

STATE OF CALIFORNIA
OFFICE OF TAX APPEALS
400 R STREET
SACRAMENTO, CALIFORNIA

REPORTER'S TRANSCRIPT
FEBRUARY 26, 2018
CORPORATE FRANCHISE AND PERSONAL INCOME TAX HEARING
APPEAL OF
AHMAD SKOUTI AND FATEN KOUR
NO. 18011162

Reported by: Kathleen Skidgel
CSR No. 9039

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P R E S E N T

Panel Lead: Andrew Kwee
Administrative Law Judge

Panel Members: Jeffrey Margolis
Acting Presiding
Administrative Law Judge

Michael Geary
Administrative Law Judge

Office of Tax
Appeals Staff: Claudia Lopez
Staff Services Manager II

Dana Holmes
Ombudsperson

Appearing for Taxpayer: Joseph J. Doerr
Attorney

Jim Betts
Witness

Dr. Richard Nordstrom
Witness

Appearing for Franchise
Tax Board: David Hunter
Tax Counsel

Adam Susz
Tax Counsel

Michael Cornez
Tax Counsel

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1 400 R STREET, HEARING ROOM
2 SACRAMENTO, CALIFORNIA
3 FEBRUARY 26, 2018

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5 JUDGE KWEE: So we're going to go on the
6 record now. We're opening the record of the appeal
7 of Ahmad Skouti and Faten Kour. This is before the
8 Office of Tax Appeals in OTA case number 18011162.
9 Today's date is Monday, February 26, 2018, and the
10 time is approximately 1:05. This hearing is being
11 convened in Sacramento, California.

12 For the record will the parties please
13 state their names and who they represent, starting
14 with the taxpayer's representative.

15 MR. DOERR: My name is Joseph Doerr. I'm
16 here representing the taxpayers Ahmad Skouti and
17 Faten Kour.

18 JUDGE KWEE: Okay, thank you.

19 MR. HUNTER: Thank you. David Hunter,
20 H-u-n-t-e-r, on behalf of the Franchise Tax Board;
21 to my left is Adam Susz, S-u-s-z; to his left is
22 Michael Cornez, C-o-r-n-e-z; all tax counsel for the
23 Franchise Tax Board.

24 JUDGE KWEE: Okay, thank you.

25 Today's hearing is being heard by a panel
26 of three administrative law judges. My name is
27 Andrew Kwee, and I will be the lead judge for
28 purposes of conducting this appeal. Judge Jeff

1 Margolis is to my right and Judge Mike Geary is to
2 my left, and we are the members of the tax appeals
3 panel.

4 All three judges will meet after the
5 hearing and produce a written decision as equal
6 participants. Although the lead judge will conduct
7 the hearing, any judge on this panel may ask
8 questions or otherwise participate to ensure that we
9 have all the information needed to make a fair
10 decision. If you have any questions, please do not
11 hesitate to ask.

12 So now we are going to go and mark and
13 enter the marked exhibits into the record. But
14 first, I have the joint exhibits:

15 Exhibit J-1, which is the OTA conference
16 minutes and orders, eight pages, and it contains the
17 parties' stipulations as to the issues in this
18 appeal;

19 The second is Exhibit J-2, Attachment 1 to
20 the Office of Tax Appeals conference minutes and
21 orders, and that's two pages and contains the
22 parties' stipulations as to the facts.

23 Do both parties agree that these joint
24 exhibits accurately represent and summarize their
25 positions?

26 MR. DOERR: Yes.

27 MR. HUNTER: Yes, we do.

28 JUDGE KWEE: Great. The two exhibits are

1 entered into evidence without objection.

2 So for the taxpayer's exhibits we have
3 marked taxpayer's Exhibits 1 to 4, which are
4 described in Exhibit J-1. And, in addition, we have
5 a new Exhibit 5, which are the jury instructions
6 dated April 12, 2005, and they're five pages, and
7 Exhibit 6, which are the closing arguments of
8 Mr. Jim Betts, undated, and 46 pages long.

9 Does the FTB have any objections to these
10 being entered into evidence?

11 MR. HUNTER: Forty-six pages long or a
12 hundred pages long?

13 JUDGE KWEE: The closing arguments of
14 Mr. Jim Betts -- oh, I'm sorry, that was updated and
15 that is now 100 pages. You're right. I'm sorry
16 about that. One hundred pages, one hundred printed
17 pages.

18 MR. HUNTER: Yes, Judge Kwee.

19 JUDGE KWEE: Okay.

20 MR. HUNTER: No objection.

21 JUDGE KWEE: Thank you. The taxpayer's
22 Exhibits 1 to 6 are entered into evidence without
23 objection.

24 FTB's exhibits, we have marked FTB's
25 Exhibits A through K, and these exhibits are
26 described in Exhibit J-1. In addition, we have
27 Exhibit L, the California resident income tax return
28 for 2007, that's 38 pages; Exhibit M, as in Mike,

1 that's the federal Schedule F-2, three pages;
2 Exhibit N, as in Nancy, that's the testimony of Mark
3 Steinberg, 48 pages; and Exhibit O, as in orange,
4 and that's the testimony of Dr. Richard Nordstrom,
5 seven pages.

6 Does the taxpayer have any objection to
7 these documents being entered into evidence?

8 MR. DOERR: No objection.

9 JUDGE KWEE: Thank you. FTB's Exhibits A
10 through O are entered into evidence without
11 objection.

12 So to briefly summarize the issues that
13 we're going to be going over today, the first issue
14 is whether the taxpayer established that all or a
15 portion of the 3.2 million amount awarded to him in
16 a civil case qualifies for deferral in their IRC
17 section 1033 for the 2007 tax year; and the second
18 is whether the taxpayer's liable for penalties
19 assessed due to recognition of that judgment amount
20 as ordinary income.

21 Do the parties agree that I've correctly
22 summarized the issues that we're going to hear
23 today?

24 MR. DOERR: Yes.

25 MR. HUNTER: Yes, Judge Kwee.

26 JUDGE KWEE: Okay. And I have a question,
27 I guess for the taxpayer, about the second issue,
28 the penalty.

1 I think your brief, dated February 20th
2 indicates that you dispute the 20 percent
3 accuracy-related penalty in the amount of 148,000.
4 As I understand it, the penalty amount includes the
5 penalty imposed for disallowance of the 3.95
6 deduction, which is not at issue, in addition to the
7 3.2 million. So I just wanted to clarify, are you
8 only disputing the accuracy-related penalty that's
9 allocated to the 3.2 million, or are you disputing
10 the entire accuracy-related penalty?

11 MR. DOERR: As to the 3.2 million.

12 JUDGE KWEE: Okay, thank you for the
13 clarification.

14 So now I'd like to go and allow the
15 taxpayer an opportunity to make an opening
16 statement.

17 MR. DOERR: Thank you.

18 First off, the taxpayer wishes he was here.
19 Unfortunately, due to some travel arrangements, he
20 was not able to be here. He's in Syria currently,
21 where he's been for the last several months. But he
22 does wish that he was here and thanks you for your
23 time today.

24 I've thought a lot about this case. My
25 initial appeal was filed back in April of 2015 and I
26 have re-read and read the briefs over and over in
27 the last couple months. And while I have nothing
28 new to add to these briefs, I think it's important

1 to put some of the information into context and to
2 highlight some of the key points and also be
3 available to answer any questions that the judges
4 may have.

5 That is why I brought Dr. Nordstrom today.
6 He was one of the expert witnesses for damages in
7 the underlying civil case that's discussed at length
8 in the briefs, also Mr. Jim Betts, who was the lead
9 trial attorney for that underlying matter. So
10 they're here today and I'll be asking them some
11 questions.

12 Factually, this case is quite simple.
13 Taxpayer is a farmer. He farms grapes by growing
14 grapevines and then turns those grapes into raisins.

15 In 2002, a chemical spray was applied to
16 his vineyards and it resulted in damage not only to
17 the grapes that were growing on the vine at the time
18 but also caused permanent damage to some of the
19 vines and killing some of the vines.

20 Taxpayer then proceeded to sue the
21 manufacturer or reseller of that spray, Britz, and
22 they had a very long trial. At the conclusion of
23 that trial, taxpayer was awarded about seven and a
24 half million dollars in damages.

25 The judgment was broken down into a number
26 of categories that, if you want to follow along
27 they're in some of the exhibits, but just to
28 summarize them, there was damage to raisin crops in

1 that span from 2002 to 2004 year and approximately
2 \$2.26 million. There was also a line item of cost
3 to repair vines and that was 160,000. I'm using
4 approximate numbers. There was also lost profits
5 from green grape purchases, which was about 467,000.
6 And then you had something called future lost
7 profits in the amount of 3 million 666 --
8 \$3.6 million. And that's kind of the focus of what
9 we're dealing with today.

10 So once the judgment was awarded,
11 taxpayer -- and this was awarded in 2007 -- elected
12 to defer part of that \$7.5 million, to defer that
13 gain under IRC, which is the Internal Revenue Code
14 section 1033.

15 To paraphrase 1033, if property as a result
16 of its destruction in whole or in part is
17 involuntarily converted into money or into similar
18 property -- sorry -- was converted into similar
19 property, there shall be no gain recognized.

20 If it's converted into money, taxpayer has
21 the option to take that money and then purchase
22 property that's similar, and that's what the
23 taxpayer did in this case, which is not in dispute.
24 What's in dispute is how much was able to be
25 converted from the money judgment into replacement
26 property. And our contention is it's \$3.26
27 million -- I have to say that over and over again --
28 so \$3.26 million, didn't use under 1033.

1 The key point there is no gain should be
2 recognized. Nowhere -- in section 1033 it says
3 nowhere shall gain be recognized except if it's --
4 if that damage is measured in lost profits or any
5 other thing, just that there should be no gain
6 recognized, that the property is destroyed in whole
7 or in part and that money that was -- that that
8 property turned into was used to buy replacement
9 property.

10 Here, taxpayer elected that under 1033 he
11 bought replacement property. Some of the FTB's
12 arguments make it seem that the taxpayer's getting
13 away with something. He's converting some profits
14 and now he's not going to be taxed on these profits.
15 But in fact what 1033 does, it allows the taxpayer
16 to buy the property which is going to be
17 income-producing property. And when that property
18 produces income, then the taxpayer will be taxed on
19 it. So it's basically trying to put the taxpayer
20 where the taxpayer was before the involuntary
21 conversion. In this case a voluntary conversion was
22 a toxic chemical spray that was applied to about 900
23 acres of grapevines.

24 So, like I alluded to before, the heart of
25 this issue is this future loss of profits award and
26 what does that stand for. The FTB will contend it's
27 just for lost profits, and lost profits I guess mean
28 ordinary income and yet you will find that profits

1 are just representing something else. And here the
2 profits are representing damage to a capital asset,
3 which grapevines are.

4 This is what Dr. Nordstrom said, and I will
5 revisit that when I speak with -- when he's our
6 witness, I will go through his quotes.

7 But really, future lost profits, that
8 damage award is a measuring stick of the damage to
9 the actual grapevine. There is no market for a
10 three-year-old, four-year-old, five-year-old mature
11 producing grapevine. They don't exist.

12 What exists is a stick that you plant in
13 the ground and after three years it starts to
14 produce grapes. Therefore, when a grapevine is to
15 be replaced, you can't look at the replacement value
16 of that stick because that's not what was destroyed.
17 What was destroyed were decades-old grapevines that
18 produced at a high level. And over time that stick
19 can become a productive replacement, but it takes
20 time. And the value of that time is measured
21 through lost profits because there's no other way to
22 do it.

23 Here, taxpayer suffered two distinct
24 losses:

25 Loss of crop on the vine and also damage to
26 the capital asset, which is the grapevine itself.
27 Clearly, the crop loss, the damage to the crop in
28 2002 that's burnt is not eligible for 1033 because

1 that crop is not a capital asset.

2 Here, the FTB contends that only 2 percent
3 of the entire jury award of \$7.5 million is eligible
4 for 1033. So basically 2 percent of this whole
5 award represents a destruction of property in whole
6 or in part -- words of section 1033, whole or in
7 part -- only 2 percent of that spray represents
8 that. And we contend that at a minimum it's 43
9 percent because that is the amount the taxpayer
10 used. He took 43 percent of those proceeds, which
11 is represented by that future lost profits in order
12 to use that by replacement in producing property.

13 That is it.

14 JUDGE KWEE: Thank you.

15 Would the FTB like to make an opening
16 statement at this time?

17 MR. HUNTER: Yes, we would.

18 JUDGE KWEE: Please proceed.

19 MR. HUNTER: Thank you.

20 This case centers on the correct tax
21 treatment of the jury award received by appellant in
22 tax year 2007.

23 Appellant owned vineyards near Fresno,
24 California. In 2002, appellant applied a chemical
25 mixture to its grapevines which were damaged.
26 Appellant sued the chemical company and received a
27 jury verdict in the amount of \$3.2 million for
28 damage to his raisin crop. Those facts are not in

1 dispute.

2 The evidence will show that the appellant
3 sued for breach of contract and alleged that this
4 consisted of losses sustained to the quantity and
5 quality of raisins harvested in the amount of not
6 less than 2.4 million, and also losses to the
7 production capabilities of his grapevines in future
8 years in the amount of not less than 2.85 million.

9 The evidence will show that this represents
10 his current lost profits from the time the chemical
11 sprayed until the judgment award was paid or entered
12 and future lost profits going into the future.

13 Internal Revenue Code section 61 and
14 Treasury Regulation section 1.61-4 provide that
15 gross income of a farmer is the amount of cash
16 received during the taxable year for the sale of
17 produce which he raised. In this case the produce
18 are the raisin grapes.

19 The law is clear when litigation proceeds
20 clearly distinguish between different damage awards,
21 this finding is binding for tax purposes. Here,
22 appellant sued for lost income, and a judgment award
23 for lost income is taxable for 2007 when he finally
24 received payment for judgment after a failed appeal
25 attempt by the defendant chemical company.

26 The evidence will show that Respondent's
27 Exhibit L, the trial testimony provided by
28 appellant's economic loss expert in the underlying

1 case -- strike that.

2 Exhibit O, trial testimony provided by Dr.
3 Nordstrom, that he walked the rows of the vineyard
4 with the plant pathologist and calculated damages
5 based on the expected production of raisin grapes,
6 assuming no damage, less the amount of raisin grapes
7 that were actually produced; and he did this by
8 referring to the tonnage or amount of tons of raisin
9 grapes that were produced after the chemical spray
10 was applied.

11 Appellant's Exhibit 6 -- strike that.

12 Appellant's Exhibit 5, which includes jury
13 instruction number 1287 that the jury was instructed
14 to award damages for lost production of appellant's
15 raisin grapes which were to be harvested and sold as
16 follows: The jury determined the expected market
17 value of the crop before the harm occurred, then the
18 jury subtracted the estimated cost of producing and
19 marketing the crop.

20 It's important to know that the appellant
21 did not produce grapevines for sale, nor did he
22 market his grapevines for sale. He produced and
23 marketed raisin grapes.

24 The evidence will show at Respondent's
25 Exhibit D, special verdict, which is filed April 13,
26 2005, which is contemporaneous with the transaction,
27 that the jury awarded appellant a total \$3.2 million
28 for damage to his raisin crops for tax years 2002,

1 2003 and 2004.

2 The evidence will show at Respondent's
3 Exhibit E, which is a judgment in favor of the
4 appellant, that the jury verdict was adopted as a
5 judgment as against the chemical company in this
6 lawsuit.

7 Appellants did not seek to revise this
8 judgment in any respect, and appellant's award for
9 damage to his raisin crops in the amount of
10 \$3.2 million is includible in his gross income for
11 2007.

12 Now in terms of the section 1033 position,
13 Internal Revenue Code section 165 provides a
14 casualty loss deduction for loss of actual property.
15 This does not encompass a failure of profits or the
16 loss of potential income. Items held for sale in
17 inventory are not property for purposes of casualty
18 loss deduction nor section 1033.

19 The IRS Treasury Regulations provide that
20 no casualty loss deduction is allowable for items in
21 inventory and no casualty loss deduction is
22 allowable with respect to growing crops since the
23 cost of producing the crops has already been
24 expensed on an annual basis.

25 The instructions to Schedule F (1040)
26 profit or loss from farming provide that taxpayers
27 in the farming business must use form 4684 to report
28 casualty or theft, gain or loss, involving farm

1 business property and refer taxpayers to IRS
2 publication 225, which provides that losses of
3 plants, produce and crops raised for sale are not
4 deductible.

5 The evidence will show that appellant also
6 sued the chemical company for complete destruction
7 or death of certain vines in the amount of no less
8 than \$210,000.

9 The evidence will also show at Appellant's
10 Exhibit 5, again jury instruction number 1287, that
11 the jury was instructed to award a separate line
12 item of damages for destruction to appellant's
13 grapevines as a -- the jury was instructed that if
14 the plants responsible for producing the crop are
15 destroyed, the measure of damages may also include
16 the cost of replanting.

17 The evidence will show at Respondent's
18 Exhibit D, special verdict, again contemporaneous
19 with the transaction, that the jury awarded
20 appellant a net total of \$160,000 for this cost to
21 repair vines for tax years 2002, 2003 and 2004.

22 So in this case the jury heard testimony
23 from the experts, from the taxpayer, and reviewed
24 evidence regarding specific items of damage alleged
25 by the appellant.

26 The jury was instructed to award a separate
27 and specific amount for lost income from the
28 production of sale -- production and sale of raisin

1 grapes. The jury was also instructed to award a
2 separate and distinct specific amount for cost to
3 repair the grapevines. After reviewing this
4 testimony and evidence, the jury made its finding on
5 these two separate and distinct specific items of
6 damage.

7 As such, appellant was already compensated
8 for the damage to his vineyard, which he said were
9 lost profits. And this was -- the lost profits are
10 includible in his gross income for tax year 2007.

11 The amount he received for cost to repair
12 the grapevines, the separate line item, was excluded
13 from his gross income for tax year 2007, and that is
14 the proper tax treatment. That's not income.

15 Relating to the accuracy-related penalty,
16 the evidence will show that respondent correctly
17 imposed this penalty which was applied under
18 California Revenue and Taxation Code Section 19164.
19 The amount of the understatement exceeded the
20 greater of 10 percent of the tax required to be
21 shown on appellant's 2007 tax return or \$5,000.

22 Here, the understatement for the tax year
23 at issue was \$742,000 and the accuracy-related
24 penalty was properly imposed.

25 Thank you.

26 JUDGE KWEE: All right, thank you.

27 Before the taxpayer calls their first
28 witness, I'd like to see if the Members of this

1 panel have any questions for the parties
2 representatives.

3 JUDGE GEARY: No questions.

4 JUDGE MARGOLIS: I have a question for the
5 FTB. The basis for the substantial, the
6 accuracy-related penalty is solely a substantial
7 understatement, it's not negligence or intentional
8 disregard of rules and regulations?

9 MR. HUNTER: Yes, the understated amount.

10 JUDGE MARGOLIS: Okay.

11 Just a question about the exhibits. You
12 have the taxpayer's return in Exhibit L. And then
13 you have separately a schedule at Exhibit M, you
14 have Schedule F-2. Was that part of the return as
15 well? I mean why is it separate from the return?

16 MR. HUNTER: Well, the electronically filed
17 return that we have on file is the complete copy of
18 the return that we submitted. There's also a
19 separate Schedule F, we call Schedule F-2. Because
20 what the taxpayer did, they reported their income
21 from current year operations on Schedule F, which is
22 appropriate. Then they submitted a separate
23 Schedule F which included income from the judgment
24 award, which consisted of future lost profits and
25 lost business opportunity for the purchase of green
26 grapes that the appellant would subsequently turn
27 into raisins.

28 The taxpayer was called in for audit and

1 Information Document Request was sent out in
2 February, I believe 2001. And in response to that
3 IDR this three-page document was submitted. So
4 that's where the statement of the taxpayer's
5 position came from. It was not filed, to the best
6 of my -- I didn't ascertain, it wasn't filed with
7 the return.

8 JUDGE MARGOLIS: Schedule M was not filed
9 with the taxpayer's return?

10 MR. HUNTER: No. The statement behind --

11 JUDGE MARGOLIS: Oh, the statement --
12 well --

13 MR. HUNTER: The statement is page 3 --

14 JUDGE MARGOLIS: Right.

15 MR. HUNTER: -- of Exhibit M. And this is
16 a statement which the taxpayer provided to explain
17 the tax reporting position on form 4684.

18 JUDGE MARGOLIS: Okay. But that was not
19 filed with the original filed return, correct?

20 MR. HUNTER: No. It was -- from what I can
21 tell, what I got back from Audit, was that it was
22 submitted in response to an IDR that was sent out a
23 couple years later.

24 JUDGE MARGOLIS: Are you aware of when this
25 was filed, Mr. Doerr?

26 MR. DOERR: I am not. I was not involved
27 in that part of it.

28 JUDGE MARGOLIS: Okay. We'll do the best

1 we can with it. Okay, thanks.

2 JUDGE KWEE: I have one question, too, I
3 guess either for the Franchise Tax Board or the
4 taxpayer.

5 Do we know how this was treated for federal
6 purposes with the IRS?

7 MR. DOERR: The IRS did not contest this
8 position.

9 JUDGE KWEE: And does the Franchise Tax
10 Board -- do you agree or disagree with that
11 statement?

12 MR. HUNTER: I have no information on
13 the -- I don't think they made a declaration on
14 these issues.

15 JUDGE KWEE: Okay. And the 160,000, did
16 the FTB allow that as a 1033, or was that just a
17 sufficient basis or why wasn't the 160 picked up by
18 the FTB?

19 MR. HUNTER: It wasn't picked up per se.
20 It was recognized as an item of the judgment that
21 the taxpayer received. But it was not reported in
22 gross income for that year, and FTB took the
23 position that's correct because it's compensation
24 for the cost to repair vines.

25 JUDGE KWEE: Okay. Would the taxpayer like
26 to call the first witness?

27 MR. DOERR: Yes, I'd like to call Mr. Jim
28 Betts.

1 JUDGE KWEE: Okay. Mr. Betts, would you
2 like to take the witness box. And before you begin
3 testimony, I'd like to swear you in.

4 Would you raise your right hand. Do you
5 swear or affirm that the testimony you're about to
6 give today will be the truth, the whole truth and
7 nothing but the truth?

8 MR. BETTS: I do.

9 JUDGE KWEE: Okay.

10 MR. CORNEZ: Judge Kwee, we would request
11 an offer of proof because we believe that the
12 testimony that's going to be offered is to
13 contradict the special verdict that the jury
14 rendered, and that the briefing that we offered
15 indicates that where you have a case involving a
16 special verdict that the verdict is binding on the
17 tax court. The tax court cases all state that, and
18 therefore any testimony to suggest that the jury
19 verdict should be disregarded is irrelevant to this
20 proceeding and it would be an undue consumption of
21 time.

22 So we'd ask for an offer of proof so that
23 we could have a standing objection.

24 JUDGE KWEE: Mr. Doerr, would you like to
25 clarify the testimony that's going to be provided
26 today?

27 MR. DOERR: That wasn't an issue I was
28 going to speak about. I was going to talk about the

1 initial filing of the Complaint as we spoke on the
2 phone under our stipulation. I'm not going to
3 discuss the special verdict.

4 JUDGE KWEE: Okay. So I'd like to let you
5 proceed. And it's -- I know it's a little late for
6 this objection because we have had, I guess we had
7 our prehearing conference and we discussed the
8 testimony of the witness at that time and I didn't
9 hear any objections at that time either.

10 MR. CORNEZ: Well, at that time we were not
11 aware of the nature of his testimony other than a
12 general statement.

13 So I'll reserve my right to raise an
14 objection afterwards.

15 JUDGE KWEE: Okay, thank you.

16 Please proceed.

17 TESTIMONY OF

18 JIM BETTS

19 a witness called by the Taxpayer, having been sworn,
20 was examined and testified as follows:

21 DIRECT EXAMINATION

22 BY MR. DOERR:

23 Q. Hi, Mr. Betts. Thanks for being here
24 today.

25 A. Good afternoon.

26 Q. Would you mind introducing yourself and
27 your relationship with Ahmad Skouti?

28 A. Sure. Good afternoon, gentlemen. My name

1 is Jim Betts. I'm a civil trial attorney with a
2 practice in Fresno, California. I was retained by
3 Amad Skouti and the Skouti Farms in fall of 2002 to
4 investigate and pursue potential legal remedies
5 associated with what appeared to a spray damage crop
6 loss case. I had not previously represented Mr.
7 Skouti.

8 Q. When you were approached by Mr. Skouti
9 regarding this spray damage, how quickly after --
10 how quickly after the spray did you file the initial
11 Complaint?

12 A. The spray went on in July of 2002, damages
13 became apparent beginning in about two weeks and
14 became more profound over time. The crops were
15 harvested in the fall, within six weeks, eight
16 weeks. The vines went into senescence. We filed a
17 Complaint in December of 2002, so fairly quickly.

18 Q. The FTB mentioned in their opening
19 statement that there was a line in the Complaint
20 where it said the complete destruction or death of
21 certain vines in the amount of not less than
22 \$210,000, where did that number come from?

23 A. It takes a little explanation if I can.
24 I'll try to be succinct.

25 JUDGE KWEE: Please proceed.

26 MR. BETTS: So, first off, in 2002, there
27 was not a substantial body of law dealing with the
28 destruction of permanent crops, trees, vines. There

1 was some case law on that, but it was an emerging
2 area.

3 From an agricultural standpoint, in that
4 time period, we did not believe that a chemical
5 spray -- we believed that a chemical spray could
6 injure a crop, certainly, could injure the canopy,
7 but as far as proving to be lethal to the plants
8 themselves, that was not an area that we believed
9 was going to result in extensive damage.

10 The general parameters of our perceptions
11 were that spray damage is not going to kill vines.

12 Remember that after the spray the vines
13 went into harvest within a matter of weeks, then
14 went into senescence. So in December of 2003 when
15 we filed the original Complaint, we did not have a
16 lot of information of how the vines were going to
17 perform.

18 In the years that followed, in '03, in 04,
19 what we saw was a continuing meltdown of the vines
20 themselves. It was helpful to review my closing
21 argument because we had a dozen different witnesses,
22 all of whom testified that this was the worst crop
23 damage case involving grapevines that they'd ever
24 seen. And we're talking about some remarkable
25 experts, Pete Christianson out of UC. And it proved
26 not only lethal to an extensive number of vines,
27 but, as Dr. Nordstrom's testimony established, we
28 had approximately 47 percent of a thousand acres of

1 vineyards in which the vines were rendered either --
2 well, they were killed or rendered commercially not
3 viable.

4 So over time the extent of the damage to
5 the vines themselves grew exponentially and
6 eventually totaled literally millions of dollars of
7 losses as opposed to what we believed at the time
8 the Complaint was originally drafted.

9 Q. (By Mr. Doerr) Okay. So there was no
10 question during this -- during when the trial
11 occurred in 2005, about three years, maybe a little
12 less, two-and-a-half years after the spray that,
13 besides the crop loss, that there was actual damage
14 to the grapevines themselves?

15 A. There was no question that we had damage to
16 the vines themselves. There was no question that
17 the magnitude was huge. I mean a thousand acres of
18 Thompsons is a lot of Thompsons. You're talking
19 about hundreds of thousands of vines. And we had
20 some fields in the Kerman area that were
21 particularly strong that weathered the spray
22 reasonably well. We had vines in Madera that were
23 turned into moonscape; they were just fried. And,
24 you know, some of the fields could be mitigated by
25 interim planting, whether through runners or new
26 seedlings. And some of them essentially needed to
27 be plowed out and replanted.

28 Q. Based on what you said, the percentage of

1 dead vines and commercially unfeasible vines, would
2 2 percent of the total jury award seem reasonable
3 for compensation for that destruction?

4 A. No. No. No, the figures referenced by
5 counsel in our special verdict, and you kind of have
6 to understand how the special verdict plays out.
7 Because as a plaintiff we want a general verdict,
8 right. We want a "Who won, plaintiff or defendant?"
9 And a line for "How much?" That's what I want.

10 The defense of course wants a special
11 verdict with very itemized line entries, which will
12 kind of chill a jury, overstating the amounts, or
13 provide a basis to pick at us on appeal, which is
14 exactly what happened.

15 In the first three years the lines for
16 repair to vines, that is the increased agricultural
17 cost of dealing with the damaged vines. That is why
18 in year one it's a positive number, and in year two
19 and three it's actually a negative number. And it's
20 negative because in '03 and '04 a reasonable
21 argument can be made that our costs of farming were
22 reduced because we're losing an increased amount of
23 the vineyards.

24 So that's why a repair to vine minus 40,000
25 is in the verdict for '03 and -- I don't remember
26 the specific numbers. But that had nothing to do
27 with the replanting. That had nothing to do with
28 the injury, with the startup time it was going to

1 take the new vines to produce. All of those numbers
2 were in that, what we call the 3903 end jury
3 instruction which are labeled as lost profits. But
4 if you look at the jury instruction -- I brought the
5 CACI book with me -- it's lost profits paren.
6 economic damage. So that's what we're looking at.

7 And I just want to say one other thing
8 before the next question. Trial judges don't get
9 reversed for letting in evidence. They get reversed
10 for excluding evidence. And trial judges, other
11 than the exclusion of evidence, the single greatest
12 basis for reversal on appeal is instructional error.

13 So any of the nomenclature that you see in
14 the jury verdict is the result of that judge
15 following the jury verdict options -- I mean, sorry,
16 the jury instruction options that we have. That is
17 3903I and 3903N. 3903I has a use note which
18 recognizes the Baker case and the Chowchilla cases.
19 They're brand new cases -- well, not brand new.
20 They're within a few years -- that talk about
21 alternative measures of damage if you have the
22 permanent destruction of -- if you have the
23 destruction of permanent crops. So that's what
24 we're going through.

25 And the way this is set up and the terms
26 that are used are because our trial judge is doing
27 what he's supposed to do. He's following the CACI
28 language, he's following the BAJI language. These

1 are established jury instructions to be used in crop
2 loss cases and where you have future economic
3 damages. So that's the language.

4 I think that's an important point in
5 understanding why 2 percent is not anywhere near
6 where our damage is worth. And why the specific
7 language that you see in the verdict form is not --
8 we live in different worlds, the tax world and the
9 civil trial lawyer's world. We're just following
10 the jury instructions so the judge doesn't get
11 reversed. That's how we do it.

12 Q. That was sort of my next question, is when
13 you were preparing the jury instructions and even
14 trying this case on damages, were you aware of
15 section 1033 or cognizant about words that you
16 should or should not be using when you're trying to
17 get your verdict?

18 A. No. I actually got a good grade in law
19 school many, many years ago in federal tax. But
20 I've never done my own taxes. I don't touch tax
21 aspect or tax work at all.

22 Q. So it's fair to say that the language and
23 the words being used in a civil trial weren't
24 necessarily crafted in a very precise manner that's
25 required under tax law and the IRC?

26 A. It would be impossible for me to answer
27 that. I will answer it this way: The jury
28 instruction language is crafted to anticipate a

1 broad array of factual scenarios in a case.

2 Again, 3903N which is that which is the
3 jury instruction at issue here, the future economic
4 damages, uses the phrase lost profits. That's why
5 that phrase is in the verdict, not because we made a
6 decision, oh, these are lost profits so this is what
7 we need to use. We're just following the language
8 of the jury instruction.

9 Q. I notice in the jury instructions, too --
10 this is our Exhibit 5, and it would be on the third
11 page of the very last line -- it says if the plants
12 responsible for producing a crop are destroyed, the
13 measure of damages may also include the costs of
14 replanting.

15 I know the FTB had mentioned that in their
16 opening statement, but what I'm focused on is it
17 says "may also include." It doesn't limit it to the
18 cost of replanting. Would it be fair to say that
19 this also would be the future lost profits award?

20 A. Try that on me again. I understood all the
21 way up to the last few sentences.

22 Q. It says if the plants responsible for
23 producing the crops are destroyed -- and that's what
24 we have here. We just testified, or it's one of our
25 stipulated facts that they were vines that were
26 destroyed -- the measure of damages may also include
27 the cost of replanting.

28 To phrase it another way, would that award

1 for this particular line item limit what was awarded
2 for the destruction of the vines?

3 A. No, it did not limit. In fact it opened it
4 up. And, again, you have to look at what we call
5 the use notes, which are the case annotations that
6 the authors of the jury instructions have included
7 to provide definition for what's going on.

8 MR. CORNEZ: Objection, those are not in
9 the record here.

10 MR. BETTS: I have CACI with me if anybody
11 wants to make copies of what I'm talking about.

12 JUDGE KWEE: So, we're allowed
13 administrative hearsay, and I'm going to allow his
14 testimony.

15 Would you like to make a standing
16 objection?

17 MR. CORNEZ: Well, this has gone beyond
18 question and answer, it's become kind of a lecture.
19 So I'm a little confused about the points being
20 made. So I'll reserve to the end.

21 JUDGE KWEE: Okay. We're in an
22 administrative hearing and we're given a lot of
23 latitude to take in any relevant evidence, and I'm
24 going to allow him to continue at this point.

25 MR. BETTS: 3903I specifically allows
26 damages for replanting, and it has the use notes
27 which talks about this expanding field of permanent
28 damage to permanent crops.

1 Our jury verdict used 3903I and 3903N which
2 is future economic damage, which the jury
3 instruction uses the phrase lost profits in order to
4 set out a year-by-year analysis of what the damages
5 were. Again, that was at the defense suggestion,
6 not mine.

7 So we have damages for 2002. Those are
8 lost crops, increased costs of farming. And we have
9 green grapes in the first couple of years as well,
10 which has nothing to do with this I don't think.

11 2003 is the same; 2004 is the same; lost
12 crops minus either increased or decreased farming
13 costs.

14 From 2005 to 2009, 2010 we had a schedule
15 of bringing in new seedlings, planting those, and
16 the time that it was going to take for those
17 seedlings to produce a commercially viable crop.
18 The damages associated with that, the jury awarded
19 us 3.2, 3.3 million. We asked for more. My total
20 request to the jury was 11 -- just over 11 million,
21 they gave us seven-and-a-half. But that award for
22 2005 forward was for damaged vines, dead vines,
23 commercially -- vines that were not commercially
24 viable, and the swing time it was going to take to
25 get those plantings up and running as mature,
26 producing again.

27 MR. DOERR: Thank you, Mr. Betts.

28 I don't have any more questions.

1 JUDGE KWEE: Would the Franchise Tax Board
2 like to ask any questions of the witness?

3 MR. CORNEZ: Yes.

4 JUDGE KWEE: Please proceed.

5 CROSS-EXAMINATION

6 BY MR. CORNEZ:

7 Q. You say that the case law on destruction
8 vines, trees was uncertain. Was that civil tort law
9 or was that tax law?

10 A. Well, it wasn't uncertain. I said it was
11 evolving. That's why we have a use note that talks
12 about the Chowchilla and the Baker cases. But I'm
13 strictly speaking in terms of civil law, counsel. I
14 will be a very poor resource for you on tax law.

15 Q. I'm not asking.

16 Did you make any effort to amend the
17 Complaint as the case progressed?

18 A. No. I would have no reason to do that.
19 And if you notice, I also asked for emotional
20 distress damages, which I wasn't ever going to get
21 on a commercial loss case. So your strategy in
22 putting the Complaint together is to preserve your
23 ability to claim damages, not to provide specific
24 amount.

25 Q. You stated that -- I think you said that
26 Dr. Nordstrom testified that 47 percent of the vines
27 were killed?

28 A. I looked at my summation, I didn't look

1 back at Dr. Nordstrom's testimony, but in my
2 summation I'm summarizing his testimony as being 47
3 percent that are not viable and/or are dead.

4 Q. And I guess I don't -- where did you say
5 that?

6 A. In my closing?

7 Q. Yes.

8 A. Can I reference my closing?

9 Q. Yes, you may, please, because I do not see
10 that.

11 JUDGE KWEE: Are we on Exhibit 6?

12 MR. HUNTER: Yes.

13 MR. BETTS: Page 3434, line 21.

14 Fifty percent of those vines need
15 replanting. Well, I said, Nordstrom's number's not
16 50 percent; Nordstrom's number is 47 percent.

17 Again, 3434, line 21.

18 Q. (By Mr. Cornez) Now, when you made your
19 closing argument, you specifically asked the jury to
20 award loss income of \$1,067,000. This was in your
21 rebuttal closing argument for the year 2002. Then
22 you also separately asked for cost of repair
23 365,000; is that correct?

24 A. If you have a page, I'm sure the court
25 reporter got it right. So if you have a page
26 reference for me, I'm happy to take a look at it.

27 Q. Page 3495 of your Exhibit --

28 A. I'm with you.

1 Q. -- 6?

2 A. No, sir. I said added cost of 265,000.
3 That's exactly what I testified to here, which is
4 the added cost of farming the damaged vines, which
5 would have been increased irrigation, consulting
6 with PCAs, looking at --

7 Q. But your closing argument said the cost to
8 repair is 265,000.

9 A. Yeah, right. That's a mitigation argument
10 for the increased cost of cultivation to the damaged
11 vines, not the replanting schedule. That was
12 millions.

13 Q. Is there testimony as to the cost of the
14 replanting schedule?

15 A. Yes, sir. Dave Nordstrom's.

16 Q. And for 2003 you asked the jury to award
17 the amount on Dr. Nordstrom's Exhibit 220 of 641,000
18 for damage to raise the crops and that's what the
19 jury awarded?

20 A. That level of specificity, I'm sorry,
21 counsel, I don't have. I mean, if you point me to
22 something I have to take a look at it, but I don't
23 recall that.

24 I think it's safe to say that I would have
25 asked the jury for as much as I could. I don't
26 remember if the jury gave us an award that matched
27 my request in '02, '03, '04, or whether they gave us
28 some reduced amount. I just don't recall that.

1 Q. Well, I can -- I can offer to you, based on
2 the exhibits I have here, that for 2002 you asked
3 for damage of raisin crops of 1,067,000, which the
4 jury awarded.

5 For 2003, you asked for damages to raisin
6 crops of 641,000, and the jury awarded six hundred
7 forty.

8 And for 2004 you asked for damages to
9 raisin crops of 1.552 million, and the jury awarded
10 1.552 million.

11 And nowhere in any of your closing argument
12 do you ever specify -- isn't it true you never
13 specified between the lost profits based on the
14 reduced production of grapes versus the cost to
15 repair the vines or replant, in your closing
16 argument, you never asked that question -- or you
17 never made that argument?

18 A. Could you --

19 Q. I'm sorry.

20 A. I was following you mostly. I'm sorry.

21 Q. No, no. I apologize.

22 In your closing argument where you asked
23 for lost grape sales, damage to raisin crops for
24 2002, 2003, 2004, isn't it true you never specified
25 a separate amount for the damage to the vines
26 themselves?

27 A. Not in '02 because we didn't replace the
28 vines in '02. We didn't start our replacement of

1 vines until '06. So it would have had no place in
2 an itemized jury award for damages in '02. Same in
3 '03, same in '04.

4 So our cost of replanting, of putting in
5 new vines and the startup that it takes for those to
6 come into production all would have been after the
7 '04 itemization in the jury award, that's why it's
8 in that last section.

9 Q. So the award for '02, '03 and '04, isn't it
10 true that it solely relates to the grapes that he
11 did not produce because the grapevines were not as
12 productive?

13 A. In '02, '03 and '04, the damages were
14 for -- well, it can't be that broad. In '02 the
15 damages would have included the fruit that was
16 actually fried. If you saw it, it just dropped on
17 the ground and shriveled up before it sugared up.

18 In '03 and '04 damages would have been for
19 reduced production because of damage to the vines.
20 A grapevine has two years of vines on it.

21 In '05 and forward it would have been for
22 the cost of replanting and the startup period to get
23 those vines to reach maturity and begin producing.

24 Q. Indulge me, I'll ask it one more time. For
25 '02, '03 and '04, what you asked of the jury was an
26 award for damage to raisin crops in specified
27 amounts which the jury awarded within a thousand
28 dollars. I think their evidence establishes that.

1 Did you ever ask the jury separately to include
2 damages to grapevines for '02, '03 and '04?

3 A. I don't think so. I think it was the crops
4 minus either the increased or the reduced farming
5 costs and then the green grape issue.

6 MR. CORNEZ: Okay, thank you.

7 JUDGE KWEE: Do you have any further
8 questions?

9 MR. CORNEZ: I do not.

10 JUDGE KWEE: I have a question for the
11 witness. I think you indicated that for 2002 that
12 part of the award from the jury was for damage to
13 grapes that were sitting on the vines; is that
14 correct?

15 MR. BETTS: Yeah. The spray actually fried
16 not just the canopy, not just the vines, but there
17 was a crop on those vines in July. The funny thing
18 about grapes is that the thing that gives grapes
19 substance and moisture is the sugar. So if we had
20 sprayed this and fried them in late August or
21 September, we would have gotten a crop. You do it
22 in July, there's no sugar in those grapes yet.
23 They're just little green beads. But it destroyed
24 them. What we saw was you can actually see the
25 pattern of where the spray hit the grapes and it
26 fried them. If there were some down low on the
27 canopy hanging down, they would be perfect. I mean
28 they were immaculate.

1 So the spray, yes, the spray in '02
2 destroyed the existing crop and it dried up. But
3 you think, well, it dried up, it should be raisins,
4 but they're not because there's no sugar in it.

5 JUDGE KWEE: Do you have any knowledge of
6 what amount of the damage would be allocable to
7 damage to grapes that were sitting on the vines in
8 2002 versus damage to the actual vines themselves?

9 MR. BETTS: In that jury award, the amount
10 of crop loss for damage to the fruit was \$1,067,000.
11 The entirety of that award was for damage to the
12 crop.

13 JUDGE KWEE: For 2002.

14 MR. BETTS: For 2002.

15 JUDGE KWEE: Okay, thank you.

16 I'd like to see if the members of the panel
17 have any questions for the witness?

18 JUDGE MARGOLIS: I have a question of the
19 witness.

20 Mr. Betts, do these vines rejuvenate? I
21 mean if they weren't completely killed, do they come
22 back if they were just damaged?

23 MR. BETTS: See, that's -- now you have my
24 full interest because that's what I -- that's what
25 we were looking at. This case was an experiment in
26 that. There was a great line in the summation that
27 brought this back. A couple things, and I'll make
28 it fast.

1 In '01 there were too many Thompson
2 grapevines. It was killing the market because there
3 were too many. In '01 you would get paid not to
4 grow grapes. It was called the RID Program, and it
5 was discontinued very shortly after that. But the
6 way you treat grapes -- or treat vines so they don't
7 grow is it's called spur pruning, and you carve all
8 of the vines off that vine.

9 So they spur pruned in '01. The result of
10 that is in '02 you get this huge crop because if the
11 vines take a year off they actually come back with
12 great viability.

13 Now to answer your question. After '02
14 when the vines languished in '03, we bought four new
15 chainsaws and went out and spur-pruned hundreds of
16 acres of these vines to try to see if the ones that
17 were really heavily damaged would come back. Some
18 did. Most did not.

19 And what we found was in '03 and '04 when
20 Dr. Nordstrom and our pathologist walked the fields
21 they rated the vines as having a livelihood of
22 recovery. They put them in these classes, zero
23 percent likelihood, meaning it was dead, 20 percent,
24 50 percent, 80 percent, hundred percent. And then
25 they walked them again nearly a year later to assess
26 the accuracy of that estimate, and it came in within
27 10 percent of their original estimate. So we did
28 try to rejuvenate. We were successful in some, but

1 the losses were still massive.

2 JUDGE MARGOLIS: And you knew all of this
3 when you went to trial.

4 MR. BETTS: Yes, sir.

5 JUDGE MARGOLIS: And did Mr. Skouti, did he
6 own the underlying real estate or did he just lease
7 this land?

8 MR. BETTS: Both. And there was some
9 trimming of our numbers during trial because our
10 initial -- our original damage estimate included
11 some rental acreage, which did not give us the same
12 damage. On the rental crops we would only get that
13 2002 burnt fruit loss. So we trimmed those out.

14 The vast majority of the acreage, a
15 thousand acres was owned. Now, we had another
16 plaintiff though who was Mr. Johnsen. Mr. Johnsen
17 was a co-plaintiff, he had leased some acreage to
18 Amad Skouti and he received a damage award
19 commensurate with his ownership, which was about
20 \$83,000.

21 JUDGE MARGOLIS: Okay. So the landowner's
22 the one who owns the vines in all respects.

23 MR. BETTS: Correct.

24 JUDGE MARGOLIS: Then I have another
25 question just on the tax returns. On the tax return
26 I saw there was an entry for litigation interest
27 from this litigation of 1.1 million. What was that
28 from?

1 MR. BETTS: Well, I'll give you an educated
2 opinion on it, is that with the appeal, our interest
3 rate on the jury award accrued interest at a
4 significant percentage. So my belief is that when
5 we ultimately got paid after the appeal -- they
6 bonded this on appeal so we didn't collect. On
7 appeal, upon the resolution we got paid, my
8 presumption is that that's the interest on the
9 original jury award between rendition and when we
10 went got paid.

11 JUDGE MARGOLIS: Okay, thank you.

12 JUDGE KWEE: Are there any other questions
13 from this panel?

14 JUDGE GEARY: I have no questions.

15 JUDGE KWEE: Okay, I'd like to turn it back
16 to the taxpayer to see if they would like to ask any
17 additional questions of the witness?

18 MR. DOERR: I have no more questions from
19 this witness.

20 JUDGE KWEE: Would you like the witness to
21 be released or would you like him to wait?

22 MR. BETTS: Oh, they're going to make me
23 wait.

24 MR. DOERR: He's released from the box.

25 JUDGE KWEE: You may call your next
26 witness.

27 MR. DOERR: I'd like to call
28 Dr. Nordstrom.

1 JUDGE KWEE: Dr. Nordstrom, I'd like to
2 swear you in first.

3 Would you please stand and raise your right
4 hand. Do you swear or affirm that the testimony
5 you're about to give today is the truth, the whole
6 truth and nothing but the truth?

7 DR. NORDSTROM: I do.

8 JUDGE KWEE: Please sit down.

9 TESTIMONY OF

10 DR. RICHARD NORDSTROM

11 a witness called by the Taxpayer, having been sworn,
12 ws examined and testified as follows:

13 DIRECT EXAMINATION

14 BY MR. DOERR:

15 Q. Hi, Dr. Nordstrom. Thank you for being
16 here with us today. I appreciate it. Could you
17 give a little bit about your background and your
18 relationship to the underlying civil case we've been
19 speaking of?

20 A. My name is Richard D. Nordstrom and I'm a
21 Ph.D in business, majoring in economics, from New
22 York to Arkansas.

23 And I taught at Fresno State. I retired in
24 2003 from Fresno State. I did consulting in
25 economic damages of a variety of natures, crop
26 losses one big part in our area. I appeared over a
27 hundred times in court, qualified as an expert.

28 I was retained by Jim Betts to represent

1 Skouti in this crop loss, and a large part of it was
2 discussing how to determine the damages and then
3 determine the damage after.

4 That was -- I don't know if I've answered
5 your question sufficiently.

6 Q. You have. I really just have a specific
7 question. I'm going to hand you --

8 This is just the transcript testimony so he
9 can follow along as I read it out loud, a few lines.

10 During the trial you testified, and I'm
11 going to read this.

12 And a part of the damage was that there
13 were vines that were killed --

14 MR. CORNEZ: Stop. Can you tell me what
15 page you're reading from?

16 MR. DOERR: Oh. So this is the exhibit,
17 trial transcript of proceedings, so it's our Number
18 4. So that would be -- it's Attachment 5 and it's
19 that highlighted part right there.

20 MR. CORNEZ: Is there a page number on the
21 top?

22 MR. DOERR: It is 2438.

23 MR. CORNEZ: Thank you.

24 Q. (By Mr. Doerr) I'm going to read it. It
25 says, and a part of the damage was that there were
26 vines that were killed and have to be replanted, so
27 I figured that's what's called future loss. In
28 other words, the loss that will take place in the

1 future, the cost of replanting the dead and damaged
2 vines over time. And then because of dead and
3 damaged vines being replaced, there is a period of
4 time and they'll have to grow back and become
5 productive again, and the damage will extend into
6 the future.

7 You testified to that during the civil
8 case. What did you mean here, just to clarify,
9 future loss?

10 A. Well, by future loss it means a loss that
11 will take place. It has not yet taken place but
12 will take place in the future. And in economics
13 when we figure the loss of -- a business loss, we
14 use the term profits to distinguish from sales.
15 Because there's a sales value of the crop, but
16 you're not entitled to cover the sales value; you're
17 only entitled to cover the profits that you could
18 make had those sales taken place.

19 So we refer to future damages as future
20 loss profits.

21 Q. So in this context in terms of trying to
22 value the damage and consider that were killed and
23 have to be replanted, you included a period for them
24 to become productive. Would that amount that to
25 become productive, would that be consistent with the
26 future lost profits award \$3.6 million?

27 A. That's included in that because what's
28 planted has to grow to maturity before it becomes

1 economically viable. And in that period of time
2 there is no crop. Had the plant not been damaged,
3 there would have been a full crop produced, so
4 that's included in the time.

5 Q. I'm going to ask you the same question I
6 asked Mr. Betts. The FTB's contention is only 2
7 percent of this total jury award, the \$7.5 million,
8 is attributable to damage to the vine for 1033
9 purposes. Would you consider 2 percent a fair
10 representative of the amount of damage that was
11 sustained due to the dead and damaged vines?

12 A. I have to go back to my original numbers,
13 but I think it was significantly more than that.

14 Q. Would it be the \$3.6 million, that future
15 lost profits award?

16 A. Yes.

17 MR. DOERR: I don't have anymore
18 questions.

19 MR. CORNEZ: Could we take a 5-minute
20 recess?

21 Today we received in the mail, finally from
22 the superior court, a Fresno exhibit that
23 Dr. Nordstrom used in his testimony that I think
24 would be useful to have some copies and have them
25 put into the record. I'm sorry to do this at the
26 last minute, but we just got them in the mail,
27 literally at noon today.

28 JUDGE KWEE: Okay. Let's take a 5-minute

1 recess.

2 (Whereupon a break was taken from 2:05 p.m.
3 to 2:21 p.m.)

4 JUDGE KWEE: We're ready to go on the
5 record again.

6 And we've received a document labeled
7 Chart 1 Summary of Losses by -- Summary of Losses by
8 Year, Less Rentals, and it's 18 pages long. And
9 it's offered by the Franchise Tax Board. I've
10 marked it for identification as Exhibit P.

11 Are there any objections to this?

12 MR. DOERR: No.

13 JUDGE KWEE: Okay. I'm going to admit this
14 document into the record.

15 And I believe the Franchise Tax Board was
16 asking questions of the witness.

17 MR. CORNEZ: Yes.

18 CROSS-EXAMINATION

19 BY MR. CORNEZ:

20 Q. Dr. Nordstrom, you have in front of you
21 Exhibit P; is this document familiar to you?

22 A. Yes, it is.

23 Q. And do you recall -- does it refresh your
24 recollection to look at it?

25 A. I had no recollection without looking at
26 it.

27 Q. All right, thank you.

28 I would ask you to look at page 2342

1 stamped at the top right corner, which I believe is
2 labeled page 4 in the exhibit pagination.

3 A. Chart 1-A?

4 Q. Correct.

5 A. Summary loss for 2002.

6 Q. So this chart reflects your calculation of
7 the amount of losses that the plaintiff's farm
8 suffered, the amount of damages; is that correct?

9 A. For 2002.

10 Q. Is there anywhere on this chart where you
11 have an amount for damage to the vines themselves?

12 A. This is the crop loss. This is not the --
13 this is not the damage -- there was no replacement
14 of vines in 2002. It was damaged but not replaced.
15 And so the only damage that I would be able to
16 calculate would be that which had actually been
17 spent.

18 Q. So then isn't it correct that the
19 \$1,067,000 amount is the total lost income -- the
20 total amount of income that the taxpayer suffered
21 because the vines were not as productive during
22 2002?

23 A. Well, it's also -- which number do you mean
24 there, the 1,333,000?

25 Q. No. The 1,067,000.

26 A. 1,067,000. Yes, that's -- yes, that's
27 correct.

28 Q. Then I would ask --

1 A. Expense for production less actual
2 production gives you loss, that's correct.

3 Q. I'll ask you to look at page 2344 or page
4 006 down at the bottom. Could you describe that
5 chart for us, please?

6 A. Yes, okay. I'm there.

7 Q. Yes. So, would you describe this chart for
8 me, please?

9 A. It's Chart Number 2, Summary of Losses for
10 2003.

11 Q. So at the bottom is the amount 640,710; do
12 you see that?

13 A. Yes, I do.

14 Q. Isn't it true that this amount is the
15 amount of income that the taxpayer did not earn
16 because the grapes were not as productive for
17 2003?

18 A. That's correct.

19 Q. I would ask you to look at page 2346. Can
20 you describe this page, please?

21 A. This is Chart Number 3, Summary of Losses
22 for 2004.

23 Q. Do you see the amount 1,552,000?

24 A. Yes, I do.

25 Q. Is this the amount of income that the
26 taxpayer did not earn during 2004 because the grapes
27 were not as productive because of the damage?

28 A. Yes, it is.

1 MR. CORNEZ: All right. No more
2 questions.

3 JUDGE KWEE: I'm going to see if the panel
4 has any questions of the witness?

5 JUDGE MARGOLIS: Yes. How many years does
6 it take for a newly planted vine to grow to
7 maturity?

8 DR. NORDSTROM: Five years.

9 JUDGE KWEE: Would the taxpayer like to ask
10 any additional questions?

11 MR. DOERR: No.

12 JUDGE KWEE: Okay. You may step down.

13 JUDGE MARGOLIS: I have one more question.
14 Excuse me.

15 JUDGE KWEE: Oh, I'm sorry.

16 JUDGE MARGOLIS: Dr. Nordstrom, just one
17 more question, please.

18 So how many acres needed to be replanted of
19 Mr. Skouti's property?

20 DR. NORDSTROM: Give me just -- how many
21 acres needed to be replanted? Well, it wasn't
22 calculated that way. We calculated how many vines
23 had to be replaced. And he was farming roughly a
24 thousand acres, slightly less than that. And we
25 went and estimated by survey and sampling to
26 determine what the loss was, and it was by
27 particular field.

28 Each field was given its own estimate of

1 amount of repair that had to be made. And some
2 fields -- and it was spotty. You couldn't just go
3 down a row and replant everything. So you had to
4 have special costs to plant one vine and then move
5 on down and plant another vine. Much more costly
6 than doing it the other way around. So we figured a
7 cost per vine rather than cost per field.

8 JUDGE MARGOLIS: What was the cost per
9 vine?

10 DR. NORDSTROM: On the charts that were
11 just handed to me --

12 JUDGE MARGOLIS: I believe on the last page
13 it looks like it's --

14 DR. NORDSTROM: If you look at page 2350 --

15 JUDGE MARGOLIS: Okay.

16 DR. NORDSTROM: And you'll see the results
17 of the sampling there which we went through, and how
18 many rows we sampled and the number of actual vines
19 that were damaged by visual report. And when we
20 sampled there were three of us sampling each time,
21 making that assessment. Myself not an expert on
22 grapes but an expert on economics and two others
23 that were expert on grapes but not expert on
24 economics. And so then the three of us came up with
25 that sampling.

26 Then the 2351 is Chart 5, is costs. And
27 this was where we have the costs involved, which
28 include costs saved where they didn't have to --

1 let's say a damaged vine didn't have to be
2 harvested. There's no harvesting, so we saved some
3 prices there. So the harvest costs are on that one.

4 And then on --

5 JUDGE MARGOLIS: I believe it's the last
6 page. The very last page of this exhibit talks
7 about \$3.70 cost of vine.

8 DR. NORDSTROM: That's correct. Yes,
9 that's correct. I'm sorry. I was getting there,
10 but not fast enough.

11 JUDGE MARGOLIS: And does a plant start
12 producing somewhere before it's 5-year return?

13 DR. NORDSTROM: Yeah, it's gets an
14 economically feasible crop at three years. There's
15 enough grapes on it that they can actually be
16 harvested at three years and be economically
17 feasible.

18 JUDGE MARGOLIS: Okay. Thank you.

19 JUDGE KWEE: I have one question.

20 So the -- I guess the total amount for the
21 three years, 2002, 2003 and 2004, that was the
22 3.2 million; was that basically the total amount of
23 grapes, profit from selling grapes that the taxpayer
24 would have had if there was no damage?

25 DR. NORDSTROM: We did this in 2005, so
26 that was fairly easy to measure what had happened in
27 the past. That's a correct assessment that you just
28 made.

1 JUDGE KWEE: So the costs that you were
2 talking about, replanting the damaged vines --

3 DR. NORDSTROM: Yes.

4 JUDGE KWEE: -- was that the 160,000?

5 DR. NORDSTROM: I don't remember the
6 number. I'm sorry. It's more than that.

7 JUDGE KWEE: Okay. So I guess would a
8 correct statement be that this is what you -- these
9 charts represent what you requested of the jury for
10 that amount of damages?

11 DR. NORDSTROM: Yeah. The very first page
12 of the exhibit is not given a stamp in the upper
13 right-hand corner. It just says Exhibit 220 at the
14 bottom, and it's titled Chart 1 Summary of Losses,
15 by year. And you can see the amount of loss per
16 year, and then I break it out as past and future.
17 And off to the right is written numbers, and those
18 numbers represent taking out the rental properties,
19 because we remember Mr. Betts referred to.

20 JUDGE KWEE: Okay.

21 DR. NORDSTROM: And so we took out the
22 rental properties and that lowered it from 12
23 million to 11 million, rounding off.

24 JUDGE KWEE: Okay, thank you.

25 Are there any other further questions from
26 the panel?

27 Mr. Doerr, would you like to ask any
28 further questions?

1 MR. DOERR: Yeah, I do have one more
2 question.

3 REDIRECT EXAMINATION

4 BY MR. DOERR:

5 Q. Dr. Nordstrom, we just discussed the price
6 per vine. I guess that's on page 2356. That
7 doesn't account for the lost production you just
8 spoke of during the first, second and third year of
9 the grapevine, correct?

10 A. No. That's just the physical, what it
11 would cost actually, buy a root stock and hire
12 somebody to put it in the ground and the fertilizer
13 and cost to get started.

14 MR. DOERR: Thank you.

15 JUDGE KWEE: Oh, I do have one more
16 question. I'm just wondering -- I'm sorry about
17 that.

18 Do you have any idea what would be a fair
19 market value or a cost for a mature vine?

20 DR. NORDSTROM: Never been established. We
21 tried to look at that to find out, because it's a
22 variation in life as with trees or anything else,
23 they don't all live the same distance. Some are
24 very mature at 25 years and keep producing good and
25 others start losing production at 20 years.

26 So there is no statement of mature vine,
27 there is no real standard and there's no market for
28 it because if you dig it up and replant it there's

1 no assurance that it will continue to planting it
2 the way it was in its original state.

3 So there is not market that we could find.
4 But we did look to see if we could find something of
5 that nature. In other words, could we buy vines
6 that we could stick in the ground and produce them
7 faster than root stock, and we couldn't find
8 anything.

9 JUDGE KWEE: Okay. Thank you. You may
10 step down.

11 If the taxpayer doesn't have any additional
12 witnesses, would you like to recall Mr. Betts or are
13 you done?

14 MR. DOERR: I don't need to call more
15 witnesses, thanks.

16 JUDGE KWEE: Okay. And I understand the
17 Franchise Tax Board doesn't have any witnesses; is
18 that correct?

19 MR. HUNTER: No witnesses.

20 JUDGE KWEE: I'd like to see if the panel
21 at this time has any questions for the Franchise Tax
22 Board?

23 JUDGE GEARY: I do not.

24 JUDGE MARGOLIS: I don't believe so, no.

25 JUDGE KWEE: Okay. I believe we're ready
26 to go on to closing arguments. Would the taxpayer
27 like to start?

28 MR. DOERR: Yes.

1 I just want to read from section 1033 one
2 more time. 1033(a), this is IRC 1033(a), if
3 property -- here, the grapevine -- as a result of
4 its destruction, in whole or in part, is
5 involuntarily converted into property similar or
6 related in service or use to the property so
7 converted, no gain shall be recognized.

8 It's exactly that we have here. We have a
9 grapevine which is a property. Some of it was
10 destroyed completely, some of it was destroyed in
11 part. And that was involuntarily through the spray,
12 and the result was a judgment in money. That money
13 was used to purchase replacement property. 1033(a)
14 applies. We're able to use that code section.

15 There was also other damage to the crop.
16 We've heard about in 2002 there was actually grape
17 berries on the vine and those were destroyed. And
18 we're not asking for 1033 treatment for that.

19 Clearly, that is a crop compared to the
20 actual thing that produces a crop, which is the
21 vine. And very distinct and there was very distinct
22 awards for that, too.

23 And in 2002, there's no -- clearly that is
24 not a capital asset, but the vine is a capital asset
25 and it was damaged and it was destroyed and we
26 received money for it and we put that money into
27 other producing property.

28 You probably often hear the form over

1 substance argument. And I think that's exactly what
2 we have here. Form cannot prevail over substance.
3 Regardless of what words were used, this is
4 actually -- the factual nature of this case is
5 pretty simple. If you go through all the trial
6 transcripts, it's not as simple when you look at all
7 the words that were used. We've got special
8 verdicts, we've got words all over the place. Those
9 words were used by trial attorneys to layman juries
10 to try to get money and had nothing to do with tax
11 or how tax consequences should come out. And here
12 again we have a destruction of a capital asset which
13 nobody will deny.

14 If you look through some of the FTB briefs
15 you see some arguments about cotton crops. Cotton
16 crops is much different. It's not a capital asset.
17 The big difference between a capital asset and a
18 noncapital asset if I go and pay a hundred dollars
19 for my cotton crop or my cotton plants, I can deduct
20 that amount. You can't do that with a capital
21 asset. It's appreciated over time. That's why 1033
22 comes into play. We avail ourself to that and that
23 should be respected.

24 JUDGE KWEE: Thank you. Would the FTB like
25 to make their closing arguments?

26 MR. HUNTER: Yes, we would. Thank you.

27 We've heard a lot this afternoon about
28 grapevines and raisin grapes. Just to paint a mind

1 picture here so we can understand this, we have a
2 situation where a taxpayer's in business and he has
3 a machine, a capital asset, in this case grapevines,
4 that produce widgets, raisin grapes, and there's no
5 question FTB's always agreed that these grapevines
6 were damaged.

7 This case centers on the appropriate tax,
8 the correct tax treatment of the award given to the
9 taxpayer by the jury.

10 So if you have another mind picture, let's
11 say you have a big rig truck that's in business.
12 And this truck, the truck is the capital asset and
13 delivers goods and it makes \$60,000 per
14 cross-country trip. And the truck gets in an
15 accident, it's damaged. And the truck has damage to
16 its fender and it's offline for two weeks.

17 The cost to repair the damage could be
18 \$6,000. But it's lost two cross-country trips, so
19 that's \$120,000. And the big rig truck driver
20 receive \$126,000, in a perfect world, in a judgment
21 against whoever caused the accident. Well, there
22 are two separate items of damage; there's \$6,000 to
23 the fender and there's \$120,000 of lost profits.
24 You don't measure the damage to the fender by
25 \$120,000 of lost profits. The damage is what the
26 damage is.

27 In this case the evidence has clearly shown
28 that the appellant sued for damage to his raisin

1 crops that he harvested and sold at market as a
2 separate line item of damages from destruction to
3 his grapevines. His expert has done a damage
4 analysis for tax year 2002, which is still
5 Respondent's Exhibit B, would show that for tax year
6 2002 he estimated appellant lost income from selling
7 raisins of about \$2.35 million.

8 The expert also presented a damage analysis
9 for 2003 onward, which is still Respondent's Exhibit
10 C, which show that for tax years 2003 through 2007
11 appellant estimated a loss of income from selling
12 raisins at 2.85 million.

13 There is a separate line item of 90,000 to
14 purchase replacement grapevines and 109,000 for the
15 additional labor to replant the new grapevines. And
16 that tracks with the testimony this afternoon
17 because that figure comes from \$3.50 per vine to
18 replant 25,000 vines which equals \$90,000 and the
19 cost of labor to plant and train these vines at
20 \$4.25 equals \$109,000. That's total of \$199,000.

21 In this case the jury awarded the taxpayers
22 \$265,000 for that line item and then backed out some
23 cost savings to arrive at a net amount of \$160,000.
24 That's the separate line item for damage to the
25 capital asset, the damage to the machine, the banged
26 up fender on the big rig truck.

27 The evidence has clearly shown that the
28 expert provided testimony at trial, which is now

1 Respondent's Exhibit O. Dr. Nordstrom indicated
2 that he and others walked the rows of the vineyard
3 and assessed damage to the grapevines, with some
4 being a hundred percent healthy, some being 80
5 percent healthy, some being 50 percent healthy, some
6 20 percent healthy, and some grapevines were just,
7 they were toast and they had to be replanted and
8 that's where the cost to repair or replace vines
9 comes from.

10 Dr. Nordstrom also testified that, again,
11 the damage to the loss of raisin crop was the
12 expected production of the raisin grapes, assuming
13 no damage to the grapevines less the amount of
14 raisin grapes that were actually produced.

15 And to break it down further, his testimony
16 at page 2442 of the transcript, he indicated that
17 the harvest for 2002 should have been 3480 tons of
18 raisin grapes, but only 1841 tons were in fact
19 harvested. This left a difference of 1999 tons,
20 which Dr. Nordstrom valued at \$1.067 million.

21 We now have an exhibit in evidence where
22 Dr. Nordstrom just testified that that was the
23 damage to lost raisin crops and he did this by
24 tonnage. The jury in fact awarded appellant \$1.067
25 million for damage to his raisin crop for 2002.

26 At page 2445 of his file testimony he
27 indicated that the harvest for 2003 should have been
28 2917 tons of raisin grapes but only 1839 tons were

1 in fact harvested. This left a difference of 1,078
2 tons which Dr. Nordstrom valued at \$641,000.

3 This is the same testimony from this
4 afternoon at the chart on Exhibit 220 which the jury
5 relied on in the underlying case. The jury in fact
6 awarded the appellant \$640,000, off by a thousand
7 dollars, for damage to his raisin crops for 2003.

8 At page 2448 of the trial testimony, Dr.
9 Nordstrom indicated that the harvest for 2004 should
10 have been 3531 tons of raisin grapes. Only 2436
11 tons were in fact harvested. This led to a
12 difference of 1185 tons, which Dr. Nordstrom valued
13 at valued at \$1.5 million. This afternoon he
14 testified that he presented an exhibit to the jury
15 with this same exact number.

16 The jury in their special verdict awarded
17 this \$1.5 million to appellant for damage to his
18 raisin grape crops that would be harvested and sold
19 at market for tax year 2004. That became the
20 judgment in this case.

21 This tracks. The jury reviewed the
22 evidence, they looked at a chart, they heard the
23 testimony. Nothing was mentioned about damage to
24 the capital asset over and above the cost to repair
25 vines. They looked at what should have been
26 harvested by tons and then what in fact what was
27 harvested in reality as caused by the chemical
28 spray, and this is a lost profits case. That's your

1 case.

2 The evidence has shown at Respondent's
3 Exhibit E, which is the judgment in favor of
4 appellant, that the jury verdict was adopted as a
5 judgment against the defendant chemical company in
6 the underlying case. The evidence has shown that
7 the defendant took the case upon appeal and this
8 judgment was affirmed.

9 The Complaint was filed and we heard
10 testimony this afternoon that things may have
11 changed after the Complaint was filed and damage to
12 the grapevines wasn't really ascertained at the time
13 that the Complaint was filed, but the Complaint was
14 never amended. There's no effort to go back to this
15 jury verdict and say, "Oh, there's something
16 different about this."

17 Everything tracks in line and everything
18 lines up. The jury found specific line items and
19 attributed them for specific items of damage and the
20 tax consequences flow therefrom.

21 The courts look to the jury verdict as the
22 best evidence of the nature or character of the
23 compensation awarded to plaintiff in an underlying
24 case.

25 As stated in Tax Court Memorandum 1993-49
26 BA Miller, the Court said, "We think the jury award
27 provides the clearest indication of the petitioner's
28 claim."

1 You look at why the money was paid.

2 Nancy J. Vincent v. Commissioner, Tax Court
3 Memo 2005-95, which is cited in our opening brief,
4 points out that the ultimate inquiry as to a
5 character of a payment from a jury award rests on
6 payer's intent or dominant reason for making the
7 payment. And then, of course, it also looks at the
8 special verdict form returned by a jury to determine
9 the cause for award. That's exactly what we have
10 here, 13 years ago.

11 Now, in order to support 1033 treatment,
12 the taxpayer has to show damage, measurable damage
13 to the property, property that was placed in
14 service, personal property. Under Internal Revenue
15 Code section 451(d), for example crop insurance
16 proceeds, insurance for payment for damaged crops
17 would be included in the gross income in the year
18 received. Proceeds from crop insurance related to
19 crop destruction or damage are treated as a deemed
20 sale of the crop.

21 Again, you sell something, that's income to
22 the taxpayer. If the taxpayer sells something, it
23 is income to said taxpayer.

24 IRS Publication 225 provides guidance to
25 taxpayers and informs them that losses of plants,
26 produce and crops raised for sale are not deductible
27 when the farmer reports income on the cash method.
28 The taxpayer has already deducted the cost of

1 raising these items as farm expenses, so their basis
2 is equal to zero every year they have expenses when
3 they work around the grapevines and they harvest
4 them.

5 IRS Publication 225 even provides an
6 example. Quote, a severe flood destroys your crops.
7 Because you're a cash method taxpayer and you
8 already deducted -- and already deducted the cost of
9 raising the crops as farm expenses, this loss isn't
10 deductible, as explained above under livestock,
11 plants, produce, and crops raised for sale. The
12 crop loss will reduce your farm income by \$25,000
13 estimated. The loss of future income is also not
14 deductible.

15 In this case the evidence has clearly shown
16 that the damage to raise a crop award was not
17 compensation for damage to property and this jury
18 award was made on specific finding of the amount of
19 lost profits, not property, and therefore it does
20 not support deferral of gain treatment under section
21 1033.

22 In closing, we had a brief that was
23 submitted related to the accuracy-related penalty.
24 There are two defenses that were asserted; one is
25 substantial authority and the other is reasonable
26 cause and good faith.

27 Substantial authority that was submitted
28 was section 1033 that says if you have property

1 that's damaged and then monetized, turned into
2 money, well, you can spend that money on replacement
3 property and defer to gain.

4 But in this case, the evidence has clearly
5 shown all afternoon this is an award for lost
6 profits, lost production of raisin grapes that would
7 be produced and harvested and sold at market. You
8 don't get to Step A for section 1033 treatment.
9 That does not act as substantial authority to
10 support a defense to the accuracy-related penalty.

11 In terms of reasonable cause, the taxpayer
12 must have -- to assert the defense of reasonable
13 cause, the taxpayer must assert, or actually has the
14 burden of proving that they relied on a professional
15 and took a reasonable position on the tax return and
16 did so in good faith.

17 But the only offer of proof in that
18 connection was an excerpt from Dr. Nordstrom's trial
19 testimony in the underlying case. And Dr. Nordstrom
20 was an expert witness retained to provide testimony
21 on economic loss damages. He was not the tax
22 advisor to this taxpayer. The taxpayer's return was
23 prepared by Mr. Rose, a CPA out of Fresno.

24 So there's no reasonable cause, and there
25 certainly isn't any reasonable cause when you have a
26 jury award and you've instructed the jury as to the
27 measure of damage for your lost profits and the
28 taxpayer unilaterally recharacterizes that award as

1 compensation for damage to property. There's no
2 authority for that.

3 Finally, in terms of taking a good faith
4 position on the tax return, the other line item in
5 this case has already been conceded, that's a
6 \$3.9 million line item. And when you have a
7 judgment award of this amount and you take the tax
8 reporting position where you exclude almost the
9 entire amount in gross income, I would submit that's
10 not a good basis for the defense to the
11 accuracy-related penalty. Which, again, was applied
12 mechanically due to the amount of the understatement
13 of income tax.

14 Thank you. I'm here to answer any
15 questions you may have.

16 JUDGE KWEE: Thank you. I believe we do
17 have a question from Jeff Margolis.

18 JUDGE MARGOLIS: Yes. I just have a
19 question for each party. First, for Mr. Hunter.

20 You seem to be saying that the jury has
21 already clearly awarded this 265,955 to repair the
22 vines, and that's your -- your position is that
23 that's the cost to replace the vines, right?

24 MR. HUNTER: That's correct.

25 JUDGE MARGOLIS: But the exhibit that you
26 just gave us today, I'm looking at page 4 of that
27 exhibit, it's page 2342, it has that same 265,955
28 figure, which is characterized as the added cost of

1 working with and around the damaged vines. Which
2 kind of makes me think that maybe this jury verdict
3 is a little screwy as to how they characterized
4 things.

5 MR. HUNTER: What page?

6 JUDGE MARGOLIS: It's page 4 of the exhibit
7 you submitted today. It's the Summary of Losses for
8 2002.

9 MR. HUNTER: Okay. Well, let's take a look
10 at that. So this Chart 1-A of this exhibit, the
11 line reads "market value of actual crop." And it's
12 based on the tonnage that was produced versus what
13 should have been produced, and that is the one --

14 JUDGE MARGOLIS: What page are you reading
15 from?

16 MR. HUNTER: Reading at page 2342, which is
17 page number 4 at the bottom.

18 JUDGE MARGOLIS: Okay. "Market value of
19 actual crop."

20 MR. HUNTER: Right, that's the crop.
21 That's what's produced and then harvested and
22 marketed for sale. If nothing happened and
23 everything was moving along, these raisin grapes
24 would have been harvested, produced, that would be
25 income to this taxpayer. Plus added costs of
26 working within realm of damaged vines, that's labor
27 component. But it's still a separate line item.
28 And this number tracks with the special verdict,

1 which is the cost to repair vines.

2 JUDGE MARGOLIS: But it doesn't -- this is
3 the cost of -- this isn't the cost of repairing the
4 vines. It's actually the cost of working in and
5 around the damaged vines, from this exhibit. This
6 doesn't seem to relate to the \$3.50 per vine to
7 replace or anything. That seems to be something
8 separate.

9 I'm just trying to figure out how this
10 exhibit that you submitted today tracks with the
11 jury verdict.

12 MR. HUNTER: Again, all I can say is that
13 this exhibit was provided to the jury and they
14 arrived at that number. And if the jury verdict is
15 somehow out of sync with, let's say, the
16 description, it's not costs to repair or replace the
17 vines, it's costs of working around the vines, then
18 this easily could have been addressed by counsel in
19 the underlying case.

20 JUDGE MARGOLIS: Okay. Would you like to
21 respond to that particular question?

22 MR. DOERR: To me, when I look at that, I
23 have the same question as you. We have this special
24 verdict and clearly these aren't tax people, they're
25 not trying to apply this for tax reasons. You've
26 got numbers and figures and words all over the
27 place, and it's difficult for us to just look at
28 that and try to determine whether or not a certain

1 part of a verdict should be eligible for 1033.

2 What we really need to do is look at the
3 substance of the underlying matter, which is a
4 destruction of a grapevine.

5 That number that you said, plus added
6 costs, that's throughout, through all the years.

7 JUDGE MARGOLIS: Mr. Doerr, I have a
8 question. In your closing you talked about how the
9 jury verdict has separate amounts and very -- and
10 clearly distinguishes between what the different
11 amounts are for. And you're claiming that the
12 \$3.2 million -- \$3.26 million figure is the amount
13 that the taxpayer was entitled to roll over. And I
14 think you're saying that those are the amounts that
15 the jury awarded for 2002, '03 and '04; is that
16 correct?

17 MR. DOERR: What we were saying here is, at
18 a minimum, the taxpayer is afforded at least 40
19 percent of the verdict, which I think matches the
20 future lost profits. And if you look at my -- in
21 the opening brief -- or I guess it's not in the
22 brief, it's in the appeal. And I think the first
23 footnote, you know, we're not conceding that.

24 What I know for sure is not eligible for
25 1033 is the spray damage to the berries, because
26 we've heard a lot about crop. I mean we just heard,
27 riddled through the closing argument and IRS
28 different publications. We're using crops in two

1 different senses. Crop is the berries, which are
2 the grapes, that is it. They are not the grapevine.
3 These are grapevines, they're like trees.

4 JUDGE MARGOLIS: And which amounts on the
5 verdict form were the damage to the berries?

6 MR. DOERR: If I go to the form -- let me
7 pull it up because I think I have it right here --
8 it would be 2002, because that's the only time the
9 berries existed when the spray was applied. 2002,
10 you've got grapevines in the field in July, they've
11 got berries on it, damage to the raisin crop,
12 \$1,670,106.

13 I'll submit that is the only one I concede
14 relates to the crop in the sense of the crop as
15 being berries.

16 That word is repeated in 2003. And my
17 question is, how can it be damage to a raisin crop
18 in 2003? What that really means is there was loss
19 of production in 2003. There was loss of production
20 in 2004. Loss of production is our measuring stick
21 to say how the vine was actually affected and
22 damaged. That is the capital asset, and its damage
23 can only be measured by lost profits. There's no
24 other way.

25 Dr. Nordstrom said they looked to see if
26 they can buy mature vines. You can't do it.
27 There's no other way to do it.

28 Now it's unfortunate the words that were

1 used. And my theory is that's the only way it can
2 relate to the jury. How else are they going to
3 understand these nuances of what is the damage here
4 when you spray a permanent planting?

5 This is not a cotton crop. Cotton crops
6 die at the end of the season. They replant them,
7 new expense those items. These grapevines can live
8 a century. You know, some of them produce good
9 until 20 years, 25 years.

10 So at the minimum I'll say that 1033
11 doesn't apply to the 1.067, but here the issue was
12 only the 3.6 that we used.

13 JUDGE MARGOLIS: Does the FTB have anything
14 to add since he's gone on quite a bit in answering
15 my question? I'll be glad to let you go ahead and
16 answer or respond.

17 MR. HUNTER: Well, sure. Back to that
18 exhibit, the \$265,000 line item is not included in
19 the gross income in any respect for that tax year.

20 Then the \$3.6 million line item was for
21 future lost profits, which the taxpayer conceded was
22 included in the income. So it can't then again be
23 used as a measuring stick for damage to something,
24 it's already included that. And by that time the
25 vines would be fully mature and producing at a
26 hundred percent.

27 So you have two lines. You have the past
28 lost profits; again, which the jury was told tons of

1 raisin grapes. There's nothing attributed to damage
2 to the grapevines. Tons of raisin grapes that
3 should have been harvested but weren't, and that was
4 \$3.2 million. And \$3.6 million for future lost
5 profits, and that number was reduced at the present
6 value. That's income.

7 So either it's lost profits or it's not.
8 And the evidence before you this afternoon clearly
9 shows that these were lost profits for the sale of
10 the raisin grapes. You don't get to go to section
11 1033 deferral treatment because you don't have
12 property.

13 JUDGE KWEE: I think I have a question, I
14 guess for the taxpayer.

15 Since the testimony today was that the 3.2
16 million was essentially measured by the lost
17 production for 2002, 2003 and 2004, are you saying
18 that the 2 percent, the \$160,000 that was awarded
19 for the cost to repair the vines, are you saying
20 that's too little to compensate for the injury to
21 the vines that was actually suffered? I guess are
22 you saying that the damage to the crop value, the
23 remaining 3.2 million is intended to include some
24 aspect of damage to the vines; if I'm understanding
25 your argument correctly, is that what you're saying?

26 MR. DOERR: Yeah. Except for the damage
27 award for the -- I'm going to say berries, but
28 they're grapes. Except for the damage award for

1 spray that was applied to the grapes and ruined the
2 2002 harvest, everything else is for the injury to
3 the vine itself.

4 Again, in 2003 there was not an injury to
5 the raisin crop. There was some measure of damages
6 based on lack of production, but there was no raisin
7 crop damage. There was just less of it. And why
8 was there less of it? The vine was stunted or there
9 was less vines available to produce the berries that
10 produced the grapes that produced the raisins.

11 So essentially everything goes back to what
12 was damaged? The property. What was the property?
13 It was the grapevine. And that's the award that we
14 have for various years in here, including the future
15 lost profits of which we took \$3.26 million to buy
16 other income-producing property which 1033 allows.

17 I mean if this was something else, if this
18 was a rental house, it's very easy because there's
19 comps. There's just no comps. for raisins. We're
20 trying to find the fair market value here of a
21 grapevine that was damaged and it's impossible to
22 figure that fair market value without looking at
23 loss of production and what that production's worth.
24 And we look at things in terms of profits. But in
25 the tax code what are profits? It's just gain,
26 right?

27 Well, 1033, that's what it says. There
28 shall be no gain. I mean is profit and gain any

1 different? Profit, when you sell a capital asset
2 your gain is your profit. It's the same. It's the
3 same kind of terminology. And here it says there
4 shall be no gain so long as that money from the
5 damage of the property is converted into similar
6 product.

7 JUDGE KWEE: So I guess just what I'm
8 having trouble grasping is supposing that there was
9 no damage, there was no spraying, and the taxpayer
10 actually had produced the grapes, this is --
11 essentially the argument was that they would have
12 received the 3.2 million as profits basically or as
13 return for the sale of the grapes and that would be
14 ordinary income. And I guess I'm just trying to
15 reconcile that with the argument that some portion
16 of that 3.2 million should be characterized as
17 damage to the vine.

18 I guess I'm wondering if you can help me
19 understand.

20 MR. DOERR: I see what you're getting at.
21 When the capital asset is damage and it's
22 income-producing, before it was damaged you have an
23 income-producing asset, and when it produces the
24 income it's taxed as ordinary income; clearly that
25 is.

26 Here, we're using the word "income" to
27 describe measure of damages to the machine itself,
28 and that's why I think there's a lot of confusion.

1 It's a very subtle nuance here.

2 We have a capital asset that was damaged,
3 and the only way we can tell you how much that
4 capital asset was damaged is to refer to the profits
5 that capital asset would have made. Again, because
6 it's a very special item that's a living plant.

7 No problem in real estate. I mean we've
8 given some examples in the briefings. But bottom
9 line is it's just a measuring stick. I mean there's
10 no -- if anybody can find a way to measure the fair
11 market value of what happened here, I mean I'd like
12 to see it. And that's just very difficult to do.

13 And I think Dr. Nordstrom showed us how he
14 did it. He did it through, well, this vine, the day
15 it's planted it has a certain cost of the vine of
16 \$3, that includes the fertilizer, it includes the
17 stick itself. Then after three years of lost
18 production, that's kind of what the value of that
19 vine would have been if you could have found that
20 and stuck it in the ground. And that represents a
21 whole lot more than 2 percent of the total 7.5 jury
22 award, which is our point.

23 And we said 47 percent was all we took, I
24 would submit that it's more than that. Because,
25 again, there was only one injury to a crop and that
26 occurred in 2002 when the berries were sprayed with
27 this poison. That was it. After that we're just
28 referencing profits in a way to make sense of the

1 damage to the canes which now can't produce like
2 they did in the past.

3 JUDGE KWEE: Okay. I'd like to see if the
4 members of this panel have any further questions.
5 Mike?

6 JUDGE GEARY: No questions.

7 JUDGE MARGOLIS: I don't, no.

8 JUDGE KWEE: All right. I guess I did ask
9 some questions of the taxpayer that required some
10 additional responses, so I'd like to see if the
11 Franchise Tax Board would like to ask -- would like
12 to make any comments at this point?

13 MR. HUNTER: No. I think we're done. I
14 mean we've fleshed out the positions of both parties
15 here. We have the award and we're looking at this
16 esteemed panel to apply the proper tax treatment.

17 Thank you.

18 JUDGE KWEE: Mr. Doerr, would you like to
19 make any final comments?

20 MR. DOERR: I would just like to address
21 the damage aspect -- or I'm sorry, the penalty
22 aspect of this. I just can't see how we did not
23 have reasonable cause for this position. I mean
24 basically that would be saying that everything I
25 said today is unreasonable. And I think given the
26 questions that were asked by the judges, this is not
27 an easy decision to make. And clearly we had a
28 position and we've made that position, and to say

1 that it's an unreasonable position, I just take
2 offense to that.

3 JUDGE KWEE: Okay, thank you.

4 We're ready to close and submit this case
5 on February 26th, 2018. The record is now closed.

6 Thank you everyone for coming in today.
7 The judges will be meeting and deciding your case
8 later on and we will send you a written opinion of
9 our decision in the next 100 days.

10 Today's hearing is now adjourned. Thank
11 you.

12 (Whereupon the proceedings concluded at
13 3:04 p.m.)

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I, Kathleen Skidgel, Hearing Reporter for the California State Office of Tax Appeals certify that on February 26, 2018 I recorded verbatim, in shorthand, to the best of my ability, the proceedings in the above-entitled hearing; that I transcribed the shorthand writing into typewriting; and that the preceding pages {PAGES} constitute a complete and accurate transcription of the shorthand writing.

KATHLEEN SKIDGEL, CSR #9039
Hearing Reporter