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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 **GERALD A. HUTCHINSON**<sup>1</sup> ) Case No. 552085

13  
14 Year Proposed  
15 2004 Additional Tax  
16 \$71,926.20

16 Representing the Parties:

18 For Appellant: Michael Leight, Esq.  
19 For Franchise Tax Board: Anjali Balasingham, Tax Counsel  
20

21 **QUESTIONS:** (1) Whether appellant has shown that the Franchise Tax Board (FTB or respondent)  
22 erred in disallowing appellant's exclusion of gain from the sale of his home under  
23 Internal Revenue Code (IRC) section 121.<sup>2</sup>  
24 (2) Whether appellant has shown that the FTB erred by disallowing appellant's  
25 deduction of claimed expenditures for home improvements as an increase to the  
26

27 <sup>1</sup> Appellant currently lists an address in Los Angeles County, California. Although appellant filed a joint 2004 return with his  
28 wife, Sharon Hutchinson, the couple is now divorced and only appellant filed this appeal.

<sup>2</sup> IRC section 121 is generally incorporated by reference by Revenue and Taxation Code (R&TC) sections 17131 and 17152.

1 home's adjusted basis.

2 (3) Whether appellant has shown that the FTB erred by disallowing a claimed  
3 deduction for home mortgage interest in excess of the amounts allowed under IRC  
4 section 163.<sup>3</sup>

5 (4) Whether appellant has shown that the FTB abused its discretion by denying  
6 appellant's request for abatement of interest on the proposed additional tax.

7 HEARING SUMMARY

8 Background

9 Appellant and his former spouse purchased a home in Coto De Caza, California, (the  
10 "first home") on August 25, 2003 for \$3,500,000. (FTB Opening Brief (OB), p 2.) Approximately a  
11 year later, on September 10, 2004, appellant and his former spouse purchased a second home in Coto De  
12 Caza, California, (the "second home") for \$2,500,000. (*Id.*) Afterwards, on October 13, 2004, they sold  
13 the first home for a price of \$4,500,000. (*Id.*)

14 Appellant and his former spouse filed a timely joint 2004 California return, reporting,  
15 among other things, (i) a selling price for the first home of \$4,500,000, an adjusted basis for the first  
16 home of \$3,753,357, and a gain on sale of the first home (before application of the \$500,000 IRC section  
17 121 exclusion) of \$746,643; (ii) an IRC section 121 exclusion of \$500,000, which reduced the reported  
18 gain on sale of the first home by \$500,000 from \$746,643 to \$246,643; and (iii) home mortgage interest  
19 deductions totaling \$93,380. (FTB OB, p. 2 & Ex. D.)

20 Upon audit of the couple's return, the FTB made the following adjustments: (a) the FTB  
21 disallowed the IRC section 121 exclusion of \$500,000, thereby increasing gain on the sale of the first  
22 home by \$500,000; (b) the FTB further increased gain on the sale of the first home by \$62,865, by  
23 disallowing claimed expenditures as an increase to the first home's adjusted basis (see FTB OB, Ex. R);  
24 and (c) the FTB partially disallowed the claimed home mortgage interest deduction, which increased the  
25 couple's California taxable income by \$66,383. (Appl. Ltr. Ex 2.) Accordingly, on November 19, 2008,  
26 the FTB issued a Notice of Proposed Assessment (NPA), which increased the couple's California  
27

28 <sup>3</sup> IRC section 163 is generally incorporated by reference by R&TC sections 17201, 17224, 17230, and 17235.

1 taxable income by \$629,248 to account for adjustments “a-c” above and resulted in an additional tax of  
2 \$58,581.00 and interest of \$7,573.24. (*Id.*)

3 Appellant timely protested the NPA. After reviewing the matter, however, the FTB  
4 affirmed the NPA in a Notice of Action (NOA) dated September 17, 2010. (*Id.*, Ex. 1.) The NOA set  
5 forth an additional tax of \$58,581.00 and interest of \$13,345.20. (*Id.*) Subsequently, appellant filed this  
6 timely appeal.

7 Question 1: Whether appellant has shown that FTB erred in disallowing appellant’s exclusion of gain  
8 from the sale of his home under IRC section 121.

9 Contentions

10 Appellant

11 With respect to the FTB’s denial of the \$500,000 IRC section 121 exclusion (i.e.,  
12 adjustment “a” above), appellant argues that he is entitled to exclude gain of \$500,000 on the sale of the  
13 first home because he comes under a “safe harbor” for “unforeseen circumstances,” as set forth in  
14 Treasury Regulation 1.121-3. Specifically, appellant states that he is entitled to the “unforeseen  
15 circumstances safe harbor” because:

- 16
- 17 • The suitability of the property as his principal residence changed materially through  
18 no fault of his own.
  - 19 • He lost the financial ability to maintain the property.
  - 20 • The *estrangement* from his wife made the disposition of the property mandatory.  
(App. Opening Br., Ex 3, p. 2.) (Emphasis supplied.)

21 As to appellant’s argument that he was estranged from his wife, appellant asserts the following:

- 22
- 23 1. As of March 2004, [appellant’s] relationship with his former wife, Sharon  
24 Hutchinson, had deteriorated to the point that she was living at one end of the  
25 [first home], a 12,000 square foot house, and he was living at the other end.  
26 They could not afford to live in separate residences and this was their  
27 temporary solution. They lived like this from approximately March 2004  
28 through October 2004. They rarely saw or spoke to each other during this  
period.
  2. The [second home] was purchased immediately after the [first home] was sold  
because the transaction was effectively a trade. The seller of the [second  
home] took title to the [first home] for the difference in value. This  
transaction was necessary because Mr. Hutchinson’s income had declined to a  
point that they could not afford to stay in the [first home] and service the debt  
and pay other reasonable living expenses.

- 1 3. Mr. and Mrs. Hutchinson lived in the [second home] from approximately  
2 October 2004 until approximately May 2006 when Mrs. Hutchinson moved to  
3 Colorado. During the time they lived in the [second home], they had separate  
4 bedrooms and rarely interacted. During this period, Mr. Hutchinson was  
5 traveling extensively for his work and their estrangement continued and  
6 intensified.
- 7 4. The [second home] was sold around May 2007 and Mr. and Mrs. Hutchinson  
8 divided the proceeds. ... (App. Opening Br., Ex. 3, p. 2.)

9 The FTB

10 In relation to the FTB's denial of appellant's \$500,000 IRC section 121 exclusion (i.e.,  
11 adjustment "a" above), the FTB argues that appellant does not qualify for the *maximum* gain exclusion  
12 (generally \$500,000 for married couples) under IRC section 121 because he and his former spouse did  
13 not own the first home for a two-year period, as required by IRC section 121. Also, the FTB argues that  
14 appellant does not qualify for a *partial* exclusion of gain for "unforeseen circumstances" under Treasury  
15 Regulation section 1.121-3 because appellant does not qualify under either a "safe harbor" or the "facts  
16 and circumstances test" of that regulation.

17 In relation to the "safe harbors," the FTB argues that none of the safe harbors for  
18 "unforeseen circumstances" set forth in Treasury Regulation section 1.121-3(e)(2) apply in this appeal.  
19 In its opening brief, the FTB specifically discusses the following two safe harbors:

- 20 • *A change in the employment or self-employment status that results in a qualified individual's*  
21 *inability to pay housing costs and reasonable basic living expenses.* Even though appellant  
22 argues that he sold the first home because his income declined, such that he and his former  
23 spouse could not afford the debt on the first home, the FTB asserts that appellant's income  
24 records (see FTB OB, Exhs. K, L and M) show that appellant earned similar wages from the  
25 same employer in 2003 and 2004, and appellant earned substantially more in 2005. (FTB OB p  
26 6.) In short, the FTB contends that "appellant has not substantiated his alleged reduction in  
27 income with documentation." (*Id.*) In addition, the FTB asserts that this safe harbor only applies  
28 when a taxpayer's reduction in income is due to a change in employment status, such as being  
furloughed (citing Treas. Reg. § 1.121-3(e)(4), Ex. 2), and the FTB alleges that appellant has not  
made such a showing. (*Id.*)
- *The divorce or legal separation of a qualified individual.* The FTB argues that this safe harbor

1 does not apply because appellant was not divorced or legally separated from his former spouse  
2 pursuant to a divorce decree or a separate maintenance order in 2003 or 2004. (Treas.Reg.  
3 § 1.121-3(e)(2).) (*Id.* p 5.)

4 Next, the FTB notes that Treasury Regulation section 1.121-3(b) provides that if a safe  
5 harbor does not apply, then the taxpayer may still claim reduced gain exclusion under IRC section  
6 121(c) by reason of “unforeseen circumstances.” The regulation specifies that a showing of “unforeseen  
7 circumstances” is based upon all “facts and circumstances”, and the regulation lists the following six  
8 factors—the FTB argues that appellant has met none of the six factors as follows:

- 9 1. *The sale and the circumstances giving rise to the sale are proximate in time.* The FTB argues  
10 that this factor is not met because “appellant has not documented that his relationship with his  
11 former spouse was amicable when they first acquired and occupied the [first home] in 2003.”  
12 (FTB OB p 10.)
- 13 2. *The suitability of the property as the taxpayer’s residence materially changes.* The FTB asserts  
14 that this factor is not met because “appellant’s living arrangement [with his former spouse] did  
15 not change when he and his former spouse sold the [first home].” (*Id.* p 11.)
- 16 3. *The taxpayer’s financial ability to maintain the property is materially impaired.* The FTB argues  
17 that this factor is not met because “appellant has not furnished any evidence to support his claim  
18 that the sale of [the first home] was due to financial distress.” (*Id.*) In fact, the FTB asserts that  
19 appellant’s income records (see FTB OB, Exs. K, L and M) show that appellant earned similar  
20 wages from the same employer in 2003 and 2004, and appellant earned substantially more in  
21 2005. (*Id.*) In addition, the FTB notes that appellant has not presented evidence that his alleged  
22 reduction in income is due to a change in employment status, such as being furloughed (citing  
23 Treas. Reg. § 1.121-3(e)(4), Ex. 2).
- 24 4. *The taxpayer uses the property as the taxpayer’s residence during the period of the taxpayer’s*  
25 *ownership of the property.* The FTB contends that this factor “does not appear to be relevant to  
26 the determination of appellant’s primary reason for the sale of [the first home].” (*Id.*)
- 27 5. *The circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer*  
28 *begins using the property as a principal residence.* The FTB generally asserts that this factor

1 has not been met “as addressed above.” (*Id.*) (Apparently, the FTB is referring to its arguments  
2 in relation to factors 1 and 2 above.)

- 3 6. *The circumstances giving rise to the sale occur during the period of the taxpayer’s ownership*  
4 *and use of the property as a principal residence.* (Treas.Reg. § 1.121-3(b).) The FTB generally  
5 asserts that this factor has not been met “as addressed above.” (*Id.*) (Apparently, the FTB is  
6 referring to its arguments in relation to factors 1 and 2 above.)

7 The FTB also acknowledges that Treasury Regulation section 1.121-3(e)(3) provides that  
8 the IRS may determine (in published rulings, etc.) specific events or situations qualifying as “unforeseen  
9 circumstances.” The FTB argues, however, that appellant does not come under any of the IRS’s  
10 published rulings for “unforeseen circumstances.” (FTB OB, pp. 7-8.) Specifically, the FTB notes that  
11 the applicable IRS rulings can be broadly characterized—as set forth below—and the FTB asserts that  
12 appellant does not come under any of those rulings:

- 13 • *Additional dependents arising out of marriage or other events:* Blended family moves to  
14 children’s school district (PLR 200601022 (January 5, 2006)); adult child moves back in with  
15 parents (PLR 200601023 (January 6, 2006)); need for bigger house for orphan adoption (PLR  
16 200613009 (March 31, 2006)); caring for disabled parent (PLR 200626024 (June 30, 2006)); co-  
17 owner became pregnant, but was no longer in relationship with father of expected child, and the  
18 home was too small for the two co-owners and child (PLR 200652041 (December 29, 2006));  
19 large blended family (PLR 200725018 (June 22, 2007)); second child and home office (PLR  
20 200745011 (November 9, 2007)); blended family and schools (PLR 200826004 (June 27, 2008));  
21 marriage with visiting child (PLR 200841022 (October 10, 2008)); neighbors were hostile to a  
22 family member joining taxpayer’s household while on house arrest/probation (PLR 200403049  
23 (January 16, 2004)).
- 24 • *Environmental factors that detrimentally affect the quality of living in a particular locale:*  
25 Assaults and threats (PLR 200601009 (January 6, 2006)); robbery at gunpoint (PLR 200630004  
26 (January 28, 2006)); excessive aircraft noise (PLR 200702032 (January 12, 2007)); child  
27 assaulted on school bus (PLR 200820016 (May 16, 2008)).
- 28 • *Job-related circumstances:* K-9 officer in neighborhood prohibiting kennels (PLR 200504012

1 (January 28, 2005)); narcotics officer threatened when address discovered by drug associates  
2 (PLR (April 14, 2006)).

3 Applicable Law

4 Burden of Proof - Generally

5 Income tax deductions are a matter of legislative grace, and a taxpayer who claims a  
6 deduction has the burden of proving by competent evidence that he or she is entitled to that deduction.  
7 (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers*, 2001-SBE-  
8 001, May 31, 2001.)<sup>4</sup> Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of*  
9 *Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

10 IRC Section 121

11 Under IRC section 121, a taxpayer can exclude up to \$250,000 of gain on sale of a home  
12 if the taxpayer:

- 13 • Owned the home for at least two years during the 5-year period ending on the date of the sale  
14 (“ownership test”),
- 15 • Used the home as his or her principal residence for at least two years during the 5-year period  
16 ending on the date of the sale (“use test”); and
- 17 • Did not exclude gain from the sale of another home during the 2-year period ending on the date  
18 of the sale.

19 Taxpayers who are married can exclude up to \$500,000 of gain on sale of a home if:

- 20 • The taxpayers file a joint return for the year of the sale;
- 21 • Either spouse meets the ownership test (as set forth above);
- 22 • Both spouses meet the use test (as set forth above); and
- 23 • Neither spouse excluded gain from the sale of a home during the 2-year period ending on the  
24 date of the sale.

25 (Int. Rev. Code, § 121(a) & (b).)

26 *Partial Exclusion:* Treasury Regulation section 1.121-3 allows for a *partial* exclusion  
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<sup>4</sup> Board of Equalization cases are generally available for viewing on the Board's website ([www.boe.ca.gov](http://www.boe.ca.gov)).

1 amount (i.e., something less than the maximum exclusion amount of \$250,000 or \$500,000) when a  
2 taxpayer fails to satisfy the ownership and use requirements (as set forth above) if the primary reason for  
3 the sale is a change in a place of employment, health problems, or the occurrence of *unforeseen*  
4 *circumstances*.<sup>5</sup> Treasury Regulation 1.121-3 provides that a taxpayer can demonstrate “unforeseen  
5 circumstances” by coming under a “safe harbor” or qualifying under a “facts and circumstances test,” as  
6 set forth in that regulation.

7 *Safe Harbors:* Treasury Regulation section 1.121-3(e)(2) provides the following “safe  
8 harbors,” under which a taxpayer is automatically deemed to be eligible for partial exclusion of gain on  
9 the sale of a home by reason of *unforeseen circumstances*:

- 10 A. Involuntary conversion of the home.  
11 B. Disasters, acts of war, terrorism.  
12 C. Death of the taxpayer or a member of the home.  
13 D. Loss of employment where a qualified individual (i.e., taxpayer, spouse, etc.) is eligible for  
14 unemployment compensation.  
15 E. A change in the employment or self-employment status that results in a qualified individual’s  
16 inability to pay housing costs and reasonable basic living expenses.  
17 F. Divorce or legal separation under a decree of divorce or separate maintenance.  
18 G. Multiple births resulting from the same pregnancy. (Treas.Reg. § 1.121-3(e)(2).)

19 *Facts and Circumstances Test:* Treasury Regulation section 1.121-3(b) provides that  
20 whether a sale is due to *unforeseen circumstances* depends on the facts and circumstances of the  
21 particular situation. Factors that may be relevant in determining the primary reason for a sale include  
22 the following:

- 23 1. The sale and the circumstances giving rise to the sale are proximate in time.  
24 2. The suitability of the property as the taxpayer’s residence materially changes.  
25 3. The taxpayer’s financial ability to maintain the property is materially impaired.  
26

27  
28 <sup>5</sup> On appeal, appellant does not allege he is entitled to a partial exclusion for a “change in a place of employment” and/or  
“health problems” (and staff finds no basis for such arguments); accordingly, this Hearing Summary will only analyze the  
“unforeseen circumstances” criteria, as discussed by the parties.

- 1 4. The taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's  
2 ownership of the property.
- 3 5. The circumstances giving rise to the sale are not reasonably foreseeable when the taxpayer  
4 begins using the property as a principal residence.
- 5 6. The circumstances giving rise to the sale occur during the period of the taxpayer's ownership and  
6 use of the property as a principal residence. (Treas.Reg. § 1.121-3(b).)

7 Treasury Regulation section 1.121-3(e)(3) provides that the IRS may determine (in  
8 published rulings, etc.) specific events or situations qualifying as "unforeseen circumstances." (See  
9 examples of such rulings in the FTB's argument above.)

10 *Calculation of Partial Exclusion:* The partial exclusion amount is computed by  
11 multiplying the applicable maximum exclusion (\$250,000 or \$500,000) by a fraction—the numerator of  
12 the fraction is generally the shortest of the following periods: (1) the period of time that the taxpayer  
13 owned the property during the 5-year period ending on the date of the sale; (2) the period of time that the  
14 taxpayer used the property as the taxpayer's principal residence during the 5-year period ending on the  
15 date of the sale; or (3) the period of time between the date of a prior sale or exchange of property for  
16 which the taxpayer excluded gain under section 121 and the date of the current sale. The numerator of  
17 the fraction may be expressed in days or months. The denominator of the fraction is 730 days or 24  
18 months (depending on the measure of time used in the numerator). (Treas. Reg. 1.121-3(g).) Thus, for  
19 example, if a married couple sells a home due to unforeseen circumstances and the couple has owned  
20 and used the home as a principal residence for 10 months at the time of the sale, the reduced maximum  
21 exclusion is \$208,333 (i.e.,  $10/24 \times \$500,000 = \$208,333$ ).

## 22 STAFF COMMENTS

23 Appellant does not qualify for the *maximum* gain exclusion (generally \$500,000 for  
24 married couples) under IRC section 121 because he and his former spouse did not own the first home for  
25 a two-year period, as required by IRC section 121(a). Thus, the inquiry is whether appellant qualifies  
26 for a *reduced maximum* exclusion of gain for "unforeseen circumstances" as provided by IRC section  
27 121(c) under either a "safe harbor" or the general "facts and circumstances test" of Treasury Regulation  
28 section 1.121-3.

1                   **Partial Exclusion—Safe Harbors:** As noted above, Treasury Regulation section  
2 1.121-3(e)(2) sets forth various safe harbors, listed as A-G above, of which only the following two  
3 appear to be relevant to this appeal:

4                   •       *A change in the employment or self-employment status that results in a qualified*  
5 *individual's inability to pay housing costs and reasonable basis living expenses:* As indicated above,  
6 appellant argues that he sold the first home because he and his former spouse were not financially able  
7 to maintain it. Here, appellant's income records (see FTB OB, Exs. K, L and M) show that appellant  
8 earned wages of \$95,400 in 2003, \$93,600 in 2004, and \$133,627 in 2005. In addition, appellant's 2004  
9 federal tax return (see FTB OB, Ex D, p 15) shows that he earned a net profit of \$39,432 from his  
10 personal business (Hutchinson Associates LLC) in 2004. Here, the couple's federal tax return for 2003  
11 is not in the appeal file; thus, it is unclear to staff what amount of net profits (if any) appellant earned  
12 from his personal business (Hutchinson Associates LLC) in 2003. Also, it is unclear whether the  
13 couple's income and/or savings changed significantly from 2003 to 2004, such that they allegedly  
14 became unable to afford the first home. Accordingly, appellant may want to consider providing  
15 additional financial documents (i.e., bank statements, a financial accounting, tax returns, etc.)  
16 substantiating the couple's income and finances in 2003 and 2004. If appellant has any further evidence  
17 that he wishes to submit, pursuant to California Code of Regulations, title 18, section 5523.6, appellant  
18 should provide his evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.<sup>6</sup>  
19 Finally, if the Board decides that appellant qualifies under this safe harbor, then the parties should be  
20 prepared to discuss the partial exclusion amount (i.e., some amount less than \$500,000) that might be  
21 applicable to the facts at hand.

22                   •       *Divorce or legal separation under a decree of divorce or separate maintenance:* As  
23 stated above, appellant argues that he was "*estranged*" from his former spouse while they lived in the  
24 first home. However, this safe harbor is only available if a court has issued a decree of divorce or a  
25 decree of separate maintenance. Here, the record reflects that appellant and his former spouse were  
26 married during the period in question and, thus, appellant has not shown that he meets this requirement.  
27

28 <sup>6</sup> Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of  
Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

1                   **Partial Exclusion—Facts and Circumstances Test:**

2                   Appellant argues that the following “facts and circumstances” support a finding of  
3 unforeseen circumstances, such that he is entitled to a partial exclusion under IRC section 121: (i) he and  
4 his former spouse were not financially able to maintain the first home (i.e., apparently appellant’s  
5 income declined, such that he and his former spouse could not afford the debt on the first home), (ii) he  
6 became “estranged” from his former spouse (i.e., living in separate parts of the home), which made  
7 disposition of the first home mandatory, and (iii) because of the foregoing problems, the suitability of  
8 the first home allegedly changed materially through no fault of his own.

9                   At the oral hearing, the parties should be prepared to discuss whether the “facts and  
10 circumstances” set forth above by appellant constitute “unforeseen circumstances.” As indicated above,  
11 appellant may want to provide additional financial documents (i.e., bank statements, a financial  
12 accounting, tax returns, etc.) substantiating the couple’s income/finances in 2003 and 2004 and showing  
13 whether the couple’s income/finances changed significantly from 2003 to 2004, such that they allegedly  
14 became unable to afford the first home in 2004. Also, the parties may want to discuss the couple’s  
15 living situation.

16 **Question 2: Whether appellant has shown that the FTB erred by disallowing appellant’s deduction of**  
17 **claimed expenditures for home improvements as an increase to the home’s adjusted basis.**

18                   Contentions

19                   Appellant

20                   With respect to the FTB’s adjustment of \$62,865 (i.e., adjustment “b” above), appellant  
21 argues that when he and his former spouse initially purchased the first home, it had been vacant for a  
22 significant period of time and was in disrepair. (App. Ltr. Ex 3, p 3.) Also, appellant asserts that the  
23 couple spent funds to improve the first home, but appellant cannot find the receipts. (*Id.*) Appellant  
24 states that he is willing to submit a declaration under penalty of perjury describing the repairs and  
25 amount of funds involved. (*Id.*)

26                   The FTB

27                   The FTB argues that it did not err in disallowing claimed expenditures that increased the  
28 basis of the first home by \$62,865 (i.e., adjustment “b” above). (See FTB OB, p 12 & Ex. R) And the

1 FTB asserts that appellant has failed to substantiate that the FTB's adjustment of \$62,865 was incorrect,  
2 or that appellant made capital improvements, which might decrease the adjustment of \$62,865. (FTB  
3 OB, p 12.) In addition, the FTB asserts that appellant cannot estimate the couple's capital improvements  
4 (if any) under the "Cohan Rule," (see *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, 544) because  
5 appellant's claim is wholly unsubstantiated and, thus, he has not provided a sufficient basis showing that  
6 he is entitled to some deduction. (*Id.* pp 14-15.)

### 7 Applicable Law

#### 8 Burden of Proof- Generally

9 As noted above, a taxpayer who claims a deduction has the burden of proving by  
10 competent evidence that the he or she is entitled to that deduction. (See *New Colonial Ice Co. v.*  
11 *Helvering, supra*; *Appeal of Michael E. Myers, supra*.) Unsupported assertions cannot satisfy a  
12 taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow, supra*.) The "Cohan Rule" stands  
13 for the proposition that a taxpayer may use estimates when the taxpayer can show there is some factual  
14 foundation on which to base a reasonable approximation of an expense (i.e., when the taxpayer can  
15 prove that he or she made a deductible expense but simply cannot prove the amount of the expenditure).  
16 (See *Cohan v. Commissioner, supra*; *Appeal of Zorik and Artimis Soukhanian*, 87-SBE-077, Dec. 3,  
17 1987.)

#### 18 Capital Improvements

19 IRC section 1001 provides that the gain on the sale of property shall be the excess of the  
20 amount realized over the adjusted basis provided for in IRC section 1011.<sup>7</sup> IRC section 1011 provides  
21 that the adjusted basis for determining gain from the sale of property shall be the property's initial basis  
22 (determined under IRC section 1012 or other applicable sections of that subchapter) adjusted as  
23 provided for in IRC section 1016.

24 The initial basis may include personal liabilities incurred by the purchaser and liabilities  
25 subject to which the property is taken. (*Crane v. Commissioner* (1947) 331 U.S. 1.) Under IRC section  
26 1016, a property's initial basis must be adjusted for capital additions and capital recoveries. Capital  
27

28 <sup>7</sup> California conforms to IRC sections 1001 and 1011-1016 at R&TC section 18031.

1 additions increase the initial basis and capital recoveries decrease the initial basis so that on the date of  
2 disposition the adjusted basis reflects the unrecovered cost or other basis of the property. (Int.Rev. Code  
3 § 1016(a); see also Hoffman, Smith & Willis, *Individual Income Taxes, 2008 Ed.* (hereinafter  
4 “Hoffman”), Ch. 14, p 4.) Capital additions include the cost of capital improvements and betterments  
5 made to the property by the taxpayer. (Hoffman, Ch 14, p 4.) These expenditures are distinguishable  
6 from expenditures for the ordinary repair and maintenance of the property, which are neither capitalized  
7 nor added to the initial basis. (*Id.*) The latter expenditures are deductible in the current taxable year if  
8 they are related to business or income-producing property. (Int.Rev. Code §§ 162 and 212; Rev. & Tax  
9 Code, § 17201; Hoffman, Ch. 14, p 4.)

10 STAFF COMMENTS

11 As noted above, the FTB states that it did not err in further increasing gain on sale of the  
12 first home by \$62,865 (i.e., adjustment “b” above), which resulted from the FTB’s recalculation of the  
13 amount realized on sale of the first home, in addition to the FTB’s recalculation of the first home’s  
14 adjusted basis. (See FTB OB, Ex. R.) Here, thus far, appellant has failed to substantiate that the FTB’s  
15 adjustment of \$62,865 was incorrect. If appellant has any evidence (i.e., checks, receipts, etc.)  
16 substantiating that the FTB’s adjustment of \$62,865 was incorrect—or that appellant and his former  
17 spouse made capital improvements, which might decrease the adjustment of \$62,865—appellant should  
18 provide such evidence to Board Proceedings 14 days before the oral hearing. As noted above,  
19 appellant’s unsupported assertions are not sufficient to carry appellant’s burden of proof. (*Appeal of*  
20 *Aaron and Eloise Magidow, supra*).

21 As indicated above, the “Cohan Rule” stands for the proposition that a taxpayer may use  
22 estimates when the taxpayer can show there is some factual foundation on which to base a reasonable  
23 approximation of an expense (i.e., when the taxpayer can prove he or she made a deductible expense but  
24 simply cannot prove the amount of the expenditure). (See *Cohan v. Commissioner, supra; Appeal of*  
25 *Zorik and Artimis Soukhanian, supra*.) Here, if appellant wants to rely on the Cohan Rule to prove that  
26 he and his former spouse made capital expenditures in relation to the first home, then appellant should  
27 be prepared to show he comes within the framework of that legal principle.

28 ///

1 Question 3: Whether appellant has shown that the FTB erred by disallowing a claimed deduction for  
2 home mortgage interest in excess of the amounts allowed under IRC section 163.

3 Contentions

4 Appellant

5 With respect to the FTB's partial disallowance of the couple's home mortgage interest  
6 deductions (i.e., adjustment "c" above), appellant does not make any specific arguments in his appeal  
7 letter.

8 The FTB

9 The FTB argues that it did not err in partially disallowing appellant's home mortgage  
10 interest deduction (i.e., adjustment "c" above) because IRC section 163 imposes limitations of \$1  
11 million on acquisition indebtedness and \$100,000 on equity indebtedness—and the FTB argues that  
12 appellant has not shown that those limitations are not applicable. (FTB OB, pp 16-17.)

13 Applicable Law

14 Qualified residence interest is interest paid or accrued during the taxable year on  
15 indebtedness (subject to limitations) secured by any property that is a qualified residence of the  
16 taxpayer. (Int.Rev. Code, § 163(h)(3); see also Hoffman, Ch. 10, p. 16.) Qualified residence interest  
17 falls into two categories: (1) interest on acquisition indebtedness, and (2) interest on home equity loans.  
18 Before discussing each of these categories, however, the term qualified residence must be defined.

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

26 Although in most cases interest paid on a home mortgage is fully deductible, there are  
27 limitations. (Int.Rev. Code, § 163, subd. (h)(3).) Interest paid or accrued during the tax year on  
28 aggregate *acquisition indebtedness* of \$1 million or less (\$500,000 for married persons filing separate

1 returns) is deductible as qualified residence interest. (*Id.*) Acquisition indebtedness refers to amounts  
2 incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer.  
3 (*Id.*; see also Hoffman, *supra.*)

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

## 12 STAFF COMMENTS

13 As noted above, qualified residence interest is limited to (i) *acquisition indebtedness* of  
14 \$1 million or less, and (ii) interest on *home equity loans* to the lesser of: (i) the fair market value of the  
15 residence, reduced by the acquisition indebtedness, or (ii) \$100,000 (\$50,000 for married persons filing  
16 separate returns). (Int.Rev. Code § 163, subd. (h)(3); see also Hoffman, *supra.*)

17 Here, appellant has not provided any evidence (or specific arguments) showing that the  
18 FTB did not properly apply the home mortgage interest limitations (i.e., adjustment “c” above). The  
19 parties should be prepared to discuss this issue at the oral hearing. If appellant has any further evidence  
20 that he wishes to submit, appellant should provide his evidence to the Board Proceedings Division at  
21 least 14 days prior to the oral hearing.

22 Question 4: Whether appellant has shown that the FTB abused its discretion by denying appellant’s  
23 request for abatement of interest on the proposed additional tax.

### 24 Contentions

#### 25 Appellant

26 With respect to interest that has accrued on the additional tax, appellant does not make  
27 any specific arguments in his appeal letter.

28 ///

1           The FTB

2           The FTB notes that interest was imposed on the proposed additional tax and the FTB  
3 asserts that appellant has not shown that the FTB caused an error or delay due to a ministerial or  
4 managerial act, which could have constituted a basis relief of such interest. (FTB OB, p 18.)

5           Applicable Law

6           Relief of Interest

7           Interest is required to be assessed from the date when payment of tax is due, through the  
8 date that it is paid. (Rev. & Tax. Code, § 19101.) Imposition of interest is mandatory; it is not a  
9 penalty, but is compensation for appellant's use of money after it should have been paid to the state.  
10 (*Appeal of Amy M. Yamachi*, 77-SBE-095, June 28, 1977.) There is no reasonable cause exception to  
11 the imposition of interest. (*Appeal of Audrey C. Jaegle*, 76-SBE-070, June 22, 1976.)

12           To obtain relief from interest, appellant must qualify under one of three statutes: R&TC  
13 sections 19104, 19112 or 21012. R&TC section 21012 is not applicable, because there has been no  
14 reliance on any written advice requested of the FTB. R&TC section 19112 requires a showing of  
15 extreme financial hardship caused by significant disability or other catastrophic circumstance. However,  
16 there is no provision in R&TC section 19112 or other law that gives the Board jurisdiction to determine  
17 whether R&TC section 19112 applies in this instance. (However, the Legislature did provide the Board  
18 jurisdiction over appeals of denied interest abatement requests under R&TC section 19104 as discussed  
19 below.)

20           Under R&TC section 19104, for tax years beginning on or after January 1, 1998,<sup>8</sup> this  
21 Board may only abate or refund interest on appeal.

22           [T]o the extent that interest is attributable in whole or in part to any unreasonable error or  
23 delay by an officer or employee of the Franchise Tax Board (acting in his or her official  
24 capacity) in performing a *ministerial or managerial act*.

(Rev. & Tax. Code, § 19104, subd. (a)(1) [emphasis added].)

25           Further, the error or delay can be taken into account only if no significant aspect is  
26 attributable to the taxpayer, and the error or delay occurred after respondent contacted the taxpayer in  
27

28 <sup>8</sup> For years prior to January 1, 1998, managerial acts were not included as a reason for abatement of interest.

1 writing about the underlying deficiency. (Rev. & Tax. Code, § 19104, subd. (b)(1).) In the *Appeal of*  
2 *Michael and Sonia Kishner* (99-SBE-007), decided on September 29, 1999, the Board adopted the  
3 language from Treasury Regulation section 301.6404-2 (b)(2), defining a “ministerial act” as:

4 A procedural or mechanical act that does not involve the exercise of judgment or  
5 discretion, and that occurs during the processing of a taxpayer’s case after all  
6 prerequisites to the act, such as conferences and review by supervisors, have taken place.  
A decision concerning the proper application of federal tax law (or other federal or state  
law) is not a ministerial act.

7 The Board has not yet adopted a definition for the term “managerial act.” However,  
8 when a California statute is substantially identical to a federal statute (such as, with the interest  
9 abatement statute in this case), we may consider federal law interpreting the federal statute as highly  
10 persuasive. (*Douglas v. State of California* (1942) 48 Cal.App.2d 835.) In this regard, Treasury  
11 Regulations section 301.6404-2 (b)(1) defines a “managerial act” as:

12 [A]n administrative act that occurs during the processing of a taxpayer’s case involving  
13 the temporary or permanent loss of records or the exercise of judgment or discretion  
14 relating to management of personnel. A decision concerning the proper application of  
federal tax law (or other federal or state law) is not a managerial act.

#### 15 STAFF COMMENTS

16 Appellant has not provided any evidence (or specific arguments) showing the FTB  
17 caused an error or delay due to a ministerial or managerial act, which could possibly provide relief of  
18 interest that was assessed on the additional tax. The parties should be prepared to discuss this matter at  
19 the oral hearing.

20 ///

21 ///

22 ///

23 Hutchinson\_wjs