Mai C. Tran
Tax Counsel III
Board of Equalization, Appeals Division
450 N Street, MIC: 85
P.O. Box 942879
Sacramento, CA 95814
Tel: (916) 324-8244
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
JOHN A. MATTSON AND	Case No. 816470
TARA L. MATTSON	

Year	Proposed Assessments[1]
2006	$ 21,372
2007	$ 20,195
2008	$ 34,166
2009	$ 23,004

Representing the Parties:

For Appellants: John A. Mattson and Tara L. Mattson

For Franchise Tax Board: Jason Riley, Tax Counsel III

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[1] Appellants owned four rental properties in the years at issue: (1) a Virginia Beach, Virginia condominium; (2) a Northstar Truckee condominium; (3) a Truckee, California house; and (4) a Devil's Knob Loop, Virginia house. The proposed assessments are based on the total adjustments for rental losses, home mortgage interest deductions, and depreciation expense deductions for these properties. Appellants have conceded the home mortgage interest and depreciation expense deductions. It appears that appellants only contest the disallowed rental losses for the Devil's Knob Loop house in Wintergreen, Virginia. According to appellants, their Virginia Beach, Virginia and Northstar Truckee condominiums are managed by management companies. Appellants state that their Truckee, California house has a full-time tenant. Appellants may want to clarify whether the Truckee, California house is also managed by a management company. In addition, respondent should be prepared to submit a calculation for the proposed additional tax amount that is attributable to the rental losses claimed for the property remaining at issue.

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QUESTIONS: (1) Whether appellants have shown error in respondent's determination that appellants' rental real estate activities did not qualify as a trade or business for the years at issue; and

(2) Whether respondent erred in determining that appellants' rental real estate activities are passive activities, such that losses from those activities may only offset their passive income for the years at issue.

HEARING SUMMARY

Background

Overview

During the years at issue, appellant-husband was employed full-time by Cisco Technologies, Inc. and was paid wages of $449,289, $595,773, $639,205, and $357,384 for 2006, 2007, 2008, and 2009, respectively. Appellants also owned four vacation properties, including one located on Devil's Knob Loop in Wintergreen, Virginia (DKL Property), and reported losses from those four properties as ordinary losses for the 2006 through 2009 tax years. As to the DKL Property, appellants claimed rental losses of $89,727, $106,985, $113,574, and $80,800 for 2006, 2007, 2008, and 2009, respectively. Appellants reported these losses under Internal Revenue Code (IRC) section 469(c)(7) as the law applies to rental real estate professionals. Respondent disallowed the claimed rental losses. On appeal, appellants contend that respondent erred in its determination that appellants' rental activities were passive activities with respect to the DKL Property. (Resp. Op. Br., p. 1, Exh. A.)

Audit

Respondent noted that appellants did not include California Form 3801, *Passive Activity Loss Limitations*, with their filed returns. Respondent determined that all of the losses from appellants' rental properties were disallowed as rental losses because California does not conform to IRC section 469(c)(7), pursuant to Revenue and Taxation Code (R&TC) section 17561, subdivision (a). In addition, respondent determined that the reported amounts of depreciation were incorrect because the depreciable basis included land. Lastly, respondent determined that appellants incorrectly calculated the amount of the mortgage interest deduction because the reported amounts of interest exceeded the

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amounts allowed for the first $1 million of indebtedness. Respondent issued Notices of Proposed Assessment (NPAs) dated March 8, 2011, for the years at issue which proposed additional tax based on the disallowed rental losses, disallowed depreciation expenses, and disallowed mortgage interest deductions.[2] (Resp. Op. Br., p. 1, Exh. F; App. Op. Br., Atths.)

For the 2006 tax year, the NPA reflected that respondent disallowed rental losses of $204,129, depreciation expenses of $14,909, and home mortgage interest of $17,591, which resulted in increasing appellants' taxable income from $169,780 to $406,409. The NPA for 2006 proposed additional tax of $22,759.[3] (App. Op. Br., Atths.)

For the 2007 tax year, the NPA reflected that respondent disallowed rental losses of $186,769, depreciation expenses of $8,458, and home mortgage interest of $35,608, which resulted in increasing appellants' taxable income from $281,378 to $512,213. The NPA for 2007 proposed additional tax of $21,468. (App. Op. Br., Atths.)

For the 2008 tax year, the NPA reflected that respondent disallowed rental losses of $341,170, depreciation expenses of $31,293, and home mortgage interest of $20,431, which resulted in increasing appellants' taxable income from $161,266 to $554,160. The NPA for 2008 proposed additional tax of $37,355. (App. Op. Br., Atths.)

For the 2009 tax year, the NPA reflected that respondent disallowed rental losses of $341,538, depreciation expenses of $22,660, and home mortgage interest of $15,354, which resulted in increasing appellants' taxable income from negative $62,120 to $317,432. The NPA for 2009 proposed additional tax of $25,383. (App. Op. Br., Atths.)

Protest

Appellants timely protested the NPAs. Appellants indicated that they were unaware of

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[2] The mortgage interest and depreciation expenses were conceded by appellants in their reply brief. As such, the parties' contentions regarding these items prior to this concession will not be addressed in the hearing summary. (App. Reply Br., p. 3.)

[3] The NPA for 2006 also reflected interest suspension under R&TC section 19116 for the period, April 16, 2010 to March 22, 2011 (fifteen days after the date of the NPA).

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the difference between federal and state law regarding real estate professionals.[4] Although the losses claimed on the returns related to four different properties, appellants focused their protest on the disallowed losses related to the DKL Property. Appellants abandoned the real estate professional position held at audit, and instead, argued that the DKL Property was not a rental activity, but that it qualified as a trade or business under an exception provided by Treasury Regulation section 1.469-1T(e)(3)(ii)(A). This exception under Treasury Regulation section 1.469-1T(e)(3)(ii)(A) provides that an activity qualifies as a trade or business if the average period of each customer's use is seven days or less during each taxable year. (Resp. Op. Br., p.2.)

Appellants submitted a schedule reflecting that the average period of customer use was seven days or less for each taxable year. Appellants also provided a log that included rental schedules with the tenant's names, arrival and departure dates, the number of days the property was rented, the daily rate, and the deposit amounts. Appellants did not submit any additional documentation such as rental contracts to substantiate their schedules. In addition, appellants provided a schedule estimating the number of hours appellants spent cleaning and performing maintenance on the DKL Property. Appellants did not submit any evidence corroborating the number of hours appellants listed on the schedule. However, appellants provided a schedule of alleged credit card purchases, including food, gas, hotel, airfare, car rental, and airport parking, which appear to demonstrate their physical presence in various locations on specific dates. After review, respondent determined that the DKL Property was considered a rental activity under IRC section 469(c)(2) because appellants did not substantiate that the DKL Property was a trade or business. (Resp. Op. Br., p. 2, Exhs. B, C, D & E.)

Respondent issued a position letter dated September 26, 2013, explaining that it disallowed the rental losses for the following reasons: the losses resulted from rental activities which were passive activities; appellants' rental activities did not qualify as a trade or business; and appellants did not materially participate in the rental activities. Respondent issued Notices of Action (NOAs) dated April 30, 2014, which took into account the adjustments allowed for the depreciation expenses

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[4] As discussed below, the Internal Revenue Code allows certain real estate professionals to treat their rental activities as non-passive activities. (Int.Rev. Code, §469(c)(7).) However, the Revenue and Taxation Code specifically excludes this treatment for California purposes. (Rev. & Tax. Code, § 17561, subd. (a).)

and the home mortgage interest deductions. The NOAs proposed additional tax of $21,372, $20,195, $34,166, and $23,004 for the 2006, 2007, 2008, and 2009 tax years, respectively. (Resp. Op. Br., p. 3, Exhs. J, G & H; App. Op. Br., Atths.)

Appellants then filed this timely appeal.

Introduction

Generally, passive activity losses may only be used to offset passive activity income. (Int.Rev. Code, § 469; Rev. & Tax. Code, § 17561.) Generally, any "rental activity" is considered to be a passive activity. (Int.Rev. Code, § 469(c)(2).) "Rental activity" is any activity where payments are principally made for the use of tangible property. (Int.Rev. Code, § 469(j)(8).)

At the federal level, certain real estate professionals are permitted to treat rental activity losses as non-passive losses. (Int.Rev. Code, § 469(c)(7).) California does not conform with this treatment. (Rev. &Tax. Code, § 17561(a).) However, California does conform to a federal provision that allows taxpayers to apply up to $25,000 of rental real estate activity losses to non-passive income. (Int.Rev. Code, § 469(i).) The allowance of this loss deduction completely phases out when taxpayers have a modified adjusted gross income (MAGI) of $150,000. As discussed below, it appears that, as appellants' MAGI in the years at issue exceeded $150,000, they are ineligible for this treatment under IRC section 469(i) (i.e., to apply up to $25,000 of their rental real estate activity losses to their non-passive income).

Nevertheless, if appellants can demonstrate that their activities involved the conduct of a "trade or business" in which they "materially participated", then their activities will not be considered passive, and they may use the losses from those activities to offset non-passive income. (Int.Rev. Code, § 469(c)(1).) For an activity involving the use of tangible property to be a "trade or business", a taxpayer must satisfy one of six tests provided under Treasury Regulation section 1.469-1T(e)(3)(ii). Here, the test at issue is whether the average period of customer use is seven days or less. (Treas. Reg., § 1.469-1T(e)(3)(ii)(A).) In addition, a taxpayer must demonstrate that he materially participated in the activity by satisfying one of seven tests provided under Treasury Regulation section 1.469-5T(a). Here, the test at issue is whether appellants participated in the activity for more than 100 hours during the tax year and whether appellants' participation is not less than the participation by any other individual

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during the tax year. (Treas. Reg. § 1.469-5T(a).)

Contentions

Appellants initially disputed the disallowed home mortgage interest and depreciation expense deductions. However, after reviewing respondent's schedules attached to respondent's opening brief, appellants no longer dispute these adjustments.

Appellants' Opening Brief

Appellants dispute respondent's characterization of their activities relating to the DKL Property as a passive activity. Appellants contend that they actively managed this property during the years at issue. Appellants contend that there was no management company involved during the years at issue and that they did not use the property for personal use for more than 14 days or 10 percent of the rental time. Appellants further contend that the DKL Property had an average rental period of seven days or less. Therefore, appellants contend that the losses from the DKL Property should be fully deductible. Appellants assert that, after discussing this with respondent's auditor, the auditor verbally agreed that he would adjust his original analysis accordingly. Appellants contend that they provided the auditor with the requested additional documentation to support their position that the DKL Property was actively managed by them as a business. Appellants contend that, despite providing three different sets of documentation to the auditor, the auditor determined that appellants did not submit sufficient documentation. (Appeal Letter, pp. 1-4, Atths.)

Respondent's Opening Brief

Respondent contends that appellants are not entitled to deduct any portion of the claimed passive rental losses from their non-passive income because appellants' modified adjusted gross income exceeded $150,000 in each of the appeal years. Respondent explains that California law generally conforms to IRC section 469 in prohibiting the use of passive losses to reduce non-passive gains, citing R&TC section 17561. Respondent states that losses from passive activities in excess of income from passive activities are suspended and carried forward to future years until the taxpayer has sufficient income from passive activities to offset the loss or until the taxpayer disposes of the entire interest in the activity in a fully taxable transaction, citing IRC section 469(b) and (g). Respondent notes that California law adopts IRC section 469(c)(2), which provides that rental activities are per se

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passive. (Resp. Op. Br., pp. 3-4.)

Respondent notes that, for federal purposes, IRC section 469(c)(7) provides an exception for qualified real estate professionals who materially participate in a rental real estate activity. Respondent contends that, for those who qualify for this exception, an activity is not treated as passive and the taxpayer is entitled to deduct losses from that activity without limit against non-passive income. Citing R&TC section 17561, subdivision (a), respondent states that California does not conform to the real estate professional exception pursuant to IRC section 469(c)(7). Respondent contends that, for California purposes, all rental activities are considered per se passive activities, and losses from rental real estate passive activities may only be used to offset income from passive activities. (Resp. Op. Br., p. 4.)

Respondent further explains that a passive activity includes any trade or business in which the taxpayer does not materially participate and any rental activity regardless of participation, citing IRC section 469(c)(1) and (2). Respondent notes that there is an exception under IRC section 469(i), which allows taxpayers to deduct up to $25,000 of passive losses against non-passive income, provided the taxpayer is an active participant in the activity. Respondent asserts that this $25,000 offset is reduced when the taxpayer's MAGI is over $100,000 and once MAGI exceeds $150,000, the $25,000 offset is reduced to zero. (Resp. Op. Br., pp. 4-5.)

Respondent notes that appellants claimed rental losses on the DKL Property of $89,727; $106,985; $113,574; and $80,800 for tax years 2006, 2007, 2008 and 2009, respectively. Respondent contends that appellants' rental losses are per se passive losses which can only be deducted against passive income. Respondent contends that, as appellants did not file California Form 3801 on their 2006 to 2009 tax returns, none of the passive losses can be deducted. In addition, respondent notes that appellants' MAGI was $485,790, $627,308, $662,226, and $395,788 for 2006, 2007, 2008 and 2009, respectively. Noting the Tax Court's decision in *Schetzer v. Comm'r*, T.C. Memo. 1999-252, respondent contends that IRC section 469(i) allows a taxpayer who is a natural person and who actively participates in a rental activity to claim a maximum loss of $25,000 per year related to rental real estate. Respondent, however, contends that, as appellants' MAGI exceeded $150,000 for each of the years at issue, appellants were not entitled to claim this offset. Respondent further contends that appellants are

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not real estate professionals and California does not allow for real estate professionals regardless of whether appellants materially participated in the activity. Accordingly, respondent contends that appellants' rental activity losses must be treated as passive losses and the $25,000 exception is not available to appellants for any of the years at issue based on appellants' MAGI for each year. (Resp. Op. Br., pp. 5-6, Exh. A.)

Respondent next contends that the DKL Property does not qualify as a trade or business, rather than being passive activity losses. Respondent notes that there are six limited exceptions provided under Treasury Regulation section 1.469-1T(e)(ii)(A)-(F) to the general rule that rental real estate activities are per se passive. As to appellants' contention that they qualify under Treasury Regulation section 1.469-1T(e)(ii)(A), respondent notes that this exception excludes from "rental activity" an activity where the average period of customer use is seven days or less. Respondent contends that an activity involving the use of tangible personal property is not a "rental activity" for a taxable year if the average period of customer use for such property is seven days or less in that taxable year, and that activity is not considered a passive activity, citing *Mordkin v. Comm'r*, T.C. Memo. 1996-187 and *Scheiner v. Comm'r*, T.C. Memo. 1996-554. Respondent notes that appellants provided several pages from a log book which appear to show the length of customer stays at the DKL Property, but contends that the information was not verifiable because appellants did not provide the contracts or rental agreements that correspond with the entries in the log book. (Resp. Op. Br., pp. 6-7)

Respondent further contends that, "[e]ven if *arguendo* the log entries are correct," appellants have not shown that they materially participated in the activity as required by IRC section 469(c). Respondent notes that Treasury Regulation section 1.469-1T(e)(1) provides that an activity is passive if it is either a rental activity, or a trade or business in which the taxpayer does not materially participate. Respondent argues that, even if the DKL Property activity is not considered a "rental activity," the activity remains passive because appellants did not materially participate in operating the DKL Property. Respondent notes that a taxpayer will not be treated as a material participant unless the involvement is "regular, continuous, and substantial," citing IRC section 469(h). Respondent contends that a taxpayer "materially participates" in a business activity if, and only if, he meets one of the seven tests provided under Treasury Regulation section 1.469-5T(a). Respondent notes that material

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participation is a year-by-year determination. (Resp. Op. Br., pp. 7-8.)

Respondent notes that appellants contend that they materially participate in the DKL Property for the years at issue based on the third test listed under Treasury Regulation section 1.469-5T(a). Respondent notes that the third test, on which appellant relies, is satisfied if appellants participate in the activity for more than 100 hours during the taxable year, and such participation in the activity is not less than the participation in the activity by any other individual (including individuals who are not owners in the activity) for such year. Respondent notes that, if appellants spent less than 100 hours during a taxable year, they have not materially participated, citing Treasury Regulation section 1.469-5T(b)(2)(iii). Citing Treasury Regulation section 1.469-5T(f)(4), respondent notes that the method of proof that a taxpayer may use to prove that he materially participated in a trade or business include "any reasonable means." Respondent acknowledges that contemporaneous daily time reports, logs or similar documents are not required if the extent of the participation may be established by other reasonable means. Respondent notes that "reasonable means" may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. Respondent contends that appellants have not provided sufficient substantiation to show that they materially participated during the years at issue. Respondent contends that, while appellants provided a schedule estimating the number of hours they spent cleaning and performing maintenance on the DKL Property, appellants have not provided any evidence to corroborate the number of hours they allegedly spent on these activities. (Resp. Op. Br., pp. 8-9.)

Respondent analyzed appellants' schedule for each year on appeal, using appellants' schedule of alleged credit card purchases. For 2006, respondent notes that appellants allege they worked 126 hours on the DKL Property based on 14 hours a day from December 22 - 31, 2006, including Christmas and New Year holidays. Respondent questions appellants' claim that they worked 14 hours on December 31, 2006, which is also listed as the check-in date for their customer, Kalow. Respondent contends that it is unlikely that Kalow would have rented and used a holiday property for $550, while appellants intruded on Kalow's use of that property for a 14-hour period. Respondent further contends that appellants have no evidence to support their claim of working 14 hours during this

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period. Respondent points out that the credit card purchase schedule shows that appellants were purportedly present at the DKL Property, and they dined at restaurants within Wintergreen, Virginia.[5] Respondent points out that the schedule does not show any purchases for supplies. Respondent further questions appellants' claim that they worked 14 hours a day because appellants appeared to have several day trips to neighboring towns approximately 50 miles away.[6] Respondent further questions appellants' claim that they worked 14 hours a day on Christmas Eve and Christmas Day working on the DKL Property because of their restaurant meals on those days. (Resp. Op. Br., pp. 9-11, Exhs. C & D.)

Respondent also contends that the claimed daily average of 14 hours a day of work in 2006 is unreasonable in light of their claims that they claimed a daily average of 12 hours of work a day in 2007, 2008, and 2009. Respondent contends that, at most, 12 hours a day is the maximum amount of time appellants could be considered devoting time to the DKL property in the best case scenario. Respondent contends that it is reasonable and likely that appellants did not work for the entire day, or at all, on the following dates in 2006: December 22, 24, 25, 29, and 31. Based on this analysis, respondent contends that, at most, appellants worked 84 hours on the DKL Property. Respondent contends that appellants did not satisfy their burden of showing that they satisfy the 100-hour requirement for material participation for 2006, citing *Akers v. Comm'r*, T.C. Memo. 2010-85. Respondent further contends that appellants must also show that their participation was more than anyone else. Respondent contends that appellants reportedly paid commissions or management fees on the DKL Property in 2006 which shows that someone else participated in the activity. Respondent contends that it is unlikely that appellants spent more time than anyone else on the property as appellants spent $5,429 on services on the property.[7] Respondent accordingly contends that appellants' activity at the DKL Property should be treated as passive in 2006. (Resp. Op. Br., pp. 11-12, Exh. K.)

For 2007, respondent notes that appellants allege they worked a total of 132 hours on the

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[5] It appears that appellants spent $91.42 on December 24, 2006, and $100.61 on December 25, 2006, at a Wintergreen restaurant.

[6] It appears that appellants made two trips to Lynchburg, Virginia, on December 22, 2006, and on December 29, 2006.

[7] Respondent contends that appellants paid $1,275 in commissions, $750 in cleaning fees, $1,500 in repairs, $984 in association fees, and $920 in management fees. Respondent indicates that this information is on appellants' Schedule E. Respondent should be prepared to produce the Schedule E at the hearing. (Resp. Op. Br., p. 12.)

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DKL Property based on 12 hours a day on the following days: January 1 and 2; August 4 to 10; and December 28 to 31. Respondent questions appellants' claim that they had 12 hour meetings with a contractor regarding a window replacement and a tree service company about tree pruning on January 1 and 2, 2007, since appellants' customer, Kalow, also occupied the DKL Property on the same dates. Respondent argues that it is hard to believe that their customer would have rented and paid $1,100 for a holiday property while appellants intruded on his use of that property for two 12 hour days. Respondent further contends that appellants' schedule of credit card purchases show that, on January 2, 2007, appellants traveled to Atlanta, Georgia via Lynchburg, Virginia, a journey of at least 8 hours. Respondent further notes that appellants then flew to San Jose, California that same day. Respondent argues that it is unreasonable for appellants to claim a 12-hour meeting with a tree company about tree pruning on January 2, 2007, while simultaneously driving eight hours to Atlanta, and then flying to San Jose, California. Respondent contends that appellants' estimates of time spent on DKL activities are clearly excessive. (Resp. Op. Br., pp. 13-14, Exhs. C & D.)

Respondent contends that the second claimed trip from August 4 - 10, 2007, was likely a trip to a different property owned by appellants on Cypress Point Circle in Virginia Beach, Virginia. Respondent points to appellants' credit card purchases that show they dined at restaurants in Virginia Beach and Norfolk on August 4, 5, and 9, 2007. Respondent notes that these restaurants are more than 200 miles and roughly 3.5 hours away from the DKL Property. Respondent contends that these trips were likely spent at the Cypress Point Circle property as the seven hour roundtrip drive would not allow appellants to spend 12 hours a day allegedly spring cleaning and meeting with contractors. With regard to the last claimed trip from December 28 - 31, 2007, respondent questions appellants' alleged work spent at the DKL Property as appellants ate at a restaurant in Norfolk on December 28, 2007 and the property was rented out to Kalow on each of December 30, 2007 and December 31, 2007, for a total of $1,100. Respondent contends that the best case scenario is that appellants spent zero hours working at the DKL Property in 2007. Respondent further notes that appellants paid commissions or management fees on the DKL Property in 2007 which shows that someone else participated in the activity. Respondent contends that it is unlikely that appellants spent more time than anyone else on

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the property as appellants spent $28,805 on services on the property.[8] Respondent accordingly contends that appellants' activity at the DKL Property should be treated as passive in 2007. (Resp. Op. Br., pp. 14-16, Exhs. C & D.)

For 2008, respondent notes that appellants allege they worked a total of 156 hours at the DKL Property based on 12 hours a day on the following days: January 1 to 6; July 10 to 13; and August 22 to 26. Respondent questions appellants' claim that they worked 12 hours a day from January 1 - 4, 2008, on spring cleaning and maintenance when their customer, Kalow, rented out the property for $2,200. Respondent further points out that appellants' schedule of credit card purchases show that, on January 6, 2008, appellants travelled from the DKL property to Gaffney, South Carolina, a journey of 300 miles and five hours, en route to Atlanta, Georgia, that same day. Respondent notes that the purchases show that appellants remained in Atlanta until January 9, 2008, when they flew to San Jose, California. Respondent contends that it is unreasonable for appellants to claim 12 hours of cleaning and maintaining the DKL Property while simultaneously driving five hours to Gaffney and then another three hours to Atlanta. (Resp. Op. Br., pp. 16 - 17, Exhs. C & D.)

As for the second trip on July 10 - 13, 2008, respondent contends that the credit card purchases show that this trip was actually to appellants' property in Virginia Beach. Respondent points out that, on July 10, 2008, appellants were at a hotel in Herndon, Virginia, near Dulles Airport in the Washington D.C. area. Respondent also points out that, on July 12, 2008, appellants dined at a restaurant in Virginia Beach and, on July 13, 2008, appellants dined at a restaurant in Norfolk. Respondent notes that the Dulles airport, Virginia Beach, and Norfolk are all more than three hours away from the DKL Property. Respondent contends that appellants likely spent this trip at the Cypress Point Circle property in Virginia Beach because the seven hour roundtrip would not allow appellants to spend 12 hours a day spring cleaning and maintaining. With regard to the third trip from August 22 - 26, 2008, respondent questions appellants' claim that they worked at the DKL Property for 12 hours on August 22, 2008, when their credit card purchases show that appellants dined at a

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[8] Respondent contends that appellants paid $500 in commissions, $500 in cleaning fees, $26,512 in repairs, $1,043 in association fees, and $250 in management fees. Respondent indicates that this information is on appellants' Schedule E. Respondent should be prepared to produce the Schedule E at the hearing. (Resp. Op. Br., p. 16.)

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restaurant in Norfolk that same day. Respondent contends that appellants have not provided any evidence for the period August 23 - 25, 2008. Respondent notes that, on August 26, 2008, appellants appeared to have purchased gas in Greenwood, Virginia, near the DKL Property, but later that day they made a purchase in Norfolk and dined at a restaurant in Virginia Beach. Respondent contends that appellants' credit card purchases to not reasonably allow appellants' claimed 12 hour work days during this trip. Respondent contends that the best case scenario for appellants is that they worked a total of 24 hours at the DKL Property in 2008: 12 hours on January 5, 2008 and 12 hours on August 25, 2008. Respondent further contends that appellants paid commissions or management fees on the DKL Property in 2008 which shows that someone else participated in the activity. Respondent contends that it is unlikely that appellants spent more time than anyone else on the property as appellants spent $25,520 on services on the property.[9] Respondent accordingly contends that appellants' activity at the DKL Property should be treated as passive in 2008. (Resp. Op. Br., pp. 17 - 20, Exhs. C & D.)

For 2009, respondent notes that appellants allege they worked a total of 118 hours at the DKL Property on the following days: May 13 to 17; and August 17 to 22. With regard to the May 13 - 17, 2009 trip, respondent contends that there is no evidence appellants made a single credit card purchase in the Wintergreen area during five of the six days where appellants allegedly spent 12 hours a day spring cleaning and maintaining the property. Respondent notes that appellants had a single credit card purchase in Norfolk on May 13, 2009, for a rental car. Respondent further points out that there is an inconsistency in the credit card purchase schedules because this May trip was listed on one of the schedules, but was not listed on the second schedule which was attached to appellants' email dated December 31, 2013. (Resp. Op. Br., pp. 20 – 21, Exhs. C & D.)

As for the August 17 - 22, 2009 trip, respondent contends that appellants' claimed 14-hour work days from August 17 - 22, 2009, is unreasonable in light of appellants' claims for the 2007, 2008 and 2009 years in which they claimed to have spent a daily average of 12 hours per day cleaning and maintaining the property, as well as their frequent absence from the property's location on

[9] Respondent contends that appellants paid $500 in commissions, $500 in cleaning fees, $23,154 in repairs, $1,116 in association fees, and $250 in management fees. Respondent indicates that this information is on appellants' Schedule E. Respondent should be prepared to produce the Schedule E at the hearing. (Resp. Op. Br., p. 19.)

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days they were allegedly working there. Respondent contends that, at most, it is reasonable that appellants' daily average work time was 12 hours a day. Respondent further contends that appellants' credit card purchases show that appellants spent part of the time claimed in 2009 at the DKL property in Atlanta, Georgia, and Norfolk, Virginia. Respondent contends that, as the DKL property is eight hours away from Atlanta, Georgia, it is unlikely that appellants could also work 14 hours on the DKL Property at the same time. Respondent contends that, from August 18 through 21, 2009, appellants made numerous credit card purchases in Charlottesville and Wintergreen, Virginia, demonstrating appellants' likely presence at the DKL Property. However, respondent points out that, on August 22, 2009, appellants made numerous purchases in Norfolk and Virginia Beach, Virginia, which were more than 200 miles and more than three hours away from the DKL Property. As such, respondent contends that it is improbable that appellants could also work 14 hours on the DKL Property on that same day. Respondent contends that the best case scenario for appellants is that they worked a total of 48 hours in 2009, based on working 12 hour days from August 18 - 21, 2009. Respondent further contends that appellants paid commissions or management fees on the DKL Property in 2009 which shows that someone else participated in the activity. Respondent contends that it is unlikely that appellants spent more time than anyone else on the property as appellants spent $4,944 on services on the property.[10] Respondent accordingly contends that appellants' activity at the DKL Property should be treated as passive in 2009.[11] (Resp. Op. Br., pp. 21 – 23, Exhs. C, D & I.)

Appellants' Reply Brief

Appellant first asserts that, over the course of the original audit and subsequent protest, they provided over 1,000 pages of documentation to respondent, in addition to multiple letters and telephone conversations. Appellants contend that respondent has been aggressive and inappropriate during this process. Appellants assert that respondent conducted a wide ranging investigation in an apparent attempt to maximize revenues, without regard to fairness or accuracy. Appellants contend that

[10] Respondent contends that appellants paid $500 in commissions, $500 in cleaning fees, $2,500 in repairs, $1,194 in association fees, and $250 in management fees. Respondent indicates that this information is on appellants' Schedule E. Respondent should be prepared to produce the Schedule E at the hearing. (Resp. Op. Br., p. 23.)

[11] The remainder of respondent's opening brief discussed the mortgage interest and depreciation expense deductions.

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respondent "is essentially attempting to pound [appellants] into submission with its relentless series of attacks and accusations." Appellants assert that respondent previously accepted the evidence they submitted with regard to the hours appellants spent on maintaining the DKL Property, as demonstrated by their telephone conferences and emails to respondent's auditor. (App. Reply Br., pp. 1-2; Resp. Op. Br., Exhs. B & L.)

Appellants contend that they are not claiming deductions for rental real estate activity on their California returns. Rather, appellants contend that they are claiming that their activities related to the DKL Property should be treated as a trade or business such that the losses are fully deductible. Appellants contend that their activities meet the exception provided in Treasury Regulation section 1.469-1T(e)(3)(ii)(A). Appellants contend that they provided respondent with their contemporaneous records of both customer reservations and rental usage. Appellants further contend that they provided summary data showing that the individual customer usage for each tax year and that information agreed with the rental income reported on their Schedule E. Appellants contend that they did not provide copies of rental contracts requested by respondent's auditor after he denied appellants' protest because they are "operating in the twenty-first century" and they conducted their business via email. Appellants assert that they no longer have access to their email records from six-to-nine years ago or they would have already provided them. Appellants assert that the FTB's auditor accepted their evidence that they satisfied the seven-day exception and question respondent's NOAs which state that the information submitted did not verify that the DKL property was rented for seven days or less. Appellants state that they understand respondent's opening brief to mean that respondent concedes the average rental period argument and respondent instead is concentrating on the material participation argument. Appellants contend that respondent conceded the one point from which respondent denied their protest and, therefore, respondent has acknowledged that the protest should be upheld and the Board should uphold appellants' full deductions for the business use of the DKL Property. (App. Reply Br., pp. 3-4.)

Appellants further contend that they satisfy the 100-hour test provided in Treasury Regulation section 1.469-5T(a). Appellants contend that, in accordance with acceptable methods of proof provide under Treasury Regulation section 1.469-5T(f)(4), they provided detailed proof, including the identification of services that they performed, the specific dates and hours of service, and

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documentation substantiating the trips taken to visit the property and perform the services. Appellants contend that, in each of the four tax years, the amount of time they spent physically at the property doing maintenance, repair, and general upkeep was greater than 100 hours for each of the appellants. Appellants state that they did not include travel time to and from the property nor did they account for the fact that their actual hours should have been doubled since both appellant-husband and appellant-wife were present and working on the reported dates. Appellants also contend that in each year they spent approximately two hours per month, in total, working on marketing and customer acquisition related activities, for a total of 24 hours per year. Appellants state that they did not include this time earlier in this process because they had already reported over 100 hours per year. Appellants state that they also spent approximately two hours per customer for each customer stay in a given year. (App. Reply Br., pp. 4-5; Resp. Op. Br., Exhs. C & I.)

Appellants also contend that respondent used the wrong time and expense schedule to incorrectly contest appellants' reporting. Appellants contend that, in documenting and reporting the time spent at the property working on the various items, they provided detailed credit card statement summaries which substantiate the approximate dates and times they visited the property. Appellants contend that the dates on the credit card statements reflect the processing date, and not the date the charges were made. As such, appellants contend that they made an effort to correct the dates to correspond as closely as possible to the actual dates when the charges were made. In addition, appellants contend that they identified one additional trip to the property taken in May 2009 which was not included in their initial submission. Appellants contend that their revised submission sent to respondent on December 31, 2013, is more accurate and therefore respondent's analysis, based on the previous submission, is incorrect. (App. Reply Br., pp. 5-6; Resp. Op. Br., Exhs. D & I.)

Appellants also contend that respondent erred in determining that appellants could not stay in the property when a customer was renting the property. Appellants explain that the DKL Property is a four-bedroom house near a mountain top, and due to its location on a slope, it spans four physical levels. Appellants explain that the master suite is on the fourth level, the main living area is on the third level, a second master suite and a large bunkroom is on the second level. Appellants explain that the property includes a completely separate apartment on the first level and that is where

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appellants stayed while their customer was renting the property. Appellants contend that this was not a problem for their customer. (App. Reply Br., p. 6.)

Appellants contend that respondent is requiring a standard of proof well in excess of what is required by Treasury Regulation section 1.469-5T(f)(4). Appellants contend that the DKL Property is located in a very isolated location and the nearest towns are Charlottesville and Lynchburg, Virginia. Appellants contend that they made purchases on occasion at the Wintergreen resort, but on most cases, they purchased supplies, gas, and food from Lynchburg and Charlottesville. Appellants contend that, in cases where purchases made in Wintergreen were not reflected in the credit card records, respondent wrongly concluded that there was no evidence to show that appellants were working on the property. Appellants point to their documented trips from their home in California to Virginia and purchases made within 50 miles of the property. Appellants further contend that, even though they cannot document purchases made at the property, they provided documentation in the form of calendars and narrative summaries. Appellants further contend that respondent made incorrect assumptions regarding the amount of time spent working on the property. Appellants contend that they traveled to the property once or twice a year to work on the property. Appellants assert that, based on how the property is situated on a relatively exposed ridge subject to the elements, the property required a great deal of minor repairs and cleaning to maintain the property in a rentable condition. Appellants assert that they have had to repair the windows, fix water leaks, and address the frequent infestation of insects which required extensive cleaning. Appellants assert that, when they were at the property, they worked from 7 or 8 in the morning to 9 or 10 in the evening, with breaks for meals, brief rests, and the occasional trip to a nearby town for supplies. Appellants contend that respondent would have appellants subtract every minute they are not engaged in physical labor and questions this approach. Appellants also contend that respondent did not calculate the work hours properly because the estimates appellants submitted were based on only one person's work and since both appellant-husband and appellant-wife worked on the property, every hour previously claimed should be doubled. (App. Reply Br., pp. 6-7.)

For the 2006 tax year, appellants claim that the actual hours worked were 280 (i.e., 126 per appellant-husband on site + 126 per appellant-wife on site + 24 marketing work + 4 customer

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coordination). Appellants assert that, contrary to respondent's position that appellants only worked 12-hour days, appellants actually worked 14-hour days. With regard to the day trips to Lynchburg, appellants contend that Lynchburg is the closest town and they traveled there to buy supplies, eat a meal, and buy gas. Appellants contend that this time spent also count as hours worked. As for the meals they had on Christmas Eve and Christmas Day, appellants contend that these meals were a treat for the holidays since they sacrificed their time to do necessary work at the property. With regard to New Year's Eve when Kalow checked-in, appellants assert that they worked a full day in preparation of Kalow's evening arrival and later worked in the first level and outside of the house. As to respondent's contention that other individuals worked more than appellants, appellants assert that the fees listed on the Schedule E were paid to different individuals or entities and none of their participation was greater than 10 hours in 2006. Appellants further argue that respondent's estimated hours of 84 hours when doubled to account for both appellant-husband and appellant-wife working on the property is equaled to 168 hours. As such, appellants contend that, even based on respondent's lower estimate plus the 28 additional hours[12] for marketing and customer administration, they satisfy the 100-hour test. (App. Reply Br., pp. 7-8.)

For the 2007 tax year, appellants claim that the actual hours worked were 298 (i.e., 132 per appellant-husband on site + 132 per appellant-wife on site + 24 marketing work + 10 customer coordination). With regard to January 1 and 2, 2007, appellants contend that, even though their customer was in the residence, appellants worked one full day and one partial day on the first level of the property and the outside of the property. With regard to their trip to Atlanta and flight back to California on January 2, 2007, appellants contend that they worked six hours on that day and traveled another eight hours to Atlanta. Appellants assert that they worked 16 hours on January 1, 2007, because they had a lot of work to do before taking their non-refundable flight back to California which brought them back to San Jose at one in the morning the following day. Appellants note that they should have reported their airport parking expense for January 3, 2007. Appellants further contend that, contrary to respondent's interpretation that appellants only met with the tree company and

[12] Although appellants referenced 34 additional hours in their reply brief, the correct amount is 28 additional hours claimed (24 marketing work + 4 customer coordination).

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contractor on those two days, appellants actually performed all the stated activities during the entire trip. As to the August 5 - 10, 2007 disallowed hours based on the lack of expenses, appellants contend that it is common to not incur expenses in the immediate area given the isolated nature of the property. Appellants state that they spend two nights, August 3 and 4, 2007, in the Virginia Beach area, where they purchased most of the needed supplies in addition to the supplies they brought from home. Appellants contend that, despite respondent's assertion, they did not visit the Cypress Point Circle property. With regard to December 28 and 29, 2007, appellants assert that they flew to Norfolk to purchase supplies prior to driving to the property. Appellants contend that their claimed 12 hours of work on these days did not include driving time. With regard to December 30 and 31, 2007, appellants again contend that they occupied the first level apartment and worked on the first level and outside the property while their customer was in residence and had approved of the situation. As for other individuals' work on the property, appellants contend that respondent has no proof other than the list of fees. Appellants assert that the fees were paid to different individuals or entities and none of their participation was greater than 30 hours during 2007. Appellants assert that the only party who worked up to 30 hours was the contractor who made repairs to the windows, siding, and other interior repairs. Appellants further argue that their original claimed hours of 132 hours when doubled to account for both appellant-husband and appellant-wife working on the property is equaled to 264 hours. As such, appellants contend that, based on this new claimed amount of hours plus the 34 additional hours for marketing and customer administration, they satisfy the 100-hour test. (App. Reply Br., pp. 9-10.)

For the 2008 tax year, appellants claim that the actual hours worked were 344 (i.e., 156 per appellant-husband on site + 156 per appellant-wife on site + 24 marketing work + 8 customer coordination). For the period January 1 - 4, 2008, appellants again contend that they occupied the first level apartment and worked on the first level and outside the property while their customer was in residence and had approved of the situation. With regard to January 6, 2008, appellants contend that they worked seven hours, from eight in the morning to three in the afternoon, and then drove six hours to Greenville, South Carolina, where they spent the night. Appellants assert that they previously worked 13 hours a day from January 1 - 5, 2008, for a total of 65 hours. As such, appellants contend that they worked 72 hours total from January 1 to 6, 2008. For the period July 10 - 13, 2008, appellants

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contend that respondent relied on the incorrect expense worksheet (Resp. Op. Br., Exh. D) versus the more current expense worksheet (Resp. Op. Br., Exh. I) in disallowing the claimed work hours. Appellants contend that they flew into Dulles airport in Washington on July 9, 2008,[13] and drove to the property the next morning on July 10, 2008.[14] Appellants assert that they purchased supplies on the way to the property and therefore did not have any expenses in the Wintergreen area. Appellants contend that they left the property on July 13, 2008,[15] to drive to Norfolk. Appellants contend that, contrary to respondent's assertion, they did not visit the Cypress Point Circle. Appellants state that the reported two full 14-hour days on July 11 and 12, 2008,[16] and two partial 4-hour days on July 10 and 13, 2008,[17] for a total of 36 hours as reported. With regard to the disallowed hours for the period August 22 - 26, 2008, due to the lack of expenses in the Wintergreen area, appellants contend that they purchased their supplies away from the property. Appellants assert that they flew into Norfolk, and purchased supplies on their way to the property. Appellants contend that a Home Depot expense of $31.47 reflecting a date of August 26, 2008, was actually incurred on August 22, 2008. Appellants state that the charge was delayed in appearing on their credit card statement. Appellants contend that they actually spent two hours on August 22, 2008, not including drive time. In addition, appellants contend that they actually spent 14 hours per day from August 23 - 25, 2008, and another four hours on August 26, 2008. Therefore, for the period August 22 - 26, 2008, appellants contend that they worked 48 hours. As for other individuals' work on the property, appellants contend that respondent has no proof other than the list of fees. Appellants assert that the fees were paid to different individuals or entities and none of their participation was greater than 30 hours during 2008. Appellants assert that the only party who worked up to 30 hours was the contractor who made repairs to the windows, siding, and other interior repairs. Appellants further argue that their original claimed hours of 156 hours when

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[13] Although appellants referenced the month in this date as August in their reply brief, the correct month is July.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

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doubled to account for both appellant-husband and appellant-wife working on the property is equaled to 312 hours. As such, appellants contend that, based on this new claimed amount of hours plus the 32 additional hours for marketing and customer administration, they satisfy the 100-hour test. (App. Reply Br., pp. 11-12.)

For the 2009 tax year, appellants claim that the actual hours worked were 276 (i.e., 118 per appellant-husband on site + 118 per appellant-wife on site + 24 marketing work + 16 customer coordination). For the period, May 13 - 17, 2009, appellants contend that respondent relied on the incorrect expense worksheet (Resp. Op. Br., Exh. D) versus the more current expense worksheet (Resp. Op. Br., Exh. I) in disallowing the claimed work hours. As to the lack of expenses during this period, appellants contend that they flew into Norfolk and purchased supplies in addition to the supplies from home prior to driving to the property on May 13, 2009. Appellants contend that their actual work hours during this period was 14 hours per day on May 14 to May 16, plus two hours on May 13, 2009, and four hours on May 17, 2009, for a total of 48 hours. For the period, August 18 - 21, 2009, appellants argue that their average full work day was 14 hours, not 12 hours as respondent suggests. Appellants contend that many of the 12 hour average days were the result of combining full 14 hour days with partial days. For August 17 and 22, 2009, appellants contend that they did not claim any hours on August 22, 2009. Appellants contend that they worked a full 14 hour day on August 17, 2009, since they arrived very late in the evening of August 16, 2009, based on a Starbuck's charge at the Atlanta airport made on that date. As for other individuals' work on the property, appellants contend that respondent has no proof other than the list of fees. Appellants assert that the fees were paid to different individuals or entities and none of their participation was greater than 10 hours during 2009. Appellants further argue that their original claimed hours of 118 hours when doubled to account for both appellant-husband and appellant-wife working on the property is equaled to 236 hours. As such, appellants contend that, based on this new claimed amount of hours plus the 40 additional hours for marketing and customer administration, they satisfy the 100-hour test. (App. Reply Br., pp. 13-15.)

Respondent's Reply Brief

Respondent contends that appellants have not provided any additional documentation to corroborate the length of any guest occupancy at the DKL Property. Respondent further states that it

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has not conceded such facts. Respondent contends that, while appellants may have provided hundreds of pages (not thousands, per appellants' assertion), the documentation relating to the DKL Property did not support nor confirm the variety of positions and factual representations appellants made over the course of this dispute. Respondent notes that it requested copies of rental agreements appellants made with each of the potential renters. Respondent notes that, as most of appellants' claimed rentals occurred in the winter, it is worth pointing out that the DKL Property is located in Virginia's Blue Ridge Mountains at the Wintergreen Resort.[18] Respondent notes that, during the winter, the Wintergreen Resort offers 32 trails for skiing and snowboarding, and roughly half of the trails are available for night-skiing and snowboarding. (Resp. Reply Br., pp. 1-2.)

As to appellants' contention that they used email instead of written contracts with their customers, respondent contends that appellants have admitted that they no longer have access to their email records from 6-to-9 years ago. Respondent contends that, contrary to appellants' assertion, appellants did not provide extensive documentation with respect to the DKL Property. Respondent contends that the email communication would be helpful to determine whether appellants communicated to potential customers, such as Kalow, that appellants would also be occupying the DKL property, spring cleaning, and performing maintenance work for 14-16 hours per day while Kalow paid $550 per night to rent the DKL Property. Respondent contends that it is convenient for appellants to claim that the reason no contract exists is because appellants used email while they simultaneously claim that they no longer have the purported email records. Respondent argues that, regardless of whether appellants provide the emails, it remains appellants' burden to prove an entitlement to the claimed deductions. Citing the Board's decision in the *Appeal of Don A. Cookston* (83-SBE-048) decided on January 3, 1983, appellants' failure to introduce evidence that is within their control gives rise to the presumption that the evidence, if provided, would be unfavorable to their position. Respondent contends that appellants provided no emails or rental contracts to show that their average rental period was less than seven days. Respondent further contends that its primary position during this dispute has been, and still is, that the information provided by appellants did not verify that

[18] Wintergreen Resort's website may be found at: http://www.wintergreenresort.com.

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the DKL Property was rented for seven days or less. Respondent states that, at no point, did it concede this issue. (Resp. Reply Br., pp. 2-3.)

Respondent further contends that appellants provided no additional documentation to corroborate the doubling of their estimate of time spent materially participating in the DKL Property. Respondent contends that appellants' estimates of the time they devoted to spring cleaning and maintenance to be excessive in relation to the vague descriptions of "spring cleaning, general repairs, and maintenance" appellants claim to have performed. Respondent contends that appellants, instead of providing additional evidence to support the original claims of 12-to-14 hours per day, have doubled the amount of time they allegedly spent cleaning and maintaining the DKL Property. Respondent questions why appellants did not provide a "correct" estimate of time participating from the outset. Respondent further contends that it already took into account both appellant-husband and appellant-wife's participation in the DKL Property because appellants' correspondence referred to their activities in the plural form. Respondent contends that appellants' original method of estimating their participation was already not reasonable under the applicable regulation and appellants go even further with their current contention that the hours are doubled since the claimed time is not supported by any authenticating third-party documentation or contemporaneous records. Respondent points out that the burden of proof on this issue lies with appellants and, while the regulation's method of proof is quite lenient, it is well established that this regulation does not require respondent or the Board to believe or rely on a "ballpark guesstimate" of the time spent on different activities. In support, respondent cites various Tax Court decisions including *Lee v. Comm'r*, T.C. Memo 2006-193; *Carlstedt v. Comm'r*, T.C. Memo. 1997-331 (*Carlstedt*); and *Specks v. Comm'r*, T.C. Memo. 2012-343. Respondent contends that here, as in *Carlstedt*, the documents themselves do not show any objective measure of time for the activities and rather appellants assigned times to activities years later based solely on their judgment and experience as to how long it must have taken him. Respondent contends that, even if such uncorroborated estimates were made in good faith, memories can fade with time, and records can be lost or thrown out. (Resp. Reply Br., pp. 4-5.)

Respondent points out that it is particularly questionable that appellants' credit card purchases often place them hundreds of miles away from the DKL Property in Virginia Beach and

Norfolk on the very days when appellants claimed to have spent 24 hours a day working at the property. Respondent contends that appellants have not adequately explained how they could incur expenses in Virginia Beach over the course of several days while at the same time transporting themselves back and forth to the DKL Property with adequate time and rest to complete 12-to-14 hour work days at the DKL Property. Respondent acknowledges that, while the documents submitted by appellants show some level of participation, their ballpark guestimates of 12, 14, or 16 hours per day for each appellant is unreasonable. As to the alleged credit card expenditures, respondent contends that it is not necessarily a substantiation issue, rather the evidence appellants provided contradicts their claim of time spent working on the DKL Property. Without some form of participation log, receipts detailing the supplies purchased to account for the 12-to-14 hour days, or some other reasonable form of evidence, respondent contends that appellants' estimates are nothing more than ballpark guestimates. Respondent further contends that it is questionable that appellants increased their time from 14-to-16 hours to 28-to-32 hours of spring cleaning and performing maintenance work at the same time their customer was paying $550 per night to rent and enjoy the DKL Property. (Resp. Reply Br., p. 5.)

Respondent further contends that appellants have many of the indicators of a taxpayer that does not materially participate in a rental property, citing the IRS Audit Technique Guide.[19] Respondent notes that appellants' home in Saratoga, California, is roughly 3,000 miles away from the DKL Property and much of appellants' use of the DKL Property was limited to typical vacation periods. Respondent further notes that appellants have numerous other vacation properties, including a condominium in Virginia Beach, Virginia, a condominium at Northstar Resort in Truckee, California, a mountain ski resort near Lake Tahoe, and a second property in Truckee, California. Respondent further notes that appellants hired a management company, Blue Ridge Getaways, for the 2006 tax year, and had another less significant management arrangement for the 2007 through 2009 tax years at issue. Appellants also paid management fees on the Northstar condo of $27,042 in 2007, $30,618 in 2008, and $19,387 in 2009. Respondent questions appellants' new claim of 24 hours for each year at issue for marketing, including the 2006 tax year when the DKL Property was rented exclusively through

[19] Respondent acknowledges that the Audit Technique Guide is not precedential, but it provides guidance in determining the facts germane to passive activity losses.

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Blue Ridge Getaways. Respondent notes that, according to the log, the renters were primarily friends and repeat guests. Respondent contends that appellants did not provide any evidence of the marketing steps they took to amount to the additional 24 hours claimed for each year. (Resp. Reply Br., pp. 6-7.)

Respondent also contends that appellants have not presented evidence establishing that the participation by Blue Ridge Getaways, or any of the contractors, or cleaning crews did not exceed appellants' participation. Respondent points out that, in 2006, appellants paid Blue Ridge Getaways $625 for maid service which is equaled to roughly 121 hours based on a minimum wage of $5.15 per hour in Virginia at the time. Respondent also contends that appellants' records show that cleaning crews spent eight days cleaning in 2009 and appellants claimed to have been present at the property for nine days while respondent determined that appellants were present for four days based on the credit card purchases. Respondent contends that appellants claimed significant costs for repairs on the DKL Property for the 2007 and 2008 tax years but appellants have not provided any documentation accounting for the hours spent nor the supplies purchased for those engaged in the alleged repairs. Respondent contends that these examples point to other individuals having spent more time participating in the upkeep of the rental property than appellants, which would disqualify appellants from having the requisite material participation. (Resp. Reply Br., p. 7.)

Respondent further notes that appellant-husband had a Form W-2 wage job as a marketing executive with Cisco Technologies during the years at issue, working at least 40 hours a week for which appellant-husband received significant compensation. Respondent questions the extent of appellant-husband's participation in the DKL Property during his vacation breaks from his high-paying job. Respondent further contends that appellants' estimates do not account for breaks for meals, travel, or leisure and holiday time with their minor daughters at the Wintergreen Resort, which is not considered material participation. Respondent contends that its calculations of hours worked as listed in respondent's opening brief are reasonable estimates based on the evidence appellants provided. (Resp. Op. Br., pp. 7-10.)

Appellants' Supplemental Brief

Appellants maintain that they provided substantial documentation to corroborate the length of each guest occupancy at the DKL Property. Appellants contend that they submitted three

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separate items of corroborating evidence and attach a fourth set of evidence with their supplemental brief. Appellants contend that they provided: (1) a spreadsheet file titled "Devil's Knob Rentals 2006-2009," which list in detail each rental customer in the years at issue; (2) copies of their original and contemporaneous Reservations Book, in which appellants registered and recorded reservations for the property rentals as they came in; and (3) copies of their original and contemporaneous Rentals Book, where appellants recorded the actual property rentals and financial details. In addition, appellants submit as additional proof, their description of the property as being in a four season resort and their experience that the typical rental stays in Wintergreen corresponds to their actual rental. Appellants contend that the average stay at their property for 2006 through 2009 was 4.58 nights. Appellants contend that that it was unusual for guests to stay longer than seven days and that they did not in fact have any stays of that length. (App. Supp. Br., pp. 1-3.)

With regard to the emails, appellants question respondent's characterization of appellants' inability to provide the emails as appellants' attempt to hide evidence detrimental to their case. Appellants contend that this "allegation is patently ridiculous" and the emails, if available, would only further support the documentation already provided. Appellants assert that they changed internet service providers (ISP) during the intervening years and no longer have access to those emails on the old ISP's email servers. Appellants contend that respondent's "continuing insistence on obtaining even more evidence is simply a transparent attempt to deny [their] legitimate deduction." As to appellants' belief that respondent conceded the seven-day rental issue, appellants contend that they relied on page seven of respondent's opening brief in which respondent stated "Appellants did not provide the contracts or rental agreements that correspond to the entries, so respondent was unable to verify that the log entries were accurate. Even if, *arguendo*, the log entries are correct . . ." Appellants further contend that they did not acknowledge that they could not verify that the property was rented for seven days or less. Appellants contend that they have done just that with their "written and verbal assertions" and the "three independent pieces of evidence" discussed above. Appellants argue that respondent is continuously raising the bar of evidence until appellants cannot satisfy it. Appellants assert that, if they had submitted the emails, respondent would then argue that it was not enough proof to verify that the property was rented for seven days or less. Appellants further question respondent's contention that its

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primary position is that appellants failed to demonstrate that they satisfy the seven-day test because appellants assert that, in the majority of respondent's opening brief, there is no reference to the seven-day test but for two sentences appellants previously noted. Appellants assert that this is "just one more example of the FTB's 'shotgun approach'" to this dispute. Appellants assert that respondent is simply following a strategy of "denial and delay" in order to deny appellants the claimed deductions. (App. Supp. Br., pp. 3-4.)

Appellants also maintain that they provided "ample documentation" in accordance with the applicable regulation to support their material participation in the business. Appellants state that, in addition to the "voluminous expense records and narrative summaries of the time [they] spent and work performed," appellants submit appellant-husband's calendar records for the time spent working on the property. Appellants contend that none of the information is new and that it is consistent with the previously-submitted evidence. Appellants contend that they provided documentation specifically referenced in Treasury Regulation section 1.469-5T(f)(4), namely the "identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars or narrative summaries." Appellants contend that respondent's insistence on parsing every minute of every hour is inconsistent with the regulation's use of the word "approximate." (App. Supp. Br., p. 4, Exh. 1.)

Appellants allege that respondent raised new issues in respondent's reply brief. Appellants argue that respondent's discussion regarding the Internal Revenue Service Audit Technique Guide is new and appellants appear to argue that respondent is inconsistent since this dispute arose from the difference between federal and California law. In response to respondent's arguments, while appellants do not agree that they should be required to respond to these allegations, appellants contend that they do not own numerous other vacation properties. Appellants state that they own several other investment properties which are rented out either on a full-time or part-time basis. Appellants contend that they purchased the DKL Property in 2001 with the intention of using the residence as their future retirement home. Appellants contend that they ended up owning "so much real estate after losing a great deal of money in the stock market, and switching to a strategy of investing in real estate." Appellants contend that this strategy has not worked out well and, as a result, they hold a number of

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mortgages and incur other expenses which they offset with rental income. Appellants state that they use management companies to rent their Virginia Beach and Northstar condominiums. Appellants state that they have full-time tenants in the Truckee house. However, appellants were unable to find a suitable management company for the DKL Property and they chose to handle it themselves beginning in the spring of 2006. Appellants contend that, while appellant-husband's salary may appear high, it is insufficient to provide an adequate standard of living on its own in the Bay Area, in light of their high debt load. Appellants state that appellant-husband is entitled to four weeks of paid vacation, and up to seven weeks of reserve vacation. Appellants contend that he has ample time to make the two trips a year to Virginia to care for the DKL Property. Appellants state that they prefer to invest their time and effort in caring for their future retirement home and protecting their investment. Appellants state that they would rather take care of the house themselves than pay another party whom they cannot rely on. (App. Supp. Br., pp. 5-6.)

As to respondent's claims regarding the $625 paid to Blue Ridge Getaways for maid service, appellants contend that they only had two rentals for that year and they paid approximately $300 to clean the house. Appellants assert that the typical maid service takes approximately three hours and is performed by two people. As such, appellants further contend that respondent's assertions regarding the eight days of cleaning in 2009 is "patently false" since the total time spent per person for maid service in 2009 was 12 hours. As to the repairs in 2007 and 2008, appellants assert that the vast majority of these expenses were for materials. Appellants state that they had multiple windows blown off the house that needed replacement. In addition, they had extensive siding replaced and interior water damage. Appellants assert that the contractor who performed the services used various individuals and not one individual spent more than 30 hours on the house. As to respondent's reference to the *Carlstedt* case, appellants contend that that case has no bearing on this situation because appellants claim that they have full documentation of where they were and how they spent their time. Appellants further contend that respondent made false statements regarding appellants being hundreds of miles away in Virginia Beach and Norfolk. Appellants also submit an additional copy of the "corrected Expense Summary" previously submitted. (App. Supp. Br., p. 6-7, Exh. 2.)

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Applicable Law

Burden of Proof

Respondent's determination is presumed correct, and the taxpayer bears the burden of proving that the determination was erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Deductions from gross income are a matter of legislative grace and the taxpayer has the burden of proving an entitlement to the deductions claimed; unsupported assertions are not sufficient to satisfy the taxpayer's burden of proof. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

Passive Activity

California incorporates, with some changes, IRC section 469, which generally prohibits the use of passive activity losses to reduce non-passive activity income (e.g., wages, interest, or dividends). (Rev. & Tax. Code, § 17561.) In general, a taxpayer's passive losses can be deducted only to the extent of income from the taxpayer's passive activities. Any unused passive losses are generally suspended and carried forward to future years to offset passive income generated in those years. (*Lowe v. Comm'r*, T.C. Memo. 2008-298; see also, *Jafarpour v. Comm'r*, T.C. Memo. 2012-165.) The term "passive activity" includes: (1) any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate; and (2) any rental activity. (Int.Rev. Code, § 469(c)(1) and (2).) "Rental activity" means any activity where payments are principally for the use of tangible property. (Int.Rev. Code, § 469(j)(8).)

Federal Exception for Real Estate Professionals

IRC section 469(c)(7) allows taxpayers in the real property business to treat rental activity losses as non-passive losses for federal purposes. However, R&TC section 17561, subdivision (a), states that, "Section 469(c)(7) of the Internal Revenue Code, relating to special rules for taxpayers in [the] real property business, shall not apply." Therefore, for California purposes, rental real estate activities are considered passive activities, and any losses from such activities generally can only be applied to offset passive activity gains. Nevertheless, IRC section 469(i), to which California conforms, allows for up to $25,000 of rental real estate activity losses to apply to non-passive income. This allowance phases out by 50 percent of the amount in which the AGI of the taxpayer for the taxable

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year exceeds $100,000, with a complete phase-out of such loss deductions at an AGI of $150,000.

Trade or Business Exception to Rental Activity

An activity involving the use of tangible property is not a "rental activity" for a taxable year if, for such taxable year, one of the following six circumstances are satisfied: (A) the average period of customer use for such property is seven days or less; (B) the average period of customer use for such property is 30 days or less, and significant personal services are provided by or on behalf of the owner of the property in connection with making the property available for use by customers; (C) extraordinary personal services are provided by or on behalf of the owner of the property in connection with making such property available for use by customers (without regard to the average period of customer use); (D) the rental of such property is treated as incidental to a non-rental activity of the taxpayer; (E) the taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers; or (F) the provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest is not a rental activity under paragraph (e)(3)(vii) of this section. (Treas. Reg., § 1.469-1T(e)(3)(ii).)

Material Participation

IRC section 469(h) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. Material participation is a year-by-year determination. (See Treas. Reg., §1.469-5T(a).) A taxpayer materially participates in a trade or business activity if, and only if, he or she meets one of the seven tests provided in Treasury Regulation section 1.469-5T(a). As relevant to this appeal, the third test requires:

> The individual participates in the activity for more than 100 hours during the taxable year, and such individual's participation in the activity for the taxable year is not less than the participation in the activity of any other individual (including individuals who are not owners of interests in the activity) for such year.

(Treas. Reg., § 1.469-5T(a).)

The methods of proof a taxpayer may use to proof that he or she materially participated in an activity:

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> The extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries.

(Treas. Reg., § 1.469-5T(f)(4).)

Tax Courts consistently hold that, while Treasury Regulation section 1.469-5T(f)(4) is somewhat ambivalent concerning the records to be maintained by taxpayers, the provision by no means allow a post-event "ballpark guesstimate." (*Moss v. Comm'r* (2010) 135 T.C. 365, 369; *Carlstedt v. Comm'r*, *supra* [taxpayer's diary of activities merely a numerical compilation of hours based on taxpayer's review of his calendar and uncorroborated estimates not considered a narrative summary]; *Lee v. Comm'r*, *supra* [non-contemporaneous time logs reconstructed based on taxpayer's personal experience and limited records not credible]; *Mowafi v. Comm'r,* T.C. Memo. 2001-111 [non-contemporaneous logs prepared in connection with taxpayer's audit and testimony at trial not credible]; *Vandegrift v. Comm'r*, T.C. Memo. 2012-14 [honest and forthright testimony of taxpayer's time estimate suspect because taxpayer was an employee and taxpayer's subjective estimate lack contemporaneous verification by records or other evidence].) Tax Courts also hold that the credibility of a taxpayer's records is diminished where the number of hours reported appears excessive in relation to the task described. (*Jafarpour v. Comm'r*, *supra*, citing *Hill v. Comm'r*, T.C Memo. 2010-200 and *Bailey v. Comm'r*, T.C. Memo. 2001-296.)

STAFF COMMENTS

Appellants own the DKL Property, which is located in Virginia's Blue Ridge Mountains at the Wintergreen Resort. It appears that, during the winter, the Wintergreen Resort offers 32 trails for skiing and snowboarding, and roughly half of the trails are available for night-skiing and snowboarding. Appellant contends that they rented the DKL Property as a trade or business. Appellants claimed rental losses on the DKL Property of $89,727, $106,985, $113,574, and $80,800 for tax years 2006, 2007, 2008 and 2009, respectively. Respondent disallowed the rental losses as passive losses. The parties dispute whether appellants' activities at the DKL Property should be treated as a

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"rental activity" or a trade or business. Rental activities are per se passive. (Int. Rev. Code, § 469(c)(2).) There is a limited exception for an activity involving the use of tangible property to be considered a trade or business. (Treas. Reg., § 1.469-1T(e)(3)(ii).) Appellants contend that they satisfy the test requiring that the average rental is less than seven days. (Treas. Reg., § 1.469-1T(e)(3)(ii)(A).)

Appellants submitted: (1) a schedule created for the audit/protest period showing the rental dates, guest names, and rent paid (Resp. Op. Br., Exh. L); and (2) a handwritten log detailing the renter's name, date of arrival, date of departure, nightly rate, number of nights rented, rent, and payment information. It appears that this log may be contemporaneous to the time period. (Resp. Op. Br., Exh. B.) Appellants indicated that Blue Ridge Getaways handled the rentals for 2006. (Resp. Op. Br., Exh. L.) Appellants should be prepared to explain whether Blue Ridge Getaways used rental contracts in 2006 and, if so, why appellants did not provide those documents. Appellants allege that they are unable to access their emails from the period at issue due to switching ISPs. Appellants should be prepared to explain why they are unable to ask their former guests for the emails between them in light of the fact that many of the guests were "friends" and "repeat" customers. (Resp. Op. Br., Exh. B.)

Appellants may want to discuss the method of payment their guests used, such as checks or direct deposit. Appellants may want to discuss whether the methods of payment may corroborate the length of each guest's stay. In addition, appellants may want to provide evidence of their marketing in the years at issue and, specifically, whether the marketing advertised their rental prices.

In addition, the parties dispute whether the activities at the DKL Property should be considered passive. For the activities to be considered not passive, appellants must demonstrate that they materially participated in the activity. (Int.Rev. Code, § 469(c)(1).) Appellants argue that they satisfy the third test for material participation requiring 100 hours of work on the DKL Property and that no other individual could have worked more hours in the activity. (Treas. Reg., § 1.469-5T(a).) The parties claim that appellants worked the following hours at the DKL Property:

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	Appellants	Respondent
2006	280	84
2007	298	0
2008	344	24
2009	276	48

Appellants submitted various schedules of credit card purchases created for the audit, protest, and appeal (Resp. Op. Br., Exhs. D & I; App. Supp. Br., Exh. 2); schedules of estimated hours created for the audit and protest, and appeal (Resp. Op. Br., Exh. C; App. Supp. Br., Exh. 2); and appellant-husband's calendar during the periods at issue which appears to have been printed out on January 27, 2015 (App. Supp. Br., Exh. 1). It appears to staff that these schedules were created in response to the audit and the subsequent dispute. The parties should be prepared to discuss the case law regarding the sufficiency of establishing material participation under Treasury Regulation section 1.469-5T(f)(4). The parties should be prepared to discuss whether appellants have established their material participation by "reasonable means."

The parties should also be prepared to discuss appellants' claimed hours of work in light of appellants' claim that they performed work on the property while guests were renting the property. Staff notes that, in appellants' protest letter dated December 13, 2012, appellants initially stated that the DKL Property "was available for rent 100% of the time during the period from January 1, 2006 to December 31, 2009, except for the occasions when [they] visited to make repairs and maintenance." (App. Op. Br., Atths.) Appellants subsequently contend that they stayed in a separate apartment within the property and performed maintenance and repairs on the property during the same time when they rented out the property to one of their customers, Kalow. (App. Reply Br., p. 6.) Appellants should also be prepared to discuss their revised claimed hours of work and provide corroborating evidence. Appellants should also be prepared to substantiate the new claimed 24 hours a year for marketing and the two hours per rental for customer acquisition. Appellants should be prepared to discuss the various trips to (1) Lynchburg, Virginia, (2) Virginia Beach, Virginia, (3) Norfolk, Virginia, (4) Atlanta, Georgia, and (5) Greenville, South Carolina, as evidenced by their schedule of credit card purchases, during the periods at issue when they allegedly both worked full 12-14 hour days at the DKL Property.

Appellants may want to submit their actual credit card statements that corroborate information on their schedule of credit card purchases during the periods at issue.

Appellants also should be prepared to provide invoices and other evidence from the contractor, the tree company, and the maid service showing the activities they performed at the DKL Property. Appellants may also want to provide receipts for supplies or other evidence demonstrating their activities of "spring cleaning, general repairs, and maintenance." (App. Supp. Br., Exh. 2.) Appellants should also be prepared to provide evidence documenting their management person's limited services as referenced in appellants' email to respondent's auditor. (Resp. Op. Br., Exh. L.) In addition, appellants may want to clarify whether their two minor daughters accompanied them on these visits to the DKL Property.

Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any additional evidence to present, they should provide the evidence to Board Proceedings at least 14 days prior to the oral hearing.[20]

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[20] 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.

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