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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
GABRIEL RUFUS AND SHIRLEY RUFUS	Case No. 599989

Year	Proposed Assessment Tax	Penalty
2006	$24,120	$4,824

Representing the Parties:

For Appellant: Gary M. Slavett, Attorney

For Franchise Tax Board: Sonia C. Deshmukh, Tax Counsel

QUESTIONS: 1. Whether appellants have established error in the Franchise Tax Board's (FTB or respondent) assessment, which is based on a federal audit adjustment.

2. Whether the accuracy-related penalty should be abated.

HEARING SUMMARY

Background

Appellants timely filed a 2006 California income tax return using the joint filing status. On this return, appellants reported federal adjusted gross income (AGI) of $98,890 and California adjustments (additions) of $6,711. After applying itemized deductions of $56,469, the couple reported

taxable income of $49,132 and a tax of $1,204. After applying exemption credits of $1,037, an income tax withholding credit of $335, and estimated tax and other payments of $137, they claimed a refund of $305. Appellants did not report any capital gain on Schedule D (540) or Schedule CA (540). (Resp. Opening Br., p. 1, Exhibit B.)

Subsequently, respondent received audit information from the Internal Revenue Service (IRS) showing that the IRS made adjustments to appellants' 2006 federal return. The IRS determined that appellants failed to include $541,999 of gains from the sales of two properties located on Leighton Avenue in Los Angeles, California (Leighton Avenue properties) in their reported taxable income. The IRS increased appellants' federal AGI by $541,999 from the reported amount of $98,890 to the adjusted amount of $638,300. The IRS determined that appellants contributed cash proceeds of $337,779 of the capital gain of $541,999 from the sale of the two Leighton Avenue properties to the Los Angeles Transition Center, Inc. (LATC), an IRC section 501(c)(3) organization operated by its executive director, Henry B. Zachary. The IRS adjusted appellants' charitable contributions by $337,779 from the reported amount of $17,425[1] to $355,217 to reflect the cash contribution to LATC. The IRS increased appellants' claimed charitable contribution deduction by only $301,725 from $17,425 to $319,150 because Internal Revenue Code (IRC) section 170(b)(1)(A) limits the charitable contribution deduction to no more than 50 percent of appellants' corrected AGI ($638,300).

The IRS adjusted appellants' self-employment tax deduction by $208 due to adjustments to their net earnings from self-employment, disallowed $156 of the claimed tuition and fees deduction, disallowed $11,000 of claimed exemptions, and increased appellants' cost of goods sold deduction by $2,953. The IRS assessed additional tax of $34,340 and imposed an accuracy-related penalty of $6,868 plus interest. On March 12, 2009, both appellants signed an IRS Form 4549, Income Tax Examination Changes, and indicated that they did not wish to appeal or contest the 2006 federal audit findings and consented to the immediate assessment and collection of the additional tax and penalty plus interest. (Resp. Opening Br. pp. 1-2, Exhibit C; Apps. Opening Brief, Attachment C.)

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[1] Although the IRS Form 886-A, Explanation of Items, shows that appellants claimed charitable contributions of $17,425 on their 2006 federal return, the Appeals Division notes that Schedule A of appellants' 2006 federal return lists $17,485 of gifts to charity consisting of $14,735 of gifts by cash or check plus $2,750 of gifts other than by cash or check. (Resp. Opening Br., Exhibit B, p. 11, Exhibit C.)

Based on this federal audit information, respondent issued a Notice of Proposed Assessment (NPA) dated April 5, 2010, which increased the reported taxable income by $257,798 from $49,132 to $306,930 ,by including $541,999 of capital gain, increasing charitable contributions by $301,665,[2] disallowing $20,209 of itemized deductions based on appellants' filing status and revised federal AGI, [3] increasing the cost of goods sold deduction by $2,953 and reducing the self-employment tax deduction by $208. After disallowing the claimed exemption credits based on appellants' revised federal AGI, the NPA proposed an assessment of additional tax in the amount of $24,120 and imposed an accuracy-related penalty of $4,824 plus interest. (Resp. Opening Br. p. 2, Exhibit D.)

Appellants protested the NPA, arguing that the gain on the sale of the two Leighton Avenue properties should not be included in their taxable income because they held the properties as nominees for LATC. At protest, appellants submitted correspondence from Mr. Zachary and copies of checks and bank statements to show that LATC made mortgage payments on the properties. According to respondent, appellants apparently provided the IRS (but not respondent) with evidence showing that they contributed some of the sales proceeds to LATC, which resulted in the IRS's increase in their charitable contribution amount. Respondent issued a Notice of Action (NOA) dated December 8, 2011, which sustained the NPA. (Resp. Opening Br. pp. 2-3; Apps. Opening Br., Attachment.)

This timely appeal followed.

Contentions

Appellants' Contentions

In their opening brief, appellants contend that the assessment is erroneous because Mr. Rufus was not the actual owner of the two Leighton Avenue properties and he did not receive any of the sales proceeds. Appellants assert that they disagree with the federal adjustments and they "inadvertently missed their opportunity to challenge the IRS proposed adjustments." They contend that two 1099-S Forms were issued to Mr. Rufus for 2006 that report the sale of the two Leighton Avenue

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[2] As discussed in footnote 1, *supra*, Schedule A of appellants' 2006 federal return lists $17,485 of gifts to charity, rather than $17,425 reflected on the IRS Form 886-A, Explanation of Items. On the NPA, the FTB therefore increased appellants' claimed charitable contribution deduction by only $301,665 from $17,485 to $319,150 due to the charitable contribution deduction limitation set forth in IRC section 170(b)(1)(A). (Resp. Opening Br., Exhibits B-D.)

[3] See Instructions for 2006 Schedule A (540), Itemized Deduction Worksheet.

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properties for $500,000 and $725,000. For the first property, appellants assert that the IRS determined a long-term capital gain of $331,571 based on a sale price of $725,000 less adjusted basis of $393,429. For the second property, appellants assert that the IRS determined long-term capital gain of $210,428 based on a sale price of $500,000 less adjusted basis of $289,572. Appellants contend that the IRS incorrectly determined that they realized total long-term capital gains of $541,999 ($331,571 + $210,428) because the properties were owned and possessed by LATC, which used them as its office and rehabilitation center. (Apps. Opening Br. pp. 1-3.)

Appellants also contend that Mr. Zachary, a pastor, introduced Mr. Rufus to LATC and Mr. Rufus became a volunteer at LATC. They further contend that, in 2003, Mr. Zachary asked Mr. Rufus to allow LATC to use his name and social security number for the purchase of real property for LATC because LATC and Mr. Zachary were unable to purchase real property based on their financial situation. Appellants state, "Mr. Rufus unwittingly agreed as he was told by Pastor Zachary that there would not be any problems with this arrangement and that the properties would ultimately be transferred to LATC and/or Pastor Henry." They argue that Mr. Rufus did not have any benefits or burdens of ownership of the properties. Appellants assert that, during the years of ownership, LATC and/or Mr. Zachary paid the mortgage and all expenses related to the properties. They also assert that, when the properties were sold in 2006, Mr. Rufus did not receive any of the sale proceeds and that LATC, Mr. Zachary, or his church ultimately received all of the sale proceeds. Attached to appellants' opening brief are copies of letters dated July 31, 2008 and September 12, 2008, from Mr. Zachary, IRS Forms 4549 and 886-A, a purported IRS report of the relevant IRS Forms 1099-S, LATC's bank statements, and a check dated March 22, 2004, from LATC to Farmer's Insurance for $672.76. (Apps. Opening Br. pp. 1-3, Attachments A-F.)

Appellants argue that a theory of nominee ownership applies to this appeal. Appellants assert that Mr. Rufus was holding the two Leighton Avenue properties as a nominee for LATC, he had no legal right to the sale proceeds, and he should therefore not be subject to tax on the capital gains. Appellants contend that, although California law recognizes this theory, California courts have not identified a test to apply in determining whether an individual is a nominee owner. Citing *United States v. Bell* (E.D. Cal. 1998) 27 F.Supp.2d 1191, 1195, appellants argue that federal courts use a six-factor

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test to determine if an individual is a nominee owner. Appellants state:

> Given the California authority referencing the nominee theory of ownership, California courts' implicit recognition of its validity, California authority on resulting trusts, and the reasoned opinions of fellow district courts, once [sic] can reasonably conclude that the California Supreme Court would likely apply a test identical or similar to the six factor test used by other courts to determine whether Mr. Rufus was LATC's nominee in holding title to property.

(Apps. Opening Br. pp. 1-7.)

Appellants assert that the charitable contribution adjustment of $319,150 is related to the capital gain adjustment for the two Leighton Avenue properties, as determined by the IRS in the federal audit. Appellants argue that the charitable contribution adjustment and the capital gains adjustment are both incorrect because Mr. Rufus was not the actual owner of the two Leighton Avenue properties, he never had possession of the properties, and he did not receive the sales proceeds. (Apps. Opening Br., pp. 3-4.)

Appellants argue that the accuracy-related penalty should be abated because Mr. Rufus had a reasonable belief that he was not the owner of the two Leighton Avenue properties. Appellants assert that he "unwittingly" became the nominee owner of the two Leighton Avenue properties for LATC. Appellants state, "Mr. Rufus'[s] belief that he did not own the real property [as] he did not have any benefits or burdens of the property, is reasonable cause for him not reporting the sale on his tax return." (Apps. Opening Br., p. 4.)

In their reply brief, appellants contend that they did not receive any proceeds from the sale of the two Leighton Avenue properties. They assert that the sale of the first property resulted in cash proceeds of $140,007.72 and that the sale of the second property resulted in cash proceeds of $197,784.84 for total cash proceeds of $337,792.56. With respect to the first property, appellants contend that, pursuant to Mr. Rufus's written instructions, the escrow company wire transferred $140,007.72 to the bank account of LATC. With respect to the second property, appellants contend that, pursuant to Mr. Rufus's written instructions, the escrow company wire transferred $150,000.00 to the bank account of Transitional Ministry of Christ DBA Helping Hands Recovery Center and it wire transferred the remaining proceeds of $47,784.84 to LATC. Appellants attached supporting documents to their reply brief. Appellants also contend that they were not the beneficial owners of the two

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Leighton Avenue properties because they did not control them, enjoy the profits, or assume the economic obligations of ownership. Appellants also assert that they have substantiated that they did not receive the sales proceeds. (Apps. Reply Br., pp. 3-4.)

In their reply brief, appellants contend that, on their 2006 return, they claimed a mortgage interest deduction of $33,196. Appellants assert that their claimed mortgage interest deduction consists of total interest they paid on mortgages they held on two residential properties located on East Olive Street in Burbank, California, and Index Street in Porter Ranch, California, which they occupied in the first and second half of 2006, respectively; they assert that they sold the East Olive Street residential property on or about July 20, 2006. Appellants contend that the total mortgage interest paid on the two Leighton Avenue properties was $36,367 and that they did not deduct any of this mortgage interest on their 2006 return. In addition, appellants assert that, pursuant to the $500,000 maximum exclusion of gain from the sale of a joint filers' personal residence set forth in IRC section 121, they were not required to report the gain from the sale of their personal residence on East Olive Street. Appellants attached to their reply brief the following documents related to the sale of the two Leighton Avenue properties: a settlement statement, sale escrow instructions, two written instructions for the distribution of sales proceeds dated April 4, 2006, and August 29, 2006, and copies of checks from the escrow company and LATC. Appellants also attached to their reply brief copies of the following documents: appellants' 2006 IRS wage and income transcript, two fax cover sheets dated May 3, 2012, from the IRS, and the purported IRS audit work papers concerning the audit of appellants' 2006 federal account. (Apps. Reply Br., pp. 4-5, Exhibits 1-5.)

Respondent's Contentions

In its opening brief, respondent contends that appellants have failed to show that the federal adjustments, which are the basis for the proposed assessment, are incorrect. Respondent asserts that appellants have not established that (1) they did not receive taxable income from the sale of the two Leighton Avenue properties and (2) the gain from the sale of real property is not includible in appellants' gross income. Respondent thus contends that appellants are liable for taxes arising from the sale of the two Leighton properties. Respondent contends that it has not received any evidence showing that the additional sales proceeds were directly or indirectly distributed to LATC and therefore the

remaining $887,221[4] of sales proceeds are "unaccounted for." Respondent states, "Without evidence accounting for all of the cash proceeds, appellants have not proven that they did not receive taxable income from the 2006 sales and accordingly the assessment should be affirmed." Respondent asserts that it accepts the federal adjustments that allow a charitable contribution deduction of $301,665, which represents the portion of the cash proceeds LATC received from the sale of the two Leighton Avenue properties. Respondent also asserts that appellants may carry forward the excess charitable contributions and apply them within the five succeeding tax years pursuant to IRC section 170(d)(1). Attached to respondent's opening brief are copies of the following documents: deed and mortgage records for the two Leighton Avenue properties, appellants' 2006 California and federal returns, IRS Form 886-A, Explanation of Items, for appellants' 2006 federal audit, the April 5, 2010 NPA, the IRS wage and income transcript for appellants' 2006 federal account, and the FTB Law Summary, Federal Adjustments or Changes. (Resp. Opening Br., pp. 3-4, Exhibits A-F.)

Respondent argues that appellants have failed to prove that they were not the beneficial owners of the two Leighton Avenue properties. Respondent contends that, although they apparently did not occupy the properties, appellants, as legal owners, had the right to sell or encumber them. Respondent also contends that appellants have not substantiated their claim that they did not receive proceeds from the sale of the properties. Respondent further contends that appellants assumed the economic obligations of ownership by borrowing money for the purchase of the properties and they would have been liable for the repayment of the loan if any mortgage payment was not made. Respondent states, "Accordingly, appellants appear to have been the beneficial owners of [the] property because they controlled the property, enjoyed its profits and assumed the economic obligations of ownership." (Resp. Opening Br., p. 4.)

In its opening brief, respondent contends that taking a mortgage interest deduction is one of the benefits of owning property and appellants apparently deducted the mortgage interest paid on the two Leighton Avenue properties on their 2006 return. Respondent asserts that appellants claimed a

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[4] Respondent contends that there is $887,221 of sales proceeds unaccounted for because appellants were issued two 1099-S Forms that report the sale of the two Leighton Avenue properties for $500,000 and $725,000 and the IRS determined that appellants contributed $337,779 of the sales proceeds to LATC ($500,000 + $725,000 - $337,779).

mortgage interest deduction of $33,196 on their 2006 return and only $17,458 was associated with appellants' primary residence. Respondent also asserts that appellants received IRS Forms 1098 for 2006 for mortgage interest paid on appellants' residential property, the two Leighton Avenue properties, and a property located on East Olive Street in Burbank, California. Respondent further asserts that the East Olive Street property was sold in 2006, but appellants failed to report any gain from its sale. Respondent states, "It is unclear whether the additional mortgage interest deductions appellants claimed in 2006 were related to the Leighton Avenue properties or the East Olive Street property." (Resp. Opening Br., pp. 4-5.)

Respondent argues that appellants have failed to cite any California legal authority supporting their argument "that a taxpayer may avoid taxes on the sale of real property held in their [sic] name by claiming that a charity actually owned the property." Respondent contends that in *United States v. Bell*, *supra*, 27 F. Supp.2d 1191, the court applied the six-factor test to a determination of whether a business entity was the nominee for an individual and, in the present appeal, appellants are not a business entity. Assuming the six-factor test applied in the present appeal, respondent contends that it would show that appellants were actual, rather than nominee, owners of the two Leighton Avenue properties for the following reasons: 1) as the named debtors on the mortgage loans, appellants were legally responsible for the repayment of the loans and they therefore paid consideration for the purchase of the two Leighton Avenue properties; 2) the two Leighton Avenue properties were not transferred to appellants in anticipation of litigation or the occurrence of liabilities while the transferor continued to exercise control over the properties; LATC did not transfer the two Leighton Avenue properties to appellants and appellants sold the properties to a third party who sold it to Mr. Zachary;[5] 3) other than the fact that Mr. Rufus volunteered at LATC, there is no evidence of a close relationship between LATC (purported transferor) and appellants (purported nominee); 4) appellants did not fail to file conveyances; appellants recorded deeds when they purchased and sold the two Leighton Avenue properties; 5) LATC (purported transferor) did not own or retain the possession of the two Leighton Avenue properties at the time appellants became the title holders; and 6) appellants enjoyed many of the benefits of owning the

[5] See a discussion of the multiple conveyances of the two Leighton Avenue properties in Staff Comments below.

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two Leighton Avenue properties, including using the properties as security to obtain loans and (apparently) claiming mortgage interest deductions for the properties on their 2006 return. (Resp. Opening Br., pp. 5-7.)

In its opening brief, respondent argues that appellants have failed to substantiate that the federal adjustments are incorrect. Respondent contends that, even if LATC paid the mortgages, property taxes, and insurance, appellants could still have been the beneficial owners of the two Leighton Avenue properties or received a portion of the taxable proceeds from the sale of the properties. Respondent requests that appellants provide documents showing that LATC received all of the sales proceeds, such as copies of bank statements, cancelled checks, or a closing statement from the sales, any written agreements showing that LATC was the true owner of the two Leighton Avenue properties, and evidence showing that appellants did not take mortgage interest deductions for the two Leighton Avenue properties, such as an itemized deductions worksheet. (Resp. Opening Br., pp. 7-8.)

With respect to the accuracy-related penalty, respondent contends that there was a substantial understatement of tax on appellants' 2006 return due to their failure to report the gain from the sale of the two Leighton Avenue properties. Respondent asserts that appellants reported a tax liability of $167, which is an understatement of tax of $24,120. According to respondent, this constitutes a substantial understatement of tax pursuant to R&TC section 19164, which incorporates IRC section 6662, because $24,120 exceeds the greater of $2,428, which is 10 percent of total taxes owed ($24,287), or $5,000. Respondent therefore contends that it properly imposed the accuracy-related penalty of $4,824, which is 20 percent of their understatement of tax. (Resp. Opening Br., p. 8.)

Respondent contends that appellants have not shown that the federal accuracy-related penalty was incorrectly imposed or that there was a reasonable cause for the understatement of tax. Citing Treasury Regulations section 1.6664-4, respondent states, "Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer." Respondent asserts that it was not reasonable for appellants to believe that they did not own the two Leighton Avenue properties for the following reasons: 1) they held title to the properties; 2) they executed grant deeds transferring title when the properties were sold; 3) IRS Forms 1099-S were

issued to appellants showing the sale terms; 4) they apparently received a portion of the sales proceeds; 5) they apparently deducted home mortgage interest related to the two Leighton Avenue properties on their 2006 returns; and 6) they never attempted to transfer title to the properties to LATC or Mr. Zachary during the three years they held title. (Resp. Opening Br., pp. 8-9.)

In its reply brief, respondent argues that the documents appellants submitted with their reply brief indicate that appellants were the beneficial owners of the two Leighton Avenue properties and exercised dominion over the sales proceeds. Respondent asserts that the settlement statement lists Mr. Rufus as the owner and seller of the two Leighton Avenue properties, and Mr. Rufus signed the sale and escrow instructions (as the seller), as well as the instructions to the escrow officer for the distribution of the sales proceeds partially to LATC and partially to Transitional Ministry of Christ. Respondent states, "This distribution reflects appellant's donative intent in dividing the sales proceeds among the two organizations." According to respondent, Mr. Rufus exercised control over the disposition of the sales proceeds by making charitable gifts of his choosing to the two organizations. Respondent asserts that appellants apparently obtained loans for the purchase of the two Leighton Avenue properties and, even if LATC made payments towards these mortgages, appellants would have been liable if payments were not made at any time on these loans. Respondent also asserts that "appellants bore the risk in the event that the properties were sold at a loss." Respondent thus contends that appellants had the benefits and burdens of owning the two Leighton Avenue properties because they controlled the properties' disposition and held "the burden of the debts secured by the properties." (Resp. Reply Br., pp. 2-3.)

In its reply brief, respondent argues that the proposed assessment properly adds the capital gain of $541,999 from the sale of the two Leighton Avenue properties to appellants' taxable income and allows a charitable contribution donation of $337,779 for the portions of the sales proceeds that were distributed to the two charitable organizations based on the federal adjustments. Respondent asserts that there is a disparity of $13.56 in the amount of charitable contribution deduction it (and the IRS) allowed appellants ($337,779.00) and the amount of cash proceeds appellants claim they distributed to LATC ($337,792.56), but that it does not affect the proposed assessment for 2006 because appellants are limited to a charitable deduction amount of $319,150 pursuant to IRC section

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170(d)(1)(A).[6] Respondent contends that the proposed assessment treated appellants as the owners of the two Leighton Avenue properties and gave them credit for the charitable contributions. Respondent states, "This treatment is appropriate because appellants were the legal owners of the properties and should be permitted a charitable deduction for the amounts that they distributed to charitable organizations." (Resp. Reply Br., p. 3, fn. 5.)

Applicable Law

Burden of Proof

R&TC section 18622 provides that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. It is well-settled that a deficiency assessment based on a federal audit report is presumptively correct and the taxpayer bears the burden of proving that the determination is erroneous. (*Appeal of Sheldon I. and Helen E. Brockett*, 86-SBE-109, June 18, 1986; *Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Unsupported assertions are not sufficient to satisfy an appellant's burden of proof with respect to an assessment based on federal action. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.) In the absence of uncontradicted, credible, competent, and relevant evidence showing that respondent's determinations are incorrect, such assessments must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)

Capital Gains

IRC section 61 includes income from gains derived from dealings in property in its definition of gross income.[7] IRC section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis.[8] 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 IRC section 1012 or other applicable sections of that subchapter) adjusted as provided for in IRC section 1016. The amount realized includes the amount of an unpaid mortgage, whether or not the mortgage exceeds the value of the property. (Int.Rev. Code, § 1001(b); *Crane v. Commissioner* (1947)

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[6] Respondent inadvertently refers to IRC 171(d)(1)(A) instead of IRC section 170(d)(1)(A). (Resp. Reply Br., p. 3, fn. 5.)

[7] California conforms to IRC section 61 at R&TC section 17071.

[8] California conforms to IRC sections 1001 and 1011-1016 at R&TC section 18031.

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331 U.S. 1; *Commissioner v. Tufts* (1983) 461 U.S. 300.) A realized gain is recognized unless a nonrecognition provision of the Internal Revenue Code applies. (Int.Rev. Code, § 1001(c).)

A taxpayer is taxed on the capital gain he realizes from the sale of property, regardless of whether he assigns the proceeds from the property sale to satisfy the debt of another individual. The assignment of income doctrine provides that income is ordinarily taxed to the person who earns it, and that the incidence of income taxation may not be shifted by anticipatory assignments. (*Lucas v. Earl* (1930) 281 U.S. 111, 114-115.) In the *Appeal of J.R. and Claudia Hengelmann*, 86-SBE-132, decided on July 29, 1986, the Board held that a taxpayer remained subject to income tax on wages he earned after he claimed to have sold his personal services property assets to a third party. Citing *Commissioner v. Culbertson* (1949) 337 U.S. 733, 739, the Board stated, "It is a fundamental principle of income taxation that income must be taxed to the one who earns it." The Board also stated that "one who earns income cannot avoid taxation by diverting it to another entity, since anticipatory assignment of income is ineffective as a means of avoiding tax liability." (Citations omitted.)

Under IRC section 1016, a property's initial basis must be adjusted for capital additions. Capital additions, such as the cost of capital improvements made to the property by the taxpayer, increase the initial basis so that, on the date of the disposition, the adjusted basis reflects the unrecovered cost or other basis of the property. (Int.Rev. Code § 1016(a).) Capital expenditures are generally not deductible. (Int.Rev. Code, § 263; Treas. Reg. § 1.213-1(e)(1)(iii).) In contrast, expenditures for the ordinary repair and maintenance of the property are deductible in the current taxable year if they are related to business or income-producing property. (Int.Rev. Code §§ 162 and 212; Rev. & Tax Code, § 17201.)

The Transfer of Property

To determine whether there was a sale for tax purposes, the courts examine the objective economic realities of a transaction. (*Gaggero v. Commissioner*, T.C. Memo 2012-331 (citing *Frank Lyon Co. v. United States* (1978) 435 U.S. 561, 573; *Houchins v. Commissioner* (1982) 79 T.C. 570, 589-90).) See also *Sollberger v. Commissioner* (9th Cir. 2012) 691 F.3d 1119, 1123; *Clark v. United States* (N. Cal. 2012) 2012 U.S. Dist. LEXIS 181928, *5 (citing *Harbor Bancorp v. Commissioner* (9th Cir. 1977) 115 F.3d 722, 729.) When interpreting the Internal Revenue Code, "the term 'sale' is given

its ordinary meaning and is generally defined as a transfer of property for money or a promise to pay money." (*Anschultz Co. v. Commissioner* (10th Cir. 2011) (citing *Commissioner v. Brown* (1965) 380 U.S. 563, 570-71. See also *Calloway v. Commissioner* (11th Cir. 2012) 691 F.3d 1315, 1327.)

In determining whether a transaction involves a sale for tax purposes, the courts consider, among other things, "whether sufficient benefits and burdens of ownership have passed to the alleged buyer." (*Clark v. United States, supra*, 2012 U.S. Dist. LEXIS at pp. 5-6.) In *Grodt & McKay Realty, Inc. v. Commissioner* (1981) 77 T.C. 1221, 1237, the Tax Court listed eight factors that are relevant to this analysis: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the purchaser to make payments; (5) whether the right of possession vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. The courts have used these eight factors to evaluate whether a loan agreement constituted a sale (*Sollberger v. Commissioner, supra*, 691 F.3d at pp. 1123-1124; *Calloway v. Commissioner, supra,* 691 F.3d at pp. 1327-1328; *Clark v. United States, supra*, 2012 U.S. Dist. LEXIS at pp. 5-6) and whether a part ownership of property sales agreement was a scheme to avoid capital gains (*Gaggero v. Commissioner*, *supra*, T.C. Memo 2012-331). These eight factors "may be relevant in a particular case," but they are not "the only indicia of a sale that a court may consider." (*Sollberger v. Commissioner, supra*, 691 F.3d at p. 1124.) The Eleventh Circuit stated:

> "[N]one of these factors is necessarily controlling; the incidence of ownership, rather, depends upon all the facts and circumstances." Some factors may be more pertinent in some situations than others, and, indeed, some factors simply may be ill-suited or irrelevant to shed light on the ownership of assets under specific circumstances.

(*Calloway v. Commissioner, supra,* 691 F.3d at pp. 1327-1328 (citations omitted).)

Nominee Theory

Under IRC sections 6321 and 6331, a lien is imposed and the IRS can record a levy on any property or rights to property belonging to a taxpayer liable to pay any delinquent debts. (See *Drye v. United States* (1999) 528 U.S. 49, 55; *Dalton v. Commissioner* (1st Cir. 2012) 682 F.3d 149, 157; *Holman v. United States* (10th Cir. 2007) 505 F.3d 1060, 1065.) "The federal tax lien attaches to

property held by a taxpayer's nominee or alter ego, and such property is subject to the collection of the taxpayer's tax liability." (*United States v. Jones* (C.D. Cal. 2012) 2012 U.S. Dist. LEXIS 21475 at pp. *22-23 ("*Jones*") (citations omitted).) In contrast, if the delinquent taxpayer is the nominee owner of the property, the property is not subject to a federal tax lien. (*United States v White* (1965, ED Ark) 1965 U.S. Dist. LEXIS 9824.)

A nominee is one who holds bare legal title to property for the benefit of another. (*United States v. Smith* (W.D. Wash. 2012) 2012 U.S. Dist. LEXIS 76482, at p. *14 citing *Scoville v. United States* (8th Cir. 2001) 250 F.3d 1198, 1202. See also Black's Law Dictionary 1149 (9th ed. 2009).) In *Jones*, the federal district court for the Central District of California provided the following explanation of the nominee theory:

> Property is held by a nominee when someone other than the taxpayer has legal title but, in substance, the taxpayer enjoys the benefits of ownership. A third party is the taxpayer's nominee where "the taxpayer has engaged in a legal fiction by placing legal title to property in the hands of a third party while actually retaining some or all of the benefits of true ownership." [Citations omitted.] "The nominee theory stems from equitable principles. Focusing on the relationship between the taxpayer and the property, the theory attempts to discern whether a taxpayer has engaged in a sort of legal fiction, for federal tax purposes, by placing legal title to property in the hands of another while, in actuality, retaining all or some of the benefits of being the true owner."

(2012 U.S. Dist. LEXIS 21475 at pp. *23-24 (citations omitted). See also *Dalton v. Commissioner, supra,* 682 F.3d at p. 157.) (The nominee theory "allows for the possibility that the true owner of a parcel of land may be someone other than the record owner.); *Fourth Investment LP v. United States* (S.D. Ca. 2010) 2010 U.S. Dist. LEXIS 78481 at p. *9 ("Property held by a nominee is subject to a tax lien attaching to the property of the true owner.")

Application of the nominee theory to support a lien or levy is based on a two-part inquiry. The first part of the inquiry looks "to state law to determine what rights the taxpayer has in the property the Government seeks to reach." (*Drye v. United States, supra*, 528 U.S. at p. 58. See also *United States v. Craft* (2002) 535 U.S. 274, 278; *Holman v. United States, supra*, 505 F.3d at 1067-1068.) The second part of the inquiry looks "to federal law to determine whether the taxpayer's state-delineated rights qualify as 'property' or 'rights to property' within the compass of [IRC sections 6321 and 6331]." (*Drye v. United States, supra*, 528 U.S. at p. 58. See also *Holman v. United States, supra*, 505 F.3d at pp. 1067-1068.)

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In the present appeal, California law provides the substantive rules of decision. (*Sunderland v. United States* (1924) 266 U.S. 226, 232-233 (the tenure, transfer, control, and disposition of real property are matters that exclusively rest with the state where the property is located).) In *Jones*, the federal district court for the Central District of California held that "California law recognizes a nominee theory of ownership." The *Jones* court found that, in two recent decisions, *Fourth Investment LP v. United States, supra,* 2010 U.S. Dist. LEXIS 78481 at p. *10 and *Leeds LP v. United States* (S.D. Cal. 2010) 2010 U.S. Dist. LEXIS 79046, *10-15, the federal district court for the Southern District of California cited and discussed California court cases that addressed the nominee theory. (*Jones, supra*, at pp. *24-26.)[9] The *Jones* court stated, "Although California law recognizes the theory of nominee ownership, it appears that no California state court has identified the factors involved in a nominee analysis." (*Id*., at p. *26.) The *Jones* court held that federal courts in California have properly relied on the guidelines of federal common law in the absence of California-law guidelines. (*Id*. at p. *26.) The *Jones* court stated:

> The Ninth Circuit has repeatedly held that where the state's highest court has not decided an issue (here, what factors are to be considered in determining nominee ownership), "the task of the federal courts is to predict how the state high court would resolve it." And in making this prediction, the federal courts may look "for guidance to decisions by intermediate appellate courts of the state and by courts in other jurisdictions." Moreover, the Ninth Circuit has said that it will give deference "to the district court's construction of the law of the state in which the district court sits." Although none of the federal district courts in California has ostensibly purported to predict what factors the California Supreme Court would adopt for determining nominee status, those courts have uniformly applied the same factors. And the factors routinely applied by the district courts in California are similar (and it [sic] many cases identical) to those applied by courts in other jurisdictions.

(*Id*. at pp. *26-28 (citations omitted). See also *Adam v. United States* (C.D. Ca. 2011) 2011 U.S.

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[9] In *McColgan v. Walter Magee, Inc.* (1916) 172 Cal. 182, 190, the California Supreme Court held that "[p]ublic policy does not permit [a debtor] to put [his property] beyond reach of his creditors while he has the beneficial use of it himself." Other California cases cited in *Jones* that addressed the nominee theory include *Lewis v. Hankins* (1989) 214 Cal.App.3d 195, 201 (affirming trial court's decision allowing a creditor to levy and sell property that the debtor's nominees owned because debtor was the beneficial owner); *Parkmerced Co. v. City and County of San Francisco* (1985) 149 Cal.App.3d 1091, 1095 (noting that one general partner held real property as a nominee for the partnership); *Baldassari v. United States* (1978) 79 Cal.App.3d 267 ("[t]he validity of the tax liens depends on whether plantiffs are the bona fide owners of the properties or are only nominees"); *Estate of Camm* (1946) 76 Cal.App.2d 104, 112 (Relying on "the rule that a person cannot place his property or the income thereof beyond the reach of his creditors so long as he himself retains the right to receive it and use it"); *Baumann v. Harrison* (1941) 46 Cal.App.2d 84 ("appellant took title as the nominee of [another party] but did not assume or agree to pay the indebtedness secured by the deed of trust"). (2012 U.S. Dist. LEXIS 21475 at pp. *24-25.)

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Dist. LEXIS 149312, *8-10 ("[S]everal California courts have identified and discussed a nominee theory of ownership.")

"Nominee status is determined by the degree to which a party exercises control over an entity and its assets." (*United States v. Bell, supra* 27 F.Supp. at p. 1195.) The *Jones* court found that numerous federal courts throughout the United States, including courts in the Ninth Circuit Court of Appeals, apply the following six factors in determining nominee status:[10]

- No consideration or inadequate consideration paid by the nominee;
- Property placed in the name of the nominee in anticipation of a suit or the occurrence of liabilities while the debtor continues to exercise control over the property;
- Close relationship between the debtor and the nominee;
- Failure to record a conveyance;[11]
- Retention of possession by the debtor; and
- Continued enjoyment by the debtor of benefits of the property.

The *Jones* court also found that "[t]he courts, however, do not necessarily require that each of these factors be present in every case." The *Jones* court further found that there is an overlap between the nominee and alter ego doctrines. The *Jones* court stated:

> This makes sense because the nominee and alter ego doctrines are closely related equitable creditor's remedies that focus on control – in one, a debtor's control over an entity, and in the other, a debtor's control over a willing nominee with respect to a specific asset. Indeed, nominee cases may be viewed as single-asset alter ego cases; although one individual cannot be the alter ego of another for all purposes, he may serve in that role with respect to holding a specific piece of property.

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[10] The *Jones* court stated that, although most courts in applying these factors refer to the true property owner as the "transferor," it used the word "debtor" instead "because recent appellate decisions have confirmed that a transfer of the property is not a prerequisite to the application of the nominee doctrine." (*Id*. at p. *29, fn. 1 (citations omitted).) See also *Politte v. United States* (S.D. Cal. 2012) 2012 U.S. Dist. LEXIS 38467, *26 ("A delinquent taxpayer who has never held legal title to a piece of property but who transfers money to a third party and directs the third party to purchase property and place legal title in the third party's name may well enjoy the same benefits of ownership of the property as a taxpayer who has held legal title."); *Leeds v. United States, supra*, 807 F.Supp.2d 946, 965, fn 22 ("It is not necessary that the taxpayer ever hold title to the property in its own name in order for the IRS to levy against it.")

[11] "Where, as here, there is no conveyance of real property, but instead a transfer of funds with which to purchase the real property, the relevant question under the fourth prong of the nominee analysis shifts from whether a conveyance was recorded to 'whether the parties adhered to the formalities one would expect them to adhere to.'" (*Politte v. United States, supra,* 2012 U.S. Dist. LEXIS 38467, *24, fn. 15.)

The *Jones* court predicted that, in considering what factors to adopt in nominee cases, the California Supreme Court would likely "adopt the familiar factors relied upon by many other courts in determining nominee ownership" and consider its alter ego decisions, which are not "as rigid as in other states." (*Id.*, at pp. *26, 28-33. See also *United States v. Smith, supra*, 2012 U.S. Dist. LEXIS 76482 at p. *15 ("The factors to be considered in determining whether an entity is an alter-ego of a taxpayer are similar to the nominee factors.").)

In *Sonora Diamond Corp. v. Superior Court* (2000) 83 Cal.App. 4th 523, 538, the California Court of Appeal explained the alter ego doctrine as follows:

> Ordinarily, a corporation is regarded as a legal entity, separate and distinct from its stockholders, officers and directors, with separate and distinct liabilities and obligations. A corporate identity may be disregarded--the "corporate veil" pierced--where an abuse of the corporate privilege justifies holding the equitable ownership of a corporation liable for the actions of the corporation. Under the alter ego doctrine, then, when the corporate form is used to perpetrate a fraud, circumvent a statute, or accomplish some other wrongful or inequitable purpose, the courts will ignore the corporate entity and deem the corporation's acts to be those of the persons or organizations actually controlling the corporation, in most instances the equitable owners. The alter ego doctrine prevents individuals or other corporations from misusing the corporate laws by the device of a sham corporate entity formed for the purpose of committing fraud or other misdeeds.

(Citations omitted. See also *Leek v. Cooper* (2011) 194 Cal.App. 4th 399, 411.) The California Court of Appeal set forth the conditions that must be established for the alter ego doctrine to apply under California law:

> In California, two conditions must be met before the alter ego doctrine will be invoked. First, there must be such a unity of interest and ownership between the corporation and its equitable owner that the separate personalities of the corporation and the shareholder do not in reality exist. Second, there must be an inequitable result if the acts in question are treated as those of the corporation alone. Among the factors to be considered in applying the doctrine are commingling of funds and other assets of the two entities, the holding out by one entity that it is liable for the debts of the other, identical equitable ownership in the two entities, use of the same offices and employees, and use of one as a mere shell or conduit for the affairs of the other. Other factors which have been described in the case law include inadequate capitalization, disregard of corporate formalities, lack of segregation of corporate records, and identical directors and officers. No one characteristic governs, but the courts must look at all the circumstances to determine whether the doctrine should be applied. Alter ego is an extreme remedy, sparingly used.

(83 Cal.App. 4th at p. 538-539 (citations omitted). See also *Politte v. United States*, *supra*, 2012 U.S. Dist. LEXIS 38467, *31 (citing *Mesler v. Bragg Mgmt. Co*. (1985) 39 Cal.3d 290).)

California also recognizes a beneficial interest in property. California Evidence Code section 662 provides:

The owner of the legal title to property is presumed to be the owner of the full beneficial title. This presumption may be rebutted only by clear and convincing proof.

(See *Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 Cal.4th 155, 164 and California cases cited in footnote 8, *supra*.) As far as how the ownership of real property is viewed in the context of the taxation of real property, R&TC section 60 provides the basic change-in-ownership test for purposes of the reassessment of property taxes under Article XIII A of the California Constitution (Proposition 13), and provides that real property shall be reassessed for property tax purposes when a "change of ownership" occurs (i.e., the property is "newly constructed" or "purchased"). (Cal. Const., art. XIII A, § 2, subd. (a).) (See *Auerbach v. Assessment Appeals Bd. No. 1* (2006) 39 Cal.4th 153, 161.) R&TC section 60 states, "A 'change in ownership' means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest." The beneficial use prong of this definition "requires that to constitute a change in ownership there must be a transfer not only of bare legal title but also of the transferor's beneficial or equitable interest in the land." (*Pacific Southwest Realty Co. v. County of Los Angeles, supra,* 1 Cal.4th at p. 163. See also *Fashion Valley Mall, LLC v. County of San Diego* (2009) 176 Cal.App.4th 871, 882. Citing *Atlantic Oil Co. v. County of Los Angeles* (1968) 69 Cal.2d 585, 594, the California Supreme Court stated in *Pacific Southwest Realty Co. v. County of Los Angeles* that "the definitions of property embodied in the Revenue and Taxation Code prevail for tax purposes even if they are inconsistent with the common law definitions codified in the Civil Code." (1 Cal.4th at p. 163.)

IRC Section 121 Tax Exclusion

Under IRC section 121,[12] as in effect in 2006, a taxpayer can exclude up to $250,000 of the gain on the sale of a home if the taxpayer meets the following conditions:

- Owned the home for at least two years during the five-year period ending on the date of the sale ("ownership test");
- Used the home as his or her principal residence for at least two years during the 5-year period ending on the date of the sale ("use test"); and

[12] California conforms to IRC section 121 with modifications at R&TC section 17152.

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- Did not exclude the gain from the sale of another home during the two-year period ending on the date of the sale.

Taxpayers who are married can exclude up to $500,000 of the gain on sale of a home if they meet the following conditions:

- The taxpayers file a joint return for the year of the sale;
- Either spouse meets the ownership test (as set forth above);
- Both spouses meet the use test (as set forth above); and
- Neither spouse excluded the gain from the sale of a home during the two-year period ending on the date of the sale.

(Int. Rev. Code, § 121(a) & (b).)

Deductions In General

IRC section 62 provides that AGI is computed by reducing a taxpayer's gross income by any available deductions listed under that section. Income tax deductions are a matter of legislative grace and the burden is on an appellant to show by competent evidence that he is entitled to deductions claimed. (*Appeal of James C. and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975; *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435.) To carry his burden of proof, an appellant must point to an applicable statute and show by credible evidence that the deductions he claims come within its terms. (*Appeal of Robert R. Telles*, 86-SBE-061, Mar. 4, 1986.) Respondent's denials of claimed deductions are presumed correct. (*Appeal of Gilbert W. Janke*, 80-SBE-059, May 21, 1980.)

Mortgage Interest Deductions

IRC section 163(h)(1)[13] generally disallows a deduction for personal interest. There is an exception to this rule in the case of a qualified residence interest. (Int.Rev. Code, § 163(h)(2)(D).) Qualified residence interest includes interest paid or accrued during the taxable year on acquisition indebtedness. (Int.Rev. Code, § 163(h)(3)(A).) Acquisition indebtedness means any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and is secured by the residence. (Int.Rev. Code, § 163(h)(3)(B)(i).) A qualified residence includes the

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[13] California conforms to IRC sections 163 and 164 at R&TC section 17201.

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principal residence of the taxpayer. (Int.Rev. Code, § 163(h)(4)(A).)

For interest on a mortgage to be deductible, the indebtedness generally must be an obligation of the taxpayer and not an obligation of another. (*Smith v. Commissioner* (1985) 84 T.C. 889, 897, affd. without published opinion 805 F.2d 1073 (D.C. Cir. 1986). However, Treasury Regulation section 1.163-1(b) provides, "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness." The courts have disallowed a taxpayer's claimed mortgage interest deduction in cases in which the taxpayer has not shown legal, equitable, or beneficial ownership of property. (*Hynes v. Commissioner*, 74 T.C. 1266, 1288 (1980); *Song v. Commissioner*, T.C. Memo 1995-446; *Bonkowski v. Commissioner*, T.C. Memo. 1970-340, affd. 458 F.2d 709 (7th Cir. 1972).)

Charitable Contributions Deductions

IRC section 62 provides that AGI is computed by reducing a taxpayer's gross income by any available deductions listed under that statute. R&TC section 17201 incorporates IRC section 170 relating to deductions for charitable contributions. Subject to certain limitations, IRC section 170(a)(1) provides for a deduction for charitable contributions described under IRC section 170(c), payment of which is made within the taxable year. IRC section 170(c)(2) states, in part, that the term "charitable contribution" means a contribution or gift to or "for the use of" a valid charitable organization. IRC 170(b)(1)(A) and (d)(1)(A) generally limit an individual's charitable contribution deduction to no more than 50 percent of the individual's contribution base (i.e., AGI) for the tax year and allow the excess amount to be treated as a charitable contribution paid in each of the five succeeding tax years. (See also Treas. Regs. § 1.170A-10.)

Accuracy-Related Penalty

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. The penalty applies to the portion of the underpayment attributable to negligence or to the disregard of rules and regulations or to any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) The Internal Revenue Code 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.*) There is a “substantial understatement of income tax” when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or $5,000. (Int.Rev. Code, § 6662(d)(1).) An accuracy-related penalty shall not be imposed as to any portion of an underpayment as to which an appellant shows that there is reasonable cause and he acted in good faith. (Rev. & Tax. Code, § 19164, subd. (d); Int.Rev. Code, § 6664(c)(1); Cal. Code Regs., tit. 18, § 19164, subd. (a).) Respondent’s imposition of a penalty for negligence is presumed correct. (*Appeal of Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.)

STAFF COMMENTS

Appellants bear the burden of proving that the proposed assessment, which is based on federal audit adjustments, is erroneous. There is no dispute that the proposed assessment is based on federal adjustments. Although appellants signed IRS Form 4549 indicating that they agree with the federal adjustments, they assert on appeal that they “inadvertently missed their opportunity to challenge” the federal adjustments. In arguing that the proposed assessment is incorrect, appellants rely entirely on the argument that they are not liable for the income tax on the capital gains realized from the sale of the two Leighton Avenue properties because they were the nominal owners and LATC was the beneficial owner of the properties.

The parties may wish to discuss whether the test set forth in *Grodt & McKay Realty, Inc., v. Commissioner, supra*, for analyzing whether the benefits and burdens of ownership have passed between parties is relevant to the facts and circumstances in this appeal.

As discussed above, state and federal courts have applied the nominee and alter ego doctrines, as set forth under state law, to determine whether a creditor, including the government, can use a lien or a levy to collect a tax debt owed by a taxpayer (as a beneficial owner) against property held by a third party (as a nominee owner). (See, e.g., *Towe Antique Ford Foundation v. IRS* (D. Montana 1992) 791 F.Supp. 1450, 1453, affd. in part 999 F.2d 1387, *supra* (“In seeking to satisfy legitimate tax debts, the government may levy on property held by a corporation or other business entity, when the corporation or other business entity [is] determined to be the alter ego or nominee of the taxpayer.”).) This is based on “sound reasons of public policy” that “one cannot by any device make his own property

free from the claims of his own creditors." (*McColgan v. Walter Magee, Inc., supra,* 172 Cal. at p. 188. See also *Towe Antique Ford Foundation v. Internal Revenue Service*, (9th Cir. 1993) 999 F.2d 1387, 1391 ("It is well settled that creditors can reach property which ostensibly belongs to a third party if that entity is the alter ego of the taxpayer.") The parties should be prepared to discuss whether there is any authority for the use of a nominee theory as a shield to protect a taxpayer from the assessment of tax on the gain realized from the sale of properties for which they held legal title at all times from when they acquired the properties through when they sold the properties to third parties. As discussed above, California Evidence Code section 662 requires clear and convincing evidence to rebut the presumption that the legal owner of real property is also the beneficial owner. For argument's sake, the parties should be prepared to discuss the application of the six-factor test set forth in cases such as *United States v. Bell, supra,* 27 F.Supp.2d at 1195. The parties may also wish to discuss how the county assessor's office characterized the two properties for purposes of property taxes during the period when appellants owned them.

It appears from the public records that, in December 2005, appellants borrowed $527,000 against one of the properties. Appellants should be prepared to discuss the facts and circumstances surrounding this loan, as well as their initial acquisition of the properties. The parties should be prepared to discuss whether the chain of title of the two Leighton Avenue properties supports appellants' argument that they should not be liable for the capital gain realized from their sale of the properties. With respect to the first property, the public records attached to respondent's opening brief show the following conveyances: Mr. Rufus purchased the first property from Ana Espino for $280,000 on October 28, 2003 (deed recording date, November 10, 2003). Mr. Rufus sold the property to Joseph Hughes for $500,000 on July 25, 2006 (deed recording date, August 31, 2006). Mr. Hughes conveyed the first property to Mr. Zachary for no consideration on September 14, 2006 (deed recording date, July 21, 2011). Mr. Hughes conveyed this same property to Robin Allen for no consideration on July 28, 2008 (deed recording date, July 29, 2008). Ms. Allen conveyed this property to Elisa Morales for no consideration on February 8, 2009 (deed recording date, February 10, 2009). Ms. Morales conveyed this property to Alejandra G. Acosta for no consideration on September 16, 2009 (deed recording date, September 16, 2009). Lastly, Mr. Hughes sold the property to Wells Fargo Bank for

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$230,000 on December 7, 2010 (deed recording date, December 13, 2010). (Resp. Opening Br., Exhibit A.)

With respect to the second property, the public records show the following conveyances: Ronald Sumi purchased the second property from Ronald N. Sumi for an unspecified consideration on April 1, 2002 (deed recording date, April 15, 2002). The second property was conveyed to Mr. Rufus by his wife, Shirley Rufus on October 17, 2003 (interfamily transfer recorded on October 31, 2003). (The public records do not list any prior transfer of the property to Ms. Rufus.) Ms. Rufus conveyed the second property a second time to Mr. Rufus on December 19, 2005 (interfamily transfer recording date, December 23, 2005). This transfer shows a "stand-alone refinance" in the amount of $527,000. Mr. Rufus sold the second property to Roy Lundy for $725,000 on March 30, 2006 (deed recording date, April 5, 2006). Mr. Lundy sold the second property to Mr. Zachary for no consideration on October 26, 2006 (deed recording date, December 7, 2009). Mr. Lundy also sold the second property to Alejandra G. Acosta for no consideration on September 14, 2009 (deed recording date, September 14, 2009). On October 5, 2009, Ms. Acosta made an interfamily transfer of the property to her husband and herself in joint tenancy (recording date, November 16, 2009). Lastly, Mr. Lundy sold the second property to Deutsche Bank National Trust Company for $731,908 on October 25, 2011 (trustee's deed recording date, October 26, 2011). (Resp. Opening Br., Exhibit A.)

At the hearing, respondent should clarify whether it concedes that (1) appellants did not claim any mortgage interest deduction for interest paid on mortgages for the two Leighton Avenue properties and (2) appellants were entitled to exclude the gain from the sale of their residence on East Olive Street pursuant to IRC section 121.

With respect to the accuracy-related penalty of $4,824, the parties should be prepared to discuss whether there was reasonable cause and whether appellants acted in good faith when they failed to report the capital gains from the sale of the two Leighton Avenue properties on their 2006 return. As noted in the NPA, respondent imposed the accuracy-related penalty in accordance with the federal audit report. It appears that there is a substantial understatement of income tax as the proposed assessment of $24,120 exceeds the greater of $2,428, which is 10 percent of the tax required to be shown on the return ($24,287), or $5,000. (Int.Rev. Code, § 6662(d)(1).) Appellants signed the IRS Form 4549 indicating

that they consented to the assessment and collection of additional tax and penalties plus interest.

Pursuant to California Code of Regulations, title 18, section 5523.6, if appellants are able to locate any additional evidence supporting their appeal, it should be submitted if possible to the Board and respondent at least 14 days prior to the hearing date.[14]

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[14] Exhibits should be submitted to: Claudia Madrigal, Board Proceedings Division, Board of Equalization. P. O. Box 942879 MIC: 80, Sacramento, CA 94279-0080