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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

9
10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **NOEL YI AND MEILING YI¹**) Case No. 479854
13

	<u>Year</u>	<u>Refund Denied</u>
	2005	\$76,294 ²

14
15 Representing the Parties:

16 For Appellants: Steven D. Dorough, CPA

17
18 For Franchise Tax Board: Delinda R. Tamagni, Tax Counsel

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20 **QUESTIONS:** (1) Whether appellants satisfied their burden of proof for increasing their cost basis in
21 a commercial property; and
22 (2) Whether appellants satisfied their burden of proof for increasing their cost basis in
23 a personal residence.

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25
26 ¹ Appellants reside in San Leandro, in Alameda County.

27 ² This is the amount respondent stated was denied pursuant to its Notice of Action on an Overassessment, Credit, or Refund,
28 issued (NOA) on December 23, 2008. (Respondent's Opening Brief (ROB) at pp. 1 and 4.) However, as explained below,
after various adjustments allowed by respondent, it appears the revised denied refund amount is now \$58,489. (Respondent's
Reply Brief (RRB) at pp 3-4.)

1 HEARING SUMMARY

2 Background

3 Appellants timely filed their 2005 joint return reporting the following:

4	Wages	\$72,000.00
5	California Adjusted Gross Income (AGI)	\$2,804,351.00
6	Deductions	\$482,139.00
7	Taxable Income	\$2,322,212.00
8	Tax Amount	\$211,903.00
9	Personal Exemption Credit	\$174.00
10	Dependent Exemption Credit	\$544.00
11	Mental Health Tax	\$13,222.00
12	Total Tax Liability	\$225,125.00
13	Withholding Credits	\$749.00
14	Withholding at Source	\$711,457.00
15	Original Refund Issued on June 13, 2006	\$489,810.71

16 (ROB, exhibit A at pp. 2-3 and exhibit B at p. 3.)

17 On August 28, 2006, appellants filed an amended 2005 California return reducing their
18 California AGI by \$800,120 and increasing their itemized deductions by \$45,788 for a refund claim of
19 \$87,128. (Appellants' Appeal Letter (AAL) dated January 14, 2009, schedule 1.)³ The change in AGI
20 was due to appellants' revised basis reporting on: (1) the sale of commercial property (the Broadway
21 property); and (2) the sale of their personal residence (the personal residence). The \$45,788 increase in
22 itemized deductions was due to the itemized limitation phase-out changes resulting from the reported
23 decrease in appellants' AGI.

24 On the amended return, appellants increased their cost basis in the Broadway property
25 from \$4,807,755 to \$5,801,952, stating that the change included prior suspended losses not deducted in
26 prior years. (AAL, schedule 1, Form 540X Attachment at p. 1.) Appellants stated that since the sale
27 was an installment sale, the current year difference was \$165,700. (*Id.*)

28 For the personal residence, appellants claimed that only the lot and selling costs were
previously included in the reported basis and that the basis should be increased by additional
construction costs of \$634,420. (*Id.*) Thus, when the \$165,700 change and \$634,420 change are added,

³ Respondent claims the return was filed on August 28, 2006 (ROB at p. 2); the return shows a signature date of August 23, 2006 (AAL schedule 1).

1 the resulting decrease in AGI is \$800,120. (*Id.*)

2 Respondent commenced an audit of appellants' refund claim on December 20, 2006,
3 requesting supporting documentation for the changes. (ROB at p. 2.) On January 13, 2007, appellants
4 provided a cost basis schedule for the personal residence and requested additional time to gather the
5 information regarding the Broadway property. (*Id.* ROB, exhibit C.) Respondent contacted appellants
6 on May 24, 2007, and stated that appellants had not supplied the documents to support the cost basis in
7 the Broadway property and requested the additional documentation by June 21, 2007. (ROB at p. 2.)
8 After a few extensions, on September 1, 2007, appellants provided a line-item schedule of expenses⁴ for
9 the personal residence and requested additional time for the supporting documentation for the Broadway
10 property (this line-item schedule will be referred to as the personal residence expense schedule). (ROB
11 at p. 3; AAL, schedule 20, also labeled as A1.29.)

12 On September 19, 2007, appellants provided a schedule for the Broadway property
13 showing a total of \$5,563,446, as opposed to the return basis of \$5,801,992, (this schedule will be
14 referred to as the Broadway expense schedule). (AAL, schedule 31, also labeled A1.37.) Appellants
15 explained they were having difficulty locating all of the expenses due to a recent change in bookkeepers.
16 (*Id.*) The Broadway expense schedule also provided line-item expense information.⁵ (AAL, schedule
17 31, also labeled A1.38.) On October 7, 2007, appellants provided a buyer's final closing statement from
18 when appellants purchased the Broadway property on October 1, 1999, and a seller's closing statement
19 for appellants' sale of the Broadway property on April 15, 2005. (AAL, schedule 32, also labeled as
20 A1.89 through A1.91.)

21 After reviewing the submitted information, in a letter dated October 19, 2007, respondent
22 requested: (1) a complete copy of appellants' federal 2005 return; (2) copies of invoices and/or cancelled
23 checks showing the address where work was done for 23 contractors or businesses listed in the
24 Broadway expense schedule (these vendors will be referred to as the Broadway vendors); (3) copies of
25 all Forms 1098 for mortgage interest paid in 2005; (4) documentation showing that appellants used the
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27 ⁴ I.e., showing line-item expense information, such as "Anderson Brothers Construction \$42,000."

28 ⁵ I.e., showing line-item expense information, such as "Alta Building Materials \$90.71."

1 personal residence as a principal place of residence for 2 of the 5 years prior to the sale; and (5) any
2 other documentation appellants believed were relevant to the examination. (AAL, schedule 84, also
3 labeled as A2.57.)⁶

4 In a letter dated September 14, 2007, respondent requested supporting documentation for
5 the personal residence expense schedule, including copies of contracts/invoices/paid checks for 14
6 items/vendors (hereafter the personal residence vendors) from the personal residence expense schedule
7 provided on September 1, 2007. (AAL, schedule 83, p. 2.)

8 Appellants provided a schedule listing all mortgage interest and the applicable Forms
9 1098 in a letter dated February 5, 2008. (Appellants' Reply Brief (ARB) exhibit A, also labeled
10 schedule A3.40.) Appellants spoke to respondent on this same date, where respondent again requested
11 copies of invoices or canceled checks showing where the work was done for the items listed on
12 appellants' schedules. (ROB at p. 3.)

13 In a letter dated April 22, 2008, appellants provided information regarding the Broadway
14 vendors, (AAL, schedule 35, also labeled as A4.20) pursuant to respondent's request letters of October
15 19, 2007, and February 29, 2008. In a letter dated September 28, 2007, appellants provided information
16 regarding the personal residence vendors pursuant to respondent's request letter of September 14, 2007.
17 (AAL, schedule 21, also labeled as A1.56.)

18 In a letter dated May 23, 2008, (AAL, schedule 87), respondent provided a list of
19 disallowed items for the two properties, which respondent states were disallowed because the documents
20 provided did not identify the location where the work was completed and requested appellants to submit
21 any additional documentation to support the cost basis for the two properties by June 20, 2008. (*Id.*;
22 ROB at p. 3.)

23 On October 21, 2008, respondent issued its Audit Position Letter (ROB at p. 4; AAL,
24 schedule 88). This letter indicated respondent was not proposing a change to appellants' investment
25 interest expense. (ROB at p. 4; AAL, schedule 88 at p. 1.) With respect to the Broadway property,
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27 ⁶ Respondent, in a later document request dated February 29, 2008, requested copies of paid invoices, cancelled checks, or
28 signed contracts showing the dates and address where the work was done for 21 of the Broadway vendors. (AAL, schedule
35 at page A4.22.)

1 respondent determined there was a gross increase in taxable gain of \$1,013,126 over the amount
2 reported on appellants' original return (i.e., \$2,540,569 gain per the audit minus \$1,527,443 gain
3 reported on the original return). (AAL, schedule 88 at p. 2.) Respondent concluded that since
4 appellants reported on the installment method, the net increase was \$331,100. (*Id.*) With respect to the
5 personal residence, respondent concluded that appellants' acceptable documentation increased
6 appellants' basis by \$288,369. (*Id.*) Since appellants' amended return reported a basis increase of
7 \$634,420, respondent proposed an adjustment of appellants' taxable income, per the amended return, in
8 the amount of \$346,051 (i.e., \$634,420 minus \$288,369.) (*Id.*)

9 Also in respondent's October 21, 2008 Audit Position Letter, respondent states that
10 appellants cited the *Cohan* Rule, (established in *Cohan v. Comm'r*, (2d Cir. 1930) 39 F.2d. 540 discussed
11 *infra*), in letters sent to respondent on July 9, 2008,⁷ and July 10, 2008,⁸ for the proposition that the
12 information submitted for the two properties should be accepted. (AAL, schedule 88 at p. 8.) In
13 response, respondent indicated that under the *Cohan* Rule, a court could approximate a deduction where
14 a taxpayer has failed to prove the amount through inadequate records, but that courts have refused to
15 apply the *Cohan* Rule where a taxpayer has offered no evidence that would provide a basis on which to
16 make a reasonable estimate. (*Id.*) Thus, respondent stated that a significant percentage of the receipts
17 were rejected due to the fact that they did not identify the location for which materials were provided or
18 services performed. (*Id.*) Respondent concluded that in applying the reasonable and credible standard
19 established in *Cohan v. Comm'r, supra* and *Zeidler v. Comm'r*, 1997 (7th Cir. 1997) 132 F. 3d. 37,⁹
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21 _____
22 ⁷ See ARB at exhibit page number DEC 2008/AUD:00657 for a copy of this letter. In this letter, appellants stated, "There is a
23 long-standing case, *Cohan*, where the court is allowed to estimate the amount of taxpayer's expenses, which normally relates
24 to oral testimony. We have written records that show expenses being incurred." (ARB at exhibit page number "DEC
25 2008/AUD:00658")

26 ⁸ See ARB at exhibit page number DEC 2008/AUD:00659 for a copy of a letter from appellants sent on this date.

27 ⁹ Respondent's auditor provided the following citation for *Zeidler v. Comm'r*, "AFTR 2d 97-7966 (132 F. 3d 37) 11/26/1997."
28 In LEXIS, at "132 F. 3d 37", Board staff identified language stating "Notice: Decision Without Published Opinion" which
identifies *Zeidler v. Comm'r* as an appeal from the Tax Court, which the Seventh Circuit affirmed, and that it was reported in
full text format at 1997 U.S. App. LEXIS 33750. Following that LEXIS link, Board staff found an order of the Seventh
Circuit containing more detail regarding the facts of the case, which, in addition to the LEXIS citation used, provided the
following additional citations, "98-1 U.S. Tax Cas. (CCH) P50,101; 80 A.F.T.R.2d (RIA) 7966." Board staff is not sure
whether *Zeidler* should be treated as an unpublished order of the Seventh Circuit or as a published case. Nonetheless, its
application of the *Cohan* Rule will be discussed *infra*.

1 documentation that does not identify the location for which materials were provided or services were
2 performed should not be considered reasonable and credible proof of expenses incurred. (*Id.*)¹⁰

3 On December 23, 2008, respondent issued its Notice of Action on an Overassessment,
4 Credit, or Refund (NOA) which revised appellants' tax liability as follows:

Taxable Income Per Amended Return	\$1,476,304.00
Audit Adjustments	
Increase in Installment Gain for Broadway Property	\$331,100.00
Increase in Capital Gains for Personal Residence	\$346,051.00
Itemized Deduction Phase-out	\$63,570.00
Revised Taxable Income (per Audit)	\$2,217,025.00
Revised Total Tax	\$202,121.00
Mental Health Services Tax	\$12,170.00
Total Tax (per Audit)	\$214,291.00
Previously Paid	\$225,140.30
Overpayment	\$10,849.30
Interest Allowed	\$2,329.63
Credit Applied to 2006	\$613.97
Amount Refunded ¹¹	\$12,564.96

14
15 (AAL, schedule 89.) Since appellants' amended return identified an overpayment of \$87,128
16 respondent's overpayment calculation of \$10,849.30 constituted a refund denial in the amount of
17 \$76,278.70. This timely appeal followed.

18 Upon receipt of appellants' appeal letter, respondent contacted appellants stating it would
19 consider additional documentation not submitted during the audit process. (ROB at p. 4.) Between May
20 2009 and August 2009, appellants submitted additional documentation as evidence of improvements
21 made to the Broadway property and personal residence. (Appellants' Additional Information received
22 May 22 and 23, 2009; June 18, 2009; August 4, 2009; and August 11, 2009.) Respondent reviewed this
23 documentation and concluded some of the documents identified the location of where the work was
24 completed. These changes resulted in an additional overpayment amount of \$11,747.70 (i.e., a revised
25 overpayment of \$22,597.00 minus the \$10,849.30 previous overpayment allowed on December 23,
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27 ¹⁰ The auditor also cited *Cohan* and *Zeidler* in its Audit Issue Section letter, dated October 3, 2008. (ARB, found on exhibit
28 pages identified as "DEC 2008/AUD:00769", "DEC 2008/AUD:00774"; and "DEC 2008/AUD:00778.")

¹¹ Respondent refunded this amount on December 19, 2008. (ROB, exhibit B, p. 3.)

1 2008.) (ROB at p. 5.) Finally, after reviewing additional documentation and appellants' contention with
2 respect to the \$18,059 interest expense (*see infra* footnote 12) respondent recalculated the allowable
3 portion of the refund to be \$28,639. (RRB at p. 3.) Thus, it appears to Board staff that the remaining
4 amount in dispute is the denied refund amount of \$58,489 (i.e., \$87,128 minus \$28,639).

5 Contentions

6 Appellants' Contentions¹²

7 *The Personal Residence*

8 With respect to the basis on the personal property, appellants claim respondent
9 overlooked \$230,485.64 in expenses from the information provided. (AAL at p. 4.) Appellants claim
10 the information they submitted on September 1, 2007, shows \$636,817.64 in improvement costs. (*Id.*;
11 AAL, schedule 20). Appellants claim respondent's auditor subsequently requested documentation from
12 "some of the items (but not all) from the September 1 list...." (AAL at p. 4.) Appellants claim that from
13 this list \$230,485.64 in construction costs were never requested and therefore omitted as part of the
14 personal residence basis. (*Id.*) Appellants claim they are entitled to this additional basis and that it is
15 irregular of an auditor to deny a deduction for information never requested. (ARB at p. 3.)

16 Appellants claim "the first state return was filed prematurely because large amounts of
17 state income taxes (\$711,457) had been withheld on several property sales and the taxpayers wanted
18 money back before they could gather complete and accurate information for the sales of their home...."
19 (AAL at p. 4.) Appellants claim the original return was filed only showing the lot costs and selling
20 expenses. (*Id.*) Appellants claim the personal residence is a 1995, custom built, one of a kind three-
21 story structure with 6,446.86 feet of living space, a two-car garage, 2 fireplaces, seven bedrooms, five
22 bathrooms, one kitchen, one dining room, and one living room on a 30,961 square foot lot. (*Id.*)
23 Appellants claim that respondent's approach of only allowing \$287,079 in construction costs, when the
24 lot price and selling expenses alone were \$238,938 does not make any sense. (*Id.*) Appellants claim the
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26 ¹² In appellants' appeal letter, they originally contended that during the audit they discovered an investment expense item in
27 the amount of \$18,059 relating to the rental and home mortgage expenses was omitted from the returns as filed. Appellants
28 claim respondent's auditor accepted the figures provided and indicated that the taxpayers would be allowed an additional
deduction for \$18,059. (AAL at p. 3.) This issue was ultimately conceded by respondent and is apparently no longer an
issue in this appeal. (RRB at p. 3; and Appellants' Additional Reply Brief (AARB) at p. 1.)

1 City of Berkeley's Planning and Development department placed a new single family dwelling cost at
2 \$89 per square foot in 1994 (*Id.* and AAL, schedule 26), while respondent's allowance of \$287,089
3 would result in a cost valuation of \$44.53 (\$2,872,079/6,446.86 sq. ft.). (AAL at p. 4.) Appellants also
4 note per the 2008 National Construction Estimator (AAL, schedule 27), the 1994 national construction
5 costs for a new single family home was \$64.33 per square foot. (AAL at p. 5.) Thus, appellants contend
6 the total cost for the sale of their home is \$875,755.64. (*Id.*)

7 *The Broadway Property*

8 Appellants appear to contend that respondent's auditor erred in calculating the adjustment
9 related to the tax calculation on the installment sale income from the Broadway property. (*Id.*)
10 Appellants contend the original return showed a sale price of \$6 million with an adjusted basis of
11 \$4,472,557 for a gain of \$1,527,443. (*Id.*) Appellants claim that on the installment method \$254,600 of
12 this gain was reported on the original 2005 return, but that respondent's auditor changed "the 2005
13 number to \$420,000 but added \$331,100 (420,000 – 88,900) to the taxpayers' income." (*Id.*) Appellants
14 claim that if one were to assume the \$420,000 gain was correct, the change in income would be
15 \$165,400 (i.e., \$420,000 - \$254,600). Thus, appellants contend the auditor made an error of \$165,700
16 because it used "the gain show[n] on the amended return versus the figure on the original return." (*Id.*)¹³

17 Appellants claim respondent's auditor disallowed \$1,154,263 per the auditor's
18 October 21, 2008 letter (AAL, schedule 88, pp. 5-6) and omitted \$787,917.43 in costs for which
19 documentation was not requested. (AAL at p. 6.) Appellants claim that respondent's request letter of
20 October 19, 2007, for additional information from the Broadway vendors (AAL, schedule 84, also
21 labeled as schedule A2.57), did not include a request from all of the vendors. Appellants contend the
22 contractor and vendor invoices per the auditor amounted to \$3,004,673 (AAL, schedule 88, pp. 5 and 6)
23 and of that amount, respondent's auditor disallowed \$1,154,263. (AAL at p. 6.) Appellants contend this
24 documentation actually showed \$3,186,138.70 in costs. (*Id.*) Appellants stated they submitted
25 cancelled checks for most of the documentation, but that respondent's auditor disallowed the deduction
26 for any check that did not have a location written on it. (*Id.*) Appellants claim these checks were for the
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28 ¹³ Board staff is not sure of the technical installment sale miscalculation appellants are alleging occurred. Therefore, at the oral hearing, appellants should be prepared to explain this contention more fully.

1 Broadway property, but that they "simply did not write the location on all of the checks." (*Id.*)

2 Appellants contend the Broadway property is believed to have been constructed in 1905
3 and incurred extensive damage during the 1989 Loma Prieta earthquake. (AAL at p. 7.) Appellants
4 claim that for safety reasons only the first floor of the eleven floors was being leased from 1989 through
5 the date of sale in 2005. (*Id.*) Appellants claim they purchased it "as is" in 1999 for \$800,000.
6 Appellants contend that when the building was appraised in May 2003, the report (AAL schedule 38 at
7 p. 3.) indicates that \$1.2 million was spent on seismic retrofitting work and the total expenses for the
8 renovation were estimated to be \$4 million. (*Id.*) Appellants state the renovation project encountered
9 several problems, including retro fitting and elevator issues. (*Id.*) Issues of whether asbestos was
10 present and financing caused project delays and the project was never completed. (*Id.*) Appellants
11 claim they have not located all of the expenses involved, and believe the building was sold at a loss.
12 (*Id.*) The gain reported was based on the records appellants could locate. (*Id.*) Appellants contend
13 respondent's conclusion that their profit is \$2,540,569 on a \$6 million sale of a renovated building over
14 90 years old and purchased with earthquake damage is not probable. (*Id.*) For an example, appellants
15 provided information regarding a different eleven story building, built in 1968, in the City of Hayward
16 that was purchased in 1998 for \$1.5 million, for which renovation was not completed because it was too
17 expensive to convert the old building. (*Id.*; schedule 45.) In sum, appellants claim the total cost for the
18 Broadway property on the amended return is correct and no adjustment is necessary. (*Id.*)

19 *Appellants' Additional Appeal Submissions*

20 Appellants' contentions above were made in appellants' appeal letter. Appellants
21 subsequently provided additional documentation as requested by respondent during this appeal. On
22 May 22, 2009, and on May 23, 2009, appellants provided copies of various documents indicating that
23 they constitute additional improvement invoices for the personal residence. On June 18, 2009,
24 appellants provided source documentation indicating that it supported \$15,164.71 in improvements for
25 the personal residence. On August 4, 2009, appellants provided source documentation for the Broadway
26 property indicating that it supported \$4,581.42 in improvement costs.

27 After respondent filed its opening brief, appellants filed a reply brief on January 4, 2009,
28 contending that they provided the cost basis information on the personal residence when requested.

1 (ARB at p. 2.) Appellants contend respondent's position implies that since appellants owned 21 rental
2 properties in 2005, appellants "were providing false information...." (*Id.*) Appellants contend that there
3 is no requirement for an address to be written on the documentation and that taking respondent's logic
4 further, since no address exists on the checks submitted, they are useless in that they "can't be used for
5 any address improvement." (*Id.*) With respect to the personal residence, appellants contend they
6 provided construction estimates to build their home that were geographically specific and related to the
7 year of construction. (*Id.*) Appellants claim they are not arguing (according to respondent's position)
8 that the estimation costs are reasonable based on fair market value data and the size of the home, but
9 rather they contend legitimate documentation was provided for the costs which was rejected because it
10 did not contain an address. (ARB at p. 3.) Appellants contend the building costs supported the
11 documentation provided. (*Id.*) Appellants claim that respondent is not following its own publication
12 (FTB Publication 1015B, "Frequently Asked Questions About Your Tax Audit") because respondent is
13 not "working with" appellants to obtain "alternative information." (ARB at p. 4.) In sum, appellants
14 contend respondent has disallowed legitimate documentation, ignored cost/construction estimates from
15 two different sources, denied deductions for information never requested and did not work with them to
16 obtain alternative documentation. (*Id.*)

17 Appellants reiterated the above contentions regarding the Broadway property, i.e.,
18 appellants provided the requested documentation, documentation without an address was rejected,
19 expenses were denied for information never requested by respondent's auditor, and respondent failed to
20 work with appellants to obtain alternative documentation. (*Id.* pp. 3-6.)¹⁴

21 Respondent's Contentions

22 Respondent contends appellants have not carried their burden in proving they are entitled
23 to the claimed adjusted bases for the two properties as reported on their amended return. (ROB at p. 5.)
24 Respondent, citing Internal Revenue Code (IRC) sections 1011, 1012 and 1016, contends that the
25 adjusted basis is the cost of the property, plus expenses incurred in connection with its purchase and may
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27 ¹⁴ Appellants also contend that refinancing costs were improperly disallowed, with an address shown, because the refinancing
28 was not on the closing (escrow) document. Appellants contend refinancing is self-explanatory, that "it's to pay off an old
loan!" (ARB at p. 5.)

1 be increased for improvements and other charges to capital. (ROB at p. 6.)

2 Respondent contends that its determinations are presumptively correct (citing "*Todd v.*
3 *McColgan* (1949) [89] Cal. App. 2d. 509, 514") and that the burden is on the taxpayer to prove
4 otherwise. Respondent also contends that deductions are a matter of legislative grace and that the
5 burden is on the taxpayer to prove she is entitled to the deductions claimed (citing *New Colonial Ice, Co.*
6 *v. Helvering* (1934) 292 U.S. 435, 436). (*Id.*)

7 Respondent states that the fact that it may be difficult, if not impossible, to substantiate
8 any claimed deduction does not relieve the taxpayer of the burden (citing *Burnet v. Houston* (1931) 283
9 U.S. 223). (*Id.*) Respondent also contends that when a taxpayer fails to provide documentation in his
10 favor, the evidence is presumptively considered unfavorable to his case (citing *Appeal of Don A.*
11 *Cookston*, 83-SBE-048, Jan. 3. 1983.) (*Id.*) Respondent argues that in the absence of un-contradicted,
12 credible, competent and relevant evidence showing respondent's determinations are incorrect, they must
13 be upheld (citing *Appeal of Oscar D. and Agatha Seltzer*, 80-SBE-154, Nov. 18, 1990). (*Id.*)

14 Respondent contends that when appellants filed their amended tax return, they estimated
15 the amount of capital improvements made to their properties in order to calculate their cost basis in the
16 two properties. (*Id.*) Respondent states that appellants provided schedules listing the improvements,
17 canceled checks, invoices and receipts, but that at the time they owned these properties at issue in this
18 appeal, they also owned 21 rental properties. (*Id.*) Respondent states that "[d]ue to appellants' extensive
19 property ownership, respondent only accepted documentation that identified the location of where the
20 improvements took place." (*Id.*)

21 With respect to what respondent refers to as appellants' appraisal and construction
22 estimates, respondent contends the documents provided do not provide a rational basis for appellants'
23 expense estimates because they focus on the properties' fair market value at the time the properties were
24 sold. (*Id.*) Respondent contends that although fair market value is sufficient to prove a property's value,
25 it is insufficient evidence of an owner's adjusted basis, that is, that fair market value does not distinguish
26 how much of the value is attributable to capital improvements versus increased land value. (*Id.*) As a
27 result, respondent contends the documentation provided does not provide a basis on which a reasonable
28 estimate could be made. (*Id.*) In sum, respondent contends that appellants' failure to keep detailed

1 records was a matter of their own neglect and that the estimate that is required as a result thereof should
2 weigh against appellant. (ROB at p. 7.)

3 With respect to additional documentation submitted by appellants in their reply brief,
4 respondent contends that of the 80 additional receipts in support of the personal residence's basis, it
5 accepted a builder's inspection receipt for \$201.25, but disallowed the rest. (RRB at p. 1.) Respondent
6 stated that some of the receipts were illegible and that others were clearly outside the scope of capital
7 expenditures (RRB at p. 2 and exhibit C.) Respondent states for example, one receipt was from Office
8 Max where appellants claimed the purchase of "How to Settle [with the] IRS for \$16.99 and "Asset
9 Protection" for \$23.96 was provided as evidence of cost basis in the personal property. (*Id.*, exhibit D.)
10 Respondent also contends numerous receipts for the purchase of non-capital improvements, such as
11 "light bulbs, lamps, tooth brush tumblers, paper towel holders, sconces, and office supplies such as pens,
12 labels, copies, a two-hole punch and a cordless phone." (*Id.*, exhibit E.) In addition, respondent states
13 that appellants submitted receipts listing "Rafael Hernandez" as the payor, but did not provide any
14 information as to his role in making improvements to the personal residence. (*Id.*, exhibit F.)

15 Respondent states that one receipt listed a customer address on "...Davis Street" which is
16 not appellants' address. (*Id.*, exhibit G.)¹⁵

17 Respondent states that appellants submitted many receipts showing proof of purchase of
18 supplies at various home improvement stores, but no contract information was provided to show how
19 these items were used and that without more, respondent could not determine whether such expenses
20 were for repairs rather than improvement, or for another reason. (*Id.*)

21 After reviewing additional documentation and agreeing with appellants' increase in
22 interest expenses, respondent agreed to allow \$28,639 of appellants' total refund claim of \$87,128.
23 (RRB at p. 3.)¹⁶

24 ///

25 _____
26 ¹⁵ In response, appellants contend the Davis address is the address for the dump site for San Leandro, i.e., where construction
27 waste was dumped. (AARB at p. 2.)

28 ¹⁶ Respondent's auditor's contentions regarding *Cohan v. Comm'r, supra* and *Zeidler v. Comm'r, supra* were discussed above
in footnotes 7, 8, and 9 and in the accompanying text.

1 Applicable Law

2 Basis Rules

3 California's basis rules conform to the federal rules for determining the cost basis of
4 property for the purpose of determining the gain on the sale of such property. (Rev. & Tax. Code,
5 § 18031.) Internal Revenue Code (IRC) section 1012 generally provides that the basis of property is its
6 cost basis, and IRC section 1016 generally provides that basis may be increased for expenditures,
7 receipts, or losses or other items properly chargeable to capital.

8 General Burden of Proof Rules

9 It is well settled that a presumption of correctness attends respondent's determinations as
10 to issues of fact and the taxpayer has the burden of proving such determinations erroneous. (*Appeal of*
11 *Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) This presumption is a rebuttable one and
12 will support a finding only in the absence of sufficient evidence to the contrary. (*Id.*) Respondent's
13 determination cannot, however, be successfully rebutted when the taxpayer fails to present
14 uncontradicted, credible, competent, and relevant evidence to the contrary. (*Id.*) To overcome the
15 presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible
16 evidence to support his assertions. (*Id.*) When the taxpayer fails to support his assertions with such
17 evidence, respondent's determinations must be upheld. (*Id.*) A taxpayer's unsupported assertions are not
18 sufficient to satisfy his burden of proof. (*Appeal of James C. and Monablanche A. Walshe*, 75-SBE-
19 073, Oct. 20, 1975.)

20 The Cohan Rule

21 Where a taxpayer has established that he has incurred an expense for which a deduction
22 may properly be claimed, but is unable to document the exact amount of the expense, the Board may
23 make a reasonable estimate of the deduction in certain circumstances, "weighing heavily" against the
24 taxpayer whose inexactitude is of his own making. The Board has declined to make such estimations
25 and disturb respondent's determinations where respondent has disallowed only a portion of the claimed
26 deductions. This rule is referred to as the *Cohan* Rule after the case from which it was articulated and
27 explained:

28 In the production of his plays Cohan was obliged to be free-handed in entertaining actors,
employees, and, as he naively adds, dramatic critics. He had also to travel much, at times

1 with his attorney. These expenses amounted to substantial sums, but he kept no account
2 and probably could not have done so. At the trial before the Board [of Tax Appeals] he
3 estimated that he had spent eleven thousand dollars in this fashion during the first six
4 months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth,
5 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The
6 Board [of Tax Appeals] refused to allow him any part of this, on the ground that it was
7 impossible to tell how much he had in fact spent, in the absence of any items or details.
8 The question is how far this refusal is justified, in view of the finding that he had spent
9 much and that the sums were allowable expenses. Absolute certainty in such matters is
10 usually impossible and is not necessary; the Board should make as close an
11 approximation as it can, bearing heavily if it chooses upon the taxpayer whose
12 inexactitude is of his own making. But to allow nothing at all appears to us inconsistent
13 with saying that something was spent. True, we do not know how many trips Cohan
14 made, nor how large his entertainments were; yet there was obviously some basis for
15 computation, if necessary by drawing upon the Board's personal estimates of the
16 minimum of such expenses. The amount may be trivial and unsatisfactory, but there was
17 basis for some allowance, and it was wrong to refuse any, even though it were the
18 traveling expenses of a single trip. It is not fatal that the result will inevitably be
19 speculative; many important decisions must be such. We think that the Board was in
20 error as to this and must reconsider the evidence.

21
22 (*Cohan v. Comm'r*, *supra*, at 543-44.)

23 Although the *Cohan* Rule was articulated with respect to estimating deductions, the U.S.
24 Tax Court relied on it for purposes of estimating the basis of property with respect to improvements. In
25 *Minchew v. Comm'r*, (USTC 1930) 12 T.C.M. (CCH) 1107, the U.S. Tax Court stated:

26 No explanation was offered on [the taxpayer's] return, or at the trial, of how he arrived at
27 a basis of \$16,906.49 for determining gain. Neither did he contest respondent's
28 allowance for depreciation on the building, and we have found that amount to be correct.
Petitioner had no records of his alleged capital improvements; and his testimony, as well
as that of his brother-in-law, left the exact amount expended for such improvements
unascertainable. Doing the best we can with this record and taking into consideration the
rule of *Cohan v. Commissioner*, 39 Fed. (2d) 540 (C.A. 2, 1930), we have found that
capital improvements, together with a paving assessment, amounted to \$11,064.22. That
amount will be added to the original cost of \$7,500 in computing the long-term capital
gain on the sale of the property, with such adjustment for allowed or allowable
depreciation of the \$3,000 capital improvement made in 1930 as may be necessary.

29 In *Appeal of Henrietta Swimmer, Executrix, et. al.*, 63-SBE-138, decided on
30 December 10, 1963, the Board considered the *Cohan* Rule with respect to respondent's disallowance of
31 portions of expenses claimed for automobile, laboratory, advertising postage, travel and entertainment
32 expenses. In that appeal, the taxpayer did not retain records of the expenditures, but based the expenses
33 on year-end estimates. The taxpayer contended she was entitled to a full deduction under the *Cohan*
34 Rule. In response to this contention the Board stated:

35 The reliance on that case is misplaced for the *Cohan* rule merely permitted the deduction
36 of a reasonable portion of unsubstantiated expenses. Here only a portion of appellant's
37 deductions have been disallowed. Generally speaking, respondent permitted appellant to

1 deduct 50 percent of the amounts he was unable to substantiate. Where respondent has
2 allowed part of a deduction, we will not alter its determination unless facts appear from
3 which a different approximation can be made. [Citations omitted.] We perceive no such
4 facts in the record before us.

5 In *Appeal of California Steel, Inc.* 2003-SBE-001-A, July 9, 2003, the Board in an
6 opinion on a petition for rehearing considered application of the *Cohan* Rule. In that appeal, the
7 taxpayer argued that its substantiation of 92 percent of its claimed costs was sufficient for respondent to
8 proceed as if adequate documentation had been provided for the remaining costs. The Board cited a
9 portion of the language quoted above from *Appeal of Henrietta Swimmer, Executrix, et. al., supra* and
10 stated that:

11 Our prior discussion of the *Cohan* Rule indicates our reluctance to disturb respondent's
12 determinations involving unsubstantiated amounts without independent facts on which to
13 base a different finding. Given no independent facts have been provided to us, we refuse
14 to alter respondent's determination regarding unsubstantiated costs.

15 In *Zeidler v. Comm'r, supra*,¹⁷ among the many deduction/expenses at issue were
16 straight-line deductions claimed by the taxpayers on rental property. In reviewing this issue, the
17 Seventh Circuit commented on the Tax Court's approach:

18 The Zeidlers' 'proof' of the purchase price consisted in large measure of ambiguous,
19 incomplete and unauthenticated documents, including three checks totaling \$4,702, all of
20 which bear notations that the checks are for taxes. This documentation was
21 supplemented by the Zeidlers' own oral testimony. The [Tax] court concluded, 'No
22 credible documentary evidence was presented that would satisfy the Court that petitioners
23 paid any amounts to acquire the property.' Nonetheless, because the [Tax] court was
24 satisfied that the Zeidlers held title to the property, that they had incurred some
25 expenditures related to the property, and had provided some basis on which to estimate
26 those expenses, the Tax Court applied the rule first set out in *Cohan v. Commissioner*, 39
27 F.2d 540, 543-44 (2d Cir. 1930), and estimated depreciation based on the credible
28 evidence presented.

(*Zeidler v. Comm'r* at p. 6.) When the Zeidlers questioned the Tax Court's approach on appeal before
the Seventh Circuit, the Seventh Circuit stated:

The Zeidlers have questioned the depreciation allowance permitted by the Tax Court, but
the court was under no obligation to guess or estimate their deductions based on
insufficient evidence: without proof, 'relief to the taxpayer would be 'unguided largesse.'
[Citations Omitted] Moreover, the [Tax] court was best situated to assess the credibility
of the witnesses and weigh the conflicting evidence concerning the amount paid for the
property. A review of the record does not suggest that the [Tax] court's resolution of the
conflict was clearly erroneous.

¹⁷ See *supra* footnote 9 and accompanying text.

1 (*Zeidler v. Comm'r* at pp. 6-7.) In discussing other expenses that the Tax Court disallowed,
2 related to travel costs, including meals, lodging and auto-related expenses purportedly incurred
3 in the maintenance of residential rental property, the Seventh Circuit noted that the taxpayers
4 produced computer spreadsheets compiled at the end of the year that were "unsupported by
5 receipts, bills or other original documentation." (*Zeidler v. Comm'r* at p. 5.) With respect to the
6 Tax Court's disallowance of these deductions, the Seventh Circuit stated, "the [Tax] court's
7 factual determination that the Zeidlers failed to produce evidence sufficient to support their
8 deductions is not clearly erroneous." (*Id.*)

9 STAFF COMMENTS

10 Appellants appear to contend that the remaining documentation (purportedly showing the
11 bases of the Broadway property and the personal residence), which respondent has not accepted based
12 on lack of an address, or illegibility, should nevertheless be allowed as demonstrating the amount of
13 capital expenditures made on these properties. It is not clear whether appellants have adequately
14 explained why they are unable to produce contracts for the improvement work completed on the
15 properties that would demonstrate the amount of the improvement costs they actually incurred. Where a
16 taxpayer establishes to the Board's satisfaction that he has incurred costs (for capital improvements), but
17 he cannot establish the exact amount of the alleged improvements, the Board may estimate those
18 amounts, "weighing heavily" against the taxpayer whose inexactitude is of his own making. (See
19 *Appeal of David and Goldie Krechman*, 86-SBE-078, Apr. 9, 1986.)

20 However, where respondent has disallowed only a portion of the claimed deductions, the
21 Board has declined to apply the *Cohan* rule to disturb respondent's determinations. Here, respondent has
22 allowed the amounts for which appellants have been able to provide documentation for costs identifying
23 the improved property. Thus, the parties may wish to discuss at the oral hearing whether the *Cohan* rule
24 is applicable here, where respondent has already allowed some of the claimed improvements. If so, the
25 parties should discuss whether: (1) appellants have established that they made the claimed capital
26 improvements such that the Board may make an estimation of the capital improvement amounts and
27 appellants' bases in the properties; and (2) under the facts and evidence submitted in this appeal (i.e.,
28 where appellants own multiple properties and the checks/invoices provided in support do not

1 specifically identify the address of the properties at issue, but where non-addressed checks, cost
2 estimates or other estimates have also been provided), whether appellants have submitted "independent
3 facts" upon which the Board may make such an estimation.

4 In this regard, staff notes that some of the documentation submitted appears to be for
5 items that were not properly chargeable to capital under IRC section 1016, such as books, copies, a two-
6 hole punch, etc. Thus, at the oral hearing, appellants will have the burden of proof in demonstrating that
7 their adjusted bases should be increased by specific expense amounts claimed for the two properties
8 involved and that such expenses were properly chargeable to capital. If the Board determines that
9 appellants have not satisfied this burden, either directly through competent and relevant evidence,¹⁸ or
10 indirectly through evidence and the use of the *Cohan* Rule (if applicable), then the Board could move to
11 sustain respondent's action.

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26 ¹⁸ Board staff suggests that given: (1) the myriad of receipts/invoices/cancelled checks provided by appellants in multiple
27 submissions throughout the audit and this appeal; and (2) the fact that some expenses were subsequently allowed and
28 disallowed during this appeal, appellants may wish to provide a lead schedule for both of the properties identifying the
remaining disallowed expenses and tying the disallowed line item expense amounts to the supporting
receipt/invoice/canceled check. If appellants choose to make such a submission for the oral hearing, it should be sent to
Claudia Madrigal, Board Proceedings Division, Board of Equalization. P. O. Box 942879 MIC: 80, Sacramento, CA 94279-
0080 at least 14 days prior to the oral hearing date.