

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

HEARING
OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Franchise/ OTA CASE NO. 18011703
Income Tax Appeals Hearing of:
EARLE A. MALM and
EVELYN A. MALM,
Appellants.
-----/

REPORTER'S TRANSCRIPT OF PROCEEDINGS

TUESDAY, APRIL 30, 2019
1:20 P.M.

OFFICE OF TAX APPEALS
400 R STREET
SACRAMENTO, CALIFORNIA

Reported by AMY E. PERRY, CSR No. 11880

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

APPEARANCES

Panel Lead:

ALBERTO ROSAS, ADMINISTRATIVE LAW JUDGE
STATE OF CALIFORNIA
OFFICE OF TAX APPEALS
400 R Street
Sacramento, California 95811

Panel Members:

JEFFREY MARGOLIS, ADMINISTRATIVE LAW JUDGE
SARA HOSEY, ADMINISTRATIVE LAW JUDGE

For Appellant:

TIMOTHY MULGREW, REPRESENTATIVE
EARLE MALM, TAXPAYER

For Franchise Tax Board:

DAVID HUNTER, TAX COUNSEL
STATE OF CALIFORNIA
FRANCHISE TAX BOARD
MS A260
P.O. Box 1468
Sacramento, California 95812

DAVID GEMMINGEN, TAX COUNSEL
STATE OF CALIFORNIA
FRANCHISE TAX BOARD
MS A260
P.O. Box 1720
Rancho Cordova, California 95741

Also Present:

CRISTINA RUBALCAVA, SUPERVISOR
OFFICE OF TAX APPEALS
FOUNDATION SUPPORT

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

I N D E X

EXAMINATIONS

<u>APPELLANT'S WITNESS</u>	<u>PAGE</u>
<u>EARLE A. MALM</u>	
Direct Examination by Mr. Mulgrew	18
Cross-Examination by Mr. Hunter	39
Examination by ALJ Hosey	43
Examination by ALJ Margolis	44
Cross-Examination by Mr. Cornez	49
Examination by ALJ Margolis	50
Examination by ALJ Rosas	54
Examination by ALJ Margolis	59
Recross-Examination by Mr. Cornez	60

EXHIBITS

<u>APPELLANT'S EXHIBITS</u>	<u>PAGE</u>
Exhibits 1-4 admitted into evidence	7
 <u>RESPONDENT'S EXHIBITS</u>	
Exhibits C-VV admitted into evidence	5

(Exhibits premarked, described
and retained by Administrative
Law Judge.)

1 TUESDAY, APRIL 30, 2019 - 1:20 P.M.

2

3 ALJ ROSAS: Good afternoon. We are on the
4 record in the matter of the Appeal of Earle and Evelyn
5 Malm, OTA Case No. 18011703. This hearing is being
6 convened in Sacramento, California on April 30, 2019,
7 and the time is approximately 1:20 p.m.

8 The panel of Administrative Law Judges
9 includes Sara Hosey.

10 ALJ HOSEY: Good afternoon.

11 ALJ ROSAS: Jeffrey Margolis.

12 ALJ MARGOLIS: Good afternoon.

13 ALJ ROSAS: And me, Alberto Rosas. And as I
14 mentioned during our recent in-person pre-hearing
15 conference, there was a recent change to the panel.
16 Mr. Margolis is replacing Judge Grant Thompson who was
17 listed in the Notice of Tax Appeal Panel that was
18 issued on February 15th this year.

19 Now, although I am the lead ALJ for purposes
20 of conducting this hearing, please note that this
21 panel, the three of us, we are all equal decision
22 makers.

23 We're going to start with appearances.
24 Please state your name for the record. And we'll
25 begin with Taxpayer's side.

1 THE APPELLANT: My name is Earle Malm. I am
2 the taxpayer in the case.

3 MR. MULGREW: Timothy Mulgrew representing
4 the taxpayers.

5 MR. HUNTER: David Hunter, Franchise Tax
6 Board.

7 MR. GEMMINGEN: David Gemmingen, Counsel for
8 tax board -- Franchise Tax Board.

9 MR. CORNEZ: Michael Cornez, Franchise Tax
10 Board.

11 ALJ ROSAS: And as you gentlemen are aware,
12 this hearing is being recorded. We have a
13 stenographer, so please just be mindful to speak
14 slowly, speak clearly, try not to speak over one
15 another. We had a telephonic pre-hearing conference
16 April 11, 2019 which resulted in five orders -- I'm
17 sorry, four orders.

18 No. 1 was that we admitted Respondent's
19 Exhibits C, Charlie, through Exhibit VV, Victor-Victor
20 into evidence.

21 (Respondent's Exhibits C-VV
22 admitted into evidence.)

23 ALJ ROSAS: No. 2, we agreed that only one
24 witness will testify today. That's Mr. Malm.

25 No. 3, we discussed that this hearing will

1 take approximately two-and-a-half hours, and the
2 parties are expected to comply with the specific
3 hearing time limits that we discussed.

4 And No. 4, we agree that OTA shall not
5 consider the pre-hearing conference statements as
6 additional briefs.

7 Is this an accurate summary of the
8 pre-hearing conference orders, Mr. Mulgrew?

9 MR. MULGREW: Yes.

10 ALJ ROSAS: Mr. Hunter?

11 MR. HUNTER: Yes, Judge Rosas.

12 ALJ ROSAS: And this afternoon before this
13 oral hearing, we met in person for a in-person
14 pre-hearing conference, and we agreed that we would
15 admit four additional exhibits. We labeled the Notice
16 of Action for tax year 2010 as Exhibit 1.

17 The Notice of Action for 2011 was labeled
18 as -- I'm sorry, as Exhibit 2 for identification.

19 The Notice of Action for tax year 2012 was
20 premarked for identification as Exhibit 3.

21 And as Exhibit 4, we premarked an excerpt
22 from Appellant's reply brief, Part 2, three pages
23 which included a summary or narrative of some of the
24 hours that were purportedly worked by Mr. Malm during
25 the tax years at issue.

1 As was discussed, Exhibit 4 is not coming in
2 for to prove those exact hours, is not coming in for
3 the truth of the matter stated in those -- in that
4 exhibit. We are just bringing it in for the purposes
5 of avoiding an undue consumption of time to prevent
6 having to have Mr. Malm read line by line those three
7 pages into the record.

8 Is that correct, Mr. Hunter, as I'm
9 understanding of our concession of Exhibit 4?

10 MR. HUNTER: That's correct, Judge Rosas.

11 ALJ ROSAS: So I hereby admit Exhibits --
12 Appellant's Exhibit 1, 2, 3 and 4 into evidence.

13 (Appellant's Exhibits 1-4
14 admitted into evidence.)

15 ALJ ROSAS: Gentlemen, before we proceed with
16 opening statements, is there anything else that either
17 of you would like to discuss or do you have any other
18 questions for me at this time?

19 Hearing none, we will move into opening
20 statements. As we discussed, each of you has up to
21 five minutes to make a brief opening statement.

22 Mr. Mulgrew, you may begin whenever you're
23 ready.

24 MR. MULGREW: Thank you. We've been on a
25 long journey to get here through a large number of

1 issues, a large number of debated issues. We are
2 thankful to be here in front of an impartial panel to
3 hopefully seek justice brought about on this case.
4 The issues have been seemingly all over the place from
5 our perspective.

6 It appears we finally had nailed it down
7 to -- the crux of the case seems to be that the
8 appellant's W-2 income is too high to allow material
9 participation. This comes from an audit technique
10 guide produced by the Internal Revenue Service that
11 says one of the things to look for that may indicate
12 somebody is not materially participating is high W-2
13 earnings from other sources.

14 The next issue appears to be that the
15 appellant was paying management fees to another, and
16 that also from the audit technique guide seems to go
17 against the idea of material participation. And so
18 ultimately, this case boils down to whether or not
19 this is a case of IRC 469 material participation.

20 The state's application of the rule seems to
21 make sense on their face, and I don't disagree with
22 how the state is applying. I disagree with how the
23 state is applying to this particular case.

24 The facts and circumstances you'll see
25 through testimony will demonstrate that that rule

1 doesn't generally apply based on the congressional
2 intent of the application of it. Testimony will show
3 the facts of the case are pretty different than what
4 they're being portrayed.

5 We intend to demonstrate how the appellant's
6 W-2 income could very reasonably be what it was and
7 have substantial time to materially participate. And
8 we intend to demonstrate the management fees paid with
9 the tax return are clearly reasonable and not an issue
10 where he hired someone else to run the company while
11 he worked somewhere else. That is not the case in
12 this.

13 The intent of legislature is to prevent
14 taxpayers from taking deductions against income from
15 investing activities. However, if the production of
16 income is under the control of the taxpayer and they
17 do control the outcome, then tax law allows them to
18 take deductions for necessary and/or reasonable
19 expenses in order to earn that income.

20 My understanding is that the transactions in
21 this case have more or less been substantiated. It's
22 not an issue of substantiation of documents, receipts
23 and expenses and that has all been taken care of.

24 The issue that the state is raising is
25 whether or not these expenses are for a valid business

1 purpose. We intend to demonstrate that they are.

2 Second, the issue concerning the date is
3 whether or not the appellant materially participated
4 in the corporation and, third, ultimately should a
5 penalty be imposed for accuracy-related deductions.

6 We will contest each of those issues through
7 Mr. Malm's testimony. And our position up front is
8 that he clearly, materially participated in this
9 corporation in all of the years in question and the
10 years before that and after that.

11 That the rules that are being applied are
12 generally designed to be applied to people who hold
13 real estate investments for the purpose of rental.
14 And while that's a part of what this corporation does,
15 it's not the only thing the corporation does.

16 So we intend to discuss those issues through
17 testimony and address through closing. Thank you.

18 ALJ ROSAS: Thank you, Mr. Mulgrew.

19 FTB, your opening statement whenever you're
20 ready.

21 MR. HUNTER: Thank you, Judge Rosas.

22 We have a difference in understanding. This
23 is a substantiation case. Appellant earned income of
24 \$1 million per year in this high ranking position at a
25 major financial institution. He was also the sole

1 shareholder, CEO and president of an S Corporation
2 that he formed, NVMLI, Inc.

3 This company reported expenses incurred from
4 real estate activities and the appellant reported
5 through losses on his personal individual income tax
6 return that averaged \$300,000 per year. And these
7 losses offset his ordinary taxable income from these
8 banking finance shops.

9 Respondent disallowed these expenses and
10 recharacterized these losses as passive which cannot
11 be used to offset Appellant's ordinary income.

12 The facts and evidence in this case will
13 clearly show that Respondent says it must be affirmed
14 for three separate independent reasons. First, we
15 have a complete lack of substantiation for the
16 expenses claimed in renting and renovating one of
17 these properties.

18 Appellant caused the company to list most of
19 these assets as available for rent 365 days per year.
20 Yet, despite the no fewer than ten requests for this
21 information since 2014 through the present, he failed
22 to produce a rental agreement, tenant contact
23 information, rental deposit, proof of advertising or
24 support for rental income.

25 ALJ MARGOLIS: That's just for one of the

1 properties, you said?

2 MR. HUNTER: That's for all of the properties
3 that were listed as available for rent.

4 ALJ MARGOLIS: Okay. Thanks.

5 MR. HUNTER: What little evidence we have
6 shows that someone else other than the appellant
7 managed the properties. It's the law. Appellant must
8 keep adequate records and provide confident evidence
9 and documentation to support claimed deductions.

10 The taxpayer's self-serving testimony is
11 insufficient and Appellant's failure to produce
12 evidence within his control gives rise to a
13 presumption that such evidence would be unfavorable to
14 this case.

15 For instance, Appellant lists his Hawaiian
16 timeshare as a corporate asset, it's listed on the
17 depreciation schedule, on the S Corporation's tax
18 return. He listed receiving, reported receiving
19 \$3,000 in income for this timeshare. He also reported
20 expenses totalling \$9,000, including depreciation
21 \$2,600, and association dues paid of \$5,000 for that
22 year.

23 This is a timeshare. It's not available for
24 365 days a year, and there's no substantiation for the
25 rental income received nor the expenses as it relates

1 to that particular property.

2 Second, even if Appellant somehow managed to
3 substantiate these expenses, which he has not, under
4 California law, these flow-through losses are passive
5 because any real estate rental activity is considered
6 to be a passive activity regardless of the level of
7 participation by the taxpayer.

8 Internal Revenue Code Section 1366(b)
9 provides that the character of a shareholder's share
10 of income or loss incurred by an S Corporation is
11 determined the income or loss were realized directly
12 by the corporation. This is known as a conduit rule,
13 based on [inaudible] of the Franchise Tax Board cited
14 in our opening brief.

15 Third, Appellant claims that he actively
16 managed the business of his S Corporation. This is
17 false. One thing I would like to knock out of the
18 park right here is that Treasury Regulation
19 1.469-5T(b)(2), sub (ii)(a) provides that Taxpayer's
20 hours spent on management do not qualify his
21 participation if another person or entity was
22 compensated for such management and services.

23 Appellant cannot possibly claim that he was
24 somehow materially participating in the company's
25 activity when he caused the company to report over

1 \$100,000 per year every year as paid to someone else
2 other than Appellant for management fees for outside
3 services, and it recently came out that he paid this
4 money to his son.

5 He also caused the company to pay over
6 \$30,000 per year to someone other than Appellant for
7 administrative fees. It's on the record. Appellant's
8 representative confirmed that Appellant did not
9 maintain or keep any log sheets or other records to
10 substantiate the daily hours he spent conducting any
11 business for the S Corporation, and Appellant did not
12 provide a time log for his hours spent at his banking
13 and finance jobs.

14 In Respondent's opening brief, we cited some
15 numerous cases which point out that the treasury
16 relations do not allow a post-event, ball park
17 guesstimate to be accepted when a taxpayer seeks to
18 establish the number of hours worked in claiming
19 material participation.

20 A recent example of the case of *Brad v.*
21 *United States* (2014). The taxpayer reported
22 non-passive losses which flowed through to her from
23 her real estate company which were disallowed.

24 ALJ ROSAS: Just want to remind you we're at
25 the five-minute mark. Wrap it up, please.

1 MR. HUNTER: Wrap it up. The taxpayer argued
2 that she spent numerous hours and materially
3 participated in the real estate company as opposed to
4 a participation in her main profession as a real
5 estate agent.

6 This taxpayer was unable to provide
7 calendars, receipts, reports or any contemporaneous
8 documentation to support the claimed number of hours
9 spent only in estimates. And that court found that
10 she did not meet her burden because there were no
11 contemporaneous documents to support the narrative of
12 hours spent.

13 Finally, the accuracy-related penalty was
14 mechanically applied in this case correctly because
15 Appellant underreported taxable income by greater than
16 10 percent of the tax required to show on the return
17 or \$5,000 for each tax year at issue. The foregoing
18 reasons pending that Respondent's action must be
19 sustained. Thank you.

20 ALJ ROSAS: Thank you, Mr. Hunter. We will
21 now proceed with witness testimony.

22 Mr. Malm, as I mentioned during our in-person
23 pre-hearing conference, a full copy of Respondent's
24 exhibits are in the witness box. You forgot to add
25 your four exhibits there. I will do that now. Just

1 give me one second.

2 Mr. Malm, whenever you're ready, you can take
3 a seat in the witness box. Thank you, sir.

4 THE APPELLANT: I take my notes, right?

5 ALJ ROSAS: Yes, sir.

6 THE APPELLANT: Thanks.

7 ALJ ROSAS: If you could remain standing
8 while I administer an oath. Raise your right hand,
9 please.

10 THE APPELLANT: Right hand.

11 ALJ ROSAS: Do you solemnly swear or affirm
12 that the testimony you are about to give shall be the
13 truth, the whole truth, and nothing but the truth?

14 THE APPELLANT: Yes.

15 ALJ ROSAS: Thank you, sir. You may be
16 seated. Mr. Mulgrew, this is your examination. You
17 may begin whenever you're ready.

18 MR. CORNEZ: Can we raise a point of order
19 here? If he has notes that he's going to be
20 consulting during his testimony, I think we're
21 entitled to see them.

22 ALJ ROSAS: Mr. Mulgrew, what notes are we
23 discussing here in terms of Mr. Malm's?

24 MR. MULGREW: He doesn't have a prepared
25 statement. We discussed what the issues are and he

1 took some notes from memory purposes but there's no
2 prepared statements. It's just his own personal
3 notes. I personally didn't get them either.

4 ALJ ROSAS: Mr. Cornez?

5 MR. CORNEZ: Well, without looking at them,
6 it's hard to say that they're not -- it's not
7 appropriate. That we get to see them ahead of time
8 during the testimony.

9 ALJ ROSAS: Mr. Malm, are you intending to
10 read from these notes?

11 THE APPELLANT: No. It's more to keep me on
12 track of the points that I want to try to communicate.

13 ALJ ROSAS: How about this. Put them face
14 down. If you need to refresh your recollection or if
15 you want to refer to your notes to help you recollect
16 something, just indicate that in the record that
17 you're going to refer to your notes just to help you
18 with your memory.

19 THE APPELLANT: Sure. I have no problem.
20 There's two things. I have some written notes for
21 myself, and then I have a kind of a fact sheet of
22 notes. I am more than happy to share -- I will use
23 the fact sheet if I can, and I'm more than happy to
24 share the fact sheet and you can take a look at it.

25 ALJ ROSAS: By any chance, do you have

1 additional copies of the fact sheet?

2 THE APPELLANT: I have about five or six.

3 ALJ ROSAS: Mr. Cornez, will that be fine if
4 we provide you a copy of the fact sheet?

5 MR. CORNEZ: That will be great. Thank you.

6 ALJ ROSAS: Okay.

7 THE APPELLANT: I have about ten.

8 ALJ ROSAS: Once again, Mr. Mulgrew, you may
9 begin whenever you are ready.

10 **EARLE A. MALM**

11 called as a witness, being first duly sworn, testified
12 as follows:

13 DIRECT EXAMINATION

14 BY MR. MULGREW:

15 Q Sure. Mr. Malm, can you describe for us what
16 NVMLI as a corporation does?

17 A Well, yes. NVMLI is involved in kind of
18 three different areas: One is real estate
19 redevelopment; two, in real estate projects in
20 general; three -- sorry, the second one is an activity
21 around student -- around an incubator that now
22 student-run businesses for Bowling Green University
23 work through that incubator where I actually take a
24 position in the company and work with the company; and
25 the third is I do consulting work in the financial

1 services industry.

2 So those are the kind of the key three areas
3 that NVMLI is involved in. I think that the key
4 behind NVMLI is that it is, that me, I am NVMLI.
5 Everything that NVMLI does, basically I do. And we'll
6 talk a little bit later, I think, about having a
7 project manager on a project.

8 But as far as what NVMLI does as a company, I
9 do. So it is my ideas, my creativity, my skills, my
10 relationships that are leveraged to make NVMLI. You
11 could say that I am at the heart and soul of that.

12 I thought that the other thing that might be
13 helpful in thinking about NVMLI is that to give a
14 little history of it. There's kind of a phase one and
15 a phase two of NVMLI with a stint in the middle.

16 In phase one, after taking a dot com company
17 public, I decided to retire to Nevada. I got bored
18 very quickly and saw an opportunity to get involved in
19 the mortgage brokerage business, and so I opened up
20 NVMLI in 2002 as a place that could act as the
21 middleman between the lenders and the borrowers.

22 And my goal then more than anything else as
23 well was to create a broader business, but started
24 through getting involved in mortgage lending. I think
25 the testimony, we talked about the fact that when I

1 did leave NVMLI to take a different position full
2 time, that NVMLI continued to run. And part of the
3 reason that it continued to run is I had a sister who
4 lived in Nevada who was involved in the real estate
5 business.

6 And actually one of the goals that we had was
7 to take NVMLI and actually have a three-prong
8 business: Residential lending; residential sales; and
9 remodeling activity, flipping kind of activity. So
10 that's how kind of phase one started.

11 When I was recruited by Union Bank to come in
12 and run their investment company, which is another
13 thing I think I should probably clear up, is that I
14 was the president of a wholly-owned subsidiary of
15 Union Bank. I was not the president of Union Bank. I
16 didn't even report to the president of Union Bank. I
17 reported to a division manager in between myself and
18 the president of the bank.

19 But when I accepted that position, kept NVMLI
20 running, but it was -- it died quickly because I was
21 the heart and soul behind generating the leads that
22 kept the business operating. And so when I was no
23 longer there to run the marketing side of it and
24 generate the leads, the business solely dried up as
25 representatives of the company.

1 And between 2004 and 2009, I kept the
2 structure active because I continued to look at
3 venture capital projects and seeing if there were
4 opportunities that I would want to invest in outside
5 of what I was doing at Union Bank.

6 Nothing at that point in time turned up that
7 had any interest to me. And I had a background in
8 that, so it wasn't like it was -- I actually invested
9 in dot com companies when I was working for another
10 corporation. And when I left that corporation, I took
11 one of the dot com companies public. So it wasn't
12 like it was something that was out of character for
13 me.

14 In 2009, it was becoming clearly evident to
15 me over things that had happened in 2007, 2008, as
16 well as what was happening in the economy that the
17 opportunity for me at Union Bank was changing rapidly.
18 And what I was hired for was no longer valid.

19 And so I had begun to think about, what would
20 I do post my life in Union Bank. And that's when I
21 decided that I would get involved in reactivating
22 NVMLI and not doing lending this time, but getting
23 hands-on involved in real estate redevelopment as well
24 as consulting and the student businesses. So that's
25 what NVMLI does.

1 Q So your role in the company, you basically
2 have different aspects, you have the real estate
3 redevelopment piece, the student incubator and the
4 consulting services, this is what the company does.

5 And what do you do personally for NVMLI for
6 each of these activities?

7 A Well, based on the way I described earlier, I
8 know it doesn't sound like I do everything, but I'm
9 basically involved in everything and do almost
10 everything. As I said, I am the visionary behind the
11 business, the creative engine for the business. And
12 so determining what I'm going to get involved in and
13 how I might get involved falls into my lap, that side
14 of it.

15 Once a decision is made that I might pursue
16 something, I am the person who goes to the market,
17 does the customer research, does the competitive
18 research and ultimately delivers, develops the
19 strategy that we're going to be implementing.

20 I then become the implementer, the influencer
21 as well in the process, as well as the financier of
22 the projects. So the things that I am getting
23 involved with, I generally either finance it
24 completely or take an equity position in the activity.

25 I get involved in everything from, I should

1 probably tell you that a little bit about my
2 background as to what I do here in leveraging my
3 skills.

4 I am particularly strong at organization,
5 strategy, picking people and developing the business,
6 growing the business. Those are probably my strong
7 skills. Coming to take cost out, that's not what I
8 do. I grow businesses and I don't kill them. So I do
9 whatever I have to do to get the revenue.

10 In some cases it involved doing maintenance,
11 in some cases it involves doing advice, and some cases
12 it involves keeping score and helping people figure
13 out why they're not meeting competition or what they
14 need to do to make that happen.

15 But none of it is to a point where I just
16 deliver a report and somebody else does the work. I
17 am very hands-on, and I thought it might be beneficial
18 to hear a couple of examples.

19 So in my redevelopment activity in the
20 particular property that we're talking about here
21 today, Estates, I was the one who identified the
22 project, went out and looked for the property, did the
23 research on the market and where the location would
24 be, found the property, got involved with the
25 architect, got involved with the city to determine

1 what we could do.

2 And even to the point where when the property
3 kind of reached its final points, I did the finished
4 grade on the lot personally. I installed the
5 dishwasher in the house. I cleaned the windows of the
6 house as we got to the point where we were getting the
7 city inspectors to come out and look at the property.
8 It's amazing what you can learn by looking at the
9 garbage about what's going on in the project.

10 In the financial service industry, I work
11 with a wealth management provider in the Bay Area
12 right now. You know, I'm considered to be, even
13 though I'm not an employee, I am technically an
14 advisor and consultant to him. I work with him on all
15 their business development strategy. I represent them
16 at business meetings with their key client, Nationwide
17 Insurance. Nationwide sees me as an extension of them
18 and relies on what I would say to be part of the
19 company as the company does as well.

20 And then in the stage of the developing
21 businesses, I began a few years back to participate in
22 the Shark Tank that was held at my university for
23 start-up companies of student-run businesses. And so
24 I've created a program where I invest in these
25 businesses. I provide mentorship to the student.

1 That mentorship, you know, like in two days
2 I'm going to be in Los Angeles on a sales trip with
3 the president of one of the companies as we try to
4 expand our distribution on the west coast.

5 So again, just trying to describe and give
6 you the nature of the activity, it's not one. I'm on
7 a couple boards. But the reality is is that boards
8 generally want people to have their nose in but not
9 their hands on. The nature of what I do tends to be
10 more hands on and less nose in. And so I look for
11 projects that I can get involved on a hands-on basis.
12 So that's what I do.

13 Q And so one of the issues that the state
14 raises is your lack of compensation by NVMLI seems to
15 indicate in their eyes nobody would work for free.

16 Can you talk a little bit about how
17 compensation works when you're not an hourly or salary
18 employee?

19 A Well, I work for return. Okay? And so the
20 return comes in what the venture does in its success
21 and I guess you could call everything, the work that
22 you're doing up until that point in time, your sweat
23 equity to get to a point where it can generate a
24 return.

25 It seems pretty strange to fund a business,

1 okay, and then to draw a salary out of that business
2 and then turn around and refund it again. So I think
3 it just works better if you, you know, live off of
4 your own funding, put the money into the business and
5 not take the money back out of the business. So...

6 Q So in the case of the, one of number of
7 projects going on, the states drive the issue here is
8 whether or not material participation was involved,
9 who these mysterious management fees were paid to, and
10 what the scope of this project was.

11 The project in the first tax year in question
12 was acquired and dismantled.

13 Can you tell me about what was involved in
14 that, what you call a green teardown?

15 A Yeah. Well, we set out to do something that
16 was different. Okay? And different more than
17 anything else at the point in time was to build
18 something that would be greener than anything else
19 that there was or at least as green as it possibly
20 could be.

21 So that included as well the teardown of a
22 property that had been in existence for 55 years, was
23 about 1600 square feet, had a unapproved addition
24 attached to it, was using the garage with a pot-belly
25 stove in it, and had a six-car garage which actually

1 was the best building on the property, six-car garage
2 on the property with stones everywhere on the
3 property, because at one point in time the owner had a
4 collection of 26 antique Cadillacs stored on the
5 property.

6 So, you know, in looking at the Estates
7 property, it was in an ideal location, and the thought
8 was is that, let's see what we can do to, you know,
9 obviously it would have been better for us from a
10 certain tax side to keep a wall or two up and build
11 around that property. But the reality was that it was
12 better to take the whole property down.

13 And so we had heard about this organization,
14 Donation Solutions, and contacted them and thought
15 that, okay, if we could recover some of our costs for
16 demo, this would be a good way to go. And so we got
17 involved with Donation Solutions, tore our little
18 property down.

19 Everything was recycled, every wire, every
20 board, every piece of furniture that was left in the
21 place, all the appliances that were there, et cetera,
22 everything was recycled.

23 Q We have photos of that. Sorry. Do you have
24 copies of the photos? So at the bottom of the first
25 side of the older house, you can see where the house

1 is being systematically dismantled so that all of
2 these pieces were donated ultimately, reused,
3 recycled?

4 A Yes.

5 Q Repurposed?

6 A Yeah. In fact, they did such a great job,
7 when you go out and see the piles of wood, it looks
8 like you're at a lumbar yard. They've just been
9 cleaned and they're ready to reuse.

10 Q So this was a fairly significant project,
11 would you say?

12 A Well, it was just the start of a significant
13 project because the second phase of that was actually
14 building the property and designing the property.
15 So -- and that's what got me involved, in getting my
16 son involved in the business. And my son is a
17 commercial real estate broker.

18 There was a point in time where that market
19 was a little bit soft. And so it was a good time.
20 I've always wanted to have a business that the family
21 could participate in. So this seemed to be like a
22 good opportunity to be able to do that.

23 My son never got involved in any of my other
24 activities at NVMLI. He was strictly the person on
25 site for this project to manage it. And what we built

1 was a 4,000 square foot marquee property.

2 Q Just on the other side?

3 A It's the flip-side of the demo. When we sold
4 it, you know, I mean my target was to try to get
5 something in the \$2 million range. I thought that the
6 market could bear \$2 million. So that was our
7 original goal to try to build something within that
8 range.

9 When we finished the property, we actually
10 ended up selling it for 2.8 million, and we were rated
11 as the second greenest home in all of Contra Costa
12 County. So we felt that we had achieved our
13 objectives of doing that.

14 Q How many hours do you think you put into just
15 this project alone personally?

16 A Easily six months of over that three-year
17 period of time.

18 Q Six-man months?

19 A Six man months of time, yeah. Easily.

20 Q And this was not management, this was what
21 type of activities?

22 A Whatever I needed to do. It was management
23 as well, but it was whatever I needed to do.

24 Q Organizing the contractors?

25 A Yeah. I mean, understanding what a

1 subcontractor is doing and where it's going right and
2 where it's going wrong. I know that that sometimes is
3 considered to be part of management, but it's also
4 considered to be part of getting the job done. So,
5 you know.

6 Q How many houses have you built in your
7 career?

8 A Prior to starting this project, I had been
9 involved in ten new constructions for -- seven of them
10 for personal use and three of them for homes that we
11 built for either my in-laws or my own parents.

12 Q So the design, the layout, the figuring out
13 what goes where, that was done by you on this
14 property?

15 A Well, you know, I don't do the drawings.

16 Q Right.

17 A But it wasn't just done by me. This was done
18 by myself, my wife, who is a wonderful stager and
19 decorator and has done these homes with me, the ten
20 that we built prior to this, done by my
21 daughter-in-law, who has been involved in the
22 decorating and design business since she's very young,
23 and my son and I.

24 So, but at the end of the day, you know, the
25 bucks stop with me as far as making the decisions

1 because it was basically I'm the one who's financing
2 the project. I'm the one who's got the responsibility
3 to turn a profit out of it at the end of it, so...

4 Q So I want to switch a moment to one of the
5 other issues at hand. The state raises that your
6 earnings during these tax years is in excess of a
7 million dollars. And the Internal Revenue Service
8 provides an audit technique guide for examiners to use
9 to try to poke holes in cases when they're doing
10 examinations to determine whether or not they hold
11 water.

12 So the state has presented an audit technique
13 guide that says people with high W-2 earnings
14 typically can't qualify for the material participation
15 rules. And that's generally true but not always true.

16 Let's talk a little bit about your W-2
17 compensation during these years and the relevance to
18 that towards the amount of time you would have devoted
19 to Union Bank's Highmark Capital in a one-year period.

20 A Well, I don't think that there's a lot of
21 connection between the two, but I'll try to answer
22 that question. And, you know, I mean, I've made more
23 money and worked less hours. I've made less money and
24 worked more hours than I did at Union Bank.

25 And in the context of Union Bank, I was hired

1 in 2002 to come in and evaluate a business and to make
2 a recommendation as to whether the bank exited that
3 business or stayed in that business. I looked at it
4 as it's going to be somewhere between a two and
5 ten-year assignment depending on what the outcome is
6 in the initial concept.

7 The bank set up a compensation program for me
8 that was -- that had three legs to it. And one leg
9 was a base salary. And my salary during that period
10 of time ranged from \$275,000 when I started it,
11 \$359,000 when I left ten years later. And then what
12 was the more important part to me was the opportunity
13 to participate in what I would develop in the business
14 and if the business did develop.

15 And so the second and third leg of the stool
16 was I had a short-term incentive plan that was based
17 on the revenue generation and the profitability of the
18 business growth that was about 65 percent of my
19 compensation. And I had a second leg of that which
20 was in the key driver in investment management
21 business is the relative rankings of the performance
22 of the investment products that you manage. And so
23 35 percent of my compensation was tied to investment
24 performance.

25 And based on those two criteria, there was a

1 very formulated driven strategy that said I could earn
2 up to 150 percent of my base salary in terms of an
3 incentive plan. And in addition to that, there was a
4 longer-term incentive plan which was designed to keep
5 me in place and put something at risk, so whatever I
6 earned in my short-term incentive plan, I earned an
7 equal amount in the long-term incentive plan, but it
8 was only paid to me over four years if I was there
9 during that period of time.

10 And so it had been very formulated right up
11 until 2008. And in 2008, I had my best year. We're
12 talking about million-dollar years here. In 2008 my
13 total from Union Bank was over 2 million. And part of
14 that was because part of my incentive was paid. It
15 was paid in stock.

16 And in 2008, Union Bank decided to privatize
17 the bank, buy their stock back. And when they did,
18 all of my stock options had to be cashed in so my
19 compensation was inflated that year.

20 Q That shows up on your W-2 as income?

21 A That's correct.

22 Q The facility stock?

23 A That's right.

24 Q You had no choice?

25 A No choice. No choice in the matter. So what

1 also got me headed in the direction of I was going to
2 need to be doing something else. I introduced a very
3 aggressive growth plan for the business. Highmark
4 Capital Management represented about 5 percent of
5 Union Bank's earnings and about 10 percent of their
6 revenue. So is it was not a big deal in terms of the
7 banking business.

8 In order to -- we'd have to get up to at
9 least 10 percent of the earnings in order to be
10 considered to be something substantial or a core
11 business. And at the peak when I took it over, we
12 were about 16 million in assets. At the peak, I got
13 up to 21 million of assets. And it needed to really
14 get to 40, 50 million in assets to be a meaningful
15 property inside of the bank.

16 The only way to do that was to acquire. And
17 so we had an aggressive growth plan. We were going
18 to -- Union Bank is a three-state bank. The
19 investment management business is a national
20 international business. If you have good investment
21 capability, the client in New York needs it just as
22 badly as the client in Los Angeles. So I built
23 national distribution in both the retail and the
24 institutional marketplace.

25 I extend the staff from three people, my

1 direct reports from three people to ten people. And
2 we set out to build this business in the bank. And
3 2005 and '6 I made a couple small acquisitions, but I
4 was never really given the opportunity to pull the
5 trigger on anything big.

6 And when the market correction came with the
7 sub-prime prices, it was obvious that that wasn't
8 going to happen. So my role of building a business
9 and growing a business was changed substantially, and
10 I was moved from the capacity of doing that to the
11 capacity of caretaking the business and making sure
12 that we avoided all the risk.

13 And that happened at about 2008, 2009. It
14 became very clear to me when my incentive compensation
15 in 2009 was the formula produced one number, and the
16 amount that I was paid was an amount that was reduced
17 by a percentage as an arbitrary number taken by a bank
18 executive.

19 So the combination of not buying anything and
20 the combination of not really participating in the
21 business before but being paid by all other bankers
22 you might say is what said to me my life at Union Bank
23 won't be forever, and I need to think about what I
24 want to do next.

25 And so the compensation was a critical issue

1 to figuring out that I was going to have time on my
2 hands, I was going to have creative energy and
3 capacity that I could do something with, and even
4 while I was still working at Union Bank.

5 Q So to boil that down effectively, the time
6 periods in question today, the 2009, '10, '11, '12
7 period, is it fair to say is that your compensation
8 was basically severance and contract and not really
9 related to eight-hour day, five-days-a-week
10 arrangement?

11 A It was a, in 2011, February of 2011, my final
12 boss that was on board with the strategy part, and so
13 it was clear from that point on that we weren't going
14 forward with this.

15 In 2011, I reached a conclusion, well, I
16 reached an agreement with the bank that my job had
17 materially changed, and that I was no longer the CEO
18 of the company or president of the company running an
19 independent strategy, but I was now a staff vice
20 president, you might say.

21 And so we agreed that my position would be
22 eliminated, and the person who came in would assume
23 those responsibilities and took over as the group
24 executive.

25 They were going to downsize the business to

1 about one-third of what it was. And so from no later
2 than midyear 2011, I was on a kind of advisory status
3 and not operating the company. And I formally severed
4 in 2012 and retired at the same time from Union Bank.

5 Q So --

6 ALJ ROSAS: Mr. Mulgrew, I just wanted to
7 remind you we estimated about 30 minutes for
8 Mr. Malm's direct testimony. We are at the mark now.

9 MR. MULGREW: Okay.

10 ALJ ROSAS: Now you will have a chance to
11 continue with examining Mr. Malm after FTB's done with
12 theirs. But if you want to wrap it up soon for this
13 portion of the examination, that would be great.

14 BY MR. MULGREW:

15 Q Yeah. Absolutely.

16 So in the periods in question, you're doing
17 your exit strategy, you're resigning from your
18 position, you're receiving compensation, but it's for
19 performance in earlier years that's being paid out,
20 and it's in the form of stock.

21 You're not actually going to work on a
22 regular basis?

23 A In 2012, that was the case. In 2011, I was
24 there in the advisory, not an operating capacity
25 basically.

1 Q Okay.

2 A In 2010, I was still operating but without
3 any commitment to strategy.

4 Q Right. But basically, you weren't committed
5 to a full-time job?

6 A No.

7 Q That would have absorbed all of your time
8 away from NVMLI?

9 A No.

10 Q Right?

11 And then finally, the management fees and the
12 \$30,000 paid in administrative fees, this is the money
13 you refer to as paying your son for the on-site
14 project manager?

15 A That's correct.

16 Q And then the \$30,000 administrative fee is --

17 A Well, I actually had my daughter on my staff
18 as well, and she happens to be very good at
19 administrative things, creative things. So she was
20 doing a lot of design work that we had as far as
21 getting our message out.

22 Q How many employees does NVMLI have?

23 A That's it.

24 Q Just you?

25 A Well, just me. And then during that period

1 of time, my son and my daughter. My daughter still is
2 engaged with NVMLI and the other things that I do.

3 MR. MULGREW: Okay. Thank you.

4 ALJ ROSAS: Thank you, Mr. Mulgrew. FTB, you
5 may begin with your examination whenever you're ready.

6 CROSS-EXAMINATION

7 BY MR. HUNTER:

8 Q Thank you, Mr. Malm. Mr. Malm, I only have a
9 couple of questions. And I can -- looking at the tax
10 returns that we have filed by S Corporation, and I was
11 looking at the properties as individual properties,
12 the respondent sent numerous requests for tenant
13 information.

14 I mean, the reporting position was that these
15 properties were held out for rental 356 days a year,
16 and we didn't receive any rents or duplication back or
17 deposits or any supporting documents to substantiate
18 the expenses reported on the returns for these
19 properties.

20 One property in particular, 1761 Carmel Drive
21 in Walnut Creek, are you familiar with that property?

22 A I am.

23 Q Who lives there?

24 A My daughter.

25 Q You reported receiving rental income for

1 2010, 2011 and 2012 from this tenant; is that correct?

2 A Yes.

3 Q Did you provide documentation of this
4 reported rental income when requested by the FTB three
5 times?

6 A I would turn to my tax advisor. No, I don't
7 think so.

8 Q Okay.

9 A That would have been a mute -- reported as
10 income.

11 Q That's the reporting position. My question
12 relates to substantiation for the reporting position,
13 the check, the deposit.

14 A No.

15 Q You previously testified that in 2010 through
16 2011, your job working for a subsidiary at Union Bank
17 was morphed from an operational position to advisory
18 role; is that correct?

19 A That is correct.

20 Q But that's still kind of vague in terms of
21 the numbers of hours that were spent working at the
22 subsidiary Union Bank.

23 Can you give us the number of hours that were
24 spent working for the subsidiary Union Bank for those
25 years?

1 A Typically I would report into work at normal
2 time, 8, 9 o'clock in the morning. Typically I would
3 leave at 5 o'clock, 5, 6 o'clock. So I was working a
4 full 40-hour week you could say.

5 Q For 2010, 2011?

6 A Yes. What I would say is that I was there
7 for 40 hours a week. And there's a difference between
8 working there for 40 hours a week and being there for
9 40 hours a week.

10 Q What is that difference, sir?

11 A I could do other things while I'm there. I
12 was just there. And I needed to be there from the
13 standpoint if something came up that I could be
14 involved in, if something didn't come up, I could be
15 involved in other activities as well.

16 But that, you know, I'm not going to try to
17 argue that with you because, you know, in my life
18 here, there's 168 hours in the week, 40 to 50 of them
19 could be spent at a job. There's still these 100 to
20 do other things. Even if I take a third out for
21 sleeping, there's still another 50 that I have
22 something to do. So the fact that I'm there was in my
23 mind kind of immaterial on that. So...

24 Q Almost the same question for tax year 2012,
25 what's your estimate of the hours spent working for

1 that subsidiary of Union Bank for 2012?

2 A 2012 was a little bit different in that there
3 were still some things that I was involved in -- well,
4 not really. Because once I entered into a service
5 period and stepped out of the bank, and that started
6 in midyear of 2012 until midyear of 2013, then they
7 couldn't call me anymore to do anything.

8 But prior to that, I would estimate that I
9 was spending maybe 10 to 15 hours a week on Union Bank
10 activities.

11 Q Thank you. Another asset that is listed on
12 depreciation schedule for the company for the S
13 Corporation is a work space in Oakland, California
14 listed as an asset of the company.

15 What takes place at that warehouse?

16 A Yeah. It is a warehouse. So I have things
17 stored there that are related to things that I do in
18 terms of my real estate. I have an office there. And
19 so I work out of there. I have my files there, and
20 keep all my files there. I have tools there, so my
21 table saw, my -- I have a lift, construction lift
22 that's there, all my hand tools that are there that I
23 would use.

24 There's a couple blow dryers, you know, that
25 the kinds of things that blow to dry things out that

1 are there. And that's predominantly it. There's
2 no -- and I know there's some contention that I guess
3 you found a record or had found a record that indicate
4 that the property is a live-work space. It is
5 exclusively a light commercial and office or
6 warehousing.

7 And having served on the board there for two
8 years as well, you know, I know that we find as well
9 as have bylaws excluding any kind of residential. And
10 I was even reminded more about that recently when I
11 tried to acquire, what do you call it, internet
12 service there, and was told that this is only -- well,
13 the price of commercial is so much higher than
14 residential. I tried to get it as a residential price
15 and I couldn't. So...

16 MR. HUNTER: Okay. That ends our
17 cross-examination, Judge Rosas.

18 ALJ ROSAS: Thank you, Mr. Hunter.

19 Mr. Mulgrew, by any chance, do you have any
20 additional questions for Mr. Malm?

21 MR. MULGREW: Not at this time. Thank you.

22 ALJ ROSAS: This point, I will turn it over
23 to the panel to see if they have any questions.

24 Mrs. Hosey?

25 BY ALJ HOSEY:

1 Q Hi. I had a question about the hours that
2 your wife helped with the property. You said she
3 staged and decorated the properties when you were
4 selling them.

5 Do you know how many hours approximately she
6 intervened?

7 A No.

8 Q Approximation?

9 A Yeah. I mean, I'm going to say two or three
10 man weeks of time involved in doing that work,
11 acquiring things, bringing it to the house, setting it
12 up, so...

13 ALJ HOSEY: Okay. Thank you.

14 ALJ ROSAS: Mr. Margolis, do you have any
15 questions?

16 BY ALJ MARGOLIS:

17 Q Yes. Your son, is his name -- is he Earle
18 Malm the second, or are you Earle Malm the second?

19 A I'm the second. My son is the third, but he
20 only goes by Drew, Drew Malm.

21 Q Okay. Fine. Fine. And I've seen there's
22 been some arguments about whether or not you own some
23 of these properties or NVMLI owns some of these
24 properties.

25 What sort of documentation did you have

1 transferring these properties to NVMLI?

2 A Well, we did not -- some of them were
3 transferred in NVMLI by going through the deed process
4 and others were not. They were, but they were adopted
5 by NVMLI as a result of corporate action.

6 Q So just the corporate adoption consent or
7 whatever, that's the only documentation for that?

8 A Right.

9 Q Okay. And I have a question. There's
10 something about the Form 4797 loss. Is that --

11 Does that relate to the Estates property when
12 you did your teardown, is that the loss that was
13 claimed?

14 A Yes.

15 MR. MULGREW: That's the dismantling. The
16 disposal of the original structure is being taken out
17 and disposed of, and then they build new.

18 BY ALJ MARGOLIS:

19 Q Okay. And let me see if there's anything
20 else.

21 You gave some estimates of hours that you
22 worked on various projects that you worked with
23 respect to NVMLI business. But you said that NVMLI
24 had three different businesses, and I'm trying to
25 figure out how can we tell whether or not your hours

1 related to --

2 Did your hours relate to just the real estate
3 business or related to all of those businesses?

4 A No. For purposes of this, it was basically
5 related to the real estate redevelopment business. So
6 the hours that had been put in this document are
7 related to real estate redevelopment.

8 Q Okay. And the Danville priority, the Estates
9 property that you sold for 2.8 million, when was that
10 sold?

11 A 2015.

12 Q And who was living in the property before
13 2015?

14 A I had my son rent it. And there was a
15 specific reason for that.

16 Q He was the tenant?

17 A He was the tenant, yes. And we put it into
18 service in 2012, and having completed construction and
19 the market wasn't right yet to sell it, so we decided,
20 okay, you're paying rent here, go pay rent there. And
21 let's minimize some of the bleeding during that period
22 of time.

23 And unfortunately, we came up with a very
24 significant construction defect that, it was a small
25 thing but it caused a major problem. One of the test

1 caps that went onto the plumbing beneath the house,
2 when the testing was done to test the surface, that
3 cap wasn't put back on and closed. As a result of
4 that, for a period of a couple months, sewage was
5 building under the house, and fortunate for us we put
6 a rat slab under the house.

7 And as a result of doing that, it was
8 building a swimming pool. So we had things growing
9 there, and we had to go through a mold process, we had
10 to go through --

11 Q I've had that problem in my house as well.

12 A Point of a new construction lawsuit. So
13 until we could deliver it with a clean bill of health,
14 okay, we kept it rented until that point in time and
15 kept working on it.

16 Q So when was the property, when was it --

17 When was it finished construction so that he
18 moved in or whatever?

19 A 2012.

20 Q 2012. And then the Nevada property, the
21 385 -- I forget the name of the street --

22 A Via Sonador.

23 Q So that's a residential property as well?

24 A Yes.

25 Q Who was that rented to?

1 A Well, that turned out to be a problem. And
2 that is when I had NVMLI, it was a Nevada company and
3 I was living in Nevada and that was my residence.
4 When I came back to accept the position with Union
5 Bank of California, you know, that was a very
6 difficult time to sell a property in the marketplace.

7 Thought I could rent that property, and I did
8 rent it for some period of time but there were two big
9 issues. Did not realize that it's not a short-term
10 rental market, so the CC&Rs precluded me from renting
11 it like weekends, and it was a great property for
12 that, but couldn't do it.

13 And then the second thing is I was actively
14 trying to market it, and it was difficult to have a
15 renter in there at the same time being marketing it.
16 So it was available for rent 365, but realistically
17 that was probably not the right thing.

18 (Clarification by Reporter.)

19 THE WITNESS: Via Sonador, V-I-A,
20 S-O-N-A-D-O-R.

21 BY ALJ MARGOLIS:

22 Q And when you were talking about the
23 management fees that were paid with respect to your
24 son?

25 A Yes.

1 Q That was 100-some thousand a year?

2 A Yes.

3 Q And that's his work on the Estates property;
4 correct?

5 A That's correct. Yes.

6 Q And when that property was sold, was that
7 reported on the Sub S return?

8 MR. MULGREW: Yes.

9 THE WITNESS: We'll look to him.

10 BY ALJ MARGOLIS: Okay.

11 A Yes.

12 Q Let me see if I have anything else.

13 And the hour estimates that you gave for the
14 work on your real estate properties, how much of those
15 hours was by you and how much was by your wife?

16 A The estimate that I gave in the documents
17 that were submitted was all by me.

18 ALJ MARGOLIS: Okay. I think that's all for
19 now.

20 MR. CORNEZ: May I ask a clarifying question
21 our two, your Honor, Judge?

22 ALJ ROSAS: Yes, Mr. Cornez.

23 CROSS-EXAMINATION

24 BY MR. CORNEZ:

25 Q Judge Margolis asked you if the hours on the

1 chart that we talked about today relate, and I think
2 you answered that they related to your real estate
3 development activity?

4 A Predominantly, yeah.

5 Q What do you mean by your real estate
6 development activity?

7 A The work that I was doing around Estates and
8 developing that particular project and getting that
9 ready to go to the market.

10 Q Estates, E-S-T-A-T-E-S?

11 A Yes.

12 MR. MULGREW: The street.

13 THE WITNESS: 106 Estates, that's the
14 property.

15 BY MR. CORNEZ:

16 Q The greenhouse?

17 A Correct.

18 Q So those hours all relate to that project and
19 not to the rental real estate activity?

20 A Primarily, yeah.

21 MR. CORNEZ: That's all I have.

22 THE WITNESS: I didn't -- there were hours
23 related to the rental real estate activity, but I
24 really didn't consider those.

25 BY ALJ MARGOLIS:

1 Q And we've covered some of these properties.
2 I think I forgot to ask about the Walnut Creek
3 property.

4 Who was renting that during 2010, '11, '12?

5 A My daughter.

6 Q Okay.

7 A And we bought the Walnut Creek property when
8 we thought it was a good time in the marketplace to
9 make that acquisition. I had the cash from, you know,
10 a little bit of windfall that had occurred from the
11 sale of the Union Bank stock.

12 And that property is kind of a, is going to
13 have an opportunity. We have to put some money into
14 it and do some redevelopment into it, but we paid
15 371,000 for that property, and the current market
16 value is 650. So at some point in time we'll flip
17 that property and --

18 Q And the Union Street in Oakland property,
19 that's the warehouse?

20 A That's the warehouse.

21 Q And you were renting that?

22 A No.

23 Q You own that?

24 A I own that and I use that to store things
25 that we use in the various projects and store my files

1 as well.

2 Q And I think there's three timeshares in
3 Hawaii; is that right?

4 A Actually --

5 Q There's one in Lahaina and two in
6 Princeville?

7 A During that period there were.

8 Q Okay.

9 A I have further developed Hawaii. I see
10 there's an opportunity, I believe, in the timeshare
11 space. I know everybody gets these phone calls, do
12 you have a timeshare that you want to get rid of. But
13 in Hawaii, in particular, I thought that there could
14 be some rental activity with that. I'm less convinced
15 of that today than I was back at that time.

16 So what I've been doing actively over the
17 last couple years is trading the portfolio and
18 reshaping the portfolio. So today I own eleven weeks
19 of timeshare all on Maui. Eight of them are on --
20 nine of them are on one property, and two of them are
21 in other property. Eight of my eleven weeks are the
22 Christmas and New Year's week, so the very specialized
23 opportunity. Six of my weeks are all that I call
24 premier deluxe oceanfront.

25 So one building, I own the top floor, both

1 corners, so you might say the penthouse floor for the
2 Christmas and New Year's weeks. And so I think that
3 the other change that's taking place in that market is
4 Mexico was a good example. You got a lease on the
5 land, you didn't actually have deeded property. In
6 Hawaii, you still have deeded property.

7 So NVMLI has deeds in Hawaii and owns the
8 property. Everything now is turning to points.
9 People buy points as opposed to buying actual property
10 in the deeds. So I think that I'm in a position where
11 that property can be -- can increase its value.

12 Q And during the years, the three properties
13 that you owned during the years at issue, 2010 through
14 2012, was it primarily rented to family members, those
15 Hawaiian properties?

16 A That's a good question. And time-wise, I
17 think it's about 25 percent was rented to the outside,
18 okay, and then about 25 percent of it didn't get used.
19 And about 25 percent of it was used by myself in going
20 over there and, one, using Hawaii but also working the
21 market and getting to know more about the market. And
22 then 25 percent could have possibly gone to friends
23 and family.

24 ALJ MARGOLIS: Again, that's all for now.

25 ALJ ROSAS: Thank you, Mr. Margolis.

1 Mr. Malm, I just have a few clarifying
2 questions. And I don't know if FTB has any more
3 questions, but we'll get to you after the panelists
4 continue with their questions. I know you don't mind
5 standing up for more time, Mr. Cornez.

6 BY ALJ ROSAS:

7 Q Mr. Malm, you mentioned that all key
8 decisions of the Nevada company were made by you; is
9 that correct?

10 A That's correct.

11 Q And how many directors were there during the
12 tax years at issue?

13 A There's three directors.

14 Q Who are the three directors?

15 A My son and my wife.

16 Q Your wife Evelyn Malm was a director, does
17 she make any key decisions regarding the Nevada
18 company's business activities during these tax years
19 at issue?

20 A Is she going to read this testimony? So
21 certainly, I want to draw a distinction between
22 seeking the consultation and advice of those people
23 who were also considered to be directors with me. I'm
24 the only shareholder of the company. And so in kind
25 of saying, okay, what do we think we want to do.

1 Okay?

2 I would seek that input, but when it came
3 time to make the decision, the go or no-go was my
4 call.

5 Q And does that also apply to your son Drew,
6 did he make any key decisions or he just provided you
7 with consultation?

8 A He had a responsibility at the site to make
9 decisions that would come up while on the site, you
10 know, of something that, you know, needed to be done.
11 But as far as are we going to go with this solar
12 company or that solar company, and are we going to put
13 this type of tile in or that type of tile, again, it
14 was an advisory input.

15 Q Mr. Malm, I know you discussed the management
16 fees and the administrative fees. I don't recall if
17 you spoke about the fees in 2012 regarding the claimed
18 deduction for outside services.

19 Can you explain these outside services?

20 A Yeah.

21 MR. MULGREW: It's the same thing, just got
22 put into a different category.

23 THE WITNESS: It was -- it's the same two
24 people doing similar things, but it's just where it
25 was categorized on the tax return.

1 BY ALJ ROSAS:

2 Q So just to be clear, the \$164,000 claim of
3 outside services were paid to your son and
4 daughter-in-law, I believe?

5 A My daughter.

6 Q Your daughter.

7 In terms of the property that was demolished,
8 can you help me understand how you determined that
9 this property resulted in a loss of \$588,000 in tax
10 year 2010?

11 MR. MULGREW: You'll need me to do the
12 accounting of that?

13 ALJ ROSAS: Sure. We'll wait for your
14 closing argument to address that area. It's not a
15 problem.

16 MR. MULGREW: Okay.

17 BY ALJ ROSAS:

18 Q Mr. Malm, in terms of -- let me back up one
19 second.

20 If this panel finds that there was an
21 understatement of tax, we will then want to determine
22 whether you established that the penalty should be
23 abated.

24 So would you like to offer any testimony on
25 the issue of whether the accuracy-related penalty

1 should be abated?

2 A Well, you know, I was actually going to make
3 a little bit of an opening statement, and I didn't.
4 And that is certainly with the idea being that, you
5 know, there was never any intention to do anything
6 wrong.

7 And obviously my reasoning for pursuing this
8 manner to this point to date is I don't believe that I
9 did anything wrong or was trying to deceive anybody in
10 any way on this.

11 So, you know, I would hope that if that was a
12 point, that certainly would be looked at that there
13 was no -- no intention on my part or NVMLI's part
14 which is me, to, you know, have disrespect for the
15 State of California or for the Franchise Tax Board.

16 Q Mr. Malm, I have one final question. Let me
17 just preface it by saying that we have a stenographer
18 transcribing your testimony and the panel will have a
19 chance to read that transcript later. And also, I've
20 heard your testimony, and believe me, I've taken good
21 notes. So I don't want you to repeat yourself, that's
22 what I'm saying.

23 So my question to you is other than what
24 you've already told us, is there anything else you
25 think this panel needs to know in order for us to make

1 an informed decision?

2 A You know, I think the only thing that I would
3 add is that it wasn't like I approached this real
4 estate redevelopment market without having some
5 background and experience at doing this kind of work.

6 And I did already inform you that I built ten
7 properties or have been involved in building ten
8 properties that in various stages throughout my
9 career. In addition to that, I did two major
10 renovations, one to my current house which was over
11 \$600,000 in renovations.

12 So I think that it wasn't like that, you
13 know, I could sit back and just hire somebody to do
14 the work for me. It was I had the experience that I
15 could get involved, get in there and do it. And I
16 didn't do the framing. I didn't do the -- but I
17 certainly monitored the framing. And every Saturday I
18 was out there with a level checking to see what was
19 going on and did discover one great beam problem
20 before we actually closed the framing.

21 So, you know, I think there was a lot of
22 involvement, and probably more than I've told you
23 about or more than I put down. I think that I
24 probably try to be conservative in that.

25 And I think that the other thing is that I

1 hope you'll take into consideration the idea that I
2 was hired to do a job at Union Bank. I came in and I
3 did that job. And what I thought was going to last me
4 two to ten years did from a time commitment standpoint
5 of being there and getting paid there.

6 But from a standpoint of workload, my
7 workload dramatically changed in about 2008 when the
8 sub-prime market came, the bank got very conservative
9 in what they wanted to do and didn't want to do with
10 their capital. And I was in a position where I was
11 really just maintaining a business as opposed to
12 trying to build something and grow something.

13 And I was also maintaining a business that I
14 knew was not going to ever be a core business in Union
15 Bank. And to that point, I would add that they
16 actually have downsized the company by two-thirds
17 since I've left and, you know, so it's a shell of what
18 it was.

19 ALJ ROSAS: Thank you, Mr. Malm.

20 THE WITNESS: And I appreciate you listening.

21 ALJ ROSAS: Mr. Margolis?

22 BY ALJ MARGOLIS:

23 Q You talked about construction on the Estates
24 property. I thought I saw something in the briefs
25 saying that two properties during this period were

1 under construction. Was there another?

2 A Two what?

3 Q Two properties were under construction during
4 this period, was it only one property?

5 Was most of your time spent overseeing
6 construction that was with respect to the Estates
7 properties?

8 A Yeah. I had a little work going on in the
9 Walnut Creek property, but nothing near what the
10 Estates was.

11 Q Thank you.

12 A Estates was a major project. It was a major
13 build.

14 ALJ ROSAS: That concludes the questions from
15 the panel, but invite the questioning from the penal
16 coming back to the parties.

17 Mr. Mulgrew, do you have any additional
18 follow-up questions for your client?

19 MR. MULGREW: No.

20 ALJ ROSAS: Thank you. FTB?

21 RECROSS-EXAMINATION

22 BY MR. CORNEZ:

23 Q Yes. Exhibit 4 which was introduced as an
24 exhibit today is from a brief filed by yourself that
25 has hours spent for 2010, '11 and '12.

1 Do you have any documents from that time
2 period such as diaries or travel logs or
3 recordkeeping that support any of these hours?

4 A The only thing that I would have is my
5 calendar of trips that I made, but it wouldn't have,
6 you know, I live 20 minutes away from the Danville
7 property, so I wouldn't have anything relative to
8 Danville property that, you know, that I was there on
9 this date. And it's just not the nature of the way I
10 operate as well. I mean --

11 Q So this brief was filed with the OTA in May
12 of 2017, so I assume that you made these estimates
13 approximately in early 2017 is the amount of time you
14 spent in '10, '11 --

15 A What I did keep is a project log of
16 everything we were doing at the time in chronological
17 order by vendor and sub that we were working with.
18 And so in order to think about this brief, I went back
19 and looked at all of my receipts and the chronological
20 log.

21 And based on what we were doing and what
22 period of time, I tried to draw some conclusion to
23 say, okay, these were the kinds of things that I was
24 doing then to be involved in this area. And that's
25 how I made my estimates.

1 MR. CORNEZ: That's it.

2 ALJ ROSAS: Anything further from FTB?

3 MR. CORNEZ: No, thank you.

4 ALJ ROSAS: Thank you, Mr. Malm. That
5 concludes your testimony. You can return to the
6 table. It is currently 2:40. We'll take a short
7 15-minute break. And when we return, we will proceed
8 with closing arguments. So we will return at
9 2:55 p.m. We are now off the record, Ms. Perry.

10 (Recess taken.)

11 ALJ ROSAS: We are back on the record. In a
12 moment we will begin with closing arguments.

13 Mr. Mulgrew, you shall go first and you will
14 have up to 15 minutes to make your closing argument.
15 Then FTB shall have up to 15 minutes to make its
16 closing argument.

17 Mr. Mulgrew, you will have the last word. It
18 will get back to you. You will have a chance to make
19 a reply closing argument for an additional ten minutes
20 if you so choose. Following closing arguments, if any
21 member of the panel has any legal question for the
22 representatives, we will ask them.

23 Mr. Mulgrew, you may begin whenever you're
24 ready.

25 MR. MULGREW: Thank you. Do you want me to

1 start with the 4797 question you had?

2 ALJ ROSAS: It's entirely up to you, sir.
3 But if any member of this panel has any questions
4 after you're done, we'll ask them after closing
5 arguments.

6 MR. MULGREW: Okay. So I think it's very
7 important for us to be careful about how we consider
8 the facts and that we make sure we look at the whole
9 story.

10 The one thing I noticed today is this
11 particular time period is a very heavy expense time
12 period. The part that we don't see is the subsequent
13 years where the income was realized. It certainly
14 appears on its face that there's a lot of expenses and
15 a lot of deductions and these types of things.

16 If we were to follow the rest of the story
17 out, obviously this property sold for a fairly large
18 sum of money. Some of the other projects had been
19 bought and sold and traded. So there is much more to
20 this picture than the little piece that we're looking
21 at. And it's important to keep it in context.

22 We've talked a lot about material
23 participation. Code Section 469 says briefly that if
24 a shareholder materially participates in the
25 operations of an S Corporation, the pass-through of

1 ordinary income or loss is nonpassive. The income or
2 loss pass-through's back to the shareholder does not
3 materially participate.

4 It also goes on to say that Congress gave
5 broad powers to determine whether income or loss from
6 an activity is active or passive. This is a decision
7 as to tax preparers, we're supposed to make each year
8 when we prepare a tax return. Our job is to discuss
9 with the taxpayer what their activities were and
10 determine whether or not we believe there is material
11 participation because the rules are wide open.

12 This is a very difficult law to manage
13 because there's not a lot of very good case law in
14 determining material participation because it's
15 100-percent facts and circumstance based, because I,
16 for example, have a client who runs an Amazon store.
17 His job basically is to restock the Amazon store
18 whenever his inventory gets low. He spends maybe two
19 hours a week running his entire company and does
20 \$2 million in sales.

21 So is that material participation? Has to be
22 because he's the only one there doing it, right? Does
23 he meet a certain 500-hour, 1,000-hour or any of
24 those, no, but he's doing 100 percent of what it takes
25 to run a company. And that's why we have that

1 provision in there.

2 We talked a lot about time and time cards and
3 these types of things. I'll be the first to admit in
4 my own company I don't keep a time card of what I do
5 every single day of my life. Most people don't. It's
6 not a reasonable standard of proof or evidence,
7 particularly if you're involved in a large number of
8 projects.

9 And so, again, we're left with facts and
10 circumstances. And we are given broad powers to
11 determine whether or not the circumstances apply. We
12 heard Mr. Malm's testimony, and he very conservatively
13 spoke about the amount of time but, you know, if
14 you've ever bought a house, you know what it takes
15 just to buy a house. The process is a very long
16 period of time. It consumes an enormous amount of
17 your time.

18 So the rule goes on to say a shareholder
19 materially participates if the shareholder or
20 shareholder's spouse is involved in the corporation's
21 trade or business on a regular continuous and
22 substantial basis.

23 And then they provide a temporary rates that
24 gives us the material participation tests. In
25 Respondent's Exhibit V, we had submitted those tests

1 and how we are addressing whether or not he met the
2 material participation rules. That's been submitted
3 as evidence. And it's important to understand the
4 rules for material participation are really intended
5 to apply to real estate holdings.

6 The idea is is that if you own a bunch of
7 rental properties and you hire management companies to
8 run them for you, and they're hiring all the people to
9 manage the repairs and maintenance and they're
10 collecting rents, and basically all you're doing is
11 cashing checks. That's where that rule is intended to
12 apply.

13 If you're actively involved in doing it
14 yourself, there's now quite a bit of case law that
15 travels down the road of a real estate professional
16 and all of those things have been a mysterious
17 question for a lot of years. But at the end of the
18 day, the question is how much time are you actually
19 spending.

20 But it's important to understand that NVMLI
21 is not simply a corporation that holds rental
22 properties for the purpose of collecting rent. And
23 NVMLI, amongst other things as you've heard, does
24 quite a bit of the property redevelopment.

25 You can see by the photos, he's basically

1 taken a [inaudible] made a gorgeous little purse out
2 of it. I was amazed when I saw these photos that
3 involved the process of completely tearing down to
4 dirt what was there in the first place, and
5 rebuilding, redesigning a huge economic improvement
6 for the whole neighborhood.

7 So he does -- they do buy real estate, and
8 they do rent it out while it's being redeveloped while
9 it's being improved, while the market is allowing for
10 opportunity for selling it at a higher price. That's
11 a part of what the corporation does to generate
12 revenues for more projects.

13 It also is very actively involved as we heard
14 in assisting students with incubator businesses.
15 That's a phenomenal thing in and of itself. What a
16 great opportunity, but, you know, it requires time and
17 money. And so the corporation is generating.

18 So when we look at the case, if you read the
19 definition of a sole shareholder in a corporation,
20 can't possibly be passive. Because a sole shareholder
21 is the person who has to do all the work, even if it's
22 just an hour a week, they're the only person doing it.
23 If the shareholder performs the predominance of duties
24 in a corporation, the activities are nonpassive.

25 If we decide this really was a rental

1 property, there's a regulation that's in the Internal
2 Revenue Code that says it's more than 50 percent of
3 the gross revenue comes from rents. In a corporation,
4 it's automatically nonpassive. So we keep hitting the
5 same nonpassive, nonpassive, nonpassive, because the
6 treatment isn't somebody who's cashing checks, the
7 treatment is somebody who is buying, selling,
8 redeveloping.

9 I'm not trying to portray NVMLI as a rental
10 property company. It's simply not. Although, it does
11 have rental activities. And this is why when I look
12 at it and I look to determine whether there's material
13 participation, it becomes very obvious to me that it
14 could not be anything but.

15 If it boils down to a period of time and
16 whether or not he meets the material participation,
17 let's take a look at the three years. In 2010, 2010
18 was the big year of acquiring the Danville property,
19 dismantling it, segregating it out, donating all the
20 parts and pieces and starting to develop plans and
21 getting permits and all of that. That alone is more
22 than 1,000 hours. If you've ever bought a house on
23 your own, you know that you spend hundreds and
24 hundreds of hours just in the paperwork alone.

25 In the 2011 tax year, what were the big

1 events? The Oakland warehouse property was purchased.
2 The Walnut Creek property was purchased. There was
3 Hawaii properties purchased, and there were Hawaii
4 properties sold. So again, more than enough activity
5 there.

6 And 2012, the big Danville project was placed
7 into service. So that's closing out all the permits,
8 getting the final pieces done, and on and on and on
9 and on.

10 So it's pretty clear that whether you had
11 time cards or not, a reasonable person could just look
12 at that and say, yeah, that's more than 1,000 hours
13 worth of work in and of itself, not to mention all the
14 rest of the work that was done.

15 Any one of these activities in a given tax
16 year would have required more than enough time to meet
17 it. The state brings up the question of whether or
18 not these expenses are for a valid business purpose.
19 Yet, the state is the one who required us to file a
20 franchise tax return for the corporation which would
21 be a valid corporation.

22 So if they thought we should file a
23 corporation tax return, they must concede that there
24 must be a valid business purpose going on. That's
25 just a logical conclusion, if you will.

1 The interesting thing about this case is
2 prior to us setting up this hearing, we received a
3 letter from the state saying that they were no longer
4 pursuing this matter, that they had decided to drop
5 it. And that's just odd that we find ourselves here
6 after a very -- we're talking about 2010. That was
7 nine years ago.

8 This has been a protracted case for a long
9 time that doesn't ever really seem to be about
10 anything that we can identify. So what we're trying
11 to do is to figure out what it is. The state has
12 brought up substantiation. If there are issues of
13 substantiation, we have no outstanding requests for
14 information. We've provided everything that they've
15 asked for. If there were any sorts of confusion, this
16 is at the examination process.

17 The examination process, they made their
18 determination. So if they still have outstanding
19 issues, I don't think the appeals arena is the right
20 place to be asking for proof of rent.

21 ALJ ROSAS: Mr. Mulgrew, just remind you, you
22 have approximately three minutes to wrap up your
23 closing argument.

24 MR. MULGREW: Sure.

25 ALJ ROSAS: We will get back to you

1 afterwards and you will have a chance to answer
2 questions.

3 MR. MULGREW: The last piece is just how the
4 4797 was calculated. When the original property was
5 purchased, what we did was we looked at the tax
6 assessor's bill to determine the ratio of improvements
7 to land. That helped us determine of the purchase
8 price what was the cost of the house. And then there
9 was also a cost of the demolition and teardown and all
10 of that built into that capitalized cost.

11 So the property was acquired, the land and
12 building were segregated, and then the building was
13 demolished and disposed of. That's how that
14 calculation was made. Submitted.

15 ALJ ROSAS: Thank you, Mr. Mulgrew.

16 FTB, whenever you're ready.

17 MR. HUNTER: Thank you, Judge Rosas. I'd
18 like to begin my closing argument by addressing a
19 couple of questions that were raised by the judge
20 earlier if I may.

21 Judge Margolis, you asked a question about
22 this S Corporation and thing, what did it do. More
23 importantly, what did it do during the tax years at
24 issue with the assessment that is before this body.
25 And I believe that's important because when you're

1 looking at the kind of lookback test, 500 hours and
2 five or three years, the amount of time the taxpayer
3 spent working on an activity, it's the not entity that
4 we're concerned about. It's the activity.

5 The NPAs that were admitted into the evidence
6 this afternoon as Exhibits 1, 2, and 3, these NPAs
7 were based on losses that have been recharacterized as
8 passive. That's why we're here. These losses did not
9 stand for mortgage lending activities, financial
10 services activities, student business incubators,
11 anything else. We're focused on the property that
12 were listed on the depreciation schedule of this
13 company that incurred losses and flow-through to the
14 taxpayer and were reported as nonpassive.

15 Secondly, the question was raised in terms of
16 the amount of time. It is contended that the taxpayer
17 or appellant's spouse spent on one of the properties.
18 I'd like to note that at least one spouse must
19 individually satisfy the 750-hour requirements.
20 Spousal attributions may not be used for the purpose
21 of satisfying the 750-hour annual service requirement
22 under the regs and case on point in *Oderio*,
23 *O-D-E-R-I-O, v. Commissioner*.

24 ALJ MARGOLIS: O-D?

25 MR. HUNTER: *O-D-E-R-I-O v. Commissioner*,

1 it's 2004 tax court. So now go ahead and unpack this.
2 We still believe this is a substantiation case because
3 this taxpayer was audited for losses which he reported
4 as flow-through losses and characterized it as
5 nonpassive.

6 But in order to have these losses to flow
7 through to the individual taxpayer who is the
8 100-percent shareholder owner of this company, you
9 have to have losses in the first place. They must be
10 substantiated. And in this case, we're not speaking
11 about a negligible amount.

12 For tax year 2010, it's \$301,000 of which 120
13 were reported as rental losses, but the taxpayer on
14 the individual return reported them as nonpassive.
15 Rental activity on the S Corp return, yet
16 nonpassive on the individual return. Losses amounting
17 to 291,000 in 2011 and 324,000 in tax year 2012. So
18 these are not minor adjustments. This offset
19 30 percent in taxpayer's income as reported for the
20 years. So again, it's the law.

21 The appellant must keep adequate reports and
22 provide copy of evidence and contemporaneous
23 documentation to support claim deductions or the
24 tax-supporting deduction.

25 We have a narrative which is presented in a

1 reply brief going back a couple years, not during the
2 tax years at issue, so it's not contemporaneous. Now
3 we have taxpayer's testimony claiming that he spent
4 time managing one of the properties, because
5 throughout the testimony this afternoon, we made some
6 headway.

7 The panel took time and we focused on
8 property by property, and what we have are properties
9 that were held out for rent. And under California
10 law, that's a passive activity. There's no coming
11 back from that.

12 Then we have one property which Taxpayer
13 alleges one property was developed, it was purchased
14 in 2009. It was in the process of being developed
15 over the tax years at issue, and eventually sold three
16 years after the last tax year at issue here. But the
17 taxpayer also testified this afternoon that his son
18 was the only manager strictly on site for this
19 property. His words.

20 So we have one remaining property that can be
21 seen as a real estate development project, but he paid
22 his son. So we don't have any contemporaneous
23 evidence. We do have this narrative. Testimony this
24 afternoon elicited that the taxpayer prepared this
25 narrative based on work logs that we requested several

1 times over and have never seen. They were never
2 presented to Respondent.

3 It's important to note that Respondent also
4 requested documentation supporting Taxpayer's
5 investment in properties held by this S Corp during
6 the same time period. When taxpayer was assessed for
7 losses on his individual return, the first question in
8 the audit, the audit division asked was, do you have
9 money at risk? Do you have skin in the game? And the
10 taxpayer was able to show that. Do you have
11 sufficient basis in these assets held by the S Corp?
12 The taxpayer was able to show that.

13 The taxpayer was more than able to provide
14 substantiation on those points, but when it comes to
15 diving into expenses from the S Corp activity or
16 rental income, we still don't have it.

17 In terms of an outstanding request from
18 Respondent for support for the expenses, assets held
19 by the S Corporation, there were at least six
20 information document requests that were sent out. I
21 have them listed in Respondent's reply brief by date.
22 And the copies of those requests are attached to that
23 particular pleading as exhibits.

24 The S Corp audit was not able to generate any
25 revenue, let's say, by looking at the reporting at the

1 S Corp level because you're looking at an \$800
2 franchise fee that would be paid by the S Corporation.
3 The S Corporation return like a partnership return,
4 the S Corp doesn't pay tax. The S Corp reports items
5 of income and loss which flow from the individual
6 taxpayer. That's who pays the money.

7 So that was a call that was made on behalf of
8 the state for efficiency purposes. The bottom line,
9 we still don't have our answer in terms of
10 substantiation for these expenses which Taxpayer
11 reported flows on his return. And it shouldn't be
12 that hard.

13 When the taxpayer's the sole owner of a
14 company that claimed several real estate assets in
15 service, upon audit, the taxpayer should readily be
16 able to show the taxing agency who rented the
17 property, the rental deposits, expenses of support
18 therefore, that the expenses were necessary and
19 reasonable in amount. And we simply don't have that
20 here.

21 The facts and evidence show that the
22 appellant's S Corporation didn't conduct a trade or
23 business activity relating to his personal assets, and
24 by that, I'm focussing on the timeshare assets, three
25 Hawaii timeshare assets. Two were listed on the

1 depreciation schedule, never rented out. The third
2 was rented out. We don't have any support for rental
3 income or expenses which are triple the amount of rent
4 that was reported as being received.

5 The expenses reported for one property, this
6 is important to note. They're listed as under
7 construction. I heard a reference to two properties
8 being developed. But there's only one during the time
9 period at issue, and that's 106 Estates Drive in
10 Danville.

11 These expenses went to develop the property.
12 They're capital improvements. They should be
13 capitalized or should have been capitalized, which I
14 believe they were when the property was sold in 2015.

15 Second, when Taxpayer claims that he actively
16 managed the business of his solely-owned S Corporation
17 on a day-to-day basis, upon audit, the taxpayer should
18 readily be able to show by contemporaneous and
19 credible evidence that the taxpayer materially
20 participated in the activity on the basis which is
21 regular, continuous and substantial.

22 The taxpayer was compensated for services.
23 There's an argument here that there was a payout in
24 the end, but that's a sale on a capital asset, and a
25 third-party management company was not paid for a

1 day-to-day oversight for care of operations. And we
2 don't have that here.

3 The facts of evidence show that Appellant did
4 not materially participate in the S Corporation
5 activity when he never got paid. The company paid
6 someone else to manage it. He can't show he visited
7 the properties. When asked, Appellant did not provide
8 any documents to show the hours he worked during the
9 tax year at issue for either the S Corp or his making
10 finance jobs.

11 The testimony listed this afternoon shows
12 that he spent 40 hours a week at his banking finance
13 jobs, his primary pursuits during the first year and
14 half the second year at issue before this panel.
15 Appellant and his representative have confirmed that
16 he did not maintain or keep any logs, sheets or other
17 records to substantiate the daily hours he spent
18 conducting business for the S Corporation.

19 Again, that's important. And look at the
20 taxpayer. He managed a company, a financial company,
21 a subsidiary of a major bank with 16 million under
22 investment management, earned \$1 million per year, but
23 claims he spent hours every week at Oakland loft
24 waiting on material that were being delivered to a job
25 site located 20 minutes away in the bay.

1 This taxpayer knows the importance of keeping
2 records. It's the law. It's every taxpayer's
3 obligation to do so. This taxpayer knows the
4 importance of keeping binding contracts in case
5 something comes up. And here we are, we're under
6 scrutiny by the taxing agency and we don't have a
7 piece of paper to support the hours claimed to be
8 spent pursuing this S Corporation activity. Thus, the
9 appellant simply has not met his burden to show the
10 flow-through losses which are
11 unsubstantiated are nonpassive.

12 Finally, the last point. Appellant has not
13 pled nor proven a defense to the accuracy-related
14 penalty which was applied mechanically. Revenue
15 Taxation Code Section 17551 clearly provides that
16 losses pass through to S Corporation shareholders are
17 limited by the passive activity loss limitation under
18 Internal Revenue Code Section 469, and California law
19 which mandates all rental real estate activities are
20 passive.

21 Therefore, there's no reasonable basis to
22 take this reporting position on other terms filed for
23 2010, 2011, 2012. Respondent's actions must be
24 sustained. Thank you.

25 ALJ ROSAS: Thank you, Mr. Hunter.

1 Mr. Mulgrew, whenever you're ready, you have
2 additional time to make your reply argument.

3 MR. MULGREW: Thank you. First, I would
4 point out under the K-1 pass-through, its made of up
5 of two elements, an ordinary income and a rental real
6 estate income. The ordinary business losses were
7 operating the corporation, are reported in the
8 ordinary box. And the ones that are specific to
9 rental properties is in Box 2. This is a typical
10 weighing structure. The Internal Revenue Service says
11 rent is rent.

12 So if you have a little property that is out
13 there available for rent, it goes on the 8825. How
14 you treat that ultimately in the end is treated as a
15 bundled K-1 to the shareholder, because you rarely
16 have a situation where you have an S Corp or any
17 pass-through entity that has passive as well as
18 nonpassive activities. It either is or it isn't. Our
19 contention is that it is because it meets the burden.

20 The states referred to the spouse's hours not
21 being able to be included in the 750-hour test.

22 Mr. Malm testified that the hours provided did not
23 include the spouse hours. Those actually are above
24 and beyond.

25 The state talks about substantiation. Again,

1 we're back to if this is a substantiation issue, this
2 is an examination. We're at the appeals process
3 because the state has made the determination.

4 In my pre-hearing brief, I talked a little
5 bit about how this case transpired. The problem is,
6 is the very first day that this case came out, the
7 state was looking for un-reimbursed employee expenses
8 and wanted us to substantiate them. They didn't exist
9 because we didn't claim them on the taxpayer's tax
10 returns.

11 So what are we supposed to provide? The
12 state conceded that they made a mistake in how they
13 looked at the tax return, but because the examination
14 was open, they decided to continue on.

15 The next layer was the pass-through losses.
16 They wanted to see the tax returns from NVMLI. Our
17 first question was do you have jurisdiction to go
18 through this corporation that is from a different
19 state? Demonstrate to us that you have that
20 jurisdiction, which they were unable to do. And
21 ultimately, we voluntarily did provide them with NVMLI
22 corporation tax returns.

23 But that's the whole mystery behind why there
24 was this seemingly uncooperative nature where we have
25 the right to ask. Our job is to defend our client and

1 his rights, and so the question is do they have
2 jurisdiction. They were unable to show it.

3 They talked a lot about work logs. I
4 discussed that. They talk about rental incomes. So
5 anecdotally this morning as I was leaving my house, my
6 tenant showed up and paid me the rent for my property.
7 United States currency. Does this actually make it to
8 the bank? Can I show a copy of this?

9 If somebody were to come and examine me to
10 determine whether or not I collected rent, the thing
11 of it is, no matter what I decide to do with this
12 money, as long as I claim it as income, I have
13 complied with the law.

14 So they've never seen evidence that rent was
15 paid. Yet, rent was declared. There's a lot of ways
16 rent could be paid. You could impute income. For
17 example, Mr. Malm had a family member stay at one of
18 his properties, and we imputed rent income. He didn't
19 charge them, but it's not proper to have a corporation
20 on a piece of property and not receive the benefit of
21 it. So we imputed income to him. There's no receipt
22 for that because it's an imputation on the fair market
23 value of something.

24 So this, we keep coming back to the
25 substantiation issue over and over. How do you

1 substantiate time? How do you substantiate something
2 that did or didn't happen? Most people don't keep
3 daily logs. And even when they do, most examiners
4 don't accept them.

5 We have cases where people are using apps to
6 track their mileage. And the Internal Revenue Service
7 has denied it because they don't see it as
8 contemporaneous. But it's the modern age. This is
9 how things are done. People don't have log books in
10 their car with different colored pens anymore. Those
11 days are long gone, right? The average person has so
12 many irons in the fire, they don't keep track of
13 everything that they do. It's not reasonable.

14 What is reasonable is to look at what NVMLI
15 did each of these tax years and determine whether or
16 not that could reasonably be done in the period of
17 time required by the law. And we submit that a
18 reasonable person could look at these activities and
19 say, yeah, very clearly, it would take at least that
20 much time.

21 So you are allowed to arrive at reasonable to
22 conclude. And we submit that any reasonable person
23 would conclude that the time is there, whether or not
24 there's a time clock or a time card, which is not how
25 things are done in the real world. Money at risk,

1 yes. Basis, yes.

2 He talked about capitalized cost. Well, with
3 the state, the only deductions that were made prior to
4 the sale were for property taxes and insurance. And
5 yes, you can elect, capitalize those costs as part of
6 your costs of construction, or you can absorb them as
7 operating costs. Since it's an operating project, we
8 elected to take those costs as operating expenses
9 related directly to the property.

10 We then capitalized 100 percent of the cost
11 of construction, and when the property was sold, that
12 was the basis that we used. And any depreciation that
13 we did take along the way was recaptured properly at
14 the time of sale.

15 So if we have issues of substantiation, I
16 don't have any open IDRs. If you want to substantiate
17 income, that's an unusual request, but okay. The
18 question at the end of the day is whether or not it's
19 reasonable to conclude that he meets the burden of
20 nonpassive in nature, and if you read through the
21 seven tests based on the testimony that you have, you
22 could very easily reasonably conclude that it would
23 take that much time. And since he's the sole
24 shareholder, he's the guy at the end of the rope.

25 And the project manager was specifically to

1 that site, but that doesn't mean he didn't have
2 involvement in that project as a whole. He's the guy
3 100 percent at risk. His son doesn't have any money
4 at risk. He has 100 percent. And we're not talking
5 about a little kid. We're talking about a 40-year old
6 man, right? His son is not just some young kid.
7 These are adults who run their own companies.

8 And what's unusual about hiring family. That
9 seems to be a stumbling point. But I would much
10 rather hire some of my family cautiously, right, but
11 if you're going to share the wealth as it were, and
12 it's perfectly reasonable that because of the issues
13 that they ran into, for example, with the Estates
14 Drive, that if, hey, if your son is paying rent
15 someplace else, why not pay rent here. You can manage
16 the crisis problems and at least we're not losing
17 money.

18 Is that wrong? I don't think so. Is it
19 proper to say that's income? Absolutely. Did he say
20 it was income? We absolutely did. I believe I
21 addressed the points. Thank you.

22 ALJ ROSAS: Thank you, Mr. Mulgrew. I will
23 now turn it over to the panelists to see if they have
24 any legal questions for either representative.

25 Ms. Hosey?

1 ALJ HOSEY: Yes, I do for Franchise Tax
2 Board.

3 Mr. Hunter, you stated this was a lack of
4 substantiation case.

5 I was wondering why did FTB recharacterize
6 the loss instead of disallowing it altogether if there
7 was a lack of substantiation?

8 MR. HUNTER: Well, on the individual tax
9 return level, the losses initially were
10 recharacterized as passive/nonpassive. And then
11 during the same exam, same process, we asked
12 questions, what does NVMLI, Respondent requested
13 information about. What this S Corporation did with
14 services it's performed, because Respondent only had
15 the loss amounts.

16 And the opening brief, it was written that
17 his S Corporation didn't receive a penny worth of
18 rental income. That was wrong because we had limited
19 information that was from the Federal Government.
20 Respondent requested the S Corporation returns. It
21 wasn't a matter of establishing jurisdiction over a
22 Nevada corporation. When a Nevada corporation is
23 reporting items of income or loss based on three
24 properties located in this state, they have a filing,
25 this California source income or loss as a filing

1 obligation, that's affirmative.

2 Once that was understood, the S Corporation
3 returns were received. And then the audit focused on
4 substantiation. So the only information in terms of
5 the amounts of these losses were passed through to the
6 taxpayer on the resident individual tax return and the
7 numbers take it from a Form K point.

8 So it took time to get to the procedural
9 posture where this agency could then request
10 substantiation for expenses reported on returns
11 because the agency was then in position -- I'm sorry
12 -- possession of said returns.

13 ALJ HOSEY: Thank you. No, I think I'm done.
14 Thank you.

15 ALJ ROSAS: Thank you, Mrs. Hosey.

16 Mr. Margolis?

17 ALJ MARGOLIS: Yes. I want to follow up on
18 Judge Hosey's question. So you know, it just, I
19 wanted to ask why your substantiation arguments of
20 whether they are new matters on which the FTB bears
21 the burden of proof.

22 Because the Notice of Action, Notice of
23 Proposed Assessments as far as I could tell, they both
24 said they were disallowing this on the grounds that
25 these are passive losses, not active losses. Not that

1 these were not losses as all. So I just wanted to
2 give you -- let you respond to that.

3 Was the substantiation for the loss at all in
4 question prior to the filing of this appeal?

5 MR. HUNTER: The protest level, the
6 outstanding issues were the characterization of the
7 losses, Judge Margolis. In the conversation with the
8 protest hearing officer, it was raised, what about
9 these losses, and how can this agency make the
10 determination whether these losses are bona fide
11 losses or not.

12 And the response that received was we don't
13 have tax returns. There's no way to un-peel the loss
14 amount. So the end going forward on the
15 characterization of these losses, they were
16 disallowed for the years at issue. That's what gives
17 rise to the --

18 ALJ MARGOLIS: Disallowed as active loss,
19 allowed as passive losses from what I can tell.

20 MR. HUNTER: Disallowed as nonpassive losses,
21 and allowed as recharacterized as passive losses going
22 forward. However, we're here now and my agency's duty
23 bound to collect the correct amount of tax. And this
24 is a 100-percent shareholder S Corporation. It's the
25 appellant that caused this corporation to report these

1 expenses and take that tax reported position. And if
2 there's not a valid business loss, then there is
3 nothing to pull through on the individual side, on the
4 individual return.

5 ALJ MARGOLIS: Okay. I did not -- to
6 Mr. Mulgrew, I did not follow exactly what you were
7 saying when you were talking about the Estates
8 property and that only the real estate taxes and
9 something else were capitalized?

10 MR. MULGREW: Oh. No. Actually, when we
11 were talking about the flow-through expenses on the
12 K-1, the state had brought up that all of the project
13 costs should have been capitalized. And so what I was
14 saying was all the costs of construction, all of the
15 insurance, the carrying costs and all that were
16 capitalized.

17 The only thing that was pushed through on the
18 8825 was the, I believe the property tax and the
19 insurance cost. And that's an election to either take
20 the expense now or carry it as cost of construction.

21 ALJ MARGOLIS: And then I'm somewhat
22 unfamiliar with the loss on the 4797. Didn't you
23 report some sort of gross receipts, you know, was
24 it --

25 You claimed a net loss, but wasn't there some

1 positive gross receipts reported on the 4797?

2 MR. MULGREW: No.

3 ALJ MARGOLIS: No? Just purely --

4 MR. MULGREW: Just the disposal of the --

5 ALJ MARGOLIS: The value of the property,
6 okay.

7 MR. MULGREW: Right.

8 ALJ MARGOLIS: And I think that in your
9 briefs, you talked about the competition of the losses
10 for each of the three years. And I guess for 2010,
11 there was a 4797 loss that was rather large, and then
12 there's some ordinary subchapter S losses and then
13 there's the rental real estate losses.

14 How, if we were to find out that -- I mean,
15 does the -- if we were to determine that let's say the
16 rental real estate activity, there was that those
17 should not be allowed, how do we know that the other
18 losses, I mean don't they also relate to the rental
19 real estate activity to some extent, or no?

20 MR. MULGREW: Not necessarily. They would be
21 things like travel costs to, you know, these incubator
22 businesses. They could be travel costs to sourcing
23 properties. They could be, you know, a lot of
24 different related to cell phone. NVMLI did buy the
25 open property, and so the property taxes and the

1 insurance and all of that would certainly be an
2 operating cost of the main corporation because the
3 Oakland property is not a rental. So that would be
4 like paying rent, right?

5 ALJ MARGOLIS: I thought he pays rent to
6 himself in the Oakland property.

7 MR. MULGREW: No. The corporation owns that
8 asset, just pays the costs of it.

9 ALJ MARGOLIS: Okay. But there's no income
10 the IRS reported from the incubator activity, I don't
11 believe, is there?

12 MR. MULGREW: Well, there wouldn't be because
13 only until those businesses mature and turn into a
14 liquidation of his holdings or a distribution of
15 income from them.

16 ALJ MARGOLIS: And are --

17 MR. MULGREW: So these are basically students
18 who are advanced degree business students and they're
19 starting a company --

20 ALJ MARGOLIS: Who holds the interest in
21 these properties, Mr. Malm or NVMLI?

22 MR. MULGREW: NVMLI would be the investor in
23 their company. And then Mr. Malm would provide his
24 consulting services and these types of things. And so
25 at some stage when that business matured, it would

1 either pay him or pay the corporation income based on
2 the shareholdership or those shares would be sold or
3 lost, if anything they didn't perform.

4 ALJ MARGOLIS: Then I guess I'll let each of
5 you respond because I'm not really sure.

6 But if some of these properties were
7 acquired, is there an issue as to whether or not some
8 of these properties were acquired for investment or
9 whether or not they were acquired for rental, for
10 rental activities?

11 Is that one of the issues in dispute because,
12 you know, it seems to me that if, I mean if you have a
13 passive activity and it's 100-percent passive,
14 regardless of whether Mr. Malm does 100 percent of
15 that business, he's still passive.

16 Now, obviously your position is certainly
17 with, you know, these properties required more than
18 were not passive activities and went to real estate
19 activities that he's actively engaged in.

20 But you know, and I guess I'm a little
21 confused in this area. So maybe both sides can just
22 talk about whether or not these properties were held
23 for investment or for rental activities. Maybe
24 Mr. Malm should start.

25 MR. MULGREW: Sure. It's difficult to ever

1 say that real estate is not held for investment
2 purposes. I mean, obviously we all expect to make
3 money on our primary homes one day and/or to buy
4 properties.

5 The idea of buying the properties is to buy a
6 property such as the Walnut Creek property that's a
7 diamond in the rough. This is a particular corridor
8 in Walnut Creek that now has been developed into a
9 huge area for properties and rentals.

10 So you buy a diamond in the rough property,
11 this would have been an older property. You rent it
12 out, or you redevelop it and then you rent it out
13 waiting for the market to mature and then down the
14 road, sell it.

15 So it's for the purpose of having, holding,
16 owning and renting and then ultimately selling. But
17 in the active years, you have rents and rents are
18 always reported on the 8825.

19 ALJ MARGOLIS: Mr. Hunter?

20 MR. HUNTER: In terms of that, the focus was
21 whether these assets were placed into service or the
22 titles held by the S Corporation. I believe Judge
23 Margolis, you asked that question.

24 So you have a taxpayer that has three
25 Hawaiian timeshares during the time period at issue.

1 They are reported as being held out for rental.

2 There's one that's being reported as renting, the
3 other two are listed and depreciated but there's no
4 rental income therefore. But they're depreciated and
5 there's expenses that were reported related to those
6 properties.

7 So the query there was were these active
8 trader business deductions, or were these assets that
9 were personally held by the taxpayer and he took the
10 position that they were owned by the S Corp. And the
11 only documentation that we have to show that they were
12 transferred to the S Corp were minutes that were
13 entered into by the taxpayer and a couple of the
14 renters and which were provided many years later.

15 The case on point is *Hoffman*, it's cited in
16 our opening brief, H-O-F-F-M-A-N, in which Taxpayer
17 cannot use avail of an S Corporation to incur or flow
18 through as business expenses which are expenses which
19 are truly personal in nature. You can't do that. If
20 you own a timeshare, family goes there, it's your
21 timeshare. They're not based into [inaudible]. So
22 that goes to whether or not these expenses were
23 reportable and substantiated in order to flow through
24 to the taxpayer audit's individual return.

25 I'd also like to address something that you

1 focused on, Judge Margolis, because this S Corporation
2 handled several real estate assets. Now, take out the
3 timeshares which I just discussed. You unpack the
4 open property which is not being used for the rental,
5 you have a condominium in Walnut Creek, you have a Via
6 Sonador residence in Nevada that are listed as being
7 rented, substantiation income or loss items, and then
8 you have the Danville property.

9 And the question was asked earlier, these
10 management fees that the company was paying over
11 \$100,000 every year, those fees don't relate to the
12 rentals, do they? The answer was no. They relate to
13 Danville.

14 So you have, for instance, the 2010, you have
15 pass-through loss in the amount of \$181,000. That's
16 made up of \$144,000 in management fee that was paid
17 for Danville. And then \$37,000 for administrative fee
18 which it was testified to that that also went to
19 Danville. But Danville was the property that was
20 being developed.

21 So these are expenses that were incurred that
22 benefited the property, this beautiful property that
23 you have in the color photograph sitting before you
24 today. Those expenses should be capitalized. It's
25 not limited just to property tax and depreciation that

1 was recaptured. This is hard money that flow through
2 as a loss, reported as nonpassive on the taxpayer's
3 individual return.

4 MR. GEMMINGEN: David Gemmingen. May I add
5 one item to that, too, please? Just like to
6 reestablish the material -- pardon me, material
7 participation Regulation, 1.469-5T, small (b), as in
8 boy, (2), small two little i's. And that talks about
9 certain management activities.

10 And Taxpayer here described his activities
11 that related to the Estates property, but he also
12 described and we're aware of the payment of \$100,000 a
13 year to his son. And in going to the test of whether
14 Taxpayer materially participated in the activity, the
15 regulation states that individual services performed
16 in the management of an activity shall not be taken
17 into account in determining whether such individual is
18 treated as materially participating in such activity,
19 unless no person who performs services in connection
20 with the management activity other than Taxpayer
21 receives compensation.

22 So since the payment of compensation for the
23 management of the project to the son occurred, the
24 taxpayer's own participation cannot be considered
25 material to participating by regulation [inaudible].

1 MR. MULGREW: That says that his time that
2 was paid for can't be considered in Mr. Malm's time
3 consideration.

4 MR. GEMMINGEN: No. It says that the
5 individual services --

6 ALJ ROSAS: Gentlemen, we're free to
7 disagree. Both of you have done a great job briefing
8 this exact issue. And we look forward to reading the
9 pleadings. Thank you very much for your time and your
10 arguments.

11 Mr. Margolis, do you have any additional
12 questions?

13 ALJ MARGOLIS: Yes. Just to the extent that
14 these passive losses are not allowed, I'm wondering
15 does that affect the gain that you report on the sale
16 of the property, or does that affect your gain when
17 you wind up the Sub S?

18 MR. MULGREW: If you were to be
19 recharacterized, we would have to amend 2015s to
20 release all the passive losses at that time, because
21 when you sell a property, any suspended passive losses
22 get released at that time. So they would become
23 ordinary losses in the year on sale.

24 ALJ MARGOLIS: Right. But your returns
25 aggregated the losses from all of your real state

1 activities, so I don't -- I mean, I don't know how you
2 can determine which of these passive, allegedly
3 passive losses should relate to the Estates property
4 versus the Hawaiian property or the Nevada property.
5 I mean, if you're going to --

6 MR. MULGREW: Well, if you were to
7 recharacterize them as passive, then you'd have to
8 make that determination as to how much was passive
9 from each one. Certainly the 1120-S wouldn't be
10 passive, those are ordinary losses of a Sub S
11 Corporation sole shareholder. The only thing in
12 question would be how you would treat the rental
13 property losses.

14 ALJ MARGOLIS: Okay. I wasn't sure if you
15 looked at the rental activity in total or if you
16 looked at each individual property.

17 MR. MULGREW: Yeah. So on the tax return
18 itself, it's different parts, 1120, and the 8825 is by
19 property. So you have different numbers by property.
20 So if you were to if -- I were to go back and
21 recharacterize some as passive and others as not, they
22 would then roll forward and then when the properties
23 sold, they would be released.

24 ALJ MARGOLIS: Okay. And do you agree with
25 that, Mr. Mulgrew's characterization?

1 MR. HUNTER: Yes. I agree with that.
2 However, the properties are listed among themselves
3 and delineated in terms of the rent received, expenses
4 that were incurred per property, and the depreciation
5 that was taken against the basis of each property.

6 And then we have a number, a general number
7 for expenses for the corporation which flow through
8 the taxpayer. And that's the management fee,
9 administrative fee. But there's testimony this
10 afternoon that those all relate to Danville.

11 So you'd have to make the determination that
12 these losses, Taxpayer pays tax for the tax years at
13 issue because they're not -- these losses are
14 recharacterized as passive, not nonpassive. So yes,
15 taxable. But he gets to carry them forward, their
16 expense until 2015. And then when the
17 income-producing properties is disposed of, then
18 they're opened up and he could take that against the
19 capital gain of \$1 million as reported.

20 ALJ MARGOLIS: Wait. What is there in the
21 record to show that the management fees and the admin
22 fees went into the ordinary side, the ordinary losses
23 rather than the rental real estate losses?

24 MR. HUNTER: It was the way they were
25 reported.

1 ALJ MARGOLIS: Okay.

2 MR. HUNTER: On the individual return or on
3 the K-1.

4 MR. MULGREW: And they properly were on there
5 because they're not really specific to the property.
6 Mr. Malm's testimony, he was talking about the Estates
7 project and how his son worked directly with the
8 Estates project, but that doesn't -- never intended to
9 be said that 100 percent of his compensation was only
10 for that project.

11 ALJ MARGOLIS: And one final question.

12 MR. MULGREW: And certainly, the daughter as
13 well, who isn't related to that. She's related to the
14 business as a whole. She still provides
15 administrative services.

16 MR. HUNTER: His question is how much was
17 related to Danville because that's the amount that we
18 carry forward was the percentage.

19 ALJ ROSAS: And if we can avoid the
20 side-by-side conversation, we'll just answer the
21 questions posed by the panel. But thank you both very
22 much for your --

23 ALJ MARGOLIS: You're being very helpful.

24 ALJ ROSAS: Yes.

25 ALJ MARGOLIS: And finally, there was

1 argument in your briefs that for Form 4797 losses,
2 that the passive activity roles do not apply to the
3 FTB.

4 Mr. Hunter, do you agree that to the extent
5 that claiming the loss on the 4797, the passive
6 activity rules apply or do not apply?

7 MR. HUNTER: Initially that was characterized
8 as -- recharacterized as passive because we didn't
9 have any information in terms of the source of that
10 loss, we just had the K-1 and the federal tax
11 information.

12 But his testimony and where we are this
13 afternoon, the taxpayer was in a real property
14 development business in terms of that one particular
15 property. So that is a loss. I'm not sure the
16 property was condemned in any event that would force
17 the demolition, but it was demolished.

18 And there's, that particular number, again,
19 we lacked substantiation on it, and we just know the
20 genesis of that number. So the taxpayer purchased the
21 property for 691,000, and it's listed on the
22 depreciation schedule and there's depreciation
23 deductions being paid against that cost basis. In
24 2010, there's not. Danville --

25 (Multiple voices.)

1 ALJ MARGOLIS: -- being disposed of.

2 MR. HUNTER: Okay. So --

3 MR. MULGREW: Even if there was, it would
4 just aggregate out.

5 MR. HUNTER: If you look at the S Corporation
6 returns for 2011, 2012, there's land and the basis of
7 680,000 going forward.

8 THE COURT REPORTER: I can't hear you.

9 MR. MULGREW: His land wasn't disposed of.

10 ALJ MARGOLIS: My question, just to make
11 clear, is the 4797 loss claimed in 2010, originally
12 that was disallowed because FTB claimed it was subject
13 to material participation rules. And now you're
14 admitting that that loss is not subject to the
15 material participation rules; is that correct?

16 MR. HUNTER: Judge Margolis, at this point in
17 time, I'll concede that now we have the information.

18 ALJ MARGOLIS: Okay. Thanks. That's all my
19 questions.

20 ALJ ROSAS: Thank you, Mr. Margolis. I had a
21 few questions for representatives, but my questions
22 have been answered as part of the other questions from
23 the panel.

24 So that concludes the hearing for today in
25 the appeal of Earle and Evelyn Malm. The record is

1 now closed. And this matter is submitted as of today,
2 April 30, 2019. This panel shall issue a written
3 decision to the parties no later than 100 days from
4 today. Thank you all very much.

5
6 (Whereupon the proceedings were
7 adjourned at 3:50 p.m.)
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

REPORTER'S CERTIFICATE

I, Amy E. Perry, a Certified Shorthand Reporter in and for the State of California, duly appointed and commissioned to administer oaths, do hereby certify:

That I am a disinterested person herein; that the foregoing hearing was reported in shorthand by me, Amy E. Perry, a duly qualified Certified Shorthand Reporter of the State of California, and thereafter transcribed into typewritten form by means of computer-aided transcription.

I further certify that I am not of counsel or attorney for any of the parties to said hearing or in any way interested in the outcome of said hearing.

IN WITNESS WHEREOF, I have hereunto set my hand this 20th day of May, 2019.

AMY E. PERRY
Certified Shorthand Reporter
License No. 11880