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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:

KARL H. POWER AND NATALIE L. POWER[1]

HEARING SUMMARY

PERSONAL INCOME TAX APPEAL

Case No. 528570

Years	Additional Tax	Penalties
2003	$ 4,259.00	$ 851.80
2004	$ 38,098.00	$ 4,099.00

Representing the Parties:

For Appellants: David Kuhner, CPA
Eichstaedt & Devereaux, LLP

For Franchise Tax Board: Eric R. Brown, Tax Counsel III

QUESTIONS: (1) Whether appellants have shown respondent erred in disallowing claimed losses for property allegedly converted from residential real property to income-producing property prior to its sale.

(2) Whether appellants have shown the accuracy-related penalties assessed for 2003 and 2004 should be abated.

[1] Appellants reside in Woodside, San Mateo County, California.

HEARING SUMMARY

Background

Appellants purchased residential real property on West Maple Way in Woodside, California (the Property) on September 21, 2000, for a purchase price of $2,450,000. (Resp. Op. Br., exhibit A.) Appellants sold the Property at a loss on March 14, 2003, for $1,740,000. (*Id*. at exhibit B.) Appellants lived at the Property from the month of purchase through June 2002, when they moved to a rental property in Menlo Park, California. Appellants indicate the move from the Property and search for a new residence was prompted by the conclusion that it could not accommodate their severely physically handicapped son. (*Id*. at exhibit C; App. Op. Br., p. 2.) Thereafter, in October or November of 2002, appellants moved to a different rental property in Woodside, California, where they resided until July of 2003. (Resp. Op. Br., exhibit C.) Appellants did not reside at the Property after they left it in June of 2002.[2]

On appellants' 2002 federal tax return, they reported $10,000 in rental income from the Property.[3] (Resp. Op. Br., exhibit D.) Appellants retract this assertion by indicating the Property was never rented while they owned it and it produced no rental income. (App. Op. Br., p. 2.) Also on appellants' 2002 federal tax return, they claimed a loss of $74,147 from "rental real estate or royalty properties."[4] (Resp. Op. Br., exhibit D.) On appellants' 2003 California return, appellants claimed a loss of $61,179 from "rental real estate, royalties, partnerships, S corporations, trusts, etc." (Resp. Op. Br., exhibit E.) Appellants claimed on their 2004 California returns a net operating loss (NOL) carryover of $238,460 based on 2003 combined losses. (Resp. Op. Br., exhibit F.)

Respondent issued Notices of Proposed Assessment (NPAs) for 2003 and 2004 on March 13, 2008, disallowing all of the claimed losses, asserting appellants had not shown they qualified for the losses under Internal Revenue Code (IRC) section 165, subsection (c)(2). (App. Op. Br.,

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[2] The history of where appellants lived as described herein appears to be based on a letter sent to respondent by appellants' representative, dated February 1, 2007. (Resp. Op. Br., exhibit C.) It appears both parties agree with these facts.

[3] Appellants' schedule E lists a "residential house" located in "Woodside, CA." The parties appear to agree that this is referencing the Property at issue in this appeal.

[4] According to line 23 of appellants' Schedule E for 2002, it appears as though the $74,147 loss from rental real estate was limited to $25,000. (Resp. Op. Br., exhibit D, p. 1.)

attachments, NPAs.) Respondent explained in the 2003 NPA that the claimed losses were denied because appellants did not use the Property as a business property and it was never placed in rental service.[5] (*Ibid*.) The adjustments made to appellants' 2003 return resulted in the elimination of the 2004 NOL carryover of $238,460.[6] (*Ibid*.) The NPAs proposed additional tax, accuracy-related penalties, and applicable interest for both 2003 and 2004.

Appellants protested the NPAs and a protest hearing was scheduled at appellants' request. Afterward, respondent affirmed the NPAs by issuing Notices of Action (NOAs) on February 23, 2010. This timely appeal followed.

<u>Contentions</u>

Appellants contend the Property was converted to income-producing property prior to its sale, and the claimed losses should therefore be allowed. Appellants assert they moved from the Property in June of 2002 and did not use it as a personal residence after that. (App. Op. Br., p. 3.) Appellants state they believed they would be able to rent the Property for enough to cover a substantial portion of the monthly costs, but that they were not able to rent the Property despite their listing of the property and best efforts to rent it. Appellants allege the sale of the Property happened quickly once they realized they could not rent the Property and needed to reduce their monthly output. (*Id*. at p. 3.) Appellants assert respondent's agents were provided with information showing their intention to convert the Property to an investment vehicle and rent it out when they vacated the premises.[7] (*Id*. at p. 2.)

Appellants indicate the furniture for the Property was initially placed in storage when they moved to the Menlo Park apartment, and then they moved it to their rental home in Woodside when

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[5] For 2003, respondent also adjusted appellants' individual retirement account (IRA) distributions because $350,000 was distributed in 2004. For 2004, respondent adjusted appellants' IRA distributions, adding $520,270 as taxable income received in 2004. Appellants do not appear to contest these adjustments. (App. Op. Br., attachments, NPAs.)

[6] The 2003 adjustments also caused a NOL adjustment of $1,250 carried over from 2004 to 2005 to be eliminated.

[7] The Board and FTB are separate and distinct agencies, and this appeal is an entirely new proceeding. Therefore, any information submitted to FTB at protest is not a part of this record unless the parties have provided it to the Board as well. Should appellants or respondent have additional information pertinent to the issues in this appeal that has not yet been submitted, such information should be submitted to the Board and opposing party at least 14 days prior to the oral hearing pursuant to California Code of Regulations, title 18, section 5523.6. Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879, MIC: 81, Sacramento, California, 94279-0081.

they relocated there. (App. Op. Br., p. 4.) Appellants allege that if they are not entitled to the loss from the sale of investment rental property, they should be entitled to the $61,179 rental property loss for 2003 and no additional tax should be due that year. (*Id*. at p. 3.) Appellants do not directly contend in their brief that the penalties should otherwise be abated if the Board were to find respondent is correct in disallowing the claimed losses.

Respondent contends appellants have failed to show error in the proposed assessments. Respondent asserts the Property was held for residential use and was not converted to income-producing use as appellants contend. Respondent asserts appellants have not provided any documentation to support their contention, other than a photocopy of an undated newspaper advertisement purporting to offer the Property for rent. (Resp. Op. Br., p. 3.) Respondent contends appellants must meet their burden of proof by presenting evidence supporting their contentions that they abandoned all use of the Property as a personal residence, attempted to generate revenues from the Property by offering it for rent, and did not place the Property on the market for sale immediately but only after it became clear it could not be rented. (*Id*. at p. 6.) Lacking such evidence, respondent contends appellants are not entitled to the claimed losses resulting from property sold as investment property.[8]

Respondent cites to tax court cases supporting its position which state that merely placing a property on the rental market is not sufficient to convert property to income-producing property when it is in fact never rented and eventually sold. (Resp. Op. Br., pp. 8-10, citing *McAuley v. Commissioner* (1976) 35 T.C.M. (CCH) 1236, and *Brinker v. Commissioner* (1975) 34 T.C.M. (CCH) 1054.) Respondent asserts these cases are influential and show that taxpayers who have provided far greater evidence are still found by the court to have not converted their residential property into income-producing property. (Resp. Op. Br., p. 10.)

Respondent asserts other adjustments made, including the allocation of Individual Retirement Account (IRA) income, are appropriate and not contested by appellants. Respondent also contends the assessment of the accuracy-related penalties is proper under R&TC section 19164. Respondent notes appellant-husband is an investment manager by profession and should therefore

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[8] When respondent denied the claimed losses from the sale of the Property, it allowed appellants to include home mortgage interest and property taxes as itemized deductions.

possess sufficient knowledge to determine if the Property was truly converted into investment property and knows that reporting phantom rental income during 2002 would mislead taxing authorities into thinking the Property was income-generating property. (*Id*. at p. 13-15.) Respondent asserts appellants are not entitled to penalty abatement based on substantial authority under IRC section 6662(d)(2)(B)(i) or adequate disclosure under IRC section 6662(d)(2)(B)(ii). Respondent also asserts appellants have not established reasonable cause under IRC section 6664(c). (Resp. Op. Br., pp. 14-16.) Therefore, respondent contends, appellants have not shown cause for the abatement of the penalties.

Applicable Law

Claimed Loss Deductions

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)

IRC section 165(a) provides, in part, that "there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."[9] IRC section 165(c) limits an individual's deduction for losses pursuant to IRC section 165(a) to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. IRC section 262 provides, in part, that "except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."[10]

A loss incurred by a taxpayer on the sale of his or her personal residence is not deductible except where prior to the sale the taxpayer has abandoned the use of the property as his or her personal residence and has converted it to profit-inspired use. (*Melone v. Commissioner* (1966) 45 T.C. 501, 505; Treas. Regs. section 1.165-9(a) and (b).) For a conversion of use to have occurred, a taxpayer's use of a

[9] The relevant portions of IRC section 165 have been incorporated into California law at R&TC section 17201.

[10] The relevant portions of IRC section 262 have been incorporated into California law at R&TC section 17201.

property would have to have shifted from a personal use to a business or profit-oriented purpose permitted under IRC section 165(c). (*Henry v. Commissioner* (1983) 46 T.C.M. (CCH) 186.) In *Newcombe v. Commissioner* (1970) 54 T.C. 1298, 1303, the Tax Court stated that to determine whether a personal residence had been converted to property held for the production of income, the court must determine the taxpayer's intent "in light of all the facts and circumstances." Merely offering the property for sale does not necessarily convert it into property held for the production of income, and mere offers to rent property should not be the focal point of the decision. (*Id*. at 1300-1301.) Placing property on the market for immediate sale, at or shortly after the time it is abandoned as a residence, will ordinarily be strong evidence that the taxpayer is not holding the property for postconversion appreciation in value. (*Id*. at 1302.) Under such circumstances, only a very exceptional situation will permit a finding that the taxpayer converted the property to income-producing purposes. (*Id*.)

Losses from the sale of personal use assets are not recognized for tax purposes, but losses from the sale of business and income-producing assets are deductible. (Int.Rev. Code, § 165; Treas. Regs. §§ 1.165-9(a) and (b).) If property is successfully converted from a personal use asset to an income-producing asset, the original basis for a loss and/or depreciation is the *lower* of the property's adjusted basis or fair market value on the date of conversion. (Treas. Regs. §§ 1.165-9(b)(2) & 1.167(g)-1; see *Grohse v. Commissioner* (1968) 27 T.C.M. (CCH) 220, 221.) Under this rule, taxpayers can only claim a loss on the amount of depreciation that occurred after the property was converted to an income-producing asset.

Accuracy-Related Penalty

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.)

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R&TC section 19164, subdivision (a), imposes an accuracy-related penalty by incorporating IRC section 6662, except as otherwise indicated. The penalty is equal to 20 percent of the portion of the underpayment to which that section applies. As it applies to this appeal, this penalty is imposed where the underpayment of tax is due to negligence or disregard of rules or regulations, or to any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) "Substantial understatement of income tax" means that "the amount of the understatement for the taxable year exceeds the greater of (i) 10 percent of the tax required to be shown on the return for the taxable year, or (ii) $5,000." (Int.Rev. Code, § 6662, subd. (d)(1)(A).)

Treasury regulation section 1.6662-3(b)(1) provides, in pertinent part, that the term "negligence" includes any failure to make a reasonable attempt to comply with the provisions of the federal revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return. That section further provides that "negligence" also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly. Treasury regulation section 1.6662-3(b)(2) defines "disregard" as including any careless, reckless, or intentional disregard. This section further clarifies that a disregard of the rules and regulations is "careless" if the taxpayer does not exercise reasonable diligence to determine the correctness of a position that is contrary to a rule or regulation. A disregard is "reckless" if a taxpayer makes little or no effort to determine whether a rule or regulation exists under circumstances which demonstrate a substantial deviation from a reasonable person's standard of conduct. Finally, a disregard is "intentional" if the taxpayer knows of the rule or regulation that is disregarded. However, taking a position contrary to a rule or regulation does not constitute a disregard if that position has a realistic possibility of being sustained on its merits. (*Ibid*.)

If an underpayment of tax is found to be due to negligence or disregard of the rules or regulations, or to any substantial understatement of income tax, the penalty may still be abated under the relevant statutes. IRC section 6662(d)(2)(B) allows for a reduction in the understatement amount for any portion of the understatement which is attributable to an item for which: (i) there is *substantial authority* for the manner in which the taxpayer treated it; or (ii) if a taxpayer provides *adequate disclosure* of the facts affecting an item's tax treatment and there is reasonable basis for the treatment. The substantial authority standard is objective and requires a substantial weight of authorities supporting the manner of treatment asserted compared to the weight of authorities supporting contrary treatment. (Treas. Reg. § 1.6662-4(d)(3).) Adequate disclosure requires proper substantiated (i.e., adequate books and records) and does not apply to treatment of an item for which there is no reasonable basis for that treatment. (Treas. Reg. § 1.6662-4(e)(2).)

In addition to the two above exceptions, IRC section 6664(c)(1), incorporated with exceptions by R&TC section 19164, subdivision (d), provides generally that no penalty shall be imposed under IRC section 6662 or 6663 with respect to any portion of an underpayment of tax if it is shown that there was reasonable cause for such portion and the taxpayer acted in good faith with respect to such portion. (See also Treas. Reg. § 1.6664-4(a).) To establish good faith reliance on the advice of a competent adviser, a taxpayer must show that he or she provided the return preparer with complete and accurate information and an incorrect return resulted from the preparer's mistake. (*Crigler v. Commissioner* (2003) 85 T.C.M. (CCH) 1091.)

STAFF COMMENTS

Claimed Loss Deductions

The parties appear to agree that appellants did not use the Property as their primary residence for the approximate nine months from when they moved out (June of 2002) to when they sold the property (March 14, 2003). The parties also agree that appellants received no rental income from the Property during this same time. Appellants provide assertions in their brief that the Property was intended to be treated as income-generating property when they vacated the premises and attempted to rent it. To support this claim, the record includes an unsigned letter from appellants' accountant and a photocopy of an undated newspaper ad stating, "$5500 Lovely Woodside hilltop / 4br 4ba. Call Karl: [number redacted]." (Resp. Op. Br., exhibits C, G.)

Appellants bear the burden in showing error in respondent's denial of their claimed deductions. Appellants need to show their intent regarding the Property shifted from a personal use to a business or profit-oriented purpose permitted under IRC section 165(c). Since the parties agree appellants did not live in the property after June of 2002 and sold the property in March of 2003, it does not appear they immediately placed the Property up for sale after they stopped using it as a primary residence. However, abandoning a property as a primary residence does not necessarily convert it into property held for the production of income. (See *Henry v. Commissioner*, *supra*; *Newcombe v. Commissioner*, *supra*, at p. 1303) Appellants should be prepared to offer more than mere assertions regarding their intent to convert the Property to income-generating property. Respondent lists types of evidence that appellants should provide to support their contention. (See Resp. Op. Br., pp. 3, 4.) Appellants should be prepared to discuss why the Board should not follow the example of the tax court cases provided by respondent, which state merely putting a property up for rent is not sufficient to convert it to income-producing property, and provide case law to the contrary.

Appellants state they did not have the Property appraised at the time of the alleged conversion from their primary residence to income-producing property. (App. Op. Br., p. 3.) The basis used to determine deductible loss on a converted investment property is the lower of the adjusted basis or appraised fair market value at the time of conversion, and not the original purchase price of the property. Should the Board decide appellants are entitled to the claimed losses from the sale of the Property, the parties should be prepared to discuss what the appropriate basis is to determine the deductible loss.

<u>Accuracy-related Penalty</u>

For 2003, the alleged underpayment of tax attributable to the penalty as reported by respondent is $4,259. This amount exceeds 10 percent of the required tax ($4,259),[11] but does not exceed $5,000, and therefore does not constitute a substantial underpayment of income tax. (Resp. Op. Br., p. 12.) Therefore, it appears respondent is imposing the $852 penalty for 2003 based on negligence or disregard of rules and regulations. Respondent contends appellants' reporting of "phantom rental income" to taxing agencies gave the false perception that the Property was income-producing property and generated significant losses, was negligent, and disregarded the relevant rules and regulations. (Resp. Op. Br., pp. 13-14.)

For 2004, the penalty has been imposed based on a "substantial understatement" of income tax. Respondent imposed the penalty on adjustment amounts on the 2004 NOA for the

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[11] Respondent provides both $4,937 and $4,259 as the amount of tax required to be shown on the return in various parts of its brief. (See, e.g., Resp. Op. Br., pp. 12, 15.) In the present facts, the difference is negligible. The first number represents the tax from the tax table according to the 2003 NPA, while the second number is total tax after exemptions. (App. Op. Br., attachments, NPA.)

eliminated NOL amount, taxable IRA distributions, and itemized deductions, and reduced the amount for the Schedule CA line 21C adjustments. Respondent did not include in the calculation of the penalty adjustments of other IRA distributions and itemized deductions that were also on the 2004 NOA. The amount respondent determined was "attributable to the penalty"[12] constituted approximately 54 percent of the adjustments for 2004.[13] (Resp. Op. Br., pp. 12-13.) Respondent should be prepared to explain why certain adjustments were included when calculating the penalty while others were not. The underpayment respondent determined was "attributable to the penalty," per its calculations, is $20,495, which exceeds both 10 percent of the required tax to be shown on the return ($38,098) and $5,000. (*Ibid*.) Therefore, if respondent's calculations are correct, imposition of the $4,099 penalty for 2004 is based on a substantial understatement and does not require a showing of negligence or disregard of rules and regulations.[14]

With respect to the penalty for 2004, appellants should address whether there was substantial authority for the resulting claimed losses (and if so, provide any such authority), and whether the penalties should therefore be reduced or abated accordingly. Appellants should also be prepared to discuss whether they believe adequate disclosure allows for the reduction or abatement of the penalties.

The parties should be prepared to discuss what amount, if any, of the penalties are appropriate if the Board decides any of the claimed losses should be allowed, but additional tax amounts remain based on other adjustments (e.g., taxable IRA distribution amounts).

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[12] Respondent uses the term, "attributable to the penalty," for adjustment amounts it has determined should be included in the calculation of the penalty. IRC section 6662, subsection (b), provides that the section applies to certain underpayments (those attributable to negligence or disregard of rules or regulations and substantial underpayments, for purposes of this appeal), and does not apply to other underpayments. It appears respondent's use of "attributable to the penalty" reflects underpayments to which respondent has determined IRC section 6662 applies.

[13] The adjustments for 2004 that are applicable to the penalty are: $238,460 in eliminated NOL; $170,270 in taxable IRA distributions; $25,681 in itemized deductions adjustments; and ($1,250) in Schedule CA line 21C adjustments for a total of $433,161. Adjustments of $372,058 in IRA distributions and itemized deductions are not applicable to the penalty, meaning 53.79 percent of the adjustments are attributable to the penalty. The total understatement of tax after all adjustments are considered is $38,098, and 53.79 percent of this amount is $20,495. (Resp. Op. Br., pp. 12-13.)

[14] The disputed adjustments for 2004 arise from the same disallowed claimed losses that create the disputed adjustments for 2003. Therefore, should the Board determine that adjustments need to be lowered or abated to the point where this penalty is no longer based on a substantial understatement of income tax, the same negligence or disregard analysis used for 2003 would then apply to the penalty for 2004 as well. (See generally Treas. Reg. § 1.6662-3(d).)