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BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)	
)	
EWV, LLC,)	OTA NO. 220811162
A. ABADY and M. ABADY,)	220811131
S. HASHEM and F. HASHEM,)	220811196
F. KANANI and J. ABRAMS,)	220811163
)	
APPELLANTS.)	
)	
_____)	

Transcript of Electronic Proceedings,
 taken in the State of California, commencing
 at 1:09 p.m. and concluding at 3:43 p.m. on
 Thursday, April 24, 2025, reported by
 Ernaly M. Alonzo, Hearing Reporter, in and
 for the State of California.

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APPEARANCES:

Panel Lead:	ALJ VERONICA I. LONG
Panel Members:	ALJ KEITH T. LONG HEARING OFFICER SETH ELSOM
For the Appellant:	NORMAN LENCZ
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD CAROLYN KUDUK BLAKE CUNNINGHAM

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I N D E X

E X H I B I T S

(Appellant's Exhibits 1-22 were received into evidence at page 6.)

(Department's Exhibits A-U were received into evidence at page 7.)

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California; Thursday, April 24, 2025

1:09 p.m.

JUDGE V. LONG: With that we are going on the record.

This is the hearing in the consolidated appeals of EWV, LLC, Abady, Hashem, Kanani, and Abrams, OTA Case Nos. 220811162; 220811131, 220811196, and 220811163. The date is April 4th, 2025, and the time is 1:09 p.m.

This hearing is being electronically with the agreement of the parties.

I am Judge Veronica Long, and I will be the lead panel member for the purpose of conducting this hearing. My co-panelists, Hearing Officer Elsom and Judge Keith Long and I are all co-equal participants in deliberating and determining the outcome of this appeal.

I'm going to ask the parties to identify themselves and who they represent, beginning with Franchise Tax Board.

MS. KUDUK: My name is Carol Kuduk. I represent Respondent.

MR. CUNNINGHAM: Blake Cunningham, also represent Respondent Franchise Tax Board.

JUDGE V. LONG: And Appellant's counsel.

MR. LENCZ: Norman Lencz, representing

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Appellants.

JUDGE V. LONG: All right. With that, I'm going to confirm the issues to be decided in this appeal which are the same as those stated in my Minutes and Orders: First, whether Appellants recognize taxable boot in relation to an Internal Revenue Code Section 1031 Exchange; and two, whether Appellants have demonstrated they are entitled to interest abatement.

Next, I'm going to discuss the exhibits in this case. Appellant submitted Exhibits 1 through 22. FTB did not object to Exhibits 1 through 20 which were represented -- prior to prehearing conference.

FTB, do you have any objection to Exhibits 21 and 22, which were submitted after the prehearing conference?

MS. KUDUK: No.

JUDGE V. LONG: All right. With that, Appellants Exhibits 1 through 22 are now admitted into evidence.

(Appellant's Exhibits 1-22 were received into evidence by the Administrative Law Judge.)

JUDGE V. LONG: FTB submitted Exhibits A through U prior to the prehearing conference, and Appellant did not object to the admissibility of those exhibits. Therefore, Exhibits A through U are now admitted into evidence.

1 (Department's Exhibits A-U were received
2 into evidence by the Administrative Law
3 Judge.)

4 JUDGE V. LONG: I'm going to ask each party if
5 you have any new exhibits today, beginning with Mr. Lencz.

6 MR. LENCZ: I do not.

7 JUDGE V. LONG: Franchise Tax Board?

8 MS. KUDUK: No.

9 JUDGE V. LONG: Great. Thank you.

10 With that, Mr. Lencz, you may begin your
11 presentation. You have 60 minutes. Begin when you are
12 ready.

13 MR. LENCZ: Thank you so much. Again, I
14 appreciate -- with the taxpayers, the Appellants
15 appreciate the opportunity to present our case to the
16 Judges and the panel. Just on the outset, I want to point
17 out I'm not a litigator. I'm a tax lawyer and don't --
18 this is actually my -- I've been a tax lawyer for now
19 20 -- over 27 years, and this is my first litigation where
20 I'm actually acting as a litigator. But I apologize in
21 advance for any faux pas or any rookie errors being again,
22 this is not my area of expertise. But again, I do have an
23 area of expertise in the subject matter, but not
24 necessarily know the procedural rules.

25 I will try my best. I've tried to learn from --

1 from others on what I need to do and how the procedural
2 aspects work, but just letting everyone know that that's
3 not my -- not -- not my comfort zone.

4 JUDGE V. LONG: Mr. Lencz, I will ask for one
5 thing. Our stenographer is transcribing everything you
6 say. You're doing very well so far. Just slow it down a
7 little so that --

8 MR. LENCZ: Sure.

9 JUDGE V. LONG: -- she's able to copy what --

10 MR. LENCZ: Okay.

11 JUDGE V. LONG: Thank you.

12 MR. LENCZ: Fair enough. Okay. Not the first
13 person told me I speak fast. Okay. But the clients love
14 it because it -- they pay by the hour. So if I talk
15 faster they pay less.

16

17 PRESENTATION

18 MR. LENCZ: But anyway, there again, there's --
19 hopefully three issues, but they're -- they're really --
20 oh, is the two issues. One is the interest abatement which
21 we'll save for last. There isn't much to talk about that.
22 The bigger issue, of course, is the boot, and that taxable
23 issue really has two subcomponents. One is the boot from
24 the escrow funds, and the second is the boot from the loan
25 expenses. From a monetary perspective, the escrow funds,

1 the issue there is a much more significant amount. So I'd
2 like to begin focusing on that.

3 Although, the Respondent in their -- in their
4 opening brief kind of started with the loan expenses, I'd
5 like to reverse it and start with the discussion of the
6 escrow funds because that's where there's a more
7 significant amount. Not getting -- not that the loan
8 expenses are insignificant, but relatively from a -- from
9 a financial perspective, they're less significant. So I
10 want to -- I want to make sure I -- I cover -- spend --
11 spend more time on the escrow issue than on the loan
12 expense issue.

13 Within the issue of loan ex -- of the -- of the
14 escrow funds, I'm a little bit unclear exactly what FTB's
15 position is, but I -- I certainly -- I did see on their
16 prehearing -- on their submission is that they believe
17 that this really is an issue with respect to both actual
18 and constructive receipt of the escrow funds. And just
19 on -- just that we're all understanding, it's my
20 perspective of what actual and constructive means. Actual
21 receipt means that actually -- the money actually came in
22 to the taxpayer's hands.

23 Constructive receipt means it didn't actually
24 come in to the hands of the -- of the taxpayer. But
25 because the taxpayer had an open door and had full access

1 to it, to the those funds, that's treated -- although they
2 did not actually receive them, but since they could have
3 received them, those are treated as having been received
4 as well, constructively received. And there's -- but
5 there's a difference between actual and constructive.

6 Yeah.

7 JUDGE V. LONG: Mr. Lencz, I'm just going to ask
8 you if you could slow it down just a little --

9 MR. LENCZ: Sure.

10 JUDGE V. LONG: -- please.

11 MR. LENCZ: Okay.

12 JUDGE V. LONG: Thank you.

13 MR. LENCZ: Okay. Sure. I apologize again.

14 So again, the difference between actual receipt
15 of funds and constructive receipt of funds is whether the
16 money actually comes into the hands of the -- of the
17 taxpayer, versus it didn't actually -- constructive
18 receipt is the way they didn't actually come into the
19 hands of the taxpayer, but the taxpayer had full access,
20 had the ability to get -- to access those fund. So, for
21 example, actual receipt of funds, if the money came from
22 the account -- from someone's account and was wired to the
23 account of the taxpayer, that's actual receipt. Nothing
24 to talk about there, really.

25 Constructive receipt is where the -- the assets,

1 the cash, didn't actually come in into the account of the
2 taxpayer but was offered to the taxpayer, and the taxpayer
3 had the ability to receive them. Whereas then the tax
4 rules in that context will say, well, look, even though
5 you didn't actually receive them, they didn't hit your
6 account, but because they were so accessible to you and
7 there was nothing stopping you from getting them, the tax
8 law will then treat them as if they had been, in fact,
9 received by the taxpayer.

10 A classic example would be it's December -- and
11 this -- it happens all the time. We get this all the
12 time. A tax -- a boss comes to the employee, December
13 31st, says, "Here, I want to pay you a bonus. Here's a
14 \$100,000 bonus. Here's a check."

15 And the tax -- the employee says, "No, no, no.
16 Just put it -- leave it in your desk right there, and I
17 don't want to take it. Give it tomorrow. Let's deal with
18 it tomorrow."

19 And the boss says, "Okay. It's right here. I'm
20 leaving for the day. Come and -- have a Happy New Year.
21 Come and get it whenever you want." That's constructive
22 receipt because there in that situation, although the
23 taxpayer classically turned his back or her back on that
24 cash, which was fully receivable on December 31st of the
25 earlier year, and the taxpayer turned its back on that --

1 on that money. That's constructive receipt.

2 Actual receipt is when you actually get the money
3 and -- and have it in your account. The reason why I'm
4 spending an inordinate amount of time on this issue is
5 because I -- I'm not entirely sure what the FTB's argument
6 is. In some places they say -- they're arguing that we
7 had actual -- the taxpayers here had actual receipt of the
8 cash. But their main argument seems to be constructive
9 receipt, but I do want to deal with both of those
10 because -- because there's some lack of clarity on what
11 precisely the FTB's position is, we will address both of
12 those points.

13 Again, in terms of these actual, you know, I
14 don't think we could -- there's much to talk about there.
15 Although, we will discuss it, you know, there was no
16 receipt of the funds. The funds went straight to the
17 escrow account, and there was no receipt until 2017, 2018,
18 2019. In those later years is where the funds were
19 received. I -- we don't believe there should be much of
20 an issue of actual receipt, but because it's been raised
21 and mentioned, we will address it as well.

22 Constructive receipt, that is why I believe the
23 main argument is the issue being, yes, assuming we don't
24 have actual receipt, but there was escrow funds that were
25 put into an escrow account. And that's where, I believe,

1 we have a point of contention with the FTB when the FTB
2 says, "Well, those funds in those escrow account did not
3 really have any significant restrictions that would have
4 prevented the taxpayer from accessing them."

5 They are like the -- like the employee in my
6 example who just turns his back on the check and said, I
7 don't want it, but could have easily taken it. The FTB's
8 position is the same thing here. These funds were in this
9 escrow account, but there was really nothing stopping them
10 from accessing those funds. And because there were no
11 significant restrictions on the taxpayer's ability to
12 access those funds, FTB believes the taxpayer had
13 constructive receipt of those funds. And that again, is a
14 point of contention, unlike the actual receipt issue where
15 I think there's really not much to discuss because it
16 never hit our account. The constructive receipt issue
17 boils down, in our view, to a discussion of whether there
18 were, in fact, the substantial restrictions placed upon
19 taxpayer's ability to access -- access the \$4.5 million of
20 escrowed funds.

21 Okay. In term of how I'm going to present the
22 argument, I would like to -- again, with the permission
23 of -- of -- of the Honorable Judges, to go through -- to
24 follow, in effect, the write-up we originally submitted,
25 August 15, 2022, which is one of the exhibits. I just --

1 and then once I've done that, I would -- again, I'm just
2 going to summarize because sometimes some of these
3 positions or arguments may be, in writing, harder to -- to
4 understand and comprehend than they are perhaps verbally.
5 So I'll make an effort in cases where perhaps the writing
6 wasn't as clear as it could have been to present a -- a
7 verbal summary of some of those arguments so that we're
8 clear about what we're arguing, what -- what the FTB is
9 arguing and be able to reach a -- a -- an appropriate
10 conclusion.

11 Once that's done, I would like to go through some
12 of the -- the Respondent's opening brief and our response
13 to that. Same idea of yes, we responded in writing.
14 Everyone has seen those submissions but would like to
15 probably -- perhaps explicate further and explain some of
16 those things that are in writing, in case there's a
17 disconnect between the written word and oral word. And
18 perhaps through -- through discussion and oral
19 presentation, those points can become clearer and --
20 and -- and more comprehensible.

21 So I'm also not -- I also don't want to waste all
22 of our time just raise -- talking about points that we all
23 agree on. I think we all fundamentally agree with the
24 facts of the case that there was relinquished property
25 sold, and there were proceeds from that relinquished

1 property that went to a qualified intermediary account.
2 And I don't think the FTB is not questioning that and has
3 not questioned that. And no one is questioning the fact
4 that there was a valid QI account. And then there were --
5 there were sums that were deposited there, and those
6 amounts went ultimately to the -- to the account of the
7 seller of the relinquished -- of the replacement property.
8 But I, again, do want to try to focus on those areas where
9 we do have points of disagreement in terms of both the
10 escrow funds, whether there was actual and/or constructive
11 receipt thereof, and the nature of the loan expense,
12 whether they should or should not be treated as boot.

13 On a -- from an economic perspective, again, I --
14 maybe some of the confusion perhaps relates to the
15 presentation on the settlement sheet. But again, I think
16 fundamentally were all in agreement, in fact, that there
17 was 54 point -- that the purchase price for the
18 replacement property was, in fact, \$54.5 million. That
19 was the purchase price. And the amounts used to pay that
20 \$54.5 purchase price was \$45.5 million of loan one, and
21 then roughly \$4 million of a second loan. That's the
22 \$8 million -- that's the \$8.5 million, part of which --
23 again, \$4 million of which was used towards the purchase
24 of the replacement property. And some of it was used --
25 was escrowed and used thereafter for tenant improvements,

1 CAPEX, leasing commissions, all the things that -- that
2 a -- a real estate owner does to improve property.

3 But that's again, an important fundamental
4 distinction that basically when you do -- when you run the
5 numbers, we've got a total alone, really, for the initial
6 purchase -- for the purchase price of the party as is, if
7 you will, was \$49.5 million, which is -- and that
8 \$49.5 million was funded with a \$45.5 million loan, called
9 loan one. And \$4 million out of the \$8.5 million loan,
10 \$4 million was accessed initially at the closing date for
11 a total of \$49.5 million, which leaves with you with
12 \$5 million of equity, which was the amount that was rolled
13 over from the original property -- from the relinquished
14 property into the replacement property.

15 Now, again, we'll -- we'll -- you know, this is
16 in the records as well in some of the exhibits. But
17 that's kind of the big picture of what happened. I don't
18 think -- I'm not sure if there's that much factual
19 disagreement as well about the those points so far that
20 \$4 million was used towards the initial purchase, and the
21 other \$4.5 was, in fact, escrowed. There may be a
22 question of conceptionally was that -- the other second
23 \$4.5 million, the escrowed amount, did that come in and go
24 out, or, you know -- and/or did the -- we could -- we
25 could -- we do dispute that whether the taxpayer had full

1 access to those funds or not.

2 But I think on those fundamental numbers, I
3 believe -- again, the FTB will have the opportunity to
4 respond later on -- that those numbers are agreed to, that
5 there was money paid for the property initially as is.
6 And there was more money that was escrowed from the loan
7 that wasn't accessible immediately but was useable and, in
8 fact, was accessed over a period of three years to fit --
9 fit up the property, to provide tenant improvements, to
10 provide leasing -- pay leasing commissions, and to do
11 CAPEX work on the properties. That's that kind of --
12 the -- the way we're viewing it to now.

13 Again, I -- I'm not going to go through all the
14 details, but if you look at the -- the Escrow Agreements,
15 there were, clearly, conditions that needed to be
16 satisfied in order for the taxpayer to access those funds.
17 So, again, we had \$49.5 million of loan amount at closing,
18 \$5 million of equity, and that was all to buy a property
19 worth \$54.5 million, and then there was \$4.5 million of
20 escrowed funds that were placed into escrow. And the
21 issue becomes what level of access did the taxpayers have
22 to those. And if you look at the Escrow Agreements -- and
23 I think FTB is aware of this as well -- there were, in
24 fact, certain things that needed to happen before the
25 taxpayer would have the right and the ability to access

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the funds.

They needed to lease out the property with leases that were satisfactory to the -- to the -- to the lender. They had -- the leases had to have a term of five years or more. They had to actually spend money to actually pay the leasing commissions. They had to deliver lien releases, estoppels. Again, I'm a tax attorney, not a real estate attorney, but I've -- I've definitely -- I've consulted with my real estate colleagues, and these are -- these are not unusual provisions in an escrow agreement that provides that in order for the taxpayer to access funds, they need to do certain things. They need to meet certain conditions. And in no way do these restrictions represent rubber stamping and, like, okay just sign the check. Give us the money. These are real things, real conditions that need to be met in order for the taxpayer to access the funds. I would like to kind of go -- go through that.

So again, going back to the economic -- economics of the transaction, we bought property worth \$54.5 million with a loan of \$49.5 million. And then we had the ability to access \$4.5 million more to investment in the property and thus, bring the value of the property up to \$59 million. We also mentioned -- did want to mention there is a case Fredericks versus Commissioner, which is

1 very close to our facts, which also addresses in the -- in
2 the context of like-kind exchange, the -- that escrowed
3 funds that are not accessible with ease by the taxpayer,
4 that have conditions, attached to them before the taxpayer
5 could access them, do not represent taxable boot. And
6 that's the case of *Fredericks v Commissioner*, TC Memo
7 1994-27. Okay.

8 In terms of what the rules are, the rules and the
9 regulations -- and there were some discrepancies between
10 the FTB's position, whether they were looking at the 451
11 regulations or the 1031 regulations. But I don't believe
12 any of that is material. At the end of the day, all the
13 regulations and all the case law pretty much says the
14 issue of constructive receipt is that a taxpayer is
15 treated as receiving property constructively if it has the
16 ability to draw -- if it's -- if it's credit to the
17 taxpayer's account, if the funds are set apart for the
18 taxpayer, or they're otherwise made available so that the
19 taxpayer may draw upon them at any time with no
20 significant restrictions. And the U.S. Tax Court has said
21 that, "The doctrine of constructive receipt is effectively
22 a fiction and therefore, it has been cautiously and
23 sparingly applied." That's quote from *Millsaps versus*
24 *Commissioner*, TC Memo 1973-146.

25 So it's worded -- it should not be applied,

1 unless there's very strong evidence that there has, in
2 fact, been constructive receipt. It's not something that
3 gets used unnecessarily or -- or in situations where it's
4 not appropriate, of course. And there -- there are many
5 cases out there that went -- that stand for the principle,
6 and we went through them in our -- in our original protest
7 where the cases say that if there's funds in an escrow
8 that are not accessible -- well, if there are funds in
9 escrow that have conditions that must be satisfied in
10 order for a taxpayer to receive them, they have not yet
11 been constructively received. Okay. Okay. So that's
12 basically the -- the concept of constructive receipt.

13 And now I want to talk about how they would apply
14 here. But first, before we go there, I want to discuss
15 the potential that there's been actual receipt. Because,
16 again, as I alluded to earlier, the FTB appears to be
17 arguing a multiprong position. Number one is that there
18 was actual receipt of the funds. And then even if there
19 wasn't actual receipt, I guess the secondary argument is
20 that well, there was constructive receipt. So let's,
21 before we apply the laws of constructive receipt to our
22 facts and discuss the restrictions that apply, I just want
23 to talk for moment about the actual receipt and maybe
24 perhaps why -- again, I will -- you know, FTB will have
25 its opportunity to present its case.

1 But we don't -- we strongly believe there was no
2 actual receipt, and we certainly believe there was no
3 constructive receipt either. I believe that perhaps the
4 possible -- the position of the -- of the FTB is based
5 upon the fact that the settlement sheet seems to indicate
6 that the loan funds were hitting, on a settlement sheet,
7 the entire amount of the loan, which is the \$40 -- the
8 \$49.5 plus the \$4.5 for a total of \$54.5, the settlement
9 sheet appears to indicate that that entire amount came in.
10 And that may or may not be true, but practically speaking
11 it didn't. In other words, if it came in, it went right
12 out. Because on that same settlement sheet where -- where
13 the -- where the -- where the \$54 million is shown as a
14 credit, there's also a debit for the \$4.5 million, which
15 went to ANIC, which is the escrow agent.

16 So again, if that's the source of why the FTB
17 believes that there was actual receipt, because of that
18 credit on the settlement sheet, that's really a misnomer
19 because there's no -- there's no -- the same settlement
20 sheet that shows it coming in shows it immediately going
21 out. So that never ever was accessible to the taxpayer
22 because it was all prewired and required. The lender is
23 not going to -- is not allowing the taxpayer to walk away
24 with that \$4.5 as part of the prewiring of the closing.
25 That money was an in and -- in as a credit and out

1 immediately. Required to go out immediately to the escrow
2 agent, such that the taxpayer did not have any access to
3 it. And therefore, we don't believe that that is in any
4 way indicative of the fact that there was actual receipt
5 of that money.

6 And if you -- again, as we've shown through the
7 bank statements and the loan statements, that money was
8 actually accessed. The \$4.5 million was accessed over a
9 period of three years. As the taxpayer did its
10 construction work, and did its tenant improvements, and
11 its leasing, they were over time -- and we've shown --
12 we've tied together the numbers showing how that \$4.5
13 million came in over that period of time but did not come
14 in. Although, again, technically it may show up as a
15 credit on the statement, but that same statement has it
16 going out as a debit to the escrow agent, which is --
17 which is exactly what happened.

18 As, you know, the other possible source of
19 confusion, perhaps we thought maybe it was some language
20 in the loan -- in the Escrow Agreements which imply that
21 the money is coming to the taxpayer, then the taxpayer is
22 going -- going to contribute it to escrow. Again, that
23 language, you know, may, in fact, have been there, but,
24 again, that's not what happened. And that's -- the lender
25 would never have allowed the taxpayer to walk away with

1 that money. The lender wants that money to be in escrow.
2 And therefore, notwithstanding such language, that
3 doesn't affect the reality of what actually happened;
4 which is at closing the money, in fact, came and then went
5 straight to the escrow agent from the lender. And the
6 taxpayer therefore, never had any access to it.

7 And the fact that the documents may imply that
8 they -- that -- that it's happening in a two-step process
9 and/or the fact the settlement statement may imply that
10 there was some sort of receipt, there was not in actuality
11 any actual receipt of those funds, which makes total sense
12 because a lender is not going to want a borrower to have
13 the money and say, well, you know, count -- I'm trusting
14 the borrower to give the escrow money back. They're going
15 to require that money to go straight to escrow, which is,
16 in fact, exactly what happened. So it was not credited to
17 EWV's account.

18 It was not set apart for EWV for the taxpayer.
19 And they were, in fact, as the escrow agreement say, they
20 were held in an unsegregated noninterest-bearing -- in --
21 in unsegregated noninterest-bearing accounts of the escrow
22 agent, and therefore -- I'm sorry -- of the lender and
23 therefore, subject to all the claims of the creditors of
24 the lender, but not subject to the claims of the borrower
25 of the taxpayer. So, therefore, we don't believe that

1 there's any argument that there's actual receipt of those
2 funds.

3 Now, with respect to constructive receipt,
4 there's room for legitimate disagreement or -- or
5 questions that, you know, again, actual receipt, there
6 wasn't. That's -- that's factual in our view.
7 Construct -- constructive receipt becomes a legal issue,
8 not a -- that's not factual issue in contrast to the
9 actual receipt, which is factual. Constructive receipt is
10 a legal issue as to whether there were sufficient
11 restrictions to the taxpayer's ability to access those
12 escrowed funds for the tax law to consider them as having
13 been received and accessible to the taxpayer and
14 therefore, treated as taxable boot.

15 Again, we mentioned a little -- a few of them
16 before, but I -- I guess, I'm -- I'm really struggling to
17 understand how there could even be an argument that these
18 restrictions that are in the Escrow Agreements are not
19 substantial. I mean, these are clearly obligations and
20 conditions that are not in the hands of the taxpayer, EWV,
21 itself. There are many things that others must do in
22 order for the taxpayer to be able to prove to the lender
23 that it has met the conditions and is, therefore, worthy
24 and entitled to receive distributions and disbursements of
25 those escrow funds.

1 For example, in the -- in the leasing commission
2 escrow, they've got to find tenants. That's not always
3 easy find tenants, and those tenants must be approved
4 by -- by the lender. And they must enter into leases
5 which are five-year leases. I mean, you know, there are
6 all sorts of risks involved. You know, if there is a -- a
7 real estate meltdown, if there's a big recession, you're
8 not going to find tenants. I mean, if there is a COVID
9 epidemic -- all sorts of things that can happen could
10 prevent the lender -- for the taxpayer from being able to
11 satisfy those restriction -- those conditions and being
12 able find appropriate tenants, to be able to get lien
13 releases from workers, estoppels and subordination
14 agreements from tenants.

15 Now, again, I'm not a real estate person, but I
16 did speak to my real estate colleagues and they assure me
17 that, yeah, these things are real conditions. These are
18 not rubber-stamped. These aren't things you just say --
19 snap your fingers and get. These are real serious
20 conditions that need to be met in order for the taxpayer
21 to be able to -- to access the funds more so and -- and
22 not easy lifts. Tenant of the -- I mean, the CAPEX -- I
23 mean, the way the agreements is they have to first spend
24 the money and then show the receipts to the lender.
25 Again, that's something which is not that easy. Not --

1 not in any way shape or form are -- are these -- these
2 conditions rubber-stamped items or things that are easy
3 lifts. Some are quite difficult. And, in fact, it took
4 the taxpayer three years to meet those conditions and
5 access disbursements of those escrow funds.

6 This is very different from the taxpayer in my
7 example on December 31st who turned its back on check that
8 the -- that the boss offered and just said put it in the
9 desk. I'll come and get it tomorrow when it's a new year
10 and give me -- give me a deferral until next year. This
11 is not that at all. They were not able to access the
12 funds. And the lender, frankly, wouldn't have let them
13 have the funds because, again, the lender wants that money
14 to be used for improvements, which increase the value of
15 the property. Of course, tenant improvement improves --
16 getting tenants itself getting into the leases leasing the
17 property. We all know a fully leased building is worth
18 for more -- far more than an unleased property. And
19 therefore, satisfying all these conditions in order to
20 improve the value -- to increase the value of the
21 property, something that the lender would have insisted on
22 and would not have allowed the tenant to just take the
23 money and -- and do things that would not increase the
24 value of the property, such that its -- its loan amount is
25 secured by greater value put into the property.

1 So under these circumstances, we don't understand
2 how the FTB could argue that the escrow funds were
3 essentially the property of the EWV. Again, there were
4 significant conditions and restrictions on their
5 entitlements to the money. The money wasn't unsegregated
6 accounts of the lender. The lender had -- they were --
7 these funds were not segregated out. The lender, its
8 creditors were unable to access those funds, whereas
9 the -- the taxpayer's creditors were -- were --were unable
10 to access those funds. That's specifically in the
11 documents. And that's why we don't believe that there --
12 we believe that there was -- that there was not
13 constructive receipt of these -- of these funds that were
14 in the escrow.

15 Now, we saw this argument made originally by the
16 FTB way back when, and it was made a second time in the --
17 in -- in -- in Respondent's opening brief that there's a
18 provision in the Escrow Agreements that says that the
19 lender's approval for disbursements could not be
20 unreasonably withheld, conditioned, or delayed. And I
21 think the FTB is interpreting that to say, well, you see.
22 You know, they -- the -- the lender had no choice. They
23 basically had to rubber stamp any request for disbursement
24 by the taxpayer. Would have to be -- under that
25 provision, would have to be satisfy -- would have to be

1 given to this taxpayer because it would be unreasonable to
2 withhold those -- those funds under those conditions; but
3 that's just not correct.

4 What the agreement is saying is that after the
5 taxpayer satisfied the onerous conditions that were
6 necessary for it to access the escrowed funds, at that
7 point, if it had satisfied its requirements, then the
8 lender could not unreasonably withhold disbursed -- could
9 not with -- unreasonably refuse to disburse funds because
10 these taxpayers has satisfied the conditions that have
11 been placed on the escrow. But that's not the same thing
12 as saying that under all conditions, whether or not
13 requirements are met, the -- the lender must disburse the
14 funds. That is not at all what the documents are saying,
15 and I -- I think there may have been a misunderstanding.
16 That language is, again, only upon the satisfaction of the
17 conditions and the requirements. That's when the
18 requirement of the lender to disburse cannot be
19 unreasonably withheld. But that does not in any way shape
20 or form indicate that somehow it was an automatic access
21 to the funds, which seems to be what the FTB was arguing.

22 One other point, again, I think we -- we saw the
23 FTB making was that the escrowed funds could be used to
24 payoff a loan. Now, that again -- I've checked with my
25 real estate colleagues. That's a very standard provision

1 and only applies if there is a -- if there's a default on
2 a loan. That's when that provision applies and that's,
3 again, in every escrow agreement. And that's very
4 standard in every loan agreement that whenever there's, God
5 forbid, a default, all hell breaks loose. And all -- and
6 all sorts of stuff like that happens. You know, you
7 accelerate their payments. We're not giving you anymore
8 escrow funds, which makes total -- we're not going to give
9 you anymore escrowed funds.

10 If you defaulted, you know, of course, we're just
11 going to take all those escrow -- we have the right. The
12 lender has the right at that point to take all the
13 escrowed funds back because you're being a -- you
14 borrowed. You're being a bad boy. You're being naughty.
15 You're not paying -- you're not -- you're not paying back
16 your debt. You've defaulted. So, of course, the lender
17 is going to say, okay, all -- all bets are off now. We're
18 taking that -- we're taking those funds back. So that is
19 not in any way indicative that that somehow should mean
20 that the -- that the borrower should have constructive
21 receipt of those funds. Because that's a standard
22 provision in every loan agreement when there's a partial
23 escrow is that -- that if there's bad things happen and
24 there's a default on the loan, at that point, the loan is
25 basically gets closed out, and all the money comes back,

1 and anymore further disbursement of the -- of the escrowed
2 amounts. So, again, we don't consider that in any way
3 indicative of construct -- and -- of constructive receipt.

4 And, in fact, if it would be, pretty much every
5 escrow would be treated as constructively received, and
6 would be treated as boot to taxpayer or taxable income
7 under other circumstances because that's standard language
8 in any escrow agreement in connection with a loan. So,
9 yeah, that's basically our -- our view again on the issue
10 of escrowed funds being actually or constructively
11 received. And just to summarize, we don't believe they
12 are actually received because they weren't as a factual
13 matter. We can show that they were disbursed in later
14 years. The fact that there may have been a line on the
15 settlement sheet showing that it came in, that settlement
16 sheet on a different side shows they went immediately out,
17 and that was all prewired to happen. And there was no
18 ability of the taxpayer to pull those funds out. And the
19 fact that there may be language in the Escrow Agreements
20 that imply that it's technically going to the taxpayer,
21 then the taxpayer is sending them to the escrow.

22 Again, that does not change the reality of the
23 facts on the ground, which is clear that that money went
24 straight to ANIC, the escrow agent, and that money was
25 held there and never hit the taxpayer's pockets and

1 therefore, should not be considered actually received.
2 And again, we don't believe that they were constructively
3 received either. Because again, there were very
4 significant restrictions; things that needed to be
5 obtained from third parties that were not in the hands of
6 the taxpayer at all that were dependent upon other people
7 who may or may not have been willing or able to set to --
8 to do the things that were being asked for. And if that
9 would have happened, then there would have been an ability
10 of the taxpayer to get those funds.

11 And again, I point out, if it was so easy just to
12 snap their fingers and get the money, they would have
13 taken it all right away. I mean, most of my clients, they
14 want to get money, you know, as soon as they can. And why
15 they wait three years over time, right? Why don't they
16 just take it all. Take the money and run, initially,
17 investment it, and make more money on it. The answer is
18 because they couldn't, because there were restrictions and
19 conditions that had to be met. And without meeting those
20 conditions and restrictions, that didn't have access.

21 So both on the issue of actual receipt, we
22 believe there's no -- the -- the position is strong that
23 there was an actual receipt of the escrowed funds. And
24 with respect to constructive receipt, which is a legal
25 issue, we believe the restrictions in place were strong --

1 sufficiently strong and out of the hands of the taxpayer
2 such that the taxpayer did not have constructive receipt
3 of those assets. So that's our presentation on the issue
4 of escrowed funds.

5 On the other issue of the loan expenses -- again,
6 moving over to the second issue, and that's -- again,
7 that's divided -- that itself is divided into two separate
8 amounts. There was a \$540,000 prepayment fee, which is
9 actually not technically a pre -- it was really a fee paid
10 by the taxpayer to -- to be allowed to prepay the debt
11 because it -- it was with respect to the new loan, and
12 there was a 1 percent fee paid. And that's one which --
13 which we -- that's -- that's one fee which we believe does
14 not represent boot, which the FTB believes does represent
15 boot.

16 And then there's a \$340,000 of lender legal
17 expenses that were paid. And the issue there becomes one,
18 is a factual issue, and one is a legal issue. The factual
19 issue is were those amounts paid from the QI account? And
20 if they weren't paid from the QI account -- for example,
21 the \$540,000 was not paid from the QI account. It was
22 just a reduction of the loan. So instead of loaning
23 100 percent of the loan amount, the lender really,
24 effectively, because it took this 1 percent, it withheld
25 the 1 percent fee, it really only lent 99 percent of the

1 loan amount keeping 1 percent for itself.

2 This is -- I mean, this is factual the way it
3 worked on the \$540,000. This is not factually how it
4 worked on the \$341,000 of lender fees -- of lender legal
5 fees. But this is the way it worked on the \$540,000 of
6 prepayment fee. But that really just was a reduction of
7 the amount that was loaned. That money did not come out
8 of the QI account. And if that money did not come out of
9 the QI account, we don't see how that could be taxable
10 factually. Again, not legally, just factually. All that
11 was -- that amount represents a smaller loan. The lender
12 basically said we're taking out of this loan amount --
13 we're taking out a 1 percent fee to allow you to prepay
14 it.

15 And, again, since it did not come out of the QI
16 account, it just was a reduction of the loan amount. We
17 don't see how that could be taxable boot. The \$340 -- and
18 that's just -- before we get to the legal issue, that's
19 just on the factual side. The \$341, in fact, did come out
20 of the QI account. And about the \$540, by the way again,
21 you see that not coming out of the QI account because you
22 see that from the settlement sheet. It's treated as a
23 debit on the settlement sheet because it effectively
24 reduced the amount of the loan that was received from the
25 lender.

1 The \$341,000, that, in fact, factually did come
2 out of the QI account. So there's no, you know, that --
3 that -- but, at the same time, our belief is that
4 shouldn't -- on the factual side, since funds and cash is
5 fungible, it shouldn't really make a significant
6 difference whether it -- you know, it shouldn't really
7 hurt the taxpayer from the fact that they took it out of
8 the QI account. It's still -- we -- we believe there's
9 a -- there's an argument that still should be viewed as,
10 effectively, a small loan amount because cash is fungible.
11 This money came out. They borrowed more, but just an
12 amount that had to be paid in order to get the loan. And
13 they needed the loan in order to purchase a replacement
14 the property.

15 And, therefore, we believe that because cash is
16 fungible, since it could have just as easily been done as
17 a reduction of the loan as well but rather, the taxpayer
18 chose to pay it from the QI account, that shouldn't
19 fundamentally affect the analysis that -- ultimately, what
20 happened is they really got a smaller loan because there
21 were fees associated with getting that loan, the \$341,000
22 of lender fees, the \$540,000 of prepayment fee.

23 Am I talking slow enough or too slow or fast?
24 How am I doing on the -- on the pace?

25 JUDGE V. LONG: Mr. Lencz, you are doing fine.

1 You are welcome to slow it down a little bit.

2 MR. LENCZ: Okay.

3 JUDGE V. LONG: We have only this hearing on our
4 afternoon calendar, so we can give you a little more time
5 if you need it --

6 MR. LENCZ: Okay. Okay.

7 JUDGE V. LONG: -- but slower is always better
8 for our stenographer. Thank you for asking.

9 MR. LENCZ: Thank you. Okay. Okay.

10 So that, I guess -- again, on the factual issue,
11 we believe the \$540 is really off the table because that
12 was not paid from the QI account at all. And, in fact, as
13 we'll see later on, I think -- I believe FTB concedes that
14 point. That was actually just reduced the amount of the
15 loan paid by the lender. And the \$3 -- the \$340 -- \$341,
16 that amount we can see was actually paid from the QI
17 account. But because it could have just as easily reduced
18 the loan, it shouldn't conceptually make a difference.
19 And it should also be viewed conceptually as a expense --
20 an expense which effectively reduces the amount of the
21 loan. That's -- that's -- that's what we believe on the
22 factual side.

23 On the legal issues, so now let's -- on the legal
24 issues, again, just in terms of conceptually, there's the
25 factual issue which we just discussed. And the legal

1 issue, which is very distinct, which is let's say that it
2 all, you know, conceptually you don't by my argument that
3 it really is a reduction of a loan. You believe it
4 really -- you know, the loan amount was the full amount,
5 and this is money that came out of the QI account. So
6 even if you go arguendo with that approach, we -- from a
7 legal perspective, we believe that there's a strong
8 argument.

9 Although, this point has not been developed in
10 the law and there is no case law explicitly on this, it's
11 a gray area we -- we can see. But we believe there's room
12 because of the fact that no court has ruled either way on
13 this. We believe the arguments is pretty compelling that
14 this is the way it should work, that these expenses
15 because they're loan related and without the loan, the
16 property couldn't -- the replacement property could not be
17 acquired. Because of that connection and that necessity,
18 we believe that it's legitimate. Even if they would have
19 been taking all these amounts out of the QI account, and
20 you don't view them as reductions of the loan, but you
21 view them -- you view the loan as being the full amount,
22 and the amounts coming off are really just expenses paid
23 out of the QI account to obtain the loan.

24 We believe because the replacement property could
25 not be acquired without a loan, that -- that should mean

1 that the -- these expenses are, in fact, expenses --
2 exchanged expenses that should be viewed as legitimate
3 expenses that you're allowed to pay with QI funds.
4 Because the general principle is, any amounts you need to
5 acquire the property, and ancillary amounts, for example,
6 recordation taxes, title searches, all those things,
7 things that you normally -- that normally go into the
8 basis of the replacement property that's acquired. That,
9 I think, you know, even FTB concedes those amounts are
10 allowed to be -- to be used -- to pay out of the QI
11 account if they are amounts that are paid in connection
12 with the acquisition of the replacement property. And we
13 believe a loan, which is needed in order to acquire the
14 property should have that same treatment as other expenses
15 that are necessary to -- to acquire the replacement
16 property.

17 Now, again, there's no case that explicitly makes
18 this argument. But there's also no case that says that
19 it's not correct either. So it's, you know, it's kind of
20 a new area of the law and I -- you know, I've seen
21 practitioners go both ways on this. But we believe the
22 better answer is, again, even if we lose on the factual
23 issue and -- and it's argued that this really were
24 expenses that were not just reduced to loan amount but, in
25 fact, were expenses paid out of the QI account. We

1 believe that there -- because of the fact that, but for
2 the loan, this is where the acquisition of the replacement
3 property couldn't -- couldn't occur, that these expenses
4 should be treated no differently than other exchange
5 expenses that everyone concedes are -- are -- are
6 accept -- are allowed to be paid from the QI account.

7 Now, one thing the FTB seems to argue is that
8 because of the fact that these amounts are normally
9 capitalized, as opposed to being written off, that seems
10 to be indicative to the FTB that they cannot be exchanging
11 expenses that come out of the QI account. Now, we do not
12 agree with that. That, as a matter of law, is not
13 correct. In fact, whenever you buy replacement property
14 or any property, you don't deduct all the acquisition
15 costs. You -- you always capitalize those costs when
16 you've got ancillary costs in connection with the
17 acquisition of replacement property. For example, you buy
18 property for \$10 million, and you pay half-a-million of
19 legal fees. Well, those half-a-million in legal fees
20 don't get to be deducted. They go into your basis for the
21 replacement property. They are capitalized.

22 So the fact that, you know, some -- I don't
23 really understand this argument that says because they got
24 to be capitalized rather than deducted, that's why they're
25 treated as boot. You know, that does not -- that is

1 just -- that -- that seems to us to be an incorrect
2 statement of the law. And the FTB cites a whole bunch of
3 cases, Woodward, Lincoln Savings and Loan, and Shaker
4 Boulevard, which all stand for the principle in the -- not
5 in -- outside of the like-kind exchange context, that when
6 you pay fees for the acquisition of property and new
7 financing that you've got to capitalize those fees. Well,
8 that's certainly true. But that's true with respect to
9 all -- all expenses that are incurred with -- with cap --
10 with replacement property.

11 You're buying new property. You don't get to
12 write off all your expenses when you paid half-a-million
13 dollars in expenses to buy a \$10,000,000 property and you
14 pay your lawyer half-a-million. You don't deduct -- you
15 can't deduct those amounts. You've got to capitalize
16 them, and your -- your property has a basis of
17 \$10.5 million. So, again, yeah. To us, it's kind of
18 like, you know, not really relevant or -- because again,
19 in fact, all expenses that are -- that are associated with
20 the acquisition of replacement property or acquisition of
21 any real estate, in fact, are added to the basis of the --
22 of the acquired property and do not get to be written off.
23 But nevertheless, no one argues that all -- that all those
24 expenses shouldn't be paid out of the QI account, because
25 we all know they are.

1 Certainly, I don't think the FTB would argue that
2 half-a-million of legal fees associated with the
3 acquisition of replacement property shouldn't be able to
4 be paid out of the QI account. They certainly can.
5 Again, you've got revenue rulings and case of Blatt versus
6 Commissioner, which pretty much stands for that -- for
7 those concepts -- for that proposition. And we also, you
8 know, as we mentioned in our -- in our initial protest, in
9 our memo, is that any amounts that are paid in connection
10 with the exchange or the 1031 are allowed to be paid out
11 of the QI account.

12 And again, our argument here is that a -- a loan,
13 which is an absolute necessity in order to be able to
14 finance the acquisition of replacement property, should be
15 treated as a -- as a -- as an expense relating to or being
16 in connection with the acquisition of replacement
17 property, as set forth in the case of Blatt versus
18 Commissioner and, therefore, should be allowed as a -- as
19 to be paid from the QI account. That -- that is because
20 that expense was -- was incurred in connection with the
21 taxpayer's exchange.

22 And that's why, even if we do not prevail on the
23 factual issue of whether the -- the amount should be
24 simply viewed as reductions of the loan amount rather than
25 expenses paid for the QI account, even if they're viewed

1 as expenses paid from the QI account, we don't see any
2 reason why they should be treated as taxable boot. So
3 that, you know, that, I guess, that rounds up our
4 discussion of the expenses before I -- before I now
5 respond to the Appellant's -- the -- the Respondent's --
6 the Respondent's opening brief.

7 And just to summarize now the arguments with
8 regard to the loan expenses. We believe, factually,
9 certainly in the \$540,000 and arguably on the \$341,000 as
10 well, they really did not -- they didn't come out of the
11 QI account. It should not be viewed conceptually as
12 expenses paid out of the QI account. They really should
13 be used -- viewed as low -- as taking out a smaller loan
14 because these are amounts being paid in order to access a
15 loan. The lender is requiring these amounts to be paid,
16 and therefore they should be viewed conceptually as
17 reductions of a loan amount, not as expenses paid from the
18 QI account. And that -- we feel that argument is
19 compelling with respect to the \$540,000 which, in fact,
20 did not come out of the QI account.

21 That, in fact, was just a reduction of the loan
22 amount from the lender, but we believe there's an argument
23 that -- that same position should apply equally to the
24 \$341 because of the concept of cash being fungible. And
25 it could have been done that way and therefore,

1 ultimately, shouldn't make a difference of how it's done.
2 It should all be viewed conceptually as just simply
3 borrowing a smaller amount because that's what the lender
4 is requiring us to pay in order to get the loan.

5 And if we don't prevail on the factual issue, we
6 believe on the legal issue, although, it's not crystal
7 clear, and we can't point to an explicit case that
8 addresses specifically expenses in connection with loans,
9 we believe that under the -- well, the authority that's
10 out there, there's certainly is a support for that
11 position because the authority looks at -- allows you to
12 access QI account for amounts paid in connection with the
13 acquisition. And because the acquisition of the
14 replacement property in this case could not possibly have
15 occurred without accessing loan amounts, we believe those
16 loan amount fees paid in connection with acquiring
17 those -- those loans should be permissible to be paid from
18 the QI account and should not be treated as taxable boot,
19 if that indeed happened.

20 Okay. So that's my initial presentation of our
21 arguments. Now, I'd like to -- again, because there were
22 some differences between what the FTB initially argued
23 versus what they argued when they presented their opening
24 brief. So I just wanted to spend a bit of time now going
25 through some of the Respondent's arguments and our

1 responses to the Respondent's arguments as they developed
2 later on, in the Respondent's brief, if I may.

3 So, again, for this we'll follow the order of
4 the -- of the Respondent. And again, the Respondent had
5 cited to PLR 8328011 to make the argument that loan fees
6 are not amounts that are -- that are considered payable
7 from the QI account. And again, as we pointed out there,
8 that PLR is not talking about loan fees. That PLR is
9 addressing other types of expenses. And, for example,
10 interest, food interest, late charges, pro rata rents, and
11 rent deposits. And those are all things clearly, which
12 are not my -- our position about but for -- but for the
13 loan, the acquisition couldn't have occurred. That
14 applies to loan fees. That argument does not apply to
15 rent deposits, pro rata rents, late charges, and therefore
16 that PLR, we don't believe is relevant as all to the case
17 that we're discussing here.

18 I'm going to -- I -- I -- I spent a bit of time.
19 I don't know if we want to actually go to the exhibit, but
20 if -- if -- there was -- there may actually be -- is there
21 a way I could pull up on the screen something, one of our
22 exhibits or a little chart? Is that doable, or is that --

23 JUDGE V. LONG: That's not necessary. All of the
24 judges have the exhibits.

25 MR. LENCZ: Okay. Okay. Fine. Okay. Fine.

1 I'm on page -- I just -- I just want to kind of go -- this
2 is kind of the -- the -- the FTB, and I'm looking now at
3 page 3 of -- let me just see what exhibit it is.

4 JUDGE V. LONG: Or if you would like, you can
5 tell us what the content of the exhibit is, and then we
6 may already know what exhibit letter you're referring to.

7 MR. LENCZ: Yeah. I'm -- I'm referring to our
8 Appellant's reply brief dated August 17th, 2023. It's
9 page 3 of our -- of our brief, which has a chart which
10 comes actually from the Respondent. I'm just having
11 trouble.

12 JUDGE V. LONG: To confirm, you're referencing
13 your April -- I'm sorry -- August 17th, 2023, reply brief,
14 page 3?

15 MR. LENCZ: Yeah.

16 JUDGE V. LONG: All right. I see you have sales
17 purchase price of relinquished property and replacement --

18 MR. LENCZ: Correct.

19 JUDGE V. LONG: Replacement property, correct?

20 MR. LENCZ: That's it. Right. Right. And
21 that's again, that's a chart that comes from the -- and
22 this again, maybe the source of why the FTB believes that
23 there was boot here. But again, I opened it up, and maybe
24 it's easier. I'm -- I'm a very visual person. Maybe it's
25 easier if we actually look at the -- look at the

1 spreadsheet or the chart itself.

2 The -- the FTB is saying that the purchase price
3 of \$54.5 million, we borrowed \$54 million, and therefore,
4 there's really only half-a-million of equity. But again,
5 as I mentioned earlier, you -- and as I put it in our --
6 in our response, and I want to just verbalize this and
7 present this as well orally is that it's -- that's a
8 misnomer because if you're talking about the \$54 million
9 loan, that concludes the entire \$8.5 million of -- of the
10 second -- the second loan. That includes both the \$4.5 --
11 the \$4 million initially used to buy the property at
12 closing. But that also includes the \$4.5 million added on
13 to that for the improvements later on.

14 So, if you're going to include that, you can't
15 have a sale purchase price, which is basically the value
16 of the property as \$54.5. You've got to increase that
17 amount by another four-and-a-half million because that
18 amount goes up as the borrowed money as the \$4.5 million
19 of escrowed funds are accessed and used to build -- to --
20 to prepare -- to construct TI, to construct CAPEX, to find
21 tenants, to lease up the building. All that increases the
22 value of the building. So you -- it's a misnomer and very
23 misleading to compare the \$54 of debt to \$54.5 of value
24 or -- or purchase price, which is effectively the fair
25 market value of the property.

1 Not only is it a misnomer, but a lender is never
2 going to lend \$54 million for a \$54.5 million property.
3 That's just the reality of the way the world works. They
4 need, you know, 80/20, 75/25 loan to value. And this only
5 makes sense if the \$54.5 million purchase price is
6 actually \$59 million, which is the reality. Because
7 you've got to include the four-and-a-half million of
8 escrowed funds that are later used to increase the value.
9 Or alternatively, take out of the \$54 million, take our
10 four-and-a-half million wasn't accessed immediately, and
11 look at the loan as being only \$49.5, not \$54. But,
12 again, this may be the source of why the FTB is -- is
13 erroneously believing there was so much boot here is
14 because they're effectively comparing apples to oranges.

15 And again, a -- the property when you -- when you
16 look at the entire \$54 million that was borrowed, which
17 ultimately was, in fact, the correct amount, we had a
18 building with a value or purchase price of \$59 million,
19 not \$54.5 million. So I just wanted to make that -- that
20 point and make sure that was clear. And I think that,
21 again, may be the source of why they're -- there's a
22 belief on the FTB's part that there's no -- I mean, there
23 was no equity in the building. But that's just not true
24 because there was more money put into the building later
25 on, which increases the value of the building.

1 Again, as I mentioned earlier, the opening brief
2 in the -- in the Respondent's opening brief, the
3 Respondent -- in Respondent's opening brief, Respondent
4 looked to section 1031 for the constructive receipt rules.
5 Earlier the FTB had said that they're looking to the
6 general rules. But again, the rules, whether it's the
7 earlier or the later, I think, are all indicative of the
8 fact that look at whether there was substantial
9 restriction on the taxpayer's access to the account. And
10 if there were not -- if there was not such unfettered
11 access to the -- to the funds, we don't -- we don't have
12 constructive receipt. And, again, as we presented
13 earlier, we don't believe there was unfettered access. We
14 believe there was very limited access and very restricted
15 access of the taxpayer to the escrowed funds at -- when
16 they were deposited there at closing.

17 One thing in its opening brief, the Respondent
18 says that the requirements are really illusory. Again,
19 they point again, to the fact that it says -- again, this
20 was both in the initial correspondence communications from
21 the FTB and the opening brief. Again, they -- they point
22 to the fact that it says that the lender's approval of
23 disbursements could not be unreasonably withheld,
24 conditioned, or delayed. We addressed that earlier. It's
25 the same argument. But again, that's only after the

1 conditions have been satisfied. That's when that cannot
2 be unreasonably withheld standard kicks in.

3 Without taxpayer satisfaction of those conditions
4 and requirements, that does not kick in. And therefore,
5 this is not to be as -- viewed as a loser -- illusory
6 requirements or rubber stamping, no. That only -- nothing
7 happens. No funds accessible, unless the -- the taxpayer
8 went through a whole long laundry list of requirements
9 that needed to be satisfied. That was completely not in
10 their own hands.

11 And again, as we've showed, it's in the record as
12 well, in fact, that \$2.5 -- the -- the \$4.5 million was
13 accessed over the years 2017, 2018, and 2019. It was
14 \$1.3 million was accessed and set in '17. And then \$3.2
15 million in 2018 and 2019 and therefore, the money had not
16 been taken earlier. And again, as I mentioned before, if
17 they could have gotten their hands on the money earlier,
18 they would have. Because every -- you know, all my
19 clients always want to get the cash and do business with
20 the cash and want to borrow money as much as they can, as
21 much loan to value as they can get. And the fact they
22 didn't, to us, is indicative that they couldn't, because
23 they would have if they could have.

24 The Respondent cited to Sullivan versus
25 Commissioner, which again, is a constructive receipt case

1 that went against the taxpayer. But again, as I pointed
2 out in our -- in our written response and want to
3 reiterate now orally as well, that -- that was a very
4 different case. Sullivan -- the taxpayer in Sullivan
5 lost. Because in that case, there was no question the
6 escrowed funds were not going back to the payor. The only
7 issue there was will the taxpayer himself be able to use
8 the funds, or will he have to share some of them to pay
9 some amounts he owed to his attorney and to his ex-wife.
10 But either way, they're going for his benefit. Either he
11 cuts a check to himself, he gets the money himself, or he
12 may be required to share some of the funds to pay off some
13 of his own obligations to his ex-wife and to his lawyer.

14 Well there, of course, that's not -- that's in
15 escrow, which we know, in any event, he's getting. Either
16 he's either receiving, or people he owes money to will be
17 receiving. They will ultimately be used for that
18 taxpayer's benefit. So, of course, over there, those
19 funds wouldn't be considered constructive and received by
20 the taxpayer. That is not like the case here where if we
21 wouldn't met -- have met our conditions, the money would
22 have gone back to the lender. We wouldn't have gotten it.

23 So that case is not evidence of what the rule --
24 of what the -- how things should work in our case. Our
25 case is very different than the Sullivan case and

1 therefore, that -- that is not really relevant to our --
2 to our case. In that case, the taxpayer had 100 percent
3 legal entitlement. The only question was, does he get it
4 himself, or does he need to share it with others to whom
5 he owes money. Very different story than what we have
6 here.

7 Then the FTB makes some sort of arguments about
8 the fact that the funds in the account served as security
9 for nonpayment. They function as a security deposit in
10 the end -- in the event EWV is -- would default on the
11 underlying note. They -- they have an immediate right --
12 ANIC, the escrow holder, would have an immediate right to
13 apply the escrow funds to fully pay the loan. And then
14 again, the -- the FTB points to section 4 -- 4(c), which
15 says that after the note is paid in full, then the money
16 goes back -- then EWV could access the money.

17 So let me -- again, one of those points we've
18 addressed earlier. The second point we didn't -- in terms
19 of the point that it's acting as security, again, we don't
20 believe that's the case at all. Again, if there's a
21 default, as in any case -- any loan, and you look at any
22 loan agreement in the world, it will be clear. If there's
23 a default on the loan, all hell breaks loose, and all bets
24 are off. The money comes back. You're not accessing
25 those funds anymore. And that's what -- that's all that

1 provision says. That's all that it means that -- that's
2 not any special benefit to the taxpayer. That's to
3 protect the lender in case of default, that they don't
4 need to then act upon the disbursed funds upon meeting of
5 the conditions.

6 Once there's an event of default, they get to
7 take all those escrowed funds back and repayment of the
8 loan. But that -- if that, in fact, is constructive
9 receipt, then pretty much every escrow in a loan context
10 would be constructive receipt, which is obviously not the
11 case. Regarding the fact that when the loan is fully
12 paid, then they get the money, well, of course. I mean,
13 if they pay the full \$54 million, then they get the escrow
14 fund. Because otherwise they'd be effectively be double
15 paying it. I mean, if they cut a check to lender for \$54
16 million, effectively paying off the \$45 million loan --
17 \$45.5 million loan and the full \$8.5 million loan, well then, of
18 course, they get the escrowed funds at that point.
19 Otherwise, they'd out -- they would have borrowed \$54, and
20 they would have paid back -- what is it? -- \$54 and --
21 \$62-and-a-half, which obviously can't happen. So again,
22 that's -- that's totally, again, a red herring here. The
23 fact that once the loan is all repaid escrowed funds --
24 you know, they get the escrowed funds. Of course, that's
25 exactly what it has -- that's how it has to work. Because

1 nothing else would make sense in that context.

2 We discussed again, that they say -- again, the
3 FTB argues that the escrowed funds were essentially EWV's
4 property. They had constructive receipt of the funds
5 because it was set apart for its use, and that it had
6 dominion and control. Again, I think we've -- we've
7 presented very, very strong evidence that that's not the
8 case at all. We did not have dominion and control over
9 the funds. We did not -- the funds were not set apart for
10 our use. They were in a special escrow fund that was
11 accessible to the lenders -- to the lender's creditors,
12 but not to our creditors. Therefore, we don't see how
13 that possibly could indicate constructive receipt. Again,
14 the fact that upon a default they get to use the -- they
15 get to pull the escrow funds back, that's considered our
16 using it. That's just protecting the lender.

17 Now, we also, we found it very interesting that
18 in the -- the FTB cited to the examples and regs
19 section 1.1031-(1)(k)-1(g)(b), examples 1, 2, 3, that
20 those examples seem to indicate that determining whether
21 escrowed funds are considered received or not, turn on
22 whether the escrow agreement limit the taxpayer's rights
23 to receive the property -- the money in the escrow, and
24 the taxpayer's immediate ability or unrestricted right to
25 receive the money. And here, the FTB writes that upon

1 meeting of the conditions stated in those agreements -- in
2 the Escrow Agreements, that's when they have access to the
3 fund. So that seems to us to be a very, very strong
4 admission of the FTB that, in fact, there were conditions
5 attached to our agreement -- ability -- attached to the
6 taxpayer's ability to access those funds.

7 Again, I'm quoting the language of the FTB that
8 here, the Escrow Agreements confer on EWV an immediate
9 right to the escrow funds upon meeting the conditions
10 stated in those agreements. Wow, that's -- that's very,
11 very -- we're very happy to see that language because that
12 tells us the FTB is conceding that there were conditions
13 that needed to be satisfied in order for the taxpayer to
14 access those funds. We agree with that. But that's
15 exactly why those examples are not indicative of
16 constructive receipt. Because under those examples, the
17 taxpayer needs to have immediate ability on -- or
18 unrestricted right to receive the money, and that is
19 lacking here. By FTB's own statement, it's lacking here.

20 And therefore, in conclusion, we believe strongly
21 that the -- there was -- there was no boot in this
22 transaction. We all, I think, are in agreement that it
23 was fundamentally a good 1031. With all the time
24 deadlines having been met, and all the QUI requirements
25 having been met, the issues are solely whether there was

1 constructive receipt of the -- of the -- whether there was
2 actual or constructive receipt of the escrowed funds, we
3 believe they were not. And there were very, very strong
4 and significant restrictions that prevented the taxpayer
5 from accessing the funds.

6 And with respect to the loan -- the loan
7 expenses, we believe factually that they should be viewed
8 as just reductions of the amount of the loan. And if the
9 factual arguments are not accepted, we believe legally
10 that the -- these -- the better argument is that those
11 amounts should be treated as expenses that are used --
12 permitted to be paid out of the QI account because, but
13 for the loan, the closing on the replacement property
14 couldn't have happened. And therefore, they are expenses
15 related to -- or are in connection with the acquisition of
16 the replacement property and therefore, they should be
17 treated as loan expenses -- or exchange expenses that can
18 be paid from the QI account.

19 My last point, again, is about the interest.
20 Again, we're not claiming to have any specific -- point to
21 any specific statute. But again, this case has gone on
22 for a very, very long time. We believe our position is
23 very strong that there should be not be treated -- viewed
24 as any boot having been given to the taxpayer in this
25 case. And then we -- and therefore, we respectfully

1 request that interest be abated because of the taxpayer's
2 strong positions of non-taxability.

3 JUDGE V. LONG: All right. Thank you, Mr. Lencz.

4 With that, I'm going to ask my panel members
5 questions if we have any questions for you about your
6 presentation. I'm going to begin with
7 Hearing Officer Elsom.

8 Do you have any questions for Mr. Lencz about his
9 presentation?

10 HEARING OFFICER ELSOM: Yes, I had several
11 questions, Mr. Lencz.

12 So I'd just like to back up a little bit here and
13 understand the entire transaction and what EWV intended to
14 relinquish and acquire in the exchange. So did EWV intend
15 to acquire only the \$54 million real property? Or is its
16 belief that the future tenant in common accounts and lease
17 commission accounts and the construction improvement
18 accounts were also part of the exchange, but because their
19 access to those funds were limited and subject to
20 restrictions that it doesn't represent constructive or
21 actual receipt of proceeds?

22 MR. LENCZ: Yeah. I mean, the -- you know, our
23 replacement property is represented by the \$54.5 million
24 of the property and the way it was on the closing date,
25 and -- and of 1031 at that point. We're not arguing that

1 somehow we received another \$4.5 and then we -- but we
2 used that \$4.5 to acquire additional replacement property,
3 because we can see that is not allowed. In other words,
4 you -- that -- and that happened, in fact, way after the
5 180 -- the 180-day deadline, that construction. And
6 construction doesn't work in a 1031. You can't use
7 constructive improvements to property in a 1031. Mainly
8 because it -- it's too late. You already owned the
9 property.

10 So we are not arguing that we received
11 \$4.5 million, but we spent it on improvements; and those
12 improvement should qualify under 1031. If I got -- if I
13 got the question correct, we are not making that argument
14 at all. We're saying we didn't get \$4.5 million until
15 after the exchange was done and basically closed on a
16 property worth \$40 -- \$54.5 million. And then subsequent
17 to that, we borrowed \$4.5 million additionally and built
18 \$4.5 million of improvements unconnected to our 1031
19 exchange.

20 HEARING OFFICER ELSOM: Okay. So that was kind
21 of my question. So basically, the \$4.5 is completely
22 separate from the 1031 exchange in the way this was
23 planned and attempted to be executed?

24 MR. LENCZ: Correct. We did not -- we did not --
25 and to use that towards our 1031, the \$4.5 million that

1 was --

2 HEARING OFFICER ELSOM: Okay.

3 MR. LENCZ: We're not arguing at all that we
4 somehow -- you know, we're not saying, oh, yeah, we got
5 the \$4.5. That would be a whole different argument would
6 be, hey, we got \$4.5. But, hey, we used it to build
7 property. So what do you want from us? No. That's --
8 that arguments does not work. We -- we can see that.
9 We're arguing we never got the \$4.5 million --

10 HEARING OFFICER ELSOM: And just to clarify --

11 MR. LENCZ: -- until after.

12 HEARING OFFICER ELSOM: -- the argument is also
13 not that your access to those \$4.5 million funds were so
14 limited that it would not constitute constructive receipt
15 as part of the exchange. It's completely separate.
16 Meaning, it's done, borrowed after, and accessed after the
17 exchange?

18 MR. LENCZ: Right. Did not have access before
19 the exchange.

20 HEARING OFFICER ELSOM: Okay.

21 MR. LENCZ: Yes. Did not have access before
22 we -- we didn't have receipt at -- upon the exchange. We
23 had receipt later on. We borrowed later on and therefore,
24 it's unconnected to the 1031 exchange.

25 HEARING OFFICER ELSOM: Okay. And second

1 question, I just want to reiterate or clarify the facts.
2 So we have three escrow accounts. We have one escrow
3 account for the replacement property. We have one escrow
4 account for tenant common improvements and lease
5 commissions. And we have one escrow account for the
6 construction improvements.

7 MR. LENCZ: Yeah. The escrow, you're saying for
8 the replacement property, that's like the standard. I
9 think that's you call -- what we call the QI account, the
10 qualified intermediary account, I think is what you mean.
11 That's where the --

12 HEARING OFFICER ELSOM: No. No.

13 MR. LENCZ: No.

14 HEARING OFFICER ELSOM: I'm referring to where
15 the funds went after, you know, from the escrow account of
16 the replacement property. So you had mentioned that there
17 just a, you know, momentary transfer of the \$4.5 million
18 from the replacement property in escrow, and then it went
19 out. And I'm clarifying whether there was two accounts
20 for that after it was transferred out. It looks like from
21 reading the -- in the briefing, that there was one account
22 dedicated by the lender to the tenant common improvements
23 and lease commissions, and then a second account for the
24 construction improvements. So I'm just --

25 MR. LENCZ: Yeah. I --

1 HEARING OFFICER ELSOM: -- trying to clarify --
2 go ahead.

3 MR. LENCZ: I'm sorry. Go ahead. Go ahead.
4 You're trying to clarify what?

5 HEARING OFFICER ELSOM: Just trying to clarify
6 the facts so we understand, you know, the flow of the
7 money and what exactly happened.

8 MR. LENCZ: Yeah. So I'm not -- I'm a little bit
9 unclear about this third escrow account. I'm aware of the
10 two, the TI -- the -- there was -- there were two accounts
11 that were escrow -- two escrow accounts that I'm aware of
12 are the ones where the \$4.5 was housed, and the other
13 money, as I understand, went to the -- to the seller of
14 the replacement property.

15 HEARING OFFICER ELSOM: Okay. So the improvement
16 accounts were held in one escrow account -- or excuse
17 me -- the improvement funds. The \$4.5 was just one
18 escrow.

19 MR. LENCZ: No. There were two. There were two
20 accounts. There was a tenant improve -- that's on the --
21 there was \$1.5 went to one escrow account. And then
22 roughly \$3 million went to the -- so \$1.5 million went to
23 the cap -- the CAPEX improvement escrow account. And
24 \$3 million went to the TI and leasing commission escrow
25 account. I'm aware of those two. I'm not aware of a

1 third escrow account where funds were going.

2 HEARING OFFICER ELSOM: Okay. Yeah. The third
3 account I was referring to was the replacement property
4 escrow account.

5 MR. LENCZ: Oh, okay. Yeah, to purchase the
6 replacement property. Yeah. But, I mean, that -- that
7 was -- as I understand it, that money went to the seller
8 of the replacement property. And the seller walked away
9 with those funds, as I understand.

10 HEARING OFFICER ELSOM: Okay. My next question
11 is, if EWV intended to borrow money separately from the
12 exchange and make future improvements to the replacement
13 property and to pay lease commissions, why didn't EWV and
14 the note holder establish an account completely separate
15 from this exchange? I was wondering if you could explain
16 that, the kind of the mechanics behind that, or why this
17 was all -- looks like it was kind of commingled in the
18 same sale. Why wasn't there a separate account set up,
19 either after the exchange or, you know, simultaneous with
20 the exchange for that \$4.5 million?

21 MR. LENCZ: Well, it was. There was a separate
22 \$4.5 -- there were two escrow accounts, which had the \$4.5
23 where the money went. And those were separated out and
24 were used for the later improvements. It's one lender,
25 but they were -- that money -- in fact, that \$4.5 million

1 was segregated from the money that went to buy the
2 replacement property. So there, in fact, was segregation
3 of those amounts.

4 HEARING OFFICER ELSOM: Okay. But it did still
5 first go to -- even if it was just for millisecond, it
6 still went to the replacement property escrow account
7 first, correct?

8 MR. LENCZ: I -- I don't think it did, actually.
9 I think it went straight from the lender to those two
10 accounts. I think --

11 HEARING OFFICER ELSOM: Okay.

12 MR. LENCZ: I don't think it ever hit. I think
13 it went straight. You know, it would be no -- it would be
14 no point in having a first -- I think it went straight
15 from the lender to those two accounts and sat there and
16 therefore, were segregated from the other loan amounts
17 that went over to purchase the replacement property. It
18 went to the seller of the replacement property.

19 HEARING OFFICER ELSOM: Okay. And then on that
20 note, it seems that there's debate on the extent of
21 control that EWV had over the funds. And I'm not clear
22 myself whether those are the escrow funds of the
23 replacement property, or you seem to indicate that those
24 funds may not have ever even touched the escrow account
25 and went straight to, you know, the separate account

1 established by the lender. So there's some debate as to
2 whether Appellant EWV had control over those funds. And
3 specifically, I'm referring to Section 1-A of the tenant
4 improvement lease commission escrow agreement. And that
5 is on, I believe, Exhibit 17, and you could see on page 1
6 and 2 -- well, you go ahead and pull it up here before --

7 MR. LENCZ: Yeah, let me pull that up.

8 HEARING OFFICER ELSOM: Yes.

9 MR. LENCZ: Which escrow agreement? CAPEX or an
10 improvement --

11 HEARING OFFICER ELSOM: This is for tenant
12 improvement lease commission escrow agreement.

13 MR. LENCZ: Yeah. What section?

14 HEARING OFFICER ELSOM: So you've highlighted --
15 it's not a provision, but it states -- it state the maker
16 or will separately deposit \$993,009.50. And I'm assuming
17 that's from its own funds separate from the exchange. And
18 \$2 million may be deposited from a portion of the -- the
19 loan proceeds. And this is in section 1.A.

20 MR. LENCZ: Yep.

21 HEARING OFFICER ELSOM: And -- okay. So then
22 you've highlighted a provision that says above
23 section 1-A, which states the maker will deposit the
24 \$2 million from the loan proceeds. And then there is
25 similar provisions for the account you're referring to as

1 the CAPEX. Account. So what I'd like to understand is
2 whether this was contractually required by the lender,
3 meaning they will, and this was like a direction of the
4 lender, or may seems to indicate that -- and I believe
5 this may be what FTB is referring to, that EWV had some
6 control over those proceeds, and it may, at its
7 discretion, whether those -- it pulls from possibly the
8 fund of the replacement property or -- or the loan funds,
9 or maybe even its own money. So can you explain the
10 difference in those two terms? Or are you aware of what
11 the differences are?

12 MR. LENCZ: Shall versus the may is what you're
13 referring to, sir?

14 HEARING OFFICER ELSOM: The will versus the may.

15 MR. LENCZ: May -- yeah. I -- no. I -- I don't
16 have a full grasp of that, but I -- I will tell you
17 practically what happened is that the entire \$4.5 million
18 went straight into these escrow accounts and never hit the
19 account of the taxpayer.

20 HEARING OFFICER ELSOM: Okay.

21 MR. LENCZ: So, therefore, you know, the language
22 may have been a little bit unclear here. But as a
23 practical matter, which is most important, what happened
24 to the funds. Did the taxpayer ever access those
25 \$4.5 million of escrowed funds? The answer to that is no.

1 At closing they went straight into the ANIC account, which
2 is on that settlement sheet. The taxpayer never had the
3 ability to get his hands on those funds. It went straight
4 into the ANIC account. Therefore, it did not have actual
5 receipt thereof.

6 The lender wouldn't have let it have the money
7 because it's not going to lend -- it's not going to-- it's
8 not going to lend that money if it -- if it -- it's not
9 going to count on the -- it's not going to rely upon the
10 taxpayer to return those funds to the escrow account. So
11 it's going to make sure that it's all prewired so at
12 closing that money goes straight into the escrow account,
13 and the taxpayer did not have access to it, those funds.

14 HEARING OFFICER ELSOM: Okay. And I do have a
15 question about the bifurcation of this \$8.5 million loan.
16 And then there seems to be some debate between FTB and
17 Appellants regarding whether this loan can be bifurcated.
18 And both loans, the \$45.5 and the \$8.5, I believe, are
19 both secured by the same real property, which is the
20 replacement property. And FTB has made a statement that
21 the loan cannot be bifurcated, and Appellants replied that
22 they don't see a reason why it can't be. Do you have any
23 legal authority that shows where there's replacement
24 property purchased, that a loan that's encumbering, the
25 replacement property may be bifurcated as, you know,

1 amount that's separate from the exchange? Do you have any
2 legal authority or analysis on that end?

3 MR. LENCZ: I don't -- I don't -- no. I'm not
4 aware of a legal authority, but I think it's -- it's -- to
5 me it seems intuitive. In other words, if -- if one part
6 of the loan I was able to access and I had actual receipt
7 of, which is the \$4 million, which we all agree we did
8 access, and used it towards the purchase of the building
9 initially, well, that amount clearly -- you know, it was
10 borrowed, and we took that money. And we're not -- we
11 don't deny that. But four-and-a-half million of the same
12 eight-and-a-half million dollar loan was not accessible
13 and was deposited straight into escrow, that should
14 receive different tax treatment, because different things
15 happen to them.

16 One amount was received as closing. One
17 amount -- one part, that's the \$4 million, was received at
18 closing and was used towards the purchase of the
19 replacement property and was transferred to the owner of
20 the replacement property, the seller. The other had \$4.5
21 million was never accessed, never received by the taxpayer, never
22 accessible by the taxpayer, but was -- was escrowed
23 immediately at closing. And therefore, that should be --
24 we don't see why that bifurcation is not absolutely
25 logical and compelling.

1 HEARING OFFICER ELSOM: Okay. And just to
2 clarify, the entire \$8.5 million is subject to the same
3 terms same terms, meaning the same interest rate, which I
4 believe was 10 percent, the same payment terms, the same
5 balloon payment. The bifurcation doesn't change the terms
6 of the loan at all?

7 MR. LENCZ: Right. The only thing that's
8 different about them is the four-and-a-half is subject to
9 the escrow and have to be escrowed, and can only be
10 accessed upon satisfaction of conditions. Whereas the
11 \$4 million was not escrowed, went straight to the purchase
12 of the replacement property; went to the seller of the
13 replacement property to purchase the replacement property.
14 So since --

15 HEARING OFFICER ELSOM: Okay.

16 MR. LENCZ: -- they were used differently -- they
17 were used differently, they've got different tax
18 treatments.

19 HEARING OFFICER ELSOM: Thank you. And can you
20 provide -- just so we have a background on these tenant in
21 common improvements, were these in -- referenced in the
22 purchase of sales agreement for the replacement property?
23 Or how was this amount negotiated and determined that, you
24 know, approximately \$4.5 million should be borrowed to
25 make these improvements? Were there work orders in place?

1 Were these preexisting, you know, work that had to be done
2 under preexisting contracts for the tenants? Or can you
3 provide some background on that?

4 And a follow-up question to that was, by looking
5 at Franchise Tax Board's audit issue presentation sheet,
6 they had referenced that EWV had attempted to obtain
7 funding from a separate lender and somehow that fell
8 through. And I don't know if that was an attempt to
9 separate this from the 1031 exchange, or what the purpose
10 of that was. But if you can just provide some background
11 on those items, I think that would be helpful for the
12 factual development here.

13 MR. LENCZ: Sure. On the first question, in
14 terms of were these tenant improvement and/or CAPEX, was
15 it part of the sale of the -- was that the contract with
16 the seller of the relinquished property -- of the
17 replacement property, I don't factually. I would imagine
18 the answer is no. Because as far as the seller was
19 concerned, it got its \$64.5 million sale price and took
20 the money and ran, and it's out of the picture. The buyer
21 then -- our client EWV then, you know, for whatever
22 reason, my understanding is wanted to improve the
23 property, bought the property for the purposes of
24 developing it or of building it out, doing this more
25 construction, leasing it up.

1 And I believe that decision and all that had
2 nothing to do with the seller of the relinquished
3 property, I believe. Although, I haven't verified this
4 fact. I believe the answer is that that was just
5 something which the buy -- the buyer itself, our client
6 the taxpayer, decided to do. Perhaps the lender wanted it
7 as well. I don't really have -- I don't have the
8 information that I can sat -- give you answer fully. But
9 I don't think it had anything to do with the seller of the
10 replacement property. I believe it has to do with the --
11 the taxpayer's desire to improve the property.

12 HEARING OFFICER ELSOM: Okay. And then the
13 purpose of the loan that was attempted prior to -- or the
14 financing that was attempted to acquire prior to the
15 \$8.5 million, it looks like EWV, according to Franchise
16 Tax Board's audit issue presentation sheet, there is an
17 entity, DPG Investments that EWV attempted to acquire
18 financing from for these future improvements. Can you
19 provide some chronology with that? And was that going to
20 be separate from the exchange again, or was that --

21 MR. LENCZ: I -- I know that there was out to --
22 I don't have any further information as to why that was --
23 that was done that way and how that would effect this, you
24 know, the fact that we ultimately went with this lender.
25 I don't -- I don't have any better information on that.

1 HEARING OFFICER ELSOM: Okay. And would you like
2 to provide the purchase and sales agreement for the
3 replacement property for additional review or --

4 MR. LENCZ: We'd be happy to -- to provide that,
5 if that -- if -- if -- if, Your Honor, thinks that's
6 helpful, we shall be happy to provide that.

7 HEARING OFFICER ELSOM: Okay. And I have no
8 further questions. Thank you.

9 JUDGE V. LONG: All right. Thank you,
10 Hearing Officer Elsom.

11 Next, I'll ask my Co-Panelists Judge Keith Long
12 if you have any questions for Mr. Lencz?

13 JUDGE K. LONG: No questions. Thank you.

14 JUDGE V. LONG: All right. Mr. Lencz, I do have
15 one question for you, and this goes back to the legal
16 argument you made regarding the exchange expenses. You
17 were mentioning you think there's an argument to be made
18 that those expenses, the payment of lender's legal fees
19 and the loan prepayment fee, or penalty, that those --
20 that there's an argument to be made that those amounts
21 should be permitted exchange expenses. And in your
22 argument today, it sounded like you might have been saying
23 that -- it sounded like you were almost discussing the
24 1031 regulation safe harbors, and kind of applying that to
25 permitting exchange expenses. I'm wondering if you can

1 talk about that more.

2 MR. LENCZ: I -- I was actually -- what I was
3 addressing was the case law which is under Blatt and GCM
4 that is up there. Just get a hold of that. Yeah, I'm
5 having trouble. Yeah, there's a GCM which allow --
6 which -- which -- which kind of -- and -- and a Revenue
7 ruling and a -- and a court case Blatt, which will
8 basically say are -- they -- they -- they're what all
9 practitioners look to for guidance as to what's
10 permissible exchange expenses. And it's really under that
11 line of -- it's under that line of reasoning where the
12 case -- I think it's the Blatt case which explicitly says
13 that any expenses in connection with the exchange can be
14 paid out of the QI account.

15 And again, the argument we're making is because
16 the loan is made in connection with the exchange and but
17 for the loan the exchange or the acquisition of the
18 replacement could -- property couldn't be -- could not --
19 could not have happened. Therefore, it's a valid exchange
20 expense under -- under that -- under the GCM and the
21 revenue ruling and the case -- in the Blatt case. I was
22 not going to the regs on that, safe harbors.

23 JUDGE V. LONG: All right. Thank you. I just
24 want to restate to confirm my understanding. Your
25 assertion is that the lender's legal fees and the

1 1 percent prepayment penalty were exchanged expenses
2 because they were, you know, but for the loan, they would
3 not have been able to purchase the real property. Is that
4 correct?

5 MR. LENCZ: That's -- that's correct. I'm not --
6 and I'm not citing to a case that says that, but there's
7 no case that says -- oppose -- against that either. It's
8 kind of an area that has not yet been fully developed.

9 JUDGE V. LONG: I understand. Thank you. That
10 concludes my questions.

11 So with that, we are going to take a 10-minute
12 recess before we move to Franchise Tax Board's
13 presentation. We're going to go off the record during
14 that time. And during that time you will be returned to
15 the waiting room in Zoom. So please don't leave Zoom.

16 And with that, we are going off the record, and
17 we will return at 2:45 p.m.

18 Thank you.

19 (There is a pause in the proceedings.)

20 JUDGE V. LONG: All right. Welcome back. If
21 everyone is ready, we're going to go ahead and go back on
22 the record.

23 With that, Franchise Tax Board, you have
24 60 minutes for your presentation. You may begin whenever
25 you are ready.

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MS. KUDUK: Thank you.

PRESENTATION

MS. KUDUK: Good afternoon.

EWV is a pass through entity. In 2016, it was owned by three individuals, Alon Abady, Sean Hashem, and Fareed Kanani, who, along with their wives, are Appellants in this appeal. In 2016, EWV exchanged property in Pasadena, California, for property in Renton, Washington, per Internal Revenue Code section 1031.

The first issue in this appeal is whether Appellants have shown that Respondent erred in determining EWV received non-like kind property in its Section 1031 Exchange. EWV had actual and constructive receipt of exchange funds, making the exchange funds non-like kind property or taxable boot. Boot can be decreased by a taxpayer's exchange expenses. Exchange expenses are cost specifically related to the fact that the transaction is a Section 1031 Exchange. They are transactional costs that relate to the disposition of relinquished property in the acquisition of replacement property.

Loan costs are not exchange expenses. They are the costs to obtain a new loan, rather than the direct costs of acquiring replacement property. Appellants cannot deduct loan costs from their boot in this appeal

1 because loan costs are not exchange expenses. Therefore,
2 the loan costs EWV paid with exchange funds cannot reduce
3 the amount of Appellants' proposed tax assessment.

4 The second issue is whether Appellants have
5 established that they're entitled to interest abatement.
6 Appellants state Respondent should abate their interest
7 because the case has been in process for a long time. As
8 Appellants do not meet the statutory requirements for
9 interest abatement, Respondent properly imposed interest
10 in this appeal.

11 EWV began this exchange with approximately
12 \$6 million in equity in the Pasadena property and ended
13 with \$500,000 of equity in the Renton property. This an
14 approximately \$5.5 million difference. The exchange
15 period spans from the day the relinquished properties
16 transferred, until the day the replacement property was
17 purchased. The Fredericks case that Appellants referenced
18 was not within the exchange period because the -- that
19 case dealt with a loan on relinquished property before it
20 was exchanged, while it was in contract but not before it
21 was sold -- or not after it was sold.

22 The funds disbursed at escrow are exchange funds,
23 as the taxpayer is yet to receive the like-kind property.
24 During the exchange period, EWV directed it's QI to
25 transfer about \$340,000 in exchange funds to its lender,

1 ANIC, to pay legal fees associated with its loan on the
2 Renton property. Then the following amounts were
3 disbursed at closing of the Renton property, about
4 \$4.5 million paid in to two escrow accounts held by ANIC,
5 and \$540,00 to ANIC as a loan prepayment fee.

6 The facts of this appeal show Respondent properly
7 assessed proposed taxes on boot that Appellants received
8 in 2016 and properly charged interest. California
9 conforms to Internal Revenue Code section 1001, which
10 requires taxpayers to pay taxes on gains from the sale of
11 property. Most taxpayers pay taxes when they sell
12 property. 1031 is an exception to the general rule. To
13 qualify as a Section 1031 Exchange, there must be an
14 exchange of like-kind property that is held by a taxpayer
15 for investment or use in a trade or business. Per
16 section 1031(a)(1), if there is no exchange of property
17 and the held for investment requirement is not met, the
18 transaction is not eligible for section 1031 treatment.

19 Per section 1031(b), when a taxpayer receives
20 non-like kind property in addition to like-kind property,
21 the gain is recognized up to the value of the boot. Per
22 section 1031(b), if a taxpayer exchanges like-kind
23 property for other like-kind property and satisfies the
24 general requirements of Section 1031, as was done in this
25 exchange, but also receives boot; only the boot is

1 taxable.

2 Further, if a taxpayer receives exchanged funds
3 during the exchange period, exchange funds become boot.
4 In this transaction, EWV completed a Section 1031 Exchange
5 that had both actual and constructive receipt of exchanged
6 funds during the exchange period, making exchanged funds
7 non-like kind property or boot. Further, the loan costs
8 are not exchange expenses and could not be netted from the
9 boot. Thus, the funds used to pay the loan costs are also
10 taxable. It is the taxpayer's burden to prove that they
11 completed a nontaxable Section 1031 Exchange. Appellants
12 have not met this burden.

13 Okay. So I'm going to begin with actual receipt,
14 and there are specific definitions of actual and
15 constructive receipt in terms of a Section 1031 Exchange.
16 I want to clarify Appellant's understanding of actual
17 receipt in the terms of a Section 1031 Exchange. A
18 taxpayer is in actual receipt of exchange funds when the
19 taxpayer actually receives the money, which Appellants
20 have referenced. But Appellants forgot this prong of the
21 law; a taxpayer is in actual receipt of funds when they
22 receive the economic benefit of the money. EWV had
23 actually received exchange funds because the money in the
24 escrow accounts was held as collateral for the \$54 million
25 load for the Renton property, giving EWV the benefit of

1 the money, and because EWV used exchange funds to pay loan
2 costs.

3 Then I'm going to look at constructive receipt.
4 Again, constructive receipt is a distinctive term used in
5 a 1031 Exchange. The Appellants have briefed constructive
6 receipt for the purposes of Internal Revenue Code
7 section 451, but FTB has always been very clear. We
8 relied on the law interpreting Section 1031, not
9 Section 451. And there's distinct differences between
10 Appellant's briefing of constructive receipt for
11 Section 10 -- Section 451 and FTB's position on
12 constructive receipt in terms of a Section 1031 Exchange.

13 For a 1031 Exchange, a taxpayer's constructive
14 receipt of exchange fund when the money credited to the
15 taxpayer's account set apart for the taxpayer made
16 available so the taxpayer may draw upon it. As the court
17 in Klein v. Commissioner stated, the power to dispose of
18 money is equivalent of ownership of it. A taxpayer is not
19 in constructive receipt of money or property if the
20 taxpayer's control of its receipt is subject to
21 substantial limitations.

22 Courts interpret substantial limitations as a
23 taxpayer being bound by contract to not use the funds. No
24 contract prohibited EWV from using the money in the escrow
25 accounts. It's not just that it's difficult to get the

1 money out of the accounts because there are onerous
2 conditions to get the money, you have to have no ability
3 to get the money. EWV was in constructive receipt of
4 about \$4.5 million in two escrow accounts. Per the Escrow
5 Agreements, EWV had the right to pay expenses, such as its
6 mortgage from funds in these escrow accounts.

7 Further, the Escrow Agreements allowed ANIC to
8 disburse money to EWV, and would provide EWV with
9 immediately available funds without constraints. An
10 escrow agreement must limit a taxpayer's ability to gain
11 funds or doesn't meet the qualified intermediary safe
12 harbor provisions of Treasury Regulation
13 section 1.1031(k)-(1)(g)(4)(ii)(B). And that's something
14 that Appellants have not shown that the Escrow Agreements
15 have not limited their ability to get the money. But
16 further, specifically, section 3 of both Escrow Agreements
17 require ANIC to approve disbursements, and stated that
18 ANIC's approval could not be unreasonably withheld,
19 conditioned, or delayed. Meaning, EWV had the ability to
20 access the fund, and there was no constraint on its use of
21 the funds.

22 The fact that EWV could receive the money if it
23 met ANIC's conditions show that EWV had constructive
24 receipt of the funds as the funds were made available, so
25 EWV could draw upon them. EWV also had constructive

1 receipt -- oh, I just want to add, a taxpayer's own
2 limitations on escrow accounts does not make the escrow
3 account a qualified escrow account. It must have that
4 limitation on the taxpayer's ability to use the money.

5 EWV also had constructive receipt of exchange
6 funds because EWV directed its QI to send about \$343,000
7 exchange funds to ANIC to pay legal fees. And EWV paid
8 \$450,000 from exchange funds to ANIC for 1 percent
9 prepayment fee on its \$54 million loan. In their opening
10 brief, Appellants describe these expenses as loan costs,
11 which is important. The payment of these loan costs was
12 directed by EWV. Therefore, EWV had constructive receipt
13 of the funds.

14 Actual and constructive receipt of cash from a
15 Section 1031 Exchange is not like-kind property but boot
16 and taxable. In contrast, certain exchange expenses paid
17 at the closing of a sale are exchange expenses. Using
18 exchange funds to pay exchange expenses is not taxable.
19 Legal guidance delineates expenses in a Section 1031
20 Exchange as either exchange expenses, which are not
21 taxable, or non-exchange expenses, which are boot and
22 taxable. Treasury Regulations do not include loan cost as
23 exchange expenses. Specifically, Treasury Regulation
24 section 1.1031(k)-(1)(g)(7)(ii) says transactional items
25 that relate to the disposition of the relinquished

1 property and the acquisition of replacement property and
2 appear under the closing statement as the responsibility
3 of the buyer or seller are not taxable.

4 The Treasury Regulations give examples, such as
5 commissions, prorated taxes, recording or transfer of
6 taxes, title company fees. Expenses to get money are not
7 the cost of the acquisition of property. These expenses
8 are different. Prepaid loan fees and attorney fees
9 related to a new loan are not closing cost because they do
10 not customarily appear on the closing statement. An easy
11 test is to ask if the expense would exist if the
12 transaction was a cash only deal. For example,
13 PLR 8328011 that Appellants reference, shows expenses that
14 are not related to an exchange -- to the exchange
15 specifically are boot.

16 Loan costs are not related to an exchange.
17 They're the personal expenses of the buyer. Loan costs
18 are the costs to use borrowed money and not transactional
19 costs that relate to the disposition or acquisition of
20 property. As such, loan costs are not exchange expenses
21 because they -- and cannot be subtracted from boot. As
22 Anover Realty Corp. instructs, expenses incurred from
23 borrowing or financing are capital expenditures and
24 properly amortized over the life of the loan. This shows
25 this is not a deductible expense that can be subtracted

1 from boot.

2 The funds that EWV had access to in the two
3 escrow accounts and the amounts EWV paid for loan costs
4 are non-like kind property and taxable. The loan costs
5 are not exchange expenses. Therefore, EWV owes taxes on
6 the income of approximately \$5.5 million, and additional
7 LLC fees of \$9,290. This income flows through to EWV's
8 owners to owe taxes on the capital gains accordingly.

9 In regards to the second issue, interest is not a
10 penalty, but merely compensation for a taxpayer's use of
11 money after it should have been paid to the State. The
12 imposition of interest is mandatory. There are three ways
13 to obtain statutory relief from interest: An unreasonable
14 error delay, reasonable reliance on written chief counsel
15 advice, or a waiver for extreme hardship. Appellants have
16 the burden of proof have not showed that they met the
17 statutory requirements for relief. Merely, stating that
18 it took FTB a long time to complete a case does not
19 qualify a taxpayer for interest abatement.

20 Appellants bear the burden of proof to show that
21 their entire transaction met the requirements of Section
22 1031 Exchange, such that they did not receive boots.
23 Appellants have not met this burden. Further, Appellants
24 have not shown that they're eligible for statutory relief
25 from interest. Respondent properly proposed a tax

1 adjustment to include boot from the sale of the Pasadena
2 property in Appellant's taxable income in taxable year
3 2016. Thus, Respondent's Notice of Action should be
4 upheld.

5 I'm available for any questions. Thank you.

6 JUDGE V. LONG: All right. Thank you, Ms. Kuduk.
7 I'm going to go ahead and start off with just a couple of
8 questions for you about your presentation. First, I'm
9 going to ask you -- I want to confirm my understanding.
10 It sounded like the Franchise Tax Board position is that
11 there is constructive receipt, if a taxpayer has the
12 ability to get money out of the escrow funds, even where
13 those funds are subject to conditions or restrictions. Is
14 that correct?

15 MS. KUDUK: Yes.

16 JUDGE V. LONG: Now, I believe Mr. Lencz has
17 discussed the case Fredericks v. Commissioner with us.
18 Can I ask how that statement, the position of Franchise
19 Tax Board's, how does that reconcile with the Tax Board's
20 holding in Fredericks?

21 MS. KUDUK: Well, Fredericks was about
22 relinquished property. And here, we're talking about
23 replacement property, so there's a distinction.

24 JUDGE V. LONG: All right. Thank you. Would you
25 like to discuss that further, or is that --

1 MS. KUDUK: If you would just give me a second to
2 look at my notes?

3 JUDGE V. LONG: Absolutely. That would be fine.

4 MS. KUDUK: Okay. Thank you.

5 So in Fredericks, the exchanger refinanced the
6 relinquished property two weeks after executing a crop --
7 a contract to sell the property. So it was relinquished
8 property. Here this is replacement property. So it's
9 different because the exchange period begins when -- as I
10 stated in -- when the relinquished property is sold, and
11 until the day the replacement property is closed. So in
12 Fredericks, it wasn't during the -- the exchange period
13 that they took the money out of the property. And I
14 believe --

15 JUDGE V. LONG: All right. So --

16 MS. KUDUK: Yeah. I believe they found for
17 the -- the Appellant in that case -- in that case, right.
18 They found for the taxpayer in that case.

19 JUDGE V. LONG: Yes. That's also my
20 understanding.

21 MS. KUDUK: Yes.

22 JUDGE V. LONG: Thank you. That answers my
23 question. And then my next question for you is, I want to
24 confirm my understanding of FTB's argument regarding the
25 ability to offset boot based on whether a cost is

1 capitalized or deductible. I'm curious if you have any
2 thoughts about the GCM 34895. I believe in that GCM it
3 was determined that commissions were able to offset boot
4 and all -- I mean, were considered exchange expenses that
5 were also added to boot. Does that have any bearing on
6 FTB's position? Or have I misstated the GCM conclusion?

7 MS. KUDUK: It was added to basis, right?

8 JUDGE V. LONG: Yes. I'm sorry. It was added to
9 basis. Thank you.

10 MS. KUDUK: Right. Well, I think there's a
11 distinction because it's a question of transactional cost,
12 and what's the definition of transactional cost. And
13 here, our position is that loan costs are not
14 transactional costs because you can close the buying and
15 selling of property with cash. This loan cost is the cash
16 for the Appellants to borrow money, and it's very distinct
17 from, you know, what is absolutely necessary to get a
18 property sold like, you know, paying the taxes, doing an
19 inspection, commissions for people who are working in the
20 transaction. But loan costs are -- it's a personal
21 expense for the Appellant, for the taxpayer.

22 JUDGE V. LONG: All right. Thank you. I
23 understand.

24 With that, I'm going to see if my co-panelists
25 have any questions. I'll begin with

1 Hearing Officer Elsom.

2 Do you have any questions for Franchise Tax Board
3 about their presentation?

4 HEARING OFFICER ELSOM: Yes, I did.

5 So, Franchise Tax Board, I just wanted to address
6 first, you had made a statement that approximately \$6
7 million of equity was realized in the sale of the Pasadena
8 property, and then about \$5.5 million was transferred into
9 the Renton property. Was that accurate? Did I hear that
10 correctly.

11 MS. KUDUK: Yes.

12 HEARING OFFICER ELSOM: Okay. And now, after
13 that was -- that amount was transferred, my question is,
14 again, regarding the bifurcation of the loan. I wanted to
15 ask, do you have any legal authority that shows that an
16 exchanger cannot bifurcate a loan that's secured by
17 replacement property? Has there been any analysis on that
18 end?

19 MS. KUDUK: I'm -- I'm not really quite sure what
20 you're talking about with bifurcated loan. I mean, they
21 took two -- two loans out, right. They weren't bi -- it
22 wasn't one loan that was cut in half. It was two distinct
23 loans, right.

24 HEARING OFFICER ELSOM: So Appellant is arguing
25 that the \$8.5 million loan was bifurcated, and a portion

1 of that went directly into an escrow account for tenant
2 common improvements, and lease commissions, and some sort
3 of construction in process, which is called CAPEX. So
4 they're arguing that that is separate as effectively from
5 the exchange.

6 MS. KUDUK: Oh, no. That wouldn't be separate
7 because it's all exchange funds, right. So when they --
8 let me get to my presentation on page -- my beginning of
9 my presentation. So you have to look at what is the
10 exchange period, right. It doesn't matter what -- what
11 kind of loans they're getting. It's like -- it's like
12 when you sell the relinquished property and before you buy
13 the replacement property, all the money that comes from
14 the relinquished property is exchange funds. And so, you
15 know, however they try to structure or hide those exchange
16 funds, they were still funds from the 1031.

17 And so it -- I don't think it really matters if
18 they used it to leverage loans, or they used it to buy
19 property, or to put into an escrow account, they -- that
20 was -- that money was exchange funds. And unless it went
21 directly into the 1031 or is it exchange expenses, it's
22 taxable.

23 HEARING OFFICER ELSOM: Okay. I think that
24 answers the question. And then the next question I want
25 to make sure I understand FTB's arguments. So you had

1 mentioned because equity was rolled in from the Pasadena
2 property into the Renton replacement property, and this
3 \$4.5 million that's going towards these future
4 improvements, that's secured by the replacement property?
5 That's actual receipt? Is that -- did I understand that
6 correctly? Because this is for the benefit of the
7 taxpayer, and I believe you'd mentioned specifically
8 because that \$4.5 million portion is secured by the
9 replacement property, which is -- there's no dispute as to
10 whether that is exchange property.

11 MS. KUDUK: I don't think -- I don't think it was
12 a question of what it is secured by. I think it was money
13 that was taken during the exchange period that were
14 exchange funds and was put into an escrow account, and
15 they had the ability to take the money out of the escrow
16 account. And not only take it out, they -- it was used
17 for their benefit to secure their loan, to pay their
18 mortgage. I mean, it was basically their money, and there
19 was no escrow agreement that said they couldn't touch the
20 funds.

21 HEARING OFFICER ELSOM: And then on the
22 constructive receipt --

23 MS. KUDUK: Oh, I'm so sorry. I can't hear you.

24 HEARING OFFICER ELSOM: Can you hear me?

25 MS. KUDUK: Yeah. Now I can. Yeah.

1 HEARING OFFICER ELSOM: Okay. I want to make
2 sure understand the constructive receipt prong of the
3 argument. Is that based upon the language that was
4 included in the \$4.5 million draw where -- is FTB's
5 assertion essentially is that Appellant directed those
6 funds into an escrow account? Or are you referring back
7 to the legal fees of \$341,250, that it was like Appellant
8 directed from the funds, and you'd mentioned the \$540,000
9 prepayment fee on the replacement property as well. Is it
10 all of those items that you -- why you're asserting
11 constructive receipt, or is just a few of those?

12 MS. KUDUK: No. Our position is that Appellants
13 had constructive receipt of all the money.

14 HEARING OFFICER ELSOM: All of the money. Okay.

15 MS. KUDUK: Yeah. I --

16 HEARING OFFICER ELSOM: And is that supported
17 by -- I'm sorry.

18 MS. KUDUK: I think I would refer you to
19 Klein v Commissioner. Whereas, the power to dispose of
20 income is equivalent to ownership of it. So they had the
21 right to draw upon the money. So they had constructive
22 receipt of the money.

23 HEARING OFFICER ELSOM: Okay. And then I'm
24 looking at the exchange facilitator agreement. This is
25 Exhibit K, and we're at page 1 of Exhibit K. And it does

1 reference that Appellant is directing payment of \$341,250
2 to Wells -- it looks like a Wells Fargo account, which is
3 for the legal fees. But then it's appearing to indicate
4 under -- I believe it's provision 12 that exchanger's
5 access to the remainder of the proceeds is limited. So,
6 again, does that -- have you -- has FTB reviewed that
7 provision or taken that into account, and Appellant had
8 control of all -- or constructive receipt of all the
9 proceeds?

10 MS. KUDUK: Well, it's in an escrow account,
11 right. So I think the -- if you go back to the Treasury
12 Regulation section 1.130(k)-(1)(g)(4)(iii)(B), they have
13 to say they can't have access to it.

14 HEARING OFFICER ELSOM: So the access your
15 referring is to the replacement property escrow account --

16 MS. KUDUK: Right.

17 HEARING OFFICER ELSOM: -- rather than the
18 facilitator's intermediary account?

19 MS. KUDUK: I'm -- I'm not sure what you're
20 talking about. He directed the \$340,000 to -- to -- for
21 the prepayment. Is that what you're asking about?

22 HEARING OFFICER ELSOM: Sorry. I'm referring
23 to -- can we go to Exhibit K, page 1? And I believe this
24 is the facilitator agreement. This is First American
25 Exchange Company. Was that the facilitator, or is that

1 the escrow company?

2 MS. KUDUK: The QI.

3 HEARING OFFICER ELSOM: That's the QI in
4 Exhibit K?

5 MS. KUDUK: No. I don't know. I'm asking you.
6 Is that -- is that what you're asking, who the QI was? Is
7 the facil -- you said facilitator. You mean QI? Is that
8 the same?

9 HEARING OFFICER ELSOM: Yeah. Exactly.

10 MS. KUDUK: Okay.

11 HEARING OFFICER ELSOM: It says -- the first
12 provision says FAEC, which is First American Exchange
13 Company, is presently holding funds, and the exchange
14 proceeds to be utilized to acquire and convey certain
15 replacement property. Exchanger has provided an exchange
16 agreement. Now is this -- am I looking at the exchange
17 agreement here, or is the escrow company here?

18 MS. KUDUK: You know, I don't know because I
19 can't get to the hearing binder. I -- it's -- it's not
20 working. Okay. It says that something -- something went
21 wrong.

22 HEARING OFFICER ELSOM: We can address it later,
23 if this -- if you're not able to access the information.
24 I'm just trying to understand the entirety of that
25 constructive receipt argument.

1 JUDGE V. LONG: Ms. Kuduk, it looks like we've
2 lost your video feed. If there's a specific exhibit,
3 perhaps we can have our staff send it over to you so that
4 you have it available.

5 Mr. Cunningham, do you know if Ms. Kuduk is still
6 online?

7 MR. CUNNINGHAM: It looks like she's -- let me --
8 let me check with -- let me send her a message and check.

9 JUDGE V. LONG: All right. Thank you.

10 MR. CUNNINGHAM: Give me one second. And I also
11 sent her over the document via email. So --

12 JUDGE V. LONG: Thank you very much,
13 Mr. Cunningham.

14 MR. CUNNINGHAM: -- let me see if she's still
15 online.

16 HEARING OFFICER ELSOM: Can you clarify,
17 Mr. Cunningham, if Exhibit K is the facilitator agreement?
18 Or is that --

19 MR. CUNNINGHAM: Exhibit K, that looks like --
20 First American Exchange Company, I believe, is the QI.

21 HEARING OFFICER ELSOM: Okay. Yeah. So my basic
22 question was whether -- you know, it appears that a
23 portion of the exchange proceeds was accessed by Appellant
24 for the \$341,250, but the remainder was restricted. And
25 that -- I was asking that question specifically with

1 respect to constructive receipt of the entire proceeds.
2 That's why I ask that question.

3 MR. CUNNINGHAM: Okay. Let me look. And --

4 JUDGE V. LONG: We will wait just a few minutes
5 for Ms. Kuduk.

6 MR. CUNNINGHAM: She said she can't get in. She
7 said, "No. I can't get in."

8 JUDGE V. LONG: Does she have internet access,
9 and she's unable to access the Zoom?

10 MR. CUNNINGHAM: Let me find out.

11 JUDGE V. LONG: All right.

12 MR. CUNNINGHAM: Or -- I mean, I can have her
13 come in with me, and we could work off the same video if
14 that would be okay. Or I would have to go see, you know,
15 what the issue is.

16 JUDGE V. LONG: Right now it looks like just
17 exited the Zoom meeting, and then she should be able to
18 rejoin.

19 MR. CUNNINGHAM: Okay.

20 JUDGE V. LONG: If you need to work out of the
21 same office, that's absolutely fine with us. But we don't
22 want to move forward with the hearing without Ms. Kuduk
23 present. So we're just --

24 MR. CUNNINGHAM: Can we take a five-minute -- can
25 we take a five-minute break, and I will go --

1 JUDGE V. LONG: Absolutely.

2 MR. CUNNINGHAM: -- resolve it?

3 JUDGE V. LONG: Absolutely.

4 With that, we're going to stop the record. We're
5 going to take a five-minute recess, and we will return at
6 3:25 p.m.

7 Thank you.

8 (There is a pause in the proceedings.)

9 JUDGE V. LONG: All right. With that, we are
10 back on the record.

11 When we had last left off, Hearing Officer Elsom
12 had been asking Franchise Tax Board a question. I'll let
13 Hearing Officer Elsom restate his question for Franchise
14 Tax Board, please.

15 HEARING OFFICER ELSOM: You know, we can move on
16 from that question. My question, really, was just
17 directed at what specifically FTB was relying on to state
18 that Appellant had constructively received exchange
19 proceeds. Was that the \$341,250 payments in legal
20 expenses? Was that the language where Appellant may have
21 directed proceeds into the separate accounts for the --
22 for the tenant in common improvements, lease commissions,
23 and construction improvement? I was just trying to, you
24 know, obtain a general understanding of the exact argument
25 for constructive receipt.

1 MS. KUDUK: Oh, I would say it's Exhibit M and N,
2 which are the Escrow Agreements. And those Escrow
3 Agreements state that the taxpayer could use the funds to
4 fund collateral loan -- to fund an additional collateral
5 loan to ANIC. And also the funds are -- could be a source
6 of immediately available funds to EWV. That's in the
7 opening brief, footnote 13, and it's Exhibit M, pages 2,
8 5, 6, and 7. That's the tenant improvement escrow
9 agreement, and then that language is kind of mirrored in
10 the capital improvement escrow agreement --

11 HEARING OFFICER ELSOM: Okay.

12 MS. KUDUK: -- which is Exhibit N.

13 HEARING OFFICER ELSOM: Thank you.

14 MS. KUDUK: Yeah.

15 HEARING OFFICER ELSOM: And I did have one final
16 question. And that is, if we -- or excuse me. If FTB
17 taxes \$4.5 million as proceeds, as gain, and then
18 Appellant uses that money to pay lease commissions that
19 are presumably are expensibile [sic] and make improvements
20 that would be either depreciated or amortized, it looks
21 like -- it feels like the economic outcome matches the
22 tax outcome. But if Appellant is then paying those funds
23 back to an unaffiliated lender, Appellants feels like
24 they're being double taxed here. Because they're paying
25 now -- they're not only paying tax on \$4.5 million, but

1 they're then having to pay that back to the lender with no
2 corresponding tax deduction.

3 Has FTB analyzed that -- that end of the, you
4 know, the tax outcome or the tax effect of treating this
5 as proceeds, rather than the loan that's being paid back,
6 and Appellants not receiving the benefit for the payments
7 it's making -- or the tax benefit for the payments it's
8 making to the lender?

9 MS. KUDUK: Why wouldn't it be able to deduct the
10 payments it made to the lender? That's what normally
11 happens, right. They deduct the interest because it's a
12 loan.

13 HEARING OFFICER ELSOM: Well, the principle, the
14 entire \$4.5 million is what FTB is proposing to tax,
15 though. And that entire amount, if I'm understanding
16 correctly, has to be paid back to the lender. So it feels
17 like -- as if Appellant is being -- could potentially be
18 double taxed here because they're taxed on that \$4.5
19 million as if that was gain. But then they're having to
20 also to pay that back to the lender, but they're not
21 receiving a tax deduction for that principle that they're
22 paying back.

23 MS. KUDUK: Oh, they're paying -- getting a tax
24 deduction from the interest. No, because that's not part
25 of the 1031 law. I mean, the economic benefits are -- I

1 mean, they're -- they're already getting a lot of economic
2 benefits by doing the Section 1031 Exchange. And we -- we
3 didn't deny the Section 1031 Exchange. We're just taxing
4 what is boot. So they're already -- I mean, like I think
5 it's that famous quote that a Section 1031 Exchange is a
6 benefit to the taxpayer, and everything within a Section
7 1031 Exchange has to be done correctly because it's such a
8 huge benefit for the taxpayer.

9 HEARING OFFICER ELSOM: Okay.

10 MS. KUDUK: Yeah.

11 HEARING OFFICER ELSOM: Thank you. I have no
12 further questions.

13 JUDGE V. LONG: All right. With that, I will
14 pass it to my last co-panelists.

15 Judge Keith Long, do you have any questions for
16 Franchise Tax Board?

17 JUDGE K. LONG: No questions. Thank you.

18 JUDGE V. LONG: All right. With that, I am going
19 to give Mr. Lencz 10 minutes for rebuttal.

20 Mr. Lencz, I will ask you to please speak slowly,
21 and you may begin whenever you're ready. Thank you.

22 MR. LENCZ: Thank you very much.

23

24 CLOSING STATEMENT

25 MR. LENCZ: I want to first touch -- to respond

1 to what Hearing Officer Elsom had asked before. I had --
2 I have confirmed, while we had a break, that the money in
3 the escrow account never actually hit the -- our -- the
4 taxpayer's bank account. They went straight. Basically,
5 the lender is the escrow agent, and they basically
6 withheld the \$4.5 billion and didn't disburse it yet.
7 That's the concept. So it's not like it actually went
8 into our account, and then we -- you know, at closing it
9 actually hit our account for a, minute, and then we
10 transferred it from our account back to the lender.

11 The lender just withheld the \$4.5 million and --
12 and it disbursed \$45.5 million for one loan. It disbursed
13 \$4 million out of the \$8.5 million of the second loan, and
14 it held on, pursuant to the escrow account -- the Escrow
15 Agreements, the other \$4.5 million. Now, had that
16 actually hit our account, I don't think the result would
17 be different, frankly, because it was prewired. If it
18 came in, it had to come back out. In other words, it was
19 all prewired. There's no way the lender would have said,
20 let -- let the taxpayer actually runaway with the money.
21 It had to be used for the purposes. It had to go to
22 escrow. But as a matter of fact, in fact, it had not hit
23 our accounts. It was just withheld by the lender.

24 Just responding to a couple of other points
25 that -- that FTB had made. I mean, according to the FTB's

1 economic calculations, the taxpayer should have walked
2 away with \$5.5 million of cash in its pocket. I mean
3 that's -- because they're saying that we only had
4 half-a-million dollars of equity, and we acknowledge there
5 was \$6 million of equity in the relinquished property.
6 And the way it works is that, you know, the only way that
7 there's boot is if the taxpayer actually walked away and
8 didn't use all the proceeds. But if you go through all --
9 and according to FTB's calculations, only -- only
10 half-a-million was reinvested. So that would mean that
11 \$5 million in the qualified intermediary account should
12 have gone out, and a check should have been written to the
13 taxpayer, but that never happened. And I don't think
14 anyone is claiming that happened.

15 So that money -- you know, that proves
16 effectively that the entire amount of equity was rolled
17 over into the replacement property, because the taxpayer
18 did not walk away with any amount of that money, which
19 would have been compelling -- would have -- compelling
20 have had to have happened -- compellingly have had to
21 happened, had the calculations of FTB been -- been -- been
22 the facts on the ground.

23 I think there also, in some of the back and
24 forth, there may have been some -- some of -- some of what
25 the FTB was presenting, there may be some confusion

1 between the escrow account versus the qualified
2 intermediary account. And FTB mentions the regulatory
3 safe harbors and the qualified escrow rules there. The
4 qualified escrow rules of the regulatory safe harbor of
5 1031 are totally nothing to do with our -- with our escrow
6 accounts.

7 There's -- there are different ways of doing a
8 deferred stock or exchange, the three-party exchange. One
9 of them is a qualified intermediary, which is what we've
10 used. Alternatively, you could use a qualified escrow or
11 a qualified trust, which we did not use in this case. So
12 those regulations about the safe harbor for a qualified
13 escrow are unrelated to what we're talking about. We went
14 with a QI and -- and with a qualified intermediary
15 approach, and separate and distinct from the qualified
16 intermediary account, which is where the equity -- where
17 the proceeds were held. They were these separate escrows
18 which were funded at the closing of the replacement
19 property purchase. Nothing to do with the -- with the
20 money that was in the QI account; just two totally
21 separate concepts.

22 And therefore, the \$341, which came -- that came
23 out of the QI account. I mean, I believe ANIC is both the
24 qualified intermediary and the lender here, but totally
25 separate accounts. The \$341 we acknowledge came out of

1 the qualified intermediary account. But that has nothing
2 to do whatsoever with the escrow accounts that were setup
3 late -- upon -- those escrow accounts were set up at
4 closing of the replacement property. Totally disconnected
5 from the qualify -- QI account from where the \$341 was
6 paid.

7 And, again, the \$540 wasn't paid from any of
8 those places. The \$540 just was a reduction of the loan
9 proceeds received from the lender and wasn't taken out of
10 the QI account, and was not taken out of the es -- of
11 the -- of the escrow accounts. They were just deducted
12 from the amount of loan that was -- that was given over --
13 that was paid over to us.

14 If I understood FTB properly, I think what
15 Ms. Kuduk was saying, was that -- that there was -- it
16 doesn't really matter. I think she's acknowledging that
17 there were multiple restrictions on accessibility of
18 the -- of the funds in the escrow -- escrow account. But
19 I think, if I understand FTB correctly, what Ms. Kuduk is
20 saying is that it doesn't matter. The fact that there was
21 any way whatsoever that the taxpayer could access the
22 funds, even if it was through third parties and things
23 that couldn't -- were not necessarily in their hands, it
24 doesn't matter.

25 Because I think, if I'm understanding the FTB's

1 position correctly, I think FTB is saying that the fact
2 that, at any point in time in the future, the taxpayer
3 could access those funds, even if it meets those
4 conditions. That alone means that those escrowed funds
5 are constructively receive -- received. And we
6 fundamentally disagree with that. That -- we don't
7 believe that is the correct statement of the law. There's
8 no question. You know, we all agree, I believe. Let's --
9 let's say a week after the closing, certainly, there's no
10 problem whatsoever with the client -- the taxpayer then
11 financing the property and taking cash out. That's fine.

12 And the only issue for us is, at the day of
13 closing, you know, before the 180 days were up, that's
14 where we want -- that's what's relevant; before the 100,
15 did it have access upon the closing of the replacement
16 property. At that point in time, did it have unfettered
17 access to the funds in the escrowed account? And the
18 answer to that is a resounding no. The fact that in the
19 future it can do things and satisfy conditions that would
20 then allow that -- that would allow it to then access the
21 funds. That doesn't make it constructively received upon
22 the date of the replacement property receipt. And
23 therefore, we don't -- we don't believe that that would
24 result in constructive receipt.

25 I wanted to point out as well that, again, the

1 FTB in the audit report -- and I'm happy to cite to it --
2 did explicitly -- it's the -- did explicitly argue that --
3 mentioned the bifurcation and said there's a 4 -- the fact
4 that the \$4 million was used for the replacement property,
5 and \$4.5 million for CAPEX. You know, that -- that -- no,
6 I'm sorry. That was the -- FTB was saying that
7 bifurcation is not permissible. And we believe -- we
8 don't see any reason why they can't be permissible. It's
9 all part of one loan, but that one loan was handled
10 differently. One part of it was disbursed immediately.
11 The other parts were not disbursable, were not accessible
12 until to a much later point in time.

13 And the other point is that in terms of the FTB,
14 I know in the latest -- in the opening brief, asserted
15 that 451 is not the place to look for the constructive
16 receipt rules. Rather, the FTB argued in the -- in the
17 opening brief that it's the 1031 context that should be
18 looked at for constructive receipt rules. But that is --
19 that was not its position in the audit report. In the
20 audit report it said specifically -- and I will -- I will
21 quote.

22 In the audit report -- page 19 of the audit
23 report the FTB said, "In the present case, Regulation
24 section 1.1031(k)(1)-(f)(1) and (2) with respect to actual
25 and constructive receipt of the exchange proceeds would

1 not apply here. In this case, we look to general
2 construct receipt rules as it would apply to cash basis
3 taxpayers."

4 And that -- again, that was a point where there
5 was a bit of a pivot later on. The IRS took a different
6 position. But again, either way I think it doesn't change
7 our position that we -- that, you know, under either one
8 of those section rules, you need unfettered access. You
9 need to have the ability to access the fund. That has to
10 be usable for your benefit immediately in order to be
11 considered constructively received, and we don't -- that
12 is -- you know, it's definitely not what happened in
13 that -- in our context over here.

14 Again, I think it was mentioned again. The FTB
15 mentioned once again here that the -- under the
16 agreement -- under the Escrow Agreements, that the funds
17 in the escrow would be able to be used as security for the
18 lender. Well, that's not a benefit of the borrower.
19 That's the lender's. The lender is looking to protect
20 itself. I mean, as lenders are always looking to do. In
21 all these documents, they want to make sure they are as
22 fully protected and as fully collateralized, and the loan
23 is as secure as possible.

24 So the fact, again, that the documents say that
25 upon default, the lender is permitted -- is permitted to

1 pull back the -- the escrowed funds. And, again, that is
2 absolutely typical and -- and -- and does not, in any way,
3 show that the taxpayer benefit. The taxpayer would have
4 preferred not to have the -- the lender have that access.
5 But that's something that the lender demands. So that,
6 again, does not show that -- that was available -- those
7 funds were available for the benefit of the taxpayer in no
8 way shape or form. That really shows that lender demanded
9 that, and as expected and typical, those rights in order
10 to protect its position, vis-à-vis, the escrowed funds.

11 But again, that's, I think, summarizes our
12 argument.

13 JUDGE V. LONG: All right. Thank you, Mr. Lencz.

14 With that, I'm going to ask my co-panelists if
15 there's any final questions for either party. I'll begin
16 with Hearing Officer Elsom.

17 Do you have any final questions?

18 HEARING OFFICER ELSOM: I have no further
19 questions. Thanks.

20 JUDGE V. LONG: All right. Judge Keith Long, do
21 you have any final questions?

22 JUDGE K. LONG: No questions. Thank you.

23 JUDGE V. LONG: I as well have no final
24 questions.

25 I want to thank both parties for your

1 presentations today.

2 This case is submitted. It is April 24th, 2025.
3 The record is now closed.

4 Again, I'm thanking everyone for participating
5 today.

6 The judges will meet to deliberate and decide
7 your case. We will issue a written opinion within
8 100 days from today.

9 And today's hearing in the Appeal of EWV, LLC, et
10 al, is now concluded.

11 And this is the last hearing of the day, and that
12 will conclude our hearing calendar.

13 Thank you, everyone.

14 (Proceedings adjourned at 3:43 p.m.)

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HEARING REPORTER'S CERTIFICATE

I, Ernalyne 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 15th day of May, 2025.

ERNALYN M. ALONZO
HEARING REPORTER