BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
DAVID LINDSEY and LORYN LINDSEY,) OTA NO. 18012098
)
APPELLANT.)
)
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TRANSCRIPT OF PROCEEDINGS

Van Nuys, California

Monday, October 28, 2019

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Proceedings, taken at 6150 Van Nuys Blvd., Van Nuys, California, 91401, commencing at 10:42 a.m. and concluding at 11:44 a.m. on Monday, October 28, 2019, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	Hon. JOHN O. JOHNSON
Panel Members:	Hon. RICHARD TAY Hon. KENNY GAST
For the Appellant:	HECTOR C. PEREZ WILLIAM K. SHIPLEY
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD By: SONIA WOODRUFF NANCY PARKER TAX COUNSEL Legal Division P.O. Box 1720 Rancho Cordova, CA 95741 916-845-2498

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(None offered)				

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Van Nuys, California; Monday, October 28, 2019
10:42 a.m.

JUDGE JOHNSON: Let's go on the record.

This is the appeal of David Lindsey and Loryn Lindsey, OTA Case Number 18012098. It is 10:42 a.m. on October 28th, 2019, here in lovely Van Nuys, California. I'm the lead ALJ for this hearing, John O. Johnson. Let me say good morning to my fellow co-panelist today.

Good morning, Judge Gast.

JUDGE GAST: Good morning.

JUDGE JOHNSON: Good morning, Judge Tay.

JUDGE TAY: Good morning.

JUDGE JOHNSON: While I'm the lead for the purposes of conducting this hearing, the panel, the three of us, will make the decision on appeal. We have read the briefs and we have the arguments, and we have looked at the briefs, and we've also examined the evidence as well.

We fully respect the importance of the decision being made on this appeal. We know, certainly, in this case it has taken a long time to get to this point. We appreciate the effort that everyone has put forth.

Let me have the parties introduce themselves and who they represent, starting with Appellant.

MR. PEREZ: Yes, Your Honor. Hector Perez and

William K. Shipley on behalf of Dr. David Lindsey and Loryn Lindsey, the taxpayers.

MR. SHIPLEY: Your Honor, we would like to call --

JUDGE JOHNSON: Oh, I'm sorry. I wanted to make sure you introduced everybody.

Now, let me go to Franchise Tax Board to introduce yourselves.

MS. WOODRUFF: Good morning. I'm Sonia Woodruff, and I'm here with Nancy Parker today for the Franchise Tax Board.

JUDGE JOHNSON: Thank you.

The primary issue we have on appeal is: Whether Appellants have shown error in the Franchise Tax Board's proposed assessment of additional tax, which is based on the unreported gain of the sale of a residential property. Proposed assessments are at issue for the 2003, 2004, and 2005 tax years for a late-filing penalty and an accuracy-related penalty was also proposed for the 2003 tax year.

Next, we'll cover the exhibits. Appellants have Exhibits 1 through 33. Franchise Tax Board, any objections to those exhibits?

MS. WOODRUFF: No objections.

JUDGE JOHNSON: Thank you.

Franchise Tax Board has exhibits, and I'll read them, A through Z1 through Z1, A2 through Z2, A3 through Z3, A4 through Z4, A5 through L5, and A6 through J6. Now, Appellants, you have submitted objections to some of those exhibits. If you'd like, I can read your objections of which exhibits.

MR. PEREZ: Your Honor, please, go ahead.

JUDGE JOHNSON: Exhibits A through T, pages 7 through 120 of Exhibits W, Exhibits A1 through F1, Exhibits T1 through X1, Exhibits A2 through L5, and Appendices A through J. Does that sound accurate?

MR. PEREZ: Yes, Your Honor. In addition to that, we would also object to the documents as lack of foundation, meaning there's no hearsay exception on which we examined those documents. For example, there's a revenue agent's report that was obtained, wherein, a lot of allegations were made. We expected those allegations to have been resolved in an IRS audit, and that's why the case was postponed.

The IRS audit came about. We went before the tax court, and the IRS conceded all of the issues. So as to all of the allegations that are set forth there, they would be objectionable hearsay because we could not examine the revenue agent, for example, and ask and inquire about all of the statements that she made in that report, for example. So it's basically lack of foundation and hearsay.

JUDGE JOHNSON: Okay. In addition to lack of relevancy as you stated in your objections?

MR. PEREZ: Yes.

JUDGE JOHNSON: And the prehearing conference minutes and orders set up a system for objections and allow the other party a chance to rely. I think your objections came in a little bit later than anticipated in prehearing conference minutes and orders. So there wasn't a proper time for Franchise Tax Board to submit a written response.

But Franchise Tax Board, would you like to reply now?

MS. WOODRUFF: Sure, we would. So all of the evidence that we've submitted is directly relevant to the question of whether or not the Appellants are entitled to reduce their gain. And so we would submit that, you know, you allow in the evidence because it is directly relevant to the issues.

JUDGE JOHNSON: Okay. Thank you.

As background information, the Office of Tax Appeals Regulation 30214(e), states that the California Rules of Evidence do not apply to proceedings, including oral hearings before the OTA. And while the panel may use the Rules of Evidence when evaluating what weight to give evidence presented and received before OTA, all relevant evidence shall be admitted. This treatment is consistent with the relaxation of evidentiary rules applicable to administrative hearings as stated in the California Supreme Court decision of Lake v. Reed. The cite is 16 Cal.4th 448.

Per our regulations of that same section, the lead ALJ has discretion to exclude evidence if it is determined that when probative value of the specific evidence is substantially outweighed by the probability that its conclusion would not necessitate an undue consumption of time.

Appellants have objected to a large amount of Franchise Tax Board's exhibits, as we just read, asserting that they're not relevant and also asserting a lack of foundation at this point. Including in the exhibits that were objected to, some exhibits such as Appellant's original and amended returns for years at issue, these appear to us to be entirely relevant to the proceeding before us.

And, although, Appellants appear to not believe, generally, that most documents relating to years after 1993 can have relevance, we find otherwise. As such, we are overruling Appellants' objections. Appellants are still free to argue that certain exhibits should not be given much probative value, but they will be admitted into the record as we do see some relevancy to them.

Accordingly, all exhibits from both parties are admitted as evidence into the record.

(All Appellant's Exhibits were received in evidence by the administrative Law Judge.)

(All Department's Exhibits were received in evidence by the Administrative Law Judge.)

JUDGE JOHNSON: I'd like to go over stipulations. FTB has revised the amounts at issue, providing for 2003 additional tax amount of $157,709, a late-filing penalty of $38,885.75, an accuracy-related penalty of $30,176.20, and additional tax for 2004 of $6,175, additional tax of 2005 of $1,302.

Franchise Tax Board, is that accurate?

MS. WOODRUFF: That's correct. Although, I think that 2004 and 2005 may not be in dispute at this time.

JUDGE JOHNSON: All right. Thank you.

In addition, Franchise Tax Board had originally proposed a failure to furnish information penalty for each year, and that has been evaded. Appellants have conceded the investment interest expense deductions and casualty of theft and loss expense deductions. Parties have stipulated to a home-mortgage interest expense deduction of $76,046 for 2003, $42,650 for 2004 and $50,724 for 2004.

Does that sound accurate?

MS. WOODRUFF: Yes.

MR. PEREZ: Can I hear again for 2003, Your Honor?

JUDGE JOHNSON: 2003, home-mortgage interest expense deduction was $76,046.

MR. PEREZ: Thank you.

JUDGE JOHNSON: With that I have no further preliminary matters, and we are ready to begin with the parties' arguments. We're going to start with Appellants who have 30 minutes cumulative for arguments and testimony.

Do you think you'll start immediately with testimony, or do we start with arguments?

MR. SHIPLEY: Your Honor, I think as a start we can speak to the taxpayer's themselves about their declarations that are already in the record, and that should shorten the presentation here. We initially wanted to advise the panel that our view is more narrow than the issue being what is the gain.

Our issue is -- we believe the issue is whether or not there are satisfactory evidence that improvements made to their residence after they purchased it were paid for by the taxpayers. And we'll -- that's a kind of subset of the main issue that you announced earlier, but that's the only issue of that, that we're going to address.

JUDGE JOHNSON: Thank you.

Let me go ahead and start as it sounds like you might go into some questions of the taxpayers and have them attest to facts. Let me go ahead and swear them both in first, and then we can keep moving along.

Please stand. Raise your right hand.

LORYN LINDSEY,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

DAVID LINDSEY,

produced as a witness, and having been first duly sworn by the Administrative Law Judge, was examined and testified as follows:

JUDGE JOHNSON: Thank you.

Okay. And depending how we proceed, if it is sort of just argument and testimony mixed in, we might wait until the end to allow Franchise Tax Board to ask their questions, if that's okay?

MS. WOODRUFF: That's fine.

JUDGE JOHNSON: Okay. You do have 30 minutes cumulative, so please begin when you are ready.

MR. SHIPLEY: Thank you. My first -- I'd like to question Dr. Lindsey, if I might, Your Honor.

DIRECT EXAMINATION

BY MR. SHIPLEY:

Q Dr. Lindsey, did you earlier provide in this proceeding a declaration under penalties of perjury regarding this case?

A I did.

Q And since that time and before this hearing, have you had an opportunity to review that declaration more carefully to see if you need to make any changes?

A I have.

Q And do you need to make any changes to that declaration?

A No, sir.

Q The declaration you filed in this case had -- was accompanied with a number of exhibits. Have you also reviewed those exhibits?

A Yes, I have.

Q And do you have any changes that you want to make to those exhibits that you submitted or any revisions of any sort to those exhibits?

A No, sir.

Q Okay. Do you have the declaration or copy of the declaration with you? I have a couple of specific questions that I'd like to ask, and that should conclude your testimony. Can you find as an exhibit to your declaration, Exhibit D, or it's now renumbered as Number 6, Exhibit D.

MR. SHIPLEY: For the panel, this is our hearing Exhibit Number 6.

THE WITNESS: D or B, as in boy?

BY MR. SHIPLEY:

Q D, yes.

A Yes.

Q All right. That's a two-page document?

A Yes.

Q Will you take a look at Page Number 2 of that document?

A Yes, sir.

Q Now, if you notice about a third of the way down this is a hearing officer's report. A third of the way down it talks about you owning a corporation and then discusses a specific check, a check dated 1998 for $3,000. Do you see where that is?

A Yes, sir.
Q Have you seen that actual check?
A Yes, sir.
Q And that is a check that the hearing officer thinks possibly is a corporate check. Is it a check drawn on a corporate account?
A No, it is not.
Q And on the face of the check does it say, as the Hearing Officer indicates, your name followed by "M.D."?
A Yes, it does.
Q And you maintain a personal bank account at this particular bank; is that correct?
A Yes, I do.
Q And after reviewing this specific check that's discussed by the Hearing Officer, can you tell the panel whether or not that's a check drawn on a personal or on a corporate account?
A That is a check drawn on a personal line of credit.
Q All right. Thank you. Now, I'd like to hand you -- before we finish, I'd like to hand you the OTA Exhibit Number 23, a two-page document. And what is that document?
A This is a letter from our accountant discussing the -- well, excuse me -- architect. Specifically, I had

some concerns about discharges.

Q Was that an accountant that wrote you the letter?

A No. This is the -- Peter Harmon who is our architect who did the revision of our home at the time.

Q All right. And why did he write you this letter? Do you know?

A Yes. I got a little heated with him because I was concerned about the costs. So, specifically, I said to him, "You need to justify the charges." And this was his response to go through the billing to show me what he was doing, what it cost, and why.

Q Now, the second page of that document is what?

A These are the bills that he submitted to Loryn and I for his services that we paid.

Q Now, are those services paid for out of a personal account?

A Yes. They were a combination of the salary I received and credit line and construction.

Q Okay. Hand that back, please.

A Okay.

MR. SHIPLEY: Your Honors, that constitutes the testimony of Dr. Lindsey.

JUDGE JOHNSON: Thank you.

Franchise Tax Board, did you want to ask questions now or hold until the end?

MS. WOODRUFF: I actually don't think I -- if that's all the testimony, I don't think I have any questions.

JUDGE JOHNSON: Okay. That sounds good.

And just as reminder, if we can, if you have a microphone, talk into it. If you don't have a microphone, try to be extra loud. Thank you.

MR. SHIPLEY: Next we would like to hear from Loryn Lindsey.

DIRECT EXAMINATION

BY MR. SHIPLEY:

Q Ms. Lindsey, during the life of this case -- a long life of this case, did you prepare and submit for consideration a declaration?

A Yes, I did.

Q Was it under the penalties of perjury?

A Yes, it was.

Q And did you submit with that declaration any exhibit?

A Yes, I did.

Q And what was the exhibit?

A My ledger of the expenses.

Q And is it your declaration that -- and your testimony that the payments in question to the architect and to the construction company was made by you personally?

A Yes.

Q And is it also your testimony that the payments were made exclusively from personal accounts?

A Yes, they were.

Q And that no payment of any sort, either to the architect or to the construction company for the work they did in 1991 and '92, was paid by anyone else?

A No, just our personal funds.

MR. SHIPLEY: Thank you. We submit that as the testimony of Loryn Lindsey, Your Honors.

JUDGE JOHNSON: Franchise Tax Board, do you have any questions?

MS. WOODRUFF: I also do not have any questions.

JUDGE JOHNSON: Thank you.

Proceed with your argument. Please make sure you have the microphone close to you, if you can.

OPENING STATEMENT

MR. SHIPLEY: The argument, Your Honor, this case is a case that got off to, kind of, an unusual start. And that is when this one -- a single check written several years after all these improvements were made was detected by the auditor and/or the Hearing Officer.

And for some reason, because Dr. Lindsey put the words "M.D." next to his name and because the account was located at the same address where he had his business, not unrealistic I would say, concluded that might be a payment made by the corporation rather than by Dr. Lindsey personally that, we believe, was incorrect. And Dr. Lindsey has so testified that check was not a corporate check.

In addition, the fact that it was dated several years later, it was not made payable to either of the two people involved in this case. That is, not to the architect and not to the contractor, Young and Burton. And it is several days -- several years later. And it on its face appears to be a check for something other than improvements. It appears to be a pool repair job.

But that, I think, was the genesis of this notion that the Lindseys did not pay all of the -- pay for all the improvements that we request be recognized, that they did not pay them with personal funds. So there is no question in this case that a massive amount of improvements were made.

We have exhibits here that will clearly demonstrate that there were improvements made. The two individuals in charge of making those improvements say they were made and say they were paid for by them. And both mention Dr. and Mrs. Lindsey by name when saying who paid for it.

So I don't believe the Franchise Tax Board is arguing that there were -- that these improvements were not made, and I don't believe that they're arguing that the people who made the improvements were not paid. The argument seems to be the prominence of the funds were used to pay these two people.

And I think it's pretty clear in this case, although, the evidence is not as terrific as a box of canceled checks would be, I think the evidence here establishes sufficiently that these expenditures were made by the Lindseys utilizing personal funds. In addition to Dr. Lindsey's dispute regarding this one particular check, there are other things that we believe support this notion that the Lindseys paid for these with their personal funds.

At one time, according to Exhibit Number 4 -- that's in the hearing Exhibit Number 4 -- the Hearing Officer speaks of a $750,000 loan that was obtained by Dr. Lindsey and his wife from a private lender, and Dr. Lindsey's declaration acknowledges that. And taking on a $750,000 in debt is -- seems inconsistent with the notions that somebody else is paying for all these improvements.

In addition, our Exhibit Number 12, which reflects recorded loan records, shows how the recorded debt -- the Lindseys recorded debt grew from $900,000 in late 1990s to $1,675,000 by early 1993, a huge increase in their recorded personal loan liability. You combine that with their $750,000 of unrecorded personal debt, you can see that there's a huge increase in personal debt at the same time that these improvements had to be paid for. And Dr. Lindsey in his declaration testifies that those were the source of his payments to the architect and to the building contractor.

There's another letter -- there's an addition, Hearing Exhibit Number 10, which is a letter that the building contractor wrote to the Franchise Tax Board Counsel. And he wrote under the penalties of perjury that all payments to the Young and Burton, Incorporated, were made by the clients, David and Loryn Lindsey.

Mr. Burton also provided, at Exhibit 8, a job-cost analysis which basis a total cost and money received for these improvements during 1991 and '92 at $1,586,816. And it further states, in his handwritten notation, that the monies were received from David and Loryn Lindsey for that work.

And in addition, Dr. Lindsey and I just discussed Exhibit Number 23, which is a letter to Dr. Lindsey from the architect trying to respond to Dr. Lindsey's concerns. The letter recites about the fees that he's being charged. Obviously or hopefully, we believe the panel will conclude that if Dr. Lindsey was not using his personal funds to pay for these improvements, he wouldn't have any concerns.

Thank you.

JUDGE JOHNSON: Thank you.

Franchise Tax Board, you have 30 minutes if you're ready.

MS. WOODRUFF: Great thank you.

OPENING STATEMENT

MS. WOODRUFF: Good morning, Judge Johnson, Judge Gast, and Judge Tay.

The only remaining issue in this case is how much gain the Appellants must recognize from the 2003 sale of their Lafayette home. Appellants concede all but approximately $1.6 million, which they claim to have spent on capital improvements to the home. The facts of this case, however, cannot support any reductions to the gain for two main reasons.

First, Appellant sold a one-half interest in their home twice. They sold one half of the residence in 1996 for approximately $1 million, and then they sold the entire residence, 100 percent of it, in 2003 for $3.6

million. They applied one half of the basis to the sale in 1996, which is why they argue they had no gain to recognize in that year.

And as a result, they may only apply the remaining one half of the basis in 2003 when they sold the entire property, which would amount to $1.4 million. Respondent has already allowed nearly that amount or $1.26 million of basis, and Appellants are not entitled to additional increases.

Second, Appellants have not substantiated their claimed home-improvement costs. They have been unable to prove both the actual amounts, and that they actually paid for these amounts with personal funds rather than from corporate funds or from some other source.

This case was deferred several times pending the taxpayers' federal audit and tax court proceedings that related to their involvement in the tax-avoidance scheme. Respondent originally intended to take the result of that federal proceeding into account in this case. However, they appear to have settled that matter with the IRS. And so, unfortunately, the U.S. tax court proceeding doesn't shed any light on the outcome of this appeal.

Appellants purchased the Lafayette residence in 1990 for $1.2 million. They performed improvements to the home in 1990 and -- excuse me -- 1991 and 1992. However, they acknowledge they don't know the precise amount of the expenses that they incurred in the remodel. In 1996 Appellants sold a one-half interest in the residence to Marbel Holdings, Incorporated, which is a Nevada corporation.

The Nevada corporation was owned by an offshore entity as part of their overall tax-planning scheme. The IRS later audited and assessed Appellants for their involvement in the entire structure, which involved an income-factoring arrangement through the use of offshore entities.

Even though the Appellants sold one half of the property in 1996 for $1.5 million, they recognize no gain at that time because they applied one half of their claimed basis to that sale. They argue that their total basis in the home was approximately $2.8 million. So after applying one half of the basis of $1.4 million, the 1996 sale actually resulted in a loss.

I want to note that the total basis claimed by Appellants of $2.8 million includes the claimed home-improvement expenses that they are claiming today, and it is not in addition to those expenses.

Under the terms of the 1996 sales agreement, Marbel paid the Appellants a down payment of $23,000 and then issued a promissory note for the remaining amount.

Marbel began making payments of principal and interest to Appellants in 1997. Neither Appellants nor Marbel ever reported any instrument reflecting the sale. However, Appellants did receive payments under that note.

When Appellants sold the property in 2003, they sold the entire interest, 100 percent of the residence for $3.6 million. Now, Appellants' attempt to argue that they actually only sold one half of the residence in 2003 and, therefore, must only recognize one half of the sales proceeds. However, this argument just defies the facts.

First, Appellants were the only parties with legal title, and they represented themselves as the sole owners of the Lafayette residence. Second, Appellants received all of the sale proceeds. There's no evidence that Marbel received any of the proceeds. And the loans discharged at the time of the sale were Appellants' loans.

So Appellants' attempts to argue that, actually, Marbel was liable for one half of the mortgage indebtedness, but there is simply no evidence that Marbel was ever named as a borrower or otherwise named in the loan instruments. So no documents reflect an agreement by Marbel to take on Appellants' personal debts. Appellants received all of the economic benefit from the 2003. And there is no evidence that Marbel or any other party may be treated as the seller of the home.

So the overall result of these transactions is as if Appellants sold one half of their residence twice. The correct income tax treatment would be to only allow the basis that was not already applied to the 1996 sale in 2003. So their available basis would be approximately $1.4 million, if we accepted all of their claimed cost.

Respondent has already allowed the entire amount of the original purchase price of $1.2 million, plus additional capital expenses of approximately $60,000, and the entire amount of selling expenses of over $200,000. Appellants cannot treat the sale as if they sold only one half of the home in order to reduce the amount of gain, when they actually sold the entire residence in 2003.

In addition to the problems with Appellants' arguments regarding the sale of the home, Appellants may not inflate their 2003 basis in their home using the Cohan Rule. They claim to have spent $1.58 million on remolding their home. And that's based on a project-cost estimate provided by Appellants' contractor.

However, they cannot show with contemporaneous documentation that they actually incurred or paid for those costs from personal funds. They have been able to show that they paid approximately $60,000 in remodeling costs, and so Respondent has allowed that entire amount.

Although, Appellants made improvements to their home, this is case is not one where a simple estimation may be allowed under the Cohan Rule. Because Appellants have not only failed to prove the amount of the cost, they failed to show that they actually paid those costs. They have mainly rely on a few pieces of evidence to support their claims of having spent over $1.5 million on the remodel; and those are Young and Burton's job-cost analysis detail showing a projected job-cost estimate, a handwritten schedule of payments allegedly made to the contractor, a statement from the contractor attesting that he did perform work on Appellants' home, a 1991 permit for improvements to the residence, and a 1995 private-appraisal report valuing the residence at $2.8 million.

The main problem with all of these documents is that they don't show the actual costs incurred within the remodel. And, importantly, they do not show that Appellants paid those costs from personal funds. So while the contractor, Mr. Burton, has stated that he performed the work and that he was paid by the Appellants, he has no record to show the actual amounts he received. And he even concedes that any statement about the costs or payments would only be a guess. And that's in Exhibit W of Respondent's exhibits.

While the permit shows that Appellants did do some remodeling to their home, Appellants reported the value of the construction at $266,000 on that permit and not the $1.5 million that they now claim. That's in Exhibit X4, which is also included in your packet of exhibits. The appraisal report does not reflect the costs that Appellants expended on improving the home. An appraisal will only show the value of the home at the time that it was performed in 996. You can see that in L1, page 3.

Value is distinct from basis, which is the cost to the Appellants to acquire and improve their home. It's also interesting to note that the appraisal values the property in $2.8 million, which is exactly the amount of basis that they claim to have had in the home in 1996 at the time of the first sale. So, again, they cannot claim that entire amount of basis again in 2003. None of these documents show that Appellants paid for the remodel from personal funds.

In fact, Appellants' handwritten ledger reflects that at least some portion of the payments were paid from Appellant's medical corporation. For example, on page 4 of Exhibit Y you see several handwritten notations next to expenses stating, "From David's corp," or "from corporate."

When you consider the fact that Appellants have established a practice of setting up offshore entities to pay large portions of their personal expenses, the notations in the handwritten ledgers deserve additional attention. Furthermore, we know that Marbel paid for many of the expenses related to the home beginning in 1996. The company made mortgage payments, but it also paid for homeowners insurance, property tax, and any and all expenses related to the home as well as Appellants' personal expenses.

You can see Exhibits F3, K3, S3, and Q4, also included in your packet, for some examples of the kinds of expenses that Marbel paid for. Appellants made claims to Marbel for repayment of electrical cost, pool building, concrete, hardwood flooring, carpets, and many more costs. Marbel even made payments for Appellants' children's college tuition, which indicates that Appellants did not adhere to very strict limits on how and when Marbel could reimburse them.

Contrary to Appellants' argument that the Marbel transactions occurred long after their construction to the home, we can see from the evidence that in some instances Marbel did pay for expenses from prior years. Also Appellants maintain that some portions of the loan secured by the home were used to pay for construction. However, after the sale in 1996, Marbel made payments toward those loans. So Marbel paid directly and indirectly for many expenses of the home, including the construction costs that Appellants are trying to claim should increase their basis.

Of course, if payments from the home remodel actually came from Marbel or from some other company, Appellants may not personally increase their basis in the home. As I mentioned, the IRS did audit Appellants and concluded that they engaged in a tax shelter. Appellants appear to have reached a confidential settlement of the matter, and so, unfortunately, the outcome of that federal proceeding does not have any bearing on the amount of Appellants' 2003 gain for California purposes.

The evidence here reflects that Appellants sold one half of their residence twice; first in the 1996 sale, and again when they sold the entire home in 2003. They applied one half of their basis in the first sale, which reduced their available basis in the second sale. They attempt to argue that the second sale was really only a sale of a one-half interest, but all the documents, including the sale of purchase agreements and deed records, reflect that they sold the home as the legal owners of 100 percent of the property in 2003.

Their debts were discharged in 2000 -- as part of that 2003 sale. And the entire amount realized from the sale is attributable to them, rather than to Marbel holdings. Furthermore, Appellants have failed to substantiate their claimed expenses and have failed to show that they personally paid the costs related to their home improvements. Appellants' appeal should be denied.

Thank you. And I'm happy to take any questions you may have.

JUDGE JOHNSON: Thank you. Let's do A 10-minute rebuttal for Appellants now, if they're ready.

CLOSING STATEMENT

MR. SHIPLEY: Yes. The first thing is the sale to Marbel. That has been admitted by the Franchise Tax Board, and it's well documented that there was a sale to Marbel in 1996 and that Marbel and the Lindseys became cotenants. And agreement -- there was an agreement as cotenants that each would pay half of the expenses, including payments due on the outstanding mortgages.

But at the conclusion of that transaction, Marbel owned one half of the residence with the Appellants owning the other half. The next step in that process was that each paid their one half share of what was owed for repairs, some improvements, and the mortgage liabilities. Then in 2003, when it became time to sell the residence, the Lindseys sold their half. And as part of the process and behalf of Marbel, the co-owner, sold Marbel's half.

They didn't sell the -- the Lindseys did not sell their half of their property twice. They sold half of their property once to Marbel and then, subsequently, sold their remaining half, and on behalf of Marbel, sold Marbel's half in 2003. So the notion that their basis, which remained after the 1996 sale to Marbel, should be the same basis that applies to the combined sale of both halves is ludicrous. They only owned half the property.

They were the only person on the title. It doesn't mean they were not the owner. They were the owner of half the property, and that's how it was treated. They reduced their basis by half in 1996 when they sold half to Marbel. That dropped their basis in their remaining one half down to 1.2 -- roughly $1.4 million. When they subsequently sold both halves, theirs and Marbel's, they utilized that $1.4 million to offset their share of the amount realized. And their share of the amount realized was the one half of the entire amount realized in the 2003 transaction.

In discussion of the Internal Revenue Service case, I hope the panel will reject it in its entirety. In that case, the Internal Revenue Service had agents working on a -- what they viewed as a very sophisticated scheme. Once the audit was completed and the case reached the hands of attorneys that were going to have to try the case for the Internal Revenue Service, the Service conceded the entire case of all the tax, all the penalties.

The conclusions of the Revenue agent were simply rejected. And it was not, like, a secret sale or anything. It was a full concession. The Franchise Tax Board has requested copies of the settlement agreement. There wasn't any settlement agreement. If you get a full concession, that's the end of it. And the position taken in this lengthy audit just disappeared. It was rejected by their own legal staff.

So there isn't any -- there isn't any question that after the one-half interest was sold to Marbel, that Marbel did contribute to improvements after they became a half owner. They were required to. However, we're not asking for the basis to be increased by those -- any of those payments. All we're asking for is that the basis be increased by the improvements made in 1991 and 1992.

And there's no question, for example, the Counsel -- Respondent's Counsel suggests that there's just -- there isn't any -- you don't have any evidence of how much was paid to this giant of improvement work done by Young and Burton. Well, that's not the case. Exhibit Number 8 that we have submitted -- and also oddly enough, I think, it was submitted by Respondent -- as Mr. Burton's notation that, "This is what the job cost, and this what we were paid by Mr. and Mrs. Lindsey."

He also has sent a letter to a Franchise Tax Board counsel, that's Exhibit Number 10, that the full -- the payment was made by the Lindseys. So the fact that there was some guesswork involved and how much was paid and by whom is not correct. There isn't anything untoward about the sale to Marbel, which has been admitted by Respondent.

The way it had to be handled was the way it was handled. Okay. The Lindseys sold half. They can only retain one half of their original basis. And when they sold their half and Marbel's half in 2003, they had to split the amount realized. They allocated themselves half the amount realized and Marbel the other half. Now, Marbel was under a separate requirement to pay some of its indebtedness to the Lindseys.

And so when it came, it had to give some of the amount it realized in order to satisfy that obligation. But that doesn't change the amount Marbel realized, and it certainly doesn't change the amount that the Lindseys realized. Amount realized is a legal term, and that is exactly what they received. And that's called a handled transaction. And it's in a -- a supplemental amount of the brief makes the calculation of how the gain should be reached.

There needs to be some tinkering with it because Respondent has graciously given Appellants a few additional improvements and that sort of thing. And I think the closing costs are a little bit different, but the treatment is described in that supplemental brief. We command it to the panel.

Thank you.

JUDGE JOHNSON: Thank you.

Let me turn now to see if my co-panelists have any questions.

Judge Tay?

JUDGE TAY: No questions.

JUDGE JOHNSON: And Judge Gast?

JUDGE GAST: No questions.

JUDGE JOHNSON: Okay. I may have a few questions just for clarification. I'll start on that last part that you were talking about, Appellants. This is the question of did the sale proceeds go to Marbel, and FTB said that 100 percent of the proceeds went to Appellants or paid off to satisfy their liabilities and debts.

At the end you mentioned that there might be a separate requirement of Marbel to satisfy obligations to the Lindseys. Can you explain that further and point to any exhibits that kind of justify that statement?

MR. SHIPLEY: Let's see. The -- there is an exhibit not in -- we have not submitted it. I think it might be among the exhibits Respondent has provided. I'm not sure. But in the record, there is a provision of how the sales receipts will be distributed, and a certain amount goes back -- I think it's $23,000 -- goes back to Marbel off the top.

And then a certain number -- I think it's the -- slightly over a million as I recall goes to the Lindseys. And my recollection is the rest is the excess. It is divided equally between the cotenants. I believe that's it.

JUDGE JOHNSON: Okay. Franchise Tax Board, does that exhibit sound familiar, or do those numbers sound familiar?

MS. WOODRUFF: I believe that may have been in the promissory note or the deed of trust with the promissory note. But I think what's --

MR. SHIPLEY: I'm not so sure it's in there.

MS. WOODRUFF: What's important to note from that is -- so if the documents required that Marbel receive $23,000 from the sale, I don't believe that Marbel did receive $23,000. Or there hasn't been any evidence that shows that Marbel received anything from the sale.

JUDGE JOHNSON: Okay. Appellants, are there any documents that show that Marbel did receive its 50 percent portion or -- with some adjustments perhaps, and that was maybe allocated to any outstanding debts they owed to the Lindseys, any post-sale documents that are concurrent with the sale?

MR. SHIPLEY: I'm not sure -- I'm not sure there are such items. I don't think it makes any difference. The amount realized is the amount realized. And a separate agreement to -- on the distribution -- it would ordinarily be called profit of the sale -- had nothing to do with amount realized.

Amount realized is defined by Internal Revenue Code. And if you have an obligation to pay part of that -- what we call profit -- after you receive it, then it doesn't change the amount that you realized. Your amount realize stays the same. It's just a difference between, you know, your adjusted basis and the sale price, period.

What happens then to those proceeds is, of course, of interest to the co-owners, but it doesn't change. It doesn't have any effect on their amount realized.

JUDGE JOHNSON: Let me stay on that topic but go to Franchise Tax Board. Looking back at the 1996 year with the sale to Marbel of 50 percent ownership and then coming to the 2003 sale, and maybe the difficulty might be because 1996 tax year, I don't think, was audited or maybe it was outside statute of limitations by the time this issue came up and this audit began.

But, I guess, walk me through how it's possible for the Lindseys to have sold 50 percent and then later to have sold 100 percent interest.

MS. WOODRUFF: Right. So I think that if this were an ordinary sale or an ordinary series of transactions, it wouldn't be possible because you would sell one half of your home, and you would only have -- you would only retain one half to sell later. But this wasn't ordinary. They didn't actually transfer anything in the first sale other than, you know, they signed the promissory note.

So there was no legal title that ever transferred. So when they actually went to sell the home in 2003, they still had the legal right to sell the home. In fact, they received the economic benefit of both sales. So they received, you know, the down payment in 1996 and then payments on the promissory note. And then in 2003 they received the benefit of, you know, the $3.6 million. And I think all of those sales proceeds went to them or to pay off their debts.

JUDGE JOHNSON: Okay. Judge Tay.

JUDGE TAY: Just to clarify, you're saying that the Lindseys received $5 billion over the course of -- from between the 1996 and 2003 sale?

MS. WOODRUFF: Well, I'm not entirely sure of how many payments on the promissory note that they ultimately received because I don't think we have documentation to show how much they receive in the end. But, yes, I mean they essentially received the economic benefit of, I guess, $1 million plus the $3.6 million, so $4.6 in -- over the course of both sales.

JUDGE TAY: If they were able to show that they were only -- they were only able to receive the $3 million or $3.5 million or so, would that change?

MS. WOODRUFF: I don't think so because there was a promissory note that in theory they could have enforced. So even if they didn't receive all of it, they still received the benefit that -- economic benefit of 1.5 -- whatever -- $1.5 million in the first sale.

JUDGE TAY: Although, taxpayers are claiming or stating that the proceeds of the sale from 2003 were in satisfaction of that promissory note?

MS. WOODRUFF: Right. And we don't have -- again, there's no evidence. There's no evidence of that. So we really have no way to know how much debt was outstanding or if there was any.

JUDGE TAY: Okay.

JUDGE JOHNSON: I think the promissory note was 30 years with 7 percent interest. Does that sound correct, the promissory note terms? But anyway, do Appellants know how much was paid on that promissory note? Was it at the standard rate? So it's about one-third paid off?

MR. SHIPLEY: There is a list. One of the exhibits we came across is actually filed by the Respondent. It was some sort of scheduling of repayments. I don't know whether it was a schedule or whether it was something, you know, listed what had actually taken place.

JUDGE JOHNSON: Okay. Thank you.

MR. SHIPLEY: I don't recall if there is a document also previously filed by Respondent that sets forth what is to happen, how the cotenants handle any of the proceeds from the sale. There's a separate document that sets that up forth. I believe it's been filed. It may even be among the exhibits that have been provided to this panel.

If not, Appellants can locate it and provide it to the panel and to Respondent if it's of interest to the panel. From our perspective, it doesn't make any difference of what that arrangement was. The arrangement set forth -- and there's a deed and promissory note and all that -- was that half of the property -- Marbel became the owner of half the property.

The Lindseys were the owners that retained one half of their property, and of course, it reduced their basis in their one half by half. And in 2003, both halves were sold. Of course, the Lindseys, since they were the only name on the title -- recorded title, had to conduct the sale on behalf of -- for their half and behalf of the cotenant. And that's how that -- how that took place.

JUDGE JOHNSON: And, Appellants, just to clarify maybe my final question here. When you look at the sale proceeds and you look at the adjusted basis, you're taking half of both of those to apply to Appellants; is that correct? Half the sales price and also half of the adjusted basis?

MR. SHIPLEY: Yes, except for a few, you know, seller expenses, that sort of thing.

JUDGE JOHNSON: Okay. Thank you.

And Franchise Tax Board, you're looking at the full sales price as it applies to Appellants, and you're giving them the full basis, but you're only giving about $61,000 in improvements --

MS. WOODRUFF: That's correct.

JUDGE JOHNSON: -- on top of the $1.2 purchase price?

MS. WOODRUFF: Right. And the entire amount of the selling expenses.

JUDGE JOHNSON: Okay. I think that's my last question. Any questions, Judge Gast?

JUDGE GAST: Yes, actually one question. If it's relevant or not, you tell me. But just so I'm clear, who owned Marbel? I hear it's an offshore entity.

MR. SHIPLEY: I believe it was linked to an offshore entity.

JUDGE GAST: Was it a third party entirely?

MR. SHIPLEY: I don't know, but it was -- there was a linkage between -- Marbel wasn't just stand-alone. It was connected to -- maybe not directly but indirectly to someone off -- an entity offshore. And according to the IRS agent, there were just a whole network of offshore entities that were doing these, what the agent regarded as shenanigans.

We haven't pursued in this case what the linkage was with Marbel. The Revenue agent's belief was that every dime that Marbel contributed was actually Dr. Lindsey's. And that was their position until it became clear to them that it was something -- they were offshore.

JUDGE GAST: Thank you.

JUDGE JOHNSON: Final questions, Judge Tay?

JUDGE TAY: No. Thank you.

MR. PEREZ: On that point, may I say something?

JUDGE JOHNSON: Yes, please.

MR. PEREZ: I want to point out something in the record in Exhibit U, to show that there was nothing untoward about Marbel from the standpoint of the taxpayer or his representatives. It wasn't a -- all of the planning that was done was legal. And at that time offshore planning was legal and proper until a certain point after all of this happened. And I point to Exhibit U where I'm providing everything the agent wanted.

And I provided, you know, on October 19, 2007, as set forth in Exhibit U, a copy of the agreement of purchase and sale between the Lindseys, sellers, and Marbel Holdings, Inc., purchaser. So I'm pointing that out in the record that there's nothing untoward from the standpoint of the clients and even of the law. Because at that point, there were a lot of offshore permissible and legal until a certain point, but that came afterwards.

JUDGE JOHNSON: Thank you.

Unless there's any further questions, I believe we've come to the end. We have the evidence that's been submitted and admitted into the record. We have the arguments and your briefs as well as oral arguments and testimony of today. Now, we have a complete record from which to base our decision.

Are there any final questions from either party before we close the record? Hearing none.

I want to thank both parties on their efforts on appeal. This oral hearing has been very helpful to us. The record is now closed. This concludes the hearing on this appeal. The parties should expect a written decision no later than 100 days from today, October 28th, 2019.

With that, we're now off the record.

(Proceedings adjourned at 11:44 a.m.)

HEARING REPORTER'S CERTIFICATE

I, Ernalyn M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 6th day of November, 2019.

____
ERNALYN M. ALONZO
HEARING REPORTER