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

12 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
 13 ) **FRANCHISE AND INCOME TAX APPEAL**  
 14 **RICHARD R. BETCHLEY AND** ) Case No. 874758  
 15 **KELLIE S. BRUNK** )

	<u>Years</u> <sup>1</sup>	<u>Proposed Assessments</u>	<u>Late Filing Penalty</u>
	2005	\$49,275.00	\$12,318.75
	2006	\$25,235.00	\$6,288.75
	2007	\$18,708.00	\$4,699.25
	2008	\$3,901.00	-

16 Representing the Parties:

17 For Appellants: Richard R. Betchley and Kellie S. Brunk  
 18 For Franchise Tax Board: Susanne E. Coakley, Tax Counsel III

19 **QUESTIONS:** (1) Whether appellants have substantiated their claimed capital improvements for the  
 20 purpose of calculating the capital gain on the sale of their residence in the 2005  
 21 tax year;  
 22 (2) Whether Decata Enterprises, Inc. (Decata) made bona fide loans or dividend  
 23

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 25  
 26  
 27 <sup>1</sup> Respondent asserts that the length of time between the year at issue and the filing of this appeal is due to appellants' filing  
 28 of a late California personal income tax return for the 2005 tax year on September 14, 2010. In addition, respondent asserts that it issued civil assessments to appellants after a criminal case against appellant-husband involving tax evasion, which was adjudicated in 2012. (Resp. Op. Br., p. 1.)

1 distributions to appellant-husband, its sole shareholder, in the 2006, 2007, and  
2 2008 tax years;

3 (3) Whether appellants calculated their home mortgage interest deduction correctly  
4 for the 2008 tax year; and

5 (4) Whether appellants have shown reasonable cause for the late filing of their tax  
6 returns for the 2005, 2006, and 2007 tax years.

7 HEARING SUMMARY

8 Background

9 *Criminal Case*

10 Appellant-husband was arrested on May 27, 2009, on various criminal charges relating to  
11 real estate fraud, mortgage fraud, securities fraud, grand theft, and state income tax evasion.<sup>2</sup> The  
12 Criminal Investigations unit (CI) of the Franchise Tax Board (FTB or respondent) seized books, records,  
13 and computers from appellants' residence in Laguna Beach, California, and interviewed appellant-  
14 husband on May 27, 2009. (Resp. Op. Br., p. 2; Ex. A.)

15 On March 2, 2012, appellant-husband pled no contest to felony counts of state tax  
16 evasion, grand theft, and securities fraud,<sup>3</sup> and was sentenced to one year in county jail, three years of  
17 formal probation, and ordered to pay \$250,000 in restitution.<sup>4</sup> CI returned appellants' computers on  
18 July 24, 2009, and their books and records on March 21, 2012. Appellant-husband signed a receipt of  
19 evidence confirming that he received all of the documents and/or property originally seized on May 27,  
20 2009. The criminal case is resolved due to the fact that appellant-husband pled no contest to various

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22 ///

23 \_\_\_\_\_  
24 <sup>2</sup> [https://www.ftb.ca.gov/aboutFTB/press/2012/Release\\_10.shtml](https://www.ftb.ca.gov/aboutFTB/press/2012/Release_10.shtml)  
25 [https://www.edc.gov.us/Government/ELDODA/Press\\_Release/2009/Betchley\\_Fraud\\_Arrest.aspx](https://www.edc.gov.us/Government/ELDODA/Press_Release/2009/Betchley_Fraud_Arrest.aspx)

26 <sup>3</sup> Specifically, appellant-husband pled no contest to grand theft in the amount of \$750,000. Respondent states that its records  
27 show that \$700,000 of this illegal income was deposited into Decata's business bank accounts and then transferred to  
appellants' personal bank accounts. (Resp. Op. Br., p. 2.)

28 <sup>4</sup> Appellant-husband paid \$50,000 to respondent in order to compensate respondent for criminal investigative costs only.  
This amount is separate from the civil tax liability at issue in this appeal. (Resp. Op. Br., p. 2.)

1 felony counts and served time in jail.<sup>5</sup> (Resp. Op. Br., pp. 2-3; Ex. B.)

2 *2005 Tax Year*

3 Appellants filed an untimely joint California personal income tax return for the 2005 tax  
4 year, due on April 15, 2006, on September 14, 2010. Appellants reported a federal and California  
5 adjusted gross income (AGI) of \$195,950, claimed itemized deductions of \$172,176, taxable income of  
6 \$23,774, and tax of \$350. After applying exemption credits of \$718, appellants reported a tax due of  
7 zero. (Resp. Op. Br., p. 3; Ex. D.)

8 Respondent issued a Notice of Proposed Assessment (NPA) on March 15, 2013, for  
9 2005. The NPA increased appellants' capital gain by \$542,323, resulting from the sale of their  
10 residence in Lafayette, California, and allowed \$164,758 of appellants' claimed itemized deductions.  
11 The NPA increased appellants' taxable income by \$377,565 (i.e., \$542,323 - \$164,758), from \$195,950  
12 to \$573,515 (i.e., \$195,950 + \$377,565).<sup>6</sup> The NPA proposed an assessment of additional tax of  
13 \$49,275.00 and a late filing penalty of \$12,318.75, plus interest. (Resp. Op. Br., p. 15; Ex. CC.)

14 *2006 Tax Year*

15 Appellant-wife filed a timely California income tax return for the 2006 tax year on  
16 April 15, 2007, using a filing status of married filing separate. Appellants then filed an amended joint  
17 California tax return for the 2006 tax year on October 11, 2010.<sup>7</sup> Appellants reported a federal and  
18 California AGI of \$9,000, a standard deduction of \$6,820, taxable income of \$2,180, and tax of \$22.  
19 After applying exemption credits of \$752, appellants reported a total tax of zero. After applying  
20 withholdings of \$80, appellants reported a tax due of zero. (Resp. Op. Br., pp. 3-4; Exs. E, F & G.)

21 Respondent issued an NPA on March 15, 2013, for 2006. The NPA increased appellants'

22 \_\_\_\_\_  
23 <sup>5</sup> The civil tax assessments currently pending against appellants, as part of this appeal, are separate from the above-described  
24 criminal case. It is common for respondent to issue civil assessments to taxpayers only after the criminal case has been  
25 adjudicated. In this case, respondent pursued the civil tax, and related penalties against appellants, administratively. As a  
26 result, the deficiency assessments at issue in this appeal are separate from the restitution payment resulting from the criminal  
27 case against appellant-husband. (Resp. Op. Br., p. 3.)

28 <sup>6</sup> The 2005 NPA states that \$195,950 is appellants' reported taxable income. However, \$195,950 is appellants' reported  
federal and California AGI. Nevertheless, after the adjustments in the NPA, the ending revised taxable income is correctly  
calculated.

<sup>7</sup> Appellant-husband did not previously file a California tax return for the 2006 tax year. (Resp. Op. Br., p. 4.)

1 income by \$268,875 for dividend income from Decata and personal expenses paid by Decata of  
2 \$46,063. The NPA increased appellants' taxable income by \$314,938 (i.e., \$268,875 + \$46,063), from  
3 \$2,180 to \$317,118 (i.e., \$2,180 + \$314,938). The NPA proposed an assessment of additional tax of  
4 \$25,235.00 and a late filing penalty of \$6,288.75, plus interest. (Resp. Op. Br., p. 15; Ex. CC.)

5 *2007 Tax Year*

6 Appellant-wife filed a timely 2007 California income tax return for the 2007 tax year on  
7 April 13, 2008, using a filing status of married filing separate. Appellants then filed an amended joint  
8 California tax return for the 2007 tax year on March 15, 2011.<sup>8</sup> Appellants reported a federal and  
9 California AGI of \$59,391, a standard deduction of \$7,032, taxable income of \$52,359, and tax of  
10 \$1,338. After applying exemption credits of \$776, appellants reported a total tax of \$562. After  
11 applying withholding credits of \$41 and payments of \$521, appellants reported a tax due of zero. (Resp.  
12 Op. Br., p. 4; Exs. H, I, & J.)

13 Respondent issued an NPA on March 15, 2013, for 2007. The NPA increased appellants'  
14 income by \$179,900 for dividend income from Decata and personal expenses paid by Decata of  
15 \$84,068, and decreased appellants' income for the repayment of dividend income to Decata of \$28,000.  
16 The NPA increased appellants' taxable income by \$235,968 (i.e., \$179,900 + \$84,068 - \$28,000), from  
17 \$52,359 to \$288,327 (i.e., \$52,359 + \$235,968). The NPA proposed an assessment of additional tax of  
18 \$21,087 and a late filing penalty of \$5,241, plus interest. (Resp. Op. Br., p. 15; Ex. CC.)

19 *2008 Tax Year*

20 Appellant-wife filed a timely California tax return for the 2008 tax year on April 15,  
21 2009, using a filing status of married filing separate. Appellants then filed an amended joint California  
22 tax return for the 2008 tax year on September 15, 2010.<sup>9</sup> Appellants reported a federal and California  
23 AGI of \$48,707, claimed itemized deductions of \$149,074, taxable income of zero, and tax of zero.  
24 After applying exemption credits of \$507 and withholdings of \$107, appellants reported a tax due of  
25 zero. (Resp. Op. Br., p. 4; Exs. K, L, & M.)  
26

27 <sup>8</sup> Appellant-husband did not previously file a California tax return for the 2007 tax year. (Resp. Op. Br., p. 4.)

28 <sup>9</sup> Appellant-husband did not previously file a California tax return for the 2008 tax year. However, respondent did not assess a late filing penalty for 2008. (Resp. Op. Br., p. 4.)

1 Respondent issued an NPA on March 15, 2013, for 2008. The NPA increased appellants'  
2 income by \$55,265 for dividend income from Decata, by \$63,785 for personal expenses paid by Decata,  
3 and by \$81,632 for the disallowance of a mortgage interest deduction and decreased appellants' income  
4 by \$4,500 for the repayment of dividend income to Decata. The NPA increased appellants' taxable  
5 income by \$196,182 (i.e., \$55,265 + \$63,785 + \$81,632 - \$4,500), from -\$100,367 to \$95,815 (i.e.,  
6 -\$100,367 + \$196,182). The NPA proposed an assessment of additional tax of \$3,901, plus interest.  
7 (Resp. Op. Br., p. 15; Ex. CC.)

8 At protest, respondent issued Notices of Action (NOAs) on April 16, 2015, which  
9 affirmed the NPAs for the 2005, 2006, and 2008 tax years. Respondent issued a revised NOA for the  
10 2007 tax year on April 16, 2015, which affirmed the adjustments on the NPA and allowed itemized  
11 deductions of \$32,615.<sup>10</sup> The NOA proposed a revised assessment of additional tax of \$18,708.00 and a  
12 revised late filing penalty of \$4,699.25, plus interest. This timely appeal followed. (Resp. Op. Br., p.  
13 15; Ex. DD.)

14 **(1) Whether appellants have substantiated their claimed capital improvements for the purpose of**  
15 **calculation capital gain on the sale of their residence in Lafayette, California, in the 2005 tax year.**

16 Background

17 Appellants sold their personal residence located in Lafayette, California, for \$2,175,000  
18 on May 5, 2005. According to their income tax return, appellants claimed a basis of \$1,479,085, a gain  
19 of \$695,915, an Internal Revenue Code (IRC) section 121 exclusion of \$500,000, and net long-term  
20 capital gain of \$195,915. Public records show that appellants originally purchased the Lafayette  
21 property for \$150,000 in 1986. In 1988, appellants built a home on the property. According to the  
22 interview with CI, appellant-husband claimed that he made \$400,000 of capital improvements to the  
23 Lafayette property. In addition, appellants claimed that there were construction costs of approximately  
24

25  
26 <sup>10</sup> For 2007, appellants claimed a standard deduction on their amended California joint income tax return. Respondent  
27 determined that appellants were entitled to claim itemized deductions in the amount of \$32,615. Therefore, respondent  
28 reduced the tax and penalty assessed for the 2007 tax year. The NOA increased appellants' taxable income by \$210,385  
(i.e., \$179,900 for dividend income from Decata + \$84,068 for personal expenses paid by Decata - \$28,000 for the  
repayment of dividend income from Decata + \$7,032 for the add-back of the standard deduction - \$32,615 for itemized  
deductions). The NOA increased appellants' taxable income from \$52,359 to \$262,744 (i.e., \$52,359 + \$210,385). (Resp.  
Op. Br., p. 15; Ex. DD.)

1 \$982,700 for the Lafayette property. Appellants submitted a list of expenses in the amount of \$392,950  
2 to support the claimed capital improvements to the Lafayette property. However, respondent  
3 determined that appellants were unable to provide verification of the payments for each of the purported  
4 expenses totaling \$392,950. Therefore, respondent allowed as the basis the 2004 assessed value of the  
5 property in the amount of \$878,571, but disallowed appellants' capital improvements of \$400,000.<sup>11</sup>  
6 Lastly, respondent allowed selling expenses of \$58,191.64 per the escrow document, as well as the IRC  
7 section 121 exclusion in the amount of \$500,000.00, to calculate the additional gain of \$542,323.00.<sup>12</sup>  
8 (Resp. Op. Br., p. 7; Exs. C, D, T, U, & V.)

9 Appellants' Contentions

10 Appellants contend that they misunderstood the tax code when they sold their prior  
11 residence. Appellants contend that they lived there for 19 plus years and did not realize the  
12 appreciation. Appellants contend that they built a new home and spent more than the amount in which  
13 the old home was sold. Appellants contend that they had extensive records of the costs and  
14 improvements they made over 20 years, such as photos, contracts for work, receipts, and canceled  
15 checks. Appellants contend that the FTB acknowledged taking their file with the home improvement  
16 records, but did not return the seized documents and emails as ordered by the court. Appellants contend  
17 that the FTB suggested that they recreate the records, which they did, but the FTB still did not recognize  
18 the costs. Appellants assert that they received the disk of the materials seized from them, postmarked  
19 February 5, 2015. Appellants assert that there are more than 18,000 pages for them to go through and  
20 that they will review the files immediately. (Appeal Letter; attachments, pp. 4 & 6.)

21 With regard to appellant-husband's criminal case, appellants contend that their civil  
22 rights and the FTB's policies are being ignored. Appellants contend that the FTB is participating in a  
23 cover-up, which has been confirmed by FTB employees. Appellants contend that the Internal Revenue  
24

25 \_\_\_\_\_  
26 <sup>11</sup> Respondent allowed \$878,571 as appellants' basis per the 2004 assessment record to account for the original purchase  
price, as well as construction costs/improvement costs to the property. (Resp. Op. Br., p. 7; Ex. T.)

27 <sup>12</sup> Respondent subtracted selling expenses from the gain from the sale of the home (i.e., \$2,175,000 - \$58,191 = \$2,116,809).  
28 Respondent then subtracted appellants' basis (the county-assessed value) from the net gain (i.e., \$2,116,809 - \$878,571 =  
\$1,238,238). Respondent then subtracted the IRC section 121 exclusion in the amount of \$500,000 from the gain (i.e.,  
\$1,238,238 - \$500,000 = \$738,238). Respondent then subtracted the gain previously reported on appellants' income tax  
return to calculate the additional gain of \$542,323 (i.e., \$738,238 - \$195,915 = \$542,323). (Resp. Op. Br., pp. 7-8.)

1 Service (IRS) audited them and issued refunds for three of the four years at issue. Appellants contend  
2 that an FTB employee provided them with internal documents showing that the tax owed was only  
3 \$274.39, which, other than interest and penalties, consisted of a principal amount of \$41.00.<sup>13</sup>  
4 Appellants contend that FTB employees told them that appellant-husband's media coverage was  
5 unwarranted, that the auditors were told by management to erroneously disallow deductions and  
6 exemptions, and that the FTB does not usually go after taxpayers for such an amount. Appellants  
7 contend that appellant-husband is innocent and that he had to plea "no contest" because it would cost  
8 too much money to continue. Appellants contend that the criminal case consisted of various forms of  
9 government corruption. (Appeal Letter, pp. 1-5.)

#### 10 Respondent's Contentions

11 Respondent asserts that appellants have not provided any substantiation of the alleged  
12 construction costs of their home in the amount of \$982,700, nor the purported capital improvements of  
13 \$400,000. Therefore, respondent asserts that it allowed as the basis the assessed value of the property in  
14 the amount of \$878,571, to account for the original purchase price of the property, as well as the  
15 construction costs/improvements to the property. (Resp. Op. Br., p. 18.)

16 Respondent asserts that appellants appear to claim that the records that support their  
17 purported capital improvements to their Lafayette property were seized by respondent's CI unit.  
18 Respondent asserts that appellants appear to argue further that these records were never returned to their  
19 possession. However, respondent asserts that the CI unit recorded all items seized from appellants'  
20 property on May 27, 2009, numbered each seized item, and eventually returned all items to appellants'  
21 possession. Respondent contends that this is evidenced by the fact that appellant-husband signed a  
22 document acknowledging the receipt of all items that were seized from appellants' home in  
23 Laguna Beach on May 27, 2009. In addition, respondent contends that, upon a review of appellants'  
24 documents and records, none contained evidence supporting appellants' claimed capital improvements  
25 to their Lafayette property. (Resp. Op. Br., p. 19.)  
26

27  
28 <sup>13</sup> Staff notes that the \$274.39 to which appellants refer is a liability for the 2007 tax year as indicated on a Notice of State  
Income Tax Due dated August 23, 2011, which is before the 2005 through 2008 NPAs were issued on March 15, 2013.  
Therefore, the \$274.39 amount is unrelated to the later assessments proposed on the NPAs, which are at issue in this appeal.  
(Appeal Letter, p. 30.)

1 Respondent asserts that appellants have claimed throughout the audit, protest, and appeal  
2 stages that the IRS examined and analyzed the issues for the 2005, 2006, 2007, and 2008 tax years.  
3 However, respondent asserts that, based on IRS records, the IRS did not open an audit examination for  
4 appellants for the 2005, 2006, 2007, or 2008 tax years. (Resp. Op. Br., p. 15; Ex. BB.)

#### 5 Applicable Law

6 Respondent's determinations are presumed correct and a taxpayer has the burden of  
7 proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Oscar D. and*  
8 *Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)<sup>14</sup> Unsupported assertions are not sufficient to satisfy a  
9 taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In  
10 the absence of uncontradicted, credible, competent, and relevant evidence showing an error in  
11 respondent's determination, respondent's determination will be upheld. (*Appeal of Oscar D. and*  
12 *Agatha E. Seltzer, supra.*)

13 IRC section 1001 provides that the gain on the sale of property shall be the excess of the  
14 amount realized over the adjusted basis as defined in IRC section 1011.<sup>15</sup> IRC section 1011 provides  
15 that the adjusted basis for determining the gain from the sale of property shall be the property's initial  
16 basis with adjustments as provided in IRC section 1016. Under IRC section 1016, the property's initial  
17 basis is increased by capital expenses, such as the cost of capital improvements made to the property by  
18 the taxpayer.

#### 19 STAFF COMMENTS

20 It does not appear to staff that appellants have provided any evidence to show that  
21 respondent improperly disallowed their claimed capital improvements. Appellants contend that they did  
22 not receive seized records of home improvement costs. However, appellant-husband signed a receipt of  
23 evidence confirming that he received all of the documents and/or property originally seized.  
24 Additionally, appellants state that they received a disk from the FTB of the seized records, and that they  
25 would review the records. However, appellants have not provided any evidence on appeal related to the  
26

27 <sup>14</sup> Board of Equalization cases (designated "SBE") may generally be found at: [www.boe.ca.gov](http://www.boe.ca.gov).

28 <sup>15</sup> California conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

1 disallowed capital improvements.<sup>16</sup> (Resp. Op. Br., Ex. B; Appeal Letter, attachments, p. 6.)

2 **(2) Whether Decata made bona fide loans or dividend distributions to appellant-husband, its sole**  
3 **shareholder, in the 2006, 2007, and 2008 tax years.**

4 Background

5 *Decata Enterprises, Inc.*

6 Decata was a Nevada corporation doing business in California.<sup>17</sup> Decata failed to  
7 register with the California Secretary of State. Appellant-husband was the president, secretary,  
8 treasurer, as well as the sole owner of Decata. Decata was suspended on April 4, 2011, and  
9 subsequently its status was permanently revoked. Decata failed to file federal and California income  
10 tax returns for the 2005 and 2006 tax years. (Resp. Op. Br., p. 5.)

11 CI interviewed appellant-husband on May 27, 2009. Appellant-husband provided that he  
12 used Decata to conduct business transactions. Decata's business activity was described as the purchase  
13 and sale of vehicles and real estate transaction fees.<sup>18</sup> Appellant-husband explained that he was the sole  
14 shareholder and handled all of Decata's business operations including, but not limited to, authorizing  
15 loans for the corporation, as well as making bank deposits and withdrawals on behalf of Decata.<sup>19</sup>  
16 Appellant-husband stated further that, when Decata earned income, he then made a loan to himself from  
17 the profits. (Resp. Op. Br., p. 2; Ex. A.)

18 \_\_\_\_\_  
19 <sup>16</sup> It appears to staff that appellant-husband's criminal charges and guilty plea are relevant to appellants' credibility with  
20 respect to all of the issues on appeal. Additionally, the issues in this appeal arise from the criminal investigation and  
21 subsequent conviction of appellant-husband. ([http://www.dbo.ca.gov/ENF/pdf/2009/Decata\\_dr.pdf](http://www.dbo.ca.gov/ENF/pdf/2009/Decata_dr.pdf);  
22 [https://www.edcgov.us/ELDODA/Press\\_Release/2009/Betchley\\_Fraud\\_Arrest.aspx](https://www.edcgov.us/ELDODA/Press_Release/2009/Betchley_Fraud_Arrest.aspx);  
23 <http://blogs.sacbee.com/crime/archives/2009/06/el-dorado-count-10.html>;  
24 <http://blogs.sacbee.com/crime/archives/2009/05/former-el-dorad.html>;  
25 <http://www.villagelife.com/news/betchley-battle-goes-back-and-forth>)

26 <sup>17</sup> Decata Enterprises filed as a Nevada corporation on May 4, 2005. The current filing status of the corporation is listed as  
27 permanently revoked. (Resp. Op. Br., p. 5.)

28 <sup>18</sup> In appellant-husband's interview with CI, he stated that a boat and Ferrari held in the name of Decata were business  
investments purchased with the intent to sell for a gain. (Resp. Op. Br., Ex. A, p. 6.)

<sup>19</sup> Appellants and Decata received a Desist and Refrain Order dated May 27, 2009, from the State of California Department  
of Corporations, which was involved in the investigation of appellant-husband along with respondent. The order stated that  
both appellants as well as Decata were "hereby ordered to desist and refrain from the further offer or sale of securities in the  
State of California, including but not limited to stock ... and promissory notes" and that, beginning in 2007, "securities were  
offered or sold in this State by means of written or oral communications which included an untrue statement of a material fact  
or omitted to state a material fact". ([http://www.dbo.ca.gov/ENF/pdf/2009/Decata\\_dr.pdf](http://www.dbo.ca.gov/ENF/pdf/2009/Decata_dr.pdf))

1                    *2007 Tax Year*

2                    Decata filed a California corporation income tax return (Form 100) for the 2007 tax year  
3 on February 15, 2009.<sup>20</sup> Appellant-husband signed the tax return. On schedule L, Decata reported a  
4 bad debt allowance of \$384,800 at the end of the year, loans to stockholders of \$169,900 (i.e., \$384,800  
5 at the end of the year less \$214,900 at the beginning of the year), and loans from stockholders of  
6 \$400,000. Decata reported the purchase of real property on October 11, 2006,<sup>21</sup> and a boat on April 1,  
7 2007.<sup>22</sup> (Resp. Op. Br., p. 6; Exs. P & Q.)

8                    *2008 Tax Year*

9                    Decata filed a California Form 100 for the 2008 tax year on February 15, 2009.  
10 Appellant-husband signed the tax return. On schedule L, Decata reported a bad debt allowance of  
11 \$63,365 (i.e., \$448,165 at the end of the year less \$384,800 at the beginning of the year), loans to  
12 stockholders of \$63,365 (i.e., \$448,165 at the end of the year less \$384,800 at the beginning of the year),  
13 and loans from stockholders of \$1,000 (i.e., \$401,000 at the end of the year less \$400,000 at the  
14 beginning of the year).<sup>23</sup> (Resp. Op. Br., pp. 6-7; Exs. R & S.)

15                    *Decata distributions to appellants in 2006, 2007, and 2008*

16                    Appellants received distributions in excess of \$500,000 from Decata, according to bank  
17 statements for Decata's corporate accounts and copies of Decata's checks. According to information  
18 provided, appellants received distributions from Decata which they deposited into their personal bank  
19 accounts. Appellants received distributions from Decata including a total of \$268,785 in 2006,  
20 \$179,900 in 2007, and \$55,265 in 2008. Respondent provided schedules detailing the distributions.  
21 (Resp. Op. Br., pp. 8-11; Exs. W & X.)

22                    Respondent received a promissory note drafted in 2005 which authorized Decata to loan  
23 up to \$500,000 to the owner, or other entities, with terms not to exceed 60 months. The document was

24 \_\_\_\_\_  
25 <sup>20</sup> Decata reported its business activity as real estate, rental, and leasing. (Resp. Op. Br., p. 6.)

26 <sup>21</sup> The reported basis in the real property was \$686,000. (Resp. Op. Br., p. 6.)

27 <sup>22</sup> The reported basis in the boat was \$64,500. (Resp. Op. Br., p. 6.)

28 <sup>23</sup> Respondent asserts that there is no record of a loan from appellant-husband to Decata in the amount of \$401,000. (Resp. Op. Br., p. 7.)

1 signed by appellant-husband, as the owner and sole board member of Decata. There are 12 promissory  
2 notes totaling \$56,665 for 2008. (Resp. Op. Br., p. 11; Exs. Y & Z.)

3 Promissory notes have not been provided for the alleged loans from the 2006 and 2007  
4 tax years. Per the information provided, appellants transferred a total of \$28,000 in 2007 and \$4,500 in  
5 2008 into Decata's bank account. Both transfers were treated as repaid distributions on the NPAs for  
6 the 2006 and 2007 tax years. With the exception of the above-mentioned transfers, appellants have not  
7 repaid any of the remaining purported loans from Decata in the 2006, 2007, and 2008 tax years.

8 Appellant-husband, on behalf of Decata, drafted and signed an undated letter disclosing that Decata  
9 made loans that were uncollectible in the amount of \$214,900 in 2006, \$169,900 in 2007, and \$63,365  
10 in 2008. (Resp. Op. Br., p. 11; Ex. AA.)

11 *Non-business Expenses/Payment of Personal Expenses*

12 Respondent's analysis of Decata's corporate bank account records and copies of  
13 cancelled checks revealed payments from Decata for non-business related expenses. Respondent  
14 determined that, throughout the years, Decata paid a significant amount of appellants' personal  
15 expenses. Respondent determined that, for example, appellant-husband used Decata to make mortgage  
16 payments on appellants' personal residence, to make payments of cash, for checks made out to  
17 appellant-wife, for payments for luxury items, and for payments made to All Points Capital. Respondent  
18 provided schedules detailing the payments. The payments totaled \$46,063 for 2006, \$84,068 for 2007,  
19 and \$65,705 for 2008. (Resp. Op. Br., pp. 11-14.)

20 Appellants' Contentions

21 Appellants argue that a loan is a loan, and not income or a dividend. Appellants contend  
22 that the loan documentation form is from the IRS and was audited by the IRS and initialed by an H&R  
23 Block senior partner and the IRS agent. Appellants argue that the FTB incorrectly claims that loans are  
24 dividends, yet recognizes the repayment. Appellants contend that there are clear records of the personal  
25 loans, and that they want collection efforts to allow the records. (Appeal Letter, p. 4.)

26 Appellants contend that they owned five cars. Appellants contend that three cars were  
27 investments, with records of the profitable sale of one, and another, a Ford, was the family car.  
28 Appellants contend that the fifth car was a business-use car, complete with trip/mileage logs.

1 Appellants contend that the FTB incorrectly takes the position that investment and business vehicles,  
2 all in a company name and not in appellant-husband's name, all with mileage logs and separate DMV  
3 titles in the company name, are money paid on appellant-husband's behalf and thus income.

4 Appellants contend that the loan documentation form was provided by the IRS, meets all requirements,  
5 and that repayments were made. (Appeal Letter, p. 4.)

#### 6 Respondent's Contentions

7 Respondent asserts that it determined that the distributions that appellants received from  
8 Decata were in fact constructive dividends, and not loans, because appellant-husband controlled  
9 Decata, there was no collateral given for the alleged loans, appellants failed to pay interest on the  
10 alleged loans, appellants failed to repay the majority of the alleged loans, and Decata never forced the  
11 repayment of the alleged loans. (Resp. Op. Br., p. 1.)

12 Respondent argues that simply labeling a transaction as a loan does not make it so for  
13 tax purposes, and that a taxpayer's actual actions demonstrate its true effect. Respondent asserts that,  
14 according to Decata's bank statements, as well as copies of Decata's checks, Decata distributed to  
15 appellants a total of \$268,785 in 2006, \$179,900 in 2007, and \$55,265 in 2008, for a combined total of  
16 \$503,950 for those years. In addition, respondent asserts that Decata made payments on behalf of  
17 appellants, or for their personal benefit, in the amount of \$46,063 in 2006, \$84,068 in 2007, and  
18 \$65,705 in 2008, for a combined total of \$195,836 for those years. Therefore, respondent contends that  
19 appellants received a total benefit of \$699,786 (i.e., \$503,950 + \$195,836) from Decata from the 2006  
20 through 2008 tax years, based on distributions and payments made from Decata. Respondent asserts  
21 that, whether withdrawals from a corporation by a shareholder represent loans or taxable dividends  
22 depends on all of the facts and circumstances surrounding the transactions between the shareholder and  
23 the corporation. Respondent argues that Decata's payments for appellants' personal expenses are  
24 reclassified as constructive dividends based on the fact that appellants neither intended, nor treated  
25 these amounts as loans. Respondent asserts that appellants argue that the expenses were  
26 reimbursements for valid business expenses. However, respondent argues that appellants fail to  
27 provide evidence showing that the expenses were business related, or that the payments were  
28 reimbursements to appellants for valid business expenses. (Resp. Op. Br., pp. 11,12, & 20.)

1 Respondent contends that Decata never recognized any interest income, nor was any  
2 interest ever paid by appellants. Thus, respondent contends that appellants' wholly-owned corporation,  
3 the purported lender, never treated the distributions in question as an ever increasing loan, subject to  
4 repayment, as it never recognized interest income on the transactions. Furthermore, respondent  
5 contends that appellants' failure to repay the purported loans likewise demonstrates the reality that these  
6 transactions are taxable distributions to appellants, and their action is no different than their  
7 corporation's failure to respect the transactions as loans for tax purposes. (Resp. Op. Br., p. 20.)

8 Respondent asserts that the determinative fact is the intention as it existed at the time of  
9 the transaction. Respondent asserts that, in addition, where a corporation provides an economic benefit  
10 to a shareholder with no expectation of reimbursement, the benefit is a constructive dividend and is  
11 taxable income. Respondent asserts that in determining whether a transfer/distribution to a shareholder  
12 should be treated as a loan versus a dividend, the courts have reviewed the following factors, citing  
13 *Benson v. Commissioner* (9th Cir. 2009) 560 F.3d 1133,1134. (Resp. Op. Br., pp. 20-21.)

14 *The extent to which the shareholder controls the corporation:* Respondent asserts that  
15 appellant-husband was the 100 percent owner and shareholder of Decata, and was also the president,  
16 secretary, and treasurer from 2005 to 2008. Respondent contends that appellants received a total benefit  
17 of \$699,786 from Decata from the 2006 through 2008 tax years, based on distributions and payments  
18 made from Decata. Respondent contends that, during this time, appellant-husband exercised complete  
19 control over Decata's corporate affairs, including unfettered discretion to control corporate funds in the  
20 manner he saw fit. Respondent contends that the distributions of monies from Decata reflect the fact  
21 that appellant-husband was advancing money from his corporation to his personal bank account, or to  
22 cover appellants' personal expenses. Respondent contends that, under these circumstances, a  
23 presumption arises that these advances were constructive dividends rather than bona fide loans. (Resp.  
24 Op. Br., p. 21.)

25 *The earnings and dividend history of the corporation:* Respondent asserts that appellants  
26 failed to provide a calculation of Decata's earnings and profits for the 2005, 2006, 2007, and 2008 tax  
27 years. Respondent argues that, generally when a corporation cannot show a history of distributions,  
28 disbursements are highly considered as dividend distributions. Respondent contends that, in addition,

1 Decata failed to file federal and California income tax returns for the 2005 and 2006 tax years.  
2 Respondent contends that, as a result, appellants have not provided enough information for respondent  
3 to provide an analysis for this factor and it is considered neutral. (Resp. Op. Br., pp. 21-22.)

4 *The magnitude of the withdrawals and whether a ceiling existed to limit the amount the*  
5 *corporation advanced:* Respondent argues that the absence of a ceiling and a trend of increasing  
6 balances weigh heavily against a conclusion that the advances were loans. Respondent contends that, in  
7 this case, there does not appear to be a ceiling as appellants continued to transfer money from Decata to  
8 themselves. Respondent contends that, from 2006 through 2008, Decata distributed \$503,950 to  
9 appellants' personal bank accounts. In addition, respondent contends that Decata made payments on  
10 behalf of appellants, or for their personal benefit, in the amount of \$195,836. (Resp. Op. Br., p. 22.)

11 Respondent asserts that appellants provided a letter dated July 1, 2005, on Decata's  
12 letterhead signed by appellant-husband, which stated that "[t]he owner and Board of Directors of decata  
13 enterprises, inc. on this date, July 1, 2005, hereby resolve and authorize the company to make loans to  
14 affiliated parties, the owner, and other entities in any amounts, with terms not to exceed 60 months, up  
15 to an aggregate amount of \$500,000.00 during its normal course of business." However, respondent  
16 argues that appellants received distributions in excess of \$500,000 and Decata paid many of their  
17 personal expenses in the amount of nearly \$200,000. Finally, respondent contends that appellant-  
18 husband provided that, when Decata earned income, he then made a loan to himself from the profits.  
19 Respondent contends that, therefore, it does not appear that there was a ceiling to the purported loans  
20 because appellant-husband was willing to distribute all of Decata's profits to himself and his spouse.  
21 Respondent argues that, as stated above, the absence of a ceiling does not support appellants' argument  
22 that the distributions were in fact bona fide loans so this factor favors a finding that the advances were  
23 dividends rather than bona fide loans. (Resp. Op. Br., pp. 22-23; Ex. Y.)

24 *How the parties recorded the withdrawals on their books and records:* Respondent  
25 asserts that appellants did not provide Decata's corporate tax returns or corporate journals. In addition,  
26 respondent contends that no documentation was provided to support that the corporation accrued  
27 interest income or made any efforts to collect or enforce a repayment. Respondent argues that, in the  
28 absence of corporate books and records, there is no manner in which to determine how the corporation

1 treated the advances. (Resp. Op. Br., p. 23.)

2           *Whether the parties executed notes, and whether a set maturity date existed for the*  
3 *notes:* Respondent contends that an executed note is generally an indicator that a real loan exists.  
4 Respondent argues that, however, demand notes with no fixed schedule for repayment contribute little  
5 as evidence of a genuine indebtedness. Respondent contends that there are no promissory notes for any  
6 of the alleged loans from 2006 and 2007. Respondent contends that 12 promissory notes were provided  
7 to respondent for the 2008 tax year in which a total of \$56,665 was purportedly loans to appellant-  
8 husband from Decata. Respondent asserts that the promissory notes provided are for a term of  
9 18 months and each promissory note has an annual interest rate of 5 percent. Respondent asserts that  
10 the notes do not contain terms for repayment. Respondent contends that appellant-husband signed each  
11 promissory note both as the borrower, and for Decata, as the lender. Respondent asserts that, according  
12 to Decata's federal and state income tax returns, it did not receive interest income for the 2007 and  
13 2008 tax years. In addition, respondent asserts that appellants did not pay interest on the purported  
14 loans and did not repay the promissory notes within the 18-month period. Respondent argues that these  
15 factors taken together weigh heavily in favor of respondent's constructive dividend treatment. (Resp.  
16 Op. Br., pp. 23-24.)

17           *Whether interest was paid or accrued on the note:* Respondent contends that there is no  
18 record that appellants paid interest on the purported loans to Decata. Respondent asserts that, according  
19 to its federal and state income tax returns, Decata did not receive interest income for the 2007 and 2008  
20 tax years. Respondent contends that the twelve promissory notes provided were interest-bearing notes,  
21 though Decata never received any interest income from appellants. Respondent argues that this  
22 indicates that a genuine debtor-creditor relationship did not exist because a third-party creditor would  
23 demand annual interest on a loan in excess of \$500,000. Respondent contends that all of the above-  
24 mentioned factors weighs in favor of a finding that the distributions were in fact constructive dividends  
25 and not loans. (Resp. Op. Br., p. 24.)

26           *Whether security was given for the loan:* Respondent argues that appellants have neither  
27 alleged nor produced any evidence to demonstrate that Decata demanded, or that appellant-husband  
28 provided, any sort of security or collateral for the alleged loans from Decata. Respondent contends that

1 the ultimate issue is the measurement of the transaction by objective tests of economic reality.  
2 Respondent contends that this type of transaction would never occur between a creditor and a debtor in  
3 an arm's length transaction because, in a genuine debtor-creditor relationship, a lender operating at  
4 arm's length would not allow a debtor to borrow more than \$500,000 without any sort of collateral to  
5 back the loan. Respondent contends that this is exactly the situation which occurred in this case, giving  
6 further credence to the fact that the distributions to appellant-husband were constructive dividends.  
7 (Resp. Op. Br., p. 24.)

8 *Whether the corporation ever undertook to force a repayment:* Respondent asserts that,  
9 according to information provided, Decata has not required a repayment, or a partial repayment, of the  
10 demand notes issued to appellant-husband from 2005 to 2008. Respondent argues that, because  
11 appellant-husband controlled Decata and acted as both the lender and the debtor, it is unlikely that  
12 appellant-husband would force the repayment of the demand notes on himself. Respondent argues that,  
13 again, this was not an arm's length transaction because an independent third-party lender would not lend  
14 over \$500,000 without any attempt to force a repayment. Respondent argues that this factor supports a  
15 finding that the distributions were constructive dividends and not bona fide loans. (Resp. Op. Br., pp.  
16 24-25.)

17 *Whether the shareholder was in a position to repay the withdrawals:* Respondent argues  
18 that, based on the information provided, appellant-husband was not in a position to repay the loans.  
19 Respondent contends that appellants reported a federal AGI of \$9,000 in 2006, \$59,391 in 2007, and  
20 \$48,707 in 2008. Respondent asserts that an undated letter signed by appellant-husband for Decata lists  
21 a summary of Decata's gross receipts and expenses disclosing that monies loaned by Decata were  
22 uncollectible in the amount of \$214,900 in 2006, \$169,900 in 2007, and \$63,365 in 2008. Respondent  
23 argues that this factor supports a finding that the distributions were constructive dividends and not bona  
24 fide loans. (Resp. Op. Br., p. 25; Exs. E, H, M, & AA.)

25 *Whether there was any indication the shareholder attempted to repay the withdrawals:*  
26 Respondent asserts that, according to information provided, appellants transferred \$28,000 in 2007 and  
27 \$4,500 in 2008 into Decata's bank accounts. Respondent contends that, with the exception of the  
28 above-mentioned transfers, appellants have not repaid any of the remaining purported loans from

1 Decata in the 2006, 2007, and 2008 tax years. Respondent argues that, since appellants have repaid  
2 only \$32,500 (i.e., \$28,000 + \$4,500) of \$699,786 over the course of nearly ten years, and appellants  
3 acknowledge that the purported loans are uncollectible, this factor supports that appellant-husband  
4 never meant to repay the purported loans from Decata. (Resp. Op. Br., p. 25.)

5 Respondent asserts that courts have examined transactions between closely-held  
6 corporations and their shareholders with special scrutiny because of the unique opportunity for a  
7 shareholder to exercise unfettered control of a closely-held company. Respondent asserts that this is  
8 especially true in the case where the party or parties engaging in the transaction are on both sides of the  
9 transaction. Respondent contends that appellant-husband was on both sides of the transaction because  
10 he was both the president and sole shareholder of Decata. Respondent contends that appellant-husband  
11 transferred large sums of money from Decata's corporate bank account to his personal bank account, or  
12 used Decata's corporate bank account to pay for personal, non-business related expenses. Respondent  
13 contends that appellant-husband, as the owner of Decata, issued a non-interest bearing demand note to  
14 himself, with no set schedule of repayment, and no requirement of collateral to Decata for the loans.  
15 Respondent contends that the relationship between the corporation and its sole shareholder is not that of  
16 a genuine debtor-creditor relationship because the sole-shareholder is the owner of the corporation and,  
17 therefore, acts as both the debtor and the creditor. (Resp. Op. Br., p. 26.)

#### 18 Applicable Law

19 Revenue and Taxation Code (R&TC) sections 17071 and 17072 define "gross income"  
20 and "adjusted gross income" by referring to and incorporating IRC sections 61 and 62, respectively.  
21 IRC section 61 provides that, unless otherwise provided, "gross income means all income from  
22 whatever source derived," including compensation for services, gross income derived from business,  
23 gains derived from dealings with property, and interest and dividends. Income includes any "accession  
24 to wealth." (*Commissioner v. Glenshaw Glass Co.* (1955) 348 U.S. 426, 431; *Appeals of Robert E.*  
25 *Wesley, et al.*, 2005-SBE-002, Nov. 15, 2005.) A taxpayer recognizes income if he or she realizes an  
26 economic gain and that gain primarily benefits him or her personally. (*United States v. Gotcher* (5th  
27 Cir. 1968) 401 F.2d 118.) Where a corporation provides an economic benefit to a shareholder with no  
28 expectation of reimbursement, the benefit is a constructive dividend and is taxable income. (*Benson v.*

1 *Commissioner, supra*, 560 F.3d 1133.)

2 A transfer of money is a loan for federal income tax purposes if, at the time the funds  
3 were transferred, the transferee unconditionally intended to repay the money, and the transferor  
4 unconditionally intended to secure the repayment. (*Jones v. Commissioner*, T.C. Memo 1997-400.)  
5 With respect to a transfer from a corporation to a shareholder, “[m]ere declarations by the parties that  
6 they intend a certain transaction to constitute a loan [are] insufficient if [they] fail[] to meet more  
7 reliable indicia of debt which indicate the ‘intrinsic economic nature of the transaction.’” (*Alterman*  
8 *Foods, Inc. v. U.S.* (5th Cir. 1979) 505 F.2d 873, 877.)

9 In determining whether such a transfer to a shareholder should be treated as a loan, the  
10 courts have considered eleven factors (restated below) as relevant in analyzing the transfer. (*Jones v.*  
11 *Commissioner, supra*; see also *Alterman Foods, Inc. v. U.S., supra*.) The various factors are not of  
12 equal significance and no single factor is controlling. (*Alterman Foods, Inc. v. U.S., supra* at 877.)

13 These factors are:

- 14 1. *The extent to which the shareholder controls the corporation*
- 15 2. *The earnings and dividend history of the corporation*
- 16 3. *The magnitude of the withdrawal and whether a ceiling existed to limit the amount advanced*
- 17 4. *How the corporation recorded the withdrawals on its books and records*
- 18 5. *Whether the shareholder executed a promissory note*
- 19 6. *Whether interest was paid or accrued*
- 20 7. *Whether the corporation ever undertook to compel repayment*
- 21 8. *Whether there was a fixed maturity date*
- 22 9. *Whether security was given for the loan*
- 23 10. *Whether the shareholder was in a financial position to repay*
- 24 11. *Whether there was any indication the shareholder attempted to repay*

25 R&TC section 17201 incorporates by reference IRC section 162, which provides, in  
26 pertinent part, that there shall be allowed as a deduction all of the necessary and ordinary business  
27 expenses paid or incurred during the taxable year in carrying on any trade or business. The expenses  
28 must be directly connected to or pertain to the taxpayer’s trade or business. (Treas. Reg. § 1.162-1(a).)

1 STAFF COMMENTS

2 It appears to staff that the distributions to appellants from Decata were constructive  
3 dividends because appellant-husband controlled Decata, there was no collateral given for the alleged  
4 loans, appellants failed to pay interest on the alleged loans, appellants failed to repay the majority of the  
5 alleged loans (appellants repaid only \$32,500 of \$699,786<sup>24</sup> over the course of nearly ten years), there  
6 was no set schedule of repayment, there was no requirement of collateral to Decata for the loans, and  
7 Decata never forced a repayment of the alleged loans.<sup>25</sup> Therefore, it appears that the distributions were  
8 not intended to be loans or treated as loans. It does not appear to staff that appellants have provided any  
9 evidence to show that payments made from Decata on behalf of appellants were business-related  
10 expenses.<sup>26</sup>

11 **(3) Whether appellants calculated their home mortgage interest deduction correctly for the 2008**  
12 **tax year.**

13 Background

14 On their 2008 California income tax return, appellants reported itemized deductions of  
15 \$149,074 for California purposes. The majority of the itemized deductions were attributed to their  
16 home mortgage interest deduction of \$147,431<sup>27</sup> Appellants claimed two separate properties located in  
17 El Dorado Hills, California (Property 1 and Property 2) as part of the home mortgage interest  
18 deduction.<sup>28</sup> The home mortgage interest deduction included \$113,588 of interest paid on a loan from  
19

20 <sup>24</sup> It appears to staff that this amount is the “illegal income” of \$700,000 deposited into Decata’s bank business bank  
21 accounts and transferred to appellants’ personal bank accounts. Based on appellant-husband’s guilty plea to tax evasion and  
22 his receipt of “illegal income”, it appears to staff that appellant-husband did not intend for the distributions to be loans and  
intended to evade tax on the distribution of taxable income. (Resp. Op. Br., p. 2.)

23 <sup>25</sup> Staff notes that, in CI’s interview with appellant-husband, he stated that he did not make interest payments on the loan, he  
24 “could not recall the [interest] rate”, and he did not know the “outstanding balance on the loans”. (Resp. Op. Br., Ex. A, p.  
3.)

25 <sup>26</sup> Respondent provides schedules detailing the payments to payees including appellant-wife, Jaguar, and Louis Vuitton.  
26 (Resp. Op. Br., pp. 12-14.)

27 <sup>27</sup> For the home mortgage interest deduction, the interest on the three loan amounts total \$147,443. However, appellants  
27 reported a slightly lower amount of \$147,431 on their income tax return. (Resp. Op. Br., p. 5.)

28 <sup>28</sup> According to public records from the El Dorado County Assessor’s website, Property 2 was purchased by appellant-  
husband on July 21, 2006, and then transferred by grant deed to Decata on July 25, 2006. On or around April 21, 2009, the  
property was foreclosed upon and sold in a trustee deed upon sale transaction. (Resp. Op. Br., p. 5; Ex. N.)

1 Washington Mutual for Property 1, \$14,376 of interest paid on a loan from Umpqua Bank for Property  
2 1, and \$19,479 of interest paid on a loan from Butte Community Bank for Property 2. Respondent  
3 determined that Property 2 was not a qualified residence and disallowed the amount in full.<sup>29</sup>  
4 Respondent allowed \$62,133 of \$113,588 from the Washington Mutual Bank loan, and \$3,666 of  
5 \$14,376 from the Umpqua Bank loan. Based on a review of the mortgage loan documents, respondent  
6 determined that appellants exceeded the limit of acquisition and equity indebtedness for the 2008 tax  
7 year.<sup>30</sup> Respondent adjusted the home mortgage interest deduction by allowing \$65,799 and  
8 disallowing \$81,632. (Resp. Op. Br., pp. 4-5, Exs. M & O.)

9 Appellants' Contentions

10 Appellants question why the bank-provided mortgage interest amounts are not allowed as  
11 a deduction. (Appeal Letter, p. 4.)

12 Respondent's Contentions

13 Respondent asserts that appellants did not calculate their home interest mortgage  
14 deduction correctly for the 2008 tax year per IRC section 163(h). Respondent asserts that a qualified  
15 residence includes the principal residence of the taxpayer and one other residence of the taxpayer's  
16 choosing, as long as the taxpayer uses it as a residence. Respondent asserts that, for 2008, appellants  
17 claimed mortgage interest deductions for loans on two properties located in El Dorado Hills.  
18 Respondent asserts that Property 1 was appellants' personal residence and, therefore, it is considered a  
19 qualified residence. However, respondent argues that Property 2 was not intended for use by appellants.  
20 Respondent asserts that, instead, appellants claim that the second property was a "spec house" built for  
21 appellant-husband's parents. Respondent asserts that, according to public records, the property was  
22 purchased by appellant-husband on July 21, 2006, and then transferred by grant deed to his corporation,  
23

24 \_\_\_\_\_  
25 <sup>29</sup> During the March 28, 2014 protest hearing, appellant-husband asserted that Property 2 was a "spec house" being built for  
26 his parents. IRC section 163(h)(4)(A)(i) defines a qualified residence as the principal residence of the taxpayer or another  
27 residence used by the taxpayer as a residence. (Resp. Op. Br., p. 5.)

28 <sup>30</sup> The home mortgage interest deduction is limited to interest paid on acquisition debt aggregating \$1,000,000, and home  
equity debt up to the lesser of \$100,000, or the difference between the fair market value of the residence, and the amount of  
acquisition indebtedness per IRC section 163(h)(3). Respondent determined that appellants exceeded the \$1,100,000 ceiling  
of acquisition debt. Therefore, respondent recalculated and limited their home mortgage interest deduction for the 2008 tax  
year. (Resp. Op. Br., p. 5; Ex. O.)

1 Decata, on July 25, 2006. Respondent asserts that, on or around April 21, 2009, the property was  
2 foreclosed upon and sold. Respondent argues that, based on the information available, it appears that  
3 Property 2 is not a qualified residence per IRC section 163 because it was neither owned by appellants,  
4 nor was it used by appellants as their residence during the 2008 tax year. (Resp. Op. Br., pp. 1 & 27;  
5 Ex. N.)

6 Respondent asserts that acquisition indebtedness is defined as any indebtedness that is  
7 incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and  
8 is secured by that residence. Respondent asserts that this includes indebtedness on the same residence  
9 due to a refinance up to the amount of the refinance indebtedness. However, respondent asserts that this  
10 deduction is limited to interest payments made on acquisition indebtedness of not more than \$1,000,000.  
11 Respondent asserts that home equity indebtedness includes any indebtedness other than acquisition  
12 indebtedness that is secured by a qualified residence up to the lesser of \$100,000 or the difference  
13 between the fair market value of the residence and the amount of acquisition indebtedness. Respondent  
14 asserts that, thus, interest payments made on an additional \$100,000 of indebtedness for each year can  
15 be deducted for a total of \$1,100,000 per year. (Resp. Op. Br., pp. 27-28.)

16 Respondent argues that, consequently, appellants cannot simply deduct the total amount  
17 of mortgage interest paid in 2008. Rather, respondent argues that appellants must apportion the interest  
18 paid for the first \$1,000,000 of mortgage debt and \$100,000 for home equity debt. Respondent  
19 contends that the FTB auditor accomplished this by calculating the average loan balance for each loan  
20 on Property 1. Respondent contends that the loan from Washington Mutual was the original purchase  
21 loan on the property, whereas the loan from Umpqua Bank was a home equity line of credit.  
22 Respondent contends that the average loan balance for the Washington Mutual and Umpqua Bank loans  
23 were then divided by the limitation per IRC section 163(h)(3) to determine the percentage of allowable  
24 interest. Respondent contends that applying this percentage to the total interest paid on the qualified  
25 residences resulted in total deductible interest of \$65,799 for 2008.<sup>31</sup> Respondent argues that, since  
26 appellants claimed deductible interest of \$147,431, respondent properly disallowed the excess mortgage  
27

28 <sup>31</sup> This includes: \$62,133 (for the Washington Mutual Bank loan) and \$3,666 (for the Umpqua Bank loan/home equity line of credit). (Resp. Op. Br., p. 28.)

1 interest in the amount of \$81,632 for the 2008 tax year.<sup>32</sup> (Resp. Op. Br., p. 28; Ex. O.)

2 Applicable Law

3 Income tax deductions are a matter of legislative grace, and a taxpayer who claims a  
4 deduction has the burden of proving by competent evidence that he or she is entitled to that deduction.  
5 (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers*, 2001-SBE-  
6 001, May 31, 2001.)

7 Qualified residence interest is interest paid or accrued during the taxable year on  
8 indebtedness (subject to limitations) secured by any property that is a qualified residence of the  
9 taxpayer. (Int.Rev. Code, § 163(h)(3); see also Hoffman, Smith & Willis, *Individual Income Taxes*,  
10 *2008 Ed.* (hereinafter “Hoffman”), Ch. 10, p. 16.) Qualified residence interest falls into two categories:  
11 (1) interest on acquisition indebtedness, and (2) interest on home equity loans. Before discussing each  
12 of these categories, however, the term qualified residence must be defined.

13 A qualified residence includes the taxpayer’s principal residence and one other residence  
14 of the taxpayer or spouse. (Int.Rev. Code, § 163(h)(4).) The principal residence is one that meets the  
15 requirement for the nonrecognition of gain upon a sale under IRC section 121. (*Id.*) The one other  
16 residence, or second residence, refers to one that is used as a residence if not rented or, if rented, meets  
17 the requirements for a personal residence under the rental of vacation home rules. (*Id.*) A taxpayer who  
18 has more than one second residence can make the selection each year of which one is the qualified  
19 second residence. (*Id.*; see also, Hoffman, *supra.*)

20 Although in most cases interest paid on a home mortgage is fully deductible, there are  
21 limitations. (Int.Rev. Code, § 163, subd. (h)(3).) Interest paid or accrued during the tax year on  
22 aggregate acquisition indebtedness of \$1 million or less (\$500,000 for married persons filing separate  
23 returns) is deductible as qualified residence interest. (*Id.*) Acquisition indebtedness refers to amounts  
24 incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer.  
25 (*Id.*; see also Hoffman, *supra.*)

26 Qualified residence interest also includes interest on home equity loans. (Int.Rev. Code,  
27

28 <sup>32</sup> For 2008: \$147,431 (amount claimed) less \$65,799 (amount allowable) is \$81,632 (excess claimed and disallowed).  
(Resp. Op. Br., p. 28.)

1 § 163, subd. (h)(3).) These loans utilize the personal residence of the taxpayer as security. Because the  
2 funds from home equity loans can be used for personal purposes (e.g., auto purchases, medical  
3 expenses), what would otherwise have been nondeductible consumer interest becomes deductible  
4 qualified residence interest. However, interest is deductible only on the portion of a home equity loan  
5 that does not exceed the lesser of: (i) the fair market value of the residence, reduced by the acquisition  
6 indebtedness, or (ii) \$100,000 (\$50,000 for married persons filing separate returns). (*Id.*; see also  
7 Hoffman, *supra.*)

#### 8 STAFF COMMENTS

9 It does not appear to staff that appellants have provided any evidence to show that  
10 Property 2 was a qualified residence and, additionally, appellants stated that Property 2 was built for  
11 appellant-husband's parents. Therefore, it appears that respondent properly disallowed the deduction  
12 for this property. It does not appear to staff that appellants have provided any argument or evidence  
13 showing that the FTB improperly calculated their home mortgage interest deduction.

#### 14 **(4) Whether appellants have shown reasonable cause for the late filing of their tax returns for the** 15 **2005, 2006, and 2007 tax years.**

##### 16 Background

##### 17 *2005 Tax Year*

18 Appellants filed an untimely joint California personal income tax return for the 2005 tax  
19 year, due on April 15, 2006, on September 14, 2010. Respondent proposed an assessment of a late  
20 filing penalty of \$12,318.75, plus interest. (Resp. Op. Br., p. 3; Exs. D & CC.)

##### 21 *2006 Tax Year*

22 Appellant-wife filed a timely California income tax return for the 2006 tax year on  
23 April 15, 2007, using a filing status of married filing separate. Appellant-husband did not file a return  
24 by the due date of April 15, 2007. Appellants then filed an amended joint California tax return for the  
25 2006 tax year on October 11, 2010. Respondent proposed an assessment of a late filing penalty of  
26 \$6,288.75, plus interest. (Resp. Op. Br., pp. 3-4; Exs. E, F, G, & CC.)

##### 27 *2007 Tax Year*

28 Appellant-wife filed a timely 2007 California income tax return on April 13, 2008, using

1 a filing status of married filing separate. Appellant-husband did not file a return by the due date of  
2 April 15, 2008. Appellants then filed an amended joint California tax return for the 2007 tax year on  
3 March 15, 2011. Respondent proposed an assessment of a late filing penalty of \$4,699.25, plus interest.  
4 (Resp. Op. Br., p. 4; Exs. H, I, J, & CC.)

#### 5 Appellants' Contentions

6 Appellants contend that an FTB agent testified that appellant-husband filed no tax returns  
7 for 18 years. Appellants contend that the FTB refused to provide transcripts of those tax returns, but the  
8 IRS provided transcripts. Appellants contend that the FTB also issued refunds for some of those years,  
9 which it would not do if someone never filed a return. Appellants contend that the FTB provided an  
10 internal report showing that all of appellant-husband's tax returns have been filed, which is proof of the  
11 FTB agent's perjury. (Appeal Letter, p. 2.)

#### 12 Respondent's Contentions

13 Respondent asserts that appellants filed an untimely joint California personal income tax  
14 return for the 2005 tax year on September 14, 2010. Respondent asserts that appellant-wife filed a  
15 timely married filing separate California income tax return for the 2006 and 2007 tax years.  
16 Respondent asserts, however, that appellant-husband filed an untimely California income tax return for  
17 the 2006 tax year on October 11, 2010, and an untimely California income tax return for the 2007 tax  
18 year on March 15, 2011. Respondent asserts that, as a result, respondent properly assessed appellants a  
19 late filing penalty for the 2005 tax year and assessed appellant-husband a late filing penalty for the  
20 2006 and 2007 tax years. Respondent asserts that appellants have a duty to ascertain the due date of a  
21 tax return and to file in a timely manner. In addition, respondent asserts that appellants have the burden  
22 of proof to show that there was reasonable cause for the late filing of the return. Respondent asserts  
23 that appellants have not stated, nor shown, reasonable cause for the abatement of the penalty. (Resp.  
24 Op. Br., pp. 29-30.)

#### 25 Applicable Law

26 R&TC section 19131 provides that respondent shall impose a late filing penalty when a  
27 taxpayer fails to file a tax return on or before its due date unless the taxpayer establishes that the late  
28 filing was due to reasonable cause and was not due to willful neglect. The penalty is computed at

1 5 percent of the tax due, after allowing for timely payments, for every month that the return is late, up to  
2 a maximum of 25 percent. (Rev. & Tax. Code, § 19131, subd. (a).) Taxpayers have until April 15th of  
3 the year following the tax year to file returns without triggering the late filing penalty. (Rev. & Tax.  
4 Code, § 18566.) If taxpayers file their returns by October 15th, they will receive an automatic extension  
5 and the penalty will not be triggered. (Cal. Code Regs., tit. 18, § 18567, subd. (a).) To establish  
6 reasonable cause, the taxpayer “must show that the failure to file timely returns occurred despite the  
7 exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinary  
8 intelligent and prudent businessman to have so acted under similar circumstances.” (*Appeal of Howard*  
9 *G. and Mary Tons*, 79-SBE-027, Jan. 9, 1979.)

10 STAFF COMMENTS

11 For the 2005 tax year, appellants filed an untimely joint tax return, due on April 15, 2006,  
12 on September 14, 2010. For the 2006 tax year, appellant-husband filed an untimely return, due on  
13 April 15, 2007, on October 11, 2010. For the 2007 tax year, appellant-husband filed an untimely return,  
14 due on April 15, 2008, on March 15, 2011. Therefore, respondent properly assessed the late filing  
15 penalties because appellants filed an untimely return for the 2005 tax year and appellant-husband did not  
16 timely file a return for the 2006 and 2007 tax years.

17 It does not appear to staff that appellants have provided any evidence to show reasonable  
18 cause for the late filing of the returns.<sup>33</sup> Based on appellant-husband’s guilty plea to felony counts  
19 including “state tax evasion” and “grand theft”, plus an “aggravated white collar crime enhancement for  
20 theft of \$750,000”,<sup>34</sup> it appears to staff that appellant-husband knew that he had a filing requirement and  
21 that he willfully failed to file his returns in order to evade tax.

22 Pursuant to Rules for Tax Appeals Regulation 5523.6, appellants should provide any  
23 additional evidence in support of their position to the Board Proceedings Division at least 14 days prior  
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25 <sup>33</sup> Staff notes that, during CI’s interview with appellant-husband on May 27, 2009 (after the due date of the returns),  
26 appellant-husband “explained that he did not file 2004 through 2006 tax returns because he had no taxable income” and that  
27 appellant-husband “stated he received 4 to 5 notices from the FTB regarding his personal returns. [Appellant-husband]  
28 stated he did not open the notices because he did not want any more crisis. [Appellant-husband] stated he felt he did  
nothing wrong and the matter would wash out. [Appellant-husband] stated he did not seek professional advice after  
receiving the notices.” (Resp. Op. Br.; Ex. A, pp. 2-3.)

<sup>34</sup> [https://www.ftb.ca.gov/aboutFTB/press/2012/Release\\_10.shtml](https://www.ftb.ca.gov/aboutFTB/press/2012/Release_10.shtml)

1 to the oral hearing.<sup>35</sup>

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<sup>35</sup> Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.