

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:) OTA Case No. 19095263
M. GELMAN AND)
R. GELMAN)
_____)

OPINION

Representing the Parties:

For Appellants: R. Gelman

For Respondent: Paul Kim, Attorney

For Office of Tax Appeals: Mai C. Tran, Attorney

V. LONG Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, M. Gelman and R. Gelman (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an additional tax of \$424,251, and applicable interest, for the 2011 tax year.¹

Office of Tax Appeals (OTA) Administrative Law Judges (ALJs) Tommy Leung, Ovsep Akopchikyan, and Eddy Y.H. Lam held a virtual hearing for this matter on May 19, 2023. At the conclusion of the hearing, the record was closed. ALJ Veronica I. Long replaced ALJ Tommy Leung on the panel. OTA reopened the record for additional briefing. Upon receipt of the additional briefing, the record was closed and the matter was submitted for an opinion.

ISSUE

Whether appellants have demonstrated error in FTB’s disallowance of appellants’ flow-through capital losses from Enhanced Affordable Development Company, LLC (EADC)

¹ All statutory and regulatory references are to the R&TC, Internal Revenue Code (IRC), and Treasury Regulations applicable to the year at issue.

resulting from the EADC's disposition of its interest in South River Road Associates (South River).

FACTUAL FINDINGS

1. In 2002, appellant-husband and a third party founded EADC, a real estate development management company focused on affordable low-income housing. Most of the properties developed by EADC use various affordable housing financing, city loans, grants, or state programs. EADC developed several projects and performed the property management services for the projects. When the third party left the business in 2009, appellant-husband assigned their 50 percent interest in EADC to appellant-wife.
2. South River owns Hidden Creek Village, a qualified low-income housing project located in San Luis Obispo County, California. The project was developed by the San Luis Obispo Nonprofit Housing Corporation (SLO Housing) and Enda-Isly Housing Corporation. South River was formed as a California limited partnership on May 26, 2009. SLO Housing is South River's managing general partner.
3. In 2009, appellant-husband formed TC Alliance Group (TC Alliance) to participate in the business of affordable housing and acted as its manager. TC Alliance set up partnerships that invested in low-income housing developments that used the Section 1602 program.² TC Alliance holds these interests for investment or sells its interests in the partnerships to investors after the acquisition of those interests. Appellants' children indirectly own 50 percent of TC Alliance through another LLC. An unrelated entity owned the remaining 50 percent. C. Clarke acted as an intermediary for TC Alliance and EADC in facilitating EADC's purchases of Section 1602 properties.
4. On March 1, 2010, South River entered into a grant agreement with the California Tax Credit Allocation Committee (the CTAC).

² In 2009, Congress enacted the American Recovery and Reinvestment Tax Act of 2009 (Public Law 111-5). Under Section 1602 of Public Law 111-5, state housing credit agencies are eligible to receive Section 1602 grants for low-income housing projects in lieu of low-income housing credits under IRC section 42. The state housing credit agency receiving the grant uses the funds to make subawards to partnerships (e.g., South River) to finance the construction or acquisition and rehabilitation of qualified low-income buildings. The subawards are subject to the same requirements as low-income housing credits under section 42. Partners in these partnerships (e.g., EADC in South River) benefit to the extent they own the interest when the grant money is received by the developer. The grant amount is not taxable to the partner (i.e., EADC), but serves to increase the partner's basis in the partnership.

- a. The grant agreement provided that the CTAC subawarded South River with a Section 1602 grant of \$14,115,450.
 - b. The grant was disbursed in three parts: \$4,653,280 on July 7, 2010; \$5,933,307 on February 1, 2011; and \$3,528,863 on November 8, 2011.
 - c. According to section 7.13 of the grant agreement, South River “shall promptly give notice in writing to the Committee in the event that [South River] syndicates and sells a portion of its ownership interest in the Development to an entity seeking tax losses associated with the Development where such syndication was not set forth in the application for the subaward.”
5. Appellant-husband began negotiating the agreement for EADC to purchase a partnership interest in South River.
 6. EADC acquired a 99.9 percent limited partner interest in South River by committing to make a capital contribution of \$576,145.³ South River’s Amended and Restated Partnership Agreement (the Partnership Agreement) states that EADC was admitted to South River effective July 1, 2010. Appellants acknowledge that appellant-husband signed South River’s partnership agreement on behalf of EADC after the effective date of the agreement. The Partnership Agreement is not otherwise dated.
 7. TC Alliance sought legal advice on the tax consequences of receiving a Section 1602 Program subaward. According to an August 2, 2010 opinion letter from Reed Smith LLP to TC Alliance regarding TC Alliance’s intent to invest in a series of partnerships that would be eligible for Section 1602 subawards, each investor’s basis in its partnership interest, at-risk amount, and its capital account will be increased by its allocable share of any Section 1602 subaward that accrues after the investor becomes a partner in the partnership.
 8. In a letter of intent (LOI) dated August 25, 2010, TC Alliance or its assigns offered to purchase a 99.9 percent partnership interest in South River. The LOI was authored by C. Clarke acting as acquisition agent of TC Alliance and directed to SLO Housing. The LOI provided:

³ The capital contributions were paid in three installments: \$115,230 on May 12, 2011; \$57,615 on July 26, 2012; and \$403,300 on December 31, 2012.

- a. The terms of “major provisions to be contained in the Partnership Agreement” which would be prepared by TC Alliance including identification of the project, amount of anticipated grant money, capital contributions to be made and their dates, and cash flow distributions;
 - b. The terms of the LOI would “ultimately be superseded by the Partnership Agreement”;
 - c. That if the SLO Housing agreed to terms, it should sign and return the LOI.
- SLO Housing accepted the offer, and its representative signed the LOI on August 27, 2010.
9. On January 10, 2011, EADC sold its interest in South River to a third party for \$1,228,851. Since EADC’s basis in the South River interest included its allocated share of the grant disbursement of \$4,648,628, EADC reported a loss from the sale of its South River interest.
10. On March 18, 2011, SLO Housing requested that the CTAC approve the sale of a partnership interest in South River (and losses) to C. Clarke (intermediary for EADC). The letter states “we respectfully request that you approve the sale of the losses to Clarke and company [referring to EADC]...please let us know if we are authorized and approved to go forward with this transaction.”
11. On their 2011 tax return, appellants claimed flow-through capital losses from EADC’s sale of the interest in South River. Appellants reported a sales price of \$1,228,851, basis consisting of \$576,145 of capital installments and \$4,648,628 from the Schedule K-1 (tax exempt income), for a capital loss of \$3,995,922.
12. FTB audited EADC’s 2010 and 2011 tax returns and determined that EADC’s basis in South River was overstated because the basis included an allocation of the grant disbursement made to South River on July 7, 2010. FTB determined that EADC was not a partner in South River as of that date, and therefore, the disbursement could not be allocated to EADC. FTB issued a Notice of Proposed Assessment (NPA) informing appellants of the corresponding adjustments to their individual return.
13. FTB examined South River’s 2011 partnership tax return. On February 14, 2017, FTB issued a No Change Letter to South River.

14. Appellants protested the adjustments to their individual return. After review, FTB issued a Notice of Action affirming the NPA. Appellants filed this timely appeal.

DISCUSSION

FTB's determination is presumed correct, and taxpayers bear the burden of proving error. (*Appeal of Davis*, 2020-OTA-182P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid.*) The applicable standard of proof is by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).) 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 Belcher*, 2021-OTA-284P.) In other words, the preponderance of the evidence standard means more than 50 percent. (*Ibid.*)

1. Effective Date of Partnership Agreement

Generally, a partner's distributive share of income, gain, loss deduction or credit is determined by the partnership agreement. (IRC, § 704(a).)⁴ A partnership agreement includes any modifications of the partnership agreement made prior to or at the time prescribed by law for the filing of the partnership return for the taxable year not including extensions. (IRC, § 761(c).) A partnership agreement that allocates to an incoming partner a portion of partnership losses attributable to the period prior to the partner's entry into the partnership violates the assignment of income doctrine. (*Williams v. U.S.*, *supra*, 680 F.2d at 385.) The assignment of income doctrine provides that income is taxable only to the taxpayer who earns it, and, as a corollary, a loss is deductible only by the taxpayer who sustains it. (*Ibid.*) The incoming partners may report only their share of the partnership items for the period during which they were members of the partnership. (*Lipke v. Commissioner* (1983) 81 T.C. 689, 697.)

To determine whether a valid partnership exists for tax purposes, courts consider whether the parties to the partnership are acting in good faith and with a business purpose intended to join in the present conduct of the enterprise. (*DJB Holding Corp. v. Commissioner* (9th Cir. 2015)

⁴ R&TC section 17851 incorporates into California law, with certain exceptions not relevant here, the provisions of federal partnership law in IRC section 701, et. seq., applicable to partnerships and partners. (R&TC § 17851.)

803 F.3d 1014, 1022, citing *Commissioner v. Culbertson* (1949) 337 U.S. 733, 742.) The parties' intent is a question of fact, to be determined from testimony disclosed by their agreement, considered as a whole, and by their conduct in execution of its provisions. (*Commissioner v. Tower* (1946) 327 U.S. 280, 286–287. See *Thoma v. Commissioner*, T.C. Memo. 2020-67.) A partnership agreement may be disregarded when other factors show that no partnership was intended. (*Commissioner v. Tower* (1946) 327 U.S. 280; *Allison v. Commissioner*, T.C. Memo. 1976-248.) Courts do not treat the simple expedience of “drawing up papers” as controlling for tax purposes when the objective realities show otherwise. (*Commissioner v. Tower, supra*, 327 U.S. at 291.)

Courts have generally found that retroactive dates may not be used for tax purposes when the actual event occurred at a later date. (*Dobrich v. Commissioner*, T.C. Memo. 1997-447; *Medieval Attractions N.V. v. Commissioner*, T.C. Memo. 1996-455.) However, an effective date provision that reduces to writing a prior oral understanding between the parties is not an impermissible backdating where the parties operated at arm's length and the parties had begun effective transfer prior to the agreement. (*Moore v. Commissioner*, T.C. Memo. 2007-134.)

In this appeal, appellants and FTB agree that the Partnership Agreement was executed after the approval process for EADC's purchase of the partnership interest in South River concluded. The parties also agree that the primary issue before OTA is whether the effective date of July 1, 2010, listed in the Partnership Agreement will be respected for tax purposes.

Appellants contend that there was a prior understanding by the parties that EADC would be a partner in South River as of July 1, 2010, the effective date of the Partnership Agreement and, therefore, EADC is entitled to an allocation of the July 7, 2010 grant disbursement. In support of their contention, appellants provide the signed partnership with an effective date as of July 1, 2010 (signed by SLO Housing, Edna-Islay Housing Corporation, and EADC), a letter dated November 25, 2019, from SLO Housing confirming the effective date of the Partnership Agreement as July 1, 2010, and testimony offered by M. Gelman confirming the effective date of the partnership as of July 1, 2010.

FTB contends that EADC was not a partner in South River on July 7, 2010, and that EADC is, therefore, not entitled to an allocation of the South River's grant disbursement. In support of their contention, FTB points to the August 25, 2010 LOI and the August 2, 2010 tax

advice letter. FTB contends that the tax advice letter and LOI demonstrate that EADC was not a partner in South River as of July 2010.

In response, appellants contend that the tax advice letter did not concern EADC's purchase of a partnership interest in South River, but was instead solicited for potential investors to purchase interests in other partnerships structured by TC Alliance. Appellants assert that EADC had no need for a tax advice letter because appellant-husband was the manager of TC Alliance. Appellants also contend that the LOI was only used by South River to notify the CTAC of the sale of the partnership interest to EADC, but that the letter was not authorized by EADC. Appellants assert that although South River was obligated to notify CTAC of EADC's purchase of an interest in South River (to avoid any amount of South River's grant being recaptured), CTAC had no control over EADC's purchase of the partnership interest and its approval was not required.

There is no question that EADC and the other partners in South River, SLO Housing and Edna-Islay Housing, desired the effective date of the Partnership Agreement to be July 1, 2010. This is the date used by the parties in their Partnership Agreement admitting EADC as the investor limited partner and the date was confirmed by SLO Housing in its November 25, 2019 letter. OTA is reluctant to set aside a partnership agreement effective date where it was the clear intent of the parties to that agreement that the effective date be respected. However, appellants have the burden of demonstrating error in FTB's proposed assessment by a preponderance of the evidence. (*Appeal of Davis, supra; Appeal of Belcher, supra.*) In this case, the evidence presented does not establish that appellants were partners in South River on the grant disbursement date of July 7, 2010.

The August 25, 2010 LOI from C. Clarke, the acquisition agent, to SLO Housing set forth the terms of a future partnership agreement and stated that the LOI "will ultimately be superseded by the partnership agreement." The LOI directed SLO Housing to "sign and return" the LOI if its terms were agreeable. The terms of the LOI identified the real estate project to be undertaken; the amount of grant money the partnership would receive; that TC Alliance or its assigns would be required to pay a capital contribution of \$549,259 in installments of 20 percent, 10 percent, and 70 percent at the occurrence of specific target dates; and that remaining cash flow after other obligations would be distributed 10 percent to TC Alliance or its assigns and 90 percent to the partnership's general partner. SLO Housing signed and returned the LOI. The

Partnership Agreement ultimately entered into by EADC and SLO Housing provided the same terms, except that the final amount of capital contributions was increased to \$576,145, but the terms of payment (i.e., to be paid in installments of 20 percent, 10 percent, and 70 percent) remained the same as set out in the LOI.

The circumstance of the LOI and the fact that EADC did enter into a Partnership Agreement pursuant to the terms of the LOI indicates that at the time of the LOI, EADC was not yet a partner in South River. The LOI indicates that at the time it was written in August 2010, EADC and SLO Housing were drafting terms for a future partnership, but had not yet entered into a joint enterprise. The increased amount of capital contributions stated in the Partnership Agreement also supports that it was drafted after the LOI, because the LOI stated that the amount of capital contributions, \$549,259, was a projection subject to change. The Partnership Agreement appears to have made a later and more accurate projection in requiring capital contributions of \$576,145, because the amount of capital contribution ultimately made by EADC was \$576,147.

Appellant asks OTA to find that EADC became a partner in South River approximately two months prior to the LOI which negotiated the terms of the Partnership Agreement. In light of the evidence presented, OTA cannot do so. Accordingly, appellants have not established that EADC was a partner in South River on the grant disbursement date of July 7, 2010, and is, therefore, not entitled to an allocation of the South River's July 7, 2010 grant disbursement.

2. TEFRA

Appellants contend that FTB is not permitted to adjust appellant's flow-through losses. Appellants asserts that they have a right to rely on South River's return and Schedule K-1 because FTB issued a No Change Letter to South River for 2011, and the statute of limitations is closed for that year to amend the return, citing Treasury Regulation section 301.6222(a)-1(a).⁵

The Tax Equity and Fiscal Responsibility Act of 1982 established, for federal income tax purposes, consolidated examination procedures that determine the tax treatment of partnership items at the partnership level for partnerships. (IRC, §§ 6221, et seq.) However, California does not conform to these provisions. Instead, California law provides that audit procedures generally

⁵ Treasury Regulation section 301.6222(a)-1(a) provides that the treatment of a partnership item on the partner's return must be consistent with the treatment of that item by the partnership on the partnership return in all respects including the amount, timing, and characterization of the item.

applicable to taxpayers subject to California's personal income tax apply to partnership audits. (See R&TC, §§ 19031, et seq.) Further, the California tax treatment of an adjustment to a partnership's items of income, gain, loss, deduction, or credit is determined for each partner in separate proceedings with separate statutes of limitations. (See FTB Chief Counsel Ruling 2002-0731.⁶) Therefore, FTB's adjustment to appellant's flow-through losses is permitted.

3. Duty of Consistency

Appellants alternatively argue that the duty of consistency should prevent FTB from assessing appellants as partners in EADC after issuing a No Change letter to the EADC partnership. The duty of consistency "precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position." (*Appeal of Davis*, 2020-OTA-182P.) The duty of consistency requires a showing of three elements: (1) a representation or report by the taxpayer; (2) on which FTB has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm FTB. (*Appeal of Chen and Chi*, 2020-OTA-021P, citing *Estate of Ashman v. Commissioner*, *supra*, 231 F.3d at 543.)

In contrast to the usual application of the duty of consistency, appellants ask OTA to apply the doctrine to prevent FTB from determining that appellants were not partners in South River on the grant disbursement date, when the statute of limitations has already passed for the grant disbursement to be allocated to another partner. Appellants have not cited any authority in support of their position in this case. OTA declines to consider extending the duty of consistency to FTB in this appeal because it is not warranted by the facts of the case. South River and appellants are separate taxpayers. Accordingly, the duty of consistency is not applicable in this case.

⁶ Although FTB Chief Counsel Rulings are not binding authority, OTA finds the Ruling and its statutory analysis persuasive. In the Ruling, FTB stated that California does not conform to TEFRA and the statute of limitations for each individual partner in a partnership is determined separately. (See R&TC, §§ 19306, 19311.)

HOLDING

Appellants have not demonstrated error in FTB’s disallowance of appellants’ flow-through capital losses from EADC resulting from the EADC’s disposition of its interest in South River.

DISPOSITION

FTB’s action is sustained.

DocuSigned by:
Veronica I. Long
32D46B0C49C949F...

Veronica I. Long
Administrative Law Judge

We concur:

DocuSigned by:
Ovsep Akopchikyan
88F35E2A835348D...

Ovsep Akopchikyan
Administrative Law Judge

DocuSigned by:
Eddy Y.H. Lam
1EAB8BDA3324477...

Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 2/21/2024