BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF:	
M. MACLEOD (DEC'D) AND K. MACLEOD,	OTA NO. 18093762
Appellant.	

CERTIFIED COPY

TRANSCRIPT OF PROCEEDINGS

SACRAMENTO, CALIFORNIA

WEDNESDAY, SEPTEMBER 21, 2022

Reported by:

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TRANSCRIPT OF PROCEEDINGS, taken at 400 R Street, Sacramento, California, commencing at 2:15 p.m. and concluding at 3:58 p.m. on Wednesday, September 21, 2022, reported by Sarah M. Tuman, RPR, CSR No. 14463, a Certified Shorthand Reporter in and for the State of California.

APPEARANCES:

PANEL LEAD:	ALJ SARA HOSEY
PANEL MEMBERS:	ALJ MIKE LE ALJ AMANDA VASSIGH
FOR THE APPELLANT:	MICHAEL HAMERSLEY
FOR THE RESPONDENT:	STATE OF CALIFORNIA FRANCHISE TAX BOARD CIRO IMMORDINO MARGUERITE MOSNIER

I N D E X

E X H I B I T S

(Appellants Exhibits 1-22 were received at page 7)

(Appellants Exhibits 23-30 were received at page 7)

(Department's Exhibits A-DD were received at page 7)

(Department's Exhibits EE-FF were received at page 8)

OPENING STATEMENT

CLOSING ARGUMENT

REBUTTAL

Sacramento, California; Wednesday, September 21, 2022

2:15 p.m.

-- oOo --

JUDGE HOSEY: We are opening the record in the Appeal of MacLeod. This matter is being held before the Office of Tax Appeals, Case Number 18093762. Today is September 21, 2022, and it's 2:15 p.m. We're here in Sacramento, California.

I am the Lead Administrative Law Judge, Sara Hosey. And with me today are Judge Vassigh and Judge Le. All three Judges will meet after the hearing and produce a written decision as equal participants.

Although the Lead Judge will conduct the hearing, any Judge on this panel may ask questions or otherwise participate to ensure that we have all the information needed to decide this appeal.

Can I please have the parties state their names for the record.

Mr. Hamersley?

MR. HAMERSLEY: Michael Hamersley for the Appellant.

MR. IMMORDINO: Ciro Immordino for the Franchise Tax Board.

MS. MOSNIER: Marguerite Mosnier for the Franchise Tax Board.

JUDGE HOSEY: Thank you.

The issues we have in front of us today are whether Appellants made an IRC Section 170 bargain sale of the Palm Springs land; who has the burden of proof on this issue; did Appellants have gain under IRC Section 731; if so, was there a computational error; and who has the burden of proof on this issue; whether under the doctrine of res judicata and other concerns such as conformity and disclosure, cause -- bar FTB's proposed California tax deficiencies; whether Appellants have shown interest should be abated pursuant to R&TC Section 1914; have Appellants shown reasonable cause to abate the late filing tax return penalty for the 2006 tax year.

These issues were set forth in the prehearing conference minutes and orders issued on September 26, 2022.

Mr. Hamersley, do those sound accurate?

MR. HAMERSLEY: Yes. With -- with exception to the res judicata complexity --

JUDGE HOSEY: Can you get a little closer to your microphone?

MR. HAMERSLEY: Yes. With the -- with the exception to the res judicata complexity that I made earlier.

JUDGE HOSEY: Right. Regarding res judicata,

conformity, and disclosure issues.

MR. HAMERSLEY: Yes.

JUDGE HOSEY: Okay. Mr. Immordino, is that accurate?

MR. IMMORDINO: Yes. Thank you.

JUDGE HOSEY: Thank you.

For exhibits, we admitted Exhibits 1 through 22, for Appellant, and A through DD, for Franchise Tax Board, into the record via the prehearing conference minutes and orders issued on September 6, 2022.

(Appellants' Exhibit Nos. 1-22 were previously received in evidence by the Administrative Law Judge.)

(Department's Exhibit Nos. A-DD were previously received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: Mr. Hamersley, you submitted 23 through 30 on behalf of Appellants.

Mr. Immordino, do you have any objection to these documents?

MR. IMMORDINO: No. Thank you.

JUDGE HOSEY: Okay. Exhibits 23 through 30 are now admitted as evidence into the record.

(Appellants' Exhibit Nos. 23-30 were received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: Mr. Immordino, you have submitted Exhibits EE and FF on behalf of the Respondent, Franchise Tax Board.

Mr. Hamersley, do you have any objections to these two documents?

MR. HAMERSLEY: Just the ones I registered previously.

JUDGE HOSEY: Yes. Mr. Hamersley was concerned about new information this late in the hearing process.

However, both Exhibits EE, the FTB Returns Received Display Printout for tax year 2006, and FF, IRS Account Transcript for Appellants for tax year 2006, have information in them that is in the record to date. So I'm going to allow these documents -- overrule the objection.

But we will consider all objections when weighing the evidence and making our decision pursuant to Regulation 30124(f)(4).

So that being said, Exhibits EE and FF are now admitted as evidence into the record.

(Department's Exhibit Nos. EE-FF were received in evidence by the Administrative Law Judge.)

JUDGE HOSEY: All right. Mr. Hamersley, are you ready for your opening statement?

MR. HAMERSLEY: Yes, I am, Judge.

JUDGE HOSEY: You have 20 minutes. Any time you

do not use, we will hold over. Go ahead and begin.

OPENING STATEMENT

MR. HAMERSLEY: So I -- before I get into the -- the substantive issues, on this issues of the weighing of the evidence, I'd like to point out that in weighing the evidence, even though the -- the OTA does not adopt the Evidence Code, Section 412 of the Evidence Code discusses the weighing of evidence with respect to weak -- weak evidence.

So I'm speaking with respect to exhibits like they're [sic] just submitted -- like the Exhibits AA and DD that were past documents -- that were all, rather than -- than provide all of them as requested in a production request and the subpoena request -- that they're -- they're -- they feel comfortable, you know, in the protection of the order, they don't have to.

But what you do when you get that is the -- the Cookston presumption -- I'm sure you're familiar with -- you cite it often -- but also this Evidence Code 412.

When you don't turn over -- and if you look in Exhibits AA and DD in the IRS communications and on, you know, the other past folders and things referenced in there -- and Judge Hosey, I know you worked at FTB. You're familiar with the past system. There's lots of

different folders and documents and stuff.

We asked for those. All we got were exhibits attached to their briefs. We got no production on the request.

So here's what Section 412 says with respect to the weight of it -- to be given to evidence, quote, "If weaker and less satisfactory evidence is offered, when it was within the power of the party --"

(Reporter admonition)

MR. HAMERSLEY: Yes.

They have the sole possession of the past documents and the IRS communications.

"If weaker and less satisfactory evidence is offered, when it was within the power of a party to produce stronger and more satisfactory evidence, the evidence offered should be viewed with distrust."

Appeal of Don A. Cookston, cited often by the OTA, it is well established -- quote, "It is well established that the failure of a party to introduce evidence, which is within his or her control, gives rise to the presumption that, if provided, it would be unfavorable."

So that's -- that's the rest of the bargain they bought when they -- when they didn't turn over those documents.

They're -- they're documents -- and I'll point out with respect to the -- they're not authenticated, and they're not complete in many cases.

ROB Exhibit X is a perfect example. ROB Exhibit X was whited out, not redacted in black, as I'll point out later. The line item that made their point in the brief 67 -- purportedly paid 67 percent of the deficiency was disallowed to the IRS.

It was 8.3 percent. They made that point. They cited Exhibit X, whited out the bottom and the top and the line-item description of the 33 percent where they got their 67.

I've never seen such a thing. That evidence is completely unreliable.

Exhibit Y, attached to their RRB -- their -- their reply brief -- page 19 to 40 is that document. And you can compare the two. They whited out the sections that -- that contradicted the argument they were making in their Respondent's Opening Brief citing Exhibit X.

So the weight given to their documentary evidence should be zero. It's not reliable.

And as I said, the exhibits that should be looked at -- their ROB's Exhibit X, which was our 7; ROB Exhibit Y, which is our 8; ROB's Exhibit T, referred to as the "smoking-gun letter" that was withheld from us for a

period of five years.

That was issued on February 15, 2013. It was cited as Exhibit C in the IRS examinations report. The IRS would not give it to us. When we asked for it, they said the FTB Protest Hearing Officer requested confidentiality. You'll have to get it from him.

When we asked for it, we were repeatedly denied. It was finally attached to -- parts of it -- to the Exhibit T to the Respondent's Opening Brief. That is not reliable evidence.

Also Exhibits 25 and 26 show the subpoena request, the two categories of documents, the past documents, and the -- and the IRS documents, which are referenced repeatedly, as I said, in Exhibits AA and DD of Respondent's briefs.

All right. With that said, you know, here we are 11 years -- 11 years into this -- this protest -- this appeal -- 7 of which was in the protest -- during the protest -- just -- just under 7 years.

If you look at even the Exhibits AA and DD, what on earth were you doing for 7 years? This -- that all goes to the -- the interest-abatement issue.

But the transaction is actually quite simple. And so I'd like to explain the transaction. The law is quite simple. There are only Federal Income Tax Code

Provisions -- 170 and 731 -- as Judge -- Judge Hosey said.

So the ownership structure exhibit -- the Respondent's Reply Brief Exhibit AA has a diagram of the -- of the ownership structure.

Basically, the Appellants owned -- I think it was 58-point-something percent directly -- indirectly of MC Properties. MC Property owned -- owned two part -- MC Properties was a tax partnership. They -- LLC -- was a tax partnership.

They owned two parcels of land that totaled 19.- -- I think it was -- -16 acres.

On or about 2003, they entered into negotiations with the Palm Springs Unified School District to sell that property to them. The Palm Springs Unified School District is a 501 organization to the extent there's excess value of the sale, there's a charitable contribution deduction.

So the -- the negotiations went on from 2003 and did not finally close until April 28th of 2006. There was a -- a letter that threatened condemnation. And finally, the taxpayer caved. And that's referenced in Section 1.2 of the Purchase and Sale Agreement.

Two things to reference there -- that it was under threat of condemnation and it's a 1033 transaction. No one disagrees about that. Well, 1033 is either

condemnation or threat of condemnation.

And the -- the -- the sale then took place and closed on April 28th of 2006 for $10.558 million, I think it was.

The taxpayer wrote contemporaneously in Section 1.2 of the Purchase and Sale Agreement that the value of the property well exceeds that $10.5 million and -- and documented that and the fact -- the fact that it was under threat of eminent domain.

The problem here on the threat of eminent domain is the appraisals and all the IRS stuff that -- that Respondent relies upon -- Respondent's closing letter, before we filed the protest -- treated that transaction as a constructive condemnation.

They said, "You didn't give your property away. There's no domain intent. They took it from you."

Well, when the IRS went and talked to the Palm Springs Unified School District after getting all of the FTB's arguments and Exhibit T and all the documents they sent to them, the Palm Springs Unified School District told them the exact opposite: It never went down that road.

Well, how's it a 1033 transaction?

So the witness then, you know, on this was -- is -- switched their stories -- granted, it was a new

person and -- at the Palm Springs Unified School District -- but they were very adamant that there was no threat, despite the existence of this threat letter and despite the fact that all the parties agree it was a 1033 transaction.

So the -- the witnesses supplying information to the FTB and the IRS are questionable.

So the bargain sale transaction took place. As I said, it was a 1033 transaction.

Procedural history of the case -- this case started with the Franchise Tax Board. The protest got it right about the beginning of -- we filed the protest at the end of 2011; they got it beginning of 2012.

Not long after, there were some IDR requests. And then the IRS opened an audit. And the original -- notice of proposed adjustment we got quoted a typographical and grammatical error from the FTB's APE's.

So it was clear at that point. We knew they were sharing information. We asked -- we asked the disclosure office; they denied it.

They got into this -- this little debate about what a "third-party contact" is. And we said "third-party," under the statute, is anyone but the taxpayer. The question is whether you have to disclose it in 19504.7.

Just -- they wouldn't answer the question. And -- and as we know in Exhibit T, which was cited in the IRS Examinations Report, there were many communications. It's in those Exhibits AA and DD. We now know.

Even though we didn't get the documents, it's absolutely clear from the evidence and the record -- they were -- they were talking regularly.

And -- and in Exhibit T, the -- the legal analysis was written from the Franchise Tax Board to the -- to the IRS, which adopted their arguments. And then vice versa, when the Notice of -- of Assessment was issued from the IRS, the FTB adopted their arguments.

So there was a lot of coordination. That'll -- that'll get to the privity issue.

So as I said, what -- what happened is, when the IRS then issued their Notice of Deficiency, which is a 90-day letter, that's the end of the IRS controversy. You're -- now, you're working with IRS Appeals and their Litigation Section.

If you want to pursue an appeal, you have to file a Tax Court petition. That's litigation. We -- as exhibit -- we gave you Exhibit 3 and 4 that show the docket and show the Tax Court decision.

I don't know why on earth we are still calling this an "IRS Determination." An IRS Determination is an

IRS examinations -- an IRS audit report.

It is very clear that that is a decision of a court of competent jurisdiction of the United States Tax Court.

So I don't know why we're talking about an IRS Determination. We don't agree with the IRS Determination. They -- they completely -- the IRS Determination completely disallowed the deduction, which was reversed by the Tax Court.

So, as I said, there's only two -- two major code sections here. Section 170 -- I think 12 percent of the deficiencies attributable to that -- the bulk of it, I think 88 percent is attributable to the 731 -- specifically, Revenue Ruling 81-242 theory.

We're being taxed on the theory based on an article that the two attorneys -- the two attorneys from Franchise Tax Board that have argued the two cases they've had on this -- wrote -- and the -- the -- the article, which is Exhibit 17, makes our case.

It says it's a horrible, horrible policy -- horrible rule. It should be done away with. But they argue that, you know, because if you -- I'll get into that -- when you look at the history of that Rev. Rule, it was originally a taxpayer-favorable ruling that GCM 38389 reversed and said that Section 1033 and 752(b) operate

independently. The problem isn't 1033; it's 752.

Well in 1991, regulations were passed in 1.752-1(f) that allowed liability that it -- you got to fix that problem.

The IRS has not litigated or even addressed in any administrative controversy have they taken a position in administrative guidance that 81-242 is still a good law.

And yet here we are -- 88 percent of our deficiency is attributable to this theory. That there's a lot -- that there's a transitory liability relief -- that, specifically, when the replacement property was purchased on that Palm Springs Unified sale [sic] District to qualify for 1033 treatment -- that when the -- when the liabilities on the sale property were paid off -- that you cannot view the replacement property transaction that are bookends for nonrecognition, under 1033, as part of a single transaction.

And so we stopped. And if you look in the middle and you cut it off, you'll have a transitory relief of liabilities that gives rise to a Section 731 gained -- deemed distribution.

The Franchise Tax Board freely acknowledges that if an individual had done that transaction, there'd be no problem. There's no -- this is purely a function of the

partnership.

This -- this -- this proposed issue -- if an individual had -- had done that exact same transaction, there would be no -- no -- no gain -- 731 gain.

Res judicata -- as I said, the Tax Court determination letter is not -- the Tax Court April 30 of 2015 decision is not an IRS Determination. It's a -- it's a -- it's a decision of a court of competent jurisdiction.

The I -- the FTB -- well let me back up a little bit. There are three elements to res judicata. It appears -- I'm not -- never clear what they've acknowledged or not acknowledged -- but it seems like we've limited it to this privity issue.

There's three elements to it that -- that -- the -- you have a final judgment on the merits. The U.S. Tax Court opinion is that. It's not an IRS Determination. You -- and that -- it's the same cause of action.

Well, the California Franchise Tax -- or the Revenue and Taxation Code is derivative for Sections 1- -- it conforms to Sections 170 and 731. The tax for California state tax purposes is derivative of the federal income tax.

The United States Tax Court looked at the exact issue of what are the federal -- federal income tax consequences applying the Internal Revenue Code 170 and

731 to that exact same transaction for the exact same taxpayer for the same tax year.

And the -- the FTB does not want to follow it. If there's no federal conformity here, and they do not have to follow this U.S. Tax Court decision, federal conformity is a complete fiction. You'll never have a better case than this for them being required to follow fed.

So on the issue of privity, the last prong -- the privity that the -- that the -- we -- the privity looks at one of the things -- one of the things it looks at is mutuality.

There is no question that, had the Tax Court gone differently and gone against the taxpayer, that this taxpayer would be barred and would have to pay the state tax based on the federal tax liability -- the decision of the U.S. Tax Court.

The FTB is playing this -- when they put it "pending federal" and agreed to do that, they're playing this "heads, FTB wins; tails, taxpayer loses" game. And it's -- it's -- it's a ridiculously bad policy.

So looking at the -- the issue of privity. This was recently addressed establishing the -- with respect to the final judgment stipulated Tax Court -- stipulated court decision being a final judgement on the merits for

res judicata purposes. There's a lot -- I mean, it's well settled.

But it was recently addressed in an October 4th, Ninth Circuit opinion Frank Lane Italiane. And it -- Frank Lane Jr. and Alicia -- BAP Number EC-20-1247-SGF -- and it confirms that, while subtle -- the law on it cites California law -- California Automobile Association versus Superior Court 50 Cal.3d 658, 664-665.

On the issue -- on the standard for res judicata -- or privity, there was a June 3rd, 2022 California Supreme Court opinion, Lynn Grande versus Eisenhower Fresh. And it, again, says here's the established standard:

Identity or community of interest -- quote, "Identity or community of interest" --

(Reporter admonition)

MR. HAMERSLEY: Sure.

"The standard for privity is an identity or community of interest such that the interest represented in the first action reasonably should have" -- they should reasonably expected to be bound -- the -- the party in privity in the first act -- in the second action should have reasonably expected to be bound in the first suit.

They cited the long-standing California standard in DKN Holdings 61 Cal.4th, 826.

So, you know, I had mentioned it's not just the IRS communications that -- that caused the FTB to be in privity. And there are lots of them. And they got -- they certainly had their chance to speak up and -- and make their case.

They did it in Exhibit T to their opening brief, argued their position. And then as the past documents, their Exhibits AA and DD, show, they had early and often -- they had lots of communications with the IRS.

So the -- the -- privity is established by the fact that the Protest Hearing Officer, who happens to be the tax counsel here, reviewed the tax documents provided by the IRS and decided to put it "pending federal," deciding that it was the same transaction tax year and federal income tax issues. That's an identity or community of interest.

The conformity policy -- conforming to a federal law is an identity or community of interest. It's, in fact -- it's derivative.

The documents shared under the disclosure statute and the MOA that's required to do that can only be lawfully shared by the FTB and IRS and vice versa if there was an identity and community of interest in the subject matter.

There's a right to know and a need to know. FTB

had significant, as I said -- significant input and meaningful voice in the IRS matters by sending its legal analysis and regularly communicating.

So that's the part about, you know, how much communication was there?

We'd like to see all of the documents. All of the IRS -- and we don't have anywhere near those. We were never given -- we have what they -- what they attached to their exhibits. That's all we have.

JUDGE HOSEY: Mr. Hamersley, you have about a minute left. Although, it seems that we're getting into some argument. So you -- if FTB is comfortable with waiving an opening and -- and just moving into arguments, we are able -- you can use the 30 minutes of argument as well.

MR. HAMERSLEY: Probably makes sense, yeah.

JUDGE HOSEY: Mr. Immordino?

MR. IMMORDINO: That's fine. Thank you.

JUDGE HOSEY: Okay. So you'd just be moving into your arguments, as well, after Mr. Hamersley, if you -- or -- Mrs. Mosnier as well --

MS. MOSNIER: If -- if you wouldn't mind, we might like just a short few minute's opening statements.

JUDGE HOSEY: Would you like to do that now? Or would you like to -- hold on. Let me stop my clock.

Would you like to do that now? Or would you like to wait until we finish with Mr. Hamersley? He's on issue three right now.

MS. MOSNIER: We would defer to the -- to the OTA. Although, our request would be to do it now.

MR. HAMERSLEY: That's fine.

JUDGE HOSEY: Mr. Hamersley, what are you comfortable with?

MR. HAMERSLEY: That's fine.

JUDGE HOSEY: We'll do a short -- okay.

FTB, please proceed.

MR. IMMORDINO: Thank you. Yeah. I think it would help to have an opening just to kind of lay some foundation.

JUDGE HOSEY: I'm sorry. Can you get a little closer --

MR. IMMORDINO: Oh, no. Thank you.

JUDGE HOSEY: Sorry. I turned my mic off.

Can you just get a little closer so we can hear you?

MR. IMMORDINO: Is this better?

JUDGE HOSEY: Yes. Thank you.

MR. IMMORDINO: Sorry about that.

JUDGE HOSEY: It's okay. Thanks.

MR. IMMORDINO: I think that having an opening

would help lay a little bit of foundation, make it a little bit better.

OPENING STATEMENT

MR. IMMORDINO: Okay. So thank you very much.

I am going to discuss the Palm Springs land and the tax impact of Appellants' partnership distributions. Then my colleague, Ms. Mosnier, will cover interest abatement, res judicata, and the late-filing penalty.

The first issue in this appeal is whether Appellants met their burden to show that they had a bargain sale of land.

In a bargain sale, the taxpayer transfers property in a transaction that is part sale and part charitable contribution. Like most cases arising out of real estate transactions, this appeal is document heavy, and the documents show what happened.

The Palm Springs Unified School District was interested in purchasing land which was owned by Appellants and others through LLC's.

The School District was also interested in purchasing the adjacent parcel of land which was owned by an unrelated third party.

During a lengthy negotiation, the School District and Appellants had multiple appraisals prepared. And as

real estate prices rose during this period, so did the valuations in the appraisals.

Appellants had two separate appraisers prepare a total of three appraisals, which had valuations starting at $8.2 million and ending at $10.7 million.

Similarly, the School District's appraisers prepared appraisals with valuations starting at $8.2 million and ending at $10.5 million.

Ultimately, the parties agreed on a sales price of $10.5 million. The unrelated third party also sold the adjacent parcel of land for the same per-acre sales price.

During negotiations, Appellants brought up the option of a part sale, part charitable contribution. The School District considered that approach but ultimately made a fair market value offer and even had the purchase agreement specifically state that the sale was made at fair market value.

Appellants originally filed a 2006 tax return, did not report the sale of the land as a bargain sale. It was not until four and a half years after the sale and the middle of the audit that Appellants filed an amended tax return and claimed that the value of the land was worth approximately $20 million, which is almost twice the sales price.

To support this inflated valuation, Appellants

did not use either of the two appraisers that they'd used during the sales negotiations.

Instead, Appellants used a new appraiser who prepared a valuation for tax purposes. During the IRS examination, the IRS inspected the land and also prepared an appraisal.

The IRS determined that the School District had paid fair market value for the land. Further, the IRS appraiser rejected the Appellants inflated $20 million appraisal, finding that it was inconsistent and biased.

To get bargain sale treatment, two separate requirements must be met: First, the Appellants must show the value of the land was clearly out of proportion to the amount paid by the School District. Here, the evidence will show that Appellants were paid fair market value for the land.

Second, Appellants must show that the excess value in the land was transferred with the intention of making a gift. Here, the law does not allow there to be intent to make a charitable contribution because the Appellants accepted the School District's fair market value offer.

Regarding Appellants' assertions to the contrary, the IRS summarized its discussions with the School District as follows, and I quote: "The attorney and

retired director stated that the taxpayer statements on the Form 8283 attachment are not accurate and misrepresent the School District's position at the time of the transaction," end quote.

In addition, the courts have been especially unwilling to allow taxpayers to unilaterally assert a gift occurred when they receive a fair market value offer, particularly in the background of eminent domain proceedings such as in this appeal.

As courts state, if the Appellant did not feel the offer was fair, they had recourse through the eminent domain process -- an option the Appellant chose not to pursue.

Next, I want to discuss -- let's see.

I'm going to discuss the -- the tax impact of Appellants' partnership distributions.

Subchapter K of the Internal Revenue Code gives partners in a partnership significant flexibility. However, with that flexibility, Subchapter K also gives limitations.

This appeal deals with one of those limitations. Specifically, the limitations surrounding a partner's basis in a partnership.

When a partner puts something into a partnership or recognizes gain, their partnership basis increases.

Similarly, when a partner takes distributions out of the partnership, their partnership basis decreases.

A partner can take distributions out of a partnership without owing any tax as long as they have basis to cover the distributions.

However, when a partner's distributions exceed their basis, Subchapter K requires that they recognize gain.

In this appeal, Appellants received cash distributions and the relief of partnership liabilities, which is also treated as a cash distribution. These distributions exceeded the Appellants' basis in the MacLeod Couch Properties, LLC. And so the Appellants are required to recognize gain.

Regarding the portion of the distributions related to the relief of partnership liabilities, there is an IRS General Counsel Memorandum directly on point. The General Counsel Memorandum, or GCM, analyzes the impact or the relief of the partnership liabilities in IRC Section 1033 transactions such as we have in this appeal.

The GCM specifically considers the Appellant's position, fully analyzes it, and then rejects it, including the single transaction netting rule that Mr. Hamersley mentioned was passed in '91.

Then one year later, a revenue ruling is issued

which memorializes the analysis and determination in the GCM and which is consistent with the FTB's position in this appeal.

Finally, there is discussion of a Tax Notes article which proposes a law change. This article is written by a tax practitioner in their personal capacity.

Further, while not authoritative, the article reiterates that the law requires a result consistent with the FTB's assessment and that a law change would be necessary for a contrary result.

And with that, I'll pass it to my colleague, Ms. Mosnier. Thank you very much.

JUDGE HOSEY: Ms. Mosnier, you have about 13 minutes.

FURTHER OPENING STATEMENT

MS. MOSNIER: Thank you. Good afternoon. Marguerite Mosnier for Franchise Tax Board. And thank you, Mr. Immordino.

I'd like to talk a bit about the concept of res judicata, interest abatement, and the Section 19131 late-filing penalty.

Res judicata is an affirmative defense. It must be proven -- it's offered up and proven by the Appellants. They must establish four elements to avail themselves of

this defense.

The evidence will show that the Appellants have not established three of the four elements necessary to prove res judicata should govern the disposition of this appeal. And there is no requirement that FTB follow a Tax Court judgment with respect to tax year 2006.

And similarly, the statutory right to interest abatement depends on the Appellant's having shown there was an unreasonable delay by FTB in working the underlying protest in this case. And here again, the evidence will show that there was no unreasonable delay or delay at all by the Franchise Tax Board.

Further, the -- the evidence will show that any delay that the OTA may determine is attributable to the Appellants.

And finally, with respect to the late-filing penalty -- and this applies only to the 2006 tax year -- the record reflects a lack of evidence to establish reasonable cause for filing a late 2006 California return.

So the evidence is clear that the Franchise Tax Board properly proposed the adjustments denying the charitable contribution deduction; proposing a Section 731 gain adjustment; and proposing a late-filing penalty; and that the Appellants have not met their burdens of proof to show otherwise.

And consequently, the OTA should sustain FTB in this case.

JUDGE HOSEY: Okay. Thank you.

Mr. Hamersley, would you like to -- you're into your closing argument time now. So you were able to cover, again, any issues before, go in-depth, continue forward --

MR. HAMERSLEY: Do I get rebuttal or -- after?

JUDGE HOSEY: No. This will be -- this will be -- yeah. Rebuttal will be after FTB's argument.

So your 30 minutes will start now.

CLOSING ARGUMENT

MR. HAMERSLEY: Yeah. And well, you know, those are wonderful narratives except they have nothing to do with reality. And the evidence will not show what evidence -- I've cited specific evidence that shows exactly the opposite.

With respect to the appraisals, those appraisals were two year -- he didn't mention dates -- two years stale.

With respect to the GCM, that's a 1980 GCM which reversed the private letter ruling -- '79 private letter ruling that led to Revenue Ruling 81-242.

How on earth, in 1980, could Gerald Cohen, the

chief counsel who wrote GCM 38389 -- who I wanted to testify as a witness, but was denied -- who thinks 81-242's was a dead letter -- How on earth could they consider those partnership regs that were written in 1991 in 1980?

They -- what Gerald Cohen said was 752(b) is the problem, not 1033. The authors of the article -- Mr. Immordino and -- and his colleague -- former colleague suggested that to fix it -- to have a -- a single transaction, you have -- you would have to modify 1033.

Well, the GCM says 1033 is not the problem; it's 752(b). And 752(b) was fixed in 1991 in 1.752-1(f). The problem's fixed.

(Reporter admonition)

MR. HAMERSLEY: Yeah.

This is a theory that an -- articles were written on. You can't tax taxpayers on theories. It's not right.

I've spoken to the author, Gerald Cohen, of GCM 38389. He doesn't agree with it. They reference Revenue Ruling 2003-59, which was adopting the liability netting and a 1031 to say, "See? It doesn't apply in 1033 because you need a 1033 liability offset rule like you have in 1031."

You don't. They're just not getting it.

The single transaction -- and Gerald Cohen

concedes that. And -- and there was -- by the way, before it was reversed, there was a lot of controversy at the IRS.

The author of 2003-59 had told me that they were trying to include 1033, but, as usual, the cases -- revenue rulings are limited to the facts of the questions that were asked. It was a 1031 question. Had they been allowed to extend it to 1033, they would have.

So this is a -- this is a problem that exists only in the mind of two Franchise Tax Board attorneys. As I said, you cannot tax a taxpayer based on that theory. And that's 88 percent of the deficiency.

So the charitable contribution is 12 percent of those two. So the bulk of it is this -- is this 81-242 theory based on their notions of what GCM 38939 was and was not.

And they're wrong. They're flat wrong. And the author -- the authors of both revenue rulings have said that. And I'd like to have them here to testify to tell you that.

And the IRS has not -- has not cited that revenue ruling since it was issued -- 40-plus years. He -- he just mentioned the rev. ruling. He didn't mention the date. It's 81-242 -- it was over 40 years ago. No one's been taxed on that except these two taxpayers that have

come before you.

All right. So with respect to these four elements of res judicata. I have -- I've laid out the elements of res judicata. And as I said, I was under the understanding, from the prehearing conference, that the privity was the only element that was in question.

Now, all of a sudden, we're reverting back to "There's other elements that are in question."

Well, I wish I -- you know, I've spoken to those -- that the U.S. Tax Court opinion's the final judgment on the merits. And the -- it's clear that it's the same cause of action. It has the same nucleus of -- of operative -- common operative facts.

So Respondent, if -- if somehow, we were to view the -- the -- the April 30th 2015 U.S. Tax Court opinion as somehow being an IRS Audit Report -- which is what an IRS Determination is -- I mean, that would be more in this fictional world.

But the -- the FTB's own pre- -- prehearing conference statement said they would carry the burden of proof, not the taxpayers. Well, to the extent that their position is inconsistent with the U.S. Tax Court opinion on Sections 170 and 731, then they have the burden, not the taxpayer.

There's a presumption of correctness in the U.S.

Tax Court opinion. They just want to disregard the -- the chief judge of the U.S. Tax Court. And they wanted to say, "Oh. It's just a stipulated decision; therefore it's a" -- you know, "it's really an IRS decision."

The law is well settled. That's not right.

Section 170 -- it -- basically, their position is based on a couple of things: Those stale -- those stale appraisals that -- you know, it was a rapidly rising market in 2003 to 2006. And the taxpayer kept saying, "I'm not closing. The price is going up. The price is going up."

And the appraisals show it. And we've already done this with the IRS. The -- the issue was resolved based on a -- a meeting on the battle of appraisals.

Their appraiser was an IRS employee. Their appraiser did a drive-by. He doesn't live in California. He did not visit the Sandy -- the Palm Springs area. There are a lot of things in the IRS Examinations Report that are not quite accurate.

And as I said, the Palm Springs Unified School District completely changed their story. They told the FTB that, you know, it was taken; that's why it's a 1033. They told the IRS that it never went down that road; it was completely voluntary.

So -- the -- there's a lot of things in the

Examination Report that are not reliable. And based on that and based on the strength of the taxpayer's appraisals from a qualified appraiser, the FTB auditor has acknowledged they don't have their own appraiser.

They are trying to rely on an IRS appraisal -- which was an IRS employee -- and -- and the FTB auditor has acknowledged "We're not qualified. The FTB is not qualified to challenge appraisals."

So let's leave that to the experts -- the -- the people who do that for a living.

And we did that. And we did a battle of appraisals with the IRS. And that's why -- why only $800,000 of $9.577 million of disallowed deficiency, charitable contribution deduction, was ultimately disallowed. Because the appraisals prove it.

That's what the evidence will show specifically, not generally.

Some of the exhibits -- point to on -- so where they sprung with this theory -- they -- they state throughout their briefs that we somehow paid 67 percent of the deficiency. Well, $800- out of $9.577 million is 8.3 percent. It's not 67 percent.

That's the whited-out Exhibit X from their -- their -- Respondent's Opening Brief. That's a litigations memo. What that is -- that was the Appeals Officer

arguing to her boss, the Chief Counsel -- who did not like their views. He thought there was weakness in the appraisals. He though there was weakness in the witness credibility. That's why it went from a complete deficiency -- a complete disallowance to 8.3 percent.

The whiting out of in the arguments in the Respondent's Opening Brief used that to springboard to say that we paid 67 percent. What that is is they were telling -- they were telling the Chief Counsel that they had a 67 percent chance of victory.

Well, why do you concede and -- and -- and have the taxpayer pay 8 percent?

So a lot changed. They're -- a lot of their information is, really, nowhere near accurate.

And I was there firsthand, as I said. This was the issue I was talking about testifying. They don't have firsthand knowledge. They're reading documents and giving a view from it.

And I'm telling you, I was there. I can testify as to what happened and what did not happen. I'm a material witness on that fact.

My clients would not have been very happy if we paid 67 percent of the deficiency.

So as I said, that's the whole issue of res judicata -- that we're not going to come here and

relitigate this battle of appraisals again. We've already done that once on the exact same transaction.

We went through the appraisals. As I said, they don't have their own appraiser. They -- they're relying on the IRS; they weren't there. It wasn't their appraiser; it was an IRS employee.

We have an appraisal. In fact, we have a second appraisal from a woman named Rose Sweet. She wasn't certified. We went out and got another one. And it said -- it's close to the one that we have in the record.

So they're looking at the stale appraisals and saying those are contemporaneous. It doesn't take a genius to figure out that, in a "rising rapid" market like we've had recently again -- that old sales aren't good value -- aren't good information.

The -- the properties in our valuations were very close in time. And there were properties to support the $20 million value.

They sold for way more, and it turns out the taxpayer was right when he put that in -- in the Purchase and Sales Agreement in Section 1.2.

The -- just -- on the 81-242 issue, just to give you the -- the exhibits, it's our Exhibit 17, 15, and 16. 17 is the Tax Notes article. 15 is the Rev. Rule 81-242. And Exhibit 16 is -- is GCM 38389.

On 81-242 and the GCM, it -- those exhibits tell you all you need to know, especially the Tax Notes article.

Excuse me one minute, please.

I guess airplane mode doesn't kill that. I apologize for the disruption.

So yes, you mentioned the computational errors as well. Exhibit 11 is EY 7 -- Section 737 computation.

On the interest abatement, look, you know, it took seven years in the protest. Three years after the -- the April 2000 -- April 30th, 2015 Tax Court decision was issued -- it took three years to issue the determination letter.

We kept responding. That's in the correspondence that we submitted. We had asked, again, during discovery for FTB to say, "Is that all of the correspondence?"

They wouldn't say -- said, "Well, it's redundant to give our correspondence. We were on -- on the other end of it."

Well, then, just -- that's fine. Just say, "That's it. That's true, accurate, and complete."

And they wouldn't do that. I can tell you; that's it.

So if you look at -- at the lack of communication; the lack of transparency; not giving us the

Exhibit C, the -- the Respondent's Opening Brief; Exhibit T letter -- smoking-gun letter; not giving us any of the documents in discovery; subsequent what was reflective of what happened in the protest.

They were trying to prevail on this Section 170 and 81-242. And there just wasn't the facts of the law to do it. So it took three years. There was communication between that 2015 to 2018 period.

Take a look at the exhibits we submitted: the -- the Franchise Tax Board notice 2006-1, which was recently updated -- or more recently updated in 2018-1. Those are the Docketed Protest Procedures.

Well, none -- we kept asking for those to be followed, including a case development plan. We were ignored. There was no communication. There's a two-year time frame for this kind of -- kind of issue.

As I said, it's a very simple fact pattern and very simple law. What on earth could it take you seven years -- albeit there was a brief hiatus for the -- the federal tax matter -- but still, on the interest-abatement issue, that's not reasonable in any world. So I would take a look on those.

Exhibits 9 and 14 -- that's all the protest corresponded [sic] in nearly seven years.

Respondent's Exhibits AA and DD -- those are the

past exhibits that they submitted, not all the past documents that are relevant.

Exhibit 7-X -- 7 -- Exhibit 7, which is Respondent's Opening Brief, X, which is the whited-out IRS document.

Exhibit 25 and 26 and '7 are the -- showed that they would not provide us with the requested IRS documents or past documents.

Exhibit T is that -- that February 15, 2013 smoking-gun letter, which was Exhibit C to IRS's Audit Report. That was withheld for five years until it was attached as Exhibit T to the opening brief -- to Respondent's Opening Brief.

Exhibit 23 is Notice 2006-6, the Docketed Protest Procedures. And Exhibit 24 is Notice 2018-1.

On the delinquent penalty, I've explained those. That's thorough -- been thoroughly discussed in our briefs. They just assessed without asking any questions. There's -- there are -- it's very well described in our brief.

But the deficiency was created from the position that the return -- the 565 was filed timely. The -- the taxpayer's CPA, at the time -- a return preparer -- was terminally ill. And I've attached a brief to show his obituary. And he died. And then it took some time.

The -- the return with the extension was one month late. So that's reasonable cause. And it's explained, as I said -- explained thoroughly in the briefs.

That's -- that's it.

JUDGE HOSEY: Sorry. That concludes your arguments for now?

MR. HAMERSLEY: Yes.

JUDGE HOSEY: Okay. Thank you, Mr. Hamersley.

Mr. Immordino, would you like to begin your closing arguments?

MR. IMMORDINO: Thank you very much.

CLOSING ARGUMENT

MR. IMMORDINO: I am going to discuss the sales of Palm Springs land and the tax impact of the partnership distributions. And then my colleague, Ms. Mosnier, will cover interest abatement and res judicata and late-filing penalty.

Initially, I want to address the burden of proof. For the precedential OTA cases of Molosky and GEF Operating Inc., FTB's determination is presumed correct, and the taxpayer has the burden of proving it wrong.

Similarly, for refund claims, per the precedential OTA appeals of Gillespie and Jolly, LLC, a

taxpayer bears the burden of proving entitlement to a refund claim. See also the OTA Regulation Section 3219.

Further, Appellants have cited no law which would cause the burden to shift from the Appellants to the FTB. Accordingly, the Appellants bear the burden of proof in this appeal.

Going to the bargain sale issue. First, I note that in the relevant law, the term "condemnation" covers eminent domain and is a term I will be using going forward.

In a bargain sale, the taxpayer transfers property in a transaction that is part sale and part charitable contribution. For a bargain sale, two separate requirements must be met:

First, Appellants must show that the value of the land was clearly out of proportion to the amount paid by the School District. Second, Appellants must show the excess value in the land was transferred with the intention of making a gift.

Going to the first prong of whether Appellants have shown that the value of the land was clearly out of proportion to the amount paid by the School District. Notably, all contemporaneous appraisals, including Appellants own appraisals by two different appraisers, support that fair market value was paid for the land.

In addition, the IRS physically inspected the land and also prepared an appraisal which determined that fair market value was paid for the land.

Further, as discussed by the IRS in Exhibit B, the IRS reviewed the Appellant's new appraisal, which valued the land at $20 million, and found that it was biased, inconsistent, and did not support the valuation.

While this appeal deals with the threat of condemnation, that threat came out just two weeks before the purchase agreement was signed.

So let's look at the year and a half during which there was no threat of condemnation and Appellants could have sold the land to third parties. And, in fact, the School District even encouraged the Appellants to accept any third-party offers.

In Exhibit H, the Appellant's attorney summarizes that the School District had informed Appellants to, and I quote, "not hesitate to accept offers from third parties because the School District may not ultimately proceed with the acquisition," end quote.

The School District reiterated in Exhibit I that Appellants are free to dispose of the property as they believe is in their best interest.

Appellants had the opportunity to sell to any third parties who offered a better deal than the School

District. But Appellants did not a sell to a third party and chose instead to pursue negotiations with the School District.

Let's look -- let's look at the negotiations between the parties and the Appellant's own words during the final round of negotiations that led to the purchase price.

Exhibit H is a July 2005 letter from the Appellant's attorney to the School District's attorney, in which the Appellant's attorney summarizes that the Appellant called the School District and told them that he thought the value of the land to be $550,000 per acre but wanted at least $600,000 per acre based on high interest from third parties.

So $600,000 per acre is the high point that the Appellants asserted in their negotiation posturing. And as we all know, the way negotiations work is that you ask for the best, each side gives a little, and you meet somewhere in the middle.

And that's exactly what happened here with the School District making a fair market offer at $550,000 per acre -- an amount that even Appellants' own July 2005 letter -- dated -- reflected fair market value.

Appellants accepted this offer. And the sale closed at $550,000 per acre, which is a $10.5 million

sales price.

The unrelated third party also sold the adjacent parcel of land for the same per-acre price. This is a sale that was fully negotiated and that closed at fair market value.

The purchase price was equal to 98 percent of the Appellant's highest appraisal and 100 percent of the School District's highest appraisal.

Now, the Appellant mentions the timing of the appraisals and that they were outdated. But the -- the exhibits I just cited -- mentioned -- came from July, which is where the Appellants mention of the property was worth -- or July 2005, where the Appellants mentioned the property's worth $550,000 per acre. But he postured in negotiations that he wanted $600,000 per acre. That was July of 2005.

Then, during August of 2005, the School District got an update to its appraisal. And that update was then modified in October of 2005.

So in October of 2005, the school district's appraisal reflected a value of $550,000 per acre. And the Purchase Sale Agreement was signed just one month later in November of 2005.

Now, the Appellants are using a date of April of 2006. That is the date that the sale closed. The

Purchase Sale Agreement was signed in November of 2005. And that is the date when the parties agreed on a price. And that's how, especially commercial, real estate transactions work.

You sign a Purchase Sale Agreement. The deal is set. And then there's a due diligence period for any real, you know -- real property purchase. Once the due diligence period is over, then the deal -- then the escrow will close and the title transfers.

But the agreement on price was in that Purchase Sale Agreement. That was a binding legal document. If either party had not wanted to go forward with their -- with their obligations under that document, they would be subject to breach.

And again, in November of 2005, the School District had let the Appellants know about the condemnation -- of the plan to begin condemnation process.

If the Appellants did not feel the School District's offer was fair, they had the -- the option to pursue remedies through the condemnation process. But they chose not to.

In Meyer Brewing, the taxpayer values property at $1.2 million but accepted $900,000. In not allowing a bargain sale, the Tax Court stated, and I quote, "The taxpayer who negotiates for the best terms he can obtain

in a commercial transaction cannot subsequently claim a deduction based upon on any excess value of the contributed property," end quote.

Also as the court in Hope stated, and I quote, "Grover Hope, now, should not be allowed to claim that he consented to the settlement only because he would later claim a bargain sale and charitable gift to the state," end quote.

Similar to the taxpayers in Hope and Meyer Brewing, Appellants engaged in lengthy negotiations which resulted in a fair market value price and are now precluded from asserting a bargain sale occurred.

The facts demonstrated that Appellants have not met -- met their burden of showing that the value of the land was clearly out of proportion to the amount paid by the School District.

Now, moving to the second prong of a bargain sale, which is whether Appellants have met their burden of showing that the transfer of any excess value in the land was made with the intention of making a gift.

Importantly, this appeal deals with properties sold under the threat of condemnation. Appellants deferred gain from the sale of the Palm Springs land under Internal Revenue Code Section 1033 by asserting that the land was sold under the threat of condemnation.

Appellants also assert, in Exhibit Q, that the implications of the condemnation were so significant that the School District would not sign the charitable contribution form because the School District was concerned about being legally required to pay more for the land.

These statements were made by the Appellants under penalty of perjury.

Now, under the case law, if Appellants feel that they are not being offered enough for their property, then they must go through the condemnation process.

Similar to Appellants, the taxpayers in Hope inserted a clause in the purchase agreement that the taxpayer believes the value of the property exceeds the purchase price.

The Hope court rejected his clause and stated that such a unilateral statement cannot change the taxpayer's negotiated fair market value deal into a bargain sale.

The Appellants argue that they should be considered under the condemnation process for some items that benefit their position in this appeal but not for others that do not benefit them.

But Appellants cannot have it both ways. In fact, the Hope court discusses exactly the

inappropriateness of the advantage Appellants, from the taxpayers in Hope, were trying to obtain at the crossroads of the condemnation process in tax law with the courts, stating, and I quote, "The condemnation procedures should not be forced to compete with the tax procedures for the right to determine value in a condemnation case," end quote.

Accordingly, if taxpayers felt the offer was too low, they had recourse through the condemnation process, which they chose not to pursue.

So in conclusion, it is the Appellants' burden to show that they met each of the two separate requirements necessary for bargain-sale treatment. In this appeal, Appellants have satisfied neither.

This leads to the second issue in this appeal, which is did the Appellants meet their burden of showing error in FTB's assessment that partnership distributions exceeded the Appellants' partnership basis.

Now, as we already discussed, partners must recognize gain when distributions exceed their partnership basis. This includes not only distributions of cash, but the relief of partnership liabilities.

This appeal deals with Appellants' distributions from the MacLeod Couch Properties, LLC, also referred to as MC Properties, LLC, in various documents.

Appellants' total cash contributions received and partnership liabilities relieved exceeded the Appellants' basis; and therefore, Appellants have taxable gain under IRC Section 731. It is a purely mechanical result.

Regarding the treatment of partnership liabilities in an IRC Section 1033 transaction, such as we have in this appeal, there are both a General Counsel Memorandum, or GCM, and a revenue ruling directly on point, which affirms the FTB's assessment in this appeal.

In GCM 38389, the IRS considered thoroughly -- and thoroughly reviewed the partnership liability netting issue -- and specifically rejected the analysis set forth by the Appellants.

Now, in their opening, the Appellants mentioned Regulation 1.752.1(f) that was referred to as the "single-transaction rule."

And so what this says is that, when there's a single transaction, you net the impact to the partnership change in liabilities in that transaction.

The examples given in that regulation are when you contribute property, which is subject to a liability, to a partnership. In this single transaction, there are multiple impacts to a partner's liabilities, and you net it.

It also gives the example of a merger. When you

have a -- a merger, which is a single transaction, you net the impact on the partnership liabilities.

But even though these -- some changes to these regs might happen after the GCM, the GCM still specifically analyzed the single-transaction-netting issue.

And it said there's no way that you could have a sale of a property followed by a purchase of another property, potentially years later, and you could say that's one transaction.

And the OTA made a similar analysis in its decision in the Appeal of Shaeffer.

And so one -- one year after the GCM was issued, the IRS then memorialized the GCM's analysis and conclusion in Revenue Ruling 81-242.

As the Ninth Circuit Court of Appeals held, revenue rulings are entitled to substantial judicial deference. With the Ninth Circuit stating The McKnight Ranch, and I quote, "It is well stated that, where federal law and California law are the same, federal rulings dealing with the Internal Revenue Code are persuasive authority in interpreting the California statute," end quote.

Also, while not precedential, the OTA analyzed this same issue in 2019 in the Appeal of Scott Schaeffer.

And consistent with the revenue ruling, made it -- a determination consistent with the FTB's assessment in this appeal, including analyzing the single-transaction rule.

In the briefing, the Appellants also discuss the unitary basis rule, as discussed in Revenue Ruling 84-53. And this revenue ruling also supports FTB's assessment.

This rule references the basis rules in IRC section 705 and states that a taxpayer who has multiple direct interests in a partnership will only have one basis in that partnership.

So the scenarios in the revenue ruling are where a taxpayer owns both a direct general interest and a limited interest in the same partnership.

So while the taxpayer has two direct interests in that partnership, the taxpayer still only has one single basis in the partnership.

This same issue comes up -- or this same issue comes up with disregarded entities. Say a taxpayer owns an interest in a partnership directly and also owns an interest in that same partnership via an entity that is disregarded for tax purposes.

Since the disregarded entity does not exist for tax purposes, the taxpayer is treated as owing -- as owning the disregarded entity's interest directly.

So for tax purposes, the taxpayer's two direct

interests in the same partnership, i.e., the interest a taxpayer owns directly and the interest the taxpayer owns through the entity which is disregarded for tax purposes.

Now, in this appeal, Appellants have a partnership interest in MacLeod Couch Properties, LLC, and accordingly have a basis in MacLeod Couch Properties, LLC.

Other partnerships also have an interest in the MacLeod Couch Properties. However, unlike the treatment of disregarded entities I just mentioned, these partnerships are not disregarded entities but are separate taxpayers that have their own interests and their own bases in MacLeod Couch Properties per IRC Section 705.

To the extent that Appellants have direct interest in these other partnerships, Appellants would have a separate basis in each partnership. However, nothing in IRC Section 705 or the revenue ruling says that these bases can be amalgamated.

For these reasons, the Appellants have not met their burden of showing the error in FTB's assessment that partnership distributions exceeded the Appellants' partnership basis.

And the last item I wanted to cover has to do with the IRS settlement.

So Exhibit 11 is the IRS Internal Settlement -- or Internal Settlement Document, where the IRS discusses

the pros and cons of going forward with the settlement.

I note that, as Exhibit X to Appellant -- or Respondent's Opening Brief, we attached a -- a copy of the schedule only. And the reason for this is that we had not yet received permission from the IRS to release their internal settlement analysis.

And so, working with FTB's general counsel, we figured out what would be permissible to be released. And a determination was made that that schedule alone could be released without the entire document.

Subsequently, the IRS gave us permission to release the full document. And it's included in Exhibit Y. On page 19 of Exhibit Y, you can see the full analysis of the settlement between the taxpayer and the IRS.

And if you go -- at the very top it says the 2010 appraisal value was $20 million. The sales price was $10.5 million. The difference is amount claimed as a charitable deduction is a -- $9.5 million. That's on line 3.

And then the next line, line 4, "estimate of government's litigating hazard," 33 percent. And so the next line, "charitable deduction for settlement purposes," $3.2 million.

For the IRS in their settlement of 33 percent concession, they allowed $3.2 million. And they

disallowed approximately $6.2 million -- or $6.3 million of the claimed charitable deduction.

And then, as you can go through the line, you'll see deducted in 2007, deducted in 2008, deducted in 2009 a total of $753,000.

And then it says, "carryover to 2010 based on solvent range," $2.4 million would carry over to 2010. There's an AGI limitation that took away $114,000. $2.3 million was used to offset the taxpayer's income. They had claimed $3.1 million. And so the resulting assessment was $800,000.

You can see that very bottom line, 2011 disallowance is $800,000 on that particular tax return.

So they lost $800,000 on their 2000 -- on their 2011 tax return. Plus the remainder -- because it -- it was a total, you know -- they -- the IRS disallowed $6.2 million; they allowed $3.2 million. And they used up that $3.2 million between 2007, '8, '9, '10, and '11 -- and it got all used up in 2011; so they had to pay $800,000 -- or they had $800,000 disallowed.

And this $800,000 figure comports with all the documentation in the case. Mr. Hamersley has conceded that's $800,000 in 2011. But what hasn't been brought up is they lost $6.2 million of their claimed $9.5 million -- or $6.3 million of their claimed $9.5 million charitable

deduction.

It's clearly a 67 percent taxpayer concession.

And with that, I'll pass it over to my colleague, Ms. Mosnier.

JUDGE HOSEY: Ms. Mosnier, you have about 20 minutes.

MS. MOSNIER: Thank you. I was just going to ask you for that number. Okay. Thank you.

FURTHER CLOSING ARGUMENT

MS. MOSNIER: Good afternoon. Marguerite Mosnier for Franchise Tax Board. And I will be addressing the issues of res judicata, interest abatement, and late-filing penalty.

Turning first to the issue of res judicata. It is Appellants' defense to the adjustments and the attendant penalty -- which are issues, I believe, 1, 2, and 4 set out in the prehearing conference minutes and orders.

In other words, the Franchise Tax Board is bound by res judicata to follow the Tax Court judgement for the 2006 tax year. That position is unsubstantiated by the law.

And before I talk about what res judicata is, I'd like to talk about what it isn't -- is not.

It is not, as Appellants assert, a conformity issue. It's not entirely clear the context in which Appellants are using that term today.

If they are using it in -- in the term that we often understand it as Franchise Tax Board, which is that we adopt as our own State tax laws specific Internal Revenue Code sections, we say that we have "adopted them by conformity."

So there is that conformity. And that is unrelated to the concept of res judicata.

If the term "conformity" is used today to mean a resulting action by the Franchise Tax Board that flows from what's called a "final federal determination," pursuant to Revenue and Taxation Code 18622, that is also not relevant to the concept of res judicata.

And I will speak a little bit more about 18622 later in my discussion about res judicata.

So what is res judicata?

It's an affirmative defense. And the burden of proof to establish entitlement to that defense rests with the party who is asserting it.

And in -- in OTA's February 4th, 2021 order regarding requests for subpoenas for documents and witness testimony, footnote 2, the OTA -- OTA noted the Appellants' assertion that it was their burden of proof on

this area. And the OTA agreed with that.

And as the OTA recited in Appeal -- its precedential opinion Appeal of Millennium Dental Technologies, a 2019 opinion, a party wishing to assert the affirmative defense of res judicata must establish the following four elements:

First, that the parties in both actions are identical or in privity. Second, that a court of competent jurisdiction must have rendered the first judgment. Third, the prior action must have resulted in a judgment on the merits. And fourth, the same cause of action or claim must be involved in both actions.

With respect to the first element, obviously there's no identity. There's no identity of parties because it was the Internal Revenue Service at the federal level, and it is Franchise Tax Board at the state level.

There is also no privity between the IRS and the Franchise Tax Board.

As FTB discussed in its opening brief, California Supreme Court defines "privity," or a "privy," as one who, after rendition of the judgment, has acquired an interest in the subject matter affected by the judgment through or under one of the parties as by inherent succession were purchased.

So in other words, what we're talking about is

someone who, quote, "stands in the shoes of that first party."

FTB does not have such an interest. There is nothing in the record that indicates FTB had any influence on or directed the Internal Revenue Service's actions, either during its examination or subsequently during the Tax Court litigation, when the matter was conducted or overseen by the IRS Appeals Office.

What there was was information sharing, which is authorized by agreement between the Internal Revenue Service and the Franchise Tax Board.

And that is all it is. It is a sharing of information. It is -- it -- it vests no interest in either party -- in the outcome reached by the other party. And so there is no identity of parties, and there is no privity.

With respect to the second element, Franchise Tax Board acknowledges that the U.S. Tax Court is a court of competent jurisdiction. That element is not in dispute.

And moving on to the third element, which is that there must have been, in the first action, a judgment on the merits.

Here, it's instructive to look at the Appellants' Exhibit 10 to its opening brief -- to their opening brief and note the first, I think it's seven words of the

judgment, "pursuant to the agreement of the parties."

This was not a matter in which the Tax Court considered the merits of either party's decision and applied relevant law to reach a judgment. It was an acceptance of an agreement negotiated between the Internal Revenue Service and the Appellants.

And as we have just heard Mr. Immordino explain, the Appeals Division of the IRS determined that it would settle for 33 percent -- allow 33 percent of the claimed deduction based strictly on hazards of litigation.

That is not a judgment on the merits. You can see that also if you look at the Tax Court docket -- it is one of the Plaintiff's additional exhibits -- one that we discussed at the beginning of the hearing today.

There are very few entries on that docket. There's nothing on it -- nothing substantive between the filing of the action in Tax Court and the entry of the judgment.

And that -- that confirms the fact that the Tax Court itself took no active role in the review of or disposition of the issues on appeal there. So they have not established the third element either.

They are equally -- they have failed equally to establish the fourth element -- that the same cause of action or claim must be involved in both actions.

Now, here, we have to take a step back and look at the procedural -- or not the procedural -- the factual difference between the taxpayer's position and their amended return filed with FTB in October of 2010 and the same amended return filed at the federal level at that time.

The Franchise Tax Board processed and accepted the 540X -- the amended return that the Appellants filed -- the one in which they claimed the charitable contribution deduction, which was subsequently disallowed as shown on the Notice of Proposed Assessment.

If, however, you look at the federal account transcript, that's Exhibit FF on page 2, you will see that in October of 2010, the Appellants did file an amended return and that the IRS disallowed that claim.

In other words, there was never a charitable contribution deduction allowed at the federal level for the 2006 tax year.

And a third way to -- to cross check that is look on the first page of the account transcript. And you see that the federal AGI is the -- its around $4,200 -- it's the same amount listed on the 540X as the amount that was reported on the original 1040 -- on the original federal return.

So there could not have been an adjudication or

an -- an issue of the -- the charitable contribution deduction between the IRS and the Appellants for the 2006 tax year. It was never allowed. It was never -- it was not a part of the negotiated settlement.

Likewise, with respect to the Section 731 gain issue, the record in this case is devoid of discussion or evidence that indicates the IRS considered the Section 31 [sic] gain issue for this tax year.

So there has not been symmetry or identity between the causes -- or causes of actions or claims that were resolved at the federal level and what is in dispute before you all today.

Appellants have failed to establish elements -- as I have them numbered here, one, three, and four -- for res judicata. And it is not applicable in this case.

And a finding that there was no res judicata is consistent with Board of Equalization precedential opinions starting with the Appeal of Der Wienerschnitzel in 1975 and followed by Appeal of Bertrand in 1985. And the OTA adopts this view as well.

In Millennium Dental Technologies, in footnote 13, the OTA noted a plaintiff's objection -- a comment regarding an objection to a proposed penalty -- and noted that the IRS had not assessed a -- excuse me -- had not assessed a penalty.

The OTA went on to note that the FTB's assessment was proper in that case and that the Franchise Tax Board does not have to follow IRS actions and cited to Der Wienerschnitzel.

Further, if you would look at the January 22, 2020 orders re discovery that the OTA issued in this appeal and look at footnote 3, it is instructive:

"Appellants have cited no authority for their claim that Franchise Tax Board is bound to accept the Internal Revenue Service's one-third concession (much less to treat it as a total concession as Appellants demand) and the law is clear to the contrary," with cites to Revenue and Taxation Code 18622(a) and to Appeal, I think it's Giselle 80-sbe-035.

And then, finally, if we look at uncertainty as to how this IRS judgment would translate to the Franchise Tax Board.

It is -- the uncertainty there is reason enough to disregard the idea that it could be a document that would govern the outcome of this appeal.

Because there's no 731 issue or 2006 issue at the federal level -- there was no charitable contribution allowed -- how could you allow one-third of a proposed deduction that wasn't even part of that?

And since there was no -- there could not be an

effect on the proposed adjustments or additional tax. So the -- the Appellants have failed to establish that res judicata should be applied in this appeal with respect to the 2006 tax year.

And when I said I would double back to 18622 on this topic, the conformity that FTB has -- and under 18622(a), when FTB issues a proposed assessment that results from a federal action, it's presumed correct. And the burden is on the taxpayer to prove that it's wrong.

However, we know under Der Wienerschnitzel that neither the OTA nor the Franchise Tax Board is bound to follow the Internal Revenue Service.

And this is not a federal action assessment. It does not result from the work and the determination of the Internal Revenue Service.

And I would just make a side note there that a final federal determination -- and when we talk about an IRS Determination -- it -- it does include a Tax Court judgment.

1862(d) [sic] defines "final federal determination" as defined in 6203 of the Internal Revenue Code. And then, if you go to the attendant regulation -- and I believe it's Revenue Ruling 1-2007- -- I'm sorry. I can't remember the last numbers -- the -- well, actually -- actually, that part probably isn't relevant

there.

What it says is what's on the account transcript is evidence of the final federal determination. And it's a point where there this is no longer any appeal or action that could be taken by the Appellants. And so, of course, that would -- that would encompass the terms of the settlement.

So to turn now to interest abatement, here, again, the Appellants have the burden of proof.

And we know from the Office of Tax Appeals precedential opinion in Appeal of GEF Operating, Inc., that to establish an abuse of discretion, the Appellants must show that in refusing to abate interest, that the Franchise Tax Board exercised its discretion arbitrarily, capriciously, or without sound basis in law and fact.

And this, the Appellants have not done. Although interest abatement is authorized in limited circumstances, Appellants haven't showed entitlement to it in this case.

FTB diligently prosecuted the protest since it was filed. It was filed towards the end of -- the protest filed towards the end of 2011. And FTB wrote promptly in January of 2012 to say, "we have the appeal" -- or excuse me "the protest. It's being assigned to the Protest Unit," and received a request then in response from Appellants asking to have the protest docketed.

So dual time got it docketed. And then the first Protest Hearing Officer promptly issued a set of info -- information and document request -- an IDR letter.

And that was followed later in 2012 by a request -- a response from Appellants, asking to have that Protest Hearing Officer switched out for a -- a conflict of interest.

And there's no -- there's no record in the file that indicates whether FTB made any decision on the merits, whether there was any actual conflict of interest. But -- or whether -- but to avoid the appearance of any, there was a second Protest Hearing Officer assigned to this case.

And he, in early 2013, sent out IDRs and responded to the Appellants' request since the first January 2012 letter saying, "you know, we may need to put this on hold because the IRS is looking at these same -- is looking at these same issues."

And so while FTB then said, "Well, you know, there are some things, issues, perhaps we can go ahead on. Maybe there are others that will have to wait." And the bottom line is that the Franchise Tax Board accommodated the Appellants' request to wait until there was a, quote, "final federal determination" before it finished its work on this protest.

And it didn't happen until July of 20- -- 2015. FTB was advised there had been a judgment. And it took almost two years after that, waiting for IRS documents, to determine the extent to which that federal judgment would affect the outcome at the state level.

And, specifically, in the July 16, 2015 letter from -- from the Appellants' Counsel -- or from their representative, they represented that both the charitable contribution deduction issue and the 731 issue were covered by that judgment.

As it turned out, and as I said, it took FTB almost two years -- until 2017, to determine that it had all the federal documents and that there wasn't the overlap and, further, that, in any event, it was not required to follow what the IRS did.

After that, the appeal -- the -- the protest hearing was held in May of 2018. The notices of -- the notices of action were issued -- oh, I don't know -- a couple weeks after that.

So throughout this -- throughout the entire time period of the protest, FTB worked with the Appellants to accommodate them and to keep working on the protest as -- as possible.

Finally, with respect to the Section 139 late-filing penalty. If you see on -- as you see it on

Exhibit EE, the Appellants 2006 California return was filed November 29, 2007.

It was due April 15th. So it was more than seven months late. And the penalty was applied -- it's applied automatically under the law.

Since the -- no return had been filed during the extension period -- there was no extension with respect to Appellant -- so the penalty was properly computed at the maximum 25 percent rate.

The Appellants' assertion in their reply brief -- the reason it was late is that the -- their tax -- the representative preparing the return had died is unsupported by any documentary evidence in record.

There is nothing to show whether he was their representative; whether he was preparing the return for that year; when they learned that he would be unable to complete that return so that they could file it; and, if so, what steps they took to ensure that if he couldn't, that someone else could prepare it so that they could meet their filing obligation.

And so for a failure of proof, they have not established that they -- that reasonable cause exists to abate that penalty.

Thank you.

Mr. Immordino and I -- this concludes our

argument. And we're happy to address your questions. Thank you.

JUDGE HOSEY: Okay. Thank you.

I am going to check with the panel and see if they have any questions before we move forward with rebuttal.

Judge Vassigh, do you have any questions?

JUDGE VASSIGH: I do not. Thank you.

JUDGE HOSEY: Judge Le, do you have any questions?

JUDGE LE: No questions. Thank you.

JUDGE HOSEY: Okay. I'm going to go ahead and deny the request for testimony since we have the documents. And, well, it was a late request. And we didn't have any questions regarding the factual circumstances.

MR. HAMERSLEY: I'm sorry. What testimony would that be?

JUDGE HOSEY: Oh. You just requested you would -- could be sworn in and testify yourself as to personal knowledge. But I just don't think we need that at this time.

MR. HAMERSLEY: There's been factual -- material fact statements back and forth.

JUDGE HOSEY: Yeah.

MR. HAMERSLEY: -- by both sides this entire time.

JUDGE HOSEY: I think we have --

MR. HAMERSLEY: But I -- but I am first -- I'm willing to go under oath. And I have firsthand knowledge.

JUDGE HOSEY: Yeah. We're not going to need that today. But thank you. I appreciate it.

We will go ahead, though, with some rebuttal time, if you'd like some.

Let me make sure I just have everything here.

Yes. You have time for some final statements, if you'd like to, Mr. Hamersley.

MR. HAMERSLEY: How long do I have?

JUDGE HOSEY: Go ahead.

MR. HAMERSLEY: How long do I have, Judge?

JUDGE HOSEY: Oh, yes. You have 20 minutes.

REBUTTAL

MR. HAMERSLEY: Okay. Well, that -- that's why this -- this protest took seven years.

No matter what we say, no matter what evidence we put into the record, they keep -- they read a script. And they just say no evidence -- we didn't prove -- they say the burden of proof is on us.

Well, I've explained thoroughly why the burden of

proof shifts from the U.S. Tax Court decision. 18622, if you look at Wienerschnitzel, Giselle, McAfee -- those cases all deal with an IRS Audit Report.

They're -- the -- the case law I gave you on the recent Ninth Circuit decision and the -- and the California Supreme decision cite well-settled law a stipulated court decision, and -- from a settlement agreement in litigation -- once you file a U.S. Tax Court petition, it's litigation.

You're done with the IRS when the 90-day letter is issued. They're -- now, you're -- they're -- now, they're their opposing party in litigation.

So I can't even begin to say how wrong that was on the law on several points and how wrong on the facts.

Adopt the law and those facts at your own peril. It's just flat wrong. The documents show it. I have testimony -- I have firsthand observed the -- the true facts.

So 18622 is not accurate here. There's never been a case where -- where -- I'm aware of where -- where the FTB refused to follow a U.S. Tax Court decision that was pending federal on the same taxpayer for the same year for the same transaction.

On the issue of the zero dollars in the 2006. It carried over to the subsequent years. The -- those --

they -- they have no idea what they're reading in those documents.

I negotiated that settlement. All but $800,000 of $9.577 million was allowed. They took the benefit of that charitable contribution benefit deduction.

Those are the facts. They don't have any firsthand knowledge to the contrary. They're reading stuff they don't understand.

On res judicata, that law is not correct. There's no identity required. Because -- I -- I read you the quote. It's an identity or community of interest.

That's the law. And it's very broad. And if you look at the case law of all of the facts that have been viewed to be -- have an identity or community of interest -- I told you, they said we didn't establish that there was an identity or -- identity of interest.

Well, they follow the same law. They could only have exchanged documents, which they did, if they had an identity or community interest in the -- in the MOA and the disclosure statutes.

The -- they didn't just send documents and exchange it. If you look at the -- if you look at the Exhibits AA and DD, they -- they talked often. And Exhibit T, the smoking-gun letter that they wouldn't give us for five years, was the legal arguments on 731 and 170.

I was there. The IRS laughed at the 81-242. Just like the chief -- former Chief Counsel who wrote the GCM, they don't think that's good law.

And they say -- and the IRS, by the way, wasn't sharing anything with us. We had to get that, ultimately, from the FTB -- from what they would disclose in their exhibits. So we were in -- just as in the dark with the IRS.

So why would there be anything -- the -- the analysis they're pointing to -- they keep saying that -- that -- that Exhibit X, which was whited out -- so you compare the other redactions -- they're all blacked out in normal redaction mode -- look at the arguments made in the Responding's [sic] Opening Brief that refers to that Exhibit X.

He's making the 67 percent argument there. We didn't pay 67 percent. It's flat wrong. And if he had left those -- if he had left those paragraphs above and below in the line-item description, that argument would not hold. It's contradicted by the information that was removed -- was whited out.

Why would you white out information? You said you were waiting on IRS approval -- that -- they had that those -- those letters for a long time. Why did you put it in there at all?

And if you did, when you put it in, why didn't you redact it in normal fashion to let people know that there was something removed?

So -- on -- on -- on the rest of the law, the 81-242, I've already testified or argued how that works and -- and doesn't work.

They just categorically do not understand the law or the facts. And no matter what we say or what we write -- and that's why we've had to write volumes in this case, and we've had to spend inordinate amounts of time to try to get the rest of the documents, the rest of the past documents, the rest of the IRS documents that they just selectively chose to put little pieces in.

If you look at Exhibits AA and DD, their own documents, you will also see that there's a reference in there that says the IRS -- the Tax Court decision -- what -- after speaking with the IRS, was decided on the merits.

It wasn't litigation hazards. They had 67 percent chance of winning -- is what it says in their memo.

The reason they settled at 8.3 percent is because their appraisal was horrible. It was from an IRS agent. And our appraisals were -- showed -- showed the value and supported it, and because their witness, as I said, in the

Palm Springs Unified School District switched their story and was completely unreliable.

Their case, on the merits, was terrible. And that's why it was settled at 8.3 percent. 67 percent is a fiction. And it's the carryover, I guess -- that they don't understand how that works.

Bottom line, $800,000 of $9.577 million was all that was disallowed. That's 8.3 percent; it's not 67 percent.

So I don't know what to tell you. Read the documents. I'd love to give firsthand testimony under oath. I'm not able to do that.

I'd love to have other witnesses testify about 81-242 -- what it means and what it doesn't. You can read their own article. It makes all the arguments that it's not good law.

So they'll say that's not authority. It sure as heck is a statement of the intent, interest, or -- or an admission that our position is well supported.

So when you're looking at the weight of evidence, consider all those things.

They said that we didn't submit any evidence that the CPA had died. I submitted his obituary that referenced that he had a long-term illness.

There was no dialogue. When you don't have

communication with a taxpayer for seven years -- and you can see from the -- the -- the -- all of the emails that I put in -- that's it over seven years.

When you don't have communications and you hide your actions in -- in -- in violating 2006-6 and transparency policies that this -- this OTA is under as well -- when you hire -- it's going to take a long time, and you're not going to get it right.

If you would talk to the taxpayer and -- and you would listen and you wouldn't keep repeating the same script no matter what they say or what they give you, then we wouldn't -- it wouldn't have taken seven years.

It took two years with the IRS because, finally, we got to a point where they realized the appraisals were bad. That the IRS appraisers -- appraisal was bad from Mr. Power, the IRS employee -- and that their witness on all those statements that were reiterated here, were not reliable or accurate.

So -- the credibility and the weight of evidence matters. Narratives are just that. They're useless statements unless they're supported by documents.

And they're -- they're citing documents to say they're supported. I'm trying to tell you that's not what those documents say. And my -- my -- my testimony can enlighten that because I was there. And I'm the one who

negotiated several of those documents.

That's all we have to say.

JUDGE HOSEY: Okay. Thank you.

I'm just going to check with my panel again to see if there's any questions before we submit the case.

Judge Vassigh, do you have any questions?

JUDGE VASSIGH: I do not.

JUDGE HOSEY: Judge Le, any other questions?

JUDGE LE: No questions. Thank you.

JUDGE HOSEY: Okay. Then we are ready to submit the case today. The record is now closed.

This concludes our hearing. And the panel will meet and decide the case based on the exhibits and arguments presented. We will aim to send both parties our written decision no later than 100 days from today.

Thank you all for your participation. The hearing is now adjourned. Thank you.

(Proceedings concluded at 3:58 p.m.)

REPORTER'S CERTIFICATION

I, Sarah M. Tuman, RPR, CSR No. 14463, a Certified Shorthand Reporter in and for the State of California, do hereby certify:

That the foregoing proceedings were taken before me at the time and place herein set forth; that any witnesses in the foregoing proceedings, prior to testifying, were duly sworn; that a record of the proceedings was made by me using machine shorthand, which was thereafter transcribed under my direction; that the foregoing transcript is a true record of the testimony given.

Further, that if the foregoing pertains to the original transcript of a deposition in a federal case, before completion of the proceedings, review of the transcript [] was [×] was not requested.

I further certify I am neither financially interested in the action nor a relative or employee of any attorney or party to this action.

IN WITNESS WHEREOF, I have this date subscribed my name.

Dated: November 4, 2022

Sarah M. Tuman, CSR, RPR, CSR No. 14463

Certified Shorthand Reporter

For The State of California

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