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10 **BOARD OF EQUALIZATION**
 11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeals of:) **HEARING SUMMARY**
 13) **PERSONAL INCOME TAX APPEALS**
 14)
 15) **WILLIAM R. DOBKIN AND**) Case No. 728014
 16) **DONYA DOBKIN;**)
 17) **DEBORAH DOBKIN¹**) Case No. 725828

<u>Appellants</u>	<u>Case Nos.</u>	<u>Year</u>	<u>Proposed Additional Tax</u>	<u>Accuracy-Related Penalty²</u>
William & Donya Dobkin	728014	2006	\$181,348.00	\$36,269.60
Deborah Dobkin	725828	2006	\$121,923.00	

18
 19 For Appellants: Joseph E. Mudd, Esq.
 20 For Franchise Tax Board: David Gemmingen, Tax Counsel IV

21
 22 CONSOLIDATED APPEALS

23 These consolidated appeals are made pursuant to section 19045 of the Revenue and

24
 25
 26 ¹ William and Donya Dobkin are currently residents of Orange County, California. Deborah Dobkin is currently a resident of Los Angeles County, California. For sake of simplicity, the parties will be referred to herein as William, Donya, and/or Deborah.

27 ² William and Donya are not disputing the accuracy-related penalty. Staff notes that the accuracy-related penalty will be reduced accordingly should the tax deficiency be reduced.
 28

1 Taxation Code (R&TC) from the actions of the Franchise Tax Board (FTB or respondent) on each
2 appellant's protest of the respective proposed assessments.

3 QUESTION: Whether appellants have substantiated the adjusted basis of their Long Beach home for
4 the purpose of calculating gain on the sale.

5 HEARING SUMMARY

6 Background

7 These consolidated appeals arise from determinations by the FTB that appellants owe
8 additional tax as a result of gain from the sale of a home in Long Beach, California (hereinafter referred
9 to as the property or the home) , in 2006. In 1987, William and Deborah, who were married at the time,
10 purchased two ocean-front lots in the Naples area of Long Beach, California, for the purpose of building
11 a home. (FTB Add. Br., 6/27/14, Ex. E.) The home they constructed was approximately 7,754 square
12 feet and was three stories tall, with all three stories above ground level. In addition, the home included a
13 large subterranean basement/garage and two boat docks. (App. Reply Br., Exhibit of building plans.)

14 After constructing the home and living in it for many years, William and Deborah filed
15 for divorce, which became final in 2003. Pursuant to the terms of their divorce, William and Deborah
16 agreed to sell the home and divide the sales proceeds equally, with each party reporting one-half of any
17 gain from the sale for tax purposes. (FTB Reply Br., Exh. B.) After obtaining a divorce, William
18 married Donya. Subsequently, the home was sold in 2006 for a price of \$6,300,000. (FTB opening
19 brief (FTB OB), p. 1.)

20 Deborah filed a 2006 California Resident Income Tax Return, reporting the sale of the
21 home and California taxable income of \$1,193,853. After reviewing her return, the FTB issued a Notice
22 of Proposed Assessment (NPA) dated February 15, 2011, increasing Deborah's California taxable
23 income by \$1,183,714 (i.e., from \$1,193,853 to \$2,377,567) resulting from a reduction in the claimed
24 adjusted basis of the home that Deborah had used to calculate gain on the sale of the home. The NPA
25 proposed an additional tax of \$121,923, plus applicable interest. (FTB Reply Br., 6/27/14, Exh. A and
26 Exh. B.)

27 William and Donya filed a joint 2006 California Resident Income Tax Return, reporting a
28 home mortgage interest deduction of \$443,711 and California taxable income of -\$28,554, which was

1 reported as zero. After reviewing their return, the FTB issued a NPA dated February 15, 2011,
 2 increasing William and Donya's 2006 California taxable income by \$1,927,628 to account for (a) "basis
 3 adjustment residence sold" of \$1,399,922, (b) disallowed mortgage interest deduction of \$443,711, and
 4 (c) itemized deduction phase out of \$83,995. The NPA proposed additional tax of \$181,348 and an
 5 accuracy-related penalty of \$36,269, plus applicable interest. (FTB Reply Br., 6/27/14, Exh. C.)

6 William and Donya concede the home mortgage interest deduction adjustment of
 7 \$443,711 which will not be addressed herein. In addition, William and Donya are not disputing the
 8 accuracy-related penalty. Accordingly, the only issue remaining is whether appellants can substantiate
 9 the adjusted basis of the home. (App. Add'l Br., pp. 1-2.)

10 Contentions

11 Appeal Letter

12 Appellants assert that they spent considerable sums of money constructing the home,
 13 which is located "right on the beach," and has a basement. Appellants also assert that they spent
 14 "significant sums" attempting to locate the builder who will have "significant recollection" of the cost
 15 of construction. In addition, appellants state they "capitalized interest." (App. Ltr., pp. 1-2.)

16 Appellants attach a schedule of itemized costs as follows:

17 Table 1		
18 Sales Price		\$6,300,000
19 Land	1,835,000	
20 Purchase escrow costs	340,000	
21 Building	2,500,000	
22 Architect	250,000	
23 Replace two docks	25,000	
24 Extend 220 voltage to docks	1,500	
25 Other building improvements	75,000	
26 Replace deck	35,000	
27 Mahogany cabinets	25,000	
28 Electrical blinds	20,000	
Electrical blinds, additional	20,000	
Sound system	12,500	
Water heaters	2,500	
Cabinets in garage	7,500	
Wine cabinets in cellar	7,500	
Darkroom cabinets	12,500	

Appeal of William R. Dobkin and Donya Dobkin and
Appeal of Deborah Dobkin

NOT TO BE CITED AS PRECEDENT - Document prepared for
 Board review. It does not represent the Board's decision or opinion.

1	Fire pit	12,500	
2	Replace doors	250,000	
3	Installation labor	75,000	
4	Replace decks	20,000	
5	Entertainment center	15,000	
6	Loan interest – capitalized	225,000	
7	Bookshelf	8,500	
8	Buffet	10,000	
9	Chandeliers	28,000	
10	Carpeting	18,000	
11	Desk – Ashley’s room	12,000	
12	Desk – Jason’s room	9,500	
13	Kitchen remodel	9,000	
14	Ceiling fans	6,000	
15	Television – exercise room	3,000	
16	Outside lighting	5,000	
17	Washer – dryer	1,000	
18	Landscaping	250,000	
19	Subtotal		-6,125,500
20			
21	Selling costs (escrow)		-345,066
22	Homeowners exemption		-500,000
23			
24	Gain (loss) on sale		-\$325,541

25 Appellants also assert that they have located the architect of the home and the architect
26 will provide testimony as to the cost of building the home if the builder cannot be located. In addition,
27 appellants provide certificates of occupancy with their appeal letter. The first certificate of occupancy is
28 dated March 9, 1988, and states that it was issued for “SHORING FOR DWELLING.” The second
certificate of occupancy is dated January 1, 1989, and states that it was issued for “INSTALL GUNITE
SPA.” The third certificate of occupancy is dated January 1, 1992, and states that it was issued for
“NEW SINGLE FAMILY DWELLING.” The fourth certificate of occupancy is dated March 21, 1994,
and states that it was issued for “124 SQ FT ROOF EXTENSION OVER EXIST DECK.” None of the
certificates of occupancy lists any expenses for construction. (App. Ltr., Exhibits attached)

The FTB

The FTB contends that appellants claimed an inflated and unsubstantiated basis in the home. The FTB asserts that appellants have continually failed to provide any substantiation for their

1 alleged basis of \$6,125,500, as set forth in the table above. In relation to the certificates of occupancy,
2 the FTB asserts that a certificate of occupancy simply shows that a home can be occupied and in no way
3 relates to any costs incurred in the construction of that dwelling. In addition, the FTB states that in
4 appellants' protest letter dated April 15, 2011, appellants' representative acknowledged appellants'
5 failure to provide substantiating documentation at the audit process when he stated in his protest letter
6 that "Taxpayer did provide a list of expenses, but without verification." In addition, the FTB contends
7 that appellants' representative stated in a protest letter dated September 30, 2011, that no documentation
8 as to the alleged expenses could be found. The FTB asserts that these "admissions" on appellants'
9 behalf nullify appellants' ability to sustain their burden of proof. (FTB OB, pp. 1-2.)

10 The FTB states that it reviewed Los Angeles County Assessor's information relating to
11 the property construction and improvements made from 1988 through 2006 to determine the tax basis
12 for the home. The FTB states that the property's assessed value did not annually increase more than the
13 two percent limit imposed under Proposition 13. The FTB asserts that because the property was not
14 assessed for improvements made after initial construction, it correctly determined that all major property
15 improvements were completed when the home was built in 1989. (FTB OB, p. 3.)

16 The FTB states that the Los Angeles County Assessor's office confirmed that
17 improvements justifying a basis in property in excess of \$6 million would have certainly been reported
18 to the County Assessor's office. The FTB states that Los Angeles County real property assessment
19 records report the property's assessed value was approximately \$3.7 million on July 1, 2006, which the
20 FTB asserts represents a two percent increase per year in compliance with Proposition 13. The FTB
21 states that the county records reflect, and the Assessor's staff confirmed to the FTB's counsel, that from
22 1988 until 2006 there was no change in ownership and there was no major or material construction
23 reported. (FTB OB, p.3.)

24 The FTB contends that property tax records show that appellants acquired the land in
25 1987 for \$300,000 and that building permits were obtained from the City of Long Beach from 1987
26 through 1989. The FTB asserts that permit information shows that the majority of the personal
27 residence construction commenced right after the 1987 land acquisition. (*Id.*, pp. 3-4.) The FTB
28 contends that, according to the Assessor's office records, the assessed value of the property in 1988 was

1 \$1,871,700 for the land and \$783,390 for the improvements, for a total assessed value of \$2,655,090,
2 (*id.*, p. 4, fn. 1) as follows:

3	Land assessed value	\$1,871,700
4	Improvements assessed value	<u>783,390</u>
	Cost basis allowed	\$2,655,090

5 Based on the foregoing, the FTB asserts that the gain for each appellant from the sale of the property is
6 computed (*id.*, p. 6) as follows:

7		<u>100%</u>	<u>50%</u>
8	Sales price (July 14, 2006)	\$6,300,000	\$3,150,000
9	Less cost basis	(2,655,090)	(1,327,545)
10	Less closing costs per escrow statement		
	Credit for repairs	(65,937)	(32,969)
	Commissions	(252,000)	(126,000)
11	Other closing costs	<u>(27,129)</u>	<u>(13,565)</u>
		\$3,299,844	\$1,649,921
12	Less IRC § 121 exclusion		<u>(250,000)</u>
13	Gain		1,399,921
14	Less gain previously reported		<u>0</u>
	Proposed additional gain for each appellant		\$1,399,921

15
16 The FTB asserts that because appellants have not provided supporting documents (such
17 as contracts, receipts, and/or cancelled checks) substantiating the claimed basis of \$6,125,500, the best
18 evidence available to support a reasonable basis is the assessed value immediately after construction
19 completion. (FTB OB, p. 4.)

20 The FTB contends, in general, that the amount of gain to be recognized from a sale is the
21 excess of the amount of gain realized from the sale over the adjusted basis of the property sold, citing
22 Internal Revenue Code (IRC) sections 1001(a) and 1011 and *Appeal of Jacob and Goldie Blanck*,
23 74-SBE-028, decided on August 1, 1974.³ The FTB also contends that its determination of tax is
24 presumed to be correct, and a taxpayer has the burden of proving error, citing *Appeal of Gordon and*
25 *June K. Fraser*, 86-SBE-157, decided on September 10, 1986. (FTB OB, pp. 6-7.)

26 Next, the FTB contends that under IRC section 121 married taxpayers may exclude gains
27

28 ³ Board of Equalization cases are generally available for viewing on the Board's website (www.boe.ca.gov).

1 of up to \$500,000 (and single taxpayers may exclude \$250,000) from the sale of a principal residence,
2 provided the following requirements are met:

- 3 • The property must have been owned and used by the taxpayer as the taxpayer's principal
4 residence for a period aggregating two years or more.
- 5 • The gain exclusion applies only to one sale or exchange every two years. (FTB OB, p. 7.)

6 Next, the FTB asserts that appellants failed to provide any evidence establishing that
7 additional improvements were made and failed to provide any records indicating the cost of such alleged
8 improvements. The FTB also asserts that appellants failed to satisfy their twin burdens of proof:
9 (i) proving that the FTB's determination is wrong, and (ii) establishing the correct amount of tax.
10 Accordingly, the FTB asserts that its determination must be sustained. In relation to appellants'
11 argument that they will provide future testimony (either from the builder or architect), the FTB contends
12 that such an argument is untimely, conclusory, uninformative, and hinders the FTB's ability to timely
13 and efficiently process returns. (FTB OB, p. 8.)

14 The FTB argues that due to the complete absence of factual support that additional capital
15 improvements were made, appellants' claimed improvement expenditures cannot be allowed. Also, in
16 relation to any oral representations that appellants are making (or might make in the future), the FTB
17 contends that such statements are often held to be insufficient to rebut the FTB's presumption of
18 correctness because skepticism is "reinforced, in modern times, by the ubiquitous paper trail of virtually
19 all commercial activity," citing *Woodland Trust v. Flowertree Nursery, Inc.* (Fed. Cir. 1998) 148 F.3d
20 1368, 1373. In addition, the FTB contends that appellants' unsupported assertions are insufficient to
21 carry their burden of proof, citing *Appeal of James C. Monablanch A. Walshe*, 75-SBE-073, decided on
22 October 20, 1975. (FTB OB, pp. 8-9, fn. 5.)

23 The FTB states that appellants must provide reliable and precise factual evidence
24 showing that they incurred the alleged improvement expenditures, citing *Vaira v. Commissioner* (3rd
25 Cir. 1971) 444 F.2d 770. In addition, the FTB states that Treasury Regulation section 1.6001-1(a)
26 requires that taxpayers "keep such permanent books of account or records, including inventories, as are
27 sufficient to establish the amount of gross income, deductions, credits, or other matters required to be
28 shown by such person in any return of such tax or information." The FTB reiterates that it allowed a

1 basis of \$2,655,090; and the FTB asserts that appellants have not have not provided evidence
2 substantiating the remaining claimed expenses of \$3,470,410. The FTB asserts that given the relatively
3 large amount of the claimed additional basis, appellants' disregard for their compulsory record-keeping
4 duties is especially unreasonable. (FTB OB, pp. 12-13.)

5 The FTB reiterates that its determination of tax is presumed to be correct, and a taxpayer
6 has the burden of proving error, citing *Appeal of Robert V. Erilane*, 74-SBE-050, decided on
7 November 17, 1974. Also, the FTB contends that when a taxpayer fails to provide ascertainable
8 evidence in the taxpayer's favor, the evidence is presumptively considered unfavorable to the taxpayer's
9 case, citing *Appeal of Don A. Cookston*, 83-SBE-048, decided on January 3, 1983. (FTB OB, p. 14.)

10 Appellants' Reply Brief

11 Appellants assert that they kept all records of repair and construction for many years but
12 apparently those records were discarded while moving during a divorce. Appellants contend that the
13 only evidence they have regarding the cost of the premises is their own testimony, the pictures attached
14 to the declaration of Deborah Dobkin, and a declaration from their builder, William Merrill which they
15 state had not yet been received as of the date they filed their reply brief. In relation to Mr. Merrill,
16 appellants contend that Mr. Merrill has no specific records concerning the construction contract, but he
17 does recall that the costs were very high due to quality, demands, the subterranean basement, and the
18 size of the property. Appellants assert that Mr. Merrill indicated that Deborah Dobkin's estimate of
19 costs of \$2,500,000 (as set forth in her declaration, below) is "not unrealistic." Appellants state that
20 since the FTB made no adjustment for Deborah Dobkin's interest deduction, appellants are under the
21 impression that the FTB is only disallowing interest on the loan balance in excess of \$1 million. (App.
22 Reply Br., pp. 1-2.)

23 Appellants contend that the records in this appeal which were retained for years, lost any
24 significance to Deborah Dobkin and they were unavailable and not reproducible at the time of the audit.
25 Appellants assert that Deborah Dobkin did not retain the records because she believed that all warranties
26 had expired and she was only required to retain the records for seven years for tax purposes. Appellants
27 contend that the court in *Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 840, held that reasonable
28 testimony of costs and expenses, if credible, can be used to substantiate expenses incurred when records

1 are not available. Appellants assert that the information and/or declaration provided by Deborah Dobkin
2 attached to the brief is credible testimony. (App. Reply Br., pp. 1-2.)

3 Deborah Dobkin's Declaration

4 In her declaration, Deborah states that she and William constructed the home from 1987
5 through 1989 at great expense. She states that she retained documents that were related to the
6 construction for many years and that several boxes containing all of the contracts, receipts, checks,
7 permit applications and warranties were stored in boxes and kept at the home until she moved out of the
8 home in 2005. She states that she did not realize she had to retain such documents beyond seven years
9 for tax purposes. She asserts that during the building, modifications, and subsequent additions, she kept
10 a summary of the total expenses, which are comprised in the following three categories:

11	Land	\$1,835,000
12	Home	\$2,500,000
	Improvements	\$ 678,500
	Total	\$5,013,500⁴

14 She asserts that three above-listed categories can be broken-down further as follows:

15 Table 2		
16	Land	\$1,835,000
	Home (8,000 sq. ft. with 3,000 additional sq. ft. underground)	2,500,000
17	Replace two docks	25,000
	Extend 220 voltage to docks	1,500
18	Replace two decks, upgrade waterproofing, repair water damage to family room, living room, master bedroom	75,000
19	Replace deck and extend roof over third floor deck at kid's room	35,000
20	Install built-in mahogany cabinets in office	25,000
	Install automatic electrical blinds in family room, move power	20,000
21	Install automatic electrical blinds in master bedroom, move power	20,000
	Install surround sound in walls of family room, repair walls	12,500
22	Replace water heaters with rapid heater	2,500
	Built cement block cabinets in garages	7,500
23	Install mahogany wine racks in wine cellar	7,500
	Install darkroom cabinets, plumbing, and electrical in photo room	12,500
24	Install fire pit in courtyard, provide gas and electrical controls	12,500
25	Replace all wood and glass doors (app. 50) with custom made mahogany and glass doors	250,000
	Install above, repair walls and drwwalls, provide new hardware	75,000

27 ⁴ Staff notes that in Table 2 below, Deborah lists the following amounts totaling \$5,036,500: land of \$1,835,000, home of
28 \$2,500,000, and improvements of \$701,500. Appellants do not explain the discrepancy between the amount of \$5,013,500 and the amount of \$5,036,500 (a difference of \$23,000).

1	Replace and upgrade first floor deck off dining room times two	10,000
2	Replace moveable television and entertainment center master bedroom	15,000
3	Deborah's Additions	
4	Custom bookshelf – 1st floor family room	8,500
5	Custom buffet – 1st floor dining room	10,000
6	Custom chandeliers x 2	14,000
7	Replace Berber carpeting	18,000
8	Custom desk and shelf units in Ashley's room	12,000
9	Custom desk and shelf units in Jason's room	9,500
10	Repaint second floor kitchen	8,000
11	Install ceiling fans x 6	6,000
12	Built-in TV in exercise room	3,000
13	Replace all wall outside light fixtures	5,000
14	Replace washer/dryer	1,000
15	TOTAL	\$5,036,500

16 She also asserts that interest expense over and above the amount allowed as a deduction
17 can be capitalized and added to the basis of the property. She states that after the tax return for the year
18 in which the property was sold was completed, her list of basis expense items was delivered to her
19 accountant and her ex-husband relied upon her summary in the preparation of his tax return. She asserts
20 that after the FTB began its audit, (i) she could not locate the actual records of construction, (ii) bank
21 account records were no longer available, and (iii) she could not locate the builder. Attached to her
22 declaration are floor plans of the home, along with pictures of the property.

23 The FTB's Reply Brief

24 The FTB states that, according to Los Angeles County Assessor's records, appellants
25 acquired the land in 1987 for a purchase price of \$300,000. In addition, the FTB states that building
26 permits dated from 1987 to 1989 show that the majority of construction occurred soon after the 1987
27 acquisition of land. The FTB reiterates that the Assessor's records indicate that in 1988 the assessed
28 value of the land was \$1,871,700 and the assessed value of the improvements was \$783,390, which is
consistent with the building permits filed with the City of Long Beach. Based on the foregoing, the FTB
states that the FTB auditor determined that \$2,655,090 (i.e., \$1,871,700 + \$783,390) was the adjusted
basis of the property. The FTB states that it is important to note that in their reply brief appellants agree
that the home's construction occurred during the years 1988 and 1989, as evidenced by their statement
that "17 years after construction, the records were destroyed." (FTB Reply Br., p. 1.)

The FTB asserts that a supplemental assessment was never issued and the property was

1 not reassessed after 1988. The FTB explains that a supplemental assessment must be added to a
2 supplemental tax roll whenever new construction is completed and whenever real property is transferred,
3 citing Chapter 3.5 to Part 0.5 of Division 1 of the R&TC. In addition, the FTB states that R&TC section
4 70 provides, in part, that new construction means (1) any addition to real property, and (2) any alteration
5 of land or any improvement. The FTB contends that reassessment of a property is required pursuant to
6 R&TC section 71 upon completion of new construction as defined by R&TC section 70. If appellants
7 had completed any new construction after 1988, the FTB contends that the property would have been
8 reassessed and a supplemental assessment would have been issued. (FTB Reply Br., pp. 1-2.)

9 The FTB contends that appellants' allegation that they disposed of the property records in
10 2005 because they were unaware of the need to retain such records conflicts with the divorce agreement,
11 filed in 2003, in which Deborah and William acknowledged they would be responsible for reporting
12 their share of taxable gain on the sale of the home. (A copy of the applicable divorce agreement is
13 attached to the FTB's reply brief as Exhibit B.) The FTB asserts that appellants had a duty to retain
14 records. (FTB Reply Br., p. 3.)

15 The FTB contends that appellants simply offer a "conjectured observation" from
16 William Merrill who has no records supporting his statement that the home's construction cost of
17 \$2,500,000 is "not realistic." The FTB asserts that appellants provide no foundation for Mr. Merrill's
18 statement. In addition, the FTB asserts that Mr. Merrill is not offering his own opinion as to costs but is
19 merely offering "a vague and self-serving opinion" with respect to Deborah's unsubstantiated opinion.
20 Also, the FTB notes that, as of the date of the FTB's reply brief, appellants' had not provided a
21 declaration from Mr. Merrill. Next, the FTB notes that appellants are alleging a cost basis in the land of
22 \$1,835,000. The FTB asserts, however, that appellants have not substantiated such a grossly inflated
23 cost basis in the land of \$1,835,000.⁵ (FTB Reply Br., pp. 4-5.)

24 With regard to the Cohan rule, the FTB contends that where a taxpayer has established
25 that he or she has incurred an expense for which a deduction may properly be claimed, but is unable to
26 document the exact amount of the expense, a reasonable estimate of the deduction may be made in

27 _____
28 ⁵ Staff notes that the FTB auditor (and the FTB's proposed assessment) allowed a cost basis in the land of \$1,871,700, which is greater than the \$1,835,000 that appellants are asserting on appeal. See Staff Comments below.

1 certain circumstances, weighing heavily against the taxpayer whose inexactitude is of his own making,
2 citing *Cohan v. Commissioner, supra*. The FTB asserts that although the Cohan rule was articulated
3 with respect to estimating expense deductions, the Tax Court has relied on it for purposes of estimating
4 the adjusted basis of property with respect to improvements, citing *Minchew v. Commissioner (1953) 12*
5 *T.C.M. 1107*. (FTB Reply Br., pp. 5-6 & 9-10.) The FTB asserts that it has made a reasonable estimate
6 of expenses in granting a basis of \$2,655,090 in the property, and the FTB contends that the Board has
7 selectively applied the Cohan rule, primarily only when a deduction has been entirely disallowed by the
8 FTB, and not when a deduction has been partially or substantially allowed, citing *Appeal of Henrietta*
9 *Swimmer, Executrix, et. al., 63-SBE-138*, decided on December 10, 1963; *Appeal of California Steel,*
10 *Inc., 2003-SBE-001*, decided on July 9, 2003; *Zeidler v. Commissioner, T.C. Memo. 1996-157, aff'd,*
11 *(7th Cir. 1997) 132 F.3d 37*. (FTB Reply Br., pp. 5-6 & 9-13.) The FTB asserts that appellants have not
12 provided any credible evidence demonstrating a cost basis in excess of the \$2,655,090 that the FTB
13 allowed based on Los Angeles County property tax records. Accordingly, the FTB asserts that the
14 Board should not find error in the FTB's proposed assessments. (FTB Reply Br., pp. 5-6 & 13-14)

15 In further support of the proposed assessments, the FTB cites a September 23, 1993
16 appraisal report prepared by "Dwyer Appraisal" as part of a loan refinance for the property. (A copy of
17 the appraisal report is attached as Exhibit D to the FTB's reply brief.) The FTB states that the appraisal
18 report is "objective" and "disinterested" and was prepared "without tax considerations" in mind. The
19 FTB states that as part of the determination of value for refinancing the home in 1993, the appraiser
20 undertook various methods of determining valuation, including his "Estimated Reproduction Cost-New
21 of Improvements" found at the top right corner of the relevant appraisal page in the "Cost Approach."
22 The FTB notes that the appraiser's 1993 new construction cost estimate, based on "estimates . . . from
23 Marshall & Swift, as well as information provided by Local Builders/Contractors," found that, as of
24 1993, the cost to rebuild the property would be \$2 million. Based on the foregoing, the FTB asserts that
25 its determination to allow a basis of \$2,655,000 falls in line with the 1993 appraisal. (FTB Reply Br.,
26 pp. 12-13.)

27 With respect to the photographs that appellants provide with their reply brief, the FTB
28 asserts that appellants have not provided a foundation for those photographs, establishing who took the

1 photographs and/or when the photographs were taken. Based on the foregoing, the FTB asserts that the
2 photographs should be disregarded. (FTB Reply Br., p. 14.)

3 Appellants' Additional Brief

4 In an additional brief dated January 7, 2014, appellants contend that they have contacted
5 Mr. Merrill and he is still attempting to reconstruct costs of construction, "which he will testify to be
6 much higher than normal square footage expenses." Next, appellants contend that they have located a
7 "proof of purchase" for one of the two lots at issue. Appellants reference a grant deed recorded on
8 March 20, 1987, which they assert shows that their records are more accurate than the FTB's suggested
9 values. The grant deed shows a transfer tax of \$330 for one of the lots. In addition, appellants provide
10 an email dated November 27, 2013, from Mark Manwaring, who states that the grant deed is computed
11 not as full value but "less liens" which means that appellants paid \$300,000 but assumed a loan from the
12 seller with an origination amount of \$802,500. Based on the foregoing, Mr. Manwaring speculates that
13 the true purchase price of the property would have been "somewhere in the neighborhood" of
14 \$1,100,000, depending on what was owed on the assumed loan. (App. Add'l Br., Exhibit attachment.)

15 Appellants assert that during the audit the FTB did not allow expenses for expanding the
16 roof over the deck areas because appellants did not provide a copy of a building permit. Appellants
17 point to the certificates of occupancy, attached to their appeal letter, as support for the expenses for
18 expanding the roof over the deck. Also, appellants contend that additional work was completed without
19 permits. For example, appellants assert that all windows and doors were replaced. In addition,
20 appellants contend that there were other expenses that are not reflected on permits, such as the cost of
21 replacing the boat dock. Appellants state that they had hoped to have specific information from
22 Mr. Merrill by the filing of their additional brief dated January 7, 2014, and are still trying to obtain
23 further evidence. Finally, appellants contend that while they are not directly disputing the
24 accuracy-related penalty as they believe there is no tax deficiency and thus the penalty is not applicable.
25 (App. Add'l Br., pp. 1-2.)

26 Additional Briefing Request

27 In a letter dated May 23, 2014, the Appeals Division staff requested that appellants
28 provide copies of all documents supporting their contentions, including the declaration of Mr. Merrill.

1 In addition, staff noted that the auditor’s determination that appellants had an adjusted basis in the land
2 of \$1,871,700 which is greater than the \$1,835,000 adjusted basis for the land that Deborah Dobkin is
3 asserting in her declaration. Accordingly, staff requested that appellants state whether they are willing
4 to agree on an adjusted basis in the land of \$1,871,700, as the FTB auditor determined.

5 Staff also noted that on page six of the FTB’s opening brief, the FTB auditor determined
6 \$2,655,090 as appellants’ adjusted basis in the property—i.e., \$1,871,700 for the land and \$783,390 for
7 the improvements based on the Los Angeles County Assessor’s records for 1988. In comparison, staff
8 noted that the appraisal report, which valued improvements to the property using a reconstruction cost
9 method, estimated that the reproduction costs of “improvements” on the property would have been
10 \$2 million as of September 23, 1993 (the date of appraisal). Based on the appraisal report, staff
11 requested that the FTB discuss whether its auditor should have allowed an adjusted basis of \$2 million
12 for the improvements instead of only \$783,390.

13 The FTB’s Additional Brief dated June 27, 2014

14 The FTB asserts that the Board should not use the appraisal report to estimate the
15 improvements that were made to the property because the \$2 million referred to in the appraisal report is
16 not an adjusted basis figure and the appraisal report was not prepared to determine appellants’ adjusted
17 basis, but rather was prepared for a third-party lender to establish the fair market value of the property as
18 of September 23, 1993, five years after the home was built. The FTB also asserts that the \$2 million
19 reconstruction cost figure referred to in the appraisal report would have been affected by “inflation and
20 other market factors, influences that are not permitted to affect a property’s adjusted basis.” (FTB Add’l
21 Br., p. 2.)

22 The FTB states that recent swings of property values in California demonstrate the
23 difference between fair market value and cost basis. Specifically, the FTB states that many homes
24 purchased in California in 2006 were purchased at a price (which establishes basis pursuant to IRC
25 section 1012) that exceeded the 2011 value of the homes, and many of those homes were purchased with
26 loans of the entire purchase price, some with interest-only payments. Because home values experienced
27 large declines between 2006 and 2011, the FTB asserts that it is apparent that a home’s adjusted basis
28 established in 2006 is not reflected by its 2011 fair market value. Thus, the FTB contends that the cost

1 that a buyer paid for a home in 2006 is irrelevant to a lender considering whether to extend a new loan in
2 2011. (FTB Add'l Br., p. 2.)

3 The FTB asserts a property's fair market value fluctuates depending on current market
4 conditions while a property's adjusted basis is determined by the qualifying construction and
5 improvement costs. The FTB argues that it would be wrong to determine adjusted basis using a
6 property's fluctuating fair market value. The FTB argues that the appraisal report was performed for an
7 independent business transaction contemplated in the fall of 1993 and to determine the property's fair
8 market value—not the property's adjusted basis. The FTB suggests that staff's additional letter implies
9 that an estimate of the property's fair market value in 1993 might act as a substitute for appellants'
10 adjusted basis of the property. The FTB asserts that an estimate of fair market value of the property in
11 1993 cannot act as a substitute for appellants' adjusted basis in such property. The FTB asserts that
12 under IRC section 1001, gain on the sale of property is generally equal to the excess of the amount of
13 money received over the adjusted basis of the property. The FTB contends that "IRC section 1001 does
14 not look to the property's later wavering and estimated value, or ensuing and hypothetical reconstruction
15 costs in determining gain, but rather its adjusted basis." (FTB Add'l Br., p. 3.)

16 The FTB also contends that several statements in the appraisal report are instructive as to
17 why the FTB auditor should not have allowed an adjusted basis (for improvements) of \$2 million.
18 Specifically, the FTB asserts that the appraisal report states that the purpose of the appraisal is to
19 estimate the fair market value of the property (not appellants' adjusted basis), and the appraisal is for the
20 sole and exclusive use of the lender/client. Furthermore, the FTB notes that the appraisal report states
21 that "[b]ecause the purpose of this report is to determine market value . . . the tax liability at the present
22 time may change should the property be sold or purchased." Based on the foregoing statement, the FTB
23 concludes that:

24 Mr. Dwyer acknowledges and recognizes that appraised value may change upon a new
25 acquisition, which would reflect a new adjusted cost basis, notes that his appraisal is
26 concerned with only a determination of fair market value for his client, the contemplated
27 lender, and that the property taxes currently assessed on the property were imposed based
28 on prior acquisition costs, are capped and subject to Proposition XIII limitations, and
could change, not as a result of his appraisal, but by a later sale or purchase.

(FTB Add'l Br., p. 4.)

1 Appellants' Additional Brief dated July 7, 2014

2 Appellants state that the adjusted basis of the property should include amounts to extend
3 the roof covering the upstairs decks. In this respect, appellants state that “[i]t has been demonstrated
4 that a permit was received to extend the roof covering the upstairs decks” and “[t]he FTB had denied
5 that such permits existed, but has still failed to increase basis by any amount.” As to the existence of a
6 subterranean basement, appellants state that the existence of the basement is a fact, whether or not the
7 existing records show that such a basement exists, as appellants and Mr. Merrill testify to its existence.
8 Appellants state that Mr. Merrill recalls in his declaration that the cost to build the home, due to its
9 extravagance, was \$350 per square foot, which appellants assert is very close to the cost appellants have
10 asserted on appeal. Appellants contend that they are willing to stipulate to an adjusted basis in the land
11 of \$1,871,700, as indicated by the FTB’s auditor and as mentioned in staff’s request for additional
12 briefing. (App. 2d Add’l Br, pp. 1-3, Declaration Exhibit.)

13 In relation to the Cohan rule, appellants assert that the Board should review the records
14 from a “common sense” understanding and make a reasonable approximation. Appellants contend that
15 the lists of costs set forth by Deborah Dobkin in her declaration is extensive and reasonable, as the list
16 was compiled years earlier from records that were subsequently discarded. Finally, appellants’
17 representative makes the following statement: “. . . a question arises as to whether depreciation interest
18 payments on a home mortgage which were not deductible are added to its basis. I do not believe this has
19 been answered by the Board. However, it should be a suspended basis similar to passive loss interest.”
20 (App. 2d Add’l Br., pp. 1-3.)

21 Mr. Merrill’s Declaration

22 In his declaration, Mr. William Merrill states the following: In the 1980s, he was a
23 builder of luxury homes in California and was the general contractor and builder of the home for
24 William and Deborah Dobkin. The home was built on two lots with direct waterfront access. The home
25 was approximately 8,000 square feet and contained a large, approximately 3,000 square foot,
26 subterranean basement. It took a considerable amount of time to obtain the necessary permits to build
27 the subterranean basement, and the building and waterproofing of the basement was an expense that
28 would not normally be associated with a home in that area. The home was constructed of the most

1 expensive materials available at the time, and the detail on the home was considerable, including doors,
2 windows, molding, lighting, and decks. After the original construction was completed, he was then
3 hired to expand the roofing over the decks. Although this task was completed approximately 25 years
4 ago, the expense associate with the home was considerable—more than any other home he built in
5 California around that time. Even though he no longer has records related to the construction, he clearly
6 remembers that the square foot cost of construction was approximately \$350. He states that this was one
7 of the most expensive dwellings he constructed at the time and, therefore, he has a fairly clear
8 recollection of the per foot cost.

9 Although the cost of \$350 per square foot would have been high for construction at the
10 time, the subterranean basement (along with the quality of the materials) chosen caused the home’s
11 construction costs to be very high. The \$350 per square foot amount includes the building, the decks,
12 deck improvements, expensive custom cabinets, a wine cellar, a darkroom, electrical window coverings,
13 a built-in sound system, oversized water heaters, built-in bookshelves, chandeliers, carpeting, and
14 finishing. The work he performed did not include landscape, hardscape, boat dock, appliances,
15 electronics, furniture, outside lighting, or personal items. (App. 2d Add’l Br., Declaration Exhibit.)

16 The FTB’s Supplemental Brief dated September 19, 2014

17 The FTB states that the home is currently for sale and public information shows that the
18 “alleged watertight basement” is actually a drive-in car garage located under the house. The FTB
19 disputes appellants’ contention that the FTB denied the existence of building permits as evidenced by
20 three attached letters in which the FTB requested relevant and supporting information from appellants
21 regarding improvements to the property. (FTB Supp. Br., p. 1.)

22 The FTB asserts that construction costs were taken into account and reflected in the
23 records from the Los Angeles County Assessor’s office which the FTB utilized to determine appellants’
24 adjusted basis in the property. The FTB asserts that appellants could have timely contested and
25 corrected the tax records when the home was being built if they believed those records were erroneous,
26 but they failed to do so. (FTB Supp. Br., p. 2.)

27 With regard to the declaration, the FTB contends that it is not surprising that
28 Mr. Merrill’s distant recollection from 25 years ago, which is not based on records or a recent inspection

1 of the property, almost exactly matches appellants' claimed but unsubstantiated basis. The FTB
2 contends that Mr. Merrill's declaration is contradicted by Los Angeles County Assessor's office records,
3 which the FTB asserts are more reliable than Mr. Merrill's unsupported estimate 25 years after the date
4 of construction. The FTB further contends that Mr. Merrill's declaration does not discuss any
5 subsequent improvements, but simply ascribes a blanket cost of \$350 per square foot for all expenses,
6 which the FTB asserts is questionable and excessive in light of "the alleged basic subsequent
7 improvements such as an extended balcony, as proposed by Appellants." (FTB Supp. Br., p. 2.)

8 The FTB argues that the declarations by Deborah Dobkin and Mr. Merrill are
9 unsupported and thus do not satisfy appellants' burden of proof. The FTB contends that when applying
10 the Cohan rule, it is not required to accept the estimates made by a taxpayer, citing *Williams v.*
11 *United States* (5th Cir. 1957) 245 F.2d 559, 560, and is not compelled to guess. Instead, the FTB
12 contends that it is entitled to make its own estimates based on available evidence, bearing heavily
13 against a taxpayer whose inexactitude is of his/her own making, citing *Cohan v. Commissioner, supra.*
14 In addition, the FTB argues that the government's estimates are to be favored over estimates of
15 taxpayers because any estimation made by the government is more favorable than the taxpayer would
16 otherwise be entitled to with no documentation, citing *Cohan v. Commissioner, supra.* In fact, the FTB
17 asserts that its estimate is to be favored even where there is no basis given for the estimate, or even if the
18 estimate seems arbitrary, citing *Lollis v. Commissioner* (9th Cir. 1979) 595 F.2d 1189, 1190-1191. The
19 FTB contends that oral testimony and estimates made by a taxpayer's representatives have been found
20 insufficient to overturn Cohan rule estimates made by the government. The FTB contends that it has
21 fully applied all estimates that are appropriate under the Cohan rule, as the FTB asserts it recognized that
22 a home was constructed and the FTB utilized existing property tax records (which show that the
23 property was not reassessed). (FTB Supp. Br., pp. 2-3.)

24 In regard to appellants' statement in their additional brief that "... a question arises as to
25 whether depreciation interest payments on a home mortgage which were not deductible are added to its
26 basis," the FTB asserts that interest is a deduction only if it meets applicable statutory grounds and is not
27 considered in a home's basis, as that could create an ever inflating basis with respect to a home
28 purchased with borrowed funds that are not eligible for the qualified home mortgage interest deduction.

1 (FTB Supp. Br., p. 3.)

2 Appellants' Supplemental Brief dated September 18, 2014

3 Appellants state that they obtained images of the subterranean garage from the website
4 Zillow⁶ which are an attachment to their additional brief.⁷ Appellant contend that the pictures support a
5 finding that the property's square foot value today is well over \$1,000. Appellants state that the Zillow
6 information describes amenities, such as a 4-stop elevator, two full gourmet kitchens, two laundry
7 rooms, two open water boat docks, and eight bathrooms. Appellants contend that the pictures and
8 information taken from the website Zillow clearly support appellants' alleged expenses. (App. Supp.
9 Br., pp. 1-2.)

10 Applicable Law

11 IRC section 1001 provides that the gain on the sale of property shall be the excess of the
12 amount realized over the adjusted basis as defined in IRC section 1011.⁸ IRC section 1011 provides that
13 the adjusted basis for determining the gain from the sale of property shall be the property's initial basis
14 (determined under section 1012 or other applicable sections of that subchapter) with adjustments as
15 provided in IRC section 1016.

16 Under IRC section 1016, the property's initial basis must be adjusted for capital expenses
17 and capital recoveries. Capital expenses increase the initial basis and capital recoveries decrease the
18 initial basis so that on the date of disposition the adjusted basis reflects the unrecovered cost or other
19 basis of the property. Capital expenses include the cost of capital improvements and betterments made
20 to the property by the taxpayer. (Int.Rev. Code § 1016(a).)

21 The FTB's determination of tax is presumed to be correct, and a taxpayer has the burden
22 of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Aaron and Eloise Magidow*,
23 82-SBE-274, Nov. 17, 1982.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of
24 proof. (*Appeal of Aaron and Eloise Magidow, supra.*)

25 _____
26 ⁶ The website address is www.zillow.com.

27 ⁷ Appellants also attach images of the front of the property.

28 ⁸ California conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

1 The Cohan Rule

2 In *Cohan v. Commissioner, supra*, the famous theatrical producer, George M. Cohan,
3 testified at trial that he had spent substantial sums of money travelling and entertaining actors,
4 employees and drama critics in furtherance of his theatrical production business. He could not
5 substantiate by records the actual amounts of such expenditures but instead estimated the amounts in
6 his testimony. The Board of Tax Appeals found that Cohan had made substantial expenditures and
7 that those expenditures were allowable expenses, but denied any deductions on the ground that, in the
8 absence of details, it was impossible to determine his actual expenses. On appeal, the Second Circuit
9 Court of Appeal held that where a taxpayer has established that he or she has incurred an expense for
10 which a deduction may properly be claimed, but is unable to document the exact amount of the
11 expense, a court may make a reasonable estimate of the deduction in certain circumstances, “bearing
12 heavily” against the taxpayer whose inexactitude is of his/her own making. This holding is referred to
13 as the Cohan rule. (*Cohan v. Commissioner, supra.*) For a court to estimate the amount of an expense
14 under the Cohan rule, the court must have some basis upon which an estimate may be made. (*Vanicek*
15 *v. Commissioner* (1985) 85 T.C. 731, 742, 743.) Without such a basis, any allowance would amount to
16 unguided largesse. (*Williams v. United States, supra*, at 560-561.)

17 STAFF COMMENTS

18 The FTB determined an adjusted basis in property of \$2,655,090, i.e., \$1,871,700 for the
19 land and \$783,390 for the improvements, based on assessment records from the Los Angeles County
20 Assessor’s Office. Appellants agreed on an adjusted basis in the land of \$1,871,700 but dispute the
21 FTB’s determination that appellants had an adjusted basis in the improvements of only \$783,390.

22 The 1993 appraisal report valued improvements to the property using a cost
23 reconstruction method and estimated the cost of reconstruction as \$2 million as of September 23, 1993,
24 the date of the appraisal. The FTB should be prepared to address whether the \$2 million value for the
25 improvements which the appraisal report estimates as the cost of construction in 1993 could provide a
26 basis for estimating the actual adjusted basis for the improvements (as the adjusted basis would also
27 reflect cost of construction).

28 Staff notes that the FTB has described the appraisal as being “objective” and

1 “disinterested”⁹ but also notes that the appraisal report states that “[b]ecause the purpose of this report is
2 to determine market value . . . the tax liability at the present time may change should the property be
3 sold or purchased.” Thus, the FTB appears to argue that the appraisal cannot be used because its goal
4 was to determine the fair market value of the property rather than tax basis. However, the appraisal was
5 based on an estimate of the cost of reconstruction, and it appears to staff that an estimate of construction
6 costs, if found to be credible and reliable, could be used to estimate (or as a factor in estimating) the
7 actual cost basis of improvements.

8 The parties should be prepared to discuss further whether the assessment records or the
9 1993 appraisal should be weighed more heavily in estimating the tax basis of the improvements. In the
10 event the Board finds the 1993 appraisal credible and probative, appellant should be prepared to address
11 how the Board might adjust any estimate of costs of construction that was based on the 1993 appraisal to
12 reflect the fact that the appraisal occurred in 1993 but most of the improvements appear to have occurred
13 prior to 1990. Both parties should be prepared to discuss further what may have caused the 1993
14 appraisal, which estimated the cost to reconstruct the improvements at \$2 million, to differ so
15 substantially from the assessor’s valuation of \$783,390.

16 Pursuant to California Code of Regulations, title 18, section 5523.6, if the parties have
17 any additional evidence that they want the Board to consider, the parties should provide their additional
18 evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.¹⁰

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22 Dobkin_et al._wjs

27 ⁹ See page 12 of the FTB’s additional brief dated November 13, 2013.

28 ¹⁰ Evidence exhibits should be sent to: Khaaliq A. Abd’Allah, Appeals Analyst, Board Proceedings Division, State Board of
Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.