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7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **ROGER E. GRODIN AND**) Case No. 507716
13 **CARROL A. GRODIN¹**)

	<u>Year</u>	<u>Proposed</u>
	2005	Assessment
		\$1,522 ²

17 Representing the Parties:

19 For Appellants: Wassim Malas, Taxpayer Appeals Assistance Program
20 (TAAP)³

21 For Franchise Tax Board: Judy F. Hirano, Tax Counsel III

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25 ¹ Appellants reside in Santa Monica, Los Angeles County.

26 ² Respondent, upon further review of additional documentation, is prepared to reduce the assessment from \$1,522 to \$1,458.
27 (Resp. Reply Br., p. 7.)

28 ³ Appellants submitted their Appeal Letter. Appellants' Reply Brief was written by Terry Guinn of TAAP. Appellants' Supplemental Brief was written by Robert G. Breunig of TAAP. Appellants' Reply to Respondent's Additional Brief was written by Wassim Malas.

1 QUESTIONS: (1) Whether appellants established error in respondent's (FTB's) proposed
2 assessment, which is based on a federal determination; and
3 (2) Whether appellants established entitlement to a Schedule A deduction for
4 additional legal expenses.

5 HEARING SUMMARY

6 Background

7 Introduction

8 Based on federal information, respondent issued a proposed assessment for unreported
9 income appellant-husband received from the Grodin Real Properties LLC (Grodin LLC). (Resp. Reply
10 Br., p. 2.) In response, appellants claimed itemized deductions, including a deduction for legal expenses
11 incurred in litigation against the former trustee of appellant-husband's grandmother's trust, the Celia
12 Silver Testamentary Trust (Silver Trust). (*Id.*) During the appeals process, the FTB determined that
13 appellants provided sufficient documentation for a partial deduction and reduced the proposed
14 assessment from \$1,522 to \$1,458. (Resp. Add'l. Reply Br., p. 7.) However, appellants contend they
15 are entitled to the full amount of the claimed deductions as well as an additional amount of legal
16 expenses discussed in their supplemental brief. (App. Supp. Br., p. 2.)

17 Filing Background

18 Appellants filed a joint 2005 California tax return, reporting \$41,364 in federal gross
19 income. On their Schedule CA (540), appellants added \$8,767 in capital gain income and made \$75 in
20 miscellaneous adjustments to their gross income. Appellants used the \$6,508 standard deduction and
21 reported \$43,548 in taxable income and \$448 in total tax. They subtracted the renter's credit,
22 withholding credits, and estimated tax payments and reported an overpayment of \$822. After applying
23 \$500 to their 2006 estimated tax, appellants claimed a \$322 refund due, which was refunded by
24 respondent. (Resp. Op. Br. p. 1, Ex. B & C.)

25 Respondent subsequently received a March 2008 CP2000 audit report from the Internal
26 Revenue Service (IRS) which adjusted appellants' federal taxable income for 2005. The federal
27 adjustment was due to unreported income, as reported on a Schedule K-1, which appellant received from
28 Grodin LLC, an entity which was taxed as a partnership. The CP2000 audit added \$1,335 in dividend

1 income and \$26,287 in partnership income to appellants' federal taxable income and assessed \$4,340 in
2 additional federal tax. (Resp. Op. Br. p. 2, Ex. D.) Appellants' California Schedule K-1 (Form 568)
3 from the Grodin LLC shows \$1,335 in dividend income, \$29,991 in net rental real estate income, and
4 \$3,704 in Internal Revenue Code (IRC) section 754 rental real estate depreciation deductions. (Resp.
5 Op. Br. p. 2, Ex. F.)

6 Based upon the IRS adjustments, respondent issued a June 12, 2008 Notice of Proposed
7 Assessment (NPA) for the 2005 tax year. The NPA added \$1,335 in dividend income and \$26,287⁴ in
8 partnership/trust/small business income, resulting in a revised state taxable income of \$71,170
9 (i.e., \$43,548 in taxable income as originally reported + \$1,335 + \$26,287). The NPA also disallowed
10 the renter's credit based on the revised California AGI and assessed \$1,818 of additional tax, plus
11 interest. (Resp. Op. Br. p. 2, Ex. G.)

12 Appellants protested the NPA and asserted that the Schedule K-1 shows an offsetting
13 \$3,704 IRC section 754 depreciation deduction not accounted for in the NPA.⁵ Appellants also claimed
14 an itemized deduction for \$37,305.35 in legal expenses allegedly incurred in litigation against the former
15 trustee of the Silver Trust. (Resp. Op. Br. p. 2, Ex. H.)

16 Respondent then issued a Notice of Action (NOA) which modified the NPA and reduced
17 the partnership/trust/small business income added to appellants' state taxable income by \$3,704 to
18 \$22,583⁶ due to "information [appellants] provided." The NOA reported a revised taxable income of
19 \$67,466 and a revised additional tax of \$1,522, plus interest. (Resp. Op. Br. pp. 2-3, Ex. A.)

20 Appellants then filed this timely appeal.

21 Appeals Process

22 Shortly after filing this appeal, appellants submitted a joint amended California return
23

24 ⁴ The \$26,287 of income added to taxable income is the net income derived by subtracting the \$3,704 IRC section 754
25 depreciation deduction from the \$29,991 in rental real estate net income, both of which are shown on the Schedule K-1
26 (\$29,991-\$3,704 = \$26,287).

27 ⁵ As discussed above, the \$26,287 of partnership rental real estate net income that was added to appellants' taxable income,
28 as reflected on the NPA, was apparently the net income after the \$3,704 deduction was subtracted.

⁶ The protest auditor allowed a second \$3,704 deduction for IRC section 754 rental real estate depreciation (shown on the
California Schedule K-1), which appellants specifically mentioned in their protest letter. It appears that this adjustment had
already been taken into account in the NPA previously issued by respondent.

1 (Form 540X) for the 2005 year at issue in this appeal. Due to this pending appeal, the amended return
2 was not processed. Respondent's representative later became aware of, and was able to obtain, the
3 amended return. Instead of taking the standard deduction as in their original return, appellants reported
4 Schedule A (Form 1040) itemized deductions on their amended return. The Schedule A reported the
5 following deductions: \$41,432 of legal fees; \$4,570 of medical expenses; \$1,647 of state income tax;
6 \$78 of personal property tax; \$850 of charitable contributions; and \$280 of unreimbursed employee
7 business expenses. The amended return reported \$72,690 of federal AGI, \$21,166 of Schedule CA
8 (540) net adjustments (reductions) from income, \$47,318 in itemized deductions, \$4,206 of taxable
9 income, and zero tax due. After applying withholding credits, estimated tax payments, and "overpaid
10 tax," the Form 540X claims a \$192 refund. (Resp. Op. Br. p. 4, Ex. L.)

11 Respondent subsequently discovered that in April 2008 the IRS made further adjustments
12 which reduced appellants' 2005 additional federal tax from \$4,340 to \$1,137. The tax, interest, and late
13 payment penalty due were paid by the transfer of funds from appellants' 2007 tax year account. The
14 IRS CP2000 transcript shows that appellants fully agreed with the federal adjustments. (Resp. Op. Br.
15 p. 3, Ex. D.) After the appeal was filed, respondent's representative called appellants and sent them a
16 letter requesting copies of their IRS correspondence that would help explain the IRS's April 2008
17 additional adjustments, documentation for their claimed legal expenses deduction, and copies of
18 Schedules K-1 they received from the Silver Trust and the Grodin LLC. (Resp. Op. Br., Ex. J.)
19 Appellants sent copies of some of the correspondence exchanged with the IRS, including an April 14,
20 2008 IRS letter reducing their additional federal tax. The letter states that appellants' account was
21 changed to correct their Schedule A, as appellants requested. The letter did not specify the items or
22 amount of deductions the IRS allowed. (App. Reply Br., Ex. E.)

23 Respondent's representative again called appellants to request additional IRS
24 correspondence that might explain further the IRS's April 2008 adjustments. Appellants thought their
25 October 15, 2007 letter to the IRS may have been the basis for the adjustments. Appellants then sent
26 copies of their October 2007 letter and other correspondence exchanged with the IRS before the IRS's
27 March 2008 CP2000 audit report. (Resp. Op. Br. pp. 3-4, Ex. K.)

28 On July 30, 2010, appellants filed a reply brief in this appeal, claiming a \$41,432 legal

1 expense deduction under IRC section 212. (App. Reply Br., p. 2.) The legal expenses specified in the
2 reply brief include the following cancelled checks totaling \$40,676.98:

- 3 1. \$619.50 to the Alameda County Superior Court dated March 15, 2005;
- 4 2. \$20,000.00 to Davis Wright Tremaine dated March 22, 2005;
- 5 3. \$4,628.23 to Sarnoff dated March 22, 2005;
- 6 4. \$429.25 to P. Callahan & Associates, Inc. dated September 21, 2005; and
- 7 5. \$15,000.00 to Ruben & Makarem dated November 2, 2005.

8 (App. Reply Br. p. 6, Ex. B.) In addition, while appellants claimed additional legal expenses of \$100
9 and \$655 for court fees, they did not submit those payments (i.e., cancelled checks) with their appeal.
10 Appellants, however, provided a cancelled check for \$15,775 drawn from the Silver Trust's bank
11 account to the Reed Smith Client Trust Account. Appellants also provided copies of: a July 28, 2010
12 letter from John Tate, an attorney from the Davis Wright Tremaine law firm (Tremaine law firm) (App.
13 Reply Br. p. 6, Ex. A.); a July 29, 2010 declaration from appellant-husband (App. Reply Br., Ex. D.); a
14 letter from appellant-husband's brother as successor trustee of the Silver Trust (App. Reply Br., Ex. B.);
15 and a February 23, 2010 letter that appellants sent to the IRS, after this appeal was filed, which indicated
16 that appellants provided documentation for a Schedule A legal expense deduction (App. Reply Br., Ex.
17 B.).

18 On August 24, 2010, respondent sent appellants a Second Request for Documentation
19 (Second Request) relating to appellant-husband's legal expense deduction. (Resp. Reply Br. p. 5,
20 Ex. M.) Respondent requested documents related to the Silver Trust, court documents filed in the
21 consolidated probate and civil action (including the court's decision), billing statements and attorney
22 retainer agreements, and invoices for court reporting services. On August 25, 2010, respondent
23 requested permission from the Board to file a reply brief and a continuance to allow time for appellants
24 to submit the documentation requested and for respondent to review the documentation. The Board
25 granted such permission and extended the due date for respondent's reply brief. Respondent's second
26 request was re-sent to appellants' new representative on September 14, 2010. (Resp. Reply Br. p. 5, Ex.
27 M.) Respondent and appellants' representative agreed that appellants would submit the Silver Trust's
28 federal tax return for 2005, Silver Trust's California return for 2005, and the last will and testament of

1 Celia Grodin Silver, and would send the remaining items by October 21, 2010. (Resp. Reply Br.,
2 pp. 5-6.) On October 1, 2010, respondent received copies of the 2005 federal and California tax returns
3 of the Silver Trust and the last will and testament of Celia G. Silver. (Resp. Reply Br. p. 6, Ex. N.)

4 On October 26, 2010, appellants' representative stated that he obtained some of the
5 requested documents but needed additional time for the remaining documents. In mid-November 2010,
6 appellants' representative indicated that they needed additional time. Appellants and respondent then
7 agreed that respondent would request a second extension of time to file respondent's reply brief to allow
8 time for appellants to obtain additional documentation. On November 19, 2010, respondent submitted a
9 request to the Board for an extension of time to file its reply brief, then due January 11, 2011. The
10 Board granted an extension and set a March 12, 2011 due date. On November 23, 2010, respondent
11 received additional documents from appellants. Appellants submitted court documents relating to the
12 former trustee's accounting and appellant-husband's objections to the accounting in the consolidated
13 probate action, the complaint in the consolidated civil action, billing statements from the Ruben and
14 Makarem law firm, an attorney terms-of-engagement letter from the Tremaine law firm. (Resp. Reply
15 Br., p. 6.)

16 Respondent sent a follow-up request on January 25, 2011. Respondent spoke with
17 appellants' new representative on January 27, 2011, regarding any further documentation that might be
18 provided. On March 2, 2011, respondent left a message regarding any additional documents appellant
19 could provide. Respondent again left messages on March 7 and 8, 2011. Appellants' representative left
20 messages on March 8 and 10, 2011, returning respondent's calls. Respondent did not receive any
21 additional documents it requested, including the court decision and judgment in the consolidated probate
22 and civil action. However, respondent was able to obtain copies of these and other court documents
23 directly from the Alameda County Superior Court. Based on the documents appellants submitted and
24 respondent obtained during the briefing process, respondent allowed a deduction for \$10,934 of legal
25 expenses in its reply brief. The taxable income was reduced to \$66,744 and the proposed additional tax
26 reduced to \$1,458, plus applicable interest. (Resp. Reply Br., pp. 6-7.)

27 Subsequently, on April 18, 2011, appellants filed a supplemental brief claiming a total
28 legal expense deduction of \$86,451.98. Appellants provided two additional checks: (1) a December 23,

1 2004 check drawn on appellant-husband's account for \$30,000 to the Tremaine law firm and (2) a
2 September 6, 2005 check drawn on the account of the Silver Trust for \$15,775⁷ to the Reed Smith Client
3 Trust Account. (Resp. Add'l. Br., pp. 7-8.)

4 The Silver Trust Litigation

5 Leonard Gross (Gross) was the trustee of the Silver Trust from December 1990 until
6 November 2000, when he resigned as the trustee. (Resp. Reply Br. p. 7, Ex. P.) In August 2000, Gross
7 submitted a first and final account to the Alameda County Superior Court, Probate Division, for the
8 period he was trustee. In October 2000, appellant-husband, a beneficiary of the trust, filed objections to
9 the first and final account. In February 2001, Gross filed a supplemental account and, in June 2001,
10 appellant-husband filed an amendment to his objections. Appellant-husband asserted that Gross violated
11 his fiduciary duty when acting as trustee of the Silver Trust. Appellants' brother, Michael Grodin,
12 joined in the objections. (Resp. Reply Br. p. 7, Ex. Q.)

13 In August 2003, appellant-husband and his brother filed a civil action in Alameda County
14 Superior Court against Gross, his son (Barry Gross), and two companies partly owned by Gross and his
15 son for damages for breach of fiduciary duty and fraud, conspiracy to defraud, and for the imposition of
16 a constructive trust. Gross demurred and was dismissed as a party. In February 2004, appellant-
17 husband and his brother filed an amended complaint for damages for conspiracy to defraud, conversion,
18 and for the imposition of a constructive trust against Barry Gross and the two companies. (Resp. Reply
19 Br., pp. 7-8.)

20 The court granted Gross' motion to consolidate the civil actions under the probate action.
21 Trial in the consolidated action began on March 4, 2005, and was completed on March 24, 2005. On
22 May 31, 2005, the court issued its decision and determined that the trustee breached his fiduciary duty
23 but acted with good faith. The court exercised its equitable powers not to impose a surcharge against the
24 trustee. The court also ruled that it would not order the return of trustee's fees already received since the
25 trustee's conduct did not harm the trust assets. Further, the court declined to award attorney's fees to
26 either party. The court found that, although appellant-husband's "level of contest was in bad faith," it
27 was not unreasonable for him to file objections to the trustee's original accounting. In the civil action,
28 _____

⁷ Appellants provided a check in the amount of \$15,755 in Exhibit B attached to their reply brief.

1 the court ruled that, since it had determined not to impose a surcharge against the trustee for any harm to
2 the assets, it would find in favor of the defendants. (Resp. Reply Br. p. 8, Ex. Q.)

3 The court's Order Settling Account and Petition of Trustee was entered in the probate
4 action on June 14, 2005. The court approved the March 2005 Amended Supplemental Account of the
5 trustee and the trustee's fees already received, and, pursuant to its broad equitable powers, exonerated
6 the trustee to the extent he committed any breaches of trust. The court overruled all objections of the
7 objectors. The court also denied both the trustee's and the objectors' requests for attorney fees and ruled
8 that the trustee was entitled to his costs of suit from the appellant-husband objector and the Trust. In
9 addition, the court entered judgment in the civil action in favor of the defendants and against plaintiffs
10 (appellant-husband and his brother), with plaintiffs and defendants to bear their own attorney fees but
11 with the defendants to recover their costs of suit from the plaintiffs (appellant-husband and his brother).
12 (Resp. Reply Br. pp. 8-9, Ex. Q.)

13 Contentions

14 Appellants

15 1. Appeal Letter

16 Appellants assert that appellant-husband's legal expenses incurred in connection with the
17 Silver Trust offsets their additional unreported income. Appellants state that they contacted the IRS to
18 resolve their 2005 issue and ultimately filed an amended return for that year to account for the income
19 and expenses related to the Grodin LLC. Appellants explain that appellant-husband was involved in
20 costly litigation with the former trustee of the Silver Trust and incurred legal expenses totaling
21 \$41,431.98. (Appeal Ltr, pp. 1-2.)

22 Appellants state that the IRS requested an updated Schedule A with all applicable
23 expenses. Appellants explain that, although they did not originally itemize their deductions, they later
24 filed an amended return that included a Schedule A. Appellants contend that, as a result of the expenses
25 and deductions exceeding the income and dividends from the formerly missing Schedule K-1, appellants
26 should receive a larger refund. Appellants state that the IRS never provided them with any final
27 resolution documents after appellants filed their amended 2005 return. Appellants state that the IRS
28 apparently suspended the proceedings pending the increased federal tax refund due. Accordingly, based

1 on appellants' amended state tax return for 2005, appellants assert that they are due a state tax refund of
2 \$192. (Appeal Letter, pp. 2-3.)

3 2. Reply Brief

4 Appellants contend their legal expenses incurred for obtaining a more accurate
5 accounting from the former trustee of the Silver Trust were ordinary and necessary expenses paid or
6 incurred during the taxable year for the production or collection of income under IRC section 212(1).
7 Appellants also assert that the legal expenses they incurred as a result of the trustee's mismanagement of
8 the Silver Trust were ordinary and necessary expenses paid or incurred during the taxable year for the
9 management, conservation, or maintenance of property held for the production of income under IRC
10 section 212(2). (App. Reply Br., p. 3.)

11 Citing *United States v. Gilmore* (1963) 372 U.S. 39, 48, appellants contend that a
12 taxpayer may show that legal expenses were necessary expenses paid or incurred during the taxable year
13 for the management of property held for the production of income if the legal expenses arose in
14 connection with the taxpayer's profit-seeking activities. (App. Reply Br., p. 4.) Appellants further cite
15 *Barr v. Commissioner* T.C. Memo 1989-1261, to support their contention that the origin of appellant-
16 husband's request for an accounting from the trustee of the Silver Trust was the recovery of lost income
17 and the origin of appellant-husband's claim involving the removal of the trustee for mismanagement of
18 trust assets was concern for preserving the trust assets which consisted of property held for the
19 production of income. (App. Reply Br., pp. 4-5.)

20 Appellants further contend that they provided credible evidence showing that appellant-
21 husband is qualified to receive a legal expense deduction for the expenses he incurred in 2005.
22 Appellants note that they provided cancelled checks, a statement from the attorney involved in the
23 litigation verifying that the checks related to the litigation, a letter from the successor trustee of the
24 Silver Trust confirming the additional legal expenses, and documentation showing that the IRS granted
25 the deduction for legal expenses. (App. Reply Br., pp. 5-7.)

26 Appellants note that they provided the cancelled checks for the legal expenses relating to
27 the litigation against the former trustee of the Silver Trust that they claimed on the Schedule A of their
28 2005 amended return. Accordingly, appellants contend the total amount of legal expenses incurred in

1 2005 was \$41,431.98. (App. Reply Br., p.6.)

2 Appellants also state that they provided a document signed by their trust litigation
3 attorney, John Tate, verifying that the cancelled checks related to the legal expenses. Appellants
4 contend the document shows that appellant-husband incurred additional legal expenses not previously
5 reported. Appellants contend they paid an additional \$30,000 to the Tremaine law firm out of a different
6 bank account. Appellants also contend they paid an additional \$15,755 from the Silver Trust, dated
7 September 6, 2005. Appellants assert that the additional payment is confirmed by John Tate and
8 Michael Grodin. Appellants note that this check was made payable to the Reed Smith Client Trust
9 Account and was forwarded by John Tate's firm to the payee as reimbursement for \$15,000 in expert
10 witness fees, exhibit preparation, deposition and transcript fees, and other trial related expenses, plus
11 \$755 in filing fees. Appellants explain that the \$755 was originally represented by the two checks
12 issued from appellant-husband in the amounts of \$100 and \$655 dated August 5, 2005, and then by two
13 checks in identical amounts issued from the Silver Trust dated August 10, 2005. Appellants further
14 explain that the final consolidated check represented a \$15,755 nontaxable return of capital distribution
15 from the Silver Trust to appellant-husband that was used by appellant-husband to pay legal expenses.
16 (App. Reply Br. pp. 6-7, Exs. A and B.)

17 Appellants state that they claimed legal expenses as a Schedule E deduction but that they
18 did not originally include these additional legal expenses as deductions because appellant-husband
19 believed he only needed to provide enough legal expenses to offset the Grodin LLC's K-1 income.
20 Appellants explained that, based on their discussion with the IRS, appellants realized that Schedule A
21 was the appropriate place to claim the deductions yet they continued to claim the lesser amount of legal
22 expenses. (App. Reply Br. p. 7, Ex. D.) Accordingly, appellants contend that the amount of legal
23 expenses appellants reported on their Schedule A was less than the amount of legal expenses appellants
24 actually incurred.

25 Appellants further contend that the IRS granted the deduction for the legal fees to correct
26 appellants' Schedule A. (App. Reply Br. p. 7, Ex. E.) Appellants state that, in August 2007, they spoke
27 with the IRS regarding the offsetting legal fees they incurred in 2005. Appellants submitted a written
28 explanation of the legal expenses to the IRS on October 15, 2007, and on March 6, 2008. (App. Reply

1 Br. p. 7, Ex. F.) Appellants note that, on April 14, 2008, the IRS sent them a revised notice lowering
2 their proposed assessment, indicating that the change was made to appellants' 2005 account to correct
3 their Schedule A. Appellants assert that while the IRS did not have a Schedule A at this time, the
4 changes to appellants' account are consistent with the information appellants previously provided to the
5 IRS. After the change was made, appellants state that the IRS requested an official Schedule A. (App.
6 Reply Br., Ex. G.) Appellants provided the IRS with an amended 2005 federal return, including a
7 Schedule A. Appellants also provided the IRS with copies of cancelled checks for the legal expenses
8 claimed on the Schedule A. Appellants state that the IRS resolved the matter and appellants now have a
9 zero federal tax balance. (App. Reply Br. p. 8, Ex. I.)

10 **3. Supplemental Brief**

11 In their supplemental brief filed April 18, 2011, appellants contend the FTB recognized
12 the claimed legal expenses are validly deductible and the FTB partially reduced appellants' tax liability
13 on the theory that appellants were entitled to deduct some of the expenses. Appellants assert the FTB
14 challenges the truthfulness of appellants' claims of having incurred the full amount of the claimed
15 expenses. (App. Supp. Br., pp. 1-2.) Appellants maintain that they are entitled to the full amount of the
16 following deductions:

<i>Date Paid</i>	<i>Amount</i>	<i>Payee</i>
3/15/2005	\$619.50	Alameda County Superior Court
12/23/2004	\$30,000.00	Davis Wright Tremaine
3/22/2005	\$20,000.00	Davis Wright Tremaine
3/22/2005	\$4,628.23	Sarnoff
9/21/2005	\$429.25	P. Callahan Associates, Inc.
11/02/2005	\$15,000.00	Ruben & Makarem
9/06/2005	\$15,775.00 ⁸	Reed Smith Client Trust Account
	\$ 86,451.98	Total Legal Expenses

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23 (App. Supp. Br., p. 2.)

24 With respect to respondent's contention that appellants may not claim the entire expense
25 for the \$20,000 paid to the Tremaine law firm because appellant-husband's brother was also represented
26 by the same firm, appellants contend respondent's reliance on *Welch v. Helvering* (1933) 290 U.S. 111,
27

28 ⁸ Although appellants claim \$15,775, staff notes that the check provided in appellants' Ex. B of their reply brief indicates that \$15,755 was paid to the Reed Smith Client Trust Account.

1 is not on point in this case because appellant-husband did not bear the cost of expenses which were
2 accrued by another taxpayer (his brother). Rather, appellants contend while the legal services may have
3 benefited his brother, appellant-husband paid for and received legal services that were primarily incurred
4 by appellant-husband. (App. Supp. Br., pp. 3-4.)

5 Appellants further contend that they provided evidence showing that appellants were
6 responsible for, and paid, the entire amount of the legal expenses. Appellants also contend that they
7 were the sole party to claim the expenses in question. Appellants note the detailed statements from
8 appellants' attorneys laid out the specific amounts due to the attorneys. Appellants also note their
9 cancelled checks show that appellants paid the entire amount. Furthermore, appellants assert that
10 appellant-husband's brother provided a statement showing that he did not claim any portion of the
11 deduction on his tax returns. Appellants note that the tax return of the Silver Trust indicates that the
12 trust did not claim the deductions either. Appellants contend that, if the only other parties that could
13 possibly claim these legal expenses did not claim them and appellants sufficiently showed their
14 entitlement to the full amount of the deductions, the FTB has no basis for denying the full deduction
15 where appellants have shown they absorbed the expense. With respect to the remaining legal expenses,
16 appellants emphasize that the FTB already conceded that these payments were validly deductible and
17 appellants proved that they alone accrued the expenses and made the payments. (App. Supp. Br., p. 4.)

18 Appellants note that they made an additional payment to the Tremaine law firm of
19 \$30,000. Appellants state that this payment, which was made on December 23, 2004, was paid in
20 anticipation of legal services to be provided by the firm in 2005. Appellants note that attorney John R.
21 Tate's 2010 letter specifically states that the entire \$50,000 (i.e., the \$30,000 paid in December 2004 and
22 an additional \$20,000 paid in March 2005 (see the table above)) was paid by appellant-husband for
23 handling the 2005 trial. Appellants state that there is no uncertainty in this declaration by appellants'
24 attorney that appellants paid the entire amount because of a 2005 expense. Accordingly, appellants
25 contend that appellants are entitled to deduct the expense under the FTB's own admissions. (App. Supp.
26 Br., p. 5.)

27 Appellants lastly contend that the payment made to the Reed Smith Client Trust Account
28 should be fully deductible as appellants have shown that they were responsible for the payment.

1 Appellants state that the nature of this payment is clear in Attorney John R. Tate's 2010 letter. They
2 assert the payment was for legal services accrued by and received by appellants in connection with the
3 production or collection of income or the management, conservation, or maintenance of income-
4 producing property. (App. Supp. Br., p. 5.)

5 4. Reply Brief to Respondent's Additional Brief

6 In appellants' final brief, they assert respondent conceded that the underlying lawsuit's
7 origin qualifies for IRC section 212 consideration, citing *Burch v. United States* (2nd Cir. 1983) 698
8 F.2d 575, and *Estate of Kincaid v. Commissioner* T.C. Memo 1986-543. Appellants note that the origin
9 or character of the lawsuit was based on multiple breaches of duty by the trustee, including his failure to
10 accurately account for his activities during his tenure as trustee. Accordingly, appellants maintain that
11 all of the ordinary and necessary legal expenses incurred for and paid by appellant-husband are
12 deductible under IRC section 212. (App. Reply Add'l. Br., pp. 2-3.)

13 With respect to the \$30,000 check paid to the Tremaine law firm, appellants explain that
14 they mailed a check on or around December 23, 2004, to secure future legal services. Appellants note
15 that the check signed on that date was thereafter placed in the firm's client trust account on
16 December 30, 2004, as shown on appellants' checking statement for December 2004. (App. Reply
17 Add'l. Br., p. 3 Ex. S.) Appellants assert that the Tremaine law firm was restricted from drawing upon
18 those funds until the completion of certain legal services. As such, appellants contend that the date of
19 delivery for a check will not constitute payment if there are certain restrictions upon the presentation of
20 the check to the payee, citing *Fischer v. Commissioner* T.C. Memo 1950-792 and *McCoy v.*
21 *Commissioner* T.C. Memo 1971-34. Accordingly, appellants contend the date of payment to the
22 Tremaine law firm does not attach to the date written on the check or the day the check was placed in
23 the mail, but rather upon the date the restrictions were lifted. Appellants argue that since most, if not all,
24 of the legal services were carried out in 2005, appellants are entitled to the deduction for this expense.
25 (App. Reply Addl. Br., p. 4.)

26 With respect to the \$15,755 payment to the Reed Smith Client Trust Account, appellants
27 contend that the Silver Trust exclusively drew from appellant-husband's entitlement under the trust.
28 Appellants state that after this payment was furnished to the Reed Smith Client Trust Account,

1 appellant-husband effectively lost \$15,755 while the interests of the other beneficiaries remained largely
2 unchanged. Appellants note that this contention is supported by the January 20, 2006 letter from the
3 successor trustee of the Silver Trust, as well as the attorney who forwarded the check. Appellants argue
4 that as a matter of law and equity, the right to deduct the expense should be given to the party that bore
5 the burden of payment. Appellants assert that, since appellant-husband was effectively responsible for
6 paying the \$15,755 check to the Reed Smith Client Trust Account, he should be entitled to take the
7 deduction. In the alternative, appellants contend that they should be able to deduct half of the legal
8 expense deduction as a jointly and severally liable party. Appellants note that respondent allowed
9 appellants to take a deduction for half of the \$20,000 fee paid to the Tremaine law firm. Appellants
10 contend that respondent's disallowance for half of the deduction relating to legal fees associated with the
11 joint representation of appellant-husband and his brother was erroneous and arbitrary. Appellants argue
12 that this arbitrary apportionment of tax liability infringes upon appellants' due process rights.

13 Appellants dispute respondent's characterization of the legal expenses paid by appellant-husband as
14 "gifts" to his brother. Appellants assert that, because the underlying lawsuit focused on the "negligible"
15 actions of the former trustee, appellant-husband directly benefited from virtually all of the legal
16 expenses he paid. Appellants assert that this is further supported by the fact that the Tremaine law firm
17 did not charge additional rates for representing appellant-husband's brother. Appellants contend that
18 any additional time spent on preparing appellant-husband's brother's representation was "minute and
19 immaterial." (App. Reply Add'l. Br., pp. 4-6.)

20 Appellants contend that, as appellant-husband was jointly and severally liable for the past
21 legal expenses of opposing counsel, the trust benefited from the option of invoking legal recourse action
22 to compel payment from appellant-husband. Accordingly, appellants assert that the \$15,755 payment to
23 the Reed Smith Client Trust Account should be fully deductible because appellant-husband was
24 ultimately responsible for paying the liability. Appellants further contend that respondent cannot
25 disallow more than half of the deduction, considering the joint and several liabilities between the trust
26 and the trust beneficiary. (App. Reply Add'l. Br., p. 6.)

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28 ///

1 Respondent

2 1. Opening Brief

3 With respect to the proposed assessment based on the federal assessment, respondent
4 notes that R&TC section 18622, subdivision (a), provides that a taxpayer shall either concede the
5 accuracy of a federal deficiency or state wherein it is erroneous. Respondent cites *Todd v. McColgan*
6 (1949) 89 Cal.App.2d 509, for the contention that a deficiency assessment based on a federal audit
7 report is presumed correct, and appellants have the burden of proof to show error. (Resp. Op. Br., p. 4.)

8 Respondent indicates that the amended federal return attached to appellants' amended
9 state return shows \$1,335 in dividend income and \$29,991 in net rental real estate income on the
10 California Schedule K-1 from the LLC. Respondent indicates that appellants reported the dividend
11 income on their federal Schedule B, the net rental real estate income as passive income on their federal
12 Schedule E, and the Schedule E total income (\$30,297) on their amended federal Form 1040. (Resp.
13 Op. Br., p. 5 Ex. L.) Respondent notes that, on appellants' California Schedule CA, they subtracted
14 \$29,882 of the \$30,297 total Schedule E income from their federal AGI. Respondent asserts that there is
15 no difference between federal and state law as a basis for excluding the net rental real estate income
16 reported on the Grodin LLC's California Schedule K-1 from appellants' California AGI. (Resp. Op. Br.,
17 p. 5.)

18 Respondent notes that the NPA added \$27,622 (\$1,335 + \$26,287⁹) to appellants' taxable
19 income, which appellants acknowledged is correct. Respondent contends that \$27,622 is the distributive
20 share of LLC income subject to federal and California income tax pursuant to IRC section 702 and
21 R&TC section 17851. Accordingly, respondent contends appellants failed to show error in the IRS's
22 CP2000 report and the NPA. Respondent also explained that, in the NOA, the FTB erroneously reduced
23 the \$26,287 of partnership/trust/small business income to \$22,583 by allowing a second \$3,704
24 depreciation deduction. As a result, respondent explained that appellants' taxable income was reduced
25 erroneously by \$3,704 to appellants' benefit. As such, respondent contends that any claim for refund
26 would be offset by the erroneous duplicative deduction. (Resp. Op. Br., pp. 5-6.)

27 _____
28 ⁹ \$29,991- \$3,704 = \$26,287.

1 With respect to appellants' claim for legal expenses deduction, respondent cites
2 *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 436, for the contention that income tax
3 deductions are a matter of legislative grace and that appellants bear the burden of establishing
4 entitlement to claimed deductions. Respondent cites the Board's decision in the *Appeal of Robert R.*
5 *Telles*, 86-SBE-061, decided on March 4, 1986, for its contention that appellants must identify an
6 applicable statute and show by credible evidence that they qualify for the deduction. Respondent notes
7 that, after the IRS issued its March 2008 CP2000 audit in April 2008, the IRS reduced the federal
8 deficiency assessment. However, respondent contends that the April 14, 2008 IRS letter appellants
9 provided merely explains the reduction by stating their account was changed to correct their Schedule A.
10 Respondent asserts that although the itemized deductions may have been a basis for that adjustment, the
11 IRS letter does not identify the specific deductions or specify the amounts. (Resp. Op. Br., 6.)

12 Respondent notes that appellants appear to assert the IRS allowed itemized deductions
13 based on deductions on the Grodin LLC's Schedule K-1. Respondent contends that the only deduction
14 on the Schedule K-1 is the \$3,704 IRC section 754 depreciation deduction that was already taken into
15 account in the March 2008 IRS CP2000 audit. Respondent asserts that the California Schedule K-1
16 shows \$27,622 as appellant-husband's distributive share of income. Respondent contends that absent an
17 IRS explanation of the nature and amounts of itemized deductions allowed in April 2008 or
18 substantiation by appellants, the FTB cannot allow the deductions, citing the *Appeal of Raymond and*
19 *Rosemarie J. Pryke*, 83-SBE-212, decided by the Board on September 15, 1983. With respect to the
20 miscellaneous deduction of \$41,432 in legal fees purportedly related to Schedule E assets, respondent
21 contends that appellants failed to provide substantiating documentation. (Resp. Op. Br., pp. 6-7.)

22 Respondent contends that the remaining deductions on the amended federal return
23 Schedule A, upon which California itemized deductions are based, totaling \$5,778¹⁰ is less than the
24 \$6,508 standard deduction appellants took on their original California return. Accordingly, respondent
25 contends that appellants properly took the standard deduction on their original California return. (Resp.
26 Op. Br., p. 7.)

27
28 ¹⁰ \$4,570 medical and dental expenses + \$78 personal property tax + \$850 charitable contributions + \$280 employee business expenses = \$5,778. (Resp. Op. Br., Ex. L.)

1 2. Reply Brief

2 Respondent contends that, because appellants have only submitted documentation to
3 establish entitlement to a portion of the \$41,432 legal expense deduction under IRC sections 212(1) and
4 (2), appellants are only entitled to a deduction for that portion and not the entire amount. (Resp. Reply
5 Br., p. 9.)

6 Citing *United States v. Gilmore, supra*, respondent contends that the characterization of
7 litigation costs as “profit seeking” or “personal” depends on whether or not the claim arises in
8 connection with the taxpayer’s profit-seeking activities. Respondent acknowledges that in both the
9 probate and civil actions, the claims of appellant-husband and his brother arose in connection with the
10 production or collection of income or the management, conservation, or maintenance of income
11 producing property, citing *Barr v. Commissioner, supra*. Accordingly, respondent acknowledges that
12 appellants are entitled to a deduction for the ordinary and necessary expenses for which they provided
13 documentation. (Resp. Reply Br., pp. 10-11.)

14 Respondent makes the following contentions regarding the specific expenses claimed by
15 appellants:

- 16 • \$20,000 to the Tremaine law firm: Respondent notes that the December 6, 2004 terms of
17 engagement letter from the Tremaine law firm (Resp. Reply Br., Ex. N.) states that the law firm
18 represented both appellant-husband and his brother. Respondent notes that the court documents
19 show that this law firm represented them during the March 2005 trial. Respondent contends that
20 appellants failed to provide the billing statements referenced in the engagement letter.
21 Accordingly, without further information, respondent contends that it is not clear whether
22 appellants are entitled to deduct the entire \$20,000 appellant-husband paid to the law firm, since
23 the representation provided was on behalf of appellant-husband and his brother and the payment
24 may have inured to the benefit of his brother, citing *Welch v. Helvering, supra*, and the *Appeal of*
25 *Jerome W. and Rita Ann Wayno*, 86-SBE-206, Dec. 3, 1986. Thus, respondent allowed a 50
26 percent deduction of \$10,000. (Resp. Reply Br., p. 12.)
- 27 • \$4,628.23 to Sarnoff Court Reporting Fees: Respondent contends the same reasoning applies to
28 this March 22, 2005 payment for court reporting fees. Respondent notes that since this payment

1 was made on the same day the Tremaine law firm was paid, it appears the fees are related to
2 depositions taken or the multi-day trial. However, respondent contends that, without further
3 documentation, it is not clear whether the payment appellant-husband made was solely his
4 obligation or also on behalf of his brother. Accordingly, respondent allowed a 50 percent
5 deduction of \$2,314. (Resp. Reply Br., p. 12.)

- 6 • \$15,000 to Ruben and Makaren Law Firm: Respondent contends that appellants failed to
7 provide documentation for this expense. Respondent notes that it is not clear what role, if any,
8 this law firm played in the consolidated action. Respondent notes that the billing statements are
9 for legal services provided between July 2002 and early March 2003. Respondent further notes
10 that both the billing statements and appellants' November 2, 2005 check to this law firm indicate
11 that the services were provided in connection with the Grodin v. Gross civil action. Respondent
12 asserts that this action was not filed until August 7, 2003, months after the law firm's services
13 terminated in March 2003. Respondent also notes that the complaint and the amended complaint
14 in the civil action were filed by another attorney, Diane Deckard of the Deckard Law Firm, who
15 represented both appellant-husband and his brother. In the probate action, appellant-husband and
16 his brother were represented by another attorney, Daniel Presher of the Law Offices of Daniel
17 Presher. Respondent contends that it is not clear why appellants made a payment to the Ruben
18 and Makaren law firm in November 2005, over two-and-a-half years after this law firm's
19 services ended. (Resp. Reply Br., pp. 12-13.)

- 20 • \$429.25 to P. Callahan Court Reporting Fees: Similarly, respondent contends that it is not clear,
21 without further documentation, whether this expense was related to the consolidated action since
22 appellant-husband made the payment on September 21, 2005, six months after the trial
23 concluded on March 24, 2005. (Resp. Reply Br., pp. 13.)

- 24 • \$619.50 to Alameda County Superior Court Fees: Respondent contends that appellants have not
25 provided documentation to be entitled to a deduction for this payment. (Resp. Reply Br., p. 13.)

26 Respondent further asserts that appellants failed to provide documentation substantiating
27 the claimed deductions on appellants' Schedule A submitted with their amended return. Specifically,
28 the Schedule A reports deductions for \$4,570 in medical expenses, \$78 in personal property tax, \$850 in

1 charitable contributions, and \$280 in unreimbursed employee expenses. Respondent notes that, if
2 appellants provide documentation for these claimed expenses, respondent will consider these additional
3 deductions. Respondent notes that any refund or reduction in tax to which appellants are entitled is
4 subject to an offset for the \$3,704 depreciation deduction erroneously allowed a second time in the
5 NOA. Moreover, respondent contends that the miscellaneous deduction for legal expenses is subject to
6 the two percent limitation pursuant to IRC section 67 and R&TC section 17076. (Resp. Reply Br.,
7 pp. 13-14.)

8 With respect to appellants' contention that the IRS granted them a deduction for the legal
9 expenses, respondent notes that the April 14, 2008 IRS letter which reduced appellants' additional
10 federal tax merely states that the IRS changed appellants' 2005 account to correct their Schedule A as
11 they requested and the letter is silent as to legal expenses. Respondent notes that appellant-husband
12 acknowledges the IRS did not even have a Schedule A from appellants at the time, since appellants took
13 the standard deduction on their original return. Respondent further notes that appellants did not send the
14 IRS the purported documentation for legal expenses until February 2010, while this appeal was pending.
15 With respect to appellants' contention that the IRS must have granted a legal expense deduction based
16 on the documentation they sent, because the June 24, 2010 IRS transcript showed a zero balance in
17 October 2009, respondent notes that the October 2009 federal transcript shows the balance for the 2005
18 tax year was paid on April 15, 2008, by a transfer of funds from the 2007 tax year. Respondent notes
19 that the most recent IRS Individual Master File respondent obtained shows that, in March 2010, the IRS
20 disallowed reconsideration in full. Respondent further contends that the FTB is not required to follow
21 the federal adjustment based merely on a list of the legal expenses claimed without the underlying
22 documentation showing that appellants are entitled to the deduction, citing the *Appeal of Raymond and*
23 *Rosemarie J. Pryke, supra*, and the *Appeal of Der Weinerschnitzel International Inc.*, 79-SBE-063,
24 decided on April 10, 1979. Accordingly, respondent contends that, after applying the allowed deduction
25 of \$10,934 of legal expenses, the additional tax now due is \$1,458, plus interest. (Resp. Reply Br., pp.
26 14-15; Ex. R.)

27 3. Additional Brief

28 In the additional brief, respondent addresses the additional legal expenses appellants

1 claim in their supplemental brief. Respondent notes that appellants, for the first time, claim a total
2 deduction of \$86,451.98 for the 2005 tax year for legal expenses related to the consolidated probate and
3 civil action involving the former trustee of the Silver Trust. Specifically, respondent indicates that
4 appellants now claim the total additional amount of \$45,755—the December 23, 2004 check of \$30,000
5 paid to the Tremaine law firm and a September 6, 2005 check drawn on the account of the Silver Trust
6 for \$15,755 paid to the Reed Smith Client Trust Account. Respondent contends that appellants have not
7 shown that they are entitled to the additional amounts claimed in their supplemental brief. (Resp. Add'l.
8 Br., pp. 8-11.)

9 Respondent makes the following arguments regarding the specific expenses claimed by
10 appellants:

- 11 • \$30,000 to the Tremaine law firm: Respondent contends that for a cash-basis taxpayer, as
12 here, an expense is generally considered to have been paid in the taxable year when a check
13 for the expense is given, and a deduction for payment may be taken for that taxable year, as
14 long as the check is honored when presented for payment, citing *Mattei v. Commissioner*
15 T.C. Memo 1978-1157. Respondent notes that for this item, appellants only provided the
16 front of the check, unlike the copies of the cancelled checks he previously submitted.
17 Respondent contends that the back of the check, which would show the stamped dates when
18 the payee cashed or deposited the check, was not submitted. Accordingly respondent asserts
19 that it is unclear when the check was a cashed payment to the law firm, citing *Eagleton v.*
20 *Commissioner* (1937) 35 B.T.A. 551, aff'd (8th Cir. 1938) 97 F.2d 62. In citing the *Appeal*
21 *of Harry and Eleanor Gonick*, 88-SBE-12, decided by the Board on May 3, 1988, respondent
22 further contends that, even if the check constituted payment, because appellants are cash-
23 basis taxpayers, and the \$30,000 check is dated December 23, 2004, any payment based on
24 this check would have been deductible in 2004, but not for 2005. (Resp. Add'l. Br.,
25 pp. 11-12.)
- 26 • \$15,755 to the Reed Smith Client Trust Account: Respondent contends that appellants are
27 not entitled to a legal expense deduction for a payment made by another individual or entity,
28 such as the Silver Trust, even if on appellant-husband's behalf. Respondent cites *Erdman v.*

1 *Commissioner* (7th Cir. 1963) 315 F.2d 761, to support the contention that appellant-husband
2 is only entitled to a deduction for payments he himself made to satisfy his own legal expense
3 obligations. Respondent notes that the check for \$15,755, on its face, does not reflect that
4 appellants made the payment since it was drawn on the account of the Silver Trust, not
5 appellants' own account, and nowhere on the face of the check is there any mention of
6 appellant.¹¹ Respondent further asserts that while appellants state the payment to the Reed
7 Smith Client Trust Account was for legal services accrued by and received by appellants,
8 there is no evidence in the court record that the Reed Smith law firm ever represented
9 appellants and provided them with legal services. Rather, respondent notes that appellant-
10 husband and his brother were represented by attorney Daniel Presher and Reed Smith
11 represented Gross, the former trustee. (Resp. Add'l. Br., p. 13.)

12 Respondent asserts that the law regarding legal expense deductions under IRC section
13 212 does not support appellants' contention that they are entitled to the deduction since neither the
14 brother nor the Silver Trust took deductions for legal expenses on their respective 2005 tax returns.
15 Respondent initially notes that appellants provided a copy of the Silver Trust's 2005 fiduciary income
16 tax return, but not appellant-husband's brother's return. Respondent notes that while appellants assert
17 the brother's statement proves the brother did not take the deduction, the record does not contain any
18 such statement from appellant-husband's brother. Respondent contends even if the brother and the
19 Silver Trust did not take the deduction, the fact that taxpayers who may have been entitled to take the
20 deduction for legal expenses failed to do so, does not entitle another taxpayer to take a deduction for
21 those legal expenses that other taxpayers were entitled to, but did not take. (Resp. Add'l. Br.,
22 pp. 14-15.)

23 Respondent also cites *Hewett v. Commissioner* (1967) 47 TC 483 and the *Appeal of*
24 *Jerome W. and Rita Ann Wayno, supra*, to support its contention that appellant-husband may only take a
25 deduction for his own expenses. Respondent further contends that payment for the expenses of another
26

27 ¹¹ Respondent states that, although appellants suggest the check drawn on the Silver Trust account was a nontaxable capital
28 distribution to appellants, the check does not reflect this. Respondent states that, if appellants provide the accounting of the
trustee of the Silver Trust for the 2005 tax year, respondent would consider that document. (Resp. Add'l. Br., p. 13.)

1 taxpayer are not deductible from income as ordinary and necessary expenses, citing *Welch v. Helvering*,
2 *supra*. As such, respondent asserts that appellants are not entitled to take a deduction for all of
3 appellant-husband's claimed legal expenses when appellant-husband's brother, who was represented by
4 the same attorneys as appellant-husband in the consolidated probate and civil action, and the Silver
5 Trust, ordered by the court to be jointly and severally liable for the former trustee's cost of suit, were
6 obligated for a portion of the legal expenses. Respondent maintains that appellants may only take a
7 deduction for payments appellant-husband made to satisfy his own obligations. (Resp. Add'l. Br., pp.
8 15-16.)

9 Respondent contends that the July 2010 letter from the Tremaine law firm attorney does
10 not show that appellants' claimed legal expenses are ordinary and necessary expenses of appellant-
11 husband that are deductible from his income. Respondent notes that the attorney's letter is not a
12 declaration signed under penalty of perjury. Moreover, respondent notes that the attorney represented
13 appellant-husband and his brother in the March 2005 trial, but the letter contains no basis for the
14 attorney's knowledge of the details relating to the cancelled checks submitted with appellants' reply
15 brief. Respondent further notes that while respondent requested that appellants provide the billing
16 statements from the Tremaine law firm, they have not done so. Accordingly, respondent asserts that, as
17 appellants failed to furnish evidence within their control, it is presumed that the evidence is unfavorable.
18 (Resp. Add'l. Br., p.16.)

19 Finally, respondent states that appellants mischaracterize respondent's position as
20 conceding that the claimed legal expenses are valid deductions. Respondent states that the issue is not
21 solely whether the legal expenses are potentially deductible under IRC section 212, but whether
22 appellants satisfied the burden to establish the expenses were ordinary and necessary expenses that are
23 deductible, citing *Honodel v. Commissioner* (9th Cir. 1984) 722 F.2d 1462. Respondent asserts the fact
24 that appellants wrote certain checks during 2005 does not establish that they are deductible payments
25 under IRC section 212. Respondent notes that if appellants provide copies of invoices or receipts
26 showing the connection between the remaining checks and the litigation, respondent will consider them.
27 (Resp. Add'l. Br., pp. 16-17.)

28 ///

1 Applicable Law

2 Burden of Proof

3 The FTB's determination is presumed to be correct, and a taxpayer has the burden of
4 proving error. (*Todd v. McColgan, supra; Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)
5 Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and*
6 *Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In the absence of uncontradicted, credible, competent,
7 and relevant evidence showing that respondent's determinations are incorrect, respondent's proposed
8 assessments must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)
9 An appellant's failure to produce evidence that is within his control gives rise to a presumption that such
10 evidence is unfavorable to his case. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

11 Federal Assessment

12 R&TC section 18622, subdivision (a), provides that a taxpayer shall either concede the
13 accuracy of a federal determination or state wherein it is erroneous. It is well-settled that a deficiency
14 assessment based on a federal audit report is presumptively correct and the taxpayer bears the burden of
15 proving that the determination is erroneous. (*Appeal of Sheldon I. and Helen E. Brockett*, 86-SBE-109,
16 June 18, 1986; *Todd v. McColgan, supra.*)

17 Legal Expense Deduction

18 Income tax deductions are a matter of legislative grace, and taxpayers bear the burden of
19 establishing their entitlement to any claimed deductions. (*New Colonial Ice Co. v. Helvering, supra;*
20 *Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.) Respondent's
21 determination that a deduction or exclusion should be disallowed is presumed correct (*Welch v.*
22 *Helvering, supra; Appeal of John A. and Julie M. Richardson*, 80-SBE-135, decided on October 28,
23 1980), and taxpayers must prove their entitlement to claimed deductions or exclusions. (*Appeal of*
24 *Ambrose L. and Alice M. Gordos*, 82-SBE-062, Mar. 31, 1982.) Taxpayers must identify an applicable
25 statute and show by credible evidence that they qualify for the deductions. (*Appeal of Robert R. Telles,*
26 *supra.*) Generally, the FTB is not bound to follow a federal action adjusting a taxpayer's federal tax.
27 (*See Appeal of Rosemary J. Pryke, supra; Appeal of Der Weinerschnitzel, supra.*)

28 R&TC section 17201, subdivision (b), incorporates, except as otherwise provided, IRC

1 section 212. IRC section 212 provides that, in the case of an individual, a deduction shall be allowed for
2 the ordinary and necessary expenses paid or incurred during the taxable year for (1) the production or
3 collection of income and (2) for the management, conservation, or maintenance of property held for the
4 production of income. Deductibility under IRC section 212 requires that the costs incurred be ordinary
5 and necessary expenses for one of the deductible categories established by the statute. (*Honodel v.*
6 *Commissioner, supra.*) As a miscellaneous itemized deduction, the deduction is allowed only to the
7 extent it exceeds 2 percent of AGI. (Int.Rev. Code, § 67; Rev. & Tax. Code, § 17076; *Glassman v.*
8 *Commissioner* T.C. Memo 1997-497.)

9 Personal expenses are not deductible under IRC section 212. (Int.Rev. Code, § 262(a);
10 Rev. & Tax. Code, §17201, subd. (c).) In *United States v. Gilmore, supra*, the United States Supreme
11 Court held that whether an expense is considered business or personal depends on the origin and
12 character of the claim with respect to which the expense is incurred, rather than its potential
13 consequences upon the forums of the taxpayer. The test for the deductibility of legal fees under IRC
14 section 212 is generally an objective test, looking to the origin or character of the claim litigated rather
15 than the subjective purpose of the taxpayer in pursuing it. (*Burch v. United States, supra*, at 577-578.)
16 The origin of the claim test requires consideration of (1) the issues involved; (2) the nature and
17 objectives of the litigation; (3) the defenses asserted; (4) the purpose for which the claimed deductions
18 were expended; (5) the background of the litigation; and (6) all facts pertaining to the controversy.
19 (*Boagni v. Commissioner* (1973) 59 T.C. 708, 713, citing *Morgan's Estate v. Commissioner* (5th Cir.
20 1964) 332 F.2d 144, 151.)

21 Deductible expenses generally must be those of the taxpayer claiming the deduction.
22 (*Hewett v. Commissioner, supra; Appeal of Jerome W. and Rita Ann Wayno, supra.*) One taxpayer's
23 payment of the obligation of another generally is not considered an ordinary and necessary expense.
24 (*Welch v. Helvering, supra.*) The United States Supreme Court noted:

25 Men do at times pay the debts of others without legal obligation or the lighter obligation
26 imposed by the usages of trade or by neighborly amenities, but they do not do so
27 ordinarily, not even though the result might be to heighten their reputation for generosity
28 [citations omitted], we should have to say that payment in such circumstances, instead of
being ordinary is in a high degree extraordinary. There is nothing ordinary in the
stimulus evoking it, and none in the response.

1 (*Welch v. Helvering, supra* at 114.)

2 The Supreme Court held the taxpayer's payments of the debts of a bankrupt corporation to enhance his
3 own reputation and standing to develop his own business were not ordinary and necessary business
4 expenses deductible from income. (*Id.* at pp. 113 – 116.)

5 Moreover, deductions must be taken in the year that they are incurred. IRC section
6 461(a), incorporated by R&TC section 17551, subdivision (a), provides that the amount of any
7 deduction shall be taken for the taxable year which is the proper taxable year under the method of
8 accounting used in computing taxable income. Treasury Regulation section 1.461.1(a)(1) provides that
9 under the cash receipts and disbursements method of accounting, amounts representing allowable
10 deductions shall, as a general rule, be taken into account for the taxable year in which paid. In the
11 *Appeal of Harry and Eleanor Gonick, supra*, citing *Helvering v. Price* (1940) 309 U.S. 409, the Board
12 held that a taxpayer using the cash method of accounting may deduct an expense only in the taxable year
13 in which the payment of the expense was made. When a payment is made by check, it is reasonable to
14 conclude that the payment dates back to the time of giving the check. (*Eagleton v. Commissioner,*
15 *supra.*) Accordingly, for a cash-basis taxpayer, an expense generally is considered to be paid in the
16 taxable year when a check for the expense is given, and a deduction for the payment may be taken for
17 that taxable year, as long as the check is honored when presented for payment. (*Mattei v.*
18 *Commissioner, supra.*)

19 In *Fischer v. Commissioner, supra*, the Tax Court considered the issue of whether or not
20 a check in payment of legal services rendered, received by the taxpayer on December 31, 1942, but not
21 deposited for collection until February 10, 1943, constituted taxable income to the taxpayer in 1942.
22 Although the taxpayer received the check on December 31, 1942, the taxpayer agreed to the drawer's
23 request to hold the check for a few days. Accordingly, the check was not deposited for collection until
24 February 10, 1943. The court held that the check was not income in 1942 because the taxpayer could
25 not use the money in that year. The court noted that what the taxpayer received in 1942 was still subject
26 to a very substantial restriction, arising from his agreement that he would not deposit the check until
27 after the first of the year in 1943. The court stated, "Income is not realized until the taxpayer has the
28 funds under his dominion and control, free from any substantial restriction as to the use thereof."

1 (*Fischer v. Commissioner, supra* at 802.)

2 In *McCoy v. Commissioner, supra*, the Tax Court considered the issue of whether a
3 partnership should be allowed deductions for business expenses incurred in the year 1964 totaling the
4 amount of \$14,166.95, for which checks were written and dated in December 1964, but not presented to
5 the bank for payment during the year 1964, and all of which were in excess of funds on deposit in the
6 partnership's bank accounts as of December 31, 1964. The court held that the partnership was entitled
7 to the claimed deduction since the president of the bank, in which the partnership and then the
8 corporation maintained its account, testified that the checks would be honored when presented for
9 payment.

10 Due Process

11 The Board has previously held that "due process is satisfied with respect to tax matters so
12 long as an opportunity is given to question the validity of a tax at some stage of the proceedings."
13 (*Appeals of Walter R. Bailey, 92-SBE-001, Feb. 20, 1992.*)

14 STAFF COMMENTS

15 Federal Assessment

16 It appears to staff that respondent based its NPA on a federal audit report from March
17 2008. Appellants provided a letter from the IRS dated April 14, 2008, which adjusted the federal
18 assessment. Respondent acknowledged that its proposed assessment did not take into account the April
19 14, 2008 federal adjustment. It appears that appellants believe the federal adjustment is based on
20 claimed legal expenses. Appellants should be prepared to explain how the IRS allegedly determined
21 that appellants were entitled to a legal expense deduction despite the fact that the IRS did not have a
22 Schedule A from appellants when the IRS issued the April 14, 2008 letter. Respondent should be
23 prepared to discuss why the April 14, 2008 IRS letter is insufficient to warrant an adjustment to
24 respondent's proposed assessment.

25 Claimed Legal Expenses

26 During the appeals process, appellants claim they are entitled to the full amount of
27 various legal expense deductions that total \$86,451.98. Respondent allowed a 50 percent deduction of
28 the March 22, 2005 payment of \$20,000 to the Tremaine law firm and the March 22, 2005 payment of

1 \$4,628.23 to Sarnoff, resulting in a \$10,934 adjustment.¹² (Resp. Add'l. Br., p. 10.)

2 At the hearing, appellants should be prepared to discuss whether the remaining claimed
3 legal expenses were ordinary and necessary expenses incurred by, and paid by, appellants pursuant to
4 IRC section 212 and the relevant case law. Specifically, appellants should be prepared to explain, and
5 provide documentation of, the connection between the cancelled checks and the consolidated Silver
6 Trust litigation. Appellants should be prepared to discuss whether these expenses were incurred solely
7 by appellant-husband or by appellant-husband and his brother. Appellants should also be prepared to
8 cite applicable authority for their contention that they may claim the deduction for legal expenses if the
9 other parties who are entitled to claim the deduction do not claim the deduction.

10 With respect to the Ruben & Makarem billing statements (Resp. Reply Br., Ex. N,
11 pp. 4-16), appellants should be prepared to discuss how it is related to the consolidated Silver Trust
12 litigation. Appellants also should be prepared to discuss the nature of the \$15,755 check drawn on the
13 Silver Trust payable to the Reed Smith Client Trust Account. Staff notes that appellants state this check
14 was made payable to the Reed Smith Client Trust Account and was forwarded by the Tremaine law firm
15 to the payee as reimbursement for \$15,000 in expert witness fees, exhibit preparation, deposition and
16 transcript fees, and other trial-related expenses, plus \$755 in filing fees. Appellants should also be
17 prepared to explain, and provide documentation of, their contention that the \$15,755 check to the Reed
18 Smith Client Trust Account was a nontaxable capital distribution to appellant-husband.

19 Respondent should be prepared to discuss what documentation appellants should provide
20 to meet their burden of proving appellants paid ordinary and necessary legal expenses for the purposes
21 of IRC section 212. In addition, respondent should be prepared to discuss whether appellants may claim
22 the deduction for amounts paid by the Silver Trust, purportedly on appellant-husband's behalf.

23 Other Schedule A Miscellaneous Deductions

24 Appellants should be prepared to discuss whether they have provided sufficient
25 substantiation for the additional claimed deductions on appellants' Schedule A submitted with their
26 amended return. Specifically, the schedule reports deductions for \$4,570 in medical expenses, \$78 in
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28 ¹² This amount was derived after offset for a \$3,704 depreciation deduction erroneously allowed a second time in respondent's NOA and given the 2 percent of AGI limitation for miscellaneous deductions. (Resp. Add'l. Br., p. 10.)

1 personal property tax, \$850 in charitable contributions, and \$280 in unreimbursed employee expenses.
2 (Resp. Op. Br., Ex. L.) If appellants provide additional documentation for these items, respondent
3 should be prepared to discuss whether appellants have met their burden in showing entitlement to these
4 deductions.

5 Due Process

6 Appellants also assert respondent violated their due process rights. Based on the Board's
7 prior decision in *Appeals of Walter R. Bailey, supra*, it appears the current appeal process satisfies
8 appellants' due process rights in providing a forum for them to question the assessment and to submit
9 evidence in support of their contentions.

10 Additional Evidence

11 Pursuant to California Code of Regulations, title 18, section 5523.6, if appellants are able
12 to locate any additional evidence supporting their appeal, such evidence should be submitted if possible
13 to the Board and respondent at least 14 days prior to the hearing date.¹³

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28 ¹³ Exhibits should be submitted to: Claudia Madrigal, Board Proceedings Division, Board of Equalization. P. O. Box
942879 MIC:80, Sacramento, CA 94279-0080