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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 **ESTATE OF CHARLES W. MOSSER** ) Case No. 600452  
13 **(DECEASED) AND ANNABELLE MOSSER<sup>1</sup>** )

	<u>Years</u>	<u>Proposed Assessments</u>
	2005	\$ 67,311
	2006	\$222,192

17 Representing the Parties:

18 For Appellants: Donald L. Feurzeig, Esq.  
19 David H. Hines, Esq.  
20 For Franchise Tax Board: Daniel V. Biedler, Tax Counsel III

22 QUESTION: Whether distributions in 2005 and 2006 from appellants' San Francisco hotel (their  
23 wholly-owned S-Corporation) can be characterized as passive income to appellants.

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25 ///

27 <sup>1</sup> Charles W. Mosser passed away in 2007 and his estate is a party to this appeal. Hereinafter, Mr. Mosser and/or his estate  
28 shall be referred to as "appellant-husband." Annabelle Mosser is referred to as "appellant-wife." Appellant-wife resides in San Francisco County, California.

1 HEARING SUMMARY

2 Introduction and Summary of Arguments

3 The issue in this appeal is whether distributions in 2005 and 2006 from the Mosser  
4 Victorian Hotel of Arts and Music, Inc.—appellants’ wholly-owned S-Corporation (Hotel)—can be  
5 characterized as passive income to appellants.<sup>2</sup> If the distributions can be classified as passive income,  
6 then (barring application of the duty of consistency as discussed below) appellants can offset that  
7 passive income against their suspended passive losses from their numerous passive activities. If not,  
8 then appellants will have to pay tax on the distributions.

9 Whether the distributions are passive income depends on whether or not the Hotel was a  
10 “passive” activity of appellants in 2005 and/or 2006, which in turn depends on whether appellant-  
11 husband “materially participated” in the Hotel’s business in 2005 and/or 2006 (or, as discussed below,  
12 whether appellant-husband materially participated in the Hotel’s business for any five taxable years  
13 [whether consecutive or not] during the ten taxable years that immediately precede the respective  
14 taxable year(s) at issue).<sup>3</sup> If appellant-husband “materially participated” in the Hotel’s business, then  
15 the Hotel would not be a passive activity and, thus, appellants could not offset the income distributed  
16 from the Hotel against their passive losses from their numerous passive activities.

17 Temporary Treasury Regulations (hereinafter sometimes referred to as the “regulations”)  
18 set forth seven tests for determining whether a taxpayer “materially participates” in a business, of which  
19 only the following two tests are specifically asserted by appellants and the FTB on appeal:

- 20 • The individual participates in the activity for more than 500 hours per year. (Temp. Treas.  
21 Reg. § 1.469-5T(a)(1).) This test focuses on participation in the current tax year(s) at issue.

22  
23 <sup>2</sup> In appellants’ reply brief, at page two, appellants clarify that (i) the S-corporation named The Mosser Companies, Inc. “does  
24 not have involvement” in this appeal, and (ii) “only the income from Hotel” is at issue. In response, the Franchise Tax Board  
(FTB or respondent) does not expressly dispute appellants’ clarification of the facts in its subsequent briefing.

25 <sup>3</sup> The FTB does not assert that appellant-wife participated in the Hotel’s activities; thus, the focus of this appeal is on  
26 appellant-husband’s activities (or lack thereof). On appeal, it is undisputed that the average period of customer use of the  
27 Hotel was seven days or less; thus, the Hotel was not a “rental activity” pursuant to Temporary Treasury Regulation section  
28 1.469-1T(e)(3)(ii)(A). Treasury Regulations (including Temporary Treasury Regulations) are generally incorporated into  
California law at R&TC section 17024.5, subdivision (d). Accordingly, the only test at issue is whether appellant-husband  
materially participated in the Hotel’s business.

- 1           • The individual materially participated in the activity for any five taxable years (whether or  
2 not consecutive) during the ten taxable years that immediately precede the taxable year.  
3 (Temp. Treas. Reg. § 1.469-5T(a)(5). As can be seen, this test focuses on participation in  
4 prior tax years. Under this test, a taxpayer who is no longer a participant in an activity can  
5 continue to be *classified* as a material participant.

6           Appellants argue that appellant-husband did not materially participate in the Hotel’s  
7 business, and thus, the Hotel’s distributions to appellants are passive income, which can be offset by  
8 appellants’ suspended passive losses from their numerous passive activities.

9           In response, the FTB argues that appellant-husband materially participated in the Hotel’s  
10 business, and thus, the Hotel’s distributions to appellants were nonpassive income, which cannot be  
11 offset by appellants’ suspended passive losses from their numerous passive activities. In support, the  
12 FTB notes, among other things, that appellants’ California income tax returns from 2000 through 2006  
13 expressly state that the Hotel was a nonpassive activity.

14           In reply, appellants assert that they erroneously stated on their California tax returns that  
15 the Hotel was a nonpassive activity. Appellants assert that, irrespective of those erroneous statements  
16 on their tax returns, the Hotel was a passive activity. In support, appellants provide, among other things,  
17 statements/declarations from the Hotel’s officers/staff (and/or affiliated agents), who allege, in essence,  
18 that appellant-husband did not “materially participate” in the Hotel’s business—the  
19 statements/declarations are set forth in detail below. In addition, appellants provide a summary of  
20 appellant-husband’s passport, indicating, among other things, that (i) appellant-husband was outside of  
21 the United States in 2000, 2001, 2005 and 2006, and (ii) appellant-husband was in the United States for  
22 only 102 days in 1999 and 191 days in 2003—the passport information is set forth in detail below.  
23 Appellants argue that this passport information (along with the statements/declarations from the Hotel’s  
24 officers/staff, and/or affiliated agents) shows that appellant-husband did not materially participate in the  
25 Hotel’s business because the Hotel is located in San Francisco but appellant-husband was located  
26 outside of the United States (in the Philippines) for long periods of time (including all of 2005 and  
27 2006).

28           In response, the FTB contends that appellants’ arguments on appeal are “inconsistent”

1 with their statements made in their California tax returns that the Hotel was a nonpassive activity.  
2 Furthermore, the FTB asserts that, even if appellant-husband was outside of the United States for long  
3 periods of time (as appellants allege), appellant-husband could have still materially participated in the  
4 Hotel's business via email, telephone, etc.

5 In reply, appellants assert that, where a taxpayer resides far away from his/her business,  
6 the Tax Court often finds that the taxpayer does not materially participate in the business, citing  
7 *Newhart v. Commissioner*, T.C. Memo 2001-289; *Iversen v. Commissioner*, T.C. Memo 2012-19; and  
8 *Bohannon v. Commissioner*, T.C. Memo 1997-153. In addition, appellants assert that, despite the  
9 representations made on their California returns that the Hotel was a nonpassive activity, the "duty of  
10 consistency" doctrine does not bar them from arguing that the Hotel's distributions to appellants can be  
11 characterized as passive income because, among other things, appellants received no tax benefit from  
12 classifying the Hotel as a nonpassive activity on appellants' tax returns for the tax years of 1995 through  
13 2004 (i.e., tax years other than the tax years on appeal)—excluding tax year 2002 where appellants  
14 assert they received a tax benefit of (only) \$2,141.

15 In response, the FTB reiterates that, even if appellant-husband was outside of the United  
16 States for long periods of time (as appellants allege), appellant-husband could have still materially  
17 participated in the Hotel's business via email, telephone, etc. The FTB notes that its proposed  
18 assessments are presumed to be correct. The FTB concludes by asserting that appellants have not shown  
19 that the FTB's proposed assessments are erroneous.

#### 20 Facts

21 Over a successful career of more than 40 years, appellant-husband accumulated  
22 numerous properties—mostly in the San Francisco Bay Area.<sup>4</sup> Some of appellants' properties were  
23 classified as passive activities for tax purposes—others were classified as nonpassive activities. (See  
24 Appeal Letter (AL), pp. 1-4.) Over time, appellants' passive activities generated large passive losses.  
25 As discussed further below, in general, a taxpayer's passive losses can be deducted only to the extent of  
26 income from the taxpayer's passive activities—any unused passive losses are generally suspended and  
27

28 <sup>4</sup> See <http://www.sfaa.org/jan2008/0801landes.html>.

1 carried forward to future years to offset passive income generated in those years.

2 One of the properties appellants owned in 2005 and 2006 was the Hotel, which, as stated  
3 above, is appellants' wholly-owned S-Corporation. (*Id.*) The Hotel is located on 4th Street in the City  
4 of San Francisco, near the Union Square shopping district.

5 *California Returns*

6 Appellants filed 2005 and 2006 California Resident Income Tax Returns, reporting,  
7 among other things, that the Hotel was a nonpassive activity.<sup>5</sup> (Appellants' Reply Brief (App. Reply  
8 Br.), p. 3 & Ex. I.)

9 *Audit and Protest*

10 In their appeal briefs, neither the FTB nor appellants discuss the procedural facts  
11 concerning the FTB's audit of appellants' California returns; nor do the parties discuss the procedural  
12 facts concerning appellants' protest proceedings. Accordingly, Appeals Division staff (staff) is not able  
13 to provide a detailed discussion of the procedural facts of this appeal. Nevertheless, it appears that,  
14 during the audit, the FTB determined that the Hotel made taxable distributions to appellants in 2005 and  
15 2006. (App. Reply Br., p. 2; see also, AL, Exs. A & B.) On November 5, 2009, the FTB issued Notices  
16 of Proposed Assessment (NPAs), setting forth an additional tax of \$67,311, plus interest, for the 2005  
17 tax year; and an additional tax of \$222,192, plus interest, for the 2006 tax year.<sup>6</sup>

18 In response, appellants filed timely protests. (Copies of appellants' protests letters are  
19 not located in the appeal record). After reviewing the matter, however, the FTB affirmed the NPAs in  
20 NOAs dated January 12, 2012.<sup>7</sup> The NOA for the 2005 tax year sets forth an additional tax of  
21 \$67,311.00, plus interest of \$17,645.62. (AL, Ex. A.) The NOA for the 2006 tax year sets forth an  
22 additional tax of \$222,192.00, plus interest of \$56,958.75. (AL, Ex. B.) Afterwards, appellants filed  
23 this timely appeal.

24 \_\_\_\_\_  
25 <sup>5</sup> As noted above, on appeal, appellants asset that the Hotel was a *passive* activity.

26 <sup>6</sup> Copies of the NPAs are not provided in the appeal record; the information concerning additional tax is taken from the  
27 Notices of Action (NOAs), which are included with appellants' appeal letter.

28 <sup>7</sup> Each NPA stated that the FTB suspended interest for the time period reflected in Revenue and Taxation Code (R&TC)  
section 19116 and that interest accrual resumed 15 days after the date of the NPA.

1           Contentions

2                   Appeal Letter

3                   Appellants assert that appellant-husband's passport shows that appellant-husband spent  
4 the following number of days within the territorial borders of the United States:

5

Year	Number of Days
1999	102
2000	0
2001	0
2002	272
2003	191
2004	247
2005	0
2006	0

6  
7  
8  
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11  
12  
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14

15                   Based on appellant-husband's passport, appellants assert that appellant-husband could not  
16 have materially participated in the Hotel's business because the passport shows that appellant-husband  
17 was not in the United States in 2000, 2001, 2005 and 2006, and was only in the United States for 102  
18 days in 1999 and 191 days in 2003. (AL, p. 2.) Furthermore, appellants contend that (i) appellant-  
19 husband was "absent quite a bit of time" in 2002 and 2003, and (ii) for the last 12 years of his life (he  
20 passed away in 2007) appellant-husband was involved with the issue of forest sustainability, not the  
21 operation of the Hotel. (*Id.*)

22                   Appellants asserts that material participation in the case of the Hotel would involve  
23 making frequent visits to the Hotel to conduct on-site inspections, meeting with on-site management,  
24 and participating in integral functions of the Hotel's business, citing to 132 Cong. Rec. 58244-46,  
25 June, 24, 1986. (*Id.*) In addition, appellants assert that an individual is unlikely to materially participate  
26 in an activity located thousands of miles from where he lives and works, especially if he does not visit  
27 the site of the activity frequently, citing to S. Rept. No. 313, 99th Cong., 2d Session at 733. (*Id.*)

28                   In relation to the "material participation" test under Temporary Treasury Regulation

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1 section 1.469-5T(a)(5), appellants assert that appellant-husband's passport shows that (i) as of 2006,  
2 appellant-husband was only in the United States 812 days out of 2,555 days for the previous seven  
3 years, and (ii) as of 2005, appellant-husband was only in the United States for 812 days out of 2,190  
4 days for the previous six years. (*Id.*) In addition, appellants assert that appellant-husband retired (in  
5 1999) and a retired person does not materially participate. (*Id.*)

6 As for the duty of consistency, appellants assert:

- 7 (i) They received "no benefit for years of 2000, 2001, 2003, 2004, 2005 and only a \$2,141  
8 benefit for 2002." (*Id.* p. 3.)
- 9 (ii) ". . . the duty of consistency is absent because the FTB performed an audit for the previous  
10 years 1999-2001 and did not make any adjustments . . .", citing to *Gmelin v. Commissioner*,  
11 T.C. Memo 1988-338, aff'd (3rd. Cir 1989) 891 F.2d 280. (AL, p. 3.)
- 12 (iii) The United States Court of Appeals for the First Circuit, the Second Circuit, and the Third  
13 Circuit require a concealment, misrepresentation, or similar wrongdoing to apply a duty of  
14 consistency (which appellants assert are not present in the facts of this appeal), citing to  
15 *Ross v. Commissioner* (1st Cir. 1948) 169 F.2d 483; *Bennet v. Helvering* (2nd Cir. 1943)  
16 137 F.2d 537; and *Commissioner v. Mellon* (3rd. Cir. 1950) 184 F.2d 157. (AL, p. 2.)

17 The FTB's Opening Brief

18 The FTB asserts that income tax deductions are a matter of legislative grace, and a  
19 taxpayer who claims a deduction has the burden of proving by competent evidence that the he or she is  
20 entitled to that deduction, citing *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435. (FTB Opening  
21 Brief (FTB OB), p. 4.) The FTB also asserts that a taxpayer's failure to provide evidence within his/her  
22 control gives rise to a presumption that such evidence, if provided, would be unfavorable to the  
23 taxpayer, citing *O'Dwyer v. Commissioner* (4th Cir. 1959) 266 F.2d 575. (FTB OB, p. 5.)

24 The FTB contends that appellants have not provided sufficient evidence showing that the  
25 Hotel was a passive activity to appellants in 2005 and 2006; thus, the FTB argues that the distributions  
26 from the Hotel to appellants in 2005 and 2006 cannot be classified as passive income and, accordingly,  
27 cannot be offset by appellants' suspended passive losses from their numerous passive activities. (*Id.*, pp.  
28 1-8.) The FTB's specific arguments in this respect are as follows:

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1 First, the FTB notes that appellants' 2000 through 2006 California tax returns expressly  
2 state that the Hotel was a *nonpassive* activity to appellants. (*Id.*, pp. 6-7.) In comparison, the FTB notes  
3 that appellants are asserting on appeal that the Hotel was a *passive* activity to appellants. (*Id.*) The FTB  
4 contends that appellants' inconsistent statements and assertions undermine their credibility. (*Id.*, p. 7.)

5 Second, the FTB contends that appellants should provide business records (i.e. corporate  
6 minutes, payroll records, daily calendars, declarations, etc.) showing that appellant-husband did not  
7 materially participate in the Hotel's business. (*Id.*, p. 6.) The FTB asserts that appellants' failure to  
8 provide such documents with their appeal letter suggests that, if provided, such documents would be  
9 unfavorable to appellants' arguments on appeal. (*Id.*)

10 Third, the FTB contends that appellant-husband's (alleged) involvement with the Hotel in  
11 preceding years (i.e., apparently years prior to 2005 and 2006) establishes a presumption of appellant-  
12 husband's material participation for the tax years at issue in this appeal, citing to Temporary Treasury  
13 Regulation section 1.469-5T(a)(5)). (*Id.*, p. 6.)

14 Fourth, the FTB argues that appellant-husband's physical presence outside of the United  
15 States does not establish that the Hotel was a passive activity of appellants (as they are alleging on  
16 appeal) because appellant-husband could have materially participated in the Hotel's business without  
17 being physically present at the Hotel (e.g., via computer, telephone, email, etc.). (*Id.*, pp. 6-7.)

18 Finally, the FTB argues that appellants have not demonstrated that the State of California  
19 is not harmed by appellants' inconsistent positions (i.e., when appellants expressly stated that the Hotel  
20 was a nonpassive activity on their returns, but assert that the Hotel is a passive activity on appeal). (*Id.*,  
21 p. 7.)

#### 22 Appellants' Reply Brief

23 Appellants argue that their California returns mistakenly classified the Hotel as a  
24 "nonpassive" activity—appellants attribute their alleged mistake to a misunderstanding, on their part, as  
25 to application of the passive loss rules. (App. Reply Br., p. 3.) Specifically, appellants assert:

26 The only reason Charles' tax returns were indicated as "nonpassive" . . . for Hotel  
27 . . . was that the various other entities in which Charles had an interest had  
28 . [a rental] for passive activity purposes.

1 Appellants reassert their argument (as made in their appeal letter) that appellant-  
2 husband's passport shows that appellant-husband spent long periods of time (including all of 2005 and  
3 2006) outside the territorial borders of the United States.

4 Based on appellant-husband's passport, appellants reassert that appellant-husband could  
5 not have materially participated in the Hotel's business. (*Id.*, pp. 2-4.)

6 Appellants also assert that in 2005 and 2006 appellant-husband was busily engaged in the  
7 reforestation of land in the Philippines. In support, appellants attach a brief biography of appellant-  
8 husband's life. (*Id.*, p. 3 & Ex. B.)

9 Next, appellants assert that material participation in the case of the Hotel would involve  
10 making frequent visits to the Hotel to conduct on-site inspections, meeting with on-site management,  
11 and participating in integral functions of the business. (*Id.*, p. 3.) Appellants contend, however, that  
12 appellant-husband was an "absentee shareholder." (*Id.*)

13 Appellants argue that where a taxpayer resides far away (and in appellant-husband's  
14 situation, thousands of miles away) from his/her business, the Tax Court often finds that the taxpayer  
15 does not materially participate in the business, citing *Newhart v. Commissioner, supra*; *Iversen v.*  
16 *Commissioner, supra*; and *Bohannon v. Commissioner, supra*. (*Id.*, p. 4.)

17 Appellants contend that "material participation" is defined as an involvement in any  
18 activity on a regular, continuous, and substantial basis, citing to Internal Revenue Code (IRC) section  
19 469(h)(1). (*Id.*) In addition, appellants contend that an activity performed in an individual's capacity as  
20 an "investor" does not qualify as participation in an activity unless the individual is directly involved in  
21 the day-to-day management of the activity, citing to Temporary Treasury Regulation section 1.469-  
22 5T(f)(2)(ii)(A) and (B). (*Id.*) Appellants assert that investor-related activities which do not qualify as  
23 material participation include: (1) studying and reviewing financial statements or reports on operations,  
24 (2) preparing or compiling summaries or analysis of the finances or operations of the activity for the  
25 individual's own use, and (3) monitoring the finances or operations of the activity in a non-managerial  
26 capacity. (*Id.*)

27 Next, appellants assert that statements/declarations from the Hotel's officers/staff (and or  
28 affiliated agents), as set forth immediately below, show that (i) appellant-husband retired from the

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1 Hotel's business in 1999; and (ii) appellant-husband did not materially participate in the Hotel's  
2 business from, *inter alia*, the date of his retirement in 1999 through the year of his death in 2007. (*Id.*,  
3 pp. 3-8, Exs. A, A-1, & L.) Specifically, appellants provide the following statements/declarations:

- 4 • Appellants provide a statement dated May 24, 2012, from Mr. Kevin Bazant, General  
5 Manager, Mosser Hotel Group, who asserts, among other things, that (i) he has worked as a  
6 general manager since September 1, 2000, (ii) he has reported to Mr. Neveo Mosser  
7 (appellant-husband's son) since September 1, 2000, (iii) he has only interacted with  
8 appellant-husband "on a few occasions such as a few Christmas parties and house parties . .  
9 .", (iv) Mr. Neveo Mosser approved all budgets and major changes to the Hotel, and (v) to  
10 the best of his knowledge, he believes that his assertions are true and correct. (*Id.*, Ex. A.)
- 11 • Appellants provide a declaration dated May 21, 2012, from Mr. Yuly Limaho, Controller,  
12 Mosser Companies, Inc., who states, among other things, that (i) he has been employed with  
13 the Mosser Companies, Inc. since 1999, and (ii) "I declare under penalty of perjury that  
14 Charles W. Mosser was not on the payroll of the Mosser Victorian Hotel of Arts & Music,  
15 Inc. for the years 1999 to 2006, inclusive." (*Id.*, Ex. L.)
- 16 • Appellants provide a declaration dated May 24, 2012, from Mr. Neveo Mosser, Chief  
17 Executive Officer (CEO) of The Mosser Companies and an "officer" of the Hotel, who  
18 declares, among other things, that (i) appellant-husband retired from the Hotel's business in  
19 1999, (ii) appellant-husband remained retired from the Hotel's business from 1999 through  
20 appellant-husband's death in 2007, (iii) since 1999, he (Neveo Mosser) oversaw and  
21 managed a complete redesign and renovation of the Hotel from 1999 to 2001, during which  
22 time he personally made the decisions, (iv) he (Neveo Mosser) personally undertook the  
23 refinancing of the Hotel property in 2000 and 2004 without the involvement of appellant-  
24 husband, other than having appellant-husband visit San Francisco from the Philippines to  
25 execute some loan documents which required appellant-husband's signature as an owner of  
26 the Hotel, (v) after 2000, he (Neveo Mosser) began to execute all loan documents, handle all  
27 litigation, and oversee the day-to-day operation of the business, in addition to strategic  
28 planning for business development, (vi) in 1999, appellant-husband was focused on putting

1 his prostate cancer into remission, and (vii) appellant-husband did not participate in the  
2 Hotel's business from 1999 through appellant-husband's death in 2007, other than as an  
3 investor. (*Id.*, Ex. A-1)

4 Next, in relation to the "material participation" test set forth in Temporary Treasury  
5 Regulation section 1.469-5T(a)(5), appellants reassert their argument (as first set forth in their appeal  
6 letter) that appellant-husband's passport shows that (i) as of 2006, appellant-husband was only in the  
7 United States for 812 days out of 2,555 days for the previous seven years, (ii) as of 2005, appellant-  
8 husband was only in the United States for 812 days out of 2,190 days for the previous six years. (*Id.*, p.  
9 5.) In addition, appellants assert that appellant-husband retired (in 1999) and a retired person does not  
10 materially participate. (*Id.*, pp. 5-6.)

11 Next, in relation to the "duty of consistency," appellants make the following allegations:

- 12 (i) As for the tax years of 1995 through 2001 and 2003 and 2004, appellants assert that they  
13 received no tax benefit from reporting the Hotel as a nonpassive activity—in support,  
14 appellants provide (1) copies of original and (apparently) pro forma tax returns for tax  
15 years 2000, 2001, 2003, and 2004, allegedly showing no change in appellants' California  
16 taxes regardless of whether the Hotel is listed as a passive or a nonpassive activity, and (2)  
17 an exhibit summary, asserting that for the tax years 1995 through 1999, appellants'  
18 California taxes would not have changed if the Hotel was classified as a passive activity (as  
19 opposed to a nonpassive activity). (*Id.*, p. 6 & Exs. E-I & K.)
- 20 (ii) As for the tax year 2002, appellants allege that they received a tax benefit of only \$2,141  
21 from reporting the Hotel as a nonpassive activity on their 2002 California return—in  
22 support, appellant provide copies of an original and (apparently) a pro forma tax return for  
23 the tax year 2002. (*Id.*, p. 6 & Ex. J.)
- 24 (iii) As for the tax years 1999 through 2001, appellants also assert that FTB performed an audit  
25 of those tax years and, thus, had a reasonable opportunity to make timely corrections; thus,  
26 appellants argue that the FTB's failure to make corrections was not due to any reliance on  
27 representations made by appellant-husband or his accountant. (*Id.*, pp. 6-7.)
- 28 (iv) Appellants assert that the United States Court of Appeals for the First Circuit, the Second

1 Circuit, and the Third Circuit require a concealment, misrepresentation, or similar  
2 wrongdoing to apply a duty of consistency (which appellants assert are not present in the  
3 facts of this appeal), citing to *Ross v. Commissioner, supra; Bennet v. Helvering, supra;*  
4 and *Commissioner v. Mellon, supra. (Id.)*

5 Included with their reply brief, appellants provide the following documents, in addition to  
6 those mentioned above:

- 7 • A spreadsheet titled “Funds Allocation.” (*Id.*, Ex. C.)
- 8 • Copies of numerous emails from appellant-husband (arguably demonstrating that appellant-  
9 husband was in the Philippines when those emails were sent). (*Id.*, Ex. D.)

10 FTB’s Reply Brief

11 The FTB notes that appellants’ California returns consistently reported that the Hotel was  
12 a *nonpassive* activity. (FTB Reply Brief (FTB Reply Br.), p. 1.) The FTB argues that appellants have  
13 not provided sufficient evidence showing that the Hotel was a *passive* activity. (*Id.*, pp. 1-3.)

14 The FTB argues that “[t]echnology has obviated the need for a person’s physical  
15 presence to participate in an activity.” (*Id.*, p. 2.) In fact, the FTB states that IRC section 469 simply  
16 defines material participation as involvement in an activity on a regular, continuous, and substantial  
17 basis, and the FTB asserts that IRC section 469 does not appear to require physical presence. (*Id.*)

18 Next, the FTB argues that appellants’ assertion that appellant-husband lacked access to  
19 email, telephones, etc. is undermined by the numerous emails that appellants provided with their reply  
20 brief. (*Id.*) In fact, the FTB asserts that an email dated September 28, 2006—from appellant-husband to  
21 Mr. Yuly Limaho—supports a finding that appellant-husband maintained a significant degree of control  
22 over the Hotel’s operations. (*Id.*, pp. 2-3.) Specifically, the FTB asserts that, in that email dated  
23 September 28, 2006, Mr. Limaho specifically requests that appellant-husband authorize payroll funds.  
24 (*Id.*)

25 Appellants’ Supplemental Brief

26 Appellants argue that the FTB has ignored the evidence showing that appellant-husband  
27 was 82 years old, retired, had cancer, and had not set foot in the United States in 2005 and 2006.  
28 (Appellants’ Supplemental Brief (App. Supp. Br.), p. 3.)

1 Appellants assert that the issue on appeal is whether the Hotel was a passive activity of  
2 appellants for the 2005 and 2006 tax years. (*Id.*, pp. 1-2.) Appellants argue that the Hotel was a passive  
3 activity of appellant-husband in 2005 and 2006 because, among other things, (i) the Hotel was operated  
4 and managed by others, (ii) appellant-husband was not on the payroll of the Hotel and he was outside of  
5 the United States for long periods of time (including all of 2005 and 2006), and (iii) appellant-husband  
6 had many activities in the Philippines leaving him no time to operate the Hotel on a regular, continuous,  
7 and substantial basis [as provided in IRC § 469(h)] or as a day-to-day routine [as provided in Temp.  
8 Treas. Reg. § 1.469-5T(f)(2)(ii)(B)]. (*Id.*, p. 3.)

9 In relation to the “duty of consistency,” appellants argue that they generally received no  
10 tax benefit by listing the Hotel as a nonpassive activity on their tax returns. (*Id.*) Furthermore,  
11 appellants assert that the issue on appeal is whether the Hotel was a passive activity of appellants for the  
12 2005 and 2006 years—and appellants assert that they can still amend their returns for 2005 and 2006.  
13 (*Id.*)

14 Appellants also assert that appellant-husband was living in a remote area of the  
15 Philippines and had to travel to another part of the Philippines to obtain access to email, telephones, etc.  
16 (*Id.*, p. 4.)

17 Next, appellants note that in the FTB’s reply brief, the FTB mentions an email dated  
18 September 28, 2006 (from appellant-husband to Mr. Yuly Limaho) as evidence that appellant-husband  
19 maintained a degree of control in California. (*Id.*) Appellants assert, however, that the email actually  
20 supports appellants’ argument that the Hotel was a passive activity of appellants because:

- 21 a. In the email, appellant-husband specifically requests that reimbursement (as mentioned  
22 therein) be *preapproved* by Mr. Neveo Mosser. (*Id.*)
- 23 b. The email contains a prior email from Mr. Yuly Limaho, who therein provides appellant-  
24 husband with information that occurred in the prior months (“past months”), which  
25 appellants assert supports their argument that appellant-husband was not involved with the  
26 day-to-day activities of the Hotel. (*Id.*)
- 27 c. In the email, appellant-husband and Mr. Limaho discuss appellant-husband’s authorization of  
28 a funds transfer—appellants argue that “monitoring the finances or operations of the activity

1 in a non-managerial capacity” is work done in appellant-husband’s capacity as an investor,  
2 citing to Temporary Treasury Regulation section 1.469-5T(f)(2)(ii)(B)(3). (*Id.*)

3 d. Appellants argue that the subject matter of the email did not involve the Hotel but, instead,  
4 relates to another company owned by appellant-husband. (*Id.*)

#### 5 Applicable Law

##### 6 Deductions

7 Income tax deductions are a matter of legislative grace, and a taxpayer who claims a  
8 deduction has the burden of proving by competent evidence that the he or she is entitled to that  
9 deduction. (See *New Colonial Ice Co. v. Helvering, supra*; *Appeal of Michael E. Myers*, 2001-SBE-001,  
10 May 31, 2001.)<sup>8</sup> Unsupported assertions are not sufficient to satisfy a taxpayer’s burden of proof.  
11 (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) A taxpayer’s failure to produce  
12 evidence that is within the taxpayer’s control gives rise to a presumption that such evidence is  
13 unfavorable to the taxpayer’s case. (*Appeal of Don A. Cookston*, 83-SBE-048, Jan. 3, 1983.)

##### 14 Passive Loss Limits

15 The IRC allows taxpayers to deduct most business-related and profit-seeking expenses  
16 under IRC sections 162 and 212; however, IRC section 469 limits those deductions when they arise  
17 from “passive activities.”<sup>9</sup> (*Lapid v. Commissioner*, T.C. Memo 2004-222.) Passive activities include  
18 both: (1) trade or business activities where the taxpayer does not materially participate; and (2) rental  
19 activities. (*Id.*, citing to Int.Rev. Code, § 469(c)(1) and (2).) Under the regulations, a rental activity  
20 does not include an activity where the average period of customer use is seven days or less.<sup>10</sup> (*Id.*, citing  
21 to Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(A).)

22 Whether a loss from a trade or business is a passive activity loss generally depends on  
23

24 <sup>8</sup> Board of Equalization cases are generally available for viewing on the Board’s website ([www.boe.ca.gov](http://www.boe.ca.gov)).

25 <sup>9</sup> IRC sections 162, 212, and 469 are generally incorporated into California law at R&TC sections 17201, 17551, and 17561.  
26 This discussion does not address At-Risk Limits. (See Int.Rev. Code, §465.)

27 <sup>10</sup> As noted above, it is undisputed that the average period of customer use of the Hotel was seven days or less; thus, the Hotel  
28 was not a “rental activity” under the regulations. Accordingly, the only test at issue is whether appellant-husband materially participated in the Hotel’s business.

1 whether the taxpayer claiming the loss “materially participated” in that trade or business. (*Lapid v.*  
2 *Commissioner, supra.*) A taxpayer will not be treated as a material participant unless his involvement is  
3 regular, continuous, and substantial. (*Id.*, citing to Int.Rev. Code, § 469(h)(1).)

4 The regulations allow a taxpayer to be treated as a “material participant” if, but only if,  
5 the taxpayer meets one of seven tests listed in the regulations. (*Lapid v. Commissioner, supra.*) On  
6 appeal, only the following two tests are specifically asserted by the parties:<sup>11</sup>

- 7 • The individual participates in the activity for more than 500 hours per year. (Temp. Treas.  
8 Reg. § 1.469-5T(a)(1).) This test focuses on the current tax year(s) at issue.
- 9 • The individual materially participated in the activity for any five taxable years (whether or  
10 not consecutive) during the ten taxable years that immediately precede the taxable year.  
11 (Temp. Treas. Reg. § 1.469-5T(a)(5). This test focuses on participation in prior tax years.

12 Under this test, a taxpayer who is no longer a participant in an activity can continue to be

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14 ///

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16 <sup>11</sup> As mentioned, Temporary Treasury Regulation section 1.469-5T provides for seven tests in determining whether an  
17 individual materially participates in an activity. Subdivision (a) of the regulation provides as follows:  
18 “(a) In general. Except as provided in paragraphs (e) and (h)(2) of this section, an individual shall be treated, for purposes of  
19 section 469 and the regulations thereunder, as materially participating in an activity for the taxable year if and only if --

- 19 (1) The individual participates in the activity for more than 500 hours during such year;
- 20 (2) The individual’s participation in the activity for the taxable year constitutes substantially all of the participation in such  
21 activity of all individuals (including individuals who are not owners of interests in the activity) for such year;
- 22 (3) The individual participates in the activity for more than 100 hours during the taxable year, and such individual’s  
23 participation in the activity for the taxable year is not less than the participation in the activity of any other individual  
24 (including individuals who are not owners of interests in the activity) for such year;
- 25 (4) The activity is a significant participation activity (within the meaning of paragraph (c) of this section) for the taxable year,  
26 and the individual’s aggregate participation in all significant participation activities during such year exceeds 500 hours;
- 27 (5) The individual materially participated in the activity (determined without regard to this paragraph (a)(5)) for any five  
28 taxable years (whether or not consecutive) during the ten taxable years that immediately precede the taxable year;
- (6) The activity is a personal service activity (within the meaning of paragraph (d) of this section), and the individual  
materially participated in the activity for any three taxable years (whether or not consecutive) preceding the taxable year; or
- (7) Based on all of the facts and circumstances (taking into account the rules in paragraph (b) of this section), the individual  
participates in the activity on a regular, continuous, and substantial basis during such year.”

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1           *classified* as a material participant.<sup>12</sup>

2           The regulations state that taxpayers can prove the extent of their activities through any  
3 reasonable means. (*Lapid v. Commissioner, supra*, citing to Temp. Treas. Reg. § 1.469-5T(f)(4).)  
4 Temporary Treasury Regulation section 1.469-5T(f)(4) states that “[c]ontemporaneous daily time  
5 reports, logs, or similar documents are not required if the extent of such participation may be established  
6 by other reasonable means.” (*Id.*) However, Temporary Treasury Regulation section 1.469-5T(f)(2)  
7 states not to count certain activities in deciding whether taxpayers have spent enough time on their  
8 activity for their participation to be material—one of the exclusions is time spent on investment  
9 activities, which does not count unless the taxpayer is directly involved in the day-to-day management  
10 or operations of the activity. (*Lapid v. Commissioner, supra*, citing to Temp. Treas. Reg. § 1.469-  
11 5T(f)(2)(ii)(A) and (B).)

12           In general, a taxpayer’s passive losses can be deducted only to the extent of income from  
13 the taxpayer’s passive activities—any unused passive losses are generally suspended and carried  
14 forward to future years to offset passive income generated in those years.<sup>13</sup> (*Lowe v. Commissioner*,  
15 T.C. Memo 2008-298; see also, *Jafarpour v. Commissioner*, T.C. Memo 2012-165.)

#### 16           Duty of Consistency

17           The United States Supreme Court has held that “. . . a taxpayer is free to organize his  
18 affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his  
19 choice, whether contemplated or not.” (*Commissioner v. Nat’l Alfalfa Dehydrating & Milling Co.*  
20 (1974) 417 U.S. 134, 149.) The duty of consistency was discussed by the Ninth Circuit Court of  
21 Appeals in *Ashman v. Commissioner* (9th Cir. 2000) 231 F. 3d 541, 543 as follows:

22           While it is true that income taxes are intended to be settled and paid annually each  
23 year standing to itself, and that omissions, mistakes and frauds are generally to be  
24 rectified as of the year they occurred, this and other courts have recognized that a  
taxpayer may not, after taking a position in one year to his advantage and after  
correction for that year is barred, shift to a contrary position touching the same

25  
26 <sup>12</sup> “The IRS [Internal Revenue Service] takes the position that material participation in a trade or business for a long period of  
27 time is likely to indicate that the activity represents the individual’s principal livelihood, rather than a passive investment.  
Consequently, withdrawal from the activity, or reduction of participation to the point where it is not material, does not change  
28 the classification of the activity from active to passive.” (Hoffman, *Individual Income Taxes*, 2008 Ed., Ch. 11, p. 14.)

<sup>13</sup> As noted above, this discussion does not address At-Risk Limits. (See Int.Rev. Code, §465.)

1 fact or transaction.

2 The Ninth Circuit identified the following three elements for meeting the duty of consistency:

3 (1) A representation or report by the taxpayer (2) on which the Commissioner has  
4 relied and (3) an attempt by the taxpayer after the statute of limitations has run to  
5 change the previous representation or to recharacterize the situation in such a way  
6 as to harm the Commissioner. If this test is met, the Commissioner may act as if  
7 the previous representation, on which he relied, continued to be true, even if it is  
8 not. The taxpayer is estopped to assert the contrary.

9 (*Id.* at p. 546 [quoting *Herrington v. Commissioner* (5<sup>th</sup> Cir. 1988) 854 F.2d 755, 758 and citing  
10 additional authorities].)

11 The Tax Court has stated that the duty of consistency doctrine does not apply where the  
12 position originally taken by a taxpayer produced no tax benefit:

13 We conclude that the duty of consistency is not applicable under the facts herein. .  
14 . . . As stated above, petitioner’s misreporting of the treatment of the consigned  
15 goods resulted in a wash when calculating the cost of goods sold deduction such  
16 that petitioner did not receive any benefit and respondent did not suffer any  
17 detriment.

18 (*Cleo Perfume, Inc. v. Commissioner*, T.C. Memo 1998-155 [emphasis supplied]; see also *United*  
19 *States v. Kollman* (2010, DC Or) 2010-1 USTC P 50,272; 2010 U.S. Dist. LEXIS 19716.)

## 20 STAFF COMMENTS

### 21 Passive vs. Nonpassive Activity

22 As indicated above, the issue in this appeal is whether distributions in 2005 and 2006  
23 from the Hotel to appellants can be characterized as passive income to appellants. If the distributions  
24 can be classified as passive income, then (barring application of the duty of consistency, as discussed  
25 below) appellants can offset that passive income against their suspended passive losses from their  
26 numerous passive activities. If not, then appellants will have to pay tax on the distributions.

27 Whether the distributions are passive income depends on whether or not the Hotel was a  
28 “passive” activity of appellants in 2005 and/or 2006, which in turn depends on whether appellant-  
29 husband “materially participated” in the Hotel’s business in 2005 and/or 2006 (or whether appellant-  
30 husband materially participated in the Hotel’s business for any five taxable years [whether consecutive  
31 or not] during the ten taxable years that immediately precede the respective taxable year(s) at issue).

32 Temporary Treasury Regulations set forth various tests regarding “materially participates”, including the

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1 following:

- 2 • The individual participates in the activity for more than 500 hours per year. (Temp. Treas.  
3 Reg. § 1.469-5T(a)(1).) This test focuses on participation in the current tax year(s) at issue.
- 4 • The individual materially participated in the activity for any five taxable years (whether or  
5 not consecutive) during the ten taxable years that immediately precede the taxable year.  
6 (Temp. Treas. Reg. § 1.469-5T(a)(5). As can be seen, this test focuses on participation in  
7 prior tax years. Under this test, a taxpayer who is no longer a participant in an activity for  
8 the tax year at issue can continue to be *classified* as a material participant based on  
9 participation in prior tax years.

10 At the oral hearing, the parties should be prepared to discuss whether appellants have  
11 provided sufficient evidence showing that appellant-husband did not materially participate in the Hotel's  
12 business (as appellants allege) either in 2005 and/or 2006 (or for any five taxable years [whether  
13 consecutive or not] during the ten taxable years that immediately precede the respective taxable year(s)  
14 at issue). In this respect, the parties may want to discuss the case of *Iversen v. Commissioner, supra*.

15 *Iversen* is a recent case that dealt with the issue of whether taxpayers, who resided in  
16 Minnesota, materially participated in a cattle ranch in Colorado via, among other things, 11 trips to the  
17 ranch and various telephone conversations with the ranch manager. Staff notes that, in comparison to  
18 appellants' arguments, the taxpayers in *Iversen* argued that they materially participated in their business.  
19 After reviewing the facts, the Tax Court held, among other things, that the taxpayers failed to prove they  
20 satisfied the 500 hour participation test of Temporary Treasury Regulation section 1.469-5T(a)(1). The  
21 Tax Court found that the evidence of 11 trips to the ranch, along with various telephone conversations  
22 with the ranch manager, did not prove that the taxpayers were material participants. In addition, the Tax  
23 Court noted that, under Temporary Treasury Regulation section 1.469-5T(f)(2)(ii)(A) and (B), an  
24 individual's activities in the capacity of an investor do not qualify as participation unless the individual  
25 is directly involved in the day-to-day management or operations of the activity.

#### 26 Duty of Consistency

27 At the oral hearing, the parties should be prepared to discuss whether the "duty of  
28 consistency" is an issue in this appeal.

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1           As noted above, appellants assert that the “duty of consistency” does not bar them from  
2 arguing that the Hotel was a passive activity because, among other things, they received no tax benefit  
3 from classifying the Hotel as a nonpassive activity for the tax years not subject to this appeal (i.e., 1995-  
4 2004)—excluding the 2002 tax year where appellants assert they received a tax benefit of only \$2,141.  
5 Accordingly, at the oral hearing the parties should be prepared to discuss whether, if the duty of  
6 consistency applies, appellants should be barred under that doctrine only to the amount of \$2,141  
7 in tax.

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