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

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **EDWARD LAVI**) Case No. 861784
13)
14)

		Proposed Assessment	
	<u>Year</u>	<u>Tax</u>	<u>Penalties¹</u>
	2007	\$211,461.00	\$71,776.25

17 Representing the Parties:

18 For Appellant: Edward Lavi
19 For Franchise Tax Board: Bradley W. Kragel, Tax Counsel III

- 21 **QUESTIONS:** (1) Whether respondent erred in determining appellant’s distributive share of
22 partnership items from a limited partnership;
23 (2) Whether respondent erred in disallowing appellant’s claimed deduction for legal
24 expenses; and
25 (3) Whether the Board has jurisdiction to determine whether the proposed
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27 ¹ The penalties include an accuracy-related penalty of \$18,911.00 and a late filing penalty of \$52,865.25. Respondent has
28 agreed to abate these penalties as a result of these penalties being discharged as part of appellant’s May 12, 2014 Chapter 7
bankruptcy discharge. Accordingly, the parties’ contentions regarding penalties are not addressed in this hearing summary.

1 assessment has been discharged through bankruptcy.

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3 HEARING SUMMARY

4 Introduction

5 Appellant acquired an interest in a limited partnership in 1995, was married in 1997, and
6 was divorced in 2004. The divorce judgment required appellant to pay child support and declared that
7 the partnership interest was appellant's separate property. In August of 2007, the partnership sold its
8 primary asset, an office building in Los Angeles. In October of 2007, appellant transferred one-half of
9 his limited partnership interest to his former spouse in exchange for a release from past due child
10 support, future child support, and other relief from the earlier divorce judgment. Appellant's former
11 spouse became a new limited partner. Appellant appeals respondent's determination (1) that appellant
12 improperly reported only one-half of the partnership's income and gain attributable to his interest in the
13 partnership throughout 2007 and (2) that appellant improperly claimed a deduction for legal services.
14 (ROB, p. 2.)

15 Background

16 Wilshire-Ardmore Partnership

17 On May 10, 1995, the Wilshire-Ardmore Partnership (WAP) was formed by Action-
18 Investment Group, Inc., as general partner, and eight limited partners. The purpose of WAP was to
19 own and operate a commercial property located on Wilshire Boulevard in Los Angeles (Wilshire
20 Property). In May 1995 and December 1995, appellant contributed \$405,000 to WAP in exchange for
21 a 16.2 percent interest in the partnership. On September 23, 2003, appellant's share in WAP was
22 reduced from 16.2 percent to 8.10 percent. The remaining 8.10 percent was transferred to appellant's
23 father, Parviz Lavi. (ROB, p. 3, Exh. G.)

24 On August 7, 2007, WAP sold the Wilshire Property for \$37 million. The total proceeds
25 to WAP, after accounting for the loan pay-off and various charges, was \$24,446,221.68. (ROB, p. 5,
26 Exh. D.)

27 Divorce and Settlement

28 On April 13, 1997, appellant and Sigal Lavi were married. They separated on January 1,

1 2001 or 2002. On June 25, 2002, appellant filed a Petition for Dissolution of Marriage in the
2 Los Angeles County Superior Court (Dissolution Action). On December 17, 2002, appellant and
3 Ms. Lavi entered into a settlement agreement in their divorce action. On July 22, 2004, the court
4 entered a judgment in the Dissolution Action. The Judgment of Dissolution required appellant to pay
5 \$4,653 in child support per month. Appellant was awarded, as his sole and separate property, the
6 interest in the Wilshire Property.² Appellant and Ms. Lavi were each awarded a one-half interest in the
7 real property located on Loma Vista Drive in Beverly Hills (Loma Vista Property). Appellant was
8 required to pay Ms. Lavi a minimum of \$150,000 from the proceeds of the litigation or the sale of that
9 property. The Judgment of Dissolution also stated that appellant was obligated to pay \$100,000 to
10 Ms. Lavi's father, Isaac Firouzman. (ROB, pp. 3-4, Exhs. A, B, C, G & H.)

11 On January 16, 2006, Ms. Lavi filed legal documents to enforce the Judgment of
12 Dissolution against appellant. On February 24, 2006, Ms. Lavi filed a civil action against appellant and
13 Gal Lipkin seeking the return of the Loma Vista Property (Lipkin Action). On February 12, 2007,
14 appellant's attorney wrote a letter to Ms. Lavi's attorney regarding certain disagreements related to the
15 Judgment of Dissolution. The letter indicated that appellant was willing to settle this matter by
16 transferring a 4.05 percent interest in WAP to Ms. Lavi. (ROB, p. 4, Exhs. C & E.)

17 On October 19, 2007, appellant, Ms. Lavi, and Gal Lipkin entered into a Settlement
18 Agreement and Release (Release). The Release stated, in part, that appellant was presently the owner
19 of an 8.10 percent ownership interest in WAP and, by entering into the Release, appellant would
20 transfer one-half of his unencumbered ownership interest (4.05 percent of 8.10 percent) to Ms. Lavi in
21 exchange for receiving a satisfaction of judgment for all financial obligations then outstanding pursuant
22 to the Judgment of Dissolution, a conditional mutual general release, and a partial modification of the
23 Judgment of Dissolution. The parties agreed that all amounts that had accumulated prior to the date of
24 the Release, based on appellant's 8.10 percent interest in WAP, would be divided equally between
25 appellant and Ms. Lavi, except for the \$110,000 that WAP already paid to Ms. Lavi for child support in
26 May of 2007 and related expenses under the Judgment of Dissolution through October 31, 2007. The
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² This property was owned by WAP. Appellant owned an 8.10 percent interest in WAP.

1 parties agreed that the Release satisfied all provisions of the Judgment of Dissolution which created a
2 monetary obligation for appellant through October 31, 2007. The Release further reduced appellant's
3 child support obligations from \$4,683 per month to \$1,000 per month. Ms. Lavi agreed to obtain a
4 release from her father, Mr. Firouzman, for the \$100,000 debt appellant owed to Mr. Firouzman under
5 the Judgment of Dissolution. Appellant and Ms. Lavi also agreed to release all claims they had against
6 each other relating to the Loma Vista property. The Release stated that the agreement was deemed
7 signed and formed as of October 19, 2007. On October 24, 2007, the court entered an order approving
8 the Release between appellant, Ms. Lavi, and Gal Lipkin. (ROB, pp. 5-6, Exhs. I & E.)

9 On November 2, 2007, the escrow company transferred the funds received from the sale
10 of the Wilshire Property. Of the total amount in escrow, disbursements were made, in part, as follows:
11 \$917,109.38 to appellant; \$124,970.00 to appellant's attorney, Felicia Mobley; and \$1,042,079.37 to
12 Ms. Lavi. (ROB, p. 6, Exhs. F, G & H.)

13 2007 Tax Returns

14 WAP filed a 2007 federal partnership income tax return, reporting rental income of
15 \$140,407, interest income of \$370,851, and IRC section 1231 gain of \$28,938,247. WAP also filed a
16 2007 California partnership income tax return, reporting rental income of \$131,687, interest income of
17 \$370,851, and IRC section 1231 gain of \$29,162,221. WAP issued Schedule K-1s allocating the
18 income to each of the partners, including appellant and Ms. Lavi. Appellant and Ms. Lavi were each
19 allocated \$5,333 in rental income, \$15,019 in interest income, and \$1,181,070 in IRC section 1231
20 gain.³ (ROB, pp. 6-7.)

21 Appellant filed his 2007 California tax return on March 25, 2009. On the return,
22 appellant reported taxable interest income of \$21,358, a business loss of -\$523,000, capital gain of
23 \$624,341, and rental real estate loss of -\$26,112. Appellant also filed his 2007 federal tax return on
24 March 25, 2009, reporting interest income of \$15,019 and a business loss based on legal service
25 expenses of -\$523,000. Appellant reported a long-term capital gain of \$1,171,999, less a short-term
26 capital loss of -\$346,964, and less a capital carryover loss of -\$200,694, for a net capital gain of
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28 ³ The record does not contain a copy of WAP's tax return or the Schedule K-1s issued to appellant and Ms. Lavi.

1 \$624,341.⁴ (ROB, p. 7.)

2 On July 14, 2011, Ms. Lavi's attorney informed respondent that the disbursements in
3 2007 were erroneously reported as taxable income to Ms. Lavi. Ms. Lavi's attorney indicated that the
4 property was sold prior to the execution of the Release, and therefore the income from the sale should
5 have been reported by appellant because he owned the entire 8.10 percent interest at the time of the
6 sale. Upon review, respondent determined that the partnership's allocation was unreasonable because it
7 did not take into account the taxpayers' varying interests in the partnership during 2007 as required by
8 IRC section 706(d)(1). Respondent concluded that the distributive shares of appellant and Ms. Lavi
9 should have been determined based on the interim closing of the books method of accounting because it
10 was the more accurate method under the circumstances. Based on the interim closing of the books
11 method, respondent calculated appellant's and Ms. Lavi's respective shares of income from WAP.
12 Respondent allocated \$10,667 in rental income, \$27,936 in interest income, and \$2,362,140 in IRC
13 section 1231 gain to appellant. Respondent allocated \$0 in rental income, \$2,104 in interest income,
14 and \$0 in IRC section 1231 gain to Ms. Lavi. (ROB, pp. 7-8.)

15 Respondent discovered additional errors in appellant's returns. Respondent issued a
16 letter to appellant dated February 17, 2012, requesting confirmation of the following facts: (1) that the
17 \$523,000 in legal fees reported on the Schedule C represents the total cost for services related to the
18 divorce settlement and child custody; (2) that the \$346,964 short-term capital loss on the Schedule D
19 was the result of Carmen Wright's failure to reimburse appellant for agreed costs related to a property
20 located on La Madre Way, in Las Vegas, Nevada that appellant and Ms. Wright purchased together as
21 their residence; (3) that appellant lived at the La Madre Way residence in 2007; (4) that the
22 Wooster Street address in Los Angeles was appellant's mailing address; and (5) that the Saybrook Point
23 Drive and Denali Avenue addresses were appellant's investment properties. Appellant signed and
24 returned the letter confirming these facts on February 27, 2012. (ROB, p. 8, Exh. I.)

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28 ⁴ A copy of appellant's 2007 tax return is not in the record.

1 As a result, respondent disallowed claimed home mortgage interest of \$21,746,⁵
2 \$523,000 in legal fees,⁶ and \$346,964 in capital losses.⁷ Respondent also reduced appellant's rental
3 loss by \$4,981.⁸ Respondent imposed an accuracy-related penalty of \$18,911 against appellant based
4 on his underpayment of tax due to the claimed legal expense deduction and the short-term capital loss.
5 Respondent further imposed a late filing penalty of \$52,865.25 because appellant filed his 2007 tax
6 return on March 26, 2009, which was after the due date of April 15, 2008 and the extended due date of
7 October 15, 2008. Respondent issued a Notice of Proposed Assessment to appellant dated July 18,
8 2012, assessing additional tax of \$211,461.00, penalties of \$71,776.25, plus interest. (ROB, pp. 9-10,
9 Exh. J.)

10 Appellant protested the NPA by a letter dated September 11, 2012. Appellant disputed
11 the assessment of additional tax based on the partnership distribution and the imposition of the
12 accuracy-related and late filing penalties. The protest did not dispute the assessment of additional tax
13 based on the disallowed deductions. Appellant stated that, with regard to the partnership distribution,
14 the 8.10 percent interest in WAP was community property. Appellant stated that the divorce judgment
15 stated that his interest was separate property. Appellant further stated that the court's confirmation of
16 the Release in October 2007, which transferred 4.05 percent of the partnership interest to Ms. Lavi,
17 changed the taxpayer's interest back to community property. Appellant contended that, as of
18 December 31, 2007, ownership in the WAP interest was community property, and therefore, all
19 earnings must be evenly split. As for the penalties, appellant contended that he reported the amounts
20 set forth in the Schedule K-1 from WAP and he should not be penalized because neither he nor his tax
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23 ⁵ The mortgage interest was limited by IRC sections 163(h)(3)(B)(ii) and (C)(ii) which provides that acquisition
24 indebtedness and home equity indebtedness for any period shall not exceed \$1 million and \$100,000, respectively.
Respondent concluded that only \$113,052 of mortgage interest claimed was allowed, and \$21,746 of other mortgage interest
claimed was disallowed.

25 ⁶ The legal expense was disallowed because IRC section 262 states that no deduction shall be allowed for personal, living,
26 or family expenses. According to the attorney billing records provided by appellant, the services provided related to
appellant's divorce settlement. Appellant also confirmed that the services related to the divorce and child custody issues.

27 ⁷ The short-term capital loss was disallowed because the loss related to the purchase of appellant's residence. In addition,
28 there was no loss because appellant continued to own the property, which he claimed as his residence in 2007.

⁸ Respondent determined that appellant's flow-through rental income from WAP reduced the rental loss by \$10,667 and the
net rental loss was limited to \$21,131.

1 preparer had the right to change the information in the document. (ROB, p. 10, Exh. K.)

2 After a review, respondent issued a Notice of Action dated November 20, 2014,
3 affirming the NPA. Appellant then filed this appeal on December 16, 2014. (ROB, Exhs. L & M.)

4 Contentions

5 Appellant's Contentions

6 *1) Allocation of Distributive Share of Partnership Items*

7 Appellant states that he has a Judgment of Dissolution dated July 22, 2004, which
8 supports finding that he owned an 8.10 percent interest in WAP as his sole and separate property.
9 Appellant contends that, prior to this judgment, the interest was community property. Appellant
10 contends that his former spouse, Ms. Lavi, filed a civil action seeking a portion of the ownership
11 interest in WAP. Appellant states that he and Ms. Lavi entered into the Release on July 9, 2007.
12 Appellant notes that Paragraphs 6 and 7 of the Release stated that Ms. Lavi owned a 4.05 percent
13 interest in WAP as of October 2007. Appellant states that the Release was approved by a court order
14 on October 25, 2007, and notes that the court order states that this action was related to the dissolution
15 of the marriage. Appellant notes that the management company for WAP, Action Investment Group,
16 transferred the 4.05 percent interest to Ms. Lavi as directed by the court order. In support, appellant
17 provided a copy of the Release and a letter from Action Investment Group dated December 21, 2011,
18 confirming that the 4.05 percent interest was transferred to Ms. Lavi pursuant to the court order.
19 Appellant contends that Ms. Lavi should be responsible for her share of the tax as she received her
20 portion of the funds from the sale of the Wilshire Property. (Appeal Letter, Atths.)

21 Appellant further contends that there has been a "conspiracy" between the partnership
22 and his former spouse, Ms. Lavi, to induce the partnership to hold appellant liable for the tax on the
23 funds Ms. Lavi received as a result of the sale of the Wilshire Property. Appellant maintains that
24 respondent is imposing the tax liability on the wrong party. (ASB, pp. 1-2, Atths.)

25 *2) Legal Expenses*

26 Appellant states that, during 2007, Mobley Law Office was hired by appellant with
27 regards to the change in ownership interest in WAP. Appellant notes that he incurred legal expenses of

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1 \$125,000 and questions why this expense was disallowed by the FTB.⁹ In support, appellant provided
2 a copy of invoices from Mobley Law Office related to the “Lavi v. Lavi” matter. (Appeal Letter,
3 Atths.)

4 *3) Bankruptcy*

5 On reply, appellant submitted a copy of a letter dated July 15, 2015 from his bankruptcy
6 attorney, James C. Shields. According to that letter, appellant filed for Chapter 7 bankruptcy on
7 January 20, 2014, and appellant received his bankruptcy discharge on May 12, 2014. In support,
8 appellant submitted a copy of the Chapter 7 bankruptcy petition and discharge order. Appellant
9 contends that, even if he did not include respondent as a creditor, the debt would still be discharged as
10 appellant has no assets and the discharge of debts is applicable to all debts that arose prior to the filing
11 of a no asset bankruptcy filing. In support, appellant cites *In re Beezley* (1993) 994 F.2d 1433.
12 Appellant requests that respondent acknowledge in writing that no further collection efforts will be
13 made by respondent to collect this pre-petition 2007 discharged debt. (ARB, pp. 1-2, Atths.)

14 In appellant’s supplemental brief, appellant appears to contend that he would experience
15 financial hardship if the proposed assessment is sustained. Appellant states that he is seeking support
16 from his father, that he is bankrupt, and that he cannot afford an attorney. In support, appellant
17 provided a copy of a letter from his father, Parviz Lavi, to the Family Court dated August 27, 2015, in
18 which Parviz Lavi states that he and his two brothers have been supporting appellant. The letter
19 requested that the Family Court forgive appellant for the payment of any further child support.
20 Appellant also submitted documentation relating to the child custody obligation issue and the
21 bankruptcy discharge order. Appellant submitted a notice from the California Department of Health
22 Care Services dated April 17, 2015, indicating that appellant was enrolled in a Medi-Cal Managed Care
23 dental plan. Appellant also submitted a copy of his California Benefits Identification Card which was
24 issued on February 4, 2014. (ASB, pp. 1-2, Atths; App’s Addl Info.)

25 Respondent’s Contentions

26 *1) Allocation of Distributive Share of Partnership Items*

27 Respondent notes that generally the partnership laws provided in IRC section 701
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⁹ It appears that appellant only disputes \$125,000 of the \$523,000 in disallowed legal expenses.

1 et seq., apply for the California taxation of partnerships and partners, citing R&TC section 17851 and
2 *Paine v. Franchise Tax Board* (2004) 118 Cal.App.4th 63, 67. Respondent notes that IRC section
3 702(a) requires each partner to report his distributive share of the partnership's taxable income, gains,
4 losses, deductions, or credits, citing *Moore v. Comm'r* (1978) 70 T.C. 1024, and other authorities.
5 Respondent acknowledges that, generally, a partner's distributive share is determined by the
6 partnership agreement, citing IRC section 704(a) and other authorities. Respondent contends however
7 that, when a new partner joins the partnership during the course of the year, the "varying interests" rule
8 in IRC section 706(d) and the assignment of income doctrine precludes a retroactive allocation of a full
9 year's income or losses to the new partner, regardless of a partnership agreement to the contrary, citing
10 *Williams v. United States* (5th Cir. 1982) 680 F.2d 382, and other authorities. Respondent contends
11 that a new partner is limited to his distributive share of the partnership profits or losses which occurred
12 after he entered into the partnership, citing *Hawkins v. Comm'r* (8th Cir. 1983) 713 F.2d 347, 350.
13 (ROB, pp. 12-13.)

14 Respondent notes that the "varying interest" rule as set forth in IRC section 706(d) and
15 Treasury Regulation section 1.706-1(c)(4) provides that, if during any taxable year of the partnership,
16 there is a change in any partner's interest in the partnership, each partner's distributive share shall be
17 determined by the use of a method prescribed by the Secretary of the Treasury by regulations which
18 takes into account the varying interests of the partnership during that year. Respondent further notes
19 that the courts have determined that a partnership agreement that allocates to a new partner a portion of
20 partnership profits or losses attributable to the period prior to the partner's entry into the partnership
21 violates the assignment of income doctrine, citing *Meinerz v. Comm'r*, T.C. Memo. 1983-191, and
22 other authorities. Respondent notes that the determination of the varying interests of the partners may
23 be made by using the interim closing of the books method, proration method, or any other reasonable
24 method, citing *Richardson v. Comm'r* (1981) 76 T.C. 512, 527. (ROB, pp. 13-14.)

25 Citing *Cottle v. Comm'r* (1987) 89 T.C. 467, respondent contends that the interim
26 closing of the books method, which requires a closing of the partnership books as to the date of entry of
27 the new partner, and the computation of the various partnership items as of that date, is the most
28 accurate method. Respondent contends that this method was the most accurate for this case because

1 WAP sold its only asset more than two months before appellant's former wife became a partner.
2 Respondent notes that the partnership property was sold in August of 2007 and, at that time, appellant
3 owned an 8.10 percent interest in WAP. Respondent notes that, two months later, in October of 2007, a
4 court-approved settlement agreement transferred one-half of appellant's interest in WAP to Ms. Lavi
5 and the money was distributed to the partners in November of 2007. Respondent contends that, except
6 for a portion of the interest earned between October 19 and November 2, the rental income, interest
7 income, and capital gain were earned while appellant was the owner of the 8.10 percent interest. (ROB,
8 p. 14.)

9 Respondent further contends that its determination that appellant was properly assessed
10 additional tax for the distribution of WAP's income and gain is further supported by the assignment of
11 income doctrine, i.e., income is taxable to the person who earns it, citing *Comm'r v. Culbertson* (1949)
12 337 U.S. 733, 739-740. Respondent contends that appellant cannot avoid taxation by entering into a
13 contractual arrangement whereby that income is diverted to some other person or entity, citing
14 *United States v. Basyne* (1973) 410 U.S. 441, 449-450. Respondent contends that, as the property is
15 transferred and the right to income with respect to that property has already matured at the time of the
16 transfer, the transferor, i.e., appellant, will be taxed on the income, citing *Gail Vento LLC v.*
17 *United States* (2013) U.S. Dist. Lexis 48472. (ROB, p. 14.)

18 Respondent contends that appellant's contention that his partnership interest was
19 community property that was converted to separate property by the Judgment of Dissolution and
20 reverted to community property under the Release is factually and legally incorrect. Respondent notes
21 that appellant became a partner in 1995 prior to marriage. Respondent contends that Family Code
22 section 760 provides that property acquired prior to marriage, such as appellant's interest in WAP, is
23 separate property. Respondent further notes that the Judgment of Dissolution stated that appellant's
24 interest in the Wilshire Property was awarded to appellant as his sole and separate property.
25 Respondent contends that the Release and the court order affirming the Release did not state that the
26 partnership interest reverted to community property. Respondent contends that neither document made
27 a determination regarding the marital characterization of appellant's partnership interest. Respondent
28 further contends that the Release could not have resulted in the partnership interest becoming

1 community property as appellant and Ms. Lavi were no longer married as of July 22, 2004. (ROB,
2 pp. 15-16, Exhs. B &E.)

3 2) *Legal Expenses*

4 Respondent contends that IRC section 262 generally provides that no deductions shall be
5 allowed for personal, living, or family expenses. Respondent notes that Treasury Regulation section
6 1.262-1(b)(7) provides that, generally, attorney's fees and other costs paid in connection with a divorce,
7 separation, or decree are not deductible by either the husband or wife. However, the part of the
8 attorney's fees and other costs paid in connection with a divorce, separation, or decree attributable to
9 the production or collection of amounts includible in gross income are deductible by the wife.

10 Respondent further notes that this position is supported by case law, citing *United States v. Gilmore*
11 (1963) 372 U.S. 39, 50, and other authorities. Respondent contends that appellant admitted that the
12 \$523,000 in legal fees was related to the divorce settlement and child custody issues. Respondent notes
13 that the billing records provided by appellant on appeal indicate that appellant was billed \$221,927
14 during the period, June 2006 to April 2008. Respondent contends that the billing records indicate that
15 the services provided related to appellant's divorce settlement and custody issues. Respondent
16 contends that appellant failed to produce records showing charges amounting to \$523,000 and appellant
17 failed to provide any evidence showing that appellant's attorney was involved in the sale of the
18 Wilshire Property. Respondent contends that appellant has not supported his assertion that
19 Mobley Law Office was working for appellant with regard to the change in her ownership interest in
20 WAP. Respondent further contends, even if this was true, the work performed was solely because
21 appellant agreed to transfer part of his interest in the partnership to his ex-wife to satisfy his past and
22 future obligations under the Judgment of Dissolution. (ROB, pp. 16-17.)

23 3) *Bankruptcy*

24 Respondent contends that appellant's bankruptcy discharge is not relevant to the present
25 appeal. Respondent contends that the Board does not have jurisdiction to determine whether a
26 discharge in bankruptcy applies to respondent's assessment of tax, penalties, and interest, citing the
27 *Appeal of Robert G. and Jean C. Smith*, 81-SBE-145, decided by the Board on October 27, 1981 and

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1 California Code of Regulations, title 18, (Regulation) 5412, subdivision (b).¹⁰ As such, respondent
2 contends that appellant's bankruptcy contentions must be raised in another forum to determine whether
3 the tax debts may be discharged. (RRB, pp. 1-3, Exh. A.)

4 Respondent also contends that the proposed assessment of tax and interest was not
5 discharged by the May 12, 2014 Chapter 7 bankruptcy discharge (Discharge). Respondent notes that
6 Bankruptcy Code sections 523 and 507(a)(8) provide that taxes are not dischargeable if, at the time the
7 bankruptcy is filed, the taxes are "assessable," but not finally assessed. Respondent contends that a
8 state income tax deficiency is assessed for bankruptcy discharge purposes when the assessment
9 contained in a notice of proposed deficiency assessment becomes final, citing *Schatz v. Franchise Tax*
10 *Board* (1999) 69 Cal.App.4th 595, 597. Respondent contends that a tax liability cannot be discharged
11 until the assessment has become final, after the taxpayer has exhausted all administrative appeals.
12 Respondent contends that the tax assessment in the present case was under protest when the bankruptcy
13 was filed and the case remains under appeal. Respondent contends that, as the assessment was not final
14 when the Discharge was issued, the assessment may not be discharged. (RRB, p. 4.)

15 Respondent further contends that the tax assessment at issue was assessable after the
16 filing of the bankruptcy petition because the statute of limitations had not run out on that date.
17 Respondent notes that it issued the NPA on July 18, 2012, appellant had 60 days to submit a protest of
18 the proposed assessment pursuant to R&TC section 19042, and appellant timely protested the NPA on
19 or about September 11, 2012. Respondent contends that the protest was still pending at the time
20 appellant filed his Chapter 7 bankruptcy petition and the pending NPA was still assessable when
21 appellant filed his Chapter 7 petition. Respondent contends that it is unnecessary to determine whether
22 the subject tax debts are of the kind specified in Bankruptcy Code section 523(a)(1)(B) or (C).
23 Respondent notes that Bankruptcy Code section 523(a)(1)(B) generally relates to tax debts where a
24 taxpayer has not filed a return or has filed a return late and after two years before the date of the filing
25 of a bankruptcy petition. Respondent notes that Bankruptcy Code section 523(a)(1)(C) generally
26 relates to tax debts where a taxpayer filed a fraudulent tax return. Respondent notes that if the tax debt
27 at issue is of the kind specified in these provisions, it was not discharged by the Discharge. (RRB,
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¹⁰ Regulation 5412 was formally adopted by the Board in 2007 and was effective on February 6, 2008.

1 p. 5.)

2 Respondent contends that, as the subject tax debt was not discharged by the Discharge,
3 any interest on that obligation was not discharged, citing *Ward v. Board of Equalization of California*
4 (*In re Artisan Woodworkers*) (9th Cir. 2000) 204 F.3d 888, and other authorities. As such, respondent
5 contends that the additional tax and interest for appellant's 2007 tax year were not discharged by the
6 Bankruptcy Court's issuance of the Discharge on May 12, 2014. Respondent notes that the penalty
7 portion of the proposed assessment was discharged by the May 12, 2014 Discharge pursuant to
8 Bankruptcy Code section 523(a)(7). As such, respondent states that it will abate the penalty portion of
9 the assessment. (RRB, pp. 5-6.)

10 Applicable Law

11 Burden of Proof

12 The FTB's determination is presumed correct and a taxpayer has the burden of proving
13 it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*,
14 2001-SBE-001, May 31, 2001.) Unsupported assertions are not sufficient to carry a taxpayer's burden
15 of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

16 Allocation of Distributive Share of Partnership Items

17 R&TC section 17851 incorporates the partnership laws provided in IRC section 701
18 et seq., into California law. IRC section 702(a) requires that each partner is required to report his or her
19 distributive share of the partnership's taxable income, gain, loss, deductions or credits. Generally, a
20 partner's distributive share of income, gain, loss, deduction, or credit shall be determined by the
21 partnership agreement. (Int.Rev. Code, § 704(a).)

22 IRC section 706(c) provides the general rule regarding the closing of the partnership tax
23 year. IRC section 706(c)(2)(B) provides that the taxable year of a partnership shall not close with
24 respect to a partner who sells or exchanges less than his entire interest in a partnership or with respect
25 to a partner whose interest is reduced. However, such a partner's distributive share of partnership items
26 shall be determined by taking into account his varying interest in the partnership during the taxable year
27 using a method prescribed by regulation. (Int.Rev. Code, § 706(d)(1).) Treasury Regulation section
28 1.706-1(c)(4), as in effect for 2007, states:

1 Disposition of less than entire interest. If a partner sells or exchanges a part of his interest
2 in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall
3 continue to its normal end. In such case, the partner's distributive share of items which he
4 is required to include in his taxable income under the provisions of section 702(a) shall
be determined by taking into account his varying interests in the partnership during the
partnership taxable year in which such sale, exchange, or reduction of interest occurred.

5 (Former Treas. Reg., § 1.706-1(c)(4).)

6 The following methods may be used in determining the allocation of a partner's
7 distributive share on the disposition of a partner's entire or partial interest: the interim closing of the
8 books method, proration method, or any other reasonable method. (Former Treas. Reg., § 1.706-
9 1(c)(2)(ii); *Richardson v. Comm'r, supra*, 76 T.C. at 525-526; *Cottle v. Comm'r, supra*, 89 T.C. at 494-
10 495.) The interim closing of the books method involves closing the partnership's books as of the date
11 of entry of the new partner and the computation of the partnership items as of that date. (*Cottle v.*
12 *Comm'r, supra*, 89 T.C. at 495.) The proration method involves computing the partnership's income or
13 loss at the end of the partnership year and allocating the year-end totals ratably over the year according
14 to the partners' percentage interests and the number of days that they owned the interest in the
15 partnership. (*Id.*) Of the two methods, the interim closing of the books method is the more accurate,
16 but the proration method is simpler to apply. (*Id.*)

17 In addition, courts have held that, when there is a transfer of a partial partnership
18 interest, IRC section 706(c)(2)(B) requires the transferor to report his distributive share of partnership
19 items for the period before the transfer, requires the transferor and transferee to report their distributive
20 shares of partnership items for the period after the transfer, and prohibits the retroactive shifting of such
21 interests. (*Moore v. Comm'r, supra*, 70 T.C. at 1032.) Courts have noted that this interpretation is
22 consistent with the assignment of income doctrine. (*Id.*)

23 The assignment of income doctrine precludes a taxpayer from excluding an economic
24 gain from gross income by assigning the gain in advance to another party. (*Comm'r v. Banks* (2005)
25 543 U.S. 426, 433-434.) The rationale for the so-called anticipatory assignment of income doctrine is
26 the principle that gains should be taxed "to those who earned them." (*Id.*, citing *Lucas v. Earl* (1930)
27 281 U.S. 111, 114.)

28 ///

1 Family Code section 760

2 Family Code section 760 provides that, generally, all property, real or personal,
3 wherever situated, acquired by a married person during the marriage while domiciled in California is
4 community property. Family Code section 770 provides that the separate property of a married person
5 includes all property owned by the person prior to marriage and the rents, issues, and profits of such
6 property. (Fam. Code, § 770, subs. (a)(1), (a)(2).) The character of the property as separate or
7 community property is fixed as of the time the property is acquired; and the character so fixed
8 continues until it is changed in some manner recognized by law, as by agreement by the parties. (*In re*
9 *Marriage of Rossin* (2009) 172 Cal.App.4th 725, 732.)

10 Deduction for Legal Expenses

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

15 IRC section 262 generally provides that no deductions shall be allowed for personal,
16 living, or family expenses. Treasury Regulation section 1.262-1(b)(7) provides that generally
17 attorney's fees and other costs paid in connection with a divorce, separation, or decree are personal
18 expenses and are not deductible by either the husband or wife. The deductibility of legal fees depends
19 upon the origin of the claim with respect to which the fees were incurred. (*Hill v. Comm'r*, T.C.
20 Memo. 2010-268 (T.C. 2010), citing *United States v. Gilmore* (1963) 372 U.S. 39, 49.) Legal fees
21 incident to a divorce generally are not deductible, because such amounts are personal expenses. (*Id.*)

22 Bankruptcy

23 Bankruptcy courts have the exclusive jurisdiction to determine whether a debt is
24 nondischargeable under section 523(a)(2), (4), and (6) of the Bankruptcy Code, and bankruptcy courts
25 and state courts have concurrent jurisdiction to adjudicate the dischargeability of debts in the remaining
26 classes. (*In re Aldrich* (Bankr. 9th Cir., 1983) 34 B.R. 776, 779.)

27 The Board is limited to the determination of the correct amount of an appellant's
28 California personal income tax liability for the appeal year. (*Appeals of Fred R. Dauberger, et al.*,

1 82-SBE-082, Mar. 31, 1982.) The Board’s jurisdiction is of a limited nature and bankruptcy discharge
2 issues are specifically proscribed. (Cal. Code Regs., tit. 18 § 5412, subd. (b)(3).) The Board
3 previously held that it lacks jurisdiction to determine whether a discharge in bankruptcy applies to
4 respondent’s assessment of tax, penalties, and interest. (*Appeal of Robert G. and Jean C. Smith,*
5 *supra.*)

6 The Bankruptcy Code enumerates certain classes of debts that are not dischargeable.
7 (11 U.S.C. §§ 523(a)(1)-(19).) Section 523(a)(1)(A) of the Bankruptcy Code provides that a chapter 7
8 bankruptcy discharge (as in this appeal) does not discharge an individual debtor from any debt for a tax
9 of the kind and for the periods specified in section 507(a)(8) of the Bankruptcy Code. Section
10 507(a)(8)(A)(iii) of the Bankruptcy Code provides a priority for a tax “not assessed before, but
11 assessable, under applicable law or by agreement, after, the commencement of the case[.]”
12 Accordingly, for a tax assessment to be discharged under chapter 7 of the bankruptcy code, it needs to
13 be assessed prior to when the individual debtor filed a bankruptcy petition. “A tax deficiency is
14 ‘assessed’ for purposes of rendering the assessment nondischargeable not when the notice of the
15 assessment is filed, but when the assessment becomes ‘final.’” (*In re Bracey* (9th Cir. 1996) 77 F.3d
16 294, 295-296, quoting *In re King* (9th Cir. 1992) 961 F.2d 1423, 1427.) R&TC section 19041 provides
17 that a taxpayer may file with respondent a written protest against the proposed assessment within
18 60 days after respondent mails the NPA. R&TC section 19042 provides that the assessment becomes
19 final upon the expiration of the 60-day period if no protest is filed.

20 STAFF COMMENTS

21 Respondent indicated that the penalty portion of the proposed assessment will be abated
22 because the penalties were discharged pursuant to the May 12, 2014 discharge of appellant’s Chapter 7
23 bankruptcy.

24 Allocation of Distributive Share of Partnership Items

25 Appellant disputes respondent’s determination that appellant is responsible for all of the
26 tax liability resulting from the income and gain related to his 8.10 percent interest in WAP because the
27 interest was community property prior to the divorce. Appellant’s former spouse, Ms. Lavi, received
28 half of appellant’s interest in WAP (4.05 percent) through a settlement, and Ms. Lavi received funds

1 from WAP in accordance with this 4.05 percent interest. It appears that appellant's 8.10 percent
2 interest in WAP was his separate property during and after the marriage. Appellant acquired the
3 interest in 1995, prior to his marriage to Ms. Lavi on April 13, 1997. As such, the interest in WAP is
4 presumed to be appellant's separate property during the marriage. (Fam. Code., § 770, subd. (a)(1).)
5 Further, the Judgment of Dissolution dated July 22, 2004 affirmed that the interest in WAP was
6 appellant's sole and separate property upon the dissolution of the marriage. (ROB, Exh. B)

7 When the sale of the Wilshire Property closed on August 7, 2007, appellant owned a
8 8.10 percent interest in WAP. (ROB, Exh. D.) Appellant's right to the income with respect to that
9 property matured on August 7, 2007, regardless of the fact that the proceeds were not disbursed until
10 November 2, 2007. Appellant and Ms. Lavi entered into the settlement on October 19, 2007, after the
11 sale of the Wilshire Property closed. (ROB, Exh. E.) When a partner disposes of a partial interest in
12 the partnership during the partnership year, the partnership is required to take into account the varying
13 interests of the partners in allocating partnership income, gain, profits, and losses. (Int.Rev. Code,
14 § 706(d)(1).) Appellant was allocated partnership items from WAP based on his year-end 4.05 percent
15 interest in WAP. However, appellant's interest in WAP was 8.10 percent in 2007 until October 19,
16 2007. Both parties should be prepared to discuss whether the partnership's allocation was unreasonable
17 as it did not take into account appellant's varying interest in the partnership during 2007. The parties
18 should discuss whether the distributive shares of appellant and Ms. Lavi should be determined based on
19 the interim closing of the books method of accounting. It appears that respondent correctly determined
20 that appellant's distributive share of the partnership items is the amount attributable to the 8.10 percent
21 interest in WAP up to October 19, 2007, including the gain from the sale of the Wilshire Property.

22 Deduction for Legal Expenses

23 IRC section 262 precludes the deduction of personal expenses. Attorney fees and
24 related costs pertaining to a taxpayer's divorce and child custody issues are a personal expense.
25 (Treas. Reg., § 1.262-1(b)(7).) The attorney billing records provided by appellant indicate that the fees
26 incurred related to a civil action between "Lavi v. Lavi," the divorce, child custody, and related matters.
27 (Appeal Letter, Atths.) In addition, appellant also signed a statement agreeing that the claimed
28 deduction for attorney's fees related to his divorce and child custody issues. (ROB, Exh. I.) It appears

1 that the evidence in the record supports a finding that the attorney fees are non-deductible personal
2 expenses.

3 Bankruptcy

4 Regulation 5412 precludes the Board from considering whether appellant's tax liability
5 for 2007 has been discharged in bankruptcy. It appears to staff that this issue must be raised in a
6 different forum, such as a bankruptcy court.

7 Further, appellant's tax assessment was not final prior to the filing of his bankruptcy
8 petition on January 20, 2014. The NPA in this appeal did not become final because he timely protested
9 the NPA in a letter dated September 11, 2012. Appellant later filed a timely appeal to this Board.
10 Assuming this Board sustains respondent's action on appeal, the assessment will not become final until
11 30 days after this Board's decision on this appeal. (Rev. & Tax. Code, § 19048.) As such,
12 respondent's tax assessment was not final before appellant's bankruptcy petition was filed and it would
13 not have been discharged in bankruptcy.

14 With regard to appellant's claims of financial hardship, these contentions do not address
15 whether respondent assessed the correct amount of tax against appellant. The Board's power is limited
16 to the determination of the correct amount of an appellant's California personal income tax liability for
17 the appeal year. (*Appeals of Fred R. Dauberger, et al., supra.*) Upon the conclusion of this matter,
18 appellant may want to contact respondent regarding his eligibility for an offer in compromise or a
19 payment plan.

20 Additional Evidence

21 If either party has any additional evidence to present, that party should provide their
22 evidence to the Board Proceedings Division at least 14 days prior to the oral hearing pursuant to
23 California Code of Regulations, title 18, section 5523.6.¹¹

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¹¹ Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of
Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.