STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

John O. Johnson
Tax Counsel
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento, CA 95814
Tel: (916) 323-3140
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
BRIAN D. ADLER AND CHERYL ADLER[1]	Case No. 601347

	Proposed Assessment	
Year	Additional Tax	Penalty
2005	$63,795	$12,759

Representing the Parties:

For Appellants: Jonathan A. Brod, Esq.

For Franchise Tax Board: Raul A. Escatel, Tax Counsel

QUESTIONS: (1) Whether appellants have shown error in respondent's denial of claimed deductions and expenses.

(2) Whether appellants have established a basis for abatement of the accuracy-related penalty.

///

[1] Appellants reside in Beverly Hills, Los Angeles County, California.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

HEARING SUMMARY

Background

Travertine Property Venture

Respondent indicates that appellant-husband has been engaged in the business of real estate development for over thirty-five years, and formed B.D. Adler, Inc., (Adler Inc.) as a wholly-owned C corporation in 1981 to facilitate his development ventures. (See Resp. Op. Br., exhibit A.) Appellants state that Adler Inc. was formed to allow them to take advantage of using a fiscal year ending method of accounting, and to take advantage of provisions under ERISA (Employee Retirement Income Security Act) to achieve generous retirement plans available to shareholders of a C corporation. Appellant-husband's business involved locating suitable undeveloped properties for large-scale developments, and, with financial aid from investors, purchasing the undeveloped properties to develop and sell for profit. Appellant-husband indicates he would enter into the contract to purchase the land, but would create a limited partnership or limited liability company (LLC) right before the closing of the sale, transfer the contract rights to the limited liability entity, and purchase the property with the limited liability entity. Appellant-husband states he would then receive ownership of a percentage of the venture, developer's fees as construction progressed, and a real estate broker's commission upon the sale of the lots. (Appeal Letter, p. 2.)

On April 26, 2004, appellant-husband made an offer to purchase, for $75 million, 933 acres of undeveloped property in La Quinta, California (the Travertine property), under the business name of Adler Development Group (ADG).[2] (Appeal Letter, exhibit 3.) This offer was made to Travertine Corporation (Travertine Corp.). Appellant-husband opened an escrow account with First American Title Company (First American) by letter on May 21, 2004, with an indication that $1 million would be deposited. (*Id*. at exhibit 4.) Appellant-husband is listed as the holdee and accrued interest is directed to be credited to him, listing his social security number. To raise the $1 million for the First American escrow account, appellant-husband indicates he sought financing from friends. Appellants provide correspondence and documents that show escrow consultants processed four escrows for

[2] Appellants assert ADG is an unregistered fictitious business name for appellant-husband, and not a dba (doing business as name) for Adler Inc.

appellant-husband on or around May 25, 2004, under the names of Finton, Valley Crest, Landry Design, and Maize (initial investors), for $250,000 each. (*Id*. at p. 2 and exhibit 5.) Appellant-husband then transferred these four amounts, totaling one million dollars, to a First American escrow holding account on May 26, 2004, under his name. (*Id*. at p. 2 and exhibit 6.) This $1 million was transferred from the First American escrow holding account to a First American escrow account on June 29, 2004, and appellant-wife deposited an additional deposit of $250,000 to the First American escrow account on the same day. (*Id*. at p. 3 and exhibits 6 and 9.)

On October 8, 2004, an option and purchase agreement (option agreement) for the Travertine property for $75,500,000 was executed by Adler Inc., dba ADG, signed and dated by appellant-husband in his capacity as president. (Appeal Letter, exhibit 7.) The option provided 60 days for Adler Inc. to exercise the option, and required consideration of $750,000 to be retained by Travertine Corp. if the option is not timely exercised. (*Id*. at exhibit 7, pp. 1-2.) Paragraph 22 of the option and purchase agreement provides, generally, that Adler Inc. had the right to assign its rights in the agreement to an entity controlled by or under common control with buyer, without seller's consent. (*Id*. at exhibit 7, pp. 11-12.) Appellants state that on October 12, 2004, the initial option agreement lapsed, resulting in the nonrefundable $750,000 consideration to be distributed from the First American escrow account to Travertine Corp., and the remaining approximately $500,000 was issued to Adler Inc. and ultimately distributed to some of the initial investors.[3] (*Id*. at pp. 3-4.)

On October 12, 2004, Adler Inc., appellants, and a California company, Peninsula Financing Corporation (Peninsula), entered into an agreement (the Peninsula Finance Agreement) under which, generally, Peninsula is to gain an interest in the option contract through a $225,000 investment paid to Adler Inc. and a $240,000 loan to appellants. (Appeal Letter, exhibit 5, "Agreement.") According to escrow documents, the option agreement was exercised on December 2, 2004, and the

///

---

[3] It appears as though the initial option agreement was the agreement entered into on October 8, 2004, and provided 60 days for Adler Inc. to exercise the option. Therefore, it appears as though the agreement would have ended in December of 2004, not four days after it was executed. No documents have been provided to show an option agreement expiring on October 12, 2004. It appears the $750,000 disbursement may have been issued from the First American escrow account to Travertine Corp. on or about October 8, 2004, in accordance with the option agreement, but there is no evidence of disbursements made to Adler Inc. on or around October 12, 2004. (See Appeal Letter, exhibit 5, "Agreement," ¶ B.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

closing date of escrow was set as December 28, 2004. (*Id*. at exhibit 8-8.)[4]

On December 21, 2004, appellant-husband formed La Quinta Travertine, LLC (La Quinta LLC). (Appeal Letter, exhibits 8-1, 8-2, 8-3, and 8-4.) On that same date, supplemental escrow instructions were recorded to reflect the assignment of Adler Inc.'s rights in the option agreement to La Quinta LLC. (*Id*. at exhibits 8-8 and 8-9.) On December 23, 2004, Adler Inc. assigned its rights in the option agreement to La Quinta LLC. (*Id*. at exhibits 8-5 and 8-6.) On December 28, 2004, Travertine Corp. assigned its lease rights to the Travertine property, conditioned on the closing of the sale of the property pursuant to the option agreement. (*Id*. at exhibit 8-7; see also *Id*. at exhibits 8-10 and 8-11.)

La Quinta LLC failed to close the escrow, and the option expired on December 28, 2004. A "First Amendment to Option and Purchase Agreement," was executed on January 7, 2005, extending the option agreement to January 31, 2005, at the request of La Quinta LLC. (Appeal Letter, exhibit 8-12.) The amendment required an additional $500,000 option consideration, and increased the sale price of the property by one million dollars to $76,500,000. (*Ibid*.) La Quinta LLC was unsuccessful in securing and providing financing for the sale prior to the expiration of the amended option agreement, and the deal fell through.

<u>Audit Process</u>

Appellants claimed $844,378 in losses from the Travertine property on their 2005 Schedule C, and reported a tax due of $273,541.[5] (Resp. Op. Br., exhibits B & C.) Respondent selected appellants' return for examination to determine whether appellants or Adler Inc. were entitled to claim the reported losses. (*Id*. at p. 3.) In response to the examination, appellants provided documentation exhibiting losses and expenditures of $844,377.58 from the following amounts: $750,000.00 for the

///

///

///

---

[4] Appellants' exhibit 8 to their Appeal Letter is a letter from Myron Meyers, an attorney with Slovak Baron & Empey, LLP. Appellants engaged the firm's legal services at some point in 2004, after entering into the option agreement and prior to forming La Quinta LLC. The letter contains its own exhibits, marked as 8-1, 8-2, etc.

[5] Appellants added $1,179 for an underpayment of estimated tax penalty, $21,883 for a late payment penalty, and $8,771 for interest, for a total amount due of $305,374. (Resp. Op. Br., exhibit C, p. 2.)

forfeited deposit,[6] comprised of $250,000.00 from Adler Inc. directly, $250,000.00 from appellants, and $250,000.00 from a mortgage on appellants' residence; Adler Inc. corporate expenses of $73,741.52 (*Id*. at exhibit D); and appellants' individual expenses of $20,636.06 (*Id*. at exhibit E). Respondent agreed that the Travertine property venture had been abandoned in 2005, and determined that all $844,377.58 in losses and expenses were attributable to Adler Inc., not appellants individually. Respondent, therefore, issued a Notice of Proposed Assessment (NPA) disallowing appellants' claimed Schedule C losses, imposing additional tax of $86,970, including an increase of $26,366 to appellants' mental health services tax, an accuracy-related penalty of $17,394, and applicable interest. (*Id*. at exhibit F.)

Appellants timely protested the NPA, asserting they were personally liable for all the funds advanced to Adler Inc. for use in the Travertine property venture. (Appeal letter, exhibit 2.) Appellants' protest letter contains similar statements of facts and arguments as in their appeal letter to the Board, including the assertion that they are entitled to claim the losses and, in the alternative, that there is reasonable cause for their reporting and therefore no penalties should be imposed.[7] After review of appellants' protest letter, respondent issued a Notice of Action (NOA) revising its NPA. (*Id*. at exhibit 1.) Based on the Peninsula Finance Agreement, respondent determined that appellants were personally accountable for $225,000 contributed toward the Travertine property venture, and therefore allowed appellants a personal investment loss for this portion of the lost option fee. This adjustment revised the additional tax to $63,795, which included a revision of the increase amount of the mental health services tax to $24,116, reduced the accuracy-related penalty to $12,759, and adjusted interest accordingly. (*Ibid*.) This timely appeal followed.

///

///

///

---

[6] This $750,000 is the nonrefundable consideration provided for in the initial option agreement. (Appeal Letter, exhibit 7.) The amendment to the option agreement provided that an additional $500,000 was to be added to the nonrefundable consideration amount, and was to be retained by Travertine Corp. "in all events." (*Id*. at exhibit 8-12.) It is unclear whether the additional $500,000 was never paid to Travertine Corp., or whether the amount was paid and returned, but this $500,000 is not included by either party as an expense or loss for the 2005 tax year.

[7] These assertions are explained in more detail in the Appellants' Contentions section below.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Contentions

Appellants' Contentions

Appellants contend Adler Inc. is merely a personal service company, and neither Adler Inc., nor appellants as individuals, ever purchase or acquire real estate. Appellants assert Adler Inc. was formed by appellant-husband for two purposes: (1) to use a fiscal year end to defer income taxation, and (2) to set up a generous retirement plan available to shareholders of a C corporation. (App. Reply Br., p. 2.) Appellants contend that Adler Inc. is a personal service corporation through which appellant-husband's real estate commissions were earned, and at no time did it own any real estate. Appellants assert they hired a new counsel for the Travertine property venture, and that counsel "mistakenly had [Adler Inc.] listed as the buyer on the purchase contract and escrow instructions." Appellants contend that a close reading of the documents show that Adler Inc. was not the intended buyer, and appellants' counsel provided a statement to this effect (dated January 19, 2010). (*Ibid*.; See Appeal Letter, exhibit 8.) Appellants allege they did not bother to change the documents to remove Adler Inc. as the buyer because they knew they would eventually set up an LLC and designate the LLC as the purchaser.

Appellants assert that they borrowed money from friends, mortgaged their residence, and personally came up with all $1,250,000 of the purchase money for the property. (App. Reply Br., p. 2.) Appellants contend none of the purchase money came from Adler Inc., and appellants assert they would never contribute capital to a personal service corporation like Adler Inc. so that it could purchase property. (*Id.* at pp. 2-3.) Appellants contend it is "ludicrous" to purchase real estate with a C corporation to attain liability protection, when LLC's provide the same liability protection and greater tax advantages. (App. Supp. Br.)[8] Appellants state that La Quinta LLC, wholly-owned by appellant-husband, was going to acquire the property, and when the purchase failed, appellants personally experienced the loss. (App. Reply Br., p. 3.) Appellants concede that it is improper to ignore a corporation's existence, but assert that the substance of a transaction cannot be ignored even though the taxpayer controlled its form. Appellants contend Adler Inc. did not have the "wherewithal" to purchase the property, and that no money to purchase the property ever flowed through Adler Inc. Appellants

[8] Appellants provided a Response to Respondent's Reply Brief, dated August 21, 2012, referred to as appellants' supplemental brief for purposes of this brief.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

assert that if Adler Inc. is determined to be the entity that obtained funds to purchase the property, then those funds must have been borrowed by appellants, and therefore appellants are entitled to deduct those loan amounts as a "non-business bad debt deduction" when the loans became worthless in 2005. (*Ibid*; Appeal Letter, pp. 4-5.)

Appellants contend that their above assertions are accurate, and therefore no penalties should apply for the 2005 tax year. In the alternative, appellants assert the facts show there was substantial authority for the taxpayers' position taken on their return (i.e., claiming the losses and expenses) and their position was adequately disclosed on their return, and therefore no penalties should apply based on a reasonable cause argument. (Appeal Letter, p. 5.)

<u>Respondent's Contentions</u>

Respondent contends that taxpayers are generally allowed to structure their business affairs in any manner they choose, but taxpayers are bound by the tax consequences of that choice, and may not enjoy the benefits of some other path they might have chosen. (Resp. Op. Br., p. 6; citing *Appeal of Sierra Pacific Industries*, 94-SBE-002, Jan. 5, 1994; *Rice's Toyota World v. Commissioner* (1983) 81 T.C. 184, 196, aff'd. on this issue (4th Cir. 1985) 752 F.2d 89; *Commissioner v. National Alfalfa Dehydrating* (1974) 417 U.S. 134, 148.) Specifically, respondent notes that taxpayers may not disregard the existence of an entity the taxpayers created when it was created for, or has, a valid business purpose. (Citing *Moline Properties, Inc. v. Commissioner* (1943) 319 U.S. 436, 438-439 [*Moline Properties*].) Respondent contends that corporations, including personal service corporations, are only ignored for tax purposes in exceptional situations where "it would otherwise present an obstacle to the protection or enforcement of public or private rights." (Resp. Op. Br., p. 7; citing *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Keller v. Commissioner* (1981) 77 T.C. 1014; *Moline Properties*, *supra*.)

Respondent asserts Adler Inc. should not be disregarded for tax purposes, noting that its returns show it was engaged in real estate as well as real estate and brokerage services, and kept books, had assets, and paid bills. (Resp. Op. Br., p. 7.) Respondent contends Adler Inc. entered into negotiations with Travertine Corp. and all documents related to the Travertine property venture listed Adler Inc. as the buyer, including the escrow instructions with First American. (*Id*. at pp. 7-8.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Respondent contends Adler Inc. did not act as an agent for appellant-husband, contrary to appellants' assertions, and that documentation relating to the venture have appellant-husband's signature in his capacity as president of Adler Inc., and not in his capacity as an individual. (*Id*. at pp. 8-9.) Respondent states appellants contend that appellant-husband performed the actions related to the Travertine property venture in his personal capacity since he had complete command and control of Adler Inc. Respondent contends, however, that appellants cannot ignore the corporate entity merely because appellant-husband was the sole shareholder, citing, "Complete ownership of the corporation, and the control primarily dependent upon such ownership . . . are no longer of significance in determining taxability." (*Id*. at p. 9; citing *National Carbide Corp. v. Commissioner* (1949) 336 U.S. 422, 429 and 433-434.)

Respondent asserts appellants contributed the funds to Adler Inc., and Adler Inc. thereafter entered into the agreement with Travertine Corp. (Resp. Op. Br., p. 9.) Respondent contends a sole shareholder is not entitled to deduct his or her payments of a corporation's expenses, and asserts that the expenses relating to the Travertine property venture belonged to Adler Inc. and not appellants in their individual capacity. Respondent contends appellants chose to do business through the corporation, and therefore appellants are not entitled to take the claimed deduction, even if they contributed the money to pay for the expenses. (*Id*. at p. 10; citing *Moline Properties*, *supra*.) Respondent asserts that any money contributed to Adler Inc. pursuant to the Travertine property venture must be treated as capital contributions, and not loans, citing that ". . . a gift or contribution to capital shall not be considered a debt for purposes of [Internal Revenue Code] section 166." (Citing Treas. Reg. § 1.166-1(c).) Respondent contends appellants have not provided any legal support for treating the contributions as loans, and have not shown any attempts to collect the alleged loans from Adler Inc. (*Id*. at pp. 10-11.)

Respondent contends the accuracy-related penalty is properly imposed under Internal Revenue Code (IRC) section 6662(a), incorporated by Revenue and Taxation Code (R&TC) section 19164, subdivision (a)(1)(A). (Resp. Op. Br., pp. 11-12.) Respondent asserts that appellants have not provided reasonable cause for why they claimed losses for funds contributed to Adler Inc., particularly when taking into account appellants' 30 years' experience in real estate development. Respondent contends appellants have not provided a reasonable explanation for why they claimed expenses and losses belonging to Adler Inc., and therefore the penalty is properly imposed. (*Id*. at p. 12.)

Applicable Law

Burden of Proof

In determining whether a taxpayer has shown that respondent improperly disallowed deductions, respondent's determination is presumed correct, and the taxpayer bears the burden of proving that the determination was erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Deductions from gross income are a matter of legislative grace and the taxpayer has the burden of proving an entitlement to the deductions claimed; unsupported assertions are not sufficient to satisfy the taxpayer's burden of proof. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

Business Expenses and Losses

R&TC section 17201, subdivision (a), relating to itemized deductions, incorporates by reference IRC sections 161, et. seq. IRC section 161 provides generally that in computing federal taxable income under IRC section 63, there shall be allowed as deductions the items specified in IRC sections 162 through 199, including certain business expenses and losses. The taxpayer who sustains a loss is the one to whom the deduction shall be allowed. (*New Colonial Ice Co. v. Helvering*, *supra*.) Payments made by an individual on behalf of a corporation are only deductible, if at all, by the corporation and not the individual. (*Rink v. Commissioner* (1969) 51 T.C. 746, 752.)

In *Moline Properties, supra*, an individual sought to ignore the existence of his wholly-owned corporation (the named petitioner) so that gain on sales of real property could be treated as personal gain and not gain of the corporation. The United States Supreme Court looked to its prior decision in *Burnet v. Commonwealth Improvement Co.* for the maxim that "[t]he choice of the advantages of incorporation to do business, it was held, required the acceptance of the tax disadvantages." (*Moline Properties, supra*; See also *Burnet v. Commonwealth Improvement Co.* (1932) 287 U.S. 415.) The court determined that the corporation had a tax identity distinct from its stockholder. (*Ibid*; See also *New Colonial Ice Co.*, at p. 442.)

The United States Supreme Court has stated that "tax laws require taxation of the corporate entity if it engages in business activity," and that "[a] corporation formed or operated for business purposes must share the tax burden despite substantial identity, in practical operation, with its

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

owner." (*National Carbide Corp.*, at pp. 426 and 429.)

IRC Section 166

The provisions of IRC section 166 are generally incorporated into California law at R&TC section 17201. To be deductible under IRC section 166, a loss must be attributable to a bona fide debt, which is defined in Treasury Regulation section 1.166-1(c) as "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." (See also *Calumet Industries, Inc. v. Commissioner* (1990) 95 T.C. 257, 284.) A gift or contribution to capital cannot be considered debt. (*Calumet Industries, Inc*., at p. 284.) Several factors may be examined to determine whether there is a valid debtor-creditor relationship, including a reasonable expectation of repayment, but each case must be decided on its own facts, and the real issue for tax purposes is "the extent to which the transaction complies with arm's length standards and normal business practice." (*Id*. at pp. 284-286.) Some factors are as follows:

> The names given to the certificates evidencing the indebtedness; presence or absence of a fixed maturity date; source of payments; right to enforce payments; participation in management as a result of the advances; status of the advances in relation to regular corporate creditors; intent of the parties; identity of interest between creditor and stockholder; thinness of capital structure in relation to debt; ability of corporation to obtain credit from outside sources; use to which advances were put; failure of debtor to repay; and risk involved in making advances.

(*Id*. at p. 285.) The fact that the debtor and creditor are related parties does not preclude the existence of a bona fide debt, but the form of the transaction and labels applied by the parties may not have as much significance when the corporation is closely held because the parties can mold the transaction at their will. (*Id*. at p. 286.)

For a taxpayer to claim a bad debt deduction, a taxpayer must "exhaust all reasonable means of collecting a debt before the trier of fact can make a determination of worthlessness." (*Poletti v. Commissioner* (1966) 25 T.C.M. (CCH) 266.) The subjective good faith opinion of the taxpayer, by itself, is insufficient to show worthlessness. (*Newman v. Commissioner* (1982) T.C.M. (CCH) 474; *Fox v. Commissioner* (1968) 50 T.C. 813.) Respondent's findings are presumptively correct, and appellant has the burden of showing that respondent's findings are erroneous. (*Appeal of Sheldon I. and Helen R. Brockett*, 86-SBE-109, June 18, 1986.)

///

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Substance over Form

The substance over form doctrine allows for the disregarding of certain transactions, even though they strictly conform to the letter of the law, because they produce tax benefits never intended by the legislature. When a taxpayer structures his business dealings in a manner involving actions taken only for the purpose of avoiding taxes, those arrangements lacking economic reality should be ignored for tax purposes. (See e.g., *Furman v. Commissioner* (1966) 45 T.C. 360, 366; *Markosian v. Commissioner* (1980) 73 T.C. 1235, 1244-46.) When these illusory actions have only the effect of creating business papers that reduce taxes but do not affect any substantive legal rights or obligations, the substance of the overall transaction should be looked to rather than the form. "It is the substance of a transaction that determines its tax consequences rather than the form or timing with which it has been carried out," and "a transaction or event, even though falling within the literal terms of a statute, may yet be outside its spirit or purpose and thus be outside its intended scope." (*Basic Incorporated v. United States* (U.S. Ct. Cl. 1977) 549 F.2d 740, 743.)

Generally, agreements knowingly and voluntarily entered into by taxpayers are binding on taxpayers; and while such agreements may be challenged by the government, those agreements cannot generally be challenged by the taxpayers. (*Palo Alto Town & Country Village, Inc. v. Commissioner* (9th Cir. 1977) 565 F.2d 1388, 1390.) ". . . [A]greements, knowingly and voluntarily made, with no suggestion of fraud, are binding on the [taxpayers]. The tax consequences of such an agreement may be challenged by the Commissioner but not by the taxpayer." (*Id*., at p. 1390 [citations omitted].)[9]

Accuracy-Related Penalty

When respondent assesses an accuracy-related penalty based on a federal action, the assessment of the penalty is presumptively correct. (*Appeal of Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.) The taxpayers bear the burden of proving any defenses to abate the penalty. (*Recovery*

[9] In *Palo Alto Town & Country Village, Inc.*, *supra*, appellants acquired two properties. "The [taxpayers] contend that the values were unintentionally reversed, and that the 9 acres were acquired for $200,000 and the 1/2 interest in the 42 acres for $400,000, so that when some 5 acres of the 42-acre parcel were sold, the basis should have been higher than the Commissioner allowed." The court concluded that the taxpayers entered into the agreements voluntarily, and therefore cannot challenge that the agreements should be looked at differently for tax purposes, based on a substance over form-type contention.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Group, Inc. v. Comm'r, T.C. Memo 2010-76.) R&TC section 19164, which incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. As relevant to this appeal, the penalty applies to the portion of the underpayment attributable to (1) negligence or disregard of rules and regulations or (2) any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) The IRC defines "negligence" to include "any failure to make a reasonable attempt to comply" with the provisions of the code. (Int.Rev. Code, § 6662(c).) The term "disregard" is defined to include any "careless, reckless, or intentional disregard." (*Ibid*.) IRC section 6662 provides that a substantial understatement of tax exists if the amount of the understatement exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000. (Int.Rev. Code, § 6662(d)(1).) "Understatement" means the excess of the amount required to be shown on the return for the taxable year over the amount of the tax imposed which is shown on the return, reduced by any rebate. (Int.Rev. Code, § 6662(d)(2).)

There are three exceptions to the imposition of the accuracy-related penalty. Under the first exception, the accuracy-related penalty will be reduced by the portion of the understatement attributable to a tax treatment of any item if there is substantial authority for such treatment. (Int.Rev. Code, § 6662(d)(2)(B).) Under the second exception, the penalty shall be reduced by the portion of the understatement attributable to a tax treatment of any item if the relevant facts affecting the item's tax treatment are adequately disclosed and there is a reasonable basis for the tax treatment of such item. (Int.Rev. Code, § 6662(d)(2)(B).) Under the third exception, the penalty will not be imposed to the extent that appellants show a portion of the underpayment was due to reasonable cause and that they acted in good faith with respect to such portion of the underpayment. (Int.Rev. Code, § 6664(c)(1); Treas. Regs. §§ 1.6664-1(b)(2) & 1.6664-4.)

A determination of whether the taxpayers acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including their efforts to assess the proper tax liability, their knowledge and experience, and the extent to which they relied on the advice of a tax professional. Generally, the most important factor is the extent of the taxpayers' effort to assess their proper tax liability. Reliance on the advice of a professional tax advisor does not necessarily demonstrate reasonable cause and good faith. However, reliance on professional advice constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayers acted in good faith. (Treas. Reg. § 1.6664-4(b)(1).)

STAFF COMMENTS

Business Losses and Expenses

Deductions are generally deductible only by the taxpayer who sustained the loss or expenses. The facts in this appeal appear to show that Adler Inc. was the obligor on the purchase option agreement and the holder of the escrow account from which the deposit was paid to Travertine Corp. Based on these facts, it appears that Adler Inc. was the taxpayer responsible for the deposit, the taxpayer that paid the deposit, and the taxpayer that incurred the loss when the deposit was forfeited. Adler Inc. also appears to be the taxpayer that incurred the corporate expenses involved in pursuing the Travertine property venture. The exception to this is the $125,000 already conceded by respondent prior to issuing the NOA, which respondent agreed was provided by appellants as individuals based on the terms of the Peninsula Finance Agreement. This amount has already been allowed prior to this appeal, and is not at issue in this appeal.

In the Appeal Letter on page 2, appellants state that "[w]ith one exception, [appellant-husband] would always personally enter into a contract to purchase such a property, but would never acquire the property in his individual name . . . ." However, in the protest letter dated January 22, 2010, appellants state that "[Adler] Inc., as [appellant-husband's] agent, would often enter into a contract to purchase such a property, but would NEVER acquire the property." (Resp. Op. Br., exhibit G, p. 1 [emphasis in original].) At the hearing, appellants should be prepared to address this apparent inconsistency and confirm which party, appellant-husband or Adler Inc., was the contracting party. If Adler Inc. acted as agent, appellants should present evidence of the scope of the agency, including any written agency authorization and explain whether appellant-husband contributed the purchase or deposit funds with Adler Inc.

Appellants should address case law discussed above stating that corporations, even wholly-owned corporations, have a tax identity distinct from its stockholder, and even when payments are made by an individual on behalf of that corporation, any resulting losses or expenses are deductible only by the corporation.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

IRC section 166

Appellants' alternative contention is that they should be able to deduct the amounts contributed because they were loans which could not be repaid after the venture fell through. However, there is no evidence in the record that appellants entered into a loan arrangement between themselves and Adler Inc. at any time before or after the amounts were contributed to the escrow account for Adler Inc.'s use in the Travertine property venture. Specifically, there is no loan document, fixed maturity date, right to enforce payments, creditor status declarations, or terms of agreement regarding any potential failure to repay the alleged loans. Appellant should address the typical factors of a valid debtor-creditor relationship and provide evidence showing they meet these factors. Among those factors evidencing such a relationship are loan documentation or other valid and enforceable obligations for Adler Inc. to repay the amounts to appellants. Appellants would also need to show attempts to collect the alleged loan amounts, and an identifiable event showing that the loan became uncollectable at some point during the year at issue.

Substance over Form

Appellants make assertions that the structure of the Travertine property venture differed from their previous property ventures in that it included Adler Inc.'s direct involvement as the principal purchaser, which may have been a mistake on their attorney's part. Appellants assert that they never intended to involve Adler Inc. as the purchaser, that it would be "ludicrous" to purchase property with a C corporation, and that the Board should therefore look at the substance of the transaction over the form of the transaction. In view of the fact that Adler Inc. is a C corporation which has a separate legal identity for tax purposes, appellants should be prepared at the hearing to explain how the substance of the transaction differs from its form. The Appeals Division notes that appellant-husband signed transactional paperwork in his capacity as president of Adler Inc., appellants state that they did not remove Adler Inc. as the buyer, and Adler Inc. had contracted to purchase property in prior transactions. Appellants should also be prepared to address the *Palo Alto Town & Country Village, Inc.*, *supra*, decision in which the court held that a taxpayer cannot knowingly and voluntarily enter into an agreement and then later challenge the tax effects of the transaction based on a substance over form argument.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Accuracy-Related Penalty

Respondent states that the accuracy-related penalty may be imposed based on negligence or substantial underpayment, but does not explain under which theory it imposes the penalty. Respondent should be prepared at the hearing to state whether or not it imposes any part of the penalty based on negligence, and to support any such contention. The penalty appears to be properly imposed based on the substantial understatement theory. According to the proposed assessment, appellants were required to show a tax liability of $337,336, but only reported $273,541, for a deficit of $63,795 (i.e., $337,336 minus $273,541 equals $63,795). This deficit is greater than both $5,000.00 and ten percent of the total tax liability (i.e., $33,733.60).

As contended by appellants, if the Board determines that appellants prevail on the main issue regarding the denied deductions, then the accuracy-related penalty would be automatically abated. Otherwise, appellants have the burden of proving error in respondent's imposition of the penalty. Appellants have asserted that there is substantial authority for their reporting position because they personally provided the investment funds, and they should provide statutory and case law to support this contention. Appellants will also need to be prepared to distinguish their appeal from the holding in *Rink*, *supra*, in which the court determined that payments made by an individual on behalf of a corporation are not deductible by the individual.

///

///

///

Adler_jj

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL