BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	
HUA QING ENTERPRISE LLC,	OTA NO. 18053084
APPELLANT.	

TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Tuesday, August 18, 2020

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Proceedings, taken at 12900 Park Plaza Dr., Suite 300, Cerritos, California, 91401, commencing at 1:00 p.m. and concluding at 2:22 p.m. on Tuesday, August 18, 2020, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ ANDREA LONG
Panel Members:	ALJ KENNY GAST ALJ JOHN JOHNSON
For the Appellant:	JENNY WANG
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD VERONICA LONG DAVID GEMMINGEN

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-6 were received at page 6.)

(Department's Exhibits A-P were received at page 6.)

OPENING STATEMENT

PRESENTATION

REBUTTAL STATEMENT

Cerritos, California; Tuesday, August 18, 2020

1:00 p.m.

JUDGE ANDREA LONG: We're now going on the record.

Good afternoon. I'm judge Andrea Long. We're here today for the consolidated appeals of Hua Qing Enterprise, LLC, and Siu Hei Lau. And the OTA Case Numbers are 18053084 and 18073451. Today is Tuesday, August 18th at 2020, and it's approximately 1:00 o'clock p.m.

This appeal was intended to be heard in Cerritos, California with me today is Judge Kenny Gast and Judge John Johnson. I'm the lead ALJ, meaning I will be conducting the proceedings, but my co-panelists and I are equal participants. We will all be reviewing the evidence, asking questions, and reaching a determination in this case.

We will begin with the parties stating their names and who they represent for the record. Please, we'll start with Ms. Wang.

MS. WANG: This is Jenny Wang representing Appellant Hua Qing Enterprise, LLC., and its single member Mr. Siu Hei Lau.

JUDGE ANDREA LONG: Okay. And for FTB?

MR. GEMMINGEN: This is David Gemmingen with the Franchise Tax Board, Tax Counsel.

MS. VERONICA LONG: This is Veronica Long, Franchise Tax Board, Tax Counsel.

JUDGE ANDREA LONG: Thank you. The parties have agreed that the issue before us today is whether Hua Qing Enterprise, LLC, acquired replacement property in the like kind exchange pursuant to IRC Section 1031 with the requisite intent to hold the property for investment or for use in a trade or business.

With respect to the exhibits pursuant to the July 30th, 2020 minutes and orders we admitted Exhibits 1 through 6 for Appellant and Exhibits A through P for FTB. These exhibits were admitted without objections, and the parties have not provided any additional exhibits at the hearing today.

(Appellant's Exhibits 1-6 were received in evidence by the administrative Law Judge.)

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

So we will begin with Ms. Wang's opening statements. You'll have up to ten minutes. You may begin whenever you're ready.

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OPENING STATEMENT

MS. WANG: This is Jenny Wang. Thank you, Your Honor.

As stated, the issue in this case is whether Hua Qing Enterprise, LLC, acquired replacement property in a like kind exchange with a requisite intent to hold the property for investment. Section 1031 generally provide that no gain or loss is recognized on the exchange of real property held for investment if such real property is exchanged solely for real property of like kind, and which continues to be held for investment purposes.

There is, however, an exception for real property held for sale. The key question that I would like to raise today is, how far are we supposed take an interpretation an application of this exception to the general rule. For purposes of this hearing, I will refer to Hua Qing Enterprise, LLC, as HQE. From time to time and refer to HQE and a single member, Mr. Siu Hei Lau, collectively as Appellant. Finally, I will refer to Millennium Diamond Road Partners, LLC, as Millennium.

This afternoon I will be discussing the facts in Appellant's case in detail. We must closely scrutinize all relevant facts because a determination of whether an exchange qualifies under 1031 is fundamentally based on the set of facts and circumstances, both leading up to and

also subsequent to the specific transaction in this case.

Before we delve into the facts, it is imperative that we recognize the underlining policy behind Section 1031. The primary purpose of the statute providing for like kind exchanges of property is to allow taxpayers to continuously maintain investments and property. Profits or losses will not be recognized until a true realization event occurs. Transactions that represent a continuation of a taxpayer's investment intent are, therefore, exempted from taxation until a future sales event takes place.

The rationale is that there is an inherent inequity in forcing a taxpayer to recognize a paper gain where funds are still tied up in a continuing investment. The key idea behind all of this is substance over form. Therefore, a taxpayer is allowed to move an investment from one form to another so long as that taxpayer stay invested in real property and does not cash out.

And gain is deferred during such period of continuous investment. When that investment ultimately ends in the form of a sale, at some point in the future, the taxpayer will then be subject to a recognition event. My presentation this afternoon will be divided into roughly three sections.

First, I will start out with a discussion of the

background facts supporting this case. I will highlight significant events that led to the purchase transaction at issue, including the nature of the five-parcel land, which was originally owned entirely by Millennium; the economic environment leading up HQE's purchase; and the financial circumstance that surrounded Millennium at the time of the purchased transaction.

Next, I will highlight the factors that contribute to HQE's decision to purchase property from Millennium. I will provide key facts and supporting documents evidencing HQE's intent to purchase and hold the property for investment purposes, as well as its continuous role as a passive investor.

I will conclude my presentation by discussing the specific set of factors that the courts have used and have applied in prior cases to determine whether a given transaction qualifies as a Section 1031 exchange. And I will apply these factors to the facts in our case.

At this point I would like to reserve any remaining time for my presentation. Thank you.

JUDGE ANDREA LONG: Thank you.

I'm going to ask the panel members, do you have any questions at this time? Judge Gast?

JUDGE GAST: This is Judge Gast. No questions. Thank you.

JUDGE ANDREA LONG: Judge Johnson?

JUDGE JOHNSON: Judge Johnson. No questions. Thank you.

JUDGE ANDREA LONG: My apologies my screen. Fixing my computer screen. Okay. We will next begin with -- have Ms. Long start with their opening statement.

You may begin whenever you're ready.

OPENING STATEMENT

MS. VERONICA LONG: All right. This is Veronica Long speaking.

At issue today is whether Appellant's acquisition of real property with the intended use of completing the property's development and selling individual lots for single-family residences as eligible replacement property under Internal Revenue Code Section 1031, which does not apply to property held primarily for sale.

Siu Hei Lau is the sole member of Hua Qing Enterprise, LLC. Hua Qing Enterprise was a single member LLC during taxable year 2010. And single member LLC are generally disregarded entities for tax purposes. I will refer to both Mr. Lau and HQE, LLC, collectively as Appellant.

Appellant has failed to comply with Internal Revenue Code Section 1031 exchange requirements and would

like to avoid paying tax on the sale of a $21.5 million commercial warehouse. Appellant never reported this large sale on its tax return. At audit, Appellant asserted it engaged in a like kind exchange under IRC Section 1031. Notably, Appellant's tax return did not report a like kind exchange and Appellant never filed a Form 8824 to report the exchange.

Internal Revenue Code Section 1031 permits taxpayers to avoid recognizing gain on the sale of property where the proceeds are reinvested in like kind replacement property. Only property held for productive use in a trade or business or for investment qualifies.

JUDGE ANDREA LONG: Ms. Long, I'm sorry to interrupt. Can you speak a little slower for Ms. Alonzo, please.

MS. VERONICA LONG: Of course.

JUDGE ANDREA LONG: Thank you.

MS. VERONICA LONG: Property that is held primarily for sale does not qualify as eligible replacement property for Internal Revenue Code Section 1031. Courts have consistently held that property purchased for subdivision, development, and sale is considered being held primarily for sale and does not qualify for Internal Revenue Code Section 1031.

This was demonstrated in the Black versus

Commissioner and Land Dynamics versus Commissioner cases discussed in our briefing. Appellant has the burden of establishing that it meets the requirement of acquiring eligible replacement property and has failed to do so. Appellant sold one property and invested the proceeds in two properties, only one of which was an eligible replacement property.

The issue in this case is that one of Appellant's property was part of a planned subdivision, which documentation clearly shows was being held primarily for sale. Not only has Appellant failed to demonstrate this property was held for investment, but the contemporaneous documentation from Appellant's purchase of the property clearly demonstrates that Appellant was aware of the planned subdivision, intended to continue the course of subdivision, and development and planned to hold the resulting residential loss out for sale.

Further, every action taken by Appellant subsequent to its purchase of the planned subdivision confirms its intent to develop and sell the lots. Appellant paid for development cost, and we will show you invoices and payment. Appellant had catalogs printed marketing the development as individual lots for sale. The cover of this catalog listed Appellant as a developer.

My plan today is to go over the applicable law,

go through the contemporaneous facts and circumstances of this attempted exchange during the 2009 and 2010, and to address the Appellant's assertions.

You're welcome to stop me at any time if you have questions. Thank you.

JUDGE ANDREA LONG: Thank you, Ms. Long.

Judge Gast, do you have any questions at this point?

Judge Gast: This is Judge Gast. No questions.

JUDGE ANDREA LONG: Judge Johnson?

JUDGE JOHNSON: This is judge Johnson. No questions. Thank you.

JUDGE ANDREA LONG: Okay. We will continue on with our presentation of arguments. Ms. Wang, you will now have 30 minutes to present your arguments. Please begin whenever you're ready.

PRESENTATION

MS. WANG: This is Jenny Wang. Thank you, Your Honor.

In addition to Exhibits 1 through 6, which I have submitted and have been admitted for purposes of this hearing, I will also be relying on exhibits submitted by the FTB and also admitted for purposes of this hearing.

During 2009, Millennium owned five parcels of

land located in an area of Diamond Bar -- in the city of Diamond Bar, commonly referred to as the "Country Estates" or simply "The Country". The land was secured by a deed of trust, and Millennium had an outstanding loan balance of $15.2 million plus interest with its lender, Preferred Bank.

On September 3rd, 2009, Millennium was facing a risk of default on making payments to Preferred Bank. I would like to point to Exhibit 1, which is the Notice of Foreclosure issued by Preferred Bank to Millennium. Page 1 of the notice shows the total outstanding balance owed to the bank of $15.8 million. Because Millennium is behind on its payments, the notice represents intent by Preferred Bank to exercise its right to sell the land if Millennium is unable to continue to make its payments.

I would also look to refer to Exhibit M, which is an appraisal report dated November 30th, 2009. According to page 2 of that report, it was prepared on the five parcels of land in order for Preferred Bank to make a collateral evaluation, presumably in preparation to foreclose on the property. This makes sense since page 76 of the report provided for an estimate of the aggregate of retail values of the land.

And it is the parties to the financing, such as Preferred Bank in our case, that typically request from

the appraiser the aggregate retail value. I want to also note that there is a distinct difference between a definition of aggregate retail value versus market value. This is because the market detached single-family houses very different from the market for large tracks of undeveloped land.

Whereas, an appraisal report such as Exhibit M is typically prepared upon a request by the lender in a foreclosure process and focuses on aggregate retail value, other appraisal reports prepared for purposes of immediate or contemplated sales would focus on market value. According to page 31 of the report, Millennium had spent the previous 12 years assembling the five large parcels, all of which were in raw condition as of the 2009 appraisal report date.

According to page 33 of the report, at that time, Millennium was still submitting documents for the city's approval, including providing the city with a colored tract map to help the city visualize what the area could look like. Notably, starting on page 50 of the report, there was a discussion of the declining value trend of existing property within the country, between January 2008 through the date of the appraisal report.

In fact, between May 2009 and November 2009, the decline was evidenced by an even steeper downward trend

representing drastic negative 10.93 percent decrease in value over a short six-month period. While this decline specifically measures the value of properties within the country, the appraisal report went on to state that similar declines can be seen in several other market segments.

This data confirms what we all know and remember from 2008. The housing and financial crisis had hit the U.S. and abroad. Page 52 of the report went onto discuss value trends for vacant lots in the country. The report unequivocally stated that there has been a lack of sales over the previous 23 months; that the majority of vacant lots that have been listed for sale have not sold; and that the sales rate for the country represents a slow sales rate.

Given these facts, a reasonable buyer would not purchase vacant land with the intent of immediately selling it. Millennium was able to avoid eminent foreclosure when HQE acquired three of the five parcels. Thereby, providing the requisite funds for Millennium to resume making payments to Preferred Bank.

Turning our attention now to Appellant's purchase transaction. HQE was formed on July 13th, 2007. At that time, it held one piece of property, a commercial warehouse for leasing. On February 3rd, 2010, HQE

relinquished the commercial property and replaced it with two properties. One of the two properties was three of the five parcels herein after referred to as the "Diamond Bar property".

The focus of our case is on the purchase of the Diamond Bar property. The purchase transaction itself can be summarized as follows: Appellant entered into a loan agreement with and issued a promissory note to Preferred Bank in the amount of $7.6 million, which represented one half of the outstanding loan balance owed to the bank by Millennium.

Concurrently, HQE entered into a purchase agreement to purchase three parcels from Millennium. Escrow closed on HQE's purchase of the land on May 7th, 2010. I will like to emphasize that there is no evidence of any marketing activities contemplated by HQE at the time of the purchase. Exhibit A and Exhibit B are the original amended purchase agreements, both of which were fully executed prior to escrow closing on the Diamond Bar property.

Attached at the end of agreements are several different tract maps of the Diamond Bar property. One map shown is dated as far as back 1993, and another is dated 1999. Also attached is a map of the five-parcel land which, according to the purchase agreement, is divisible

but was not actually divided at the time of the purchase. While the map was included to present to Appellant an idea of the land's investment potential, the land was undisputedly in raw form and not intended for resale at the time of the purchase.

Prior case law emphasized that acquisition of land for future development does not automatically reflect that the land is held for sale. Furthermore, the proximity of the land to readily available nearby attractions and facilities directly affect an investor's expected value of the land itself.

I would like to turn once again to Exhibit M. Page 27 of the report states that the raw land is located within a gated community that offers a wide range of attractive amenities, including a natural wilderness park, community swimming pool, clubhouse, tennis court, and equestrian facilities with miles of equestrian trails. All of these existing facilities provide HQE with the confidence to invest in the land over a long-term period, during a severe global financial crisis at the time of the purchased transaction.

HQE's intent to enter into a 1031 exchange and hold the Diamond Bar property for investment purposes can also be supported by the following facts and circumstances. First, I would like to refer to page 1,

paragraph 1 of Exhibit B, which is the first amended purchase agreement. The terms of the agreement clearly stipulated that HQE as the buyer, quote, "Intends to acquire the property through a Section 1031 exchange and shall fully ensure the transaction complies with applicable laws and regulations."

Second, on page 20 of Exhibit L, which is the audit issue presentation sheet, FTB stated that, quote, "The numerous requirements of a Section 1031 exchange were met with the only remaining item being intent of the taxpayer at the time of the exchange." Page 3 of the AIPS stated that, "while Appellant failed to file Form 8824 with its 2010 return, FTB was able to reconcile.

Appellant's 2011 balance sheet and confirm that the amount of deferred gain computed by Appellant is substantially correct." While Appellant's failure to include a form, 8824 triggered an audit of its 2010 tax return. Appellant's actions, viewed as a whole, are evident of its intent to enter into a 1031 exchange.

Finally, HQE not only maintained its 2010 investment but further its investment in 2012 and 2013. In order to ensure that Millennium does not run into another risk of default and in order to preserve its existing investment, HQE modified its existing loan in March 2012. HQE later extended financing to Millennium in

September, October, and December of 2012.

Exhibit 2 is an e-mail correspondence between Grace Chung of Millennium and Jean Tong of HQE discussing the additional loan obtained by HQE to help resolve Millennium's liquidity issues. HQE then refinanced its loan with Preferred Bank several times during 2013 in order to continue to provide a source of financing to Millennium.

Exhibit L, page 3, of the AIPS provides for a timeline of the loan modifications and refinancing with the bank. What happened was that when Millennium encountered liquidity issues again in February 2012, Millennium briefly proposed putting together brochures to raise cash by soliciting advanced deposit payments from third parties. This initial proposal was nothing more than preliminary attempt by Millennium to raise money in order to keep up with its loan payment.

Exhibit 3 is an e-mail correspondence between Grace Chung and Jean Tong discussing Millennium's liquidity issues. Note that nothing in the brochure contain any requisite details necessary to effectuate an actual sale, for example, pricing or lot size. I must also point out that in 2012, just as in 2010, there were no individual lots that Millennium could have sold because all five parcels of land remained in raw condition; not

subdivided and not graded.

Note also that in the e-mail correspondence between Millennium and HQE, Millennium's central concern at the time was the issue of cash flow, as it is finding more difficult to obtain new bank loans to help pay its expenses. HQE's role as a passive investor is evident during several other occasions.

Exhibit P is an appeals case decided in 2017 over Millennium and HQE's right to the full use and enjoyment of the land. The case itself is wholly unrelated to the issue in our case. However, page 4 of that case in establishing the facts states, quote, "In 2010 Millennium conveyed three parcels to Appellant, but Millennium continued to managed predevelopment activities," end quote. This statement supports the fact that HQE is not actively involved in the management of the Diamond Bar property.

We can also turn to Exhibit O to distinguish HQE's passive role from Millennium's active management role. Exhibit O is an appraisal of the Diamond Bar property dated February 2012. Note on page 1, that in 2012 the land is still in raw condition two years after HQE's purchase. On page 7, the appraiser stated that while HQE partnered with Millennium, Preferred Bank instructed the appraiser to value the land as though

Millennium is the only borrower.

This supports the fact that HQE's role had been and continues to remain passive in nature, limited to providing a source of funds to keep Millennium financially viable. In addition, let us refer back to Exhibit K, the AIPS. Page 11 referred to HQE as only an occasional participant in progress meetings with progress updates reported to HQE. This is not unlike investors, who from time to time receive quarterly updates on the status of their investment.

In fact, FTB's opening brief stated that Preferred Bank also attended such meetings. The reason both HQE and Preferred Bank are interested in attending such meetings are the same. They have money tied up in the respective investments. In some, Appellant's role as a passive investor is well established.

We now turn to a discussion of the rules that have been applied in the analysis Section 1031 cases. The tax court in many prior cases have applied a set of Winthrop factors to determine whether a transaction was entitled to non-recognition treatment as follows:

One factor that courts look to is the purpose of the acquisition of the property and the holding period of the property. Note that the hold period has been recognized as the second most important factor under

consideration, where a very long holding period establishes investment intent.

As I mentioned earlier, the location of the subject property within the country along with preexisting facilities and amenities make the land an attractive investment for HQE. Thus, despite the economic downturn at the time, HQE expects the land to be a sound investment in the long run. Exhibit 4 is an appraisal of the Diamond Bar property dated September 4, 2015. Page 4 the appraisal stated that the land remains raw vacant land as of the 2015 appraisal report date. On page 5, the report stated that quote, "The most likely purchaser of the land would be an investor or developer."

At this point, we can make two concludes based on the above facts. First, after more than five years since HQE purchased the Diamond Bar property, the land remained essentially unchanged and in the same raw condition. Second, a professional appraiser maintains that the best use of the same piece of land in 2015 continues to be for investment purposes.

I would also like to turn back to Exhibit P, the Appeals Case. While it is a case that discusses in detail the disagreement arising from access rights and offers no insight on HQE's purchase intent, I would nevertheless; like to point out that page 4 of the case generally

referred to a purchaser of the subject property as a developer investor. In addition, to date, after holding the Diamond Bar property for more than a decade, HQE currently still owns all three parcels of land.

The second factor that courts look at is the extent of improvements made to the property and the number and frequency of sales over time. Note that frequency of sales has often been deemed the most important factor for courts to use and weigh. If we turn back to Exhibit P, on page 7 we will find that Millennium filed suit over access rights in March 2014. And according to page 9, trial commenced in March 2017, or over 7 years after HQE's purchase.

According to page 25, at the time of trial in 2017, Appellant had not obtained a grading permit nor made any sales to any purchasers. Note also that according to page 9, the process of grading is only part of pre-develop. As I mentioned extent of improvements and number and frequency of sales are key factors with frequency of sales as the most important factor in an analysis of 1031 cases.

Appellant clearly lacked the level of activity necessary to be viewed as making extensive improvements, because according to page 9, there were no improvements and no development activity on the property through the

end of March 2017.

I would also like to turn to Exhibit 6, which represents a 2019 map of the property and a 2019 tax bill. As of 2019, no grading and no improvement have been performed on the land other than subdivision. The 2019 property tax bill shows that Appellant remains the current owner of the Diamond Bar property and has not sold any part of the Diamond Bar property.

A third factor that the courts look to is the amount of advertising and promotion that has been performed. HQE has never had a sales office or enlisted any brokers because it had no intention to sell. Although Millennium in 2012 made a proposal in an effort to advance some money due to it its cash flow issues, Appellant met that need by modifying and refinancing its loans with the bank.

The fact that Millennium had already invested 12 years into the land prior to Appellant's purchase, and Appellant and Millennium have jointly owned the five-parcel land for more than ten years clearly show an intent for long-term investment.

Finally, courts also assess the nature of the taxpayer's business, including other activities and assets. HQE sole business when it was first formed was entirely passive in nature. Exhibit I represents HQE's

2010 California tax return, which consisted of $36,000 in rental income with a small remaining balance consisting of interest income.

HQE's lack of sales activity prior to acquiring the Diamond Bar property, and its lack of selling activity since purchasing the land, all support Appellant's long-term investment purpose. Only when HQE's investment in the Diamond Bar property ultimately ends in the form of a sale should Appellant then be subject to tax.

Thank you. At this time I'm ready to answer any questions.

JUDGE ANDREA LONG: Thank you.

Panel members, do you have any questions? Judge Gast?

JUDGE GAST: This is Judge Gast. I don't have any questions at this time. Thank you.

JUDGE ANDREA LONG: Thank you.

And Judge Johnson, do you have any questions?

JUDGE JOHNSON: This is Judge Johnson. No questions at this time. Thank you.

JUDGE ANDREA LONG: Thank you.

Let me just review my notes for a minute. I think I'm going to save my questions for now, and we'll continue on with FTB's presentation.

Ms. Long. You may begin whenever you're ready.

Thank you.

PRESENTATION

MS. VERONICA LONG: This is Veronica Long speaking.

On February 3rd, 2010, Appellant sold the commercial warehouse in Rancho Cucamonga, California for $21.5 million. To clarify a point, this property was relinquished in a like kind exchange and sold in 2010 and not 2009 as stated previously. Notably, Appellant's federal and state tax returns failed to report the sale of $21.5 million of -- $21.5 million commercial warehouse entirely. No Schedule D for the sale of the property or Form 8824 reporting the attempted like kind exchange was filed with the Franchise Tax Board.

Generally, the entire amount of gain or loss on the sale of property must be recognized in the year the property was sold. However, there was a narrow exception from gain recognition under Internal Revenue Code Section 1031 where properties of a like kind are exchanged. To qualify, all properties in the exchange must be held for productive use in a trade or business or for investment.

Appellant sought to qualify for non-recognition of gain on a sale of the commercial warehouse under this provision, IRC Section 1031, by investing its proceeds in

two properties. On February 11, 2010, Appellant purchased the first property, 3129 Windmill Drive. Respondent accepts this portion of the exchange was valid and allowed the non-recognition of gain from the warehouse sale the extent it was reinvested in the purchase of this replacement property.

However, on May 7th, 2010, Appellant made a second acquisition of three of the five parcels comprising of Diamond Road Development from Millennium Diamond Partners, that I will refer to as MDRP. These three parcels are the subject of our case today because they do not meet the requirements for a like kind exchange and, thus, to the extent Appellant reinvested proceeds from the sale of its commercial warehouse in the parcels, it must recognize the corresponding gain.

These three parcels cannot qualify for like kind exchange treatment because they were acquired with the intention to resell them as individual lots to the public. And, thus, are not eligible for Internal Revenue Code Section 1031 because the property must be held for productive use in a trade or business or for investment. Property held primarily for sale does not meet this requirement.

Courts have consistently held that property purchased for subdivision, development, and sale is

considered property held primarily for sale and does not qualify for Internal Revenue Code Section 1031. To be clear, a taxpayer does not have to be a real estate developer or dealer to hold property primarily for sale. Whether or not a taxpayer is a dealer in real property and, thus, whether the property is inventory in their hands, or a capital asset is a separate inquiry unrelated to our analysis today.

That is because holding property primarily for sale disqualifies a property from Internal Revenue Code Section 1031 regardless of whether the sale is in the ordinary course of the taxpayer's trade or business. Merely holding the property for sale, regardless of one's trade or business, is enough to exclude the property from 1031 treatment.

Whether a property is held primarily for sale or investment is determined at the time of the exchange. Appellant's attempt to introduce an appraisal from 2015 fails to address the appropriate testing period. And we should look to the documents created in 2009 and 2010 when the exchange transaction was undertaken. Thus, to determine the taxpayer's intent at the time of the exchange, we look to contemporaneous facts from the time of the exchange.

Contemporaneous facts, not self-serving

statements given years later are important in establishing intent. Objective facts not uncorroborated statements regarding subjective intent are used to determine a taxpayer's intent at the time of the exchange. Appellant has the burden of demonstrating that it had the intention to hold the Diamond Bar property for investment at the time Appellant purchased it.

Today we will walk through the fact and circumstances of these parcels before, during, and after Appellant's purchase. The evidence demonstrates that the parcels had long been undergoing development efforts when Appellant purchased them. The facts of Appellant's purchase demonstrated that it intended to continue the development efforts to subdivide these three parcels into 24 single-family residential lots.

I'd like to begin with a brief history of the development of these parcels. In the 1960s the parcels at issue in this appeal were part of a larger tract. That tract was divided into southern tract, which contain the parcels at issue here today, plus two others which are still owned by MDRP, and a northern tract adjacent to public streets. A southern tract was landlocked with only access at the northern tract. The northern was sold to Diamond Bar Develop, which subdivided the tract into home sites.

The original owner of both tracts, which continued to own the southern tract, kept access rights and an easement for road access through the northern tract which accessed the southern tract. The northern tract became the Diamond Bar Country Estate, the housing development which resulted in individual homes being sold to the public. The southern tract was eventually sold to MDRP in early 2000.

MDRP performed development work using the Diamond Bar Country Estate's roads and gatehouse. In 2005 MDRP sought development -- sought tentative tract approval for the subdivision and development of the parcels. In 2010 MDRP sold three of its five parcels to Appellant. To determine Appellant's intention at the time of the exchange, we look to contemporaneous facts from the time of the exchange.

Prior to Appellant entering into the exchange, its lender, Preferred, Bank, obtained an appraisal that would later be referenced in Appellant's purchase agreement. This appraisal demonstrates that the plans for the five parcels were subdivision, development, and final sale as 48 individual lots. As you can see from the appraisal at Exhibit M, page 1, the appraisal is titled "848 Lot Proposed Finished Lot Subdivision".

The title of this appraisal alone makes clear

that this was the appraisal of a planned development. At the time of the appraisal, eight lots were in presale. Meaning, deposits on the lots had already been received. Appellant certainly was aware of these deposits and upcoming intended sale of the eight lots. Thus, as Appellant was acquiring the property, over 10 million in pre-sales of individual lots to the public had already been contracted.

The appraisal notes that the appraiser asked the owner at the time, MDRP, which lots would be finished first and which order -- in what order grading would be done. MDRP replied that the tract would be finished all at once. The appraiser also interviewed the site engineers who informed him that the geological settlement period, which is the time from site reading to development, can be as much as six months and could cause a delay in the final sale of the lots.

In conducting the, appraisal, the appraiser spoke with Ms. Diana Chang, known as the Country Queen, because of her dominance in selling lots in nearby developments. She stated that she had a group of buyers set up and was only waiting on grading to begin putting sales into escrow. She further estimated that all 48 lots would sell within six to nine months.

The appraiser estimated that tract development

would be begun by May of 2010. It would take six months to complete. And he foresaw the lots would be salable by November of 2010. All evaluation forms in the appraisal are predicated on a subdivision, development, and sale of individual lots. The sales time frames were estimated to be 12 to 48 months. The appraisal concluded the highest and best use of the property was residential development, which was the property's intended and proposed use.

The appraiser stated that, "There is no other development like this that has its subdivision being planned where multiple lots are to be sold." The appraiser did not value these lots as a long-term investment because that was not the intent of anyone at the time the appraisal was performed. Rather, the intent was to finish them all at once as provided on Exhibit M, page 6, paragraph 8.

In paragraph 8, the appraiser stated, "I was unable to obtain a development schedule from the borrower, e.g., an estimate as to which lots were going to be developed first, and/or which order the tract is going to be graded. The borrower, basically, verbally reported that the tract was going to be finished off all at once."

On December 4th, 2009, Appellant entered into the purchase agreement to buy three of the five parcels of the development. Appellant's purchase agreement is located at

Respondent's Exhibit A. At page 1 the terms of the purchase agreement at paragraph 1 state the parcels consist of 41 acres or approximately one-half of the land of a development project and are divisible into 24 lots.

At page 18 of Exhibit A, you can see the planned subdivision map for the development that was attached as an exhibit to the purchase agreement. In the purchase agreement, the seller MDRP, planned to deliver any deposits paid on pre-sold lots to Appellant. And MDRP was required to provide Appellant with a detailed budget within 10 days of escrow. The budget had to include the cost of all work acquired to sell the individual lots, and the budget was subject to Appellant's approval.

At page 31 of Exhibit A, you can see the schedule of improvements that was attached as an exhibit to the purchase agreement. The schedule includes improvements to development to prepare the lots for individual sale, such as grading, street improvements, sewer and water, storm drains, landscaping, utilities and permits.

Purchase agreement required that substantial construction to complete the 24 individual lots requires that Appellant's half of the development must be begun by December 31st, 2010, or else MDRP would be required to pay Appellant a $500,000 penalty. From Appellant's purchase agreement alone, you can see Appellant purchased the

parcels with the intent to subdivide and sell the property as individual lots.

Courts have consistently held that this behavior is considered holding property primarily for sale, and that it cannot qualify for non-recognition under Internal Revenue Code Section 1031. The tax court and land dynamics held that regardless of whether the property was acquired for bulk sale or subdivision and sale, both types of acquisition fall outside of Internal Revenue Code Section 1031.

Similarly, in Phil Hall Corp. versus U.S., the Sixth Circuit Court of Appeals, when considering whether a taxpayer holds a property primarily as an investment or for sale, the Court stated that the plan wording of the contract indicates the development or subdivision of the land was intended. The Court then held, if evidence is overwhelming, the taxpayer's primary purpose is not to hold the property for investment, but rather for resale to customer in the ordinary course of business.

On May 7th, 2010, Appellant entered into a promissory note and loan agreement with Preferred Bank for $7.6 million. These are Respondent's Exhibit C and E. The promissory note at Exhibit C requires the balance to be paid in full by April 8 of 2012, or based on whether final tract approval was granted, then payment is due by

the extended maturity date of October 8, 2012. Thus, repayment of Appellant's loan reflected the plan to develop the parcels because the loan maturity date was predicated on tract map approval, as well as raising sufficient funds from the intended sale of the lots to repay the loan.

At Exhibit C, page 10, Appellant's promissory note stated that Appellant acknowledges and agree that the credit worthiness and expertise of the borrower, which was HQE, and owning, developing, and operating real property covered by the deed of trust is the basis upon the lender has determined it is provided against impairment of the security and risk of people.

Appellant's loan agreement located at Respondent's Exhibit E, page 13, required Appellant to provide monthly reports on the development to the bank, including the permits filed, hearings, and estimates of the completion of all pending applications, including recognition of the final tract map. Both the promissory note and the loan agreement that Appellant entered into, reflect that Appellant intended to subdivide and develop the parcels into individual lot, and Appellant's loan was predicated on the sale of the lots to repay the loan.

Appellant asserts the fact it still hasn't sold any lots, supports its claim of -- I'm sorry.

Appellant asserts that the fact that it still hasn't sold any lots supports its claim that it intended to hold the lots for investment. However, this assertion lacks merit for three reasons.

First, courts have consistently held at the determinative inquiry is the taxpayer -- Appellant's intent at the time of the exchange. Here the Appellant intended at the time of the exchange -- the Appellant's intent at the time of the exchange was clear from contemporaneous documents. And it clearly demonstrates Appellant's intent to subdivide, develop, and hold the property up for sale.

Second, a taxpayer's failure to sell property is not determinative of intent at the time of the taxpayer's acquisition of property. It does not negate the contemporaneous documentation which clearly establishes the intent to sell individual lots. Courts have held that having to hold real estate for many years due to changed circumstances does not establish the taxpayer always intended to hold the property for investment purposes rather than sale.

This is especially true in this case where Appellant's development efforts were later stymied by a multi-year lawsuit during which time their parcels were inaccessible for development. Even if we examine

Appellant's actions after its purchase of the parcels, they further support that Appellant intended to subdivide, develop, and sell the property as individual lots in a retail fashion.

Appellant's actions after the exchange include, working to develop the lots, paying for lot development, and obtaining final tract approval for the individual lots. At Exhibit F, page 2, there are sample invoices for development paid by Appellant. These invoices include cost for engineering groups and construction companies to develop the site, including soil testing, grading plans, street plans, retaining wall and sewer and storm drain plans, staking the site boundaries, tree pruning and debris removal, and work on the final tract map.

These invoices also reflect that Appellant made payments to the city for approval of storm drain improvement plans and as a deposit for the City Planning Department. Bi-monthly progress meetings were held to discuss the project and the progress of the development of the parcels with representatives from MDRP and project engineers. Jean Tong, vice president of Appellant, attended and participated in many of these meetings.

74 meetings were held between June 8th, 2010 and June 25th, 2013. After each meeting, a summary was forwarded to Appellant's representative. At one of these

meetings, at Respondent's Exhibit K, page 3, an engineer stated that Appellant's representative wanted a catalog prepared so that Appellant market the lots for sale in China. Respondent requested a copy of the catalog. In response, Appellant provided a copy of an order date, February 7th, 2012 for 950 copies of a 42-page catalog, which marketed the development with examples of luxury homes built on the lots.

As you can see at Exhibit K, page 13, the catalog title "Red", jointly developed by Appellant and MDRP. A full copy of the catalog located at Respondent's Exhibit H. This catalog was produced to distribute to potential buyers and market the lots for individual sales. The catalog markets each individual lot of the development for sale. It shows the lot's location of the development via the subdivision map. It states the size of each lot, and it shows potential luxury home design that could be built on the lot.

In addition to contracting for development, paying for development, holding progress meetings on the development, and marketing the individual lots for sale, Appellant also joined MDRP in filing a lawsuit to proceed development of the parcels. As previously stated, MDRP and Appellant owned parcels that were landlocked and can only be accessed through the north tract, which became the

Diamond Bar Country Estates.

Beginning in October 2013, The Diamond Bar Country Estates Association in the north area, stopped allowing MDRP and Appellant access through its gates or use of its roads. This stopped development because the site was inaccessible. In March of 2014, MDRP and Appellant filed suit against the Diamond Bar Country Estate Association. Eventually, Appellant and MDRP obtained a final tract map approval for their subdivision that the city refused to -- refused their request for a grading permit, because the Diamond Bar Country Estate's Association refused to allow them access rights through the parcel.

Development was at a standstill until the lawsuit could be decided. In March 2017, the trial court entered judgment for MDRP and Appellant against the Diamond Bar Country Estates. Thus, it's clear the parcels had been in development for many years prior to Appellant's purchase of the three parcels, MDRP had been working towards development for many years by the time Appellant -- Appellant purchased three of the five parcels.

Also clear, the development did not happen from 2013 to 2017, because it was thwarted by third parties as opposed to Appellant's own actions. As demonstrated in the Court of Appeal decision, found at Respondent's

Exhibit P, page 7, MDRP and Appellant were unable to access the parcels for development because the Diamond Bar Country Estate Association would not allow them to use the roads or gatehouse.

It's also clear that Appellant sought to access the parcels for development because -- sorry. It is also clear that Appellant sought to access the parcels for development because it sought final map tract approval and a grading permit to continue developments on the parcel.

Notably, Appellant makes assertions regarding the Winthrop factors. However, I would just like to note the purpose of the Winthrop factors is to determine if a taxpayer is holing property out for sale in ordinary course of a taxpayer's trade or business. As previously discussed, that's not the issue in this case because Internal Revenue Code Section 1031 has no requirement regarding the ordinary course of a taxpayer's trade or business.

That was consistently held by courts and Land Dynamics Black versus Commissioner and Neal T. Baker Enterprises. Therefore, because we're not concerned with the taxpayer's ordinary course of business, the frequency of a taxpayer's sales in the course of a trade or business is entirely irrelevant to this issue. The only -- to be excluded from Internal Revenue Code Section 1031, you

merely have to hold the property up for sale. There's no requirement that you be a dealer in that property.

Now, Appellant asserts that it purchased these parcels as an investment, and that MDRP, not Appellant, performed the subdivision and development. This assertion is without merit because Appellant isn't a bank which loaned funds to MDRP. That is not what happened in this case. Rather, Appellant purchased parcels from MDRP and had discretionary control over the development of the lots and was actively engaged in the project.

When Appellant's sees a return on its investment, it won't be in the form of repaid loan from MDRP or a fixed return. When the subdivision and development is complete and the lots are sold individually, it will be Appellant that sells the lots and transfers the titles to buyers.

Appellant's attempt to cast himself as a mere passive investor is not supported by the control he had over the project nor his status as a direct owner of the property who was planning on finishing the lots off all at once as soon as possible after the properties acquisition in 2010, the relevant testing period.

Appellant's purchase of property with the intent to sell as individual lots is straightforwardly first of division, development, and sale. Appellant's facts fall

squarely into the definition of property that is ineligible as 1031 replacement property as describe in 1031(a)(2)(a). This is not a close case given the obvious disqualifying circumstances.

The U.S. Tax Court has considered the Internal Revenue Code Section 1031 requirement that property be held for productive use in a trade or business or for investment many times. In each of these cases, a taxpayer's pursuit of development or improvements to property for the purpose of sale was considered to be holding for sale. And therefore, the taxpayers were unable to obtain IRC Section 1031 treatment because the property acquired was not held for productive use in a trade or business or for investment.

In the case of Neil T. Baker Enterprises versus Commissioner, the taxpayer asserted that he purchased property to construct a rental apartment and then planned to hold the rental apartment as a long-term investment. However, the taxpayer's purchase of the property was contingent on the city's approval of the tentative subdivision map, which proposed to subdivide the very same property into lots for construction of residential housing for sale.

The Court ruled Baker found that the taxpayer acquired the property primarily for sale and not as an

investment. Because of the time of the exchange, the taxpayer took efforts to further development, including seeking tract recordation and payments of development fees. The Sixth Circuit Court of Appeals considered the health for sale issue in Phil Hall Corp. versus U.S.

In that case a taxpayer bought an option to purchase 188 undeveloped acres of land and later sold the option. The issue was whether the taxpayer had held the option for investment or for sale in the ordinary course of business. Notably, this is even a narrower standard in IRC Section 1031, because IRC Section 1031 has no requirement the property be held for sale in ordinary course of business.

In Phil Hall the purchase agreement stated the taxpayer would attempt to have the property rezoned for sale and get a tentative subdivision map approved by the city. The taxpayer attended city planning commission meetings and presented an informal proposal, including an illustration of the subdivision plan.

However, no improvements were actually made to that property. The Court in Phil Hall held that regardless of the fact that no improvements were made to the property, the evidence overwhelmingly show the taxpayer's primary purpose not to hold the property for investment but for resale to customers through ordinary

course of business.

The intent to sell the property was demonstrated by the plain wording of the taxpayer's purchase agreement which made it clear that subdivision of the land was intended by the fact that the Appellant told the planning commission that he intended to develop the property, and the fact the taxpayer made inquiries about sewers and zoning. The facts of Appellant's case are similar but more severe than the facts in Neil T. Baker Enterprises and Phil Hall Corp. versus U.S.

The parcels in this case had long been planned for development before Appellant's purchase. And Appellant's purchase was predicated on the development and sale of individual lots. The tentative subdivision map is already approved by the City of Diamond Bar. And tract approval was even attached at -- excuse me. And the tract map was even attached as an exhibit to Appellant's purchase agreement.

Appellant's purchase agreement also put in a schedule of planning developments. Other documentation, including Appellant's own catalog clearly show that Appellant planned to sell the individual lots as soon as the subdivision was complete. After its purchase Appellant pursued development, paid for development cost, and sought for -- and sought for and obtained a final

subdivision map.

Under these facts the result is clear. Appellant held these parcels primarily for sale. Thank you. I'm available for any questions.

JUDGE ANDREA LONG: Thank you, Ms. Long.

Judge Johnson, do you have any questions?

JUDGE JOHNSON: This is Judge Johnson. No questions at this time. Thank you.

JUDGE ANDREA LONG: Judge Gast, do you have any questions.

JUDGE GAST: The same. No questions at this time.

JUDGE ANDREA LONG: Thank you.

And Ms. Wang, would you like time for a rebuttal?

MS. WANG: Yes, I would.

JUDGE ANDREA LONG: Okay. You may begin.

REBUTTAL STATEMENT

MS. WANG: This is Jenny Wang. I believe that there are some facts that are in dispute, and I will speak to the most important and key fact that is in dispute. And this is regarding the pre-sold lots. If we turn to Exhibit L, page, 18 of the determination letters, FTB referred to eight, quote, "pre-sold lots" to support its finding that HQE's intent was to sell.

These pre-sold lots occurred between December 2008 and July 2009. Appellant's purchase did not take place until May 2010. FTB made an unsubstantiated statement in concluding, quote, "Most likely, Millennium provided the same presale information to HQE," end quote.

FTB then attempted to conclusively state in the same determination letter that such pre-sales, all of which were dated prior to Appellant's purchase, indicate Appellant's intent to sell. These baseless conclusive statements from FTB are patently untrue. The pre-sold lots existed months before HQE was ever involved.

Furthermore, the purchase agreement between HQE and Millennium as stated on page 1 and on page 10 of Exhibit A, clearly stipulated that HQE entered into an agreement to purchase three parcels of land with no indication that it was ever aware of such pre-sold lots. In fact, HQE had no knowledge of any pre-sold lots. We know that by 2009 Millennium had already invested 12 years of time and expenses into the land. Millennium was running low on cash and was facing imminent foreclosure.

If we turn to Exhibit M, page 79 of the 2009 appraisal, the reports stated that, quote, "Credit was given to all of these pre-sales, and they were included as cash flow to the development." Clearly, prior to HQE stepping in as an investor, Preferred Bank was getting

ready to sell the underlying land securing its loan to Millennium. Millennium may have pre-sold a few lots as a last-ditch effort to maximize the cash flow figures in the report.

Of course, the land was not subdivided into any actual salable lots. And in any event, the issue of any pre-sold lots is moot, since no part of the land was ever actually sold subsequent to HQE's purchase. And I know that Respondent, you know, described and mentioned a lot of different case law, and I would like to just defer that to my reply brief to Respondent's opening brief in addressing some of the key differences and facts in the case law that was cited.

And, ultimately, that goes to why I believe that the facts in this particular case is so important and need to be scrutinized based on the facts and circumstances in our particular case because of the outcome of different cases turn on the facts of each case. Furthermore, in terms of the -- in terms of the sales for the lots, Respondent also mentioned that the lots were intended to all sell at once, not individually.

So that further goes to intent for investment -- for long-term investment purposes. And as I mentioned in my presentation, the land had always been in predevelopment stage, and it was intended to be a

long-term investment on the part of Appellant. And so the statement that the reason to purchase was to sell as a whole, actually, supports position of the -- the Appellant's position that it was meant to be sold over a long-term period.

And finally, in my presentation I mentioned brochure which -- the brochures which took place in 2012, two years after HQE purchased the land, and that the brochures were never intended to market to others. It was rather Millennium's attempt to obtain cash flow because it was running low on covering expenses and was unable to obtain additional loans from the bank.

Furthermore, if we take a look at the brochure, I know that there is some Chinese on it. And the Chinese phrasing, if I may translate, it essentially says, "Oh, we're open to start work," roughly translated. So -- and I mention furthermore in my presentation, that there were no indication of lot size or pricing on these brochures. It was not intended for -- for any immediate sale of the lots because the land was not subdivided, not salable in 2012.

And that concludes my rebuttal. Thank you.

JUDGE ANDREA LONG: Thank you.

Judge Johnson, do you have any questions for either party?

JUDGE JOHNSON: Judge Johnson. I have no questions at this time.

JUDGE ANDREA LONG: Judge Gast, do you have any questions?

JUDGE GAST: Yeah, I have a few questions for Ms. Wang. Maybe I missed it, but could you go over what was the purpose for acquiring the property at issue if it wasn't to develop it and eventually sell it? What was the purpose?

MS. WANG: So I mentioned that purpose was for long-term investment. And, you know, as any investor, ultimately, they -- what they're looking for is a return on their investment. But I think the issue at hand is whether or not this land that they've held for over 10 years still qualifies -- still met the definition under 1031 to -- and meet the definition to be able to defer its gain until a point of sale in the future.

So when HQE entered into the transaction to purchase the three parcels, the role that it had was to provide a source of financing as I've mentioned, because Millennium had run into liquidity issues and can no longer obtain anymore funds or loans from bank. Its role, I would essentially state, that HQE was not only an equity partner by obtaining loans from Preferred Bank and essentially having cash flow now in order to pay the --

pay the bank the loans that are outstanding. But it also -- HQE also directly offer -- had promissory notes between HQE and Millennium further proving that it offered a source of financing to Millennium for purposes of development.

JUDGE GAST: Thank you. This is Judge Gast. So the ultimate exit strategy was to eventually sell the property? Or was it to develop the property and obtain rental income? How was he supposed to get his money back?

MS. WANG: I -- I believe that, ultimately, they wanted to be able to obtain a return on its investment, but I'm not able directly comment on whether or not it was to lease the property. I -- I personally do not have any evidence to support the intent that they were intending to lease the property.

JUDGE GAST: This is Judge Gast.

MR. GEMMINGEN: This is David. I'm sorry.

JUDGE GAST: Go ahead.

MR. GEMMINGEN: May I address the development questions? This is David Gemmingen from Franchise Tax Board.

JUDGE GAST: Sure.

MR. GEMMINGEN: Okay. Thank you. If you look at the promissory note, which is Exhibit C of Respondent's exhibits, and at paragraph 24 of the promissory note,

there's a statement there where the borrower, who is our taxpayer, acknowledges and agrees the credit worthiness and expertise to borrower in owning, developing, and operating the real property covered by the deed of trust is the basis upon which the lender has determined it is protected.

So there is a statement at the time of acquisition that it's the borrower's intent to develop the property at that point in time, and that's what the lender is relying on. I wanted to address that. Thank you.

MS. WANG: I do want to -- this is Jenny Wang, and I do want to highlight, as I have in my presentation, the passive nature and the lack of activity and involvement in HQE throughout the years and supporting the position that they are there as a source of financing and taking on a passive role.

JUDGE GAST: Okay. Thank you.

And then this is Judge Gast. One more question for Ms. Wang. Again, I apologize if you had already covered this. This is just so I'm clear. The loan agreement was entered into May 6th, 2010, with HQE and Preferred Bank and it had a very short maturity date of about two years. Can you address why that maturity date was so short?

MS. WANG: This is Jenny Wang. So I'm taking a

look at the promissory note and, you know, in terms of the -- with regarding terms of promissory notes and loan agreements between banks and the borrower, I -- I can't directly address or provide an explanation for the two-year period. However, I did also mention in the presentation that, you know, loan agreements and promissory notes, it's very common to amend them when circumstances change.

And the initial reason that HQE entered into the agreement was to provide, again, cash flow for purposes of Millennium needing -- running into cash flow issues. And two years later in 2012, we can see that, you know, once again HQE entered the picture and provided additional sources of finance by refinancing loans because, unfortunately, you know, cash flow has been an issue that has -- that's an ongoing issue from year after year.

And so while the initial promissory note and loan agreement stated a specific term, it was -- as circumstances changed, extended and amended in 2012 and also during 2013.

JUDGE GAST: This is Judge Gast. Thank you very much. I have no further questions.

JUDGE ANDREA LONG: This is Judge Long, and I have a couple of questions. FTB, Ms. Wang mentioned that -- that the pre-sold lots should be attributed to

Millennium and not to HQE. Can you address that, please?

MS. VERONICA LONG: Yes. So the purpose of bringing up the pre-sold lots -- well, let me confirm. Your question was whether or not the pre-sold lots should be attributed to MDRP or Appellant; correct?

JUDGE ANDREA LONG: Correct.

MS. VERONICA LONG: The reason that we discussed the pre-sold lots is because the determinative inquiry is the taxpayer's intent at the time that they acquired the property. So we look to the facts and circumstances of the property. We looked to the objective facts and circumstances that existed at the time that they entered into that agreement.

So whether or not the sales eventually went through is not -- is not really relevant to that -- to that ultimate inquiry of what the taxpayer's intention was based on the objective facts in 2009 and 2010 when they were entering into an arrangement for the purchase agreement.

Now, the pre-sale -- pre-sold lots that are discussed in the 2009 appraisal, I have to find the exact location for you, but I do believe there is a provision in one of the purchase agreements, either the original or the amended, that provides that MDRP has to forward the deposit amounts to Appellant. So it is clear that

Appellant was aware of the pre-sold lots -- the status of those lots is pre-sold.

Further, the 2009 appraisal is referenced in the loan agreement that Appellant eventually entered into with Preferred Bank of the $7.6 million that both myself and Wang had discussed. So that appraisal is referenced that it is clear the Appellant was aware that the lots were in presale at the time that they entered into the agreement to purchase the lots.

So we're just looking at the time the Appellant entered into that exchange, their knowledge with that, at least 8 of the 48 lots were already in presale condition.

JUDGE ANDREA LONG: Okay. Thank you.

And Ms. Wang, you mentioned that the lots were supposed to be sold all at once and not as individual lots. I think you might have referenced something in the exhibit. Can you repeat what that was?

MS. WANG: Oh, I actually made that comment in response to -- during Respondent's presentation stating that the lots were meant to all be sold at once.

JUDGE ANDREA LONG: Okay. Got it. Thank you.

MS. VERONICA LONG: I'd be happy to address that issue if you would like further information.

JUDGE ANDREA LONG: Sure.

MS. VERONICA LONG: All right. So what we we're

discussing when we mentioned the lots for sale all at once, what we're discussing is part of the appraisal where the appraiser went and they asked at the time the owner of the parcels, this was in 2009. It was MDRP. And the appraiser went and asked MDRP if the lots were going to be done in any particular order, and MDRP replied, no we're going to finish the grading. We're going to do the lots. We're going to develop them all at once.

And that was the purpose of bringing up that information. And the purpose of that is really to show the lots -- that a development was contemplated in the 2009 appraisal, which I believe is undisputed at this time. But development was clearly the intent of the property in 2009 during that appraisal.

Now, when it comes time to selling the lots all at once, we're not making the assertion that HQE has been able to sell the lots. Clearly, they are still in possession of the lots. But that does not -- that does not address the determinative inquiry in this case, which is whether or not at the time that Appellant entered into the exchange agreement, whether or not they had the intent to subdivide, develop, and hold the properties for sale.

Merely, I wanted to bring up the statements of MDRP to support the fact that these lots were clearly in development at the time they were purchased.

JUDGE ANDREA LONG: Thank you.

And one last question. Ms. Wang, is there evidence of the canceled sale in the exhibits?

MS. WANG: So as I -- this is Jenny Wang, Your Honor. As I mentioned, these eight pre-sold lots mentioned in the appraisal report, were dated months before HQE entered the picture. So although Respondent did indicate that based on evidence it's possible that Appellant was aware of pre-sold lots.

The factor of the matter is Appellant was not present when these lots were being contemplated to be sold by Millennium. And whether these pre-sold lots, you know, when Millennium and the pre-sold lots -- entered into the transaction for these pre-sold lots, HQE was not present. And ultimately, under the terms of the purchase agreement, HQE purchased three of the five parcels, and no other part of the land was ever sold.

So based on these circumstances, we know that the pre-sold lots never actually took place. I do not have any -- I was not able to -- I was not able to obtain anything from Appellant, because after all, the transaction was between Millennium and other parties without the awareness of HQE.

JUDGE ANDREA LONG: Okay. Thank you.

Are there any additional questions from the panel

members?

JUDGE JOHNSON: I do have one question -- this is Judge Johnson -- if that's okay. This is a question, I guess, for both parties. We'll start with Franchise Tax Board. There's been arguments and also some point to the evidence regarding Appellant's involvement in the properties themselves. And a lot of direction towards their activities and their involvement and whether they were sort of passive investors.

I guess the question for both parties -- I'll let Franchise Tax Board go first. Is there any requirement that -- that acquires the property and in exchange has to actively engage in the sale, or is it sufficient that they purchase it with the intent that someone else handle the sale for them? In other words, is being a passive investor would automatically make it an investment rather than intent to sell?

MS. VERONICA LONG: Okay. This is Veronica Long speaking. There is no requirement that the taxpayer be the active developer. The only -- the exception -- so exceptions to the general rule of recognizing gain are narrowly drawn. A matter of -- you know, a matter of statutory construction are narrowly drawn.

And that includes the exceptions to those exceptions. So the only -- so if a property is held for

sale, it does not matter if the taxpayer who is holding that property for sale. It does not matter if it's in ordinary course of their business. It does not matter if they are the developer. It does not matter if they are the past person or if they are employing a subcontractor or if they themselves are the developer; none of those is relevant.

Merely holding the property primarily for sale at the time the taxpayer acquire the property will cause the property to not qualify under Internal Revenue Code Section 1031 treatment.

JUDGE JOHNSON: This is Judge Johnson again. Thank you.

And Ms. Wang, would you like to also discuss that?

MS. WANG: This is Jenny Wang, Your Honor. And, you know, I do want to reiterate some of the points in my presentation that a 1031 -- an issue under 1031 of whether a transaction meets the requirements for gain deferral, it is a facts and circumstances-based issue. And in order to find -- perform some factor finding, I went into detail in describing the economic circumstances at the time, that a reasonable buyer would not purchase property immediately for resale and that the intent -- again, the intent of HQE was to hold the property for the long run.

And also, as I pointed out, the purchase agreement itself and also the 2011 balance sheet, all supported the intent of HQE to enter into a 1031 transaction and hold the property for investment until some future point in time when that property does sell in the future is when there is a gain recognition event that would occur.

And that's all I have to say. Thank you.

JUDGE JOHNSON: This is Judge Johnson. Thank you. No more questions.

JUDGE ANDREA LONG: Judge Gast, do you have any additional questions?

JUDGE GAST: This is Judge Gast. I don't have any additional questions. Thank you.

JUDGE ANDREA LONG: Well, I think that concludes the hearing today. The panel will meet and decide the case based on the briefings, the arguments presented, and exhibits admitted as evidence. We will send both parties our written decision no later than 100 days from today.

I want to thank everyone for your participation. This case is now submitted, and the record is closed.

Thank you.

(Proceedings adjourned at 2:22 p.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 17th day of September, 2020.

_____
ERNALYN M. ALONZO
HEARING REPORTER