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10 **BOARD OF EQUALIZATION**  
 11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeals of: ) **SUPPLEMENTAL HEARING SUMMARY<sup>2</sup>**  
 13 ) **PERSONAL INCOME TAX APPEALS**  
 14 )  
 15 ) **WILLIAM R. DOBKIN AND** ) Case No. 728014  
 16 ) **DONYA DOBKIN; AND** )  
 17 ) **DEBORAH DOBKIN<sup>1</sup>** ) Case No. 725828

<u>Appellants</u>	<u>Case Nos.</u>	<u>Year</u>	<u>Proposed Additional Tax</u>	<u>Accuracy-Related Penalty<sup>3</sup></u>
William & Donya Dobkin	728014	2006	\$181,348.00	\$36,269.60
Deborah Dobkin	725828	2006	\$121,923.00	

18 For Appellants: Joseph E. Mudd, Esq.  
 19 For Franchise Tax Board: David Gemmingen, Tax Counsel IV

20 <sup>1</sup> For sake of simplicity, the parties sometimes will be referred to herein as William, Donya, and/or Deborah.

21 <sup>2</sup> An oral hearing for these consolidated appeals was held on February 24, 2015. At the conclusion of the oral hearing, the Board granted the parties additional time to file further briefing (i.e., the 30-30-30 process). In addition, the Board requested that the oral hearing be continued upon the completion of the additional briefing.

22 <sup>3</sup> William and Donya are not disputing the accuracy-related penalty. Staff notes that the accuracy-related penalty will be reduced accordingly should the tax deficiency be reduced.

1 CONSOLIDATED APPEALS

2           These consolidated appeals are made pursuant to section 19045 of the Revenue and  
3 Taxation Code (R&TC) from the actions of the Franchise Tax Board (FTB or respondent) on each  
4 appellant's protest of the respective proposed assessments.

5 QUESTION: Whether appellants have substantiated the adjusted basis of their Long Beach home for  
6 the purpose of calculating the gain on the sale of the property.

7  
8 HEARING SUMMARY

9           Background

10           These consolidated appeals arise from determinations by the FTB that appellants owe  
11 additional tax as a result of gain from the sale of a home in Long Beach, California (hereinafter referred  
12 to as the property or the home), in 2006. In 1987, William and Deborah, who were married at the time,  
13 purchased two ocean-front lots in the Naples area of Long Beach, California, for the purpose of building  
14 a home. (FTB Add. Br., 6/27/14, Ex. E.) The home they constructed was three stories tall, with all three  
15 stories above ground level. In addition, the home included a large subterranean basement/garage and  
16 two boat docks. (App. Reply Br., Exhibit of building plans.)

17           After constructing the home and living in it for many years, William and Deborah filed  
18 for divorce, which became final in 2003. Pursuant to the terms of their divorce, William and Deborah  
19 agreed to sell the home and divide the sales proceeds equally, with each party reporting one-half of any  
20 gain from the sale for tax purposes. (FTB Reply Br., Exh. B.) After obtaining a divorce, William  
21 married Donya. Subsequently, the home was sold in 2006 for a price of \$6,300,000. (FTB opening  
22 brief (FTB OB), p. 1.)

23           Deborah filed a 2006 California Resident Income Tax Return, reporting the sale of the  
24 home and California taxable income of \$1,193,853. After reviewing her return, the FTB issued a Notice  
25 of Proposed Assessment (NPA) dated February 15, 2011, increasing Deborah's California taxable  
26 income by \$1,183,714 (i.e., from \$1,193,853 to \$2,377,567) resulting from a reduction in the claimed  
27 adjusted basis of the home that Deborah had used to calculate the gain on the sale of the home. The  
28 NPA proposed an additional tax of \$121,923, plus applicable interest. (FTB Reply Br., 6/27/14, Exs.. A

1 & B.)

2 William and Donya filed a joint 2006 California Resident Income Tax Return, reporting a  
3 home mortgage interest deduction of \$443,711 and California taxable income of -\$28,554, which was  
4 reported as zero. After reviewing their return, the FTB issued a NPA dated February 15, 2011,  
5 increasing William and Donya's 2006 California taxable income by \$1,927,628 to account for (a) a  
6 "basis adjustment residence sold" of \$1,399,922, (b) a disallowed mortgage interest deduction of  
7 \$443,711, and (c) an itemized deduction phase out of \$83,995. The NPA proposed additional tax of  
8 \$181,348 and an accuracy-related penalty of \$36,269, plus applicable interest. (FTB Reply Br., 6/27/14,  
9 Exh. C.)

10 William and Donya concede the home mortgage interest deduction adjustment of  
11 \$443,711 which is not addressed herein. In addition, William and Donya are not disputing the accuracy-  
12 related penalty. Accordingly, the only issue remaining on appeal is whether appellants can substantiate  
13 the adjusted basis of the home. (App. Add'l Br., pp. 1-2.)

14 Contentions

15 Appeal Letter

16 Appellants assert that they spent considerable sums of money constructing the home,  
17 which is located "right on the beach," and has a basement. Appellants also assert that they spent  
18 "significant sums" attempting to locate the builder who will have "significant recollection" of the cost  
19 of construction. In addition, appellants state they "capitalized interest." (App. Ltr., pp. 1-2.)  
20 Appellants attach a schedule of itemized costs as follows:

21

Table 1		
<b>Sales Price</b>		<b>\$6,300,000</b>
Land	1,835,000	
Purchase escrow costs	340,000	
Building	2,500,000	
Architect	250,000	
Replace two docks	25,000	
Extend 220 voltage to docks	1,500	
Other building improvements	75,000	
Replace deck	35,000	
Mahogany cabinets	25,000	

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1	Electrical blinds	20,000	
2	Electrical blinds, additional	20,000	
3	Sound system	12,500	
4	Water heaters	2,500	
5	Cabinets in garage	7,500	
6	Wine cabinets in cellar	7,500	
7	Darkroom cabinets	12,500	
8	Fire pit	12,500	
9	Replace doors	250,000	
10	Installation labor	75,000	
11	Replace decks	20,000	
12	Entertainment center	15,000	
13	Loan interest – capitalized	225,000	
14	Bookshelf	8,500	
15	Buffet	10,000	
16	Chandeliers	28,000	
17	Carpeting	18,000	
18	Desk – Ashley’s room	12,000	
19	Desk – Jason’s room	9,500	
20	Kitchen remodel	9,000	
21	Ceiling fans	6,000	
22	Television – exercise room	3,000	
23	Outside lighting	5,000	
24	Washer – dryer	1,000	
25	Landscaping	250,000	
26	<b>Subtotal</b>		<b>-6,125,500</b>
27			
28	Selling costs (escrow)		-345,066
	Homeowners exemption		-500,000
	Gain (loss) on sale		<b>-\$325,541</b>

Appellants also assert that they have located the architect of the home and the architect will provide testimony as to the cost of building the home if the builder cannot be located. In addition, appellants provide certificates of occupancy with their appeal letter. The first certificate of occupancy is dated March 9, 1988, and states that it was issued for “SHORING FOR DWELLING.” The second certificate of occupancy is dated January 1, 1989, and states that it was issued for “INSTALL GUNITE SPA.” The third certificate of occupancy is dated January 1, 1992, and states that it was issued for

1 “NEW SINGLE FAMILY DWELLING.” The fourth certificate of occupancy is dated March 21, 1994,  
2 and states that it was issued for “124 SQ FT ROOF EXTENSION OVER EXIST DECK.” None of the  
3 certificates of occupancy lists any expenses for construction. (App. Ltr., Exhibits attached.)

#### 4 The FTB’s Contentions

5 The FTB contends that appellants claimed an inflated and unsubstantiated basis in the  
6 home. The FTB asserts that appellants have continually failed to provide any substantiation for their  
7 alleged basis of \$6,125,500, as set forth in the table above. In relation to the certificates of occupancy,  
8 the FTB asserts that a certificate of occupancy simply shows that a home can be occupied and in no way  
9 relates to any costs incurred in the construction of that dwelling. In addition, the FTB states that, in  
10 appellants’ protest letter dated April 15, 2011, appellants’ representative acknowledged appellants’  
11 failure to provide substantiating documentation at the audit when he stated in his protest letter that  
12 “Taxpayer did provide a list of expenses, but without verification.” In addition, the FTB contends that  
13 appellants’ representative stated in a protest letter dated September 30, 2011, that no documentation of  
14 the alleged expenses could be found. The FTB asserts that these “admissions” on appellants’ behalf  
15 nullify appellants’ ability to sustain their burden of proof. (FTB OB, pp. 1-2.)

16 The FTB states that it reviewed Los Angeles County Assessor’s information relating to  
17 the property construction and improvements made from 1988 through 2006 to determine the tax basis  
18 for the home. The FTB states that the property’s assessed value did not annually increase more than the  
19 two percent limit imposed under Proposition 13. The FTB asserts that, because the property was not  
20 assessed for improvements made after the initial construction, it correctly determined that all major  
21 property improvements were completed when the home was built in 1989. (FTB OB, p. 3.)

22 The FTB states that the Los Angeles County Assessor’s office confirmed that  
23 improvements justifying a basis in the property in excess of \$6 million would have certainly been  
24 reported to the County Assessor’s office. The FTB states that Los Angeles County real property  
25 assessment records report that the property’s assessed value was approximately \$3.7 million on July 1,  
26 2006, which the FTB asserts represents a two percent increase per year in compliance with Proposition  
27 13. The FTB states that the county records reflect, and the Assessor’s staff confirmed to the FTB’s  
28 counsel, that from 1988 until 2006 there was no change in ownership and there was no major or material

1 construction reported. (FTB OB, p.3.)

2 The FTB contends that property tax records show that appellants acquired the land in  
3 1987 for \$300,000 and that building permits were obtained from the City of Long Beach from 1987  
4 through 1989. The FTB asserts that permit information shows that the majority of the personal  
5 residence construction commenced right after the 1987 land acquisition. (*Id.*, pp. 3-4.) The FTB  
6 contends that, according to the Assessor's office records, the assessed value of the property in 1988 was  
7 \$1,871,700 for the land and \$783,390 for the improvements, for a total assessed value of \$2,655,090,  
8 (*id.*, p. 4, fn. 1) as follows:

9	Land assessed value	\$1,871,700
10	Improvements assessed value	<u>783,390</u>
	Cost basis allowed	\$2,655,090

11 Based on the foregoing, the FTB asserts that the gain for each appellant from the sale of the property is  
12 computed (*id.*, p. 6) as follows:

13		<u>100%</u>	<u>50%</u>
14	Sales price (July 14, 2006)	\$6,300,000	\$3,150,000
15	Less cost basis	(2,655,090)	(1,327,545)
16	Less closing costs per escrow statement		
17	Credit for repairs	(65,937)	(32,969)
18	Commissions	(252,000)	(126,000)
	Other closing costs	<u>(27,129)</u>	<u>(13,565)</u>
19		\$3,299,844	\$1,649,921
20	Less IRC § 121 exclusion		<u>(250,000)</u>
	Gain		1,399,921
21	Less gain previously reported		<u>0</u>
22	Proposed additional gain for each appellant		\$1,399,921

23 The FTB asserts that, because appellants have not provided supporting documents (such  
24 as contracts, receipts, and/or cancelled checks) substantiating the claimed basis of \$6,125,500, the best  
25 evidence available to support a reasonable basis is the assessed value immediately after the completion  
26 of construction. (FTB OB, p. 4.)

27 The FTB contends, in general, that the amount of the gain to be recognized from a sale is  
28 the excess of the amount of the gain realized from the sale over the adjusted basis of the property sold,

1 citing Internal Revenue Code (IRC) sections 1001(a) and 1011 and the *Appeal of Jacob and Goldie*  
2 *Blanck*, 74-SBE-028, decided on August 1, 1974.<sup>4</sup> The FTB also contends that its determination of tax  
3 is presumed to be correct, and a taxpayer has the burden of proving error, citing the *Appeal of Gordon*  
4 *and June K. Fraser*, 86-SBE-157, decided on September 10, 1986. (FTB OB, pp. 6-7.)

5 Next, the FTB contends that, under IRC section 121, married taxpayers may exclude  
6 gains of up to \$500,000 (and single taxpayers may exclude \$250,000) from the sale of a principal  
7 residence, provided the following requirements are met:

- 8 • The property must have been owned and used by the taxpayer as the taxpayer's principal  
9 residence for a period aggregating two years or more.
- 10 • The gain exclusion applies only to one sale or exchange every two years. (FTB OB, p. 7.)

11 Next, the FTB asserts that appellants failed to provide any evidence establishing that  
12 additional improvements were made and failed to provide any records indicating the cost of such alleged  
13 improvements. The FTB also asserts that appellants failed to satisfy their twin burdens of proof:  
14 (1) proving that the FTB's determination is wrong; and (2) establishing the correct amount of tax.  
15 Accordingly, the FTB asserts that its determination must be sustained. In relation to appellants'  
16 argument that they will provide future testimony (either from the builder or architect), the FTB contends  
17 that such an argument is untimely, conclusory, uninformative, and hinders the FTB's ability to timely  
18 and efficiently process returns. (FTB OB, p. 8.)

19 The FTB argues that, due to the complete absence of factual support that additional  
20 capital improvements were made, appellants' claimed improvement expenditures cannot be allowed.  
21 Also, in relation to any oral representations that appellants are making (or might make in the future), the  
22 FTB contends that such statements are often held to be insufficient to rebut the FTB's presumption of  
23 correctness because skepticism is "reinforced, in modern times, by the ubiquitous paper trail of virtually  
24 all commercial activity," citing *Woodland Trust v. Flowertree Nursery, Inc.* (Fed. Cir. 1998) 148 F.3d  
25 1368, 1373. In addition, the FTB contends that appellants' unsupported assertions are insufficient to  
26 carry their burden of proof, citing the *Appeal of James C. Monablance A. Walshe*, 75-SBE-073,  
27

28 <sup>4</sup> Board of Equalization cases are generally available for viewing on the Board's website ([www.boe.ca.gov](http://www.boe.ca.gov)).

1 decided on October 20, 1975. (FTB OB, pp. 8-9, fn. 5.)

2 The FTB states that appellants must provide reliable and precise factual evidence  
3 showing that they incurred the alleged improvement expenditures, citing *Vaira v. Commissioner*  
4 (3rd Cir. 1971) 444 F.2d 770. In addition, the FTB states that Treasury Regulation section 1.6001-1(a)  
5 requires that taxpayers “keep such permanent books of account or records, including inventories, as are  
6 sufficient to establish the amount of gross income, deductions, credits, or other matters required to be  
7 shown by such person in any return of such tax or information.” The FTB reiterates that it allowed a  
8 basis of \$2,655,090; and the FTB asserts that appellants have not have not provided evidence  
9 substantiating the remaining claimed expenses of \$3,470,410. The FTB asserts that, given the relatively  
10 large amount of the claimed additional basis, appellants’ disregard for their compulsory record-keeping  
11 duties is especially unreasonable. (FTB OB, pp. 12-13.)

12 The FTB reiterates that its determination of tax is presumed to be correct, and a taxpayer  
13 has the burden of proving error, citing the *Appeal of Robert V. Erilane*, 74-SBE-050, decided on  
14 November 17, 1974. Also, the FTB contends that, when a taxpayer fails to provide ascertainable  
15 evidence in the taxpayer’s favor, the evidence is presumptively considered unfavorable to the taxpayer’s  
16 case, citing the *Appeal of Don A. Cookston*, 83-SBE-048, decided on January 3, 1983. (FTB OB, p. 14.)

#### 17 Appellants’ Reply Brief

18 Appellants assert that they kept all of the records of repair and construction for many  
19 years but apparently those records were discarded while moving during a divorce. Appellants contend  
20 that the only evidence that they have regarding the cost of the premises is their own testimony, the  
21 pictures attached to the declaration of Deborah Dobkin, and a declaration from their builder,  
22 William Merrill which they state had not yet been received as of the date they filed their reply brief. In  
23 relation to Mr. Merrill, appellants contend that Mr. Merrill has no specific records concerning the  
24 construction contract, but he does recall that the costs were very high due to quality, demands, the  
25 subterranean basement, and the size of the property. Appellants assert that Mr. Merrill indicated that  
26 Deborah Dobkin’s estimate of costs of \$2,500,000 (as set forth in her declaration, below) is “not  
27 unrealistic.” Appellants state that, since the FTB made no adjustment for Deborah Dobkin’s interest  
28 deduction, appellants are under the impression that the FTB is only disallowing interest on the loan

1 balance in excess of \$1 million. (App. Reply Br., pp. 1-2.)

2 Appellants contend that the records in this appeal which were retained for years, lost any  
3 significance to Deborah Dobkin and they were unavailable and not reproducible at the time of the audit.  
4 Appellants assert that Deborah Dobkin did not retain the records because she believed that all warranties  
5 had expired and she was only required to retain the records for seven years for tax purposes. Appellants  
6 contend that the court in *Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 840, held that reasonable  
7 testimony of costs and expenses, if credible, can be used to substantiate expenses incurred when records  
8 are not available. Appellants assert that the information and/or declaration provided by Deborah Dobkin  
9 attached to the brief is credible testimony. (App. Reply Br., pp. 1-2.)

10 Deborah Dobkin's Declaration

11 In her declaration, Deborah states that she and William constructed the home from 1987  
12 through 1989 at great expense. She states that she retained documents that were related to the  
13 construction for many years and that several boxes containing all of the contracts, receipts, checks,  
14 permit applications and warranties were stored in boxes and kept at the home until she moved out of the  
15 home in 2005. She states that she did not realize she had to retain such documents beyond seven years  
16 for tax purposes. She asserts that, during the building, modifications, and subsequent additions, she kept  
17 a summary of the total expenses, which are comprised in the following three categories:

18	Land	\$1,835,000
19	Home	\$2,500,000
20	Improvements	<u>\$ 678,500</u>
	<b>Total</b>	<b>\$5,013,500<sup>5</sup></b>

21 She asserts that three above-listed categories can be broken-down further as follows:

22 Table 2	
23 Land	\$1,835,000
24 Home (8,000 sq. ft. with 3,000 additional sq. ft. underground)	2,500,000
25 Replace two docks	25,000
26 Extend 220 voltage to docks	1,500

27 <sup>5</sup> Staff notes that, in Table 2 below, Deborah lists the following amounts totaling \$5,036,500: land of \$1,835,000, home of  
28 \$2,500,000, and improvements of \$701,500. Appellants do not explain the discrepancy between the amount of \$5,013,500  
and the amount of \$5,036,500 (a difference of \$23,000).

1	Replace two decks, upgrade waterproofing, repair water damage to family room, living room, master bedroom	75,000
2	Replace deck and extend roof over third floor deck at kid's room	35,000
3	Install built-in mahogany cabinets in office	25,000
4	Install automatic electrical blinds in family room, move power	20,000
5	Install automatic electrical blinds in master bedroom, move power	20,000
6	Install surround sound in walls of family room, repair walls	12,500
7	Replace water heaters with rapid heater	2,500
8	Built cement block cabinets in garages	7,500
9	Install mahogany wine racks in wine cellar	7,500
10	Install darkroom cabinets, plumbing, and electrical in photo room	12,500
11	Install fire pit in courtyard, provide gas and electrical controls	12,500
12	Replace all wood and glass doors (app. 50) with custom made mahogany and glass doors	250,000
13	Install above, repair walls and drywalls, provide new hardware	75,000
14	Replace and upgrade first floor deck off dining room x 2	10,000
15	Replace moveable television and entertainment center master bedroom	15,000
16		
17	<b>Deborah's Additions</b>	
18	Custom bookshelf – 1st floor family room	8,500
19	Custom buffet – 1st floor dining room	10,000
20	Custom chandeliers x 2	14,000
21	Replace Berber carpeting	18,000
22	Custom desk and shelf units in Ashley's room	12,000
23	Custom desk and shelf units in Jason's room	9,500
24	Repaint second floor kitchen	8,000
25	Install ceiling fans x 6	6,000
26	Built-in TV in exercise room	3,000
27	Replace all wall outside light fixtures	5,000
28	Replace washer/dryer	1,000
	<b>TOTAL</b>	<b>\$5,036,500</b>

21 She also asserts that interest expense over and above the amount allowed as a deduction  
22 can be capitalized and added to the basis of the property. She states that, after the tax return for the year  
23 in which the property was sold was completed, her list of basis expense items was delivered to her  
24 accountant and her ex-husband relied upon her summary in the preparation of his tax return. She asserts  
25 that after the FTB began its audit, (i) she could not locate the actual records of construction, (ii) bank  
26 account records were no longer available, and (iii) she could not locate the builder. Attached to her  
27 declaration are floor plans of the home, along with pictures of the property.

28 ///

1                    The FTB's Reply Brief

2                    The FTB states that, according to Los Angeles County Assessor's records, appellants  
3 acquired the land in 1987 for a purchase price of \$300,000. In addition, the FTB states that building  
4 permits dated from 1987 to 1989 show that the majority of construction occurred soon after the 1987  
5 acquisition of land. The FTB reiterates that the Assessor's records indicate that in 1988 the assessed  
6 value of the land was \$1,871,700 and the assessed value of the improvements was \$783,390, which is  
7 consistent with the building permits filed with the City of Long Beach. Based on the foregoing, the FTB  
8 states that the FTB auditor determined that \$2,655,090 (i.e., \$1,871,700 + \$783,390) was the adjusted  
9 basis of the property. The FTB states that it is important to note that in their reply brief appellants agree  
10 that the home's construction occurred during the years 1988 and 1989, as evidenced by their statement  
11 that "17 years after construction, the records were destroyed." (FTB Reply Br., p. 1.)

12                    The FTB asserts that a supplemental assessment was never issued and the property was  
13 not reassessed after 1988. The FTB explains that a supplemental assessment must be added to a  
14 supplemental tax roll whenever new construction is completed and whenever real property is transferred,  
15 citing Chapter 3.5 to Part 0.5 of Division 1 of the Revenue and Taxation Code. In addition, the FTB  
16 states that R&TC section 70 provides, in part, that new construction means (1) any addition to real  
17 property, and (2) any alteration of land or any improvement. The FTB contends that the reassessment of  
18 a property is required pursuant to R&TC section 71 upon the completion of new construction as defined  
19 by R&TC section 70. If appellants had completed any new construction after 1988, the FTB contends  
20 that the property would have been reassessed and a supplemental assessment would have been issued.  
21 (FTB Reply Br., pp. 1-2.)

22                    The FTB contends that appellants' allegation that they disposed of the property records in  
23 2005 because they were unaware of the need to retain such records conflicts with the divorce agreement,  
24 filed in 2003, in which Deborah and William acknowledged they would be responsible for reporting  
25 their share of the taxable gain on the sale of the home. (A copy of the applicable divorce agreement is  
26 attached to the FTB's reply brief as Exhibit B.) The FTB asserts that appellants had a duty to retain  
27 records. (FTB Reply Br., p. 3.)

28                    The FTB contends that appellants simply offer a "conjectured observation" from

1 William Merrill who has no records to support his statement that the home's construction cost of  
2 \$2,500,000 is "not realistic." The FTB asserts that appellants provide no foundation for Mr. Merrill's  
3 statement. In addition, the FTB asserts that Mr. Merrill is not offering his own opinion as to costs but is  
4 merely offering "a vague and self-serving opinion" with respect to Deborah's unsubstantiated opinion.  
5 Also, the FTB notes that, as of the date of the FTB's reply brief, appellants had not provided a  
6 declaration from Mr. Merrill. Next, the FTB notes that appellants are alleging a cost basis in the land of  
7 \$1,835,000. The FTB asserts, however, that appellants have not substantiated such a grossly inflated  
8 cost basis in the land of \$1,835,000.<sup>6</sup> (FTB Reply Br., pp. 4-5.)

9           With regard to the Cohan rule, the FTB contends that, where a taxpayer has established  
10 that he or she has incurred an expense for which a deduction may properly be claimed, but is unable to  
11 document the exact amount of the expense, a reasonable estimate of the deduction may be made in  
12 certain circumstances, weighing heavily against the taxpayer whose inexactitude is of his own making,  
13 citing *Cohan v. Commissioner, supra*. The FTB asserts that, although the Cohan rule was articulated  
14 with respect to estimating expense deductions, the Tax Court has relied on it for purposes of estimating  
15 the adjusted basis of property with respect to improvements, citing *Minchew v. Commissioner* (1953)  
16 12 T.C.M. 1107. (FTB Reply Br., pp. 5-6 & 9-10.) The FTB asserts that it has made a reasonable  
17 estimate of expenses in granting a basis of \$2,655,090 in the property, and the FTB contends that the  
18 Board has selectively applied the Cohan rule, primarily only when a deduction has been entirely  
19 disallowed by the FTB, and not when a deduction has been partially or substantially allowed, citing the  
20 *Appeal of Henrietta Swimmer, Executrix, et. al.*, 63-SBE-138, decided on December 10, 1963; *Appeal of*  
21 *California Steel, Inc.*, 2003-SBE-001, decided on July 9, 2003; *Zeidler v. Commissioner*, T.C. Memo.  
22 1996-157, *aff'd*, (7th Cir. 1997) 132 F.3d 37. (FTB Reply Br., pp. 5-6 & 9-13.) The FTB asserts that  
23 appellants have not provided any credible evidence demonstrating a cost basis in excess of the  
24 \$2,655,090 that the FTB allowed based on Los Angeles County property tax records. Accordingly, the  
25 FTB asserts that the Board should not find error in the FTB's proposed assessments. (FTB Reply Br.,  
26 pp. 5-6 & 13-14.)

27 \_\_\_\_\_  
28 <sup>6</sup> Staff notes that the FTB auditor (and the FTB's proposed assessment) allowed a cost basis in the land of \$1,871,700, which is greater than the \$1,835,000 that appellants are asserting on appeal.

1 In further support of the proposed assessments, the FTB cites a September 23, 1993  
2 appraisal report prepared by “Dwyer Appraisal” as part of a loan refinance for the property. (A copy of  
3 the appraisal report is attached as Exhibit D to the FTB’s reply brief.) The FTB states that the appraisal  
4 report is “objective” and “disinterested” and was prepared “without tax considerations” in mind. The  
5 FTB states that, as part of the determination of value for refinancing the home in 1993, the appraiser  
6 undertook various methods of determining valuation, including his “Estimated Reproduction Cost-New  
7 of Improvements” found at the top right corner of the relevant appraisal page in the “Cost Approach.”  
8 The FTB notes that the appraiser’s 1993 new construction cost estimate, based on “estimates . . . from  
9 Marshall & Swift, as well as information provided by Local Builders/Contractors,” found that, as of  
10 1993, the cost to rebuild the property would be \$2 million. Based on the foregoing, the FTB asserts that  
11 its determination to allow a basis of \$2,655,000 falls in line with the 1993 appraisal. (FTB Reply Br.,  
12 pp. 12-13.)

13 With respect to the photographs that appellants provide with their reply brief, the FTB  
14 asserts that appellants have not provided a foundation for those photographs, establishing who took the  
15 photographs and/or when the photographs were taken. Based on the foregoing, the FTB asserts that the  
16 photographs should be disregarded. (FTB Reply Br., p. 14.)

17 Appellants’ Additional Brief

18 In an additional brief dated January 7, 2014, appellants contend that they have contacted  
19 Mr. Merrill and he is still attempting to reconstruct costs of construction, “which he will testify to be  
20 much higher than normal square footage expenses.” Next, appellants contend that they have located a  
21 “proof of purchase” for one of the two lots at issue. Appellants reference a grant deed recorded on  
22 March 20, 1987, which they assert shows that their records are more accurate than the FTB’s suggested  
23 values. The grant deed shows a transfer tax of \$330 for one of the lots. In addition, appellants provide  
24 an email dated November 27, 2013, from Mark Manwaring, who states that the grant deed is computed  
25 not as full value but “less liens” which means that appellants paid \$300,000 but assumed a loan from the  
26 seller with an origination amount of \$802,500. Based on the foregoing, Mr. Manwaring speculates that  
27 the true purchase price of the property would have been “somewhere in the neighborhood” of  
28 \$1,100,000, depending on what was owed on the assumed loan. (App. Add’l Br., Exhibit attachment.)

1 Appellants assert that during the audit the FTB did not allow expenses for expanding the  
2 roof over the deck areas because appellants did not provide a copy of a building permit. Appellants  
3 point to the certificates of occupancy, attached to their appeal letter, as support for the expenses for  
4 expanding the roof over the deck. Also, appellants contend that additional work was completed without  
5 permits. For example, appellants assert that all windows and doors were replaced. In addition,  
6 appellants contend that there were other expenses that are not reflected on permits, such as the cost of  
7 replacing the boat dock. Appellants state that they had hoped to have specific information from  
8 Mr. Merrill by the filing of their additional brief dated January 7, 2014, and are still trying to obtain  
9 further evidence. Finally, appellants contend that they are not directly disputing the accuracy-related  
10 penalty as they believe there is no tax deficiency and thus the penalty is not applicable. (App. Add'l Br.,  
11 pp. 1-2.)

#### 12 Additional Briefing Request

13 In a letter dated May 23, 2014, the Appeals Division staff requested that appellants  
14 provide copies of all documents supporting their contentions, including the declaration of Mr. Merrill.  
15 In addition, staff noted that the auditor's determination that appellants had an adjusted basis in the land  
16 of \$1,871,700 which is greater than the \$1,835,000 adjusted basis for the land that Deborah Dobkin is  
17 asserting in her declaration. Accordingly, staff requested that appellants state whether they are willing  
18 to agree on an adjusted basis in the land of \$1,871,700, as the FTB auditor determined.

19 Staff also noted that, on page six of the FTB's opening brief, the FTB auditor determined  
20 \$2,655,090 as appellants' adjusted basis in the property—i.e., \$1,871,700 for the land and \$783,390 for  
21 the improvements based on the Los Angeles County Assessor's records for 1988. In comparison, staff  
22 noted that the appraisal report, which valued improvements to the property using a reconstruction cost  
23 method, estimated that the reproduction costs of "improvements" on the property would have been  
24 \$2 million as of September 23, 1993 (the date of appraisal). Based on the appraisal report, staff  
25 requested that the FTB discuss whether its auditor should have allowed an adjusted basis of \$2 million  
26 for the improvements instead of only \$783,390.

#### 27 The FTB's Additional Brief dated June 27, 2014

28 The FTB asserts that the Board should not use the appraisal report to estimate the

1 improvements that were made to the property because the \$2 million referred to in the appraisal report is  
2 not an adjusted basis amount and the appraisal report was not prepared to determine appellants' adjusted  
3 basis, but rather was prepared for a third-party lender to establish the fair market value of the property as  
4 of September 23, 1993, five years after the home was built. The FTB also asserts that the \$2 million  
5 reconstruction cost amount referred to in the appraisal report would have been affected by "inflation and  
6 other market factors, influences that are not permitted to affect a property's adjusted basis." (FTB  
7 Add'l Br., p. 2.)

8           The FTB states that recent swings of property values in California demonstrate the  
9 difference between fair market value and cost basis. Specifically, the FTB states that many homes  
10 purchased in California in 2006 were purchased at a price (which establishes basis pursuant to IRC  
11 section 1012) that exceeded the 2011 value of the homes, and many of those homes were purchased with  
12 loans of the entire purchase price, some with interest-only payments. Because home values experienced  
13 large declines between 2006 and 2011, the FTB asserts that it is apparent that a home's adjusted basis  
14 established in 2006 is not reflected by its 2011 fair market value. Thus, the FTB contends that the cost  
15 that a buyer paid for a home in 2006 is irrelevant to a lender considering whether to extend a new loan in  
16 2011. (FTB Add'l Br., p. 2.)

17           The FTB asserts a property's fair market value fluctuates depending on current market  
18 conditions while a property's adjusted basis is determined by the qualifying construction and  
19 improvement costs. The FTB argues that it would be wrong to determine the adjusted basis using a  
20 property's fluctuating fair market value. The FTB argues that the appraisal report was performed for an  
21 independent business transaction contemplated in the fall of 1993 and to determine the property's fair  
22 market value—not the property's adjusted basis. The FTB asserts that an estimate of the fair market  
23 value of the property in 1993 cannot act as a substitute for appellants' adjusted basis in such property.  
24 The FTB asserts that, under IRC section 1001, a gain on the sale of property is generally equal to the  
25 excess of the amount of the money received over the adjusted basis of the property. The FTB contends  
26 that "IRC section 1001 does not look to the property's later wavering and estimated value, or ensuing  
27 and hypothetical reconstruction costs in determining gain, but rather its adjusted basis." (FTB Add'l  
28 Br., p. 3.)

1           The FTB also contends that several statements in the appraisal report are instructive as to  
2 why the FTB auditor should not have allowed an adjusted basis (for improvements) of \$2 million.  
3 Specifically, the FTB asserts that the appraisal report states that the purpose of the appraisal is to  
4 estimate the fair market value of the property (not appellants' adjusted basis), and that the appraisal is  
5 for the sole and exclusive use of the lender/client. Furthermore, the FTB notes that the appraisal report  
6 states that "[b]ecause the purpose of this report is to determine market value . . . the tax liability at the  
7 present time may change should the property be sold or purchased." Based on the foregoing statement,  
8 the FTB concludes that:

9           Mr. Dwyer acknowledges and recognizes that [the] appraised value may change upon a  
10 new acquisition, which would reflect a new adjusted cost basis, notes that his appraisal is  
11 concerned with only a determination of [the] fair market value for his client, the  
12 contemplated lender, and that the property taxes currently assessed on the property were  
13 imposed based on prior acquisition costs, are capped and subject to Proposition XIII  
14 limitations, and could change, not as a result of his appraisal, but by a later sale or  
15 purchase.

14 (FTB Add'l Br., p. 4.)

15           Appellants' Additional Brief dated July 7, 2014<sup>7</sup>

16           Appellants assert that the adjusted basis of the property should include amounts to extend  
17 the roof covering the upstairs decks. In this respect, appellants state that "[i]t has been demonstrated  
18 that a permit was received to extend the roof covering the upstairs decks" and "[t]he FTB had denied  
19 that such permits existed, but has still failed to increase [the] basis by any amount." As to the existence  
20 of a subterranean basement, appellants state that the existence of the basement is a fact, whether or not  
21 the existing records show that such a basement exists, as appellants and Mr. Merrill testify to its  
22 existence. Appellants state that Mr. Merrill recalls in his declaration that the cost to build the home, due  
23 to its extravagance, was \$350 per square foot, which appellants assert is very close to the cost appellants  
24 have asserted on appeal. Appellants contend that they are willing to stipulate to an adjusted basis in the  
25 land of \$1,871,700, as indicated by the FTB's auditor and as mentioned in staff's request for additional  
26 briefing. (App. 2nd Add'l Br, pp. 1-3, Declaration Exhibit.)

27 \_\_\_\_\_  
28 <sup>7</sup> Appellants assert that "Dr. Dobkin is willing to concede the home interest adjustment."

1 In relation to the Cohan rule, appellants assert that the Board should review the records  
2 from a “common sense” understanding and make a reasonable approximation. Appellants contend that  
3 the lists of costs set forth by Deborah Dobkin in her declaration is extensive and reasonable, as the list  
4 was compiled years earlier from records that were subsequently discarded. Finally, appellants’  
5 representative makes the following statement: “. . . a question arises as to whether depreciation interest  
6 payments on a home mortgage which were not deductible are added to its basis. I do not believe this has  
7 been answered by the Board. However, it should be a suspended basis similar to passive loss interest.”  
8 (App. 2nd Add’l Br., pp. 1-3.)

9 Mr. Merrill’s Declaration

10 In his declaration, Mr. William Merrill states the following: In the 1980s, he was a  
11 builder of luxury homes in California and was the general contractor and builder of the home for  
12 William and Deborah Dobkin. The home was built on two lots with direct waterfront access. The home  
13 was approximately 8,000 square feet and contained a large, approximately 3,000 square foot,  
14 subterranean basement. It took a considerable amount of time to obtain the necessary permits to build  
15 the subterranean basement, and the building and waterproofing of the basement was an expense that  
16 would not normally be associated with a home in that area. The home was constructed of the most  
17 expensive materials available at the time, and the detail on the home was considerable, including doors,  
18 windows, molding, lighting, and decks. After the original construction was completed, he was then  
19 hired to expand the roofing over the decks. Although this task was completed approximately 25 years  
20 ago, the expense associate with the home was considerable—more than any other home he built in  
21 California around that time. Even though he no longer has records related to the construction, he clearly  
22 remembers that the square foot cost of construction was approximately \$350.

23 Although the cost of \$350 per square foot would have been high for construction at the  
24 time, the subterranean basement (along with the quality of the materials) chosen caused the home’s  
25 construction costs to be very high. The \$350 per square foot amount includes the building, the decks,  
26 deck improvements, expensive custom cabinets, a wine cellar, a darkroom, electrical window coverings,  
27 a built-in sound system, oversized water heaters, built-in bookshelves, chandeliers, carpeting, and  
28 finishing. The work he performed did not include landscape, hardscape, boat dock, appliances,

1 electronics, furniture, outside lighting, or personal items. (App. 2nd Add'l Br., Declaration Exhibit.)

2 The FTB's Supplemental Brief dated September 19, 2014

3 The FTB states that the home is currently for sale and public information shows that the  
4 "alleged watertight basement" is actually a drive-in car garage located under the house. The FTB  
5 disputes appellants' contention that the FTB denied the existence of building permits as evidenced by  
6 three attached letters in which the FTB requested relevant and supporting information from appellants  
7 regarding improvements to the property. (FTB Supp. Br., p. 1.)

8 The FTB asserts that construction costs were taken into account and reflected in the  
9 records from the Los Angeles County Assessor's office which the FTB utilized to determine appellants'  
10 adjusted basis in the property. The FTB asserts that appellants could have timely contested and  
11 corrected the tax records when the home was being built if they believed those records were erroneous,  
12 but they failed to do so. (FTB Supp. Br., p. 2.)

13 With regard to the declaration, the FTB contends that it is not surprising that  
14 Mr. Merrill's distant recollection from 25 years ago, which is not based on records or a recent inspection  
15 of the property, almost exactly matches appellants' claimed but unsubstantiated basis. The FTB  
16 contends that Mr. Merrill's declaration is contradicted by Los Angeles County Assessor's office records,  
17 which the FTB asserts are more reliable than Mr. Merrill's unsupported estimate 25 years after the date  
18 of construction. The FTB further contends that Mr. Merrill's declaration does not discuss any  
19 subsequent improvements, but simply ascribes a blanket cost of \$350 per square foot for all expenses,  
20 which the FTB asserts is questionable and excessive in light of "the alleged basic subsequent  
21 improvements such as an extended balcony, as proposed by Appellants." (FTB Supp. Br., p. 2.)

22 The FTB argues that the declarations by Deborah Dobkin and Mr. Merrill are  
23 unsupported and thus do not satisfy appellants' burden of proof. The FTB contends that, when applying  
24 the Cohan rule, it is not required to accept the estimates made by a taxpayer, citing *Williams v.*  
25 *United States* (5th Cir. 1957) 245 F.2d 559, 560, and is not compelled to guess. Instead, the FTB  
26 contends that it is entitled to make its own estimates based on available evidence, bearing heavily  
27 against a taxpayer whose inexactitude is of his/her own making, citing *Cohan v. Commissioner, supra.*  
28 In addition, the FTB argues that the government's estimates are to be favored over estimates of

1 taxpayers because any estimation made by the government is more favorable than the taxpayer would  
2 otherwise be entitled to with no documentation, citing *Cohan v. Commissioner, supra*. In fact, the FTB  
3 asserts that its estimate is to be favored even where there is no basis given for the estimate, or even if the  
4 estimate seems arbitrary, citing *Lollis v. Commissioner* (9th Cir. 1979) 595 F.2d 1189, 1190-1191. The  
5 FTB contends that oral testimony and estimates made by a taxpayer's representatives have been found to  
6 be insufficient to overturn Cohan rule estimates made by the government. The FTB contends that it has  
7 fully applied all estimates that are appropriate under the Cohan rule, as the FTB asserts it recognized that  
8 a home was constructed and the FTB utilized existing property tax records (which show that the  
9 property was not reassessed). (FTB Supp. Br., pp. 2-3.)

10 In regard to appellants' statement in their additional brief that "... a question arises as to  
11 whether depreciation interest payments on a home mortgage which were not deductible are added to its  
12 basis," the FTB asserts that interest is a deduction only if it meets applicable statutory grounds and is not  
13 considered in a home's basis, as that could create an ever inflating basis with respect to a home  
14 purchased with borrowed funds that are not eligible for the qualified home mortgage interest deduction.  
15 (FTB Supp. Br., p. 3.)

16 Appellants' Supplemental Brief dated September 18, 2014

17 Appellants state that they obtained images of the subterranean garage from the website  
18 Zillow<sup>8</sup> which are an attachment to their additional brief.<sup>9</sup> Appellants contend that the pictures support a  
19 finding that the property's square foot value today is well over \$1,000. Appellants state that the Zillow  
20 information describes amenities, such as a 4-stop elevator, two full gourmet kitchens, two laundry  
21 rooms, two open water boat docks, and eight bathrooms. Appellants contend that the pictures and  
22 information taken from the website Zillow clearly support appellants' alleged expenses. (App. Supp.  
23 Br., pp. 1-2.)

24 Board Member Inquiry before the February 24, 2015 Board Hearing

25 Prior to the Board hearing that took place on February 24, 2015, the Appeals Division  
26

27 <sup>8</sup> The website address is [www.zillow.com](http://www.zillow.com).

28 <sup>9</sup> Appellants also attach images of the front of the property.

1 received a request from a Board Member, asking the parties for additional information and evidence in  
2 this appeal pursuant to California Code of Regulations, title 18, section (Regulation) 5435, subdivision  
3 (b). Both parties were asked the following:

4 The Dwyer appraisal (dated September 23, 1993) estimated the cost of reconstructing the  
5 improvements on appellants' property in 1993 as being \$2,000,000. The Franchise Tax  
6 Board (FTB) acknowledged that the Dwyer appraisal is objective, disinterested, and was  
7 prepared without tax considerations in mind. The FTB, however, argues that this  
8 appraised value cannot be used to approximate appellants' adjusted basis because this  
9 amount is affected by inflation and other market factors.

10 With such in mind, the parties are requested to provide a response to the  
11 following. According to an inflation calculator, \$1 in 1993 had the value of \$0.81 in  
12 1988, for a total inflation between those years of 22.96%. (See  
13 <http://www.dollartimes.com/inflation/inflation.php?amount=1&year=1988>.) It appears  
14 that \$2,000,000 in 1993 had the value of \$1,540,800 in 1988 (i.e., \$2,000,000 –  
15 (\$2,000,000 \* 0.2296)). Please discuss whether the Board should use this adjusted value  
16 (i.e., \$1,540,800) as an estimate of the cost of reconstructing the improvements in 1988  
17 for purposes of calculating appellants' adjusted basis in the house.

18 After sending the above-listed inquiry to the parties, the following clarification was also sent to the  
19 parties to provide additional context when responding to the inquiry:

20 The parties have agreed that appellants' basis in the land is \$1,871,700. The dispute in  
21 the appeal is only over the tax basis of the improvements.

22 The potential methodology raised by the Board Member's office would allow a total  
23 adjusted basis of \$3,412,500 (the basis in the land of \$1,871,700 plus a basis in the  
24 improvements of \$1,540,800). This is the total basis that the parties are being asked to  
25 address.

26 If either party believes that this potential methodology is problematic or raises concerns,  
27 the party should address such in its response to this inquiry.

#### 28 The FTB's Response to Board Member Inquiry

The FTB states that it has never agreed that appellants' basis in the land is \$1,871,700,  
and it has consistently maintained that appellants acquired the land for \$300,000. In support of the land  
acquisition price of \$300,000, the FTB provides Los Angeles County property tax records, showing that  
appellants purchased the land (i.e., the two lots) in 1987 for a total purchase price of \$300,000. (FTB  
Resp. Bd. Inq., p. 2 & Ex. C.)

1           The FTB asserts that in its opening brief (at page three, line 24) and in its reply brief (at  
2 page one, lines four and five) it clearly stated that “Appellants acquired the land in 1987 for a purchase  
3 price of \$300,000”. (FTB Resp. Bd. Inq., p. 2 & Exs.. D & E.) The FTB then contends that appellants  
4 (i) have always been circumspect about their initial cost basis, (ii) have never provided third-party  
5 documents confirming their initial purchase price in 1987, and (iii) neglected to provide a cost or  
6 adjusted basis for the property in their returns. Also, the FTB asserts that Mr. Dobkin even failed to  
7 report the sale of the home for \$6.3 million in his 2006 tax return. In addition, the FTB states that  
8 Deborah Dobkin’s 2006 Schedule D (and its corresponding attachment), while alluding to the sale of the  
9 property, fails to include both the sales price and cost or other basis for the property. The FTB also  
10 asserts that its consistent use of the sales price of \$300,000 is evidenced by the auditor’s November 18,  
11 2010 letter, which states that, according to “information available to the Franchise Tax Board, your  
12 client acquired the land in 1987 for a purchase price of \$300,000.” (FTB Resp. Bd. Inq., p. 2.)

13           Next, the FTB contends that, based on assessment records, the land (i.e., the two lots)  
14 was purchased for a total purchase price of \$300,000 in 1987. Also, the FTB contends that assessment  
15 records show that in 1988 the Los Angeles County Assessor’s Office assessed the land at \$1,871,700  
16 and the improvements at \$783,390—for a total assessed value of \$2,655,090. The FTB contends that  
17 the assessed value in 1988 (which the FTB contends occurred after the construction of the home) does  
18 not change the fact that assessment records show the land was purchased in 1987 for \$300,000. The  
19 FTB contends that the 1988 assessment of \$2,655,090 “is the most accurate determination of [the]  
20 adjusted basis, in consideration of the information available.” In addition, the FTB contends that the  
21 1988 assessment of \$2,655,090 “reflects a bifurcation and allocation based on current market value at a  
22 time not only after Appellants initial acquisition of the Lido Lane property, but after the construction of  
23 their new home.” Also, the FTB asserts that “it is not unexpected that, after [the] construction of the  
24 new home was completed . . . the assessor assigned significant value to the beachfront location.” (FTB  
25 Resp. Bd. Inq., p. 3, Exs.. G & H.)

#### 26           Appellants’ Response to the Board Member Inquiry

27           Appellants assert that the Board’s proposed inflation index is not an accurate valuation  
28 tool, given a decline in real estate prices between 1988 and 1993, citing (author unknown) *History of a*

1 *housing bubble*, available at [http://www.rntl.net/history\\_of\\_a\\_housing\\_bubble.htm](http://www.rntl.net/history_of_a_housing_bubble.htm); and Gabriel,  
2 *House Price Differentials and Dynamics: Evidence from the Los Angeles and San Francisco*  
3 *Metropolitan Areas*, FRBSF Economic Review (1999), No. 1. In addition, appellants briefly assert that  
4 the decline in real estate prices between 1988 and 1993 was discussed in the Dwyer Appraisal. (App.  
5 Resp. Bd. Inq., p. 1.)

6 Next, appellants argue that the Dwyer Appraisal incorrectly lists the square footage of the  
7 property as follows:

8	Wine Cellar	160
9	Lot Level	2882
	2nd Level	2533
	3rd Level	2339
10	Total	<u>7914</u>

11 Appellants contend that the subterranean footage listed in the Dwyer Appraisal does not  
12 include the garage area, only a wine cellar. In support, appellants note that, in Mr. Merrill's declaration,  
13 Mr. Merrill states that the "[t]he home was approximately 8000 square feet and contained a large,  
14 approximately 3000 square foot, subterranean basement." Appellants assert that Mr. Merrill can recall  
15 the approximate square footage of the home because it was one of the most expensive homes he ever  
16 constructed. Next, appellants argue that Ms. Dobkin's claimed valuation of \$2.5 million for the building  
17 and \$250,000 for the architect (see Table 1 and/or Table 2 above in this hearing summary) is similar to  
18 the valuation set forth in Mr. Merrill's declaration. (App. Resp. Bd. Inq., p. 2.) Appellants assert that  
19 Mr. Merrill's declaration notes that it does not include landscape, hardscape, boat docks, electronics, or  
20 outdoor lighting. In addition, appellants assert that the following improvements were added after the  
21 home was constructed:

- 22 • replacement of the boat docks
- 23 • extension of power to the boat docks
- 24 • addition of kitchen built-ins and cabinets
- 25 • electrical blinds
- 26 • sound system
- 27 • cabinets in the garage
- 28 • cabinets in the darkroom
- fire pit
- bookshelves
- buffet
- chandeliers
- built-in desks

- 1 • ceiling fans
- 2 • installation of television included in sale
- 3 • washer and dryer included in sale
- 4 • landscaping
- 5 • hardscaping

6 Appellants argue that Ms. Dobkin’s valuation of the above-listed items, given the size of  
7 the house and the size of the lot, is not unreasonable. Appellants contend that, while it would have been  
8 optimal to retain all of the records, Ms. Dobkin destroyed boxes of records more than 10 years after  
9 appellants built the house, not realizing that she would need all of the records of the cost of construction  
10 and the additions. Appellants concluded with the assertion that the values set forth by Ms. Dobkin,  
11 when accompanied by Mr. Merrill’s declaration and photographs, are reasonable and should be  
12 accepted. (App. Resp. Bd. Inq., pp. 2-3.) Included with appellants’ response are copies of, among other  
13 things, the following documents: (i) Mr. Merrill’s declaration dated June 27, 2014, (ii) an article titled  
14 “*History of a housing bubble,*” available at [http://www.rntl.net/history\\_of\\_a\\_housing\\_bubble.htm](http://www.rntl.net/history_of_a_housing_bubble.htm); and  
15 (iii) an article titled “*House Price Differentials and Dynamics: Evidence from the Los Angeles and  
San Francisco Metropolitan Areas,*” FRBSF Economic Review (1999), No. 1.

16 The FTB’s Additional Response to the Board Member Inquiry

17 The FTB asserts that the issues in this appeal are the cost of the underlying land and the  
18 home construction costs, not the fair market value of the home. The FTB contends that appellants  
19 reference to “value”—and their inclusion of the article titled “History of the housing bubble”—is  
20 misleading, in that the total costs of what appellants expended (their adjusted basis) is a fixed amount  
21 that is not affected by the fluctuations of home prices after the home was completed. The FTB notes  
22 that the Board’s previous reference to the Dwyer Appraisal was in relation to reconstruction costs, not  
23 fluctuating values of property. In summary, the FTB asserts that the costs of the home’s materials and  
24 land do not necessarily reflect the subsequent and vacillating “value” of the home, and the FTB contends  
25 that appellants’ attempt to equate the two concepts is erroneous and improper. (FTB Add. Resp. to  
26 Bd. Inq., pp. 1-2.)

27 ///

28 ///

1                    Appellants' Additional Brief after the February 24, 2015 Oral Hearing<sup>10</sup>

2                    After the Board hearing on February 24, 2015, appellants provided an additional brief  
3 dated April 6, 2015. In their additional brief, appellants contend that “the FTB has determined an  
4 unbelievably low valuation for [the] determination of [the] sales price of the Dobkins’ luxurious home  
5 on Naples Island in Long Beach, CA, resulting in a very large increase in capital gain and accompanying  
6 income taxes.” Appellants also contends that they are faced with the “unenviable task of supporting the  
7 price paid for building a home 27 years ago when the records showing all costs were destroyed after  
8 18 years.” (App. Add’l Br. 4/6/15, p. 1.)

9                    Appellants state that Ms. Dobkin prepared a list of all costs incurred in building the  
10 home, and she testified that the list is accurate. (See Table 1 and/or Table 2 above in this hearing  
11 summary.) Appellants contend that, because the home was so expensive to build, Mr. Merrill has a clear  
12 recollection that the cost to build the home was \$350 per square foot. Appellants also contend that the  
13 \$300,000 valuation by the County Assessor for the two vacant lots, based upon the stamps placed on the  
14 deed, is clearly erroneous. (With their additional brief, appellants provide a copy of the grant deed.) In  
15 addition, appellants contend, in a general manner, that the interest on the debt used to purchase the  
16 vacant lots (before the home was completed) is properly capitalized and includable in basis. (App.  
17 Add’l Br. 4/6/15, pp. 1-2.)

18                    Letter from Keith Muirhead: Appellants contend that Keith Muirhead, a real estate broker who  
19 lived down the street from the property, has a clear recollection about introducing Mr. Dobkin to the  
20 owner of the two lots, who appellants assert was asking \$1 million per lot. Appellants contend that  
21 Mr. Muirhead also recalls that Mr. Dobkin purchased the two lots for a total price of \$1.8 million.  
22 Appellants assert that the amount of \$1.8 million concurs with Mr. Dobkin’s assertion under oath at the  
23 Board hearing that he assumed debt of \$1.5 million (with possibly \$300,000 down). Appellants assert  
24 that Mr. Muirhead closely watched the construction of the home and regularly discussed the cost of the  
25 home with the builder, Mr. Merrill. In support, appellants provide a letter dated March 20, 2015, from  
26

27  
28 <sup>10</sup> At the conclusion of the oral hearing on February 24, 2015, the Board Members requested additional briefing via a “30-30-30”. As such, the Appeals Division sent an additional briefing letter to the parties, requesting that appellants “gather and submit additional documentation and evidence in support of their alleged adjusted basis in the real property sold.”

1 Mr. Muirhead. The letter is not signed under penalty of perjury. In the letter, Mr. Muirhead states in  
2 part, “As I recall the Lots were listed for \$1,000,000 each and I believe William paid \$1,800,000 for the  
3 two.” Mr. Muirhead also states, “I remember that the cost per square foot was running \$350.00 which,  
4 at this time in late 1980’s, was very expensive.” In addition, Mr. Muirhead states “Mr. Dobkin hired  
5 one of the best local builders, Mr. Bill Merrill to build this amazing dream Home” and “I remember the  
6 invoice for the windows alone was \$200,000!” (App. Add’l Br. 4/6/15, p. 2 & Ex. B.)

7 Declaration of Royce Woodbury: Appellants assert that Royce Architectural, a company that  
8 appellants contend sold the upgraded windows and doors for the home to replace those not wearing well  
9 due to ocean proximity, was able to retrieve a 1994 invoice, which lists revised costs of \$158,500.90. In  
10 support, appellants provide a declaration dated March 18, 2015, from Royce Woodbury, the owner of  
11 Royce Architectural, wherein Mr. Woodbury states, in part, that “In 1994, I quoted a price to  
12 Dr. William Dobkin and his wife, Deborah Dobkin to build replacement and upgraded windows and  
13 doors” and “[t]he actual cost to Dr. Dobkin for the replacement windows and doors was \$158,500.90.”  
14 In addition, appellants provide a document dated May 19, 1994, from Royce Architectural to  
15 Mr. Dobkin, listing an original cost estimate of \$93,744.32 and an actual/revised cost of \$158,500.90.  
16 (App. Add’l Br. 4/6/15, p. 2 & Ex. C.)

17 Declaration of Dennis Treffry: Appellants state that Dennis Treffry, whom appellants contend  
18 was the subcontractor that upgraded windows and doors in the home, was located and has provided a  
19 declaration. Appellants assert that Mr. Treffry’s declaration corroborates the cost of the subsequent  
20 construction as well as the cost of the original construction. Appellants contend that Mr. Treffry recalls  
21 that the original construction cost was more than \$2.5 million. In support, appellants provide a  
22 declaration dated April 3, 2015, from Mr. Treffry, who states in part that: (i) he did all the interior finish  
23 work, installed all soffits and plaster molding details, hung and locked all interior and exterior doors,  
24 and milled and installed roof fascia board, for which his company was paid \$120,000; (ii) he had close  
25 contact with Mr. Dobkin and Mr. Merrill throughout the building of the home; (iii) he removed the old  
26 windows and doors, and he replaced them with new windows and doors that the Dobkins purchased  
27 separately in 1994—and he was paid approximately \$38,000 for his labor; (iv) the Dobkins’ home was  
28 constructed with the most expensive materials possible; (v) the home was 8,000 square feet and was

1 located directly across the street from the water; (vi) the home had a large subterranean basement that  
2 was very expensive to build; (vii) he discussed accumulating costs with Mr. Merrill as work progressed;  
3 and (viii) construction of the home itself exceeded \$2,500,000, which was exclusive of landscaping and  
4 did not include the cost of improvements to the doors and windows. (App. Add'l Br. 4/6/15, pp. 2-3 &  
5 Ex. D.)

6 Next, appellants contend that “common knowledge” can be used to determine the basis of  
7 the property, citing *Cohan v. Commissioner, supra*. Also, appellants contend that the “the only facts  
8 used by the FTB for reducing the basis for the house sale was the County Assessor valuation.”  
9 Appellants state that they will testify at a continued Board hearing that they were surprised by the  
10 County Assessor’s valuation. Appellants assert that the assessed value was wrong and California law  
11 does not require that homeowners correct a low valuation. (App. Add'l Br. 4/6/15, p. 3.)

12 Next, appellants assert that, “without coaching of any kind,” Mr. Muirhead recalled that  
13 the cost of the home was \$350 per square foot and Mr. Treffry recalled that the cost of original  
14 construction was more than \$2.5 million. Appellants contend that the cost of the home’s construction  
15 was the “discussion of the neighborhood as such price was very high for the time.” Appellants also  
16 contend that the Board should keep in mind that the basis of the home includes numerous other items  
17 that were added after the original construction, such as appliances, televisions, bookcases, built-in desks,  
18 window coverings with remote controls, a boat dock(s), electricity to the boat dock, landscaping, and  
19 hardscaping. (App. Add'l Br. 4/6/15, p. 3.)

20 Next, appellants contend that they are entitled to capitalize the interest they paid on the  
21 two vacant lots before the home was completed in 1992. As for the amount of interest that appellants  
22 contend should have been capitalized, appellants assert that “Mr. Dobkin testified [that the interest was]  
23 9% on \$1,500,000 from the time of purchase in 1987, until the building was complete in 1992 . . .”<sup>11</sup>  
24 Finally, appellants assert that the adjusted basis of the home must include “the new windows and doors  
25 at a cost of \$158,000, [installation] at \$8,000, and the professional extension over the decks for which a  
26 permit has already been introduced.” (App. Add'l Br. 4/6/15, p. 3.)

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<sup>11</sup> Staff notes that in Table 1 of this hearing summary, appellants list (allege) capitalized interest of \$225,000.

1                   The FTB’s Additional Brief after the February 24, 2015 Oral Hearing

2                   After the Board hearing on February 24, 2015, the FTB provided an additional brief,  
3 wherein the FTB asserts that the issues in this appeal are the cost of the underlying land and the home’s  
4 construction costs, not the sales price of the home. The FTB contends that appellants are improperly  
5 attempting to add hundreds of thousands of dollars to their home’s adjusted basis via declarations that  
6 are inconsistent and that are based on purported recollections spanning over 25 years. In addition, the  
7 FTB asserts that appellants acknowledge that they had a duty to retain all documents but voluntarily  
8 destroyed them in 2005. (FTB Add’l Br. 6/1/15, pp. 1-2.)

9                   Next, the FTB contends, in a general manner, that Ms. Dobkin included items in her  
10 adjusted basis calculation (see Table 1 above) that are not allowed, such as (i) a \$500,000 IRC section  
11 121 gain exclusion amount, (ii) amounts related to movable personal property, and (iii) interest paid on  
12 debt. The FTB argues that its determination of the adjusted basis should be upheld and that appellants  
13 have failed to carry their burden of showing error therewith, citing *Todd v. McColgan* (1949)  
14 89 Cal.App.2d 509; *Appeal of James B. and Martha W. Mears*, 78-SBE-115, decided by the Board on  
15 December 5, 1978. (FTB Add’l Br. 6/1/15, p. 2.)

16                   The FTB asserts that two obvious areas for review in this appeal are (i) the methodology  
17 of Ms. Dobkin’s computation of appellants’ claimed adjusted basis in the home, and (ii) the reliability of  
18 Mr. Merrill statements, including the statements Mr. Merrill made in his declaration. In relation to the  
19 methodology of Ms. Dobkin’s computation of the adjusted basis, the FTB asserts, in a general manner,  
20 that appellants have provided only post hoc, generalized, and unspecific recollections that fail to identify  
21 specific costs and expenditures. In relation to the reliability of Mr. Merrill’s statements, appellants  
22 contend that Mr. Merrill has made inherently conflicting statements. Specifically, appellants note that,  
23 in Mr. Merrill’s declaration, he stated that even though he did not have a recollection of specific costs, it  
24 was his recollection that the home’s construction cost was \$350 per square foot. The FTB asserts that  
25 Mr. Merrill’s degree of specificity in his declaration is quite different from appellants’ statement in their  
26 reply brief dated September 3, 2014, wherein appellants stated that Mr. Merrill indicated that  
27 Ms. Dobkin’s estimate of construction costs of \$2.5 million for the home itself was “not unrealistic.”  
28 The FTB contends that the reliability of Mr. Merrill’s statements in his declaration are questionable,

1 given that, in 2013, he was only willing to venture that Ms. Dobkin’s estimate was “not unrealistic,”  
2 which the FTB asserts is a most tepid endorsement. Also, the FTB contends that, while appellants assert  
3 in their recent brief that the statements/declarations of Mr. Merrill and Mr. Muirhead were not coached,  
4 it would have been better if witnesses had been asked to provide records and estimates without first  
5 being made aware of Ms. Dobkin’s estimate. The FTB also argues that, if Mr. Merrill actually had a  
6 recollection that construction costs were in the neighborhood of \$350 per square foot, one would expect  
7 a completely different statement from him in 2013, especially considering the fact that his purported  
8 statements in 2013 were closer in time to the home’s construction. Also, the FTB asserts that  
9 Mr. Merrill’s and Mr. Muirhead’s estimates of \$350 per square foot are dubious, given the fact that their  
10 estimates match exactly, and “there is a repeated and fortuitous conformity of the recollections 25 years  
11 after construction.” (FTB Add’l Br. 6/1/15, pp. 3-5.)

12           Next, the FTB argues that none of the construction costs for commercial and residential  
13 properties listed in the 1999 version of the National Building Cost Manual reflect construction costs  
14 anywhere near the \$350 per square foot value that appellants are asserting on appeal.<sup>12</sup> Specifically, the  
15 FTB notes that the National Building Cost Manual gives cost estimates for a variety of residential  
16 construction types, from Best, to Good, to Average, to Low. (Included with the FTB’s additional brief  
17 are excerpts from the National Building Cost Manual.) The FTB asserts that that the “Best” building  
18 cost estimate for a 4,000 square foot, 10-corner, home was listed at approximately \$66 per square foot,  
19 and the FTB states that the cost per square foot decreases as the structure increases in size. The FTB  
20 contends that, while it is not suggesting that appellants built their home for \$66 per square foot, the cost  
21 estimate of \$66 per square foot, as listed in the National Building Cost Manual, reflects that appellants’  
22 generalized post hoc cost estimate of \$350 per square foot is not reasonable. Also, the FTB notes that  
23 the National Building Cost Manual has several adjustment factors for construction in California, with  
24 the highest adjustment factor being 24 percent for construction in San Francisco, compared with  
25 10 percent for San Diego and 13 percent for Anaheim. The FTB asserts that, even with an adjustment  
26 factor of 24 percent, the listed cost of \$66 per square foot would be increased to roughly only \$82 per  
27

28 <sup>12</sup> The FTB asserts that, because the National Building Cost Manual was published in 1999, the dollar amounts listed therein  
are adjusted for inflation up to the 1999 tax year.

1 square foot. In addition, the FTB states that the National Building Cost Manual provides cost estimates  
2 for a wide variety of buildings, such as banks, medical buildings, and multi-family buildings. The FTB  
3 states that a general office building (of at least two stories in height) with 7,500 square feet and a  
4 construction grade of “Exceptional” had an estimated construction cost of approximately \$100 per  
5 square foot. Also, the FTB states that banks had higher cost estimates, and the estimated cost for a bank  
6 with a “length less than twice the width” (of at least two stories in height) with a 7,500 square foot area  
7 was \$108.23 per square foot—and a similar quality bank with a 10,000 square foot area had a cost  
8 estimate of \$104.75 per square foot. Also, the FTB asserts that the estimated cost for a bank with a  
9 “length between 2 to 4 times width” (of at least two stories in height) with a 7,500 square foot area was  
10 approximately \$112 per square foot, which if adjusted by 24 percent (the adjustment factor applicable to  
11 construction in San Francisco) would only result in an estimated cost of approximately only \$139 per  
12 square foot. (FTB Add’l Br. 6/1/15, pp. 5-6.)

13           Next, the FTB argues that the “declaration” (letter) of Mr. Muirhead is problematic  
14 because it is not specific as to the few particularities it provides. Specifically, the FTB contends that  
15 Mr. Muirhead claims to remember that the invoice for the windows alone was \$200,000 but he fails to  
16 state whether he was referring to original construction—or the windows that appellants claim to have  
17 replaced at a later date. In comparison, the FTB states that the declaration of Royce Woodbury states  
18 that the cost of the replacement windows and doors was \$158,001,<sup>13</sup> a lower and very different amount  
19 than the amount proposed by Mr. Muirhead. In addition, the FTB asserts that the original invoice from  
20 Mr. Woodbury (a copy of which was provided with his declaration) states that the revised window cost  
21 was \$158,001.00,<sup>14</sup> adjusted upward from the original estimate of \$93,744.32. Based on the foregoing,  
22 the FTB contends that it is doubtful that the windows cost \$200,000, which the FTB asserts calls into  
23 question the accuracy of Mr. Muirhead’s recollection of events. (FTB Add’l Br. 6/1/15, pp. 6-7.)

24           Next, the FTB asserts that the declaration of Mr. Treffry is problematic because it  
25 incorrectly states that the home was constructed “across the street from the water,” when the home is  
26 \_\_\_\_\_

27 <sup>13</sup> Staff notes that Mr. Woodbury stated that the cost to replace the windows and doors was \$158,500.90.

28 <sup>14</sup> Staff notes that the invoice lists an amount of \$158,500.90.

1 actually constructed right next to the water. The FTB asserts that this error demonstrates Mr. Treffry's  
2 lack of familiarity with the home. (FTB Add'l Br. 6/1/15, p. 7.)

3 Next, the FTB sets forth the following concession: The FTB states that "Respondent,  
4 after consideration of the various conflicting material that Appellants have provided throughout the audit  
5 and appeal proceedings, is willing to increase the adjusted basis figure by \$158,001<sup>15</sup> to reflect that it  
6 was likely Appellants encountered weathering issues with their windows, and had to replace them."  
7 (FTB Add'l Br. 6/1/15, p. 7.)

8 Record-Keeping Requirements: The FTB asserts that taxpayers are required to keep  
9 permanent books and records sufficient to establish matters reported in a return, citing IRC section 6001;  
10 Treasury Regulation section 1.6001-1; *Cracchiola v. Commissioner* (9th Cir. 1981) 643 F.2d 1383,  
11 1385. (FTB Add'l Br. 6/1/15, p. 7.)

12 The Cohan Rule: In relation to the Cohan Rule, the FTB asserts that, where the FTB has  
13 disallowed only a portion of the claimed deductions, the Board has declined to disturb the FTB's  
14 determinations and estimates of claimed deductions, citing the *Appeal of Henrietta Swimmer, Executrix,*  
15 *et. al*, 63-SBE-138, decided by the Board on December 10, 1963, and the *Appeal of California Steel,*  
16 *Inc.*, 2003-SBE-001-A, decided by the Board on July 9, 2003. In addition, the FTB notes that, in  
17 *Coloman v. Commissioner* (9th Cir. 1976) 540 F.2d 427, 431-432, the Ninth Circuit distinguished the  
18 facts before it from the facts in *Cohan* by stating:

19 The evidence in the instant case was insufficient to establish that the basis was other than  
20 zero, whereas in *Cohan* there was substantial evidence and an express finding that  
21 "considerable sums" were spent, and the question was whether failure to pin down the  
22 exact amount was to mean disallowance of the declaration in full. In the instant case, to  
allow the *Cohan* doctrine to be invoked by the taxpayers would be in essence to condone  
the use of that doctrine as a substitute for burden of proof.

23 The FTB then asserts that other than the amount the FTB conceded, the declarations appellants  
24 submitted do not support Ms. Dobkin's adjusted basis calculations, as the declarations submitted are  
25 general and inconsistent. (FTB Add'l Br. 6/1/15, pp. 7-9.)

26  
27  
28 <sup>15</sup> Staff again notes that Mr. Woodbury stated that the cost to replace the windows and doors was \$158,500.90. Also, staff notes that the invoice included with Mr. Woodbury's declaration lists an amount of \$158,500.90.

1                    Adjusted Basis Computation: The FTB notes that, in Table 1 of this Hearing Summary  
 2 (which is reproduced below), appellants assert that they incurred a loss on the sale of the home and that  
 3 their adjusted basis is computed as follows:

Table 1		
<b>Sales Price</b>		<b>\$6,300,000</b>
Land	1,835,000	
Purchase escrow costs	340,000	
Building	2,500,000	
Architect	250,000	
Replace two docks	25,000	
Extend 220 voltage to docks	1,500	
Other building improvements	75,000	
Replace deck	35,000	
Mahogany cabinets	25,000	
Electrical blinds	20,000	
Electrical blinds, additional	20,000	
Sound system	12,500	
Water heaters	2,500	
Cabinets in garage	7,500	
Wine cabinets in cellar	7,500	
Darkroom cabinets	12,500	
Fire pit	12,500	
Replace doors	250,000	
Installation labor	75,000	
Replace decks	20,000	
Entertainment center	15,000	
Loan interest – capitalized	225,000	
Bookshelf	8,500	
Buffet	10,000	
Chandeliers	28,000	
Carpeting	18,000	
Desk – Ashley’s room	12,000	
Desk – Jason’s room	9,500	
Kitchen remodel	9,000	
Ceiling fans	6,000	
Television – exercise room	3,000	
Outside lighting	5,000	
Washer – dryer	1,000	

1	Landscaping	250,000	
2	<b>Subtotal</b>		<b>-6,125,500</b>
3			
4	Selling costs (escrow)		-345,066
5	Homeowners exemption		-500,000
6			
7	Gain (loss) on sale		<b>-\$325,541</b>

8 In relation to the above-listed computation, the FTB asserts that appellants improperly  
9 included items in their adjusted basis calculation that are not allowed, such as (i) a \$500,000 IRC  
10 section 121 gain exclusion amount, (ii) amounts related to movable personal property, and (iii) interest  
11 paid on debt. In relation to the IRC section 121 exclusion, the FTB notes that, under IRC section 121,  
12 taxpayers who are married and file a joint return can exclude up to \$500,000 of gain on the sale of a  
13 home if, among other things, the taxpayers owned and lived in the home for at least two years during the  
14 5-year period ending on the date of the sale. The FTB asserts that the IRC section 121 exclusion amount  
15 is not added to the property's basis but is applicable, if at all, only if it is later determined that the  
16 taxpayer realized gain. The FTB asserts that appellants' attempt to include the \$500,000 section 121  
17 exclusion in their adjusted basis represents appellants' continued misrepresentation of the tax code,  
18 which the FTB contends follows Mr. Dobkin's initial failure to even report the sale of the home on his  
19 California return. The FTB notes that IRC section 1011 provides that the adjusted basis for determining  
20 the gain from the sale of property shall be the property's initial basis, with adjustments as provided in  
21 IRC section 1016 (e.g., for capital expenses and capital recoveries). The FTB then contends that  
22 appellants did not and could not "pay" for the IRC section 121 exclusion, as it is a specific tax benefit  
23 only to those who report a gain on a qualifying sale—and the FTB notes that appellants reported a loss  
24 on the sale of the property, which the FTB asserts is not supported by the facts and law. The FTB  
25 contends that appellants' inclusion of the \$500,000 section 121 gain exclusion in their adjusted basis  
26 demonstrates the ongoing erroneous assertions of their home's adjusted basis calculations with no regard  
27 to applicable law. (FTB Add'l Br. 6/1/15, pp. 9-12.)

28 In relation to interest, the FTB asserts that, as a general rule, IRC section 163(h) prohibits  
a taxpayer from claiming a deduction for personal interest. The FTB notes, however, that one of the

1 limited exceptions to the general rule permits individuals to deduct qualified residence interest, citing  
2 IRC section 163(h)(2)(D). The FTB states that qualified residence interest is interest paid or accrued  
3 during the taxable year on acquisition indebtedness or home equity indebtedness with respect to any  
4 qualified residence of the taxpayer, citing IRC section 163(h)(3)(A). The FTB asserts that the  
5 United States Congress and the California Legislature have established that, with respect to any personal  
6 interest, no tax benefits are allowed with respect to such amounts except to the extent allowed by IRC  
7 section 163(h), as incorporated into California law pursuant to R&TC section 17201. The FTB then  
8 makes the following arguments: First, the FTB contends that appellants have conceded the home  
9 interest issue noting that, in appellants' additional brief dated July 7, 2014, appellants stated that  
10 "Dr. Dobkin is willing to concede the home interest adjustment." Second, the FTB asserts that  
11 appellants cannot avoid IRC section 163(h)'s restrictions on personal interest by trying to add interest to  
12 their home's adjusted basis, while providing no legal support for that treatment. The FTB notes that, in  
13 Table 1 above, appellants attempt to add unspecified loan interest of \$225,000 to the adjusted basis of  
14 the home. The FTB asserts that appellants have the burden of showing that they are entitled to deduct  
15 interest, citing *O'Neill v. Commissioner* (9th Cir. 1959) 271 F.2d 44, 50. The FTB contends that  
16 appellants have failed to provide any legal authority for their assertion in their recent brief that the  
17 interest on the debt used to purchase the vacant lots (before the home was completed) is properly  
18 capitalized and included in basis. The FTB contends that to adopt such a position would result "in the  
19 incorrect proposition that an individual that purchased the same home with only cash would have a  
20 different adjusted basis than a person that takes out a mortgage." (FTB Add'l Br. 6/1/15, pp. 12-14.)

### 21 Applicable Law

#### 22 Adjusted Basis

23 IRC section 1001 provides that the gain on the sale of property shall be the excess of the  
24 amount realized over the adjusted basis as defined in IRC section 1011.<sup>16</sup> IRC section 1011 provides  
25 that the adjusted basis for determining the gain from the sale of property shall be the property's initial  
26 basis (determined under section 1012 or other applicable sections of that subchapter) with adjustments

27 \_\_\_\_\_  
28 <sup>16</sup> California conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

1 as provided in IRC section 1016.

2 Under IRC section 1016, a property's initial basis must be adjusted for capital expenses  
3 and capital recoveries. Capital expenses increase the initial basis and capital recoveries decrease the  
4 initial basis so that, on the date of disposition, the adjusted basis reflects the unrecovered cost or other  
5 basis of the property. Capital expenses include the cost of capital improvements and betterments made  
6 to the property by the taxpayer. (Int.Rev. Code, § 1016(a).)

#### 7 Mortgage Interest Deduction

8 As a general rule, individuals may not deduct personal interest. (Int.Rev. Code,  
9 § 163(h).)<sup>17</sup> An exception to this general rule permits individuals to deduct qualified residence interest.  
10 (Int.Rev. Code, § 163(h)(2).) Qualified residence interest is interest paid or accrued during the taxable  
11 year on acquisition indebtedness or home equity indebtedness on a qualified residence. (Int.Rev. Code,  
12 § 163(h)(3)(A).) Acquisition indebtedness means any loan that is secured by the residence and that is  
13 incurred to acquire, construct, or substantially improve a taxpayer's qualified residence. (Int.Rev. Code,  
14 § 163(h)(3)(B).) Home equity indebtedness means any loan secured by the qualified residence to the  
15 extent that the aggregate amount of the indebtedness does not exceed the taxpayer's equity in the  
16 residence (i.e., the fair market value of the qualified residence reduced by the acquisition indebtedness  
17 of the residence). (Int.Rev. Code, § 163(h)(3)(C); *Smoker v. Commissioner*, T.C. Memo. 2013-56.) The  
18 aggregate amount that may be treated as acquisition indebtedness for any period is generally limited to  
19 \$1 million, and the aggregate amount that may be treated as home equity indebtedness for any period is  
20 generally limited to \$100,000. (Int.Rev. Code, §§ 163(h)(3)(B)(ii), (C)(ii).) A cash method taxpayer is  
21 allowed a deduction for interest paid during the taxable year in cash or its equivalent. (*Smoker v.*  
22 *Commissioner, supra.*) The mere delivery of a promissory note to satisfy an interest obligation, without  
23 an accompanying discharge of the note, is a mere promise to pay and not a payment in a cash equivalent.  
24 (*Id.*)

#### 25 IRC Section 121

26 Under IRC section 121, a taxpayer can exclude up to \$250,000 of the gain on the sale of a  
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28 <sup>17</sup> The relevant portions of IRC section 163 have been incorporated into California law at R&TC section 17201.

1 home if the taxpayer: (i) owned the home for at least two years during the 5-year period ending on the  
2 date of the sale (“ownership test”); (ii) used the home as his or her principal residence for at least two  
3 years during the 5-year period ending on the date of the sale (“use test”); and (iii) did not exclude a gain  
4 from the sale of another home during the 2-year period ending on the date of the sale. Taxpayers who  
5 are married can exclude up to \$500,000 of the gain on the sale of a home if: (i) the taxpayers file a joint  
6 return for the year of the sale; (ii) either spouse meets the ownership test (as set forth above); (iii) both  
7 spouses meet the use test (as set forth above); and (vi) neither spouse excluded a gain from the sale of a  
8 home during the 2-year period ending on the date of the sale. (Int.Rev. Code, §§ 121(a) & (b).)

#### 9 Burden of Proof

10 The FTB’s determination of tax is presumed to be correct, and a taxpayer has the burden  
11 of proving error. (*Todd v. McColgan, supra; Appeal of Aaron and Eloise Magidow, 82-SBE-274,*  
12 *Nov. 17, 1982.*) Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof.  
13 (*Appeal of Aaron and Eloise Magidow, supra.*)

#### 14 The Cohan Rule

15 In *Cohan v. Commissioner, supra*, the famous theatrical producer, George M. Cohan,  
16 testified at trial that he had spent substantial sums of money travelling and entertaining actors,  
17 employees, and drama critics in furtherance of his theatrical production business. He could not  
18 substantiate by records the actual amounts of such expenditures but instead estimated the amounts in  
19 his testimony. The Board of Tax Appeals found that Cohan had made substantial expenditures and that  
20 those expenditures were allowable expenses, but denied any deductions on the ground that, in the  
21 absence of details, it was impossible to determine his actual expenses. On appeal, the Second Circuit  
22 Court of Appeal held that, where a taxpayer has established that he or she has incurred an expense for  
23 which a deduction may properly be claimed, but is unable to document the exact amount of the  
24 expense, a court may make a reasonable estimate of the deduction in certain circumstances, “bearing  
25 heavily” against the taxpayer whose inexactitude is of his/her own making. This holding is referred to  
26 as the Cohan rule. (*Cohan v. Commissioner, supra.*) For a court to estimate the amount of an expense  
27 under the Cohan rule, the court must have some basis upon which an estimate may be made. (*Vanicek*  
28 *v. Commissioner* (1985) 85 T.C. 731, 742, 743.) Without such a basis, any allowance would amount to

1 unguided largesse. (*Williams v. United States, supra*, at 560-561.)

2 STAFF COMMENTS

3 The FTB auditor accepted \$2,655,090 as appellants' adjusted basis in the property—i.e.,  
4 \$1,871,700 for the land and \$783,390 for the improvements. At the prior oral hearing, appellants  
5 argued that they had an adjusted basis in the land of \$1,835,000. Appellants are disputing the auditor's  
6 determination that they had an adjusted basis in the improvements of only \$783,390.

7 At the prior oral hearing, the Board addressed whether appellants had adequately  
8 substantiated their adjusted basis in the land and improvements. In relation to the adjusted basis of the  
9 land, the Board noted that the FTB auditor accepted \$1,871,700 as appellants' adjusted basis in the land.  
10 In doing so, the Board rejected the FTB's argument that the land (i.e., the two beachfront lots in the  
11 Naples area of Long Beach) was purchased for a total purchase price of \$300,000 in 1987.

12 Appellants assert that many of the documents substantiating the alleged improvements  
13 were discarded in 2005. At the prior oral hearing, the Board attempted to estimate the adjusted basis of  
14 the improvements. The Board first noted that the FTB auditor estimated improvements of \$783,390, as  
15 set forth in the FTB's arguments on appeal. Nevertheless, the Board paid special attention to the 1993  
16 appraisal report of Dwyer Associates, which valued improvements to the property using a cost  
17 reconstruction method and estimated that the cost of reconstruction was \$2 million as of September 23,  
18 1993 (the date of the appraisal). Prior to the hearing, a Board Member inquired as to whether the  
19 estimated reconstruction costs of \$2 million for improvements as of September 23, 1993, should be  
20 adjusted for an inflation factor of 22.96 percent, as set forth in the Board Member Inquiry, which would  
21 tentatively result in improvement costs of \$1,540,800.<sup>18</sup> At the conclusion of the oral hearing, the Board  
22 granted the parties additional time to file further briefing and/or evidence. After the oral hearing,  
23 appellants provided the following additional evidence:

- 24 • A letter dated March 20, 2015, from Keith Muirhead, who states in part "I remember that the  
25 cost per square foot was running \$350.00 which, at this time in late 1980's, was very expensive"

26  
27 <sup>18</sup> Near the conclusion of the oral hearing, Ms. Stowers made a motion in which she proposed an adjusted basis for the real  
28 property of \$3,412,500, which was composed of a land component of \$1,871,700 and an improvements component of  
\$1,540,800. Please see the summary of the Board Member Inquiry on page 20 of this hearing summary for the rationale  
behind this proposed adjusted basis of appellants' property.

1 and “I remember the invoice for the windows alone was \$200,000.”

- 2 • A declaration under penalty of perjury, dated April 3, 2015, from Dennis Treffry, who states in  
3 part that: (i) he installed numerous improvements to the property, for which his company was  
4 paid \$120,000; (ii) he had close contact with Mr. Dobkin and Mr. Merrill throughout the building  
5 of the home; (iii) he removed the old windows and doors, and he replaced them with new  
6 windows and doors that the Dobkins purchased separately in 1994—and he was paid  
7 approximately \$38,000 for his labor; (iv) the Dobkins’ home was constructed with the most  
8 expensive materials possible; (v) the home was 8,000 square feet and was located directly across  
9 the street from the water; (vi) the home had a large subterranean basement that was very  
10 expensive to build; (vii) he discussed accumulating costs with Mr. Merrill as work progressed;  
11 and (viii) construction of the home itself exceeded \$2,500,000, which was exclusive of  
12 landscaping and did not include the cost of improvements to the doors and windows.
- 13 • A declaration under penalty of perjury, dated March 18, 2015, from Royce Woodbury, who  
14 states in part, “In 1994, I quoted a price to Dr. William Dobkin and his wife, Deborah Dobkin to  
15 build replacement and upgraded windows and doors” and “[t]he actual cost to Dr. Dobkin for the  
16 replacement windows and doors was \$158,500.90.”
- 17 • A copy of a document (invoice) dated May 19, 1994, from Royce Architectural to Mr. Dobkin,  
18 listing an original cost estimate of \$93,744.32 and an actual/revised cost of \$158,500.90.
- 19 • A Grant Deed dated March 20, 1987, listing a transfer tax of \$330.

20 In response to appellants’ recently-provided evidence, the FTB states that it “is willing to  
21 increase the adjusted basis figure by \$158,001 to reflect that it was likely Appellants encountered  
22 weathering issues with their windows, and had to replace them.” Staff is under the impression that the  
23 FTB is conceding the improvement amount set forth in the 1994 invoice recently provided by  
24 Royce Architectural, which lists revised costs for replacement windows and doors of \$158,500.90. At  
25 the oral hearing, the FTB should indicate whether it is conceding the amount of \$158,500.90 (as set forth  
26 in the Royce invoice)—or \$158,001.00.

27 Finally, Board staff notes that appellants were provided with an opportunity, through the  
28 “30-30-30” process, to submit additional evidence in support of their estimate of the adjusted basis of

1 the improvements to the property sold. At the prior oral hearing, the Board Members discussed whether  
2 any evidence relating to the homeowners' insurance policy for this property was available. Staff notes  
3 that appellants' submission is limited to the evidence summarized immediately above.

4 Pursuant to California Code of Regulations, title 18, section 5523.6, if the parties have  
5 any additional evidence that they want the Board to consider, the parties should provide their additional  
6 evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.<sup>19</sup>

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28 <sup>19</sup> Evidence exhibits should be sent to: Khaaliq A. Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of  
Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.