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

10 In the Matter of the Appeals of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEALS**
12 **ALAN R. YOUNG AND LISA E. YOUNG;**) Case No. 554473
13 **LESTER YOUNG AND BEVERLY YOUNG¹**) Case No. 554480

<u>Appellants</u>	<u>Case Nos.</u>	<u>Years</u>	<u>Proposed Assessments</u>
Alan R. & Lisa E. Young	554473	2003	\$ 75,874
Lester & Beverly Young	554480	2003	\$146,293

17 For Appellants: Martin Belak-Berger, CPA
18 For Franchise Tax Board: Susanne E. Coakley, Tax Counsel

20 CONSOLIDATED APPEALS

21 These consolidated appeals are made pursuant to section 19045, of the Revenue and
22 Taxation Code (R&TC) from the actions of the Franchise Tax Board (FTB or respondent) on each
23 appellant's protest of the respective proposed assessment.

24 QUESTION: Whether appellants are required to recognize income as a result of a partnership's
25 liquidation.

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28 ¹ Each appellant lists an address in Los Angeles County.

1 HEARING SUMMARY

2 Background

3 These consolidated appeals arose from determinations by the FTB that appellants owed
4 tax as a result of their winding up their general partnership, Alesco Development Company Partnership
5 (Alesco), formed by Alan R. Young (“Alan”) and Lester Young (“Lester”) (partners). Alan and Lester
6 were partners in Alesco for the 2003 tax year. Alan held a 20 percent partnership interest and Lester
7 held the remaining 80 percent partnership interest. (FTB OB, p 1.)

8 Alan² – Audit and Appeal

9 Alan received federal and state Schedule K-1s showing that he had a deficit capital
10 account of \$733,810 in Alesco for the 2003 tax year. Both the federal and state Schedule K-1’s reported
11 that Alan restored his deficit capital account via a capital contribution of \$773,364 in the 2003 tax year.
12 The FTB subsequently audited Alesco to verify, among other things, that Alan made a capital
13 contribution of \$773,364 in 2003. The FTB states that, during the audit, Alan confirmed that he did not
14 make a capital contribution of \$773,364 to Alesco in the 2003 tax year; instead, the FTB asserts that
15 Alan stated that he and Lester made several advances to Alesco prior to 2003. During the audit, the FTB
16 asked Alan to substantiate his claim that he and Lester made advances to Alesco in the form of either
17 loans or capital contributions. (FTB OB, p 1.) In reply, Alan provided, among other things, Schedule
18 K-1s and Alesco’s general ledger entries. (*Id.* p 4 & Audit Report.) Alan, however, did not provide any
19 cancelled checks or loan documents to verify that he made advances to Alesco prior to 2003. (FTB OB,
20 p 4 & Audit Report.) Alan stated that he and Lester disposed of Alesco’s documents in 2005.

21 After reviewing the above-listed evidence, the FTB determined that Alan failed to restore
22 his deficit capital account via a capital contribution in 2003, as reported on the Alesco’s federal and state
23 partnership returns. Subsequently, the FTB issued a Notice of Proposed Assessment (NPA) that (a)
24 increased Alan’s California taxable income by \$773,364 to account for Internal Revenue Code (IRC)
25 section 731 gain; (b) increased Alan’s California taxable income by \$32,430 to account for Alan’s
26 revised itemized deductions, which resulted from the increased income of \$773,364; and (c) reduced
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28 ² Alan R. Young and Lisa E. Young are married and filed joint federal and state tax returns for 2003; accordingly, to simplify the discussion of the facts herein, all references to “Alan” will include, as applicable, his wife, Lisa E. Young.

1 Alan's exemption credits to zero. (FTB OB, Ex. I.) In response, Alan filed a timely protest.

2 At protest, Alan continued to assert that he made advances to Alesco prior to 2003. After
3 reviewing the matter further, the FTB issued a Notice of Action (NOA) affirming the NPA. In response,
4 Alan filed this timely appeal.

5 Lester³ – Audit and Appeal

6 Lester received federal and state Schedule K-1s showing that he had a deficit capital
7 account of \$1,542,196 in Alesco for the 2003 tax year. Both the federal and state Schedule K-1's
8 reported that Lester restored his deficit capital account via a capital contribution of \$1,540,414 in the
9 2003 tax year. The FTB subsequently audited Alesco to verify, among other things, that Lester made a
10 capital contribution of \$1,540,414 in 2003. The FTB states that, during the audit, Lester confirmed that
11 he did not make a capital contribution of \$1,540,414 to Alesco in the 2003 tax year; instead, the FTB
12 asserts that Lester stated that he and Alan made several advances to Alesco prior to 2003. During the
13 audit, the FTB asked Lester to substantiate his claim that he and Alan made advances to Alesco in the
14 form of either loans or capital contributions. (FTB OB, p 1.) In reply, Lester provided, among other
15 things, Schedule K-1s and Alesco's general ledger entries. (*Id.* p 4 & Audit Report.) Lester, however,
16 did not provide any cancelled checks or loan documents to verify that he made advances to Alesco prior
17 to 2003. (FTB OB, p 4 & Audit Report.) Lester stated that he and Alan disposed of Alesco's
18 documents in 2005.

19 After reviewing the above-listed evidence, the FTB determined that Lester failed to
20 restore his deficit capital account via a capital contribution in 2003, as reported on the Alesco's federal
21 and state partnership returns. Subsequently, the FTB issued an NPA that (a) increased Lester's
22 California taxable income by \$1,540,414 to account for IRC section 731 gain; (b) increased Lester's
23 California taxable income by \$44,953 to account for Lester's revised itemized deductions, which
24 resulted from the increased income of \$1,540,414; and (c) reduced Lester's exemption credits to zero.
25 (FTB OB, Ex. I.) In response, Lester filed a timely protest. (FTB OB, p 5.)

26 At protest, Lester continued to assert that he made advances to Alesco prior to 2003.
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³ Lester Young and Beverly Young are married and filed joint federal and state tax returns for 2003; accordingly, to simplify the discussion of the facts herein, all references to "Lester" will include, as applicable, his wife, Beverly Young.

1 After reviewing the matter further, the FTB issued an NOA affirming the NPA. In response, Lester filed
2 this timely appeal.

3 **Issue: Whether appellants are required to recognize income as a result of the partnership's**
4 **liquidation.**

5 Contentions

6 Appellants⁴

7 Appellants argue that they have no gain on the liquidation of the partnership in 2003
8 because they received no money in excess of their partnership interest bases under IRC section 731(a).
9 (App. Ltr., Ex. Dtd. Aug. 9, 2010, p 1.) Furthermore, appellants assert that the FTB's application of the
10 relevant law and facts is incorrect. Specifically, appellants contend that there is no provision under IRC
11 section 731, or the regulations thereunder, that requires a partner to include as income his negative
12 capital account upon the liquidation of his partnership interest. In this respect, appellants assert that the
13 FTB is improperly trying to substitute the term "negative capital account" for the term "adjusted basis"
14 under IRC section 731(a). Appellants state that the FTB has provided no authority to support its
15 position. (*Id.*, Ex. Dtd. Aug. 9, 2010, pp 2-3.)

16 Also, appellants argue that the FTB incorrectly cites and applies IRC section 704(b),
17 which deals with income and loss allocations between partners by requiring the allocations to have
18 economic effect. Appellants state that the section 704(b) language does not override or supplement IRC
19 section 731 and has no application whatsoever when determining the gain or loss on the liquidation of a
20 partner's partnership interest. Appellants assert that during the audit, the FTB auditor incorrectly cited
21 to IRC section 704(b), and appellants argue that, on appeal, the FTB is choosing to remain complicit in
22 the auditor's incorrect application of the tax laws. (App. Ltr., Ex. Dtd. Aug, 9, 2010, p 2; see also App.
23 Ltr. pp 2-3.) Appellants state:

24 According to page 2 paragraph 2 of the hearing officers (sic) August 9th 2010 correspondence
25 (sic) we quote his statement '[t]herefore, I assert the taxpayer's basis i[s] \$0.' Going further to
26 paragraph 3 stating again we quote '[t]herefore since the basis is \$0, the entire amount of the
negative capital account would be considered taxable.'

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28 ⁴ In their appeal letter, appellants specifically incorporate arguments that their certified public accountant (CPA) made in a
letter dated August 9, 2010, a copy of which is attached as an exhibit to appellants' appeal letter. Those arguments are
described herein.

1 This fundamental conclusion which (sic) upon which the FTB has drawn its conclusion has no
2 basis under the tax law a (sic) clearly outlined in our recitation of IRC section 731(a) and our
3 previous correspondence on this matter. (App. Ltr. p 3.)

4 Appellants also argue that the FTB has “no support in the tax law” and has provided “no
5 tax law citations” for the proposition that the liquidation of Alesco in 2003 was a triggering taxable
6 event. (App. Reply Br. p 4.) As to the allegation that the partnership assumed the liability of the general
7 partners to restore their negative capital accounts, appellants argue that the FTB has “abused its powers
8 of assessment, by claiming the general partnership has assumed its general partners (sic) obligations to
9 fund the deficit capital.” (*Id.* p 5.) Appellants state:

10 The taxpayer/partner was a general partner of Alesco. As such, the liabilities of Alesco are the
11 liabilities of its general partners. To argue that Alesco, a general partnership, assumed the
12 liability of the general partners to restore their deficit capital account liability would simply give
13 rise under IRC section 752(a) as an increase in the partner’s share of liabilities. (App. Reply Br.
14 pp 3-4.)

15 Appellants assert that because the FTB cannot find a legitimate precedent in the tax law
16 to cause the liquidation of Alesco to result in taxable event, the FTB has created an unknown “mythical”
17 creditor whose name is “deficit capital” to support the FTB’s assessment. (App. Reply Br. p 4.)

18 Appellants further assert that the FTB is making a “circular argument,” which masks the
19 fact that the FTB has no support in the tax law for the determination that the liquidation of Alesco
20 results in a taxable event. (App. Reply Br. p 4.) Appellants state:

21 As stated by Mr. Cunningham, FTB Hearing Officer Protest Unit, in the attachments hereto,
22 ‘[w]e have requested the taxpayer provide a basis schedule both at audit and at protest and the
23 taxpayer has failed to do so. Thus, when I state ‘I am unable to determine the taxpayer’s basis in
24 Alesco’ it is because the documentation was not provided. Therefore, I assert the taxpayer’s
25 basis i[s] \$0.’

26 It appears that the FTB has agreed that the taxpayer/partner’s basis in their partnership interest is
27 zero, has the taxpayer/partner funded the deficit capital the basis in their partnership interest
28 prior to the liquidation of Alesco their basis in their partnership interest would be increased by
the amount of the deficit funding. Accordingly, the taxpayer/partner could have distributed the
funds on liquidation without any tax effect. (App. Reply Br. p 4.)

Finally, in relation to the issue of a “duty of consistency,” appellants state that they
loaned money to Alesco prior to 2003, but unfortunately, they disposed of Alesco’s documents in 2005.
Appellants argue, however, that the loans occurred in tax years which are now closed by the statute of
limitations. (App. Reply Br. pp 1-2.) Appellants state that they have never attempted to recharacterize

1 the transactions and, thus, have not violated the duty of consistency. (*Id.*, p 3.) Specifically, appellants
2 assert that in the years prior to 2003, the loans were correctly reflected as partner loans, and in 2003 the
3 loans were correctly reflected as contributions to capital under IRC section 752(a):

4 We contend that at all times with the exception of the year at liquidation the loans were
5 reflected as partner loans and were the basis for the loss deductions. In the year of
6 liquidation those loans were reflected as contributed capital as mandated by IRC section
7 752(a) . . . (App. Ltr. p 3.)

8 Appellants assert that the only party to this appeal that is violating the duty of consistency
9 is the FTB, which (allegedly) is wrongly trying to dispute the existence of the loans in an audit of the
10 2003 tax year, when an audit of the prior years (during which the loans were made) is barred by the
11 statute of limitations. (App. Reply Br. p 3.) Appellants state that the duty of consistency applies to both
12 taxpayers and the government. (See App. Ltr. p 3.) In support, appellants cite to the Ninth Circuit's
13 decision in *Estate of Ashman v. Commissioner* (9th Cir. 2000) 231 F.3d 541, 545, which in turn cites to
14 the Fifth Circuit's decision in *Orange Sec. Corp. v. Commissioner* (1942 5th Cir.) 131 F.2d 662, 663,
15 wherein the Fifth Circuit stated " . . . there is a duty of consistency on both the taxpayer and the
16 Commissioner with regard to, whether or not there be present all the technical elements of an estoppel."
(*Id.*, p 2.)

17 The FTB

18 The FTB states that appellants received Schedule K-1s for 2003, showing that Alan had a
19 negative capital account balance of \$733,810 and Lester had a negative capital account balance of
20 \$1,542,196. The FTB contends that appellants failed to provide sufficient evidence (i.e., cancelled
21 checks, loan documents, etc.) showing they restored their deficit capital accounts in Alesco upon
22 dissolution of the partnership. (FTB OB. pp 7-8.) As a result, the FTB argues that Alesco assumed
23 appellants' individual liabilities to restore their deficit capital accounts, resulting in deemed distributions
24 to appellants. In support of this argument, the FTB notes that the partnership agreement is silent as to
25 the partners' deficit capital account restoration obligations upon dissolution of the partnership; thus, the
26 FTB states that California law must provide the substituted terms, and the FTB states that California
27 Corp. Code section 16807(b) requires each partner in a partnership to restore his or her deficit capital
28 account. (*Id.*, p 7, citing Cal. Corp. Code § 16807(b).) Based on the foregoing California statute, the

1 FTB argues that Alesco assumed appellants' individual liabilities to restore their deficit capital accounts.
2 The FTB argues that Alesco's assumption of appellants' liabilities resulted in deemed distributions to
3 appellants under IRC section 752(b). The FTB further argues that appellants had the burden of
4 establishing their bases in Alesco, but they failed to do so. (*Id.* p 8, citing *Welch v. Helvering* (1933)
5 290 U.S. 111.) Thus, the FTB argues that it properly treated the deemed distributions as taxable income.

6 Finally, in relation to a duty of consistency, the FTB contends that appellants' failure to
7 restore their deficit capital accounts, in the amounts of \$773,364 for Alan and \$1,540,196 for Lester,
8 upon the dissolution of the partnership, is a violation of appellants' duty of consistency. (FTB OB,
9 pp 11-13.) Citing to *LeFever v. Commissioner*, (1996 10th Cir.) 100 F.3d 778, 786-788, the FTB states
10 that the three factors for application of the duty of consistency are (1) a representation or report by the
11 taxpayer, (2) on which the government has relied, and (3) an attempt by the taxpayer after the statute of
12 limitations has run to change the previous representation or to re-characterize the situation in such a way
13 as to harm the government. (*Id.*)

14 The FTB asserts that appellants have met all *three factors* for application of the duty of
15 consistency. In relation to the first factor, the FTB argues that appellants received Schedule K-1s from
16 1989 through 2003. Also, the FTB notes that the 2003 Schedule K-1s reported that appellants had
17 deficit capital accounts in 2003 and they restored their deficit capital accounts in 2003. Furthermore, the
18 FTB states that appellants did not dispute the information reported on the Schedule K-1s. Based on the
19 foregoing, the FTB argues that appellants made representations or reports and, therefore, the first factor
20 of the test has been met. (FTB OB, pp 11-13.)

21 In relation to the second factor, the FTB argues that in determining a taxpayer's tax
22 liability, the FTB must, of necessity, rely on the taxpayer's returns and schedules. The FTB states that it
23 relied upon appellants' Schedule K-1s and the partnership's tax returns for 2003; therefore, the FTB
24 asserts that the second factor of the test has been met.

25 In relation to the third factor, the FTB argues that appellants have attempted to re-
26 characterize the transactions after the statute of limitations has closed. Specifically, the FTB states that
27 appellants are trying to re-characterize their capital contributions as reported on their Schedule K-1s for
28 2003 as advances made to the partnership prior to 2003. In addition, the FTB states that appellants are

1 not able to provide credible evidence to support their allegations, in part because they disposed of their
2 documents. The FTB asserts that appellants have the burden of proof and must substantiate their
3 arguments and tax positions. (FTB OB, p 11.)

4 Applicable Law⁵

5 Gross Income

6 IRC section 61 provides that unless otherwise provided, “gross income means all income
7 from whatever source derived,” including income from the discharge of debt.

8 Negative Capital Account

9 A partner’s capital account is increased by the fair market value of any contributions,
10 property (net of liabilities), and income/gain allocated to the partner. Likewise, a partner’s capital
11 account is decreased by draws on the capital account, distributions (net of liabilities), and
12 losses/expenditures allocated to the partner. (Treas. Reg. § 1.704-(1)(b)(2)(iv)(d).)

13 If a partner’s negative capital account balance is cancelled or discharged, absent an
14 agreement to the contrary, each partner will be liable to the partnership to the extent of such partner’s
15 negative capital account balance upon liquidation and dissolution of the partnership. (*Park Cities Corp.*
16 *v. Byrd* (Tex. 1976) 534 S.W.2d 668.) If the obligation is ultimately cancelled, the partner will be
17 treated as having received a distribution of money and will recognize gain. (*Ehrensperger v.*
18 *Commissioner*, T.C. Memo. 1994-279 [partner realized income when relieved of obligation to restore
19 negative capital account on dissolution of partnership]; *Monahan v. Commissioner* (1994) T.C. Memo
20 1994-201 [taxpayer failed to repay negative capital account]; see generally Fred T. Witt, Jr. & William
21 H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 Va. Tax Rev. 1, 4
22 (1990) [as a general rule, absent an agreement to the contrary, a partner with negative capital account
23 balance upon liquidation and dissolution will be treated as having received a distribution of money and
24 will recognize gain under IRC section 731].

25 California Law Regarding the Winding Up of a Partnership

26 Cal. Corp. Code section 16103, subdivision (a), provides that “[t]o the extent the
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28 ⁵ The provisions of IRC sections 61, 731, and 752 are generally incorporated into California law at R&TC sections 17071 and 17851.

1 partnership agreement does not otherwise provide, this chapter [Chapter 5, California Uniform
2 Partnership Act of 1994]⁶ governs relations among the partners and between the partners and the
3 partnership.” Cal. Corp. Code section 16807, subdivision (b), provides that in the winding up of the
4 partnership, “a partner shall contribute to the partnership an amount equal to any excess of the charges
5 over the credits in the partner’s account.”

6 IRC sections 731(a)(1), 752(a), and 752(b)

7 In accordance with IRC section 731(a)(1), a partner recognizes gain to the extent that a
8 distribution exceeds the partner’s *adjusted basis* of his or her partnership interest immediately before the
9 distribution.

10 Pursuant to IRC section 752(a) “[a]ny increase in a partner’s share of the liabilities of a
11 partnership . . . shall be considered as a contribution of money by such partner to the partnership.”
12 Conversely, under IRC section 752(b) “. . . [a]ny decrease in a partner’s individual liabilities by reason
13 of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of
14 money to the partner by the partnership.”

15 Duty of Consistency

16 The duty of consistency was discussed by the Ninth Circuit Court of Appeals in *Ashman*
17 *v. Commissioner, supra*, as follows:

18 While it is true that income taxes are intended to be settled and paid annually each year
19 standing to itself, and that omissions, mistakes and frauds are generally to be rectified as
20 of the year they occurred, this and other courts have recognized that a taxpayer may not,
21 after taking a position in one year to his advantage and after correction for that year is
22 barred, shift to a contrary position touching the same fact or transaction. When such a
23 fact or transaction is projected in its tax consequences into another year there is a duty of
24 consistency on both the taxpayer and the Commissioner with regard to it, whether or not
25 there be present all the technical elements of an estoppel.

26 In *Ashman, supra*, 231 F.3d at 546, the Ninth Circuit articulated the following three
27 elements for finding that a taxpayer breached the duty of consistency:

28 (1) A representation or report by the taxpayer; (2) on which the Commissioner has
relied; and (3) an attempt by the taxpayer after the statute of limitations has run to
change the previous representation or to recharacterize the situation in such a way as
to harm the Commissioner. If this test is met, the Commissioner may act as if the

⁶ Cal. Corp. Code section 16111 provides that “On or after January 1, 1999, this chapter governs all partnerships.”

1 previous representation, on which he relied, continued to be true, even if it is not.
2 The taxpayer is estopped to assert the contrary.

3 Burden of Proof

4 The FTB's determination of tax is presumed to be correct, and a taxpayer has the burden
5 of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Aaron and Eloise Magidow*,
6 82-SBE-274, Nov. 17, 1982.)⁷ Unsupported assertions are not sufficient to satisfy a taxpayer's burden
7 of proof. (*Appeal of Aaron and Eloise Magidow*, *supra*.)

8 STAFF COMMENTS

9 As set forth above, if a partner's negative capital account is cancelled or discharged,
10 absent an agreement to the contrary, each partner will be liable to the partnership to the extent of such
11 partner's negative capital account balance upon liquidation and dissolution of the partnership. (*Park*
12 *Cities Corp. v. Byrd*, *supra*; see generally Cal. Corp. Code §§ 16103(a) and 16807(b).) At the oral
13 hearing, the parties should be prepared to discuss (i) whether *Park Cities Corp.* and/or Cal. Corp Code
14 sections 16103(a) and 16807(b) are applicable to the facts of this consolidated appeal, and (ii) whether
15 appellants had an obligation to restore their negative capital accounts and were liable to the partnership
16 to the extent of their respective negative capital account balances upon liquidation.

17 As noted above, if an obligation to restore a negative capital accounts is cancelled, the
18 partner will be treated as having received a distribution of money and will recognize gain.
19 (*Ehrensperger v. Commissioner*, *supra* [partner realized income when relieved of obligation to restore
20 negative capital account on dissolution of partnership]; *Monahan v. Commissioner*, *supra* [taxpayer
21 failed to repay negative capital account].) At the oral hearing, the parties should be prepared to discuss
22 whether *Ehrensperger* and *Monhan* are applicable to the facts of this consolidated appeal.

23 If possible, appellants will want to provide documentary evidence, such as cancelled
24 checks or loan documents, substantiating any loans and/or advances that could have increased the
25 balances of their partnership capital accounts. Pursuant to California Code of Regulations, title 18,
26 section 5523.6, any additional evidence should be provided to Board Proceedings at least 14 days prior
27

28 ⁷ Board of Equalization cases are generally available for viewing on the Board's website (www.boe.ca.gov).

1 to the oral hearing.⁸

2 With regard to appellants’ argument that FTB is violating a duty of consistency by
3 examining facts from a year that is closed by the statute of limitations, staff notes that the FTB is
4 attempting to determine the tax for the years at issue, rather than impose a tax on a prior year. In this
5 regard, staff notes that “[t]he duty of consistency has nothing to do with tolling [the statute of
6 limitations]; it deals with the equitable insight that a person should be prevented from taking different
7 positions about the same historical transactional facts in different years” (*Estate of Ashman v.*
8 *Commissioner, supra*, at 544.)

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12 Young, et al._wjs

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⁸ Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.