

CALIFORNIA STATE BOARD OF EQUALIZATION
SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of:

)
) Case ID No. 571973
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ROBERT H. LOWE AND

SHERYL L. BERKOFF

) Oral hearing date: February 23, 2016
) Decision rendered: September 27, 2016
) Publication due by: February 24, 2017

Representing the Parties:

For Appellants:

Mark Bernsley, Attorney at Law

For Respondent:

Sonia Woodruff, Tax Counsel III

Counsel for the Board of Equalization:

Louis A. Ambrose, Tax Counsel IV

LEGAL ISSUE

Whether appellants have shown that respondent Franchise Tax Board erred in its determination of the basis of real property sold by appellants and the resulting taxable gain.

BACKGROUND AND FINDINGS OF FACT

Appellants purchased a residential property on Garden Lane in Montecito, California (Garden Lane) in 1997 with an original cost basis of \$2,858,126. Appellants undertook extensive construction work and improvements on Garden Lane, including the construction of the house, guest house, and pool and extensive landscaping and other improvements. Appellants sold Garden Lane in 2005 for approximately \$25,000,000 and reported a capital gain of \$10,139,773. Respondent determined that appellants underreported the gain on the sale by \$9,344,604, made an adjustment to the adjusted basis of the property and issued a Notice of Proposed Assessment (NPA) dated February 5, 2009. The NPA increased the taxable capital gain income by \$8,830,086, reduced itemized deductions by \$4,255 and proposed an assessment of additional tax of \$909,938. The NPA also imposed a penalty for the failure to furnish information in the amount of \$227,484. At protest, the hearing officer allowed

1 total construction costs of \$3,736,056 and determined the adjusted basis as \$6,671,112. Respondent
2 then issued a Notice of Action (NOA) revising the assessment to increase the capital gain income of
3 \$6,934,444, leaving the reduction in itemized deductions unchanged and proposing the assessment of
4 additional tax of \$714,686. The NOA also reduced the failure to furnish information penalty to
5 \$178,671.50.¹ Appellants filed a timely appeal.

6 Appellants stated that a large portion of the documentation to substantiate the adjusted basis of
7 Garden Lane was lost when they changed their professional representative and when their
8 representative's computer system crashed in 2002. However, appellants stated that they expected that
9 Craig Szabo, their certified public accountant (CPA), was properly tracking all costs and expenses of
10 the construction of Garden Lane and maintained bank and other financial records, receipts, and
11 information. Appellants stated that Mr. Szabo's firm prepared documents and schedules "based on
12 available information showing an adjusted basis of \$12,991,000" and that their subsequent
13 representative, Boulevard Management, added \$535,000 to the computation based on information
14 obtained from appellants and filed the return in October of 2006.

15 Appellants initially maintained that the available records, which substantiated approximately
16 50 percent of the construction costs, together with secondary evidence, were sufficient to support the
17 amount of the basis reported by appellants. There is correspondence in the appeal record from
18 Mr. Szabo, dated August 20, 2009, submitted as support for the claimed basis, and included a summary
19 of the Garden Lane construction costs, a schedule titled "Capitalized Interest (1999-2004)",
20 construction period interest amounts, and a cost basis recap of the Garden Lane home. During the
21 course of appeal, appellants also hired two experts to estimate the construction costs of Garden Lane as
22 a means of determining the adjusted basis of the property as of the date of sale in 2005.

23 APPLICABLE LAW

24 Burden of Proof

25 The FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of
26 proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Aaron and Eloise Magidow*,

27
28 ¹ Prior to the oral hearing, respondent withdrew the penalty for failure to furnish information.

82-SBE-274, Nov. 17, 1982.) This presumption is a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Appeal of George H. and Sky Williams et al.*, 82-SBE-018, Jan. 5, 1982.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Aaron and Eloise Magidow, supra.*)

Gain on the Sale of the Properties

IRC section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis as defined in IRC section 1011.² IRC section 1011 provides that the adjusted basis for determining the gain from the sale of property shall be the property's initial basis (determined under section 1012 or other applicable sections of that subchapter) with adjustments as provided in IRC section 1016. Under IRC section 1016, the property's initial basis must be adjusted for capital expenses and capital recoveries. Capital expenses, such as the cost of capital improvements made to the property, increase the initial basis and capital recoveries, such as deductions for depreciation, reduce the initial basis so that, on the date of disposition, the adjusted basis reflects the unrecovered cost or other basis of the property. (Int.Rev. Code, § 1016(a).)

Capitalized Interest

Treasury Regulation section 1.266-1 provides that a taxpayer may elect to capitalize certain taxes and carrying charges with respect to property of a type described in that section. Subsection (b)(1) provides that "[t]he taxpayer may elect . . . to treat the items enumerated in this subparagraph which are otherwise expressly deductible under the provisions of Subtitle A of the Code as chargeable to capital account either as a component of original cost or other basis, for the purposes of section 1012, or as an adjustment to basis, for the purposes of section 1016(a)(1)." Among those items enumerated are:

(i) In the case of unimproved and unproductive real property: Annual taxes, interest on a mortgage, and other carrying charges.

(ii) In the case of real property, whether improved or unimproved and whether productive or unproductive: (a) Interest on a loan (but not theoretical interest of a taxpayer using his

² California conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

own funds), . . . paid or incurred for the development of the real property or for the construction of an improvement or additional improvement to such real property, up to the time the development or construction work has been completed.

(Treas. Regs., §1.266-1(b)(1)(i) & (ii)(a).)

Thus, for an improved real property, a taxpayer may elect to capitalize construction loan interest and include it in the adjusted basis but may not include capitalized mortgage interest in the adjusted basis of such property.

ANALYSIS AND DISPOSITION

In this appeal, there has been an abundance of evidence presented to establish the adjusted basis of Garden Lane as of the date of sale in 2005. We have reviewed the records and declarations submitted by appellants, the reports prepared by the expert witnesses for the parties, and the schedules and other materials submitted by Mr. Szabo. After consideration of all the evidence, we find that the information compiled and provided by Mr. Szabo is the most reliable as appellants state that “he was and is confident of the computations done by his staff in 2008.” Moreover, Mr. Szabo stated in a declaration that he was confident that his former employee prepared a competent computation of the adjusted basis prior to the filing of the 2005 return.

We note that the evidence submitted by Mr. Szabo reflects amounts for capitalized construction loan interest of \$739,099 and capitalized mortgage interest of \$1,358,792 included in the reported adjusted basis of \$13,526,000. Those amounts are tracked meticulously on a detailed schedule from 1999 through 2004 that reflects the exact amounts of interest that were paid and whether appellants had claimed those mortgage interest payments as current year deductions or had capitalized those amounts. However, under Treasury Regulation section 1.266-1(b)(1)(i), mortgage interest is chargeable to a capital account only on unimproved and unproductive property and, because Garden Lane was improved real property, only the construction loan interest may be capitalized and added to basis pursuant to Treasury Regulation section 1.266-1(b)(1)(ii)(a). Thus, we find an adjusted basis for Garden Lane in the amount of \$12,167,208 computed as follows: the reported basis of \$13,526,000 reduced by \$1,358,792 in claimed capitalized mortgage interest that could not be added to the basis.

ORDER

Pursuant to the analysis of the law and facts above, the Board ordered that the action of the Franchise Tax Board on appellants' protest against the proposed assessment for the year 2005 be modified in accordance with the foregoing determination. Adopted at Sacramento, California, this day of January, 2017.

_____, Chairwoman

_____, Member

_____, Member

_____, Member

_____, Member

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