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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 **JAMES U. HANNON AND**) Case No. 613264²
13 **SANDRA J. RIDDLE**¹)

	<u>Years</u>	<u>Proposed Assessments</u>
	2007	\$10,879
	2008	\$ 2,321
	2009	\$ 3,288
	2010	\$ 3,286

19 Representing the Parties:

20 For Appellants: James U. Hannon and Sandra J. Riddle
21 For Franchise Tax Board: Jaclyn N. Appleby, Tax Counsel

23 **QUESTIONS:** (1) Whether appellants have shown error in the Franchise Tax Board's
24 (respondent's) determination that rental real estate activity losses are passive
25 losses.

27 ¹ Appellants reside in Aliso Viejo, in Orange County, California.

28 ² This matter was originally scheduled for the February 26-28, 2013 oral hearing calendar. A postponement request by appellants was granted, and this matter was rescheduled to the April 24-26, 2013 Culver City oral hearing calendar.

1 (2) Whether respondent's proposed assessment for the 2007 tax year is barred by the
2 statute of limitations.

3 HEARING SUMMARY

4 Background

5 2007

6 Appellants filed a timely 2007 joint California tax return reporting federal adjusted gross
7 income (AGI) of \$151,126, California income adjustments (subtractions) of \$7,377 for a state tax
8 refund, a California AGI of \$143,749, and a taxable income of \$83,909. (Resp. Op. Br., p. 1 and
9 exhibit A.) Appellants self-assessed tax in the amount of \$2,712, applied withholding credits of
10 \$18,267 and excess SDI credits of \$713, and claimed a refund of \$16,268. Appellants' refund was
11 reduced to \$16,253.92 based on a correction by respondent of appellants' excess SDI credits to \$698.92
12 (i.e., a difference of \$14.08; \$713.00 - \$698.92), and appellants' refund was issued on February 11,
13 2008. (*Id.* at pp. 1-2 and exhibit B, Ins. 3-4.) Appellants attached their federal return to their state
14 return, which showed that their federal AGI included a deduction for rental real estate losses in the
15 amount of \$117,770. (*Id.* at p. 2 and exhibit A, p. 8.)

16 2008

17 Appellants filed a timely 2008 joint California tax return reporting federal AGI of
18 \$205,870, California income adjustments of \$16,209 for a state tax refund (subtractions) and \$33,990
19 for Schedule E adjustments (additions), a California AGI of \$223,651, and a taxable income of
20 \$181,783. (Resp. Op. Br., p. 2 and exhibit C.) Appellants self-assessed tax in the amount of \$11,481,
21 applied withholding credits of \$16,141 and excess SDI credits of \$694, and claimed a refund of \$5,354.
22 Appellants' refund was issued on March 18, 2009. (*Id.* at p. 2 and exhibit D, In. 4.) Appellants
23 attached their federal return to their state return, which showed that their federal AGI included a
24 deduction for rental real estate losses in the amount of \$58,942. (*Id.* at p. 2 and exhibit C, p. 10.)

25 2009

26 Appellants filed a timely 2009 joint California tax return reporting federal AGI of
27 \$147,804, California income adjustments (subtractions) of \$5,354 for a state tax refund and \$1,365 for
28 Schedule E depreciation, a California AGI of \$141,085, and a taxable income of \$99,026. (Resp. Op.

1 Br., p. 2 and exhibit E.) Appellants self-assessed tax in the amount of \$4,523, applied withholding
2 credits of \$10,908, and claimed a refund of \$6,385. Appellants' refund was issued on February 5,
3 2010. (*Id.* at p. 2 and exhibit F, ln. 3.) Appellants attached their federal return to their state return,
4 which showed that their federal AGI included a deduction for rental real estate losses in the amount of
5 \$33,041. (*Id.* at p. 2 and exhibit E, p. 9.)

6 2010

7 Appellants filed a timely 2010 joint California tax return reporting federal AGI of
8 \$171,764, California income adjustments (subtractions) of \$6,385 for a state tax refund and \$4,772 for
9 Schedule E depreciation, a California AGI of \$160,607, and a taxable income of \$113,435. (Resp. Op.
10 Br., p. 3 and exhibit G.) Appellants self-assessed tax in the amount of \$5,857, applied withholding
11 credits of \$13,925, and claimed a refund of \$8,068. Appellants' refund was issued on February 3,
12 2011. (*Id.* at p. 3 and exhibit H, ln. 3.) Appellants attached their federal return to their state return,
13 which showed that their federal AGI included a deduction for rental real estate losses in the amount of
14 \$29,642. (*Id.* at p. 3 and exhibit G, p. 8.)

15 Audit

16 On March 2, 2011, respondent sent appellants a letter indicating that their tax years 2007
17 through 2010 were being examined and that their rental losses were being disallowed. (Resp. Op. Br.,
18 p. 3 and exhibit I.) Respondent's letter indicated that California does not conform to Internal Revenue
19 Code (IRC) section 469(c)(7), which allows qualified real estate professionals to treat rental real estate
20 activities as not per se passive activities. The letter also informed appellants that they were not entitled
21 to the \$25,000 special allowance for passive rental losses as an offset to nonpassive income because the
22 allowance was phased out based on appellants' modified AGI for each year at issue. (*Ibid.*)

23 Appellants responded to respondent's letter, disagreeing with the adjustments, and in a
24 separate letter, indicated that they were actively engaged in the management of their rental real estate
25 property and that the losses should therefore not be considered passive. (Resp. Op. Br., exhibits J &
26 K.) On July 8, 2011, respondent issued Notices of Proposed Assessments (NPAs) for each of the four
27 years. (Appeal Letter exhibits.) The NPAs proposed the disallowance of rental real estate losses in the

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1 amount of \$117,770, \$24,952, \$34,406, and \$34,414 for the 2007, 2008, 2009, and 2010 tax years,
2 respectively. These disallowances resulted in the proposed assessments at issue in this appeal.

3 Appellants protested the NPAs, asserting that they materially participated in the
4 management of their rental real estate property and, therefore, the rental activity and corresponding
5 losses were not passive. (Resp. Op. Br., exhibit L.) After a protest hearing, on June 17, 2012,
6 respondent affirmed the NPAs by issuing Notices of Action. (Appeal Letter, exhibits.)

7 Contentions

8 Appellants assert that the rental activity at issue is not a passive activity. Appellants
9 contend that they run the rental property as a business, and therefore the losses from the rental property
10 are not passive losses. Appellants assert that they feel the 2007 tax year proposed assessment is barred
11 by the statute of limitations.³ Appellants contend that respondent's proposed assessment constitutes a
12 civil rights violation as well as an antitrust issue, and they hope to have their case heard before a judge
13 with a lawyer assisting them. Appellants indicate that they are not represented, but feel that the issue in
14 this appeal "could be considered for class action based on the treatment from the State of California to
15 its citizens." (Appeal Letter.)

16 Respondent asserts that California does not conform to IRC section 469(c)(7), which
17 provides that rental real estate activities performed by qualified real estate professionals are not per se
18 passive activities and, therefore, all rental activities are considered passive activities for California
19 purposes. Respondent contends that losses from passive activities can only be used to offset income
20 from passive activities. Respondent states that the general exception to the general passive loss rules
21 for rental activities allow for a deduction of up to \$25,000 of passive rental losses against non-passive
22 income if the taxpayer is an active participant in the rental activity. Respondent notes, however, that
23 the \$25,000 special allowance is phased out beginning when a taxpayer's modified AGI exceeds
24 \$100,000 and is completely phased out at an AGI of \$150,000. (Resp. Op. Br., pp. 4-5; citing Rev. &
25

26 ³ Appellants also state that they would consider "closing and paying" on the other three tax years in an effort to "close" the
27 2007 tax year. The Board serves as the administrative appeal body over final actions made by the FTB. The FTB is
28 responsible for collecting and administering income taxes. R&TC section 19442 authorizes the FTB, not the Board, to settle
civil tax matters in disputes that are the subject of protests, appeals, or refund claims. Therefore, only the FTB has the ability
to settle an income tax appeal currently pending before the Board and appellants should direct any settlement requests to the
FTB's Settlement Bureau.

1 Tax. Code, § 17561; Int.Rev. Code § 469.) Respondent asserts that appellants' claimed rental losses
2 are per se passive losses which can only be deducted against passive income, and appellants' modified
3 AGI for each year at issue exceeded \$150,000, so appellants' rental activity losses can only be used
4 against passive income. (Resp. Op. Br., p. 5.)

5 Respondent asserts that the NPA for 2007 was issued on July 8, 2011, prior to the
6 expiration of the four-year statute of limitations for filing a proposed assessment for 2007. (Resp. Op.
7 Br., pp. 5-6.) Respondent contends that the Board, as an administrative agency, is prohibited from
8 addressing the constitutionality of California statutes, citing California Constitution, article III, section
9 3.5. (*Id.* at p. 1, fn. 1.) Respondent states that the Board is also precluded from determining whether a
10 statute is unconstitutional and the Board has a longstanding policy of abstaining from deciding
11 constitutional issues. (*Ibid.*; citing *Appeal of Aimor Corporation*, 83-SBE-221, Oct. 26, 1983; *Appeal*
12 *of Castle & Cooke, Inc.*, 87-SBE-043, June 17, 1983; *Appeal of Capital Industries-EMI, Inc.*, 89-SBE-
13 029, Oct. 31, 1989.) Respondent states that it will therefore not address appellants' assertions
14 regarding any violation of civil rights and antitrust issues. (Resp. Op. Br., p. 1, fn. 1.)

15 Applicable Law

16 In determining whether a taxpayer has shown that respondent improperly disallowed
17 deductions, respondent's determination is presumed correct, and the taxpayer bears the burden of
18 proving that the determination was erroneous. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.)
19 Deductions from gross income are a matter of legislative grace and the taxpayer has the burden of
20 proving an entitlement to the deductions claimed; unsupported assertions are not sufficient to satisfy the
21 taxpayer's burden of proof. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435; *Appeal of James*
22 *C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.) In general, respondent must issue a
23 proposed deficiency assessment within four years of the date the taxpayer filed its California return.
24 (Rev. & Tax. Code § 19057.)

25 California incorporates, with some changes, IRC section 469, which generally prohibits
26 the use of passive activity losses to reduce nonpassive activity income (e.g., wages, interest, or
27 dividends). (Rev. & Tax. Code, § 17561.) In general, a taxpayer's passive losses can be deducted only
28 to the extent of income from the taxpayer's passive activities; any unused passive losses are generally

1 suspended and carried forward to future years to offset passive income generated in those years. (*Lowe*
2 *v. Commissioner*, T.C. Memo 2008-298; see also, *Jafarpour v. Commissioner*, T.C. Memo 2012-165.)
3 IRC section 469(c)(2) provides that the term “passive activity” includes any rental activity. IRC
4 section 469(c)(7) allows taxpayers in the real property business to treat rental activity losses as non-
5 passive losses for federal purposes; however, R&TC section 17561, subdivision (a), states that,
6 “Section 469(c)(7) of the Internal Revenue Code, relating to special rules for taxpayers in [the] real
7 property business, shall not apply.” Therefore, for California purposes, rental real estate activities are
8 considered passive activities, and any losses from such activities generally can only be applied to offset
9 passive activity gains. IRC section 469(i) allows for up to \$25,000 of rental real estate activity losses to
10 apply to nonpassive income. This allowance phases out by 50 percent of the amount by which the AGI
11 of the taxpayer for the taxable year exceeds \$100,000, with a complete phase-out of such loss
12 deductions at an AGI of \$150,000.

13 Section 3.5 of article III of the California Constitution states in relevant part:

14 An administrative agency, including an administrative agency created by the Constitution
15 or an initiative statute, has no power (a) [t]o declare a statute unenforceable, or refuse to
16 enforce a statute, on the basis of it being unconstitutional unless an appellate court has
17 made a determination that such statute is unconstitutional; (b) [t]o declare a statute
18 unconstitutional; (c) [t]o declare a statute unenforceable, or to refuse to enforce a statute
on the basis that federal law or federal regulations prohibit the enforcement of such
statute unless an appellate court has made a determination that the enforcement of such
statute is prohibited by federal law or federal regulations.

19 In addition, the Board has a long-established policy of declining to consider constitutional issues. In
20 the *Appeal of Aimor Corporation, supra*, the Board stated:

21 This policy is based upon the absence of any specific statutory authority which would
22 allow the Franchise Tax Board to obtain judicial review of a decision in such cases and
23 upon our belief that judicial review should be available for questions of constitutional
importance. Since we cannot decide the remaining issues raised by appellant,
respondent’s action in this matter must be sustained.

24 This policy was in place long before the enactment of article III, section 3.5. As far back as 1930, the
25 Board stated:

26 It is true that we have occasionally asserted that right [to question the constitutionality of
27 a statute]. But this has been only under circumstances wherein such action on our part
28 was necessary in order to protect the revenues of the state and get the problem before the
Courts In the instant case, and in all others like it before us, the taxpayers will have
the opportunity of taking the question to the Courts for decision. . . . It might be argued
that, if the law is plainly unconstitutional, why should taxpayers be put to that trouble and
expense? However, there is diversity of opinion as to the constitutionality of the Act, and

1 it seems to us desirable that this controversy should be settled by the Courts, whose
2 authority to hold acts of the Legislature invalid cannot be questioned.

3 (*Appeal of Vortex Manufacturing Co.*, 30-SBE-017, Aug. 8, 1930 [internal citations omitted].)

4 STAFF COMMENTS

5 Appellants raise statute of limitations concerns for the 2007 tax year. Appellants' 2007
6 tax return was filed prior to the due date, and therefore the general statute of limitations for respondent
7 to issue a proposed assessment began on April 15, 2008, and expired four years later on April 15, 2012.
8 Respondent issued its 2007 NPA on July 8, 2011, and thus appears to have been issued timely.

9 As explained above, California law generally conforms to IRC section 469 in
10 prohibiting the use of passive losses to reduce nonpassive gains. Important to this appeal, California
11 law adopts IRC section 469(c)(2), which provides that rental activities are per se passive, but does not
12 adopt IRC section 469(c)(7), which provides, for federal purposes, an exception to the per se passive
13 rule for rental activities for taxpayers in the "real property business." Therefore, for California
14 purposes, all rental real estate activity losses are typically considered passive losses, regardless of
15 whether the taxpayers actively participated in the rental business. California law allows for up \$25,000
16 of such losses to be applied to reduce nonpassive income, but this exception completely phases out at
17 an AGI of \$150,000. Appellants had an AGI in excess of \$150,000 for each year at issue. Based on
18 this analysis, it appears as though appellants' rental activity losses must be treated as passive losses,
19 and the \$25,000 exception is not available to appellants for any of the years at issue, based on
20 appellants' AGI for each year.

21 Appellants raise contentions regarding civil rights violations, antitrust issues, class
22 action lawsuits, and other judicial concerns. As stated above, the California Constitution prohibits an
23 administrative agency, such as the Board, from ruling on constitutional or federal preemption issues
24 unless an appellate court has made such a determination. Therefore, the Board has no jurisdiction to
25 rule on these bases, and should abstain from considering such issues in its determination.

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