OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **J. MORLEY AND** **L. MORLEY**	OTA Case No. 240917482

OPINION

Representing the Parties:

For Appellants: David R. Davis, CPA

For Respondent: Sonia D. Woodruff, Attorney

For Office of Tax Appeals: Thomas Lo Grossman, Attorney

E. PARKER, Hearing Officer: Pursuant to Revenue and Taxation Code (R&TC) section 19045, J. Morley and L. Morley (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $68,068, and applicable interest, for the 2018 tax year.

Appellants waived the right to an oral hearing; therefore, the matter was submitted to the Office of Tax Appeals on the written record pursuant to California Code of Regulations, title 18, section 30209(a).

ISSUE

Whether appellants have demonstrated error in FTB's determination that appellants received taxable distributions in excess of shareholder stock basis.

FACTUAL FINDINGS

1. Appellant J. Morley is the sole shareholder of two S corporations, California Real Estate Management Corporation (CREM)[1] and JSM Enterprises, Inc. (JSM).
2. Effective January 11, 2015, CREM modified its insurance policy (the policy) issued by The Hartford Fire Insurance Company (Hartford Insurance) to include JSM and CREM

[1] CREM was previously named California Management Company, but for ease of reference, this Opinion will refer to CREM whenever facts relate to California Management Company.

401(k) Savings Plan as two additional "Named Insured[s]." All other terms and conditions remained unchanged, and CREM remained the first "Named Insured" party on the policy. Section VII, subsection O of the policy states, "If more than one 'Named Insured' is named in the Declarations, the first 'Named Insured' will act for itself and every other 'Insured' for all purposes of this Policy." The policy provides coverage for employee theft limited to $500,000.

3. On January 11, 2017, JSM filed a Complaint for Nondischargeability with the Sacramento Division of the United States Bankruptcy Court for the Eastern District of California, alleging that debtor/defendant, who was a former employee, embezzled at least $1,359,469.92 from JSM. JSM argued that the debtors/defendants were not entitled to discharge the debt owed to JSM. The complaint also states that JSM filed a separate complaint related to the alleged embezzlement with the Santa Clara County Superior Court on April 26, 2016, which resulted in the court issuing a writ of attachment and real estate levies on four parcels of real property.
4. A claim was filed with Hartford Insurance for the employee theft.
5. On March 15, 2017, in a letter to Hartford Insurance, JSM provided Harford Insurance a list of the job duties the former employee performed for JSM and CREM, including many financial and accounting duties (i.e., bank reconciliations, bookkeeping, bank transfers, accounts payable). JSM stated, "In that [JSM], and [CREM], and [another entity] are each entities wholly owned by [appellant J. Morley], it was determined that the named Plaintiff would solely be [JSM] for purposes of litigation strategy, and if/when recovery was made, financial allocations to the other related entities/individuals would be undertaken."
6. On June 12, 2018, CREM received a $500,000 deposit;[2] on June 22, 2018, CREM transferred $500,000 to appellants' living trust and recorded the transfer as a distribution to appellant J. Morley.
7. CREM issued appellant J. Morley a 2018 California Schedule K-1 (Schedule K-1) reporting ordinary income of $588,213, and distributions of $1,100,000.
8. Appellants timely filed a joint California Resident Income Tax Return for the 2018 tax year, reporting the Schedule K-1 flow through income from CREM of $588,213. Appellants did not report distributions in excess of shareholder stock basis.

[2] A copy of the bank statement is not included in the record. However, the parties agree that the $500,000 deposit on June 12, 2018, was from Hartford Insurance in settlement of the employee theft claim.

9. FTB audited appellants' 2018 return. FTB determined that appellant J. Morley's shareholder stock basis in CREM was zero at the beginning of 2018,[3] and that appellant J. Morley's shareholder stock basis should be increased by $588,213 to account for his pro rata share of income from CREM. Consequently, FTB concluded that CREM's reported distributions of $1,100,000 resulted in a distribution in excess of shareholder stock basis of $511,787 ($1,100,000 - $588,213), which was a taxable distribution.
10. FTB issued a Notice of Proposed Assessment (NPA), proposing to increase appellants' taxable income by $511,787 to account for the taxable distribution in excess of shareholder stock basis.
11. Appellants timely protested the NPA. On May 4, 2023, during protest, appellants transferred $500,000 to JSM.
12. FTB issued a Notice of Action affirming the NPA.
13. This timely appeal followed.

DISCUSSION

In general, a shareholder's stock basis of an S corporation is increased by their share of pass-through items of income and decreased by their share of pass-through items of loss and deductions, nondeductible expenses, and distributions. (Internal Revenue Code (IRC), § 1367(a)(1)-(2).)[4] The amount of distributions that exceed a shareholder's adjusted basis of S corporation stock shall be treated as a gain from the sale or exchange of property. (IRC, § 1368(b)(2).)[5]

Here, FTB determined that appellant J. Morley's 2018 beginning stock basis in CREM was $0. However, because appellant J. Morley reported income of $588,213 from CREM, FTB increased his shareholder stock basis by the same amount. (See IRC, § 1367(a).) Moreover, since the reported distribution of $1,100,000 was in excess of appellant J. Morley's adjusted

[3] Appellants provided a carryforward schedule indicating that appellant J. Morley's shareholder stock basis was $0 at the end of 2017.

[4] Under the Personal Income Tax Law (PITL), for the 2018 tax year, California conformed to the federal subchapter S rules of the IRC, as of an IRC specified date of January 1, 2015, "relating to the tax treatment of 'S corporations' and their shareholders, shall apply, except as otherwise provided under [the PITL] or [the Corporation Tax Law] (commencing with Section 23001)." (R&TC, §§ 17087.5, 17024.5(a)(1)(P).)

[5] IRC section 1368(c) provides for different treatment of distributions from S corporations that have earnings and profits. Here, neither party asserts that CREM is an S corporation that has earnings and profits; therefore, IRC section 1368(b) applies here.

shareholder stock basis by $511,787 ($1,100,000 - $588,213), FTB treated the $511,787 distribution as a gain from the sale or exchange of property, which is considered taxable income. (See IRC, § 1368(b)(2).)

FTB's determination is presumed correct and a taxpayer has the burden of proving error. (*Appeal of Chen and Chi*, 2020-OTA-021P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid*.)

On appeal, appellants contend that CREM overstated its reported distribution of $1,100,000 by $500,000. Appellants assert that JSM, as a named insured, was the entity that filed the claim under the policy, and that Hartford Insurance "erroneously" paid the $500,000 claim disbursement to CREM instead of JSM. Appellants argue that CREM then "inadvertently transferred" the funds to appellants' personal bank account and recorded it as a distribution to appellants. Appellants claim that CREM discovered the "inadvertent distribution" to appellants in May 2021, during the course of FTB's audit. As a result, appellants argue, CREM updated its books and records to properly account for the receipt of the insurance proceeds as an account payable to JSM, and appellants transferred $500,000 to JSM on May 4, 2023, on CREM's behalf, to satisfy the account payable.

Based on the above, appellants argue that FTB's determination that appellants received a taxable distribution from CREM in the 2018 tax year is incorrect. Appellants' primary arguments are that: (1) upon receipt of the insurance payment, CREM became an involuntary trustee of JSM, and a constructive trust was created; and (2) under the claim of right doctrine, appellants or CREM are entitled to relief under IRC section 1341.[6]

<u>Constructive Trust</u>

A constructive trust applies when a person obtains property to which they are not justly entitled through "fraud, accident, mistake, undue influence, the violation of a trust, or other wrongful act," and that person becomes an involuntary trustee of the property for the benefit of the person who would otherwise have had it. (Cal. Civ. Code, § 2224.) The theory of constructive trust was adopted by equity as a remedy to compel the return of property when the holder of the property is not entitled to the property. (*Bainbridge v. Stoner* (1940) 16 Cal. 2d

[6] During audit, appellants initially argued that the distribution in excess of shareholder stock basis was an "informal" loan to appellant J. Morley as a shareholder. However, appellants provided no documentation in support of this argument, and it appears appellants have abandoned this argument on appeal. Therefore, this Opinion will not discuss the purported loan-to-shareholder argument.

423, 428.) A constructive trust is established if the acquisition of the property was wrongful and the keeping of the property constitutes unjust enrichment. (*Calistoga Civic Club v. City of Calistoga* (1983) 143 Cal.App.3d 111, 116.) However, "[t]he mere fact that income received by a taxpayer may have to be returned at some later time does not deprive it of its character as taxable income when received . . . ." (*Nordberg v. Commissioner* (1982) 79 T.C 655, 665.)

Here, appellants assert that a constructive trust "existed automatically by virtue of the inadvertent and improper payment" to CREM. Appellants argue that CREM and appellants had a legal duty to return the insurance payment, which was obtained "by mistake," to JSM. Appellants contend that they willingly returned the funds to JSM on behalf of CREM because they recognized that CREM held the insurance proceeds as an "involuntary trustee" of JSM. Appellants also argue that they made the proper accounting entries in the books and records of CREM and JSM to rectify the "improper payment," and that appellants had sufficient shareholder stock basis in JSM to receive a nontaxable distribution.[7]

However, appellants have not established that CREM (or appellants) received the insurance proceeds due to "fraud, accident, mistake, undue influence, the violation of a trust, or other wrongful act," or that the keeping of the proceeds by CREM (or appellants) constitutes unjust enrichment. The evidence indicates that Hartford Insurance issued the insurance proceeds to CREM as the primary "Named Insured" on the policy, in accordance with the terms of the policy.[8] CREM then distributed the proceeds to appellants, who are the sole shareholders of both CREM and JSM. Therefore, CREM was rightfully entitled to the payment, and appellants were not unjustly enriched by the distribution.

Moreover, there is no evidence that JSM, CREM, or appellants identified any error in their internal treatment of the insurance proceeds until FTB determined there was a taxable distribution.[9] "[W]hile a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not, and may not enjoy the benefit of some other route he might have chosen to follow but did not." (*Commissioner v. National Alfalfa Dehydrating & Milling Co.* (1974) 417 U.S. 134, 149, internal citations omitted.)

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[7] Appellants provide no evidence in support of their purported shareholder stock basis in JSM.

[8] The policy states that "the first 'Named Insured' will act for itself and for every other 'Insured' for all purposes of [the policy]."

[9] During audit, appellants initially characterized the distribution in excess of shareholder stock basis as an "informal loan" to shareholder appellant J. Morley that was incorrectly reported as a distribution.

Moreover, a gain "constitutes taxable income when its recipient has such control over it that, as a practical matter, [the recipient] derives readily realizable economic value from it." (*James v. U.S.* (1961) 366 U.S. 213, 219, citing *Rutkin v. U.S.* (1952) 343 U.S. 130, 137.) Here, appellants received the distribution of the insurance proceeds on June 22, 2018, and had unrestricted control over the funds. Whether a constructive trust is deemed to exist or not does not affect the determination of whether the distribution is taxable as of the 2018 tax year. (See *Healy v. Commissioner* (1953) 345 U.S. 278, 282-83 [observing that a later year judicial declaration of constructive trust on funds cannot retroactively render funds nontaxable for the year received, when the taxpayer initially had control and economic benefit].)

Based on the foregoing, appellants have not established that a constructive trust was created, and therefore FTB's determination that they received a taxable distribution in excess of shareholder stock basis is correct.

<u>Claim of Right</u>

R&TC section 17049 is California's version of, and substantially similar to, IRC section 1341, which codifies the "claim of right" doctrine concerning disputed income. These statutes address the situation of a taxpayer that pays taxes on income that the taxpayer must later restore because it is established in a subsequent year that the taxpayer did not have an unrestricted right to the income. R&TC section 17049 has three general requirements for the claim of right doctrine to apply: (1) an item of income was included in an individual's gross income for a prior year (or years) because it appeared that the individual had an unrestricted right to that item; (2) the item is later repaid by the individual; and (3) the deduction for the repayment exceeds $3,000. (R&TC, § 17049(a).) The deduction is generally claimed in the year of the repayment and there are special rules for claiming and computing the deduction. (See R&TC, § 17049(a).)

Here, appellants fail to meet the first requirement; i.e., appellants did not include the 2018 distribution in excess of shareholder stock basis in their individual gross income for the 2018 tax year, which they characterize as their prior tax year because the alleged repayment occurred during the 2023 tax year. Appellants assert that CREM included the insurance proceeds in gross income because it appeared CREM had an unrestricted right to the funds before realizing the payment was made to CREM by mistake. Even if appellants' assertion is true,[10] appellants provide no legal authority in support of their position that CREM's purported

[10] The record does not contain evidence supporting appellants' assertion that CREM included the insurance proceeds in gross income. On the contrary, during audit, appellants argued the insurance proceeds were originally recorded as an account payable, not as an item of income.

inclusion of income establishes that appellants meet the first requirement of R&TC section 17049 when appellants failed to report the distribution in excess of shareholder stock basis.

Additionally, appellants have not established the second requirement is met; i.e., they later repaid the distribution because they no longer had the unrestricted right to the distribution.[11] Here, JSM and CREM both were insured under the policy, both were affected by the employee theft that gave rise to the insurance claim, and both entities are wholly owned entities of appellant J. Morley. According to a document provided by appellants, for the purposes of litigation strategy, JSM was the sole plaintiff in the legal filings related to the employee theft. However, as the primary "Named Insured," CREM received the insurance proceeds and distributed the funds to appellants. The record does not indicate that appellants no longer had an unrestricted right to the funds or that they were required to repay the distribution to JSM.

Furthermore, a deduction under R&TC section 17049 is claimed in the year of the repayment. Here, the purported repayment at issue occurred on May 4, 2023. However, the tax year on appeal is 2018. Thus, the claim of right deduction does not apply to the tax year at issue in this appeal.

In conclusion, appellants have not established that FTB erred in determining appellants had a taxable distribution from CREM in excess of shareholder stock basis in the 2018 tax year.

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[11] Appellants base their claim on IRC section 1341(a). Like R&TC section 17049(a), IRC section 1341(a) provides that all three requirements be met in order for a deduction to be allowable for the tax year. However, appellants have not shown that they meet the requirement of IRC section 1341(a)(2), which provides that "it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item[.]"

HOLDING

Appellants have not demonstrated error in FTB's determination that appellants received taxable distributions in excess of shareholder stock basis.

DISPOSITION

FTB's action is sustained.

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Erica Parker
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Erica Parker
Hearing Officer

We concur:

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Veronica I. Long
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Veronica I. Long
Administrative Law Judge

DocuSigned by:
Steven Kim
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Steven Kim
Administrative Law Judge

Date Issued: 3/19/2026