

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	OTA Case No. 21108817
	)	
T. UTMAN AND	)	
S. UTMAN	)	
	)	
	)	

OPINION

Representing the Parties:

For Appellants:	Greg S. Tolleson, CPA
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For Respondent:	Carolyn S. Kuduk, Attorney
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For Office of Tax Appeals:	Linda Frenklak, Attorney
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E. LAM, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, T. Utman and S. Utman (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of \$103,943.00, an accuracy-related penalty of \$20,788.60, and applicable interest for the 2010 tax year.

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

ISSUES¹

1. Whether appellants have demonstrated error in FTB's determination to include debt relief in the amounts realized when calculating the gains from the sale of their membership interest in their limited liability company (LLC) and the sale of their corporate stock.
2. Whether appellants are liable for the accuracy-related penalty.
3. Whether FTB's proposed assessment is barred by the statute of limitations as provided by R&TC section 19058.

¹ Appellants have not presented any arguments, and evidence in the record does not show any error in FTB's disallowance of the \$158,005 net operating loss carryover deduction or itemized deductions adjustment of \$4,688. Accordingly, OTA will not address these matters further, as appellants have not met their burden of proving error in FTB's proposed assessment relating to these two adjustments.

FACTUAL FINDINGSNewport Marina, LLC

1. In 2000, Newport Marina, LLC (Newport Marina) was formed as a California LLC that operated as a rental real estate company. Newport Marina elected to be treated as a partnership for tax purposes.²
2. In 2004, Newport Marina secured a loan from City National Bank (CNB) for an original principal amount of \$11,700,000 (CNB Loan). As of April 1, 2010, the CNB Loan had a balance due of \$10,225,000.
3. At the beginning of 2010, appellants, as trustees of the Utman Family Trust (UFT) owned a one-third (1/3) interest in Newport Marina.
4. According to the Membership Interest Purchase Agreement dated April 7, 2010 (Membership Interest Purchase Agreement), appellants, as trustees of UFT, agreed to sell their one-third interest in Newport Marina to J. Galardi, as trustee of J. Galardi Trust dated September 10, 2009 (J. Galardi). J. Galardi was also a member of Newport Marina.
5. The recitals of the Membership Interest Purchase Agreement provided, in relevant parts, that: (a) appellants, as trustees of UFT, are guarantors of the CNB Loan under a written guaranty (Utman – CNB Guaranty); and (b) that appellant T. Utman is indebted to Galardi Group, Inc. in the amount of approximately \$700,000 under a certain promissory note executed by T. Utman (Utman – Galardi Loan).³

² Since Newport Marina is classified as a partnership for federal and California income tax purposes, this Opinion uses the terms “membership” interest and “partnership” interest interchangeably.

³ On appeal, appellants provide contradictory statements about the Utman - Galardi Loan discussed in the Membership Interest Purchase Agreement. First, appellants imply that the Utman - Galardi Loan is the same loan as the Utman - UGS Loan referenced in the Stock Purchase Agreement for UGS Development, Inc. (a different entity at issue for this appeal), stating that the Utman - Galardi Loan was “made directly to the [appellants] outside of the partnership by UGS Development, Inc.” and that the “correct balance was \$757,000 as evidence by the Form 1099-C issued by UGS Development, Inc. to the taxpayers in 2010.” Appellants also state, “UGS [Development, Inc.] had loaned \$757k to Utman directly to fund his investment in Newport.” However, when later discussing the sale of UGS Development, Inc., appellants state that the “loans made to Utman . . . from UGS [Development, Inc.] were for deferred compensation.” Thus, it is unclear whether there were two loans to appellants from J. Galardi and/or UGS Development, Inc. (one loan for the purchase of the membership interest in Newport Marina and a second loan related to compensation for services provided to UGS Development, Inc.) or only a single loan. As a result, it is unclear whether the \$700,000 Utman - Galardi Loan discussed in the Membership Interest Purchase Agreement is the same as the Utman - UGS Loan discussed in the Stock Purchase Agreement. Regardless, FTB did not seek to adjust appellants’ taxable income to include the Utman - Galardi Loan in connection with the sale of the membership interest in Newport Marina. Accordingly, this Opinion will not further address the Utman-Galardi Loan as it relates to the sale of the membership interest in Newport Marina because it is not an issue on appeal.

6. Section 2 “Purchase Price” of the Membership Interest Purchase Agreement stated that in consideration of, and in exchange for, the sale and transfer of the membership interest, J. Galardi agreed to indemnify and defend appellants from and against all guarantor liabilities under the: (a) Utman – CNB Guaranty and (b) Utman – Galardi Loan.
7. The Membership Interest Purchase Agreement was executed, and the transaction was completed.

UGS Development, Inc.

8. On October 1, 2004, UGS Development, Inc. (UGS) was formed and elected to be taxed as an S corporation that operated as a real estate development company. The purpose of UGS was to fund the development of the real estate occupied by the Newport Marina Apartments owned by Newport Marina. At the beginning of 2010, appellants, as trustees of UFT, owned a one-third (1/3) interest in UGS.
9. According to the Stock Purchase Agreement dated April 7, 2010 (Stock Purchase Agreement), appellants, as trustees of UFT, agreed to sell their shares to J. Galardi.
10. The recitals of the Stock Purchase Agreement provided, in relevant parts, that UGS is the borrower of a certain outstanding loan with an original principal amount of \$6,400,000 made by La Jolla Bank, FSB (La Jolla Loan). The Stock Purchase Agreement stated that the current balance was approximately \$7,000,000. Additionally, the recitals provided that: (a) appellants, as trustees of UFT, are guarantors of the La Jolla Loan under a commercial guaranty (Utman – La Jolla Bank Guaranty); and (b) appellant T. Utman is personally indebted to UGS in the approximate amount of \$772,500, which is referenced as the Utman – UGS Loan (Utman – UGS Loan).⁴
11. Section 2 “Purchase Price” of the Stock Purchase Agreement provided that in consideration of, and in exchange for, the sale and transfer of the shares, J. Galardi agreed to: (a) indemnify appellants, as trustees of UFT, from any obligation under the Utman – La Jolla Bank Guaranty; and (b) forgive and cancel the Utman – UGS Loan.⁵
12. The Stock Purchase Agreement was executed, and the transaction was completed.

⁴ FTB did not seek to adjust appellants’ taxable income related to the Utman – La Jolla Bank Guaranty in connection with the stock sale of UGS. Therefore, this Opinion will not further address the Utman – La Jolla Bank Guaranty as it pertains to the UGS stock sale because it is not at issue on appeal.

⁵ The Stock Purchase Agreement contains a scrivener’s error, referring to the term as the “Utman – USG Loan” instead of the intended “Utman – UGS Loan.” This Opinion will use “Utman – UGS Loan,” as it is presumed to reflect the intended meaning of the Stock Purchase Agreement.

13. Although the Stock Purchase Agreement refers to the Utman – UGS Loan in the amount of \$772,500, UGS issued a 2010 Form 1099-C, Cancellation of Debt, to appellant T. Utman, reporting the discharge of indebtedness income, also commonly referred to as cancellation of debt (COD) income, in the amount of \$757,500 on April 7, 2010. Both appellants and FTB appear to agree that the correct balance of the Utman – UGS loan is \$757,500 reflected in Form 1099-C.⁶

Appellants' 2010 Tax Returns

On October 15, 2011, appellants filed their joint 2010 California Resident Income Tax Return (Form 540). As relevant to this appeal, appellants' Form 540 reported federal adjusted gross income (AGI) of -\$628,407. This amount included \$757,500 in COD income, recognized from the discharge of the Utman – UGS Loan.⁷ Appellants did not report any gain or loss from the sales of their membership interest in Newport Marina or stock in UGS. Appellants also reported a California net operating loss (NOL) carryover in the amount of \$158,005. Appellants ultimately reported a California tax liability of \$0.

⁶ On UGS's 2010 California S Corporation Franchise or Income Tax Return (Form 100S), Statement 2, Schedule L, Line 6, Loans to Shareholders, UGS reported that appellants had a shareholder loan balance of \$757,500 at the beginning of 2010 and a shareholder loan balance of \$0 at the end of 2010. Both appellants and FTB appear to agree that the correct amount of the cancellation of a loan is \$757,500. However, it seems that FTB inadvertently used \$757,000, rather than \$757,500, in computing appellants' gain on the sale of the UGS stock. Since the \$757,000 figure benefits appellants, this discrepancy will not be further addressed, and this Opinion will refer to the Utman–UGS Loan as amounting to \$757,500.

⁷ While the \$757,500 COD income was included in appellants' reported federal AGI of -\$628,407, it was not actually included in appellants' reported California AGI of -\$154,598. On appellants' federal return (Form 1040), appellants reported "other income" of -\$631,129. Per Statement 1 attached to appellants' Form 1040, this amount included the following: "1099 Galardi Group nonemployee compensation" of \$100,000; "1099 Pacific Skies Estates nonemployee compensation" of \$68,320; "1099 UGS debt cancellation" of \$757,500; "K-1 Fiscal Therapy Investment Group disbursement" of \$3,408; and a federal NOL carryover of -\$1,560,357. ($\$100,000 + \$68,320 + \$757,500 + \$3,408 - \$1,560,357 = -\$631,129$.) However, on appellants' California return, appellants report a California adjustment (addition) of \$631,814 (Form 540, line 16). Per Schedule CA, California Adjustments - Residents, this includes \$685 additional capital gain and an elimination of the federal other income amount of -\$631,129. ($\$685 + \$631,129 = \$631,814$.) Therefore, appellants effectively eliminated each of the above federal "other income" amounts as reflected in Statement 1.

As a result, for California purposes appellants' report California AGI of -\$154,598 (Form 540, line 17), which includes only the following: wages of \$49,570 (Form 1040, line 7); dividends of \$12 (Form 1040, line 9a); federal capital gain of \$1,698 (Form 1040, line 13); additional California capital gain of \$685 (Schedule CA, Line 13, Column C); rental real estate loss of -\$48,558 (Form 1040, line 17); and a California NOL carryover of -\$158,005 (Form 540, line 14) ($\$49,570 + \$12 + \$1,698 + \$685 - \$48,558 - \$158,005 = -\$154,598$). Notably, appellants' California AGI does not include any of the items included in appellants' federal "other income" as reflected in Statement 1, including the \$757,500 COD income from the discharge of the Utman – UGS Loan.

Audit and Proposed Assessment

7. FTB audited appellants' 2010 return and issued a Notice of Proposed Assessment (NPA) dated October 4, 2017. The NPA increased appellants' California taxable income from -\$166,626⁸ to \$1,123,448, in order to: (1) include gain of \$1,455,895 from the sale of appellants' membership interest in Newport Marina; (2) include gain of \$428,486 from appellants' sale of their stock in UGS;⁹ (3) exclude the COD income of \$757,000 previously included in appellants' federal AGI;¹⁰ (4) disallow the claimed California NOL carryover of \$158,005; and (5) disallow itemized deductions of \$4,688. The NPA proposed additional tax of \$103,943 and an accuracy-related penalty of \$20,788.60, plus applicable interest.
8. Appellants timely protested the NPA.
9. FTB issued appellants a Notice of Action, affirming the NPA.
10. This timely appeal followed.
11. On appeal, FTB notes that the NPA's proposed gain of \$1,455,895 from the sale of Newport Marina, is based on appellants' claimed adjusted basis in Newport Marina of \$1,952,438.¹¹ However, FTB determined that appellants' adjusted basis in Newport

⁸ Appellants' California AGI of -\$154,598 minus itemized deductions of \$12,028.

⁹ FTB determined that appellants' basis in the UGS stock was \$328,514, which is comprised of appellants' 2010 tax year beginning stock basis of \$328,901, less appellants' \$387 allocable share of UGS' ordinary losses.

¹⁰ This adjustment appears to assume that appellants erroneously included the \$757,500 COD income from the discharge of the Utman – UGS Loan in their California AGI. However, as noted in footnote 7 above, while this amount was included in appellants' federal AGI, it was excluded from appellants' California AGI as a result of the California adjustment (addition) of \$631,814 reported by appellants on Form 540, line 16. As noted in footnote 7 above, this California adjustment effectively reversed/eliminated all amounts reported by appellants as federal "other income," which included the \$757,500 COD income, among other things. Because this amount was not included in appellants' California AGI or taxable income, there was no need for FTB to reduce appellants' California taxable income by \$757,000. It appears that FTB made this adjustment in error; however, since it is beneficial to appellants, this Opinion will not address it further.

¹¹ Appellants' claimed adjusted basis in Newport Marina of \$1,952,438 is comprised of the following claimed items: appellants' claimed 2010 tax year beginning negative tax capital account of \$1,479,229; their 2010 capital contribution of \$23,334; and their pro rata share of the CNB Loan liability of \$3,408,333 (-\$1,479,229 + \$23,334 + \$3,408,333 = \$1,952,438).

Marina should have been \$1,626,169, instead.¹² FTB notes that it will not pursue an additional adjustment for this difference and requests that OTA affirm the NPA's proposed gain adjustment of \$1,455,895, based on appellants' claimed adjusted basis of \$1,952,438.

DISCUSSION

Issue 1: Whether appellants have demonstrated error in FTB's determination to include debt relief in the amounts realized when calculating the gain from the sale of their membership interest in their LLC and the sale of their corporate stock.

I. Burden of Proof

FTB's determinations are presumed correct, and a taxpayer has the burden of proving error. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) The applicable burden of proof requires proof by the preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b); *Appeal of Rios*, 2021-OTA-341P.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Johnson*, 2022-OTA-166P.) 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.) A taxpayer's failure to produce evidence within the taxpayer's control gives rise to a presumption that the evidence, if provided, would be unfavorable to the taxpayer. (*Appeal of Bindley*, 2019-OTA-179P.)

II. Gain from Sale or Disposition of Property

Tax shall be imposed on the entire taxable income of every resident of California. (R&TC, § 17041(a).) Except as otherwise provided, gross income means all income from whatever source derived, including, but not limited to, "[g]ains derived from dealings in property." (Internal Revenue Code (IRC), § 61(a), (a)(3); R&TC, § 17071.)¹³ The specific rules for computing the amount of gain or loss from dealings in property under IRC section 61(a)(3) are contained in IRC section 1001 and the regulations thereunder. (Treas. Reg. § 1.61-6(a).) The gain from the sale or other disposition of property shall be the excess of the amount

¹² During appellants' protest of the NPA, FTB's protest determination letter concluded that appellants' adjusted basis should be \$1,626,169, not \$1,952,438. The discrepancy stems from the 2010 beginning negative tax capital balance, which FTB determined was \$1,805,498, instead of appellants' claimed amount of \$1,479,229. ($-\$1,805,498 + \$23,334 + \$3,408,333 = \$1,626,169$.)

¹³ For the 2010 tax year, R&TC section 17024.5(a)(1)(O) provides that for Personal Income Tax Law purposes, California conforms to the January 1, 2009 version of the IRC. References herein to the IRC are, therefore, to the January 1, 2009 version. Pursuant to R&TC section 17071, California conforms to IRC section 61.

realized therefrom over the adjusted basis provided in IRC section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. (IRC, § 1001(a).)¹⁴

III. Discharge of Indebtedness Income

Gross income also includes “[i]ncome from discharge of indebtedness,” commonly referred to as COD income. (IRC, § 61(a)(12).)¹⁵ “A discharge of indebtedness occurs when ‘the debtor is no longer legally required to satisfy his [or her] debt either in part or in full.’ [Citations.]” (*Black v. Commissioner*, T.C. Memo. 2014-27.) In general, income from the discharge of indebtedness is recognized as ordinary income. (*Callahan v. Commissioner*, T.C. Memo. 2013-131; *Appeal of Johnson*, 2022-OTA-166P.) The amount of ordinary income realized from the discharge of indebtedness is calculated as the difference between the debt discharged and any amount paid in satisfaction of the debt (including the fair market value of the property received by the lender). (*Bui v. Commissioner*, T.C. Memo. 2019-54; see also Treas. Reg. § 1.1001-2(c), Example 8.)

IRC section 108 excludes certain discharges of indebtedness from gross income.¹⁶ Gross income does not include any amount that would otherwise be included in the gross income of a taxpayer if the discharge of indebtedness occurs when the taxpayer is insolvent. (IRC, § 108(a)(1)(B).) The excluded amount shall not exceed the amount by which the taxpayer is insolvent. (IRC, § 108(a)(3).)¹⁷ For purposes of IRC section 108, a taxpayer is insolvent if, immediately before the discharge of indebtedness, the taxpayer’s liabilities exceed the fair market value of the taxpayer’s assets. (IRC, § 108(d)(3).)

¹⁴ Pursuant to R&TC section 18031, California generally conforms to IRC sections 1001 through 1103, relating to gain or loss on disposition of property, except as otherwise provided.

¹⁵ For the 2010 tax year, the applicable provision requiring the inclusion of discharge of indebtedness in income is IRC section 61(a)(12). OTA notes that after the enactment of the Tax Cuts and Jobs Act in 2017, IRC section 61(a)(12) was redesignated as IRC section 61(a)(11). (2017 Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11051(b) (Dec. 22, 2017).)

¹⁶ California generally conforms to IRC section 108 pursuant to R&TC section 17131.

¹⁷ A taxpayer who excludes discharge of indebtedness income due to insolvency under IRC section 108(a) that would otherwise be recognized under IRC section 61(a)(12), must reduce certain tax attributes (but not below zero) by the amount excluded, including NOL and capital loss carryovers. (IRC, § 108(b).)

IV. AnalysisA. Appellants' sale of their membership interest in Newport Marina.

There is no dispute that appellants, as trustees of UFT, held a one-third membership interest in Newport Marina and that Newport Marina owed a total outstanding debt of \$10,225,000 from the CNB Loan at the time of the sale of their membership interest. The Membership Interest Purchase Agreement provided that the purchase price in exchange for the sale and transfer of appellants' membership interest in Newport Marina was that the purchaser J. Galardi agreed to indemnify and defend appellants from and against all guarantor liabilities under the: (a) Utman – CNB Guaranty, and (b) Utman – Galardi Loan.¹⁸ The parties exchanged no other considerations in accordance with the Membership Interest Purchase Agreement. Here, OTA determines that appellants have not met the burden of proving error in FTB's computation of the amount realized on the sale of their membership interest in Newport Marina.

Gain from the Sale of Partnership Interest.

In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. (IRC, § 741.)¹⁹ Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in IRC section 751 (relating to unrealized receivables and inventory items). (*Ibid.*) Therefore, the computation of a gain or loss realized by a partner selling a partnership interest is the amount realized, less the partner's adjusted basis in the partnership. (IRC, §§ 741, 1001(a).)

1. Amount Realized on the sale of Newport Marina

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. (IRC, § 1001(b); Treas. Reg. § 1.1001-1(a).) Treasury Regulation section 1.1001-2(a)(1) generally provides that “the *amount realized* from a sale or other disposition of property *includes the amount of liabilities* from which the transferor *is discharged as a result of the sale or*

¹⁸ To reiterate, this Opinion will not further address the Utman–Galardi Loan as it relates to the sale of membership interest in Newport Marina because this loan was not included in FTB's computation of appellants' gain on the sale of Newport Marina and it is not at issue on appeal.

¹⁹ California incorporates IRC sections 701 through 761 relating to partners and partnerships with certain exceptions. (R&TC, § 17851.) When applying the IRC, California also incorporates Treasury Regulations to the extent that they do not conflict with regulations promulgated by FTB. (R&TC, § 17024.5(d); see also *Appeal of Rios, supra.*) All references to Treasury Regulations are based on the version that applies to the transactions and/or tax year at issue.

disposition.” (Italics added.) The sale or other disposition of property that secures a nonrecourse liability²⁰ discharges the transferor from the liability. (Treas. Reg. § 1.1001-2(a)(4)(i).) The sale or other disposition of property that secures a recourse liability²¹ discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability). (Treas. Reg. § 1.1001-2(a)(4)(ii).) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor’s share of the liabilities of the partnership. (Treas. Reg. § 1.1001-2(a)(4)(v).) When a partnership interest is sold, the amount realized from the sale of the partnership interest includes the reduction in the transferor partner’s share of partnership liabilities. (IRC, § 752(d); Treas. Reg., §§ 1.752-1(h); 1.1001-2(a)(4)(v) & (c), Example 3.)

Although the “amount realized” from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition, which would include recourse liabilities (see Treas. Reg. § 1.1001-2(a)(1), (a)(4)(ii)), Treasury Regulation section 1.1001-2(a)(2) provides that “[t]he amount realized from the sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the *discharge of indebtedness under [IRC] section 61(a)(12).*” (Italics added.) Additionally, Treasury Regulation section 1.1001-2(b) states, “[t]he fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under . . . [Treasury Regulation section 1.1001-2(a)] the amount of liabilities from which the taxpayer is discharged or treated as discharged.” Therefore, “the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property.” (Treas. Reg. § 1.1001-2(b).) However, Treasury Regulation section 1.1001-2(a)(2) still remains applicable when there is COD income under IRC section 61(a)(12). (*Ibid.*) Accordingly, when an asset securing recourse debt is transferred to the creditor and the debt exceeds the property’s fair market value, the transaction is bifurcated into: (1) an amount realized on the sale or other disposition of property under IRC section 61(a)(3); and (2) COD income under IRC section 61(a)(12), which is then subject to the exclusion rules under IRC section 108. (Treas. Reg. § 1.1001-2(a)(2) & (c), Example 8; *Appeal*

²⁰ In general, a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability. (Treas. Reg. § 1.752-1(a)(2).)

²¹ In general, a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability. (Treas. Reg. § 1.752-1(a)(1).)

of Johnson, supra.) Treasury Regulation section 1.1001-2(c), Example 8 provides the following illustration:

In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 – \$6,000).

Here, FTB determined that under Treasury Regulation section 1.752-1(h), the amount realized by appellants is the reduction in their share of membership liabilities due to the assumption of those liabilities from the sale of appellants' membership interest in Newport Marina, totaling \$3,408,333. This figure corresponds to appellants' one-third share of the outstanding CNB Loan ($\$10,225,000 \times 1/3 = \$3,408,333$).

Appellants, however, cite to Treasury Regulation sections 1.1001-2(a)(2) and (b), asserting that the facts of this appeal are similar to Treasury Regulation section 1.1001-2(c), Example 8. Appellants contend the fair market value of their one-third membership interest in Newport Marina, which appellants contend is valued at \$1,983,333, is less than their share of the partnership's recourse liabilities of \$3,408,333.²² Therefore, appellants argue that J. Galardi's assumption of their share of the partnership's recourse liabilities COD income of

²² Appellants estimated the fair market value of their membership interest in Newport Marina to be \$1,983,333. Appellants claim they provided the auditor with an August 19, 2009, appraisal from CB Richard Ellis, showing the Newport Marina Apartments were valued at \$14 million. Appellants assert their one-third interest in this value equates to \$4,666,667. However, appellants argue that their membership interest should be discounted by 15 percent for lack of control (appellants owned one-third, a minority interest in Newport Marina), and by 50 percent for lack of marketability. Citing Revenue Ruling 59-60 as support, appellants calculate the estimated value of their membership interest in Newport Marina on April 7, 2010, to be \$1,983,333 ($\$4,666,667 \times 0.85 \times 0.50$).

After thorough consideration, OTA has concluded that the fair market value of appellants' membership interest in Newport Marian is irrelevant in determining the amount realized from the appellants' sale of their membership interest in Newport Marina for purposes of this Opinion. Consequently, appellants' valuation method based on Revenue Ruling 59-60 is also irrelevant for purposes of this appeal and OTA will not discuss further.

\$1,425,000 (\$3,408,333 - \$1,983,333) under IRC section 61(a)(12), which is excluded from gross income under IRC section 108(a)(1)(B) due to appellants' insolvency.²³

OTA finds appellants' attempt to apply Treasury Regulation section 1.1001-2(a)(2) to the sale of their membership interest in Newport Marina and the CNB Loan to be misplaced for two reasons. First, appellants have not established that the CNB Loan was secured by appellants' membership interest in Newport Marina. Second, appellants have not established that the property sold (appellants' membership interest in Newport Marina) was transferred to the relevant creditor pursuant to *Moore v. Commissioner*, T.C. Memo. 1994-446.

As previously noted, Treasury Regulation section 1.1001-2(a)(2) provides, "[t]he amount realized on a sale or other disposition of *property that secures a recourse liability* does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under [IRC] section 61(a)(12)." (Italics added.) Pursuant to the plain language of Treasury Regulation section 1.1001-2(a)(2), it applies to and provides the rule for determining the amount realized on a sale or other disposition of property that *secures* a recourse liability. Thus, in order for Treasury Regulation section 1.1001-2(a)(2) to apply here, appellants would need to establish that the property interest sold (i.e., their one-third membership interest in Newport Marina) secured the relevant recourse liability at issue (i.e., the CNB Loan).

Appellants do not assert or provide evidence establishing that the CNB Loan was secured by appellants' membership interest in Newport Marina. Appellants have not provided the CNB loan agreement, the promissory note, security instrument, their personal guarantee of this loan, or any other evidence or documentation relating to the CNB loan. Thus, appellants have failed to establish whether the CNB loan was a secured or unsecured loan, and if secured whether their membership interest rather than some other property (such as the real estate – i.e., the Newport Marina Apartments) was the security for the CNB loan to Newport Marina. Because appellants have failed to establish that the property sold secured the CNB Loan, appellants have failed to establish that Treasury Regulation section 1.1001-2(a)(2), and the

²³ Appellants incorrectly cite to IRC section 108(b)(1)(B). Appellants bifurcated the transaction. Appellants' share of the CNB Loan that was relieved when they sold their membership interest in Newport Marina was \$3,408,333. Of this amount, appellants treat \$1,983,333 (the purported fair market value of their membership interest in Newport Marina on the date of the sale) as the amount realized on the sale of their membership interest, and the remaining amount of \$1,425,000, as COD income (\$3,408,333 - \$1,983,333 = \$1,425,000).

associated example in Treasury Regulation section 1.1001-2(c), Example 8,²⁴ apply here instead of the general rule provided in Treasury Regulation section 1.1001-2(a)(1).

Additionally, the facts here are similar to those in *Moore v. Commissioner*, T.C. Memo. 1994-446 (*Moore*). In *Moore*, the petitioner owned a one-quarter interest in a partnership and sold that interest to the purchaser. The purchaser was also a partner in the same partnership. (*Ibid.*) The partnership had a loan, and as part of the transaction, the purchaser explicitly assumed petitioner's share of the partnership liabilities. (*Ibid.*) Petitioner argued that the amount realized from the sale of his partnership interest should not include his share of the partnership's liabilities that were assumed by the purchaser as a result of the sale or disposition of the partnership interest. (*Ibid.*) Instead, petitioner argued that the assumed liabilities should be treated as COD income under IRC section 61, which is excludable from gross income under IRC section 108 to the extent the taxpayer is insolvent. (*Ibid.*) However, the U.S. Tax Court determined that the amount realized by petitioner upon the sale of his partnership interest included an amount equal to his share of the partnership's outstanding debt, which the purchaser assumed. (*Ibid.*) The U.S. Tax Court reasoned that because the transaction occurred between petitioner and the purchaser, not directly with the creditor, and no property or partnership interest was transferred to the creditor as part of the transaction, there was no COD income. (*Ibid.*, citing *Slavin v. Commissioner*, T.C. Memo. 1989-221, [assumption of partnership liabilities by a purchasing partner in a sale of partnership interest does not constitute a discharge of indebtedness based on the fact that purchaser was not a creditor].) Accordingly, the U.S. Tax Court concluded that the sale of petitioner's interest in the partnership comes within the "purview of" IRC section 61(a)(3), and that of IRC section 108 "is not applicable," when the debtor-creditor relationship never existed. (*Moore, supra.*)

In this case, similar to *Moore*, appellants have failed to establish that J. Galardi's assumption of their share of the partnership debt related to the CNB Loan constitutes COD income under IRC section 61(a)(12), and that it should be excluded from gross income under IRC section 108(a)(1)(B). Here, the outset of the debtor-creditor relationship in this appeal is between CNB and Newport Marina. Similar to *Moore*, the transaction at issue here occurred between appellants and the purchaser, J. Galardi, not directly with the creditor, CNB. No property or partnership interest was transferred to the creditor, CNB as part of the transaction.

²⁴ Treasury Regulation section 1.1001-2(c) expressly notes that the provisions of Treasury Regulation section 1.1001-2 may be illustrated by the examples that follow and that "each example assumes the taxpayer. . . sells or disposes of all property *which is security* for a given liability." (Italics added.) Thus, unlike the facts here, the asset transferred to the creditor in Example 8 was the security for the loan, which the creditor discharged in connection with the transfer.

Additionally, there is no evidence that CNB, as the creditor, agreed to release appellants from any obligation to repay the CNB Loan. There is also no evidence in the record to indicate that CNB did not intend to enforce its claim under the guarantee against appellants in exchange for appellants transferring their membership interest in Newport Marina to J. Galardi, had Newport Marina and/or J. Galardi defaulted on payment of the CNB Loan. In fact, the transaction at issue solely occurred between appellants and J. Galardi, where J. Galardi assumed appellants' share of partnership liabilities and indemnified and defended appellants from and against all guarantor liabilities under the Utman – CNB Guaranty. The evidence in the record does not show that appellants' sale of their membership interest in Newport Marina to J. Galardi affects their obligations with CNB. Since the creditor did not discharge the debt for appellants, no income from the discharge of indebtedness arose. Accordingly, appellants' sale of their membership interest comes within the purview of IRC section 61(a)(3), and that of IRC section 108 "is not applicable," when appellants' share of partnership liabilities was assumed by J. Galardi and not discharged by the creditor, CNB, under IRC section 61(a)(12). (*Moore, supra.*)

Appellants also argue that requiring a debtor-creditor relationship, as interpreted in *Moore*, to classify the income as COD income under IRC § 61(a)(12), conflicts with the plain language of Treasury Regulation § 1.1001-2(a)(4)(ii), as each refer to the word "discharge." Appellants highlight that Treasury Regulation section 1.1001-2(a)(4)(ii) specifically states that "the sale or other disposition of property that secures a recourse liability *discharges* the transferor from the liability," while IRC § 61(a)(12) states that gross income includes income recognized from the "*discharge* of indebtedness." (Italics added.) Therefore, appellants appear to argue that under the plain language of the statute and regulation, the discharge of liability following the sale or disposition of property securing a recourse liability should be sufficient to recognize the income as COD income under IRC § 61(a)(12).

However, appellants' argument conflates the two distinct tax treatments: (1) the determination of the "amount realized" in a sale or disposition of property under IRC section 1001, and (2) the treatment of income from the discharge of indebtedness under IRC section 61(a)(12). Here, Treasury Regulation section 1.1001-2(a)(1) provides that the amount realized from a sale or other disposition of property (under IRC section 1001) includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treasury Regulation section 1.1001-2(a)(4)(ii) then provides the special rule to ensure the "amount realized" on the sale or other disposition of property that secures a recourse liability includes such recourse debt if another person agrees to pay the liability (whether or not the

transferor is in fact released from liability). Similarly, Treasury Regulation section 1.1001-2(a)(4)(v) provides the special rule to ensure the “amount realized on the sale or disposition of a partnership interest includes the transferor’s share of liabilities of the partnership.”²⁵ Therefore, Treasury Regulation section 1.1001-2(a)(4)(ii) and (a)(4)(v) provides the interpretation for the determination of the amount realized on a sale or other disposition of property under IRC section 1001, but does not apply to or govern the recognition of COD income under IRC section 61(a)(12).

To reiterate, as established by *Moore* and in reference to Treasury Regulation section 1.1001-2(c), Example 8, discharge of indebtedness income under IRC section 61(a)(12) is recognized to the extent that a *creditor* agrees to discharge a recourse liability in exchange for property of a lesser fair market value than the amount of the liability. In appellants’ case, there was no debtor-creditor relationship between appellants and J. Galardi regarding the partnership’s CNB Loan liabilities. As previously discussed, Treasury Regulation section 1.1001-2(a)(1) provides the general rule that the amount realized on the sale or disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treasury Regulation section 1.1001-2(a)(4)(ii) the sale or disposition of property that secures a recourse liability discharges the transferor from the liability, if another person agrees to pay the liability (whether or not the transferor is in fact released from liability). Treasury Regulation section 1.1001-2(a)(4)(v) provides a similar rule for the sale or disposition of a partnership interest, stating that the liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor’s share of the partnership liabilities. Furthermore, when a partnership interest is sold, the amount realized under IRC section 1001 from the sale of the partnership interest includes the reduction in the transferor partner’s share of partnership liabilities. (Treas. Reg. § 1.752-1(h).) Accordingly, appellants’ sale of their membership interest in Newport Marina, including the debt discharge resulting from the reduction to appellants’ share of the LLC’s liability to CNB in the amount of \$3,409,333, results in an amount realized, not COD income under the facts of this appeal.²⁶ (Treas. Reg. §§ 1.752-1(h), 1.1001-2(a)(4)(v) & 1.1001-2(c), Example 3.)

²⁵ OTA notes that Treasury Regulation section 1.1001-2(a)(4)(v) rather than Treasury Regulation section 1.1001-2(a)(4)(ii) applies here since Treasury Regulation section 1.1001-2(a)(4)(ii) applies to the “sale or other disposition of property that secures a recourse liability” and appellants have not established that their membership interest in Newport Marina secured the CNB loan. However, both Treasury Regulation section 1.1001-2(a)(4)(ii) and (a)(4)(v) use similar terms: “discharges” and “discharged”.

²⁶ As a result, further analysis or discussion of whether the discharge of indebtedness income is excluded from gross income under IRC section 108(a)(1)(B) is unnecessary for purposes of this Opinion.

2. Adjusted Basis and Gain from Sale of Membership Interest in Newport Marina

Generally, a partner's adjusted basis in a partnership is the amount of money and the adjusted basis of property contributed to acquire the 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. (IRC, §§ 705, 722.) Additionally, 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 nonliquidating distribution to the partner, and (2) the partner's distributive share of partnership losses and expenditures. (IRC, §§ 705, 733.) A partner's adjusted basis in a partnership interest is also increased by the partner's share of partnership liabilities, which is considered a deemed contribution of money. (IRC, §§ 752(a), 705(a); Treas. Reg. § 1.752-1(b).)

According to the NPA, FTB proposed additional gain from the sale of appellants' membership interest in Newport Marina of \$1,455,895, which is the difference between the adjusted amount realized of \$3,408,333 and appellants' claimed basis of \$1,952,438 in Newport Marina.

On appeal, FTB determined that appellants' adjusted basis in Newport Marina should have been \$1,626,169, instead of \$1,952,438. However, FTB indicates that it will not pursue an additional adjustment to appellants' claimed adjusted basis. Instead, FTB requests that OTA affirm the NPA's proposed gain adjustment of \$1,455,895, based on appellants' claimed adjusted basis of \$1,952,438, which is to appellants' advantage.²⁷ Here, appellants' have not provided any argument or evidence to establish that they are entitled to additional adjusted basis beyond the \$1,952,438 allowed by FTB. Therefore, OTA finds no error in FTB's determination of the gain adjustment of \$1,455,895 that would negatively impact appellants.

B. Appellants' Sale of Corporate Stock in UGS

According to the recitals of the Stock Purchase Agreement, appellant T. Utman was personally indebted to UGS, which was referenced as the Utman – UGS Loan. The Stock Purchase Agreement provided that appellants, acting as trustees of UFT, agreed to sell and transfer their UGS stock shares in exchange for J. Galardi's agreement to: (a) indemnify appellants, as trustees of UFT, from any obligation under the Utman – La Jolla Bank

²⁷ FTB contends that the proper gain adjustment should be \$1,782,164, which is based on the difference between the amount realized of \$3,408,333 and FTB's determined adjusted basis of \$1,626,169; however, FTB indicated that it will not pursue an additional adjustment for this difference.

Guaranty,²⁸ and (b) forgive and cancel the Utman – UGS Loan. Evidence in the record shows that UGS issued appellant T. Utman a 2010 Form 1099-C reporting COD income in the amount of \$757,500, representing the balance of the Utman – UGS Loan. There was no other consideration exchanged in accordance with the Stock Purchase Agreement.

FTB determined that appellants realized \$757,000 from the sale of their UGS stock, as this represented the liability which, in exchange for the sale of the appellants' UGS stock, J. Galardi agreed to cancel and forgive. However, appellants assert that there should be no amount realized from the sale of their UGS stock. Instead, they claim that the \$757,000 was COD income under IRC Section 61(a)(12) and was excluded because appellants were insolvent pursuant to IRC section 108(a)(1)(B). Here, OTA also determines that appellants have not met the burden of proving error in FTB's proposed assessment related to the sale of corporate stock in UGS.

i. Sale of Corporate Stock

A shareholder of an S corporation, selling stock in a taxable transaction, will realize gain or loss measured by the difference between the amount realized for the stock less the adjusted basis of the stock sold. (IRC, § 1001(a).)

1. Amount Realized

It is well established that the "amount realized" from a sale or disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such disposition, regardless of whether the debt is recourse or non-recourse, subject to certain exceptions. (Treas. Reg. § 1.1001-2(a)(1), (a)(2), (a)(4)(i) & (a)(4)(ii); *Yarbro v. Commissioner*, (5th Cir. 1984) 737 F.2d 479 (*Yarbro*); *Crane v. Commissioner*, (1947) 331 U.S. 1 (*Crane*); *Commissioner v. Tufts*, (1983) 461 U.S. 300 (*Tufts*).) This corresponds to Treasury Regulation section 1.1001-2(a)(1), which, as discussed above, provides that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

According to the Stock Purchase Agreement, appellant T. Utman was personally liable to UGS, and appellants sold their UGS stock to J. Galardi in exchange for J. Galardi's promise to forgive and cancel the Utman–UGS Loan in the amount of \$757,000. Therefore, FTB

²⁸ To reiterate, this Opinion will not address the Utman – La Jolla Bank Guaranty as it pertains to the UGS stock sale because this loan was not included in FTB's computation of appellants' gain on the sale of UGS and it is not at issue on appeal.

determined that appellants' amount realized from the stock sale is \$757,000, which is the amount of debt that was discharged as a result of the sale.

Here, appellants assert that UGS intended to treat the discharge of debt as a separate transaction, not associated with the sale of UGS stock. In other words, according to appellants, the discharge of the Utman – UGS Loan was not a result of the sale or disposition of UGS stock, and should not be included in the amount realized or in the sale proceeds from the sale of their UGS stock. Appellants assert that the \$757,000 should be treated as ordinary income based on the Form 1099-C that was issued by UGS. Appellants also assert that the loans made to Utman from UGS were for deferred compensation.

In deciding whether debt relief results in an amount realized on the sale or disposition of property or COD income, the courts focus on the facts surrounding how the taxpayer-debtor satisfied or extinguished the underlying debt. (*Parker v. Commissioner*, T.C. Memo. 2023-104 (*Parker*) citing *Danenberg v. Commissioner*, (1979) 73 T.C. 370, 381.) If debt relief is conditioned upon a sale or exchange of property or is otherwise part of that underlying sale or exchange, the amount of debt relief is properly included in the amount realized and is not COD income. (*Parker, supra.*) In such an instance, it is immaterial whether debt relief takes the form of an assumption of debt by a purchaser or a cancellation by a lender. (*Ibid.*)

Here, like in *Parker*, the record is clear that the cancellation of the Utman – UGS Loan was part of the sale of the UGS stock by appellants.²⁹ The Stock Purchase Agreement clearly and unambiguously stated that the forgiveness and cancellation the Utman – UGS Loan was “[i]n consideration of, and in exchange for, the sale and transfer of” appellants’ shares of UGS stock to J. Galardi. Appellants provide no other evidence on appeal with regards to their contention that the Stock Purchase Agreement was “drafted in error and should not be determinative” and that the discharge of the Utman – UGS Loan was not a result of the sale of the UGS stock. Appellants also have not provided any evidence on appeal to show that the Utman – UGS Loan was intended for deferred compensation. As such, it remains unclear whether the claim regarding deferred compensation is true, and even if true, appellants have not demonstrated its relevance to excluding the relief of the Utman – UGS Loan from the amount realized on the sale of the UGS stock. To reiterate, unsupported assertions are not sufficient to satisfy appellants’ burden of proof. (*Appeal of Johnson, supra.*) Accordingly, appellants have not established error in FTB’s determination that the amount realized on the sale of UGS stock

²⁹ In *Parker*, the tax court concluded creditor’s forgiveness of the loans at issue was dependent on the sale of the property securing the debt to third-party buyers and was part of the same transaction based in part on the fact that the loan termination agreements with the creditor represented that the loan cancellation was made “[i]n connection with the proposed sale.”

includes the \$757,000 debt relief from the discharge of their liability under the Utman – UGS Loan.³⁰

Stock Basis and Gain

IRC section 1367(a)(1) provides that the basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period: (A) the items of income described in IRC section 1366(a)(1)(A); (B) any nonseparately computed income determined under IRC section 1366(a)(1)(B); and (C) the excess of the deductions for depletion over the basis of the property subject to depletion.³¹ IRC section 1367(b)(2) provides, in relevant part, that the basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period: (A) distributions by the corporation that were not included in the income of the corporation by reason of IRC section 1368; (B) the items of loss and deduction described in IRC section 1366(a)(1)(A); (C) any nonseparately computed loss under IRC section 1366(a)(1)(B); and (D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account.

Here, FTB determined that appellants' basis in the UGS stock was \$328,514, which is comprised of appellants' 2010 tax year beginning stock basis of \$328,901, less \$387 of ordinary loss distribution. On appeal, appellants appear to claim a stock basis of \$328,901, referring solely to the 2010 beginning stock basis, but they did not address the reason that the \$387 ordinary loss distribution should not reduce their stock basis in UGS. In the absence of any credible, competent, and relevant evidence showing that FTB improperly calculated stock basis of \$328,514, OTA sustains FTB's determination. (See *Appeal of Chen and Chi, supra.*) Based on the finding that appellants had an amount realized of \$757,000 and stock basis of \$328,514, FTB properly determined that appellants had a gain of \$428,486 (\$757,000 - \$328,514) from the

³⁰ Appellants assert that the discharge of the Utman-UGS Loan should be treated as a separate transaction, unrelated to the sale of UGS stock. Appellants have not argued and the record does not indicate by the preponderance of the evidence that the sale of UGS stock involved the sale or disposition of property that secures recourse debt exceeding the stock's fair market value, which would require bifurcation of the transaction into: (1) an amount realized under IRC sections 61(a)(3) and 1001, and (2) COD income under IRC section 61(a)(12). (See Treas. Reg. § 1.1001-2(a)(2) & (c), Example 8; *Appeal of Johnson, supra.*) Therefore, OTA need not address further whether the Utman-UGS Loan is: (1) recourse debt exceeding the stock's fair market value; (2) COD income under IRC section 61(a)(12); and/or (3) excluded from gross income under IRC section 108.

³¹ Under R&TC section 17087.5, California generally conforms to IRC sections 1366 and 1367, except as otherwise provided.

sale of their UGS stock. Appellants have not met their burden of showing error in FTB's proposed adjustment relating to the sale of their stock in UGS.

Issue 2: Whether appellants are liable for the accuracy-related penalty.

R&TC section 19164 generally incorporates the provisions of IRC section 6662, which provides for an accuracy-related penalty of 20 percent of the applicable underpayment of tax. (See also *Appeal of Daneshgar*, 2021-OTA-210P.) When FTB imposes a penalty, it is presumed to have been imposed correctly. (*Appeal of Xie*, 2018-OTA-076P.) The taxpayer “bears the burden of proving any defense” to the imposition of the accuracy-related penalty. (*Recovery Group, Inc. v. Commissioner*, T.C. Memo. 2010-76.)

As relevant here, IRC section 6662(b)(2) provides that the accuracy-related penalty applies to the portion of the underpayment attributable to any substantial understatement of income tax. An “understatement” of tax is defined as the excess of the amount of tax required to be shown on the return for the tax year over the amount of tax that is shown on the return, reduced by any rebate. (IRC, § 6662(d)(2)(A)(i)-(ii).) For individuals, an “understatement” constitutes a “substantial understatement” if the amount of the understatement exceeds the greater of either 10 percent of the tax required to be shown on the return or \$5,000. (IRC, § 6662(d)(1)(A)(i)-(ii).)

The accuracy-related penalty does not apply to any portion of an underpayment if it is shown that there was reasonable cause for that portion of the underpayment and the taxpayer acted in good faith with respect to that portion of the underpayment. (R&TC, § 19164(d); IRC, § 6664(c)(1).)³² A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on all the pertinent facts and circumstances. (Treas. Reg., § 1.6664-4(b)(1).) “Generally, the most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability.” (*Ibid.*) An honest misunderstanding of fact or law that is reasonable considering all the facts and circumstances, including the taxpayer’s knowledge and education, may indicate reasonable cause and good faith. (*Ibid.*)

Here, appellants were required to report a total tax of \$103,943 on their 2010 return. Appellants reported tax of \$0 on their 2010 return, which amounts to an understatement of \$103,943. The understatement of \$103,943 is substantial because it exceeds \$10,394, which is

³² This Opinion applies the version of R&TC section 19164(d) in effect for the 2010 tax year, which provided that IRC section 6664, relating to definitions and special rules, shall apply, except as otherwise provided. IRC section 6662(d) provided other exceptions or defenses to the accuracy-related penalty, such as substantial authority and adequate disclosure, that are not relevant to this appeal.

10 percent of the tax required to be reported on appellants' return (\$103,943 x 10 percent), and \$10,394 is greater than \$5,000. FTB thus properly imposed an accuracy-related penalty of \$20,788.60, which is 20 percent of the total understatement of tax of \$103,943.

Appellants argue that the accuracy-related penalty should be abated based on reasonable cause. Appellants assert that they could not afford to consult a tax advisor, and they exercised significant diligence and good faith when they prepared their 2010 federal and California returns. They also assert that, although they read the instructions for preparing individual returns, they had no knowledge of IRS Publication 541 or other relevant commentaries and were not aware of the relevant partnership rules. They further assert that they reported all income and loss items reported to them and they did not receive any form or notice informing them that there was any capital gain incident to the transfer of their interest in Newport Marina. They state that the issues concerning the "transfer of a partnership interest of low or zero value in return for the discharge of recourse debt" may be a case of first impression. They rely on *Williams v. Commissioner* (2004) 123 T.C. 144 (*Williams*), where the court abated the accuracy-related penalty acknowledging that taxpayer had incorrectly attempted to interpret complex bankruptcy and tax laws in a case of first impression. Appellants contend that they recognized COD income of \$757,500 as reported on the Form 1099-C, even though they could have excluded the COD income based on their insolvency pursuant to IRC section 108(a)(1)(B).³³

The most important factor in determining whether appellants acted with reasonable cause and in good faith is the extent of their efforts to ascertain their proper tax liability. (Treas. Reg., § 1.6664-4(b)(1); *Appeal of Steffier*, 2024-OTA-017P.) Appellants present no evidence that they took reasonable steps to ascertain the proper tax treatment of the adjusted items.³⁴ Furthermore, it is well established that the "amount realized" from a disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such disposition, whether the debt is recourse or non-recourse, subject to certain exceptions. (Treas. Reg. § 1.1001-2(a)(1), (a)(2), (a)(4)(i) & (a)(4)(ii); *Yarbro, supra*; *Crane, supra*; *Tufts, supra*.) In fact, Publication 541 even provides that "[i]f the selling partner is relieved of any partnership

³³ While the discharge of indebtedness income of \$757,500 amount was included in appellants' federal AGI, it was not included in appellants' California AGI or taxable income.

³⁴ Appellants have not proffered any evidence and described the specific steps they took to determine the correct amount of gain, such as the research performed, or the resources relied upon where their transactions in this appeal would not result in any gains for California tax purposes. This is especially important for the sale of their membership interest in Newport Marina as the sale of the UGS stock resulted in a net decrease to appellants' taxable income (gain of \$428,486 from appellants' sale of their stock in UGS minus the adjustment to exclude the COD income of \$757,000).

liabilities, that partner must include the liability relief as part of the amount realized for his or her interest.” Therefore, unlike the case in *Williams, supra*, the law requiring the inclusion of discharged liabilities as part of the amount realized from a sale or disposition of property is not a case of first impression. Here, ignorance or a misunderstanding of the law generally does not excuse a taxpayer’s noncompliance with California tax laws. (*Appeal of Wright Capital Holdings, LLC*, 2019-OTA-219P.) Under the relevant facts and circumstances, appellants have failed to prove that they acted with reasonable cause when they understated their tax liability by \$103,943. FTB properly imposed the accuracy-related penalty.

Issue 3: Whether FTB’s proposed assessment is barred by the statute of limitations as provided by R&TC section 19058.

In general, FTB must mail an NPA within four years of the date when the taxpayer files his or her California return. (R&TC, § 19057(a).) R&TC section 19058(a), however, provides that if a taxpayer omits from reported gross income an amount properly included therein that exceeds 25 percent of the reported gross income, FTB may mail an NPA to the taxpayer within six years after the taxpayer files a California return.

It is undisputed that appellants’ reported total California gross income of \$441,056 on their 2010 California return.³⁵ The NPA increased appellants’ reported taxable income by adding gross income of \$1,884,381, which is more than 100 percent of appellants’ reported California gross income. The six-year statute of limitations set forth in R&TC section 19058(a) therefore applies and FTB had until October 15, 2017, to mail an NPA to appellants. FTB issued the NPA on October 4, 2017, which is just under six years from the date when appellants filed their 2010 return on October 15, 2011. The NPA was therefore timely mailed.

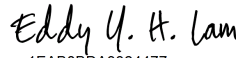
³⁵ This amount includes wages of \$49,570, dividends of \$12, capital gain of \$1,698 reported per appellants’ federal return plus a California adjustment (addition) of \$685, and gross rent of \$389,091. FTB includes “1099 Galardi Group Nonemployee” compensation of \$100,000, “1099 Pacific Skies Estates Nonemployee” compensation of \$68,320, “1099 UGS Debt Cancellation” of \$797,500, and “K-1 Fiscal Therapy Investment Group Distribution” of \$3,408 in its computation of the gross income appellants reported on their California return. While these amounts were included in appellants’ federal gross income as “other income,” as noted in footnote 7 above, these amounts were eliminated from appellants’ California return as a result of the California adjustment of \$631,129 (Schedule CA, Line 21c, column C), which entirely eliminated the amount appellants reported on their federal return as “other income.”

HOLDINGS

1. Appellants have not demonstrated error in FTB's determination to include debt relief in the amounts realized when calculating the gain from the sale of their membership interest in their LLC and the sale of their corporate stock.
2. Appellants are liable for the accuracy-related penalty.
3. FTB's proposed assessment is not barred by the statute of limitations as provided by R&TC section 19058.

DISPOSITION

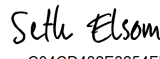
FTB's action is sustained.

DocuSigned by:

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Eddy Y.H. Lam
Administrative Law Judge

We concur:

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Cheryl L. Akin
Administrative Law Judge

Signed by:

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Seth Elsom
Hearing Officer

Date Issued: 2/20/2025