BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	)	
	)	
S.W.S. REALTY, LLC	)	OTA No. 21088351
M. SHORAKA and K. SHORAKA	)	21088354
S. SHORAKA	)	21088356
B. SHORAKA	)	21088359
S. SHIDFAR	)	21088360
J. VARJAVAND,	)	21088361
	)	
Appellants.	)	
_____	)	

TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Tuesday, June 6, 2023

Reported by:

MARCENA M. MUNGUIA,
CSR No. 10420

Job No.:
42313 OTA(A)

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TRANSCRIPT OF PROCEEDINGS, taken at 12900 Park Plaza Drive, Suite 300, Cerritos, California, commencing at 9:47 a.m. and concluding at 11:38 a.m. on Tuesday, June 6, 2023, reported by MARCENA M. MUNGUIA, CSR No. 10420, a Certified Shorthand Reporter in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ VERONICA LONG
Panel Members:	ALJ JOHN JOHNSON ALJ EDDY LAM
For the Appellant:	DAVID RILEY DONNA LA PORTE
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD: CAROLYN KUDUK MARGUERITE MOSNIER

I N D E X

E X H I B I T S

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Cerritos, California, Tuesday, June 6, 2023

9:47 a.m.

JUDGE LONG: We are opening the record in the appeal of S.W.S. Realty, LLC, et al., OTA case numbers 21088351, 21088354, 21088356, 21088359, 21088360, 21088361.

This matter is being held before the Office of Tax Appeals. Today's date is Tuesday, June 6th, 2023, and the time is approximately 9:47 a.m.

My name is Veronica Long and I am the lead Administrative Law Judge for this appeal. With me today are Administrative Law Judges John Johnson and Eddie Lam.

As a reminder, the Office of Tax Appeals is not a court. It is an independent appeals body. The office is staffed by tax experts and is independent of the state's tax agencies.

With that, let me please have the parties introduce themselves for the record, starting with Appellants.

MR. RILEY: My name is David W. Riley. I'm the representative for S.W.S. Realty.

MS. LA PORTE: Donna LaPorte of LaPorte Law and I'm a representative of Appellants as well.

JUDGE LONG: And Respondent, Franchise Tax Board?

MS. KUDUK: My name is Carolyn Kuduk. I'm appearing for Franchise Tax Board.

MS. MOSNIER: Marguerite Mosnier for Franchise Tax Board.

JUDGE LONG: Okay. Thank you very much. Judge Long speaking.

As confirmed at the prehearing conference and in my minutes and orders following that conference, the issue to be decided in this appeal is: Whether Appellants have established that S.W.S. Realty, LLC's disposition of real property located at Slauson -- that's S-l-a-u-s-o-n -- Avenue, qualifies for nonrecognition treatment pursuant to Internal Revenue Code Section 1031.

Subsequent to the prehearing conference, FTB identified a second issue for this appeal and that issue is: In the alternative that the 1031 transaction is allowed, whether Appellants had additional taxable boot as a result of the transcription.

So with that, let's move on to the evidence in this appeal.

Subsequent to the prehearing conference, Appellants submitted Exhibits A through D. OTA's regulations require Appellants to use numbers instead of letters, so I'm retitling the exhibits Appellants' Exhibits 1 through 4.

FTB, do you have any objection to these exhibits?

MS. KUDUK: No.

JUDGE LONG: Thank you. Appellants' Exhibits 1 through 4 are now admitted and entered into the record.

(Appellants' Exhibits 1 through 4 were received in evidence by the Administrative Law Judge.)

JUDGE LONG: FTB submitted Exhibits A through S. Exhibits A through Q were submitted by FTB prior to the prehearing conference and Appellants indicated they did not have any objection to the exhibits. FTB's Exhibits R and S were submitted subsequent to the prehearing conference.

Appellants, do you have any objection to these exhibits?

MR. RILEY: No.

JUDGE LONG: Thank you. FTB's Exhibits A through S are now admitted and entered into the record.

(Respondent's Exhibits A through S were received in evidence by the Administrative Law Judge.)

JUDGE LONG: I'd like to quickly go over the order of the proceedings today. In my minutes and orders, I indicated that Appellants would have 60 minutes for its presentation. Following Appellants' presentation, I will turn to my panel to see if they have any questions for

Appellants.

Then FTB will make its presentation. It will also have 60 minutes.

Following that, I will again turn it over to the panel for any questions.

Finally, Appellants will have an additional minute -- an additional 30 minutes for its closing or rebuttal, which will be followed by any final questions the panel may have for either party.

Once we hit the two-hour mark or sooner if requested by any party, panel member or staff, I may order a short ten-minute recess.

With that, I think we are ready to begin.

Appellants, you may begin your presentation whenever you are ready.

MR. RILEY: To start off, the judge at our last phone call requested that we answer our question dealing with the basis on the property and when depreciation would change if the Court determines that the exchange was invalid.

The answer is that the depreciation, the cost basis, of the property would jump to 14 million, which is the installment purchase price of the property to the related party, and that will occur on December 1st, the day after the exchange, the purchase of the property.

And so there would be new additional depreciation owed on -- for the 2010 period and then every year afterwards.

Just to note, I have had one litigated exchange of a 1031 at the property with the FTB previously and in that previous arrangement, we actually -- they -- we agreed on a settlement to, you know, go and calculate the tax and do the offsetting of the tax as the depreciation did occur. So we actually took like a 15-year period and we commingled the payments so that the interest could be calculated, corrected, and all those other things.

So I'm just saying that possibility has been used by the FTB previously.

It should be noted that -- it should be noted that a 1031 exchange does not stop the change or increase to the exchange or its tax basis for property tax purposes, and this is why this Section 1031 has been great for California.

In the Teruya Bros. case, the FTB -- the F.D. -- decided by the FTB, the taxpayers used expensive attorneys to structure and complete the exchange. In 2010, with the standardization of the 1031 rules, S.W.S. paid a thousand dollars. So just -- I mean, there's mention in those cases about how complex it is, but it's become a very standard process.

The accommodator used in this case is a national

entity that does thousands and thousands of exchanges every year and basically, you know, every 1031 gets structured exactly the same way.

Once the taxpayer enters into a contract to sell a business property, he enters into an exchange agreement with a qualified intermediary and assigns the relinquished property to the QI, which is the qualified and a nickname for the qualified intermediary. The qualified intermediary completes the sale of the purchase of the property and receives the cash from the seller and holds the cash until that seller can -- until they can -- until the QI can purchase the property that is designated by the taxpayer and where the such purchase is and the amount and terms of that purchase are determined by the taxpayer.

This -- this property has to be -- for the 1031 purposes, they only get six months. The property has to be identified within 45 days and then there's -- and then the property has to be completed within the six months of the exchange.

The standardization was -- is really principally the result of the deferred exchange regulations adopted in 1991, which established the QA/QI as a safe harbor for exchange providing that the QI is not an agent of the taxpayer and the regulations provide no exceptions for

such treatment. At least I -- you know, I'm just saying there's essentially no exceptions for it.

The federal government basically stays away from the Section 1031, principally because they realize that the sale and purchase of property is good for business and if 1031 wasn't in place, taxpayers, rather than pay the tax, would just hold on to the property until they die and that's when the property's basis gets stepped up; and when they score -- when the federal government scores the cost or benefit from a law change or a tax increase or a tax decrease, they look at how much they expect to receive from it.

The 1031 laws never change because there is usually no change because people -- the government realizes that there's more benefit from it than their losses, than -- you know, more benefit from a 1031 exchange than not having the 1031 exchange.

California benefits from this in that, as I said, property tax still increases no matter what. In this exchange in itself where the property tax -- because of using the 1031 exchange, rather than allowing the property to be foreclosed upon, California, over this 11-year period, received $824,000 more in property tax. This is principally due to the fact that if it had been foreclosed upon, you would have used a purchase price as

the amount of the debt, which is like 8 million 6, so 8 million 6 times 1.25 percent for the property tax rate, and you compare that to 14 million times 1.25 percent. That difference is so much annually and it multiplies.

Over the period since the -- it became standard for everyone to use -- do an exchange, the property taxes earned by -- by California have decreased -- paid have increased dramatically. In 1991, as -- as stated by the L.A. Times in an article, that property tax was 20 percent -- 27 percent of the total or around 16,400,000. In 2021, as stated by Mrs. Cohen, the California's controller, the property taxes had increased to 80 million dollars. So going from 16,400,000 to 80 million, and I would attribute that -- yes, Mrs. Cohen attributes it to a vibrant economy, but you don't have a vibrant economy if property -- if the properties are not sold. So it doesn't equate into property taxes until the people sell the property. So, you know, that's a case of the 80 -- the increase of essentially people sold property. Okay. That's a brief.

I wanted to get through just a couple of administrative matters. The first is one of the boot arguments added by the FTB wherein the FTB kind of wrongly stated that the standardized exchange agreement that we used, or that our accommodator used, did not

include the required language in the engaging -- in the engagement agreement signed. That's in the May 28th, 2021 determination letter.

The amount that is -- the amount that -- the language that requires this statement is in the IRS regulations and that's at 1.131 K1-1 G4 little 2. It provides, A paragraph of this section only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of money or other property held by the qualified intermediary as provided in, you know, paragraph G6 of this section.

The engagement agreement, which is part of the Respondent's exhibits, at 3.2, paragraph 3.2 provides, The exchange party acknowledges and agrees that the cash proceeds constituting the exchange value shall be the sole and exclusive property of the qualified intermediary, provided in this exchange agreement and the escrow agreement, as such term is defined in paragraph 3.3 hereof, shall have -- the parties -- the exchange party shall have no right to receive, pledge, borrow or otherwise obtain the benefit of all or any portion of the exchange value and the interest earned thereof, period.

So it seems like we've included that language,

but if you -- and it's in the exhibits. And if anybody wants to look at it, I have it here. So -- and I have the regs, too.

One of the exhibits that I added at the end because there is -- there is a lot of funds flowing around. If you look at this and read it, they are here and there and everywhere and someone could say, Oh, well, no, that's not true. You know, one of our arguments is -- there's two arguments. One, you know, it doesn't make sense to -- it does not make sense to -- for -- there's not really a tax reason to do this exchange and the basis as it -- was that, you know, so that's one exchange, and I'll go and talk about that, too; but the other part of the exchange was -- was that there is no cash-out. You'd have to have a cash-out.

We'll go on to describe that, but essentially that's -- that's boot income where the party is not paying income tax. In a normal boot income event, which is common in every Section 1031 exchange, principally because they never know exactly -- they never calculate the amount of loan exactly, so there's always cash coming in or cash coming out. But if there's a net cash going out in a normal exchange, it's treated as boot income and subject to 100 percent income tax.

So -- and that's essentially the same for a --

the same for a nonrelated entity except because the tax -- the tax issue is that they figure out some way to not pay the full tax or not pay tax on it by this complicated structuring.

So anyways, one thing that I did for this hearing is I -- on Exhibit D, I tracked all the cash and there were -- you know, I tracked all the cash and that's on Exhibit D and you can see basically where all the payments went, and -- and so -- and so that I said is in -- and I probably will hear back about it, but that was in Exhibit B.

And the consequence of the -- there were a couple of consequences of doing this tracking. The first was I believe I proved the point that there was no cash that came out, and you can see that -- you could see that in Exhibit B, of our Exhibit B. And in Exhibit B, on Exhibit B, we show the amount of the debt payments, which includes principal and interest and other expenses, of 9,017,738 and increased by the $750,000 Slauson sale expense attributable to payments of money into a toxic fund, for a total of 9,767,738.

Then the 9,017,738 comes from -- comes from Exhibit D. It comes from Exhibit D where -- where we add up all the payments of principal, interest that was made, and, you know, expenses, escrow expenses and stuff here

and add that to the last -- the payment on the last payment, which part of it was actually added by T.S., the taxpayer, and did not come directly out of escrow but was added at the last minute to pay off the debt timely of 2,450,470, so that's where the 9 million comes for.

So I would say that all -- that is what the source of the payments that came from the money was that needed to be required to pay.

And then down at the bottom of Exhibit B, I show the cash flow from the Slauson sale, which comes from Exhibit A.

On Exhibit A, I have two items. I have the expected escrow amount of 2,091,900 [sic], which comes from the Slauson escrow statement, and then -- but there was -- and part of the 9 million 291- was an installment note of 6.5 million that was entered into with the -- with the buyer of the Slauson property. So -- but when that was paid in, there was some interest paid and some other amounts. So it wasn't 9 million 91 [sic]. It ended up being 9,359,282.

For purposes of the law -- the law, looking at the -- you know, a taxpayer's intent, it has to be what people expected at that time, what -- when they entered into the -- after the sale. When they entered into the sale of the property, what -- how do you structure? What

did they expect to occur? Okay?

And the two things that the taxpayer expected was the amount that was in the escrow and that within the six-month period, they would be required to pay this $750,000 into this soil fund because -- but that payment was contingent upon -- was contingent upon the buyer making all of his payments by October 25th, 2000- -- 2010. That's in the -- that's in the -- that's in all the -- those documents are -- are in -- in the sales agreement and the -- and the amendment to the sales agreement, which is in the Respondent's exhibits.

So anyways, that's the money that they received, the 9 million 3. So on this schedule, you can see that essentially at the end of the day, at the end of that period, that includes the $750,000. The taxpayer's in the hole by $400,000, so how could someone say I cashed out of something when he's in the hole?

And the other point is, Well, what went to the -- what went to the -- what went to the related party? It's a big zero. There's no cash that came out from the Slauson property, because we're looking at where that cash goes. All the cash went to pay for the purchase of the new property. And that -- yes, because it was a bankrupt property, which the bankruptcy occurred in like March, March 1st of 2010. So basically you're

bankrupt. Your company, your rent from your company is -- you're 74 percent empty, as mentioned in their, you know, early brief, their supplement brief, their 2021 brief. They're 74 percent empty. They have losses of over 800,000. That's what's on the -- that's what's on their 2010 tax return for essentially ten months.

So -- so, yeah. So we have, you know, huge losses on the property. So they -- at that time, their only option -- and you're in the middle when not only was the lender getting out of the real estate business because of the, you know, great recession, they had no business, no ability to even sell the property or do anything. Matter of fact, it took -- how long did it take to buy the -- to sell the Slauson property?

MS. SIMA: I don't remember, but it was long.

JUDGE LAM: This is Judge Lam speaking. Can you please speak into the mic.

MS. SIMA: I don't remember now, but it was more than -- more than six months, between six months to a year to negotiate that with -- the City of Los Angeles wanted, I mean, the property, a lot of negotiation because of the remediation of the land and all of those things. All those negotiations took long and that was no -- absolutely no cash flow for us.

So getting into that escrow took at least six to

seven months -- I don't remember -- or nine months to get into that escrow, yeah.

MR. RILEY: But you say, well -- you could say, Well, you had the sale of the Slauson property. Why add to that a toxic waste process, too? No one wants to lend on a toxic waste process. But you say, Why couldn't they do exactly like Slauson? Well, after dealing with a government entity with a building that is basically rented to City agencies and that not using a loan, that's why -- that's why you have an insolvent sale. They're not going to. They're funding it out of, you know, what they have on hand to pay it, so there's no lender in that situation. There is basically just -- the only lender in this case was the seller. So --

MS. SIMA: And the seller was in the hospital for two months.

MR. RILEY: So that was the two other things. The first thing -- the first thing that it helped me do is confirm -- to confirm that there was a substantial loss on the -- a cash loss on the property during that period.

The second issue was more or less the surprise. This $750,000 is -- first of all, in my calculations, we included it, but it appeared that both the accountant and the IRS kind of forgot or intentionally forgot -- but we didn't intentionally forget -- that that $750,000 is a

deduction. It's a cost of the sale, the Slauson sale.

How could you miss that? But my point is that -- and you say, Well, how would it be allocated? Well, what happened -- the reason why -- one reason why it was delayed is the buyer didn't meet the October 25th deadline, so he was penalized. And the agreement provided that that $750,000, rather than being paid within the six-month period, basically is deferred because it's based upon the buyer note being paid off timely. So when the buyer's last payment is made, it gets deferred.

So it was -- yes, it was paid and in 2012, it was -- it was paid in 2012 at the time that the -- that the buyer paid the penalty of 2.6 million dollars, plus actually ran -- with interest, ran to 2.9.

How could you miss -- how could you miss a payment with a penalty of, you know, 2.6 million dollars? You wonder where your government money goes. But so anyways, that was deferred.

So the first thing is that's a deduction. Okay?

And the second issue is, you know, they -- is another I consider an error on the taxpayer's accountant's part, because I also considered it an error, too, in that they picked up 2.5 million and 50 of boot income; and boot income comes when a payment is made

after, after the buyer -- after the taxpayer receives the replacement property. So anything he receives after the replacement property, it would be treated as boot income, 2.5.

Well, that assumes that any payment made is made after receipt of that boot income. But what I found looking at the numbers -- and we have attached it in the numbers in exhibit -- the attachments to the Exhibit D -- is, guess what, the taxpayer paid 2.4 million dollars on 11/30/2010, which is guessly on the day before the property -- when the property is being exchanged.

So actually, the boot gain should have been reduced by -- from the 2.550 or the 2 million 6 that's provided in the -- in the accommodator's exchange escrow. You know, there's 2.6 million. I know that 2.6 money would be reduced by interest income and some other items and actually other cash paid in. I mean, I think during -- if you look at the deed, the deed, you'll see that the deed amounts don't exactly tie to the amount from the escrow, so there's like $62,000 that was put in at that time, too, from transferring from one to the other, but -- so, you know, I'm just saying that was another huge kind of -- huge kind of difference in the transfer.

Do you have any questions? I'm just talking

away here, but -- sorry.

JUDGE LONG: We as a panel will hold questions until after you're done with your presentation. Thank you.

MR. RILEY: Okay. My -- my next -- I next want to deal with the question of two -- one question just to deal with is I want to just spend a moment just dealing with a part of this added point, this added issue of boot, a boot receipt.

JUDGE LONG: Appellants, I just want to go ahead and remind you we're at the 30-minute mark on your presentation. Thanks.

MR. RILEY: Thank you.

I wanted to deal like a moment with the -- because it comes out throughout this whole thing, is just dealing with the IRS regulations in regards to the QI.

The Regulation 1.131 K-G-4 expressly provides that the QI is deemed to be not an agent of the taxpayer and that the QI can use the cash proceeds from the Slauson sale to purchase the replacement property as long as that occurs prior to the QI's transfer of the property to the taxpayer. And I would say due to the default of the property, every interest mortgage payment would be considered to be part of this purchase.

The exchanger would lose the property if these debt payments were not made. The debt payments in the

promissory notes, the two, note modifying the agreements, were the last one needed to be paid by the November 30th, 2010, but they were very specific in what needed to be paid.

And -- and in regards to the law, just not considering the regulations but the law, the common law, the Teruya case, for example, the Teruya case basically provides that it would not be boot income. It would not be boot income if there's still a like-kind investment into the replacement property. So if someone puts money in an exchange, it's not boot. In an exchange before these rules, it's not considered boot as long as it's used for investment in a 1031 exchange.

I mean, the applicable language is it cannot be a situation where cash -- where they cash in on their other investments and that's what is stated in the Teruya court, but that is also stated in every case because that's the language that comes from the committee reports that are put together for the Section 1031(f) rules.

And then the same Court states that when an investor -- and this is from the Stocker case, but when an investor exchanges a piece of property for another like-kind property, he is merely continuing his ongoing investment.

So when you look at investments on this first

paragraph, it's not referring to the sale of the relinquished property as long as that funds are used to purchase a replacement property, a like-kind property. If it's not used for that, then it's -- it would be considered to be boot and it would be illegal. It would invalidate the exchange if that boot was not treated as -- you know, were not subject to income tax.

So that's what the rules are about. It's actually boot being paid out, being paid out; but because of the structuring, we're either not picking up the full amount of that boot in a lower tax rate or the boot is just not being recognized because the related party is a -- has a higher value. So -- but I said the important thing to know, that it is -- that those two things. It doesn't -- when they say "investment," it doesn't treat it as boot. It has to be on -- you know, as long as it's an ongoing like-kind investment. So it was intended to get language where they sell a property and buy a car or buy gold. Well, those aren't like-kind exchanges and those would be boot.

The Senate -- as I mentioned, it is normal for boot to be included in every Section 1031 exchange and the government figured out people were trying to -- were figuring out ways to avoid it and one of the ways that things -- they were figuring out to avoid it was by using

a thing called basis shifting, and it's in the committee reports. They provide an example in the committee report of basis shifting and that's -- and it's basically cited in both Teruya and Ocmulgee, both cited, and they cite basis shifting.

Now, there's a couple basic facts with basis shifting that you have to understand. But first of all, if you're just doing one 1031 exchange, can you have basis shifting? The answer is no. Guess what? If you have a high basis asset or a ridiculously low basis asset, you still pay no tax. It still gets deferred. It doesn't matter. So you have to have two -- two things have to happen. There has to be a -- there has to be an exchange and someone's spaces and then outside of it, there has to be another sale.

So the goal would be to have the property that is -- that is being sold outside of the 1031 exchange have a higher basis.

Now, the problem with applying this to our facts are simple. We only have one sale. We just have a 1031 exchange and the way the government tried to combat this is saying, oh, if -- by 1031(f) provides a two-year rule. So if within -- if someone gets a property within the exchange and they sell the property within two years, they are deemed to have done a bad thing and it's

invalidated.

But this did not happen in our case. Yes, the S.W.S. got the Brand property, but it still owns the Brand property. It still owns the Brand property. I put the property tax bill of the 2023 in Exhibit -- I think it's Exhibit A, showing a 2023 ownership proving it's there. So they haven't sold it. So why -- I don't -- it's been mentioned that there's some exchange. And even that, who would -- who would schedule an exchange where you lose 15 million dollars in basis? That's the opposite of the planning you want to do.

When we first met, I said, This is bad planning. What they should have done is basically taken out the 8.6, walked away from the loan, and they would have had 8.6 dollars of cash and paid very little tax because of the high basis on the property.

Now, the government argument, they use a lower gain -- a lower loss amount, I mean, and particularly because they use -- they use the 14 million dollars to a related party, which basically, the related party, T.S. is paying no cash for. It just takes a note that is payable in the future. Now, I would do that deal for it. I don't care what it is. I have the future to kind of deal with, but this is not the case at the time. People with no banks -- you know, entities were getting out of

providing loans. You had the great recession where Lehman Brothers and Bear Stearns went out of business because why? They went and bought properties that was probably 74 percent or more empty and they went bad. So no one was making those loans, so what options do you have?

The only reason we did it was to tax it, and it was actually at a tax disadvantage. We lost 15 million dollars. We increased our property taxes by -- over an 11-year period by 824,000. It's a -- you know, there were huge numbers. We ended up losing tax basis and we put -- we added most of these and most of those are on Exhibit A.

Okay. In regards to -- okay. The question there is a place that the IRS has identified: What is boot income. Okay? So what is boot income? Boot income is basically items that are deemed to be cash. So boot income is cash, the net cash received by the taxpayer. And when I say "taxpayer," I mean cash to the taxpayer and if there's an accommodator, it's the -- not the cash the accommodator receives. It's the cash the accommodator eventually pays out to the person.

Now, if you look at their instructions, which is where I would look at, they have it actual cash paid by the taxpayer, and I put in parentheses "not paid to the

QI"; the fair market value of nonlike-kind exchanges, nonlike-kind property received. That's like in that Teruya example. In Teruya, they say that it has to be like-kind property, but it's like the gold, if you receive gold; and net liabilities assumed by the taxpayer release net liabilities assumed by the other party. So it's resumed by the buyer. It's resumed by the buyer versus a liability that the taxpayers assume.

So it's -- you'd add that stuff together and if it's positive, it goes on line 15 of the Form 8824. So if you look for the instructions in that line, which I have a copy of that. If you want to look at it, I have a copy of that, of the 8824. So those are the ones that -- that -- in Teruya and they would consider as boot income.

And if you look at the cases, you look at the Teruya, you know, the entities in Teruya and Ocmulgee, in Teruya, the Court says -- it makes its conclusions because the Times was essentially paid with two properties, was paid $14,300,000 of cash and then -- and that Times was the related party, and Times didn't purchase any other property, that money; and then -- so that's -- what they said was, Well -- in Teruya, they said Well, this is a bad situation. You've got your cash balance increased by $14,300,000 and your equity decreased by $14,300,000 and so that's what they consider

a bad tax planning situation.

So basically, money went -- did not -- there's a bunch of money because of the related parties that was not used to purchase -- between the two of them, was not used to purchase more equity.

Those banks don't -- those don't apply to our facts. First of all, we don't have a Times receiving any -- related party receiving any cash. We have zero cash receiving by T.W.S.

And then you go to Teruya and you look at R -- you know, R, you look at the numbers I put down. I didn't get -- S.W.S. didn't get money. They had to put money in. So there's really no cash there and they would say -- they say -- in the Respondent's brief, they said that our equity -- that our equity went down. That's absolutely -- they say, Well, you sold these properties. You sold Slauson. That's all your equity. No. They meant investments. When they say "abandoned," they say lose your investments. That's -- when they say lose your investments, cash in on their investments, they mean -- they don't include related parties.

So -- so in our case is that there was equity because every dollar of that money was not paid out for principal. It was paid and invested in the replacement property. They used it to pay the obligation. They

didn't -- it wasn't paid early. It was paid at the last moment. They used the money to pay obligations. So their equity did not go any way. Their net equity invested, cash invested, did not change at all. It did not go down as it did in Teruya and Ocmulgee. It did not go down at all.

So anyways, that's -- I wanted to go -- I have some handouts that I wanted to just -- a couple of them are just to help explain things and compare it between what is said in the FTB's brief compared to what -- what -- what our assertions are because, I mean, sometimes you look at things and you say, Well, why is -- why is their stuff different than what I've -- what we're saying? And so if I could get those out --

JUDGE LONG: All right. Appellants, I just want to let you know you have 15 minutes remaining.

MR. RILEY: Okay.

JUDGE LONG: And these handouts, are they the exhibits or is it something additional?

MR. RILEY: We can -- I mean, I don't -- they can be included as exhibits. I don't -- it doesn't -- it's not --

JUDGE LONG: May I ask what is shown on the documents?

MR. RILEY: What is shown is -- yes. I have the

FTB's protest. It's at -- it's R at Exhibit S. It shows their numbers from that, in that document, and then I have the S.W.S. plan, which basically includes the Slauson closing documents, the loan repayments. All of the items on here are as exhibits. The detail on here is as exhibits and --

JUDGE LONG: So I'd like to confirm, do you mean that everything you have there has already been submitted as an exhibit? It was in the exhibits?

MR. RILEY: It's already in the exhibits, but it's not organized together.

JUDGE LONG: All right. I understand. So, yeah, if --

MR. RILEY: Yeah. So it's just --

MS. KUDUK: So I just want to clarify, this is analysis that opposing counsel prepared from our exhibits?

MR. RILEY: Well, yes, mostly yes.

MS. KUDUK: So this is new analysis that we haven't seen?

MR. RILEY: Well, yeah. I don't think it's -- my alternative is to explain the differences or show it and I'm using this as really something to help organize it in people's minds.

JUDGE LONG: Sorry, Appellants. I have to ask you to

sit and speak into the microphone. Otherwise, you can't be heard through our YouTube stream. Apologies.

MR. RILEY: Hi. I'm sorry. The purposes of this brief is just as comparison purposes. All the information in here is, yes, provided in the exhibits, provided by us and provided by them; but as I said, there's a lot of complicated things here and it's hard for anybody to put them all together and I'm just trying to put it in a mode that you guys can see.

I mean, I'm just saying I looked at one of the things from the -- from the Respondent and it didn't total. It didn't total up, but here's something that at the bottom of it has a $600,000 cash payment to my client and I figured out that, no, by my analysis that that didn't exist. But you're going to look at that same agreement, same point, and you're going to say, Well, how did they get something different? And I just wanted to show that, yes, I see where they got the difference --

JUDGE LONG: All right.

MR. RILEY: -- but I don't believe so. That's the purpose of it.

JUDGE LONG: All right. Thank you. So because briefing has already closed for this appeal, I'm going to ask you instead of providing us with handouts, you can use the handout that you have to guide us through your

analysis and we have the exhibits in front of us electronically, so you can reference those as you go through, if that's helpful to your presentation.

MR. RILEY: I'm just saying it's just simpler to put it in writing, but if that's too -- and maybe I said this will come up after the -- and we can do it in cross if this comes up, if these things come up before, but okay.

JUDGE LONG: Yes. You are going -- you will have 30 minutes to respond to FTB's presentation and you are welcome to discuss that at that point.

MR. RILEY: Okay. Then I would like to go to -- and I'll mention it.

MS. KUDUK: Hi. Can I take five minutes to look over this? This is brand-new argument that I haven't seen, so I don't -- I haven't -- I have not seen this document and I would like to look over this. Is that possible?

JUDGE LONG: All right. I'm going to go ahead and order a five-minute recess.

MS. KUDUK: Thank you.

JUDGE LONG: So we're going to stop the record and we will reconvene the record at 10:45 a.m.

MS. KUDUK: Thank you.

(Recess)

JUDGE LONG: All right. I'm going to go ahead and welcome everyone back. We're going to begin the record

again.

So Appellants, I want to remind you, you have ten minutes left in your presentation, and you may pick up whenever you're ready.

MR. RILEY: Hi. So I guess I'm not going to be able to give these out even though it's just like talking. It's just I was trying to summarize what I had, but you don't want my notes. So I'm just going to kind of go through and describe where things are, and maybe I can show pictures.

So first of all, this is in regards to Exhibit -- it's Exhibit -- Respondent's Exhibit S, page 5 of 18. Okay?

On this -- on this document -- do you have that document there?

On this document, they have in the middle of the page, they have a loan amount of -- loan repayment of 3,450,127. They have a debt repayment of 8,762,047, and other of 220 and cash out of 616,474.

Okay? So that's -- so more or less, they're saying here that there's boot, there's cash, extra cash, hanging around of 660,474, and that we lose. That's what essentially they're saying.

Now -- now, but that -- that -- and what I wanted to show is our comparison to that number. Okay?

Our comparison is yes, we agree with the 13 million dollars in regards to that. We agree with the loan repayment of 3 -- the loan repayment of 3,450,127, but I would put a comma on that. That's really principal, principal payment. Okay? So there's, yes, the principal payment, and that dates back. There's the Marq loan, you know, a North Marq package. Actually, the 3,004,127 comes back from the Slauson closing statement, which is right here. And if you look at it, that's this amount. Okay?

And so these two amounts and the 8,762,047 comes from the North -- the North Marq statement. It's listed as an exhibit and that's this --

MS. SIMA: Exhibit A.

MR. RILEY: -- Exhibit -- what?

MS. SIMA: Exhibit A of FTB.

MR. RILEY: And that's 8,762,047. I don't know where the 220 comes from, and they can tell you where it comes from, but my corresponding numbers would be if you look at the -- if you look at this escrow statement, this is the -- no, not that one. No, this one. This is the Slauson. It's all this other stuff down here. It's -- this is -- I have that as 2,058,696.05, so that's all of this stuff in here. Okay?

And so I have that compared to the $220,000. So

she has 220 -- they have 220,000. I don't know where that comes from.

The additional items we would add to that is the interest payment of 225,696, which comes from Exhibit D, which comes from Exhibit D and is essentially all of these lower amounts, the -- and I actually have that total down there and I actually included that as one of the exhibits, totaling that up. But that's -- that's essentially on this thing all of these interest, 96,216, the 32,461, on this Exhibit D. It shows all of those payments, plus down below, the -- you know, but that's where the 200 -- our number would have added 225,692.

The total expenses -- we end up after adding and -- you know, adding a different amount, we come out to 558,468 loss at the bottom. So we have 13 million. We have -- you add the 3.45 and the 258 from the Slauson. That gives you 3,708,224. If you add the principal interest, the principal and the interest of 225 plus the escrow amount on the 115,904, plus, which they don't have, the $750,000 loan that was supposed to -- the payment to Slauson escrow costs that was part of the -- you know, it's part of the sale agreement and it was basically put in and we have an Exhibit A -- we have copies of letters indicating the $850,000. $750,000 is still there. So that comes to a loss of 558,000 compared

to the 600,000.

Now, the 600,000, if you add all of these amounts on this page, this page right here, page five, if you add all of those amounts together, you don't get 13 million. You get -- you get -- you're off by $48,000. So on that count, it didn't add up. I'm just saying this schedule, if you add this, it doesn't equal 13 million. It equals 13,048,000. So the schedule doesn't add.

So -- so -- and then the other point I wanted to make on -- I know I'm running out of time. It's just I have on this other schedule, Schedule 2, I have the different timing of the various payments on the loan and the boot calculation and -- and -- and showing the amount of gain if you take the 11,235,699 of costs that's listed in the protest for the -- for Respondent at the Schedule C.

Subtract out a share of the $750,000 which is $625,000, making that -- that gain 10,610 -- 699, and the reversal of the boot would be taking the boot amount of 2 million 4 -- 2,551,547, which is listed on boot on the Respondent's and subtracting out the 2,450,347, which the -- which the wire transfer on Exhibit -- the wire transfer on Exhibit D -- no. Is that right -- wire transfer on Exhibit D shows was paid on 11/30, you end up with 92,503 rather than 2,550,547.

And the allocation of the 750, I used the original selling price of 13 million and then the other side of that would be 2.6 million on this penalty note, for a $15,600,000, and 83.3 percent of that should have been included in the -- in the reduction of the gain on -- of the 11 million 235 gain.

So anyways, those are my two last little points, but I appreciate the time you have for giving me to talk. I guess I'm done, if you have questions.

JUDGE LONG: Thank you.

I'll go ahead and turn it over to my copanelists for questions.

Judge Johnson, do you have any questions for Franchise Tax before -- for Appellants?

JUDGE JOHNSON: No questions at this time. Thank you.

JUDGE LONG: Judge Lam, do you have any questions for Appellants?

JUDGE LAM: No questions at this time. Thank you.

JUDGE LONG: All right. Well, with that being said, I'm going to go ahead and let FTB begin their presentation.

FTB, you have 60 minutes and you may begin whenever you are ready.

MS. KUDUK: Thank you. Can I take a second? Thank

you.

Thank you. Thank you for giving me that five-minute break.

Again, my name is Carolyn Kuduk. The primary issue in this appeal is: Have Appellants overcome the presumption that their Section 1031 exchange which involved related parties and basis shifting between exchange properties was done for tax-avoidance purposes and, therefore, properly disallowed by the antiabuse provisions of Internal Revenue Code Section 1031, resulting in additional income of approximately 8.5 million dollars assessed to S.W.S. Realty?

If and only if the panel finds that the Section 1031 exchange is valid, the second issue is: Have Appellants shown that Respondent erred in assessing an additional 6.6 million dollars in gain to S.W.S. Realty income in taxable year 2010?

And I would like to say up front that there's a reason that the amount is 6.76 million dollars in boot rather than the approximately 9 million dollars that Appellants reference in payments for the debt of the Brand property.

Respondent used the 6.6 million dollars referenced on their escrow statement of the Slauson property that was categorized as an early release of

funds, so we did not track the money payment by payment. We used that 6.6 million dollars because it was clearly referenced on the escrow statement that it was an early release of funds.

S.W.S. and T.W.S. Realty are limited liability companies that are taxed as partnerships. S.W.S. and T.W.S. are related parties per Internal Revenue Code Section 707(b) because they both were 100 percent owned by the same five family members.

S.W.S. sold the Slauson property, the relinquished property, in the alleged exchange with a basis of 1.5 million dollars and used money to buy the Brand property, the replacement property in the alleged exchange. It bought it from T.W.S. for 14 million dollars. Appellants claim that T.W.S. had a basis of 19 million dollars in the Brand property.

Because of the basis rules in Section 1031(d), which opposing counsel has referenced and explained, the low basis of the Slauson property was swapped with the high basis of the Brand's property. Appellants deferred taxation on approximately 8.5 million dollars in gain and did not pay taxes on 6.6 million dollars in boot. Appellants have recognized 2.5 million dollars in boot in taxable year 2010.

Appellants' attempted Section 1031 exchange in

taxable year 2010 is properly disallowed, pursuant to the antiabuse provisions of Section 1031, as S.W.S. and T.W.S. are related properties -- sorry -- related parties, they cashed out of their investments by moving money from one property to another, and Appellants have not overcome the presumption that the alleged exchange was done for taxable avoidance purposes.

Case law tells us that the fact that Appellants theoretically could have paid less taxes if the transaction was structured differently does not overcome the presumption that the exchange was done for tax-avoidance purposes. As a result, Section 1031(f) --

(Interruption in the proceedings)

MR. RILEY: Sorry.

MS. KUDUK: No worries.

As a result, Section 1031(f) requires that the office uphold Respondent's determination that the attempted Section 1031 exchange is invalid.

If the panel finds that the exchange is valid, Appellants have not shown that Respondent erred by adding 6.6 million dollars to S.W.S.'s income as unreported boot. S.W.S. took constructive receipt of 6.6 million dollars as an early release of funds. It was labeled as an early release of funds from the sale of the relinquished property in the exchange. S.W.S. directed

its qualified intermediary to use sale proceeds to pay off debt on the replacement property before S.W.S. even owned the replacement property, violating the Section 1031 requirement that the taxpayer cannot receive sale property or sale proceeds during the exchange. As a result, the 6.6 million dollars is boot and taxable to Appellants.

Gain is taxable. Gain from the sale of property is income and subject to income tax. Gain from the sale of property is calculated by subtracting the adjusted basis from the amount realized by the sale. Taxpayers typically pay taxes on the gain from the sale of property at the time the property is sold. 1031 is an exception to gain recognition. Because Section 1031 is an exception, a taxpayer must follow all the requirements of Section 1031, both the spirit and the letter of the law, for the Section 1031 exchange to be valid. The spirit of Section 1031 is the taxpayer continues his investment and does not cash out of his investment in the property.

In a Section 1031 exchange, Congress provided that the basis of the taxpayer's relinquished property would carry over and become the basis of the replacement property received in the Section 1031 exchange. Because basis transfers from one property to another, related parties could shift basis from the relinquished property

to the replacement property to reduce or avoid recognition of gain and reduce or avoid taxes.

In effect, the related parties would then have cashed out of their investment and the transaction doesn't meet the spirit of Section 1031. The law treats related parties as one economic unit and tries to determine if the Section 1031 exchange allows the economic unit to escape taxation through basis shifting. If it does, the Section 1031 exchange is disallowed.

This leads us to the antiabuse provisions of Section 1031(f). To prevent tax avoidance, Congress enacted Section 1031(f) to limit nonrecognition treatment for a Section 1031 exchange between related parties who have cashed out of their investment. Section 1031(f)(1) is used when there's an exchange and a sale and automatically disallows recognition when a taxpayer directly exchanges his property with a related party and there is a sale of that property within two years.

At issue in this appeal is Section 1031(f)(4). That section is used when there is a sale of relinquished property and the taxpayer then buys replacement property from a related party with money from the sale. Congress enacted Section 1031(f)(4) to prevent related parties from structuring transactions in a manner that avoided the technical provisions of Section 1031(f)(1) but also

cashed out of the investment, i.e. selling property to each other through a qualified intermediary, as happened here.

However, when there is a Section 1031 exchange between related parties and basis shifting, there is a presumption that the transaction was done for tax-avoidance purposes. Taxpayers must overcome that presumption. Taxpayers can overcome the presumption per Section 1031(f)(2). Here, the taxpayer must establish to the satisfaction of the taxing agency that neither the Section 1031 exchange nor the disposition of the exchange property has one of its principal purposes the avoidance of income tax, and I'm going to say this again, one of its principal purposes, the avoidance of income tax, not its principal purpose.

The transaction in this appeal is the exact type of transaction that the antiabuse provisions were enacted to stop and we know this because case law and IRS guidance tells us so.

It is undisputed that S.W.S. and T.W.S. are related parties. 1031(f)(1) automatically disallows an exchange when a taxpayer directly exchanges property with a related party and the property is sold within two years because the law considers it a cashing out of the investment.

Section 1031(f)(4) may disallow an exchange where a taxpayer engages in an exchange that only indirectly involves a related party. Congress enacted Section 1031(f)(4) to prevent related parties from structuring transactions in which the property's not directly exchanged between related parties but economically has the same result of cashing out of the investment.

Here, Appellants took the equity out of the Slauson property and put it in the Brand property by paying off debt on the Brand property. S.W.S. cashed out of its investment because S.W.S. took at least 6.6 million dollars from the sale of the Slauson property and paid down debt on the Brand property before S.W.S. owned the Brand property, benefiting the economic unit. Therefore, pursuant to Section 1031(f)(4), Respondent properly disallowed this transaction.

Appellants argue that the transaction is a viable Section 1031 exchange per Section 1031(f)(2) because Appellants have established to the satisfaction of the taxing agency that neither the exchange nor the disposition of exchanged property has one of the principal purposes the avoidance of income tax, but we know this is not the case because Internal Revenue Code -- or Internal Revenue Service released revenue

Ruling 2002-83 which analyzed a similar transaction and concluded that a taxpayer who transfers relinquished property to a qualified intermediary in exchange for replacement property isn't entitled to nonrecognition per Section 1031 if as part of the transaction the related party receives cash or other nonlike-kind property for the replacement property.

Here, T.W.S. received 6.6 million dollars in debt relief from S.W.S. S.W.S. effectively gave T.W.S. 6.6 million, and then T.W.S. invested the money in the property it owned. At that time, S.W.S. didn't even own the Brand property.

Additionally, the cases of Teruya Bros. and Ocmulgee Fields analyzed similar transactions and determined that they didn't meet the exemption provided for in Section 1031(f)(2).

Specifically, the tax court in Ocmulgee Fields found that the loss of tax benefits, like the immediate tax paid by the related party, a tax rate differential, the reduction in the depreciation -- a reduction in the depreciation deduction, like occurred in this appeal, and the ability to take a loss on the property, like occurred in this appeal, cannot overcome the presumption that the transaction was done for tax-avoidance purposes.

So I'm going to emphasize this. Appellants

can't overcome the presumption that the transaction was done for tax-avoidance purposes by the loss of tax benefits and by the fact that, as Appellants said, they paid less taxes than they could have with good tax planning.

Specifically, the antiabuse provisions of Section 1031(f) require that the transaction fail as a Section 1031 exchange. Therefore, Respondent's determination must be upheld.

If the office rules that the Section 1031 exchange is valid, then the 6.6 million dollars in cash proceeds that were diverse -- sorry -- disbursed early from the escrow prior to the conclusion of the exchange and before S.W.S. took possession of the Brand property was boot; a taxpayer must recognize gain in the Section 1031 exchange if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives replacement property, as noted in the determination letter that FTB sent to Appellants and which is our Exhibit F -- S, Exhibit S.

Here, S.W.S. took control of the 6.6 million dollars in cash proceeds before it bought the Brand property by directing the qualified intermediary to use payments for the Slauson property to pay down debt on the Brand property. Because S.W.S. took control of that

money, it is boot and taxable.

Boot was briefed by Appellants in their opening brief, so it is not a new issue raised by Respondent. As such, it's Appellants' burden to show that Respondent's assessment is not correct. Appellants have not met this burden and, therefore, Respondent's alternative proposed assessment should be upheld if and only if the exchange is allowed.

Thank you.

JUDGE LONG: FTB, does that conclude your presentation?

MS. KUDUK: Yes, it does.

JUDGE LONG: All right. Stenographer, would you like to take a break before we continue?

THE REPORTER: No. We're good.

JUDGE LONG: Okay. In that case, I'm going to pass it to my copanelists for questions.

Judge Johnson, do you have any questions for Franchise Tax Board?

JUDGE JOHNSON: I think I just have one question.

You mentioned boot being raised in Appellants' brief and then you provided Exhibit S, which has a discussion of boot at the earlier stage. I think it starts at page 16 of that document. Would you incorporate what's in that document as your arguments

regarding boot in addition to what you've presented here, or is there anything in that determination letter that you disagree with or want to change at this point?

MS. KUDUK: No. I believe the determination letter did address my constructive receipt argument that I presented.

JUDGE JOHNSON: Okay. Thank you.

JUDGE LONG: All right. Judge Lam, do you have any questions for Franchise Tax Board?

JUDGE LAM: No questions. Thank you.

JUDGE LONG: All right. I do not have any questions for FTB at this time.

With that, we are now ready for Appellants' rebuttal or closing remarks.

Appellants, you have 30 minutes and you may begin when you are ready.

MR. RILEY: I'll start now.

JUDGE LONG: Okay. Please, go ahead.

MR. RILEY: First, I wanted to -- she mentioned 6,676,216 coming from the exchange from the Brand agreement, Brand agreement, and that's basically -- we tied that amount down on this schedule; and if you look at this schedule, all of it went to debt payment. So we agree with that.

Now, the Plaintiff -- I mean -- the Plaintiffs.

The Respondent basically makes the point that they basically -- first of all, their argument is you have to look at the two parties together, you have to consider the S.W.S. and T.W.S. as the same. All their cases look at them together, not separately; right? They look at them together.

So -- but in regards to their argument, they're saying we're going to treat them separately, but for just this one little situation, we're going to treat T.W.S. differently. We're going to say all of this debt, which by the way, you understand that every -- every purchase and sale of property, every Section 1031 exchange deals with the QI paying off the debt. They're saying that that's boot.

I gave you the regulations. Boot is not that. First of all, the QI is an exempt entity. It's a nonagent. The money that came from the buyer came from the sale of the replacement property and the money going out is totally excluded from their consideration as what is boot. That was the reason why it was set up.

The IRS realized people like California would want to abuse this and try to argue every little point, every little thing, in an exchange. That's not what the government wanted. The government wanted it to be clean so that everybody can do it and that yes, the debt was

going to be paid off. It can deal with bankrupt debtor. Yes. Guess what? If you didn't pay that debt, the replacing property would disappear. It would go -- it would go to the bank. The bank is not -- the bank is not S.W.S. and it is not T.W.S. It is not -- it is a third party. You have to pay it to purchase the property.

They're saying contrary to every 1031 exchange that that's an illegal -- that that is a boot. Now, in their definition of boot, that is not included, the definition of boot. But even now, that definition would only play when the money goes out of the exchange here.

So with the regulation, this is a little place that they say, Hey, we don't make determinations in that. That six-month period that the QI holds the property, we don't do that. That's not a basis. All we care about out of the exchange promulgated is what we get out at the end of the day. They got out the Brand property, period, and no cash.

Every example they give in their documents, they basically include cash, hard money cash going out to -- going -- that's what they consider boot. They didn't say, Oh, this is magical boot or whatever it is that you're paying off the debt. It comes when cash go out and the intermediary and the other person does not

replace that cash.

When I say "other people," both the taxpayer and any related party, and they did not replace that. They did not put that back into property. That's what they mean and that's not what they're referring.

So the boot example in the regulations say it's cash or net cash out. They say it's noncash, you know, gold, that we receive. And they say -- number three is they say it's the -- that the amount that you got released from debt compared to the amount that you are -- debt that you ensued, and they're looking at the taxpayer's level. They're not looking at the -- they're not looking at the ongoings and every little thing that goes in a complicated sale of a -- of a property in a difficult time in the year.

It is clear that all of the money was used by the accommodator to more or less purchase property for -- for the S.W.S., but that's what we look at, the end result. We don't look at those little mechanics.

What they're saying, Oh, no, you have to look at those little mechanics and if there's little -- if they're a little bit different, they do it earlier, they're doing it -- basically, the title to the property in a normal exchange occurs when? It occurs at the end of the exchange. So what happened before when the

property is transferred out, that's when it occurs. In every exchange, it occurs then.

So every time you pay that debt early in an exchange, you're saying that's boot? That's ridiculous. You're saying, Oh, we can't pay boot. We don't have any money to pay. We have losses of 800 million dollars in that, in 2010. We have no cash. You're saying, Oh, by the way, you're going to violate the rules if -- if you have the accommodator pay the dude so that he can save the property from foreclosure, and then you're saying there's a tax loss.

And we did the numbers previously. And basically, if it's foreclosed upon, if -- this is my alternatives. If it's foreclosed upon, my client gets 8.6 million dollars of cash or I think in my exhibit after reducing the 750, it's 7 million something, and that's in -- it's in one of the exhibits. They get that money and essentially if you add another $650,000 deduction, if you add another $650,000 deduction, then basically you end up with a loss of $26,000 from -- from basically selling, walking away from the property, paying -- basically not -- not paying the 8 million 6 of cash, and then you have some tax basis, which is the 19 million. They're -- I agree, we're going to use that 19 million and -- but the tax and -- you know, but if we

use that, we actually end up with cash in our hands and essentially paying no tax.

Now, on the other side of that, I basically picked up 2 million 5 of gain and I believe it was wrong gain. So here's a taxpayer. Of course you're saying they're looking at every means and sneaky people sneaking around. They actually paid more -- more tax than they -- income than they should have and you're saying, Oh, by the way, you did bad, even though my alternatives are walk away, take the money, and have the California lose $800,000 of property tax and it would disrupt the business model or whatever it is. You're saying, Oh, take the money and run.

That's the example Franchise Tax Board are saying. They're saying bankruptcy is not -- is not a reason. I think that's a big reason. That kind of voids out the kind of -- some kind of assertion of tax basis. I mean, I lose 15 million dollars of tax basis. You don't think that's money? I mean, they're saying it's not money if other things are righted, but -- so anyways, I would say the other thing to consider, I said, is what they're really -- their argument is really saying, Hey, let's take the benefits of let's just disregard the regulations that establish the QI. Let's basically say that we get to look at everything. Okay?

Is that what you really want, your government trying to toss out every kind of exchange they can find? So -- and I would -- I said -- I would say on both points, if you look at -- if you look at Teruya, Teruya basically, one, they say that you have to. It's not liberal. It's saying you have to meet those rules and there's two steps. One step is to look at the cash, where the cash went and if there was any kind of cash going out and they alert that it's real, I would consider it a purchase of property, which is nowhere anywhere. They say -- I mean, you're saying you're treating this as two entities together and they want to separate them out. They want to say, Oh, well, they're the same entity, but we want to look at the construction receipt because this person did not own that property until the end of the deal.

So the fact that they made payments, you know, earlier to pay off the loan, that's bad. But that doesn't make sense. That's why you have six months. That's why the regulations say -- they say, No, this is QI's time. They get to do what they want to do. Unless it's aggressively bad, we don't provide any exceptions in our regulations. So they say QI is not an agent and he has control of all the money. So then they're saying, No, that's obviously not the rule and with the related

party, they say, Oh, yeah, there's two people. We look at them together. They're also saying that's not the rule because we want to win; this is what we want to do. So we want to exclude that and make some kind of stretched argument that the regulation -- that the regulations don't apply, and so that's why we -- that's why we're asserting these things and if they're citing the cases, all the cases say exactly the same thing.

Every case, there's cash going out to someone. I mean, not hard cash, cash not going to pay the debt. Cash -- you know, there's plenty of examples in the regulations where the payment and the existence of debt before and after are calculated and they just measure them. They say, This is the amount of debt before, this is the amount of debt. You equal the debt, the difference of debt as additional.

In this case, yes, we gave up some debt on the sale of the property, 3.4 million. We had more debt with the promissory note of 7.1 million at the end.

So there's no -- there's not a debt issue, and everything else occurred in the process of getting -- is QI territory. They're saying those regulations don't apply because we want to make a late-night argument.

So anyway -- oh. And I just -- the other thing, just understand there was cash put out. There was -- at

the end, I said there seemed to be this mix-up of cash coming out, but all that cash the client took out is boot and paid income tax on it. As I mentioned, that's not tax avoidance. That's just somehow we -- the loan wasn't estimated and we got some cash out. But I just -- I said that number -- if you add the -- if you add the $750,000 note, then, you know, it's -- you know, there's basically going -- you know, that was spent out of the taxpayer's funds.

So I guess that would do it. Sorry about the timing. Thank you.

JUDGE LONG: That's fine. Thank you, Appellants.

Let me circle back to my copanelists to see if they have any questions for either party.

Judge Johnson, do you have any final questions for Appellants or Franchise Tax Board?

JUDGE JOHNSON: I have a question for Appellants, actually. It's maybe a clarification.

The loan on the Brand property that T.W.S. had, I think in your opening statements you mentioned that it was that, you know, end of December 1st, 2010. Is that the date you provided?

MR. RILEY: What? The --

JUDGE JOHNSON: The loan of the Brand property.

MR. RILEY: The loan on the Brand property, yes.

JUDGE JOHNSON: When was it going to --

MR. RILEY: I think the loan payment was due -- the loan on the -- was paid later. It was paid I think December 12th. Let me look.

JUDGE JOHNSON: Okay. Maybe it helps and --

MR. RILEY: Give me a second.

JUDGE JOHNSON: Yeah. I was looking at Exhibit P as far as the escrow document that has the November 30th, 2010 date stating that the 6.6 million --

MR. RILEY: Yeah.

JUDGE JOHNSON: -- had come in.

MR. RILEY: There was a date on the loan November 30th, 2010, so that's when the loan had to be paid off.

JUDGE JOHNSON: Okay. And I was looking also at Exhibit L, which caught my eye. On page six of that, this is the second loan modification agreement --

MR. RILEY: Yes.

JUDGE JOHNSON: -- between Nationwide and T.W.S.

On page six, it looks like it's a 3. It looks like the termination date of the loan was extended to December 1st, 2011?

MR. RILEY: It says -- okay. So on the second promissory note, it was extended to 2011, but that was modified in the note number 3.

JUDGE JOHNSON: Okay. So a third note came after that.

MR. RILEY: The note came after that and that exchange was reduced to the -- to the November 30th, 2010 in note number 3, and it also got more specific. I think as part of it, they paid more earlier. They required more payment like the 2.5 million that was paid earlier and then it was all required to be paid by the November 30th. And that's in the note, the third.

So there was the first modification and then I think it's the second. So it was the third, the third modification.

JUDGE JOHNSON: Okay. Thank you. I see that on page 11 of Exhibit L, it looks like.

MR. RILEY: Yeah.

JUDGE JOHNSON: They, okay, accelerated back to December 2010.

MR. RILEY: Yeah, because I think if all of that -- you know, I said at that time -- I would say after the March 30th default upon the loan that essentially the title owner -- first of all, the title owner of the -- the title owner of the Brand property at all times was the lender. I mean, that's just a normal trustee.

When someone defaults on a loan, then essentially the bank becomes essentially controlling

party of -- of that arrangement. Okay?

So that -- the loan, if you look at the second modification, it's May 18th of that year. The due date of the -- from the first loan is -- is November -- was March. I think it was March 1st of 2010. Well, they were supposed to have everything paid off by that time period and that didn't occur. So they were -- then the second loan modification came out in May to kind of get at least things under contract, and then they changed and then later they had the third modification to change some of the terms, and basically some of the terms require earlier payments of the remaining balance, and then they left the 3.7 to be due November 30th, 2010.

JUDGE JOHNSON: Okay. Thank you. That helps clarify some of the urgency you were mentioning about trying to get that paid off.

MR. RILEY: No. No. That's -- that's the whole game. We were not -- they were not trying to do anything. They were just -- I mean, they were not trying to do anything. They were just trying to -- to, you know, get the cash. As I say, the other alternative was walking.

JUDGE JOHNSON: And a question: You mentioned so the earlier withdrawal payment that went to pay off the Brand loan, that was from the qualified intermediary to the

loan holder or the lender?

MR. RILEY: What did I say?

JUDGE JOHNSON: The 6.6 million or whichever amount was taken out early to apportion to pay off the Brand loan --

MR. RILEY: Yeah.

JUDGE JOHNSON: -- that was processed by the qualified intermediary to the lender?

MR. RILEY: Yeah. The only -- everything was -- on this -- if you look at this on my Exhibit -- my Exhibit D, what -- what -- so the amount of the loan on here, the principal of the loan is basically -- was 2.5, so 5 million and then another million 336. The million 336 was paid -- was paid out of the last principal payment they received of the 3 million 67- -- the 3 million 6 -- 3,762,048, which was due November 30th.

It was basically paid partially from the escrow. That's 1,336,740. And then 2,450,347 which was paid on November 30th was actually wire transferred, which the support of that is in our Exhibit D; was transferred from the taxpayer in to the lender, directly to the lender, to make the final payment. And that amount, that 2.4 million 530 just comes from the balance, like the balance that Nationwide sent to T.W.S., really is how much left on your loan? So that's why that payment was made and

they wanted to make it by the due date.

As I mentioned, that changes the boot calculation. I mean, the boot calculation appears to be based upon the cash going out first and then -- and then the payment being made, but that's not what happened. The payment was made late. I think it was in December 12th, and -- you know, so it wasn't made.

So anyways, thanks.

JUDGE JOHNSON: Thank you. That's all.

MS. SIMA: Can I add something? Everything was through escrow and accommodator. Nothing came directly to us.

MR. RILEY: I mean, so anyways --

JUDGE LONG: All right. Judge Johnson, any other questions?

JUDGE JOHNSON: No, thank you.

JUDGE LONG: Okay. Judge Lam, do you have any questions for either party?

JUDGE LAM: No questions. Thank you.

JUDGE LONG: All right. I also have no questions.

And with that, I think we are ready to conclude the hearing. I want to thank the parties for their presentations today.

The panel of administrative law judges will meet and decide the case based upon the arguments, testimony,

and evidence in the record. We will issue a written decision no later than 100 days from today.

The case is submitted and the record is now closed. This concludes our morning hearing. OTA will reconvene at 1:00 p.m. for the afternoon session.

Thank you, everyone.

(Proceedings adjourned at 11:38 a.m.)

REPORTER'S CERTIFICATION

I, the undersigned, a Certified Shorthand Reporter of 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 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: June 6, 2023

Marcena M. Munguia, CSR No. 10420
Certified Shorthand Reporter
For The State Of California

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