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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 **EZRA ZIV AND RUTH ZIV** ) Case No. 567507  
13

	<u>Year</u>	<u>Proposed</u>	
	2006	<u>Assessment</u> <sup>1</sup>	<u>Penalty</u> <sup>2</sup>
		<u>Tax</u>	
		\$57,374.00	\$11,474.80

17 Representing the Parties:

18 For Appellants: Mortimer L. Laski, Attorney at Law  
Kenneth G. Gordon, Attorney at Law

20 For Franchise Tax Board: Daniel V. Biedler, Tax Counsel III

22 QUESTIONS: (1) Whether appellants have shown that the amount of the basis of a home they sold  
23 was greater than the amount allowed by the Franchise Tax Board (respondent or  
24 the FTB).  
25

26  
27 <sup>1</sup> As discussed below, respondent is now prepared to reduce its proposed assessment of additional tax from \$57,374.00 to \$48,881.00 and its accuracy-related penalty from \$11,474.80 to \$9,355.20.

28 <sup>2</sup> The penalty is attributable to an accuracy-related penalty imposed by respondent for 2006.

1 (2) Whether appellants have shown that respondent improperly imposed an  
2 accuracy-related penalty against them.

3 HEARING SUMMARY

4 Background

5 In 2006, appellants sold their personal residence in Sherman Oaks, California, for  
6 \$2,300,000. Allegedly, the residence structure consisted of approximately 6,100 square feet whose  
7 construction appellants completed in the early 1990's. Appellants had used a portion of the residence  
8 as a home office. On their return for 2006, appellants reported gain of \$31,951 on the sale of the  
9 portion of the property used for a home office and no gain on the sale of the remainder of the property.

10 In review of appellants' 2006 return, respondent requested documentation supporting  
11 appellants' claimed basis of \$1,802,770 in the property. According to respondent, appellants replied  
12 that they no longer possessed documents relating to the acquisition of the land or to the construction of  
13 the residence but estimated building costs of \$180 per square foot. Respondent states that appellants  
14 did provide it with the following documents in support of their claimed basis: (1) an appraisal dated  
15 April 23, 1991, which was prepared by Candidate Appraisal Institute for Western Express Mortgage  
16 (the Western Express Mortgage appraisal). (App. Reply Brief, Exhibit A.) Respondent states that the  
17 appraisal was prepared for the purpose of mortgage refinancing. Respondent also states that while the  
18 appraisal was completed when the property was still under construction, it was appraised as being  
19 complete and in good condition, with a value of \$1,200,000. Furthermore, respondent states that the  
20 appraisal noted a number of features, including granite kitchen counters, marble flooring, and recessed  
21 wiring; (2) an assessor report indicating an assessed value in 1991 of \$341,600 for the land and  
22 \$619,000 for improvements, for a total value of \$960,600. (App. Reply Brief, Exhibit B.) Respondent  
23 states that the assessment records were confirmed through the Los Angeles County Assessor showing  
24 appellants purchased the land for \$340,000 on June 1, 1989; and (3) a letter from a State Farm  
25 Insurance agent dated February 10, 2010 (the State Farm letter). (App. Reply Br., Exhibit C.)  
26 Respondent states that the State Farm letter indicated that the agent inspected the property in 1990 and  
27 estimated building costs of between \$200 and \$250 a square foot during 1990. Furthermore,  
28 respondent states that the letter also estimated damage to the property as a result of the 1994 Northridge

1 earthquake to be in excess of \$150,000.

2 Respondent states that, after reviewing the evidence presented by appellants, it  
3 determined that a reasonable estimate of appellants' basis in the property was a blending of the  
4 purchase price (\$341,000), the assessed value of the improvements (\$619,000), and the State Farm  
5 Insurance agent's estimate of construction costs (\$1,220,000 to \$1,525,000). Respondent asserts that  
6 its basis estimate of \$1,080,300 resulted in additional gain on the sale of the property and additional  
7 tax.

8 In a Notice of Proposed Assessment (NPA) dated April 21, 2010, respondent increased  
9 appellants' gain from the sale of their residence to \$559,510 and reduced their gain from the sale of  
10 their "residence/business" to \$29,554, as well as making other adjustments. (Attachment to App. Op.  
11 Br.) As a result, in the NPA, respondent proposed the assessment of additional tax of \$57,374 and an  
12 accuracy-related penalty of \$11,474.80. In a Notice of Action dated February 18, 2011, respondent  
13 affirmed its NPA. (Attachment to App. Op. Br.) This timely appeal followed.

#### 14 Contentions

15 In their opening brief, appellants state that 95.2 percent of the residence had been used  
16 as a personal residence and 4.8 percent of the residence had been used for business.<sup>3</sup> Appellants state  
17 that the "realized gain before separation for business use" was calculated in the following manner: sales  
18 price of \$2,300,000 less selling expenses of \$106,770 and basis of \$1,696,000 for a "realized gain" of  
19 \$497,230. They state that the "business portion of the gain" was calculated as follows: sales price of  
20 \$110,400, less "selling expenses and basis" of \$86,533 and depreciation of \$8,084, for a "recognized  
21 gain" of \$31,951. Appellants assert that they recognized gain of \$31,951 from the sale of the residence  
22 and that the remaining realized gain was not recognized because it was less than the \$500,000  
23 exclusion allowed by Revenue and Taxation Code (R&TC) section 17152 and Internal Revenue Code  
24 (IRC) section 121. Appellants state that the "above basis" includes the cost of building the residence  
25 but that documentation to substantiate the costs no longer exists because the residence was built more  
26 than 20 years earlier.

27  
28 <sup>3</sup> The percentages stated by respondent in the text above appear to be undisputed.

1 Appellants state that respondent's auditor averaged the appraisal amount of \$1,200,000  
2 and the assessor amount of \$960,600 in making his determination that the most reasonable amount to  
3 use as the basis of the residence in 1991 was \$1,080,000. Appellants argue that the cost to build the  
4 residence was significantly higher than the amount determined by respondent. They state that they will  
5 be hiring an appraiser/structural engineer to prepare a report detailing in 1990 dollars the cost of  
6 building the residence. Appellants contend that the amount in the report of the appraiser/structural  
7 engineer should be added to the land cost and the total amount substituted for the basis amount of  
8 \$1,080,000 determined by respondent. Appellants also contend that costs of \$130,000 resulting from  
9 damage in the Northridge earthquake in 1994 should be added to its previous calculations of basis.  
10 They allege that substantiation for those costs will be provided on or before the hearing in this matter.

11 In its opening brief, respondent contends that its action should be sustained because  
12 appellants do not appear to possess evidence to establish a basis in their property above zero, much less  
13 the estimate of basis accepted by respondent. Citing *Cohan v. Commissioner (Cohan)* (2d Cir. 1930)  
14 39 F.2d 540, respondent states that a taxing agency may estimate the amount of deductible expenses  
15 when there is credible evidence that there are deductible expenses. Respondent argues that, under  
16 *Cohan*, it may reasonable rely upon credible available evidence to establish appellants' basis in the  
17 property they sold. Citing *New Colonial Ice Co. v. Helvering (New Colonial Ice)* (1934) 292 U.S. 435  
18 and other authority discussing the burden of proof regarding items of deduction, respondent argues that  
19 appellants have the burden of proving a basis different from the basis it has accepted.

20 Respondent alleges that when it requested documentation supporting appellants' claimed  
21 basis in the property they sold, they provided the information described above and indicated they had  
22 no additional information. Respondent states there is no doubt that appellants are entitled to basis in  
23 the land and the home constructed on the property but argues that the available evidence does not  
24 support the amount of basis appellants have claimed.

25 Respondent states that, as a result of the lack of documents showing the actual building  
26 costs for the improvements made on the property, it moved to the next most reliable evidence of the  
27 basis of appellants' property. Respondent argues that if they reflect at least what appellants paid for the  
28 property and improvements, county property tax records provide what can be considered a minimum

1 amount (\$960,600) to ascribe to the basis of their property. With regard to the appraisal of the land and  
2 improvements allegedly performed in 1991 that resulted in a total appraised amount of \$1,200,000,  
3 respondent states that the appraisal seems to have been performed before the construction of the  
4 personal residence was complete. With regard to the figures provided by the State Farm Insurance  
5 agent in 2010 (\$200 to \$250 a square foot), respondent indicates that the application of those figures to  
6 a 6,100 square foot personal residence would result in an estimated cost between \$1,220,000 and  
7 \$1,525,000.

8 Respondent also contends that appellants should not prevail with regard to the  
9 accuracy-related penalty because they have provided no argument or evidence during protest or the  
10 appeal process that the penalty was inaccurately applied or calculated.<sup>4</sup> Respondent states that it  
11 respectfully reserves the right to reply to any argument regarding that accuracy-related penalty that  
12 appellants may subsequently provide.

13 In their reply brief, appellants state that respondent determined that the total allowed  
14 adjusted basis, after the inclusion of selling expenses, should be \$1,187,069, of which \$1,130,090 was  
15 allocable to the personal portion of the residence and \$48,895 to the business portion. Appellants state  
16 that, as a result, respondent determined that there should be taxable gain on of \$559,510 on the personal  
17 portion of the residence and \$61,505 on the business portion.

18 Appellants allege that respondent's determination on audit of adjusted basis is derived  
19 from an average of the estimated value of the property (\$1,200,000) stated in the Western Express  
20 Mortgage appraisal and the 1991 valuation by the Office of the County Assessor (\$960,600).  
21 Appellants assert that this averaging process results in approximately \$177.09 a square foot.  
22 Appellants observe that respondent's determination of adjusted basis does not take into account  
23 construction costs associated with the 1994 earthquake. Appellants note that, in its brief, respondent  
24 stated that its determination was based on a blending of the purchase price (\$341,000), the assessed  
25 value of improvements (\$619,000), and the State Farm Insurance agent's estimate of \$200-\$250 a  
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27  
28 <sup>4</sup> Respondent states that appellants reported tax liability of \$2,105 for 2006. Citing IRC section 6662(d)(1)(A), respondent states that the amount of tax required to be shown on appellants' 2006 return is \$70,004. Respondent asserts that the understatement of \$67,899 (\$70,004- \$2,105) exceeds \$5,000 as well as ten percent of the amount (\$7,000= 10 percent x \$70,004) required to be shown on appellants' 2006 return.

1 square foot. Appellants state that they do not understand how respondent's "blending" works but, in  
2 any event, such "blending" was not contained in the examination report.

3 Appellants observe that the State Farm Insurance agent opined in his letter that the  
4 estimated building costs at the time of construction would have been between \$200 and \$250 a square  
5 foot. Appellants allege that respondent, on audit, ignored the letter. Appellants state that "[i]n other  
6 words, [r]espondent's audit determination used an average of values as distinguished from costs. There  
7 was no "blending," but merely the use of an unweighted average of two values." (App. Reply Br.,  
8 p. 3.)

9 Appellants state that, subsequent to the audit determination but while respondent was  
10 still considering the case, they retained a forensic expert in residential construction, Mr. Robert G.  
11 McConihay, and have attached his report, dated July 7, 2011 (the McConihay Report), as Exhibit D to  
12 their reply brief.<sup>5</sup> Appellants allege that respondent has failed to address the expert's opinion regarding  
13 costs associated with the residence. Appellants also argue that respondent has failed to explain how the  
14 average of two values relates to actual costs. Appellants state that the expert concluded that the  
15 building costs were \$225 a square foot (while the State Farm Insurance agent estimated the costs to be  
16 between \$200 and \$250 a square foot) but instead used \$220 a square foot. Appellants also state that  
17 when costs associated with the 1994 earthquake are included, the total estimated costs of the building  
18 would be \$1,636,000.<sup>6</sup>

19 Appellants describe the calculations of their expert in concluding that there was no  
20 taxable gain with respect to the personal portion of the residence and taxable gain of \$2,266 with  
21 respect to the business portion as follows: (1) the adjusted basis of the property was calculated to be  
22 \$2,084,369 by adding together the basis determined by the forensic expert (\$1,636,000), selling  
23 expense (\$106,769), and land cost (\$341,600); and (2) the total gain was calculated to be \$215,631 by  
24 subtracting the adjusted basis of \$2,084,369 from the sales price of \$2,300,000, with the personal  
25 portion of \$205,280 ( $\$215,631 \times 95.2$  percent) excluded from tax because that amount is less than  
26

27 <sup>5</sup> Appellants also attached a copy of the listing brochure for the property as Exhibit E to their reply brief.

28 <sup>6</sup> Appellants state that they have not taken the General Contractor's fee of \$327,200 into account because they were their own  
General Contractor.

1 \$500,000 and the business portion of \$2,266 (\$10,350 (\$215,631 x 4.8 percent) less depreciation of  
2 \$8,084) remaining subject to tax.

3 Appellants state that both parties are, under *Cohan*, beyond the issue of the ability to  
4 allow a reconstructed basis in the absence of direct evidence. Appellants assert that the remaining issue  
5 is whether respondent's determination of adjusted basis (after taking into account selling costs) of  
6 \$1,187,069 is more credible than their forensic expert's determination of adjusted basis (\$1,636,000  
7 plus selling expenses and land costs) of \$2,084,369. Appellants contend that they have met their  
8 burden of proof by providing the forensic expert's report, as supplemented by the opinion of the State  
9 Farm Insurance agent.

#### 10 Additional Briefing

11 In a letter to the parties dated January 15, 2013, staff requested additional briefing from  
12 each party. Staff requested appellants to provide legal argument that they may wish to make, together  
13 with supporting documentary evidence, with regard to the accuracy-related penalty imposed by  
14 respondent. Staff requested respondent (1) to provide a detailed analysis of the McConihay Report,  
15 including as part of its analysis which, if any, of the items described in the report as "1994 Northridge  
16 Earthquake repair-out of pocket costs for earthquake repair" should be treated as part of appellants'  
17 basis in the property at issue, (2) to address appellants' contention that they have met their burden of  
18 proving the amount of their basis in the property by providing the McConihay Report, as supplemented  
19 by the State Farm letter, and (3) to provide any authority that explicitly applies the rule stated in *Cohan*  
20 to the calculation of the basis of a taxpayer's property.

21 Citing R&TC section 19164 and IRC sections 6662 and 6664, appellants argue in an  
22 additional brief dated June 10, 2013, that no accuracy-related penalty should be imposed because, under  
23 the circumstances, reasonable cause exists and they acted in good faith. Appellants state their inference  
24 that respondent imposed the accuracy-related penalty because it believed they were negligent as a result  
25 of not having actual records of cost basis. Appellants assert that the records were unavailable to  
26 determine cost basis when their tax return was being prepared because the home they were renting after  
27 they sold the residence at issue was flooded and the records destroyed.

28 In an additional brief dated June 12, 2013, respondent first reiterates a number of its

1 factual allegations and legal arguments. Respondent then briefly summarizes the McConihay Report  
2 and states that appellants provided the following documents (attached as Exhibit A to its additional  
3 brief) in response to its request: (1) respondent's protest position letter dated January 1, 2011;  
4 (2) City of Los Angeles Certificate of Occupancy dated February 6, 1992; (3) Los Angeles Department  
5 of Building and Safety, description of building permits for new construction (dated June 13, 1990) and  
6 for building addition (dated June 13, 1990); (4) the State Farm letter; (5) three pages of property tax  
7 bills from 2002 to 2004; (6) County of Los Angeles, notice of assessed value change; and  
8 (7) photographs of the residence at issue taken by Mr. McConihay.<sup>7</sup> (Resp. Add. Br., pp. 3-4.)

9 In footnote seven of its additional brief, respondent asserts, in answer to the third  
10 question posed to it by staff, that the Tax Court in *Bayly v. Commissioner (Bayly)* T.C. Memo  
11 1981-549, applied the rule stated in *Cohan* to the calculation of a taxpayer's property. Respondent  
12 states that, in *Bayly*, taxpayers' records had been stolen or destroyed and, as a result, they could make  
13 only rough estimates of the amounts expended on improvement they remembered making to their  
14 home. Respondent states that the estimates were based on Mr. Bayly's experience in the construction  
15 business and the collective memories of him and his former wife regarding the cost of such  
16 improvements. Respondent states that the Tax Court noted that it was unable to determine with any  
17 exactitude the total amount of capital improvements invested in the home. Respondent asserts that the  
18 Tax Court applied the rule stated in *Cohan*, "bearing heavily" against the taxpayer, to find an amount of  
19 expenditures for capital improvements that were less than the amount estimated by the taxpayers and  
20 more than the amount allowed by the Internal Revenue Service.

21 Asserting that the rule set forth in *Cohan* requires it to make as close an approximation  
22 as it can of appellants' basis in the residence at issue, respondent states that because actual evidence of  
23 the construction costs was in short supply, it looked to indirect evidence of the construction  
24 improvements to the land to establish appellants' basis. Respondent states that an agent of the  
25 Los Angeles County Assessor's office personally inspected the residence when it was constructed and  
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27 <sup>7</sup> A request for information, dated March 13, 2013, from respondent to Mr. McConihay, included in Exhibit A, clarifies that  
28 the documents provided by appellants were in response to respondent's request for documents he relied upon in preparing  
the McConihay Report and were requested to assist respondent in answering questions posed by staff in its additional  
briefing letter.

1 that a licensed appraiser also performed a personal inspection of the construction in 1991. Respondent  
2 alleges that records of those inspections (see Resp. Add. Br., Exhibit C, for two pages of the Assessor's  
3 file for the property and the Western Express Mortgage appraisal, respectively) indicate certain features  
4 of the improvements and argues they corroborate one another.

5 Respondent asserts that the remaining documentation appellants have presented  
6 demonstrates that they purchased the land upon which they built their residence, actually had the home  
7 constructed, and paid property taxes on an assessed value substantially lower than both the 2006 sales  
8 price and their claimed basis. Respondent states that the McConihay Report and the State Farm letter  
9 are not based on factual evidence of what appellants actually paid to construct and to repair the  
10 residence at issue. It argues that appellants must bear the burden of the "inexactitude" of factual  
11 evidence. Respondent asserts that appellants have not established a reasonable factual foundation for  
12 concluding that they had a greater basis in the residence at issue than the amount of \$1,200,000 stated  
13 in the Western Express Mortgage appraisal.

14 In response to the first question posed to it by staff, respondent states that the  
15 McConihay Report estimates the "value" (as opposed to the cost) of the "project" to be \$1,636,000, an  
16 amount that is comprised of \$1,531,000 of site improvements and the dwelling and \$105,000 of "1994  
17 Northridge Earthquake repair." Respondent argues that the McConihay Report is of limited use in  
18 applying the rule stated in *Cohan* because of very limited evidence of amounts incurred. Respondent  
19 asserts that the McConihay Report "tells a story of what might possibly have occurred with [the  
20 residence at issue], but has very little in it to suggest that it is the story of the cost of constructing and  
21 repairing [the residence at issue]." (Resp. Add. Br., p. 6.) As an example, respondent states that the  
22 McConihay Report's discussion of the earthquake repairs are all based upon the recollection of  
23 someone, presumably appellant-husband, of what had to be replaced and his memories or estimates  
24 from seventeen years earlier of material costs. As another example, respondent states that the  
25 McConihay Report's explanation for how it arrived at a \$220 per square foot construction cost of the  
26 dwelling and \$189 for site improvements is Mr. Conihays's recollection of experiences with  
27 supervising and performing the construction of home in the area in 1990, two decades before the  
28 production of the report.

1 Respondent states that the McConihay Report offers no direct evidence of the costs of  
2 the projects to which it makes reference and does not provide industry or government historical data  
3 regarding the costs of construction in the area of the residence at issue, Los Angeles, or even California  
4 in general. Respondent asserts, in other words, that the McConihay Report has no basis in documented  
5 fact and alleges that its estimate of “value” is generated entirely from the recollection of  
6 Mr. McConihay and appellant-husband of information from seventeen to twenty-one years before the  
7 issuing of the report. Quoting language from *Bayly* that “[p]etitioner was in the construction business  
8 and would be pretty well qualified to estimate the cost of such work if he was not relying so much on  
9 memory and generalizations,” respondent argues that the absence of documented fact undermines the  
10 value of estimates.

11 With regard to the eligibility of earthquake repair costs for addition to basis, respondent  
12 states that repairs to keep a structure in good condition but that do not make it substantially better than  
13 it was previously are not includible in basis. Respondent indicates that, in the *Bayly* matter, the Tax  
14 Court stated that the amounts expended for wallpapering and painting could be capitalized and added to  
15 basis if they were incurred as part of an overall plan of remodeling or renovation. However, respondent  
16 also indicates that the Tax Court added that, if the expenditures for wallpapering and painting were  
17 incurred independent of such a plan and there was no showing that such items standing alone either  
18 appreciably added to the value of the home or prolonged its useful life, it would not be considered a  
19 capital expenditure and, therefore, would not add to the adjusted basis of the property.

20 Respondent acknowledges that appellant’s residence was damaged by the 1994  
21 Northridge Earthquake and that the repairs made to residence to recover from the damage comprise  
22 improvements includible in their basis in the residence because the repairs had the effect of making the  
23 property more valuable or useful than with the damage. However, respondent states that, unfortunately,  
24 although repairs necessary to renovate earthquake damage may generally qualify as capital expenses  
25 added to basis, appellants have provided no documentation of damage, work actually performed, or the  
26 cost of any such eligible repairs. As a result, respondent argues, none of the “out of pocket” earthquake  
27 costs listed in the McConihay Report meets the *Cohan* standard for inclusion in the estimated basis of  
28 the residence at issue.

1 In response to the second question posed to it by staff, respondent states that the State  
2 Farm letter, like the McConihay Report, presents a story based on recollection of circumstances almost  
3 two decades earlier. Respondent argues that the evidentiary value of the State Farm letter is  
4 compromised by complete lack of documentation supporting the asserted points. Respondent states  
5 that inspection referenced in the letter occurred in 1990, which allegedly was before completion of the  
6 improvements. Respondent also states that the author of the State Farm letter offers no report he  
7 created then or even contemporaneous notes that he took but, rather, offers his recollection of what he  
8 saw twenty years earlier and his experience “in the insurance business.” In addition, respondent states  
9 that the author of the letter refers to “this figure” being supported by State Farm’s XACTWare cost  
10 guide and his experience without clarifying whether he is referring to his \$200 to \$250 square foot  
11 figure in 1990 or to “over \$450 per square foot” in 2010. Furthermore, respondent states that it does  
12 not “have documentation of such support from the XACTWare cost guide, which might be probative if  
13 based on historical information regarding building costs.” (Resp. Add. Br., p. 7.)

14 Respondent asserts that contemporaneous documentation of the value or replacements  
15 costs of the residence at issue would have been any evaluations, applications, or reports that would  
16 have been prepared when appellants wanted State Farm Insurance to insure their home. Respondent  
17 also observes the author of the State Farm letter stated that he viewed earthquake damage at the  
18 residence in 1994 but provided no notes, reports, estimates, or photographs from that time to support  
19 his assertions regarding the extent of the damage. In making reference to another opportunity for  
20 documentation, respondent states that the author indicated that he insured the residence with State Farm  
21 Insurance in 1998 but again provided no evaluations, applications, reports, or replacement cost  
22 estimates, much less documentation of the actual levels of insurance that were provided at that time.

23 Respondent argues that what is especially troubling about the reliability of both the  
24 McConihay Report and the State Farm letter is the contrast between the “values” or “figures” they  
25 present and those presented by the Los Angeles County Assessor (\$960,000) and the 1991 Western  
26 Express Mortgage appraisal (\$1,200,00), the two of which include the land and improvements.  
27 Respondent states that the McConihay Report estimated a “value” of the improvements of \$1,531,200  
28 (\$1,342,200 for the dwelling and \$189,000 for site improvements). Respondent asserts that the

1 estimate in the State Farm letter does not specify whether it is for the dwelling alone or includes site  
2 improvements. Respondent states that the estimate in the letter ranges from \$1,221,000 to \$1,526,250  
3 and that, when the cost of the land (\$335,000) is added in, those figures increase to \$1,866,200, with a  
4 range from \$1,556,000 to \$1,861,250.<sup>8</sup>

5 Respondent asks if appellants actual costs were as high as estimated in the McConihay  
6 Report and the State Farm letter, what explains the distinctly lower figures provided by the  
7 Los Angeles County Assessor and the Western Express Mortgage appraiser. Respondent argues that,  
8 given the lack of documentation of actual costs, the best available evidence is the real property  
9 assessment and the appraisal because they were based on contemporaneous inspection and  
10 documentation. Respondent states that although repairs necessitated by the Northridge earthquake  
11 might comprise capital improvements that are properly added to basis, the cost of such repairs actually  
12 paid are not in evidence and no documentary foundation has been laid for estimating them. Respondent  
13 contends that when the rule stated in *Cohan* is applied, a basis of \$1,200,000 (plus \$106,769 of allowed  
14 selling expenses) is a reasonable amount and satisfies the *Cohan* rule. In a footnote in its additional  
15 brief, respondent states that, upon consideration of the materials presented by appellants, including the  
16 McConihay Report, it is prepared to recognize appellants' cost basis in their former property (land and  
17 improvements) of \$1,200,000 and to revise the amount of additional tax to \$48,881.00 and to revise the  
18 amount of the accuracy-related penalty to \$9,355.20. (Resp. Add. Br., fn. 1.)

19 In a reply dated July 23, 2013, to respondent's additional brief, appellants state that  
20 respondent is attempting to minimize the importance of the McConihay Report by characterizing it as a  
21 valuation appraisal. Appellants state that the label put on the total cost at the bottom of the report,  
22 "Total value of project," was loosely worded language. Appellants argue that such loosely worded  
23 language does not change the fact that the report itself, as reflected by its title "Scope and Cost of  
24 Repair," is clearly a cost reconstruction and not a valuation appraisal.

25 Appellants state that because the issue before the Board is the amount of cost basis they  
26 should be allowed, the most relevant evidence would be actual costs. However, appellants state that  
27 because information regarding actual costs is no longer available, they are offering a cost

28 \_\_\_\_\_  
<sup>8</sup> Respondent indicates that the figures in this paragraph do not include earthquake repair costs.

1 reconstruction. Appellants assert that even though respondent apparently agrees that a cost  
2 reconstruction is permitted, it attempts to minimize the cost reconstruction report prepared by  
3 Mr. McConihay and offers instead appraisal reports of value as evidence. Appellants state that because  
4 the Board is trying to determine their costs, a cost reconstruction report seems more accurate than an  
5 opinion of value. Appellants argue that respondent fails to see the connection of value to cost.

6 Appellants state that “cost” is a static amount while, in contrast, “value” is fluid in the  
7 respect that it is an economic reflection of the marketplace at a particular point in time. Appellants  
8 state that, in their case, real estate took a drastic plunge in value between the time the project was  
9 started in 1989 and the time of “the appraisal for value” in 1991. (App. Add. Reply Br., p. 2.)  
10 Appellants have attached to their brief as Exhibit A “a copy of an internet printout setting forth  
11 Los Angeles Times articles describing the real estate market- as it peaked in a bubble during 1989 and  
12 then tanked by 1991.” (App. Add. Reply Br., p. 2.) Appellants have also attached as Exhibit B “an  
13 article from the internet, showing the S&P/Case-Schiller house price index for Los Angeles in the late  
14 1980’s.” (App. Add. Reply Br., p. 2.) Appellants assert that the article states that the peak of the  
15 Los Angeles real estate market occurred in December 1989.

16 Appellants state that, in *Bayly*, the Tax Court applied the *Cohan* rule “bearing heavily”  
17 against the taxpayer to allow \$27,300 of his claimed basis while disallowed \$4,700. Appellants state  
18 that the Tax Court made its determination even though the taxpayer and his former wife “used their  
19 combined experience and memories to estimate the amounts expended for all the improvements to the  
20 Glen Burnie home.” (App. Add. Reply Br., p. 3.) Appellants allege that part of the amount of \$4,700  
21 related to certain expenses that the court disallowed because they were (1) repairs or other items that  
22 were not capital expenditures or (2) duplications of some of the claimed expenditures. Appellants  
23 indicates that the likely amount the court disallowed was \$2,637.50 (washer and dryer- \$425, wallpaper  
24 and paint- \$250, new heat duct/new breaker box and electrical wiring- \$1,250, and carpet “\$1,900 x 3/8  
25 (estimated)”- \$712.50). (App. Add. Reply Br., p. 3.)

26 Appellants state that, after reducing the amount of \$4,700 by \$2,637.50, the remaining  
27 amount of \$2,062.50 appears to represent the amount the Tax Court disallowed because of the  
28 inexactitude of the taxpayer’s rough estimates. Appellants state that the disallowed amount of

1 \$2,062.50 represents only 6.45 percent of the total amount claimed by the taxpayer.

2 Appellants argue that, in their case, if the Board follows *Bayly* and uses the same  
3 percentage disallowance as the Tax Court did in that matter, then the amount of \$1,636,000 they  
4 claimed based on the cost reconstruction in the McConihay Report should be reduced by \$105,522  
5 (\$1,636,000 x .0645). As a result, appellants argue, the amount allowable when the same percentage  
6 disallowed in *Bayly* is taken into account would be \$1,530,478 (\$1,636,000- \$105,522).

7 Appellants argue that Mr. McConihay has extensive experience that qualifies him to  
8 make an acceptable cost reconstruction report. Appellants allege that he has been a lead witness for  
9 “general contracting and scope and cost of repair” in approximately 1,200 mediations during his career.  
10 (App. Add. Reply Br., p. 4.) Furthermore, appellants allege that he has more than 30 years of  
11 experience as a general contractor and extensive experience in cost of repair matters. Appellants have  
12 attached to their brief as Exhibit C a statement regarding Mr. McConihay’s background. Appellants  
13 request that the Board accept the McConihay Report in full under the *Cohan* rule.

14 In conclusion, appellants argue that the full amount of \$1,636,000 set forth in the  
15 McConihay Report should be allowed as basis. In the alternative, appellants argue that if the Board  
16 believes that a lesser amount should be allowed, such an amount should be determined in line with the  
17 percentage of 6.45 disallowed in *Bayly*. Appellants state the resulting amount allowed as basis under  
18 that approach would be \$1,530,478.

19 In a reply dated July 26, 2013, respondent states that it applied the accuracy-related  
20 penalty because of the substantial understatement of tax resulting from appellants’ underreporting of  
21 their tax liability for 2006 by an amount in excess of the greater of \$5,000 or ten percent of the amount  
22 required to be shown on their 2006 return. Respondent states that the penalty is also attributable to  
23 negligence because appellants (1) failed to maintain adequate books and records and (2) failed to  
24 substantiate items properly that they used to support the position they took on their 2006 return with  
25 regard to income from the sale of their residence.

26 Respondent contends that appellants are subject to the accuracy-related penalty because  
27 of their inability to substantiate their basis in their residence and their inability to establish grounds for

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1 a “reasonable cause” exception.<sup>9</sup> Respondent argues that appellants have failed to demonstrate  
2 “reasonable cause” for the underpayment related to the basis claimed for their residence or for their  
3 failure to produce documents in support of their position. Respondent states that appellants have  
4 provided no explanation or work papers illustrating the steps they took to attempt to reconstruct records  
5 of the cost basis in their residence at the time their 2006 return was prepared and filed. Respondent  
6 also states that appellants have provided no evidence supporting their assertion that the records were  
7 lost because of flooding of their garage or an insurance claim for property damaged as a result of the  
8 flooding.

9 Applicable Law

10 R&TC section 18031 incorporates by reference the following provisions of the  
11 IRC regarding basis. IRC section 1001(a) provides, in pertinent part, that the gain from the sale of  
12 property shall be the excess of the amount realized from the sale over the adjusted basis provided in  
13 IRC section 1011 for determining gain. IRC section 1011(a) provides, in pertinent part, that the  
14 adjusted basis for determining gain from the sale of property shall be the basis determined under  
15 IRC section 1012 or other applicable section of the IRC. IRC section 1012(a) provides generally that  
16 the basis of property shall be the cost of such property. IRC section 1016(a)(1) provides generally that  
17 proper adjustments in respect of the property shall in all cases be made for expenditures, receipts,  
18 losses, or other items, properly chargeable to capital account.

19 R&TC section 17201, subdivision (c), incorporates by reference IRC section 263, except  
20 as otherwise provided. IRC section 263(a)(1) provides generally that no deduction shall be allowed for  
21 any amount paid out for new buildings or for permanent improvements made to increase the value of  
22 any property. Treasury Regulation section 1.263(a)-1(b) indicates that such amounts include amounts  
23 paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by  
24 the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use.  
25 Furthermore, the regulation states that amounts incurred for incidental repairs and maintenance of  
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28 <sup>9</sup> Respondent states that the accuracy-related penalty based on negligence may be abated upon a showing of reasonable basis  
for the return position. However, respondent states that appellants have not raised this defense to challenge the  
accuracy-related penalty.

1 property are not capital expenditures.

2 IRC section 17152 incorporates by reference, with certain modifications, the provisions  
3 of IRC section 121. IRC section 121(a) provides, in pertinent part, that gross income shall not include  
4 gain from the sale of property if, during the five-year period ending on the date of the sale, the property  
5 has been owned and used by the taxpayer as his principal residence for periods aggregating two years  
6 or more. IRC section 121(b) provides generally that, in the case of a husband and wife who make a  
7 joint return for the taxable year of the sale of the property, the gain shall be limited to \$500,000 if either  
8 spouse meets the ownership requirement of IRC section 121(a), both spouses meet the use requirement  
9 of IRC section 121(a), and neither spouse excluded gain under IRC section 121(a) for another sale  
10 within the two-year period stated in that section.

11 The Second Circuit Court of Appeals in *Cohan* stated that, when a taxpayer has spent  
12 much and the sums were allowable expenses, the taxing authority should make as close an  
13 approximation of the deductible expenses as it can, bearing heavily if it chooses upon the taxpayer  
14 whose inexactitude is of his own making. (*Cohan v. Commissioner, supra*, 39 F.2d at p. 544.)  
15 Furthermore, the appellate court stated that allowing nothing at all seems inconsistent with saying that  
16 something was spent. (*Cohan v. Commissioner, supra*.)

17 In *Bayly*, the taxpayer and his former wife purchased a residence in Maryland in 1964  
18 for \$11,000. The taxpayer was an experienced construction worker, and his former wife kept books for  
19 the family and maintained records of the expenditures made with respect to the Maryland residence. In  
20 1971, the taxpayer and his former wife obtained a home improvement loan in the amount of \$7,215 to  
21 make such improvements as adding two bedrooms and a lowered family room with a fireplace and a  
22 cathedral ceiling (the 1971 improvements). Because the funds from the home improvement loan were  
23 insufficient to complete the construction of the three rooms, the taxpayer expended additional sums to  
24 complete the 1971 improvements as well as for other improvements he made to the home during the  
25 twelve years that he resided there. (*Bayly v. Commissioner, supra*.)

26 After the taxpayer and his former wife separated, he left the country on business and  
27 stored his personal belongings in a summer house owned by his former wife's mother. During the  
28 winter when that house was unoccupied, vandals broke into the house and stole, burned, or otherwise

1 destroyed everything in the house, including receipts and records of the expenditures for the  
2 improvements to the Maryland residence purchased in 1964. The taxpayer notified the Maryland State  
3 Police and submitted to them a written report of the items that had been destroyed or stolen, including  
4 the records and receipts for the Maryland residence. (*Bayly v. Commissioner, supra.*)

5           The taxpayer and his former wife sold the Maryland residence in 1976. In preparing his  
6 federal tax return for 1976, the taxpayer calculated that the total investment in the residence, including  
7 the initial purchase price of \$11,000, exceeded \$32,000 and concluded that the adjusted basis of the  
8 residence exceeded the amount of \$38,626 realized from its sale. The taxpayer did not report a gain  
9 with respect to the residence. Because of the loss of the records regarding the residence, the taxpayer  
10 could make only rough estimates of the improvements he and his former wife remembered making to  
11 the residence. Those estimates were based both on his experience in the construction industry and the  
12 collective recollections of him and his former wife regarding the cost of the improvements. (*Bayly v.*  
13 *Commissioner, supra.*)

14           After review of the taxpayer's 1976 return, the Internal Revenue Service determined that  
15 the residence had an adjusted basis of \$18,215 and was sold at a gain of \$20,411. At the Tax Court, the  
16 taxpayer described expenditures for itemized improvements to the residence in the total amount of  
17 \$14,521. In its analysis of the the expenditures for improvements to the residence claimed by the  
18 taxpayer, the Tax Court stated that because of some apparent duplications in the expenditures  
19 (apparently somewhat in excess of \$3,100) claimed by the taxpayer and the admittedly rough estimates  
20 used to calculate the amounts expended, it was unable to determine with any exactitude the total  
21 amount invested in the residence in the way of capital improvements. Applying the *Cohan* rule and  
22 "bearing heavily" against the taxpayer because of inexactitude of his own making, the Tax Court found  
23 that expenditures for capital improvements to the residence (\$9,085), together with the home  
24 improvement loan of \$7,215, amounted to \$16,300. The Tax Court stated that the amount of \$16,300,  
25 when added to the original cost of \$11,000, yielded an adjusted basis of \$27,300, with the result that  
26 there was a realized gain on the sale of the residence of \$11,326. (*Bayly v. Commissioner, supra.*)

27           It is well established that a presumption of correctness attends respondent's  
28 determinations of fact and that an appellant has the burden of proving such determinations erroneous.

1 (*Appeal of George H. and Sky Williams, et al.*, 82-SBE-018, Jan. 5, 1982.) This presumption is a  
2 rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary.  
3 (*Appeal of George H. and Sky Williams, et al., supra.*) Respondent’s determinations cannot, however,  
4 be successfully rebutted when the taxpayer fails to present credible, competent, and relevant evidence  
5 as to the issues in dispute. (*Appeal of George H. and Sky Williams, et al., supra.*)

6 R&TC section 19164, subdivision (a)(1)(A), provides that an accuracy-related penalty  
7 shall be imposed under the Personal Income Tax Law and shall be determined in accordance with  
8 IRC section 6662, except as otherwise provided. IRC section 6662(a) provides that if that section  
9 applies to any portion of an underpayment of tax required to be shown on a return, there shall be added  
10 to the tax an amount equal to 20 percent of the portion of the underpayment to which it applies. IRC  
11 section 6662(b) provides, in pertinent part, that the section will apply to any portion of the  
12 underpayment that is attributable to (1) negligence or disregard of rules or regulation or (2) any  
13 substantial understatement of income tax. IRC section 6662(c) provides that, for purposes of the  
14 section, “negligence” includes any failure to make a reasonable attempt to comply with the provisions  
15 of the IRC. IRC section 6662(d)(1)(A) provides that, in general, there is a “substantial understatement”  
16 of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the  
17 greater of (i) 10 percent of the tax required to be shown on the return for the taxable year or (ii) \$5,000.

18 IRC section 6662(d)(2) provides, in pertinent part, that the term “understatement” means  
19 the excess of (i) the amount of tax required to be shown on the return for the taxable year over (ii) the  
20 amount of tax imposed which is shown on the return. IRC section 6662(d)(2)(B)(i) provides that the  
21 amount of the understatement of tax is reduced by the portion of the understatement that is attributable  
22 to the tax treatment of any item by the taxpayer if there is or was “substantial authority” for such  
23 treatment. IRC section 6662(d)(2)(B)(ii) provides, in pertinent part, that the amount of the  
24 understatement of tax is also reduced by the portion of the understatement that is attributable to any  
25 item if (I) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or  
26 in a statement attached to the return and (II) there is a “reasonable basis” for the tax treatment of such  
27 item by the taxpayer. IRC section 6664(c)(1) provides, in pertinent part, that no penalty shall be  
28 imposed under section 6662 on any portion of an underpayment if it is shown that there was a

1 reasonable cause for such portion and that the taxpayer acted in good faith with regard to that portion.

2 Treasury Regulation section (Regulation) 1.6662-3(b)(1) provides generally that the  
3 term “negligence” includes any failure to make a reasonable attempt to comply with the internal  
4 revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.  
5 Furthermore, that regulation states that “negligence” includes any failure by the taxpayer to keep  
6 adequate books and records or to substantiate items properly.<sup>10</sup> Regulation 1.6662-3(b)(1)(ii) states  
7 that negligence is strongly indicated when a taxpayer fails to make a reasonable attempt to ascertain the  
8 correctness of a deduction, credit, or exclusion on a return that would seem to a reasonable and prudent  
9 purpose to be “too good to be true” under the circumstances.

10 Regulation 1.6664-4(b) provides generally that the determination of whether a taxpayer  
11 acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all  
12 pertinent facts and circumstances. That regulation also provides that, in general, the most important  
13 factor is the extent of the taxpayer’s effort to assess his proper tax liability. Furthermore, that  
14 regulation provides that circumstances which may indicate reasonable cause and good faith include an  
15 honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances,  
16 including the experience, knowledge, and education of the taxpayer. In addition, that regulation states  
17 that reliance on an information return or the advice of a professional tax advisor or appraiser does not  
18 necessarily demonstrate reasonable cause and good faith. However, that regulation also states that  
19 reliance on an information return, professional advice, or other facts constitutes reasonable cause and  
20 good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good  
21 faith.

## 22 STAFF COMMENTS

23 At the hearing, appellants will want to persuade the Board that respondent erred by not  
24 allowing a greater cost basis than the \$1,200,000 it has agreed to allow on appeal. In addition,  
25 appellants should, if possible, provide evidence supporting their assertion that the relevant records, both  
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27 <sup>10</sup> Regulation 1.6662-3(b) also states that a return position that has a “reasonable basis,” as defined in Regulation 1.6662-3(b)  
28 (3), is not attributable to negligence. Regulation 1.6662-3(b) (3) states that “reasonable basis” is a relatively high standard of  
tax reporting that is significantly higher than not frivolous or not patently improper. Furthermore, that regulation states that  
the reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim.

1 of the initial construction and the earthquake repairs, were destroyed by flooding (such as, perhaps, an  
2 insurance claim). Respondent should be prepared to discuss in detail at the hearing the components of  
3 its revised cost basis of \$1,200,000 and how it arrived at the amount of each of the components.

4 For quick reference, staff provides the following summary of key documents in the  
5 appeal:

6 McConihay Report- Scope and Cost of Repair (dated July 7, 2011)

7 Based on his experience in the contracting business in the greater Los Angeles area,  
8 Mr. McConihay estimated the cost per square foot of constructing a home in the 1990's that was the  
9 size of appellants' home (6,100 square feet) was \$220, for a total cost of \$1,342,000. Mr. McConihay  
10 estimated that total out-of-pocket cost for earthquake repair would be \$105,000, comprised of \$40,000  
11 for marble on the first floor, \$15,000 for installing or replacing tile in the bathrooms, \$30,000 for  
12 repainting the house, and \$20,000 for concrete work in the driveway, backyard, and walks on the side  
13 of the house. Mr. Conihay added to the foregoing amounts site improvements in the total amount of  
14 \$189,000 to reach "net cost-dwelling and site improvements" of \$1,636,000.

15 State Farm letter- apparently presented by appellants at audit (dated February 10, 2010)

16 The State Farm Insurance agent stated that he inspected appellants' home in 1990.  
17 Based upon his experience in the insurance business, the agent estimated building costs to be between  
18 \$200 and \$250 a square foot at that time. The agent stated that he viewed the earthquake damage to  
19 appellants' home shortly following the Northridge earthquake in 1994 and estimated that they suffered  
20 well over \$150,000 in earthquake damage.

21 Los Angeles County Assessor's Report (undated)

22 The assessor's report indicates an assessed value of \$341,600 for the land and \$691,000  
23 for improvements, for a total value of \$960,600. The assessed values are for 1991.

24 Western Reserve Mortgage Appraisal- prepared for purposes of appellants' mortgage refinancing  
25 (dated April 23, 1991)

26 The appraisal states that, on the basis of comparisons of properties in the immediate  
27 area, the indicated value of appellants' home was \$1,200,000.

28 The parties should be prepared to discuss the merits of appellants' application of *Bayly*

1 in its additional briefing to the facts of this matter. It appears to staff that, rather than applying a  
2 percentage to reduce the basis claimed by the taxpayer in that case, the court evaluated the specific  
3 assertions and evidence in the record (e.g., removing double-counted items) and, “bearing heavily”  
4 against the taxpayer, made a reasonable estimate of basis. Staff notes that the taxpayer in *Bayly*  
5 evidently provided a police report in which they had listed the relevant records as having been  
6 destroyed or stolen.

7           With regard to the accuracy-related penalty, appellants should, if possible, provide any  
8 workpapers or correspondence (such as emails or letters) showing their efforts to make a reasonable  
9 estimate of their basis at the time they filed their tax return. Respondent will want to address further  
10 whether, based on appellants’ testimony and/or any additional evidence provided, abatement of the  
11 accuracy-related penalty could be warranted.

12           Pursuant to California Code of Regulations, title 18, section 5523.6, any party wishing  
13 to provide additional evidence should provide it to the Board Proceedings Division (with copies to the  
14 other party) at least 14 days prior to the oral hearing.<sup>11</sup>

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<sup>11</sup> Evidence exhibits should be sent to: Khaaliq Abd’Allah, Government Program Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.