



Office of Tax Appeals (OTA) Administrative Law Judges (ALJs) Teresa A. Stanley, Amanda Vassigh, and Richard Tay held an oral hearing for this matter in Cerritos, California on March 13, 2024. At the conclusion of the hearing, OTA held the record open for additional briefing. Due to the unavailability of ALJ Tay prior to the completion of post-hearing briefing and deliberation, ALJ Tay was replaced by ALJ Cheryl L. Akin.

### ISSUES

1. Have appellants shown they are entitled to a greater cost basis in shares of Arden Realty Group, Inc. (Arden) stock sold in 2003 than allowed by FTB?
2. Was there a reduction in Ziman's share of partnership liabilities in Arden Realty Limited Partnership (ARLP) in 2003 and, if so, did it exceed Ziman's basis in the partnership?
3. Did Ziman receive a taxable distribution from JETA Realty Group, Inc. (JETA) in 2005?
4. Are appellants entitled to itemized deductions disallowed by FTB?<sup>3</sup>
5. Are appellants entitled to additional interest abatement under R&TC section 19104(a) for the taxable years at issue?

### FACTUAL FINDINGS

#### General Background

1. In 1990, Ziman co-founded Arden. Through an initial public offering (IPO) in 1996, Arden and other affiliated entities became a publicly traded company and a real estate investment trust, which owned, acquired, managed, leased, and renovated office properties in Southern California. Ziman was the organizer, chairman of the board, and chief executive officer of Arden. Arden was the sole general partner, and Ziman, as an individual, was a limited partner of ARLP, a related operating partnership.
2. During the taxable years at issue, Ziman was also the sole owner of JETA, an S corporation.
3. In 1996, Ziman received 582,186 operating partnership (OP) units of ARLP. Each of the OP units was convertible into one share of Arden stock. Ziman also acquired 100 shares

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<sup>2</sup> At the hearing, Ziman and FTB stipulated that Edwards is entitled to innocent spouse relief for each of the taxable years at issue. Therefore, the Opinion will only note that stipulation and will not address it further.

<sup>3</sup> While this was not raised as an issue in the briefing during the appeal or at the hearing, OTA requested and received additional post-hearing briefing from the parties specifically on this issue.

of Arden stock.<sup>4</sup> In addition, Ziman was granted a total of 400,000 options to acquire shares of Arden stock in three increments of 133,333 shares in 1997, 1998, and 1999 at the exercise price of \$20 per share, which was the price per share of Arden stock when Ziman was granted the options.

4. At the end of 1997, Ziman converted 178,882 OP units into 178,882 shares of Arden stock and exercised his option to acquire 133,333 shares of Arden stock, which had vested and become exercisable in October 1997, at the exercise price of \$20 per share. A financial services firm granted Ziman a margin line of credit of \$2,666,660 in December 1997, so that he could pay the total exercise price of \$2,666,660; i.e., 133,333 shares at \$20 per share.
5. ARLP filed a California Partnership Return of Income (Form 565) for taxable year 2003, which reported Arden purchased various partners' interests in ARLP. ARLP issued to Ziman Schedules K-1, Partner's Share of Current Year Income, Deductions, Credits, and Other Items, for the 2002 and 2003 taxable years indicating that Ziman's interest in ARLP was reduced from approximately 0.196 percent at the end of 2002 to approximately 0.148 percent at the end of 2003.
6. Appellants filed joint California Resident Income Tax Returns (Forms 540) for taxable years 2003, 2004, and 2005.<sup>5</sup>
7. FTB audited appellants' returns for taxable years 2003, 2004, and 2005. The audit period began when FTB mailed to appellants an Initial Contact Letter and Information Document Request (IDR) dated August 24, 2007. FTB sent Ziman six IDRs between August 24, 2007, and September 30, 2009. In at least two of the IDRs, FTB requested a basis schedule for the calculation of any reduction of liabilities in ARLP in 2003.
8. On October 11, 2010, FTB issued to appellants Notices of Proposed Assessments (NPAs) for taxable years 2003, 2004, and 2005.<sup>6</sup>

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<sup>4</sup> In his declaration signed under penalty of perjury, Ziman states that he "purchased" the 100 shares of Arden stock and that he contributed real property to ARLP in exchange for the OP units at the time of the IPO.

<sup>5</sup> Copies of appellants' 2003, 2004, and 2005 Forms 540 are not in the appeal record.

<sup>6</sup> As acknowledged by FTB in an IDR dated September 30, 2009, appellants signed a statute of limitations waiver dated September 22, 2009; therefore, the 2003, 2004, and 2005 NPAs were timely issued.

9. Appellants protested each of the proposed assessments. FTB issued Notices of Action (NOAs) for taxable years 2003, 2004, and 2005 dated August 1, 2018.<sup>7</sup>
10. The 2003 NOA revised the 2003 NPA by increasing appellants' reported taxable income by \$18,886,975, from \$3,328,321 to \$22,215,296 by: (1) adding \$3,902,696 of capital gain from the sale of Arden and Citigroup, Inc. (Citigroup) stock;<sup>8</sup> (2) adding \$12,591,554 of taxable gain from a decrease in allocable partnership liabilities ; (3) adding capital gain of \$2,268,489 from the conversion of OP units in ARLP to Arden stock;<sup>9</sup> and (4) disallowing itemized deductions of \$124,236. The 2003 NOA reduced the NPA's proposed additional tax from \$1,780,147 to \$1,757,167 and the NPA's accuracy-related penalty from \$356,029 to \$351,433, plus interest.
11. The 2005 NPA increased appellants' reported taxable income by \$9,183,195, from \$6,575,209 to \$15,758,404 by: (1) adding unreported capital gain of \$4,485,960 resulting from the sale of a Pacific Coast Highway property (PCH property), because FTB disallowed the claimed Internal Revenue Code (IRC) section 1031 like-kind exchange (1031 exchange) of this property; (2) adding capital gain of \$2,232,055 from the conversion of OP units in ARLP to Arden stock;<sup>10</sup> and (3) disallowing itemized deductions of \$2,465,180. The 2005 NOA affirmed the 2005 NPA's adjustments to appellants' reported taxable income, its proposed additional tax of \$945,869, and the accuracy-related penalty of \$189,174, plus interest.
12. These timely consolidated appeals followed.
13. On appeal, FTB agrees to withdraw the accuracy-related penalties and to abate interest for a total of 1,246 days for taxable years 2003 and 2005.<sup>11</sup>

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<sup>7</sup> As noted in footnote 1, above, FTB agrees on appeal to withdraw its proposed assessment for the 2004 taxable year, and the 2004 NPA and NOA will not be discussed further in this Opinion.

<sup>8</sup> The 2003 NOA only attributes the adjusted gain to the sale of the Arden stock; however, the adjusted gain also includes gain from the sale of Citigroup stock, so the total amount of adjusted gain represents the aggregate sales prices of the Arden stock and the Citigroup stock.

<sup>9</sup> As noted in footnote 1 above, FTB concedes this adjustment on appeal and agrees to reduce its 2003 adjustments to the reported income by \$2,268,489.

<sup>10</sup> As noted in footnote 1 above, FTB concedes this adjustment on appeal and agrees to reduce its 2005 proposed additional income by \$2,232,055.

<sup>11</sup> Again, FTB has agreed to withdraw its proposed assessment for the 2004 taxable year in its entirety.

2003 Sale of Arden and Citigroup Stock

14. On Schedule D, Capital Gains and Losses, of their federal return for taxable year 2003, appellants reported the sale of shares of Arden and Citigroup stock. Appellants reported the sale of 2,000 shares of Citigroup stock and a total of 150,333 shares of Arden stock consisting of 89,733 shares and 43,600 shares that were acquired on December 13, 1997, and 17,000 shares that were acquired on various dates. As a result of these four transactions, appellants reported capital losses totaling \$500,197. The Schedule D reports the following details about each of these sales:
- The 2,000 shares of Citigroup stock were sold on June 11, 2003, at a per share price of \$43.69, for a total of \$87,386, and had a basis of \$90,000, resulting in a long-term capital loss of \$2,614.
  - The 89,733 shares of Arden stock were sold on August 20, 2003, at a per share price of \$26.98, for a total of \$2,421,371, and had a basis of \$2,759,290, resulting in a long-term capital loss of \$337,919.
  - The 43,600 shares of Arden stock were sold on August 21, 2003, at a per share price of \$26.89, for a total of \$1,172,562, and had a basis of \$1,340,700, resulting in a long-term capital loss of \$168,138.
  - The 17,000 shares of Arden stock were sold on September 3, 2003, at a per share price of \$27.56, for a total of \$468,474, and had a basis of \$460,000, resulting in a short-term capital gain of \$8,474.
15. Ziman filed SEC Forms 4, Statement of Changes in Beneficial Ownership, concerning his sales of Arden stock in 2003. The SEC Forms 4 report the following: (1) 89,733 shares sold for a price per share of \$27.0355 on August 20, 2003; (2) 43,600 shares sold for a price per share of \$26.945 on August 21, 2003; and (3) 17,000 shares sold for a price per share of \$27.6089 on September 3, 2003.<sup>12</sup>
16. Appellants reported on Schedule D of their 1997 federal return the exchange of “OP units” for 178,882 shares of “stock” on December 30, 1997, for a total sales price of \$7,998,993, and a cost basis of \$0, resulting in a gain of \$7,998,993. The

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<sup>12</sup> The per share prices reported on the SEC Forms 4 are slightly different from the per share prices reported on appellants’ Schedule D for 2003. Appellants do not provide an explanation for the differences.

1997 Schedule D does not identify the specific OP units exchanged, or the specific stock received. The Schedule D reports an acquisition date of October 15, 1996.

17. FTB initially determined that appellants had a basis of \$0 in all shares of Arden and Citigroup stock sold in 2003 because they failed to provide substantiating documents, resulting in additional capital gain of \$3,902,696 as reflected in the NOA.
18. On appeal, appellants provide a declaration signed under penalty of perjury by Ziman and a copy of an SEC filing concerning the exercise of the 133,333 options for Arden stock in 1997. In his declaration, Ziman indicated that Arden's SEC filing for 1997 discloses that he exercised his vested options for 133,333 shares of Arden stock at a realized value of \$1,433,330. This amount equals the \$10.75 difference between the \$30.75 closing price per share on December 31, 1997, and the \$20 exercise price that Ziman paid to exercise the options ( $\$1,433,330 / 133,333 = \$10.75$ ). Attached to his declaration is a copy of a document entitled, *Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values*, which indicates that during 1997, Ziman exercised his vested options for 133,333 shares of Arden stock at a realized value of \$1,433,330, which was computed based on the closing price of \$30.75 per share on December 31, 1997.
19. In its additional brief, FTB concedes that appellants provided sufficient documentation to substantiate that Ziman exercised the 133,333 Arden stock options at a price of \$20 per share. As a result, FTB agrees to reduce the adjustment resulting from the sale of the Arden and Citibank stock from \$3,902,696 per the NOA, to \$1,227,562, which is equal to the revised gain of \$727,365 as computed on appeal, minus the \$500,197 capital loss originally reported on the return ( $\$727,365 - (-\$500,197) = \$1,227,562$ ). FTB calculated the revised gain of \$727,365 as follows:
  - 2,000 Citigroup Shares:  $\$87,386$  (sales price) -  $\$0$  (basis) =  $\$87,386$
  - 89,733 Arden Shares:  $\$2,451,371$  (sales price) -  $\$1,792,660$ <sup>13</sup> (basis) =  $\$628,711$
  - 43,600 Arden Shares:  $\$1,172,562$  (sales price) -  $\$872,000$ <sup>14</sup> (basis) =  $\$300,562$

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<sup>13</sup> 100 shares x a basis of \$0 per share, and 89,633 shares x a basis of \$20 per share = a total basis of \$1,792,660.

<sup>14</sup> 43,600 shares x a basis of \$20 per share = a total basis of \$872,000.

- 17,000 Arden Shares: \$468,474 (sales price) - \$757,768<sup>15</sup> (basis) = (\$289,294).

2003 Taxable Distribution from a Decrease in Allocable Partnership Liabilities

20. On the 2002 Schedule K-1 issued to Ziman, ARLP reported that Ziman’s share of partnership nonrecourse liability was \$336 and his share of partnership qualified nonrecourse (QNR) financing liability was \$14,270,442.
21. On the 2003 Schedule K-1 issued to Ziman, ARLP reported Ziman’s share of partnership nonrecourse liability was \$266, which is \$70 less than reported on the 2002 Schedule K-1, and the share of QNR financing liability was \$1,760,465, which is \$12,509,977 less than the \$14,270,442 reported on the 2002 Schedule K.1.
22. FTB initially determined that Ziman had a taxable distribution of \$12,591,554 for the 2003 taxable year, because of the \$12,510,047 (\$70 + \$12,509,977) decrease in liabilities as reflected in the Schedules K-1. FTB initially computed this amount using a basis of \$0 at the beginning of the 2003 taxable year because Ziman failed to substantiate his basis in ARLP. (\$0 beginning basis + \$127,244 income for 2003 – \$208,751 cash withdrawals – \$12,510,047 decrease in liabilities = \$12,591,554).
23. In post-hearing briefing, FTB revised its calculation of Ziman’s taxable distribution resulting from the reduction of Ziman’s share of ARLP liabilities for the 2003 taxable year. FTB determined that at the end of 2002 Ziman had a basis of \$3,139,761 in ARLP. As set forth below, FTB thus determined that Ziman had unreported income of \$9,451,793:<sup>16</sup>

2003 Beginning Basis in ARLP	\$3,139,761
Plus 2003 Income per Schedule K-1	\$127,244
Minus Cash Withdrawals	\$208,751
Minus Decrease in Liabilities in 2003	<u>\$12,510,047</u>
Unreported Income	\$9,451,793

24. On appeal, appellants provide declarations signed under penalty of perjury. The relevant statements in the declarations are as follows:

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<sup>15</sup> 100 shares x a basis of \$20 per share, and 16,900 shares x a basis of \$44.72 per share = a total basis of \$757,768.

<sup>16</sup> Reduced from the \$12,591,554 of additional income per the 2003 NOA.

- a. F. Low (Low) is a CPA who was a managing director of an accounting firm. Low stated in his declaration that he reviewed the accounting firm’s workpapers for ARLP’s returns for 2000 through 2004. He described two errors in these workpapers that impacted Ziman’s 2002 and 2003 ARLP Schedules K-1: (1) the 2002 debt allocation schedule reported built-in gain (BIG) of \$7.7 million pursuant to Treasury Regulation section 1.752- 3(a)(3)<sup>17</sup> that was not included in the 2001, 2002, and 2004 Schedules K-1, resulting in the QNR of \$14,270,442 reported on Ziman’s 2002 Schedule K-1; and (2) the 2003 debt allocation schedule had a “crossfoot” error that resulted in incorrectly reported QNR for 2003 which excluded a \$5.6 million bottom dollar guarantee. Attached to Low’s declaration are copies of the 2002 and 2003 ARLP Debt Allocation Schedules and the first pages of the 2002 and 2003 Schedules K- 1 that ARLP issued to Ziman.
- b. A. Gavinet (Gavinet) is Arden’s Chief Accounting Officer and served in that capacity for the taxable years at issue. One of Gavinet’s jobs was to supervise ARLP’s debt allocations. Gavinet reviewed the debt allocation schedule for 2002 and believes that there is likely an error in the \$7.7 million reported as QNR to Ziman. To Gavinet’s recollection, there was no such allocation of debt in 2002.

FTB’s Recalculation of the 2003 Proposed Assessment

25. On appeal, FTB makes various concessions regarding its proposed assessment for the 2003 taxable year and provides the following recalculation in its post-hearing briefing:

Taxable Income as Reported	\$3,328,321
Sale of Arden and Citibank Stock (revised)	\$1,227,562
Capital Gain from ARLP Distribution (revised)	\$9,451,793
Disallowed Itemized Deductions	<u>\$124,236</u>
Total Taxable Income, as revised	<u>\$14,131,912</u>
Proposed Tax, as revised	\$1,310,435
Total Tax, as originally reported	<u>\$305,023</u>
Additional Tax (revised)	\$1,005,412

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<sup>17</sup> Treasury Regulation section 1.752-3(a)(3) generally allows a partnership to allocate excess QNR to a partner up to the amount of BIG that is allocable to the partner on certain property described in IRC section 704(c).

2005 Taxable Distribution from JETA

26. On February 22, 2005, JETA executed a contract with a third party to purchase real property and furnishings located on Malibu Road in California (Malibu Road property) for a purchase price of \$13 million. JETA's purchase of the Malibu Road property was recorded on March 1, 2005. Appellants produced a copy of the Buyer's Final Settlement statement dated March 2, 2005, which indicated that JETA purchased the Malibu Road property for \$11.5 million and its furnishings for \$1.5 million. Ziman contributed \$2 million to JETA in February 2005, prior to the close of escrow, and JETA paid the \$2 million into escrow.
27. On April 1, 2005, JETA transferred the Malibu Road property by quitclaim deed to appellants' marital trust. The parties agree that the fair market value of the property as of April 1, 2005, was \$13 million, which is the same fair market value as it was one month earlier when JETA purchased it.
28. JETA filed a 2005 U.S. Income Tax Return for an S Corporation (Form 1120S). The 2005 Form 1120S reported no accumulated earnings and profits at the end of the taxable year.
29. In its post-hearing briefing, FTB calculates that at the end of the 2005 taxable year, Ziman had a basis of \$4,497,974 in JETA.<sup>18</sup> FTB contends that Ziman received a taxable distribution of \$8,502,026<sup>19</sup> from JETA after subtracting Ziman's estimated basis of \$4,497,974 from the \$13 million fair market value of the Malibu Road property and furnishings distributed to appellants.
30. With their supplemental brief, appellants attach a declaration signed by Ziman under penalty of perjury, which describes JETA's purchase of the Malibu Road property and its subsequent transfer of the property to appellants' marital trust in 2005. Ziman's declaration states that Ziman transferred \$2 million from his personal account to JETA to be placed in the purchase escrow, and JETA borrowed \$11 million from City National

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<sup>18</sup> FTB initially calculated a basis of \$2,497,974, but prior to the hearing corrected the basis amount to include the \$2 million contribution made by Ziman to JETA prior to the close of escrow for the purchase of the Malibu Road property.

<sup>19</sup> FTB also contends that pass-through losses and capital loss carryovers from JETA totaling \$1,114,227 should be disallowed.

Bank (CNB) pursuant to an LOC loan (CNB LOC). The Ziman declaration states, in relevant part, that:

- The CNB LOC was used solely to purchase the Malibu Road property, and it was always Ziman's intent to personally assume the CNB LOC obligation when title to the Malibu Road property was transferred to appellants' marital trust;
- Ziman executed a personal guarantee for the \$11 million loan to JETA;
- On May 2, 2005, appellants' marital trust executed a new \$6.5 million trust deed loan secured by the Malibu Road property, which paid off part of the CNB LOC; and
- On June 2, 2005, Ziman wired \$4,495,951 of personal funds to CNB to pay off the remaining balance owed on the \$11 million CNB LOC.

31. Attached to Ziman's supplemental declaration are copies of:

- Wire transfer instructions directing CNB to transfer \$2 million from Ziman's personal account to JETA;
- Ziman's contemporaneous CNB money market account register for February and March 2005 reflecting Ziman's transfer of \$2 million to JETA on February 23, 2005;
- A promissory note executed by JETA in favor of CNB dated February 23, 2005, reflecting JETA's promise to pay CNB the principal sum of \$11 million, plus accrued interest, on or before September 1, 2005;
- A loan agreement between JETA and CNB dated February 23, 2005, reflecting the terms of the \$11 million CNB loan to JETA;
- Corporate Resolutions to Obtain Credit and Grant Security dated February 23, 2005, authorizing Ziman to act on behalf of JETA to obtain and authorize loans with CNB;
- Ziman's signed, personal guarantee of the \$11 million loan by CNB to JETA dated February 23, 2005 (the Continuing Guaranty);
- JETA's February 23, 2005 agreement to pay the CNB loan and documentation fees of \$14,000 in connection with the \$11 million CNB loan to JETA;
- Instructions dated February 23, 2005, directing CNB to pay the sum of \$11 million to the escrow for the purchase of the Malibu Road property;

- The buyer's final settlement statement dated March 2, 2005, for JETA's purchase of the Malibu Road property for total consideration of \$13 million (\$11.5 million for the real property and \$1.5 million for the furnishings);
  - The grant deed dated March 1, 2005, reflecting JETA's purchase of the Malibu Road property;
  - The quitclaim deed dated April 25, 2005, reflecting JETA's transfer of the Malibu Road property to appellants' marital trust;
  - The trust deed dated May 2, 2005, reflecting CNB's security interest in the Malibu Road property as a result of CNB's \$6.5 million loan to appellants' marital trust on or about May 2, 2005;
  - CNB's payoff request to JETA dated June 1, 2005, reflecting a payoff amount of \$4,495,951.04 as of June 2, 2005;
  - Ziman's contemporaneous CNB money market account register for May and June 2005 reflecting Ziman's payment of \$4,495,951.04 to CNB on June 2, 2005;
  - A July 2012 CNB Commercial Loan Billing Statement issued to appellants' marital trust reflecting a then-current principal balance of \$4,133,133.46 on the \$6.5 million CNB loan made to the trust;
  - An Estimated Closing Statement for the marital trust's sale of the Malibu Road property to a third party in April 2013, reflecting that \$3,817,090.59 was paid to CNB to pay off a loan; and
  - The grant deed dated April 10, 2013, reflecting the marital trust's sale of the Malibu property to a third party.
32. Appellants also provide a declaration signed under penalty of perjury by M. Forbes (Forbes). Forbes stated that he was employed by CNB during the years at issue and was Ziman's main point of contact for loans issued by CNB. In his declaration Forbes stated:
- Ziman wanted to close on the purchase of the Malibu Road property quickly which left insufficient time to arrange for permanent financing;
  - It was much easier for CNB to quickly process a commercial unsecured loan;
  - CNB was willing to provide Ziman with an unsecured loan to allow the sale to close (the bridge loan);

- It was intended that this bridge loan would be repaid when the longer term secured financing could be obtained;
- The loan documents are standard CNB loan documents for unsecured commercial loans and were prepared for JETA as the borrower;
- The determination to provide bridge funding of \$11 million would have been the same whether the funding was issued to JETA or to Ziman;
- CNB would have never made this loan to JETA without Ziman's personal guaranty;
- CNB did extend the permanent financing on the Malibu Road property by making a consumer mortgage to Ziman, and all proceeds of this new mortgage loan were used to pay down the bridge loan.

#### FTB's Recalculation of the 2005 Proposed Assessment

33. The 2005 NPA increased appellants' reported income by: (1) \$4,485,960 due to the disallowed 1031 exchange of the PCH property; (2) \$2,232,055 due to conversion of ARLP OP units into Arden stock; and (3) disallowed itemized deductions by \$2,465,180 due to a phase-out based on the proposed increased income.
34. Despite FTB's concessions that the ARLP OP units were directly donated to the University of California, Los Angeles (rather than converted into Arden shares by appellants) and that the 1031 exchange was valid, FTB asserts an offset based on the distribution of the Malibu Road property by JETA to appellants' marital trust.
35. On appeal, FTB calculates a taxable distribution of \$8,502,026, plus disallowed pass-through losses and capital losses from JETA of \$1,114,227, for a total income adjustment of \$9,616,253, which exceeds the additional income of \$9,183,195 per the 2005 NPA and NOA. Based on that calculation, FTB also proposes to increase the amount of disallowed itemized deductions from \$2,465,180 in the NPA to \$2,569,140 because the revised additional income also increases the phase-out of appellants' itemized deductions. Based on these additional income amounts FTB computes a revised "total deficiency assessment" of \$1,135,042,<sup>20</sup> which is equal to the tax of \$945,869 plus the accuracy related penalty of \$189,174 included in the NPA and NOA.

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<sup>20</sup> The \$1 difference is likely due to rounding.

### Interest Abatement

36. With the appeal letter filed on August 30, 2018, appellants submit a copy of an FTB Form 3701, Request for Abatement of Interest, dated August 27, 2018, which was previously submitted to FTB. Appellants requested interest abatement for the 2003 to 2005 taxable years for the period from December 10, 2012, to December 31, 2018.
37. FTB reviewed the protest period, which lasted approximately seven years and nine months, i.e., 92 months, and identified unreasonable delays that justified the abatement of almost three and one-half years' worth of interest for an aggregate of approximately 41 months or 1,246 days during the protest period. FTB did not abate interest for the remaining four years and three months, i.e., 51 months of the protest period or for any of the audit period. Specifically, FTB agreed to abate interest for the following periods:
- August 27, 2011, to December 10, 2012 (472 days);
  - February 3, 2013, to July 17, 2013 (165 days);
  - March 21, 2014, to October 20, 2014 (214 days);
  - December 19, 2015, to June 6, 2016 (171 days); and
  - December 30, 2016, to August 10, 2017 (224 days).

### DISCUSSION

Issue 1: Have appellants shown they are entitled to a greater cost basis in shares of Arden stock sold in 2003 than allowed by FTB?

#### Burden of Proof

The question of a taxpayer's basis is an issue of fact. (*Vaira v. Commissioner* (3d Cir. 1971) 444 F.2d 770, 774.) Proof of basis is a specific fact that the taxpayer has the burden of proving. (*O'Neill v. Commissioner* (9th Cir. 1959) 271 F.2d 44, 50.) The burden of proof is on appellants as to all issues of fact and requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30129(a), (c).) FTB's determinations of fact are presumed to be correct, and the taxpayer has the burden of proving FTB's determinations are erroneous. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Chen and*

*Chi*, 2020-OTA-021P.) “The fact that basis may be difficult to establish does not relieve a taxpayer from his [or her] burden.” (*Coloman v. Commissioner* (9th Cir. 1976) 540 F.2d 427, 430 (citing *O’Neill v. Commissioner, supra.*)

### Appellants’ Gain on the Sale of Arden Stock

IRC section 61(a)(3) defines gross income to include all income from whatever source derived including gains derived from dealings in property.<sup>21</sup> IRC section 1001(a) provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis of the property.<sup>22</sup> IRC section 1001(c) provides that the entire amount of gain or loss on the sale or exchange of property is recognized unless otherwise provided. IRC section 1011(a) provides that the adjusted basis for determining the gain from the sale of property shall be the property’s initial basis with adjustments provided in IRC section 1016. IRC section 1012(a) states that generally the basis of property shall be the cost of such property. Except as provided in Treasury Regulation section 1.012-1(e)(2) (dealing with stock for which the average basis method is permitted), if a taxpayer sells or transfers shares of stock in a corporation that the taxpayer purchased or acquired on different dates or at different prices and the taxpayer does not adequately identify the lot from which the stock is sold or transferred, the stock sold or transferred is charged against the earliest lot the taxpayer purchased or acquired to determine the basis and holding period of the stock. (Treas. Reg. § 1.1012-1(c)(1)(i).)

A taxpayer adequately identifies the lot from which the stock is sold or transferred if the taxpayer establishes “that certificates representing shares of stock from a lot which was purchased or acquired on a certain date or for a certain price were delivered to the taxpayer’s transferee.” (Treas. Regs. § 1.1012-1(c)(2).) When the stock is left in the custody of a broker or other agent, the taxpayer adequately identifies the lot from which the stock is sold or transferred if: (a) at the time of the sale or transfer, the taxpayer specifies, to the broker or other agent who has custody of the stock, the particular stock to be sold or transferred; and (b) within a reasonable time thereafter, the broker or other agent provides confirmation of the specification in a written document. (Treas. Regs. § 1.1012-1(c)(3).)

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<sup>21</sup> Pursuant to R&TC section 17071, California conforms to IRC section 61 relating to gross income, except as otherwise provided.

<sup>22</sup> Pursuant to R&TC section 18031, California conforms to IRC sections 1001, 1011, 1012, and 1016, except as otherwise provided.

Here, the record (including the SEC filings), indicates that Ziman acquired 312,315 shares of Arden stock between 1996 and 1997 as follows: (1) 100 shares purchased by Ziman during the 1996 IPO; (2) 133,333 shares through the exercise of stock options in December 1997; and (3) 178,882 shares through the conversion of ARLP OP units in December 1997. These 312,315 (100 + 133,333 + 178,882) shares are the earliest recorded lots of Arden shares that Ziman acquired.

Appellants' 2003 Schedule D reports the total sale of 150,333 shares of Arden stock consisting of 89,733 shares and 43,600 shares (for a total of 133,333 shares) that Ziman acquired by exercising his stock options on December 13, 1997, plus 17,000 shares of Arden stock that Ziman acquired on various dates. The 2003 Schedule D also reports the sale of 2,000 shares of Citigroup stock. FTB does not dispute the reported number of shares sold or the reported sales prices of the items reported on appellants' Schedule D.

Applying the basis ordering rules set forth in Treasury Regulation section 1.1012-1(c)(1)(i), FTB contends that, because appellants did not adequately identify which shares were sold, the gain is computed on a first-in, first-out basis. Appellants' 2003 Schedule D reflects the following sales of Arden stock: 89,733 shares on August 20, 2003, 43,600 shares on August 21, 2003, and 17,000 shares on September 3, 2003. FTB computed the basis for the 150,333 total shares sold in 2003 as follows: (1) 100 shares from the August 20, 2003 sale were treated as acquired in the IPO in 1996 and given a basis of \$0 per share; (2) 133,333 shares (89,633 shares from the August 20, 2003 sale, 43,600 shares from the August 21, 2003 sale, and 100 shares from the September 3, 2003 sale) were treated as acquired through the exercise of stock options on or about December 13, 2003, and given a basis of \$20 per share; and (3) the final 16,900 shares from the September 3, 2003 sale were treated as acquired through the conversion of OP units into Arden stock on or about December 30, 1997, and given a basis of \$44.72 per share. After revising the total basis of the 133,333 shares from \$0 to \$2,666,660 (133,333 x \$20) and determining that the total basis of 16,900 shares was \$1,983,330 (16,900 x \$44.72 = \$755,768) and that the 100 shares had a total basis of \$0, FTB contends that appellants had a gain of \$727,365 from the sale of the Arden stock for the 2003 taxable year.<sup>23</sup>

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<sup>23</sup> This results in revised additional capital gain on appeal of \$1,227,562 (the revised capital gain of \$727,365 minus the capital loss originally reported on the return of -\$500,197).

Appellants argue that FTB erroneously determined that the 133,333 shares of Arden stock sold in 2003 had a basis of \$20 per share, and the 16,900 shares of Arden stock sold in 2003 had a basis of \$44.72 per share. They contend that the 133,333 shares of Arden stock sold in 2003 had a basis of \$30.75. They assert that when Ziman exercised the 133,333 options in December 1997, the Arden stock had a per share price of \$30.75, as reflected on the SEC filings for the option exercise. Appellants contend that the SEC filings for the option exercise show a “value realized” of \$1,433,330 on Ziman’s exercise of the 133,333 options. Appellants state, “This is based on the \$30.75 Arden share price on December 31, 1997, the date of exercise. ( $\$30.75 \text{ value} - \$20.00 \text{ exercise price paid from the margin loan proceeds} = \$10.75 \text{ ‘gain’} \times 133,333 = \$1,433,330$ ).” Appellants assert that on their 1997 return, they reported this gain as capital gain, rather than as Ziman’s compensation. Appellants assert that the 1997 Schedule D reported capital gain of \$7,998,993 on the December 30, 1997 conversion of 178,882 ARLP OP units for 178,882 shares of Arden stock includes the \$1,433,330 of capital gain associated with Ziman’s exercise of the 133,333 Arden options in December 1997. Appellants explain that at a per share price of \$30.75, even if Ziman had a basis of \$0 in the 178,882 OP units converted, the total gain from the conversion of 178,882 OP units for 178,882 shares of Arden stock could only amount to \$5,500,621.50 ( $\$30.75 \times 178,882 = \$5,500,621.50$ .) Appellants state, “The additional gain reported of \$2,498,371.50 ( $\$7,998,993.00 - \$5,500,621.50$ ) included the \$1,433,330 gain realized by [appellants] based on the \$10.75 excess of the Arden share price over the \$20.00 exercise price paid.”

Appellants further contend that there is no merit to FTB’s assertion that the 178,882 OP units had a per share price of \$44.72 in 1997. Appellants claim that FTB fails to explain how they could have reported gain based on a per share price of \$44.72, which was \$14 higher than the share price on December 31, 1997, as reflected on the SEC filings. According to appellants, Arden stock did not achieve a share price of \$44.72 until 2005, which was more than seven years after Ziman converted the OP units in 1997.

Appellants also assert that the 17,000 shares of Arden stock sold in 2003 originated from the 178,882 shares of Arden stock acquired in 1997 from the conversion of the OP units, stating that “gain was fully reported on the conversion of these OP Units to Arden shares of at least \$30.75 per share.” Thus, appellants argue that the reported gain in 1997 establishes that the

17,000 shares of Arden stock also had a basis of \$30.75, rather than the \$44.72 computed by FTB.

Appellants failed to meet their burden of proving that FTB erroneously adjusted the reported basis in the Arden stock sold in 2003. The first batch of stock acquired by appellants is the 100 shares purchased or acquired in 1996 during the IPO. Appellants do not dispute that the 100 shares of Arden stock Ziman received in 1996 had a basis of \$0 or that Ziman sold the original 100 shares of Arden stock on August 20, 2003 (the date of the first reported sale of Arden stock in 2003).

The next batch of Arden stock acquired by appellants is the 133,333 shares acquired through Ziman's exercise of options in December 1997. Appellants rely on the SEC filings for the per share price (value) of the 133,333 options exercised in 1997. Appellants contend that the SEC filings establish that Arden stock had a per share price of \$30.75 on December 31, 1997, and Ziman exercised his 133,333 options on December 31, 1997. However, appellants' 2003 Schedule D reports that Ziman exercised the options on December 13, 1997, rather than December 31, 1997. No evidence in the appeal record identifies the type of options exercised in December 1997,<sup>24</sup> or establishes the per share price of Arden stock on December 13, 1997. Assuming, without finding, that Ziman likely exercised the options near the time when Arden stock had a price of \$30.75 per share as it did on December 31, 1997,<sup>25</sup> and the OP units had a basis of \$0, it remains unclear whether the additional gain of \$1,433,330 was included in the \$7,998,993 of gain appellants reported in connection with the conversion of the 178,882 ARLP OP units for Arden stock on December 30, 1997. Thus, appellants have failed to establish error in FTB's determination that 133,333 of the Arden shares sold during 2003 had a basis of \$20 (this includes the remaining 89,633 shares sold on August 20, 2003, all 43,600 shares sold on August 21, 2003, and 100 of the 17,000 shares sold on September 3, 2003).

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<sup>24</sup> Neither party identifies the 133,333 stock options as statutory, nonstatutory, or incentive stock options (ISOs). (See IRC, §§ 83, 421, 422.) "The timing, type, and amount of income inclusion depend on whether [the taxpayer] receive[s] a nonstatutory stock option or a statutory stock option." (IRS Publication 525, Taxable and Nontaxable Income, p. 11.)

<sup>25</sup> The Aggregated Options Exercises in Last Fiscal Year and Fiscal Year-End Option document states that Ziman had "value realized of \$1,433,330 "[b]ased on the closing price of \$30.75 per Common Share on December 31, 1997," but does not identify the date these options were exercised. Because appellants have failed to substantiate the precise date the options were exercised, OTA treats them as exercised on December 13, 1997, as reported by appellants on their 2003 Schedule D.

The last batch of Arden stock sold by appellants during 2003 was from the conversion of 178,884 ARLP OP units to Arden stock on December 30, 1997. Appellants' 1997 Schedule D reports that 178,884 OP units were exchanged for stock on December 30, 1997, and reports a price of \$7,998,993, a cost of \$0, and a gain of \$7,988,993. Thus, appellants' 1997 Schedule D supports FTB's determination that Ziman had a per share basis of \$44.72 obtained through the conversion of the 178,882 OP units to Arden stock. Applying the first in, first out ordering rule set forth in Treasury Regulation section 1.1012-1(c)(1)(i), FTB properly determined that Ziman had a per share basis of \$44.72 in the final 16,900 Arden shares of stock sold on September 3, 2003. Lastly, appellants reported on their 2003 Schedule D that the 17,000 shares of Arden stock were acquired at various times and sold for a short-term capital gain, which belies appellants' argument that they acquired all 17,000 shares on December 30, 1997, from the conversion of ARLP OP units to Arden stock.

OTA concludes that appellants have not established error in FTB's revised adjustments of the cost basis of the shares of stock Ziman sold in 2003. Thus, OTA finds that FTB properly determined appellants had additional gain of \$1,227,562 on the sale of Arden and Citigroup stock in 2003.

Issue 2: Was there a reduction in Ziman's share of partnership liabilities in ARLP in 2003 and, if so, did it exceed Ziman's basis in the partnership?

#### Burden of Proof

FTB's determination is presumed correct, and a taxpayer has the burden of proving error. (*Appeal of Davis*, 2020-OTA-182P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Stabile*, 2020-OTA-198P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Davis, supra.*) The burden of proof requires proof 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 the party asserts are more likely than not to be correct. (*Appeal of Belcher*, 2021-OTA-284P.)

#### Reduction of Liabilities in ARLP

IRC section 705 generally provides that the adjusted basis of a partner's interest in a partnership is the partner's original basis, as determined under IRC section 722 (relating to

contributions to a partnership), increased by: (1) the amount of money and the partner's basis in property subsequently contributed to the partnership; and (2) the partner's distributive share of the income of the partnership.<sup>26</sup> (See also *Appeal of Davis, supra.*) The partner's adjusted basis is decreased (but not below zero) by: (1) the amount of money and the partnership's adjusted basis in property distributed to the partner in a non-liquidating distribution to the partner; and (2) the partner's distributive share of partnership losses and expenditures. (IRC, §§ 705(a), 722, 732(a), 733; *Appeal of Davis, supra.*) As relevant here, the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution. (IRC, § 722; Treas. Reg. § 1.722-1.)

“A partner is required to determine the adjusted basis of his [or her] interest in a partnership only when necessary for the determination of his [or her] tax liability or that of any other person.” (Treas. Reg. § 1.705-1(a)(1).) In general, the determination of the adjusted basis of a partnership interest is made as of the end of a partnership's taxable year. (*Ibid.*)

Additionally, IRC section 752(a) provides that any increase in a partner's share of liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership. Similarly, and as relevant here, IRC section 752(b) states, “Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.” IRC section 731(a)(1) provides that non-liquidating distributions of money in excess of a partner's basis in the partnership interest will result in taxable gain to the partner.

Here, the 2002 and 2003 Schedules K-1 that ARLP issued to Ziman show that in 2003, ARLP decreased by \$12,510,047 the liabilities allocable to Ziman. Appellants assert that the Schedules K-1 were incorrectly prepared by the independent accounting firm for ARLP during 2002 and 2003. In the appeal letter, appellants note that the accounting firm stated in writing that it mistakenly failed to include a \$5.6 million bottom dollar guarantee on the Schedule K-1 issued to Ziman for 2003, which was included on the 2000, 2001, 2002, and 2004 Schedules K-1

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<sup>26</sup> Pursuant to R&TC section 17851, California generally conforms to the provisions of the IRC relating to partners and partnerships referenced herein, unless otherwise provided.

issued to Ziman. Appellants further note that the accounting firm confirmed it erroneously included \$7.7 million of IRC section 704(c) BIG in the 2002 Schedule K-1 issued to Ziman.

With their reply brief, appellants provide a declaration signed under penalty of perjury by Low, who was a managing director of the accounting firm. In his declaration, Low reiterated that the accounting firm made two scrivener's errors on the 2002 and 2003 Schedules K-1 that ARLP issued to Ziman. Low asserts that the first scrivener's error concerns the accounting firm's schedules that determined the QNR financing liability for 2002. Low asserts that these schedules inaccurately list \$7.7 million of QNR financing liabilities for 2002. Low stated, "There was no event in 2002 that would have caused this BIG allocation to apply in 2002 but in no other year." According to Low, ARLP had no BIG for any year from 2000 through 2004. Low claims that this scrivener's error caused Ziman's 2002 Schedule K-1 to report incorrectly that there was QNR financing of \$14,270,442 while the correct amount was \$6,570,778. Attached to Low's declaration are copies of the 2002 and 2003 ARLP Debt Allocation Schedules and the first pages of the 2002 and 2003 Schedules K-1 ARLP issued to Ziman.

Low asserted in his declaration that the second scrivener's error concerns the 2003 Schedule K-1 that ARLP issued to Ziman. According to Low, there was a cross footing spreadsheet error that failed to add a \$5.6 million bottom dollar guarantee in determining the total QNR financing liability for the 2003 taxable year. Low stated that this scrivener's error caused Ziman's 2003 Schedule K-1 to report incorrectly that there was \$1,760,465 of QNR financing liability while the correct amount was \$7,360,465. Low contended that, due to these two errors, it erroneously appears that Ziman had a debt reduction of \$12,509,977 in 2003 (\$14,270,442 in 2002 compared to \$1,760,465 in 2003) when in fact he had an increase of debt of \$789,687 (\$6,570,778 in 2002 compared to \$7,360,465 in 2003).

Appellants argue that they have met their burden of proving with clear and convincing evidence that FTB's determination is wrong. Appellants contend that FTB's refusal to accept the accounting firm's admission of these computational errors is frivolous."

FTB contends that Low's declaration does not indicate that he had personal knowledge of the preparation of the 2002 or 2003 ARLP partnership tax returns. Instead, FTB asserts, Low reviewed documentation given to him by Ziman. Additionally, FTB notes that Low was never provided a copy of the asserted \$5.6 million bottom dollar guarantee.

Appellants also submitted a declaration signed by Gavinet under penalty of perjury. Gavinet stated he is Arden's Chief Accounting Officer, he served in that capacity for the taxable years at issue, and one of his jobs was to supervise ARLP's debt allocations. Gavinet also stated he reviewed the debt allocation schedule for 2002 and that there is likely an error in the \$7.7 million reported as excess QNR to Ziman. To Gavinet's recollection, there was no such allocation of debt in 2002. FTB asserts that like Low's declaration, Gavinet's declaration does not show that he had personal knowledge of the contents of Ziman's 2002 K-1 or that he personally prepared and sent information to the accounting firm for preparation of ARLP's tax returns. FTB contends that Gavinet's declaration is unreliable because he only recently reviewed a document prepared by the accounting firm and has no specific, personal knowledge of the claimed errors.

Based on the evidence in the record, appellants have failed to establish error in FTB's determination that ARLP reduced Ziman's allocable partnership liabilities as reflected on his 2002 and 2003 ARLP Schedules K-1. Appellants have not produced a copy of the \$5.6 million bottom dollar guarantee they contend was omitted from the 2003 Schedule K-1 or explained why they are unable to produce a copy. Thus, appellants have failed to prove that this amount should have been included in Ziman's ARLP debt allocation for 2003 (or for any other taxable year).

In addition, appellants have not provided corroborating documents that establish that the 2002 Schedule K-1 incorrectly lists \$7.7 million of BIG debt allocation to Ziman. Neither appellants nor the declarants explain what the \$7.7 million of BIG allocation is, and why it was incorrectly included in appellants' debt allocation for 2002, what specific error or mistake was made, or the proper tax treatment of this item. Without such evidence, appellants have failed to satisfy their burden of showing that the \$7.7 million BIG allocation was incorrectly included in Ziman's 2002 ARLP debt allocation, resulting in a decrease in 2003 when such amount was no longer included in Ziman's 2003 ARLP debt allocation.

In his declaration, Low did not attest that he reviewed the \$5.6 million bottom dollar guarantee or that he had personal knowledge concerning the calculation of ARLP's QNR financing liabilities at the time the calculations and debt allocations were made (i.e., the \$7.7 million BIG debt allocation in 2002 and the \$5.6 million bottom dollar guarantee in 2003). Gavinet declared that Arden's accounting department would review any new debt financing and communicate with the accounting firm to determine what amounts of the bottom dollar guarantee

should be included in new debt obligations. To the best of Gavinet's knowledge, "there was no instance in which this process failed." Gavinet did not attest to personal knowledge of, or involvement in, any transactions occurring in 2003. The fact that Gavinet was unaware of any failure in the process does not prove that the 2003 Schedule K-1 incorrectly omitted a \$5.6 million bottom dollar guarantee. Furthermore, appellants do not explain why, if the 2002 and/or 2003 Schedules K-1 had two very large errors (\$7.7 million erroneously included in 2002 and \$5.6 million erroneously omitted in 2003), they did not request corrected Schedules K-1 from ARLP for these taxable years or file amended tax returns following the discovery of these errors. While there appear to be anomalies in the 2002 and 2003 Schedules K-1 when compared with the 2001 and 2004 Schedules K-1, the presumption that FTB's determination is correct cannot be overcome by unsupported assertions that the accounting firm committed errors in preparing ARLP's Schedules K-1 for two consecutive years or that the bottom dollar guarantee was properly included in Ziman's basis in other years.

### Issue 3: Did Ziman receive a taxable distribution from JETA in 2005?

#### Jurisdiction and Burden of Proof

In its reply brief, FTB concedes the 1031 exchange issue stating that it will withdraw from its position that appellants did not execute a valid 1031 exchange of the PCH property. FTB argues, however, that the proposed assessment that was initially based on a disallowed 1031 exchange should be sustained because Ziman received a taxable distribution of \$8,502,026 from JETA when JETA signed a quitclaim deed transferring title to an unrelated property, the Malibu Road property, to appellants' marital trust (the distribution determination).

Appellants argue that OTA should prohibit FTB from raising its new position concerning a taxable distribution from JETA during taxable year 2005 because there are fundamental differences between the 1031 exchange determination and the distribution determination. Appellants contend that the distribution determination involves the Malibu Road property, which was not a part of the 1031 exchange. Appellants assert that the 1031 exchange and the purported distribution involve entirely different sets of facts, and the distribution determination is based on a completely new legal theory which differs from the legal theories applied by FTB to disallow the 1031 exchange at audit and at protest. Appellants assert that the auditor erroneously determined that the replacement property for the 1031 exchange was the Malibu Road property.

Appellants also assert that at protest, FTB realized that the Malibu Road property was not the replacement property for the PCH property but still disallowed the 1031 exchange treatment involving the PCH property and the designated replacement property because FTB had determined that the PCH property was not held primarily for investment or productive use in a trade or business. Appellants state that FTB now concedes the 1031 exchange issue and adopts an entirely new factual and legal position that involves the Malibu Road property.

Appellants argue that OTA lacks jurisdiction over FTB's distribution determination, which appellants assert is an entirely new matter that was not included in the 2005 NOA that affirmed the 2005 NPA. Citing California Code of Regulations, title 18, section 30103(a)(1), appellants argue that, although OTA has jurisdiction to decide issues included in an NOA, it lacks jurisdiction to decide issues not included in an NOA. Citing R&TC section 19044, appellants state, "Protest can uphold or reject the proposed assessment but is precluded from adding to amounts determined in the NPA."

FTB asserts that it raised this alternative position during the protest process and in its opening brief. The 2005 NOA expressly stated, "We are affirming the Notice of Proposed Assessment in accordance with the determination in the January 29, 2018 determination letter and June 27, 2018 letter." The January 29, 2018 determination letter notified appellants of FTB's alternate theory, stating "if it has been shown that there was a valid IRC 1031 exchange, the taxpayer has taxable income in 2005 under the alternative argument that the taxpayer received a taxable property distribution from JETA."

OTA rejects appellants' argument that FTB should be prohibited from raising its new position. First, FTB is required to timely issue an NPA advising a taxpayer of the basis for a proposed assessment. (R&TC, §§ 19033(a), 19034(a), 19057(a).) FTB satisfied this requirement when it issued the NPA for taxable year 2005, which set forth the reasons for the proposed assessment and the computation of the additional tax. Second, it is well established that FTB is permitted to change the basis for its proposed assessment if FTB does not seek to assess additional tax beyond the deficiency amount proposed in the timely issued NPA. (See, e.g., *Appeal of Mendelsohn* (85-SBE-141) 1985 WL 15923.) Lastly, appellants do not contend, and the evidence does not show, that they will be unduly prejudiced by FTB's failure to raise its new alternative position earlier because, as will be explained in more detail below:

(1) appellants have had an opportunity to present facts, argument and evidence relating to this

issue during this appeal; (2) FTB has the burden of proof on this newly raised issue; and (3) FTB is bound by the proposed deficiency amount in the NPA and may not assess additional tax beyond this amount.

On appeal, both parties have had the opportunity to present facts, arguments, and evidence supporting their positions concerning the distribution determination. After FTB conceded the 1031 exchange issue in its reply brief, FTB proposed its new position that Ziman received a taxable distribution from JETA. Appellants addressed the matter in a supplemental brief, at the hearing, and in post-hearing briefing. At issue here is the deficiency assessment as reflected in the NPA and affirmed in the NOA for the 2005 taxable year. Again, it is well established that FTB is permitted to raise a new theory to sustain its deficiency assessment on appeal as long as it does not seek to assess additional tax beyond the deficiency amount proposed in the timely issued NPA. (*Appeal of Mendelsohn, supra.*) Accordingly, OTA has jurisdiction to hear and decide FTB's distribution determination.

The burden of proof shifts from the taxpayer to the tax agency with respect to any new matter that the tax agency raises. (Cal. Code Regs., tit. 18, § 30219(a); *Sage v. Commissioner* (2020) 154 T.C. 270, 278; *Appeal of Mendelsohn, supra*; *Appeal of Praxair*, 2019-OTA-301P.) A new theory that is raised to sustain a deficiency is treated as a new matter when it either results in a larger deficiency (had FTB adopted it initially) or requires the presentation of different evidence. (See, e.g., *Appeal of Sierra Pacific Industries*, (94-SBE-002) 1994 WL 14076; *Shea v. Commissioner* (1999) 112 T.C. 183, 191; *Sham v. Commissioner*, T.C. Memo. 2020-119.) A new theory is not a new matter if it merely clarifies or develops the original determination without being inconsistent with it, increasing the amount of the deficiency, or requiring the presentation of different evidence. (See, e.g., *Appeal of Sierra Pacific Industries, supra*; *Friedman v. Commissioner* (6th Cir. 2000) 216 F.3d 537, 543.)

Resolution of the issue of whether a 1031 exchange is valid requires entirely different evidence than resolution of the issue of whether an S corporation made a taxable distribution of a different, unrelated property to its sole shareholder. By raising this alternative determination, FTB is not merely clarifying or developing its original determination in the NPA that the 1031 exchange treatment was invalid. Accordingly, the distribution determination constitutes a new matter on appeal, and the burden of proof as to any issues of fact regarding this issue shifts to FTB. (Cal. Code Regs., tit. 18, § 30219(a).)

### Treatment of Corporate Distribution

IRC section 1371(a) provides that except as otherwise provided in this title, and except to the extent inconsistent with subchapter S, subchapter C shall apply to an S corporation and its shareholders.<sup>27</sup> IRC section 301(a) states, “Except as otherwise provided in this chapter, a distribution of property (as defined in [IRC] section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in [R&TC section 301](c).”<sup>28</sup>

IRC section 301(b)(1) provides that the amount of any corporate distribution made to a shareholder with respect to its stock “shall be the amount of money received, plus the fair market value of the other property received,” which “shall be determined as of the date of distribution.” IRC section 301(b)(2) provides that the amount of the corporate distribution shall be reduced (but not below zero) by the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and the amount of any liability to which the property is subject immediately before and immediately after it is distributed to the shareholder. Treasury Regulations section 1.301-1(f)(1) explains, “For purposes of [IRC] section 301(b)(2), no reduction in the amount of a distribution is made for the amount of any liability, except to the extent the liability is assumed by the shareholder within the meaning of [IRC] section 357(d).”<sup>29</sup> IRC section 301(d) provides, “The basis of property received in a distribution to which [IRC section 301](a) applies shall be the fair market value of such property.”

For a C corporation, IRC section 301(c) generally provides that the portion of a corporate distribution that is a dividend (as defined in IRC section 316) shall be included in gross income, and the portion that is not a dividend (as defined in IRC section 316) shall be applied against and reduce the adjusted basis of the stock and the amount that exceeds the adjusted basis of the stock

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<sup>27</sup> California conforms to the federal subchapter S rules of the IRC relating to the tax treatment of S corporations and their shareholders pursuant to R&TC section 17087.5, except as otherwise provided,

<sup>28</sup> California conforms to the federal subchapter C rules of the IRC relating to corporate distributions and adjustments pursuant to R&TC sections 17321 and 24451, except as otherwise provided.

<sup>29</sup> IRC section 357(d)(1) provides that “a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability[.]” A debt is a recourse liability when the borrower is personally liable for the debt, whereas a debt is a nonrecourse liability when the borrower is not personally liable for the debt and the creditor's only recourse is the secured asset. (*Appeal of Johnson*, 2022-OTA-166P.)

shall be treated as gain from the sale or exchange of property.<sup>30</sup> For an S corporation, IRC section 1368(a) provides that a distribution of property made by an S corporation with respect to its stock to which (but for this subsection) IRC section 301(c) would apply shall be treated in the manner provided in IRC section 1368(b) or (c), whichever applies. For an S corporation with no accumulated earnings and profits that makes a distribution of property to its shareholder, only the amount of the distribution that exceeds the shareholder's adjusted basis of stock shall be treated as gain from the sale or exchange of property. (IRC, § 1368(b)(1), (2); see *Hacker v. Commissioner*, T.C. Memo. 2022-16.) Taken together, these statutes establish that the amount of a distribution by a corporation to its shareholder is determined pursuant to 301(b), while the taxation of that distribution is governed by IRC section 301(c) for C corporations and IRC section 1368(b) or (c) (whichever is applicable) for S corporations.<sup>31</sup>

#### JETA's Distribution of Property to Appellants

FTB argues that appellants received a taxable distribution from JETA because JETA's distribution of the Malibu Road property to appellants' marital trust exceeded Ziman's adjusted stock basis in JETA. In its post-hearing briefing, FTB contends that JETA made a gross distribution of \$13 million to Ziman because JETA purchased the Malibu Road property for \$13 million on March 1, 2005, and then JETA transferred the Malibu Road property by quitclaim deed to appellants' marital trust on April 1, 2005. FTB thus contends that the fair market value of the Malibu Road property was \$13 million on March 1, 2005, and on April 1, 2005.<sup>32</sup> Based on JETA's 2005 return and documentation regarding a 2003 contribution to JETA by Ziman,

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<sup>30</sup> IRC section 316(a) generally defines "dividend" as any distribution of property made by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, or out of its earnings and profits for the taxable year computed at the close of the taxable year.

<sup>31</sup> See IRC section 1368(a), which directs S corporations to apply IRC sections 1368(b) or (c) (whichever is applicable) in place of IRC section 301(c) where IRC section 301(c) would otherwise apply, but for IRC section 1368(a).

<sup>32</sup> Prior to the oral hearing, FTB treated the conveyance of the Malibu Road property as a gross distribution of \$11.5 million noting that appellants' purported purchase of furnishings accounts for the difference of \$1.5 million. FTB now agrees with appellants that the fair market value of the transferred property is \$13 million.

FTB estimates that Ziman had a stock basis in JETA of \$4,497,974<sup>33</sup> at the end of 2005, the year of the distribution. By subtracting the estimated basis of \$4,497,974 from \$13 million, the Malibu Road property's fair market value, FTB contends that Ziman received a taxable distribution of \$8,502,026 pursuant to IRC section 1368(b). Based on its determination that Ziman's basis in JETA is reduced to \$0 as a result of the distribution, FTB disallows a pass-through entity loss of \$108,424 and a capital loss carryover of \$1,005,803. FTB thus calculates a net adjustment of \$9,616,253 to appellants' 2005 taxable income as a result of the distribution.

Appellants argue that JETA did not make a distribution in excess of Ziman's stock basis in JETA. Ziman states in his declaration that in 2005 he purchased the Malibu Road property through JETA for a purchase price of \$13 million. Appellants contend that under IRC sections 301(b)(2) and 357(d)(1), Ziman assumed the recourse CNB LOC liability that JETA used to purchase the Malibu Road property. Appellants assert that on February 23, 2005, Ziman transferred \$2 million from his personal account to JETA to be deposited into the purchase escrow for the Malibu Road property, and JETA acquired the CNB LOC for \$11 million from CNB for which Ziman was a personal guarantor. Appellants also contend that on February 23, 2005, Ziman instructed CNB to wire \$11 million from the CNB LOC into the purchase escrow account for the Malibu Road property, and on February 25, 2005, JETA wired the \$2 million received from Ziman into the same escrow account. Appellants further assert that escrow closed on the purchase of the Malibu Road property on March 1, 2005, and JETA signed a quitclaim deed transferring title to the Malibu Road property to appellants' marital trust on April 1, 2005. Appellants state that the CNB LOC was used only to purchase the Malibu Road property. In Ziman's supplemental declaration, he states, "it was always my intention, both individually and as the shareholder of JETA, for me to personally assume the CNB [LOC] obligation when title to [the Malibu Road property] was transferred to the Marital Trust." Attached to Ziman's supplemental declaration are copies of a promissory note wherein JETA promises to pay CNB \$11 million, a loan agreement between JETA and CNB, and Ziman's personal guarantee wherein he guarantees and promises to pay CNB any indebtedness of JETA.

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<sup>33</sup> FTB used an estimated \$168,529 basis at the beginning of 2005 (capital stock of \$50,000 + paid-in capital of \$965,180 – retained earnings of \$846,651). FTB added to basis the contribution of the PCH property to JETA, the \$2 million Ziman contributed to JETA just prior to the close of escrow on the Malibu Road property, ordinary income of \$15,821, interest income of \$11,787, dividends of \$22, and gain of \$25 to reach a year-end basis of \$4,497,974.

Appellants assert that their marital trust executed a new trust deed loan with CNB in the amount of \$6.5 million on May 2, 2005, which was secured by the Malibu Road property, and this new trust deed loan was used to pay off part of the remaining balance of the CNB LOC. Appellants also assert that Ziman wired personal funds of \$4,495,951.04 to CNB to pay off the remaining balance owed on the CNB LOC on June 2, 2005. Appellants contend that for approximately eight years they owned the Malibu Road property as a personal residence, and appellants' marital trust made monthly payments to CNB on the trust deed loan. Lastly, appellants assert that the marital trust sold the Malibu Road property on April 10, 2013, for \$10,235,700 and the proceeds paid off the remaining balance of \$3,187,030 on the CNB trust deed loan. In support of these contentions, Ziman signed a declaration under penalty of perjury attesting to these facts and provided supporting documentation, as discussed below.

Both parties agree that the fair market value of the Malibu Road property, including furnishings, was \$13 million on the date JETA distributed it to appellants' marital trust. (IRC, § 301(b)(1), (3).) Appellants do not dispute FTB's calculation of Ziman's basis in JETA of \$4,497,974 at the end of the 2005 taxable year. Furthermore, FTB does not dispute that the \$11 million loan was a recourse loan that was assumed and ultimately paid by Ziman.<sup>34</sup>

The main issue in dispute is the application of the law to the facts of this appeal. Relying on IRC section 301(b)(2), Treasury Regulation section 1.301-1(f)(1), and IRC section 357(d)(1), appellants argue that the \$13 million fair market value of the Malibu Road property must be reduced by the CNB loan to JETA of \$11 million that Ziman assumed in connection with this distribution. FTB, on the other hand, contends that only C corporation distributions are governed by IRC section 301(b)(2) and Treasury Regulation 1.301-1(f)(1) while S corporation distributions are governed by IRC section 1368.

As noted above, the provisions of subchapter C are applied to S corporations except to the extent those provisions are inconsistent with subchapter S provisions. (IRC, § 1371.) OTA finds no inconsistency between IRC sections 301(b) and 1368. IRC section 1368(a) directs S corporations to apply the rules provided in IRC section 1368(b) or (c) to determine the tax treatment of distributions in place of IRC section 301(c), which governs the tax treatment of

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<sup>34</sup> The loan is a recourse loan because it was personally guaranteed by Ziman evidencing the fact that the creditor's (CNB's) recourse was not limited to the secured property (i.e., the Malibu Road property). (*See Appeal of Johnson, supra.*) OTA addresses the evidence regarding Ziman's assumption of this \$11 million loan below.

distributions made by C corporations. IRC section 1368 does not provide any rules for determining the amount of a distribution by an S corporation.<sup>35</sup>

Federal authority shows that IRC section 301(b) applies when determining the amount of a distribution to an S corporation shareholder. (See *Allen v. Commissioner*, T.C. Memo. 1993-612 [calculating the amount of a distribution by an S corporation to its shareholder by applying IRC section 301(b)(1) and (2)]; see also *Hacker v. Commissioner*, *supra* [after calculating the amount of distributions under IRC section 301(b), the court states that it next addresses the treatment of distributions applying IRC section 1368(b)].)

Additionally, an Oregon case, while not controlling, provides persuasive authority as it directly analyzes and applies the rules set forth in IRC section 301(b)(2)(A) and (B) to an S corporation distribution very similar to the distribution at issue in this appeal. (See *Shadbolt v. Dept. of Revenue*, Oregon Tax Court (2019) 2019 WL 6249449 (*Shadbolt*.) In *Shadbolt*, the court determined that, pursuant to IRC section 301(b), the amount of a distribution by an S corporation is the fair market value of the property received by the shareholder reduced by the amount of corporate liabilities assumed by the shareholder in connection with that distribution.

To summarize the above, there are four steps to apply in determining whether an S corporation shareholder receives a distribution and, if so, what the tax consequences of that distribution are: (1) determine whether there is a distribution under IRC sections 301(a) and 1368(a); (2) determine the amount of any distribution under IRC section 301(b); (3) determine the amount of any distribution that is taxable under IRC sections 1368(b) or (c);<sup>36</sup> and (4) determine the basis of property received by the shareholder in a corporate distribution under IRC section 301(d). (See also Treas. Reg. § 1.301-1.)

Here, it appears undisputed that Ziman received a distribution of the Malibu Road property from JETA with respect to his stock in JETA (Step 1). Ziman was the sole shareholder of JETA when it transferred title to the Malibu Road property to appellants' marital trust approximately one month after it purchased the property. (IRC, § 301(a); Treas. Reg. § 1.301-1(d).) The parties also agree that on the date of the transfer the fair market value of the

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<sup>35</sup> IRC section 1368 also does not contain any provision directing S corporations to apply provisions in IRC section 1368 in place of IRC section 301(b).

<sup>36</sup> C corporations apply IRC section 301(c) here, rather than IRC section 1368(b) or (c).

Malibu Road property, including furnishings, was \$13 million. (IRC, § 301(b)(1), (3); Treas. Reg. § 1.301-1(b).)

There is no merit to FTB's argument that IRC section 301(b)(2) and Treasury Regulation section 1.301-1(f)(1) do not apply to S corporation distributions of property under subchapter S. FTB appears to mix up and combine steps (2) and (3) arguing that IRC section 1368 provides a separate or inconsistent rule in subchapter S for determining the *amount* of the distribution (Step 2). However, IRC section 1368(a) states, "A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in [IRC section 1368](b) or (c), whichever applies." This language specifically states that IRC section 301(c) does not apply to S corporations and that IRC section 1368(b) or (c) (whichever is applicable) takes its place. IRC section 1368(a) makes no mention of IRC section 301(b), nor does it contain any rules for determining the *amount* distributed, which is presumed to be determined before application of the rules in IRC sections 301(c) or 1368(b) or (c) for determining how much of that distribution amount is taxable (Step 3).

Additionally, if FTB's reading of the statutes were upheld, it would have no basis to assert that the amount of the distribution shall be the fair market value of the Malibu Road property (\$13 million). (See IRC, § 301(b); Treas. Reg. § 1.301-1(b).) OTA is unaware of another provision in subchapter S that supersedes or contradicts IRC section 301(b). It is undisputed that Ziman assumed and eventually paid \$11 million in debt that was secured by the Malibu Road property. The loan is a recourse loan because it was personally guaranteed by Ziman, and by the fact that CNB's recourse was not limited to the secured property (i.e., the Malibu Road property). (*See Appeal of Johnson, supra.*) Ziman testified under oath at the oral hearing and in a declaration signed under penalty of perjury that he guaranteed and repaid the \$11 million loan using personal funds, funds obtained from other loans, and funds from the sale of the Malibu Road property. Appellants present a document entitled Continuing Guaranty, wherein Ziman guarantees and promises to pay CNB any debts of JETA, not limited to the debt secured by the Malibu Road property. In addition, appellants provide a Deed of Trust dated May 2, 2005, reflecting a loan by CNB to appellants in the amount of \$6.5 million secured by the Malibu Road property; Ziman's contemporary check register reflecting his personal payment of \$4,495,951 to CNB on May 26, 2005; a CNB Commercial Billing Statement showing Ziman's

continued payments on the \$6.5 million loan appellants' took out as permanent financing of the Malibu Road property; and a seller's closing statement establishing that the remaining loan balance was paid off when appellants' sold the Malibu Road property in 2013.

Also, in support of their position, appellants submit a declaration signed under penalty of perjury by Forbes, an employee of CNB. The declaration states that the determination to make the loan would have been the same whether it was made to Ziman or to JETA, the loan documents include a continuing guaranty from Ziman, and the bridge loan was based on Ziman's personal promise to pay. Forbes declares that CNB would never have made this loan to JETA without Ziman's personal guaranty. OTA finds Forbes' and Ziman's declarations and testimony to be credible and, based on this evidence combined with the documentary evidence discussed above, OTA finds that Ziman assumed the \$11 million CNB LOC in connection with the distribution of the Malibu Road property to his marital trust.<sup>37</sup> (IRC, § 301(b)(2)(A).) Therefore, appellants are entitled to reduce the \$13 million fair market value of the distributed property determined pursuant to IRC section 301(b)(1) by the \$11 million CNB LOC assumed in connection with the distribution pursuant to IRC section 301(b)(2)(A), resulting in a net distribution of \$2 million (Step 2). In determining the amount of the distribution pursuant to IRC section 301(b), the relevant facts are Ziman's assumption and subsequent payment, of JETA's \$11 million debt to CNB. (See IRC section 301(b)(2)(A); Treas. Reg. section 1.301-1(f)(1); IRC section 357(d)(1).)<sup>38</sup>

After the amount of the distribution is determined, the next step is to ascertain how much of that distribution amount is taxable (Step 3). For S corporations with no accumulated earnings and profits, IRC section 1368(b) provides that only distributions in excess of the shareholder's adjusted basis of the stock are treated as gain on the sale or exchange of property. JETA had no

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<sup>37</sup> IRC section 357(d)(1) provides that "a recourse liability (or portion thereof) shall be treated as having been assumed if, as determined on the basis of all facts and circumstances, the transferee has agreed to, and is expected to, satisfy such liability (or portion), whether or not the transferor has been relieved of such liability[.]" Thus, there is no requirement that JETA be relieved of the \$11 CNB LOC in order for such liability to be treated as assumed by Ziman in connection with the distribution of the Malibu Road property to appellants.

<sup>38</sup> OTA notes that this outcome is consistent with the economic reality of the transaction. Appellants received the Malibu Road property with a fair market value of \$13 million but also assumed and ultimately paid the \$11 million CNB LOC that JETA incurred to purchase this property. This is economically different from a situation where the Malibu Road property is distributed to appellants, but JETA remained responsible for and ultimately paid the \$11 million CNB LOC incurred to purchase the property. In the latter example, the net economic benefit to appellants would be \$13 million, but here the net economic benefit to appellants is \$2 (the \$13 million value of the Malibu Road property minus the \$11 million debt appellants assumed in connection with the distribution and ultimately paid).

accumulated earnings and profits, as reported on its tax return for 2005. Thus, the distribution is not included in gross income to the extent that it does not exceed the adjusted basis of the stock. (IRC, § 1368(b)(1).) FTB calculated the adjusted basis of Ziman's stock to be \$4,497,974. Appellants have not established a basis higher than that amount.<sup>39</sup> Here, subtracting the \$2 million net distribution from the \$4,497,974 adjusted basis results in a taxable distribution of \$0.<sup>40</sup> As discussed above, FTB's new position constitutes a new matter for which FTB bears the burden of proof. FTB determined the amount of the taxable distribution to be \$8,502,026. Given OTA's finding that the taxable distribution was \$0, FTB fails to meet its burden of proof on this issue. FTB's action proposing additional tax based on a distribution from JETA to appellants for the 2005 taxable year is reversed.

Issue 4: Are appellants entitled to additional itemized deductions disallowed by FTB?

IRC section 68 provides for a limitation on itemized deductions where adjusted gross income (AGI) exceeds certain applicable amounts. California adopts IRS section 68 pursuant to R&TC section 17077, with certain modifications. The applicable AGI threshold is adjusted annually in the same manner as tax brackets are adjusted. (R&TC, § 17077(c).) For taxpayers exceeding the AGI threshold for the taxable year at issue, the amount of the itemized deductions otherwise allowable for the taxable year shall be reduced by the lesser of: (1) 6 percent of the excess of AGI over the applicable amount; or (2) 80 percent of the itemized deductions otherwise allowable to such taxable year. (IRC, § 68(a); R&TC, § 17077(a).)

Here, FTB initially disallowed itemized deductions of \$124,236 for 2003 and \$2,465,180 for 2005. Both taxable years disallowances were due to limitations, or phase-out, of appellants' claimed itemized deductions based on the proposed increases to appellants' AGI. Following several concessions made by FTB over the course of the appeal, FTB recalculated the phased out

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<sup>39</sup> FTB argues that pursuant to IRC section 1368, a shareholder's debt basis in an S corporation is separately calculated and does not impact the shareholder's stock basis when determining the taxable amount of a distribution. OTA does not use Ziman's debt basis in JETA in its calculation of the amount of the taxable distribution. Rather, OTA merely applies IRC section 301(b) to determine the *amount* of the distribution to appellants before applying IRC section 1368(b) to determine how much of that distribution amount is taxable. OTA accepts FTB's calculation of Ziman's stock basis in JETA of \$4,497,974.

<sup>40</sup> FTB also disallowed a pass-through entity loss of \$108,424 and a capital loss carryover of \$1,005,803 based on its determination that Ziman's basis in JETA is reduced to \$0 as a result of the \$13 million distribution. However, after subtracting the net taxable distribution of \$2 million from the basis amount of \$4,497,974, appellants still had remaining basis of \$2,497,974, which is sufficient to allow appellants to take the loss of \$108,424 and a capital loss carryover of \$1,005,803 as originally claimed on their 2005 return.

itemized deductions, calculating that for 2003 itemized deductions of \$124,236 (no change) should be disallowed. After FTB conceded the items in the NPA for 2005, it asserts an income adjustment as a result of its new argument relating to the distribution of the Malibu Road property to appellants. FTB, therefore, contends that itemized deductions of \$2,569,140 (an increase of \$103,960) should be disallowed due to the phase-out limitations.

Appellants, while they continue to dispute the underlying proposed assessment for 2003, do not dispute the calculation for the phase-out if FTB prevails. For taxable year 2005, appellants continue to dispute the proposed assessment that is now based on FTB's new theory. Appellants also dispute that FTB can adjust their income by more than the additional tax of \$945,869 stated in the 2005 NPA, so even if FTB's 2005 proposed assessment is upheld, it is improper to increase disallowed deductions by \$103,960. Appellants point to R&TC section 19043, which defines a deficiency as "an amount of tax," which does not contemplate the conceded accuracy-related penalty.<sup>41</sup>

OTA need not address whether a deficiency includes penalties because, as stated above, FTB's action proposing additional tax based on FTB's alternative position (the distribution from JETA to appellants for the 2005 taxable year) is reversed. As a result, appellants' 2005 income is not increased, and there is no resulting phase-out or limitation of appellants' itemized deductions for the 2005 taxable year.

Based on the foregoing, OTA sustains FTB's disallowance of itemized deductions of \$124,236 for 2003; however, OTA reverses FTB's disallowance of itemized deductions of \$2,465,180 per the NPA (and the recalculated itemized deductions disallowance of \$2,569,140 as asserted by FTB on appeal) for 2005.

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<sup>41</sup> OTA also questions whether the amount of a penalty may be included when determining the deficiency amount on an NPA. R&TC section 19043 defines a deficiency as the amount by which tax imposed exceeds the excess of the amount shown as the *tax* on an original or amended return plus amounts previously assessed as a deficiency over the amount consisting of abatement, credit, refunds, or other repayments.

Issue 5: Are appellants entitled to additional interest abatement under R&TC section 19104(a) for any of the taxable years at issue?

Applicable Law

Interest must be assessed from the date a tax payment is due through the date that it is paid. (R&TC, § 19101.) Imposition of interest is mandatory; it is not a penalty, but it is compensation for a taxpayer's use of money after it should have been paid to the state. (*Appeal of Moy*, 2019-OTA-057P.) As relevant here, FTB may abate interest to the extent it is attributable in whole or in part to any unreasonable error or delay by an officer or employee of FTB (acting in his or her official capacity) in performing a ministerial or managerial act. (R&TC, § 19104(a)(1).) The error or delay can be considered only if no significant aspect is attributable to the taxpayer, and only if the error or delay occurred after FTB contacted the taxpayer in writing about the deficiency. (R&TC, § 19104(b)(1).)

OTA has jurisdiction to determine whether a failure by FTB to abate interest was an abuse of discretion and may order an abatement in such cases. (R&TC, § 19104(b)(2)(B).) To show an abuse of discretion, a taxpayer must establish that, in refusing to abate interest, FTB exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. (*Appeal of Gorin*, 2020-OTA-018P.) Interest abatement provisions are not intended to be routinely used to avoid the payment of interest, and abatement of interest should therefore only be ordered when the failure to abate interest would be widely perceived as grossly unfair. (*Ibid.*)

FTB's Grant of Interest Abatement

On appeal, FTB agrees to abate interest for a total of 1,246 days of the protest period but argues that no interest abatement is required for any of the audit period. FTB argues that pursuant to R&TC section 19104(a), it did not abuse its discretion in its determination that appellants are not entitled to additional interest abatement.

Purported Additional Error and/or Delays During the Protest Period

Appellants note that the protest period lasted almost eight years and that FTB has agreed to abate interest for three years and five months of the protest period. Appellants state, "The obvious contention then is that a reasonable time to consider the protest was four and a half years." Appellants contend that it is "ludicrous" for FTB to suggest that a protest period of four

and one-half years is reasonable. Appellants state, “The protest was no doubt prolonged by the dreadfully unsupported audit determination underlying the NPAs.” According to appellants, an additional two years of interest abatement is required for the protest period, because a properly implemented protest should have taken only one or two years.

FTB’s Determination Not to Abate Interest for Certain Periods During the Protest

December 13, 2010, through August 26, 2011

FTB argues that it is not authorized to abate any additional interest that accrued during the protest period. According to FTB, the protest period began when it received appellants’ protest letter on December 13, 2010. FTB asserts that, although appellants claim that it did not respond to their protest until July 6, 2011, FTB’s records show that it sent appellants correspondence on March 18, 2011. FTB contends that its communication or lack thereof does not constitute a managerial or ministerial act or indicate an unreasonable error or delay on its part. FTB indicates that just because it may not have been communicating with appellants does not mean that it was not working on the matter. FTB asserts that it promptly transferred this matter to its Legal Division, and FTB employees gathered and reviewed documents and actively and properly worked on this matter between December 13, 2010, and August 26, 2011.

December 11, 2012, through February 2, 2013

FTB agreed to abate interest for the 472-day period running between August 27, 2011, and December 10, 2012, and declined to abate interest between December 11, 2012, and February 2, 2013. FTB contends that it did not unreasonably err or delay in the performance of a managerial or ministerial act between December 11, 2012, and February 2, 2013. FTB asserts that its records show that during this period, its employees were actively working on the protest, and FTB sent appellants a letter dated January 2, 2013, that requested a response within 30 days concerning potential protest hearing dates. FTB contends that it properly waited to receive a response from appellants between January 2, 2013, and February 2, 2013.

July 18, 2013, through March 20, 2014.

FTB agreed to abate interest for the 165-day period running between February 3, 2013, and July 17, 2013, and declined to abate interest between July 18, 2013, and March 20, 2014. FTB further contends that it did not unreasonably err or delay in the performance of a managerial

or ministerial act between July 18, 2013, and March 20, 2014. FTB asserts that its records show that other than a couple of reasonably minor delays during this period, its employees were actively working on the protest, and FTB held a protest hearing on September 25, 2013. FTB notes that after appellants timely responded to its information requests on November 20, 2013, appellants did not receive written communication from FTB until January 12, 2015. FTB states that “a lack of communication from [FTB] is not equivalent to a managerial or ministerial act and not necessarily an indication of an unreasonable error or delay caused wholly by [FTB].”

October 21, 2014, through December 18, 2015

FTB agreed to abate interest for the 214-day period running between March 21, 2014, and October 20, 2014, and declined to abate interest between October 21, 2014, and December 18, 2015. FTB contends that it did not unreasonably err or delay in the performance of a managerial or ministerial act between October 21, 2014, and December 18, 2015. FTB notes that after appellants timely provided documents on February 23, 2015, FTB did not contact appellants and took no action until October 30, 2017. FTB states, however, that its “records show that its employees were actively and diligently working on the protest from October 21, 2014, through December 18, 2015.” FTB states, “A lack of communication from [FTB] is not equivalent to a managerial or ministerial act and is not necessarily an indication of an unreasonable error or delay caused wholly by [FTB].”

June 7, 2016, through December 29, 2016

FTB agreed to abate interest for the 171-day period running between December 19, 2015, and June 6, 2016, and declined to abate interest between June 7, 2016, and December 29, 2016. FTB contends that it did not unreasonably err or delay in the performance of a managerial or ministerial act between June 7, 2016, and December 29, 2016. FTB asserts that its records show that other than a reasonably minor delay during this period, its employees were actively working on the protest.

August 11, 2017, through August 1, 2018

FTB agreed to abate interest for the 224-day period running between December 30, 2016, and August 10, 2017, and declined to abate interest between August 11, 2017, and August 1, 2018. FTB contends that it did not unreasonably err or delay in the performance of a managerial

or ministerial act between August 11, 2017, and August 1, 2018. FTB notes that it did not contact appellants until October 30, 2017, when it requested additional documents, which appellants provided on November 29, 2017. FTB does not dispute that appellants timely responded to FTB's requests. FTB issued a Preliminary Determination Letter on January 28, 2018, and FTB issued the 2003, 2004, and 2005 NOAs on August 1, 2018. FTB states that "a lack of communication from [FTB] is not equivalent to a managerial or ministerial act and is not necessarily an indication of an unreasonable error or delay caused wholly by [FTB]." FTB states that its "records show that, other than some reasonably minor delays, its employees were actively and properly working on resolving the protest." With respect to appellants' claim for abatement of interest for the period from August 2, 2018, to December 31, 2018, FTB contends that no error or delay was caused by it as appellants entered the appeal process on August 27, 2018.

### Conclusion

OTA reviewed the evidence provided by FTB; specifically, the copies of the event logs for the protest periods during which FTB did not grant interest abatement. OTA finds that this evidence supports FTB's assertions that the protest hearing officer was actively working on the protest during the time periods for which interest was not abated. Thus, appellants have not shown that FTB exercised its discretion arbitrarily, capriciously or without sound basis in fact or law, in declining to abate additional interest during the protest. The mere passage of time does not establish error or delay in performing a managerial or ministerial act. (*Appeal of Gorin*, *supra* citing *Cosgriff v. Commissioner*, T.C. Memo. 2000-241.)

In addition, appellants have failed to substantiate that, for two years during the protest FTB committed unreasonable errors or delays for which no significant aspect of the error or delay can be attributed to them. (R&TC, § 19104(b)(1).) The matters in dispute are complex and required substantial documentation to support appellants' reporting as accurate. The complexity is evidenced by the fact that appellants responded to six IDRs during the audit and still provided additional supporting documentation at protest and on appeal. Appellants have not met their burden of establishing that in refusing to abate additional interest, FTB exercised its discretion arbitrarily, capriciously, or without sound basis in fact or law. (*Appeal of Gorin*, *supra*.)

OTA finds that no additional interest abatement is warranted. With respect to taxable year 2005, interest will be abated in full due to reversal of FTB's action.

#### Purported Errors and/or Delays During the Audit Period

Appellants argue they are entitled to an interest abatement of at least two years for “excessive prolonged delays during the audit” period. Appellants assert that the audit period lasted approximately 42 months, and that on multiple occasions FTB changed tax auditors. Appellants also assert that FTB admitted that a complete review and revision of the preliminary audit determinations was required because one of its earliest auditors was a “rogue auditor.” Appellants further contend that many issues FTB raised at audit “were so entirely groundless” that they were not included in FTB's position on appeal. Appellants claim that, even though they promptly responded to information requests, “the audit dragged on interminably.” Appellants state that, although FTB contends that they are not entitled to any interest abatement for the audit period, “interest abatement of at least two years is warranted for these excessive prolonged delays during the audit.”

#### FTB's Determination Not to Abate Interest During the Audit Period

FTB argues that it is not authorized to abate any interest that accrued during the audit period, because it did not commit any error or delay in performing any managerial or ministerial act. FTB notes that the audit period began with its Initial Contact Letter dated August 24, 2007, and ended on October 11, 2010, the date when FTB issued the 2003, 2004, and 2005 NPAs. FTB acknowledges that during the audit period, there were some minor delays in May, June, and August of 2010 that were due to reasonable workload constraints. FTB states that “the August delay was partially caused by an employee undergoing back surgery and partially attributable to [appellants], as [FTB] was waiting for a response from [their] representative.” FTB also states that, other than these minor delays, its “records show that its employees were actively and properly working on this matter throughout the entire audit period.” While appellants contend that delays were caused because FTB made erroneous initial determinations and personnel changes, FTB asserts that appellants fail to identify any unreasonable errors or delays caused by personnel changes, and FTB's records show no “unreasonable delay occurred as a result of personnel changes.” In addition, FTB states that any initial determinations that ultimately proved to be incorrect “were neither managerial nor ministerial acts,” because they “require judgment and concern the proper application of law.”

During the audit period, FTB sent appellants at least six IDRs to which appellants responded, and FTB subsequently sent appellants Audit Issue Presentation Sheets explaining the auditor's analysis and determination on several issues. Appellants' responses included additional documents that were not originally available to FTB, which FTB used to modify its proposed assessments in appellants' favor as that new information was received. Given the complexity and number of issues, appellants' have not established unreasonable error or delay by FTB during the audit period. Moreover, with respect to appellants' argument that the audit was unreasonably delayed because of incorrect determinations made at audit, such errors are neither managerial nor ministerial acts as they require judgment and the proper application of law to facts. (See *Lee v. Commissioner*, (1999) 113 T.C. 145, 149-150 [a "ministerial act" is a procedural action, not a decision in a substantive area of tax law].)

OTA finds that appellants have not established a basis to abate any interest in addition to the 1,246 days conceded by FTB.

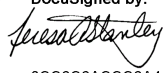
HOLDINGS

1. Appellants have not shown they are entitled to a greater cost basis in shares of Arden stock sold in 2003 than allowed by FTB.
2. The 2003 reduction in liabilities in ARLP exceed Ziman’s basis in the partnership resulting in gain for 2003.
3. Ziman did not receive a taxable distribution from JETA in 2005.
4. FTB properly disallowed itemized deductions of \$124,236 for 2003. Appellants are entitled to the full amount of their claimed itemized deductions for 2005.
5. Appellants are not entitled to additional interest abatement for 2003.


DISPOSITION

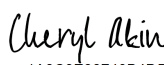
As conceded by FTB on appeal, FTB’s action for the 2003 taxable year is modified to reduce the proposed additional tax assessment from \$1,757,167, to \$1,005,415, and to abate the accuracy-related penalty. Additionally, as conceded by FTB, interest is abated for the periods of: August 27, 2011, to December 10, 2012; February 3, 2013, to July 17, 2013; March 21, 2014, to October 20, 2014; December 19, 2015, to June 6, 2016; and December 30, 2016, to August 10, 2017.

As conceded by FTB, FTB’s action proposing additional tax and an accuracy-related penalty for the 2004 taxable year is reversed. FTB’s action proposing additional tax and the accuracy-related penalty for the 2005 taxable year is reversed in its entirety. Pursuant to the parties’ stipulation, Edwards is granted full innocent spouse relief of the tax liabilities at issue pursuant to R&TC section 18533(b).

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Teresa A. Stanley  
Administrative Law Judge

We concur:

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Amanda Vassigh  
Administrative Law Judge

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Cheryl L. Akin  
Administrative Law Judge

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