BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	
S. YARI and L. YARI,	OTA NO. 18042718
APPELLANT.	

TRANSCRIPT OF PROCEEDINGS

Cerritos, California

Tuesday, September 12, 2023

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Proceedings, taken at 12900 Park Plaza Dr., Cerritos, California, 91401, commencing at 12:55 p.m. and concluding at 2:30 p.m. on Tuesday, September 12, 2023, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ RICHARD TAY
Panel Members:	ALJ ANDREA LONG ALJ AMANDA VASSIGH
For the Appellant:	STEVEN MATHER
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD TODD WATKINS MATHEW MILLER

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-4 were received at page 6.)

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

OPENING STATEMENT

CLOSING STATEMENT

Cerritos, California; Tuesday, September 12, 2023

12:55 p.m.

JUDGE TAY: We are opening the record in the Appeal of Yari before the Office of Tax Appeals, Case No. 18042718. This hearing is being convened in Cerritos, California on September 12th, 2023. Today's case is heard and decided equally by a panel of three judges. My name is Richard Tay, and I will be acting as the lead judge for the purposes of conducting this hearing. Also on the panel with me today are Judges Andrea Long and Amanda Vassigh.

Will the parties please introduce themselves for the record, beginning with Appellants.

MR. MATHER: Steve Mather appearing for the Appellants Steven and Leah Yari.

JUDGE TAY: Thank you.

MR. BROWN: Dennis Brown as a witness.

JUDGE TAY: Thank you.

And Franchise Tax Board.

MR. WATKINS: Todd Watkins appearing for Respondent Franchise Tax Board. And with me today appearing also for Respondent is Matt Miller.

JUDGE TAY: Thank you. Welcome to -- everyone here.

The issue we'll discuss today is whether Respondent's Notice of Proposed Assessment for Appellant's 2006 tax year was timely for purposes of the statute of limitations.

Prior to the hearing, we circulated the exhibits submitted by both parties during the briefing period in a file we call the hearing binder. It contains Appellant's Exhibits 1 through 4 and FTB's Exhibits A through O. Franchise Tax Board submitted Exhibits P and Q. We will also include Exhibit P, but we will not include Exhibit Q, and we will admit those into the record now so as long as there are no objections to Appellant's Exhibits 1 through 4 and Franchise Tax Board's Exhibits A through P.

Appellant any objections?

MR. MATHER: No objections.

JUDGE TAY: Franchise Tax Board?

MR. WATKINS: No, Your Honor.

JUDGE TAY: Okay. The exhibits will now be admitted into evidence.

(Appellant's Exhibits 1-4 were received in evidence by the Administrative Law Judge.)

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

JUDGE TAY: Appellant would like to make an opening statement, and so I want to give you that

opportunity to do so.

Mr. Mather, you have 10 minutes whenever you are ready to begin.

MR. MATHER: Thank you.

PRESENTATION

MR. MATHER: There are a lot of facts cited by the Franchise Tax Board in their prehearing conference statement. And actually, we agree with all of them. We have no factual dispute with any of those assertions. Only a few of these are critical. And really, this case in our view only comes down to one fact is that the taxpayers received a K-1 from United Enterprises and didn't report the income. And that's an amenable fact that is not contended by the Franchise Tax Board, but I think it dictates the outcome in our case.

Referring to the facts that -- the broader facts that matter in the Franchise Tax Board's prehearing conference statement, Fact No. 2 is that Topaz Global, the entity that received the K- 1 in our case, is a disregarded entity. And that meant that the interest in United Enterprises was reported on the taxpayer's individual return.

In Fact No. 8, the Franchise Tax Board acknowledges that the United Enterprises actually issued

the K-1 for 2006 to Topaz, reporting an $3 million 1231 gain that was realized at the partnership level.

In Facts No. 10 and 11, on October 15th, 2007, the taxpayer filed their 1040 and 540 and didn't report that the amount from the K-1 from United Enterprises. We agree that's true.

In Fact No. 21, on December 8th of 2011 -- so roughly four years later -- the Franchise Tax Board opened an audit of the taxpayer's 2006 years. This was more than four years after the return was filed but fewer than six.

And then finally, Fact No. 25, on April 6th of 2015 the Franchise Tax Board issued the NPA three-and-a-half years after the audit started and more than six years after the 540 was filed. So the question is when did that NPA have to be issued, and there are a number of options. The first is under Revenue & Taxation Code Section 19057(a) the normal rule is four years. Well, they were beyond four years. And in fact, the audit even started beyond four years.

We believe the optical statute here is 19058, which is the 6-year period for omissions of gross income. This, as I indicated, the real issue in this case is that United Enterprise issued a K-1 reporting an amount payable by taxpayers to Topaz, which is reportable on their personal return, and they didn't report it. The Franchise

Tax Board started their audit well within the six-year period, but for some reason waited for a year-and-a-half after the expiration of that many period to issue their NPA.

The Franchise Tax Board claims that the optical statute of limitations is 19755(a)(2), which is a 12-year period for an abuse of tax avoidance transaction. The facts in our case show that no such transaction existed. There was no transaction as all. There was a misunderstanding that was -- that resulted in -- in some reporting that simply didn't mirror the facts in the case that the transaction that the Franchise Tax Board complains about is a purported sale of the partnership interest by Topaz to a company called Supreme Dynamics.

That sale was prohibited by the partnership agreement. Couldn't occur. Didn't occur and, really, is largely irrelevant to the issues in our case. Because what our case is, is the failure to report the K-1 that was issued to the taxpayer.

That concludes our remarks.

JUDGE TAY: Thank you, Mr. Mather.

Since Franchise Tax Board waived their opening statement, I'm going to allow Appellant to go ahead and begin its presentation, including the examination of witnesses. Before you begin, I would like to swear in

Mr. Brown as a witness.

So, Mr. Brown, if you could please stand and just raise your right hand for me.

D. BROWN,

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

JUDGE TAY: Thank you. Please feel free to have a sit.

Mr. Mather, you much 30 minutes for your presentation. Please begin whenever you are ready.

MR. MATHER: Sure. Thank you.

DIRECT EXAMINATION

BY MR. MATHER:

Q Mr. Brown, can you describe your educational background?

A I've got a bachelors degree in business with a concentration in accounting.

Q And briefly describe your work history?

A I practice as a certified public accountant for roughly 15 years. After that, I went in to private practice, and I've been working for a family office for

the last 28 years. My role is -- has always been kind of accounting, tax, finance, operations. It's, you know, over 28 years, you tend to handle quite a few functions.

Q Okay. So let me do the math on that. 28 years ago was what year?

A '90, '95, '96.

Q Okay. The mid90s anyway. So -- and who was the family office?

A It's the Yari family.

Q Who are the members of the Yari family?

A There's Parvi Yari -- he's the father -- Bob Yari, Steven Yari, Shawn Yari, and Dory Yari.

Q And the last four are siblings?

A They are all siblings. Yes, sir.

Q And how is the job response -- or who -- let's strike that.

Which of the Yaris do you do most of your work for.

A At the time I was handling Parvi Yari, the father, and Bob Yari along with Dory Yari. Steven Yari and Shawn Yari were handled by another CFO.

Q So we're talking now about the 2006 tax year. And so who -- what was the name of the person that was -- or had been handling Steven Yari's business up until that point?

A Keith Schrup.

Q And that's -- could you spell Schrup?

A S-c-h-r-u-p-p [sic]. I think that's correct.

Q And so you're familiar with United Enterprises; is that correct?

A I am.

Q And what is United Enterprises?

A United Enterprises is a partnership that consist of several properties located in New York. It's strictly commercial -- I'm sorry, not commercial -- strictly real estate. And it basically acquired a number of properties and they act as the landlord where they rent out the properties to tenants.

Q And how many of the Yari family members participated in that United Enterprises partnership?

A All five of them.

Q And the -- what transactions occurred in 2006 that caused United Enterprises to have income; if you recall?

A I don't remember the specifics, but I do know that this sold a property that was located in New York.

Q Did that trigger gain for the members of the Yari family as members of the partnership?

A Yes, it did.

Q So you heard me in the opening statement mention

Topaz Global. What -- how is the structure of the ownership of the Yari family members in United Enterprises set up?

A All the Yaris have a holding company, if you will. They've got a number of investments, primarily, concentrating in real estate. And they use their holding companies to be the primary investor in these various different entities.

Q And so would Topaz Global be the holding entity for Steven Yari?

A It was.

Q And was that a partnership or a corporation or do you recall?

A Topaz?

Q Yes.

A It was a limited liability company formed, if I'm not mistaken, in Nevada, and it was a single member. Steven Yari was the sole member.

Q Okay. So that made it a disregarded entity for tax purposes?

A Yes, sir.

Q Okay. There was a -- so the record in our case shows that K-1s were issued by United Enterprises to Topaz Global from all years from 2006 through 2016. Are you aware of any transactions that would have caused a

transfer of that interest from Topaz Global to another entity?

A There was a transaction that was contemplated, but it was never completed.

Q And how did you become aware of that transaction?

A I was -- I was involved in the discussions on the transaction. There was a -- there was a CPA firm and a tax lawyer who was involved in trying to structure some additional entities to hold certain interests that were held by the Yaris in that particular entity.

Q So was that a transaction structured that all the members of the Yari family were engaging in?

A They had all considered it, yes.

Q Yes. And what ultimately happened to that transaction?

A It never did -- it was never completed.

Q And why was that?

A A number of reasons. So they -- for starters, the transfer from Topaz to another entity was not allowed by the partnership. In addition to that, the -- you know, as we -- some of the experiences that we have with the tax lawyer they we're getting advice from was -- started to become somewhat questionable. And so it was decided not to proceed with this particular transaction.

Q So in our case the record shows that a tax -- the

transfer was going -- at least contemplated to a company called Supreme Dynamics, and Supreme Dynamics actually prepared a tax return for the 2006 year. Why would that have happened, if you have any information?

A You know, the only reason why it could have happened is there was a breakdown in communication primarily because Keith Schrup -- who is the CFO. He was kind of my counterpart overseeing Steven and Shawn Yari's tax returns -- passed away. Ad so, unfortunately, I think the CPA firm that was involved in the structuring of the transaction in the first place never got -- it was never communicated to them that the transaction was never -- was not going forward.

Q So did you have occasion to investigate this further, the attempted transfer, for example, on behalf of your members of the Yari family?

A Yes, I did.

Q And what transaction documents or anything did you ever find to show that the deal actually happened?

A None. Nothing -- nothing was solidified. Nothing was signed, and the transfers never occurred.

Q And so for your members of the Yari family, did they K-1s continue to be issued to the holding companies by United Enterprise all the time as well?

A They did. To this day, they're still made out to

the same holding companies.

Q And so the Yari family members still own interest in the United Enterprises; is that right?

A That's correct.

Q And there's been no transfer -- no actual transfer that was ever implemented from 2006 on?

A No, there has not been.

Q And so they're still held by those holding companies; is that correct?

A That's correct.

MR. MATHER: I have no further questions of the witness.

JUDGE TAY: Okay. I want to give Franchise Tax Board an opportunity to cross-examine before you proceed with your rest of presentation.

And so I'm going to turn it over to Franchise Tax Board.

Mr. Watkins, please proceed whenever you're ready.

MR. WATKINS: Thank you.

CROSS-EXAMINATION

BY MR. WATKINS:

Q Hello, Mr. Brown.

A Hello, sir.

Q I have few questions. I hope you can clarify a few things for me. You said in your testimony that you were not involved with the businesses of Bob Yari and Steve Yari; is that correct? I believe you said in your testimony that you were involved in the businesses of the other family members but not of Steve Yari; is that correct?

A I was primarily involved in the businesses related to Paul] Yari and Parvi Yari and Bob Yari and Dory Yari to the extent that there were some crossover because there's a number of investments that the Yari family have invested in, not only between all of the members of family.

Q So how were you involved with the businesses of Steve Yari that's relevant to this appeal?

A My only involvement would have been my interaction with his CFO.

Q Okay. And you said that would have been related to transactions regarding United Enterprises?

A Yes.

Q Okay. And were you involved in the -- well, you've said that Keith Schrup was the CFO who was directly involved in Mr. Yari's business; is that correct?

A For Steven Yari.

Q Steven Yari?

A Yes, sir.

Q Okay. And so who was it who communicated with the accountants who prepared the return of Supreme Dynamics?

A It would have been Keith Schrup.

Q Okay. Do you have any knowledge of what documents were provided by Keith Schrup to the accounting firm that prepared the return of Supreme Dynamics?

A I do not. The only -- the only issue is that I know we had a family meeting, you know. It usually included all five Yari members along with myself and Keith to talk about these transactions. And Keith was well aware that we were not moving forward with that particular transaction. What he submitted to the CPA firm, I could not confirm.

Q Well, would he have given them the K-1 of United?

A I do not know.

Q If the -- have you seen the return of Supreme for 2006?

A I have not.

Q Are you aware that the items -- the partnership items, the distributive share of partnership items for 2006 were reported on the 2006 federal S corporation return of Supreme?

A I have not actually seen it. I have only heard

about it.

Q Okay. Have you seen the K-1 of United for 2006?

A Yes.

Q Okay. In your -- did you prepare tax returns in your 15 years as a CPA?

A Yes, I did.

Q And if someone was reporting -- did you receive K-1s for purposes of preparing a return of the partners as a normal course of preparing tax returns?

A Yes.

Q Okay. So would it have been unusual for the accounting firm that prepared this return for Supreme to not have had a copy of the K-1 of United that was issued to Topaz?

A I can only assume that if they prepared a return reporting the income from United, they must have had a K-1.

Q Okay.

A That's only an assumption.

Q In your 15 years of experience as a CPA, if someone had handed you a K-1 that was listing one entity as a partner and you were told that that was not the actual partner, that there had been a sale of a partnership interest, would you have taken that information and then prepare the tax return of the

transferee based on that verbal information?

A No.

Q Okay. What about would you have, if that advice included verbal information that there was a basis adjustment due to the -- in the partnership property and that information was not reflected -- well, let me ask you this.

If there was a sale of partnership interest, would there with an item on the partnership K-1 that included the basis adjustment to the transferee's share of the adjusted basis of partnership property, in your experience?

A I think that would vary depending on the partnership agreement. There's what's considered the outside basis and inside basis. So it's not always reflected in the partnership of it.

Q Well, there is -- let's assume that there is a basis adjustment. Let's assume that the partnership had a 754 election in place and that there was a difference in the adjusted basis of the properties of the partnership to the cost -- the purchase price, including any partnership that -- of the purchaser, would there be an item on the K-1 showing a basis adjustment for the transferee partner?

A I would think so.

Q So the -- okay. So then, again, a return

preparer who was given a K-1 that listed one entity as a partner what was told, despite the name of that partner, that, actually, the true partner was some -- another entity and -- and that even though there was no basis adjustment stated on the K-1 that there was an actual basis adjustment, that would be an unusual situation, would you agree?

A Yes, that seems unusual to me.

Q Okay. And if the basis adjustment was not on the K-1, do you have any idea how a basis adjustment would be then entered on the partner's return? Is that something that would -- have you ever seen in your 15 years of CPA practice?

A I'm not sure if I understand the question.

Q Well, if there's not a basis adjustment on the K-1 that's reported to a partner, wouldn't it be unusual that the return preparer would put a basis adjustment on the partner return? Would reporting, you know, a nonexistent or non-reported basis adjustment just based on information?

A It seems unusual.

Q Okay.

A There is -- you know, again, there's inside basis based on that 754 election versus outside basis. What the preparers ware thinking when they prepared the tax return

for Supreme Dynamics, I have no idea. Bear in mind that they -- you know, they were instrumental in structuring the transaction in the first place. And so there was -- I think there was some motivation on their part to maybe prepare. Honestly, it all sounds very suspicious to me.

Q Well, if in your 15 years of practice based on that, would that be professional malpractice to report partnership items to an entity that's not listed on a K-1 and to report a basis adjustment that's not reported as an item on the K-1?

A I don't know. I -- I don't think I'm in a legal position to answer that.

MR. WATKINS: No further questions.

JUDGE TAY: Okay. Thank you, Franchise Tax Board.

And thank you, Mr. Brown, for your testimony thus far. Before you go, I'm just going to turn to my Panelist to see if they have any clarifying questions for you.

Okay. So I'm going to turn first to Judge Vassigh. Do you have any questions for our witness?

JUDGE VASSIGH: I do not have any questions at this time. Thank you.

JUDGE TAY: Thank you.

And Judge Long?

JUDGE LONG: I don't have any questions either.

Thank you.

JUDGE TAY: Okay. I don't have questions either. So I'm going to turn it over to Mr. Mather for him to continue his presentation.

MR. MATHER: We actually have no further presentation.

JUDGE TAY: Okay. Thank you very much.

In that case, I'm going to turn it over to Franchise Tax Board to allow Franchise Tax Board to make it's presentation. And then after Franchise Tax Board makes it's presentation, then I'll come back and, Mr. Mather, allow you to present your closing and rebuttal. Okay.

Franchise Tax Board, Mr. Watkins, please proceed whenever you're ready.

MR. WATKINS: Thank you, Judge.

PRESENTATION

MR. WATKINS: The issue in this appeal is whether Respondent's Notice of Proposed Assessment, or NPA, was timely issued within the 12-year statute of limitations under Revenue & Taxation Code Sections 19755, because the NPA relates to an abusive tax avoidance transaction, also refer to hereinafter as an ATAT.

Appellant's were assessed additional tax in the

amount of nearly $340,000. The NPA also imposed penalties under Sections 19774 and 19777. However, as stated in a memorandum to the OTA in 2021, Respondent will not pursue an penalties included on the NPA and affirmed on the Notice of Action and Protest.

The facts have been stated in Respondent's brief, but it is helpful to provide a clear and accurate summary of what the relevant facts actually are. In addition, it is helpful to understand how the facts can lead to no other conclusion than that Appellant's return reporting was for the purpose of tax avoidance. So let's review the facts.

Appellant Mr. Yari owned a disregarded single member LLC, Topaz Global Holdings, LLC. The LLC was a 10 percent partner in a partnership named United Enterprises that owned rental property in New York. The partnership did not file returns in California. In 2006, United sold five properties that had appreciated significantly in value. It sold the properties for a total gross proceeds of about 32-and-a-half million, recognizing gains under IRC Section 1231 of close to 30 million on his 2006 federal partnership return.

The share reported on the federal schedule K-1 issued to Topaz was nearly $3 million. However, Appellants did not report the $3 million in gains directly

on their -- on their own return, nor did they report any of the other partnership items directly on their own individual federal and California income tax returns. FTB learned about Mr. Yari's indirect ownership interest in United and after opening an audit, asked where they had reported the partnership item on the return.

Their representative eventually responded by providing the 2006 federal return of Mr. Yari's 100 percent owned S corporation, Supreme Dynamics. Supreme is a Nevada corporation that did not file a corporate return in California. The federal return of Supreme reported the items from the United partnership, including the $3 million of Section 1231 gain. Therefore, it is completely inconsistent with the actual facts when Appellants say that the 1231 gain was not actually reported and was omitted. It was reported. It was reported on the return of Supreme.

However, on Supreme's federal Form 4797, sales of business property, Supreme reported a positive basis adjustment in the amount of about $3.1 million. This was described as United Enterprises' basis step-up. Supreme netted the basis step-up against the Section 1231 gain and passed a $136,000 loss through to Mr. Yari as the sole shareholder. Appellants then reported the loss on their 2006 federal and California income tax returns.

United had not reported any basis adjustment for Topaz on the federal partnership return of United and had not reported any base adjustment to Topaz on the partnership schedule K-1. In addition, there's no evidence that United had a Section 754 election in effect for the 2006 taxable year. Furthermore, Appellants did not report any sale of the partnership interest on their own return, such as by filing an installment sale form or by reporting gain on their Schedule D. This is despite that they received a $7 million distribution during the year as reported on the K-1 to Topaz.

The reporting of a basis step-up without any gain under IRC Section 741 from the sale of the partnership interest had the effect of completely eliminating any of the 3 million in gain from the partnership property sales in 2006. After FTB requested an audit that Appellants provide a commutation for the basis adjustment reported on the return of Supreme, their representative responded that the partnership income, including the Section 1231 gain, had been mistakenly reported on the S corporation return, and said that Topaz had never actually sold the interest in United to Supreme.

Respondent issued its NPA in 2015 to Appellants in reliance on the 12-year statute of limitations under R&TC Sections 1975582. The 12-year SOL applies to NPAs

issued for taxable years that were not closed as of August 1st of 2011. Appellants' 2006 taxable year was still open under the four-year regular SOL as of August 1st, 2011, because they filed their return on October 15th, 2007.

The definition of an other abusive tax avoidance transaction for purposes of the 12-year SOL is contained in R&TC Section 1977 subdivision (b). Based on the various amendments made to Chapter 9.5 bye Senate Bill 862011, the definition of an ATAT in 19777(b) applies to NPAs issued on or after March 24th, 2011. An abusive tax avoidance transaction includes as relevant for this appeal any of the following:

One, a gross misstatement within the meaning of IRC Section 6404(B)(2)(d); a transaction -- two, a transaction with respect to which R&TC Section 19774 applies; and three, a tax shelter as defined in IRC Section 6662(D)(2)(c).

The NPAs issued to Appellant -- excuse me.

The NPA issued to Appellants is related to each one of these definitions of an abusive tax avoidance transaction.

The first reason there was a ATAT is because there was a tax shelter. As modified by 19777(b)(1), the term tax shelter means a partnership or other entity, and

investment planner or arrangement, or any other plan or arrangement, if a significant purpose of such partnership entity planned or arrangement is the avoidance or revision of income or franchise tax. According to applicable federal regulations, "typically features of tax shelters "the mischaracterization of the substance of the transaction," unquote.

The overstatement of basis of property is recognized under the regulation as a type of tax shelter item. Case law, such as the Sam Davis Jr. case cited by Respondent in its briefs, also provides that for the purposes of definition of a tax shelter, the analysis is directed to the purpose for the plan or arrangement rather than the subjective motivation of the taxpayer. The Tax Court in the Sammy Davis Jr. case said, "It is clear that when profit is not one of the plan's possible outcomes and the tax benefits sought are substantial, the plan's principal purposes is tax avoidance."

In this case, the reporting by Appellants of the basis step-up to offset the Section 1231 gains of United pursuant to IRC Section 743(b) as if they had sold their partnership interest to Supreme was one, a plan or arrangement that two, objectively had the purpose of avoiding income tax. The transaction Appellants engaged in was a various on what is referred to as an installment

Bogus Optional Basis transaction or IBOB where a taxpayer sells an interest in a partnership to a related entity, takes a step-up in basis per IRC Section 743(b), but indefinitely defers recognizing any gain on the sale of the partnership interest.

This results in an extreme reduction of the present value of the tax or potentially a complete elimination if the taxpayer never reports the gain. BOB transactions were described in FTB Notice 2008-4 as potentially subject to ATAT related penalties. Appellants' reporting was even worse than most IBOB in that they failed to report any gain on the transfer of their interest in United to Supreme that was a necessary precondition for any basis step-up. For this reason, the plan was for the purpose of complete tax avoidance, not just deferral.

Appellants' NPA related to a tax shelter whether not they actually transferred their interest in United to Supreme since further case law cited in Respondent's briefs a fictitious plan or arrangement can qualify as a tax shelter. Therefore, even if the transfer of the interest in United did not, in fact, occur, it is still a plan or arrangement for the significant purpose of tax avoidance and, hence, a tax shelter for purposes of Section 6662(d)(2)(c).

Appellants' explanation that the basis step-up was a mistake us not credible because it assumes the tax return preparer committed professional malpractice or worse in the preparation of Appellants and his S corporation's returns. The K-1 is the document used to prepare a partner's returns, but no basis step-up was reported on the scheduled K-1 from United and the K-1 listed Topaz as the partner, not Supreme.

The second reason there was an ATAT is that Section 19774 applies. The Ninth Circuit has stated in several cases, including Casebeer V. Commissioner, that the economic substance doctrine is not a rigid two-step analysis but instead, focuses holistically on whether the transaction had any practical economic effects other than the creation of income tax losses. The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. The economic substance factor looks at whether the substance of transaction reflects its form and involves an examination of whether the transaction was objectively capable of creating a profit or effecting the taxpayer's financial situation.

The OTA has applied the Casebeer version of the economic substance doctrine in La Rosa Capital Resource. In addition, in La Rosa the OTA cited favorably the

opinion of the Federal Circuit in Coltec Industries V. United States in which the Court said, quote, "A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance."

Additionally, the taxpayer bears the burden of proving that the transaction has economic substance. As discussed in Respondent's briefs, the transaction -- excuse me -- the economic substance doctrine applies to the transaction that was reported. A taxpayer is generally not allowed to disavow the reporting of a transaction and is held to the manner of the reporting on a return.

Here, Appellants seek to disavow the reporting of a sale of their partnership interest in order to try to avoid applicability of the economic substance doctrine. But if the Appellants are held to the form and reporting of the partnership sale transaction, it clearly had no purpose other than tax avoidance and did not alter any control of the partnership interest. It achieved only tax benefits. As described in Respondent's brief, an abusive IBOB transaction, like that reported by Appellants, is similar to the transaction at issue in Higgins V. Smith in which a loss on a sale of stock to a wholly-owned corporation was disallowed.

Pursuant to Coltec, the reported transfer entirely failed the economic substance prong because it lacked any economic reality or substance. In addition, there's no evidence that there was any nontax business purpose for the reported transaction. If the taxpayers are held to their reporting, then the transaction should be disregarded with the result that Appellants were required to include the $3 million gain without any basis step-up. Because Section 19774 applies to Appellants' return, there was an ATAT.

The third reason there was an ATAT is there was a gross overstatement of basis with respect to the properties claimed on Appellants' return, and the purpose for the overstatement was tax avoidance. IRC Section 6404(g)(2)(d)does not itself define the term gross misstatement. The Treasury Regulation 301.6404-4(b)(4)(i) as amended by -- is amended in 2011 provides a definition. That definition includes B, a gross valuation misstatement within the meaning of Section 6662(h)(2)(a) and (b).

The regulation was issued in 2011, but it is consistent with the earlier legislative history regarding the meaning of, quote, "Gross misstatement," unquote, as discussed in Respondent's briefs. A gross valuation misstatement as defined in IRC Section 6662(h)(2) is a substantial overstatement of the value or the basis of

property claimed on the return under subdivision (e), but by substituting 400 percent for 200 percent. With respect to a partnership or S corporation item, the regulations provide that whether there is a gross valuation misstatement is determined at the entity level by reference to the S corporation's or partnership's return.

With respect to Appellants' return, the NPA relates to an abusive tax avoidance transaction because there was a gross overstatement of the basis of each property of United claimed on the return of Mr. Yari's 100-percent-owned S corporation and, therefore, claimed by Appellants on their return. Supreme reported the basis step-up pursuant to IRC Section 743(b) based on a natural or fictitious sale of Mr. Yari's partnership interest in United to Supreme. If the sale did not occur as Appellants' assert was the case, then Supreme overstated the basis of the properties by reporting the $3.1 million basis step-up.

If there was an actual sale, then Supreme still overstated the basis of the property sold because there's no evidence that United had an IRC Section 754 election in effect to step-up the transferee partner share of partnership property. The basis step-up amount reported by Supreme on its Form 4797 was at least 400 percent of the adjusted basis reported for each of the five

properties United sold in 2006. This can be seen by reference to the basis overstatement computation that Respondent provided as a visual aid, which is based on the return information of United and Supreme. The overstatement of basis was passed by Supreme through to Appellants in the form of the $136,000 loss.

I'll just take a quick moment to address the visual aid, the amounts in Column E represent Appellants' share of the gross proceeds from the sale of each property. The adjusted -- in Column D is the adjusted Appellants' share, 10 percent share of the adjusted basis of each property. Comparing just the Columns D and E, which are strictly the amounts, the share of the gross proceeds for each property reported to Topaz and the share of the adjusted basis of each property reported to Topaz that was combined in the total 1231 gain, one can clearly see there was a --

MR. MATHER: I'm going to object to this line of discussion because this is a -- the Franchise Tax Board is talking about an exhibit that's not part of the record. And it's referring to the document that's not admitted and is excluded like it's going to be something useful. Because when you're talking about Column D in an exhibit that's not in the record, that's meaningless.

JUDGE TAY: Mr. Watkins, I would ask you to

discuss and refer to the content that you're trying to describe, rather than the form of the document that is visual aid you're looking at. So if you can refer to specific properties as well as a description of the number that you are referring to, then I think that would be helpful. Okay.

MR. WATKINS: Sure.

JUDGE TAY: Does that make sense?

MR. WATKINS: No, I understand. Respondent prepared this as a visual aid to -- in order to reduce the amount of time that would be needed to explain that there is a 400 percent or more overstatement of basis. I'm concerned that I will perhaps now use up more than my allotted time. I'm close to finishing, but I'm going to stop to -- since this is a crucial fact, I will go through this as quickly as possible and limit the references to the return information itself. But I may have to cite the specific numbers.

JUDGE TAY: Yeah. That would be fine.

MR. WATKINS: Okay.

On the Form 4797 of United, one property, 146th 5th Avenue was listed with a gross sales price $9,002,135. The adjusted basis for that property reported on United Form 4797 was $421,281. Appellants' share of that was 10 percent of the basis. And share of the gross sales

price would have been 10 percent. So his share of the gross sales price would have been the $900,213. His share of the 10 percent of the adjusted basis of that property would have been $42,000. $900,213 is well over 400 percent of the 10 percent of adjusted basis of$42,000.

In addition, the basis adjustment reported on the return of Supreme reported an additional $131,421 basis step-up. If we were to allot a portion of that based on the fair market value of that property in relation to the total of all five properties, the basis overstatement would increase by $37,747. The total overstatement of adjusted basis for that property flowing through and reported by Supreme was 2,226 percent. So that's well over 400 percent.

With respect to the second property, 535 Third Avenue, the adjusted basis reported by United was $616,515. The gross sales price was $7,827,343. 10 percent of the gross proceeds allocated to Topaz's distributive share is $782,734. 10 percent of the adjusted basis of that property allocated to Topaz would be $61,652. $782,734 is well over 400 percent of $61,652. In addition, if we add allocated portion of the $131,421 additional basis step-up to 535 Third Avenue based on the preceding allocation by fair market value principal, it's stepped-up by an additional $32,821. The overstatement of

adjusted basis for that property is 1,323 percent. That's well over 400 percent.

Third property, 325 East 54th Street, gross sales price reported by United on its Form 4797 was --

THE STENOGRAPHER: I'm sorry to interrupt, but can you report that last amount?

MR. WATKINS: $8,389,995. The adjusted basis -- total adjusted basis was $936,138. 10 percent of the gross sales price allocated to Topaz on the K-1 would be 839,010 percent of the adjusted basis. Allocated to Topaz on the K-1 would be $9,306,714. That's well over the 10 percent of the gross sales price is well over 400 percent of the 10 percent of the adjusted basis allocated to Topaz on the K-1. An additional portion of the $131,421 basis step-up that Supreme reported that would be allocated per fair market value proportioned to the properties. And to this property would be $35,180 leading to a gross overstatement of 934 percent.

The fourth property was 416 East 74th Avenue. The total gross sales price per United's Form 4797 was $7,079,926. The adjusted basis per United's Form 4797 was $593,934. 10 percent of that allocable to Topaz on its K-1 of the gross proceeds would be $707,993. 10 percent of the adjusted basis allocable to Topaz is $59,393. Based on those figures, there's already an overstatement

of adjusted basis on a return of Supreme with respect to that property of 400 percent or more.

If we add a portion of the additional $131,421 basis step-up amount reported by Supreme allocated to the 416 East 74th property would be an amount equal to $29,687. A total overstatement of adjusted basis by this method leads to a total overstatement of 1,242 percent.

The last property is apartment 210. At least that's how it was described on the return of United. The gross sales price was $235,000. The adjusted basis was $15,959. 10 percent of the gross sales price allocable to Topaz is $23,500. 10 percent of the adjusted basis allocable to Topaz on the K-1 would be $1,596. Based on those two figures, shares of gross proceeds and adjusted basis allocable to Topaz, there's already an overstatement of basis of 400 percent or more on the return of Supreme. And, additionally, the share of the additional $131,421 basis step-up reported by Supreme allocable to the apartment 2010 property is $985 leading to a total overstatement of adjusted basis for this property claimed on the return of Supreme and by Appellants of 1,534 percent.

Okay. Based -- excuse me. In their briefs Appellants made two argument for why there was not a gross overstatement of basis. The first is that they assert

there was not a basis overstatement at all, but Appellant simply failed to report the income from United. In other words, they characterize the failure to include the pass through item of Section 1231 gain as an omission from income. They've repeated that argument here again today.

This is easily dismissed because Appellants ignore that the Section 1231 gain was, in fact, reported and was not omitted. The Section 1231 gain was reported on Supreme's return, and it did pass through to Appellants. But Appellants reduced the gains by reporting an even greater basis step-up that completely offset the total Section 1231 gains and produced a loss. The facts that occurred that are properly characterized as a basis overstatements, and the basis overstatement was 400 percent or more with respect to each property United sold in 2006.

The second argument Appellants make is that Appellants had reasonable cause for reporting of the gross misstatement. This second argument was probably made with respect to the penalty under Section 19777. However, Appellants may be arguing that the reasonable cause provision of IRC Section 6664 is incorporated into the definition of a gross valuation misstatement under 6662(h). This is not correct.

The definition of gross misstatement provided in

the Regulation under IRC 6404(g)(2)(d) cross references only paragraph H-2 not H-1, and so does not incorporate the word underpayment in H-1 of 662. As a result, gross valuation of misstatement is defined in IRC 662(e)(1) as modified only by subdivision (h) paragraph 2 of IRC Section 662. Therefore, the definition of gross valuation misstatement does not incorporate the reasonable cause provisions of IRC Section 6664.

It should be noted that Section 19755 the extended statute of limitations uses the words, quote, "Related to," unquote, as opposed to quote, "Attributable to", unquote, in reference to an abusive tax avoidance transaction. The words, quote, "Related to," unquote, are different than, quote, "Attributable to," unquote. The words "related to" generally denote a connection between two things or a reference from one thing to another. "Attributable to" denotes a more direct causal relationship.

The California legislature uses the words relates to with intention in 19755. It used the words "attributable to" elsewhere nearby in Chapter 9.5. Under federal law, there was until 2013 some uncertainty as to whether the words, quote, "Underpayment attributable to a gross valuation misstatement," unquote. In IRC Section 6662(h)(1) required that the gross valuation or

gross basis overstatement be the only possible reason for the disallowance of a deduction.

However, the holding and reasoning of the United States Supreme Court in the 2013 case of United States V. Woods resolved any uncertainty on that point. In Woods, the Supreme Court held that a disallowance of a deduction for an overstatement of basis occurs whether the transaction or entity giving rise to the overstatement was a sham in fact or a sham in substance. In Woods, the outside basis of partners was disallowed because it was held the partnership was a sham.

The accuracy-relate penalty for a gross overstatement of basis was upheld. Cases applying the Woods holding since that time have made the point clear that there's nothing left of the minority rule under the Todd V. Commissioner and the Heasley V. Commissioner, Fifth Circuit cases and the Gainer V. Commissioner and Keller V. Commissioner Ninth Circuit case. The federal authority that had been relied upon by the Fifth and Ninth Circuits Courts of Appeal of the minority rule that the Supreme Court overruled in Woods simply does not apply to R&TC Section 19755 or 19777(b), nor does it even apply to interpret Section 19777(a).

These provisions in the R&TC are California acts that are the product of California legislative intent.

However, Woods is instructive for whether the NPA relates to a gross overstatement of basis. Under Woods, even if an overstatement of basis arose from a sham in fact, the disallowance is attributable to a basis overstatement. If this allowance is attributable to a basis overstatement, it certainly relates to it as well.

Therefore, whether the Appellants' reporting of the basis step-up was in sham in substance or a sham in fact, the NPA relates to a gross overstatement of basis, and Appellants' purpose for the basis overstatement considering all the facts was a tax avoidance purpose. Therefore, there was an abusive tax avoidance transaction because there was a gross overstatement of basis.

In conclusion, the NPA is that is the subject of this appeal was timely issued under R&TC Section 19755 because it relates to an abusive tax avoidance transaction for the aforementioned reasons. For this reason, the Respondent respectfully request that its action be sustained.

Thank you.

JUDGE TAY: Mr. Mather, I'm going to turn to you and allow you to make any closing statements and rebuttal that you would like to make.

But before I do -- I'm sorry -- I just want to turn to my Panelist to see if there's any questions for

Franchise Tax Board, any clarifying questions for Franchise Tax Board.

Judge Vassigh, do you have any questions for Franchise Tax Board at this time.

JUDGE VASSIGH: I do not.

JUDGE TAY: Thank you.

And Judge Long?

JUDGE LONG: I do not.

JUDGE TAY: Thank you.

Mr. Mather, please proceed whenever you're ready. You have 15 minutes.

MR. MATHER: Thank you.

CLOSING STATEMENT

MR. MATHER: That was a very nice presentation by the Franchise Tax Board. It has nothing to do with the issues in our case, unfortunately. So our case, again, to repeat what we've said all along is the receipt of a K-1 and not reporting by the taxpayer and not reporting it on a return.

The Franchise Tax Board, even though they started the audit well within the period of a 25 -- the a six-year period -- six-year statute of limitations for a 25 percent omission of income, nevertheless, took years on the audit and left themselves with this untenable position that

they're -- which they're essentially fabricating a transaction that didn't occur at all, even to the extent of labeling an IBOB transaction when there was no transaction to begin with.

So they take it from the point where there's no transaction whatsoever and say well, yeah, but they meant to do this, and they meant to do this, and this would have been an IBOB and that makes it an ATAT transaction. And so, therefore, we get to come into this, the ATAT transaction under, you know, by the circuitous route of the Franchise Tax Board fabricating a transaction that didn't occur, and then so for the sole purpose of putting the ATAT label on it. And then getting into questions about lengthy presentations on what the omission or the overstatement of basis was, which only matters if you're in an ATAT in the first place.

And we're not in an ATAT. We have no transaction. It is not related to a transaction. It is not attributable to a transact. There was no transaction. There's no case. I was an attorney for the IRS in the 1980s. I was a tax shelter coordinator. I've had a career litigating tax shelter cases. There's absolutely no case out there where the transaction doesn't exist, and it is treated as a sham or a noneconomic substance transaction or anything that we just listened to for the

last half hour that the Franchise Tax Board wants the characterize this case as. It is simply not that case.

And so everything -- and a very nice presentation -- just doesn't have anything to do with our issue, which is the receipt of K-1 to the taxpayer, and the taxpayer didn't report the income and the statute is blown by over year and a half, if that is the fact. And that is the fact. It's the only facts that we know. The conjecture of the Franchise Tax Board and whether accountant malpractice would have occurred if somebody did this or that or the other, you know, to me, I mean, that particular aspect of the argument seems almost disingenuous. Because as the Franchise Tax Board well-know, they commenced a criminal investigation of this accounting firm that did this, that filed the Supreme Dynamics return in this cases, and actually brought charges against some of the members of that firm that were involved in the advice that was given in these transactions.

So to say, oh, well, yeah. We thought they should be in jail, but they couldn't have committed malpractice because, you know, because that doesn't fit with our story, with our invented circumstance of this transaction. You know, that -- that to me, like I say, is quite disingenuous. So the bottom line is there was no

transaction. We don't get under the 19744 definition because there's no transaction. And I guess in closing I would say that even the kind of invention of the transaction by the Franchise Tax Board strikes me as a little inconsistent with their position with respect to the penalty. Because they've conceded the NEST penalty in this case for a noneconomic substance transaction, and they've conceded the ATAT interest.

So what is -- what is the position here is when you say okay, there's no NEST penalty. There's no ATAT penalty, cut somehow there's an ATAT because we have concocted this grand scheme of what was supposed to happen here, even though none of this did. And, you know, that's the issue in the case is that they can't invent a transaction for the sole purpose of calling this a transaction that is was an a ATAT transaction. And that's what they're doing in this case, and there's just no factual basis for it whatsoever.

And that concludes our remarks.

JUDGE TAY: Okay. I'm going to turn to my Panelist for questions for either party, and I will turn to Judge Vassigh first. Any questions for the parties?

JUDGE VASSIGH: I do have a couple of questions for Appellant.

Are you able to tell us, has Supreme continued to

report the income from United on the returns?

MR. MATHER: No. No. I'm not sure. I can't say cata -- I haven't seen all of the returns, but I know at least many, many years they have not.

JUDGE VASSIGH: Okay. And then I also wanted to ask you, do you have any correspondence Kruse Mennillo stating that they made a mistake reporting a transaction? Is there any indication?

MR. MATHER: No, I don't believe so.

JUDGE VASSIGH: Okay. Thank you. I have no further questions.

JUDGE TAY: Thank you, Judge Vassigh.

I will turn to Judge Long and if she has any questions for the parties.

JUDGE LONG: I do not have any questions. Thank you.

JUDGE TAY: Okay. I have a couple of questions for Franchise Tax Board. Appellant argues that there's no case out there that would allow a finding that an ATAT occurred if no transaction occurred. Would you be able to respond to that at all?

MR. WATKINS: Thank you, Judge.

As stated and discussed in my opening presentation, there are cases that clearly find there was a tax -- there could be a tax shelter when -- when the

transaction did not occur or is fictitious, and I cited to one in my opening brief. I believe it's the Scherping case. I can -- if you want me to specifically -- let me -- yes. Scherping V. Commissioner TC memo 1998-288. The Tax Court held that a fictitious transfer of farming assets and operations to corporations was a tax shelter for purposes of IRC Section 6662(d)(2)(c).

In addition, there was and Eighth Circuit Court of Appeals case in 2011, United States V. A. Blair Stover, Jr. The Court affirmed the lower court's holding that a promotor's structures involving creation of management entities in which fictitious fees were reported were abusive tax shelters for purposes of the promoter penalty under Section 6700, which was incorporated by R&TC Section 19177.

In addition, we have federal cases where particularly the straddle cases involving former contracts and straddles and, I believe, possibly in the options cases where offsetting losses and gains in where in some cases the transactions occurred only on paper. I believe the case of Sochin, the Tax Court case was Brown V. Commissioner, but the Ninth Circuit case was Sochin, S-o-c-h-i-n.

The Tax Court determined those were factual shams, and the sham transaction analysis was applied by

the Ninth Circuit to those in that case. And with regards to the gross overstatement definition, there's no reason there would need to be a transaction requirement for a gross overstatement of basis. So the facts in this case are that a basis step-up was reported on the return of Supreme as if there had been a sale of the partnership interest. And whether or not that sale actually occurred does not appear to be a requirement for the finding of a basis overstatement.

And so that would my response.

JUDGE TAY: Thank you.

I'll allow Mr. Mather an opportunity to respond if he like to, to what Mr. Watkins just identified. If you would like.

MR. MATHER: Sure. A couple of things on the cases that Mr. Watkins cited. He noted that in the Sochin case that the court disregarded the transactions as just being paper transactions. That happens often in tax shelter cases. That is a legitimate statement to make. We have no paper. We never did a transaction. We didn't purport to do a transaction. There's no documents. There were never any agreements. There was never anything that purported to be a transaction of any kind. You will not find that case anywhere in the Franchise Tax Board's brief or anywhere else.

With respect to the Blair Stover case, I actually testified as a witness in the Blair Stover case in Kansas City. So I know something about that case. And, in fact, the substance of that case with respect to the action against Mr. Stover was the earlier involvement that the Yari family had with Kruse Mennillo that caused them to sour on this deal before it was done. And so -- and in those cases, yeah, the fees were paid. They just were -- it was just part of a scheme that didn't -- that didn't -- wasn't going to be respected for tax purposes because you were basically paying the fees to yourself.

But there were transactions established. There were contracts. There were payments made. There were companies set up. They were all of those things. That's what happened in the Blair Stover case. And that was the essence of what he was charged with being a tax shelter promotor for was creating fictitious -- or not fictitious -- creating actual entities that received monies that a taxpaying entity claimed a deduction for and wasn't being reported as income on the other side. That was the essence of those transactions, but they all happened.

So that in no way supports the FTB's position on a case which never happened. And there were never paper. There was never any transaction that occurred.

JUDGE TAY: Okay. Thank you very much.

I have no further questions for the parties. So I believe we're ready to conclude here.

I just want to thank the parties for appearing today and for your presentations.

The record in this appeal is now closed, and the appeal submitted for decision. We will endeavor to send you our written opinion within 100 days of today.

The hearing is adjourned.

Thank you, again, and have a nice day.

(Proceedings adjourned at 2:30 p.m.)

HEARING REPORTER'S CERTIFICATE

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

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

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

I have hereunto subscribed my name this 3rd day of October, 2023.

_____

ERNALYN M. ALONZO
HEARING REPORTER