

HEARING
OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Franchise/

Income Tax Appeals Hearing of:

B.B.C.A.F, INC.,

OTA Case No. 18011333

Appellant.

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REPORTER'S TRANSCRIPT OF PROCEEDINGS

WEDNESDAY, MAY 29, 2019

10:28 A.M.

OFFICE OF TAX APPEALS
400 R Street
Hearing Room
SACRAMENTO, CALIFORNIA 95811

Reported by Peter Petty

APPEARANCES

Panel Lead:

JEFFREY MARGOLIS, ADMINISTRATIVE LAW JUDGE

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OFFICE OF TAX APPEALS
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TOMMY LEUNG, ADMINISTRATIVE LAW JUDGE

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YELENA KUZNETSOV, AUDITOR
STATE OF CALIFORNIA

Also Present:

KATHY FREEMAN, WITNESS

DANIELLA CALDWELL, PRICEWATERHOUSECOOPERS, LLP

EXHIBITS

	PAGE
Appellant's 1-14	10
(Exhibits premarked, described and retained by Administrative Law Judge.)	
18	64
Respondent's A - I	10

1 WEDNESDAY, MAY 29, 2019 - 10:28 A.M.

2 ALJ MARGOLIS: Okay. We are on the record in the
3 appeal of B.B.C.A.F, OTA Case Number 180111333. The date is
4 May 29th, 2019, and the time is 10:28.

5 This hearing is being held in Sacramento, California
6 before Judges Jeffrey Margolis, Kenny Gast, and Tommy Leung.

7 Would the parties and their representatives identify
8 themselves for the record starting with the taxpayer.

9 MR. KAPLAN: Edward Kaplan, Counsel for the taxpayer.

10 MS. FREEMAN: Kathy Freeman, witness for the
11 taxpayer.

12 MS. CALDWELL: Daniella Caldwell, representative of
13 the taxpayer.

14 ALJ MARGOLIS: For the FTB.

15 MS. ISKANDER: Irina Iskander, Tax Counsel IV for the
16 Franchise Tax Board.

17 To my left we have Craig Swiesco, Assistant Chief
18 Counsel for the Multistate Tax Division. And Michael Cornez,
19 who is a Tax Counsel V.

20 ALJ MARGOLIS: Okay. Thank you.

21 MS. ISKANDER: We should probably -- we should
22 probably also state that we have two more representatives, an
23 auditor, introduce himself. And also another attorney to
24 discuss procedural issues, if necessary, is Brian Werking.

25 ALJ MARGOLIS: Okay. That's fine. I would hope, I

1 know -- I'm not sure if I said this in advance but I hope
2 when it comes to the examination of witnesses, you can limit
3 yourself to having one attorney question a witness rather
4 than do any sort of tag teaming of the witness.

5 MR. KAPLAN: That is our plan.

6 ALJ MARGOLIS: Okay. Thank you.

7 Okay. So let me go over the issues in dispute. The
8 parties have agreed that the issues, that if -- they've asked
9 us to decide or whether the FTB's interest expense
10 adjustments constitute a new matter such that OTA should
11 prohibit the FTB from raising that issue. Or alternatively,
12 that FTB should bear the burden of proof on its
13 determination.

14 The second issue is whether the interest expenses
15 deducted by Appellant must be allocated between his in-state
16 and out-of-state nonunitarian barter -- nonunitarian
17 investments. And whether once the expenses allocated to the
18 out-of-state investment should be disallowed. If an
19 allocation is required, how should that allocation should be
20 performed.

21 The final issue is whether interest on any
22 deficiencies that might be determined in this matter should
23 be abated or suspended for any period of time.

24 Does that -- does that accurately state the issues to
25 be decided, Mr. Kaplan?

1 MR. KAPLAN: It does, Your Honor.

2 ALJ MARGOLIS: Ms. Iskander?

3 MS. ISKANDER: Yes, it is.

4 MS. FREEMAN: This is Kathy Freeman. There is one
5 additional issue that was raised as an offset issue during
6 this process which you know the application of the interest
7 offset under 24344(b) should apply.

8 ALJ MARGOLIS: Oh, thank you. You're right. That's
9 correct. It's where an interest offset should apply, that's
10 correct. That's an additional issue --

11 MS. FREEMAN: Yeah.

12 ALJ MARGOLIS: The loan time is raised.

13 MS. FREEMAN: And it is raised as an offset. We
14 realized it was raised later in the process and it can't
15 result in a refund.

16 ALJ MARGOLIS: Okay. And I believe there are no
17 stipulations; is that correct? I have no further
18 stipulations? Let's see.

19 Oh, there's one stipulation that if it is determined
20 that an apportionment of the interest expense, it should be
21 based on the original cost of the properties that of the
22 in-state property versus total property. That the in-state
23 costs represents 27.6 percent of the total cost of the
24 properties.

25 MS. ISKANDER: Well, again, that percentage was

1 calculated without knowing that a California property was
2 purchased prior to the loan. So I'm not sure how we would
3 address this.

4 ALJ MARGOLIS: Okay. I --

5 MS. ISKANDER: Because this was not our position and
6 this is not something that we argued was our position.

7 ALJ MARGOLIS: Okay. I understand.

8 MS. ISKANDER: So if you -- if there is a -- you
9 know, whether or not 27.6 percent is accurate representation
10 of cost basis. It is an accurate representation of cost
11 basis whether or not it actually goes to the allocation and
12 should be used under the law, this is the question. Because
13 the allocation is required to be based on two -- on two
14 factors which I will discuss during the argument.

15 ALJ MARGOLIS: Okay. Will you also address in your
16 argument whether this new fact that was raised in
17 Mr. Kaplan's brief about the loans being made after the
18 acquisition?

19 MS. ISKANDER: Of one of the properties.

20 ALJ MARGOLIS: Of one of those properties. How does
21 that affect your position in chief of the allocation of the
22 couple of months --

23 MS. ISKANDER: Should I address it now?

24 ALJ MARGOLIS: No. But will you be addressing that
25 when you get to your argument?

1 MS. ISKANDER: If I have to.

2 ALJ MARGOLIS: Okay. Okay, then let's go over the --
3 the exhibits. Parties have agreed that what was marked in
4 the -- in the prehearing binder that was sent to both parties
5 prior to the hearing that Exhibits Nos. 1 and 2 will be
6 admitted. That Exhibit 3 will be admitted for discussion
7 purposes only. Exhibit 4 will be admitted for discussion
8 purposes only. The Exhibit 5, the cover e-mail will be
9 admitted as argument only.

10 Is that correct so far before we continue?

11 MR. KAPLAN: Yes.

12 MR. CORNEZ: Yes.

13 ALJ MARGOLIS: Okay. Exhibits 6 through 14, they
14 will be admitted without objection. And Exhibits 15 through
15 17 will be admitted but the FTB does not concede the accuracy
16 of the figures; is that correct?

17 MR. CORNEZ: Correct.

18 ALJ MARGOLIS: Okay. And Exhibit 18, the K-1s and
19 tax documents themselves will be admitted without objection.
20 But the tax documentation scenarios will be admitted but the
21 FTB does not concede their accuracy. Is that correct with
22 respect to Exhibit 18?

23 MR. CORNEZ: Correct.

24 (Exhibits admitted into evidence)

25 ALJ MARGOLIS: Okay. Now moving on to Respondent's

1 exhibits. There's no objection to Exhibits A through H.
2 They will be admitted, correct?

3 MR. KAPLAN: Correct.

4 ALJ MARGOLIS: Then for Exhibit I, that will be
5 admitted but the taxpayer does not necessarily agree to the
6 accuracy of the numbers in that exhibit; is that correct?

7 MR. KAPLAN: Also correct, yes.

8 ALJ MARGOLIS: Okay. These exhibits will all be
9 admitted subject to the qualifications that we discussed in
10 the record.

11 (Exhibits admitted into evidence)

12 ALJ MARGOLIS: And each side has one witness to my
13 understanding, correct?

14 MS. ISKANDER: Correct.

15 MR. KAPLAN: Danni Caldwell is here, we don't intend
16 to call her as a witness but we have her here. She has great
17 familiarity with the computations and the issues in the event
18 a question comes up that either I cannot respond to or Kathy
19 Freeman, our designated witness can respond to, we would like
20 the opportunity to allow Danni to jump in.

21 ALJ MARGOLIS: That's fine. That's fine. And
22 Ms. Iskander, you have --

23 MS. ISKANDER: We have one witness.

24 ALJ MARGOLIS: -- one witness? Okay. Thank you.

25 Now we're ready for opening statements. Each side

1 will have 30 minutes. I know that the panels got lots of
2 questions. We will try to hold -- may ask questions during
3 the opening, but for the most part, we'll try to wait until
4 both sides are done.

5 Mr. Kaplan, you may begin whenever you're ready.

6 MR. KAPLAN: Before I begin in the substance of my
7 opening statement, I would like since this is on the record
8 and will be in print and in posterity forever, I would like
9 it reflected that today's Kathy Freeman's birthday and I'd
10 like the state of California to acknowledge the fact.

11 ALJ MARGOLIS: Okay. I will knock that off your
12 time.

13 MR. KAPLAN: Thank you.

14 ALJ MARGOLIS: Happy birthday, Ms. Freeman.

15 MS. FREEMAN: Thank you.

16 MR. KAPLAN: Okay. This matter involves five tax
17 years, 2005 through 2009. The Notice of Proposed Assessment
18 with respect to the 2005 and 2006 years was issued on
19 February 17, 2011. A little more than a year later on
20 May 9th, 2012, another Notice of Proposed Assessment was
21 issued for the 2007, 2008, and 2009 tax years. Each of those
22 notices was protested and after the parties were unable to
23 resolve the issues during the protest stage, Notices of
24 Action were issued for all five years on September 28, 2015.

25 Appellant filed a timely appeal on October 28, 2015

1 after the statute of limitations for assessment had expired
2 for all tax years involved. The Notices of Action for each
3 of the five years involved two separate issues, both of which
4 were appealed to the Board of Equalization and transformed
5 into the current action before the Office of Tax Appeals.

6 The first issue was whether the taxpayer is separate
7 investments in real estate ventures are independent
8 activities or a single trader business requiring it to be
9 taxed on a unitary basis.

10 The second issue was whether cash advances made to
11 the taxpayer by its sole shareholder were bona fide loans as
12 the taxpayer claimed and reported or capital contributions.

13 A third issue was initially present in the Notice of
14 Proposed Assessment with respect to 2006, whether the
15 taxpayer was entitled to tax deferred exchange treatment
16 under Section 1031 or whether the disposition of its interest
17 in certain relinquished property was properly subject to
18 immediate tax. This issue was conceded by the Protest
19 Hearing Officer prior to the issuance of the Notice of Action
20 for 2006 and is not before this panel.

21 Again, this appeal was filed on October 28, 2015. In
22 the hopes of being able to resolve both the unitary and debt
23 equity issues without the need for formal hearing, the
24 taxpayer did not object to extensions for the Franchise Tax
25 Board's filing of its opening brief while discussions took

1 place. In that opening brief filed on December 20, 2016, the
2 Franchise Tax Board conceded both of the remaining appealed
3 issues in full in effect resolving all of the audit
4 adjustments in favor of the taxpayer. It agreed that the
5 taxpayer was not unitary and did not have to file returns on
6 that basis and it agreed that the cash advances made to it
7 were bona fide debts, not equity investments and therefore
8 agreed that the taxpayer was entitled to treat repayments
9 back to its sole shareholder as deductible interest and not
10 as nondeductible dividends.

11 Although dismissal of this action should have
12 resulted from the concessions of the only two issues
13 appealed, instead the Franchise Tax Board raised a new issue
14 for the first time in its opening brief. Specifically, the
15 Franchise Tax Board asserted that although it now finally
16 agreed that the taxpayer was entitled to claim interest
17 expense deductions, such deductions should be limited to the
18 taxpayer's indebtedness used to invest in California
19 properties. In other words, the Franchise Tax Board now
20 argued for the first time an entirely new and distinct issue
21 from those previously raised at audit, that the taxpayer's
22 interest expense deductions should be allocated between the
23 states in which property was zoned and not allowed to be
24 fully deducted from its California income. Taxpayer asserts
25 that this constitutes an entirely new issue raised after the

1 statute of limitations expired and the Franchise Tax Board
2 should be precluded from raising it at this time.

3 This issue was not raised in the Notice of Proposed
4 Assessment on February 17, 2011 after years under audit, nor
5 was it raised in the subsequent notice of proposed assessment
6 issued May 9, 2012. Franchise Tax Board does not argue here
7 that it was in any way precluded from raising this issue
8 during the lengthy examination process. Further, this issue
9 was not raised or discussed in any fashion during the
10 following four years that the matter was before the protest
11 unit. Again, there was no assertion here that the Franchise
12 Tax Board was somehow precluded from raising this issue at
13 the protest level.

14 What the Franchise Tax Board does argue is that in
15 raising this issue more than a year after the taxpayer's
16 appeal had been filed for all five years, that this is not a
17 new issue. And that all of the information necessary for its
18 delayed determination was in hand. That the facts necessary
19 to an analysis and determination of this issue did not
20 require presentation of additional or different evidence.
21 Such an argument, however, only emphasizes the injustice that
22 would result from allowing this issue to be raised now.
23 There is no dispute that the Franchise Tax Board had every
24 opportunity, with all of the taxpayer's information in hand
25 to raise this issue as an alternative to the question of debt

1 versus equity. But it did not do so. Not at the examination
2 level, not at protest.

3 It is not uncommon for a taxing agency to assert
4 alternative theories with respect to the proper treatment of
5 a particular item, but that is not what occurred here. By
6 statute a Notice of Proposed Assessment is required to inform
7 the taxpayer of the basis for the Franchise Tax Board's
8 assertion that additional tax is owed. Once issued, the
9 Franchise Tax Board's published policy provides that new
10 issues should rarely be pursued after audit and in no -- and
11 in no circumstance will they be allowed to increase the
12 amount of tax originally stated as due. It is akin to a
13 statute of limitations. If a party has something to say,
14 there are timelines within which it must be said.

15 The question of whether advanced funds are properly
16 characterized as debt or equity is entirely different than
17 the question of the appropriateness of an allocation of
18 interest expense deductions. Debt versus equity looks to the
19 character of the transactions to determine which set of rules
20 to apply. Allocation of an expense, however, is not
21 character based. It is much more than accounting issue and
22 involves a completely different analysis of a completely
23 different set of facts. Further, there is question as to
24 whether all the necessary information was truly at hand. The
25 Franchise Tax Board's opening brief references the additional

1 information provided by the taxpayer subsequent to the filing
2 of this appeal. While this additional information led to
3 respondent's concession on the unity and debt versus equity
4 issues, it is now being relied upon in part to support its
5 new issue. The legal division should not be allowed to
6 engage in a new examination of the taxpayer's return after
7 the statute of limitations expires. This is not an instance
8 where fraud or misconduct was discovered unknown at earlier
9 stages of the procedural process.

10 The Franchise Tax Board also argues the question of
11 interest expense allocation is not a new issue and that under
12 its position, if correct, it does not result in an increase
13 in tax that would be owing beyond what is asserted in the
14 Notices of Action. But this is also not quite true as can be
15 seen and what is marked as Exhibit 3 as well as the new
16 Exhibit I, I believe it is. Under the Franchise Tax Board's
17 methodology for allocating interest expense deductions in at
18 least two of the five years, the resulting tax would be
19 significantly greater than that shown on the Notices of
20 Action. Granted the Franchise Tax Board agrees that it is
21 not entitled to that increase, but that is for policy reasons
22 and not prohibited by statute. In other words, to borrow
23 from the terminology used in criminal matters, the allocation
24 of the interest expense deduction is not a lesser included
25 defense -- offense of the determination of whether the

1 character of the cash advance is debt or equity. This
2 allocation issue should not be allowed to be raised at this
3 stage under the circumstances of this case.

4 In the event that the Franchise Tax Board is allowed
5 to raise this allocation issue, two new corollary issues
6 arise. The first is which party has the burden of proof. As
7 this panel is aware, the issue in dispute is whether an
8 allocation is required. If so, the question then turns to
9 the methodology to be used in making such an allocation.
10 Obviously it is the taxpayer's position that the burden lies
11 with the Franchise Tax Board on both of these questions.

12 A second corollary issue is potentially lurking
13 applicable only if this panel ultimately determines that
14 additional taxes owed in any particular year. Interest would
15 accrue on any such deficiency normally from the date the tax
16 return was due until the date of payment of that tax. Here,
17 in light of the fact that the taxpayer was never made aware
18 of the issue that would result in additional tax owing until
19 the Franchise Tax Board filed its opening brief on
20 December 22, 2016, never had an opportunity to discuss this
21 issue with either of the examination agent or the protest
22 hearing officer, the taxpayer should not suffer the effect of
23 the interest accrual during the entire time this matter has
24 been at issue.

25 Under Revenue and Taxation Code Section 19116(b)(1),

1 as in effect for all years at issue here, interest on tax
2 deficiencies is to be suspended starting 18 months after the
3 filing of the return starting up again only when the
4 taxpayer's notified that the Franchise Tax Board believes
5 additional tax is owed and why. In this case, the earliest
6 interest would properly start to accrue again would be the
7 December 22, 2016 date that the Franchise Tax Board notified
8 the taxpayer of this new issue.

9 MARGOLIS: That date again, September or December?

10 MR. KAPLAN: December.

11 MARGOLIS: December 22nd, '16 again.

12 MR. KAPLAN: 2016.

13 Because she is able to explain the interest deduction
14 and allocation rules far more intelligently than I can, I've
15 asked Kathy Freeman, formally from PWC as well as from the
16 Franchise Tax Board, to be here to discuss the details of
17 this aspect of the case. Kathy was intimately involved in
18 our discussions with the Board on this issue and oversaw the
19 tax computations for the taxpayer under the various
20 methodologies being discussed. Without trying to step on her
21 toes, I will let Kathy explain more about why the statute of
22 limitations has expired prohibiting the raising of this new
23 issue as well as why no allocation at all is warranted in
24 this action. If it is, Kathy will explain why the allocation
25 is to be done after determining the taxpayer's net income,

1 that is after offsetting its income by its interest expense
2 to determine its net income and then allocating only any
3 excess.

4 Finally, Kathy will explain why the authorities cited
5 by the Franchise Tax Board to support its position are simply
6 inapplicable to the facts of this case. Each of the
7 authorities relied upon deal with the proper treatment of
8 expenses attributing -- attributable to generating tax exempt
9 income. Franchise Tax Board has tried to shift the focus to
10 Revenue Procedure 72-18, but that is the wrong place to look.
11 The IRS explained the purpose of this revenue procedure in
12 its Revenue Ruling 2004-47. I'm going to read now just the
13 first few lines of the law and analysis section of Revenue
14 Ruling 2004-47. This is the IRS's own explanation of this
15 revenue procedure: In general, a deduction is allowed under
16 Section 163 of the Code for all interest paid or accrued on
17 indebtedness. Under Section 265(a)(2), however, no deduction
18 is allowed for interest on indebtedness incurred or continued
19 to purchase or carry obligations the interest on which is
20 wholly exempt from Federal income taxes. Revenue Procedure
21 72-18 sets forth guidelines on the application of Section
22 265(a)(2).

23 Again, we do not have tax exempt income in this -- in
24 this matter. We have no quarrel with the authorities cited
25 by the Franchise Tax Board. Only with the relevance to this

1 case. They simply have none. And again if this -- if this
2 issue is allowed to go forward, the Franchise Tax Board has
3 the burden of proof every step of the way. Franchise Tax
4 Board has relied on Revenue and Taxation Code Section 24425
5 as the basis of allocating interest expense in this case and
6 has not relied on CCR Section 25120, little D in parenths.

7 While the Revenue and Taxation Code cite at 24425 may
8 have relevance with respect to income excluded from the
9 measure of tax, no such income exists in this case. There is
10 no tax exempt income. The Franchise Tax Board, after being
11 silenced on the two issues appealed to the Board of
12 Equalization, continues to bark. But it's barking up the
13 wrong tree. Accordingly, absent relevance to the expense
14 allocation at hand, Franchise Tax Board position should not
15 be rejected if it is even allowed to be considered by this
16 panel.

17 Thank you, Your Honor.

18 ALJ MARGOLIS: Thank you.

19 MS. FREEMAN: Your Honor, this is Kathy Freeman and
20 I'm going to elaborate on his argument but more of a
21 technical basis.

22 So basically in this case, the taxpayer's audited for
23 two cycles and three adjustments were made. The first issue
24 was ==

25 ALJ MARGOLIS: One second, Ms. Freeman. Is anything

1 wrong with that microphone? Okay, continue.

2 MS. FREEMAN: You need me to scoot over? Sorry.

3 So there were -- there were three issues. The first
4 issue is based on whether a unitary business existed under
5 25101, Revenue and Taxation Code. The second issue was
6 whether money contributed to the taxpayer was debt or equity
7 and that was an adjustment based on Revenue and Taxation
8 Code, Section 24344(a), and -- which is California's
9 conformity to IRC Section 163 which relates to interest
10 expense deductions. And the third issue was the validity of
11 a like-kind exchange adjustment for 2006.

12 Procedurally at protest, the like-kind exchange
13 adjustment was withdrawn, meaning just the first and second
14 issues' at hand. During their discussions after the appeal
15 was filed, the FTB has conceded both issues that were
16 appealed. The issue of whether there was a unitary business
17 between the partnerships holding the properties and the
18 deductibility of the interest under IRC Section 163. So all
19 of the issues were conceded.

20 The reliance of the primary issue, what's in dispute
21 here is a 24344(b) issue -- or a (a) issue, whether it's
22 deductible interest. What was raised in the FTB's brief
23 filed in December of 2016, which was by the way filed after
24 the statutory of limitations expired, was a new issue based
25 on 24425. Using an expense allocation under Rev Procedure

1 72-18 to allocate interest between the various partnership
2 investments in the real property.

3 So our position, first and foremost, is that it is a
4 new issue similar to what happened in ComCON where they
5 raised a sales factory issue and the court denied it even
6 though it was related to the issues at hand. This was a new
7 issue based on a new statute and it was barred by the statute
8 of limitations.

9 We believe in this case that raising a 24425 issue is
10 not permitted. We believe that you could perhaps raise a new
11 theory under 24344(a), how to disallow the interest, but
12 24425 is a different issue where allocating interest expense
13 to exempt income. We believe, further, and we're not arguing
14 FTB's case that if an expense allocation is warranted it
15 should have been done California Code of Regulations Section
16 25120(d) which provides --

17 ALJ MARGOLIS: D as in dog?

18 MS. FREEMAN: D as in dog, which provides for and I
19 can read it to you. I actually wrote it down.

20 ALJ MARGOLIS: We're familiar with it.

21 MS. FREEMAN: Okay. It does provide for the
22 allocation of expenses to -- between business income and
23 nonbusiness income, or between business, different trades or
24 businesses, or between various nonbusiness investments. And
25 what it says in there is you use a reasonable method. There

1 is no set way to do it and actually if you read the FTB's
2 audit manual, they provide various means to allocate the
3 interest based on a reasonable method. In this case, the FTB
4 is insisting on either based on the original investment or
5 changing investment over time for these partnership interest.
6 We proposed if one were warranted under 24120(d), we don't
7 believe any adjustments warranted under 24425 because we
8 don't have exempt income that were believed that based on
9 cash flow ability pay -- repay the debt which was the basis
10 for the loan itself and all the documents we discussed that
11 they lent us the money based on our ability to repay which is
12 based on cashflow.

13 We had provided that analysis on the ability to pay
14 in the documents that we provided. And that would be a
15 reasonable method based on the FTB's own MAPM -- or MATM
16 manual. And it's in section 4060.

17 So even if an allocation was warranted, the FTB is
18 citing the wrong section and has not raised 25120(d) in any
19 of its briefs as a means to allocate the interest. So if
20 24425, which is allocating interest expense among its
21 investments, is not the proper authority, the FTB has not
22 raised the proper grounds to allocate the interest and their
23 argument should fail based on lack of arguments within the
24 statute of limitations. I would go further to say that
25 Revenue and Taxation Code Section 24425, California for

1 franchise tax purposes doesn't have exempt income and the
2 only time you actually see this issue raised is for dividend
3 deductions under RC, or sorry, RNTC Section 24410 related to
4 the insurance dividend deduction. You don't see it for 24411
5 which is a 75 percent DRD because it is separate interest
6 allocation for that purpose under 24344(c) and you don't see
7 it for the dividend eliminations because there isn't a
8 provision to allocate interest when there's eliminations.

9 So we don't think the FTB has raised the right
10 arguments to achieve an offset in this case or an allocation.

11 And I think our final argument here is that even if
12 they were to be sustained, the interest offset under 24344(b)
13 should be applied in this case as an offset issue. The FTB
14 has raised the fact that they believe an offset is required.
15 It should be done after you allocate the interest expense
16 between California and non-California investments. However,
17 if you look at 24344(c), that allocation itself is done
18 before you consider business and nonbusiness income.

19 Further if you read into 25106.5, the FTB has
20 reserved and provided no guidance on this. So we believe
21 that the 24344(b) allocation for the interest offset should
22 be done consistent with the allocation under 24344(c) which
23 also does the allocation before consideration in nonbusiness
24 income.

25 ALJ MARGOLIS: Is that it?

1 MS. FREEMAN: Yeah.

2 ALJ MARGOLIS: Thank you very much.

3 Ms. Iskander.

4 MS. ISKANDER: Good morning again.

5 ALJ MARGOLIS: Good morning.

6 MS. ISKANDER: To see this case for what it is and it
7 is really not a complicated case, it's important to keep in
8 mind the original issues in this appeal and how the
9 resolution of those issues still resolve within this hearing.

10 This appeal was first filed during audit -- was first
11 filed because during audits and protests, undocketed
12 protests, respondent disagreed with Appellant's filing
13 position and determined that first, Appellant and its pass
14 through entities constituted the single unitary business
15 subject to UDITPA apportionment and allocation rules. And
16 second, that the 156 million funds that Appellant received
17 from its UK parents, Pension Trust, owned by British
18 Broadcasting Corporation, also known as BBC, for
19 contributions and not loans to Appellant.

20 As a consequence of treating funds as contributions,
21 Respondent denied interest expense deduction associated with
22 the funds in full, during audit and during undocketed
23 protests. Appellant disagreed with Respondent's positions
24 and appealed. In it's opening brief, Appellant stipulated
25 that it was organized by BBC Pension Trust as an invalid

1 corporation, that was an entity with no employees, and it had
2 business office in United States, that it was formed to
3 facilitate BBC Pension Trust investments in U.S. real estate
4 and not to engage in active trade or business here.

5 Rather Appellant's business consisted of passive
6 ownership of the investments. In fact, Appellant stipulated
7 that it functions essentially as a holding company that
8 oversees its investments and it is nothing more than an
9 investor with oversight rights related to its investments as
10 opposed to inactive participant in operational management of
11 any of those investments. Essentially Appellant held
12 interest in limited partnerships, LLCs, and tenancies-in-
13 common, as a limited partner, or a nonmanaging member or
14 tenant.

15 Each pass-through entity owns a separate commercial
16 real estate. Each real estate is located within a single
17 state. All aspects of each pass-through entities are managed
18 by Grosvenor, a nonrelated entity and the partner in these
19 investments. Appellant relied entirely upon Grosvenor for
20 operation and management of its properties. Point of
21 ministrations -- administrative fee, Grosvenor also provided
22 accounting, auditing, and tax functions for the investments.

23 As for earning income, in its opening brief,
24 Appellant stipulated that Appellant's income is solely
25 attributable with distributive share generated from rental

1 activities of partnerships. That there is nothing from the
2 operation of one of the taxpayer's property interest that
3 affects, positively or negatively, its other property
4 interest conducted inside or outside of the state. As far as
5 its interest in real properties located in and outside of
6 California, Appellant also stipulated that if pass-through
7 interests are distinct from each other as they do not
8 cross [indiscernible] in one minute or another, there is no
9 part of any pass-through interest contributes or depends on
10 any parts of the other pass-through interests.

11 Based on this Appellant's stipulations and
12 corroborating evidence that Appellant provided during this
13 appeal process and this is the additional evidence that
14 allowed Respondent to agree with Appellant, that Appellant
15 was not engaged in unitary business with its pass-through
16 entities and that each of his pass-through interests
17 contributed -- constituted, I'm sorry, a separate trade or
18 business generating income source to a single state.

19 This Respondent's concession is particular important
20 because it puts the question of the UDITPA provisions
21 application in this case to rest. As Appellant is not
22 engaged in unitary business that generate income with or
23 without California, Appellant is not subject to UDITPA
24 apportionment allocation provisions, which I covered in
25 Revenue and Taxation Code 25120 through 25140.

1 The second issue originally on appeal involved
2 specification of 156 million of funds Appellant received from
3 its parent, BBC Pension Trust, as either debt or equity.
4 Once funds are classified in one way or another, certain tax
5 consequences follow naturally based on governing law. If
6 funds add in capital contribution, the tax consequence is
7 there can be no interest deduction that is associated with
8 the funds. If funds are loans, the recipient is entitled to
9 the interest expense deduction but only to the extent that
10 interest deduction is attributable to taxable in California
11 [indiscernible].

12 In attempt to resolve this appeal, Respondent agreed
13 to treat 156 million in funds from BBC Pension Trust to
14 Appellant as loans. Again, because the loans were
15 reclassified, because the funds were reclassified as loans,
16 California will mandate that certain tax consequences follow.
17 Tax consequences here are part and parcel of
18 reclassification. And Respondent is not free to ignore the
19 law that reclassification triggers automatically. But as it
20 stands today, while Appellant agrees with reclassification,
21 it argues that Respondent should be precluded from enforcing
22 the tax consequences that tax law mandates.

23 As such, despite FTB's concession on both issues, the
24 actual issues before this appeal is a procedural issue of
25 whether by merely respecting the consequences associated with

1 treatment of funds as loans during the appeal. FTB is
2 raising a new issue and must carry the burden accruing the
3 tax consequences.

4 And the second substantive issue is whether and to
5 what extent should Appellant interest expense deduction be
6 allowed against its California income. There is also an
7 interest expense issue, the interest on assessment issue that
8 we will address as well. As to procedural issue on whether
9 the issue is new or not, the application of tax consequences
10 following a change in treatment of funds from contributions
11 to loans cannot be new issue. In view of Mendelsohn, Board
12 of Equalization ruled that an issue is not new if it does not
13 increase tax and it does not require introduction of the new
14 evidence or facts.

15 A tax consequence of allowing a previously disallowed
16 expense mathematically cannot resolve in more tax because
17 allowance of a deduction previously disallowed reduces
18 taxable income. And application of tax consequences does not
19 require an introduction of new facts. The same facts that
20 allowed Respondent to treat funds either as loans or
21 contributions determine the consequence of the
22 classification. As those facts did not change from audit,
23 Respondent's assessment of the same facts changed, not the
24 facts. Therefore, by enforcing California law and the
25 correct tax consequence, Respondent is not raising an issue,

1 a new issue. However, for the sake of the argument, FTB will
2 proceed as if the issue was new. Under Mendelsohn, this
3 merely means that the burden of proving the extent of the
4 allowed deduction would have shifted to the FTB. Having
5 evidence on file provide FTB and this panel with sufficient
6 reasons of establishing the need for limiting the extent of
7 Appellant's interest expense deduction.

8 We'll first start with the law. California Revenue
9 and Taxation Code 24425 specifically imposes a matching
10 principle between income and deduction. In essence that
11 section directs that expenses incurred and generated -- in
12 generation of income excluded from California tax base should
13 also be excluded from California. Notably allowing expenses
14 unrelated to generation of California income would
15 effectively resolve in a double deduction. First in the form
16 of the included income and second in the form of reducing
17 included income but unrelated to the income expenses.

18 Now looking at the structure of California Revenue
19 and Taxation Codes, Articles 1 through 3 of Chapter 7 part 11
20 is instructive in calculation net income for California
21 purposes. Revenue and Taxation Code 24341 defines net income
22 as gross income computed under Chapter 6, less the deductions
23 allowed under this Article and Article 2, commencing with
24 24401. Article 1 and 2 cover various allowable deductions.
25 Article 3 of the same part specifies items not deductible.

1 Article 3 begins with Revenue and Taxation Code 24421 which
2 states that in computing net income of taxpayer under this
3 part which includes Article 1 and Article 2, no deduction
4 shall be allowed for the items specified in this article,
5 Article 3. Specifically therefore Article 3's directs for
6 exclusion of certain deductions notwithstanding Article 1 and
7 2. Furthermore, Subsection A of Revenue and Taxation Code
8 24425 specifically states that no deduction shall be allowed
9 for any amount otherwise allowable as deduction which is
10 allocable to one of more classes of income not included in
11 the measure of tax imposed by this part, regardless of
12 whether income was received or accrued during the taxable
13 year.

14 In appeal of Signal International, the Board of
15 Equalization held that RTC Section 24425 controls over
16 Revenue and Taxation Code 24344 which addresses the allowable
17 deductions for interest expense. The Board Equalization
18 stated: the overriding language of revenue and taxation code
19 24425 compels us to conclude that the section is controlling
20 over section 24344.

21 We have previously reached that same conclusion with
22 respect to predecessor of these two sections. Furthermore, a
23 few years later, California Supreme Court also took a closer
24 look at Revenue and Taxation 24425 in Greater Western
25 Financial Corporation. In Great Western, a taxpayer after

1 deducting certain dividends from his gross income, pursuant
2 to 24402, excluding the deduction portion from California
3 measure of tax, sought to also deduct the interest expense
4 attributable to the excluded income dividends -- from the
5 excluded from the income dividends. While Respondent allowed
6 for the dividend increase of deduction, it applied Section
7 24425 to denied the deduction for the expenses attributable
8 to the excluded income. California Supreme Court, the trial
9 court ruled for the taxpayer and the Supreme Court--
10 California Supreme Court reversed and remanded emphasizing
11 the broad nature of Revenue and Taxation 24425. Section -- it
12 says: Section 24425 is operated whenever income is
13 eliminated from the measure of tax under any authority for
14 any purpose. It states with incontestable clarity that items
15 not deductible when allocable to income not included in the
16 measure of tax. The purpose of this section is to prevent a
17 double exemption.

18 So evidence, this is the law and the law mandates
19 that 24425 trumps 24344. Now where they do have in evidence
20 to support the fact that some of the interest deduction is
21 not related to production of interest -- production of income
22 from investments. Evidence in file supports the finding that
23 Appellant borrowed 156 million from its parent and invested a
24 big chunk of the funds in assets that do not generate
25 California income. First Appellant stipulated that it is a

1 passive holding company with the sole purpose of facilitating
2 BBC Pension Trust Investments in U.S. real estate. It has no
3 other function.

4 Appellant borrowed -- second, Appellant borrowed from
5 his parent 156 million all of which is accounted for in
6 Respondent's Exhibit A. The promissory notes were submitted
7 as part of the audit in 2009. It is not in new evidence. In
8 Respondent's Exhibit B, Appellant stipulated the loans were
9 provided so that B.B.C.A.F. has sufficient funds to make
10 capital contributions to existing or new joint ventures which
11 were acquiring real estate investments in U.S. This evidence
12 submitted in response to an audit IDR. It is also not in new
13 evidence. Income from each investment is sourced to a single
14 state based on the real estate location here. Hence, only
15 income from California real estate is included in California
16 tax base. This is also not in new evidence. In fact, this
17 is how Appellant filed its tax returns. Since all of the
18 loans were used to invest in existing and new real estate
19 investments, it follows that interest expense on those loans
20 is attributable to investments that generated income that
21 both included -- it was both included and excluded from
22 California tax base. It follows, therefore, that Appellant
23 should be able to deduct from its California income only that
24 portion of the expense that is attributable to assets
25 generating income from California. It's akin to California

1 real estate that generated California income. So the
2 deduction unquestionably must be limited. The only question
3 here, really, is how in accordance to which formula.

4 While Appellant appears to be bringing up various
5 UDITPA provisions to divert this panel's attention from
6 general rule that applies to allowable deductions, Respondent
7 would like to remind this panel that Appellant is not
8 generating any apportionable business income or allocable
9 nonbusiness income.

10 The Uniform Division of Income protects purpose of
11 tax purposes provisions, covered by Revenue and Taxation
12 25 -- Section 25120 to 25140 was enacted to address
13 businesses that operate a unitary business within and out of
14 California. Appellant here does not operate unitary business
15 and none of its investments generate income subject to
16 taxation in more than one state. UDITPA provisions therefore
17 are not applicable in this case including Revenue and
18 Taxation Code Section 25120.

19 Again, this case before this panel is much simpler
20 once you consider once you consider that UDITPA provisions do
21 not apply in 24425 provide guidance.

22 Now we come to allocation methodology. Respondent
23 draws attention to the appeal of *Zenith*, a 1998 published
24 Board Equalization decision which California Court of Appeals
25 found persuasive in *Apple v. FTB* in 2011. *Zenith* and *Apple*

1 are precedential on the issue and must be considered by this
2 panel in deciding this case. In *Apple*, the Court of Appeals
3 summarized appeal of *Zenith* to stand for the rule that the
4 proper allocation of interest expense involves two
5 considerations. One is the purpose of the borrowing, and
6 two, an accounting as to how the funds were actually used.
7 Unless the taxpayer can establish a direct allocation between
8 the borrowing expense and the investment purpose, the FTB's
9 allocation would otherwise apply. And this is a quote from
10 both *Zenith* and *Apple*. In *Apple*, the Court at page 25
11 states: We again find the State Board of Equalization
12 analysis on this issue persuasive. This issue is not what
13 the FTB may seek and to allocate otherwise deductible expense
14 between taxable and nontaxable income.

15 Unquestionably it can. The question is simply
16 whether *Apple* then met its burden under totality of facts and
17 circumstances to establish that its dominate purpose in the
18 borrowing and the actual use of the funds was to support and
19 was allocable to is domestic income-producing activities.
20 What was involved in *Apple* with respect to the interest
21 deduction issue is *Apple* included domestic income-producing
22 activities which were taxable and excluded foreign
23 activities. So the *Apple's* burden was to show that the
24 interest expense deduction was incurred in order to sustain
25 its domestic operation and not its foreign. And because

1 *Apple* provided sufficient evidence in direct -- of direct
2 tracing, the Court honored it by allocating interest expense
3 among the income-producing assets that *Apple* conclusively
4 established we're funded by the debt which produced
5 California taxable income.

6 In this case, Appellant in its reply brief,
7 stipulates that it is unable to direct the link debt to
8 specific real estate investments. Because Appellant is
9 unable to directly link funds to specific assets, both *Zenith*
10 and *Apple* decisions direct that FTB's formula should then
11 apply. Specifically both SBE, State Board of Equalization in
12 *Zenith*, and Court of Appeals in *Apple* stated: unless the
13 taxpayer can establish its dominant purpose in a sufficiently
14 direct relationship between the expense and the income,
15 Respondent's allocation formula will provide the best news to
16 allocate interest expense between taxable and nontaxable
17 activities.

18 In *Zenith*, taxpayer was not able to directly link
19 borrowing the specific assets during one of the years at
20 issue. For that year, State Board of Equalization endures
21 IRS Revenue Procedure 72-18 by stating: That Revenue
22 Procedure 72-18 provides the most workable solution over the
23 long term and should be used in order to calculate the
24 nonallowable portion of the deduction.

25 That is exactly what Respondent did in this case.

1 Based on evidence collected during audit that conclusively
2 established that Appellant borrowed 156 million to invest in
3 its real estate. And I use word borrowed broadly. To allow
4 United States and on behalf of its parent entity, Respondent
5 seeks to allocate the interest expense on those loans among
6 Appellant's California and non-California real estate
7 investments based on the assets average adjusted basis.

8 The IRS Revenue Procedure formulas specifically
9 provides the disallowed expense should factor in average
10 adjusted basis of the excluded assets here in non-California
11 real estate investments, over Appellant's total assets,
12 which may only not include additional to real estate
13 investments assets. Respondent's Exhibit F provides such
14 calculations. There's absolutely no basis to treat Revenue
15 Procedure 72-18 formula that Respondent seeks to apply as
16 unreasonable. Nothing in the evidence supports a
17 proposition that a Respondent's formula is unreasonable or
18 even that an allocation based on income is more reflective
19 of Appellant's purpose and use of the funds. Respondent's
20 Exhibit F and I are to the point and Respondent is open to
21 any questions this panel may have on the issue.

22 As such, this panel must sustain Respondent's
23 position in this case.

24 ALJ MARGOLIS: Okay.

25 MS. ISKANDER: Thank you.

1 ALJ MARGOLIS: Thank you.

2 Panel, is there any questions at this time?

3 AJM LEUNG: I want to know whether the
4 [indiscernible] witness taking the stand or?

5 ALJ MARGOLIS: There will be witnesses for each
6 side.

7 AJM LEUNG: Okay, I'll wait for the witnesses to
8 speak, please.

9 ALJ MARGOLIS: Judge Gast, you can ask some
10 questions now, if you want.

11 AJM GAST: Yeah, have some clarifying questions.
12 Maybe I'll start with FTB. Actually we'll start - start
13 with the taxpayer. How the returns were filed. Yeah, if we
14 start with 2005, it seems like both parties agree that the
15 non-California, non-unitary partnership distributes share of
16 income was not included in the returns? Is that how -

17 MS. FREEMAN: It was removed from the return. It
18 was in the base -

19 AJM GAST: Okay.

20 MS. FREEMAN: -- and taken out as nonbusiness.
21 It's not treated as exempt income in the return.

22 AJM GAST: Okay. So.

23 ALJ MARGOLIS: There's no Schedule R to take it
24 out as nonbusiness in those returns, as I recall.

25 MS. FREEMAN: We made an adjustment on the face of

1 the return because the rest of their business activities
2 were wholly within California. There wasn't a need for a
3 Schedule R.

4 ALJ MARGOLIS: So there's a subtraction or
5 something.

6 MS. FREEMAN: There's a subtraction, yes. And it
7 was treated as business income removed on the face of the
8 return through an adjustment. Subsequently we've made more
9 refinements in the schedules we provided to more - to go
10 back and forth between what the auditor did and the
11 corrections to the base to reflect what it should be treated
12 as California's business income. It is subject to UDITPA
13 because it is a single pact pair with partnership income
14 within and without the state. And 25105 does say UDITPA
15 applies to it, the fact it has activity within and without
16 the state. And it is a single legal -

17 ALJ MARGOLIS: 25101.

18 MS. FREEMAN: 25101, yeah. Does apply. UDITPA
19 does apply because the activities of a single legal entity
20 are done within and without the state. So while it may not
21 be a standard methodology to treat nonbusiness income to
22 remove it from the face of the return, that's not the first
23 time we've seen it done that way.

24 AJM GAST: You say nonbusiness - how come, and you
25 think UDITPA applies, but what about 25137-1?

1 MS. FREEMAN: Partnership returns?

2 AJM GAST: You get me? Of a separate trade or
3 business.

4 MS. FREEMAN: Yeah. So -

5 AJM GAST: Yeah.

6 MS. FREEMAN: -- yeah. So basically under
7 25137-1, each of the partnerships that they're not unitary,
8 they're treated as separate allocable and allocated - or
9 apportioned at the partnership level and then treated as
10 added together the pieces that are California source on a
11 post apportioned basis taxed for each of the partnerships
12 added together. Because you wouldn't add them together and
13 apportion the whole piece, you apportion each taxpayer to
14 California - or each investment to California to get to the
15 total.

16 AJM GAST: Okay. And because the non-California,
17 non-unitary partnerships essentially are separate trades or
18 businesses, --

19 MS. FREEMAN: Yeah.

20 AJM GAST: -- they don't any California
21 apportionment that was just -

22 MS. FREEMAN: To add back.

23 AJM GAST: Yeah, so it was essentially deducted
24 from the California return as a subtraction adjustment?

25 MS. FREEMAN: Yeah, you get to the - you get to

1 the -

2 AJM GAST: Same answer.

3 MS. FREEMAN: -- same answer whether you do it
4 using Schedule R OR methodology the taxpayer employed.
5 Essent - everything that's being pulled out on the
6 [indiscernible] return on side 1 is not going to be added
7 back as post apportion, partnership income. Taking, yeah,
8 has the same effect as doing it after -- on Schedule R,
9 after you apportion income and not adding anything back. You
10 get to the same answer.

11 AJM GAST: Okay.

12 MS. FREEMAN: Mechanically.

13 AJM GAST: Okay. I have one more.

14 ALJ MARGOLIS: Go ahead.

15 AJM GAST: For FTB, if you're arguing this is --
16 the taxpayer's not subject to UDIPTA, then isn't all this
17 income and losses taxable? Aren't they hundred percent
18 California?

19 MS. ISKANDER: No, it's not. Because, okay so,
20 there's an appeal of *Halloway Investment Company* in which a
21 similar situation involved - was involved. A taxpayer owned
22 several pass-through interests in different states. In that
23 state - in that Board of Equalization decision specifically
24 states: For our purposes, unless a unitary business exists,
25 there can be no business income. The income in question

1 would merely be specifically allocated by situs.

2 Because here, we don't have business and
3 nonbusiness income. We have - they have income from their
4 pass-through entities. But because it's not unitary, the
5 business is -- the income by each pass-through entity only
6 is sourced through a single state based on the location of
7 the real estate investment that is part and parcel of that
8 pass- through entity.

9 AJM GAST: So is that separate accounting?

10 MS. ISKANDER: It is - it is in a way separate
11 accounting. Basically they source all of their income, that
12 have to source all of their income from pass-through
13 entities that generate -- that own commercial real estate in
14 a different state to that specific state. And they only can
15 source to California under that theory, under theory that
16 they have separate trades of businesses. Only that income
17 that is attributable to California real estate.

18 AJM GAST: Okay.

19 MS. ISKANDER: So even California real estate,
20 let's say they have about four or five properties in
21 California, even each of that real estate and pass-through
22 interests is separate from other California real estate or
23 interests. So if they apportioned - or they not
24 apportioned, I'm sorry, they tax by situs - by situs, and
25 not by allocation and apportionment. And if we go back to

1 UDITPA provisions, for one Revenue and Taxation 25121
2 specifically provides: any taxpayer having income from
3 business activity which is taxable both within and without
4 California is subject to allocate an apportionment income as
5 provided in this UDITPA act.

6 What that means is had they had a pass-through
7 interest that generated income within and without
8 California, that would be subject to apportionment then one
9 state would take a chunk of it and the other state would
10 take another chunk. But here they don't have it. Each
11 pass-through entity's income is limited to a single state.
12 There is no issue of apportionment in allocation.

13 ALJ MARGOLIS: But under your authority, even if
14 one of the pass-through entities wasn't an apportionable
15 entity, you're taking the position that UDITPA wouldn't
16 apply though because the parent taxpayer -

17 MS. ISKANDER: Is not unitary.

18 ALJ MARGOLIS: -- is not unitary. So.

19 MS. ISKANDER: But we are - we are not there. So,
20 you know, based - what we have here is we have this
21 situation. The taxpayer wants various pass-through entities
22 and each pass-through entity's income is limited to a single
23 state. So under the current facts that we have right now
24 before us, UDIPTA provisions simply are not triggered.

25 ALJ MARGOLIS: Well, I'm just kind of wondering

1 what would happen if you have, I mean, what if you have one
2 of the partnership entities wasn't an apportioning taxpayer
3 and it's not unitary as here with the parent company. How
4 would we treat the income from that - that partnership end?
5 Would it be apportioned to California? And, I mean, does it
6 come under - does it come in under UDITPA or not?

7 MS. ISKANDER: I'm sorry. I can't answer that
8 question on the fly. I would have to think about it and get
9 back to you if that's important decision. But under --

10 MR. SWIESCO: What would end up happening --

11 MS. ISKANDER: -- the fact -

12 MR. SWIESCO: Pardon me. Craig Swiesco. Is if
13 what you're asking for is let's say you had a partnership
14 that wasn't unitary with a partner, correct?

15 ALJ MARGOLIS: Correct.

16 MR. SWIESCO: Okay, and that partnership does
17 business within and without California, correct?

18 ALJ MARGOLIS: Correct.

19 MR. SWIESCO: Okay, you would use the
20 apportionment factors of that partnership to determine the
21 California source income of that partnership that would be
22 the distributive share to the partner.

23 ALJ MARGOLIS: Okay. Thank you.

24 MS. ISKANDER: And that is [indiscernible] --

25 MR. SWIESCO: Yes.

1 ALJ MARGOLIS: So say -

2 MR. SWIESCO: Presuming and they're not unitary
3 with one another, that would be under Regulation 2517 -

4 ALJ MARGOLIS: 137-1(g).

5 MR. SWIESCO: -- 25137-1(g).

6 AJM GAST: So the dash 1(g) doesn't have examples
7 in there of partnerships that are wholly outside of
8 California? And I think there's a loss and then that gets
9 either wholly allocated to California or not depending on
10 the partnerships within or without California. If so, why
11 does that regulation apply in that situation but not in
12 these facts?

13 MR. SWIESCO: If I understood you correctly,
14 you're saying that there's an example under 25137-g where
15 you have a partnership that has a loss but the partnership
16 in and of itself has no activity in California?

17 AJM GAST: It's a non-unitary -

18 MR. SWIESCO: Yes.

19 AJM GAST: -- partnership, yes. It has no
20 activity in California, has a loss completely generated in
21 another state.

22 MR. SWIESCO: Correct. And none of that activity
23 would be considered for determining the overall California
24 source income of the partner of that non-unitary
25 partnership. Because that activity would be assigned to

1 another state because obviously then none of the -- that
2 entity, that partnership's factors would be in California
3 since it had no activity in California.

4 AJM GAST: Okay. So -- so why does UDIPTA that
5 regulation apply in that situation but not under these
6 facts?

7 MR. SWIESCO: Theoretically what UDITPA is -- what
8 UDITPA stand - the standard for UDITPA is when you're
9 dealing with necessarily a taxpayer. So when you're talking
10 about a pass through, it comes down to the entity agency
11 theory under a pass through. So when you -- you would look
12 at the UDITPA for purposes of sourcing the income of a
13 non-unitary taxpayer because obviously that does business
14 within and without California, correct? You would look at
15 UDITPA. But in this fact pattern, it's agreed that each of
16 these individual pass-through entity interests are localized
17 in California. So you don't necessarily need to rely on
18 UDITPA for determining their California source income
19 because in effect all of the activities in California, in
20 other words, just saying all of their factors would be in
21 California. So you don't really need to look to UDITPA.

22 AJM GAST: Okay. Thank you.

23 ALJ MARGOLIS: I have a question for probably it's
24 Ms. Freeman. So why do you contend that if UDITPA applies
25 which you seem to think it does, why does 25120(d) not apply

1 here?

2 MS. FREEMAN: FTB - so at audit, the FTB only
3 raised the issue of 24425 at appeal. At audit, the only
4 issue raised was 24344(a), the deductibility of the interest
5 expense. 24425 is a new issue. They have not raised
6 interest allocation under 25120(d) at all. So that's not -
7 technically before the court. It's our position that 25101
8 does apply which applies when a taxpayer's subject to tax
9 imposed under this part, has income attributed to sources
10 within or without the state. We have that situation. My
11 taxpayer has partnership interest that flowed through to it
12 as a taxpayer that are within and without the state. And
13 the rules -- we believe the rules under 25137-1 would apply
14 which is why we remove the non -- the allocable income on
15 the face of the return and didn't source it on a post
16 apportioned basis when you've taken [indiscernible] each
17 partnership and apportion the activity to each partnership,
18 none of it comes to California for the out-of-state
19 partnerships because they're -- they're pretty microcosmed
20 into whatever particular state they were in. We believe
21 25137 would apply to determine the amount of income that
22 would be attributable to California and that's what we
23 provided in those schedules. And we believe 25120(d) would
24 apply to allocate the interest amongst the partnerships
25 after the interest offset applies, if FTB had actually

1 raised that issue.

2 ALJ MARGOLIS: Okay, so your position is that they
3 can't, the FTB can't use 25120(d) because it's kind of
4 renouncing in this state [indiscernible] --

5 MS. FREEMAN: They have not raised that issue,
6 yes.

7 ALJ MARGOLIS: Thank you. Let's take a 10-minute
8 recess before we get the witnesses. Okay, thank you very
9 much.

10 [Recess taken at 11:30 a.m.]

11 [Proceeding resumed at 11:47 a.m.]

12

13 ALJ MARGOLIS: Mr. Kaplan, would you like to call your
14 first witness?

15 MR. KAPLAN: At this time, I'd like to ask
16 Kathy Freeman to -- as our witness.

17 ALJ MARGOLIS: Ms. Freeman, would you prefer to
18 testify from there or would you like to go to the witness
19 spot? It's your choice.

20 MS. FREEMAN: I'm fine here, Your Honor, if that
21 works for you.

22 ALJ MARGOLIS: Okay. That's fine.

23 Ms. Freeman, please stand and we'd like to swear
24 you in now.

25

[Witness sworn in]

1 ALJ MARGOLIS: Thank you. Be seated.

2 Proceed.

3 MR. KAPLAN: Okay. I believe that most of what
4 Ms. Freeman was going to be testifying to she covered to a
5 great extent as part of the opening statement. If possible
6 I would like that the comments made during the opening
7 statement that came from her to be used as part of her
8 direct testimony.

9 MS. FREEMAN: I can repeat it, if you'd like.

10 ALJ MARGOLIS: What's that?

11 MS. FREEMAN: I can repeat what I initially said,
12 if you'd like. It's up to you.

13 ALJ MARGOLIS: Ms. Iskander, would you like her to
14 repeat it for you?

15 MS. ISKANDER: Not for me, no.

16 ALJ MARGOLIS: Okay. That would be admitted as
17 her testimony.

18 MR. KAPLAN: Thank you, Your Honor.

19 MS. FREEMAN: The only other comment I would add
20 is that we have offered at the methodology, both 24425 and
21 25120(d), both offer for reasonable methods of allocation.
22 The MATM Section 4060 also discusses, you know, alternative
23 methodologies to allocate expenses between biz-on-biz or,
24 you know, even between exempt income and nonexempt income.
25 And we believe our method is reasonable and the FTB has not

1 provided any evidence whatsoever to rebut the fact that our
2 methodology is just as reasonable as their method. And so
3 we do not believe, in the event it comes to that point, that
4 they've met their burden if it was establishing our method
5 as unreasonable.

6 ALJ MARGOLIS: Questions further for Ms. Freeman?

7 MR. KAPLAN: I guess I have one question and that
8 is during the FTB's opening statement, I believe what I
9 heard was with respect to the question of whether this is a
10 new issue, the allocation of interest is a new issue or not.
11 That -- that the interest was recharacterized as such and
12 that the question of the allocation naturally follows from
13 this recharacterization.

14 I would like to ask Ms. Freeman how was the
15 interest originally reported on the tax returns? And
16 whether such a recharacterization did in fact occur.

17 MS. FREEMAN: So I did spend 23 years at the FTB
18 as a -- significant chunk of those years as a FTB auditor
19 and also providing legal support work for the FTB legal
20 staff.

21 ALJ MARGOLIS: Could you speak more slowly.

22 MS. FREEMAN: So I did spend 23 years at the FTB
23 providing -- both as a field auditor taking the technical
24 resource section, reviewing audits, and providing legal
25 support work for the FTB attorneys.

1 When you look at the return as filed, like I
2 discussed earlier, there's different ways that returns get
3 presented. There's no -- there's a general way and then
4 there's unique ways presenting the same information.
5 Sometimes the numbers, they get to the same point, it's just
6 the presentation is a little bit different. Here is a
7 situation where the presentation was different but you get
8 to the same result of treating income as nonbusiness. When
9 you examine an expense in this case, interest was
10 reported -- interest expense was reported on the return and
11 deducted as was interest income. The taxpayer reported the
12 interest income and interest expense just as that. The FTB
13 had proposed to recharacterize it as not interest and
14 thereby deny the deduction for interest expense. So nothing
15 changed here.

16 The issue of an interest allocation is a separate
17 and unique issue where you would have perhaps an insurance,
18 a receipt of an insurance dividend and then seeing if it
19 would apply. Or you would have allocation issue which you
20 would see on supporting schedule, the Schedule R, when you
21 have nonbusiness income. And then you net those adjustments
22 and add them back in on Schedule R on a post apportion
23 allocated basis. So an interest allocation issue does not
24 logically flow from the audit issues proposed. That's a
25 unique issue that would be raised.

1 ALJ MARGOLIS: I have a question. Oh, continue.

2 MS. FREEMAN: That was it.

3 ALJ MARGOLIS: Well, are you saying that if an
4 interest expense allocation should have been raised, I mean,
5 if -- are you saying there was an interest expense
6 allocation inherent from the beginning in terms of as
7 originally reported --

8 MS. FREEMAN: Yes --

9 ALJ MARGOLIS: -- there should -- there perhaps
10 should have been an interest expense adjustment even if
11 there is no change in the unitary status or anything?

12 MS. FREEMAN: I'm not aware whether the taxpayer
13 was aware that an allocation was required and the return is
14 reported, but if there - the FTB was looking at the fact
15 that you had multiple partnerships that were treated as
16 non-unitary, an interest expense allocation would have been
17 a logical issue for the auditor to pursue. They did not
18 choose to pursue that issue. Instead they chose to pursue
19 where there was the contribution to capital or debt. That
20 is a unique issue that exclusively falls under IRC Section
21 163 if California would conform to the same rules as federal
22 in determining whether its debt versus equity. And that was
23 when - that's what the auditor chose to audit. They could
24 have pursued an expense allocation issue. They chose not
25 to. Those are two very unique issues.

1 ALJ MARGOLIS: Are you done with your direct?

2 MR. KAPLAN: I would like Ms. Freeman to - one
3 more question.

4 Can you discuss the - the concept of the measure
5 of tax?

6 MS. FREEMAN: Yeah. So when you look at the
7 return, Schedule F is usually the income computation whether
8 it's done in conformity with the federal return or rely
9 basis. And that number carries over to line 1. And you can
10 determine how income is computed by comparing what's online.
11 One to the federal return, if it doesn't tie, then you have
12 to go back and look to see if they've added in foreign.
13 That's one methodology but really line 1 is the income base
14 and side 1 of the return is used to make state adjustments
15 from federal to state numbers. For example, cap gains and
16 losses normally is adjusted on side 1 of the return.
17 Dividend -- California only dividend deductions are made on
18 side 1 of the return. And contribution adjustments, tax
19 measure, that's all differences between the tax base and fed
20 state differences. All of the income including allocable
21 income is included in that base. It's not until you get to
22 Schedule R that you generally -- I've seen them take it out
23 on side 1, but generally you're supposed to use side 1, or
24 Schedule R, to take out and separately handle nonbusiness
25 items. So in order to get something excluded from the

1 measure of the base, there either needs to be a deduction,
2 which in this case we've discussed *Zenith* and the 25 -- or
3 24410 dividend deduction where there's generally an 85
4 percent allowed DRD, dividend deduction. Or there's exempt
5 interest income. But in the franchise tax, exempt interest
6 income is included in the base so you'll always see an
7 addition on side 1 for exempt interest to add it back
8 because it is in the base.

9 So usually you will only see the DRDs as being
10 subject to the 24425 deduction. So in our case, unless you
11 have an M1 adjustment or an M3 adjustment removing it from
12 book income, because book -- it should be in book income.
13 You'd need an M-1 or M-3 to back it out and remove it from
14 the measure of tax or you would need a DRD, under 24410, to
15 remove it from the measure of tax. You don't have an item
16 excluded from measure of tax. Instead you go over to
17 Schedule R and you have items that are removed like cap
18 gains and losses which require separate handling and you add
19 them back in when you're done and you have allocable income
20 that you have to remove from the base because you have to
21 separately handle that as well. But then it comes back in
22 if it's allocable to California or it's left out but it's
23 not excluded from measure of tax. It's included in the
24 overall computations. And that's why there's a requirement
25 and a need for 24120(d) or sorry 25120(d) to make those

1 allocations and expenses that were in the base to - to get a
2 clear reflection of the allocable income that should be
3 separately handled in the return.

4 ALJ MARGOLIS: Judge Gast, do you have any
5 questions?

6 MS. FREEMAN: Sorry, it's complicated.

7 ALJ MARGOLIS: He's our CPA on the panel.

8 ALJ GAST: That's true. Are you going to go over
9 the schedules you provided, Exhibit 18 or is that -- before
10 I ask questions on that, I wasn't sure if I was jumping --

11 MS. FREEMAN: We can discuss the schedules. I
12 think the logical answer is that the numbers will logically
13 flow from the legal conclusions. The legal conclusions,
14 one, we have separate trades or businesses for each of the
15 partnerships that have been handled. And then we have the
16 adjustments that reflect the interest issue at hand, that
17 the FTB has proposed. We've also taken out the like-kind
18 exchange in 2006 as the FTB has already conceded. And then
19 really it comes down to once you get through the base, does
20 interest offset apply before you allocate the interest or
21 after which is what the FTB has already that it's after.

22 Our position is it's before consistent with what
23 you do with 24344(c). That adjustment is made before
24 consideration business or nonbusiness treatment, on Schedule
25 R, it's at the top of Section R. You make that adjustment

1 first. And since these two code sections are in the same
2 statute, there's no logical reason to treat them
3 differently. And then -- then it's an issue of how to
4 allocate that interest expense, if it is required at all,
5 how to allocate it between what's within California and
6 without. We proposed a methodology that's based on net
7 income because if you read through our protest, what it says
8 is that in evaluating how much money to lend to the U.S. for
9 purposes of investment, they looked at their ability to
10 repay the loans. Both on a cash flow basis for the interest
11 expense itself and on its investments itself in event
12 principal needed to repaid. So we believe using a cash flow
13 income ability to repay the debts is consistent not only
14 with how the money was borrowed, it's consistent with the
15 flexibility of the statutes as well as the FTB guidance in
16 may have to be guidance in MATM 4060.

17 ALJ GAST: Okay. So I've gone through the numbers
18 and it makes sense what the schedules are trying to do.

19 MS. FREEMAN: Yeah.

20 ALJ GAST: I had two questions. One is more of a
21 technical one and the other one is more where the numbers
22 come from. I guess I'll start with more of the technical
23 one. The interest offset was held on constitutional so
24 why -- in *Hunt-Wesson*, so why - why would a taxpayer be in
25 entitled to interest offset in this case?

1 MS. FREEMAN: So the FTB issue guidance FTB Notice
2 2000-9 saying that for domestic, you know, California
3 entities, they would still buy the offset. And I have a
4 copy of that if you need that.

5 ALJ GAST: That's okay. I'm aware of that.

6 MS. FREEMAN: Okay.

7 ALJ GAST: Maybe - maybe we'll come back to it.

8 ALJ MARGOLIS: I want to address the --

9 ALJ GAST: Okay.

10 ALJ MARGOLIS: -- correspondence, Counsel.

11 Well why --

12 MS. ISKANDER: I'd actually like to respond -

13 ALJ MARGOLIS: Okay, yeah, go ahead. Sorry -

14 MS. ISKANDER: -- to a lot of it.

15 ALJ GAST: -- yeah.

16 MS. ISKANDER: I'm not sure how this is witness
17 testimony when a witness here is religious putting together
18 a balance case. I'm not sure why - I've never seen a
19 witness, a witness putting together substantive arguments so
20 I'm not sure how to even respond to this and I'll treat just
21 as a reply, I guess.

22 ALJ MARGOLIS: No problem. I think it is -- I
23 think the question that I'd like to ask and I think Kenny
24 was getting at is why - why does the FTB not, why is the FTB
25 not applying Notice 2000-9 here?

1 MS. ISKANDER: Because it does not apply here.
2 24425 trumps 24344 and both the Supreme Courts states that
3 and the setup of the 24425 does.

4 But I would like to address something else that
5 has been stated. Number --

6 ALJ MARGOLIS: Well, you'll be able to respond to
7 her testimony through cross-examination and your closing
8 argument.

9 MS. INSAKER: Right. But her testimony seems to
10 be really a re-argument of the case. It seems --

11 ALJ MARGOLIS: You'll be able to bring up your --

12 MS. ISKANDER: -- to be more of a substantive
13 nature than factual nature.

14 ALJ MARGOLIS: You'll be able to re-argue your
15 case in closing and we'll also have some questions that
16 you'll be able to make your points.

17 MS. ISKANDER: Okay.

18 ALJ MARGOLIS: Judge Gast, anymore questions for
19 now? Walk through the computation -

20 ALJ GAST: Yeah, okay, --

21 ALJ MARGOLIS: -- settlement.

22 ALJ GAST: -- maybe we'll revisit interest offset.
23 So for the percent of interest allocated -

24 MR. CORNEZ: Can I - can you indicate which
25 document you're looking at, please.

1 ALJ GAST: Exhibit 18 -

2 MR. CORNEZ: What -

3 ALJ GAST: -- page 2 of 197.

4 MR. CORNEZ: All right. So -

5 ALJ MARGOLIS: I have an extra copy if you need
6 it.

7 MR. CORNEZ: It would appear that when we printed
8 this off at work yesterday, we did not get page 2 through
9 96.

10 MS. ISKANDER: We have to - when we address the
11 interest offset, we have to keep in consideration the fact
12 that allocation of interest expense deduction pursuant to
13 24425 has two considerations that are - that we get
14 direction from both *Zenith* and Court of Appeals. Both
15 consideration is when we allocate an interest expense
16 deduction, we have to consider the purpose and the actual
17 use of the loans. Here the purpose and the actual use of
18 the loans has no relations to the generation interest
19 income. If it does have a relation, meaning that if
20 taxpayer stipulation that it earns income solely from
21 partnership income and does not have any other source of
22 income, other than its passive holdings, partnership
23 holdings, then we don't need to allocate separately to
24 interest income because allocation based on *Zenith* would
25 provide for allocations of loans based on purpose and use.

1 So an interest -- it seems to be detour talking interest
2 offset as if the loans that we're talking about are related
3 to generation of that income. It is not --

4 ALJ GAST: But in the -- in FTB's notice, don't
5 you, you disregard the direct tracing initially and if you
6 have any business income, interest income, you get a direct
7 offset regardless if you can directly trace it. Isn't that
8 how the notice --

9 MS. ISKANDER: You said business income.

10 ALJ GAST: Business interest income, yeah.

11 MS. ISKANDER: We don't have - okay, again, 24425
12 defines what deductions are allowed. By going through Notice
13 or 24344, you go around 24425. That is not proper. You
14 first, you first supposed to look at what deductions are
15 allowable. 24425 tells you what is not allowable. You
16 first determine the allowable amount of deduction, then you
17 allocate it how you want on your return. You want to offset
18 your interest expense first, that's fine. What the
19 Appellant is trying to do here, they want to ignore the
20 existence of 24425. Allocate it first which means take a
21 big chunk of the expense against the interest income to
22 which that interest expense is not in related to based on
23 the purpose of the loans that we have in Exhibit B. It's
24 stipulated and it's admitted in - as evidence.

25 What they want to do is they want to somehow

1 ignore 24425 disallowance. And first, allow a big chunk
2 against interest income. And only then allocate. Well this
3 is not what the 24425 stands for and this is not what
4 California Supreme Court decision stands for. What it
5 stands for is you first determine what deduction, what
6 portion deduction is allowable. And then you offset or do
7 anything else, you have to do with that allowable amount.
8 To determine that allowable amount, you first have to see
9 how was that expense generated. By, you know, how? You
10 borrowed to generate the expense. Fine. But did you borrow
11 what for. What's the purpose of the loan? The purpose of
12 the loan here we know to invest in the real estate
13 properties on behalf of the BBC Trust.

14 ALJ GAST: So this is why Notice 2000-9 in your
15 view doesn't apply --

16 MS. ISKANDER: It does not --

17 ALJ GAST: -- in this situation.

18 MS. ISKANDER: -- apply.

19 ALJ GAST: Okay.

20 MS. ISKANDER: It does not apply to 24425. It
21 does not trump 24425. Revenue and Taxation Code 24425
22 trumps all considerations that has to do with 24344. It
23 just follows it. It does not precede it. 24344 does not
24 precede --

25 ALJ GAST: Okay.

1 MS. ISKANDER: -- 24425 for purposes of
2 determining allowable deduction.

3 ALJ GAST: Okay. So does - my next question is
4 and I'm not trying to be -- I'm just trying to understand
5 how these interest provisions work. Or expense --

6 MS. ISKANDER: We're here to answer your
7 questions.

8 ALJ GAST: -- disallowance provisions work.

9 Does your interpretation of 24425 render the
10 interest offset 25120(d), even 25137-1(d)? Is that all that
11 surplusage now? Because you just have 24425 and that's it.

12 MS. ISKANDER: In this situation, in this specific
13 situation where we don't have apportionable business income,
14 where we only have income from separate trade of business
15 allocated, well, source specifically to a single state, yes,
16 would go to 24425 first. In this specific situation, that's
17 the only way we can go about. There's no unity between the
18 partner and the partnership. There's no unity between the
19 partnerships itself. We don't need to even get there.

20 What we have to determine is, you have an expense.
21 Let's match it to the income that produce that - that
22 expense was used to produce, and after that let's allocate
23 that expense based on how you used it to generate the
24 income. And that's a matching principle. And for
25 California purposes, even though Appellant here says, well,

1 you know, we excluded as a nonbusiness income, they excluded
2 it because they have to source it to the location of the
3 real estate to the state. They excluded the income from
4 partnerships owning interest in real estate outside of
5 California because they have to. They have to do it and
6 appeal of Halloway states specifically without a
7 consideration, without the unitary business there or an
8 activity that generates income both within and without, you
9 just simply source it to the situs. You don't have to go
10 through business then business. It just doesn't have any
11 application here.

12 So saying that California investment income is
13 business income, but New York investment is nonbusiness
14 income, simply makes no sense. It's just income from
15 separate trade of business that is sourced through the situs
16 of the investment.

17 ALJ GAST: Okay. Thank you.

18 Should I continue or?

19 ALJ MARGOLIS: Yes, please.

20 ALJ GAST: Okay. So Ms. Freeman, on the schedules
21 you provided, Exhibit 18 -

22 MR. CORNEZ: Okay. And I don't mean to interrupt,
23 but I think an evidentiary clarification is needed here.
24 Exhibits 15, 16, and 17 were drafts and now Exhibit 18,
25 pages 2, 3, and 4 are the actual document that I think

1 Appellant believes is the correct document. So without
2 springing this on them, I don't think 15, 16, and 17 even
3 need to be admitted as evidence. Because I believe Exhibit
4 18, pages 2, 3, and 4 are the documents they want admitted.
5 Is that -

6 MS. FREEMAN: That's correct. We did update the
7 schedule to add -

8 MR. CORNEZ: Yeah.

9 MS. FREEMAN: -- a couple additional iterations of
10 the same schedules.

11 ALJ MARGOLIS: Okay.

12 ALJ GAST: Okay.

13 MR. CORNEZ: Sorry about that.

14 ALJ GAST: It's okay. I'm able to trace the
15 numbers, you know, going through this, but one main question
16 I had was other than the 28 percent in Scenario 1, yeah
17 Scenario 1, that seems to come from the FTB's 27.6 percent.
18 It's just a rounding thing?

19 MS. FREEMAN: Yeah.

20 ALJ GAST: Okay. Where did the other percentages
21 come from and why were the K-1s provided? How does that
22 help us with that?

23 MS. FREEMAN: So the K-1s were provided as
24 evidence in support of the numbers themselves, the taxable
25 income bifurcations between the partnerships. And then the

1 percentages proposed for 1A, those were the revised
2 percentages that the FTB provided using investments, I
3 believe, on the financial tenants.

4 MS. ISKANDER: I can - I can address it -

5 MS. FREEMAN: Yeah.

6 MS. ISKANDER: -- because it's our percentages.

7 MS. FREEMAN: Yeah.

8 MS. ISKANDER: We - we came to those percentages.

9 ALJ GAST: Which scenario?

10 MS. ISKANDER: Scenario 1A.

11 MS. FREEMAN: Yeah.

12 ALJ GAST: Okay, those are your -- okay.

13 MS. ISKANDER: Yes, the percentages are ours and
14 it's based on direct application of Revenue and Procedures
15 72-18 and it takes into consideration average adjusted basis
16 of investments over total investments. So I can go to that
17 formula and explain how it works and why it actually
18 benefits the taxpayer once you have the question.

19 ALJ GAST: I think I'm okay for that -- on that
20 piece for now. Just trying to understand what their --

21 MS. ISKANDER: In Exhibit F, --

22 ALJ GAST: -- percentages are.

23 MS. ISKANDER: -- our Exhibit F shows exactly how
24 we arrived in that -- in those percentages.

25 ALJ GAST: Exhibit F?

1 MS. ISKANDER: Exhibit F --

2 ALJ GAST: Okay.

3 MS. ISKANDER: -- provides -- calc -- provides how
4 these percentages were calculated.

5 ALJ GAST: Okay, so then moving on to Scenario 2,
6 okay we've got 28 percent there, okay. And then 2A, is that
7 the same as 1A?

8 MS. FREEMAN: Yeah, so the original numbers that
9 we had discussed prior to get getting into the detail before
10 the hearing --

11 ALJ GAST: Yeah.

12 MS. FREEMAN: -- they had proposed initially this
13 28 percentage, refined it's 27.6 percent. And then during
14 these discussions, they provide a new iteration of
15 percentages, as she discussed. So we want to show what they
16 originally proposed and what the proposing now. And then
17 our number as far as the percentages have remained unchanged
18 and those were in Exhibits 3 and - 3 and 4? Yeah.

19 MS. ISKANDER: I just need to make a correction.
20 We didn't propose those percentages during the discussion.
21 Because we were conceding issues and we explained to the
22 taxpayer during concession that certain tax consequences
23 would follow and that even if they agreed to the debt issue,
24 debt versus equity issue, there would not be a full
25 allowance of the deduction. And taxpayer said, well, what

1 you do mean it wouldn't be full deduction. That would
2 explain, well, you know, without even going into financial
3 statements and looking at how we should allocate this, just
4 simply looking at cost basis, look, you only use about
5 28 percent of your loans to invest in California and produce
6 California income. So at that the most, you can use 28
7 percent, you know, just taking -- it was not one of those,
8 in a situation would said, you know we'll give you 28
9 percent. It was not our consideration. It was simply for
10 illustration purposes to explain that your tax consequences
11 taken into consideration simply original basis would be
12 something like that.

13 ALJ GAST: So your position is in scenario -- the
14 percentage is --

15 MS. ISKANDER: 1A.

16 ALJ GAST: I'm sorry, what did you say?

17 MS. ISKANDER: Our position is Scenario 1A.

18 ALJ GAST: 1A. Okay. Okay. And then Scenario 3,
19 now these are the taxpayer's percentages?

20 MS. FREEMAN: Right.

21 ALJ GAST: Okay. And where do those percentages come
22 from? What are they telling us? Is that an income
23 allocation by partnership or what is that telling us?

24 MS. FREEMAN: So what -- our methodology is that if
25 you look back to the protest even it says that in evaluating

1 the -- making the loans they use the ability to repay the
2 lending. Because none of the debt was tied to any particular
3 investment, the money was loaned to the company and then they
4 could choose the investments themselves. So there's no
5 secured debt here. It's all that and has been refinanced,
6 some of it's been repaid. Some of the properties have been
7 resold and the money is sitting in an account to make future
8 investments. So that the mo -- the money has changed and
9 then there's been a like-kind exchange so some of the basis
10 is reflecting, you know, carryover basis instead of what the
11 actual cost of the investment was.

12 So in light of the fact that the money was borrowed
13 on the premise of the ability to repay, we went back and
14 looked at the re -- ability to repay the debt as the grounds
15 so the net income from the partnerships over total net income
16 from the partnerships before tax. So we're just using
17 taxable income from the partnerships' own ability to repay.

18 ALJ GAST: Okay.

19 MS. FREEMAN: So that's where the percentages come
20 from.

21 MS. ISKANDER: Can I say?

22 ALJ MARGOLIS: You're including capital gains in that
23 computation as well as regular income?

24 MS. FREEMAN: Yes. Yes, all income. The ability --
25 the question was the ability to repay and that's how we would

1 decide how the money was being borrowed that's the --
2 basically the basis for repayment, and that's how we
3 allocated the interest expense using 25120(d) not 24425.

4 MS. ISKANDER: If I would like to.

5 ALJ MARGOLIS: Yes, Ms. Iskander.

6 MS. ISKANDER: I hear Appellant keep on saying
7 ability to repay and that's how the loans were given. The
8 whole difficulty of this case is based on a factual -- the
9 difficulty of determining whether these advances were loans
10 or contributions is still there. We simply agreed to honor
11 the form. We -- it was never, if you look at all the facts
12 in the case, there was never an ability to pay as a
13 consideration. Appellant was set up simply as a holding
14 company of a Pension Trust that has to diversify its
15 investments.

16 It's a UK Pension Trust, it has to diversify
17 investments in order to be a sound investment -- to have a
18 sound investment property. It wants to invests in U.S. real
19 estate. It has a partner that is a UK company that is a very
20 well known in UK real estate investor, a private company that
21 does it for the last three, four hundred years. That
22 investor picks properties for the UK Pension Trust and
23 invests with the U.S. entity for the form purposes.

24 So it's not as if they formed an entity, right? The
25 entity is a 100 percent owned by the UK Pension Trust. They

1 don't have credit worthiness or anything else without being
2 fully first funded by the Pension Trust. There's no --
3 there's absolutely no evidence of credit worthiness
4 evaluation or any of that.

5 The sole purpose of the Appellant was simply to
6 accept money from the Pension Trust and to invest it into the
7 properties that Grosvenor selected. Okay. There's
8 absolutely no credit worthiness issue. They keep on saying
9 that because with time B.B.C.A.F. Appellant has accumulated a
10 portfolio of investments but that portfolio of investments it
11 holds on behalf of B.B.C.A.F -- on behalf of BBC Pension
12 Trust in UK.

13 So the whole difficulty of determining whether this
14 was loans or contributions was when you look at the substance
15 of the transaction. It's not -- that doesn't -- you don't
16 see very often a one-page promissory note signed only by a
17 subsidiary for 156 million. You just don't see that.
18 Usually there's agreement, there's authorization, there is
19 all of that. But here it was not necessary because all of
20 these investments were still directly owned by the Pension
21 Trust through the Appellant. So --

22 ALJ MARGOLIS: Ms. Iskander.

23 MS. ISKANDER: -- saying that credit worthiness --

24 ALJ MARGOLIS: Ms. Iskander, I just want to make it
25 clear that, I mean, right now you're making a lot of

1 allegations that, I mean, we can take this in as argument but
2 there's no testimony or evidence about a lot of what you're
3 saying right now in terms of the activities of the -- of how
4 this company decided to operate. And --

5 MS. ISKANDER: There is. It's in their Appellant --
6 is in their opening brief. It's --

7 ALJ MARGOLIS: That's argument.

8 MS. ISKANDER: -- it has been stipulated.

9 ALJ MARGOLIS: That's argument, that's not evidence.

10 MS. ISKANDER: It's fact that Appellant has provided
11 in it's opening brief in order for the Respondent to change
12 its position as to unity.

13 ALJ MARGOLIS: Well, to the extent that it's in their
14 opening brief we will consider them as admissions but.

15 MS. ISKANDER: Thank you.

16 ALJ MARGOLIS: Mr. Gast, do you have?

17 ALJ GAST: No. I think that's all my questions
18 [indiscernible].

19 ALJ MARGOLIS: Okay. I just have a question just for
20 Ms. Iskander. When were these figures, the percentages that
21 varied by year, when were they first communicated to the
22 taxpayer?

23 MS. ISKANDER: It was communicated --

24 ALJ MARGOLIS: We first saw them in I think your
25 pretty recent brief on one of the -- I think your last brief.

1 MS. ISKANDER: It was communicated in the reply
2 brief.

3 ALJ MARGOLIS: And was it provided to the taxpayers
4 before then?

5 MS. ISKANDER: Whether or not we did the
6 allocation -- we never agreed to an allocation. Taxpayer's
7 position has always been that they're entitled to 100 percent
8 of the deduction. So our reply brief was to set up -- to
9 explain that no, they're not entitled to 100 percent and this
10 is how - and this is how it should be calculated.

11 ALJ MARGOLIS: Okay. So that -- the first time you
12 laid out these varying percentages by year was in your reply
13 brief.

14 MS. ISKANDER: We did -- I think so, yes. The reply
15 brief, correct.

16 ALJ MARGOLIS: Okay. Is that correct Ms. Freeman?

17 MS. FREEMAN: They had communicated originally of
18 this 28 percent and then we provided schedules showing what
19 we thought was the correct computation because there were
20 errors in the audit schedules that we corrected. And then
21 that the most recent provision of these revised numbers was
22 when I was in Hawaii, which was the week of May 4th when we
23 saw the revised numbers.

24 ALJ MARGOLIS: Which was before the -- oh, most
25 recent numbers, May 4th of this year?

1 MS. FREEMAN: Yeah, with the varying numbers.
2 Because before it was just, you know, 28 percent that the
3 revised numbers in 1A, those we got the week I think I was in
4 Hawaii, which was mid -- the week of May 4th.

5 ALJ MARGOLIS: Okay.

6 MS. FREEMAN: That's the first time we saw these
7 revised numbers.

8 MR. KAPLAN: Could I --

9 ALJ MARGOLIS: Sure, take a moment.

10 [Colloquy between counsel and witness]

11 MS. FREEMAN: Okay. I think it -- from numbers from
12 then they may have given us in their reply brief itself.

13 ALJ MARGOLIS: Okay. And when did you first
14 communicate your income apportionment numbers to the FTB? Is
15 that first -- was that first communicated in your brief or
16 before then?

17 MS. FREEMAN: We believe we gave them numbers
18 originally under their theory but using 25120(d) probably in
19 2018.

20 ALJ MARGOLIS: Okay. Thank you. And Ms. Freeman,
21 do -- did some of the pass-through entities hold multiple
22 properties in multiple states?

23 MR. KAPLAN: Could you repeat the question?

24 ALJ MARGOLIS: Didn't some of the pass-through
25 entities hold multiple properties?

1 MS. FREEMAN: I thought they were primarily one per
2 partnership.

3 ALJ MARGOLIS: Okay.

4 MS. FREEMAN: Because they usually listed an address
5 on the partnership.

6 MR. KAPLAN: Right. They, I mean, certainly each
7 property interest was held in its own separate entity,
8 whether it was as tenants-in-common, or as a partner in a
9 partnership, or a member in a LLC. I don't know off hand.

10 ALJ MARGOLIS: I'm looking at Exhibit C, page 7 of 7.
11 Maybe they are.

12 MR. KAPLAN: They're may -- it is possible that there
13 are multiple properties owned in a particular state. I just
14 don't recall off hand.

15 ALJ MARGOLIS: I'm not sure. Okay.

16 MS. FREEMAN: Yeah. I don't recall off hand.

17 ALJ MARGOLIS: Okay. Thank you.

18 Judge Leung, you had a question?

19 ALJ LEUNG: Yeah. I have several for Ms. Freeman and
20 I'm going to take you back some and I think Mr. Kaplan gave
21 introduction but little bit more clear about what your role
22 here was. Were you on the audit team in response to FTB's
23 audit? Were you present there or what was exactly your role?

24 MS. FREEMAN: So I got involved during the appeal.

25 ALJ LEUNG: Okay.

1 MS. FREEMAN: And may be late in the protest process
2 for the original years -- I was involved in the subsequent
3 audit for the subsequent years and assisted with the --
4 including the initial audit meeting for the subsequent years.

5 ALJ LEUNG: And you're familiar with this particular
6 taxpayer, the way they file their returns during the audit
7 years, during the current audit and even prior years, is that
8 correct?

9 MS. FREEMAN: I've seen the tax returns and I did not
10 have to prepare them but I've seen them during the protest
11 and appeal process.

12 ALJ LEUNG: Okay. So prior 2005, was this -- when
13 they were filing at the unitary group, was the in --
14 distributive shares of these non-California pass-through
15 entities, were they classified as business or non-business
16 income?

17 MS. FREEMAN: My understanding is they treated it as
18 a unitary business in the prior years and determined during
19 the current years that it was -- should have been treated as
20 separate trades or businesses for each of the partnerships.

21 ALJ LEUNG: But that wasn't my question. During the
22 prior years, was this income from non-California part - pass-
23 through entities treated as business or non-business income?
24 If you're not -- you only learned, then that's fine.

25 MS. FREEMAN: From reading the protest itself and the

1 appeal, it does indicate in there that as the prior years
2 they didn't treat it as unitary business. I have not
3 personally seen those returns.

4 ALJ LEUNG: Okay. As far as interest expense
5 deductions are concerned for prior years, prior to 2005, were
6 there interest expense deductions taken on this \$156 million
7 loan on the returns?

8 MS. FREEMAN: My understanding is line 18 would have
9 reflected interest expense from the loans and it wasn't -- it
10 was a no change on it was my understanding.

11 ALJ LEUNG: Okay. So that would have been part the
12 federal tax base and they'll be no further California
13 adjustments?

14 MS. FREEMAN: Yes.

15 ALJ LEUNG: Okay. So we flash forward to current
16 year. So from what you're telling me on the prior years the
17 interest expense was fully deducted because there's no
18 California adjustment and those interest expenses for
19 allowable in the federal in term of Revenue Code. So on the
20 current years '05 through '09, you want to use that same
21 methodology to allow the federal computation to flow through
22 without any other California adjustments, is that correct?

23 MS. FREEMAN: On the return as filed there were no
24 state adjustments to allocate interest in their 25120(d).

25 ALJ LEUNG: Okay. Should there be?

1 MS. FREEMAN: In my opinion?

2 ALJ LEUNG: Yes.

3 MS. FREEMAN: Had it been timely raised, there should
4 have been an allocation under 25120(d). And my understanding
5 is in subsequent years we've rectified this situation with an
6 allocation.

7 ALJ LEUNG: Okay. So you're talking about the new
8 issue, issue.

9 MS. FREEMAN: Yeah.

10 ALJ LEUNG: So let's go back to Ms. Iskander's
11 opening statement where she indicates that in her Exhibits A
12 and I believe B that was documentation they sent out to the
13 taxpayer earlier on during the audit or protest that there's
14 some indication that interest expense allocation would be an
15 issue. What is your response to that claim?

16 MS. FREEMAN: My issue is that that issue was raised
17 after the statute of limitations on appeal as a new issue.
18 And it's not using the correct code section. It's using
19 24425 when there's no income excluded from the measure at the
20 base. And 25120(d) should be the correct --

21 ALJ LEUNG: Regards of whether they're approach is
22 correct or incorrect, is Franchise Tax Board correct that
23 their Exhibits A and B indicate that early on before the
24 appeal that the expense -- interest expense allocation issue
25 would be something to be discussed?

1 MS. FREEMAN: I'm not aware that it was brought up
2 before the appeal was filed. My understanding is it was
3 brought up during the discussions between when the appeal was
4 filed and October of 2015 and when the brief -- the response,
5 their brief was filed in December of 2016.

6 ALJ LEUNG: Okay. In the --

7 ALJ MARGOLIS: Wait a second. What happened during
8 that time period? That was the time period that the interest
9 allocation issue was raised?

10 MS. FREEMAN: Yeah. My understanding is when we were
11 at protest the issue of the like-kind exchange was resolved
12 but the issue of debt versus equity and the issue of unitary
13 business was not resolved at protest which was a subject
14 matter of the appeal. And after the appeal was filed, that's
15 when the discussions came up and the concession was made on
16 the unitary business issue, and the debt versus equity issue,
17 and the new issues was raised once they realized the
18 auditor's adjustments were incorrect.

19 ALJ MARGOLIS: Okay.

20 ALJ LEUNG: Okay. And I believe my final question, I
21 promise, in Franchise Tax Board's Reply Brief on pages 3 and
22 5, lines 16 and 11 respectfully, they reference some sort of
23 agreement reached with you or your taxpayer about the proper
24 allocation of interest expense. Did we -- you record any
25 such agreement on any such discussion and if you do record

1 them when did those discussions occur?

2 MS. FREEMAN: I personally would not have been
3 involved in those discussions.

4 ALJ LEUNG: Okay.

5 MS. FREEMAN: That would have been likely maybe
6 Ed Kaplan, if there were any.

7 ALJ LEUNG: Okay. I would ask that same question to
8 give you Mr. Kaplan or Ms. Caldwell guess to testify when she
9 does testify. Mr. Kaplan?

10 MR. KAPLAN: My recollection is -- we certainly never
11 agreed to any methodology of an allocation. We did discuss
12 our whole -- the series of discussions were all premised on
13 the question of, if in fact an allocation is required --

14 ALJ LEUNG: Hu-huh.

15 MR. KAPLAN: -- how would we go about doing it.

16 ALJ LEUNG: Okay. And --

17 MR. KAPLAN: We did not agree that an allocation was
18 required in this instance and we obviously did not agree on
19 what methodology --

20 ALJ LEUNG: Right.

21 MR. KAPLAN: -- would be used if we needed to make
22 one.

23 ALJ MARGOLIS: So is there any documentation or
24 evidence linking the FTB's concession to an agreement to
25 allow them to raise this allocation issue, Mr. Kaplan?

1 MR. KAPLAN: One more -- it --

2 ALJ MARGOLIS: Was FTB's concession of the main
3 issues, the originally raised issues --

4 MR. KAPLAN: Yes.

5 ALJ MARGOLIS: -- that all contingent upon the
6 FTBing -- FTB being permitted or allowed to raise an
7 allocation issue?

8 MR. KAPLAN: Certainly not that was ever communicated
9 to us.

10 ALJ LEUNG: So getting back to my original question,
11 you mentioned there was some sort of discussion. What's the
12 timeframe, post appeal filing, during protest, between your
13 opening brief and their opening brief, what's your
14 recollection?

15 MR. KAPLAN: The very first time we heard about the
16 question of interest allocation was after the filing of the
17 taxpayer's appeal in this matter. The -- after the filing of
18 the appeal, both the issues of unitary and debt equity were
19 being addressed. The initial discussions were only related
20 to those issues and then at some point in time, I do have
21 notes, not with me here, receiving a phone call that the --
22 or maybe it was an email, that the Franchise Tax Board was
23 conceding the two main issues but now had another question
24 about the deductibility of how much of the interest could be
25 deducted for California purposes.

1 ALJ LEUNG: Okay. Ms. Iskander, is Mr. Kaplan's
2 recollection as to the approximate time of when the interest
3 expense allocation issue was put up accurate?

4 MS. ISKANDER: As soon as they filed -- they filed an
5 app -- the brief -- the opening brief and then legal division
6 received that opening brief and I was assigned to that
7 appeal. When I reviewed the issues and decided that --
8 another attorney actually reviewed the debt versus equity
9 issue and as soon as that attorney decided that debt
10 equity -- decided to side with the Appellant for us to
11 concede, we all -- we communicated that even though they
12 would be allowed to take an interest expense deduction that
13 that interest expense deduction would be limited.

14 And we had extensive discussions about that and we do
15 have a record of that in the form of emails. I also believe
16 I have an email stating specifically to the taxpayer that 28
17 percent was not something that we proposed but it was
18 something for illustration purposes only to inform taxpayer
19 how this would look so that they would know their rights and
20 decide whether or not to appeal this issue further.

21 ALJ LEUNG: Thank you, Ms. Iskander. Thank you, Ms.
22 Freeman. Thank you, Mr. Kaplan. That's all.

23 ALJ MARGOLIS: Ms. Freeman, what were the other
24 partners in BBC -- who were the other partners in B.B.C.A.F.
25 besides the British Broadcasting Company Pension Fund?

1 MR. KAPLAN: No, Pension Fund is the sole owner of
2 B.B.C.A.F. B.B.C.A.F. makes investments with Grovner [sic]
3 USA or Grovner [sic] California.

4 ALJ MARGOLIS: Grosvenor.

5 MR. KAPLAN: I don't remember which of the entities.

6 ALJ MARGOLIS: Okay.

7 MR. KAPLAN: And it makes it in tandem with
8 Grovner [sic] either as partners in partnership, members in
9 an LLC, or as tenants-in-common. They generally, I don't
10 know if this is always been the case, but certainly the vast
11 majority if not all. They are 50/50 owners. Grovner [sic]
12 handles the management of the properties and essentially most
13 of the financing.

14 ALJ MARGOLIS: Okay. And I guess there was an issue
15 raised by you in your brief and commented on by Ms. Iskander
16 in her opening statement about the fact that one of the
17 properties was purchased before the first loan was made. So
18 it's -- that's a little bit, you know, confusing about if we
19 do look at the -- where the money went to it would seem that
20 that money, you know, could not be allocated to any
21 particular property unless it was a refinancing or something.
22 Is there any indication as to, I mean, there's a statement in
23 the record -- one of these exhibits was an IDR response where
24 basically the person who represented for B.B.C.A.F. says that
25 this money came in and was used to purchase properties?

1 MR. KAPLAN: Yes.

2 ALJ MARGOLIS: But one property was purchased before
3 the first loan.

4 MR. KAPLAN: I'm not certain that that's the case.
5 I don't know it to be true or not true. This is the first
6 time the question of whether --

7 ALJ MARGOLIS: I think it was mentioned in your brief
8 about that.

9 MR. KAPLAN: That -- well, if it was then I'm -- my
10 recollection is not as good as it should be.

11 MS. FREEMAN: I think that if there was property
12 purchased without lending, then that would be an issue
13 impacting potentially the calculations. Because should the
14 properties in -- that are not subject to the financing go
15 into the allocation or you consider it all or nothing when
16 you go to all their assets. So and just remember some of
17 their assets have been sold and are sitting in cash and
18 nothing's been allocated to that, but the interest has been
19 treated as California - a hundred percent in California.

20 ALJ MARGOLIS: Mr. Kaplan, it's on page 6 of your --
21 I think it's your reply brief. You said, the first property
22 was purchased in January 1, '97 but the first loan wasn't
23 made until October 29th, 1998.

24 MR. KAPLAN: I will not back off of the statement
25 contained in the brief, Your Honor. I stand reminded.

1 ALJ MARGOLIS: Ms. Iskander, how should we deal with
2 that fact -- the fact that, I mean, does that fact which is
3 apparently is -- how would that be taken into account in your
4 computations?

5 MS. ISKANDER: There's several ways to think about
6 this problem. One way is -- when we use Revenue Procedure
7 72-18, and I would be happy to walk through that formula to
8 explain why it is really a reasonable long-term formula.
9 When we take that, we consider circumstantial evidence and
10 then we don't pay attention to the actual link. All we do is
11 we say how much assets do you owe during a given year in
12 California versus all of your assets and we assign based on
13 that.

14 So let's say the tax -- that allows for flexibility
15 for the taxpayer and it also reflects the purpose and use.
16 So we don't even have to say well, how much did you spend on
17 this property or did this property was part of the loan, or
18 did you finance it further. So as long the loans are
19 maintained and not paid off, so for example we know that in
20 2013 they paid off some of the loan so the insurance
21 deduction would be smaller but the percentage would still
22 vary on the taxpayer's holdings of the investments. And it
23 would be reflected the purpose and use of loans because since
24 loans are still on the books and the interest expense is
25 still generated, it will be prorated based on the formula.

1 And again, I would be happy to walk through that
2 formula to explain why it actually is beneficial to the
3 taxpayer in the long run and it's easy to administer for the
4 FTB.

5 However, if we don't go with 72-18, then we have to
6 pick and choose and that becomes difficult. So for example,
7 we know from the evidence from this page 6 of the brief that
8 states that, California property was purchased prior to the
9 initial loan. So, you know, BBC Pension Trust made a capital
10 contribution and that purchased -- and was purchased and then
11 their followed loans. We have an evidence on file that BBC
12 Trust made a capital contribution for example.

13 So if we do that, then we have a direct link for that
14 specific property which means no interest expense reduction
15 will be assigned to that property and then we are stuck in
16 determining -- so if we can't allocate, if we can't allocate
17 anything to this California property, then what should we do?
18 Should we consider income from that California property as a
19 repayment of the loan? Should we consider all other
20 properties they purchased after and, you know, basically
21 bifurcating an evidentiary into direct and indirect, which
22 makes it very messy. And that's exactly why Revenue
23 Procedure 72-18 formula is very helpful. Because it treats
24 the interest expense as either supported by direct link or
25 supported by circumstantial evidence.

1 In this case we have -- we don't have a direct link
2 to all the properties but we have sufficient circumstantial
3 evidence suggesting that loans were used to purchase real
4 estate in and out of California. And to allocate that
5 interest expense is most reasonably and most easily to
6 administer is to look at the average assets in California
7 versus total assets.

8 ALJ MARGOLIS: Okay. Do you have any more questions
9 on the - for them?

10 ALJ LEUNG: Yeah. From -- not for Ms. Freeman but
11 for Ms. Iskander this last point about Rev Proc 72-18. Now,
12 that's the IRS's answer for IRC 265. So is FTB's position
13 that Revenue and Tax Code 24425 is to California equivalent
14 of IRC 265 was there some other stand-alone Revenue and Tax
15 Code provision that conforms to IRC 265?

16 MS. ISKANDER: No. It is patterns, 24425 is
17 patterned under the federal provision that you mentioned but
18 because we have different rules for income that is included
19 and excluded for a measure of tax, the tax-exempt language
20 that is used for federal purposes is not the same for
21 California purposes. And that's why it uses excluded from
22 measure of tax instead of using something like tax-exempt
23 obligations.

24 ALJ LEUNG: Which would allow FTB to use that
25 provision against non-interest type exclude or accept income,

1 for instance insurance company dividends.

2 MS. ISKANDER: Which would allow a tax Respondent to
3 use that formula in order to allocate expenses -

4 ALJ LEUNG: Uh-huh.

5 MS. ISKANDER: -- that are not matched with the
6 income that is included in the measure of tax.

7 ALJ LEUNG: But in your discussion of flexibility,
8 nether the Franchise Tax Board, nor the taxpayers, nor this
9 panel is bound to use Rev Proc 72-18, correct?

10 MS. ISKANDER: Well, Revenue Procedure 72-18 was
11 actually a part of precedential appeal of *Zenith* case.

12 ALJ LEUNG: Uh-huh.

13 MS. ISKANDER: That formula specifically was not
14 applied in Court of Appeal decisions in *Apple v. FTB* that
15 endorsed the appeal of *Zenith*, but had there been needs for
16 circumstantial evidence in appeal -- in the appeal of
17 *Apple v. FTB*, I'm pretty sure that they would turn to Revenue
18 Procedure as well.

19 So then it is binding unless this panel decides that
20 it doesn't want to be bound by it or it's not precedential
21 anymore. And *Zenith* -- appeal of *Zenith* did discuss Revenue
22 Procedure 72-18, did apply it and did state that it's the
23 best solution in long term.

24 ALJ LEUNG: Okay.

25 MS. ISKANDER: I also would like to just state for

1 the clarification as far as the prior years when they filed
2 unitary, the expense -- the interest expense that they would
3 have included in that return would have been apportioned as
4 well. So it's not as if they would provide income based on
5 the unitary basis but full of the interest. The interest
6 expense would also be apportioned during the unitary years.

7 ALJ LEUNG: I would ask that to you auditor when she
8 took the stand but I guess, I won't have to.

9 ALJ MARGOLIS: She won't be taking the stand
10 probably.

11 Any more questions for Ms. Freeman?

12 ALJ LEUNG: No.

13 MS. FREEMAN: I have one statement regarding the Rev
14 Proc, is that the securities themselves would never fluctuate
15 in value and so, you know, you spent \$100 million buying a
16 \$100 million worth of securities, you know how much you
17 borrowed for a specific dollar amount with respect to
18 partnership investments. In this case, we would sold some
19 we've done like-kind exchange, we felt reflected their value.
20 The partnership itself if I don't take distributions, the
21 value is up, if I take distributions the value goes down.
22 Depending on depreciation methods and amortization can
23 significantly inflict -- effect the investment base versus
24 the income you're going to earn from real property is going
25 to be fairly static. So.

1 ALJ MARGOLIS: Well, yes but your numbers go way up
2 and down each year. Your percentages based upon the --

3 MS. FREEMAN: Yet, and some of its --

4 ALJ MARGOLIS: -- source of income it goes up and
5 down considerably.

6 MS. FREEMAN: Right. Right. Because we have sold
7 stuff over the years and the interest income's gone up and
8 things like that so there are reasons why that there are some
9 fluctuations. But currently a hundred percent of the
10 interest income is coming to California anyways so you're --
11 like I said we believe the offset applies but we don't -- we
12 think our methodology is just as reasonable actually more
13 reasonable than the methodology proposed by the FTB and under
14 25120(d) which is the appropriate authority and actually
15 applicable under 24425 a reasonable method can be used. The
16 FTB has not disproved that our method is unreasonable.

17 ALJ MARGOLIS: Okay. Let's move on to FTB your
18 witness.

19 MR. CORNEZ: Yes.

20 ALJ MARGOLIS: Would you like to call a witness?

21 MR. CORNEZ: Yes.

22 ALJ MARGOLIS: Thank you.

23 Ms. Iskander, I'm sorry, did you want to
24 cross-examine Ms. Freeman and additionally you were asking
25 questions and speaking about your --

1 MS. ISKANDER: No. But again, like I am not sure, to
2 be honest with you, because Ms. Freeman is making statements
3 that are argumentative. I feel like I have to explain that
4 it's not necessarily so, but I can't because she's a witness
5 and she's supposed to, so I'm not sure whether I'm supposed
6 to reply to things that are stated otherwise or if I just
7 supposed to let it go and this is admitted as a fact.

8 ALJ MARGOLIS: Well, I think that you --

9 MS. ISKANDER: So for example --

10 ALJ MARGOLIS: -- had an opportunity to make your
11 arguments, I mean, we could go on. If you want to respond to
12 Ms. Freeman's most recent response, if you want to ask her
13 specific questions, you're allowed to cross-examine her. And
14 you'd be allowed to make your position in closing argument as
15 well.

16 MS. ISKANDER: Right. Then I'll do that.

17 ALJ MARGOLIS: Okay.

18 MR. CORNEZ: We, the Franchise Tax Board was
19 requested at a pre-hearing conference to have the schedules
20 that the taxpayer provided which are now Exhibit 18, pages 2
21 through 4, I believe, could review those schedules to make
22 sure that they were mechanically accurate and tied to tax
23 return information. And so I call to the stand
24 Yelena Kuznetsov to testify so would you like to swear her
25 in?

1 ALJ MARGOLIS: Ms. Kuznetsov, please raise your right
2 hand and repeat after me.

3 [Witness sworn in]

4 ALJ MARGOLIS: Thank you. Please be seated.

5 MR. CORNEZ: Could you state your name for the record
6 please?

7 MS. KUZNETSOV: Yelena Kuznetsov.

8 MR. CORNEZ: And what is your position?

9 MS. KUZNETSOV: Tax Auditor of the Franchise Tax
10 Board State of California.

11 MR. CORNEZ: And were you asked by FTB staff to
12 review the numbers shown on Exhibit 18?

13 MS. KUZNETSOV: Yes.

14 MR. CORNEZ: And did you do that?

15 MS. KUZNETSOV: Yes.

16 MR. CORNEZ: And in response, did you find any
17 numbers that were different than the amounts that you thought
18 should be on that schedule?

19 MS. KUZNETSOV: Yes. So for 2005, the interest
20 deducted a hundred percent. The taxpayer's schedule shows
21 \$9,413,348, and that number does not agree with what we have
22 in our schedule which is \$10,037,194.

23 MR. CORNEZ: So where -- so you re -- you re-prepared
24 that schedule and that is Exhibit I?

25 MS. KUZNETSOV: That's correct.

1 MR. CORNEZ: And on Exhibit I which amount did you
2 use for Schedule 1A on Exhibit I -- or Scenario 1A on Exhibit
3 I, which amount did you use?

4 MS. KUZNETSOV: The amount that I used was
5 \$10,037,194.

6 MR. CORNEZ: And where did that amount come from?

7 MS. KUZNETSOV: That amount came from the originally
8 reported California tax return.

9 MR. CORNEZ: And as a result of changing that amount
10 on 1A, what other changes to Schedule 1A occurred?

11 MS. KUZNETSOV: So as a result, we have a different
12 interest -- additional interest allocated to California and
13 then also the amount of tax due.

14 MR. CORNEZ: And for a schedule for Scenario 2A, --

15 MS. KUZNETSOV: Uh-huh.

16 MR. CORNEZ: -- what changes did you make?

17 MS. KUZNETSOV: So for --

18 MR. CORNEZ: Comparing our Exhibit I to the
19 taxpayer's Exhibit 19.

20 MS. KUZNETSOV: So for Scenario 2A the -- again
21 interest deducted instead of \$9,413,348 as provided in the
22 taxpayer's schedule, the amount that we have is \$10,037,194.
23 So that's the difference between the taxpayer's schedule and
24 our schedule.

25 MR. CORNEZ: And on schedule Scenario 3 of Exhibit I

1 as compared to Exhibit 19, what changes did you make?

2 MS. KUZNETSOV: So in Scenario 3, again the
3 difference between the taxpayer's schedule and our schedule
4 is the taxpayer's schedule reflects the interest deducted of
5 \$9,413,348 and our schedule shows interest deducted of
6 \$10,037,194.

7 MR. CORNEZ: And on Schedule 4 of -- Scenario 4 of
8 Exhibit I as compared to the taxpayer's Exhibit 19, what
9 change was -- did you make?

10 MS. KUZNETSOV: So in Scenario 4, the difference
11 between our schedule and the taxpayer's schedule is again the
12 interest deducted of a hundred percent and so our schedule
13 reflects the originally reported amount of interest deducted
14 of \$10,037,194 and the taxpayer's schedule shows interest
15 deducted of \$9,413,348.

16 MR. CORNEZ: And in reviewing the taxpayer's schedule
17 and preparing Exhibit I, did you review the mathematics or
18 the mechanics or the arithmetic of the schedules?

19 MS. KUZNETSOV: Yes, I did.

20 MR. CORNEZ: And it would - isn't your opinion are
21 they all correct?

22 MS. KUZNETSOV: Yes, they are.

23 MR. CORNEZ: Did you look at the propriety of the --
24 or the -- whether or not the methodology was appropriate?

25 MS. KUZNETSOV: No. I have not looked at the

1 methodology.

2 MR. CORNEZ: I have no further questions.

3 ALJ MARGOLIS: Mr. Kaplan, I just note that the one
4 change she's made which is the 2005 interest deduction
5 amount, she seems to -- you seem to have the correct amount
6 on Exhibit 15 but the amount that you claim discretion on
7 Exhibit 15 somehow between Exhibit 15 and 18 that figure got
8 changed. I'm not sure what the reason for it is.

9 MS. FREEMAN: I think the issue is whether it ties to
10 the audit schedules versus the return. And I think we're
11 bound by the audit schedules, if that's the case. So the
12 question is whether she pulled a number from the return or
13 from the audit schedules.

14 ALJ MARGOLIS: Okay. Well, maybe, Mr. Kaplan, may
15 we? Did you pull these -- this \$10 million figure from the
16 audit schedules or from the return?

17 MS. KUZNETSOV: From the return, from the original
18 tax return.

19 ALJ MARGOLIS: Okay. Mr. Kaplan, do you have any
20 cross-examination?

21 MR. KAPLAN: A couple of minor questions. Did you
22 compare the interest expense deduction number to the numbers
23 used on the Notice of Proposed Assessment or Notice of Action
24 with respect to 2005?

25 MS. KUZNETSOV: No. I did not compare it because I

1 don't have the Notice of Proposed Assessment. I'm not sure
2 which Notice of Proposed Assessment we are referencing here
3 to.

4 MR. KAPLAN: No other questions.

5 ALJ MARGOLIS: Ms. Kuznetsov, which -- so you were
6 not involved in, you know, the interest allocation
7 percentages at all?

8 MS. KUZNETSOV: No, not in the interest allocation
9 percentages.

10 ALJ MARGOLIS: Okay. See if any of my colleagues
11 have any questions?

12 MS. FREEMAN: I think we would concede to whatever
13 numbers right, but I think we're bound by the audit
14 schedules, if it's going to increase tax.

15 ALJ MARGOLIS: Okay. You're dismissed -- the witness
16 here.

17 Ms. Iskander, I have a question. You have Exhibit F
18 which is I believe your interest -- is how you came up with
19 your interest allocation --

20 MS. ISKANDER: Yes.

21 ALJ MARGOLIS: -- percentage. Can you tell us how
22 that was done?

23 MS. ISKANDER: Yes. The formula that Revenue
24 Procedure 72-18 provides is the average -- is it -- that
25 formula is to first calculate excludable interest. So the

1 formula is how much of the interest -- what portion of the
2 interest is excluded from a California return. So that's the
3 starting point for that formula and it's calculated by taking
4 average out-of-state investments because those investments
5 produce excludable from California return, average
6 investments out of California and divide that by the total
7 assets for the year.

8 So the total assets for the year include both real
9 estate investments and any other assets that the taxpayer may
10 have. So any cash or cash accounts for example or any other
11 assets that Respondent may have that is -- has been
12 separated, for example, from real property investments.

13 So you can see the total assets for financial
14 statements -- so all of these numbers were pulled from
15 Respondent from a balance financial statements that are also
16 attached as an exhibit so they easily can be verified. If
17 you take average -- for total assets in financial statements
18 you can see that for 2004 it's 271 million, for 2005 it's
19 283.8 million. You can see that, right? I would like to
20 make sure that you guys follow and I don't just rant.

21 ALJ GAST: Okay. Which part?

22 MS. ISKANDER: So I'm looking at Exhibit F.

23 ALJ GAST: Uh-huh.

24 MS. ISKANDER: And I'm asked to explain how these
25 numbers were calculated. This Exhibit F provides assets and

1 there adjusted -- and there value as stated in the --
2 adjusted basis actually that stated in the financial
3 statements.

4 So we first have California assets and a subtotal of
5 California investment line which says 35 million, 43 million,
6 48 million. Do you see that line?

7 ALJ MARGOLIS: Wait, where -- how far down the --

8 UNIDENTIFIED SPEAKER: Do you need a copy? Do you
9 have a copy of this form?

10 MR. KAPLAN: I don't have a copy.

11 MS. ISKANDER: It's Exhibit F.

12 ALJ MARGOLIS: We can share. Mr. Kaplan may
13 approach.

14 [Colloquy between parties]

15 ALJ MARGOLIS: Okay. The -- okay, I see it now it's
16 the first line that's in the --

17 MS. ISKANDER: Okay. So we'll start over. Okay, the
18 first line is interest expense deduction for Schedule F of
19 the return. We can see that the 2005 through 2009 it lists
20 the interest expense deduction, right?

21 ALJ MARGOLIS: Uh-huh.

22 MS. ISKANDER: Then we have assets for financial
23 statements. The assets of start -- the value starts on 2004
24 and goes through 2009. At first, we have California
25 investments and those investments are subtotaled as -- for

1 example for 2004 is \$35,400,065.03, do you see that? It's
2 right after --

3 ALJ GAST: Yes.

4 MS. ISKANDER: -- 306 Rodeo Drive.

5 ALJ GAST: Okay. You're right here.

6 MS. ISKANDER: Yes?

7 ALJ GAST: Yes.

8 ALJ MARGOLIS: Yes.

9 MS. ISKANDER: Subtotal California investments. Then
10 if we move farther down -- further down you see all the
11 investments that are non-California investments, and it says,
12 subtotal out-of-state California investments. Yes?

13 UNIDENTIFIED SPEAKER: Yes.

14 MS. ISKANDER: And we have 2009, 2004.

15 Then it says, total other investments 244. You can
16 see that, right? So this is the sum 244 million this is the
17 sum of California investments and out-of-state investments.
18 Now we see the line total assets for financial statements
19 that's 271. You can see that the total assets are greater
20 than the sum of the real estate investments. Right?

21 So then we move to formula. The formula takes into
22 account average adjusted basis which means it takes the
23 beginning of the year, and end of the year, and averages for
24 the purposes of calculating. And that is helpful because
25 even in the beginning of the year Appellant has one set of,

1 you know, their portfolio investment is one -- includes one
2 set of investments and the end of the year is different than
3 the average would reflect that. Right?

4 So an average out-of-state investment for the year
5 beginning and ending divided by two, you see that line,
6 right?

7 ALJ GAST: Hu-huh.

8 MS. ISKANDER: Is 207. Well, 207 million is an
9 average of 209 million for 2004 out-of-state investments and
10 204 million for 2005. So the numerator of the formula is
11 out-of-state investments averaged at their adjusted basis.
12 And the denominator of that formula is a total assets, again,
13 averaged. If you take total assets for the 2004 and 2005,
14 you average them and that becomes 2007 -- 277 million.

15 That is how -- this is how you divide to
16 out-of-state investment proportion consider -- compares to
17 total assets, right? So you say, 74 percent -- 74.63 percent
18 of the interest expense deduction should not be included in
19 California return. So the remainder would be included in
20 California return.

21 I stated earlier that this calculation -- first do
22 you have any question so far?

23 ALJ MARGOLIS: Uh-uh.

24 MS. ISKANDER: Okay.

25 Early I stated that this calculation the Revenue

1 Procedure applied -- provides is actually helpful to the
2 taxpayer. And the reason it is helpful because instead of
3 first calculating California investments over total assets,
4 it calculates out-of-state assets total -- over total assets
5 and total assets usually are larger so denominator is larger.

6 For illustration purposes and I think that would be
7 more helpful than me just trying to prove it to you, I would
8 like to provide you with and this is not an exhibit it's
9 simply an illustration that had the formula played --

10 ALJ MARGOLIS: Let's at least mark this. Simply
11 marked as Exhibit J.

12 UNIDENTIFIED SPEAKER: Thank you.

13 ALJ MARGOLIS: Purpose of -

14 Go ahead.

15 MS. ISKANDER: Okay. So for illustration purposes if
16 we took, and I had to make correction you can see California
17 in a formula, average California state's investments over
18 total assets, right. That will give you -- you would think
19 well; we could just do that and get straighter percentage of
20 the includable interest expense. Well, that amounts to 14
21 percent instead of the 25 percent on our prior Schedule F.
22 If you compare this number, the last number, allowed portion
23 of interest expense on this Exhibit J to the last number on
24 Exhibit F, you will see that by using Revenue Procedure
25 taxpayer gets to deduct 25 percent of the expense against his

1 income -- California income instead of 14 percent.

2 And if you think about it, the only -- based on
3 average value, right? They only use 14 percent but they get
4 to deduct 25 because the formula actually favors a deduction
5 and gives taxpayer a better leverage.

6 ALJ LEUNG: Now, Ms. Iskander, when you talk about
7 adjusted basis of assets, are you talking about assets in
8 terms of the pass-through entity as the asset --

9 MS. ISKANDER: Yes.

10 ALJ LEUNG: -- or as asset or as the real estate
11 itself as the asset and other assets within that pass-through
12 entity? Which would you have?

13 MS. ISKANDER: It's pass-through entity.

14 ALJ LEUNG: Is the value of the entity itself.

15 MS. ISKANDER: It's the value of the entity itself.

16 So the distributions, for example, from the properties would
17 reduce basis and contributions will increase basis. So it is
18 the basis of the investments, not the basis of real property.

19 ALJ LEUNG: Well, the problem is that the loan itself
20 doesn't change based on the how the adjustment bases the
21 assets whether they go up or down. They're still the same,
22 correct?

23 MS. ISKANDER: The loan does not change, the
24 assignment of that loan changes based on average assets. And
25 this is so because Revenue Procedure 72-18 is only triggered

1 when we try to approximate in the absence of direct link.

2 ALJ LEUNG: Well when you say the assignment, you
3 mean the assignment the interest expense not the separate
4 loans stating --

5 MS. ISKANDER: The interest expense on those loans.

6 ALJ LEUNG: Okay. Thank you.

7 ALJ MARGOLIS: Okay. I'm trying to track this
8 through to the financial statements, Ms. Iskander, and I see
9 for example for 2009 you come up with a -- well, looking at
10 your Schedule F for 2009 come up with a figure for Atlantic
11 Freehold which is halfway down Exhibit F on the far right of
12 \$43,083,016 --

13 MS. ISKANDER: I'm sorry I have to find the where
14 you're looking at in financial statements, is that correct?
15 You're trying to verify the number?

16 ALJ MARGOLIS: You will in a second, I'm just trying
17 to show you what you're comparing -- yeah you can look at
18 Exhibit G, page 120 of 128.

19 MS. ISKANDER: Okay. Exhibit G, the new one that --
20 I'm looking at Exhibit G, correct?

21 MR. CORNEZ: No.

22 ALJ MARGOLIS: Yes.

23 MR. CORNEZ: That's J. G is --

24 MS. ISKANDER: I'm sorry.

25 MR. CORNEZ: G is there.

1 MS. ISKANDER: G is financial statements. Okay. And
2 which page?

3 ALJ MARGOLIS: Page 120.

4 MS. ISKANDER: Okay. Exhibit G starts with page 128.
5 You are looking at -- I'm sorry, 120.

6 ALJ MARGOLIS: So.

7 MS. ISKANDER: Yes.

8 ALJ MARGOLIS: I see on the bottom row of page 120 of
9 Exhibit G the numbers that appear I believe on the righthand
10 side, on the right row's column of Exhibit F for these
11 partnerships. So if this does track through from the
12 financials but you --

13 MS. ISKANDER: Can you give me a second please. Just
14 a second.

15 ALJ MARGOLIS: Sure.

16 MS. ISKANDER: I'll have my manager help me with the
17 tracing of the numbers from financial statements. Okay. So
18 I'm looking at page 120 of Exhibit G and which property?

19 ALJ MARGOLIS: Well, all the property -- I mean, all
20 the properties the bottom row I believe corresponds with the
21 right most row of Exhibit F. So for example half way down
22 Exhibit F, you see on the right row's column you see a
23 \$43 million figure?

24 MS. ISKANDER: Yes.

25 ALJ MARGOLIS: And that's at the bottom of the first

1 column of Exhibit G for Atlantic Freeholds of their net
2 assets.

3 MS. ISKANDER: Yes.

4 ALJ MARGOLIS: I just don't -- I'm not -- you say
5 that you're comparing these assets or using these assets
6 through adjusted basis but I don't -- I'm not so certain that
7 the financial statements is based on their adjusted basis for
8 tax purposes. I don't, I guess, that's my question, are you
9 comparing apples and oranges here.

10 MS. ISKANDER: I don't think so I'm looking at the --
11 what they have here. I'm looking at the value of their
12 assets on a given year -- during a given year and a given
13 date.

14 ALJ MARGOLIS: Okay. Where do you get -- okay, well
15 let's -- so you're taking the numbers from this page. Where
16 do you get -- come up with the -- which page of Exhibit G do
17 you use to find out the total assets for financial
18 statements? Are you just summing up these columns or is
19 there a separate entry on the financial statements?

20 MS. ISKANDER: No. The total assets I believe is in
21 the --

22 ALJ MARGOLIS: Judge Leung said this might have to do
23 with some M-1 and M-3 adjustments but let's, let's figure it
24 out --

25 MS. FREEMAN: All right.

1 ALJ MARGOLIS: -- in a second.

2 MS. FREEMAN: Can we take a five-minute break?

3 ALJ MARGOLIS: Yes. Let's take a about a five-minute
4 break. I would like to have these figures kind of explained
5 to me how you came up with them. And I kind of have some
6 questions about --

7 MS. ISKANDER: Right there -- okay. So I can -

8 ALJ MARGOLIS: Ms. Iskander, -

9 MS. ISKANDER: -- tell you where that number is.

10 ALJ MARGOLIS: -- Ms. Iskander, we're going to take a
11 break but I -- but when we get back, I'd like to kind of
12 track these numbers. And I have some questions about using
13 deductions, withdrawals, and things and making your
14 computations, and depreciation deductions things like that.

15 MS. ISKANDER: I just would like to -- are we done?
16 I'm sorry, I mean, are we not talking --

17 ALJ MARGOLIS: We're going to take a recess.

18 MS. ISKANDER: -- I'm going to tell -- talk later,
19 right?

20 ALJ MARGOLIS: Yeah.

21 MS. ISKANDER: Okay.

22 ALJ MARGOLIS: Work on your project more.

23

24 [Recess taken at 1:07 p.m.]

25 [Proceeding resumed at 1:20 p.m.]

1

2 ALJ MARGOLIS: Okay. We're back on the record.

3 MS. ISKANDER: So your last question was, where the

4 total assets come from?

5 ALJ MARGOLIS: Yes.

6 MS. ISKANDER: Okay. That's page 108.

7 ALJ MARGOLIS: 108.

8 MS. ISKANDER: Of Exhibit G.

9 ALJ MARGOLIS: Of G. I'll pull it up. This one?

10 [Colloquy between parties]

11 ALJ MARGOLIS: Okay. And so the total assets is

12 \$625 million, okay.

13 Okay. I have a question then. If you look at the --

14 page 120, the \$43 million figure you're using for let's say

15 Atlantic Freeholds, that is net assets -- assets plus

16 liability. But it looks like the number you're comparing to

17 for the corporation is total assets, it doesn't take in to

18 account liabilities.

19 MS. ISKANDER: Well, if you look at -- it seems that

20 their presentation has changed in the later years, but the

21 numbers may, you know, if you look at page 13 for example, of

22 the same exhibit.

23 [Colloquy between parties]

24 ALJ MARGOLIS: Okay. Go ahead.

25 MS. ISKANDER: And you see there, Atlantic Freeholds

1 balance at the end of the year?

2 ALJ MARGOLIS: Yes.

3 MS. ISKANDER: And it says 13,330,717 for the year
4 2005.

5 ALJ MARGOLIS: Right.

6 MS. ISKANDER: That's -- that number corresponds to
7 Atlantic Freehold for 2005 on the Schedule F.

8 ALJ MARGOLIS: Corresponds to what number?

9 MS. ISKANDER: Schedule F. Atlantic Freehold for
10 2005. I mean Schedule F, the Exhibit F.

11 MR. COR NEZ: Exhibit F.

12 ALJ GAST: Right here.

13 ALJ MARGOLIS: Oh. You changed gears on me --

14 MS. ISKANDER: It seems that they have.

15 ALJ MARGOLIS: -- I thought we were talking about
16 2009.

17 MS. ISKANDER: It seems that their financial
18 statements have different presentation but the numbers that
19 are reflected as a actually a value at the end of the year.

20 They just -- it seems they name it differently but if
21 you look at 2004, 2005.

22 ALJ MARGOLIS: Can we stick with 2009? We're talking
23 about -- we were at page 120 of 128 of Exhibit G and we have
24 a \$43 million which was net.

25 MS. ISKANDER: Yes.

1 ALJ MARGOLIS: And then you said that on page, what
2 was it, 108 of that exhibit it had the total assets. I just
3 want to make sure that that year tracks through.

4 So after you take out liabilities -- when you take
5 out liabilities for the parent company like you do for the
6 pass-through entities it's only 384 million. I'm not an
7 expert in this.

8 MS. ISKANDER: What I'm trying to say here is that --
9 well, I'm also an attorney -- I'm also not an auditor. This
10 case was put by an auditor. Looking at the financial
11 statements and taking to consideration the value of the
12 financial -- of the assets based on financial assets trying
13 to apply the formula.

14 Now, the formula applies equally to every property on
15 that list. Which means if we take net assets for one
16 property, let's say like I did somewhere else, it will be the
17 same amount of calcs -- the same calculation for the property
18 in California. So it's not as if we treat different
19 properties out of state differently from California real
20 property.

21 This is their financial statements. If you look at
22 2004, 2005, their presentation is reflective of adjusted
23 basis of their investments. It seems that the presentation
24 on page 120, they tried to achieve the same presentation for
25 financial statement purposes but they do it in a different

1 way.

2 So again, if you trace those numbers to value of the
3 assets, then you will find them in this schedules. If you
4 want me to explain to you why 43 number is the value of their
5 asset is because it says that this is the -- because it says
6 that this is the net asset value of that specific asset. And
7 again, it's used across for all the properties it's not as if
8 one property is prejudiced against the other.

9 ALJ MARGOLIS: Okay. Let me ask you one --

10 MS. ISKANDER: So the percentage --

11 ALJ MARGOLIS: -- more question before I move to
12 Ms. Freeman. You've been saying that you've been using the
13 adjusted basis -- I think you -- you're not really using
14 their adjusted basis for tax purposes in determining their
15 values. I think you're using -- the financial statements
16 seem to be using the fair value for financial reporting
17 purposes. Is that correct?

18 MS. ISKANDER: That's possibly so but the Revenue
19 Procedure does not differentiate -- it does not require for
20 us to use tax basis or [indiscernible] basis.

21 ALJ MARGOLIS: No, I was concerned because I thought
22 you were using tax basis --

23 MS. ISKANDER: We're using financial statements and
24 we made it clear that we use numbers from financial
25 statements. And during our pre-hearing conference, I was

1 specifically asked why I submitted financial statements and I
2 specifically responded because those support numbers in
3 Exhibit F.

4 ALJ MARGOLIS: Okay.

5 Ms. Freeman, can you explain -- or help shed some
6 light on the FTB's computation?

7 MS. FREEMAN: Sure.

8 ALJ MARGOLIS: I know it's kind of weird to ask you
9 to this but.

10 MS. FREEMAN: No, no, no. I understand. So the
11 Revenue Procedure that they're talking about 72-18 is dealing
12 with securities -- tax exempt securities. Your basis is
13 never going to change. So if I pay \$100 million for the
14 securities and my debt is 100 million, it's static until I
15 sell them and obviously the interest is going to, you know,
16 change because I've obviously repaid it.

17 ALJ MARGOLIS: I understand.

18 MS. FREEMAN: Yeah. Here you have a situation and I
19 think the one entity that you did pick is representative of
20 our concerns over the reasonableness of their methodology is,
21 you know, we started out with \$156 million in debt, that
22 didn't change. And we actually did pay down \$35 million of
23 it. So what you see here is for example in 2004 for Atlantic
24 Freehold, you see an \$11 million base. So let's just assume
25 that is what they paid for it, you know, I don't know that it

1 is, but you see over time that this out-of-state investment
2 goes up to \$60 million investment when the loans haven't
3 changed.

4 So to use a -- try to force a Revenue Procedure to
5 apply to a type of asset it was never intended to apply to,
6 in our opinion, is somewhat distortive and doesn't clearly
7 reflect the base of the asset in question that were purchased
8 with these -- with the funds in question. So and it's not
9 just that one asset. You now have a 100 -- say the
10 \$156 million continued on through -- when they refinanced 12.
11 So for all these years you have \$156 million in debt but
12 you're looking at \$822 million in assets and you're not
13 actually looking at the properties your -- necessarily
14 itself. It could be other assets sitting in the partnership
15 as well and undistributed, you know, share the partnership
16 income. And, you know, whether you choose to pull money out
17 of a California investment or an out-of-state investment
18 absolutely can impact this ratio and it's sort of arbitrary
19 in my opinion. Because of the nature of the asset I don't
20 think it -- the Re Proc is reasonable means.

21 ALJ MARGOLIS: Okay. But if their method is
22 conceptually correct, I guess, my question is are they, in
23 your opinion, are they comparing fair value of individual
24 assets versus fair value of total assets or are they doing
25 something else here?

1 MS. FREEMAN: My understanding --

2 MR. SWIESCO: If I may opine, for financial statement
3 purposes, one of the principals is conservatives. Being
4 conservative meaning with respect to assets, you either do
5 cost or the only way you do value is if value has shown to be
6 over a period of time lower than cost. So the -- what's in
7 the financial statements is predominately not going to be
8 value, it's going to be the cost of the asset. Again, unless
9 there's been a write down to value because the value is less
10 than the cost.

11 ALJ MARGOLIS: Okay. Ms. Freeman.

12 Thank you, Mr. Swiesco.

13 MS. FREEMAN: So for partnership -

14 MR. SWIESCO: Pardon me.

15 MS. FREEMAN: -- investments, they actually are
16 adjusted for earnings and distributions and then their
17 contributions you made which may not have been funded through
18 debt. So there's -- can be things in those investments for
19 financial statement and tax purposes that are not reflective
20 of the debt itself.

21 So that's just our opinion and I think the disparity
22 in the numbers between the underlying debt and the
23 investments themselves, you know, is consistent with our
24 concerns.

25 ALJ MARGOLIS: Okay. Mr. Gast, do you have any

1 questions?

2 ALJ GAST: No. No questions.

3 ALJ MARGOLIS: Judge Leung?

4 ALJ LEUNG: No.

5 MS. ISKANDER: Can I add a few points?

6 ALJ MARGOLIS: You may.

7 MS. ISKANDER: Revenue Procedure addresses portfolio
8 investments that may include investment in real estate.
9 That's one thing to consider. Which means that real estate
10 would be subject to Revenue Procedure 72-18 allocation.

11 ALJ MARGOLIS: You say 72-18 mentions real estate
12 assets.

13 MS. ISKANDER: Mentions portfolio investments
14 including investments in real estate, yes.

15 ALJ MARGOLIS: Okay.

16 MS. ISKANDER: And next what Revenue Procedure does,
17 it does not exactly match because the exact match can only be
18 done if taxpayer provides a direct link between the loan and
19 the asset. Here we don't have that fact so we have to rely
20 on circumstantial evidence and Revenue Procedure is an
21 approximation. What it does, it approximates holdings. When
22 holdings vary, the percentage vary, but when you look at
23 Revenue Procedure 72-18 percentages, you can see that they
24 tag along within the same range. They don't spike to hundred
25 percent or fifty percent or zero. They reflect the asset

1 holdings during a given year based on their financial
2 statements which we were just told is cost, is at cost.

3 So Revenue Procedure is actually closer to even the
4 original basis consistently closer than for example relying
5 on income and Revenue Procedure also traces what is a
6 present -- what is the -- traces the purposes and the use of
7 the loans exactly what the Court of Appeals told us we should
8 be using when we apply -- when we allocate interest expense
9 deduction.

10 ALJ MARGOLIS: Mr. Kaplan, since I gave Ms. Iskander
11 a [indiscernible] moment, would you like to say something
12 further before we go to closing arguments?

13 MR. KAPLAN: No, Your Honor.

14 ALJ MARGOLIS: Thank you.

15 MR. KAPLAN: In a weird way. Thank you.

16 ALJ MARGOLIS: Okay. Are parties ready for closing
17 arguments?

18 Mr. Kaplan, you have ten minutes for your closing
19 argument.

20 MR. KAPLAN: All right. I hope not to take that
21 long.

22 First and foremost, the issue we've been discussing
23 primarily today, one of the interest allocation is
24 100 percent of the interest expense paid by the taxpayer
25 deductible against its California income, was readily

1 apparent on the tax returns that the taxpayer filed. One
2 hundred percent of the interest income was deducted on those
3 returns. The returns were audited over a period of years,
4 another four years at the protest level. No one ever
5 mentioned an issue with respect to the allocation of the
6 interest expense. It was raised for the first time after
7 this appeal was filed.

8 With respect to the debt equity issue, some of what I
9 heard sounded to me like the Franchise Tax Board was trying
10 to back off on its concession of the debt equity issue by
11 saying that the ability to repay the debt was not really a
12 concern of the taxpayer's parent. It owned the properties
13 one way or the other. But in my experience and in my
14 analysis of any issue involving a distinction between debt
15 and equity, the ability to pay is a fundamental element of
16 any determination of whether or not there's truly a debt
17 involved. The ability to pay is not something that is not --
18 is not something that is insignificant. The Franchise Tax
19 Board in making its determination that they did have debt
20 here and not equity investments presumably took that into
21 account and I do not think they should be able to back off of
22 that conclusion, at this point.

23 Franchise Tax Board continues to push for Revenue
24 Procedure 72-18 as providing a methodology to be used for the
25 allocation. Taxpayer continues to believe that that Revenue

1 Procedure is irrelevant and that it did not have any
2 tax-exempt income that would trigger its relevance.

3 Franchise Tax Board mentioned the appeal of Signal is
4 establishing the 24344 trumps all other allocation
5 methodologies but as Judge Leung noted neither party is bound
6 to use it, it's not a statutorily required methodology; and
7 two, if it does trump other methodologies, it's in the
8 context of exempt income. Again, taxpayer simply doesn't
9 have any.

10 Taxpayer believes that UDITPA does apply. We've got
11 partnership income from within and without California.
12 25137-1 applies to treat each partnership as a separate trade
13 or business. 25120(d) should be applied to allocate expenses
14 not section 24 -- 24425.

15 We believe the statute of limitations expired at the
16 time the Notices of Proposed Assessment were issued. This
17 issue was not raised prior to that time. We believe the
18 statute prevents it from being raised today.

19 The interest income reported by the taxpayer in some
20 years was relatively significant 1, 2, plus million dollars.
21 All of that is reported on its California returns as
22 originally filed. The interest expense the Franchise Tax
23 Board would like to allocate to other states and not be
24 allowed to -- and not allow the taxpayer to deduct it against
25 their California income but it does not seem to have a

1 problem with including all the interest income that it earned
2 on its California tax base.

3 I think that, again, if we get past the statute of
4 limitations issue, if the Franchise Tax Board is allowed to
5 pursue this issue and this panel wants to consider it and if
6 ultimately this panel determines that there is a tax
7 liability owing from the taxpayer during one or more of these
8 years, we believe that the interest abatement provisions
9 apply -- or the interest suspension provisions rather apply
10 and interest should not accrue on any such deficiencies at
11 least from the 18 months following the filing of the return
12 through the time the taxpayer was notified for the first time
13 of this issue.

14 I want to thank the panel for it's -- not only its
15 patience but its ability to delve deeply into complex
16 computational matters. Something that which is somewhat
17 beyond me which again is why I brought Ms. Freeman with me.
18 And we hope if the panel has any remaining questions, we will
19 do our best to answer them. Thank you.

20 ALJ MARGOLIS: Thank you very much. I did have one
21 question about something you said about -- you said interest
22 income was significant and it was reportedly California
23 returns and then you just made it an argument that the FTB
24 didn't have any problem requiring to include a hundred
25 percent of that income. Can you just explain what you to me?

1 I didn't quite follow.

2 MR. KAPLAN: Well, it seems to me, I mean, in our
3 mind the interest income and the interest expense offset.
4 It's the monies that the taxpayer has essentially are all
5 originating from its sole shareholder, it makes investments,
6 it receives distributions whether returns money to its
7 shareholder at that point in time or invests it on a
8 short-term basis. It has interest income.

9 If the interest expense is being allocated to
10 out-of-state investments, it would seem logical to me. I
11 have not really pursued this all the way through, but it
12 would seem logical to me that a portion of the interest
13 expense --

14 ALJ MARGOLIS: Interest income.

15 MR. KAPLAN: -- interest income would also be
16 allocated outside of California. It's not an issue that we
17 have ever pursued or discussed and it would be too ironic for
18 me to try to raise a new issue on that right now. So I won't
19 do so.

20 ALJ MARGOLIS: Okay. Thank you, Mr. Kaplan. Any
21 further questions for Mr. Kaplan?

22 Ms. Iskander.

23 MS. ISKANDER: This appeal involves after the
24 concessions that Respended -- Respondent has made, this
25 appeal really involves a tax consequence that follows a

1 concession on classification of funds as either debt or
2 contributions. Because FTB changed its classification based
3 on the same facts, the tax consequences require a certain --
4 certain steps to be taken. Those steps are we have to
5 determine which portion of the allowed interest expense is
6 deductible and for that we turn to 24425, a specific
7 provision that specifically provides that expenses not
8 attributable to assets generating California -- generating
9 income excluded from California tax base is non-deductible
10 against California income because otherwise it would result
11 in a double deduction.

12 This issue, again, FTB argues that the issue is not
13 new because it's consequential. It has not been raised, the
14 allocation issue has not been raised during audit or protest
15 because the interest deduction was -- the interest expense
16 was denied in full because of the classification. Neither
17 auditor nor a protest officer had to consider alternatives
18 because what they had to do is issue Notice of Proposed
19 Assessment and Notice of Action whether or not they agree
20 with prior -- with audit for example at the protest level.

21 So alternatives do not answer notices. Notices have
22 to be based on the position that Respondent takes.
23 Respondent took a position that interest expense is fully not
24 a lot -- fully disallowed because the funds were considered
25 during audit and protest to be contributions, not loans.

1 During appeal, Appellant reconsidered and agreed to
2 honor the form ignoring few of the wrinkles in the substance.
3 And based on that, the tax consequences follow that those tax
4 consequences include first, the way we allocate -- the way we
5 calculate the allowable interest expense. And second, how do
6 we do that. Again, Respondent has used a precedential
7 opinion in the appeal of *Zenith*, the Board of Equalization
8 appeal that this panel is bound by -- by its own rule 30504,
9 I believe.

10 And also, Court of Appeals -- California Court of
11 Appeals endorsed *Zenith* and stated specifically that unless
12 the taxpayer can directly link the loans to the assets that
13 produce income. The Respondent's formula is reasonable and
14 should be used.

15 Now, going through a few of the things 25120(d) it
16 seems that Appellant here would like the UDITPA be triggered
17 so that they can rely on 25120(d) proration. That proration
18 is in the regulations 25120(d) and specifically covers
19 allowable deduction.

20 Well, even if we ignored the fact that UDITPA
21 provisions don't apply and we went to California Regulation
22 25120(d), because that regulation covers allowable deduction,
23 we would only be talking about the portion that is allowed.
24 A disallowed portion calculated on the 24425 would not even
25 answer that proration.

1 So again, once we calculated the allowable deduction
2 under 24425 and Appeal of *Zenith* endorsed by California
3 Appellant Court in *Apple v. FTB*, then we can may be move to
4 25120(d) using that portion that is allowed.

5 As far as the interest offset, again, as already
6 stated Revenue and Taxation Code 24425 trumps 24344 because
7 the form is specifically disallows the deduction.
8 Furthermore, to specifically allocate interest income, --
9 interest expense to interest income both the appellant of
10 *Zenith* -- appeal of *Zenith* and *Apple* Court of Appeals
11 decision required that the allocation is based on the purpose
12 and the use of the loans.

13 But Appellant did not illustrate that is borrowed
14 funds in order to generate interest income it seeks to
15 offset. Rather it specifically stated that it borrowed the
16 funds to facilitate UK Trust Investments in U.S. real estate
17 to produce rental income.

18 Appellant also stated that its income comes solely
19 from the interest in real estate held by pass-through
20 entities and taking in to account Appellant's own statements
21 of face value interest income report in California return
22 either relates to the production of income by real estate
23 interest funded by the money Appellant borrowed, or it simply
24 does not have any relationship to that interest income.

25 Again, offsetting here, would justify against the

1 precedent set by both appeal of *Zenith* and *Apple* as well as
2 Revenue and Taxation Code 24425.

3 Now, the Revenue Procedure 72-18 formula we argue is
4 reasonable. First, we didn't come up with it. I rested and
5 we endorsed it because the appeal of *Zenith* provided that
6 after considering the formula, it found that formula to be
7 working the best in the long run. And that's exactly what
8 we're trying to do for the purposes of administration. We're
9 trying to reach a solution that works in the long run not
10 just for these years.

11 In the long run, if Appellant continues to maintain
12 the same loans they borrowed in order to keep those loans
13 working for their real estate investments, then however they
14 choose to construct their portfolio real estate, it will be
15 reflected in the ratio of their adjusted basis as provided by
16 the formula that Revenue Procedure 72-18 provides.

17 Appellant's offered income-based allocation is
18 inferior to Respondent's proposed asses -- proposed
19 allocation formula. And its exhibits are showing because
20 some years may result in hundred percent deduction against
21 California income only. And when that happens, suddenly
22 Revenue Procedure -- Revenue and Tax Code 24425 is subverted
23 by simply looking into income. And looking into income also
24 forgets about underlying purpose of the loans and the actual
25 use of them.

1 For this reason, Respondent argues that, one, the
2 issue's not new and it should not be precluded because it's
3 merely a tax consequence of its reclassification based on
4 available facts, not new facts -- not a single new fact was
5 considered for that tax consequence to apply. Two, that
6 interest offset would not reflect precedential -- the
7 precedent in California law. Three, even if UDITPA applies,
8 25120(d) would still not allocate separately some additional
9 to allowable deduction expense to interest income.

10 And to address taxpayer's argument about interest
11 abatement, suspension is not allowed -- is not something that
12 is overaged to a corporation, interest suspensions can only
13 be done with individuals. Corporations are -- can
14 sometimes -- an interest can sometimes be abated for
15 corporations but that would be done only if there is even
16 administerial error or managerial act.

17 If taxpayer disagrees that there was not
18 administerial or managerial act, then it has to show that FTB
19 abused its discretion when determining not to abate the
20 interest by exercising the discretion arbitrarily,
21 capriciously or without some basis of fact or law.

22 In neither and neither of its briefs, Appellant
23 provided basis for concluding that Respondent abused its
24 discretion not to abate the interest.

25 As such, Appellant's request that interest be abated

1 should be denied and Respondent positions that only limited
2 amount of interest expense should be allowed against
3 California income calculated under Revenue Procedure formula
4 should be sustained. Thank you.

5 ALJ MARGOLIS: Thank you.

6 Mr. Kaplan, you have five minutes.

7 MR. KAPLAN: I'll keep my final comments very, very
8 brief. I think that again the question of, if the matter
9 moves down that road to where this panel is trying to
10 determine what an appropriate methodology would be, I would
11 like to remind the panel that the requirement is that the
12 methodology used be reasonable if it's not mandated by
13 statute.

14 We believe that the methodology we've advanced in the
15 event that it is required is reasonable. We believe that
16 whether there are rationales that make one party thinks this
17 methodology is better, somebody else thinks the other
18 methodology is better, the real question is, is the
19 methodology used by the taxpayer reasonable? And we believe
20 that if required to make such an allocation, that the
21 allocation based on income produced by the properties is the
22 most reasonable methodology possible and is certainly not
23 unreasonable.

24 ALJ MARGOLIS: Okay. Thank you very much.

25 I -- if there's nothing further, I want to thank

1 you -- thank both sides for very ably briefing and arguing
2 this case. It's very complicated even for us who have been
3 practicing multi-state law for a long time. And we
4 appreciate your participation and your cooperation with us
5 and with each other in this process.

6 We will meet to discuss the case in private and send
7 you our decision within a hundred days. We will -- we may
8 come back to you and request additional input in which case
9 we'll extend that date. I want to let you know that you have
10 nothing akin to the IRS Rule 155 process. So when we come
11 out with a decision, both said that you think you can work
12 out numbers and if -- you have 30 -- at 30 days after our
13 decision is done, it's final.

14 You know, you could pay the tax and come back and
15 want to collect for refund but, you know, you can't --
16 hopefully you can come and work out your numbers together.
17 If you do come up with something, that is not -- has not
18 exactly been briefed in your schedules, hopefully you can
19 work that out very quickly and get back to us in the context
20 of the petition for a hearing or whatever.

21 But with that the record is now closed and there's
22 nothing further, we are adjourned.

23 Thank you very much.

24 ...

25 ...

1 MR. KAPLAN: Thank you.

2 MR. SWIESCO: Thank you.

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4 (Thereupon, the Hearing was adjourned at 2:58 p.m.)

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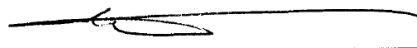
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I do hereby certify that the testimony in the foregoing hearing was taken at the time and place therein stated; that the testimony of said witnesses were reported by me, a certified electronic court reporter and a disinterested person, and was under my supervision thereafter transcribed into typewriting.

And I further certify that I am not of counsel or attorney for either or any of the parties to said hearing nor in any way interested in the outcome of the cause named in said caption.

IN WITNESS WHEREOF, I have hereunto set my hand this 9th day of July, 2018.



PETER PETTY
CER**D-493
Notary Public

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I do hereby certify that the testimony in the foregoing hearing was taken at the time and place therein stated; that the testimony of said witnesses were transcribed by me, a certified transcriber.

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IN WITNESS WHEREOF, I have hereunto set my hand this 19th day of June, 2019.



Jill Jacoby
Certified Transcriber
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