Louis A. Ambrose
Tax Counsel IV
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento CA 95814
Tel: (916) 445-5580
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:

WILL C. JAMISON AND LYNETTE P. JAMISON[1]

HEARING SUMMARY

PERSONAL INCOME TAX APPEAL

Case No. 576614

Deficiency

Year	Amount	Penalty
2005	$2,274.00	- 0 -
2006	$8,663.00	$2,165.75 (Delinquent Return) $1,732.60 (Accuracy-Related)
2007	$4,456.00	- 0 -

Representing the Parties:

For Appellant: Joseph Fleishon, Unicorn Tax Services

For Franchise Tax Board: Jenna Mayfield, Tax Counsel

QUESTIONS: (1) Whether appellants have shown that respondent erroneously disallowed certain deductions for mortgage interest payments for rental real estate.

[1] Appellants reside in Carson, California.

(2) Whether appellants have met their burden of proving that the late filing penalty was not properly imposed.

(3) Whether appellants have established a basis for the abatement of the accuracy-related penalty.

HEARING SUMMARY

Factual Background

In 2005, appellants reported state wage income of $118,990, including wages from Pacific Sunwear, Pacific Bell and Farmers' Insurance. Appellants also reported $12,462 in interest, $742 in Schedule C business income and deducted $10,236 of pass-through real estate losses from their wholly-owned limited liability company, Mison LLC. Appellants applied total itemized deductions of $51,966, consisting of real estate taxes, home mortgage interest, charitable contributions, and unreimbursed employee expenses, and made California adjustments which resulted in California taxable income of $71,871 for 2005. (Resp. Op. Br., p.1.)

In 2006, appellants reported state wage income of $150,083, as well as $3,540 of taxable interest, $1,675 in Schedule C business income and $70,607 in pension distributions. Appellants also reported $4,945 of gain from an exchange of real property. Appellants claimed total itemized deductions of $52,175, consisting of real estate taxes, home mortgage interest and points, and charitable contributions, resulting in California taxable income of $170,675 for 2006. (Resp. Op. Br., pp.1-2.)

In 2007, appellants reported state wage income of $158,833, taxable interest income of $1,429, dividends income of $69, Schedule C business income of $340 and capital gains of $696. Appellants claimed total itemized deductions of $76,529, consisting of real estate taxes, home mortgage interest and charitable contributions, resulting in California taxable income of $83,677 for 2007. (Resp. Op. Br., p.2.)

At audit, respondent concluded that several of appellants' claimed mortgage interest amounts (which had been claimed on Schedule A of appellants' returns) were paid for rental or investment property rather than for a primary or a secondary residence as required by Internal Revenue Code (IRC) section 163(h)(3). On December 29, 2009, respondent issued a Notice of Proposed Assessment (NPA) for each of the tax years 2005, 2006, and 2007, disallowing mortgage interest and points deductions in the amounts of $22,694, $20,653, and $39,722, respectively.[2] Appellants initially asserted that they were entitled to deduct the mortgage interest for two properties in addition to their primary residence but subsequently changed their position with respect to one of those properties. After consideration, respondent only allowed home mortgage interest deductions for appellants' residence located on Galway Avenue in Carson, California. (Resp. Op. Br., pp. 2-3.)

Appellants argued that, if respondent disallowed the claimed deductions for the mortgage interest payments, those payments should be allowed as Schedule E deductions. Respondent took the position that such interest payments were allowable as Schedule E deductions only if the income arising from the properties was reported on the Schedule E. In addition, respondent determined that appellants' rental activity losses were subject to passive activity loss limitations and that such losses were suspended until appellants earned passive income that could be used to offset those losses. Respondent affirmed the disallowance of the mortgage interest deductions as set forth in the NPAs with minor corrections. (Resp. Op. Br., p. 3.)

Respondent also reviewed appellants' 2006 and 2007 Schedule C relating to a real estate business operated by appellant-wife. On the 2006 Schedule C, appellants reported gross receipts of $58,072 and claimed a deduction of $56,397 for a net profit of $1,675. At audit, appellants provided a schedule showing $21,750 of purported expenses but without any other documentation or explanation of the business purpose of the expenses. At protest, respondent requested additional information about the

---

[2] In the 2005 NPA, respondent increased appellants' taxable income by $26, 207, from taxable income of $71,871 to taxable income of $97,898, resulting in additional tax of $2,274. Respondent made the following Schedule A adjustments which totaled $26,027: (1) a $22,694 reduction in the home mortgage interest deduction; (2) a $2,298 reduction in the charitable contribution deduction; and (3) a $1,035 reduction in the miscellaneous itemized deduction.

In the 2006 NPA, respondent increased appellants' taxable income by $492,580, from taxable income of $170,675 to taxable income of $663,255, resulting in additional tax of $46,847. Respondent made the following adjustments which totaled $492,580: (1) a $20,653 reduction in the home mortgage interest Schedule A deduction; (2) a $6,657 reduction in the charitable contribution Schedule A deduction; (3) a $56,397 reduction in Schedule C business expenses; (4) a $390,828 increase for an IRC section 1031 like kind exchange; (5) a $24,865 reduction in itemized deductions; and (6) a $6,820 increase for the standard deduction.

In the 2007 NPA, respondent increased appellants' taxable income by $56,510, from taxable income of $83,677 to taxable income of $140,187, resulting in additional tax of $5,176. Respondent made the following adjustments which totaled $56,510: (1) a $39,722 reduction in the home mortgage interest Schedule A deduction; (2) a $2,071 reduction in the charitable contribution Schedule A deduction; (3) a $11,000 reduction in Schedule C business expenses; and (4) a $3,717 increase for unreported wages.

$44,501 amount reported as "other expense" on the Schedule C. Appellants stated that the amount was claimed to offset income erroneously reported to appellant-husband on a Form 1099 which should have been attributed to appellants' wholly-owned corporation, JKJ Group. Appellants failed to provide any substantiation for this claim and respondent disallowed the entire $56,397 claimed expense deduction. On the 2007 Schedule C, appellants reported $11,340 in gross receipts and $11,000 of total expenses resulting in a $340 net profit. Appellants provided no substantiation for the expenses amount and claimed that it was claimed to offset income that was properly attributable to JKJ Group. Respondent also disallowed this Schedule C expense deduction. (Resp. Op. Br., pp. 3-4.)

Appellants engaged in a like-kind exchange of real property in 2006 and at audit provided documentation showing that the relinquished property was located on W. 92nd Street in Los Angeles and the three replacement properties were located on Clark Vista Drive in Dallas, Texas, on Canterbury Drive in Memphis, Tennessee and on Goodlett Road in Memphis, Tennessee. Appellants also stated they obtained another property in the exchange located in Indio, California which they claimed as a second home and for which they deducted mortgage interest on the Schedule A. Based on that treatment of the Indio property, respondent's auditor determined that it was not "like-kind" property and treated the proceeds from the relinquished property used to purchase the Indio property as taxable boot. The auditor also concluded that the payoff of loan proceeds which appellants received during the exchange was cash received, and that appellants should recognize a total of $390,828 of additional income from the exchange. At protest, respondent accepted appellants' characterization of the Indio property as investment property owned by Mison, LLC and that appellants completed a valid IRC section 1031 with respect to all the properties and received $48,800 of taxable boot from the transaction. After applying the $4,945 in gain that appellants reported on their return, respondent included additional gain in the

///

///

///

///

///

///

amount of $43,885 on the 2006 Notice of Action (NOA).[3] (Resp. Op. Br., pp. 4-5.)

Contentions

Appellants

In the appeal letter, appellants state that all mortgage interest paid was deductible pursuant to IRC sections 162 and 163 and Revenue and Taxation Code (R&TC) section 17201, regardless of whether it was reported as an itemized deduction on the Schedule A, as an expense on the Schedule E, or as "pass through via K-1 from another entity." Appellants attach a Form 540X for tax year 2005 which they state shows "the Mortgage Interest as a flow through from Mison LLC." Appellants also state that both members actively participated in the purchase and operation of rental properties owned by the LLC and one of the members is a professional real estate agent. Appellants assert that the protest hearing officer agreed that the mortgage interest was deductible and appellants submitted the amended return as she requested. (Appeal Letter.)

In their reply brief, appellants concede many of the issues noted above and make the following arguments with respect to those issues that remain in dispute:

For 2005, they agree with the allowed deduction of mortgage interest in the amount of $16,303 allocated to the Carson residence and with an "allocation of the Mortgage Interest and the Income to each rental property" as set forth in the letter from respondent's protest hearing officer dated March 8, 2011 at pages 7 through 10. Appellants also agree with the mortgage interest deductions reported on the Schedule E attached as an exhibit to their reply brief. Appellants state that they disagree

---

[3] Respondent issued NOAs for each of the three years at issue on June 20, 2011.

In the 2005 NOA, respondent affirmed the NPA, resulting in additional tax of $2,274.

In the 2006 NOA, respondent modified the NPA and increased appellants' taxable income by $81,991, from taxable income of $170,675 to taxable income of $252,666, resulting in additional tax of $8,663. Respondent made the following adjustments which totaled $81,991: (1) a $20,654 reduction in the home mortgage interest Schedule A deduction; (2) a $6,657 reduction in the charitable contribution Schedule A deduction; (3) a $45,572 reduction in Schedule C receipts reported by others; (4) a $56,397 reduction in Schedule C business expenses; and (5) a $43,855 increase for an IRC section 1031 like kind exchange.

In the 2007 NOA, respondent modified the NPA and increased appellants' taxable income by $48,766, from taxable income of $83,677 to taxable income of $132,443, resulting in additional tax of $4,456. Respondent made the following adjustments which totaled $48,766: (1) a $40,122 reduction in the home mortgage interest Schedule A deduction; (2) a $2,071 reduction in the charitable contribution Schedule A deduction; (3) a $2,858 reduction in Schedule C business expenses; and (4) a $3,715 increase for unreported wages.

with respondent's statement that "no income was reported initially on Sch. E." Appellants attach as an exhibit a copy of a 2005 Form 540X reporting, for each rental property, income and expenses for mortgage interest, insurance, property taxes and depreciation. With respect to the passive activity losses, appellants contend that they have met the "At Risk, Material Participation, and Real Estate Professional Rules" in that appellant-husband is a licensed real estate agent and loan processor, both appellants actively participate in the management of the properties and appellants' income was less than "the limitation of the Passive Activities Rules adjustments." Finally, appellants concede the adjustment of $2,298 in the claimed charitable contribution deduction amount. (App. Reply Br., p. 3.)

For 2006, appellants agree with respondent's proposed adjustments but request an abatement of the delinquent return penalty in the amount of $2,166. Appellants assert that their records show that they filed a hard copy of the return on August 22, 2007 by mail and it was not returned. They also request an abatement of the accuracy-related penalty "because the taxpayer followed the instruction provided to them by Haven Exchange Company and the complexity of multiple properties exchange." For tax year 2007, appellants accept respondent's proposed adjustments with respect to the mortgage interest deductions and with respondent's adjustment of $2,071 in the claimed charitable contribution deduction amount. (App. Reply Br., p.4.)

<u>Respondent</u>

Respondent contends that appellants are not entitled to claim mortgage interest paid for investment real properties as a Schedule A deduction. Respondent states that IRC section 163(h)(3) provides for a deduction for interest paid for acquisition indebtedness or home equity indebtedness on a principal residence and one other residence of the taxpayer. Respondent asserts that appellants claimed deductions of $36,166, $38,121 and $69,319 for home mortgage interest on the 2005, 2006 and 2007 Schedule A, respectively, which appellants initially claimed was attributable to their primary residence in Carson and a second home in Indio. Respondent further asserts that appellants later changed their position and characterized the Indio property as investment property for purposes of reporting it as like-kind property acquired in an IRC section 1031 exchange in 2006. Appellants then argued that a property in Georgia was actually their second home and mortgage interest paid for the acquisition of that property should be deductible under IRC section 163. However, respondent states appellants reported the

Georgia property on their 2006 and 2007 Schedule E as rental real estate, which is inconsistent with their characterization as a second residence. Respondent further states that appellants provided copies of Forms 1098 reflecting interest paid on the three properties described above and three other real properties that appellants reported as rental real estate. Thus, respondent concludes that none of mortgage interest deductions claimed on appellants' Schedule A, other than the interest claimed for their Carson residence, was for a qualified residence. (Resp. Op. Br., pp. 5-6.)

Respondent takes issue with appellants' contention that the mortgage interest paid reported on the Schedule A should be deductible as expenses from nonpassive rental real estate activities on the Schedule E. Respondent states that appellants did not include the Indio property, W. 92nd Street property or the Memphis property on their Schedule E for any year and so respondent contends that appellants are not entitled to claim deductions for interest paid for those properties as Schedule E expenses. Respondent further contends that, even if appellants had reported the mortgage interest for those properties on the Schedule E, those interest expenses could only offset passive activity income earned in the taxable year because appellants' rental real estate business is a passive activity and IRC section 469 provides that passive activity losses may only offset income from that passive activity in subsequent years. Respondent asserts that IRC section 469(c)(2), to which California law conforms, provides that rental activities are included as passive and, although subsection (c)(7) of the statute creates an exception for certain real estate operators who materially participate, California law does not conform to that exception. (Resp. Op. Br., pp. 6-7.)

Respondent contends that appellants are not entitled to their claimed business expense deductions reported on the 2006 and 2007 Schedule C. Respondent argues that appellants failed to provide any documentation to substantiate their position that the deductions were intended to offset payments incorrectly made to appellants rather than to JKJ Corporation. Respondent also argues that appellants incorrectly reported officer compensation in the amount of $12,500 received from JKJ Corporation as gross receipts on the Schedule C and were not entitled to deduct Schedule C business expenses against this income. Rather, this compensation should have been reported as wage income of $12,500 on appellants' return. (Resp. Op. Br., pp. 7-10.) However, as noted above, appellants state in their reply brief that they accept respondent's disallowance of the 2006 and 2007 Schedule C deductions so this amount is no longer in issue.

Respondent states that it assessed taxable boot in the amount of $48,800 as a result of the 2006 IRC section 1031 exchange transaction although the actual amount of taxable boot was $57,145. However, respondent asserts that it is now barred from making an additional assessment of the greater amount. Respondent also contends that appellants have not established by competent and credible evidence that the $40,000.00 reflected as a "loan payoff" to Mison LLC and the associated interest amount of $9,671.23 on the closing statement was actually the repayment of a loan. Thus, respondent concludes that those amounts must be treated as a distribution of cash, which is taxable boot to appellants. In addition, respondent notes that the closing statement for the W. 92nd Street property reflected that a $500 lease deposit fee and $2,220 in prorated rental amounts were paid from the $695,000 sales proceeds received by appellants. Respondent contends that those amounts constitute taxable boot because the rental prorations appear to reflect a payment to the buyer of prepaid rents received by appellants and, thus, appellants used sales proceeds to satisfy debts not secured by the exchange property. Finally, respondent states that appellants' use of sales proceeds to pay off mortgage debt was offset by the amount of debt assumed when they purchased the replacement properties and, consequently, appellants did not recognize taxable boot from debt relief. However, respondent contends that loan payoff costs of $4,753.90 which were paid out of proceeds from the sale of the W. 92nd Street property must be recognized as taxable boot. (Resp. Op. Br., pp. 10-13.) Nonetheless, as noted above, appellants state in their reply brief that they accept respondent's assessment of taxable boot so these amounts are no longer in issue.

With respect to appellants' claimed deductions for charitable contributions for 2005, 2006 and 2007, respondent contends that appellants have substantiated the portion of the contributions that respondent allowed as deductions but have not provided any documentation to support additional amounts. (Resp. Op. Br., pp. 13-14.) As noted above, appellants state in their reply brief that they accept respondent's charitable contribution disallowance determinations for these years so these amounts are no longer in issue.

Respondent contends that the delinquent filing penalty was properly calculated pursuant to R&TC section 19131 at 25 percent of $8,663, the amount that remained on the due date of the return, because appellants filed the 2006 return 22 months after the April 15, 2007 due date. In addition, respondent contends that the accuracy-related penalty was properly imposed for appellants' substantial understatement of tax, i.e. $8,663, which exceeded the greater of 10 percent of the tax owed for that year ($2,100) or $5,000. Respondent properly calculated the penalty as $1,732.60, which is 20 percent of the understatement amount. (Resp. Op. Br., pp. 14-15.)

In its reply brief, respondent states that appellants have conceded all the issues for 2007 but still dispute the amount of the Schedule E losses allowed for tax year 2005 and the penalties for tax year 2006. With respect to the Schedule E losses for tax year 2005, respondent states that appellants have consistently reported their rental real estate activities as passive activities but appear to argue in their reply brief that those activities were not passive because they materially participated in them. Respondent repeats its assertion that under California law rental real estate activities are per se passive, regardless of whether the taxpayer materially participates. Thus, respondent argues for the application of the passive activity loss limitations which are generally limited to the taxpayers' passive income and any special allowance for active participation in rental real estate. However, respondent states that appellants on their amended Forms 3801 did not report any additional passive income and reported a special allowance of $7,678, which amounts were less than those reported on the original Form 3801. For that reason, respondent contends that appellants have not shown or claimed that these activities resulted in additional passive income or that they are entitled to an increased special allowance. (Resp. Reply Br., pp. 2-4.)

Respondent contends that appellants have not provided evidence proving that they filed their 2006 tax year return within the extended filing deadline. Respondent states that appellants submitted a printout of their representative's computer screen showing that the return was filed August 22, 2007, but respondent's computer records show that the return was received on February 1, 2008, and the date stamp on the return is the same. In addition, information received from the IRS indicates that appellants filed their federal return on August 18, 2008. For those reasons, respondent contends that the delinquent filing penalty was properly imposed. (Resp. Reply Br., p.4.)

Finally, respondent contends that appellants have not provided any evidence to support their position that the accuracy-related penalty should be abated for the 2006 tax year because they relied on the advice of Haven Exchange Company for their like-kind exchange. Respondent explains that the accuracy-related penalty may be abated upon a showing of reasonable cause and good faith pursuant to IRC section 6664(c) which is determined by an examination of all the pertinent facts and circumstances, the most important of which is the taxpayer's effort to assess the proper tax liability. Specifically, respondent cites Treasury Regulation section 1.6664-4(c) which provides that reliance on professional advice may constitute reasonable cause where the taxpayer (1) provided necessary and accurate information to the advisor; (2) the advisor or preparer had sufficient experience to justify reliance and (3) the taxpayer actually and reasonably relied in good faith on the advisor's judgment. Because appellants have not provided any documentation to support their assertion or to show that their reliance constituted reasonable cause, respondent contends that the accuracy-related penalty should not be abated. (Resp. Reply Br., pp. 5-6.)

Applicable Law

Burden of Proof

On appeal, there is a presumption of correctness of the penalties assessed by respondent. (*Appeal of Robert Scott*, 83-SBE-094, Apr. 5, 1983.) Taxpayers have the burden of proving error in respondent's determination that a penalty applies. (*Leuhsler v. Commissioner* (6th Cir. 1992) 963 F.2d 907; *Neely v. Commissioner* (1985) 85 T.C. 934, 947.) To overcome the presumption of correctness of a penalty, including showing reasonable cause, taxpayers must provide credible and competent evidence to support their claim; otherwise, the penalty should not be abated. (*Appeal of Winston R. Schwyhart*, 75-SBE-035, Apr. 22, 1975.)

Rental Real Estate Losses

IRC section 469(a)(1), which is incorporated by reference by R&TC section 17201, provides generally that "neither (A) the passive activity loss, nor (B) the passive activity credit, for the taxable year shall be allowed." Subsection (b) of section 469 provides that "except as otherwise provided in this section, any loss or credit from an activity which is disallowed under subsection (a) shall be treated as a deduction or credit allocable to such activity in the next taxable year." Subsection (c)(2) provides that "passive activity" includes any rental activity but subsection (c) paragraph (7) provides for an exception whereby a taxpayer's rental activity business is not a passive activity if the taxpayer materially participates in such business and other conditions are met. However, R&TC section 17561 expressly provides that "section 469(c)(7) of the Internal Revenue Code, relating to special rules for taxpayers in real property business, shall not apply." Thus, appellants' rental real property activities are passive activities under California law and any losses from those activities are subject to the passive activity loss limitations.

Late Filing Penalty

California imposes a penalty for failure to file a return by its due date, unless the failure to file was due to reasonable cause and not due to willful neglect. (Rev. & Tax. Code, § 19131.) Taxpayers have until April 15th of the year following the tax year to file returns without triggering the penalty. (Rev. & Tax. Code, § 18566.) If taxpayers file by October 15th, they receive an automatic extension and the penalty is not triggered. (Cal. Code Regs., tit. 18, § 18567.) The late filing penalty is computed at a rate of 5 percent of the tax due for every month that the return is late, up to a maximum of 25 percent. (Rev. & Tax. Code, § 19131, subd. (a).) The minimum amount of the late filing penalty for individuals is the lesser of $100 or 100 percent of the tax required to be shown on the return. (*Id*. at subd. (b).) The tax amount upon which the penalty is based is the amount of tax required to be shown on the return, reduced by any amount of tax paid on or before the prescribed due date for payment of the tax and any credit against tax which may be claimed upon the return. (*Id*. at subd. (c); *Appeal of Mary Kay Cosmetics, Inc*., 81-SBE-042, May 19, 1981.)

To establish reasonable cause, a taxpayer "must show that the failure to file timely returns occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinary intelligent and prudent businessman to have so acted under similar circumstances." (*Appeal of Howard G. and Mary Tons*, 79-SBE-027, Jan. 9, 1979.) Ignorance of a filing requirement or a misunderstanding of the law generally does not excuse a late filing. (*Appeal of Diebold, Incorporated*, 83-SBE-002, Jan. 3, 1983.) Reliance on erroneous advice from a tax professional is not reasonable cause where an unambiguous deadline is at issue. (*United States v. Boyle* (1985) 469 U.S. 241; 249-250.) However, reliance on advice regarding a matter of substantive tax law, such as whether it is necessary to file a return, may be reasonable cause. (*Id*. at p. 250.)

Each taxpayer has a personal, non-delegable obligation to file the tax return by the due date. (*Appeal of Thomas K. and Gail G. Boehme*, 85-SBE-134, Nov. 6, 1985.) Illness or other personal difficulties may be considered reasonable cause, but not when the difficulties simply cause the sacrifice of the timeliness of one matter (e.g., filing tax returns) so that the taxpayer can pursue other matters. (*Appeal of W. L. Bryant*, 83-SBE-180, Aug. 17, 1983; *Appeal of Michael J. and Diane M. Halaburka*, 85-SBE-025, Apr. 9, 1985; *Appeal of William T. and Joy P. Orr*, 68-SBE-010, Feb. 5, 1968.) The fact that tax information is lost or difficult to obtain is insufficient to meet the taxpayer's burden of establishing reasonable cause. (*Appeal of Stephen C. Bieneman*, 82-SBE-148, July 26, 1982.)

<u>Accuracy-Related Penalty</u>

R&TC section 19164, which incorporates the provisions of Internal Revenue Code (IRC) section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty applies to the portion of the underpayment attributable to negligence or to the disregard of rules and regulations or to any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) The IRC defines "negligence" to include "any failure to make a reasonable attempt to comply" with the provisions of the code. (Int.Rev. Code, § 6662(c).) The term "disregard" is defined to include any "careless, reckless, or intentional disregard." (Ibid.) There is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or $5,000. (Int.Rev. Code, § 6662(d)(1).)

There are three potential exceptions that may provide relief from the imposition of the penalty. First, IRC section 6662(d)(2)(B)(i) provides that the amount of the understatement of tax is reduced by the portion of the understatement that is attributable to the tax treatment of any item by the taxpayer if there is, or was, "substantial authority" for such treatment. Second, IRC section 6662(d)(2)(B)(ii) provides, in pertinent part, that the amount of the understatement of tax is also reduced by the portion of the understatement that is attributable to any item if (a) the relevant facts affecting the item's tax treatment are "adequately disclosed" in the return or in a statement attached to the return <u>and</u> (b) there is a "reasonable basis" for the tax treatment of such item by the taxpayer. Third, IRC section 6664(c)(1) provides, in pertinent part, that no penalty shall be imposed under IRC section 6662 with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with regard to that portion.

With regard to the first exception, IRS regulations state, in part, that:

> (d) Substantial authority. . . .
> (2) *Substantial authority standard*. The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard . . . , but more stringent than the reasonable basis standard as defined in Sec. 1.6662-3(b)(3). The possibility that a return will not be audited or . . . raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.
> (3) *Determination of whether substantial authority is present*.
> (i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. . . . There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.
> (ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. . . .
> (Treas. Reg. 1. § 1.6662-4(d)(2)-(3).)

The IRS regulation explains that, among other authorities, the IRC and other statutory provisions, regulations, revenue rulings and court cases may constitute substantial authority. (Treas. Reg. § 1.6662-4(d)(3)(iii).)

With regard to the second exception (i.e., where there is “adequate disclosure” and a “reasonable basis”), IRC section 6662(d)(2)(B)(ii) provides that the penalty shall be reduced to the extent attributable to an item if “(I) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return, and (II) there is a reasonable basis for the tax treatment of such item by the taxpayer.”

With regard to the meaning of “reasonable basis”, the Treasury regulations provide, in part, as follows:

> Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities [permitted for the purpose of the “substantial authority” test], the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in Sec. 1.6662-4(d)(2). . . . In addition, the reasonable cause and good faith exception in Sec. 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard. . . . (Treas. Reg. § 1.6662-3(b)(3).)

With regard to the third exception, the reasonable cause and good faith exception, Treasury Regulation section 1.6664-4(b)(1) provides in relevant part:

> The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. . . . Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer. . . .

<u>STAFF COMMENTS</u>

In their reply brief, appellants seem to argue that they materially participated in the rental real estate activities and met the other requirements of the special rule set forth in IRC section 469(c)(7) excepting rental real estate activity as a passive activity. In this regard, they state that appellant-husband is licensed to sell real estate and to process real estate loans and that both "[a]ppellants are actively participating in the purchasing, daily operation of all owned rental properties." As noted above, under R&TC section 17561, subdivision (a), California does not conform to IRC section 469(c)(7) and, therefore, whether appellants "actively participated" in the rental real estate activities has no bearing on the proper characterization of that activity as a passive activity to which the other provisions of IRC section 469 apply. Secondly, appellants assert that their income was less than "the limitation of the Passive Activities Rules adjustments." As stated above, any loss deductions from their rental real estate activities may be offset only by income from passive activities in a year and any special allowance for active participation in rental real estate if the taxpayers' federal adjusted gross income is less than $150,000. Respondent allowed the amounts reported on appellants' original Form 3801, *Passive Activity Loss Limitations*, and appellants' amended Form 3801 did not report any additional passive income and a special allowance amount lower than originally reported.

At the hearing, appellants should be prepared to clarify their position on the claimed Schedule E deductions, including whether they believe the rental real estate activities were nonpassive activities under the IRC section 469(c)(7) exception and the additional deduction amount to which they believe they are entitled.

With respect to the late filing penalty for tax year 2006, appellants argue that they mailed it on August 22, 2007, within the extended filing period but they have provided no evidence such as a certified mail receipt to prove that it was mailed on that date. Respondent has presented a copy of the return with a date stamp of February 1, 2008 and a computer record that also shows that the return was received on that date. At the hearing, appellants should be prepared to provide additional evidence to prove that the return was filed before the expiration of the extended filing period or, alternatively, if they concede that it was not timely filed, they should be prepared to show that the delay was due to reasonable cause and in the absence of willful neglect.

Appellants' only reason for an abatement of the accuracy-related penalty is that they followed the advice of the exchange intermediary and that the transaction was complex. Based on appellants' scant information, there is no way to determine whether appellants met any of the conditions for an abatement of the penalty, such as whether appellants acted with reasonable cause and in good faith. At the hearing, appellants should be prepared to explain in detail their attempts to assess the proper tax liability resulting from the IRC section 1031 exchange transaction and the instructions given to them by the exchange intermediary that led to the substantial understatement of taxable income.

///

///

///

Jamison_la.doc