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

10 In the Matter of the Appeal of:) **HEARING SUMMARY¹**
11) **PERSONAL INCOME TAX APPEAL**
12 **ESTATE OF SYLVIA JANE LUKOFF,**) Case No. 528898
13 **(DEC'D)**)

		<u>Proposed</u>	
		<u>Assessment</u>	
	<u>Year</u>	<u>Tax</u>	<u>Penalty</u>
	2004	\$118,938.00	\$29,734.50

18 Representing the Parties:

19 For Appellant: Denis M. McDevitt, Attorney at Law
20 For Franchise Tax Board: David Lopez, Tax Counsel IV

22 QUESTIONS: (1) Whether appellant² has shown that part of a theft loss was properly deducted in
23 2004 rather than in 2005.

26 ¹ This appeal was originally calendared for oral hearing at the Board meeting in Culver City scheduled on June 21-24, 2011.
27 At the request of appellant, the oral hearing was postponed to allow additional time to gather information and rescheduled to
the October 25-28, 2011 Culver City oral hearing calendar.

28 ² For ease of reference, this hearing summary will generally use the term "appellant" to refer to the decedent, even though her
estate is technically the appellant here. This hearing summary will also sometimes use the terms "appellant" and "appellant's
representative" interchangeably.

1 (2) Whether appellant has shown that she had reasonable cause for filing a late return
2 for 2004.

3 HEARING SUMMARY

4 Background

5 After reviewing appellant's 2004 California return, which was apparently filed on
6 April 28, 2006, the Franchise Tax Board (FTB or respondent) issued a Notice of Proposed Assessment
7 (NPA) for that year dated August 19, 2008. The NPA disallowed a claimed theft loss of \$1,288,250 on
8 the basis that it did not satisfy the requirements of Internal Revenue Code (IRC) section 165. The NPA
9 further stated that it was allowing a theft loss of \$2,398,250³ for 2005 (but that the tax liability for 2005
10 would not change as a result). The NPA also imposed a late filing penalty against appellant for 2004.

11 After considering appellant's protest, respondent issued a Notice of Action (NOA) to
12 appellant's estate dated March 5, 2010. In its NOA, respondent revised its NPA by increasing the
13 amount of appellant's itemized deductions (allegedly as the result of the disallowance of appellant's
14 claimed theft loss for 2004) and making other associated adjustments. Otherwise, the NOA affirmed
15 respondent's NPA for 2004. The NOA noted that appellant was entitled to claim a theft loss in 2005 and
16 the carryforward of a Net Operating Loss of \$2,446,570 to 2006. This timely appeal followed.

17 Appellant was 88 years old during 2004, had poor eyesight as the result of diabetes to the
18 point she could no longer read, and suffered from dementia, a disease that allegedly greatly affected her
19 short-term memory.⁴ Her granddaughter, Ms. Cynthia Horner (Cynthia), was allegedly appellant's
20 "person of confidence" for most of that year and previously, as manifested by Cynthia's regular visits
21 with appellant and her assistance with the completion of appellant's daily tasks, "including the paying of
22 bills by writing checks. Cynthia would assist [appellant] in this matter by writing the check and then
23 telling [appellant] where to sign." Appellant's representative alleges that this process eventually
24 resulted in Cynthia writing checks made payable to an advance fee fraud known as the "419 Nigerian
25 Scam (the Nigerian Scam)" as described below. The representative further alleges that, in view of
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27 ³ On her 2004 and 2005 returns, appellant claimed theft losses of \$1,288,250 and \$1,110,000, respectively, for theft losses
28 totaling \$2,398,250 for the two-year period.

⁴ According to LexisNexis, appellant (was born in December 1915 and) died on September 24, 2008, at the age of 92.

1 appellant's elderly age and declining health, Cynthia took advantage of appellant by inducing her to sign
2 checks so that Cynthia could use the funds to participate in the Nigerian Scam. (App. Ltr., p. 2.)

3 The representative explains that an advance fee fraud is a confidence trick in which the
4 victim of the fraud is persuaded to advance relatively small amounts of money in the hope of realizing a
5 much larger gain. In the variant of the advance fee fraud at issue here, the Nigerian Scam begins by the
6 victims receiving an unsolicited letter or e-mail from a purported official representing the Nigerian
7 government or its military. The letter or e-mail contains an urgent request for help in transferring
8 millions of dollar from Nigeria to the victim's personal bank account in exchange for the victim's
9 assistance with, or participation in, a bogus business deal. To achieve their goals, swindlers use
10 elaborate subterfuges, including seemingly-official documents with government seals to convince the
11 victim of the legitimacy of the scheme. The victim is asked to advance funds to cover various fees and
12 to provide personal information, such as Social Security and bank account numbers. If the victim
13 complies with the requests, the swindlers reply with excuses of why the funds promised by the swindlers
14 cannot be remitted. That reply is followed by demands for payments to cover various "taxes" and "fees"
15 purportedly to facilitate the processing of the promised funds.

16 The representative states that Cynthia wired various amounts of money, for a total
17 amount of \$2,398,250, to a number of unidentified foreign banks from July 2004 to February 2005.
18 (App. Ltr., p. 2.) The representative states more specifically that "during the tax years 2004 and 2005
19 when Cynthia transferred \$1,288,250 and \$1,110,000, respectively, from [appellant's] partnerships and
20 sale of [appellant's] residence into foreign bank accounts with the belief that Cynthia would receive a
21 portion of a \$20.5 million 'contract,' at which point Cynthia believed she would repay [appellant] the
22 'borrowed' funds and retain the rest for herself." (App. Ltr., p. 3.) Respondent states that although not
23 all of the details of the Nigerian Scam are known, the available information indicates that the bogus
24 business proposal related to procuring a contract with the Nigerian Federal Ministry of Health.
25 Respondent attached to its brief, as Exhibits A through D, documents to demonstrate Cynthia's role in
26 the scam.

27 Contentions

28 Appellant's representative contends that respondent improperly disallowed appellant's

1 claimed theft deduction for 2004 of \$1,288,250. In support of that contention, the representative alleges
2 that, in late 2004, appellant's son and the current personal representative of her estate, Mr. Frederick
3 Lukoff (Fred), an attorney who lived out of the country, became suspicious of his mother's financial
4 affairs after communicating with her.⁵ The representative states that "[appellant] communicated to Fred
5 that Cynthia was having her write numerous checks and that she was uncertain as to what the checks
6 were for or where the funds were going." The representative further states that, as a result of appellant's
7 advanced age and associated poor health and short-term memory problems, it was difficult for Fred to
8 extract details from her but that Fred, nonetheless, researched the payments and discovered they were
9 being used to fund the Nigerian Scam. He then states that "Fred informed [appellant] in December 2004
10 that she was involved in a fraud and that she should not sign any more checks until he was able to return
11 to the United States from his home abroad in early 2005." Finally, the representative asserts that, as a
12 result of her poor short-term memory, appellant continued to sign some checks at Cynthia's request
13 through February 2005, until Fred returned to the United States and halted all payments. (App. Ltr., p.
14 3.)

15 Appellant relies heavily upon *McComb v. Commissioner (McComb)* (1977) T.C. Memo
16 1977-176, and *Rod Warren Ink v. Commissioner (Ink)* (9th Cir. 1990) 912 F.2d 325, revg. (1989) 92
17 T.C. 995, to prove she is entitled to a theft loss deduction in 2004 under IRC section 165(a). In
18 *McComb*, the Tax Court stated the rule that, for purposes of determining the time of discovery of a theft
19 loss under IRC section 165(e), a loss is considered to be discovered when a reasonable person in similar
20 circumstances would have realized that she suffered a theft loss. IRC section 165(e) provides that, for
21 purposes of IRC section 165(a), any loss arising from theft shall be treated as sustained during the
22 taxable year when the taxpayer discovers such loss. Appellant argues that a reasonable person under the
23 facts of the instant matter would have realized that she suffered a theft loss in 2004. Appellant also
24 states that the Internal Revenue Service (IRS) audited her federal return for 2004 with regard to the theft
25 loss and allowed her claimed theft loss deduction for that year.

26 In *Ink*, the issue before the Ninth Circuit Court of Appeals (Ninth Circuit) was whether
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28 ⁵ The record does not indicate whether Fred was Cynthia's father or uncle.

1 theft losses are deductible only in the year of discovery pursuant to IRC section 165(e) for purposes of
2 calculating the personal holding company (PHC) tax under IRC sections 541 through 565. (*Rod Warren*
3 *Ink v. Commissioner, supra*, 912 F.2d at p. 326.) In reversing the Tax Court, the Ninth Circuit
4 concluded that a departure from the literal meaning of IRC section 165(e) was warranted there to avoid
5 an absurd result and to effectuate the intent of Congress. (*Rod Warren Ink v. Commissioner, supra*, 912
6 F.2d at p. 327.) The Ninth Circuit observed that, although Congress enacted IRC section 165 as a relief
7 measure for taxpayers, a literal application of IRC section 165(e) would have unduly penalized the
8 taxpayer in *Ink* by forcing it to declare income, under the PHC rules, that it never received in the year
9 the theft loss occurred and then preventing the taxpayer under those rules from offsetting that income
10 through the carry back of the theft loss from the year in which the loss was discovered. (*Rod Warren*
11 *Ink v. Commissioner, supra*, 912 F.2d at pp. 327-328.) Appellant argues that, even if the Board
12 determines that appellant's theft loss was discovered in 2005 rather than in 2004, it would be improper
13 under *Ink* to deny her a theft loss deduction in 2004 for funds she was defrauded during 2004.

14 Appellant also contends that the application of the late filing penalty is not justified in the
15 instant matter because IRC section 7491(c) states that the government has the burden of proof for the
16 application of a penalty. Appellant argues that, under the statute, the IRS has the burden of production
17 in any court proceeding with respect to the liability of any individual for any penalty, addition to tax, or
18 additional amount imposed by the IRC, notwithstanding any other provision of the IRC.⁶

19 Appellant states that Fred, as well as possibly Cynthia and unidentified other family
20 members, will testify at the hearing regarding appellant's state of mind in 2004 in relation to the
21 Nigerian Scam and other relevant issues.⁷ Appellant also states that the tax professionals who prepared
22 appellant's tax returns for 2004 and 2005 will testify at the hearing regarding the circumstances
23 surrounding appellant's late filing of her returns and the late payment of tax.

24 Respondent contends that all of appellant's theft loss was deductible in 2005 and that no
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26 ⁶ Staff is aware of no provision of the R&TC that incorporates by reference IRC section 7491(c).

27 ⁷ Appellant appears to contemplate that the Board will issue subpoenas compelling Cynthia and the yet unidentified other
28 family members to testify at the hearing. Staff notes that the issuance of subpoenas by the Board for a personal income tax
hearing would be extremely unusual.

1 part of appellant's theft loss was deductible in 2004 because appellant did not discover the loss during
2 2004. Respondent denies that appellant should prevail under *McComb* because, in its view, no
3 reasonable person under the facts of the instant matter would have continued to make payments to the
4 scammers in 2005 if she had discovered the Nigerian Scam in 2004. (Resp. Br., p. 3.) Further, quoting
5 extensively from *Ink*, respondent argues that the exception stated there was specifically confined to the
6 facts of that case and, for that reason, should not be controlling here. In addition, respondent notes that
7 the IRS stated in an Action of Decision (AOD 1991-016, dated July 3, 1991) that the decision of the
8 Ninth Circuit in *Ink* lacked sound analytical foundation and announced that it will not follow that
9 decision outside the Ninth Circuit. (Resp. Br., pp. 3-6.) In a footnote in its brief, respondent states that
10 an argument could be made that Cynthia committed theft against appellant on the bases that appellant
11 allegedly had poor short-term memory and was in bad health and that Cynthia communicated with the
12 scammers. However, respondent argues, without further discussion, that all of the theft loss would only
13 be deductible in 2005 in any event. (Resp. Br., p. 1, fn. 1.)

14 Respondent states that it received no information from appellant regarding the audit
15 allegedly performed by the IRS with respect to her 2004 federal return. Respondent requests appellant
16 provide documentary evidence that the IRS audited her 2004 federal return, especially with regard to the
17 theft loss deduction at issue here. Respondent also argues that, even if the IRS determined that the theft
18 loss was deductible in 2004, respondent is not bound by the IRS's determination. Appellant replies that
19 it is attempting to obtain from the IRS, through a Freedom of Information Act (FOIA) request, audit
20 information for 2004 and 2005 and believes that such information will confirm that the IRS properly
21 allowed the deduction of the theft loss in 2004. Appellant requests that the hearing in the instant matter
22 be held after the IRS has responded to her FOIA request.⁸

23 Respondent also contends that appellant has not shown she had reasonable cause for
24 filing a late California return for 2004. Respondent argues that because appellant has offered no
25 justification for filing a late 2004 return, other than a bare assertion that the late filing penalty is not
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27 ⁸ It would seem as though the IRS should have responded in some manner to appellant's FOIA request by this time.
28 Appellant should be prepared to discuss at the hearing information provided by the IRS or to explain why the information has
not yet been provided.

1 justified in this case, appellant has not proven that she had reasonable cause for that late filing.

2 Applicable Law

3 R&TC section 17201, subdivision (a), incorporates by reference IRC section 165, except
4 as otherwise provided. IRC section 165(a) provides generally that there shall be allowed as a deduction
5 any loss sustained during the taxable year and not compensated by insurance or otherwise. IRC section
6 165(c)(3) provides, in pertinent part, that a deduction under IRC section 165(a) shall be allowed to an
7 individual for losses not connected with a trade or business or a transaction entered into for profit, if
8 such losses arise from theft. IRC section 165(e) provides that, for purposes of IRC section 165(a), any
9 losses arising from theft shall be treated as sustained during the taxable year in which the taxpayer
10 discovers such loss. It is well settled that deductions are a matter of legislative grace and the taxpayer
11 has the burden of proving that he is entitled to the deductions claimed. Unsupported statements by the
12 taxpayer are insufficient to carry that burden. (*Appeal of James C. and Monablanche A. Walshe*, 75-
13 SBE-073, Oct. 20, 1975.)

14 R&TC section 19131, subdivision (a), provides, in pertinent part, that if a taxpayer fails
15 to file a tax return before the regular or extended due date of the return, a late filing penalty shall be
16 imposed, unless it is shown that the failure is due to reasonable cause and not due to willful neglect.
17 Respondent's determinations with respect to both tax and penalties are presumptively correct and the
18 burden is on the taxpayer to prove them erroneous. Unsupported statements by the taxpayer are
19 insufficient to carry that burden. (*Appeal of David A. and Barbara L. Beadling*, 77-SBE-021, Feb. 3,
20 1977.)

21 STAFF COMMENTS

22 As appellant suggests, staff requests that appellant's representative provide testimony at
23 the hearing regarding appellant's capacity during 2004 and 2005, including her ability to remember
24 recent events and her susceptibility to pressure by a trusted relative. As for appellant's capacity during
25 this period of time, the parties should be prepared to discuss that, under IRC section 165, losses are
26 treated as being sustained in the year in which taxpayer discovers the loss.

27 Appellant's representative should be prepared to further develop how appellant became
28 involved in the Nigerian Scam, including Cynthia's involvement in the scam. If appellant's

1 representative has further documentation to present, including information regarding an audit by the IRS
2 of appellant's 2004 federal tax return, it should present such evidence to the Board Proceedings Division
3 at least 14 days prior to the hearing.⁹

4 Additionally, at the hearing, the parties should be prepared to discuss the following: (1)
5 the relationship of Frederick Lukoff and Cynthia Horner (i.e., whether Mr. Lukoff is Cynthia's father or
6 Cynthia's uncle); and (2) whether any of appellant's monies were found in accounts held by Cynthia
7 Horner. Staff notes that at the website of Certified Forensic Loan Auditors, LLC,¹⁰ Cynthia Horner of
8 Clark County, Nevada, is identified as a certified forensic loan auditor and as a mortgage securitization
9 auditor. Appellant should be prepared to address whether Cynthia has or ever had those certifications.

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26 ⁹ Any such documents should be submitted to: Claudia Madrigal, Board Proceedings Division, Board of Equalization, P. O.
27 Box 942879 MIC:80, Sacramento, CA 94279-0080.

28 ¹⁰ Certified Forensic Loan Auditors, LLC provides attorneys and loan modification companies with forensic loan audits evens
the playing field with lenders and successfully negotiate (1) principal reductions on loans, (2) interest rate reductions on
loans, and (3) loan modifications on behalf of homeowner clients.