protested the NPA. Appellant provided a Financial Income and Expenditure Accounting Statement for the Moffett Property (adjusted basis schedule), listing claimed expenditures from 1998 through 2019 for the Moffett Property.<sup>6</sup>
  12. FTB rejected appellant's adjusted basis schedule because it listed repairs and expenses which are not capital expenditures, and because appellant was unable to substantiate with documentation of any of the claimed expenditures listed on the schedule.

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<sup>3</sup> As reported on the Estimated Sellers Settlement Statement, appellant's claimed selling expenses consisted of escrow charges, title charges, recording fees, additional charges, prorations and adjustments, and commissions. Appellant reported a federal cost or other basis of \$2,657,789. The California cost or other basis of \$2,966,158 reflects an increase of \$338,369 ( $\$2,657,789 + 338,369 = \$2,996,158$ ).

<sup>4</sup> FTB also reviewed the county assessor's records of the Moffett Property's annual value for the 1999 through 2019 tax years and allowed a basis increase of \$118,110 to reflect significant increases in the Moffett Property's assessed improvement value for the 2001 and 2002 tax years.

<sup>5</sup> Based on its income adjustments, FTB proposed to reduce appellant's claimed itemized deductions by \$10,299, and to assess a mental health services tax of \$21,095. Appellant does not dispute either adjustment. Appellant also does not dispute interest. Thus, this Opinion does not discuss these adjustments or interest further.

<sup>6</sup> Appellant's adjusted basis schedule lists a gain of \$534,636.81, more than she reported on her 2019 Form 540.

13. On December 29, 2022, FTB issued appellant a Notice of Action affirming the NPA.
14. This timely appeal followed. On appeal, appellant provides a schedule calculating her gain, a copy of the adjusted basis schedule and copies of two photographs of the Moffett Property captioned “Befor[e] Construction” and “After Construction.”

### DISCUSSION

#### Issue 1: Whether appellant has shown error in FTB’s proposed assessment of additional tax for the 2019 tax year.

FTB’s determination is presumed correct, and a taxpayer has the burden of proving error. (*Appeal of Johnson*, 2022-OTA-166P.) 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 they are 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 error in FTB’s determination, it must be upheld. (*Appeal of Smith*, 2023-OTA-069P.) 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 Smith*, *supra*.)

#### *Gain from 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.)<sup>7</sup> 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).)<sup>8</sup> The gain from the sale or other disposition of property is generally

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<sup>7</sup> R&TC section 17024.5(a)(1)(P), as in effect for the 2019 tax year, provides that for Personal Income Tax Law purposes, California conforms to the IRC as effective on January 1, 2015. Thus, references to the IRC contained in this Opinion are to the IRC as effective on January 1, 2015.

<sup>8</sup> 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).)

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).) Here, the amount realized on the sale of the Moffett Property (\$3,458,000 in gross proceeds) is not in dispute. Rather, appellant claims that FTB improperly disallowed adjustments to basis of the Moffett Property.

### *Adjusted Basis*

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.) The cost of real property shall not include any amount in respect of real property taxes which are treated under IRC section 164(d) as imposed on the taxpayer, and basis is not adjusted for taxes or carrying charges. (IRC, §§ 1012(b), 1016(a)(1)(A)(i).) The cost or other basis of property shall be properly adjusted (increased) for expenditures, receipts, losses, or other items properly chargeable to capital account, including the cost of improvements and betterments made to the property. (Treas. Reg. § 1.1016-2(a).) Selling expenses related to real estate are properly chargeable to the capital account under IRC section 1016(a) and are therefore an adjustment (increase) to the seller's basis in the property. (*Kirschenmann v. Commissioner* (9th Cir. 1973) 488 F.2d 270, 272-273).

No deduction shall be allowed for capital expenditures. (IRC, § 263(a)(1); R&TC § 17201(c).) Ordinary and necessary incidental repairs and maintenance may be deducted by a cash basis taxpayer when paid, but such expenses are not capital assets. (IRC, § 162; R&TC § 17201(a), (c); see *Schroeder v. Commissioner*, T.C. Memo. 1996-336.). Whether an expense is deductible or must be capitalized is a question of fact. (*Schroeder v. Commissioner, supra.*)

The cost or other basis shall be properly adjusted (decreased) for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount allowed as deductions in computing taxable income under the IRC. (IRC, §§ 167, 1016(a)(2); R&TC, § 17201.) The expense for depreciation shall not be less than the amount allowable under the IRC and R&TC. (IRC, § 1016(a)(2)(B); R&TC, § 18031.) The applicable depreciation method for nonresidential real property shall be the straight-line method with a 39-year recovery period. (IRC, § 168(b)(3), (c).) Generally, taxpayers that dispose of certain depreciable property must report ordinary gain in respect of depreciation deductions made on the property. (IRC, § 1250; R&TC, § 18171 [modifying IRC section 1250, but as inapplicable to this appeal].)

Here, it is undisputed that appellant purchased the Moffett Property for \$410,000 in 1998. At issue is the property's adjusted basis. Concerning selling expenses, appellant claimed selling expenses of \$338,369.09. FTB allowed \$191,053.50 of the claimed expenses and disallowed the remaining \$147,315.59, which consisted of state income tax withholding of \$115,152; prorated property tax of \$2,162; and a deferred maintenance credit of \$30,002. On appeal, appellant again claims \$338,369.09 in selling expenses, reversing FTB's disallowance of the selling expenses listed above, without explanation or support for her adjustment. As described above, taxes are generally not capital expenditures. (IRC, § 1016(a)(1)(A)(i).) Additionally, ordinary and necessary incidental repairs and maintenance are not capital assets; rather, they are generally deductible in the year incurred. (See *Schroeder v. Commissioner, supra.*) Because appellant fails to establish error in FTB's determination that she must reduce her adjusted basis for disallowed selling costs of \$147,315.59, the determination must be upheld. (See *Appeal of Smith, supra.*)

Concerning other capital expenditures, on appeal, appellant provides a gain schedule which calculates a gain of \$44,109.72, along with an adjusted basis schedule for the Moffett Property which reports capital expenditures totaling \$2,923,363.19.<sup>9</sup> The adjusted basis schedule includes the purchase price of \$410,000 and selling expenses of \$338,369.09.

As a preliminary matter, the schedules appellant provides on appeal erroneously claim the purchase price of \$410,000 and the selling expenses of \$338,369.09 twice, once on the gain schedule, and a second time on the adjusted basis schedule. Subtracting the duplicated expenses from the total expenditures of \$2,923,363.19, appellant appears to be claiming capital expenditures of \$2,174,994.10. FTB disallowed appellant's claimed capital expenditures because appellant failed to substantiate them with supporting documents. Moreover, appellant's adjusted basis schedule includes amounts that appear to be incurred for repairs or maintenance and, which FTB determined were therefore not capital expenditures. On appeal, appellant concedes that during her move from Mountain View, California, to Hacienda Heights, California, the movers lost her original receipts and no longer has them. However, appellant

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<sup>9</sup> The gain schedule shows a purchase price of \$410,000, and makes the following adjustments: increases for selling expenses of \$338,369.09 and capital expenditures of \$2,923,363.19, and a reduction for accumulated depreciation of 257,842. From a sales price of \$3,458,000, appellant calculates a gain of \$44,109.72. Therefore, appellant's cost or other basis is \$3,413,890.28 ( $\$3,458,000 - \$44,109.72 = \$3,413,890.28$ ). As described above, appellant's 2019 Form 540 reports a cost or other basis of \$2,996,158, and her 2019 federal income tax return reports a cost or other basis of \$2,657,789. Appellant does not explain the variances.

claims that the adjusted basis schedule and two photographs of the Moffett Property are bona fide evidence of her adjusted basis.

Appellant has not provided any documents, such as receipts, cancelled checks, bank statements, or similar third-party documents, to support her assertions on appeal and on the schedules she provides. Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Silver, supra.*) Concerning the photographs, appellant does not explain the purpose of the photographs, when they were taken, or by whom, and what improvements are evident by comparing the photographs. In the absence of credible, competent, and relevant evidence showing error in FTB's determination, it must be upheld. (*Appeal of Smith, supra.*)

Concerning basis adjustments for depreciation, appellant has not produced a depreciation schedule for the Moffett Property. As described above, taxpayers disposing of certain depreciable property must recapture the depreciation deductions under IRC section 1250. The depreciation expense shall not be less than the amount allowable under the IRC and R&TC. (IRC, § 1016; R&TC, § 18031.) On appellant's 2013 federal Form 4562, appellant reported that the Moffett Property was placed into service in July 2013, its basis for depreciation was \$463,671 and that the property was a nonresidential real property depreciable with a 39-year recovery period using the straight-line method. (See IRC, § 168(b)(3), (c).) Based on that information, FTB calculated a total depreciation expense of \$178,335 for the 15-year period beginning from the property's acquisition in 1998 through 2012.<sup>10</sup> Appellant claimed depreciation expenses on 2013 through 2019 federal Schedules E for the Moffett Property totaling \$79,507. Thus, FTB determined a total unrecaptured IRC section 1250 gain of \$257,842 (\$178,335 + \$79,507), and accordingly reduced appellant's adjusted basis by that amount.

On appeal, appellant does not address FTB's depreciation adjustment; furthermore, her gain schedule incorporates FTB's adjustment. It appears that appellant concedes that FTB properly reduced her basis in the Moffett Property. If appellant disputes the depreciation adjustment, then she fails to meet her burden of proof. (See *Appeal of Smith, supra.*)

#### *Application of the Cohan Rule*

The *Cohan* rule provides that if a taxpayer proves that the taxpayer is entitled to a tax benefit (i.e., an expense for which a deduction may properly be claimed) but does not

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<sup>10</sup> FTB calculated an annual depreciation expense of \$11,889 (\$463,671 divided by 39 years = \$11,889). For the 15-year period, the estimated total was \$178,335 (\$11,889 x 15 years = \$178,335).

substantiate the amount of the tax benefit, the court should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of the taxpayer's own making. (*Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 543-544 (*Cohan*); see *Appeal of First Solar, Inc.*, 2023-OTA-532P, fn. 5.) The *Cohan* rule or similar principles have been applied to estimate a taxpayer's basis in property. (*Huzella v. Commissioner*, T.C. Memo. 2017-210.) However, to estimate basis, a taxpayer must produce a reasonable evidentiary basis for making the estimate. (*Wheeler v. Commissioner*, T.C. Memo. 2014-204; see *Opperwall v. Commissioner* (9th Cir. 1997) 1997 WL 8473.) The *Cohan* rule is inapplicable when the taxpayer presents no evidence at all that would permit an informed estimate of basis. (*Ibid*; see *Vanicek v. Commissioner* (1985) 85 T.C. 731, 742-743; see also *Appeal of Hakim* (90-SBE-005) 1990 WL 176081.)

OTA's predecessor, the California State Board of Equalization (BOE), applied the *Cohan* rule, stating "[w]here [FTB] has allowed part of a deduction, [BOE] 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, BOE 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.)

Here, the auditor reviewed the county assessor's annual property values for the Moffett Property from 1999 through 2019 and determined that there were significant year-over-year increases to the Moffett Property's assessed improvement value for the 2001 and 2002 tax years. The auditor allowed a total basis increase of \$118,100 pursuant to IRC section 1016 and Treasury Regulation section 1.1016-2 because the increases to the assessed improvement value presumably reflected major capital expenditures.<sup>11</sup>

On appeal, appellant does not specifically address FTB's allowance of estimated capital expenditures of \$118,100 based on the assessed improvement value of the Moffett Property for the 2001 and 2002 tax years. Moreover, appellant fails to provide a reasonable evidentiary basis under the *Cohan* rule for OTA to estimate a different amount of capital expenditures incurred. As described above, appellant's adjusted basis schedule contains errors and does not include any

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<sup>11</sup> FTB determined that assessed improvement value increases for the other tax years were attributable to Proposition 13's annual allowable increase in property taxes and did not reflect major capital expenditures.

original receipts or documentation. Therefore, appellant fails to establish error in FTB's determination. (See *Opperwall v. Commissioner, supra.*)

*Principal Residence Exclusion*

Gross income 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 taxpayer as the taxpayer's principal residence for periods aggregating two years or more. (IRC, § 121(a); R&TC, §§ 17131 [generally conforming to IRC section 121], 17152 [containing modifications of IRC section 121 which are inapplicable to this appeal].) A taxpayer who does not file a joint return can exclude up to \$250,000 of the gain with respect to a qualified sale or exchange. (IRC, § 121(b)(1).) Whether property is used by the taxpayer as the taxpayer's residence depends on all the facts and circumstances. (Treas. Reg. § 1.121-1(b).)<sup>12</sup>

Here, the undisputed facts show that the Moffett Property was not a residential property and indicate that it was not appellant's primary residence in the five-year period prior to its sale on September 27, 2019. The Moffett Property was a commercial nonresidential property which appellant used as her office until 2000. Appellant later used half of the Moffett Property for storage and rented the other half. Moreover, with respect to appellant's principal residence, between 2015 and 2016, appellant listed the East Evelyn Property as her mailing address on her tax returns. Between 2017 and 2019, appellant listed the Hacienda Heights Property as her mailing address on her tax returns. Consistent with her returns, the County of Santa Clara's 2017-2018 and 2019-2020 property tax assessments for the Moffett Property were addressed to appellant's Hacienda Heights Property address. The property tax assessments also reported a homeowner exemption of zero for the Moffett Property. That appellant occasionally stayed at the Moffett Property, by itself, does not indicate that it was her primary residence for periods aggregating two years or more in the five-year prior to the Moffett Property's sale in 2019.

On appeal, appellant does not specifically address FTB's disallowance of her claimed principal residence exclusion and does not claim that she used the Moffett Property as her principal residence during the five-year period ending in 2019, when she sold the

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<sup>12</sup> 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. § 1.121-1(b)(2).)

Moffett Property.<sup>13</sup> Appellant has the burden of proving by competent evidence that she is entitled to the principal residence exclusion. (*Appeal of Silver, supra.*) However, appellant provides no credible evidence to show that she qualified for the principal residence exclusion and is entitled to make the \$250,000 subtraction from her gain on the sale of the Moffett Property.

Issue 2: Whether the ARP was properly imposed.

R&TC section 19164, which incorporates the provisions of IRC section 6662, provides for an ARP of 20 percent of the portion of an underpayment of the tax that was required to be shown on the taxpayer's return. (See *Appeal of Daneshgar*, 2021-OTA-210P.) As relevant here, the penalty applies to the portion of the underpayment attributable to any substantial understatement of income tax. (IRC, § 6662(b)(2).) For individual taxpayers, there is a "substantial understatement of income tax" when the amount of the understatement for a tax year exceeds the greater of 10 percent of the tax required to be shown on the return or \$5,000. (IRC, § 6662(d)(1)(A).)

The record shows that the ARP was properly imposed for the 2019 tax year. The tax required to be shown on the return was \$388,329. The understated tax of \$361,726 exceeds both \$38,833, which is 10 percent of the tax required to be shown on appellant's return, and \$5,000, so it is a "substantial understatement of income tax." (IRC, § 6662(b)(2).) FTB correctly calculated the ARP of \$72,345.20, which equals 20 percent of \$361,726.

There are various exceptions to the imposition of the ARP. The ARP shall be reduced by the portion of the understatement attributable to the tax treatment of any item if there was substantial authority for that treatment, or the relevant facts affecting the item's tax treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item. (IRC, § 6662(d)(2)(B)(i-ii).) Additionally, the ARP will not be imposed to the extent that a taxpayer has shown that a portion of the underpayment was due to reasonable cause and the taxpayer acted in good faith with respect to that portion of the underpayment. (IRC, § 6664(c)(1); Treas. Reg. §§ 1.6664-1(b)(2), 1.6664-4(a).) The taxpayer bears the burden of proving any defenses to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.)

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<sup>13</sup> On appeal, appellant's gain schedule does not include the \$250,000 principal residence exclusion in calculating her gain on the sale of the Moffett Property.

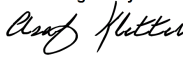
Appellant has not asserted any facts or legal authority to establish any applicable exceptions, and the record does not reflect any potential grounds for abating the ARP. Therefore, the ARP cannot be abated.

HOLDINGS


1. Appellant has not shown error in FTB’s proposed assessment of additional tax for the 2019 tax year.
2. The ARP was properly imposed and cannot be abated.


DISPOSITION

FTB’s action is sustained.

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 Asaf Kletter  
 Administrative Law Judge

We concur:

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 Josh Lambert  
 Administrative Law Judge

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 Sheriene Anne Ridenour  
 Administrative Law Judge

Date Issued: 5/30/2024