HEARING

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Franchise and/

Income Tax Appeals Hearing of:

PAUL B. THOMPSON AND OTA Case No. 18011377

KATHLEEN D. THOMPSON,

Appellants.

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REPORTER'S TRANSCRIPT OF PROCEEDINGS

MONDAY, AUGUST 26, 2019

10:17 A.M.

OFFICE OF TAX APPEALS
1400 R STREET
SACRAMENTO, CALIFORNIA

Reported by: Peter Petty

APPEARANCES

Panel Lead:

TOMMY LEUNG, ADMINISTRATIVE LAW JUDGE

STATE OF CALIFORNIA
OFFICE OF TAX APPEALS
1400 R STREET
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NEIL ROBINSON, ADMINISTRATIVE LAW JUDGE

JOHN JOHNSON, ADMINISTRATIVE LAW JUDGE

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EXHIBITS

MONDAY, AUGUST 26, 2019 - 10:17 A.M.

ALJ LEUNG: This is Monday, August 26, 2019. This is appeals of Paul and Kathleen Thompson, Case No. 18011377. The time is approximately 10:20 a.m. in Sacramento, California.

My name is Judge Tommy Leung, I'm the lead judge in this panel, along with Judge Neil Robinson, Judge John Johnson. And the court reporter is Peter Petty.

Good morning, welcome everybody to Office of Tax Appeals.

Would the parties please introduce themselves to the record.

MS. WILLIAMS: Good morning, Your Honor, I'm Betty Williams, attorney for the Appellants.

MR. CASSELMAN: I'm Chris -- oh, sorry.

MR. PEARSON: Michael Pearson, attorney for the Appellants.

ALJ LEUNG: Thank you.

MR. CASSELMAN: Chris Casselman, from the Franchise Tax Board. Sitting to my right is Roman Johnston. And sitting to my left is Michael Cornez.

ALJ LEUNG: Thank you. The three judges today, myself, Judge Robinson, and Judge Johnson, we'll be deciding the case together, although I'm the lead. We'll be taking into account everything that is submitted into the record and the record will consist of everything that happens today, including testimony, witness statements, exhibits, oral arguments, closing, all the opening statements, and the briefs filed into this, and exhibits taken into the record. And the reason being that OTA is totally separate from the Franchise Tax Board. Anything that happened that's not in the record will not be considered by this panel to decide this case.

The issues in this case are whether the statute of limitations under the eight-year statute for the fiscal tax of all these transactions or the six-year state for gross underestimate from 2001 to 2002 applies. If the statute is open, then the question is whether the structure of these transactions have economic substance and if they do, whether the income that is being reallocated was properly reallocated. And number 4, whether the Appellant under the economic substance penalty and the interest-based penalty, whether those two penalties could be sustained.

We have objections to exhibits submitted by Franchise Tax Board, Z, zulu; double AA, (indiscernible) apple; BB, blueberry; CC, cherry cobbler; FF, French fry; and JJ, Jamba Juice. Those were technically overruled during prehearing conference. I'm officially overruling those objections now. The objections have been written and submitted into the record and they are part of the record. The objections included such arguments as relevancy, the timing of the -- some of the IRS documents being beyond the 2002 year and some confidential tax collect stipulated settlement documents. They are being overruled because frankly the panel can determine the relevancy here, there's no jury here, and we'll get the appropriate weight to each one of those documents.

One of the other -- one of the other arguments concerned the confidentiality of the stipulation agreement with the IRS and that was overruled because that document was originally submitted by Ms. Williams' predecessor in this case during -- at our initial briefing. So those will be overruled.

We have an issue regarding Ms. Williams' latest brief that was filed last Thursday, the 22nd. That's the declaration of Ms. Vicky -- I forget her last name, Ms. Williams, what's her last name?

MS. WILLIAMS: Nance.

ALJ LEUNG: Nance.

MS. WILLIAMS: Previous name in the record is Sacco, S-A-C-C-O.

ALJ LEUNG: Okay. So should we refer her to Ms. Sacco or should it be Nance?

MS. WILLIAMS: Nance.

ALJ LEUNG: Nance? Okay.

MS. WILLIAMS: That's her current name.

ALJ LEUNG: Okay. So, Mr. Casselman, let's here your objections to the declaration of Ms. Nance.

MR. CASSELMAN: We have no objections to declaration being submitted. However, we would request 30 days under the regulations to submit questions to Ms. Nance.

ALJ LEUNG: Ms. Williams?

MS. WILLIAMS: We have no objection.

ALJ LEUNG: Okay. Clearly, the declaration is late. But I understand why it was submitted. Looks like it's addressing some questions put forth by the Franchise Tax Board.

What we will do is this, I will give Franchise Tax Board until noon Wednesday, the 28th of August to submit the questions from Ms. Nance. And Ms. Williams, you will have until next Tuesday, 12 noon, which is September, I believe the 3rd to respond to those questions.

MS. WILLIAMS: Thank you, Your Honor.

ALJ LEUNG: You're welcome. And at that time, we will close the record. Okay.

Scheduling today, we have 60 minutes for opening statements equally divided between the parties. 240 minutes for witness testimony equally divided among the parties. And we have 30 minutes for closing, equally divided. And then five minutes for the final word from Ms. Williams.

I hope we can get through all the witness testimony by the end of today. And tomorrow, we will be back at 1 p.m. at this location and -- with the -- we will commence with the judge's questions, if any, followed by closing statements and rebuttal.

I plan to have all the witnesses on sworn in at the time. After that is done, Ms. Williams, you will call your first witness and then the rest will please be -- leave the room and go outside the lobby, relax, it's nice out there, it's nice and cool. And you are instructed not to discuss the case among each other and not to observe the hearing through the live feed.

And this is going to be a long day, so get yourselves nice and comfortable. And I believe we might be ready for opening statements unless either side has anything to add. Any questions?

MS. WILLIAMS: Your Honor, I would just like to add that the notice we received indicated a start time of 10:30 today so my sincere apologies to the panel and to my opposing counsel for not starting at 10.

ALJ LEUNG: That's okay. We've got six-plus hours, less three minutes, among friends. So we're okay. So if you're ready to proceed, Ms. Williams, we're ready to proceed.

MS. WILLIAMS: I am, Your Honor.

ALJ LEUNG: And Mr. Casselman, are you ready to proceed?

MR. CASSELMAN: Yes, sir.

ALJ LEUNG: Ms. Williams, begin your opening statements.

MS. WILLIAMS: Thank you. I will review the history of -- some background information and the history because it's highly relevant to Paul Thompson's motive in creating a ESOP in 1999. I will review the history of the 2005 IRS audit of the same transaction but for later tax years, for tax years 2002 through 2004. The IRS chose not to audit the earlier years as it could have if it thought one of the theories applied that the FTB now asserts.

I will provide you the details about the IRS audits that were settled with the taxpayers paying only a small portion of what was initially assessed by the IRS, along with only a 10 percent penalty. And with four closing agreements which specifically state the ESOP was not a listed transaction and that it was revoked because the IRS determined the defect in the plan's tax qualified status. I will also describe to you the ESOP laws in place of the time the ESOP was created and how this changed in 2001 which was effective for this ESOP in 2005.

At the end of this hearing, I will ask that you find in favor of the Appellants for each issue.

Paul Thompson is the owner of a construction company called Thompson Builders. It was called West Bay Buildings or WBB during the tax years at issue and until about five years ago when he changed the name. So for our purposes, we'll call it WBB. WBB constructs schools, hospitals, and other commercial and residential real estate projects. Mr. Thompson has worked in this industry his entire adult life and this year he celebrates 30 years owning the same business.

WBB opened in 1989 by Paul and his brother Peter Thompson where for ten years, they worked in the business. They also formed a construction consulting company called Thompson & Thompson Consulting, Inc., which was an S Corporation that performs services such as engineering, estimating, financing, and marketing. This is common in the construction industries to have separate entities to divide functions and assets primarily for bonding purposes but also to limit the liability of any one company from potential claims.

In 1998, Paul Thompson sold 3,000 of his WBB shares to a WBB employee Frederick Joseph Hass, Joe Hass. By 1998, the two brothers had significant disagreements in the direction and operation of the company. Paul was already discussing with his advisors his concern that Peter might leave WBB and the use of an ESOP to retain employees. Ultimately Peter left WBB and in January 1999 he created a new construction company called Thompson Pacific, Inc.

Now with Peter's departure, of course, that was the end of Thompson & Thompson Consulting, the construction management company that served WBB. So in its place, each brother created a new construction management company. Paul called his West Bay Builders Management or WBBM. WBBM was created not in addition to Thompson & Thompson Consulting, but to replace it. Paul was concerned about the viability of the business. Peter didn't just leave WBB but he also took 12 key employees with him which was about half of the employees at the time. Paul didn't want to make sure he didn't lose any more of his valued employees and he said in his declaration, the nature of his business requires considerable delegation to supervisors and foremen in the field. On his judgment, he must have complete competence, which is why retention of key employees is critical, one of the reasons.

Paul had already been discussing an ESOP with his financial and business advisors prior to Peter's departure. This is in the late 1990s. The Taxpayer Relief Act of 1997 provided for the ESOP structure. ESOPs were becoming more popular. There were ample publications in 1998 and 1999 discussing employee ownership as the feature of the best places to work. Our Exhibit 13 in the first footnote provides a list of several articles and summaries of dozens of surveys regarding a relationship between ESOPs and improved employee performance and retention. The IRS even had two frequent public speakers who gave presentations and answered questions regarding ESOPs and confirming the validity of the ESOP structure allowed in the 1997 act.

Now at that time, WBB had union employees had a collective bargain agreement which included a qualified pension plan. WBB also had nonunion employees that had a self-directed simplified employee pension, an S-E-P, an SEP. And Paul contributed 10 percent of their gross salaries to the SEP which vested immediately. But the idea of an ESOP would provide employees with actual ownership to the business which Paul thought would be employees -- it would be appealing to his employees and that they would also be more committed to the business if they had an opportunity to participate in the stock ownership plan.

Now as a construction company, turns out any action Mr. Thompson takes has to be pretty much approved by his bond underwriter and his financial team. The surety company effectively underwrites a construction company's ability to its work. Construction companies like WBB make bids on large public projects and then they have to provide a bond to secure the project. WBB had to demonstrate financial stability to be bondable, which is something he has to do on every single project which at that time was about 20 projects per year. Similarly, a construction company's banker is crucial for financing a project before payments are made by WBB clients to -- of WBB.

So before creating an ESOP, Mr. Thompson discussed this ESOP with his primary tax advisor CPA Cary Gaidano, his bankers, an attorney, and an experienced benefit plan administrator that specializes in ESOPs, American Qualified Plans, or AQP. So the ESOP was formed in 1999. And in 1999 or 2000, about 25 WBB employees were transferred to WBBM. I say 1991 or 2000 because it depends on whether the reference is to WBBM which reports on a calendar basis or WBB which reports on a fiscal year ending May 31st for each year. So an event that occurs in January of 2000 would be considered 2000 for WBBM but 1999 for WBB tax return purposes.

We do know that by 2001, WBBM had as many of 43 employees based on the quarterly wage and withholding reports that were submitted to the California EDD, that's our Appellant's Exhibit 34. WBBM was not just an entity on paper or a sham. While true, WBBM only had one employee participating in the ESOP initially, WBBM had many employees. It's also clear that the employees had the opportunity to participate in the ESOP but that only one employee Frederick Joseph Hass, Joe Hass, ever did and that wasn't immediate. In 1999, 22 employees signed statements affirming their election to continue participating in their SEP instead of the ESOP, and in 2000, 23 employees signed the statements, Exhibits 35 and 6.

Joe Hass changes election and began participating in the ESOP, and in fact he still works for WBBM today. Actually 9 of the 23 employees who signed the statement in 2000 are still working for Paul Thompson some 19 years later. So even though the ESOP might not have been popular with his employees, he certainly met his goal to retain employees.

One of those nine employees is Victoria Nance. She worked in WBB's accounting department and she's now the company's chief financial officer. Through her declaration, Exhibit 45, she explains that she did not participate in the ESOP because she preferred her SEP plan. So her retirement investment and her employer were the not the same companies. She didn't want all of her eggs in one basket. And her understanding that other employees felt the same way.

In August of 2000, so that's 2000, the IRS issued its favorable determination letter to WBBM for the ESOP, that's our Exhibit 2. At some point in 2001, Mr. Thompson was advised that WBBM could not have a SEP and an ESOP at the same time in WBBM so all of the employees who were not participating in the ESOP were transferred back to WBB where they remained. They were transferred to WBBM, then they were transferred back to WBB.

In 2001, Congress enacted Internal Revenue Code

Section 409P, like Paul, which restricted the use of ESOPs in certain circumstances. As originally written, the code allowed for single member ESOPs but 409P required testing to show that the plan benefitted a certain number of employees. Now Section 409P was effective March 14th, 2001 for new plans. But plans that were already in existence like WBBM's ESOP were grandfathered in and were given a compliance date of January 1st, 2005.

In 2004, the FTB audited WBBM for tax years 2000 through 2002. And in 2005, the IRS audited WBBM for tax year 2002 which the audit ultimately expanded to include tax years 2003 and '04 and it went on for a few years. At no time did the IRS move to expand the audit and include earlier years as it could have if it thought an extended statute applied like the FTB now asserts. Nor did the IRS ever assert more than a 10 percent penalty.

In November 2008, the IRS issued a final revocation regarding the ESOP and analyzing whether the ESOP satisfied the coverage requirements and found, and I quote, "The ESOP violates the coverage requirements of IRC Section 410B and as a result is not -- not a qualified plan under IRC Section 401A." The IRS issued statutory notices of deficiencies to the Thompson's WBBM and the ESOP to which the Mr. Thompson's former counsel filed petitions in the U.S. tax board after which the case was assigned to IRS appeals where the case was negotiated with the IRS national office’s involvement and ultimately settled with the IRS with three closing agreements in January 2012. Those three closing agreements are collectively Appellant’s Exhibit 9. And Joe Hass, the other ESOP participant also has a closing agreement at Exhibit 6 which states he had 93,000 vested in the ESOP.

All four of the closing agreements state the IRS issued a final revocation letter to the ESOP because it determined a defect in the plan’s tax qualified status. So not because of fraud, abuse, a sham, or tax avoidance, but because of a defect. All four closing agreements state the ESOP was quote, “Not part of a listed transaction as described in guidance promulgated under Treasury Regulation 1.6011-4b2” unquote. Listed transactions are defined by the IRS as the same or substantially similar to one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance.

The closing agreement to the Thompsons and to Mr. Hass states there will be no income tax adjusted against the Thompsons or Mr. Hass for participating in the plan and the closing agreements to the ESOP and WBBM states there will be no income adjustments accrued to the taxpayer prior to 1/1/2005. Recall IRC 409P did not require compliance for grandfathered in ESOPs until 1/1/05.

When the IRS issued its notices of deficiency, the

IRS asserted the taxpayers owed over 14 million in tax and almost another 3 million in penalties for a total of over 17.5 million. When the taxpayers settled with the IRS, they agreed to a liability of less than 10 percent of what was initially assessed by the IRS. They agreed to pay $1,453,015 and a 10 percent penalty of $145 for a total of just shy of 1.6 million.

The IRS spent significant time with the taxpayers and their CPA Mr. Gaidano. They conducted a full examination whereas the FTB conducted no independent review. The IRS findings should be highly instructive and given that the IRS did not go back to the earlier years like the FTB supports a determination that there was no fraudulent intent or primary purpose of tax avoidance by Mr. Thompson.

Nowhere in any of the closing agreements or the IRS decision documents does the IRS ever conclude the ESOP was adopted merely for the purpose of tax avoidance was abusive, lacked economic substance or similar theories. Instead it clearly states the plan failed due to a defect and that the transactions were not listed transactions.

Now the FTB does not like the facts of these case because unless you think Mr. Thompson had a primary purpose of tax avoidance, they have no case here. The oridinary four-year statute of limitations for assessment expired before the FTB issued its notices of proposed assessments.

So the FTB is asserting an extended statute of limitations based on theories such as the transaction was a sham for tax avoidance purposes or had no economic substance. I'll explain why the transactions had a significant business purpose unrelated to tax savings for Mr. Thompson and I'll show you that there was economic substance in the transaction. And in Mr. Thompson's business judgment, both objectively and subjectively through the exhibits submitted and the testimony of the witnesses.

The FTB does not dispute the MPAs were not timely filed, but it does dispute some of the other facts. During the course of the hearing today and as you review the various briefs and exhibits, I ask that whenever you hear something persuasive, whether by me or opposing counsel, you review the record to confirm the accuracy and the completeness of the statement to see if it's true or really just an opinion or a conclusion offered to try to show Mr. Thompson was trying to avoid taxes when he created the ESOP which is simply not true.

The FTB will offer no credible evidence that the transactions we discuss were an abuse of tax shelter or tax avoidance transaction or otherwise described in the relevant RTC section (indiscernible).

In our Exhibit 13, beginning at page 6, we provide the legal authority that says when a party faced with an expired statute of limitations seeks an exception here, the FTB, the burden of proof shifts to the party requesting the benefit of the exception.

So not to elaborate on the burden of proof and instead will discuss the eight-year statute of limitations. RTC 19755 which provides authority for the extended statute requires that an abusive tax avoidance transaction exists. But that code section is defined in abusive tax avoidance transaction. The FTB is not promulgated regulations or other administration guidance to clarify what it considers to be an abusive tax avoidant transaction for purposes of the statute of limitations.

The eight-year statute is contained in Article 2 of Chapter 9.5 of the RTC. There is a definition Article 1 for purposes of voluntary compliance initiative 1 that says an abusive tax avoidance transaction is defined as a plan or arrangement devised for the principal purpose of avoiding taxes.

Abusive tax avoidance transactions include but are not limited to listed transactions. In another section, RTC 18407A, the code modifies IRC Section 6011 to include the FTB in a definition of a list of transaction. And it says in 1840784 that list in transaction includes any transaction that is the same or substantially similar to a transaction specifically identified by the secretary of the treasury for federal income tax purposes or by the franchise tax board under this section for California income or franchise tax purposes as a tax avoidance transaction including deductions, basis, credits, entity classification, dividend, elimination or omission of income that shall be reported on the return or statement required to be made. And subsection A, capital A says the franchise tax work shall identify and publish listed transactions through the use of franchise tax or notices or other published positions. In addition, the listed transactions identified and published pursuant to the proceeding sentence, shall be published on the website of the franchise tax board.

I believe currently the FTB has two listed transactions on its website, neither of which are the transaction we're discussing today. Neither the FTB nor the IRS in the tax court proceedings related to this case have alleged the transaction is a listed transaction. Accordingly and having the burden proof of the eight-year statute of limitations, the FTB is required to establish the transaction in question was devised for the principal purpose of avoiding tax.

The FTB will cite guidance that was issued a decade after the transaction took place after the IRS that indicates this type of transaction could have been abusive. Just because a transaction could be abusive does not mean it would be abusive in this case. And I submit it is not. The FTB has not offered any evidence to support its position and instead confuses the issues with erroneous, irrelevant, and incomplete facts. The FTB will tell you about distinguishable cases involving tax shelter promoters or disallowed hobby lost cases and nonprecedential opinions. It will draw conclusions without developing or presenting any evidence, analysis, or expert review for its conclusions. For example, the fact that the ESOP was disqualified does not mean the transaction had a principal purpose of avoiding tax. The IRS already clearly stated it was disqualified on technical grounds. Similarly, the fact that the Appellants could not participate in a corrective program the IRS established does not mean the ESOP was established for the principal purpose of avoiding tax. It means it didn't qualify for the corrective plan.

In its opening brief, the FTB purports to show three facts that demonstrate the principal purpose of the tax avoidance. First, the FTB says their surety of knowledge this was all about tax savings and stated their CPA has filled their heads with great tax deduction ideas and certainly a corporate structure allowing for significant tax reduction is enticing.

The FTB concludes that the reason the surety stated this in their interoffice e-mail is because the structure was formed for tax avoidance purposes and not for other purposes. This conclusion is entirely without merit. If you read, the Resiants Surety internal e-mail messages in their entirety which relate to another crime, not Mr. Thompson, you will note that Susan McKinney writes about whether the ESOP will affect the surety's ability to bond the corporation. She describes concerns in the event of a bankruptcy liquidation, a stock valuation and the fact that indemnification of an ESOP is unavailable which she says is her greatest concern.

She says quote, "I do not feel qualified to advise on an ESOP account one way or another," end quote but the personal indemnification indemnity is a critical issue. Ultimately later that day Ms. McKinney writes again to her work colleagues describing that she had other discussions with the people of Reliants Surety Group and confirms how Reliants can write the bond to the account and provide their credit to the client. She concludes they can do it, was not a problem which I think is the point for that taxpayer.

The second fact the FTB alleges is that Mr. Thompson already owned Thompson & Thompson Consulting and he didn't need the form WBBM. I think the FTB may have missed the fact that Thompson & Thompson ended when Peter Thompson left which is why Paul Thompson created WBBM, it was a replacement not an addition to Thompson & Thompson.

And then the third fact the FTB claimed is that the

Appellant agreed with the IRS that the ESOP was disqualified and applicants were liable for additional income and penalties because Appellants used -- utilized a structure that was invalid and abusive. That statement is patently false. The closing agreements that the taxpayer signs specifically state the transaction was not a listed transaction. Nowhere in the closing agreement is the word abuse or abusive used.

The activity will also try to show that tax avoidance was the primary purpose by drawing your attention to its first exhibit, Exhibit A, a four-page document prepared by Mr. Thompson's CPA spanning years 1998 through 2012 regarding his recollection of some of the events that transpired during that time. The activity will take one entry which identifies four reasons as to why WBBM was incorporated, take the second the reason and ignore the others. The sentence I refer to has an entry date of 3 -- March 8th, 1999 which provides the four reasons WBBM was incorporated.

Number 1, WBBM was formed to replace Thompson & Thompson.

Number 2, WBBM was formed to take advantage of ESOP structure not allowed by the Taxpayer Relief Act of 1997.

Three, WBBM was used to split value away from WBB allowing key employees to more easily afford buyout with WBB and to retain and motivate those employees resulting in reduced risk.

Number 4, WBB would receive greater borrowing and bonding capacities.

It is remarkable that the FTB picks out only the second purpose when four clearly listed and claims this is evidence of tax avoidance. I assure you that not -- I ask that you not only take into consideration the complete entry on that date but also the one from nine months earlier on 6-1-1998 when Peter sold his 3,000 share to WBB employee Joe Hass. Cary writes, quote, "Paul notes the highly competitive nature of keeping good, component employees under the prevailing marketing conditions. Paul also expresses how Peter is unhappy with WBB. He mentions anxieties and worry with Peter leaving with key personnel." Cary in shrambling discussed ESOP similar to other client's use of the new structure now available due to tax law changes to help keep and lock in employees.

The FTB also asserts a theory of noneconomic substance which is also briefed in our Exhibit 13 beginning at page 10. The noneconomic substance penalty may be applied only if the taxpayer does not have a valid nontaxed California business purpose, prior training with the transaction, the Ninth Circuit applies a two-prong inquiry, assessing both the objective and subjective nature of the transaction and motivation of the taxpayer which is a single inquiry into whether the transaction had any practical economic effect other than tax benefits. In this case, the economic substance was met when WBBM was formed because it provided important segregation assets and functions of WBB which is common in the construction industry and it serves to limit liability and improves the ability for employee buyout options and improves the ability to get bond because of the preference of the surety companies.

The ESOP had the economic substance and purpose of retaining key employees which was important in this case where Paul Thompson's brother and business partner had just left the company taking almost half of the employees with him. Mr. Thompson had very valid nontax California business purposes performing WBBM in establishing the ESOP, therefore the transaction at issue had economic substance. The FTB has offered no economic analysis or valuation from any expert. The FTB cites cases that are easily distinguished from the facts in the instant matter. WBB and WBBM never acted like corporation typical of abusive transactions. WBBM -- excuse me, WBB did not pay enough to WBBM to reduce its tax liability to zero and instead paid a reasonable management fee.

Unlike the cases FTB relies on, WBBM truly performs services for WBB. Construction management is a special services very commonly used by the general contractors to segregate liability and improve company's financial reporting to secure bonds from surety companies. This distinguishes this matter from specific management group, the commissioner, the appeal of Marshal Reddick, and the structures mentioned in A. Blair Stover, the commissioner. The next penalty was protested to FTB chief counsel in 2008 in more detail in Exhibit D.

The FTB argues and alternative theory for tax years 2001 and '02 for a six-year statute of limitations based on whether its 25 percent omission of gross income. The IRS has an almost identical provision for income omissions. California courts incorporate state tax provisions that are substantially identical to federal tax court provisions in a manner consistent with federal law.

Cases interpreting the federal six-year statute have long held that for purposes of the extended stated related to a 25 percent gross admission, an amount is considered to be disclosed, not admitted, where the income question is disclosed on the tax return of a partnership or corporate return.

For Taxers 1 and 2, the Appellants reported substantial wage income and income tax withholding from WBBM and WBBM reported substantial gross receipts from each of those years as well. The Form W2 attached to the Thompsons' individual returns clearly connects the taxpayers to WBBM and because of the taxpayers -- excuse me, the tax returns for the taxpayers and the entity disclose the incoming question, the six-year statute of limitations is precluded. The FTB is wrong on the facts and wrong on the law. Mr. Thompson will tell you the primary reason he created the ESOP was to retain the current employees and attract other quality employees. He thought employees would value sharing in the company's ownership and sharing in its success.

When you consider the evidence and the testimony you hear at the time Mr. Thompson formed the ESOP, it was clear he was worried about retaining his key employees and he thought the ESOP was a good way to do this. He was not focused on his bottom line and tax savings. His CPA and his former banker are both here today to attest to his concern and purpose of Mr. Thompson. Just as the IRS did not open its audit for earlier years for an abusive or listed transaction, nor should the FTB be allowed to do so.

Thank you.

ALJ LEUNG: Thank you, Ms. Williams.

Before we go any further, two more housekeeping matters. I need to admit the exhibits into the record. So Exhibits 1 through 54 from the Appellants with the replacement of Exhibit 11 for a clearer copy and Exhibit 40 being blank, it's admitted into the record.

And for the Franchise Tax Board, Exhibits A through

SS is admitted in the record.

On the second matter about the declarant, Vicky Nance, Ms. Williams, is there a possibility of producing the witness today or tomorrow?

MS. WILLIAMS: Pardon me? Is there a possibility of?

ALJ LEUNG: Producing the witness.

MS. WILLIAMS: Producing a witness?

ALJ LEUNG: Her. Producing Ms. Nance.

MS. WILLIAMS: Vicky Nance.

ALJ LEUNG: Because we can dispense with the questions and answers if you can produce her.

MS. WILLIAMS: Well, I can certainly ask her, but you know I don't know with certainty. We would have had her today if we could have.

ALJ LEUNG: Uh-huh.

MS. WILLIAMS: I mean, we did ask if she could either testify or provide the declaration.

We -- you know, we were making an effort to finish our final brief well before it was due. Andin doing so, that's, as you know, it's what included the additional questions.

ALJ LEUNG: Yes. Well, let us know.

MS. WILLIAMS: Okay.

ALJ LEUNG: Maybe after lunch break, you might be able to --

MS. WILLIAMS: Yeah. I can -- we can make a phone call.

ALJ LEUNG: -- contact her. Okay.

Mr. Casselman, your opening.

MR. CASSELMAN: All right. Thank you.

The evidence in this appeal will show that Mr. Thompson, together with his advisors, implemented an abusive tax structure commonly referred to as the Management S corporation ESOP shelter. With this shelter, an operating company's income is siphoned through the guise of management fees or employees' leasing fees into an S corporation purportedly owned by an ESOP but in fact controlled levy owner of the operating company.

This structure and other similar structures were determined by the IRS and the courts to lack business and economic substance and are implemented solely for their tax benefits. Effective for tax years beginning on or after January 1st, 1999, the Internal Revenue Code was invented to allowed ESOPS that were shareholders and S corporations to exempt the earnings allocated to the ESOP from the related business income tax. S corporations or past remedies pay only the 1.5 percent income tax in California and no income tax at the federal level.

Congress intended by making this change, S corporations like C corporations be able to encourage employee ownership through an ESOP. But the new laws immediately led to abuse of arrangements where an S corporation was used to pass corporate income to a tax exempt ESOP in which the only people allocated stock are the owners of the business.

Congress became aware that the law was subject to abuse and in 2001 amended the Code to add Section 409P which limits the tax benefits of S corporation ESOPs unless the ESOP provides meaningful benefit to rank and file employees. It's important to note that 409P nearly laid out statutory guidance as to what was already considered an abusive structure.

The IRS and the national ESOP organization issued various guidance on the abusive nature of this structure. This structure is the subject of numerous cases -- court cases including Pacific Management BUS, USVB Blair Stover, and the appeal of Reddick which was recently heard before the RTAA. And though it's nonprecedential, it's highly persuasive.

In all these cases, an S corporation ESOP structure identical in every material way to the structure implemented by Appellants who was found a lack sufficient business purpose in economic substance to be respected for tax purposes.

Now determining whether a transaction has economic substance so as to be respected for tax purposes, both the objective economic substance of the transaction and the subjective business motivation must be reviewed. The Appellants have asserted that their business purpose in implementing the management S corporation ESOP structure was primarily to provide ownership in the business to rank and file employees to encourage employee retention. The evidence, however, supports the FTB position that the structure at issue was implemented for the primary purpose of reducing Appellant state and federal income taxes as only Mr. Thompson was ever intended to benefit from the ESOP and he was the only person ever allocated stock in the ESOP.

Now the evidence provided by Appellant support the FTB's position that the structure is abusive. Respondent's Exhibit Z tells us that November of 1998, Mr. Thompson's CPA, Mr. Guiadano, quote "filled his head with great tax reduction ideas." Specifically the surety noted that there are new in 1998 tax advantages for an S corporation to form an ESOP. While Mr. Thomson's surety agreed that a corporation structure allowing for significant tax reductions is enticing, they express some reservations with the structure. Mr. Thompson's surety signed off on the structure, however, because management control appeared to remain consistent. In other words, Mr. Thompson did not intend to give up any control through the structure.

On March 8th of 1999, the S corporation ESOP structure was implemented when Mr. Thompson purportedly selling off of his shares in WBBM what I would refer to going forward as management just to avoid some confusion. Management -- the shares were sold to the ESOP. The ESOP then allocated all the shares to Mr. Thompson's ESOP account. Exhibit B carried that on a January 2000 letter to the IRS discusses the thought process implementing the management S corporation ESOP structure. I would urge the panel to review this letter closely in light of the business purposes asserted during this appeal process.

The versions of events presented in Exhibit B and not presented by Appellants in this appeal cannot be reconciled. In the letter Mr. Gaidano states that the plan was feasible and I quote, "Barring a minimum number of participant requirement for an ESOP." Mr. Gaidano writes, The structure was meant to replace its predecessor Thompson & Thompson Consultant, Inc., which was also an S corporation. At this time, Peter Thompson, Appellant's brother, owned 51 percent of the outstanding stock of the operating company WBB. Appellant owned the remaining shares of WBB and was the sole employee of management and the sole participant in the ESOP at that time.

It is extremely important in analyzing the motives for this structure to note that Mr. Gaidano makes a point of emphasizing in the letter the fact that Mr. Thompson did not own more than 50 percent of WBB at the time the ESOP was implemented. According to the letter, Appellant's advisor thought this management in WBB would not be considered a controlled group for purposes of IRC Section 414B. 414B provides that for purposes of testing whether an ESOP adequately benefits the rank and file employees as opposed of the owners or highly compensated individuals, a controlled group of corporations considered a single employer.

This is important to the plan because IRC Section 410(b)(1)(B) requires qualified plans to benefit rank and file employees in the amount that is at least 70 percent of the number of highly compensated employees benefitting under the plan.

Because Mr. Thompson did not own more than 50 percent of WBB when the structure was implemented, Appellants and their advisors believe that WBB's employees would not count towards testing whether the plan met the 70 percent threshold as indicated in Exhibit B. This is why the control group issue was so important to Mr. Gaidano. The plan implemented by Mr. Gaidano and Appellant's other advisors took a major blow when his brother left the business on September 24th, 1999. Mr. Thompson could no long argue that WBB and management were not a controlled group as he now owned all of WBB stock.

Now even under the advisor's strained reading of the law, Mr. Thompson's ESOP was top heavy. This is why Mr. Gaidano states on page 2 of Exhibit B that it was still Mr. Thompson's intention to utilize the ESOP structure even after his brother left the business indicating that ESOP was in place well before they realized Peter Thompson was leaving.

In an attempt to develop an argument, the employees of WBB were not denied the benefits of an ESOP. Mr. Gaidano claims that a Simplified Employee Pension Plan, or SEPP, existed in WBB. The claim was set to provide equal benefits to the WBB employees as the ESOP did to Mr. Thompson. Mr. Gaidano writes and I quote, "When the conflict of the two plans was pointed out by that initial year by AQP, the taxpayer and the CPA reasoned that since the contributions were comparable cash contributions only, the two different plans were equitable." Repeatedly Mr. Gaidano emphasizes in the letter that after 1999 when Peter Thompson left creating the control group issue that no further of their stock was issued by the ESOP. He stated that this was due to, quote, "The evolving nature of complex tax laws."

I'd like to emphasize that again. In this letter, Mr. Thompson's accountant insists that in 1999, a decision was made to not issue or allocate any further stock due to the fact it appears that this structure had not identified as a tax shelter. Finally, lest there be any doubt that Appellant wished to set up an ESOP where he would be the only beneficiary, on page 4 of Exhibit B, Mr. Gaidano discusses that following the enactment of 409P if we can clear Congress did not intend for ESOPs where the sole beneficiary was the owner of the company. Mr. Gaidano states and I quote, "Hindsight being 20/20, it would appear that Congress did not intend for companies to take advantage of the taxpayer as past and establish this kind of transaction."

At the beginning of 1999 when the taxpayer entered into the tax transaction, the professionals that were consulted believed that Congress intended and in fact promoted similar arrangements to this. However, in light of the various reports and announcements after 1999, in Section 409P's effective date of March 14th, 2001, it appears that this is not the case.

If this is the Appellant's content, the ESOP was always intended to benefit WBB and management's rank and file employees, 409P would not be relevant to the analysis. This action is intended to limit the establishment of ESOPs by S corporations to those that broad-based employee coverage and that benefit rank and file employees as well as highly compensated employees in historical owners.

Appellant's Exhibit 2, page 9 makes clear that they did not intend for WBB employees to be included in the ESOP testing. The total number of employees included in the ESOP is shown to be one. WBB employees were not included in this amount because the belief was that as Mr. Thompson only owned 40 percent of WBB at that time, there was no control group and therefore those employees did not count for purposes of the 410B testing.

Respondent's Exhibit D, page 8 AQB's valuation report of management as of April 1st, 1999, provides further evidence as to Appellant's thought process at the time the management S corporation ESOP structure was implemented. AQB writes and I quote, "The principal source of revenue anticipated by WBB Management, Inc. would be derived from the services of Paul Thompson, the sole employee of management."

In Exhibit GG, the IRS explanation of the revocation of the WBBM ESOP's tax exempt status, the service concludes Mr. Thompson was a highly compensated employee of the WBB Management, WBB Construction West Bay Controlled Group. Mr. Thompson was covered by the ESOP. None of the nonhighly Compensated employees of the control group were covered by the ESOP. The IRS ultimately concluded the ESOP violated the coverage requirements of 410B and was not a qualified plan. Why did it not meet the requirements? Because as a controlled group, the WBB employees now counted in the calculation of whether the ESOP only benefitted the owner of the company to the exclusion of rank and file employees.

The Thompsons ultimately agreed to this treatment in their settlement agreement with the IRS and that can be seen in seen in Respondent's Exhibit U.

Now the financial documents submitted by Appellants support FTB's position that the structure is abusive. In its valuation analysis of Management as of December 31st, 1999, AQB observed WBB Management, Inc. continued to contract the services of Paul Thompson West Bay Builders, Inc. All fees are negotiated and approved by Paul Thompson as they relate to West Bay Builders, Inc. involvement in construction and renovation of commercial and public buildings. That year, the parties prepared a purported employee leasing agreement between Management and WBB that was made effective April 1st, 1999 per the terms and fee agreement. The agreement provided that WBB would pay Management $960,000 for a single employee during the first year of the agreement and left the fee open for subsequent years. This amount was far and excessive Mr. Thompson's salary for Management of $275,000. To date, Appellants have provided no documentation of how the Management fees were derived or most importantly whether any arm's length analysis was applied at all.

Management's only income was purported in accompany fees. When asked to indicate the amount of revenue generated from third-party contracts, Appellant stated that it is unknown. This is at the very least calls into question of bookkeeping at the management level.

For prior year -- for years prior to the enactment of 409P, the reported employee leasing fee was separately stated on the return as an employee leasing fee. Once 409P made clear of the structures such as Appellant's were abusive, as the note to the financial statement, Respondent's Exhibit OO makes clear, the leasing fee was buried in cost of construction apparently making it less obvious to an auditor. The entire residual profit and management in 1999 was returned to WBB as was evidenced by the $731,000 notes receivable to WBB indicated in Management's 1999 tax return.

Respondent's Exhibit OO, the financial statements provided during the appeals process show notes payable by WBB to Management ranging from approximately $1 million in Tax Year 2000 to $1.5 in Tax Year 2002. The tax return show that significant amounts of money were transferred to Mr. Thompson. In 2000 and 2001, he took over $380,000 out of Management. Respondent requested all documentation related to the purported loans to Mr. Thompson and WBB provided nothing. The remaining cash and management was invested not in the business but in the marketable securities and life insurance policies.

Now let's turn to the IRS findings. Appellants have repeatedly asserted in their briefs that the IRS never found that the structure at hand was at abusive and that their settlement with the service supports the nonabusive nature of this structure. The assert -- this assertion is unfounded and contradicted by the evidence submitted by Appellants during this appeals process. Per Cary Gaidano's outline, Respondent's Exhibit A, the auditor assigned to review the structure was quote, "a fraud auditor." Mr. Gaidano also notes that the IRS asserted this structure was covered by Example 21 of IRS Announcement 2005-80 which offered a settlement program for certain abusive structures.

Per Respondent's Exhibit A, the IRS issued notices of deficiency December 15th, 2008, then imposed significant tax and penalties on the Appellants, WBB, and Management. Appellants appealed this decision within the IRS and that appeal was denied.

Appellants eventually filed a petition in the tax court which is Respondent's Exhibit JJ which makes clear what the IRS position was going into the trial. The IRS disregarded the separate corporate existence of Management and attributed payments by WBB to Management as having been made to Petitioners. Management was disregarded as an entity because it lacked legitimate business purpose in economic substance. The transactions at issue were determined to have been entered into for the sole purpose of obtaining tax benefits. Now Appellant's point to the subsequent IRS settlement is proof that these determinations were found erroneous. However, the meaning of the settlement can best be interpreted in light of Announcement 2005-80. Respondent's Exhibit RR is a letter from Appellant's attorney Edward Perry to Timothy Adel of the IRS dated November 21st, 2008 where Mr. Perry indicates that he was not engaged before the window to apply for settlement under Announcement 2005-80 had expired. The Appellants wish to explore other avenues to resolve the matter apparently with terms similar to 2005-80. The terms of the settlement negotiated by the IRS and Appellants are almost identical to the terms proposed in the announcement to settle abusive tax shelter No. 21. Per Respondent's U through X and QQ, we see that Appellants were assessed additional tax and a 10 percent penalty. The ESOP's exempt status was revoked.

Now under 2005-80, a tax exempt entity used to perpetrate an abusive tax shelter was to have its exempt status revoked and the Appellants agreed to never again engage in a transaction that has the effect of benefitting officers, owners, or highly compensated employers at the expensive of rank and file employees. Essentially the IRS agreed to settle for the terms the taxpayers would have received under Notice 2005-80 except the penalty for the structure was twice that required by the notice.

The taxpayers make a point that the IRS agreed that the structure did not fall within a listed transaction.

Respondent does not dispute that this is not a listed transaction. However the IRS, Respondent, and numerous courts have determined the structure to be abusive.

In conclusion, as you evaluate the testimony and assertions you will hear today, I ask you keep one thought ever present in your minds. Do the assertions make sense in light of the evidence in what actually transpired?

Thank you.

ALJ LEUNG: Thank you, Mr. Casselman.

Ms. Williams, how many witnesses do you have here today?

MS. WILLIAMS: We have four, Your Honor. The first two I mention will be much shorter testimony.

ALJ LEUNG: Okay.

MS. WILLIAMS: And the second two will be significantly longer.

ALJ LEUNG: Okay. If I could ask witnesses to please so Mr. Petty can get them all sworn in at the same time.

MS. WILLIAMS: Do you want the taxpayer to stand as well?

ALJ LEUNG: If he’s going to be a witness, yes.

MS. WILLIAMS: Thank you.

ALJ LEUNG: Mr. Petty.

MR. PETTY: Please raise your right hands.

Do you swear or affirm the testimony you give in today's proceedings will be the truth, the whole truth, and nothing but the truth?

THE WITNESSES: I do.

(Witnesses sworn in.)

MR. PETTY: All right. You're sworn. Please be seated.

ALJ LEUNG: Okay. Ms. Williams, who's your first witness?

MS. WILLIAMS: Michael Johnson.

ALJ LEUNG: Mr. Johnson, please take the stand.

I'm going to ask the other witnesses to please leave the room until you are called later on. And you're instructed to discuss this case amongst your selves and not to view the live feed of this hearing and we will get you in here when we can. Thank you.

Mr. Johnson, please state your name for the record.

MR. JOHNSON: Michael Johnson.

ALJ LEUNG: Thank you. Ms. Williams, please proceed.

MS. WILLIAMS: Thank you, Your Honor. May I approach the witness to give him --

ALJ LEUNG: Yes.

MS. WILLIAMS: Thank you.

We have provided the witnesses with binders with all of the exhibits that are numbered but because I'm only going to reference one exhibit, I separately provided that.

ALJ LEUNG: And which Exhibit is that?
MS. WILLIAMS: Well that is -- is that 53?
MR. JOHNSON: 53.
MS. WILLIAMS: Exhibit 53.
ALJ LEUNG: 53.
MR. CASSELMAN: Judge Leung.
ALJ LEUNG: Mr. Casselman.
MR. CASSELMAN: Would it be possible for us to take a look at the binder just to ensure that there are no notes in the binder other than the exhibits?
ALJ LEUNG: Ms. Williams?
MS. WILLIAMS: I find the motion highly disrespectful but I have no objection if he really feels the need to do that.
ALJ LEUNG: Yeah, go ahead. Take a few minutes.
MR. CASSELMAN: May I approach?
ALJ LEUNG: Yes.
MR. CASSELMAN: Thank you.
(Pause in proceedings)
MR. CASSELMAN: Thank you very much, we have no objection to them all.
ALJ LEUNG: Thank you. Ms. Williams, you may proceed.
MS. WILLIAMS: Thank you, Your Honor.
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DIRECT EXAMINATION

BY MS. WILLIAMS:

Q And thank you for being here today, Mr. Johnson.

Mr. Johnson, where did you work from 1996 through 2008?

A California National Bank, then we converted it to California Pacific Bank.

Q Okay. And what was your job at California Pacific Bank?

A Originally executive vice president senior credit officer, and then I ended up as president, chief operating officer.

Q Okay. And how long have you been involved in banking?

A A long time, 40-some years.

Q Do you know Paul Thompson?

A Yes.

Q How so?

A I was introduced to him when I joined California National Bank which I believe was 1996 by Mr. Gaidano.

Q Do you know how long he was a client?

A Mr. Thompson?

Q Yes, sorry. Mr. Thompson.

A As long as -- as long as I was with the bank and then I do some consulting and I consider him still a client.

Q Thank you. Can you describe some of the transactions that Paul and his companies did with California Pacific just generally?

A We were never the main bank because he was too big for us. We were about $150 million bank in total assets. But we would do short-term loans on numerous occasions over the 10 or 12 years that I was there. And everything always went well.

Q Is a common -- well, did you have a lot of construction clients?

A I don’t know what a lot means, but yeah, 10 to 12.

Q And is it common for them to need short-term loans?

A Yes.

Q Why?

A All contractors need loans all the time.

Q Why is that?

A It’s just the nature of their business. They’re biding on numerous contracts and at times some come all at once, some are very few. So cash flow is very important. And of course bonding, bonding, bonding.

Q Was it common for contractors to use a separate construction management company?

A Of those ten, maybe, clients I had probably half of them did.

Q Can you explain why they would do this?

A I think I can. My explanation would be to make a presentation, a financial presentation to the surety by putting the best food forward.

Q And why are bonds important? Why is a surety important?

A If you're in the public works arena, it requires bonds.

Q Okay. And let's see, do you remember Paul's brother Peter Thompson?

A I do.

Q Do you remember when Peter left WBB?

A About the same time I met Paul when I joined California Pacific Bank. Maybe '98, '99, something like that.

Q And did Paul talk to you about any concerns he had with his brother leaving?

A No. It was just coincidental that we formed a ESOP at the California, then, National Bank. And I think that conversation came up with me, Paul, and I indicated that I thought it was -- not that I was going to stay with the bank for 12 years but it surely worked out and it worked out with a substantial number of our employees to retain them. And we had that conversation with Paul.

Q In your declaration I think it's point 12, I believe you state that he told you he was concerned about losing employees.

A Yes, ma'am.

Q Do you advise any clients on tax matters?

A No, ma'am.

Q Did you consider Paul or West Bay Builders a good customer to you?

A Absolutely.

Q Why is that?

A He's an honest guy and a very good business person.

Q Okay. And what kind of financial documents did you require when Paul needed loans?

A All financial statements and tax returns on all entities that I knew about.

Q And who did you work with? Did you work with Paul Thompson or Cary Gaidano or both of them?

A All of the above.

Q How much -- who's really calling the shots in a construction project, is it the bank, the general contractor, the surety, the bonder? Who's --

A It's not the bank.

Q Okay.

A It's the management of the construction company and the bonding company.

Q Okay.

A Without the bonds, you don't get the work.

MS. WILLIAMS: I have no further questions.

ALJ LEUNG: Your witness, Mr. Casselman.

MR. CASSELMAN: Okay. Thank you.

CROSS-EXAMINATION

BY MR. CASSELMAN:

Q Mr. Johnson, you state that a company wants to create the best financial statement possibly in order for the bonding agency; is that correct?

A That's correct.

Q So if you created additional deductions and reduced profitability in the entity that gets the bonding, wouldn't that work against that?

A Could you repeat that, please.

Q Yes. So if you created a lie, essentially lower profitability in the entity that is getting the bonding from the surety, wouldn't that work against having the cleanest possible financial statements?

A Probably, yes.

MR. CASSELMAN: Okay. Thank you. I have no further questions.

ALJ LEUNG: Redirect, Ms. Williams?

REDIRECT EXAMINATION

BY MS. WILLIAMS:

Q Do you know if the surety would have asked for the same financial documents that the bank asks for?

A It think they would ask for that and much, much more. I've seen one application from a surety company. It was very, very lengthy and cumbersome.

Q How many pages was it?

A I don't know.

Q Was it 100 pages, maybe?

A Probably 50.

MS. WILLIAMS: Okay.

MR. PEARSON: Just one. In this case with Mr. Thompson, the surety probably would have asked for WBB -- both the operating company and the construction management (indiscernible).

MR. JOHNSON: Absolutely.

MR. PEARSON: Okay.

BY MS. WILLIAMS:

Q So just --

MR. CASSELMAN: Objection. He's not a surety expert.

ALJ LEUNG: Overruled. You may continue.

BY MS. WILLIAMS:

Q So your testimony is that the surety would have asked for the financial records of both WBB and WBBM; is that right?

A I would think so, yes.

Q And so the -- making a deduction on one entity that might make the other entity look better really isn't relevant.

A Not really, if you're looking at the whole picture.

Q Thank you.

ALJ LEUNG: Recross.

RECROSS-EXAMINATION

BY MR. CASSELMAN:

Q Yes. So Mr. Johnson, you've stated in your declaration that we separate the entities in order to get the security the best picture but now you're saying they look at everything and separating them really doesn't matter; is that correct?

A In my opinion.

Q Okay. Thank you.

MR. CASSELMAN: No further question.

MR. JOHNSON: But I could be wrong if they ask for all the different entities. I did.

MR. CASSELMAN: Thank you.

MS. WILLIAMS: Could I ask another question?

ALJ LEUNG: Okay. Last one.

FURTHER EXAMINATION

BY MS. WILLIAMS:

Q Mr. Johnson, do you know if the surety would have held one of the entities primarily responsible for the bond? Well to all of them, but is one primarily responsible?

A In my personal opinion, I think the surety, as well as the agents working for the surety would do anything possible to sell them a bond.

MS. WILLIAMS: Thank you, Mr. Johnson.

ALJ LEUNG: Judge Robinson, any questions?

ALJ ROBINSON: No questions.

ALJ LEUNG: Judge Johson?

ALJ JOHNSON: No questions.

ALJ LEUNG: Mr. Johnson, thank you for your testimony, you may step down.

MR. JOHNSON: Thank you.

ALJ LEUNG: Ms. Williams, call your next witness.

MS. WILLIAMS: I call Eric Storjahnn.

ALJ LEUNG: Okay. Someone get Mr. Storjahnn.

MS. WILLIAMS: Would you please (indiscernible) go out and grab him, please.

MR. CASSELMAN: Will Mr. Johnson possible be recalled?

MS. WILLIAMS: No.

MR. CASSELMAN: No? Okay.

MR. JOHNSON: Free to go?

MR. CASSELMAN: You're free to go from my understanding.

MR. JOHNSON: I would ask her.

MS. WILLIAMS: Yes, you can stay or you can go.

ALJ LEUNG: You can stay or you can go. You can stay here or you can go.

MR. JOHNSON: I know you can't see me, Your Honor, but goodbye.

ALJ LEUNG: You have a great day and a nice drive back. Thank you.

Morning, sir.

MR. STORJAHNN: Good morning.

ALJ LEUNG: Your reminded you're still under oath. And please state your name for the record.

MR. STORJAHNN: Eric Storjahnn.

ALJ LEUNG: Thank you. Ms. Williams.

MS. WILLIAMS: Thank you, Your Honor, may I approach the witness to give him Exhibits D, E, like Elephant, and G, like George?

ALJ LEUNG: Absolutely. Mr. Casselman, you don't want to see those, do you?

MR. CASSELMAN: No, no.

ALJ LEUNG: Okay. Go ahead.

MS. WILLIAMS: Mr. Storjahnn, the exhibits are in these binders but because these are not as easy to turn --

MR. STROJAHNN: Okay.

MS. WILLIAMS: -- I may ask you questions about these three exhibits so I printed some of them for you.

DIRECT EXAMINATION

BY MS. WILLIAMS:

Q Where do you work, Mr. Storjahnn?
A American Qualified Plans.
Q What is your position there?
A President.
Q How long have you worked for American Qualified Plans?
A Since 1991.
Q And how long have you been involved in plan administration?
A Since that time.
Q Do you administer other plans or specifically ESOPs?
A Specifically ESOPs. There was a time in the '90s where we did 401K administration. But because we're not product people or in the investment side, we decided to get out of that -- that area, but we were experienced in 401K as well.
Q Okay. And back in the 1999 era, why did companies use ESOPs?
A ESOPs were primarily put into law by Congress to retain employees, to attract employees, and to share private equity with employees so that they have a stake in the company and hopefully they have -- that gives them an incentive to be more productive and to also care about the company and watch costs and expenses and things like that. That's --

Q Has that -- oh, excuse me.

A That’s my idea why they were --

Q And has that -- is that the same reason today or has the reasons changed?

A Absolutely that’s the same reason today. There’s -- you know, that’s the primary motivating factor of a lot of company to put in an ESOP, private company, that is. Most Fortune 500 companies already give their employees stock, but the Employee Stock Ownership Program allows private companies to do the same thing which is a big deal.

Q I see. So -- I see what you’re saying, so a private company can’t give stock traded on the exchange, correct?

A Correct.

Q Does AQP have a lot of construction clients?

A No, not really.

Q Are you familiar with Paul Thompson’s ESOP from AQP administrative plan?

A Yes.

Q When -- did you ever handle Mr. Thompson’s account?

A Yes, I did.

Q When did you begin handling his account?

A I believe it was around 2003.

Q Okay. And now just a practical matter, can ESOP allocate cash or stock? Can it allocate cash and reallocate stock? Are there --

A Absolutely. ESOPs can allocate stock and take a deduction for a stock transaction or they can contribute cash just like a profit sharing plan and take a -- take the same expense. Many ESOPs will cash fund ESOP for a while and then do a stock transaction.

Q Okay. Do you value employer stock for ESOPs?

A Yes, I have.

Q Can you explain that valuation process when you value an ESOP?

A It's quite extensive. I mean, their -- the Department of Labor receives the revenue of ruling 5960 where they have to -- you have to look at certain things, you have to look at -- at least our firm, we look at five years of historical financials. We also look at current operational results. We discuss with management on projections and what they're going to do in the future. We have to find out if there are any significant events, any litigation or anything on the horizon that could adversely affect the value. We have to look at industry information, the industry outlook.

It's quite an extension process. It's not an exact science. So we try to come up with an investment value. We're not looking at a premium on control or anything like that, we're just trying to arrive at investment value similar to what a person when they buy a public company stock, they're not trying to buy the company out, they're just doing it as an investment. So an ESOP appraisal is kind of the same thing, a reasonable buyer, a reasonable seller, and what it would be form the stock market perspective.

Q Thank you. Now when you obtain information, do you get that from the -- in this case, would it come from Paul Thompson or his CPA or his in-house CFO?

A Both. It would come from Mr. Thompson, it would come from the CPA. It would come from any advisor that has to do with the financials operation of the company, bookkeepers, anything like that. We want all the financial information that we can get, whether it's audited or not audited. Preferably audited.

Q When you audited, you don't mean contacts AQP. It's a term of art.

A No. But the Corporate 1120, the tax return.

Q Okay. Would there be a difference in a company valuation if they had one employee versus 2 or 25?

A That -- not really. I mean, we're looking at from our perspective, we look at it from their future earning -- earnings capacity that they have going forward. Most people believe that the more employees you have, the more valuable your company is. That's not necessarily true all the time. I mean, you can have a proprietary product and no employees but value very highly.

So we do ask the number of employees that are in there and we do look at all the highly compensated people, the key figures and stuff. But we're just generally not going to not value a company high because they have, you know, very few employees.

Q Okay. Do you deal with plan compliance and nondiscrimination testing?

A Yes, I do.

Q Do you know when it became required that ESOPs have more than one member?

A I believe it was around the 2001 when 409P was put into law, that's when a lot of the smaller ESOPs had to -- had to either convert to a C corp or they had to close it down.

Q Do you recall the plans that were in existence at that time or grandfathered in and had until 2005 to comply?

A Yes.

Q Do you remember performing valuations for WBBM for their ESOP?

A Yes.

Q Okay. Now I'm going to ask you to look at the first valuation that AQP did which is FTB D, like dog. And on page 9 --

A What is the date of that valuation? April --

Q April 1, 1999.

A Okay. All right.

Q So this is the first valuation that was prepared the time the ESOP was formed.

And on page 9 of Exhibit D, we'll talk about two things. There was a paragraph on to the middle -- the first paragraph about the middle of the page, there's a statement that says, "It is not reasonable to assume, however, that the sole employee would be motivated to divest himself of some portions of these personal services earnings for the benefit of some third-party past investor in a corporation."

Can you explain what that means or why that would be included in the first valuation of a company?

A My interpretation of that is just simply the -- the owner of the company or the key person has a vested interest in the company. And so that they wouldn't -- they wouldn't necessarily want to leave because they -- they own the company and it's in their financial best interest to remain with the company.

Q Okay. And in an ESOP, are other employees considered past third-party passive investors?

A I'm not investing -- third-party passive investor, I don't know, but they are definitely, you know, have a vested interest in the company and how it's doing. So if they have stock allocated to their account, how well the company's doing and the stock value helps their account, helps their retirement account, and so forth.

Q Thank you. Okay. So now, on the same page of Exhibit D, page 9, when ESOP was formed, it shows a per share value based on 2,000 shares at $5.00 per share; is that right?

A Yes.

Q I can do the simple math, 2,000 at $10,000 is $5.00 per share; is there any more magic to that?

A Hopefully that's what it is, yeah, that's $5.00.

Q Okay. Thank you. Now six months later at the end of the calendar year, December 31st of 1999, which is Exhibit E, on page 9, you have a new value conclusion. Now the share -- the per share value has gone up to about $255. From $5.00 to 255. Do -- can you explain why?

A Yeah. I mean, in the initial valuation, Exhibit D, the company was -- was incorporated that year and so there was no past results to -- to go by. There was no -- I didn't personally do this appraisal at that time, but from my thought process would be that there was little data to base a -- to base a value on other than the money that used to start the company which was $10,000. And so that -- that is my -- my thought process on that one.

And then the subsequent December 31st, 1999, there was some -- obviously some assets and there was some liabilities. And so there -- there was some money now that could be used to determine the value of the company. So that’s why there was such a drastic difference between the appraisals. But.

Q Okay. And then on Exhibit G, like George, now we’re looking a year later, December 2000, on page 9. A year later the shares have gone up to $1,087, rounding, per share. Is it sort of the same conclusion or is there anything remarkable about that? Any increase in value?

A It’s remarkable in the fact that it’s increasing. And I think the reason it increased so -- so drastically is because they changed the methodology to a discounted future earnings methodology which is one of the accepted valuing methodologies that the DOL you could use to value an ESOP company. So. And that essentially is is you take your projected future earnings for the next year and you either grow it or maintain it flat and then you discount that back to a present value. And then you arrive at a value that way.

And it looks as if they were projecting quite of earnings going forward and so it was discounted back and they had a terminal value assumption and then came up with the $2,173,613 value per share of 1,087.

MS. WILLIAMS: Thank you. I have no further questions.

ALJ LEUNG: Mr. Casselman.

MR. CASSELMAN: All right. Thank you.

///

CROSS-EXAMINATION

BY MR. CASSELMAN:

Q Now sir, you had said that in performing valuations, projections and future earnings are important, correct?

A Yes.

MR. CASSELMAN: May I approach the witness?

ALJ LEUNG: Yes.

MR. CASSELMAN: I'm going to bring Exhibit C.

ALJ LEUNG: Ms. Williams, do you need to see that?

MS. WILLIAMS: No, Your Honor, I don't. Thank you.

ALJ LEUNG: Proceed.

BY MR. CASSELMAN:

Q Now Exhibit C is an employee leasing agreement, dated April 1st, 1999; is that correct?

A Yes.

Q That's the same date as your evaluation; is that correct?

A Yes.

Q Now would it not be relevant to a projection of the value of WBB that a contract had been signed that was going to give the company an assured gross receipts of $960,000 with Mr. Thompson's salary being $275,000 and no other material expenses in the company? Does $10,000 seem reasonable for a valuation given $960,000 contract that was in existence at that time?

A Well, us as the valuators, if we never saw the contract, we would not know about it so I don’t know whether or not we knew this contract existed or it existed after we did the 10,000 -- after we did the initial appraisal. I don’t the answer --

Q But it would be --

A -- to that. But if it were -- it would be good to know something like this because it’s part of the valuation collection process.

Q So it’s your assertion that this contract was never provided to AQP?

A I don’t know.

Q But just to confirm, it would be relevant, a contract that was dated as of the date of the -- of the valuation, that Mr. Thompson had negotiated with himself for $960,000 to be paid to WBB, correct?

A It would be relevant. But I just don’t know if this was in our files or not. I would assume it was not.

Q But had you had that contract, the value of WBB would have been much higher? WBBM, excuse me, WBBM would have been much higher, correct?

A I don’t know. I didn’t do the initial appraisal so it -- we’ve never done an appraisal based upon -- or at least I’ve never done an appraisal or I know the people that have worked with appraisals, I don’t know if they’re just strictly basing appraisal on an employee leasing agreement.

I mean, there's lots of different methodologies to do an appraisal, but I don't know if just basing it on the leasing agreement is an accepted one.

Q Would you base it on contracts that were signed for gross receipts that were certain to come into the company?

A Probably.

MR. CASSELMAN: Okay. I have no further questions.

May I approach to get the exhibit?

ALJ LEUNG: Yeah, sure.

Ms. Williams, redirect?

REDIRECT EXAMINATION

BY MS. WILLIAMS:

Q Mr. Strojahnn, I know you didn't prepare the valuation and you're not sure you had -- had reviewed this document which is not signed, but regardless assuming it is an accurate employee leasing agreement, wouldn't a statement about a payment plan of 960,000 make it seem like the ESOP was actually more valuable?

A Yeah. I mean, if we have a guaranteed or a very solid foundation of future earnings, we're going to take that into -- take that into account.

It's just like if a construction company got a contract for a big project that's going to take five years, we're going to take that project into account when we do our valuation.

Q But can't things change? So what happens if that -- in that example, if that project fails or whatever, is it going to then be part of the valuation the next time you value the stock?

A Yeah, we would have to consider the fact that that project failed and so now we have to adjust our projections and a lot of different things. I mean, we have to find out why it failed.

Q Right.

A And if it's going to be corrected and all that. I mean, it's quite extensive.

Q Okay. So when you -- did the initial evaluation based on the 10,000 stock, by the time you did the valuation at the end of the year, December 31st of 1999, you did have some work added, you had some assets, you had some -- I'm reading from Exhibit E, page 9. So nonoperating income, liabilities, you gave a discount. You did some things. So then you did have data.

MR. CASSELMAN: Excuse me, I would object. That calls for speculation because he did not work on the valuation at the time.

ALJ LEUNG: I think I will allow the question. Your objection is noted. He is -- he's done this for a long time. I will allow the question.

Go ahead. Answer the question, please.

MR. STROJAHNN: I'm sorry, what was the question?

MS. WILLIAMS: That's fine.

BY MS. WILLIAMS:

Q So when you did the initial valuation just based on the stock, for whatever reason that is -- or your firm did. But then at the end of that year on December 31st, 1999, you had more data, which in part we already testified as to why the share -- value went up so much from $5.00 to $255. I don't know how many percentages that is, but it's a lot.

So you had more assets, you had more assets value now. You had one operating income, liability, you had things to consider. So at that point in time, you know, it would make sense that you did have more financial debt to actually make a valuation, is that correct?

A Absolutely. I mean, that's -- I can tell immediately that there was more data to go by when we initially -- when we did this appraisal.

Q And that would be actual data, not purported data, a hopeful, you know, hoping the case --

A No. This is probably -- I can tell you right now in Appendix B of that exhibit, we attached a U.S. Income Tax Return 1120S --

Q Okay.

A -- and all the related schedules to there.

ALJ LEUNG: Mr. Strojahnn, what exhibit are you looking at?

MR. STORJAHNN: It's confusing because in your Exhibit E on Appendix -- or it's Exhibit E, page --

MS. WILLIAMS: 13.

MR. STORJAHNN: -- 13.

ALJ LEUNG: Okay. Thank you.

MR. STORJAHNN: That tells me right there that we attached the 1120S to the return and we considered that return as a very critical part of our appraisal. We don't ever attach anything that's not -- that we don't -- if we use something, we attach it.

BY MS. WILLIAMS:

Q And this may be obvious, but the valuation date says as of December 31st, 1999, was done some months thereafter, after you had the tax returns, so forth.

A Exactly. It's --

Q Okay.

A -- a lot of times in an ESOP appraisal, you'll have the close of the fiscal year December 31st and most clients in a practical sense don't finish it until June.

MS. WILLIAMS: Okay. Thank you, Mr. Strojahnn.

MR. CASSELMAN: One question.

ALJ LEUNG: Yes.

///

RECROSS-EXAMINATION

BY MR. CASSELMAN:

Q So if the valuation was done after the April 1999 date, wouldn't that make it more likely that you should have been provided the leasing agreement?

A It would seem so. I mean --

Q Okay. And you --

A Again, when I reviewed this case and went through the files, I didn't -- I did not see that document that you presented me with. I did not see that. But, yes, it should be part of our record if we were going to use it.

MR. CASSELMAN: All right. Thank you very much.

FURTHER EXAMINATION

BY MS. WILLIAMS:

Q And if it was something that you considered, then it would have been included in the --

A Absolutely. We would have --

Q -- (indiscernible) exhibit.

A We would have attached that because we need to, number 1, remember what we did. Number 2, when we have to defend this appraisal, we have to have what we used attached to it as well. So. I'm not saying it didn't exist, but I'm saying that it's curious that it's not in this report.

Q It's fine. Thank you. So the yearend report valuation, though, would be based on real data that occurred during the year.

A Right.

Q Thank you.

MS. WILLIAMS: Thank you.

ALJ LEUNG: Judge Robinson?

ALJ ROBINSON: No questions.

ALJ LEUNG: Judge Johnson?

ALJ JOHNSON: No questions.

ALJ LEUNG: I have. Explain to me when someone has stock allocated -- when a participant has stock allocated to his account, what does that mean?

MR. STORJAHNN: That just simply means that they are now a part owner in the company. With an ESOP plan, as I mentioned before, ESOPs can have either cash or stock put into all of the participants' accounts. And some ESOPs will contribute cash for a number of years and then do a stock transaction later. And they'll -- they'll transfer their cash over to stock and do a stock transaction that way.

Or they can contribute stock immediately from day one when they put the ESOP in and give the employees stock. So when you have that allocation of stock, that now means number one, you have a vested interest and equity interest in that company. You don't have a controlling interest but you just have now whatever the value of that company is by a third party going forward, you're entitled to that -- that fair market value of that stock. You have a -- we like to say a guaranteed market for that stock, should you leave, you get the value of that stock at the time that you leave.

So you are now, you know, an owner of the company from -- from a financial sense.

ALJ LEUNG: So in terms of vesting, when participant is allocated either cash or stocks into his or her account, vesting means the value of that allocation?

MR. STORJAHNN: Vesting is usually tied to years of service. So currently the IRS -- I don’t know if I need to -- they allow two different vesting schedules. There’s one a three-year cliff where you have to be with a company for three years and then you’re a hundred percent vested. If you leave before that, you’re zero percent vested.

ALJ LEUNG: Uh-huh.

MR. STORJAHNN: The other one they have is a six-year graded where each year you go up by 20 percent, 20, 40, 60, 80, 100 and then you’re a hundred percent vested. So from a -- and this is the same with all qualified -- or profit sharing plans 401A is they have a vesting schedule. The company can design this if they want or not. Some companies just say you’re 100 percent vested the day you start. It’s rare but most companies want the employee to put in some years of service before they leave or before they get their account, a hundred percent of it.

So vesting, if you leave when you're zero percent vested, that means you receive nothing for that account and that account reverts back to the trust and gets reallocated to all the people that are still there. If you're a hundred percent vested, that doesn't happen at all. So that's vesting.

ALJ LEUNG: Okay. So with respect to the WBBM ESOP, was there a three-year cliff or a six-year graduate?

MR. STORJAHNN: I don't recall what their vesting was.

ALJ LEUNG: Okay. So when someone's vested and they cannot touch the account until they decide to leave. They couldn't take distributions while they're still employed?

MR. STORJAHNN: Correct. There's -- this plan had no service distribution provisions, it didn't have any hardship provisions, and it also didn't have any loan provisions. It's not like a most whirlwind case, have all those things.

ESOPs are different because they're not a liquid investment so it's tough to borrow against the stock account. And they just from administrative standpoint, we don't get involved with a lot of plans that have -- have loans and in-service distributions.

ALJ LEUNG: Okay. So somebody with respect to a WBBM ESOP, the only way a participant can pull money out is if that participant actually left the company and that participant was invested.

MR. STORJAHNN: Correct.

ALJ LEUNG: Thank you. You are excused, you may sit down. Thank you.

Ms. Williams, your next witness is?

MS. WILLIAMS: It's Cary Gaidano, Your Honor. And I do expect his testimony will last a significant portion of time.

ALJ LEUNG: Well that's why I don't want to -- because we're getting close to noon. So I don't want to interrupt in the middle of his testimony. If you're going to call him next, we might as well break for lunch now. What would you like to do?

MS. WILLIAMS: Thank you. I think that's a good idea.

ALJ LEUNG: Okay. And if you wouldn't mind contacting Ms. Vicky Nance during your lunch break to see if she could be asked to appear.

MR. CASSELMAN: And, sir, what time would you like us to return?

ALJ LEUNG: What time is it now?

MR. CASSELMAN: 10 of.

MS. WILLIAMS: 10 till 12.

ALJ LEUNG: 10 till 12? So 10 of 1.

MR. CASSELMAN: All right. Thank you.

ALJ LEUNG: We are in recess. Thank you.

(Off the record at 11:50 a.m.)

(On the record at 12:52 p.m.)

ALJ LEUNG: We're back on the record. Case Number 18011377, Appeal of Paul and Kathleen Thompson.

Ms. Williams, would you please call your next witness?

MS. WILLIAMS: My next witness is Cary Gaidano.

Would you like me to report on Vicky Victoria Nance?

ALJ LEUNG: Yes, that would be great.

MS. WILLIAMS: I'm sorry to say that she is not available tomorrow. She indicated she has a full day. I highly suspect it also has to do with personal reasons of tremendously disliking traffic drive leading here, the area. She did promise, though, to be immediately responsive to the questions and turn those around right away.

ALJ LEUNG: Okay. So we'll stick to the original plan of having Franchise Tax Board submit questions to her by noontime Wednesday and having Vicky Nance respond by noontime next Tuesday, the 3rd.

MS. WILLIAMS: That's -- thank you, Your Honor.

ALJ LEUNG: Okay. You're welcome. Okay.

MS. WILLIAMS: Our next witness is Cary Gaidano.

ALJ LEUNG: Good afternoon, Mr. Gaidano.

MR. GAIDANO: Hello.

ALJ LEUNG: You're reminded you're still under oath. And please state your name for the record.

MR. GAIDANO: Cary Joseph Gaidano, Jr.

ALJ LEUNG: Thank you. Ms. Williams.

MS. WILLIAMS: Thank you, Your Honor, may I approach the witness for --

ALJ LEUNG: Yes, you may.

MS. WILLIAMS: Thank you. These are Exhibits 10, 11, page from our brief submitted last week. Exhibit 50. All of these are in the binders, too, but --

MR. GAIDANO: Okay.

MS. WILLIAMS: -- just in case it's a little easier in order.

DIRECT EXAMINATION

BY MS. WILLIAMS:

Q Cary, please tell us a little bit about your background. How long have you been a CPA?

A I've been a CPA since 1988.

Q And how many construction contractors do you represent?

A Probably 20.

Q Okay. Do they represent a significant portion of your client -- client base?

A They do.

Q Okay. Was that true back around 1999?

A Yes.
Q How long have you represented Paul Thompson and West Bay Builders?
A Since the early '90s.
Q And do they do -- what kind of work do they do? Small projects, large projects?
A Well, I would say they do public works contracts and those are generally on the larger side.
Q Now do you recall that when Peter and Paul worked together they also had a company called Thompson & Thompson Consulting?
A Yes, I do.
Q Do you know what that entity did?
A That company did construction management, estimating, project management, and various type of duties like that.
MS. WILLIAMS: Can the panel hear the witness okay?
ALJ LEUNG: I can't.
MR. GAIDANO: Do I talk into this?
MS. WILLIAMS: Is it on?
MR. GAIDANO: This?
MS. WILLIAMS: Okay.
BY MS. WILLIAMS:
Q Was Thompson & Thompson ever audited by the IRS and Franchise Tax Board?
A Yes, they were.

Q What was the result?
A There were minimal changes -- change results to it.
Q Okay. Now at some point Peter left WBB. Do you remember when he left?
A I believe it was 2000.
Q Okay. So I thought -- my temp -- my records show it was January 1999, and there's a document that's finally signed September 1999. Would there be a reason it would be --
A It was '99, then.
Q It was '99?
A Yeah.
Q Was it January or?
A January of '99 he formed his new company.
Q He did. Okay. He meaning Peter formed his new company?
A Yes.
Q Construction company?
A Correct.
Q Okay. So now he's a competitor of his brother Paul; is that right?
A Correct.
Q Okay. And then why did it take -- do you know why it took until September 1999 to complete all the documents or the stock sale?

A It's just -- just the way things worked. It takes time to set up a new shop and get a new banker and all of those things.

Q Okay.

A Stationery, that type of thing.

Q Okay.

ALJ LEUNG: Excuse me, Ms. Williams.

Mr. Gaidano, could you just speak closer into the mic if that's possible?

MR. GAIDANO: Is this any better?

ALJ LEUNG: Thank you.

MR. GAIDANO: Hello? Hello?

MS. WILLIAMS: Your voice is soft. We have a lot of questions.

BY MS. WILLIAMS:

Q So that's in early 1999. So after Peter left, what happened to Thompson & Thompson?

A Thompson & Thompson, we -- I didn't want Thompson & Thompson to be an issue between Peter and Paul. It was not a friendly break up. And so taking one chip off the table, we let Thompson & Thompson die.

Q Okay. So then did each brother replace Thompson & Thompson with a construction management company?

A Yes.

Q Okay. Now tell me what -- what is -- what's the relevance to separate the companies for exposure or liability limiting?

A Definitely for those things. The liability and just separating duties for -- for liability purposes.

Q Okay. What's a surety's involvement in a construction business like Mr. Thompson's?

A The only thing that we -- that you just talked about earlier was the Thompson & Thompson when you asked about the audit and the results of that audit. I think it's important to note that the service did a compensation, special testing that included various testing and measurements for the related activities between the companies.

Q Okay. Why is that relevant?

A Just because the arm's length transactions and nature of the business.

Q So did that continue with West Bay Builders Management?

A Yes.

Q Okay. So how -- how is a surety involved in a construction business?

A The surety involved, I often refer to it as the tail wagging the dog. The surety has great influence over -- over the contractor and how he conducts his business.

Q Do they like to see companies separated for like WBB and WBBM?

A They do. They like to see the client contractor being proactive in terms of separating their liabilities and exposures. It’s a highly litigious endeavor.
Q Okay. So was there -- so did WBBM have a legitimate purpose or was it kind of a sham?
A It had a legitimate purpose.
Q All right. Now when Peter left and he took many of the company’s employees, did you and Paul talk about ways Paul would keep the rest of his key employees?
A Yes, without a doubt.
Q Was Paul worried about that?
A Very much so. I mean it could have put him out of business, Peter leaving.
Q How often do you talk to Pete -- Paul Thompson back then or now with business matters?
A I don’t know. Goes in flows. Probably on average, once a week.
Q Okay. Did West Bay Buildings already have a retirement plan?
A West Bay Builders did have a retirement plan.
Q In 1999?
A Correc.t
Q 1998, 1999?
A Correct.
Q Okay. And what was that plan?

A That was the SEP.

Q And what contribution did Paul give to his employees participating in the SEP?

A That was a 10 percent contribution.

Q Okay. And do you know when that vested?

A It vested immediately.

Q So it didn't matter if the employees stayed another one, two, three, four, five years, it vested immediately.

A Correct.

Q Okay.

A I should clarify that there was a one-year wait before he contributions and before the immediate vesting.

Q So an employee starts today, they can't participate for a year.

A Correct.

Q Is that normal with plans?

A I think it's very normal. Just to make sure the person --

Q Okay.

A -- is the right fit.

Q When did you first learn about ESOPs?

A First learned about them in mid-'90s.

Q Okay. What kind of research or did you do any research or learn about consensus, about plans?

A Did a lot of research, more than I care to admit and got familiar with them. I needed to know answers or know where to go get the answers on for any ESOP-related question.

Q Is that common for a CPA to do?

A I think it's very common.

Q Okay. What about single-member ESOPs? As it grows, participants were added. Did you look into whether that was a viable plan?

A I did. I have a number of single member ESOPs.

Q How many did you have?

A Four or five.

Q And so did you recommend ESOPs to all of your clients?

A No.

Q No?

A No.

Q Why not?

A They're very expensive to implement and time consuming. There's quite a bit of recordkeeping to be done.

Q Why did you talk to Paul about ESOP or recommend an ESOP to Paul?

A Well, with Peer split, you know, just exploring any -- any and all possibilities to try to keep employees there and happy.

Q And you talked to Paul and Peter about the ESOP before Peter left; is that right?

A Correct.

Q So you were probably talking -- were you talking to others -- two or three others that you talked to about a plan. Were you also talking to them?

A Correct. Correct.

Q Okay. So the ESOP was set up. WBB employees were transferred to WBBM. Do you recall when they originally transferred?

A I believe that was in 2000.

Q Okay. And do you know if any of the employees participated in the ESOP the first year?

A They did not.

Q Do you know why?

A They preferred their SEPs.

Q Okay. Did -- did you talk about any other ideas to give ownerships to employees or to retain employees? Other plans to give employees?

A Yes, I did. Everything from bonuses, deferred comp. Earn out of shares of company or companies.

Q Did Mr. Thompson give employees bonuses?

A Yes.

Q Did he offer a deferred compensation plan?

A Yes.

Q Was that deferred compensation plan funded by insurance?

A Yes.

Q Who owned the policies?

A I believe WBB and WBBM owned the policies and they were required to pay the -- pay any possible claim on any death benefit out to the employee.

Q Were any loans taken out against the policies while the ESOP owned WBBM?

A Yes.

Q Were any WBBM plans used to purchase the policies?

A No.

Q Do you know if the insurance funded deferred comp plan was set up before or after the employees transferred to WBBM?

A I don't remember.

Q Okay. I want to talk a little bit more about the surety and the financial reporting.

So we've got this operating company and a construction management company for a variety of reasons, including a loss for financial reporting that's preferred by sureties. We understand the bonds are required to work for -- for contractors who work. You said -- well, I was going to ask you how important it is for a surety -- surety works for a contractor. Can -- you likened it to a tail wagging a dog.

What kind of things would a surety ask you to provide in the way of financial documents? What kind of request would they make?

A They would like preliminary financial statements, balance sheet, PNL, job costs report, so I might provide those things for discussion in the event for yearend planning, say.

Q Okay. So let's say -- so we've got Paul working for WBBM, he's got a regular draw. And what happens -- what happens with the surety looks at the draw, for example, that Paul's receiving and the balance sheet. Did they ever ask you to make changes to the way -- well, I guess if it's a draw it's not yet characterized whether it's salary or loan but.

A No. It was always classified as a loan. They were amortization schedules with interest being charged. And at the end of -- generally, for sure it was done at the end of the year, sometimes midyear where we would evaluate the loan account, chat with the surety, and confirm what was going to be an okay salary to -- to pay to Paul to recognize.

Q Okay. So -- so all the money Paul took was considered a loan or all were loans or a portion?

A I would say most of the time, I don't know, a preponderance of it was a loan. And --

Q Okay. We're --

A -- that --

Q We're going to look at some of those documents in a minute that you prepared. Because it does look like on the face of the documents which I realize you're willing to do a few words per line, but it does look like WBBM is loaning money to Paul and Paul's loaning to WBBM and WBB owed money to WBBM. So we'll go through those.

But did WBBM really loan money to Paul? I mean, I guess, you mentioned it was a loan.

A I don't know, is withdraw a loan?

Q Okay. But were there notes, did he repay it?

A There were notes and he did repay it.

Q Did he pay interest?

A He did pay interest.

Q Okay. Did the surety ever want to see the loan documents?

A Yes. Now, Betty, when we say surety, a lot of times it was the surety broker.

Q So it was like a bond -- there's a surety and then there's like a bond broker?

A Correct.

Q Different agents representing different interests, I guess; is that --

A Correct. Because a lot of times -- not that I was forbidden from speaking to the insurance company directly, but the more common interface was with the surety broker. Me between him and then the surety broker with the surety.

Q Okay. So if you had to take some of the draw that Paul received and classify it as a loan, would you also change payroll reported for that year to Paul?

A Well, not until the salary was recognized and paid.

Q Okay. So then what would happen to the payroll expense, would it be reduced?

A No. The pay -- no, so we would have these draws accumulating during the year, interest being charged on that. And then at the end of any particular period, we might recognize a salary. When that salary is recognized, then both the payroll taxes as well as the withholding taxes would be paid at that time.

Q Okay. Is it common for an owner's draw to be classified as loans and claim them as bonus at the end?

A It is very common.

Q And why is that?

A Because owners generally don't know if -- what their bottom line looks like. It's hard to recreate or to take back a salary if -- if it's been claimed and recognized. And, you know, I would, you know, there's been times where at the end of the year, the charity says we don't want that type of salary, you know, how do you pay it back? And, you know, it's difficult to get it back in the bottle.

Q Okay. So around 1999 and 2002, how many bonds was

WBB requesting each year?

A 15, 20, somewhere in that range, maybe.

Q All right. And I'm trying to understand, too, why would the surety, so WBB is the one getting the bond. Why does a surety care about WBBM's books? Why is it better to have some transactions on one entity versus the other?

A Well, the surety -- there's also more than one entity involved. And the surety's concerned about WBB, WBBM, as well as other entities that Paul owns.

Q What do you mean, are you saying that they looked to other entities for indemnity or?

A No, not indemnity. But they -- he's got a number of real estate investments that, you know, the surety may or may not allow him to pull money out for it.

Q So if he wanted to -- so they would care what he was using money for.

A Correct. Without a doubt.

Q Why do they care so much? I mean, what is it that they want?

A Well, they want every cent retained in the companies that they have direct control over.

Q Okay. Now at some point in time, it looks like the financials were combined in 2001 or 2002.

A Yes.

Q Is that accurate? Why did that happen?

A I don't specifically remember. I can only guess it was the requirement of the surety.

Q Okay. The FTB pointed out that at some point the management fees were lumped into cost to consult. Can you explain why that happened?

A I think specifically that had to do with the job costing. Whenever a surety will inquire with -- with a contractor, one of the things that they want done is they want all -- all costs of the construction company, whether, you know, in this case, West Bay and WBBM, they want all those costs accounted for. And so they will -- if those are job costed, that gives them a different comfort level than if they -- when they inquire it is not job costed.

In those tax years that you're referring to, there were a number of different expenses that were lumped into one cost of contract.

Q So the surety didn't want the job to look like it cost a lower amount, it wanted to see everything, every cost conceivable included --

A Accounted for --

Q -- as evaluated the --

A Correct.

Q Okay. Now it also appears there might be loans from WBBM to WBB. Did that really happen, was WBB borrowing money from WBBM?

A It did borrow money. Again, interest was charged. When I saw those comments, you know, I immediately pointed that there's also other -- those are investments by WBBM. There's also other investments by WBBM, other nonrelated investments.

Q Did the surety while at WBB show that it kept cash on its books?

A It did.

Q Was the WBB, the entity primarily responsible for the surety?

A I would agree with that.

Q All right. There are two exhibits, Exhibits 10 and 11. There a lot of numbers on Exhibit 10 has West Bay Management, WBBM at the top. And Number 11 is WBB. Do you recognize those documents?

A Yes. I prepared these.

Q Okay. We're going to start with Exhibit 10, walk through this a little bit. What is this?

A This is a -- a what's referred to in the accounting business as a basically a trial balance. So each column represents a trial balance at the end of any particular period. This happens to be at 12/31 of every year.

Q Okay. Under cash, which is the first line, the second line says notes receivable from West Bay. What is this?

A The first half of -- the top half, basically, is the balance sheet for WBBM and the cash is the cash in the WBBM cash account. And the 731,000 is the loan from WBBM to WBB. Still an asset that's owed.

Q Okay. Two lines down it's got loan to Paul Thompson. In the year ending 2000, the loan to Paul Thompson is two hundred and sixty-two.

A That's loan from Paul Thompson.

Q Okay. And then 2001, it's 388,000. So is that -- what would be consider the draw or the funds that Paul received as being treated as a loan?

A That's correct.

Q Okay. You have to characterize money that Paul is taking either as a loan or a salary, you have to characterize it as something. Is it the surety that likes to see the loan versus salary?

A It depends. I think it depends on a number of factors. But generally what'll happen is at the end of the year, this loan balance will be evaluated and the surety would approve a salary that would make them happy that they could live with and provide the insurance for Paul.

Q See why he's the tail wagging the dog.

A few lines lower, there's a loan from Paul to WBBM of $34,000 in 1999 and $27,000 in 2002. Do you know what those are?

A Yes, those are monies that are owed to Paul. It happened in 1999, the company owed Paul $34,000. And again, that was run by the surety to allow for that. And then in, as you can see the subsequent year it flipped to a loan to Paul Thompson --

Q Okay. Is that normal?

A -- based on the draws. What?

Q For construction companies, is this normal accounting?

A It is, it's very normal.

Q Okay. Because it might seem unusual for some of us.

A Well, I think it's normal for small business owners.

Q Is Paul considered a small business owner?

A He is.

Q Okay. Now, let's see here. Go down to expenses about middle of the page. You've got a salary paid to Paul Thompson salary of 275,300; 375,000; up to a million, one in 2002. Then it drops back to 200,000 followed by a line that says payroll other employees which in 1999 a million, 700,000 and it goes to 2.2 million, 2.6 million, then it drops again to 192,000.

A Yes.

Q My first question is, all those -- all that salary paid to employees, are those -- so Paul -- it says, Paul Thompson's salary on one line. Then it says payroll other employees. Seems obvious but I just want to make sure making a point there were other employees at WBBM; is that accurate?

A That is correct. That's --

Q Then one --

A -- a non -- non Paul Thompson.

Q Okay. And so what happens when it drops to -- it goes from 2 point -- almost 2.67 million in 194,000 in 2003.

A The 2.6 was the last year that the bulk of the employees remained in WBBM.

Q I see. Okay. A few lines further there's a pension expense and it goes from 13,999 up to 172,000 in 2000. 206,000 the next year. 232,000 and then it drops again to 20,000. What is this?

A That's the pension for both -- both -- both -- all other -- all employees as well as Paul Thompsons.

Q Until it was separated back to WBB?

A Correct.

Q Till the second separated?

A Yeah, 2002 would be the last year.

Q Okay. So did every single employee get either a SEP or ESOP, some kind of pension contribution?

A Without a doubt.

Q Unless they were there from the first year and (indiscernible)?

A Correct.

Q All right. Was there ever a time the pension payment would show up someplace else other than the pension line like in another category?

A I don't believe so. I mean, possible, but I don't -- I don't think that's happened.

Q I think the FTB had asserted as some point there was no pension expense in 2002 or 2003. On the tax return I'm talking about, sorry, not on the trial balance.

A Maybe they were referring to WBB? I don't know.

Q Would there have been a time where the pension payments would have been included in payroll expenses?

A It's possible.

Q Okay. Now the next to the last line here, penultimate line says California taxable income reported. And so for 1999, we've got about looks like about 695,000. And in 2000, it's about 806,000. It jumps up to a million, three in 2001. And then a million, two. Back to the millions.

Is that correct?

A Yes.

Q So --

A That should tie it to the tax return that was filed for WBBM.

Q Okay. Okay. Was this an amount that's left in -- let's see here. That's the last question for that one.

Now let's look at Exhibit 11. And this is one -- is this something you prepared for West stakeholders?

A It is.

Q Is it also a trial balance or what is this?

A It is. It's a trial balance, balance sheet, PNL on top of one another in each column.

Q Okay. So slightly more than halfway down the page under -- after total income, it says Expenses. And it looks like it says, employee leasing fees. And in 1997, 1998 it says T&T. Is that Thompson & Thompson?

A Yes, it is.

Q And so what were the employee leasing fees in '97 and '98 for Thompson & Thompson?

A Ask me again.

Q So for '97 and '98, the employee leasing fees for Thompson & Thompson were? Can you read that?

A Yes. The one point -- rounding, 1.6 and 1.4.

Q Million?

A Yes.

Q And then in 1999 for the next four years it's under WBBM instead of Thompson & Thompson. And it looks like those number started 900,000 -- about 915,000 and then go up quite a bit to 1.7 and 2.3 million; is that right?

A Yes.

Q Okay. So these are -- this is indicative of T&T

being the predecessor of WBBM; is that right?

A Correct.

Q Okay. The next to the last line on the form, California income tax reported in '98 we show a loss -- well, in '97 -- let's see here, '96, '97, we've got about a half million and 400,000. Then there's a loss, then from '99 through 2002 it goes up to million, two; 253, 735, 364.

Do you know why the -- why there were such large swings?

A I don't remember specifically, although when I did see this, I kind of circled the 531, '98; 531, '99, the way that contractors can report income using -- I don't want to get too detailed but percent complete reporting.

Q Percent complete of what? A job?

A Of specific jobs.

Q Okay.

A And so there might be a swing like that, that's why I just circled both those years. And if you combine them, it's probably more indicative of the return for the average return --

Q Is that required --

A -- for both of those years.

Q -- on accrual-based taxpayers?

A Say it again?

Q I that something specific to accrual-based taxpayers or is it?

A It is. It’s a variation of accrual, but yes.

Q All right. Let’s talk about the ESOP launching for a minute. So what happened in 2001, Congress enacts Section 409P. Did that make Paul’s ESOP invalid?

A It did not. I think 409P -- I’d been hearing through rumblings that there were going to be changes in the SESOP structure and so I ended up kind of putting the brakes on things, telling Paul to wait, see what comes down. And what came down was 409P which limits the -- it shuts down the SESOP structure that we had set up with WBBM.

Q Okay. Did it affect WBBM’s ESOP immediately in 2001?

A It did. It caused us to reevaluate the plan and if you look at the details of 409P, I believe there’s a grandfathering for plans that have been set up prior to I think it was March of ’01.

Q So wasn’t Paul’s compliance date 1/1 of ’05 then?

A Correct.

Q Okay. Okay. So the FTB audited WBBM for tax years 2000, 2001, and ’02. Then the next year in 2005, the IRS audited WBBM, the ESOP for ‘2, ‘3, and ‘4. Were you still their representative at that time?

A Yes, I was.

Q Okay. Was there ever any discussion by the IRS about looking at the earlier years extending the audit past the normal three-year statute?

A You know what? I think there was. I don't -- you know, we were in so many different meetings. I think they were looking at all of the years and we kept explaining to them that we were grandfathered in. And they kept -- kept persisting. And, you know, sometimes it's difficult to get people to hear you or understand a complicated structure like this. And I think in the end when -- when the agreement was made, they -- I don't want to say they apologized, but they basically admitted that they were not a listed transaction, they were not abusive, and they even put it in their -- their agreement.

Q Let me see here. Okay. So at some during the IRS audit, there was kind of a corrective plan, not an amnesty program but kind of a corrective plan or something called ECPRS.

Do you recall that and why the Thompsons were not able to participate in that?

A I do recall that. I think -- I think the service was taking a hard line, initially, well, through 99 percent of it. But their hard line was that's a voluntary program, doesn't apply if you're under audit.

MS. WILLIAMS: Those are the only questions I have right now.

ALJ LEUNG: Mr. Casselman.

MR. CASSELMAN: Thank you. Actually, if I can approach he witness with the Respondent's copy of the exhibits.

ALJ LEUNG: Sure.

MR. CASSELMAN: Excuse me. Thank you.

CROSS-EXAMINATION

BY MR. CASSELMAN:

Q Now, excuse me I think I flipped to Exhibit B but we should actually be at Exhibit A. So my apologies.

If you turn to Exhibit A, you wrote that Peter Thompson left WBB with many key employees on January 26th, 1999; is that correct?

A Yes. For the Tab A?

Q Excuse me?

A Tab A, is that what you're saying?

Q That's correct, yes, Exhibit A.

A This, by the way, is my work paper. I know there's some typos and some things that are not solely exactly correct, it was written five years after Peter left. Four or five years left after.

Q So --

A But go ahead.

Q Okay. Isn't it true that Peter Thompson was majority shareholder of WBB until September 24th, 1999?

A Yes, I believe it was.

Q Okay. If you could turn to Exhibit Z in the FTB's exhibit binder. These are the e-mails you provided to Franchise Tax Board in response for information related to the work on the Thompson ESOP structure, correct?

A Okay. Z? I don't have --

Q Z.

A -- a Z here. Oh, the first Z.

Q Yeah. Sorry, there's Z and then --

A Yes.

Q Okay. Now if you can turn it to -- well, is it your assertion that this e-mail does not relate to the Thompsons?

A It relates in general to an SESOP structure.

Q Okay. Could you turn to Exhibit B, page 1, I believe. And this is the letter that you wrote to the appeals office at the IRS, correct?

A Okay.

Q If you could look at page 1 in the middle of the last paragraph on the page. It states and I quote, "I have an e-mail from within Reliance acknowledging the ESOP structure." Exhibit Z is the e-mail you reference in here, correct?

A Uh-huh.

Q Okay. Now if you can turn to Exhibit A, the timeline. And again I believe on the first page. This is the timeline you prepared.

Please look at the entry for March 8th, 1999.

A March 8th, ’99. Yes.

Q At the very bottom it says, “Cary Gaidano has an e-mail from Ken Chapman of Reliance, approving Paul setting up a company with ESOP, Chapman has asked Cary to keep this e-mail confidential.

Did you write that?

A Yes.

Q And this is in reference to Exhibit Z, correct?

A I think it is Exhibit Z.

Q Thank you.

A Those Reliance e-mails, yes.

Q So in that e-mail, if you look at the bottom of page 1 where Susan McKinney writes, “This is a good account and their CPA has filled their heads with great tax reduction ideas.”

You would be the CPA referenced in that statement, correct?

A Yes.

Q Thank you. Now Thompson & Thompson Consulting was closed down due to liability considerations, correct?

A No. I think it was shutdown to prevent further fighting.

Q Okay. Now in WBB, Peter Thompson was the majority shareholder, correct?

A Okay.

Q Before September 24th, '99. Why wasn't that same consideration applied to WBB? Why would there be concerns with Thompson & Thompson Consulting but not with WBB if they were both owners of the two companies?

A Because WBB had contracts with a hundred different third -- many different third parties. It was easier to shut down T&T than it was to shut down WBB --

Q Because T&T -- oh, excuse me.

A -- is that what you're asking?

Q Yes. Because T&T's contracts were all intercompany and basically had been negotiated by the parties, correct?

A Correct.

Q Okay. Now you testified every employee received a pension plan; is that correct?

A Correct.

MR. CASSELMAN: May I approach the witness?

ALJ LEUNG: Yes.

MR. GAIDANO: Yes.

BY MR. CASSELMAN:

Q So what I've given you here is Exhibit 47, I belief, the W2s from Ms. Nance.

A Uh-huh.

Q Is that -- does that appear correct? Okay.

If you look in Box 15, is the pension benefit box checked?

A It is not.
Q So that's for '98. Can you look at '99. Is the pension benefit box checked there?
A It is not.
Q Okay. If we turn to the WBB here 2000, is the pension benefit box checked there?
A It is not.
Q Is it your testimony that all the employees that were in WBB that went to WBBM chose to transfer back to WBB because they wanted to participate in their SEPs?
A Correct.
Q Did Ms. Nance have a SEP based on her W2?
A Yes.
Q That Box 15 would have been checked if she had -- if she were to have participated in the SEP; is that correct?
A These W2s are wrong.
Q So it's your assertion that the W2s are wrong?
A Correct.
Q Okay. If you don't mind, I'll collect those documents.
Now what research was done to show that two jointly controlled and intimately related company such as WBB and WBBM would separate liability by -- by having two distinct companies? What research was done to show that -- that was a viable defense?

A Discussions with attorneys.
Q Were those discussions documented?
A I believe so.
Q And to your knowledge, were those documents provided to the Franchise Tax Board?
A I don't know that they were.
Q Now what documents did you look at in preparation for today?
A I looked at the documents in my green folder that's over here.
Q And do you know if all of these documents had been submitted into evidence?
A I believe they have.
Q Now you testified the surety 1 and 2 ensured WBB had cash on its books; is that correct?
A Yes.
Q Now if we look at Exhibit 10. For the years -- years ending 1999, 2000, and 2001, is it correct that the --
A I'm sorry, I was looking for the paper, could you start over?
Q I'm sorry, yes. I apologize. So Exhibit 10, for the years 1999, 2000, and 2001, two years show negative cash and one year shows 900,000 in cash; is that correct?
A Yes.
Q Okay. Thank you.

A For WBBM.
Q Right. Now if we look at Exhibit 10. There were two employees in the year 12/31/2004; is that correct?
A Yes.
Q And the lease entry for that year was $5.6 million rounding up, correct?
A Okay. Yes.
Q Why would the employee leasing fee jump from 1.8 million to 5.6 million when the two same employees were providing the same services from year to year?
A Could have been for personal guarantees. Maybe there were some results of particular contracts that were bonuses were deemed or extra payments were deemed.
Q Is that speculation or based on knowledge?
A I would say based on a hunch.
Q So we’ve testified the IRS apologized for the position they took regard to the ESOP; is that correct?
A It’s hard to believe that.
Q How did they apologize? (Indiscernible.)
A I can see a little smirk. I said it’s hard to believe. I’m sorry.
Q Oh, I see what you’re saying. It’s hard to believe. Okay.
MR. CASSELMAN: I think that -- that’s all of my questions. Thank you.

ALJ LEUNG: Ms. Williams, redirect?

MS. WILLIAMS: Thank you.

ALJ LEUNG: You're welcome.

MS. WILLIAMS: I'm going to go in reverse order.

REDIRECT EXAMINATION

BY MS. WILLIAMS:

Q The IRS did apologize, essentially?

A Yeah.

Q Okay. I'm going to go backwards here. Did you say -- I've heard you say that it's important that WBB show cash but I understand that opposing counsel heard that it was cash in WBBM that was important. Can you clarify that?

A No. It's -- well, cash in both but more importantly cash in WBB.

Q In WBB?

A Yeah.

Q Okay. So was there cash in WBB and the surety's happy?

A Yes.

Q Okay. Thank you for clarifying that.

I want to ask you about the Exhibit A, the first exhibit of FTB's. You said you didn't prepare this contemporaneously with the time, we prepared this sometime later?

A Yeah. I don't know which one is Exhibit 1.

Q I'm sorry, the WBB history.
A Okay.
Q Why was this prepared?
A During the Franchise Tax Board initial audit and then the IRS audit, I just, you know, explaining that to everybody made far more sense to start jotting it down on a piece of paper.
Q Okay. So is this all inclusive? How did you -- did you go back to --
A It' not. It's more or less important facts and tidbits that seemed important to me.
Q So no matter whether I like something you wrote or the FTB like something you wrote, it's not necessarily everything that happened during this time period.
A Correct. That's very correct.
Q Okay. And returning just to Exhibit 11 (indiscernible). What -- nineteen -- pick a year, 1998, 1999, 2000, what was the cash of WBB?
A The cash in WBB was rounding up 5 million in 5/31/98 and 1.8 million in 5/31/99.
MS. WILLIAMS: Okay. I have no further questions.
ALJ LEUNG: Thank you. Mr. Casselman?
MR. CASSELMAN: No, I think that's all our questions. Thank you.
ALJ LEUNG: Okay. Judge Robinson?

ALJ ROBINSON: No questions.

ALJ LEUNG: Judge Johnson.

ALJ JOHNSON: I do have a couple of questions.

Mr. Gaidano, you gave us testimony earlier about the vesting period for the SEP is a one-year wait period and then they're 100 percent invested in the lease; is that correct.

MR. GAIDANO: Correct.

ALJ JOHNSON: Do you know what the vesting period was for the ESOP?

MR. GAIDANO: I don't remember. I want to say it was the same but I can't say with 100 percent certainty.

ALJ JOHNSON: Okay. And you mentioned that they would have looked at the books at the end of the year to determine load amounts and recommendation of salary. When they're doing that sort of (indiscernible) or finalizing the numbers, how would they effectively make those changes, would it be actual any kind of cash distributions or recharacterize loans, or would it be loan forgiveness? How would that work?

MR. GAIDANO: No. Never loan forgiveness. I would give them, you know, a sheet with one of these columns and say, you know, this is what -- this is what things look like on April 30th, maybe it would be mid-May. And they might take a look at it and say he's had a good year or he's had a bad year and I would say, you know, I'm planning on recognizing a $100,000 salary at 5/31; is that okay? And they would say, you know what? He wants to bid a $2 million job coming up and he needs more -- more equity in the company. Treat half of that 100,000 as a salary and treat the other half as a loan on the books due back for Paul Thompson.

ALJ JOHNSON: Okay. So they would retroactively go back and turn some of those instead of loans into contributions into his ESOP interest.

MR. GAIDANO: No, I don’t think that’s the way it works. He would -- we would always treat them as loans until in my example $100,000 salary, they were always treated as loans, interest charged, and then when maturity approved, the proper gross salary, then we would recognize a salary at that date. So it would be an annual salary, essentially.

ALJ JOHNSON: But there wouldn’t be any new distributions at that time (indiscernible).

MR. GAIDANO: Sometimes there would be.

ALJ JOHNSON: Okay.

MR. GAIDANO: So there might be in the example, you know, $100,000 they might say well, Paul’s had a good year, he’s not being aggressive, you know, you can pay him a little bit more. So I might bump it up from a hundred to 150,000 in the example.

ALJ JOHNSON: And last question, you know, did WBBM work for other companies or just WBB?

MR. GAIDANO: I have a note in the -- in the time line about a JV that WBB was part of. JV being a joint venture with another contractor. So there was a -- it was still a WBB-related type of entity. I don't remember how large or small WBB's ownership was of that JV was, but that was the only other company.

ALJ JOHNSON: And do you remember prior to WBBM at Thompson & Thompson, did they work with any outside companies or just WBB?

MR. GAIDANO: Just with WBB. I know there was a pamphlet that was made out, you know, kind of announcing this and trying to, you know, I don't know who was passed on to but there was a little sample pamphlet that was made up.

ALJ JOHNSON: Thank you, Judge Leung.

ALJ LEUNG: Okay. Mr. Gaidano, I want to take it back to one of Judge Johnson's question. For example, about the loans and about the salary, and surety approving, surety saying Mr. Thompson's had a great year, he should be getting a little bit more, you --

MR. GAIDANO: Yes.

ALJ LEUNG: -- tag on $50,000 so his income of action convert the loan into the salary of $150,000. What would happen if surety said, well, you know, it wasn't quite that good so the draw was a little bit too high. What would happen then?

MR. GAIDANO: There were a number of years that were like that. Not in this time period. But sometimes we would be able to assure the surety that Paul was going to sell one of his properties. Something to that effect. That where we were able to keep the salary at a minimum but that there was an unwritten promise to sell a piece of property and put the net proceeds from that property back into WBB.

ALJ LEUNG: So as far as payroll was concerned, so you would keep the $100,000 draw, would somehow sell a piece of property and put money back into the company. You'd have to do like a W2 adjustment or how would that --

MR. GAIDANO: No, that would be -- I would consider that a separate transaction.

ALJ LEUNG: Okay.

MR. GAIDANO: So we might keep the $100,000 salary that would be on his W2. And then if he sold a piece of property where might generate $200,000 of cash, he would put that cash back into WBB and there would be a -- the cor -- because we had double entry books, the corresponding entry would be to his loan account.

So his loan -- the cash would go up 200K --

ALJ LEUNG: Uh-huh.

MR. GAIDANO: -- and the load account would go about 200K, in our example, showing that the company owed him 200,000.

ALJ LEUNG: Okay. Okay. Going back to the (indiscernible) in the Franchise Tax Board. When the IRS -- when Mr. Thompson and the IRS agreed in 2012, as part of the agreement, the ESOP was disqualified going all the way back in 1999. How did that affect the S corporation election for WBBM?

MR. GAIDANO: Well, by then the election had been rescinded at the end of 2004. So we were looking at a regular C corp, then. I'm not sure if that's your question, Judge.

ALJ LEUNG: Well, at this point, what about these -- the taxable years they're looking at now, '99, 2000, 2001, 2002, did you file many returns for the --

MR. GAIDANO: No, it was an all encompassing agreement those earlier years were left as filed and the settlement was on '03 and '04.

ALJ LEUNG: And the effect of the DQ, disqualification, would be to revoke the election, the S corporation election?

MR. GAIDANO: No, the effect of 409P was why the S election was rescinded. So the 409P grandfathered in the arrangement in order to comply with -- with that particular law, the S election was rescinded.

ALJ LEUNG: So that was done -- so here's -- the 409P came into law in 2001.

MR. GAIDANO: Yes.

ALJ LEUNG: So this particular arrangement was grandfathered in so there was no need for the S election to be rescinded.

MR. GAIDANO: Until?

ALJ LEUNG: 2004.

MR. GAIDANO: Exactly.

ALJ LEUNG: So there was no need to file amended returns for the state of California for either the ESOP or for the WBBM.

MR. GAIDANO: Correct.

ALJ LEUNG: Okay. I forget which exhibit number it is but as part of the exhibits submitted by Mr. Thompson on Thursday, all the IRS 90-day deficiencies --

MR. GAIDANO: Yes.

ALJ LEUNG: My question to you was what -- what did the IRS use to adjust Mr. Thompson's income? What was -- what were the figures from?

MR. GAIDANO: I believe the figures were from the -- I think it was maybe the bottom line for the company for that year, those particular years.

ALJ LEUNG: When you say company, you mean WBBM.

MR. GAIDANO: Yes. Sorry.

ALJ LEUNG: So do we take number -- bottom line federal taxable income?

MR. GAIDANO: Yes.

ALJ LEUNG: And they just plop it on to Mr. Thompson's return?

MR. GAIDANO: You're saying it that way, I'd have to go back and look. I don't remember.

ALJ LEUNG: Well, as generally speaking. I mean, under this -- the day I look at the contracts between WBB and WBBM, they said the contract was worth $2 million and then added $2 million to Mr. Thompson's taxable income or did they take the $2 million, subtract out any of the expenses related to thereto then subtract out what Mr. Thompson took out as a salary, then added that and went back to Mr. Thompson.

MR. GAIDANO: Right. That type of in and out. I don't remember what went into the 1.6.

ALJ LEUNG: Right. Generally speaking, that's your recollections of how they did it.

MR. GAIDANO: Correct.

ALJ LEUNG: Okay. And when the Franchise Tax Board issued this MPAs, was the general approach they took also?

MR. GAIDANO: When who issued the MPA?

ALJ LEUNG: The Franchise Tax Board.

MR. GAIDANO: I think they took the bottom lines and by year and added those to Mr. Thompson.

ALJ LEUNG: So basically the same approach as the IRS?

MR. GAIDANO: Yes.

ALJ LEUNG: Okay. And to your knowledge, the adjustments form the IRS, did they include any loans made to Mr. Thompson?

MR. GAIDANO: They did not.

ALJ LEUNG: And the adjustments made by the Franchise Tax Board, did they include any loans made to Mr. Thompson?

MR. GAIDANO: You know what? I don’t believe so.

ALJ LEUNG: All right. That’s enough for me. Thank you.

MR. CASSELMAN: Judge, if we may, Mr. Cornez has a question for the witness if that’s all right.

ALJ LEUNG: Let me hear the question.

MR. CORNEZ: Relates -- the question relates to the conversion of the draws in the salary and whether or not the withholding which for social security, unemployment insurance, et cetera, was done or not and if they did it late, did they pay penalties?

ALJ LEUNG: I will allow it. Go ahead.

MR. CORNEZ: So my understanding is Mr. Thompson took a draw and just for example during the year 2000 and then early in 2001 when it was determined that was appropriate, that some of that would be salary, you made a journal entry, converted it from a draw to payroll.

At that point, I presume no social security had been withheld or unemployment insurance had been deposited on his behalf.

MR. GAIDANO: That's probably true.

MR. CORNEZ: Did the company then pay penalties for those late payments?

MR. GAIDANO: No. Because what happens, let me change your example a little bit. Let's say the draws amounted to $700,000. That $700,000 draw would be converted to a salary. And in order to do that, that salary might be $1 million. The $1 million gross amount would have say 300,000 in both federal and California withholdings as well as the payroll taxes paid in at that time. And there were no penalties because payroll taxes, withholding taxes are considered earned equally through the year even though they're paid on the last day of the year.

MR. CORNEZ: Well, I'm not -- so even in the years when he had a draw, he was still drawing a salary during the year on which you were doing withholding?

MR. GAIDANO: It was usually at the end of the year but the draws always had interest applied to them and then the salary at the end of the year would reduce that loan account, but there would have to be a gross up for the income and payroll taxes.

MR. CORNEZ: Okay. Thank you.

ALJ LEUNG: Okay. Thank you, Mr. Gaidano.

MR. GAIDANO: Thank you.

ALJ LEUNG: You may step down.

Ms. Williams, your next witness.

MS. WILLIAMS: That would be Paul Thompson.

ALJ LEUNG: Mr. Thompson, please take the stand.

Good afternoon, Mr. Thompson, you're reminded you are still under oath. And if you wouldn't mind please stating your name for the record.

MR. THOMPSON: Paul Brian Thompson.

ALJ LEUNG: Thank you. Ms. Williams, please proceed.

MS. WILLIAMS: Thank you, Your Honor, maybe I approach the witness?

ALJ LEUNG: Yes, you may.

MS. WILLIAMS: Thank you.

DIRECT EXAMINATION

BY MS. WILLIAMS:

Q Okay. Paul, please tell us what you do for a living and a little bit of background, how long you've been doing and projects you do.

A I own a company now referred to -- to add further confusion, Thompson Builders. Started it 30 years ago this coming up fall. We are a commercial public works contractor. We say public works, that's anything government funded that, you know, requires the 100 percent performance in payment bonds which has been coming up in our conversations here.

I consider us a medium sized construction company for the Bay area. We have probably anywhere from 150 to 200 employees. Most of those -- a lot -- a big percentage of those are union craftsmen that are either carpenters or laborers signatory to the union agreements.

Q Thank you. Now when you were in business with your brother from 1989 through 1999, were you two the only stockholders?

A Yes, that is correct.

Q And then at some point did you sell some shares to Joe Hass?

A Yes. I think I still have documents that refresh my memory. There was about 3,000 shares sound about right?

Q That's right. Exhibit 54 is a copy of the note and security agreement from June 1st of 1998.

Okay. So we've talked today about Thompson & Thompson and what that was. Similar question, is that common in the construction industry to have a separate construction management business?

A From my circle of people that I interact with, yes. There is oftentimes a separate company that provides preconstruction services, constructability analysis, estimating, scheduling, such as.

Q Then why is it important to separate those? Does it separate liabilities?

A Well, that's -- yes. Short answer is yes. That's what I was told by our attorney that if we can separate liabilities and then in the event there's problems in one entity, there's less of a chance of it rolling over into the other entity.

Q And what about separating the assets and functions, does the -- do the surety or bond companies care about that as well?

A They look at everything. And their concern, as we discussed is our credit worthiness with cash and bottom-line profits.

Q So it sounds like the surety wants to see everything but, you know, liability situation at least in theory a claim that might be limited to the company, to the assets of the company suing --

A Correct.

Q -- making a claim against. Okay.

So what happened to Thompson & Thompson?

A I don't know what technically happened, I thought we just dissolved it when my brother left. And with the advice of Cary, our CPA, and Glen Storjahnn -- George Storjahnn, excuse me, we started to set up WBBM.

Q Okay. When did Peter leave?

A I think he left -- it was a long drawn out process of negotiations. He physically left the office I think before January of '98 -- or excuse me of -- yeah, '98. Or was it

’99.

Q ’99 is what the documents seem to show.

A He left and what we did was he took a couple of projects, he took a bunch of staff and finished them. But the negotiations for the dollars and everything took several months.

Q So he took some jobs and finished them. Who got the -- did he get good jobs, bad jobs, how did you guys separate the jobs?

A As I said or has been discussed, it was a very nonfriendly division. And at the time, you know, we were a growing company, experiencing growing pains, learning how to manage people.

And at that time when he left, to be honest from my perspective, it created a positive buzz with the people going to his side. He left us with what I’ll say, you know, the short end of the stick on several contracts that went south. He kind of cherry picked the projects. And so back at that time, it was very trying for me. And, you know, I’ve said this before, contractors, we don’t really offer a commodity. We’re not, you know, we’re not a plumbing contractor or a painting contractor. We’re just a management company providing all our expertise in services and managing all the crafts involved in a construction project.

And I have found, you know, over the years that I’m only as good as our employees and that they are the ones I'm relying on to provide our goods and services. And when there is a -- when Peter was leaving, it was very, like I said, it was trying, concerning. I was worried about an exodus of people and I had to try to retain them. And one of the vehicles was he ESOP --

Q Okay.

A -- and we talked about a deferred comp plan. And I've incorporated and gave bonuses every year. I'll try different things, some are better than others, obviously. But trying to have good employee retention. And --

Q Now you said you're only as good as your employees. And in your declaration you state on page 3 you state that you were highly concerned to retain as many key employees as possible and you talk about the nature of your business required considerable delegation to supervisors and foremen in the field and that you rely on their judgment and any complete confidence.

Why is that so? Why aren't they more replaceable?

A Well, I think I'm relying on their knowledge of experience and what's there than demonstrating to the project clients. So if we're doing a project for BART, I don't have a hands-on interaction with that agency or CalTrans. You know, my people do. They're the representatives of Thompson Builders now. I'm more just steering the ship.

Q Okay. All right. So you had already offered your employees the SEP, which was pretty generous, I might add, with 10 percent of salaries vesting immediately.

Who told you about the ESOP?

A I think both plans were proposed or discussed with Cary and implemented.

Q Okay. And why did you think employees would like the idea of an ESOP?

A Well I learned that it’s not just compensation. Even though that is an important factor, employees want recognition and to be rewarded and have ownership. And me being an owner of the business, I understand that. So that was an appealing thing that I thought would attract and keep and retain our employees.

Q Okay. It sounds like your bonding -- that a lot of people kind of telling you how you get to drive ship. Even though you were the one doing it, you’ve got a bonding company, surety, these people are kind of looking at your books.

Does Cary ever talk to the bonding company or the surety -- he’d mentioned that you -- you work with the bonding broker; is that right?

A Correct. We -- our interaction’s primarily with the bond broker who is independent from the surety or the underwriter. They’re the -- we have the insurance company and then they have a broker they go through who interacts with us. But every time we're looking at bidding a large project or any year financials, we will get together with the surety, the broker, Cary, our attorney, and have roundtable discussions where we're trying to, you know, if we're bidding a project, we want to get their permission, so we have to get a bid bond. And so there's always -- we're always navigating the surety's needs.

Q So you have to get a bid -- a bond before you actually can bid a project that says I am bondable to do this huge project; is that right?

A A bid bond is -- correct -- is a guarantee that if you are low bid, the owner when they tender you a contract that you'll enter into the contract and if you don't, you would forfeit your bid bond. So it's a bid guarantee that you're going to provide a bid bond -- I mean a performance bond and sign the contract.

Q Okay. So you can't just throw in a little bid and then not take the project --

A Correct.

Q -- not perform, okay, without penalty there.

Okay. So the bonding company, the insurance company, the surety, they get paid a -- they get paid by you or the percentage of the -- how do they get paid?

A They get paid as a percentage of the contract. So their rates vary anywhere 1 to 2 percent.

Q Okay. And so they're motivated to issue bonds to you if they think you're credit worthy; is that right?

A You'd think so. But they're very, you know, they hold their cards close to their chest. They give themselves a lot of wiggle room. But obviously have to have confidence in our ability. And it's a constant, like Cary said, a bit of the tail wagging the dog.

Q How often do you talk with -- so every project you have to have this kind of a review and --

A We only have a review with the surety on larger projects. So we'll have a credit capacity, say we can bid a $20 million job and if we wanted to bid a $50 million job, then we got to kind of go to home office and have a little bit of a pow-wow.

Q How often does that happen back -- how often did those kind of things happen back in 1999 through 2002?

A I would say once every -- for bigger jobs back then, it was probably about once a month.

Q Okay. So you're going through the year and you're getting some draw money. Cary and insurance people, everybody's looking at your books when you're bidding projects, trying to keep you have a successful company. And then at point they're saying to you, you're going to treat some of this as a draw, you're going to repay the money you took with interest.

Is that something that's happened?

A Yeah. We -- we -- what hasn't come up is I also own a development division that land acquisition entitlements, and we're always buying and selling properties. Back then it was a much bigger component than it is now.

Q Which -- sorry, back in the years at issue here, that was a bigger component?

A We were actively pursuing more projects back then through development, correct.

Q Gotcha. Okay. So did it bother to have to pay interest back on money that you borrowed? I mean.

A Yeah.

Q But it -- you just agreed to do it because that's --

A Cost of doing business. But we would also, you know, if we want to bid a big project and the bonding company was unhappy with my salary or draws, we -- you know, oftentimes, we'd be selling -- I'd be having a property for sale. And I'd say, look, we're selling this little house or duplex down the road. When the sale proceeds close, we'll put the money in the company.

Q How many little projects like that were you buying a year back then do you think?

A There's a broad range from that to large office warehouses complexes. So, you know, we were always in flux

three or four a year.
Q Three or four? Okay. So it’s kind -- is it kind of like flipping of houses or no?
A Buying land, getting the entitlements which getting their approvals, getting the financing, and then building it.
Q Oh, okay. So that sounds like a big project.
All right. Let’s see here. Okay. So back in -- when you started West Bay Builders Management when Peter left, you had -- how many employees did you have left? Less than 20 or (indiscernible)?
A I think we had about 50 in management, and I think Peter took about 20 or so, 20, and I probably retained about 30.
Q Okay.
A And I’m only talking about management, not union craftsman.
Q Okay. Does it surprise you that from 2000, you still have nine employees that are still with you all these years later?
A Yeah, that did actually surprise me.
Q Did it? Okay. And today you have, you said you have about 150 employees?
A Correct.
Q So you’ve had some growth?
A Well, we had quite a bit of growth until the

recession. And then now we're kind of rebounded back.
Q So in your business you've talked about owning -- you said you're only as good as your employees and you also talked about the importance of the bankers and your CPA. You talked about your surety being the tail wagging the dog.
Who's most important when you're trying to figure -- figure out all of these things? I mean, what's most crucial to your business?
A Well, the employees. If I didn't have the employees, then we wouldn't be able to do business.
Q Okay. Now the FTB's had a little bit of a hard time believing but at the time you set up the ESOP, you didn't have some other primary purpose to avoid paying income tax. Certainly you would -- I would expect that Paul would give all of his clients tax advice. Was there some consideration for the fact that this was a -- you would receive a tax benefit?
A I understood that there was going to be similar tax benefits very similar to our SEP plan or any other IRA plan as a one component of it.
Q As one component. Okay. But there might be other tax savings, did you talk about that a lot?
A Uh-uh. I don't think so.
Q Okay. And then did your employees have an option? Those who were already in the SEP, did they have an option to

become part of the ESOP right away?

A That is correct. I thought that the ESOP was going to be a very attractive vehicle for them. And it turns out that the SEP with the immediate vesting, they were secure with that. It was -- I don't know how many years we had it in existence but it was something that they all wanted to keep and it kind of surprised me.

Q So the investments in the SEP, they could self-direct. It surprised you they didn't want to invest their retirement into just you?

A Yes, it did.

Q Okay. Did anybody ever get added, join the ESOP? Did Fred Hass join it -- Joe Hass join the ESOP?

A Oh, yeah, I thought we already -- yes, he did.

Q In his declaration, which is our Exhibit 53, you don't have to look at it. But he does state as an employee, I was very interested in being part owner of the company and participating in the company's growth.

And he also already had some shares in WBB and I understand he's still employed by WBBM today; is that right?

A Yes, it is.

Q So at least for Joe Hass, he's -- he really likes this idea of owning part of the company; is that right?

A It's consistent because Joe Hass used to own his construction company and then they had some financial tough times so I hired him so that doesn't surprise me that he would want to -- he has a little more appreciation, I think, of actually ownership.

Q Status of the ownership, yeah, once an owner. Right.

Okay. So your former attorney Ed Perry provided -- so I understand you also had a buyout option plan for WBB that you were considering. And if you look at Exhibit 49, I know that Ed Perry provided at least one copy of the option agreement to the FTB previously, which is kind of got me chasing down the exhibit. I found five of them that in 2000 -- Exhibit 49 shows it looks like a draft person, something you were considering to do (indiscernible). Do you recall this at all?

A Give me a minute here so I can find it.

Q Sorry. It's 49.

A Okay. I have it in front of me.

Q Okay. So there -- I have five different drafts here, one's for Joe Hass. One's for somebody named Clayton Fraser, Leland Jones, Michael Roberts, and Victoria Sacco, then, that's our Victoria Nance.

Do you recall these at all?

A Vaguely. I just -- when I saw this it just kind of rekindled my memory of it, but I don't remember the specifics.

Q Okay. It does state that -- let's see here. One

Point Number 2, it says, The right to purchase shares is for West Bay assets and liabilities only and granted to buy for his loyalty and to keep West Bay's efficiencies at focus.

So it's -- to me it seems that maybe you were -- this was another way you were trying to retain your employees. Do you remember -- tell me that you don't recall a lot about that.

A No, I was exploring, like I said, different ways to keep the employees. It was a little bit of a -- I felt like an exodus from our company and I was brainstorming on how to keep people.

Q It sounds like it was a really bad falling out. You're both successful construction businesses. Did you resolve things and are you on speaking terms with Peter?

A Not really.

Q Now records have been a bit hard to come by. I understand there was a fire.

A Can I clarify that?

Q Sure.

A I talk to him but he won't talk to me.

Q Okay. Well, you don't have to. He's not happy?

A Yeah.

Q Okay. Records. Okay. So now I understand there was a fire in May of 2008; is that right?

A Correct. The fire was actually in a piece of property that we were developing, it was a warehouse on the old Navy -- or Army -- no, Navy base in Novato. And we used it for storage of our equipment and all our old paper files. And it was quite an extraordinary fire.

Q Do you know what caused the fire?

A Yeah, they think that there was -- it was a real hot day and some of our equipment had gas or diesel and they think something ignited, sparked.

Q Inside?

A Yeah.

Q If you look at Exhibit Number forty -- well, 45 and 46. 45 is the declaration of Victoria Nancy on which she does represent fire. And she provided us with Exhibit 46 which says Warehouse fire, May 16, 2008.

Do you have that?

A Give me a minute. Yes.

Q Now Victoria said this was made contemporaneously at the time of the fire.

Does that sound accurate to you?

A Yes.

Q Okay. So you just scanned down the variety of equipment of things, I have no idea what these things are. That looks like things that were destroyed in that fire.

A Yes.

Q The last two items there, what does that -- what do those say?

A All job correspondence of the past ten years, accounting and payroll files of the last ten years.

Q So you -- why didn't you keep your -- why would you put your accounting records in a -- for ten years in a warehouse?

A I think we -- there's some requirement we've got to keep them for ten years or something like that.

Q Why not just keep them in the office behind Vicky's desk?

A Too many boxes.

Q Are there a lot?

A Yeah, there's, you know, hundreds of file boxes.

Q Okay. Thank you. Okay. So now I'm going back to all these people you were talking about at the time you were considering the ESOP and after your brother left.

Do you recall talking to -- okay, so we -- you talk to Cary, you talk to your banker about your ESOP. We have a declaration from Gordon Strojahnn which I assume, is that Eric's father?

A I believe so.

Q And he was the -- he said he was the president of AQP at the time you started the ESOP.

A Correct.

Q Okay. He says -- and this is from his declaration which is Exhibit 53. He says, Most of my clients did, Paul Thompson was worried about keeping good employees. I had a similar discussion with clients who are studying the ESOPs and I told Paul Thompson that the benefit -- that the benefit most ESOP-owned companies get is keeping employees. I tell clients that ESOP participation gives employees part ownership in the company and then owner employees stay with the company and are better employees.

Do you recall him telling you that?

A I recall having these conversations in general.

Q Okay. Now when the IRS case settled, did you -- so some tax was going to be owed, it started that they -- the IRS made its first assessment and everything in the kitchen sink on the ESOP including we had a sizable (indiscernible) deficiency. Over 17 million and ultimately that was resolved for significantly less. Understanding that the early years were treated as the returns were accepted as filed and they only looked at those years that followed the compliance period were in that three-year audit period.

Why did you pay the IRS? You said you personally paid the IRS debt. Why didn't you want that assessed to WBB?

A Again it falls back to the bonding. I wanted to keep the corporate construction company free and clear of any tax liability or debt and I had the whole thing assigned to me personally, liquidated my retirement accounts, I sold my house, paid it off.

Q Did the IRS care who they assessed it to at that point?

A They did not.

MS. WILLIAMS: Those are my questions, Your Honor.

ALJ LEUNG: Mr. Casselman.

MR. CASSELMAN: Thank you.

CROSS-EXAMINATION

BY MR. CASSELMAN:

Q Good afternoon, Mr. Thompson.

If the purpose of WBBM and the ESOP was to have the rank and file employees own the company, why did you join the ESOP as a participant and have 100 percent of the stock allocated to your account?

A I was following the advice of AQP and our CPA.

Q Okay. Thank you. And Joe Hass was not allocated any stock through the ESOP; is that correct?

A I don't know -- technically, I don't know how that transpired. So I don't know.

Q Okay. Thank you. Do either of your companies have an ESOP today?

A We do not.

Q Why not?

A Well, I don't know if -- first off, I thought that we had this ownership -- I had this ownership concept and when the employees selected the SEP, that was kind of a telling sign for me that they really didn't value I think the ownership stock as much as I did. So it didn't seem to generate any interest from them.

Q Okay. Thank you. Now the option call agreements that we discussed, they were not signed or ever used; is that correct?

A The which agreements?

Q The option call agreements.

A What are option call agreements?

Q The stock buyback. I think we might have described it when Ms. Williams was asking you.

Let me see what exhibit that is. It's in her most recent submissions.

A Are you referring to the employees where they do have stock buy-ins?

Q Yeah. So we were talking about Exhibit 49, pages 1 through 10.

A Yep.

Q These were not signed or utilized in any way; is that correct?

A That's what it appears.

Q Okay. Thank you. Is it your assertion that none of the employees who transferred to WBBM wanted to participate in the ESOP?

A That's what I was told.
Q Okay. I believe the binder with FTB exhibits is still up there.
A Yes, it is.
Q Okay. Going back to the last question. You said that was what you were told. Who told you that?
A The question being the employees.
Q Right.
A They had -- there was a couple of meetings, I don't know if Cary orchestrated them or Vicky. But I was told by both collectively Cary and Vicky that the employees wanted to stay in the SEP.
Q Okay. Now if we turn to Exhibit G in FTB's exhibits binder. That's AQP's valuation of WBBM for the period ending 12/31/2000.
A Okay. I see it.
Q Okay. On page of that exhibit, go down to paragraph 4.
A I see it.
Q It shows that the value of WBBM in that year was $2.173 million; is that correct?
A Yes, it does.
Q Was there about roughly 30 employees in WBBM?
A Sounds about right.
Q Okay. So that would be over $70,000 per employee if

you distributed the ESOP evenly; is that correct, in value?

A Okay.

Q Why didn't a single employee elect to participate with that much capital at stake?

A I'm not sure. You say why didn't they participate in the ESOP?

Q Right.

MS. WILLIAMS: Objection. Calls for speculation.

ALJ LEUNG: I will note the objection. I will allow the question.

BY MR. CASSELMAN:

Q So if we take the $2.1 million and we have 30 employees. If we allocate that across the 30 employees, it would come out to roughly $70,000 per employee at the value of the company. So every single employee elected not to accept that volume in the ESOP; is that correct?

MS. WILLIAMS: Objection, Your Honor. There's no foundation that all of the value of the company would be immediately assessed to all the stock distributed to all the employees and that you're create -- he's creating.

BY MR. CASSELMAN:

Q If the company was worth $2.1 million, then if you took 100 percent of that stock it would be worth $2.1 million according to the valuation, correct?

ALJ LEUNG: I'll sustain the objection.

MR. CASSELMAN: All right. I'll move on.

BY MR. CASSELMAN:

Q Prior to transferring employees from WBB to WBBM, did you discuss with them that WBBM would provide an ESOP to replace their SEP?

A The employees were -- like I said, it was orchestrated between Vicky and Cary regarding their enrollment in the ESOP or the decision not to.

Q I'm sorry. Vicky and --

A Cary Gaidano, our -- my CPA. I myself did not participate in those meetings.

Q So to your knowledge, the employees were not told about the ESOP? The question is, did your employees before they transferred into WBBM know that they would be getting an ESOP in WBBM or have the ability to participate?

A I think that was the whole premise of what we offered them was to join the ESOP. And then the issue came up where they -- we had to get rid of the SEP and they wanted -- they chose to stay in the SEP.

Q So did you explain to them that all the shares that you sold had been allocated to your account and there were no shares to allocate to their accounts?

A I didn't -- like I said earlier, I was not conversing with them, anything about this set up.

Q Okay. Is it your assertion that all but two of the

WBBM employees transferred back to WBB sometime in 2002?
A I'm not assuring anything.
Q Is that the case?
A I'd have to look at a document to refresh my memory.
Q Okay. So let's -- Mr. Gaidano, I believe, testified to that fact. So how did losing almost all of its workforce disrupt WBBM's business?
A I'm sorry, could you say that a little louder?
Q Yes. So in -- I believe it's 2002, all employees transferred back to WBB from WBBM. Did this not have a major impact on WBBM's ability to do business as an employee leasing company?
A Well definitely decreased the numbers.
Q Okay. Now why WBBM's net income from 2002 to 2003 increase after the loss of almost all of its employees?
A I don't know.
Q Okay. Now you're the decision maker for both WBB and WBBM; is that correct?
A Well, my brother was partners with me in WBB for a time so there would be both of us on WBB -- on the builder's side until he left, then it would be solely me.
Q Okay. And he was majority shareholder until September 24th, 1999; is that correct?
A I understand he was majority shareholder in WBBM.
MS. WILLIAMS: WBB.

BY MR. CASSELMAN:

Q Your brother was majority shareholder in WBBM; is that correct?

A Well, I know -- it’s my understanding I was majority owners in West Bay Builders, Inc.

Q All right. In the Declaration 14, you stated that the structure would make WBB more affordable for employees to purchase shares, correct?

A I’d have to read this thing more carefully. Can you direct me your --

Q I apologize. So Declaration 14 --

A My declaration?

Q Your declaration. Which I believe is submitted as Respondent’s Exhibit 1.

A I have the declaration.

Q Or excuse me, Appellant’s Exhibit 1, Declaration 1. I apologize.

A Show me what page.

Q Declaration 14 is on page 6 of 7.

A Number 14. Okay.

Q Okay. So you’re there?

A Yes, I am.

Q As you stated, the structure would make WBBM more affordable for employees to purchase shares; is that correct?

A That’s what it says in the last sentence. That was after discussing this with Cary.

Q Okay. And the reason WBB would be more affordable is because it would be a less valuable entity, correct?

A Again, I was relying on what Cary was telling me and this is in response to that.

Q Okay. In Michael Johnson's response to FTB's questions, he said if the bonding company wants to see the highest net worth, lowest debt, highest liquidity and highest profitability. Reducing WBB's value, therefore, would conflict with what bondholders wanted to see, wouldn't it?

A If I knew exactly what bondholders that the surety company was looking for, like I said it was kind of a bit of a movie -- it's not black and white and more of -- it's very difficult. There's -- so to answer your question, I don't know what -- I know the surety is looking for working capital and cash and profitability, and experience. How they weigh all those different factors, I don't know.

Q Okay. Can I have you turn to Exhibit F in the exhibit binder?

A I am there.

Q Okay. Do you know what this document is?

A I do not.

Q It is a worksheet, essentially that was given to AQP by the company reporting the number of employees that WBBM had, I believe.

Does that sound correct when you look at it?

A I have no idea, I've never --

MS. WILLIAMS: Objection, Your Honor, the document says new employees, not employees.

MR. CASSELMAN: Okay. I'll amend it to new employees.

ALJ LEUNG: Okay.

BY MR. CASSELMAN:

Q For new employees in 2000, the document says none; is that correct?

A Well, that's what it says on this form.

Q Now in Gordon Storjahnn -- and I'm sorry, I'm probably ruining that name -- response to FTB's question number 4, he stated that plan eligibility consisted of 1,000 hours of work and still employee on December 31st.

Is it your contention that not one employee in WBBM other than yourself met this definition?

A I'm not contending anything.

Q Okay.

A I don't know who signed or filled this form out.

Q Now according to Mr. Storjahnn's responses to FTB's questions, his response to number 2, he indicated that you filled it out.

Does that sound correct?

A No. I have no idea. There's some handwriting on here that says none. That's not mine. I don't even recall seeing this before so I'm not sure if Mr. Storjahnn is confused, but I've never seen this document before.

Q Did you review the AQP annual valuation reports?

A As I sit here, I vaguely recall seeing them.

Q Okay. Did you believe them to be accurate?

A I have no reason to believe otherwise.

Q Okay. Thank you. The document says men -- actually, let me direct you to the right exhibit.

Can you -- can you go to Respondent's Exhibit H?

A I am there.

Q Okay. Now this is a similar document that you just looked at. And it is the employee census form that AQP provided to WBBM. And for employees, it lists Paul Thompson as the sole employee; is that correct?

A That's what it says.

Q Now Mr. Storjahnn stated in his response to FTB's questions on his declaration that he believed other than you, there was one other employee hired and he wasn't sure of the year. He did not mention any other additional employees. Do you know why that would be?

A I'm thinking that it's Joe Hass but I'm not sure the timing or anything.

Q Right. He was indicating there were two employees in WBBM as far as he was aware.

Is the person who provided the valuations for AQP, wouldn't it be crucial for him to know how many employees WBBM had?

MS. WILLIAMS: Objection, Your Honor, he's not an expert in valuation.

ALJ LEUNG: Sustained.

MR. CASSELMAN: All right. I will withdraw.

I think that's all of my questions. Thank you.

ALJ LEUNG: Redirect, Ms. Williams?

MS. WILLIAMS: Your Honor, I will ask some questions -- I do have a redirect. But I'm wondering because this is our last witness if we might have time to recall Cary Gaidano to answer some of the questions that appear to be unanswered. I don't know if you want to entertain that.

ALJ LEUNG: Unanswered questions from you or questions from the Franchise Tax Board?

MS. WILLIAMS: Well, I think I can ask the questions the Franchise Tax Board is seeking. Either way, they could answer some of those unanswered questions.

ALJ LEUNG: If you're trying to clarify answers that the Franchise Tax Board is seeking because the person we asked those questions before are not qualified to give the spots, that will be fine.

MS. WILLIAMS: That's exactly what I --

ALJ LEUNG: If there are questions from you, I would say no, because you had your chance.

MS. WILLIAMS: Okay. That's fair.

ALJ LEUNG: Okay.

MS. WILLIAMS: Thank you.

ALJ LEUNG: Okay.

MS. WILLIAMS: So I would like to make that available if we're going to get some of these questions clarified from Mr. Gaidano. We'd like to make him available if that's of interest.

ALJ LEUNG: Okay.

REDIRECT EXAMINATION

BY MS. WILLIAMS:

Q Okay. Paul, I wanted to ask you, one of the questions that the FTB asked you today in your declaration, Exhibit 1, page 6, item 14. Let's look at that bold statement there. Because I do think it ties in with those option agreements that you are recalling as Exhibit 49.

The full paragraph says your declaration --

A Hold on, Betty, where am I?

Q Sorry. And I realize this was several years ago.

But in Exhibit 1, which I gave you a loose copy of in your declaration.

A Yes.

Q Okay. On page 6, your Point Number 14 says, I intended the creation of WBBM and its ESOP to facilitate employee retention in another highly significant way. I was considering an employee buyout plan for WBB. By splitting functions, too, and between other companies, I believed after consulting with my tax advisor that WBB would be more affordable to those employees participating in the buyout.

My question is, just to facilitate some of the understanding here, was that buyout part of the option agreement buyout at Exhibit 49 that you looked at today for those five employees, those draft that --

A I believe so.

Q Do you -- okay.

And then I also want to draw your attention to Exhibit 48. And you're probably going to have to get that out of our binder, I don't think I gave you a copy of that.

A I have the respondent's exhibit, but it's alphabetical.

Q Okay.

A Oh, there's --

Q A lot of paper. This is ours. Okay.

A Okay. I see it.

Q Okay. So this says Stock Transfer Ledger at the top. And if I do some math here looking at how many shares you have and I see Peter Thompson has shares, you have shares, and Joseph Hass. I see the 3,000 that Joseph Hass has which looks like at line -- Item Number 8, you had 20,000 shares and you gave three -- you sold 3,000 shares to Joe Hass which would mean you would have 17,000 shares left; is that right?

A I see that.

Q Okay. And then it shows that Peter Thompson still has his 16,364 shares.

Do you see that?

A Yes.

Q Okay. So that would make you the -- barely, but that would make you the majority shareholder, not -- pardon? Well, yeah, by about one percent but more so than Peter.

A Yes.

Q Okay. Now just also to clarify testimony, you made a comment, it's my understanding that when your brother left, Thompson & Thompson ended, he created a new construction company and a new construction management company, just like you kept WBB but you created a construction management company WBBM; is that right?

A Correct.

Q That's your -- okay. I think your testimony might have been a little bit confused in part it's probably the acronyms. But Peter Thompson was never part of WBBM as an owner, employee, or otherwise, right?

A Correct.

Q Okay. Because you did testify that you thought he was the majority holder --

A Yeah.
Q -- of WBBM and --
A Right.
Q -- I just want to give you a chance to remember -- reflect on that. Okay.

MS. WILLIAMS: I don't have any more questions.

MR. PEARSON: I have one. Mr. Casselman asked you about some tax years after the ESOP -- or after the ESOP was ended in 2003, 2004 and your leasing fees went up for WBBM.

When does -- when do your leasing fees -- when did your management fees get paid? When you provided the services or when the jobs were completed or?

MR. THOMPSON: A combination of both.

MR. PEARSON: And how long can it take to complete some of the schools, large apartment complexes, how long can that take from the time the management fees -- the management services just started when you're bidding the job, when you're estimating the job, when you're looking at what possible change orders are going to be needed from that process to actually the completion and getting paid.

MR. THOMPSON: Unfortunately, it could take years.

ALJ LEUNG: Mr. Casselman.

MR. CASSELMAN: Can I have just a moment? Apologies, I'm just looking for something. Okay.

///

RECROSS-EXAMINATION

BY MR. CASSELMAN:

Q Mr. Thompson, can you turn to Exhibit C, page 2.

A Yes.

Q In regards to the testimony we just heard, it says, Agencies shall be compensated for all services provided at the rate of $960,000 during the first year.

Wasn't the amount set in 1999 of what would be made?

A What's the question? Was the amount set? What does that mean?

Q Right. So we just heard testimony that the amount that could be received in fees could vary. But looking at this contract, it's a set fee.

A For the first year. I'm just reading what it says.

Q Uh-huh. And a -- let's see, and a rate agreed upon in writing by the parties each year thereafter the (indiscernible) agreement remains in effect.

Is that correct?

A That's what it says.

Q Okay.

MR. CASSELMAN: Thank you.

ALJ LEUNG: Judge Robinson, any questions?

ALJ ROBINSON: No questions.

ALJ LEUNG: Judge Johnson?

ALJ JOHNSON: I do. Thank you, Mr. Thompson for being here today.

I'd like to turn to Exhibit 45, look at the declaration of Ms. Nance. I know you didn't write this, obviously, but I wanted to just compare some things in her statement versus what we've heard today to make sure we get in the record.

Now her Statement Number 5, she says that most employees had the same reaction to the ESOP I did. And after a discussion with Paul Thompson, nearly all employees signed forms confirming they were electing a SEP over an ESOP.

This statement to me seems to suggest that you spoke personally with each employee to discuss the ESOP with them.

Is that what happened, did you speak to each employee about the ESOP?

MR. THOMPSON: No, I did not. That was my discussion with Vicky.

ALJ JOHNSON: Okay. (Indiscernible) like that.

Did you speak to any employee other than Vicky about the ESOP option?

MR. THOMPSON: I can't remember. I maybe spoke with Joe Hass because he was a little bit different than the rest of them, but I don't remember.

ALJ JOHNSON: My next question was going to be in Vicky's statement here -- I'm sorry, Ms. Nance's statement, she says that her reason for wanting an SEP over ESOP was to (indiscernible) investment so it’s not the same employer’s (indiscernible).

Did you hear of any other reasons why employees were choosing not to go with the ESOP and choosing to stay with the SEP?

MR. THOMPSON: I did not.

ALJ JOHNSON: And then the transfer employees that came over from WBB to WBBM then transferred back to WBB. Was the whole point of that transfer back to WBB to allow them to just be in the SEP versus the ESOP or (indiscernible).

MR. THOMPSON: Correct, that’s what I was told that they had to go back in order to maintain their SEP status.

ALJ JOHNSON: And I think we’ve seen some different evidence about number of employees and dates and all that. Can you just give us a general statement of when you remember the transfer to the WBBM of the employees how many there were and then the date they transferred back?

MR. THOMPSON: I couldn’t tell you the date because that was more of an administrative process happening with Vicky and Cary. And to be honest, I’m kind of guessing, I thought it was around 20. It’s just kind of -- I never saw a list, I never counted people.

ALJ JOHNSON: Was there any attempts to sort of retroactively stop the transfer of WBB and -- excuse me, sorry, WBBM to make it effect that they never left WBB so there was break in their SEP plan?

MR. THOMPSON: I don't know if there was -- I don't know the answer to that question.

ALJ JOHNSON: No problem. Thank you.

ALJ LEUNG: Mr. Thompson, I've got a couple of brief questions. And if you don't know the answer, that's fine.

You mentioned when the IRS finally settled with you, you basically paid out of your own pocket. Now, the IRS bill went to you, correct?

MR. THOMPSON: I think it went to our attorney.

ALJ LEUNG: Well, I mean, your name was the name as the taxpayer on the IRS notices and bills; is that correct?

MR. THOMPSON: I don't know.

ALJ LEUNG: Okay. Did you know what you were paying for? I know there's a 10 percent penalty. So there's a million, four total, 10 percent that was penalty. Do you know what you were paying for? Again, if you don't know, that's fine.

MR. THOMPSON: Yeah, I know. I'm trying to jog my memory. I could probably make an educated guess, but again, it would be more of a guess.

ALJ LEUNG: Uh-huh.

MR. THOMPSON: I thought it was based on the settlement proposal where they agree for payment for a couple of years.

ALJ LEUNG: Okay. Thank you, Mr. Thompson --

MR. THOMPSON: Okay.

ALJ LEUNG: -- appreciate your time today. You may step down.

We're getting close to a break, Ms. Williams. How long do you expect Mr. Gaidano to be recalled for?

MS. WILLIAMS: If only -- if he's answering questions that the FTB has or any of the judges on the panel have, I can't imagine that would take more than ten minutes.

MR. CASSELMAN: Your Honor, the FTB does not have any questions. We feel we've adequately received responses to our questions, so we don't feel this is necessary.

ALJ LEUNG: Okay. I'll allow Ms. Williams recall Mr. Gaidano limiting the questioning to what was procedurally questions asked to a witness (indiscernible) ask other questions. You might be satisfied, I wasn't. So I will allow that for that purpose.

So call Mr. Gaidano.

MS. WILLIAMS: Thank you, Your Honor.

ALJ LEUNG: Uh-huh.

DIRECT EXAMINATION

BY MS. WILLIAMS:

Q Cary, Mr. Gaidano, I'd like to ask you about the stock ownership of WBB and WBBM. There is a stock ledger, Exhibit 48.

A When Mr. Casselman asked me the question, I think I affirmed it, and that bothered me. When I sat back down, I looked at the -- at the stock ledger. Because he said that Peter was the majority owner. And I kind of went along with that, agreed with it. But that's true, Paul was always the owner and that's why I brought that to your attention.

Q Okay. And did you and Vicky explain the ESOP to the employees or any benefits, health and benefits or other benefits --

A Multiple times.

Q But was Paul -- why wasn't Paul involved in that.

A He was. He just doesn't remember. He's --

Q Okay. You recall that he was there?

A I do. So. You know, I mean. He took the owner of a large small business that, you know, gets pulled in every direction every day.

Q Okay. So you said there were multiple discussions about the ESOP?

A Yeah.

Q With the employees?

A With the employees.

Q So tell me what were those discussions like? Was this a group meeting or a small --

A You know, it was more on an individual basis. I would say, you know, Vicky met them 80 percent of the time and I worked with them 20 percent of the time, you know, people had questions.

You know, the bottom line was that they liked the control of the SEP as opposed to no control and they were beneficiaries or --

Q Did the employees see --

A -- part of the ESOP.

Q Oh, thank you. Did the employees see the AQP valuations that were --

A No.

Q -- provided? So the FTB has made an analysis that if the stock was worth the amount stated in December 30th -- 31st, 2000, which showed the stock was valued a little -- about 2 point -- almost 2 point -- 2.173 million out of those 2,000 shares. And he's questioning well, why wouldn't that -- I mean, why didn't you go back and tell the employees, look, you could be having this humungous -- wouldn't they just get all this stuff out of you?

A There's -- the employees have no control over that as opposed to the SEP where they've got total control over that.

Q Okay.

A And so that -- I mean, that's what it came down to.

Q Now there was also a question about when the employees were transferred -- well, explain to me how the employees had a SEP when they were with WBB, then they moved to WBBM. Do they keep that same -- if they elected to stay in their SEP, nothing changed with the SEP so there wasn't a -- was there a stop and a restart?

A No, there was no stop. I think it was, you know, my foul up in terms of misunderstanding with Storjahnn, with Gordon Storjahnn. I understood it to believe that they could have both plans but they cannot have both plans.

Q In the -- in the -- in WBBM --

A Correct.

Q -- they can only have one plan.

A Correct.

Q And when you discovered that, the solution?

A Well, the solution was both plans were 10 percent plans. We kind of felt like, you know, according to my discussions with Gordon, that the plan could be correctable if and when it was ever picked up or criticized but that's obviously not -- wasn't in the cards.

Q Okay. So I think the FTB is trying to also make a statement. They asked about when you had to transfer all these employees back, didn't that have this big adverse effect on WBBM for its activities?

A Right. And I took a quick look at that. It looks to me like the -- I think the statement was that the fee kept going up. Well, it didn't keep going up. It looks like it went -- I mean, if the next year it way down, the following year after that, it went way up and then it went down. And then --

Q What are you looking at, please?

A -- consistently down.

Q Sorry. Is that one of your exhibits?

A I'm looking at -- it's -- it is this exhibit.

Q 10 or 11?

A It's the WBB Management.

Q Okay. So that's Exhibit 10. And you're looking at --what are you looking at? Pension expense? Or no, you're looking at --

A No. I think it was said that -- or the question was asked, I don't know if it was me or of Paul. But the -- when you look at the total income lying right in the center of the page.

Q Okay.

A Goes from 1 million, 3 million, 4 million. Well, okay, yeah, the employees -- all the employees are in there helping to generate additional income.

And then when they moved back in '02, '03 the income went down to 1.8. But then it went up the following year. You know, I've kind of got those both circled. You know, it's an average of 3.8. So it didn't continue going up, it went down, and then it went down further in '05 and '06.

Q Okay. Thank you.

A And this was 20 years ago.

Q Okay. Do you know when AQP sent their annual surveys who completed them, these employee census forms? I'm referring to the Respondent's Exhibit F, like Frank, where it says, New employees, none.

And when they're asking about the employee census, are they asking about, is it your understanding that that's about -- well, first of all, who filled this form out? Did you fill it out or Vicky or Paul or do you know?

A I think it was Vicky and I.

Q Okay. Did you understand the question to mean employees of WBBM or those interested in participating?

A I'm not quite sure I understand the question.

Q Okay. So we're hearing about all these employees that are at WBBM, but we don't see a list of 23 names. We see just Paul Thompson's name --

A Right.

Q -- for example.

A Right.

Q Well, and this is to say -- day at the end of December, December 31st, 2002.

A Is that the actual report or is that the census?

Q It's a census.

A Okay. Yeah, I don't know. I don't know if it was -- if Vicky filled that out or I filled that out.

Q Okay.

MS. WILLIAMS: All right. Thank you, Your Honor. I'm finished with the questions. If the panel has questions.

MR. CASSELMAN: I actually have questions to follow up on that.

ALJ LEUNG: Mr. Casselman. Within the scope.

MR. CASSELMAN: It is very much within the scope.

CROSS-EXAMINATION

BY MR. CASSELMAN:

Q Mr. Gaidano, can I have you please turn to Exhibit B, page 2.

A Exhibit B, page 2. Yes, my letter.

Q Yes, your letter.

A Yes.

Q I'm going to read from the first full paragraph.

On March 8th, 1999, WBBM was formed as a replacement for Thompson & Thompson Consulting, Inc., a California S Corporation. When WBBM was incorporated, Paul Thompson owned 49 percent of the outstanding stock of West Bay Builders, Inc., a construction company.

And then I'm going to go down to the last sentence.

Under IRS 414B, there was not a control group since Paul Thompson, while allocated shares of WBBM, owned by the ESOP exceeded more than 80 percent ownership, did not own and it's emphasized more than 50 percent of West Bay Builders, Inc.

How do you reconcile this statement to your statement earlier?

A Let me look at that ledger real quick.

So I haven't -- I don't have a 10 key or a calculator. I'm going to guess that when you figure in Paul and the other employees, even the fractional shares that they own, that that gets them to 50 percent.

Q Now did you not state in this letter that Paul Thompson did not own more than 50 percent and that's emphasized of West Bay Builders, Inc.?

A Right. So maybe he owned exactly 50 percent.

Q Now it says in the first sentence, Paul Thompson owned 49 percent of the outstanding stock of West Bay Builders, Inc. So which is it?

A Yeah, on March of 1999 -- I'm going to guess it's 50 percent. I guess the 49 percent is wrong.

Q So it's your assertion that your letter to IRS that was owned 49 percent is wrong; is that correct?

A Not that it's wrong, I just can't get to the bottom of it at this exact moment.

MR. CASSELMAN: Thank you, no further questions.

ALJ LEUNG: Okay. I think --

MS. WILLIAMS: May I just ask a question that might clear that up?

ALJ LEUNG: No. I think that's enough of this witness.

MS. WILLIAMS: Okay. Thanks.

ALJ LEUNG: We'll take a 15-minute recess. Be back at 3:15. Be back for the Judges' questions to both sides. And then after that, hopefully closing and then we might be out of here by 4:30.

MS. WILLIAMS: Thank you.

MR. CASSELMAN: Fantastic.

ALJ LEUNG: Fifteen minutes.

(Off the record at 2:58 p.m.)

(On the record at 3:13 p.m.)

ALJ LEUNG: We're back on the record for 18011377, the appeal of Paul Thompson, Paul and Kathleen Thompson.

And we're in the process in this appeal of having the judges on panel ask questions of the parties.

ALJ LEUNG: Judge Robinson.

ALJ ROBINSON: No questions.

ALJ LEUNG: Judge Johnson.

ALJ JOHNSON: Just had one question to clarify. I'll go to Appellants.

It was stated by Mr. Gaidano towards the end here that when an employee is moved over to WBBM, there's the impression that they could have both SEP and ESOP. (Indiscernible) state, you can only have one.

Can that statement be clarified? Does that mean that employees that were in WBBM could choose an SEP while Appellant was ESOP at the time.

MS. WILLIAMS: I think I understand your question. So the employees had their SEP plan and they kept that. That never -- ended up most, you know, never changing that. They did have the option to participate in the ESOP. And our Exhibits 35 and 36 are the documents that they signed opting to keep their SEP in lieu of the new ESOP.

Does that answer your question?

ALJ JOHNSON: At least it made more pointed. For WBBM, could it operate both the ESOP for some employees and SEP for other employees --

MS. WILLIAMS: That was the clarification Mr. Gaidano made. He thought it could, found out it couldn't. So that's the transfer of the employees that wanted to get their SEPs back to WBB.

ALJ JOHNSON: Thank you.

MR. PEARSON: Can I add to that a little bit?

Okay. They actually operated both plans within WBBM and found out that was not okay and transferred it back.

ALJ JOHNSON: Do you know how long that process was and (indiscernible)?

MR. PEARSON: We believe that it was for 2000, 2001, and 2002 are the years that they were -- all the employees were there. And that was -- they had the SEP while they were there and maintained the SEP and the ESOP but found out sometime in 2002 that that was not -- didn't comply with regulations for the ESOP and then transferred the employees back to keep everybody with their retirement plans.

MS. WILLIAMS: And that's consistent with the W2s of Victoria Nance, although admittedly they have an error, she went from being a WBB employee in 1998 and then 1999 -- oh, I'm sorry, so that's in 2002 that she was a WBBM employee. I'm sorry, I thought I had the additional W2s.

ALJ JOHNSON: I'm just going to ask Franchise Tax Board, did you have to (indiscernible) impose or transfer to WBBM and back to WBB?

MR. CASSELMAN: Yes. Actually, and this will be addressed in our closing but in the Appellant's, I believe, timeline, it says 2001. In the Appellant's opening brief, it says 2002. And then financial statements, and I will actually reference what (indiscernible) it is, I don't remember off the top of my head. It actually says January 2004.

ALJ LEUNG: I have several questions. And I'll start with the one I asked Mr. Thompson earlier.

When he was on the stand regarding the IRS final bill, what exactly did Mr. Thompson pay for? And I'll ask that to the Appellant's. Besides the 10 percent penalty.

MS. WILLIAMS: Besides the what, Your Honor?

ALJ LEUNG: The 10 percent penalty.

MS. WILLIAMS: Oh, they paid 1 million, 4 hundred -- do you mean the dollar amount?

ALJ LEUNG: No, what -- what were they paying for? What was -- I mean, is that a settlement number, off the top --

MS. WILLIAMS: No. Oh, I see what you're saying.

ALJ LEUNG: -- litigation, rest of litigation or is it for particular income that should have been reported (indiscernible).

MS. WILLIAMS: Right. So -- let's see here. I can -- Your Honor, I can get you the exact answer, but I believe it was one year -- it was either 2003 or 2004 that they paid for the assessments that were made.

We did provide all of the notices of deficiency, the pages that showed the dollar amounts. And we have in our latest brief that we filed with a chart that shows the years 2002, '03, '04 --

ALJ LEUNG: Uh-huh.

MS. WILLIAMS: -- and those amounts that were assessed in the notice of deficiency to each of the taxpayers, the Thompsons, WBBM. And then for years 2003 and '04, WBB was added.

Ultimately there is an amount for each of the years, 2002, ’03, and ’04 assessed. I would have to -- I would have to spend time reviewing that to give you that exact answer what they ended up settling that for.

ALJ LEUNG: Okay.

MS. WILLIAMS: But I can brief that if you’d like me to do that in the next few days.

ALJ LEUNG: Let me see if FTB has an answer.

MR. CASSELMAN: My understanding is that it was the vested balance in the ESOP.

ALJ LEUNG: So the balance of the ESOP account.

MR. CASSELMAN: Right.

MS. WILLIAMS: I don’t think that’s right. The financial statement says --

MR. CASSELMAN: His vested amount in the ESOP account.

MS. WILLIAMS: That doesn’t sound right to me. Because Paul [sic] Hass’s closing agreement, he took his 93 vested and transferred it somewhere else.

ALJ LEUNG: Okay. Let me do this. Give me the answer by Thursday. Only that issue, no other attachment. If you find it in an existing exhibit, fine. But I just need an explanation as to what Mr. Thompson paid for all those years that were in audit with the IRS. If it’s the vested account, the vested ESOP account, then -- then fine. Just give me the value of the vested amount -- the vested amount of the account that year.

And FTB do the same by Thursday. Okay.

As far as penalties, NEST penalty. The statute calls for appeal protest to chief counsel of the Franchise Tax Board and her decision, here we go by an (indiscernible) or by close. I want each party to address what this bind OTA is precluding from ruling on the issue of whether the NEST penalty should be imposed.

We'll start with you Ms. Williams.

MS. WILLIAMS: I want to try to understand what you said. I understand that a decision is supposed to be made by the FTB which I also saw that former counsel did write a letter regarding the NEST penalty I think in 2008.

What is your question to me?

ALJ LEUNG: Whether OTA is precluded from ruling either abating or not abating that penalty as per the statute language. I believe it was 19777.

MS. WILLIAMS: You're asking me for the legal authority that this --

ALJ LEUNG: That would allow OTA to overturn FTB chief counsel's determination.

MS. WILLIAMS: Wow. Well, she didn't answer that as far as I can tell from the record.

At the time that the MPAs were issued, the only matter of recourse on that penalty was to the chief counsel of Franchise Tax Board. I apologize, I actually -- we made the arguments I our briefs as to why it shouldn't apply. But I don't know about the legal authority for the OTA to hear that.

ALJ LEUNG: Okay.

MS. WILLIAMS: Ninth Circuit would hear it. And of course Ninth Circuit would hear everything de novo but the Ninth Circuit would certainly be willing to entertain that. So under the circumstances with the new structure of the OTA versus the prior structure of the MPAs were issued, it would be reasonable to think that this intelligent body of panel judges would be able to make that decision. I'm working it here.

ALJ LEUNG: I was going to say mutually exclusive but I won't say it.

Franchise Tax Board, what do you think?

MR. CASSELMAN: Yes.

ALJ LEUNG: Do we have the authority to review chief counsel's penalty determination on the NEST penalty?

MR. CASSELMAN: First of all, the chief counsel did receive a request and it was denied.

I would say that the Reddick OTA panel addressed this issue very well. And yes, once a determination is made that this is an abusive tax shelter, then the penalty applies and the OTA does not have the ability to remove that penalty once the decision is made that it is an abusive tax shelter.

ALJ LEUNG: And is there -- has there been anything published that would -- that you can cite for that proposition? Or is this a first impression answer?

MR. CORNEZ: Judge, let me address this. The FTB has formally stated the position that the penalty once issued on the MPA, the jurisdiction of the then BOE and now OTA presumably would be to conclude that the transaction had economic substance and therefore no penalty was appropriate.

But the decision of the chief counsel not to reduce or eliminate the penalty per statute is not reviewable. So --

ALJ LEUNG: It would be determination.

MR. CORNEZ: Her determination not to reduce or eliminate the penalty is not reviewable. So the penalty was I believe 40 percent. This panel does not have the -- it's the FTB's position that this panel does not have the authority to say well, we think the penalty should be 30 percent.

But if this panel determines the transaction was valid and had economic substance, obviously, the penalty goes away. And the FTB has stated that in written authority when the statute was first enacted.

ALJ LEUNG: So should this panel determine that the -- there was a problem, that this was an abusive tax of (indiscernible) transaction but not to the extent FTB says it is, just by reduce the amount of the tax owed then it will sell reduce the final penalty amount and it will stay 40 percent.

So for instance, if the original MPA was up to 100 bucks and this panel determines that the amount of taxes owed should be 60 bucks, that penalty goes down from 40 bucks to 24 bucks.

MR. CORNEZ: Mechanically I would agree. I would add the caveat that the penalty in this case is based on an understatement, not an underpayment. So as long we’re talking about those understatement --

ALJ LEUNG: Understatement of income.

MR. CORNEZ: Of income, then yes, we would agree with that position.

ALJ LEUNG: Okay. Ms. Williams, any --

MS. WILLIAMS: Yeah, I have a few things to say about that. Because the FTB I don’t believe has stated anything since the -- I mean for the FTB since the OTA created. And not that it needed to, but these were comments that were made or decisions that were made long before 2018.

But there is -- I would think that there would also be authority on the 25 percent omission, the law is clear that if you disclose the questioned income on a corporate or partnership return which is the case here, then the six-year statute wouldn’t apply.

So it’s not omitted. And that is a decision before you so that would take -- wouldn’t that take the NEST pelanty away?

ALJ LEUNG: Well, that’s way -- econ -- economic substance transaction.

So I’m just trying to ask other than that, is there any way that, you know, we do find this is an ATAT, A-T-A-T, whether this body has authority to change the penalty amount, either from 40 to 20 or would the IRS get a 10 percent or some other number other than changing the amount on the statement.

The language in the statute quite broad in saying that no judicial or admin agency can change a determination once the chief counsel has made her call. That’s what I was asking. So.

MS. WILLIAMS: Well, the OTA wasn’t in existence at that time. So.

ALJ LEUNG: It didn’t say board in the lang -- I’ve never seen the language in the penalty say anything about board. Just says no judicial or admin agency raise a whole host to other --

MS. WILLIAMS: We should breathe that.

ALJ LEUNG: No. No. That might be for a different forum, but not this one.

At any event, we will begin our closing statements.

Ms. Williams, you have the floor. Fifteen minutes.

MS. WILLIAMS: Thank you, Your Honor.

There are some crucial points for you remember whenever (indiscernible) considering this in making your decision all of which have been proven with exhibits and testimony.

There's no doubt that Paul Thompson had a construction management company Thompson & Thompson when West Bay Builders was owned by Peter and Paul Thompson which is common in the construction agency.

The replacement and current company is WBBM. Paul Thompson did have a significant business purpose unrelated to tax savings from forming WBBM and the ESOP, both of which had economic substance objectively and subjectively. The creation of WBBM replaced Thompson & Thompson. And the purpose of the ESOP was employer retention. Segregation from WBB limited the exposures and liabilities of WBB and it made both companies more bondable. It made WBB less expensive and an employee purchase of the company as well.

Paul sought advice from his CPA and attorney, his banker, and an ESOP administrator. Only his CPA gave him tax advice which one would expect from a CPA. Paul's banker and his CPA and his ESOP plan administrator have all attested to Paul's concern about employer retention and support Paul's testimony that his primary purpose of the ESOP was a way to retain and attract employees.

Mr. Thompson’s banker Michael Johnson testified about the discussions he had with Mr. Thompson at the time Paul was considering the ESOP and later after Peter left. He said that Mr. Thompson discussed his concern of employer retention with him and the ESOP is a way to entice employees to stay after his brother left WBB. He also confirmed that the discussions were not about tax advice or about tax savings.

We have a declaration signed by Gordon Storjahnn, the former president of American Qualified Plans who served as the plan administrator for WBB and who describes the advice that he gave to Paul Thompson when they discussed the ESOPs. He said Paul Thompson was worried about keeping good employees. He said he told Mr. Thompson that ESOP participation gives employees part ownership of the company and that owners or employees stay with the company and are better employees.

And we heard from Eric Storjahnn the current president of American Qualified Plans who testified to the type of good advice given to clients like Mr. Thompson and the number of employees -- and that the number of employees was not relevant for the purpose evaluation of the plan at that time. The primary reason to use an ESOP was for employee retention back in 1998 just as it is today.

He also described that employees could receive stock or cash and he described the valuation, the initial valuation based on the actual amount paid and then the subsequent valuations based on more information that happened and was presented on the tax returns.

Mr. Thompson, WBB, and AQP are all still in business today and ESOPs are still viable and (indiscernible) product. We have Frederick Joe Hass, a man who's also still an employee of WBBM and who was an ESOP participant. He signed a declaration attesting to the fact that as an employee, he was very interested in being part owner of the company and participating in the company's growth.

And we have a declaration of Victoria Nance who states that all the employees had the option to participate but no one did initially. In her case, she didn't want her retirement and her employment in one company but that Joe Hass did participate.

The ESOP was initially approved by the IRS. It was a valid plan as enacted. Ultimately, after the law was changed, Joe Hass was not enough for the ESOP to be in compliance by 1105. The FTB ignores this and continues to talk about 2001 year, it was 2005 for the grandfathered entities.

When the ESOP was revoked, the IRS never said the ESOP lacked economic substance, was abusive, or that it was adopted merely to avoid taxes. It concluded the ESOP failed to satisfy the complex, nondiscriminatory rules of 410B after applying the controlled test group of 414B.

If you review Exhibit 48 in the stock ledger, you will see that there were a total shares of -- total number of shares of 36 -- 36,368. That -- the percentage held by Paul Thompson was 17,000 which is 46.74 percent. Peter held 16,364 shares or 44.99 percent. Joe Hass at 3,000 shares or 8.2 percent, and four different people had 1 percent, one share.

The IRS did not go beyond the ordinary statute of limitations. And I assert if it thought it could have, it would have. The FTB will typically follow the IRS results in an audit. And the IRS does have the years of 2003 and ’04 still before it. The FTB, excuse me.

The IRS national office in settling the IRS audit did not pierce the corporate veil, allege fraud or abuse, it never concluded WBBM or the ESOP lacked economic substance, was abusive or adopted merely to avoid taxes or similar theories. It just added a 10 percent penalty, the minimum penalty the IRS might add and it sought no other penalties.

The IRS specifically stated this is not a list of transaction and so the ESOP failed because it determined a defect in the plan’s tax qualified status.

The draws that Paul received were later classified as interesting bearing loans with notes as we discussed done to meet the requirements of the bonding company. Without the bonds, Mr. Thompson could not conduct business. The loans were documented and payments were made with interest. WBB reported substantial taxable income to California or taxable sales -- gross receipts to California for each of the years at issue ranging from a few hundred thousand to over 1.2 million.

Unlike the cases the FTB relies on, Mr. Thompson’s businesses were not shams and not hobbies or fake deductions as unsubstantiated. In Pacific Management and the Reddick Cases, those companies never had management companies. They -- they set up secondary corporations so that the ESOP could own it and so that they could take advantage of the new ESOP structure.

Reddick took -- really did take loans for purposes -- both of those cases they used the money to circulate. They both had a circular use of funds whereas in our case that is not what happened with the transactions between the entities.

This is not a case where the plan administrator or the CPAs were investigated as promoters or fraudulent tax shelters or otherwise penalized by the government. In fact, they’re still in business today. Mr. Gaidano, American Qualified Plans, the banks, even the lawyer at age 80 is still not entirely retired.

Mr. Thompson told you the primary purpose of the ESOP and his interest in rewarding his employees. He's credible as is the evidence that supports his stated purpose. The fact that nearly half the employees that he had in 2000 are still with him today speaks volumes of the success he's had in employee retention.

He talked about other ways that he worked by paying bonuses or there was some consideration of a buyout plan. It's not extraordinary if Mr. Thompson doesn't remember 20 years ago sitting down with each employee and talking about an ESOP plan any more than he would have talked about any other benefits plan or part of a benefits package. That's something that he was -- that administration often handles.

The six-year statute in this case does not apply because there's no 25 percent omission of income. Income that's disclosed on a related tax return is not considered omitted.

And finally, if you're not persuaded by what you heard, we assert the FTB has the wrong taxpayers. If the transaction is unwound it's WBB that loses its deduction and the income would be allocated to WBB. The MPAs issued to the Thompsons should have been issued to WBB which is discussed more fully on the briefs.

The FTB has offered only its opinion. Hindsight, thoughts regardless of whether those are by Congress or by the taxpayer are really not relevant. What is relevant is that Mr. Thompson's thought at the time he entered into the agreement. So long as any rational business purpose can be articulated by Mr. Thompson regarding why he set up WBB in the ESOP and the business judgment rule prohibits the FTB from substituting its own notions of what is or not sound business judgment. In fact, the IRS even recently said in a national office technical advice memorandum that the quote, "IRS cannot substitute its judgment for the employers and what the business purpose was." End quote.

The FTB's request to extend the statute of limitations beyond the ordinary four-year statute of limitations for under any theory should be rejected and all issues should be found in favor of the Appellants.

Thank you.

ALJ LEUNG: Mr. Casselman.

MR. CASSELMAN: All right. Thank you.

Through the various briefs that have been filed in this case and the testimony of witnesses, we have seen two very different interpretations of the evidence. Appellants' version of the facts ask you to disregard numerous pieces of evidence as either not related to the taxpayer or misleading. However, Appellants' documents tell a clear story.

Mr. Thompson's advisors proposed him a structure that would purportedly allow him to escape immediate taxation of millions of dollars of income without actually having to give up any ownership of the business or control of the income to his employees.

Let’s look at Issue 1. The Sham Transaction Doctrine is a well-established tax law principle that a transaction with no economic effects in which the underlying documents are a device to conceal its true purpose is not respected for tax purposes. An appeal of (indiscernible) the BOE adopted a two-part test for determining whether a transaction is a sham. The subject business purpose inquiry simply concerns the motives of the taxpayer in entering into the transaction.

Under the business purpose test, we must determine whether the taxpayers have shown that they had a valid business purpose for engaging in the transaction other than tax avoidance.

The economic substance test involves a broader examination of whether the substance of a transaction reflects its form and whether from an objective standpoint, the transaction was likely to produce economic benefits aside from a tax benefit. A lack of economic substance is sufficient to invalidate the transaction regardless of whether the taxpayer has motives other than tax avoidance. Now whether the taxpayer meets the business purpose of economic substance test is a factual determine.

So get the business purpose here. The sole reason Mr. Thompson set up the S corporation ESOP structure was to create a tax deduction for WBB while isolating the corresponding income in an S corporation that allocated the income to a nontaxable entity for tax purposes.

Appellants have made many arguments during this appeal as to why they implemented the management S corporation ESOP structure. However none of these asserted business purposes are supported by the evidence.

The primary reason put forth for the structure was that it was intended as an incentive to retain rank and file employees. No one other than Mr. Thompson was ever allocated any stock by the ESOP. In fact at all times Mr. Thompson owned 100 percent of the issue and outstanding shares of the S corporation through the ESOP that he effectively controlled.

The April 1st 1999 valuation of management stated that the income anticipated by the ESOP was to be derived from the management services of Appellant is the sole employee of the corporation.

Mr. Gaidano's letter to the IRS makes clear that they never intended to allocate ESOP stock to anyone after 1999. To bolster their assertions that the ESOP was intended to benefit employees, Appellants make unsupported assertions that 12 employees left when Peter Thompson departed the business and the ESOP was formed as a direct reaction to stem the loss of employees.

As we have seen, when Peter Thompson left the business, this actually threw Mr. Thompson’s tax shelter into turmoil. Now there was a controlled group issue that resulted in the structure clearly failing the requirements of the code. In order to get around the developing guidance that held that held that even as intended the structure was abusive, the Appellants created this business purpose to make I appear as if Mr. Thompson at least intended to provide for the rank and file employees.

Appellants also claim that they transferred 25 WBB employees to management so that they could benefit from the ESOP but every single employee refused to participate in the ESOP foregoing any pension benefits while at management rather than increasing their personal wealth by owning in their employer. The more logical conclusion based on the evidence is that the Appellants purportedly transferred employees into management in the year 2000 following the realization the intended structure was not supportable in order to give management the veneer of a legitimate employee leasing company.

Mr. Gaidano stated during the FTB audit that the reason that these employees did not participate in the ESOP was because they were set up as participants in a Simplified

Employee Pension Plan or SEP in error and that this was corrected for the 2003 tax period. However, we know based on Mr. Gaidano’s own letter to the IRS this was not the case.

As was stated, no employees ever received stock from the ESOP after -- no employees could ever receive stock from the ESOP after 1999 because Appellants had then realized that the IRS would treat this structure as an abusive tax shelter. The Appellants hoped that if they could show that the employees had a comparable SEP, this would be sufficient to avoid a finding that the structure was abusive.

Were these movements of reported employees anything more than tax motivated maneuvers, we would expect that the dates of transfer would be clear. However, Appellants cannot seem to keep straight the years the employees move between the companies. Respondents’ Exhibit A, the timeline prepared by their accountant puts the date the employees transferred from management to WBB at the end of 2001. Appellants’ opening brief puts the date at 2002. And to make matters more confusing, the financial statements provided by Appellants as Exhibit 10 state the employees transferred out of management in January 2004.

No credible explanation has been provided as to why to date all the employees of management but for Mr. Thompson and Mr. Hass transferred to WBB is so uncertain. Appellants appear to have never offered employees a true choice to join the ESOP. As the purported election forms only allow the employees to elect not to participate.

We must also note neither the operating company WBB nor management claimed any deductions for pension benefits provided to employees other than the ESOP. I want to say this again. Neither company claimed any deductions for a SEP during the years at issue based on review of the tax returns, financial statements, or any other financial documents provided during audit or the appeals process. If the SEP was provided, it's clear no contributions were made to the employees' accounts by Mr. Thompson's companies.

In Appellants' most recent brief, they included the declaration of Victoria Nance. She states in her Declaration Number 6, 10 percent of her salary was contributed to the SEP. She does not say WBB or WBBM contributed to any funds to her SEP on her behalf.

Additionally, Appellants included W2s purportedly related to Ms. Nance, although the names do not match. In Box 15 of Ms. Sacco's W2s for 1998 and 1999 from WBB, we see that the pension plan is not checked. Per the instructions to the W2 form for this year, this box should be checked in the employee was an active participant in a SEP.

In her 2000 W2, we see she worked for management yet Appellants insist that every management employee refused to receive the ESOP benefits because they wanted to return to their SEP. At the very least in Ms. Sacco's case this is untrue. That she did not receive a pension in 1998 or 1999 from WBB as shown on her W2s.

Appellants' other purported business purposes are also not supported by any evidence. Appellants refer to a buyout plan that was to take place in WBB and that they wished to reduce the value of the company in order to allow for stock purchases. No credible evidence is in record to support that this business purpose ever truly existed and is illogical to think that an S corporation ESOP structure in management was required to allow for a buyout plan in WBB. The most logical response to wishing to establish a buyout would have been to have the ESOP own WBB. But this would have come without tax benefits.

The goal of reducing WBB's value runs directly counter to what Mr. Michael Johnson claimed in his declaration was the goal of the structure to create the strongest balance sheet possible for WBB so that WBB was able to obtain bonds. He stated that it was important for a construction business in purchasing bonds to have the cleanest financial statements possible. He states the bond company wants to see the highest net worth, lowest debt, highest liquidity, and highest profitability.

Mr. Thompson also claims he wanted to separate the two lines of business, contracting which was done in WBB, and

construction management which was performed by Mr. Thompson and purportedly moved to management in order to isolate the liability from each company from the other and to make both companies more attractive to perspective buyers. This purpose had already been accomplished prior to the implementation of the S corporation ESOP structure.
Mr. Thompson was an employee of Thompson Consulting and could have continued this structure even after his brother left the companies just as he continued the business of WBB.

Additionally, Appellants have not provided any analysis or research that shows that separating two wholly owned, controlled, and intimately related companies in any way provides liability protection.

Now let's look at the economic substance briefly. The sole purpose of the management leasing fee charged the WBB was to generate large tax deductions for WBB while siphoning income into a paper entity only by a tax exempt ESOP and controlled entirely by Mr. Thompson. Mr. Thompson and any employees that did in fact transfer into management continued to perform the same job duties as they did prior to the structure.

That management was simply a paper entity is amply demonstrated by the fact that AQP, experts in the field of ESOPs according to Appellants and Mr. Thompson's hand chosen advisors were not even clear how many employees worked for management. Their valuation reports for the years at issue indicate that Mr. Thompson was the sole management employee. AQP cannot be blamed for making this assertion, however, as it was based upon documentation provided by the company itself that indicated Mr. Thompson was the only employee. And you can see that in Respondents' Exhibits F and H.

Additionally as we heard testified to, excuse me, by Mr. Storjahnn, the sole contract of WBB was not even reviewed in setting the value of the ESOP. Why is this? The logical conclusion is that the more valuable the ESOP is, the larger tax amount of capital gains Mr. Thompson would have had to pay on the transaction. This allowed additional income to be allocated to the ESOP for tax purposes.

The financial statements and tax returns of management also point to the abusive nature of the structure and the fact that management lacked economic substance. WBB paid fees with enormous markup to management for the use of employees it could have employed directly at far lesser expense. Then the company needed management to give back a significant percentage of the fees to WBB so that WBB could continue operations.

The only logical reason for this structure is the tax deduction that was generated in WBB coupled with the siphoning of untaxed cash into an entity Mr. Thomson controlled. Mr. Thompson utilized management as a tax-free investment tool that he alone controlled. Again, all evidence shows us that Mr. Thompson had all times had complete control of the ownership and income of management. The tax returns and financial statements show that significant loans were made to Mr. Thompson as officer of management. Respondent requested all documentation related to the loan to Mr. Thompson and WBB but nothing was provided.

It’s interesting to note that according to Respondent’s Exhibit A, ten days after the IRS issued News Release 2004 155 which is entitled, “IRS Warns Businesses and Retirement Plans against Abuses involving ESOPs and S Corporations,” management was converted to a C corporation. Ten days later. The news release quoted the director of the IRS’s Employees Plan Division as saying the IRS is determined that many existing arrangements designed to take advantage of the benefits of S corporation ESOP rules would not only involve taxation under 409P, but would also violation qualification requirements of the tax laws such as the covered rules under Code Section 410B. It would appear this was not a coincidence.

Now let’s look at whether the income was properly allocable to the Appellants. The Pacific Management decision covers who was assessed tax abusive management S corporation ESOP structure is involved. In summary, the Court found that both the operating company, in this case WBB, and the individuals were liable for tax on the abusive structure where the S corporation was found to be a paper entity utilized solely to allow the owner to siphon off income into a tax exempt entity.

In determining where to assign income, the focus is on who controls the earning of the income. Paul Thompson had completely and total control over WBB and management. Imposing tax on the Appellants is also consistent with the IRS determination where Appellants agreed that they were the appropriate party to pay the tax and penalties.

Now let's turn to the issue of the SOL and NEST. Because the structure the Appellants implemented was intended for the principal purpose of tax avoidance, the eight-year statute of limitations under CRTC Section 19755 applies to all years. Additional the NEST penalty under CRTC Section 19774 is appropriate because this was a transaction that lacked economic substance. Appellants did not disclose the structure in a return submitted to the Franchise Tax Board and therefore they do not receive a reduction of the penalty to 20 percent.

And finally, let's address the IBP, the interest base penalty. Revenue and Taxation Code Section 19777 provides for penalty in cases involving potentially abusive tax shelters and the taxpayer receives notice from the FTB that the transaction has been identified as a potentially abusive tax shelter. A potentially abusive tax shelter included an arrangement which was of a type that has been determined by regulation as having potential for tax avoidance or evasion.

Section 19777 references the characteristics found within treasury regulation 1.6011-4T. The first characteristic applicable here is contractual protection. The ESOP was a critical component of the S corporation management company structure. Without the ESOP's involvement the abusive tax avoidance transaction would not be successful. Per Exhibit FF, AQP provided its customers with a guarantee that the IRS would issue a favorable determination letter or the customer would get a full refund of all costs incurred. Thus the transactions -- the transaction satisfied this characteristic.

The second characteristic applicable -- applicable here is the involvement of a person such as a tax exempt entity that is in a more favorable tax position in the taxpayer and the taxpayer knows that the difference in the tax position has permitted the transaction to be structured on terms that are intended to provide the taxpayer with a more favorable federal income tax treatment than the taxpayer could have obtained without the participation of the person.

Appellant structure involved an ESOP which is a tax exempt entity. Mr. Thompson was aware that the ESOP's involvement provide him with a more favorable tax treatment than if the ESOP was not involved. Because Appellants' structure is of the type determined by regulations as having potential for tax avoidance or invasion, Respondent properly included the interest based penalty on the MPA.

In conclusion in evaluating the evidence provided in this appeal, only one conclusion can logically be drawn. Mr. Thompson has emphasized in his surety's e-mail desire to take advantage of a perceived loophole in the law related to S corporation owned by an ESOP in order to stash significant amounts of income tax -- income in a tax-free piggybank he alone controlled.

While Appellants have asserted this structure was implemented to benefit employees alone, no evidence supports these assertions. In fact, the evidence provides a clear roadmap to what in fact occurred. Because this structure lacked any business purpose or economic substance and was implemented for the sole purpose of avoid significant amounts of tax, I would respectfully ask the panel to sustain Respondent's determinations.

Thank you.

ALJ LEUNG: Rebuttal, Ms. Williams?

MS. WILLIAMS: Thank you, Your Honor.

WBBM had economic substance just as Thompson & Thompson had economic substance. Thompson & Thompson was also audited. The IRS revoked the ESOP. The IRS did not say that WBBM had -- was a sham and needed to be dissolved in any way. It's still in existence today.

The FTB, they don't -- they don't want the truth of what happened in this case. Granted, some of the dates, things are conflicting as I explained in my opening. WBBM was on a calendar year and WBB was on an accrual based, on a fiscal year ending May 31st of each year. So sometimes if we say 1999 or 2000, it's because for the WBB, an event in January through May would be 1999 versus the year 2000 for WBBM.

The FTB continues to overstate what's actually being heard or what's been provided. Today we heard Mr. Gaidano testify that they were watching to see what the IRS would do. Opposing counsel says that he testified that he knew the transaction was abusive. That's not what he testified to.

Eric Strojahnn was here. He wanted to testify that -- that participants could receive cash or stock and there could be reissuances of stock -- additional stock could have been issued. While he was sitting here, rather than asking him those questions and saying well, how could that work or wouldn't somebody have had to have elect to be a participant in the ESOP to ever get any of this stock? Would that be required? The FTB didn't ask those questions.

In its closing, the FTB's pulling out some literature, I believe, that they found about a guarantee or something in a -- I'm not sure, in an exhibit that AQP may have provided. But AQP was here and they didn't ask them what does that mean or what is that about? Instead, they are trying to convince you of what should be logic or what your judgment should be today or what their judgment would be. I mean, why not just say to Paul, why didn't you just ask the employees if they wanted it before he spent all this money doing it. There's a thought.

But he's not required to do that. We need to look at what was he thinking at the time? All of this looking backwards and saying, you know, could have, should have, would have isn't what the law was, what the law requires. He has clearly articulated about purpose to what he did. It's supported by the evidence and it's supported by the testimony.

To think that Paul and carried it out on testifying that Paul contributed 10 percent of each of employees' gross wages to their retirement, whichever plan they selected, to imply that that's not true because Victoria Nance wrote that she contributed to her SEP, I think is disingenuous at best. And I'm glad we'll have a chance to ask her if her employer contributed to her retirement plan.

Paul described to you that his brother left, kind of took the high ranking or a lot of the good employees and some of the better projects with it. He's explained he was scrambling a little bit. He was thinking of different ways, what he could do. He's hearing from his advisor why don't you try an ESOP? He's doing bonuses, he's doing other things. I think it's very credible that he was worried about keeping his employees and if an ESOP was a way to do that, that was primary purpose for him.

The FTB asserts that the taxpayer did not file tax returns to disclose the questioned income and that's also patently false. They absolutely did file the tax returns that would disclose the income as required for the extended six-year statute.

And I just respectfully will ask that this panel not substitute its judgment or the FTB's judgment or what they might believe as logic but instead look at Mr. Thompson's rational business purpose that he has articulated for the purposes of setting up WBBM and the ESOP.

And I thank you for your consideration.

ALJ LEUNG: Thank you, Ms. Williams.

This brings the hearing to a close. I do have two procedural questions to ask.

For Franchise Tax Board, do you still want to pose questions to Vicky Nance?

MR. CASSELMAN: Can we confer for just one moment?

ALJ LEUNG: Okay.

MR. CASSELMAN: We do not.

ALJ LEUNG: Okay. So my earlier ruling regarding timelines and submitting questions and responses is hereby reversed. I reversed myself. Nice.

I don't -- I would like to see an answer to my question about what Mr. Thompson paid for to the IRS aside from the 10 percent penalty. And FTB, the case (indiscernible) for the amount that was vested in the ESOP, if that's the case, then please confirm that with the vested amount in his ESOP account for each of 1999, 2000, 2001, 2002. If there's some other basis for why he paid the IRS what he did pay, then I would like to know that and get numbers for that.

I will give parties, both parties up until this Friday, August 30th, close of business to submit their simultaneous briefing on that and that one issue alone. If there are exhibits existing in the record, please point to those exhibits. If there's any particular IRS exhibit, I stress only IRS exhibit that would explain what happen, you may submit that as part of your -- your explanation.

Any questions?

MR. CASSELMAN: Yes, Your Honor, you mentioned earlier years also during your --

ALJ LEUNG: 1999, 2000, 2001, 2002. If indeed the -- what the IRS did was the amount of the ESOP account that was vested.

MR. CASSELMAN: Thank you.

ALJ LEUNG: If not, then we might not need the (indiscernible) if I don't know what the answer is.

I thank both parties for their wonderful presentations today. I would thank the witnesses for -- for suffering through a whole day of hearings. And hopefully we will have a written decision out to everybody within 100 days or when the record closes. I fully expect the record to close, close of business Friday, August 30th.

Thank you very much. Have a great day.

MR. CASSELMAN: Thank you.

(Whereupon the proceedings were adjourned at 4:01 p.m.)

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REPORTER'S CERTIFICATE

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

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

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

PETER PETTY
CER**D-493
Notary Public

TRANSCRIBER'S CERTIFICATE

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

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

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

Jill Jacoby

Jill Jacoby
Certified Transcriber
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