

In the Matter of the Appeal of:) OTA Case No. 19105425
GATEWOOD CORPORATION)
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1. Appellant was indirectly owned by J. Previti through the J. Previti Family Trust and Forecast Corporation.

2. Prior to the transactions at issue, J. Previti owned all the stock of Forecast Construction, Inc. (Forecast Construction), which had no assets or operations. J. Previti and L. Day were officers and directors of Forecast Construction. Appellant describes L. Day as a “former employee.”
3. J. Previti also directly or indirectly owned Forecast Mortgage Corporation (Forecast Mortgage). In 1994, Forecast Mortgage formed a qualified settlement fund (QSF),¹ the Forecast Qualified Settlement Forecast Fund (Forecast Fund), with L. Day as administrator. The Forecast Fund was formed through an irrevocable trust agreement (Trust Agreement) to settle “present and future claims” (Wong/Dixon Litigation). The Trust Agreement was approved by a judge and could not be amended without the court’s approval. The judge’s order also states that it allowed the Forecast Fund to be used to pay claims other than claims related to the Wong/Dixon Litigation and “for other Forecast purposes.”²
4. The Trust Agreement states that the trustee’s powers are only “ministerial” and that it will “take such action or refrain from taking such action as the Administrator [L. Day] or the Court from time to time shall direct.” In a letter dated August 21, 2001, the trustee stated that it is to hold cash or property for the Forecast Fund “and distribute that property as directed by [L. Day],” as the Administrator of the Forecast Fund.³
5. On May 17, 1999, Forecast Mortgage and other parties, including Forecast Development, LP (Forecast Development) executed an “Addendum” to the Forecast Fund. The Addendum purports to “supplement” the Trust Agreement and “expand” the scope of the Forecast Fund to include “as yet unidentified claimants” regardless of when such claims arose or whether such claims were related to any specific real estate development or litigation. In addition, the Addendum purports to allow L. Day to expand the Forecast

¹ QSFs provide a potential tax advantage for accrual taxpayers because, under Internal Revenue Code section 468B, economic performance is deemed to occur “as qualified payments are made by the taxpayer” to the QSF. Thus, accrual taxpayers can obtain a tax deduction for the tax year in which they contribute property to the QSF rather than having to wait until the year the claimant receives the payment.

² The judge’s order indicates that, also participating in the settlement “are insurers for some of the subcontractor cross-defendants and the insurers for Forecast Mortgage Corporation, Forecast Corporation, J.P. Development and James P. Previti (collectively ‘Forecast’).”

³ The Trust Agreement states that on termination of the Forecast Fund any undistributed income or principal will be distributed to Forecast Mortgage or its successors or assigns.

Fund to include claims against any additional defendants that “in the exercise of his business judgment,” he deems in keeping with the purposes of the Forecast Fund.⁴ The Addendum was not approved by the court.⁵

First Note Transactions

6. On June 25, 2001, J. Previti wrote a \$10 million promissory note (First Note) to Forecast Construction and transferred all the stock shares of Forecast Construction to appellant.
7. On June 29, 2001, Forecast Construction contributed the First Note to Forecast Group, LP (Forecast Group). According to the partnership agreement for Forecast Group, Forecast Construction assumed “all monetary obligations associated with [Forecast Group]’s then current and future litigation” in return for an interest in Forecast Group and a guaranteed preferred return.
8. On June 29, 2001, appellant assigned stock of Forecast Construction to the Forecast Fund. According to a June 29, 2001 Assignment Agreement, Forecast Fund agreed to “assume . . . all litigation settlement (but not pre-settlement expenses, unless such costs are included as a part of a settlement) obligations . . . arising out of . . . [Forecast Development’s] prior homebuilding activities, which arise from and after [June 29, 2001].”
9. Appellant provides correspondence indicating that it sent the bank trustee for the Forecast Fund, City National Bank, a stock certificate for shares of Forecast Construction, accompanied by documentation assigning the stock to the Forecast Fund.
10. According to account statements from City National Bank, the Forecast Fund had less than \$300 in assets. The statements do not list the Forecast Construction stock, even after the purported transfer of stock.⁶

⁴ The Addendum purports to dedicate any remaining assets of the Forecast Fund, after payment of any claims or potential claims as broadly defined, to the J. Previti’s Family Foundation.

⁵ No claims were paid from the Forecast Fund following June 2001; however, appellant asserts that claims are still being contested and that millions of dollars of legal fees were paid from the Forecast Fund.

⁶ Appellant provides adjusted trial balances showing other assets held by the Forecast Fund, including a \$10 million investment in Forecast Construction during 2001. Appellant also provides an April 2, 2007 form letter from City National Bank indicating that it is the trustee for the Forecast Fund and asking Forecast Construction to estimate the value of the Forecast Construction stock. L. Day completed the form and estimated the value of the stock as \$16 million.

11. According to appellant, on July 27, 2001, Forecast Group distributed \$10 million to Previti Realty Forecast Fund, LP, which was one of Forecast Group's limited partners, and Previti Realty Forecast Fund, LP distributed \$10 million to J. Previti (together with additional distributions so that the distributions totaled \$16,097,762). Appellant states, and there is some evidence indicating, that J. Previti repaid the First Note on or about July 27, or July 30, 2001. Although more than \$60,000 of interest had accrued by the terms of the First Note, J. Previti paid no interest on the note.

Sale of Forecast Group

12. According to appellant, between May and August of 2001, Forecast Group negotiated with a company, DR Horton, to sell its business. Appellant states that, after the negotiations with DR Horton ended, Forecast Group began negotiating a potential sale to another company, Hovnanian Enterprises, Inc. (Hovnanian). Pursuant to an Asset Purchase Agreement dated January 2, 2002, Hovnanian purchased certain assets of Forecast Group for a stated purchase price of \$115.5 million, with \$70 million paid in cash and the remainder paid with Hovnanian stock.

Second Note

13. In 2003, Forecast Group redeemed Forecast Construction's partnership interest in return for an unsecured \$13,388,479 promissory note (Second Note), which resulted in the Forecast Fund owning an interest in Forecast Construction, which, in turn, owned the note from Forecast Group.
14. Forecast Construction extended the due date of the Second Note three times: first, from 2005 to 2012, second, from 2012 to 2017, and third, from 2017 to 2022.⁷ Payments were not made on the Second Note in accordance with its terms, and, at most, less than 25 percent of accrued interest was paid.⁸ Forecast Construction reported interest income with respect to the Second Note for tax years 2003 through 2009.

⁷ Referred to in the third Extension Agreement as "the '4th' Extended Due Date."

⁸ Appellant provides a schedule showing \$21,668,229 of accrued interest on the Second Note, with \$4,981,618 of that interest paid. Appellant has not provided bank records or other source documents to substantiate the payments shown on the schedule.

15. According to documentation provided by appellant, Previti Realty Fund, LP filed an Administrative Adjustment Request with the IRS on November 25, 2009, to claim a deduction of accrued interest of \$1,094,485 on the Second Note. An IRS Form 870-PT, dated June 22, 2011, indicates that, for 2007, the IRS adjusted the income of Previti Realty Fund, LP to allow the interest expense. On a Form 886-A, the IRS states that FCI reported interest income with respect to the Second Note for tax years 2003 through 2009, and that Previti Realty Fund, LP should have deducted accrued interest on the note.

Tax Return, Audit, and Proposed Assessment

16. Appellant filed a California Corporation Franchise or Income Tax Return on Form 100, for fiscal year ending 2000, stating it used the cash method of accounting. Based on an appraisal, appellant claimed a \$10 million deduction for its contribution of Forecast Construction to the Forecast Fund. Specifically, appellant claimed a deduction under Internal Revenue Code (IRC) section 468B.
17. Appellant also reported “other income” of \$9,726,970. According to Forecast Development’s partnership agreement, appellant and Forecast Mortgage, as partners, agreed to permit the special allocation of up to \$7,300,000 of Forecast Development’s income to appellant. According to a June 29, 2001 Assignment, Assumption and Stock Transfer Agreement (Assignment Agreement), the allocation was made on December 31, 1999 “in consideration for [appellant]’s agreement to assume financial responsibilities for all of the expenses and potential settlement obligations of [Forecast Development], as a predecessor-in-interest to [Forecast Group].”⁹
18. FTB audited appellant and other related entities, and determined that the deduction should be disallowed for reasons including that it had no economic substance. FTB issued a Notice of Proposed Assessment (First NPA) for the 2001 tax year disallowing the claimed \$10 million deduction and proposing additional tax of \$831,398.06. On July 3, 2009, FTB issued a second NPA (Second NPA) for the 2001 tax year proposing a non-economic substance transaction (NEST) penalty of \$332,559.

⁹ According to the aforementioned account statements from City National Bank, for the 1999 tax year there is an assignment assumption of a 5 percent interest as limited partner in Forecast Development with a market value of \$1. It may be that appellant received additional allocations of income from Forecast Development.

19. Appellant protested the NPAs and, on September 23, 2019, FTB affirmed the NPAs in two Notices of Action. Appellant then filed this timely appeal.
20. On appeal, FTB concedes the NEST penalty.

DISCUSSION

When a “taxpayer claims a deduction, it is the taxpayer who bears the burden of proving that the transaction has economic substance.” (*Coltec Industries, Inc. v. Commissioner* (Fed. Cir. 2006) 454 F.3d 1340, 1355 (*Coltec*).) Also, intercompany arrangements that do not affect third parties are subject to “particularly close scrutiny.” (*Coltec, supra*, at p. 1357.)

When examining whether a particular transaction may be disregarded, courts have examined two related factors: (1) whether, from a subjective standpoint, the transaction was motivated by a business purpose other than tax avoidance, that is sufficient to justify the form of the transaction; and (2) whether the transaction had economic substance beyond tax avoidance. (*Appeal of Nag and Rudd*, 2023-OTA-150P (*Nag and Rudd*); *Appeal of La Rosa Capital Resource, Inc.*, 2020-OTA-220P (*La Rosa*).) The economic substance factor includes an examination of whether the substance of the transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax benefit. (*Nag and Rudd, supra*.)

Where there is a genuine multiparty transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the government should honor the allocation of rights and duties effectuated by the parties. (*Frank Lyon Co. v. U.S.* (1978) 435 U.S. 561, 583-584 (*Lyon*); *Nag and Rudd, supra*.)

To summarize, J. Previti contributed a \$10 million note to Forecast Construction, which previously had no operations or assets, in exchange for stock. J. Previti then contributed that stock to appellant, which in turn transferred the stock to Forecast Fund and claimed a deduction for the transfer of related party stock to a QSF. (See, IRC, § 468B, Treas. Reg. § 1.468B-2(b) (1).) Meanwhile, Forecast Construction transferred the \$10 million note to Forecast Group in exchange for a limited partnership interest, and Forecast Group, through another limited partnership, distributed the \$10 million back to J. Previti. FTB disallowed the deduction for reasons including that it had no economic substance.

Appellant contends that FTB's determination is erroneous because the transfer of stock to the Forecast Fund had a business purpose related to litigation. Appellant contends that, in June of 2001, it was anticipated that Forecast Group would reach a deal with DR Horton for the sale of its business and that claims would need to be settled as DR Horton was not assuming potential construction defect liabilities. Appellant further contends that the potential deal with DR Horton was anticipated to be based on a multiple of 1.5 times net book value and that, as a result, if Forecast Group had simply transferred \$10 million in cash to the Forecast Fund, the purchase price would have been reduced by \$15 million. Appellant argues that, if the special allocation of income to appellant had not been made and Forecast Group had contributed cash to the Forecast Fund, the amount of taxable income reported by Forecast Group's partners would be substantially the same as reported.

FTB contends that Forecast Fund's Trust Agreement did not provide authority for the expansion to other claims outside the Wong/Dixon Litigation and no court approval was obtained as required. FTB asserts that Forecast Fund held stock of a related party, Forecast Construction, whose only asset was a promissory note from another related party, which was never paid. FTB argues that the purpose of appellant's actions was to receive the deduction through related party transactions. FTB asserts that the deduction was useful to appellant because it had received a special allocation of \$7.3 million from Forecast Development, which was the operating construction entity.

In the economic substance analysis, the transaction to be considered is the one that gave rise to the alleged tax benefit. (See, e.g., *La Rosa, supra*, citing *Coltec, supra*, 454 F.3d 1340, 1356.) In *Coltec*, the court explained that it is not appropriate to look only at the ultimate transfer resulting in the claimed tax benefit. (*Coltec*, at p. 1356.) *Coltec* further explained that such an approach would allow a business purpose for the ultimate sale to justify prior unnecessary intercompany transfers leading up to the sale. (*Ibid.*) In *Coltec*, the critical question was the basis of stock that was later sold. It therefore focused on the transactions that allegedly created that basis, rather than focusing simply on the later sale of the stock, which was not at issue.

In this respect, appellant's reported transfer of stock is different from the ultimate transaction in *Coltec*. In *Coltec*, the ultimate transaction was a straightforward sale of stock to an independent third party, so the sale was not at issue. What was at issue was whether preceding

steps, which allegedly generated a high tax basis in the stock, had economic substance. Here, the ultimate transaction was not a straightforward sale to an independent third party but a reported transfer of stock to a Forecast Fund that was administered and controlled by L. Day, who was a related party. If this transaction had no economic substance, appellant is not entitled to its claimed \$10 million deduction, regardless of whether the surrounding steps, such as the First Note (J. Previti's \$10 million loan), had economic substance. In other words, the requirements of the economic substance doctrine are not avoided by coupling potentially legitimate transactions with a transaction lacking economic substance. (See *Bank of New York Mellon Corp. v. Commissioner* (2013) 140 T.C. 15, 34, affd. (2d Cir. 2015) 801 F.3d 104.)

Business Purpose

The Office of Tax Appeals (OTA) first considers whether the transaction had a non-tax business purpose. There are several issues with appellant's professed business purpose. Most important, there is no evidence in the appeal record to support the assertions made. For example, the appeal record contains no evidence showing how the DR Horton purchase price was expected to be calculated, that negotiations contemplated that DR Horton would not assume construction defect liabilities, or that concerns about affecting the purchase price in fact motivated the transaction.¹⁰

Appellant's explanation of its business purpose is also problematic because about a month after the reported contribution to the Forecast Fund (i.e., on or about July 27, 2001), Forecast Group distributed \$10 million to its limited partner Previti Realty Forecast Fund, LP (which in turn distributed \$10 million to J. Previti), thus reducing the net book value of Forecast Group's assets.¹¹ Under appellant's logic, this distribution would have been ill-advised because it would have reduced Forecast Group's net book value and therefore reduced the purchase price of the Forecast Group. It seems unlikely that J. Previti and his controlled entities would have so

¹⁰ In support of its business purpose argument, appellant notes that J. Previti and/or his affiliated entities have been and continue to be embroiled in various lawsuits. However, appellant has not shown that the transactions at issue were designed to satisfy claimants or potential claimants from these lawsuits.

¹¹ Although J. Previti reportedly repaid the \$10 million principal amount of the First Note at the same time, this repayment would not have increased the net book value of Forecast Group's assets as the note was already an asset of Forecast Group. Also, J. Previti received \$16,097,762 in additional distributions from Previti Realty Forecast Fund, LP; it is not clear whether Previti Realty Forecast Fund, LP received these funds from Forecast Group.

carefully structured this complicated series of transactions in order to prevent Forecast Group from making a \$10 million contribution to the Forecast Fund that would reduce Forecast Group's net book value, but then, while sale negotiations were ongoing, reduce Forecast Group's net book value by \$10 million by having Forecast Group distribute that amount.¹²

OTA is also not persuaded by appellant's argument that the same tax result would have been achieved if Forecast Group contributed cash to the Forecast Fund. When a taxpayer is alleged to have undertaken a transaction without economic substance, it is no answer to say that the same tax result could have been achieved by a different transaction with economic substance. (See *Nag and Rudd, supra.*) The issue is whether the taxpayer's reported transaction had economic substance, not whether some other transaction would have had economic substance.

Appellant has not shown that there were any claims or potential claims outstanding from the Wong/Dixon Litigation. Moreover, even if there were outstanding claims from this litigation, no claims were ever paid out of the QSF and appellant has not shown that this purpose motivated the transaction. Appellant also contends that the transaction was designed in part to satisfy liabilities described in the Addendum. The failure to obtain court approval for the Addendum casts further doubt on appellant's claimed business purpose of satisfying potential claims. The Forecast Fund's original irrevocable Trust Agreement clearly requires the court's approval to amend the trust. OTA finds it likely that, if the transactions had been designed to satisfy potential liabilities, court approval would have been sought to ensure that the Addendum was effective.¹³

The June 29, 2001 Assignment Agreement claims that appellant transferred the Forecast Construction stock in order to be relieved from litigation settlement obligations of Forecast Development that the Forecast Fund could allegedly satisfy by redeeming the Forecast Construction stock. However, according to account statements from City National Bank, the

¹² Appellant states that negotiations with DR Horton continued into August of 2001. There is no evidence in the appeal record showing precisely when the negotiations ended.

¹³ The Addendum purports to expand the Forecast Fund to include "yet unidentified claimants" regardless of when such claims arose or whether such claims were related to any specific real estate development or litigation. In addition, the Addendum purports to allow L. Day to expand the Forecast Fund to include claims against any additional defendants that he deems in keeping with the purposes of the Forecast Fund. OTA finds it doubtful that the transactions were motivated by a desire to satisfy potential claimants described in the Addendum when the Addendum fails to identify any specific potential claimants or any specific litigation risk.

Forecast Fund had less than \$300 in assets, even after the purported transfer of stock.¹⁴ As the Forecast Fund evidently lacked any material assets with which to fulfill its obligations, it seems unlikely that the transfer of stock was motivated by a desire to obtain the Forecast Fund's promise to assume potential liabilities.

OTA also notes the absence of evidence of planning documents or correspondence from the year at issue that might shed light on the objectives of the transaction. Appellant sought a substantial tax benefit and the series of steps leading up to the reported tax benefit were complex. Therefore, one would expect to see planning documents, letters, or emails prior to the transaction discussing the amount of potential liabilities that the transaction sought to address. In addition, one would expect documentation to discuss the goals sought to be achieved by, within a five-day period, contributing the \$10 million note to Forecast Construction, transferring Forecast Construction stock to appellant, replacing the note with a limited partnership interest, and contributing Forecast Construction stock to the Forecast Fund. The absence of such evidence suggests that the documentation produced by appellant does not provide a reliable picture of the actual motivation for the transaction.

In sum, appellant's claimed business purpose is not supported by the evidentiary record. Appellant has not shown that the transfer of Forecast Construction stock, or the related transactions preceding it, were designed to facilitate a settlement or achieve other nontax business purposes.

Economic Substance

The next prong of the economic substance analysis is to consider whether the transaction had objective economic substance. (See, e.g., *La Rosa, supra.*) "The economic substance factor involves a broader examination of whether the substance of a transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax deduction." (*Bail Bonds by Marvin Nelson, Inc. v. Commissioner* (9th Cir. 1987) 820 F.2d 1543, 1549 (*Bail Bonds*).)

This prong requires that the transaction have economic benefits beyond the creation of tax benefits. (See *Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360, 1365; *Bail Bonds*,

¹⁴ Appellant provides adjusted trial balances showing other assets held by the Forecast Fund. However, appellant has not shown who prepared the trial balances or explained why OTA should give them greater weight than final account statements prepared by the bank trustee. OTA finds the statements prepared by the bank trustee to be more reliable.

supra, 820 F.2d at p. 1549.) In *Casebeer*, Casebeer contacted the end-user of certain computer equipment (which the user was leasing) to verify the existence, value, and useful life of the equipment, and then purchased the computer equipment with promissory notes, including a \$25,000 recourse note, and immediately leased the equipment back to the purchaser.¹⁵ (*Casebeer v. Commissioner*, T.C. Memo. 1987-628, *affd.* *Casebeer*, *supra*, 909 F.2d 1360.) Casebeer then claimed depreciation deductions on the equipment over a period of several years. The tax court found that the transaction lacked economic substance, despite the existence of a recourse note (for which it allowed a deduction for interest payments), and despite the fact the transaction involved actual equipment and spanned several tax years. (*Ibid.*) In theory, the court might have viewed the transaction as having some economic effect as it spanned several years and included a recourse note on which Casebeer paid interest. Nevertheless, the tax court found that there was no “realistic opportunity for economic profit” and that the transaction was “devoid of economic substance.” (*Casebeer v. Commissioner*, *supra*, T.C. Memo. 1987-628.)

Casebeer illustrates that a theoretical economic effect, and even the involvement of recourse debt on which interest is paid, is not necessarily sufficient to demonstrate that a transaction has economic substance. Moreover, as noted previously, if appellant’s reported transfer of stock lacked substance, appellant is not entitled to the claimed deduction, even if other surrounding transactions arguably had some substance.

Here, it appears that appellant attempted to use the cover of the Forecast Fund to create a tax deduction, without complying with the terms of the irrevocable Trust Agreement that governs the Forecast Fund.¹⁶ Appellant’s reported assignment of the Forecast Construction stock to the Forecast Fund did not pay or satisfy any business expenses. The Forecast Construction stock was never used to pay any claims. At the time of the transaction, no claimant or other party was bound to accept payment from the Forecast Fund to satisfy a claim or potential claim. There is no evidence that any actual or potential claimants were aware of the existence of the Forecast

¹⁵ *Casebeer* involved multiple taxpayers who engaged in similar transactions. The above highlights facts from Casebeer’s case.

¹⁶ At protest, appellant argued that the judge’s order allowed the Forecast Fund to be used to pay claims other than claims related to the Wong/Dixon Litigation and “for other Forecast purposes.” It appears that this language is taken out of context and, even if this were not the case, the express terms of the irrevocable Trust Agreement prohibited its amendment without a court order and limited the purposes and uses of the Forecast Fund. So, even if the judge intended to allow the establishment of an open-ended fund that was not limited to any specific categories of claims (which seems doubtful), this is not the type of fund that was established by the irrevocable Trust Agreement.

Fund or the Forecast Construction stock. In addition, after the transaction, J. Previti, who was appellant's ultimate owner, retained effective control of Forecast Construction and the Forecast Fund through L. Day.

It does not appear that the transaction helped protect appellant from potential liabilities. Assuming, for the sake of argument, that the reported transfer to the Forecast Fund was effective, appellant has not shown that the Forecast Fund had any significant assets other than the Forecast Construction stock and thus has not shown that the Forecast Fund's promise to assume appellant's liabilities provided any practical benefit to appellant that was not already provided by appellant's ownership and control of the stock. If the Forecast Construction stock was sufficient to pay claims, it would be sufficient regardless of whether the stock was purportedly held by the Forecast Fund or held directly by appellant. If the Forecast Construction stock was not sufficient to pay claims, appellant would still be liable to pay any remaining liability, just as it would have been if it had not transferred the stock, as the Addendum would not bind third parties who were not a party to the agreement or even aware of its existence. (See *Coltec, supra*, 454 F.3d at p. 1360 [noting that an intercompany assumption of liabilities would not bind third parties].)

Furthermore, it appears that Forecast Construction was not managed in a manner designed to preserve funds for the payment of potential claims. Forecast Construction was allowed to exchange its limited partnership interest in Forecast Group for the Second Note, which was an unsecured promissory note from Forecast Group, a partnership controlled by J. Previti. No principal was ever paid on the Second Note, and appellant has not provided bank records or other source documents to substantiate payments of interest payments.¹⁷ There is no evidence that L. Day or any other party ever caused Forecast Construction to demand payment. Instead, appellant provides documentation indicating that Forecast Construction agreed three times to extend the due date of the Second Note, first from 2005 to 2012, then from 2012 to 2017, and then from 2017 to 2022.

Appellant notes that the IRS determined that the Forecast Group note was a bona fide debt for which interest accrual should be deducted. Assuming, for the sake of argument, that the IRS correctly determined that the note was a valid debt, the determination does not show that the purported transfer of Forecast Construction stock to the Forecast Fund had economic substance. The claimed deduction arises from the purported transfer of the Forecast Construction stock to

¹⁷ If any interest was paid on the note, it was less than 25 percent of the interest owed.

the Forecast Fund, not from interest that was paid or owed to Forecast Construction. Whether or not those interest accruals were deductible has no bearing on whether the reported transfer of Forecast Construction stock to the Forecast Fund had any practical economic benefit for appellant apart from purported tax benefits.

As noted previously, a court approved the establishment of the Forecast Fund as a QSF in 1994 in order to resolve the Wong/Dixon Litigation. The Forecast Fund was established with an irrevocable Trust Agreement, which was signed by a bank trustee. The agreement states that the Forecast Fund is irrevocable and “may not be amended without the prior approval of the Court.” Despite this requirement, the 1999 Addendum amended, or rather purported to amend, the irrevocable Trust Agreement without court approval. The Forecast Fund’s trustee is not a party to the Addendum, and there is no evidence that the trustee, or any court or potential claimant, is aware of the Addendum.¹⁸ While the Addendum purports to merely “supplement” the irrevocable Trust Agreement, its terms would clearly and materially amend the irrevocable Trust Agreement by, among other things, significantly expanding both who could claim benefits from the Forecast Fund and which defendants could take advantage of the Forecast Fund. In fact, the Addendum’s definitions of potential claimants, beneficiaries and defendants remove virtually any significant practical limitation on the potential claimants and defendants who could benefit from the Forecast Fund.¹⁹ Because the irrevocable Trust Agreement prohibited the amendment of the Forecast Fund without court approval, and court approval was not obtained, the Addendum could not and did not alter the Forecast Fund. While the Addendum professed to “supplement” and “expand” the Forecast Fund, it had no legal effect on the Forecast Fund.

The documentation provided to evidence the Forecast Fund’s holding of the Forecast Construction stock is contradictory. On the one hand, account statements issued by the trustee, for the period from January 1, 2000, through December 31, 2003, do not list the Forecast

¹⁸ Also, while appellant argues that the QSF continues to be “subject to” the court’s jurisdiction, there is no evidence that any court or potential claimant is aware of the transfer of Forecast Construction stock to the Forecast Fund.

¹⁹ In addition, the Addendum allows L. Day to expand the Forecast Fund to any persons or entities that he, “in the exercise of his business judgment,” deems consistent with the purpose of the Forecast Fund, as “supplemented” by the Addendum. As noted above, the original Forecast Fund was formed for the express purpose of satisfying potential claims from the Wong/Dixon Litigation, but the Addendum covers virtually any potential claims or claimants. Therefore, the restriction that any further expansion of the Forecast Fund by L. Day be consistent with the purpose of the Forecast Fund, as “supplemented” by the Addendum, does not appear to impose a significant practical limitation on the claimants that L. Day could pay.

Construction stock and show assets of less than \$300. On the other hand, appellant provides correspondence indicating that it sent the bank trustee for the Forecast Fund a stock certificate for shares of Forecast Construction, accompanied by documentation assigning the stock to the Forecast Fund. Also, appellant provides adjusted trial balances that list a \$10 million investment in Forecast Construction during 2001. It is not clear who prepared the trial balances or why they differ from the bank trustee's account statements. Appellant also provides an April 2, 2007 form letter from City National Bank indicating that it is the trustee for the Forecast Fund and asking Forecast Construction to estimate the value of the Forecast Construction stock. L. Day completed the form and estimated the value of the stock as \$16 million.²⁰

Assuming, for the sake of argument, that the trustee held the stock on behalf of the Forecast Fund, it is not clear when it accepted the stock or whether it assigned any material value to the stock. Moreover, it appears the trustee was subject to L. Day's direction. The Trust Agreement states that the trustee's powers are only "ministerial" and that it will "take such action or refrain from taking such action as the Administrator [L. Day] or the Court from time to time shall direct." Also, in a letter dated August 21, 2001, the trustee stated that it is to hold property for the Forecast Fund "and distribute that property as directed by [L. Day], as the Administrator for the [Forecast Fund]." Therefore, the Forecast Construction stock reported to be transferred remained under the control of appellant's beneficial owner, J. Previti, and appellant's employee, L. Day.

Appellant contends that any unused assets of the Forecast Fund are irrevocably dedicated to a charitable foundation, so there is no tax avoidance motive. However, as noted above, it is not clear that the trustee accepted the stock on behalf of the Forecast Fund, or, if it accepted the stock, when it did so. Moreover, the irrevocable Trust Agreement states that on termination of the Forecast Fund any undistributed income or principal will be distributed, not to a charitable foundation, but to Forecast Mortgage (an affiliate of appellant) or its successors or assigns. The Addendum purports to dedicate any remaining assets of the Forecast Fund, after payment of any claims or potential claims as broadly defined, to the [JP] Family Foundation, but, as noted

²⁰ The bank trustee's account statements raise the possibility that the transfer of stock was a "sham in fact," meaning that it did not occur. (See, e.g., *Kirchman v. Commissioner* (11th Cir. 1989) 862 F.2d 1486, 1492.) However, given that some documents appear to indicate that some transfer occurred or was at least attempted, OTA considers whether the reported transfer had a substantial economic effect, rather than finding simply that it was a sham in fact.

previously, the Addendum cannot amend the Trust Agreement as it was not approved by the court.²¹ Therefore, even if one accepts that Forecast Construction became an asset of the Forecast Fund, the record does not support appellant's contention that any remaining assets of the Forecast Fund are irrevocably dedicated to charity.²²

To summarize, appellant has not established that it had a subjective nontax business purpose for the reported transfer of stock, or that the reported transfer had economic substance.²³ There is no indication that the obligations or rights of any independent third parties were materially affected by the reported transfer, and potential claimants were not bound by or even aware of the transfer. In short, the reported transfer reflected nothing more than "drawing up papers" to obtain a tax benefit, rather than any business reality.²⁴ (See *Lyon, supra*, 435 U.S. at p. 573, quoting *Commissioner v. Tower* (1946) 327 U.S. 280, 291.) As a result, appellant is not entitled to its claimed \$10 million deduction.

²¹ Also, no independent party was a party to the Addendum, and the Addendum does not indicate that it is irrevocable or could not be amended. It appears that L. Day and J. Previti could cause it to be amended at any time.

²² Moreover, given Forecast Construction's failure to enforce the terms of its sole asset, the Second Note, it is not clear that, if the Forecast Fund were ever formally terminated, any material assets would remain to be distributed.

²³ To the extent appellant raises arguments that OTA has not addressed in this Opinion, OTA finds them to be without merit.

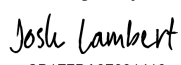
²⁴ As OTA has determined that the transaction lacked economic substance, there is no need to consider whether, if the transaction had economic substance, its substance reflected its form or would have entitled appellant to the claimed deduction.

HOLDING

Appellant has not shown that the reported transfer of stock had any economic substance. Therefore, it is not entitled to the claimed \$10 million deduction.

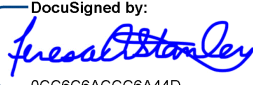
DISPOSITION

FTB's action is modified as conceded to abate the NEST penalty and related interest. FTB's action is otherwise sustained.

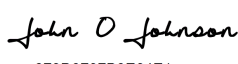
DocuSigned by:

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Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:

0CC6C6ACCC6A44D...

Teresa A. Stanley
Administrative Law Judge

DocuSigned by:

873D9797B9E64E1...

John O. Johnson
Administrative Law Judge

Date Issued: 7/3/2024