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**BOARD OF EQUALIZATION**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of:

) **HEARING SUMMARY**  
) **PERSONAL INCOME TAX APPEAL**  
)  
) Case No. 571973

**ROBERT H. LOWE AND**  
**SHERYL L. BERKOFF**

<u>Year</u>	<u>Amount</u>	<u>Penalty</u>
2005	\$714,686.00	\$178,671.50

Representing the Parties:

For Appellants: Mark Bernsley, Esq.

For Franchise Tax Board: Sonia Woodruff, Tax Counsel III

QUESTIONS: (1) Whether appellants have shown that respondent Franchise Tax Board erred in its determination of the basis of real property sold by appellants and the resulting taxable gain.  
(2) Whether appellants have established reasonable cause for the abatement of the penalty for the failure to furnish information.

HEARING S UMMARY

This appeal involves an amount in controversy that is \$500,000 or more and thus is covered by Revenue and Taxation Code (R&TC) section 40. Please see Staff Comments below for

1 details.

2 Background

3 Appellants owned a residence on Garden Lane in Montecito, California (Garden Lane)  
4 which they sold in 2005 for \$25,000,000. Appellants reported a gain of \$10,139,773 but, according to  
5 respondent, they did not report the sale price or the adjusted basis of Garden Lane on their 2005  
6 California return. Respondent examined the 2005 return and determined that appellants underreported  
7 the gain on the sale by \$9,344,604, made an adjustment to the adjusted basis of the property and issued a  
8 Notice of Proposed Assessment (NPA) dated February 5, 2009. The NPA increased taxable capital gain  
9 income by \$8,830,086, reduced itemized deductions by \$4,255 and proposed an assessment of additional  
10 tax of \$909,938. The NPA also imposed a penalty for the failure to furnish information in the amount of  
11 \$227,484. (Appeal Letter, exhs. 3 and 14; Resp. Op. Br., p. 1.)

12 Appellants timely protested the NPA and, at protest, the hearing officer allowed total  
13 construction costs of \$3,736,056 and determined the adjusted basis as \$6,671,112. Respondent then  
14 issued a Notice of Action (NOA) revising the assessment to increase capital gain income of \$6,934,444,  
15 leaving the reduction in itemized deductions unchanged and proposing the assessment of additional tax  
16 of \$714,686. The NOA also reduced the failure to furnish information penalty to \$178,671.50.

17 Appellants then filed this timely appeal. (Appeal Letter, exhs. 2 and 5.)

18 **Issue (1): Whether appellants have shown that respondent Franchise Tax Board erred in its**  
19 **adjustments to the basis of real property sold by appellants and the resulting determination of an**  
20 **increase in taxable gain.**

21 Contentions

22 Appellants' Contentions

23 In their appeal letter, appellants state that they purchased Garden Lane in 1997 and that  
24 respondent has acknowledged an original cost basis of \$2,858,126, the original land cost and acquisition  
25 expenses. Appellants state that the property was a "tear down" and that respondent acknowledges they  
26 undertook "extensive remodeling and improvements". Appellants state that a house, guest house, and  
27 pool were constructed and extensive landscaping was performed and they include photographs of  
28 Garden Lane as exhibits to the appeal letter. Appellants also state that construction "was so extensive it

1 took some two years to complete” and the property was featured in Architectural Digest magazine.  
2 Appellants state that the protest hearing officer allowed construction costs of \$3,736,056 and a total  
3 basis of \$6,671,112 but that “secondary evidence”, including signed attestations by subcontractors and  
4 suppliers, substantiating additional construction and improvement costs of \$2,697,793 was disregarded.  
5 (Appeal Letter, pp. 2-3, exhs. 5-8.)

6 Appellants state that, during the period prior to the purchase of the property in 1997  
7 through the present time, their financial and business dealings have been handled by professionals who  
8 were responsible for maintaining records. Appellants state that “a perfect storm” of events occurred,  
9 including “changes in professional representation and a computer crash, in which documentation of  
10 construction costs was lost.” In addition, they state that they moved multiple times since the sale of  
11 Garden Lane and the general contractor of most of the construction closed his business and moved out  
12 of the country. Because some construction costs were paid as loan disbursements directly from the  
13 lending bank and as a result of the loss of documentation, appellants assert that their representatives  
14 “were unable to produce canceled checks, some invoices and pertinent contracts quickly.” (Appeal  
15 Letter, p.4.)

16 Appellants assert that selling expenses for title insurance, tax stamps and credits to the  
17 buyer in the total amount of \$83,473 were not allowed as deductions from the selling price even though  
18 such expenses were substantiated as being deducted in escrow. Appellants contend that the protest  
19 hearing officer “misstated and misapplied the law” by rejecting signed statements of witnesses attesting  
20 to payments totaling \$2,697,793 for construction labor and materials. Appellants state that the hearing  
21 officer cited the *Appeal of Aaron and Eloise Magidow* (82-SBE-274), decided on November 17, 1982  
22 (*Appeal of Magidow*),<sup>1</sup> in which respondent determined deficiencies based on federal adjustments that  
23 increased the taxpayer’s taxable income. In the *Appeal of Magidow*, the taxpayer testified that he had  
24 deductible expenses to offset the additional income but he provided no substantiation and the federal  
25 report showed no such offsetting deductions were allowed. The Board held that the taxpayer’s  
26 unsupported assertions were not sufficient to meet his burden of proof to show error in respondent’s  
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<sup>1</sup> Board of Equalization cases are generally available for viewing on the Board’s website  
(<http://www.boe.ca.gov/legal/legalopcont.htm>).

1 determination. Appellants contend that the hearing officer relied on the *Appeal of Magidow* to disregard  
2 the testimony of other witnesses whereas the Board held that only the taxpayer's testimony may be  
3 disregarded. Appellants further contend that disregarding the testimony of any witness for any  
4 administrative or judicial proceeding is contrary to law and, in this appeal, the "uncontradicted third  
5 party witnesses provided the very corroboration absent in *Magidow*." (Appeal Letter, p. 5.)

6 Appellants cite *Cohan v. Commissioner* (2d Cir. 1930) 39 F.2d 540, in which the  
7 taxpayer, a famous playwright, incurred substantial expenses for entertaining and travel but the taxpayer  
8 did not keep records to substantiate those expenses. The taxpayer claimed his estimate of \$50,000 as a  
9 business expense deduction but the Board of Tax Appeals allowed no deduction because it was  
10 impossible to know the exact amount. The Court of Appeals held that the denial of the entire amount  
11 was an error and, according to appellants, "authorized estimates of the expenses and the reliance upon  
12 indirect evidence in making such estimates." Appellants assert that the "Cohan rule" is recognized and  
13 applied for California and federal tax law purposes. (Appeal Letter, pp. 5-6.)

14 Appellants cite the *Appeal of Zorik and Artimis Soukhanian* (87-SBE-077), decided on  
15 December 3, 1987, in which the taxpayers claimed a business loss deduction suffered as a result of  
16 expropriation by the Iranian government of their real property used for the production of income. The  
17 taxpayers had no receipts to substantiate construction expenses so they submitted a list of expenses  
18 "supported by a letter from a contractor." This Board held that the Cohan Rule was applicable to  
19 approximate the expenses because it was "readily apparent that 'something was spent'" but the  
20 taxpayers' record were inadequate for an accurate determination for deduction purposes. (Appeal Letter,  
21 p. 6.)

22 Appellants assert that respondent has not challenged "the fact of the improvements"  
23 described by appellants and has not questioned that such expenditures would increase appellants' basis  
24 in Garden Lane. Appellants contend that their "substantial improvements" had a "significant cost" and  
25 that respondent takes the "unreasonable" position that appellants could build a \$22 million mansion for  
26 less than \$4 million. Thus, appellants conclude that the approximately \$11 million in reported  
27 construction costs is consistent with the increase in value. Appellants assert that the only issue is the  
28 method of establishing the cost of improvements which presents "the precise circumstances" in which

1 the Board has previously applied the Cohan Rule. (Appeal Letter, pp. 6-7.)

2 In their opening brief, appellants state that the available records, which substantiate  
3 approximately 50 percent of the construction costs, together with secondary evidence are sufficient to  
4 support the amount of the basis reported by appellants. Appellants assert that respondent erroneously  
5 disallowed expenses of the sale listed in the escrow closing statement, that respondent's determination  
6 of basis is in error, and that appellants' evidence, which includes expert testimony, establishes that  
7 appellants' claimed adjusted basis should be upheld. (App. Op. Br., p. 1.)

8 Appellants state that they hired experts to commence designing and then building a new  
9 home on the property. The existing one-story home would be substantially demolished, leaving the  
10 foundation and some framing, the septic system would be relocated, and a new two-story structure in the  
11 style of an "Old English manor house and separate pool house would be constructed using the finest  
12 materials." Appellants state that every detail was the result of "collaboration" between appellant-wife,  
13 the designer, the architect, and the general contractor and that even accents were custom designed and  
14 made. Appellants further state that the parcel of between five and six acres was meticulously  
15 landscaped, a guest house was constructed above the garage, a custom conservatory was built onto the  
16 main house, and the second floor was altered to add a master bath and to expand the master closet.  
17 According to appellants, the project took four-to-six years and was featured in Architectural Digest in  
18 July of 2001 and Santa Barbara Magazine in February of 2004. (App. Op. Br., p. 3.)

19 Appellants present a schedule of what they describe as expenses of the sale totaling  
20 \$1,334,496.50 and explain the items agreed upon and disputed. They also present their accountants'  
21 computation of the gain on the sale which includes an adjusted basis of \$13,526,000 and a recognized  
22 gain of \$9,639,773. Appellants state that Craig Szabo (Szabo), their certified public accountant (CPA),  
23 provided services as their business and financial manager and accountant and they expected that he was  
24 properly tracking all costs and expenses of the construction of Garden Lane. Appellants further state that  
25 Szabo kept records based on bank and other financial records, receipts, and information and that  
26 appellants and their business and financial managers used several bank accounts and transferred money  
27 between accounts when necessary. (App. Op. Br., p. 5.)

28 Appellants state that the costs of construction were paid from multiple checking accounts

1 opened for use by the general contractor, one or more of appellants' personal accounts and through one  
2 or more accounts that the Szabo firm maintained on behalf of appellants. Appellants state that they  
3 "originally intended to completely self-finance the construction" but a few months after commencement  
4 they realized they would need to obtain financing to supplement their own funds. Appellants obtained  
5 two loans from First Republic Bank (First Republic): a \$500,000 unsecured loan funded in September of  
6 1996 and a \$3,000,000 loan secured by a deed of trust on Garden Lane, the first disbursement of which  
7 retired the original purchase money loan on the property in late 1997. Appellants state that  
8 First Republic engaged C.E. Williams & Associates, owned and operated by Carl Williams, to review  
9 construction documentation and proposed building costs, to inspect the project, to monitor costs and  
10 approve vouchers and to monitor and control disbursements from the Construction Loan. (App. Op. Br.,  
11 p. 6.)

12 Appellants state that the first disbursement, other than the payment to retire the purchase  
13 money loan, occurred in January 1998,<sup>2</sup> by which time the main house had been framed, the windows,  
14 exterior doors and roof were being installed, electrical and heating systems were started, and the  
15 foundation of the pool and pool house "were in early stages" as evidenced by photographs taken by  
16 Mr. Williams which show the state of construction at various points in time. (App. Op. Br., p. 6,  
17 exhs. 77, 92 and 97.) Appellants further state that the construction loan was increased twice to a total of  
18 \$4.75 million and the last disbursement occurred on October 26, 1998, but appellants continued to  
19 expend personal funds while and after the construction loan proceeds were disbursed.

20 Appellants state that Garden Lane was structurally complete by early to mid-1999 when  
21 appellants did not have sufficient funds to finish the project. They considered selling the property but  
22 they resumed construction when appellant-husband was cast in a television series and, from that time  
23 through mid-2001, significant additional work was performed. Appellants further state that, in 2002  
24 through 2003, a detached garage was remodeled with the addition of a second floor guest house, which  
25 included a bedroom, living room, kitchen, bathroom marble and wood floors, and an entertainment  
26 system and, in the main house, an addition of a second-story master bathroom, a conservatory in the  
27

28 <sup>2</sup> Appellants' opening brief gives the year as 2008 but it appears to be typographical error.

1 rear, and a master closet expansion. Appellant also state that the “lush English gardens” were finished.  
2 (App. Op. Br., p. 7, exh. 19.)

3 Appellants state that invoices and receipts for goods or services paid by appellants or  
4 Mr. Sweet were generally provided to the Szabo firm and hard copy files were periodically sent to the  
5 Szabo firm’s storage unit with the content descriptions and storage locations being maintained on the  
6 firm’s computer system. Appellants state that, in 2002, the firm had a computer crash which resulted in  
7 the loss of “much of the computer-stored detail concerning [appellants] to that point in time, including  
8 both financial records in the general ledgers and data concerning contents and storage locations of  
9 various files.” Appellants state that Szabo is uncertain about the adjusted basis in Garden Lane and  
10 “lacks sufficient data to reconstruct it with much confidence” but “he was and is confident of the  
11 computations done by his staff in 2008.”<sup>3</sup> Appellants state that they left Szabo and hired  
12 Boulevard Management (Boulevard), an accounting and management firm, in February of 2006 and  
13 Boulevard requested that Szabo provide information concerning appellants’ basis in Garden Lane for the  
14 preparation of appellants’ 2005 tax returns. Appellants state that Szabo’s firm prepared a document  
15 “based on available information showing an adjusted basis of \$12,991,000” and Boulevard added  
16 \$535,000 to the computation based on information obtained from appellants and filed the return in  
17 October of 2006. (App. Op. Br., pp. 8-9, exhs. 19 and 60.)

18 After respondent notified appellants of its intention to examine their 2003, 2004, and  
19 2005 returns by letter dated July 5, 2007, appellants state that Boulevard requested that Szabo provide  
20 documentation to substantiate the adjusted basis in Garden Lane. Appellants state that Szabo searched  
21 for the documentation for the next few months but was unable to find many of the documents for four  
22 reasons: (1) computer ledger records of construction expense records prior to 2002 and computer files  
23 listing stored records were lost in the “computer crash”; (2) confusion over which files Szabo already  
24 delivered to Boulevard, which files Szabo retained, and which files were unaccounted for; (3) Szabo’s  
25 staff members “most directly involved” with appellants’ account during the years in issue had left  
26

27  
28 <sup>3</sup> In his declaration, Mr. Szabo states that a former employee who was the “most involved and familiar with the Lowe’s  
affairs” prepared a computation of adjusted basis of \$12,991,000 in 2006. Mr. Szabo describes the former employee as  
“competent and trustworthy” and states that he is “confident in her work and that her efforts would have reflected a  
competent computation of basis.” (App. Op. Br., exh. 60.)

1 Szabo's firm; and (4) a physical search was not successful in locating many of the requested files. (App.  
2 Op. Br., p. 9.)

3 Appellants state that they provided two sets of materials to respondent. The first set  
4 which "involved issues other than basis" was provided by letter dated November 27, 2007, and the  
5 second set which "addressed the basis of Garden Lane" was provided by Szabo to Boulevard on  
6 January 23, 2008, and then forwarded to respondent. Appellants assert that the basis information, which  
7 was "primarily general ledger entries and some estimates", suggested a substantiated basis of  
8 \$11,631,825. Appellants further state that respondent's examiner allowed an adjusted basis of \$6 million  
9 based on an interest statement for a loan of that amount and the NPA reflected that amount. Appellants  
10 state that, during the protest Szabo provided "an additional Cost Basis Report", which included  
11 attestations from contractors, subcontractors, and suppliers, supporting expenses of \$2,697,793, and  
12 additional invoices, receipts, and other documents supporting costs and fees of \$1,104,359, to establish  
13 construction costs of at least \$8,433,506. (App. Op. Br., pp. 10-11, exhs. 3, 16 and 63.)

14 Appellants state that, on March 1, 2010, Szabo sent a letter to the protest hearing officer  
15 and had a telephone conference with her on May 19, 2010, summarized by the hearing officer in a letter  
16 dated June 4, 2010, in which she stated that "the Franchise Tax Board listed the cost basis of  
17 \$11,326,000" and that Szabo stated that he had additional documents to substantiate his claimed basis of  
18 \$11,631,875. Appellants further state that, on August 24, 2010, the hearing officer wrote to Szabo  
19 advising him that she was allowing construction costs of \$4,109,468 and an adjusted basis of \$7,044,524  
20 and advising him of the types of additional documentation to be submitted to support a higher basis.  
21 Appellants state that, in the final determination, construction costs of \$3,736,056 and an adjusted basis  
22 of \$6,671,112 were allowed as reflected in the NOA issued April 18, 2011. Appellants describe the  
23 types of evidence submitted with their appeal letter and opening brief. (App. Op. Br., pp. 10-11, exhs. 2,  
24 5, 60, 65, 66, 67A and 67B.)

25 Appellants argue that respondent erred by disallowing as an addition to basis expenses of  
26 the sale totaling \$79,826, which include title insurance of \$40,656, city/county tax stamps of \$27,500,

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28 ///

1 and “misc. credit to buyer” of \$11,670.<sup>4</sup> Appellants assert that it has long been recognized that all  
2 expenses of sale reduce the amount realized and that debits and credits are not uncommon in real estate  
3 transactions as offsets, thus reducing the amount realized. (App. Op. Br., p. 13; Resp. Op. Br., p. 9.)

4 Appellants assert that construction costs are the most significant component of the  
5 adjusted basis in Garden Lane although, as described above, appellants are unable to prove the exact  
6 amount of those costs. However, appellants contend that, under the Cohan rule, a taxpayer who has  
7 otherwise proven an entitlement to a tax deduction or other benefit but who cannot show the exact  
8 amount of a deduction or benefit with precision is entitled to the benefit in an amount as best as can  
9 reasonably be determined. Appellants cite *Cohan* and the *Appeal of Soukhanian* as they did in the appeal  
10 letter and conclude that the Cohan rule should be applied in this appeal. Appellants note that the  
11 photographs of construction are evidence of the improvements and that an expert retained by the  
12 construction lender to supervise the use of the loan proceeds provided a cost analysis and opinion of  
13 construction costs at just under \$10 million. (App. Op. Br., pp. 14-16, exhs. 6, 7, 21-59, and 106.)

14 Appellants further argue that respondent’s method of making the cost determination was  
15 flawed and that neither party attempted to apply the Cohan rule during the examination or protest  
16 process. Appellants assert that the examiner concluded the original cost was \$2 million and “the increase  
17 in debt of \$4 million over the purchase money mortgage represented the costs of construction.”

18 Appellants assert that the examiner failed to make “the correct inquiry under *Cohan* . . . whether that  
19 amount represented a reasonable estimate of what it would cost to build a house of a size and quality  
20 that only a few years after completion sold for \$25 million.” Appellants contend that respondent’s  
21 examiner did not use an “analytically sound approach” by determining a basis equal to debt which  
22 effectively assumed that appellants financed the land purchase and the construction of improvements.  
23 Appellants further contend that the hearing officer’s determination was also flawed for the following  
24 three reasons:

25 (1) She relied on erroneous information provided by Szabo that the loan proceeds were paid directly  
26

27  
28 <sup>4</sup> However, in its opening brief, respondent states that it will allow the expenses for title insurance and city/county tax stamps totaling \$68,156 as a reduction to the amount realized on the sale. In its supplemental brief, respondent states that it will allow appellants to deduct the \$11,670 miscellaneous expense based on a review of documentation submitted by appellants. Thus, these expense deductions are no longer in issue.

1 by the lender and totaled \$3.3 million.

2 (2) She erred as a matter of law by rejecting witness statements of \$2.7 million in payments as  
3 “unsupported assertions” and cited the *Appeal of Magidow* as legal authority. In the *Appeal of*  
4 *Magidow*, the taxpayer provided no evidence to corroborate his testimony that he had unclaimed  
5 expenses that offset additional income and there was no federal adjustment that reflected such  
6 expenses. The hearing officer misinterpreted the *Appeal of Magidow* to justify ignoring the  
7 testimony of any witness which was the only evidence presented whereas in this appeal  
8 appellants established that expenses were incurred and those amounts were substantiated by the  
9 testimony of numerous independent third-party witnesses who were uncontradicted.

10 (3) The hearing officer viewed this issue as a “substantiation matter” based on the reliability of the  
11 documentation rather than whether the total amount stated in the documents she accepted “made  
12 sense in light of the property and the improvements.”

13 (4) The hearing officer used the \$6 million in debt “as the measure of reasonableness” which, as  
14 discussed above, was an analytically flawed measure of the construction costs.

15 Appellants argue that respondent’s determination was unreasonable and erroneous based  
16 on the increase in average home values in Montecito during the relevant period from 1997 to 2005.  
17 Appellants state that they used the website Zillow.com to determine that average home values rose  
18 between 0 percent and 100 percent during that period and selecting the value most favorable to  
19 respondent would suggest that the \$2.85 million cost of land would account for \$5.7 million of the sale  
20 price leaving \$19.3 million attributable to improvements. If the cost of improvements was \$4 million as  
21 determined by the hearing officer, appellants assert that they realized a profit of 383 percent on those  
22 costs which is an implausible return. Appellants further contend that the determination is also  
23 unreasonable because it is illogical to assume that a buyer would pay more for improvements than the  
24 cost to reproduce them plus a premium for the convenience of not reproducing them. According to  
25 appellants, it is “absurd to think that someone would pay between \$19.3 million and \$22.2 million” for  
26 improvements that would cost only \$4 million plus a “nominal inflation factor” which is corroborated by  
27 appellants’ expert, Mr. Williams. (App. Op. Br., pp. 19-20, exh. 93.)

28 Appellants contend that the two Bruce Sweet account ledgers submitted match and are

1 corroborated by records of three of the bank accounts. Appellants assert that the ledgers which represent  
2 a portion of the accounts used for only part of the construction period reflect costs totaling more than  
3 \$3.2 million through mid-1999 and that other accounts were used by Mr. Sweet and appellants and their  
4 CPA made payments from appellants' other accounts. On that basis, appellants contend that the costs  
5 were clearly more than \$3.2 million and "some of that excess can be shown and/or deduced." Appellants  
6 state that \$2.06 million of the \$4.75 million construction loan funds was used to retire the original  
7 purchase money loan and \$650,000 was used to retire the \$500,000 unsecured loan, which means that  
8 approximately \$2 million of the construction loan was used for construction (in addition to the \$500,000  
9 unsecured loan which was also spent on construction). Appellants further state that a comparison of the  
10 loan disbursements and the two ledgers shows that about \$1.8 million of the \$2 million went into the  
11 bank accounts shown on those ledgers, with at least \$200,000 going to other accounts used for  
12 construction. For that reason, appellants assert that they had to contribute at least \$1.4 million to fund  
13 the \$3.2 million expended by Mr. Sweet as shown in those ledgers and, when the \$500,000 of unsecured  
14 loan proceeds and the \$200,000 going to other accounts are added, there is evidence of a total of  
15 \$3.9 million in construction costs through mid-1999, as represented by a small portion of the evidence.  
16 (App. Op. Br., pp. 20-21, exhs. 70-72, 74, 75 and 77.)

17 Appellants further assert that the attestations of some of the tradespersons as to payments  
18 they received for goods and services must be considered. Appellants state that some appear to be based  
19 on recollection and others appear to be based on actual business records. In addition, appellants state that  
20 some are unclear as to whether they refer to payment in full while others clearly state that they were  
21 only partial payments. Appellants provide as examples an attestation by Mr. Sweet which included only  
22 a few items on a small part of the project and an attestation by McCoy Electric for \$105,000 while the  
23 general ledgers show payments to McCoy Electric in excess of \$167,000 for part of the construction.  
24 Appellants state that those inconsistencies show that the attestations provide only approximations of  
25 minimum amounts expended for portions of the project but represent the best recollection of  
26 independent witnesses to determine a minimum cost level. (App. Op. Br., pp. 21-22.)

27 To prevent the possibility of double-counting costs from the attestations and general  
28 ledgers, appellants state that they created Appendix A to compare the attestations and other evidence

1 used in the Cost Basis Report with the payments to those same vendors in the general ledgers and other  
2 records. Appellants state that they excluded from the analysis any documentation for repairs, from  
3 vendors who provided attestations, or which was duplicated or might have been duplicated. Appellants  
4 conclude that the difference is the identification of at least \$2.185 million in additional construction  
5 costs “under the most stringent assumptions.” Appellants contend that, even if one assumes that the  
6 \$700,000 discussed above was applied to the amount derived in Appendix A, at least another  
7 \$1.4 million is accounted for which results in “minimum proven costs of construction” between \$5.3 and  
8 \$6 million. (App. Op. Br., p. 22.)

9 Appellants assert that Mr. Williams is an expert in construction costs, particularly in the  
10 Montecito area and is personally familiar with the Garden Lane project, and from an extensive review  
11 and detailed analysis determined the minimum costs of construction at that time would have been  
12 \$9,987,962. Mr. Williams testified that the \$10.668 million claimed for the adjusted basis on the 2005  
13 return as computed by the Szabo firm was within the reasonable range for probable construction costs.  
14 Appellants assert that, when Mr. Williams’ adjusted basis estimate is added to the \$2,858,126 original  
15 cost, the claimed basis is only 5 percent higher which establishes that the 2005 return is consistent with  
16 the expert’s best estimate of construction costs. Therefore, appellants conclude that they correctly  
17 reported the adjusted basis and the gain on the sale of Garden Lane. (App. Op. Br., p. 23.)

#### 18 Respondent’s Opening Brief

19 Respondent asserts that its determinations have a presumption of correctness and the  
20 taxpayer has the burden of proving error by presenting credible, competent, and relevant evidence to the  
21 contrary. In addition, respondent states that a taxpayer’s unsupported assertions are not sufficient to  
22 satisfy his or her burden of proof. (Resp. Op. Br., pp. 3-4.)

23 Respondent states that appellants present as exhibits to their briefing many of the same  
24 documents that they provided during the protest. Respondent states that appellants maintained at protest  
25 that the payments for construction expenses came from (1) the main construction loan from  
26 CE Williams & Associates (CE Loan), the Bruce Sweet construction loan (Bruce Sweet Loan), and  
27 direct payments from appellants. Respondent explains that, during the protest, appellants did not provide  
28 any documentation to substantiate the payments from the CE Loan in the amount of \$3,311,476 and,

1 according to the general ledgers provided on appeal, there were total deposits into the CE Loan account  
2 of \$2,862,174.71 and total disbursements of \$1,199,520.40. Despite that discrepancy, respondent states  
3 that it allowed the full amount of the CE Loan as an adjustment to basis because that amount was  
4 consistent with the loan balance on Garden Lane. Respondent asserts that the entire amount of the  
5 CE Loan was allowed and, therefore, there are no more funds from that account that may be added to the  
6 basis. (Resp. Op. Br., pp. 4-5, exhs. E, F and G; App. Op. Br., exh. 75)

7 Respondent states that appellants argued during the protest and appeal that they paid a  
8 total of \$1,043,549 to Bruce Sweet Construction. Respondent states that the hearing officer determined  
9 that the documentation showed that amounts paid directly to Bruce Sweet Construction were paid from  
10 the CE Loan and, therefore, already included in appellants' adjusted basis. Respondent further states that  
11 appellants have provided bank statements, canceled checks, and a check register showing that \$383,400  
12 was deposited into the account and, assuming that amount was paid directly to Bruce Sweet  
13 Construction, appellants should be allowed an increase in basis of that amount but they have not  
14 provided any documentation to substantiate the remaining \$660,149 which they claim was paid to  
15 Bruce Sweet Construction. (Resp. Op. Br., pp. 5-6.)

16 Respondent asserts that Treasury Regulation section (Treas. Reg. sec.) 1.6001-1(a) and  
17 IRS Publication 523 require taxpayers to maintain books and records "to support tax information" and  
18 that "mere uncorroborated assertions, even if signed under penalty of perjury, do not qualify as support"  
19 citing the *Appeal of Magidow*. Respondent states that a majority of the "alleged" payments totaling  
20 \$3,802,152 are "supported" solely by attestations from appellants, contractors, and various other  
21 individuals and by photographs. Respondent further states that many of the exhibits supporting the direct  
22 payments were provided at protest and properly considered by the hearing officer. According to  
23 respondent, the only new documents are appellants' exhibits 80 through 91 reflecting additional  
24 capitalized costs paid directly from appellants' personal account. Respondent states that the payments of  
25 \$126,089 which are substantiated by a bank statement and canceled checks should be added to the basis  
26 but the remaining \$3,251,483 (\$3,802,152 less \$424,580 allowed at protest and \$126,089 allowed on  
27 appeal) is not corroborated and was properly disallowed pursuant to Treas. Reg. sec. 1.6001-1(a) and  
28 IRC Publication 523. (Resp. Op. Br., p. 6.)

1 Respondent argues that appellants fail to recognize that the premise of the Cohan rule is  
2 substantiation and reliance on the Cohan rule is misplaced here. Respondent asserts that the Tax Court  
3 has applied the Cohan rule and held that, where a taxpayer has established costs for capital  
4 improvements but has failed to document the exact amount, the courts may make a reasonable estimate  
5 of the expenditure in certain circumstances, “bearing heavily against the taxpayer whose inexactitude is  
6 of his own making” citing *Minchew v. Commissioner* (1930) 12 T.C.M. 1107. Respondent also cites the  
7 *Appeal of Henrietta Swimmer, Executrix, et al.* (63-SBE-138), decided on December 10, 1963 (*Appeal*  
8 *of Swimmer*), in which this Board held that “[t]he Cohan rule merely permitted the deduction of a  
9 reasonable portion of substantiated expenses” and respondent allowed the taxpayers a deduction for  
10 50 percent of the amounts they were unable to substantiate. Under those circumstances, the Board  
11 concluded that it would not alter respondent’s determination unless there are facts presented that indicate  
12 a different approximation would be appropriate. (Resp. Op. Br., p. 7.)

13 Respondent argues that the Cohan rule is inapplicable because the issue is not whether  
14 appellants are entitled to an increase in basis but rather whether respondent was able to reasonably  
15 determine the adjusted basis using the clear evidence provided by appellants. Respondent points out that  
16 this Board declined to alter respondent’s determination in the *Appeal of Henrietta Swimmer* which was  
17 based on the evidence provided. Respondent asserts that the \$6 million adjusted basis allowed at audit  
18 was a reasonable determination based on publicly available information and far exceeded the  
19 documented expenses. In addition, respondent states that it allowed a full adjustment of \$3,311,476.00  
20 for the CE Loan even though only \$1,199,520.40 in disbursements was supported. Respondent also  
21 states that it has allowed additions to basis “by piecing together bank statements and canceled checks”  
22 but that “amounts that are merely stated as capital expenditures” without any supporting proof cannot be  
23 allowed even under the Cohan rule. (Resp. Op. Br., pp. 7-8.)

24 Respondent further argues that appellants’ reliance on the *Appeal of Soukhanian* is  
25 misplaced because in that appeal the taxpayer was unable to provide any records or receipts to  
26 substantiate expenses but there was some evidence that money was spent. Respondent states that, as the  
27 court held in *Cohan*, this Board held it was unreasonable to disallow all expenses when there was some  
28 evidence that the taxpayer was entitled to a basis adjustment. Respondent contends that the facts

1 presented in this appeal are distinguishable because appellants have been allowed adjustments to basis  
2 by over \$4,000,000 even though the total disbursements from the accounts are less than that amount.  
3 Respondent notes that appellants acknowledge that the information provided, which respondent relied  
4 on, is “limited and incomplete.” However, respondent contends that it cannot allow expenses that are  
5 corroborated only by self-serving statement by appellants and third parties. Respondent further contends  
6 that the Cohan rule is inapplicable because there is insufficient evidence for this Board to conclude that  
7 appellants are entitled to the full amount claimed and that respondent’s basis estimate is unreasonable.  
8 Moreover, respondent contends that accepting appellants’ speculative estimates on the basis of the  
9 Cohan rule would impermissibly substitute the application of that rule rather than requiring appellants to  
10 satisfy the burden of proof. (Resp. Op. Br., pp. 8-9.)

11 As stated above, respondent concedes that appellants are entitled to reduce the amount  
12 realized by an additional \$68,156 as expenses of the sale but may not deduct the remaining  
13 miscellaneous expense amount of \$11,670 because it is not an enumerated expense pursuant to IRS  
14 Publications 17, 523, and/or 530. (Resp. Op. Br., p. 10.)

15 Appellants’ Reply Brief

16 Appellants take issue with respondent’s statement of facts as follows:

- 17 • The purchase price and appellants’ initial basis was \$2,858,126, and their cash outlay was  
18 \$858,216. (App. Reply Br., p. 2.)
- 19 • The project was not a “remodel”, they constructed a mansion from “a much smaller tear-down.”
- 20 • Appellants did not receive a reduction for exemption credits because their AGI exceeded the  
21 threshold for allowing the credits and they self-assessed and paid a penalty of \$5,552 for an  
22 understatement of estimated tax. (App. Reply Br., pp. 2-3.)
- 23 • Respondent makes misleading and speculative statements about appellants’ reporting and copies  
24 of files provided by respondent to appellants did not include a schedule shown in Exhibit 4,  
25 which explains how the gain on the Garden Lane sale was computed or many other pages from  
26 the return. Respondent suggests that the absence of that information from respondent’s record  
27 does not appear to be attributable to appellants or their accountants but rather to the process of  
28 electronic filing “that were necessarily approved by Respondent.” Hard copies of the returns

1 prepared by Boulevard and provided to appellants included statements and schedules that did not  
2 appear in respondent's generated return copy, including the schedule shown in Exhibit 4. Thus, it  
3 is clear that information about the gain was absent from respondent's files as a result of  
4 respondent's technical and policy decisions and not intentional or negligent misreporting by  
5 appellants. (App. Reply Br., pp. 3-4.)

6 Appellants assert that they have two burdens to meet, first the burden of overcoming the  
7 presumption of correctness of respondent's determination and second, the burden of proving the  
8 adjusted basis in Garden Lane. Appellants further assert that, once they have overcome the presumption  
9 of correctness, the presumption disappears and is no longer relevant. In this regard, appellants argue that  
10 respondent's determination is not, as respondent suggests, a starting point from which amounts should  
11 be added or subtracted because, when the presumption disappears, "the evidence must be looked at anew  
12 and in total." Appellants also take issue with respondent's citation of authority for the proposition that  
13 "[a] taxpayer's unsupported assertions are not sufficient to satisfy the burden of proof." Appellants  
14 contend that they made no unsupported assertions and respondent's refusal to acknowledge evidence  
15 does not negate it or eliminate it as corroboration for other evidence. (App. Reply Br., pp. 6-8.)

16 Appellants maintain that they made diligent efforts to keep and retain records by hiring  
17 CPAs to manage their affairs, to keep records and accounts, to prepare their returns and to retain  
18 documents necessary to support their reporting and they cooperated with the CPAs in that regard. Thus,  
19 according to appellants, they complied with the applicable law and the evidence shows that books and  
20 records were kept, some of which are available in this appeal. Appellants state that a CPA suffered a  
21 computer crash and some documents were either destroyed or irretrievably lost but that "casualty" was  
22 not a disregard of the regulations. Appellants also acknowledge that they present on appeal many of the  
23 same documents presented at protest because this is a *de novo* review and "the evidence is analyzed in  
24 this appeal quite differently." (App. Reply Br., pp. 8-9.)

25 Appellants argue that the arguments made at protest are irrelevant because "the analysis  
26 used in this appeal is different from the protest arguments" and "how and why respondent arrived at its  
27 determination is legally irrelevant" citing *Crowther v. Commissioner* (9th Cir. 1959) 269 F.2d 292, 293,  
28 and *Greenberg's Express v. Commissioner* (1974) 62 T.C. 324, 327. Appellants further argue that

1 “respondent’s recap of appellants’ argument during the protest is apparently derived from a ‘breakdown  
2 of construction costs’” from the hearing officer’s letter and respondent “completely confuses and  
3 misstates both the evidence and [appellants’] position.” Appellants assert that much of the discussion  
4 during the protest process was confusing, duplicative, and incorrect and some of the evidence was  
5 misunderstood by both parties. Appellants further assert that explanations of the evidence provided by  
6 appellants’ CPA to respondent are not “adopted” on appeal. (App. Reply Br., p. 10.)

7 Appellants state that, contrary to respondent’s characterization, CE Williams and  
8 Associates was the disbursing agent for the construction lender and not the recipient of funds. In  
9 addition, appellants assert that “[a]ny gaps in evidence” concerning construction loan funds that may  
10 have existed during the protest process “have been largely, if not fully, rectified on appeal.” Appellants  
11 further assert that most of the funds can be traced through ledgers and Mr. Williams has testified about  
12 the use of the funds and the minimum necessary construction costs. Appellants contend that the amount  
13 of the construction loan totaled \$4.75 million rather than \$3,311,476, which appears to be a reference  
14 from the hearing officer’s letter. Appellants assert that respondent’s statement that, based on the ledgers,  
15 total deposits to the CE Loan account were \$2,862,174.71 and total disbursements were \$1,199,520.40 is  
16 explained by the declaration of Craig Szabo which states that these amounts are from an “account  
17 register for one of several checking accounts” used by Bruce Sweet and “is corroborated in part by some  
18 available bank records.” (App. Reply Br., pp. 11-12.)

19 Appellants state that respondent’s exhibit F “appears to be a summary of the deposits  
20 made to three of the bank accounts controlled by Bruce Sweet . . . as reflected in two Bruce Sweet  
21 account registers shown in Exhibits 74 and 75.” Appellants state that the summary omits the interest  
22 earned on the accounts in the amount of \$950. Appellants asserts that one column of exhibit F  
23 represents complete deposit records “from *one* bank account” and is compared with expenditures listed  
24 in respondent’s exhibit G, “which is derived from disbursement records regarding *several* bank  
25 accounts, all of which are admittedly *incomplete*.” Thus, appellants contend that exhibit G omits  
26 information, and does not match the exhibit F deposits. Appellants further state that exhibit 75 is a  
27 register for one of several accounts used and covers only the period September 26, 1997 through  
28 June 25, 1999 and the left column of exhibit F includes all deposits except interest for that one account.

1 Appellants further state that exhibit G appears to be derived from appellants' exhibit 72 and other  
2 exhibits and includes only four months of expenditures matching the account used for deposits and "a  
3 limited number of checks/expenditures from several entirely different accounts (shown in Exhibits 70,  
4 71, 73, 78, and 79.)" Appellants assert that exhibit G does not include many of the checks from exhibit  
5 75 and so it does not contribute to a logical analysis of the adjusted basis. (App. Reply Br., pp. 12-13;  
6 Resp. Op. Br., exhs. F and G.)

7 Appellants assert that exhibits 74 and 75 disclose both deposit and disbursement  
8 information and show that the entire amounts deposited to those accounts was spent and are evidence  
9 that "certain other expenses are not accounted for by the deposits to those two accounts." Appellants  
10 further assert that exhibit F, which references exhibits 74 and 75, supports the first step of their analysis  
11 because, as they explain in their opening brief, the \$2.86 million shown in exhibit 75 is added to the  
12 \$383,400 shown in exhibit 74 and totals approximately \$3.2 million in construction costs. Appellants  
13 also argue that the reference to a "Bruce Sweet Loan" is inaccurate because there was no loan to or from  
14 Bruce Sweet and, while appellants' CPA provided a summary at protest of expenses "Paid to  
15 Bruce Sweet", there is no evidence of a loan. In addition, appellants contend that respondent has  
16 conceded that its determination was incorrect and, as a result, the presumption of correctness is rebutted.  
17 Therefore, according to appellants, the question is a determination of the adjusted basis given the totality  
18 of the evidence. Finally, appellants assert that respondent's reference to bank accounts are two accounts  
19 used by Bruce Sweet which are shown in exhibits 70 and 71 and on a single register in exhibit 74 with  
20 deposits totaling \$383,400. Appellants contend that respondent cites no evidence connecting these  
21 accounts to a second construction loan and there is no basis for respondent's comparison of deposits  
22 from the exhibit 74 accounts to "multiple lines" references in the hearing officer's letter because  
23 appellants never claimed that the amounts shown in exhibit E totaling \$1 million were drawn on those  
24 accounts. Thus, the deposits shown in exhibit 74 and the \$1 million characterized as being paid to Sweet  
25 should not be expected to match. (App. Reply Br., pp. 15-16, exhs. 70, 71, and 74; Resp. Op. Br.,  
26 exhs. E and F.)

27 Appellants acknowledge that, at protest, their CPA stated that they paid \$3,802,152 to  
28 various vendors for construction but they assert that "the suggested analytical approach is not taken in

1 this appeal.” Appellants also take issue with respondent’s position that their “attested documents” are  
2 “uncorroborated assertions” that do not support appellants’ adjusted basis and respondent’s reliance on  
3 the *Appeal of Magidow* in that regard. Appellants contend that the *Appeal of Magidow* involved  
4 uncorroborated assertions by the taxpayer whereas here all of appellants’ assertions are corroborated,  
5 including “appropriate and probative” third party attestations and photographic evidence. Additionally,  
6 appellants state that they purchased a “virtual tear-down house” for \$2.86 million and constructed a  
7 home that sold for \$25 million and there is further support from check registers, partial bank records and  
8 testimony from contractors, subcontractors and suppliers, and the lender’s disbursing agent. Appellants  
9 contend that respondent errs by relying on the evidence provided at protest “which is irrelevant to this  
10 de novo proceeding.” (App. Reply Br., pp. 16-17.)

11 Appellants contend that respondent cites Treas. Reg. sec. 1.6001-1(a) “as support for its  
12 vague assertion that evidence other than checks are ‘uncorroborated’” which is an attempt “to refute[] an  
13 analytical approach” that appellants have not used. Appellants further contend that the suggestion that  
14 there is any authority for the proposition that only bank records may be used as evidence “is either  
15 reckless or dishonest.” Appellants contend that the law does not require the use of bank records and any  
16 competent evidence is permissible, citing California Evidence Code section 351. Appellants also take  
17 issue with respondent’s position that the Cohan rule does not apply because appellants have not shown  
18 “clear evidence of some amount of capital expenditures.” Appellants assert that the construction of a  
19 \$25 million mansion is clear evidence of capital expenditures. Appellants further assert that they have  
20 shown, and respondent concedes, that respondent’s adjusted basis determination at protest was incorrect.  
21 Thus, appellants contend that respondent’s reliance on the *Appeal of Swimmer* is misplaced because in  
22 that appeal this Board held that it would not alter respondent’s determination “unless facts appear from  
23 which a different approximation can be made.” Here, appellants contends, the facts show that the  
24 determination was incorrect and, for that reason, the presumption of correctness disappears. As a result,  
25 appellants contend that the only inquiry is whether the evidence is consistent with the claimed adjusted  
26 basis of \$13.5 million and that Garden Lane could not have been constructed for the amount determined  
27 by respondent. (App. Reply Br., pp. 18-19.)

28 Appellants assert that they do not rely on the Cohan rule as a substitute for meeting their

1 burden of proof. Appellants state that, under the Cohan rule, the taxpayer must first show that some  
2 amount was spent which is satisfied by the construction of Garden Lane and then must show sufficient  
3 evidence to allow a reasonable estimate of costs which appellants claim they have done. Appellants  
4 repeat their statements that there is photographic evidence and assert that the best evidence is  
5 Carl Williams' testimony and report which estimates construction costs of not less than \$9.988 million  
6 and that respondent does not challenge Mr. Williams' conclusions. Appellants contend that such amount  
7 (i.e., \$9.988 million) added to the purchase price of \$2.8 million results in a minimum basis of  
8 \$12.788 million which is consistent with the reported basis of \$13.526 million. (App. Reply Br., pp. 19-  
9 20.)

10 Appellants contend that they rebutted the presumption of correctness by showing the  
11 following facts which respondent has not refuted or challenged:

- 12 • Respondent's reliance on the amount of debt secured by the property as "the foundation" of its  
13 determination was a flawed method because it does not suggest the total cost of purchase or the  
14 cost of improvements.
- 15 • It is "illogical and contrary to common, ordinary experience" to suggest that a \$2.8 million  
16 acquisition and expenditure of \$3.8 million in improvements would yield a property that sold for  
17 \$25 million over the period during which prices rose by no more than 100 percent.
- 18 • The financial records establish an adjusted basis significantly greater than respondent's  
19 determination, which respondent conceded by acknowledging that its basis determination should  
20 be increased.
- 21 • An expert who was engaged by the lender to oversee the use of construction loan funds testified  
22 that the construction costs must have been at least \$9.988 million resulting in a basis of \$12 to  
23 \$13 million.

24 (App. Reply Br., pp. 20-21.)

25 With respect to the disallowed cost of sale item, appellants contend that IRS publications  
26 are not legal authority and that respondent cites no recognized authority for its position that a  
27 "miscellaneous expense" may not be used to reduce the amount realized from the sale. Appellants state  
28 that the escrow closing statement lists the \$11,670 in the section titled "Reductions in Amount Due to

1 Seller” and, thus, it was not an expense but was “an effective reduction of the price.” Appellants  
2 conclude that this “credit to the buyer” clearly reduced the amount realized because it reduced the  
3 “effective amount” from the buyer.<sup>5</sup> (App. Reply Br. pp. 21-22.)

4 Additional Briefing

5 By letter dated November 2, 2012, the Appeals Division requested additional information  
6 concerning the claimed adjusted basis of Garden Lane based on the Appeals Division’s review of  
7 property tax assessment records and building permits which indicated reported costs of construction that  
8 were at variance with appellants’ reported costs of construction. The letter informed the parties that  
9 records from the Santa Barbara County Assessor’s office showed that a new base year value of  
10 \$5,103,024 was enrolled for the 1999/2000 assessment year and that assessed value was increased by the  
11 inflation factor pursuant to Article XIII A, section 2(a), of the California Constitution for each year  
12 through the 2005/2006 assessment year. Enclosed with the letter was a form from the Assessor’s office  
13 dated January 15, 1999, requesting information about new construction at Garden Lane. The form was  
14 signed under penalty of perjury and stated that the project was a “complete remodel”, was 100 percent  
15 complete by December 15, 1998, and the total costs of construction were \$2,859,000 as of the date of  
16 completion. The letter also stated that the demolition and construction authorized by the building  
17 permits appeared to be consistent with the work described in the briefing and requested that appellants  
18 explain the disparity between the construction costs reported to the Assessor’s office and the amount  
19 reported to substantiate their claimed adjusted basis in Garden Lane.

20 Appellants’ Additional Brief

21 Appellants list various building permits and state that, on or about January 15, 1999, the  
22 Assessor’s office sent an inquiry letter referencing a permit for the removal of an existing pool which  
23 requested a project description, the date of completion, or an estimate of the percentage of completion  
24 and the total cost of work completed as of January 1, 1999. Appellants state that this permit had a final  
25 sign off as of March 4, 1999, and the other permits that had final sign offs as of January 29, 1999, were  
26 for demolition of the interior and roof, and for grading while the remaining permits remained open.  
27

28 <sup>5</sup> In respondent’s supplement brief, summarized below, at page 23, respondent states that it made a determination to allow appellants to deduct this expense after reviewing appellants’ “most recent documents submitted regarding the expense.”

1 Appellants state that someone in Szabo's firm completed the form but the amount stated, the original  
2 purchase price of the property, was a mistake and Mr. Szabo signed the form without noticing the error.  
3 Appellants state that they were never advised of the inquiry or Szabo's response. (App. Add'l Br., pp. 2-  
4 3, exhs. 112 and 113.)

5 Appellants assert that the error is substantiated by the original property cost which  
6 matches the amount stated on the form. Appellants further assert that the \$2.859 million could not reflect  
7 the complete construction costs by January 29, 1999, as demonstrated by the accrued costs from the  
8 Bruce Sweet ledgers which totaled over \$3 million by year end 1998 and show that construction was  
9 continuing as of January 29, 1999. Appellants also state that, at the time of the response, most of the  
10 building permits remained open. (App. Add'l Br., p. 3.)

11 Appellants contend that they are aware of no authority that would not allow for income  
12 tax purposes the full adjusted basis in a property because of an error in information submitted to the  
13 assessor. Thus, appellants contend that "the Assessor's records do not impact the analysis" presented in  
14 their brief or "the relevant and unrefuted evidence of the costs of construction." Appellants assert that  
15 the Appeals Division has made assumptions and conclusions that are not accurate as follows:

16 The letter stated that, based on appellants' cost reporting, "one would have expected the  
17 assessor enroll a base year value in the range of \$12 to \$14 million after completion of new  
18 construction." Appellants contend that there is no evidence to support that conclusion and that the  
19 statement assumes with any basis that all of such costs are additive, and value increases to the same  
20 extent as the costs incurred. Appellants also contend that, absent an inquiry from the assessor, there is no  
21 duty to report construction costs, the inquiry letter was ambiguous but Szabo provided a response of  
22 broader scope than requested, and, even if the construction costs had been correctly reported, there is  
23 "unequivocal" evidence that substantial costs were incurred after January 29, 1999. Appellants assert  
24 that a further inquiry by the assessor could have prompted examination and possible correction of the  
25 error and would likely have resulted in a further increase in the assessor's valuation "by the amount of  
26 the construction costs related to the permits issued after January, 1999." (App. Add'l Br., pp. 4-5.)

27 Appellants assert that the assessed valuation and the income tax basis cannot necessarily  
28 be expected to match and it would be reasonable to expect a highly variable degree of disparity.

1 Appellants further assert that there is no factual basis for the conclusion of the Appeals Division that  
2 “four permits covered all the construction” and nine permits were issued. Appellants also contend that  
3 there is no evidence to conclude that all work done on Garden Lane would have required permits or that  
4 all costs are reflected in the work described in the building permits. Appellants assert that all costs are  
5 not reflected in the permits and specific portions of construction are excepted from permit requirements,  
6 including most finish work and appliances, which may be significant. Appellants also assert that the  
7 Appeals Division concluded that the disparity between the reported basis and the assessed valuation was  
8 due to “additional construction, if any, that was completed but not reported to the assessor.” Appellants  
9 state that none of the construction costs were actually reported to the Assessor’s office and that the  
10 response to the January, 1999 letter erroneously stated property acquisition cost rather than any  
11 construction costs. Appellants maintain that absent further inquiry they had no obligation to report costs  
12 to the Assessor’s office. Thus, appellants conclude that the Assessor’s records are not a reliable indicator  
13 of income tax basis. (App. Add’l Br., pp. 6-7.)

14 Appellants state that “it appears that the Appeals Division’s independent investigation  
15 itself may have been beyond the scope of its role” and cites Board Rule for Tax Appeals section 5523.6  
16 which provides that, in addition to evidence submitted by the parties, the Board may take “official notice  
17 of any fact that may be judicially noticed by the courts of this State.” Appellants also cite California  
18 Evidence Code sections 450 through 452.5 which set forth matters that may be judicially noticed and  
19 state that assessor’s records are not specifically or categorically included. Appellants further state that  
20 they are concerned that the Appeals Division “has engaged in advocacy or prejudged the merits of this  
21 case” and that the Appeals Division “might conclude that it is justifiable to use the income tax system to  
22 ‘punish’ the taxpayers for an error in respondent to the Assessor’s inquiry regarding property taxes, or  
23 otherwise recoup whatever perceived property tax windfall might have resulted from the error, despite  
24 the lack of any legal authority or justification for such an approach.” (App. Add’l Br., pp. 7-8.)

#### 25 Respondent’s Additional Brief

26 Respondent states that the issues raised in appellants’ additional brief have been fully  
27 addressed in respondent’s opening brief. Respondent also asserts that appellants’ argument that not all of  
28 the construction work on Garden Lane required a permit does not address the issue of appellants’ failure

1 to substantiate by documentation the construction costs necessary to determine a correct adjusted basis  
2 in the property. Respondent also points out that appellants state they did not report “substantial  
3 construction costs” incurred after January 29, 1999 because the Santa Barbara County Assessor’s office  
4 did not make further inquiry. However, respondent notes that appellants also state that “it was they, who  
5 failed to report construction costs beyond January 29, 1999.” Finally, respondent states that appellants  
6 assert that the information from the Assessor’s office has no probative value but they offer no evidence  
7 to support their claimed adjusted basis. Respondent further states that appellants have already been  
8 allowed an increase to the adjusted basis during the appeal process and, without documentation, no  
9 further increases are merited. (Resp. Add’l Br., pp. 1-2.)

#### 10 Summary of Appeals Conference

11 On June 18, 2013, the Appeals Division held a prehearing conference at which time the  
12 following issues were discussed:

- 13 • Appellants’ counsel stated that there have been difficulties in obtaining documentation to support  
14 appellants’ position on appeal and respondent explained that it has the authority to request  
15 records and issue subpoenas under R&TC section 19504.
- 16 • Respondent presented records from the Santa Barbara County Assessor’s office indicating that  
17 the “guest house” over the garage described in Mr. Williams’s report had not been constructed  
18 prior to appellants’ sale of Garden Lane. Appellants agreed to review the documents from the  
19 Assessor’s office to determine whether the guest house over the garage had been  
20 completed while appellants owned the property.
- 21 • Appellants requested information from respondent concerning appellants’ sale expenses and the  
22 application of the penalty against appellants’ account. Respondent agreed to provide the sale  
23 expense and penalty information.
- 24 • Appellants agreed to provide copies of the computer-generated data sheets for the construction  
25 loan and a packet of photos Mr. Williams brought to the conference.

26 After the conference, the parties submitted the following information and took the  
27 following actions:

- 28 • By letter dated July 10, 2013, respondent requested authorization from appellants to review

1 financial information from First Republic Bank regarding their construction and mortgage loans  
2 related to Garden Lane for the years 1997 through 2005. The letter stated that respondent would  
3 request a description of all loans, the purpose and amounts of the loans, any documents and  
4 correspondence, any appraisals, any records, ledgers, or other writings reflecting the property  
5 value, complete loan applications, inspection reports and any other documents related to the  
6 purchase, improvement, or refinance of the property. Appellants executed the authorization on or  
7 about July 18, 2013.

- 8 • By letter dated July 18, 2013, respondent notified appellants that it was allowing a reduction of  
9 the amount realized on the sale by \$68,156.00 as stated in respondent's opening brief, which  
10 resulted in total selling expenses of \$1,322,826.50. The letter also states that respondent believes  
11 the failure to furnish penalty was properly imposed because appellants were granted numerous  
12 extensions to provide the requested information and failed to do so. Attached to the letter was a  
13 copy of an escrow settlement statement dated April 29, 2005.
- 14 • In an email message to the Appeals Division and respondent dated July 5, 2013, appellants'  
15 counsel stated that he had confirmed that the guest house had not been constructed by appellants.  
16 He explained that appellants referred to the "pool house" as both the "pool house" and "guest  
17 house" which resulted in a misunderstanding that was not recognized by appellants. Appellants'  
18 counsel also requested additional time in the supplemental briefing schedule to correct this error.

19 By letter dated July 10, 2013, the Appeals Division provided a supplemental briefing  
20 schedule which allowed appellants 30 days to provide additional documentation, including a revised  
21 appraisal report by Mr. Williams, a 90 day period for respondent's supplemental reply brief and a 30 day  
22 period for appellants' supplemental reply brief.

### 23 Appellants' Supplemental Brief

24 Appellants state that they confirmed after the appeals conference that, although  
25 architectural plans were prepared and permits were granted, the guest house had not been constructed  
26 prior to the sale of Garden Lane in 2005. Appellants further state that they and their contractor,  
27 Bruce Sweet, referred to the "pool house" and "guest house" as the same structure and, as a result,  
28 appellant-wife "was not alerted to any issue by the use of both terms in her declaration." Appellant-wife

1 submitted a second declaration as an exhibit to the brief. Appellants further state that Mr. Williams  
2 revised his conclusions in a supplemental declaration to reflect the correction which states a minimum  
3 cost of construction of \$9,783,783, affirms that construction costs could not have totaled approximately  
4 \$4.5 million, and states that the claimed adjusted basis was within the range of a reasonable probable  
5 cost of construction. (App. Supp. Br., pp. 1-2.)

6 Appellants contend that “neither the actual project nor its cost changed” as a result of the  
7 error and Mr. Williams’s conclusion of the minimum cost of construction changed by only 2 percent.  
8 Appellants further contend that the extensive improvements which they believed were made to the guest  
9 house were actually for the pool house. Appellants repeat their contentions that the original  
10 documentation of the costs of construction was not available due to mistakes by their accountants and  
11 business managers, any available documentation is already in the record, and their expert report and  
12 photographs and other evidence was submitted as alternative evidence pursuant to the Cohan rule.  
13 Appellants assert that respondent’s determination has been shown to be clearly erroneous and  
14 appellants’ claimed adjusted basis is within a reasonable range of probable actual costs. (App. Supp. Br.,  
15 pp. 2-3.)

16 Appellants state that, during the appeals conference, appellants’ counsel discovered that  
17 respondent might contend and the Appeals Division might agree that the presumption of correctness is  
18 applicable to “any position [respondent] might take during the course of this (or any) tax proceeding.”  
19 Appellants dispute that interpretation of the law and cite *Valley Title Company v. Commissioner*  
20 (9th Cir. 1977) 559 F.2d 1139, in which the court held that the determination of a deficiency is  
21 presumed correct. Appellants assert that the term “determination” is “the specific determination,  
22 disclosed in a statutorily-required notice, which provides the taxpayer with the statutory right to contest  
23 it.” Appellants further assert that such a specific determination is presumed correct “until the  
24 presentation of evidence sufficient to support an alternative conclusion.” Once such evidence is  
25 presented, appellants contend that “the presumption has disappeared for good and the normal burden of  
26 proof applies.” (App. Supp. Br. p.4.)

27 Appellants contends that the only determination that exists for purposes of this dispute is  
28 set forth in the NOA and that determination has been shown by the evidence and respondent’s briefing

1 to be incorrect. Thus, appellants contend that respondent may no longer rely on the presumption and  
2 appellants have shown by uncontradicted evidence and reliance on the Cohan rule that the claimed  
3 adjusted basis is correct. (App. Supp. Br., p. 4.)

4 With respect to the remaining item of expenses of sale in dispute, appellants attach an  
5 exhibit which they asserts shows that the credit in question was a “quid pro quo for the release of some  
6 contingency(ies) of closing escrow, further substantiating the debit as a reduction of the amount realized  
7 in an effective renegotiation of the transaction.” (App. Supp. Br., p. 5 and exh. 141.)

#### 8 Respondent’s Supplemental Brief

9 In the introduction to the supplemental brief, respondent asserts that appellants have  
10 failed to substantiate over \$8 million in construction costs which constitutes over 80 percent of the  
11 claimed expenses with verifiable financial documents. Despite the lack of documentation, respondent  
12 states that it has allowed an adjusted basis of \$7,180,671 which includes construction, improvements,  
13 and other costs of \$4,322,545. Respondent further asserts that Mr. Williams’s initial report was based on  
14 erroneous information discovered by respondent and, rather than acknowledging his mistake and only  
15 deducting the amount for the guest house, he made other adjustments that offset that reduction in basis.  
16 In addition, respondent contends that Mr. Williams’s report is inconsistent with an appraisal performed  
17 closer in time to the construction and sale of the property. Respondent also states that it engaged an  
18 expert in construction valuation, Kory Kruckenberg, and attached a declaration from Mr. Kruckenberg  
19 in which he concluded that overall construction costs for Garden Lane could have been \$3,903,410.  
20 (Resp. Supp. Br., p. 1 and exh. R.)

21 Respondent contends that appellants’ argument has “transformed at every stage of this  
22 administrative process.” Respondent states that appellants filed the 2005 return with a reported gain of  
23 \$10,139,773 and, during the 15-month audit, respondent attempted to obtain information from appellants  
24 to confirm that reporting. When appellants failed to provide the requested information, respondent states  
25 that it relied on available public records to determine an adjusted basis for Garden Lane. Respondent  
26 further states that, during the protest, appellants provided some documentation and initially maintained  
27 that the total adjusted basis of \$13,392,374 was calculated based on land cost of \$2,843,551,  
28 construction costs of \$8,433,506, construction period interest of \$739,099, capitalized mortgage interest

1 of \$1,358,792 and loan fees of \$17,420. Respondent states that appellants then provided another  
2 adjusted basis of \$11,631,826 with the following items and costs: land, \$2,952,996, improvements,  
3 \$4,347,284, refinance fees, \$17,420, landscaping, \$62,510, repairs, \$142,147 and construction costs,  
4 \$4,109,468. Respondent assert that, on appeal, appellants introduced an entirely new argument. After  
5 abandoning their claim that construction period interest and mortgage interest may be capitalized and  
6 added to basis, appellants argue for the first time that their claimed adjusted basis is supported by an  
7 expert witness cost estimate of at least \$9,783,783.20, which was revised from \$9,987,962. (Resp. Supp.  
8 Br., pp. 2-3, exhs. H and I.)

9           Respondent further states that the appeals conference brought to light the erroneous  
10 information about the construction of the guest house which was included in Mr. Williams's report.  
11 Respondent states that appellants previously maintained that they built a guest house above the existing  
12 garage which included a bedroom, full kitchen, full bathroom, with Calcutta slab marble, wood floors,  
13 and an audio visual package. After respondent's inquiry, appellants acknowledged that the guest house  
14 had not been built and they maintain that they confused the guest house with the pool house. Respondent  
15 points out that, unlike the guest house, the pool house is a free-standing structure that was built as part of  
16 the original construction project in 1997 and 1998. Respondent notes that the guest house and pool  
17 house are clearly distinguished in appellant-wife's original declaration and "explicitly described".  
18 Respondent further notes that appellant-wife executed an agreement with the Santa Barbara Assessor's  
19 office in 1997 which stated that the pool house would not include a kitchen or sleeping quarters and was  
20 not to be used as a guest house. (Resp. Supp. Br., pp. 3-4, exhs. J and S.)

21           Respondent contends that the "shifting computations of basis and the legal and factual  
22 positions" of appellants, such as the guest house confusion, create uncertainty about the actual work  
23 performed and the credibility of witness statements. As an example, respondent states that there does not  
24 appear to be a permit for the addition of a master bathroom and remodeled master closet which occurred  
25 between 2002 and 2003, as stated in appellant-wife's declaration. Respondent asserts that such  
26 construction would likely require architectural drawings, building and planning approval, and septic  
27 approval. Due to those questions, respondent sought the opinion of an expert familiar with construction  
28 of like homes in the Montecito area. (Resp. Supp. Br., pp. 4-5, exh. R.)

1 Respondent contends that, at the conference and in the supplemental brief, appellants  
2 contend that the taxpayer is relieved of the burden of proof “if the taxpayer is able to establish any sort  
3 of error in the FTB’s determination, even if the ‘error’ they allege is based on omitted evidence or  
4 incorrect information provided by the taxpayers.” As an example, respondent states that appellants  
5 contend that respondent’s adjustment of the assessment during the appeal process proves that  
6 respondent’s assessment is incorrect, even though the adjustment was based on additional  
7 documentation provided with appellants’ opening brief. According to appellants’ reasoning, respondent  
8 contends that this interpretation of the burden of proof would reward taxpayers for withholding  
9 information or providing incorrect information during an audit and protest in order to argue error in the  
10 assessment. In addition, respondent maintains that this argument “fails to satisfy the underlying purpose  
11 of the burden of proof” which is placed on the taxpayer as the party who is generally in control of the  
12 relevant evidence, citing the *Appeal of Eugene and Lily Heller* (97-SBE-014), decided November 20,  
13 1997. (Resp. Supp. Br., p. 5.)

14 Respondent contends that appellants have failed to meet their burden of proof by  
15 presenting uncontradicted, credible, competent, and relevant evidence to prove error in respondent’s  
16 determination. Respondent states that appellants have admitted losing information that would  
17 substantiate their claimed \$10 million in expenditures related to Garden Lane. Respondent asserts that  
18 the failure to produce these records give rise to a presumption that those records if produced would be  
19 unfavorable to appellants, citing the *Appeal of Don Cookston* (83-SBE-048), decided January 3, 1983.  
20 Respondent also asserts that, during the protest and appeal, appellants have provided some evidence  
21 relevant to the basis but respondent has already allowed basis adjustments for any evidence that is  
22 uncontradicted, credible, competent, and relevant and has allowed adjustments significantly greater than  
23 the evidence supports by applying the Cohan rule. (Resp. Supp. Br., pp. 5-6.)

24 Respondent contends that it properly denied basis adjustments based on the attestations  
25 for several reasons:

- 26 • The costs quoted by each service provider appear to represent costs that respondent has probably  
27 already allowed in the \$4.3 million allowance for improvement costs. This amount includes the  
28 entire amount of appellants’ claimed construction loan during the protest in the amount of

1 \$3,311,476 which appears to have been used to pay construction costs through June 25, 1999.  
2 Respondent asserts that much of the work described in the attestations occurred prior to and  
3 during 1999, so it is reasonable to presume that the service providers received payment through  
4 the construction loan.

- 5 • The attestations identify in dollars a gross amount of work performed and also identify numerous  
6 projects completed over multiple years. Thus, the attestations lack the specificity to have any  
7 evidentiary value because it is impossible to trace any specific dollar amount to any project to  
8 determine whether the payment was made.
- 9 • The attestations failed to state who paid the service provider or whether the service provider  
10 received payment from appellants' personal bank account or an account that held construction  
11 loan funds.
- 12 • The attestations do not establish on which facts or documentation such costs were established  
13 and such professionals generally retain documents related to a construction project for a  
14 minimum of ten years which is the time period for filing a construction defect lawsuit. It is  
15 troubling that those documents were not made part of the record and instead the attestations  
16 appear to be based almost entirely on old recollections and approximations provided to  
17 appellants' counsel who prepared the attestations.

18 (Resp. Supp. Br., pp. 6-7.)

19 Respondent concludes that the attestations are unreliable as gross estimates or very  
20 speculative numbers gleaned from appellants' recollections and thus are not credible evidence for an  
21 increase in basis. In addition, respondent contends that many of the attestations conflict with other  
22 evidence in the record or are questionable upon closer examination. Respondent describes the  
23 attestations in greater detail as follows:

24 Juliana Rondelle, faux painter – This is “the most troubling” because it is unsigned and presumably was  
25 never reviewed by the attestant and is not supported by any documentation of cost. In addition, the  
26 initial construction loan budget included \$7,182.00 for faux painting according to the Project Cost  
27 Analysis data provided to respondent during the conference, and an additional \$43,449.44 for painting  
28 and the painting was completed as of the September 28, 1998 inspection before the construction loan

1 funds were expended. The Itemized Categories Report provided during the protest reflects \$32,470 for  
2 faux finishing and \$196,320 for painting, which amounts were allowed as part of the original claimed  
3 construction loan.

4 Barrett Heating & Air Conditioning – The attestation states that appellants paid \$89,000 in August, 2000  
5 to install air conditioning because the home was built without it which directly contradicts the  
6 Project Cost Analysis data provided at the conference which shows that the construction loan budgeted  
7 \$19,000 for heating and air conditioning which was disbursed and was 90 percent complete on  
8 September 28, 1998. In addition, HVAC costs were listed as \$31,702 and \$1,814 in the Itemized  
9 Categories Report provided at protest. The attestation contradicts the handwritten log provided during  
10 the protest by Bruce Sweet which includes entries for HVAC and a new air conditioner in late 1997 and  
11 1998. There do not appear to be any permits for work performed in 2000 and the installation of a new air  
12 conditioning unit would likely have required a permit and mechanical drawings filed with the building  
13 department. Moreover, appellants have not stated that they lived in a home without air conditioning until  
14 August, 2000.

15 James Boysel, Landscape Superintendent – The attestation states that appellants paid him \$137,223 for  
16 “labor and materials” and \$626,300 for supplies between June 1998 and 2004 but is not supported by  
17 invoices or other supporting documentation and it is not clear whether these are costs for improvements  
18 to the property that would be added to the basis or are merely maintenance expenses. The Itemized  
19 Categories Report included \$456,202 in landscaping costs paid from the original construction loan  
20 which was allowed at protest as well as an additional \$62,510 in such costs. Mr. Sweet’s log lists  
21 payments for landscaping, supplies, materials, and labor and respondent allowed an additional \$383,400  
22 on appeal for payments made to the Bruce Sweet construction account. Thus, respondent has already  
23 allowed more than \$500,000 in landscaping costs.

24 Sandra Devine, Landscape Architect – The attestation states that appellants paid her \$53,000 from 1997  
25 to 1999 which included \$28,000 for labor and \$25,000 for materials but these costs contradict the  
26 Project Cost Analysis at line 46 which shows that the construction loan already budgeted \$73,066.94 for  
27 landscaping costs and described these costs as 100 percent complete as of August 27, 1998.

28 Iain Garner, Finish Carpenter – The attestation states that he received \$181,000 for work performed in

1 2000 and 2002 including building a mudroom and media room and remodeling the fireplace hearth and  
2 flue and the kitchen and family room, and redoing drainage in the basement. There are no permits to  
3 reflect this work during those years and the addition of a fireplace, mudroom, basement and kitchen and  
4 family room remodel would appear to require a permit under the California Building Code.

5 Chris Kay, Mason Carpenter – This attestation and the attestations of Mr. Lundin and Mr. Sweet all take  
6 credit for doing essentially the same work and, as described above, the guest house was never  
7 constructed. Mr. Kay claims to have received \$300,000 for building a guest house in 1999, which he  
8 then rebuilt in 2003 (after an alleged septic flood) building an outdoor entertainment area, outdoor  
9 kitchen, foundation for the conservatory, and hardscape around the pool for which he allocates \$170,000  
10 for labor and \$130,000 for materials. It is unclear whether the attestation refers to the pool house or  
11 guest house that was never built and any costs incurred in 1999 were likely paid from the construction  
12 loan. In addition, these amounts could have been included in several different items in the Itemized  
13 Categories Report which shows the payment of \$130,295 for the pool house which was allowed in full.  
14 Respondent also allowed \$6,143 for foundations, \$35,468 for stone work and \$42,694 for patios, which  
15 amounts may overlap with Mr. Kay's claimed costs.

16 Ken Lundin, Contractor/Finish Carpenter – The attestation states he received \$365,000 for work  
17 performed in 1999 and 2003 and costs could be attributed to various budget categories paid through the  
18 construction loan as detailed in the Project Cost Analysis. There is no detailed statement of each cost  
19 item and the Itemized Categories Report lists \$354,810 for carpentry and \$57,402 for stairs, which  
20 amounts were allowed as payments from the original construction loan. Mr. Lundin also describes  
21 building a conservatory but appellants have stated that the conservatory was purchased pre-fabricated.

22 Corey Sweet, Finish Carpenter – He claims he received \$91,000 for work in 2002 and 2003 installing  
23 the outdoor conservatory, outdoor kitchen, and mounting and framing a television, which conflicts with  
24 Mr. Lundin's statement that he built the conservatory. The Itemized Categories Report assigns \$52,202  
25 to the installation of the conservatory which was allowed at protest as a payment from the original  
26 construction loan.

27 Locker Pool, Pool/Spa Contractor – The attestation states costs of \$120,000 to build a pool, spa,  
28 children's pool, fountain pool, and koi pond which contradicts the Project Cost Analysis which budgeted

1 \$28,000 for a pool completed in 1998. There are no permits for a children's pool, fountain pool, or koi  
2 pond but there are permits for a new pool and spa with an estimated value of \$40,000 which accords  
3 with the amount listed in the Itemized Categories Report of \$44,009 which was allowed as a payment  
4 from the original construction loan.

5 McCoy Electric – The attestation describes electrical work for gates, a floodlight system and creek,  
6 performed in 1999 and 2002, most of which may be incorporated in various budget categories in the  
7 Project Cost Analysis and most likely were already paid from the original construction loan. Electrical  
8 work costs were listed as \$61,000 in the initial budget and work was 95 percent complete as of the  
9 September 28, 1998 inspection. In addition, the Itemized Categories Report lists \$151,426 in electrical  
10 costs which was allowed as a payment from the original construction loan.

11 Don Nulty, Architect – The attestation lists \$350,000 for architect and engineering work that was likely  
12 already paid from the original construction loan. The Itemized Categories Report listed \$83,884 in  
13 architectural expenses paid from the construction loan and, during the protest, respondent allowed an  
14 additional \$28,265 of costs based on invoices for total allowed architectural costs of \$112,149.

15 Bruce Sweet, Contractor – The attestation states that he received \$230,000 for work performed in 1998,  
16 1999, and 2000 but he does not identify the dates the work was performed. It appears that he received  
17 payment from the original construction loan for these amounts. (Resp. Supp. Br., pp. 7-12.)

18 As stated above, Corey Sweet's claim of installing the conservatory conflicts with  
19 Ken Lundin's claim of building the conservatory but, nonetheless, respondent states that \$52,202 was  
20 allowed as the cost of installing the conservatory. Respondents contends that the attestations are not  
21 uncontradicted, credible, competent, and relevant evidence and it is likely that the majority of these  
22 expenses have already been allowed as payments from the original construction loan of \$3,311,476.  
23 Thus, respondent concludes that appellants have not established error in respondent's determination that  
24 would overcome the burden of proof. In addition, respondent contends that the \$25 million sale price of  
25 Garden Lane does not prove that appellants spent at least \$10 million improving the property.  
26 Respondent asserts that property values were soaring in 2005 and the fact that appellant-husband is a  
27 celebrity may have resulted in a buyer paying substantially more for the property. Respondent further  
28 asserts that the sales price of a property is not a factor to be considered in the computation of basis and

1 does not demonstrate error in respondent's determination. Finally, respondent contends that this  
2 argument is inconsistent with the independent appraisal dated December 19, 2003. (Resp. Supp. Br.,  
3 p. 13, exh. U.)

4 Respondent maintains that appellants misconstrue the burden of proof which "merely acts  
5 as a tie-breaker in cases where the balance of factual evidence is in equipoise, citing *Payne v.*  
6 *Commissioner*, T.C. Memo. 2003-90 and *Steiner v. Commissioner*, T.C. Memo. 1995-122. Respondent  
7 further states that the appeal will not be determined by the burden of proof when a preponderance of the  
8 evidence favors one party. Therefore, the burden of proof is applicable only if the Board determines that  
9 the evidence on both sides has equal weight. (Resp. Supp. Br., pp. 13-14.)

10 Respondent contends that appellants mistakenly argue that all of their claimed expenses  
11 must be allowed under the Cohan rule. Respondent states that *Cohan* held that, if there is sufficient  
12 evidence to indicate that the taxpayer incurred a deductible expense, but the precise amount cannot be  
13 determined, the finder of fact may make an approximation of the amount "bearing heavily against the  
14 taxpayer whose inexactitude is of his own making." Respondent further states that the courts have held  
15 that there must be some basis for making an estimate, that is, the taxpayer must prove an entitlement to  
16 the underlying expense. Respondent again cites the *Appeal of Swimmer* in which this Board found that  
17 50 percent of unsubstantiated expenses was sufficient to satisfy the Cohan rule and held that the  
18 Cohan rule merely permits the deduction of a "reasonable portion of substantiated expenses" and that  
19 the Board would not alter respondent's determination "unless facts appear from which a different  
20 approximation can be made." Respondent also cites the *Appeal of California Steel Industries, Inc.*  
21 (2003-SBE-001-A), decided on July 9, 2003, in which this Board affirmed the discussion of the  
22 Cohan rule in the *Appeal of Swimmer*. Respondent concludes that appellants have already been granted  
23 substantially more basis than they have proved through verifiable documentation. (Resp. Supp. Br.,  
24 pp. 14-15.)

25 Respondent discusses its application of the Cohan rule by explaining how the  
26 Garden Lane basis determination was made. At protest, respondent states that it added the acquisition  
27 cost of \$2,854,959, purchase expenses of \$3,167, refinance fees of \$14,420, landscaping costs of  
28 \$62,510, constructions costs and improvement of \$3,736,056 for a total of \$6,671,112. The amount of

1 \$3,311,476 for construction costs and improvements was the amount appellants claimed to have  
2 received from a construction loan from First Republic Bank and appellants provided documentation of  
3 an additional \$424,580 from their own funds. On appeal, respondent states that an additional \$383,400  
4 was allowed based on a bank statement, canceled checks, and a check register provided by appellants  
5 showing that this amount was deposited into a bank account that appears to have been controlled by  
6 Bruce Sweet. Respondent also allowed an additional \$126,089 based on a bank account and canceled  
7 checks from appellants' personal account that appear to be payments for items that increase basis. The  
8 addition of these amounts resulted in an adjusted basis determination of \$7,180,601. (Resp. Supp. Br.,  
9 pp. 15-16.)

10 Respondent states that Treas. Reg. sec. 1.6001-1(a) requires, in part, that taxpayers keep  
11 "such permanent books of account or records . . . as are sufficient to establish any amount of gross  
12 income, deductions, credits . . . or other matters required to be shown by such person in any return of  
13 such tax or information." Respondent asserts that there is no precise type of documentation required but  
14 that taxpayers must generally provide more than just a listing or inventory of claimed expenses, they  
15 must maintain hardcopy records to substantiate a computerized record or ledger and "mere bookkeeping  
16 entries" or "summaries of underlying transactions" are generally not sufficient substantiation.  
17 Respondent further asserts that evidence will typically serve to substantiate if it is "a verifiable,  
18 contemporaneously prepared document" which includes canceled checks, bank statements, receipts,  
19 invoice or wire transfer receipts. Here, respondent states that appellants submitted such evidence in the  
20 total amount of \$1,711,115 but respondent allowed \$4,245,545 in improvement and construction costs  
21 and the difference was reflected in ledgers and appellants' claim at protest of receiving a construction  
22 loan in the amount of approximately \$3,311,476, even though the ledgers are incomplete and do not  
23 show the disbursement of the entire amount of the construction loan. By "allowing a generous portion of  
24 the unproven costs", respondent asserts that it has applied the Cohan rule. (Resp. Supp. Br., pp. 16-17.)

25 Respondent states that, on appeal, appellants claim that the construction totaled  
26 \$4.75 million but respondent contends that approximately \$2 million of this amount refinanced the  
27 existing mortgage and only \$2.75 million was available to pay construction costs. Respondent maintains  
28 that it has already allowed \$3.3 million in claimed construction loan amounts. (Resp. Supp. Br., pp. 17-

1 18.)

2 Respondent contends that Carl Williams's report is unreliable because it erroneously  
3 assumed that the guest house had been built. In the revised report, respondent states that Mr. Williams  
4 deducts \$665,000, the value assigned to the guest house, but increases the cost of the pool house by  
5 \$366,705 and adds another \$94,116 for "Other Revised Adjustments". As a result, the estimated value  
6 changed by only \$200,000. Respondent asserts that appellants' explanation of the misunderstanding  
7 between the guest house and pool house does not "diminish the fact that appellants' experts and tax  
8 representatives were misinformed" and "all of appellants' representatives appear to have been  
9 misinformed regarding the work throughout various stages of the administrative process." Respondent  
10 notes that Mr. Williams made the three "significant errors" in his initial report, described above, which  
11 are oversights that call into question his entire revised report which is similarly based on information  
12 provided by appellants. Although appellants contend that Mr. Williams has particular knowledge of the  
13 construction because he was closely involved with the construction loan and property inspection for the  
14 bank, respondent contends that the fact that he was unaware that the guest house was never actually built  
15 highlights the fact that Mr. Williams had no personal involvement with the property after 1999 and has  
16 no "special insight" as to the work performed after that year. (Resp. Supp. Br., pp. 18-19.)

17 Respondent asserts that Mr. Williams appears to have had personal interaction with the  
18 construction from 1997 through 1999 but it is unclear why he did not rely on his actual knowledge and  
19 contemporaneously prepared documentation. Respondent further asserts that Mr. Williams's personal  
20 record would seem to be more reflective of the actual costs rather than relying on appellants'  
21 representations which lead him to believe, among other things, that a guest house was constructed.  
22 Mr. Williams's actual data created during construction lists every category of construction, a budgeted  
23 amount, and "an ultimate statement of the amount of work that was actually completed." Respondent  
24 states that, according to that data, the work was substantially complete by October 27, 1998, the date of  
25 Mr. Williams's final inspection. In his declaration, Mr. Williams states that he made distributions totaling  
26 \$2.1 million but, respondent asserts that, despite having actual budgeted cost data, Mr. Williams used a  
27 questionable method of performing an estimate of the costs that could have been spent based on his  
28 personal knowledge of similar work performed in Santa Barbara County. (Resp. Supp. Br., p. 19, exh. L;

1 App. Op. Br., exh. 92.)

2 Respondent states that the checks and ledgers, which show the payments from the  
3 construction loan accounts and the disbursements, appear to accord with appellants' claim that they did  
4 not have personal funds available during 1997 through 1999 to complete the construction and "they  
5 relied heavily on the construction loan during that period." Respondent further states that "the majority  
6 of the construction and improvement happened during 1997-1999 and, accordingly, the major portion of  
7 the work performed was paid through the construction loan. In addition, respondent states that  
8 Mr. Williams's Project Cost Analysis reflects that, for most categories, 100 percent of the construction  
9 was complete as of October 27, 1998. Respondent further states that most of the building permits reflect  
10 work performed and completed from 1997 through 1999 and that the only permit issued after this period  
11 was for the guest house, which was never built. With respect to the Architectural Digest article of July,  
12 2001, respondent notes that appellant-husband references 15 months of construction which correlates  
13 with the rest of the factual record. (Resp. Supp. Br., pp. 19-20, exhs. L and S.)

14 Respondent states that the invoices and checks submitted by appellants for expenses, all  
15 of which respondent allowed, for finishes and décor were incurred in 1998. Respondent adds that  
16 Bruce Sweet submitted a handwritten log of work performed that included entries in 1998 for appliance  
17 installation, pantry finishing, hardware finishing, and the installation of hardwood floors. Respondent  
18 asserts that this type of work suggests that appellants were applying finishing touches and installing  
19 décor as early as 1998. (Resp. Supp. Br., p. 21.)

20 Respondent states that it obtained appellants' loan file from First Republic Bank but  
21 First Republic Bank informed respondent that the file for the original loan had been destroyed.  
22 However, respondent states that the file contained documents related to a refinancing loan on the  
23 property in 2003, which included an appraisal report for Garden Lane. Respondent notes that the  
24 appraiser, John Harding, appears to have been familiar with the property and work performed because  
25 he previously appraised it in October 21, 1997, July 10, 1998, June 29, 1999, and October 1, 2001.  
26 Respondent states that the appraisal determined a reproduction cost of all improvements of \$5,281,520  
27 as of December 19, 2003, with an additional \$760,000 for the cost of general site improvements such as  
28 security gates, landscaping, and a swimming pool. Respondent contends that this estimate is more

1 credible than appellants' claimed costs because it was performed in 2003, closer in time to the actual  
2 construction than Mr. Williams's report and the appraiser conducted a physical inspection of the  
3 property as well as several prior inspections during the period of construction. In addition, respondent  
4 asserts that the 2003 appraisal is more credible because it was performed independently by an objective  
5 third party. (Resp. Supp. Br., pp. 21-22, exh. U.)

6 Respondent contends that the 2003 appraisal exceeds the basis amount allowed by  
7 respondent but does not indicate that an additional amount should be allowed because the reproduction  
8 cost appraisal was performed several years after the actual construction and Mr. Harding states that  
9 "construction costs have increased substantially over the past five years." Thus, respondent asserts that  
10 appellants' actual costs were significantly lower than the 2003 reproduction costs. In addition,  
11 respondent states that the appraisal valued the property as if the home were a completely new building  
12 whereas the actual construction retained the original foundation and most of the original framing. Thus,  
13 respondent asserts that the 2003 reproduction cost value exceeds the actual costs to appellants which  
14 indicates no increase to basis. (Resp. Supp. Br., pp. 21-22, exh. U.)

15 Respondent states that appellants' homeowner's insurance policies reflect replacement  
16 cost values of approximately \$3.3 million in 1998 and 1999 and \$4.4 million in 2001 and \$4.7 million in  
17 2002 and 2003. Respondent asserts that it is unlikely that appellants would only insure their home for  
18 \$4.7 million if they had spent more than \$10 million to build it. Respondent also references a report of  
19 Kory Kruckenberg, a licensed contractor and residential construction cost valuation expert with  
20 extensive experience in Santa Barbara County and other California counties. Respondent states that  
21 Mr. Kruckenberg also serves as an expert witness in construction-related litigation. After a  
22 comprehensive review of the file, Mr. Kruckenberg concluded that the construction could have been  
23 completed for \$3,903,410 during the relevant time period. (Resp. Supp. Br., pp. 22-23, exhs. R and V.)

#### 24 Second Appeals Conference

25 At appellants' request, the Appeals Division conducted a second appeals conference on  
26 May 20, 2014, to allow the parties' expert witnesses, Mr. Williams and Mr. Kruckenberg, to be  
27 questioned and to present testimony as to their respective value determinations for Garden Lane. By  
28 letter dated August 13, 2014, the Appeals Division requested additional information about specific

1 issues discussed at the conference and requested that the parties file simultaneous briefing and reply  
2 briefing. Appellants were requested to provide additional information regarding the “Project Cost  
3 Analysis” and Mr. Williams’s statements that (1) the document reflects costs funded by an interim loan  
4 and not the costs to complete the project and that the notation “Percent Complete: 98.00%” reflects the  
5 expenditure of funds on certain categories and (2) to explain the purpose of the two sub-columns titled  
6 “Disbrs” and “Complt” after each line item category. Appellants were also asked to provide an  
7 explanation for Mr. Williams’s adjustments to the cost determination based on the nonexistence of the  
8 guest house and to explain his disagreement with the statement from the Harding Appraisal that “the  
9 remodel has utilized the entire existing foundation, which is raised with a finished cellar area.”  
10 Respondent was asked for an explanation of Mr. Kruckenberg’s basis for his determination that a  
11 photograph that he stated showed that about 95 percent of the lower floor appeared to be completely  
12 intact after the completion of demolition was taken after demolition had been completed. Respondent  
13 was also asked for any legal authority to supported Mr. Kruckenberg’s statement that the addition of a  
14 master bathroom, the installation of a new air conditioning system, and a basement remodel would have  
15 required county building permits.

#### 16 Appellants’ Second Supplemental Brief

17 Appellants assert that Mr. Williams is not a “hired gun” but rather a professional who  
18 oversees the disbursement of construction loan funds and the costs of construction for lenders.  
19 Appellants state that Mr. Williams, a licensed contractor, acquired a specific expertise in construction  
20 costs and has a “rich trove” of comparable cost data as a result of years of such work. As an expert in  
21 relevant costs and with first-hand knowledge of this project and many like it in the area, appellants state  
22 that Mr. Williams’s concluded that respondent’s basis determination is “grossly inadequate for this  
23 project.” In addition to Mr. Williams’s analysis, appellants state that there are a substantial number of  
24 documents available that support his conclusions. (App. 2d Supp. Br., p. 2.)

25 Appellants contend that respondent “has sought desperately to discredit Mr. Williams’  
26 conclusions” and “searched desperately for some ‘gotcha’ evidence – evidence that somehow would rip  
27 such a gaping hole in appellants’ case that it would crumble.” Appellants contend that one of  
28 respondent’s “consistent and specious arguments” is that appellants have been inconsistent in their

1 arguments and computations. Appellants argue that they have always maintained that the basis used to  
2 compute the gain on the return represents the most accurate calculation of basis because it was  
3 determined by the Szabo firm employee most knowledgeable of the facts closest in time to when the  
4 costs were incurred. Appellants assert that, during the appeal, they and respondent have made efforts to  
5 reconstruct or rediscover the exact costs for purposes of respondent's examination despite the absence of  
6 adequate documents. Appellants acknowledge that, prior to the appeal stage of the process, their  
7 representative made "different basis computations" but appellants contend that respondent's agents  
8 "were equally inconsistent in their own analysis of, and conclusions from, the exact same evidence."  
9 Appellants list dates and differing basis amounts determined by respondent "based on the exact same  
10 documents and information that appellants' representatives had at the time." Appellants conclude that  
11 the only significance of the clear inconsistencies in both parties' analyses is that the available  
12 documentation is insufficient to prove the construction costs with any certainty. Appellants contend that,  
13 as a de novo appeal proceeding, the record in the prior administrative stages is irrelevant. (App.  
14 2d Supp. Br., pp. 4-5.)

15 Appellants contend that respondent has been inconsistent in its position about the  
16 application of the Cohan rule by stating in its opening brief that the rule does not apply and later that the  
17 Cohan rule was already applied by respondent. Appellants further contend that respondent has been  
18 wrong on both counts because the Cohan rule applies and respondent's determinations are not consistent  
19 with "the letter or spirit of *Cohan*." (App. 2d Supp. Br., p. 5.)

20 With respect to the error about the construction of a guest house in Mr. Williams's  
21 analysis, appellants state that they explained the confusion about the guest house and pool house and  
22 Mr. Williams amended his report. Appellants address respondent's point that appellants agreed with the  
23 county that the pool house would not contain a kitchen or sleeping quarters by arguing that the pool  
24 house was built without those features to be compliant with the county restriction but the kitchen and  
25 sleeping quarters were later added and finished, "as was undoubtedly" appellants' intention. Appellants  
26 further argue that the agreement with the county is irrelevant and that a "local Santa Barbara counsel"  
27 informed them that the county only wanted "to prohibit commercial renting of . . . guest houses" and  
28 was not concerned about "true 'guest' quarters" for the temporary use of personal guests. Appellants

1 contend that guest houses “presumably in technical violation of these agreements were (and probably  
2 still are) common.” (App. 2d Supp. Br., pp. 7-8, exh. 142.)

3 Appellants assert that respondent takes the position that Mr. Williams’s revised report  
4 made an error by adding back the costs of the kitchen and sleeping quarters. Appellants contend that  
5 these additions are the appropriate costs of the construction of these improvements and that the \$200,000  
6 amount at issue is minor. (App. 2d Supp. Br., p. 9.)

7 Appellants repeat their assertion that this appeal is a de novo proceeding and that  
8 respondent’s determination has been rebutted, thus the presumption of correctness no longer attaches.  
9 As a result, appellants argue that the basis amount allowed by respondent is “meaningless and  
10 insignificant in the context of this proceeding.” Appellants note the basis adjustments made by  
11 respondent during the briefing period and contends that, once the presumption has been rebutted, “the  
12 burden generally shifts to the other party, the Respondent, to go forward with evidence”, citing the  
13 *Appeal of Robert L. Webber* (76-SBE-101), decided on October 6, 1976. Appellants further contend that  
14 the issue is the estimation of the adjusted basis for Garden Lane “pursuant to the Cohan Rule”,  
15 regardless of respondent’s prior determinations, which appellants have shown with the available  
16 evidence. (App. 2d Supp Br., pp. 9-10.)

17 Appellants assert that they used the attestations “in a way that met all of Respondent’s  
18 concerns and arguments” and, other than the unsigned attestation,<sup>6</sup> appellants’ use is “logically  
19 consistent and analytically sound.” Appellants further assert that respondent could have contacted  
20 witnesses during the examination when their memories of events would have been better and requested  
21 further information from them or requested that appellants’ “then representative do some further follow-  
22 up.” Appellants contend that respondent “simply chose to ignore them as evidence it didn’t like” or “to  
23 pick at perceived technical deficiencies in an attempt to undermine them.” Appellants further contend  
24 that their current attorney has presented the only comprehensive analysis of the evidence in this appeal  
25 as opposed to comprising evidence of different costs and has shown how the attestations support  
26

27  
28 <sup>6</sup> Appellants argue that the unsigned Rondelle attestation represents an “inconsequential adjustment” of \$50,000 that makes  
no difference to the point made by appellants or to an overall *Cohan* analysis. Appellants assert that Mr. Rondelle “most  
probably did provide the services” for a fee. Appellants contend that “respondent’s nit-picking has little if any substantive  
significance.”

1 approximately \$2.185 million in costs not otherwise reflected in the available financial documentation.  
2 Appellants summarize an attachment to their brief, titled Appendix B, which “traces the flow of funds to  
3 the extent that available evidence enables such tracing.” (App. 2d Supp. Br., pp. 11-12.)

4 Appellants reiterate their contentions regarding respondent’s position on the application  
5 of the Cohan rule and argue that respondent’s suggestion that it was “generous in allowing costs” is  
6 “clearly refuted.” Appellants argue that the issue is not whether or how respondent may have applied the  
7 Cohan rule but how this Board should apply the Cohan rule. Appellants further argue that “the starting  
8 point of a *Cohan* analysis is not the available substantiation (because the very need for *Cohan* assumes  
9 its absence) but the nature of the expense or cost to be estimated.” Appellants assert that respondent  
10 never made a *Cohan* inquiry until it engaged Mr. Kruckenberg and appellants contend that respondent’s  
11 reliance on Mr. Harding and Mr. Kruckenberg is totally flawed. (App. 2d Supp. Br., pp. 15-16.)

12 Appellants assert that Mr. Williams’s report uses a methodology unencumbered by gaps  
13 in the documentation by comparing the Garden Lane construction with which he was personally familiar  
14 to other like construction projects in the area based on costs from data he compiled as a loan disbursing  
15 agent and construction overseer for the lender. Appellants contend that respondent’s attempts to  
16 discredit Mr. Williams’s report “essentially comprise a series of nit-picks” and that Mr. Williams’s  
17 revision of his report to correct the misunderstanding about the guest house does not affect the validity  
18 of his analysis or conclusions. Appellants acknowledge that Mr. Williams had first-hand knowledge of  
19 the property during a limited time period but argue that this fact is insignificant because his involvement  
20 was at a critical time during the project and he is the only independent witness with any first-hand  
21 knowledge of the project. Appellants state that Mr. Harding testified that Mr. Williams’s background  
22 and experience are well-suited to the task. (App. 2d Supp. Br., pp. 16-17, exh. 143.)

23 Appellants assert that a recurring flaw in respondent’s analysis is the ascription of “a  
24 desired meaning to the evidence rather than querying witnesses” and that respondent’s inferences have  
25 consistently been wrong. As an example, appellants assert that respondent states that the Project Cost  
26 Analysis (Exhibit L) establishes that “100% of the construction was complete as of [Williams’] last  
27 inspection date of October 27, 1998.” Appellants contend that Bruce Sweet’s ledgers which continue  
28 into 1999 show that respondent’s inference is incorrect. Appellants also state that Mr. Williams explains

1 in his attached declaration that the document “concerned itself only with the application of the loan  
2 proceeds.” (App. 2d Supp. Br., pp. 17-18, exh. 142.)

3 In his declaration, Mr. Williams responds to the questions posed in the Appeals  
4 Division’s letter dated August 12, 2014, regarding his statements about the purpose of the Project Cost  
5 Analysis and an explanation for the purpose of the two sub-columns titled “Disbrs” and “Complt” after  
6 each line item category. Mr. Williams states that the document reflects the amount of construction loan  
7 funds allocated to each line item, based on budgets submitted by the contractor, changes to those  
8 amounts and the current “commitment” of loan funds to the item at the time the report is generated. He  
9 states that “[l]ater columns indicate the percentage of the committed amounts that had been disbursed as  
10 of the report date.” He states that “[t]he “Percent Complt” column represented my or one of my  
11 inspector’s estimate of the percentage of completion for the indicated line items as of the date of the last  
12 inspection.” He further states that the “Percent Complt” column was “to give a context to the application  
13 of the loan funds and some indication of results accomplished from the loan funds on the line item.” He  
14 states that during the second appeals conference he explained the “Percent Disbrs” column when asked  
15 about the “Percent Complt” column. (App. 2d Supp. Br., exh. 142.)

16 Mr. Williams states that he did not have access to, and did not account for, amounts spent  
17 before the construction loan, amounts spent from other sources, or amounts spent after the construction  
18 loan was paid off. For that reason, he concludes that his records and reports, including the Project Cost  
19 Analysis, would not have reflected any amounts other than loan funds and “would not have reflected any  
20 expense category not listed on the exhibit, i.e., for which loan funds were not budgeted.” He further  
21 concludes that, even if the report indicated that all funds were disbursed and all line items were  
22 complete, the project would not necessarily be complete. He states that the printouts were generated  
23 from computer software “designed for tracking construction projects generally, and could indeed be  
24 used to account for the entire cost of a construction project.” He states that the information he used was  
25 limited to the construction loan funds for disbursement and report titles and column headings were  
26 generated by software. (App. 2d Supp. Br., exh. 142.)

27 With respect to the adjustments to the cost determination based on the nonexistence of  
28 the guest house, Mr. Williams states that the revised report provides a computation of the changes which

1 reduced the amount by \$665,000.00 to eliminate the costs of the guest house and by \$130,295.47 to  
2 eliminate the costs of the interior improvements. He then added \$497,000.00 for interior improvements  
3 to the pool house and he made another adjustment of \$94,116.61 but he is not able to locate notes that  
4 would explain that adjustment. With respect to his disagreement with Harding Appraisal's statement that  
5 "the remodel has utilized the entire existing foundation", he states that he was advised by one of his  
6 inspectors that the foundation was partially removed and replaced over the crawl space, that there was  
7 an addition, and that much of the remainder of the foundation was resurfaced for cracks and  
8 irregularities. Finally, Mr. Williams explains his methodology as a review of the actual cost data for  
9 each component or line item in the general time frame of the construction for projects comparable in  
10 type, size, scope, and quality and then assigning a cost to the line item for Garden Lane. Mr. Williams  
11 states that the amount spent on any line item, even for two comparable projects, may vary depending on  
12 the quantity of items required for each project but "the nature of [his] approach is less a function of  
13 individual details of the project than the other named attributes (type, location, size, scope and quality,  
14 and [his] experience of decades of applying this approach is that the variations tend to even out in the  
15 total." (App. 2d Supp. Br., exh. 142.)

16 Appellants take issue with respondent's statement that the only permit issued after 1999  
17 appears to have been for the guest house because there were applications for two other permits for a  
18 106 foot addition and for a conservatory but it is unclear whether the permits were issued. Nonetheless,  
19 appellants contend that the photographs show that such construction was undertaken. Appellants address  
20 the Architectural Digest article reference to 15 months of construction and to the receipts for finishing  
21 work which respondent asserts indicates the completion of construction in 1998. Appellants assert that  
22 the article does not attribute the quote to appellant-husband or anyone else and does not explain what it  
23 refers to. Appellants state that it is possible that they moved into the house 15 months after the purchase  
24 but that construction was ongoing after 1998 and additional improvements were made. (App. 2d Supp.  
25 Br., pp. 18-19.)

26 Appellants contend that the 2003 Harding Appraisal "has nothing to do with the actual  
27 cost to build Garden Lane." Appellants attach a declaration from Mr. Harding in which he states that the  
28 appraisal "is not an appropriate tool for extrapolating actual costs" and that his estimate "cannot be

1 presumed to predict, or to have predicted, actual costs for any given project.” He further states that his  
2 cost approach is a method of estimating value, not costs” and integrates his assessment of land and  
3 improvement costs “as components of a single valuation, not as independent determinations of actual  
4 costs which can be used for other purposes” and reflects his assessment of “the extent to which  
5 improvement costs add or contribute to value, not of what actual construction costs were or would be.”  
6 Mr. Harding further states that he would not expect his estimate of reproduction cost to match or predict  
7 the amount spent by appellants. (App. 2d Supp. Br., pp. 19-20, exh. 143.)

8 Appellants point to the Harding Appraisal estimate of \$30,000 for the cost of the  
9 conservatory to appellant-wife’s statement in her declaration that it cost \$80,000, as specifically  
10 demonstrating that the appraisal numbers do not match actual costs. Appellants assert that appellant-  
11 wife’s testimony is corroborated by “an on-line discussion from 7 years ago” which shows that a slightly  
12 larger “Amdega conservatory” in 2002 to 2003 cost 50,000 British pounds, exclusive of shipping  
13 charges, or at the then current exchange rate, \$80,000. Appellants further assert that the Harding  
14 Appraisal did not include the cost of blinds for the conservatory which were \$30,000 plus an installation  
15 charge of at least \$7,697.64. (App. 2d Supp. Br., pp. 20-21, exhs. 19, 69, 144; Resp. exh. U.)

16 Appellants further assert that “another possible explanation for at least part of the  
17 difference” between Mr. Harding’s costs and the actual costs is that “[h]e might have gotten things  
18 wrong.” Appellants state that the Harding Appraisal attempts to reconcile “a market analysis and cost  
19 analysis” and Mr. Harding “is not an expert on costs and derived his cost information from periodic  
20 informal surveys of general local contractors and architects.” Appellants argue that he applied that  
21 “generalized information on a square foot basis to his appraisals” but there is no evidence “about how he  
22 applied what he learned from them.” Appellants further argue that his approach is “fraught with too  
23 many possibilities for error” to be a valid indicator of historical costs. Appellants assert that, if the  
24 reproduction cost indicator was significantly higher than or otherwise varied from his market  
25 conclusions, “Mr. Harding would have had a very difficult dilemma” reconciling those two indicators to  
26 reach a single value conclusion. Appellants further assert that “[b]y having them come out reasonably  
27 close, his appraisal could be smooth, straightforward and consistent.” Appellants state that Mr. Harding  
28 concluded that the property had a value of \$13 million which suggests his valuation may have been

1 inordinately low. (App. 2d Supp. Br., pp. 21-22.)

2           With respect to respondent's position that appellants would not insure for \$4 million a  
3 house that cost \$10 million to construct, appellants contend that respondent fails to consider the  
4 allocation of costs, many of which would not be incurred again in the event of even a catastrophic fire.  
5 Appellants list items like site work, "general requirements", concrete work and landscaping and  
6 professional fees which they claim total \$2.987 million. Appellants also assume that additional non-  
7 insurable costs of \$1 million would be attributable to "doing the project in phases and stopping and  
8 starting as finances permitted". After deducting that \$4 million, appellants assert they had \$4 to  
9 \$4.5 million in insurance on a property that would only cost \$6 million to replace and they suggest that  
10 some reasons for the difference of \$1.5 million to \$2 million are that the non-recurring costs were a  
11 higher portion of the \$10 million total cost, a deliberate decision to self-insure a portion, or another error  
12 by their business managers. In any event, appellants contend that the insurance declaration proves  
13 nothing. (App. 2d Supp. Br., pp. 23-24.)

14           Appellants contend that Mr. Kruckenberg's opinion as set forth in a declaration is  
15 unsupported by any written analysis and raises numerous serious questions. Appellants assert that  
16 Mr. Kruckenberg took the reproduction cost amount from the Harding Appraisal, made certain  
17 adjustments using Mr. Williams' cost analysis, and discounted that result by 18 percent. Appellants  
18 argue that the starting point of using the Harding Appraisal was invalid and the appraisal stated that it  
19 was made for First Republic Bank and "[i]t may not be suitable for other uses and should not be used or  
20 relied upon by any other party." Appellants also quote a statement of limiting conditions which provides  
21 that the appraisal estimated the value of "the improvements at their contributory value" and "separate  
22 valuations of the land and improvements must not be used in conjunction with any other appraisal."  
23 Appellants also quote portions of Mr. Harding's declaration, some of which are quoted above, in which  
24 he concludes that he would not expect his estimate of reproduction cost to match or predict the amounts  
25 actually spent, even if adjustments were made. (App. 2d Supp. Br., pp. 26-27, exh. 143.)

26           Appellants contend that Mr. Kruckenberg did not follow his typical process of breaking  
27 down a project into materials and man-hours which appellants describe as two "recognized approaches  
28 to job costing used by contractors" and, as a result, ceased being an expert and his opinion carries no

1 weight, citing *In re Lockheed Litigation Cases* (2004) 115 Cal.App.4th 558. Appellants further contend  
2 that Mr. Kruckenberg's testimony that he relied on the Harding Appraisal reproduction cost because it  
3 was consistent with Project Cost Analysis which he erroneously assumed reflected 98 percent project  
4 cost completion also shows a flawed rationale. Appellants contend that the similarity in the amounts is  
5 coincidental and there is factual or analytical support for his estimate of costs. (App. 2d Supp. Br.,  
6 pp. 28-29, exhs. 142 and 145; Resp. Exh. R.)

7 Appellants assert that Mr. Kruckenberg adjusted the Harding Appraisal reproduction cost  
8 by estimated percentages applied to the costs determined by Mr. Williams even though appellants  
9 contend that no connection can be shown between those costs. Appellants contend that there is no  
10 analytical basis for this approach as Mr. Harding stated in his declaration. Appellants state that  
11 Mr. Williams's costs were almost twice those of the Harding Appraisal and appellants conclude that,  
12 therefore, for any given line item, Harding's cost would be one-half Williams' cost. As a result,  
13 appellants contend that Mr. Kruckenberg's adjustment of 75 percent to the foundation, for example,  
14 represented a reduction of 150 percent "of the implicit value of that item contained in Mr. Harding's  
15 appraisal" which demonstrates an invalid methodology. Appellants state that Mr. Kruckenberg  
16 explained that "his analytical rationale" was that those were the only numbers he had which appellants  
17 assert is not "analytically sound." Appellants further state that, in his testimony, Mr. Kruckenberg  
18 conceded one adjustment might be incorrect and "on other matters, he conceded he was guessing" and  
19 "either he or Respondent inferred information that is inconsistent with, or simply not in the record" such  
20 as the replacement of the septic system. (App. 2d Supp. Br., pp. 29-30, exhs. 143 and 145.)

21 Appellants contend that Mr. Kruckenberg has no actual experience with costs in  
22 Montecito, as he claims to have completed post-litigation repairs on one home there and served as an  
23 expert in six or more cases involving Montecito properties. Appellants contend that "Mr. Kruckenberg is  
24 quick to please his client and express his opinions" to support respondent's adjusted basis but he lacks  
25 the knowledge and experience and did not inform himself or use an analytically sound methodology.  
26 Appellants accuse Mr. Kruckenberg of a "willingness to say whatever is most expedient at the time."  
27 Appellants state that the Contractors State License Board (CSLB) requires that contractors with  
28 employees carry workers' compensation insurance but Mr. Kruckenberg has represented since 2002 that

1 his business was exempt from this requirement because it has no employees. However, appellants state  
2 that Mr. Kruckenberg testified that he currently has one employee and had several as late as 2005 or  
3 2006. Appellants further contend that Mr. Kruckenberg “has drawn multiple tax lien filings” from the  
4 California Employment Development Department for 2012 and 2013, “presumably for unpaid  
5 employment taxes.” Thus, appellants contend that his credibility is questionable. (App. 2d Supp. Br.,  
6 pp. 31-32, exhs. 145, 147 and 148.)

7 Respondent’s Second Supplemental Brief

8 Respondent states that its brief will discuss the significance of the Harding Appraisal,  
9 address the Appeals Division’s requests, and comment on the testimony of Mr. Williams and  
10 Mr. Kruckenberg. Respondent states that, according to Mr. Williams, after appellants sold Garden Lane  
11 the home was significantly remodeled and no longer appears as it did when owned by appellants.  
12 Therefore, respondent states that the only document in the record that reflects a cost analysis based on  
13 physical inspection of the home as improved by appellants is the 2003 Harding Appraisal. Respondent  
14 asserts that Mr. Harding’s “credentials are impeccable” and that Mr. Williams stated that Mr. Harding is  
15 a very active appraiser in the Santa Barbara area and “he only had good things to say about  
16 Mr. Harding.” Respondent further asserts that the record shows Mr. Harding was familiar with  
17 Garden Lane and appraised the property on five occasions from 1997 through 2003 which were  
18 performed before, during, and after the construction. (Resp. 2d Supp. Br., pp. 1-2, Deposition of  
19 Carl Williams (CW).)

20 Respondent notes that, as part of the Harding Appraisal, Mr. Harding prepared “an  
21 estimated reproduction cost new” which he defined as “the cost of construction at current prices of an  
22 exact duplicate or replica, using the same materials, construction standards, design layout, and quality of  
23 workmanship . . .” Under this approach, respondent states that Mr. Harding determined that, in  
24 December 2003, the cost to reconstruct an exact replica of Garden Lane on the same site was \$5,281,520  
25 with additional costs of \$760,000 for general site improvements such as security gates, landscaping, and  
26 a swimming pool. Respondent states that Mr. Williams testified that, unlike his own method which  
27 relied exclusively on his database, Mr. Harding’s approach was completed on a “contractor’s basis, on a  
28 material, item and subcontractor bids and everything else.” Respondent contends that, contrary to

1 Mr. Williams' testimony, Mr. Harding actually "placed great emphasis upon cost data estimates from  
2 local Santa Barbara sources, including periodic surveys of area building contractors, cost estimators and  
3 architects because of the higher building trade and material costs in the Santa Barbara area." Respondent  
4 also states that Mr. Harding noted that construction costs increased substantially in the five years from  
5 the construction period. In addition, respondent notes that Mr. Williams "incorrectly dismissed" the  
6 Harding Appraisal approach because Mr. Williams claimed it was based on the Marshall and Swift cost  
7 guide, but that the Harding Appraisal states that it gave "minimal consideration" to the Marshall and  
8 Swift guide and instead relied on costs specific to Montecito and Santa Barbara. (Resp. 2d Supp. Br.,  
9 pp. 2-3, exh. U and Deposition of CW.)

10 Respondent contends that the Harding Appraisal was prepared by a respected and well-  
11 qualified appraiser very familiar with the local market and this particular property and used a  
12 contractor's approach for "determining exact cost of duplicating or reproducing Garden Lane."  
13 Respondent further contends that Mr. Harding was neutral in this appeal, inspected the Garden Lane  
14 property throughout the process, and placed "great emphasis" on Santa Barbara costs of construction.  
15 For those reasons, respondent concludes that the Harding Appraisal should be used as a guide in  
16 determining the adjusted basis of Garden Lane, as Mr. Kruckenberg has done. (Resp. 2d Supp. Br., p.3.)

17 Respondent addresses the question posed in the Appeals Division's letter dated  
18 August 12, 2014, regarding the support for Mr. Kruckenberg's statement about the photograph showing  
19 that about 95 percent of the lower floor of the residence appearing to be "completely intact" after the  
20 completion of demolition. Respondent states that the only person who disputes this fact is Mr. Williams,  
21 while the Harding Appraisal clearly states that, during the remodel, the existing home was "reduced to  
22 framing" and "the remodel has utilized the entire . . . foundation." The Harding Appraisal also states that  
23 the building permit was for "partial demolition of the existing residence." Respondent further notes that  
24 the Harding Appraisal "compares favorably" to the Architectural Digest article in which appellants  
25 stated that "they saved a couple of walls and the foundation of the original 1958 house." Respondent  
26 also notes that appellants hired architect Don Nulty to draft plans for the remodel and retained the  
27 services of Mr. Nulty for several subsequent projects, including another home in Santa Barbara. Based  
28 on the long-standing relationship with Mr. Nulty, respondent questions why appellants did not consult

1 Mr. Nulty concerning the nature of the property at the time of construction which would have also  
2 explained “how the ‘permitted’ remodel was really an ‘unpermitted’ new construction project, as  
3 Mr. Williams suggests.” Respondent concludes that Mr. Williams lacked first-hand knowledge while  
4 Mr. Kruckenberg’s opinion is consistent with the building permits, the Harding Appraisal, and the  
5 Architectural Digest article. (Resp. 2d Supp. Br., pp. 3-4, exhs. B, C, and U and Deposition of CW.)

6 With respect to the second question about the legal authority for Mr. Kruckenberg’s  
7 statement that the construction of a master bathroom, the installation of an air conditioning system, and a  
8 basement remodeling required building permits, respondent states that Santa Barbara County adopted  
9 the International Model Code which is reflected in the California Building Code (CBC) as amended by  
10 the county. Respondent states that section 105.1 of the CBC requires a permit for any construction,  
11 repair, remodel, or the like with exceptions limited to Santa Barbara County’s amendments. Respondent  
12 further states that remodeling of a bathroom, air system, and basement are not listed as exceptions under  
13 section 105.2 of the CBC. Thus, respondent asserts that permits were required for all of these projects  
14 which also appears to accord with Mr. Williams’s understanding of the law, especially in Montecito.  
15 (Resp. 2d Supp. Br., pp. 4-5, exhs. C and D, Deposition of CW.)

16 During the second appeals conference, respondent states that Mr. Williams declared that  
17 he is “not an expert” and “if anyone classifies me as an expert, they are wrong.” Respondent further  
18 states that, after taking several breaks, appellants’ counsel attempted to rehabilitate Mr. Williams as a  
19 witness by asking a leading question to which Mr. Williams replied that he is not an expert witness but  
20 is rather “a witness of what [he does] and how [he does] it, based on [his] experience.” Respondent  
21 states that Mr. Williams operates a firm that “is an intermediary between lenders and homeowners that  
22 serves as ‘fund control’ during the disbursement of loan funds” which typically involves some type of  
23 site inspection. Respondent asserts that, after a homeowner and contractor agree on the price for the  
24 project, Mr. Williams’s firm inspects the property to ensure the work is complete and, if so, authorizes  
25 the lender to make the payment. Respondent contends that the issue here is the interaction and  
26 agreement between the homeowner and contractor which are “events that occurred well before  
27 [Mr. Williams’s] involvement in a particular case. Thus, respondent contends that Mr. Williams by his  
28 own admission is not qualified to provide an expert opinion on the issues related to this case. (Resp.

1 2d Supp. Br., p. 5, Deposition of CW.)

2 Respondent states that, over the course of his firm’s work, Mr. Williams has allegedly  
3 created a database of construction projects in the Santa Barbara and Montecito area. However,  
4 respondent states that Mr. Williams has declined to provide the database for inspection upon request by  
5 respondent and the Appeals Division citing certain confidentiality agreements with lenders. Despite  
6 these confidentiality agreements, respondent asserts that Mr. Williams has relied on his database to  
7 provide an estimate of what appellants could have paid for the Garden Lane construction. Respondent  
8 contends that it is disingenuous of Mr. Williams to disclose confidential information as to alleged  
9 construction costs but to use the confidentiality agreement so as not to disclose the same information  
10 when the database could be redacted to hide the identities of the alleged lenders. Because Mr. Williams  
11 refuses to provide any information from the database, respondent contends that it is impossible to  
12 determine whether he relied on similar homes built during the same period using similar materials.  
13 (Resp. 2d Supp. Br., pp. 5-6.)

14 Respondent states that Mr. Williams provided a “sample copy” of his database which,  
15 respondent contends, reveals “the limitations of the database and why [it] cannot be relied on.”  
16 Respondent states that “the database does not represent the square footage, materials used and the like  
17 for any project” and “is nothing more than a general line item, matched to a cost.” As an example,  
18 respondent notes that it states a cost of \$221,493 for “wood doors interior” without providing any  
19 supporting detail such as the number of doors installed, the type of wood, and the fire rating of the  
20 doors, so that a comparison with the subject property is impossible. As another example, respondent  
21 points to a cost of \$25,000 for wrought iron railing without any description of the number of linear feet,  
22 the manufacturer, or the style and quality. Again, respondent asks how one can compare this item  
23 without such information and respondent asserts that this is true of each line item. (Resp. 2d Supp. Br.,  
24 p. 6, exh. E.)

25 Respondent asserts that the basic premise of Mr. Williams’s opinion “is that if his  
26 database reflects that another homeowner paid a certain amount for a roof [or master bathroom] then, in  
27 theory, appellants could have paid the same amount for a roof [or master bathroom].” As a result,  
28 respondent contends that Mr. Williams “essentially harvested the finer points of many homes in the

1 Santa Barbara area and created a fictional house for purposes of his opinion.” Respondent summarizes  
2 Mr. Williams’s approach as follows: “if the Appellants had installed a pool and the homeowner down  
3 the road installed a pool, regardless of comparisons of materials used, square footage or size, and the  
4 date it was installed, then the Appellants could have spent the same amount for the pool as their  
5 neighbor.” Respondent finds this approach particularly troublesome for two reasons: (1) Mr. Williams  
6 possessed specific information, i.e., the Project Cost Analysis, related to Garden Lane but chose to  
7 ignore it; and (2) the sample database lacks specific details, like square footage and materials used, that  
8 would enable a valid comparison. (Resp. 2d Supp. Br., p. 7, exh. 1004 to the Kruckenberg deposition.)

9 Respondent asserts that the sample database lacks specific details necessary to make a  
10 meaningful estimate and his method also disregards the time period during which the alleged  
11 comparable work occurred as it includes houses constructed up to 2005. Respondent further asserts that  
12 the most troubling fact was that Mr. Williams had no idea of the square footage of appellants’ home.  
13 When asked to clarify the square footage discrepancies in his report, which stated both 8,800 square feet  
14 and approximately 10,000 square feet, respondent states that Mr. Williams responded, “I’m not sure. I’m  
15 really not sure.” Respondent contends that it is impossible to perform an accurate estimate of  
16 construction costs of a home without knowing the square footage of the home. Respondent further notes  
17 that “the same disconnect” was “prevalent throughout Mr. Williams’s testimony” and cites as examples:

- 18 • He attributed a cost of \$50,000 for fireplaces without knowing the number of fireplaces in  
19 appellants’ home because another home in the database had five fireplaces with construction  
20 costs of \$50,000.
- 21 • Without knowing whether appellants made changes and upgrades during the course of  
22 construction, he increased his estimate of basis by nearly \$1.5 million because another home in  
23 the database incurred the same cost.
- 24 • Without knowing the specifics of certain projects, including the roof, the number of exterior  
25 doors, and the age and quality of HVAC, plumbing lines and fixtures and electrical work, he  
26 attributed costs simply because another home in his database incurred such costs.

27 (Resp. 2d Supp. Br., pp. 7-8, Deposition of CW.)

28 Respondent contends that Mr. Williams’s opinions are nothing more than a guess because

1 he either lacked the knowledge or did not seek the knowledge to render his opinions more than  
2 speculation and respondent asserts that Mr. Williams did not even speak to appellants. Respondent  
3 further contends that Mr. Kruckenberg “took a much more pragmatic approach” by using the  
4 Harding Appraisal as a starting point and adjusting it to reflect costs for the pre-existing construction  
5 and improvements, such as the foundation and framing, and to discount the construction costs for the  
6 steep increase in such costs from 1998 to 2003. Finally, respondent asserts that the Harding Appraisal  
7 and Mr. Kruckenberg’s expert opinion are also in accord with the replacement cost insurance of  
8 \$3.3 million in 1998 and 1999 and \$4.4 million in 2001 to 2002 and \$4.7 million in 2002 to 2003. (Resp.  
9 2d Supp. Br., pp. 8-9, exhs. R and U.)

10 Appellants Second Supplemental Reply Brief

11 In their simultaneous reply brief to respondent’s second supplemental brief, appellants  
12 contend that respondent and Mr. Kruckenberg treated Mr. Harding as a cost expert and relied on a part  
13 of the Harding Appraisal “out of context, without ever speaking to him.” Appellants state that their  
14 counsel spoke with Mr. Harding and learned that respondent’s reliance on the appraisal was “grossly  
15 misplaced” and that “his analysis and appraisal contribute nothing to any legitimate analysis of this  
16 case” as was made clear in appellants’ last brief and Mr. Harding’s declarations. Appellants further state  
17 that, during the last briefing, respondent’s counsel spoke with Mr. Harding and requested and received  
18 documents from him, including prior appraisals of Garden Lane. Respondent requested and was granted  
19 an extension of the briefing schedule in order to take Mr. Harding’s sworn testimony but later  
20 respondent notified appellants and the Appeals Division that it decided not to take his testimony.  
21 Appellants assert that respondent apparently wanted Mr. Harding to review files that were more than  
22 10 years old but decided that it did not want to pay Mr. Harding for such a review. Appellants conclude  
23 that those actions reflect “respondent’s changing position on Mr. Harding’s status as an expert” and  
24 appellants contend that “he has little knowledge and no expertise in construction costs (other than how  
25 such costs might impact appraisals).” (App. 2d Supp. Reply Br., pp. 1-3, exh. 149.)

26 Appellants repeat their contentions that respondent’s reliance on the Harding Appraisal is  
27 misplaced as it was taken out of context and was not an opinion of historical or actual costs as pointed  
28 out in Mr. Harding’s declaration. Appellants contend that Mr. Harding is an appraiser and “real estate

1 appraisal is a function that likes to use cost numbers, but it not one that generates them.” Appellants  
2 assert that appraisers “get cost numbers for their analyses” most often from Marshall & Swift, which  
3 appellants assert is not a reliable guide to the Montecito market, or through a “query process.”  
4 Appellants dispute respondent’s implication that Mr. Harding’s reliance on local professionals for costs  
5 gives his cost figures credibility and appellants contend that respondent demonstrates it does not  
6 understand Mr. Harding’s methodology which is outlined in his declarations. Appellants assert that  
7 respondent finds as “compelling evidence” Mr. Harding’s cost inquiries of one or more unknown  
8 persons with unknown credentials at unknown times. Appellants argue that he made those inquiries  
9 because he knew he had no expertise in construction costs and there is no information available about  
10 the actual inquiries or the answers he received other than costs on a square footage basis to which he  
11 made unknown additional adjustments. Appellants further assert that this is the first time in  
12 Mr. Harding’s career that “anyone has ever attempted to compare his conclusions of cost to actual costs  
13 of a project” and thus Mr. Harding “has no way of knowing whether any of his cost numbers were ever  
14 accurate – in any appraisal.” (App. 2d Supp. Reply Br., 3-5, exhs. 143 and 149.)

15 Appellants contend that respondent wrongly assumes that Mr. Harding’s approach is the  
16 same as a contractor’s approach to determining costs and that he does not possess such knowledge and  
17 experience. Appellants further contend that the contractor’s approach was not used by the persons  
18 queried by Mr. Harding because no information about Garden Lane was provided to them. Appellants  
19 argue that the law requires no reliance on the Harding Appraisal and they repeat their contentions above  
20 regarding his lack of expertise, the fact that no one queried made an actual cost determination, that the  
21 appraisal was not a cost analysis, and that there has been no verification of the accuracy of the appraisal.  
22 Appellants argue that Harding Appraisal is “so unreliable that it would reversible error for a court (or a  
23 jury) to consider such evidence.” Appellants assert that Harding’s earlier appraisals before the  
24 Garden Lane construction was completed do not “provide any legitimate insight” and the appraisals state  
25 that Mr. Harding describes the cost portion of his appraisal in two steps: (1) Using the “query process”  
26 to determine completed cost; and (2) applying his estimate of the percentage of completion. Appellants  
27 contend that these appraisals are “meaningless for purposes of understanding actual historical costs” for  
28 the same reasons as the 2003 Harding Appraisal. (App. 2d Supp. Reply Br., pp. 5-8, exh. 149.)

1 Appellants assert that they showed in their last brief that costs through mid to late 1999  
2 could not have been less than \$3.9 million but that the Harding 1999 appraisal completed about that  
3 same time included a cost analysis of \$2.6 million and thus Mr. Harding's cost numbers are not a  
4 reliable guide to actual costs. Appellants further assert that the use of Mr. Harding's other appraisals  
5 "without supporting or explanatory testimony" by Mr. Harding would be a "sham." (Resp. 2d Supp.  
6 Reply Br., pp. 8-9, Resp. Harding Exhibits.pdf.)

7 Appellants state that respondent's counsel, rather than Mr. Kruckenberg, appears to have  
8 provided responses to the questions posed by the Appeals Division. Appellants contend that whether the  
9 foundation and framing remained intact "was made moot by Harding's declarations revealing the  
10 invalidity of Mr. Kruckenberg's approach" because "for a contractor doing either a time and materials  
11 analysis, or requesting subcontractor bids", the amount of the prior structure retained would be relevant.  
12 Appellants assert that neither Mr. Kruckenberg nor Mr. Harding did such an analysis whereas  
13 Mr. Williams performed "a different analysis using costs of comparable projects as a guide" and all of  
14 those comparable projects "retained some portion of the structure sufficient to qualify them as  
15 remodels." (App. 2d Supp. Reply Br., pp. 9-10, exh. 142.)

16 With respect to Mr. Williams's statement during the second appeals conference that he  
17 was not an expert, appellants quote portions of the transcript and conclude that Mr. Williams intended to  
18 convey that he is an expert in his professional field but not "an expert at being a witness, i.e. someone  
19 whose vocation or business specifically anticipate and involves being called on to testify." Appellants  
20 further state that Mr. Williams was pointing out that he does not hold himself out as an expert to testify  
21 in legal cases. Appellants contend that respondent sought to exploit Mr. Williams's verbal gaffe but that  
22 Mr. Williams's experience and knowledge qualify him as an expert in construction costs under  
23 California Evidence Code section 720. (App. 2d Supp. Reply Br., pp. 10-13, exhs. 92 and 106.)

24 Appellants contend that respondent's request that Mr. Williams produce his database at  
25 the second appeals conference was not reasonable and he declined to produce it on the advice of  
26 counsel. However, appellants state that he provided, as a sample, the database record for "one of the key  
27 properties" he relied on located at 700 Picacho Lane. Appellants assert that respondent "wasn't really  
28 interested" in the database information and "likely knew their demand was unreasonable and wouldn't

1 be complied with, and wanted the opportunity to complain about the database not being provided, rather  
2 than any opportunity to really understand the data in it.” Appellants further assert that the sample “was  
3 almost completely ignored” but that it was “certainly relevant” because, like Garden Lane, the property  
4 had a slate roof and custom windows which are two features that increase costs. Appellants state that the  
5 database record shows that the final Picacho Lane construction budget was \$15 million of which only  
6 60 percent was allocated to hard costs “which is on a par with Garden Lane’s entire construction cost”  
7 and 40 percent to soft costs. Appellants further state that \$9.5 million of the \$15 million budget had  
8 actually been spent, which is also on par with Garden Lane, but that it was unknown whether the  
9 remaining \$6 million was spent. Appellants contend that respondent “didn’t care enough to ask” about  
10 those details. (Resp. 2d Supp. Reply Br., pp. 14-15.)

11 Appellants take issue with respondent’s statement that Mr. Williams “refused to provide  
12 any information from his database” as “patently false” and asserts that Mr. Williams “provided  
13 information that indeed showed that comparable projects were used in his analysis.” Appellants further  
14 assert that respondent reviewed the sample as it was attached it to its second supplemental brief. Based  
15 on the sample, appellants contend that respondent used it to argue that Mr. Williams “could not possibly  
16 determine how the projects compare” because he did not “count[] doors, or indicated what the doors  
17 were made of, etc.” Appellants contend that respondent’s arguments are specious because “door counts  
18 and the like” are not necessary for Mr. Williams’ approach. Appellants further contend that respondent  
19 is not aware of “how the costs of comparable construction projects align and how one determines  
20 comparable construction projects.” (App. 2d Supp. Reply Br., pp. 16-17.)

21 Appellants argue that Mr. Williams’s methodology is not “a labor and materials analysis”  
22 but rather an analysis “as a funds controller and construction lender’s representative who knows  
23 Montecito luxury home construction costs from supervising the financing of many such projects.”  
24 According to appellants, Mr. Williams looked at “actual construction costs of similar projects at or  
25 around the same time frame” and his methodology works better than any other in this case. Appellants  
26 state that his “analysis assumes that homes of approximately the same size, quality, and features built in  
27 the same community around the same time will, on average, have approximately the same door budget,  
28 the same window budget, etc.” and “no one would know better about the validity of those underlying

1 assumptions than Mr. Williams.” Appellants contend that respondent has presented no evidence to  
2 suggest that Mr. Williams’s assumptions are not valid and respondent’s contention that his method is  
3 “seriously flawed” is not supported by logic or evidence. (App. 2d Supp. Reply Br., pp. 17-18.)

4 Appellants argue that Mr. Williams’s method is the same process by which real estate  
5 brokers and appraisers have determined home values for 100 years or more “by relying on comparable  
6 property transactions found in a compilation of prior transaction data.” Appellants state that brokers and  
7 appraisers use prior sales data but in Mr. Williams’s analysis, the process is identical, but the  
8 “transactions” are construction projects with the construction costs being considered. Appellants contend  
9 that this method has worked well and been accepted despite the fact that comparable properties are  
10 rarely identical to a subject property. Appellants add that the Board must apply the Cohan rule which  
11 does not require pinpoint accuracy. (App. 2d Supp. Br., pp. 18-19.)

#### 12 Respondent’s Second Supplemental Reply Brief

13 Respondent states that, in the last round of briefing, appellants submitted a declaration by  
14 Mr. Harding, and since the filing of that brief respondent spoke with Mr. Harding and obtained his file  
15 on Garden Lane which included an “engagement letter” from appellants’ counsel, Mr. Bernsley, a copy  
16 of the original job cost estimate from Bruce Sweet and a series of appraisals he performed in 1998, 1999  
17 and 2001. Respondent asserts that the newly produced appraisals “depict a timeline of the work  
18 performed on Garden Lane that clearly contradicts appellants’ claimed timeline.” (Resp. 2d Supp. Reply  
19 Br., p. 2, exh. A.)

20 Respondent contends that the 1998, 1999, and 2001 appraisals are particularly relevant  
21 because the appraisals were performed during and just after the completion of Garden Lane and in each  
22 appraisal Mr. Harding determined the reproduction cost of Garden Lane at the time of the appraisal.  
23 Respondent asserts that the appraisals are more accurate than the 2003 appraisal because these appraisals  
24 provide an estimate of cost close in time to the actual construction. Respondent states the dates of the  
25 appraisals and the reproduction cost indicators are follows: July 10, 1998, \$2,600,552; June 29, 1999,  
26 \$2,803,340; October 21, 2001, \$4,925,708. Respondent contends that these amounts “are likely the  
27 closest estimates available in the record of the amount spent by appellants” and that “Mr. Harding  
28 visited Garden Lane numerous times during the years in question and performed a detailed site

1 inspection at the time of performing each appraisal.” Furthermore, respondent asserts that his estimate  
2 reflects his review of the property, plans, documents from Bruce Sweet, and careful scrutiny of the  
3 finishes and materials actually used. As an example, respondent quotes from the 1998 appraisal in which  
4 Mr. Harding states that “[d]uring the most recent inspection I was informed that the quality of the  
5 interior surfaces and finishes had been substantially upgraded from the original plans. . . . The additions  
6 are . . . similar in quality to most newer Montecito estate properties that have recently sold.” (Resp.  
7 2d Supp. Reply Br., pp. 2-3.)

8           Respondent states that appellants allege that reproduction cost may not be used to  
9 estimate actual construction costs but respondent asserts that, given the absence of documentary  
10 evidence of the exact construction costs, an estimate is necessary under the Cohan rule. Respondent  
11 further asserts that Mr. Harding’s reproduction cost value indicator “determined a likely cost for  
12 reproducing an exact duplicate of appellants’ home.” Respondent contends that Mr. Williams’s report is  
13 merely an opinion which is unreliable because “it is not based on the specific materials, finishes and  
14 specifications of Garden Lane, but rather on a composite of other houses in Mr. Williams’ alleged  
15 database.” Respondent further asserts that Mr. Williams prepared his report many years after the  
16 construction occurred as compared with Mr. Harding’s data which was obtained close in time to the  
17 actual construction. Thus, respondent concludes that it is entirely appropriate to use Mr. Harding’s  
18 appraisals. (Resp. 2d Supp. Reply Br., pp. 3-4.)

19           Respondent asserts that, based on the reproduction costs from the 1999 and 2001  
20 appraisals, the cost to complete Garden Lane may be estimated to range from \$2,803,340 to \$4,925,708  
21 and respondent’s allowance of \$4,325,642 by the application of the Cohan rule “is toward the high end  
22 of that range and is entirely appropriate when considering the fact that the construction of Garden Lane  
23 was substantially complete at the time of the 1999 appraisal, and entirely complete by the time of the  
24 2001 appraisal.” Respondent further asserts that the reproduction costs are not entirely accurate because  
25 the reproduction costs include costs of a complete residence, which includes a new foundation and  
26 framing, and the appraisals clearly establish that the foundation and framing for the first floor were  
27 retained from the original home. Respondent states that this information is confirmed as Mr. Harding  
28 notes he reviewed Bruce Sweet’s original project cost estimate which indicates \$5,000 for concrete and

1 \$1,000 for concrete cutting and that he met with Mr. Sweet while performing the appraisal in 1998.  
2 Thus, respondent concludes that Mr. Harding's reproduction costs are likely higher than appellants'  
3 actual costs but that respondent's estimate is still within the appropriate range and reflects a reasonable  
4 approximation of actual costs. (Resp. 2d Supp. Reply Br., pp. 4-5, exh. A.)

5 Respondent states that appellants contend that the construction on Garden Lane  
6 commenced in 1997 and continued through 2003, but that the loan funds were exhausted by 1999 so  
7 appellants paid for "substantial work" after that time with their own funds, despite the lack of "any  
8 significant verifiable documentation" to support this claim. Respondent also notes that appellants claim  
9 that Garden Lane was constructed "in phases, stopping and starting as finances permitted rather than  
10 doing the project once from beginning to end . . ." which added \$1 million in costs. However,  
11 respondent contends that the record reflects that the vast majority of the work occurred between 1997  
12 and 1999. Although appellants state that the "final phase" occurred in 2002 and 2003, respondent asserts  
13 that Mr. Harding's appraisal states that, as of July 10, 1998, Garden Lane was 80 percent complete, with  
14 the construction in the "final phase of completion" and with the pool house in the framing stage."  
15 Furthermore, respondent states that the June 29, 1999 appraisal states that "as of the current date the  
16 main house is complete and occupied by the owners" and "the interior finish of the pool cabana is not  
17 yet completed" but that all interior finishes on the main house were complete. In the October 21, 2001  
18 appraisal, respondent states that Mr. Harding notes that "since the date of the last appraisal the interior  
19 of the guest/pool cabana has been completed and conservatory has been constructed." Mr. Harding also  
20 comments that "subject was completed two years ago." (Resp. 2d Supp. Reply Br., pp. 5-6, exh. A.)

21 As further support for its construction timeline, respondent notes that the majority of  
22 checks, invoices, and ledgers reflect payments and disbursements from 1997 through 1999, the  
23 Architectural Digest article described the project as a 15-month process, and completed building permits  
24 were issued between 1997 and 1999. Respondent also notes that, despite appellants' prior representation  
25 it is now known that the guest house was never constructed during 2002-2003, which "creates  
26 substantial uncertainty as to whether appellants failed to communicate with their counsel regarding any  
27 other claimed work on the property." (Resp. 2d Supp. Reply Br., p. 6.)

28 Respondent states that Mr. Harding's file included a document titled "Berkhoff

1 Residence Job Cost Estimate” which reflects Bruce Sweet’s estimated costs as of August 8, 1997, in the  
2 amount of \$1,748,197. Although costs substantially increased from this 1997 estimate, respondent  
3 asserts that “it is difficult to ascertain” how costs could have increased more than fivefold as appellants  
4 contend. Respondent further asserts that nothing in the record explains the change or upgrades that  
5 would have caused such an increase, the original architectural plans do not appear to have changed and,  
6 as was noted in the 1998 appraisal, the quality of the finishes did not vary from the earlier stated plans.  
7 (Resp. 2d Supp. Reply Br., p. 7, exh. A.)

8 Respondent states that appellants continue to make the erroneous claim that a completely  
9 new foundation was poured and none of the original framing was utilized which is contradicted by the  
10 1998, 1999, and 2001 appraisals which clearly establish the utilization of the entire existing foundation  
11 (with the addition of 300 square feet) and the existing framing. Respondent further states that appellants  
12 maintain they added a master bathroom between 2002 and 2003 but when questioned about this  
13 construction, Mr. Williams was unable to state whether the master bathroom was built as part of the  
14 original plans or was added later. Respondent states that a photo attached to the 1998 appraisal shows  
15 that a master bathroom existed in 1998 which establishes that it was built as part of the original plans  
16 and not in 2002-2003 in a “later phase” of construction as appellants claim. Respondent asserts that this  
17 demonstrates that Mr. Williams’s report is based on a misunderstanding of the work actually performed  
18 and when it was completed, which resulted in excessive costs estimates throughout the report. (Resp.  
19 2d Supp. Reply Br., pp. 7-8, exhs. A and B, Deposition of CW.)

20 Respondent contends that Mr. Williams’s report grossly inflates many expenses based on  
21 his misunderstanding of the work performed although the total amount due to the errors is unknown  
22 “because of the organization of the report into categories.” As an example, respondent asserts that it is  
23 unclear how much additional cost was allocated to the alleged master bathroom construction in 2002-  
24 2003 which was actually performed as part of the original project. Because appellants claim that the  
25 piecemeal nature of the construction substantially increased their costs, respondent states that it is  
26 reasonable to assume that Mr. Williams added more cost to the construction of the master bathroom than  
27 should have been included. Respondent also notes the following items as “clearly excessive”:  
28 Contractor’s Overhead, Profit and Fees – “[O]ne of the most egregious examples of exaggerated costs”

1 is the contractor's fee of \$53,000 and overhead and profit of \$914,088.51, which represents about  
2 11 percent of the alleged cost of construction, whereas Mr. Sweet stated in his attestation that he  
3 received only \$230,000. Even if the attestations are credible as appellants argue, the amount estimated in  
4 Mr. Williams's report is grossly excessive. In addition, assuming the entire \$230,000 was Mr. Sweet's  
5 overhead and profit and this amount represented 11 percent of the total project cost, the total project  
6 costs would amount to \$2,090,909 and thus the estimate is unsupported by appellants' own evidence.  
7 Finally, Mr. Sweet's job cost estimate includes two items of "contractor's fee" which total \$129,000,  
8 which is also far less than the amount stated in the attestation. (Resp. 2d Supp. Reply Br., pp. 8-9,  
9 exh. E.)

10 Concrete – Mr. Williams's report estimates \$152,850 for concrete as compared to the \$6,000 job cost  
11 estimate by Bruce Sweet. Mr. Williams maintained that this amount is an appropriate cost for an entirely  
12 new foundation despite the fact that the Harding appraisals stated that the existing foundation was  
13 utilized with only a 300 square foot addition and that information likely came from Mr. Sweet. (Resp.  
14 2d Supp. Reply Br., pp. 9-10, exhs. A and E.)

15 Framing – Mr. Williams's report estimates \$307,000 for rough framing and \$300,000 for "rough  
16 lumber" in addition to \$497,000 for framing the cost of the pool house and another \$130,000 for the  
17 conservatory. Mr. Williams stated that these amounts are appropriate for new framing of an entire house  
18 but the Harding appraisals state that all first floor existing framing was utilized and Mr. Sweet was  
19 present when Mr. Harding inspected the property in 1998. Thus, great weight must be given to  
20 Mr. Harding's statements as his statements relate to the condition of the property and the actual work  
21 performed during the original construction. (Resp. 2d Supp. Reply Br., p. 10, exhs. A and E.)

22 Electrical Rebuild, Changes and Upgrades – Mr. Williams's report estimates \$1,161,329 in electrical  
23 "rebuild, changes and upgrades" and Mr. Williams stated that this amount represented change orders for  
24 similar projects in his database but did not represent actual change orders during the Garden Lane  
25 construction. Thus, Mr. Williams's estimate includes over \$1 million in charges for work that did not  
26 occur during the Garden Lane project. (Resp. 2d Supp. Reply Br., p. 10, exhs. D and E.)

27 Respondent notes that Mr. Harding's file on Garden Lane did not include any evidence of  
28 Mr. Williams's opinions, which form the basis of appellants' position, but that Mr. Harding was

1 provided with Mr. Kruckenberg’s curriculum vitae and declaration. As such, respondent states that  
2 Mr. Harding was asked to make sense of the large gap in opinions of the actual cost without actually  
3 comparing the two expert opinions. Respondent further notes that the file contains an “engagement  
4 letter” dated November 22, 2013 from appellants’ counsel, Mr. Bernsley, which appears to retain  
5 Mr. Harding to provide an expert opinion. Although appellants’ deny this relationship, respondent  
6 asserts that Mr. Harding was paid to provide insight and to comment specifically on the cost estimates of  
7 Mr. Kruckenberg and Mr. Williams even though appellants never provided him with Mr. Williams’s  
8 report. Respondent contends that appellants suggest that Mr. Williams is very familiar with the costs of  
9 construction and that he has access to a substantial database of actual construction projects in the  
10 Montecito area and their costs which is misleading because Mr. Williams has clearly stated that he did  
11 not rely on his inspections, or review the construction and loan fund disbursements in reaching his  
12 conclusions, and it is clear from the sample of Mr. Williams’s database that it lacks specific details to  
13 make the estimates meaningful. (Resp. 2d Supp. Reply Br., pp. 11-12, exhs. A, D and F.)

14           Respondent states that the engagement letter asks Mr. Harding “whether there should be a  
15 substantial difference between the cost data he received from his source, a former contractor who built  
16 homes in Montecito, and Mr. Williams’ data.” Respondent asserts that one explanation for the large  
17 difference between Mr. Harding’s amounts (which were based in part on cost data from his source) and  
18 Mr. Williams’s estimate, is that Mr. Williams never built a home in Montecito, has built very few homes  
19 at all and “relies on data that largely lacks the specificity to be relevant.” Respondent further states that  
20 the absence of Mr. Williams’s report from the file “is even more perplexing in light of the fact that  
21 Mr. Harding was asked to ‘make sense of the huge gap in opinions of actual cost (\$10 million,  
22 \$6 million, \$4 million) and the various estimates offered . . .” Respondent contends that requesting  
23 Mr. Harding to make sense of these differences but only providing one expert’s opinion, ensures that  
24 Mr. Harding’s opinion will be skewed. (Resp. 2d Supp. Reply Br., pp. 11-12, exhs. A, D and G.)

25           Respondent contends that the engagement letter misrepresents facts and cite as an  
26 example the statement that, soon after the sale, appellants and their managers claimed that the  
27 Garden Lane cost just over \$13.5 million, of which a little over \$2.844 million was allocated to the  
28 original purchase price “and the balance to the actual cost of improvement . . .” The letter also represents

1 that appellants' managers lost most of the documentation to support the claimed basis at the time of the  
2 audit. Respondent asserts that this explanation fails to clarify that appellants' CPA initially took the  
3 position that nearly \$2 million in capitalized interest expense was properly included in that \$13.5 million  
4 amount for basis. Respondent contends that this omission creates the impression that at one time  
5 appellants had documents to prove their claimed construction costs but, according to their CPA, nearly  
6 \$2 million of that claimed basis amount was improperly capitalized interest expense. Respondent further  
7 notes that the letter represents certain contested facts as undisputed, such as the statement that "the  
8 construction was mostly self-financed". Respondent asserts that certain statements are puzzling and  
9 misleading and that Mr. Harding appears to have questioned the statement that "Garden Lane was built  
10 in phases, with some portions being added on or partially replaced . . . That usually increases the  
11 probable actual cost (the issue in this case), but does not increase replacement cost." Respondent further  
12 asserts that Mr. Harding contradicts this notion that additions or replacements may not be reflected in  
13 reproduction cost by stating in his declaration that "if a structure was modified during its life, my  
14 analysis would consider the cost to build it to the state that existed on the date used for the appraisal . . ."  
15 The letter also states that if Mr. Harding "comes to the same conclusion" as stated in the 2003 appraisal  
16 that there is "no point to the assignment" which respondent asserts is appellants' attempt to sway him to  
17 revise his reproduction cost to match appellants' claimed basis. Because Mr. Harding did not provide a  
18 different reproduction cost amount in his declaration or elsewhere, respondent contends that one must  
19 logically conclude that his opinion did not change. (Resp. 2d Supp. Reply Br., pp. 13-14, exhs. A and F.)

20 In reviewing his declaration, respondent agrees that Mr. Harding has vast experience and  
21 is highly qualified to determine the reproduction cost of Garden Lane and for that reason respondent  
22 argues that great weight should be given those determinations as was recognized by Mr. Kruckenberg  
23 who used the reproduction cost as a starting point for his analysis. Respondent also agrees that there is a  
24 difference between actual cost and reproduction cost as defined by Mr. Harding in his appraisals and in  
25 his declaration. Respondent asserts that the two reproduction cost indicators stated in the 1999 and 2001  
26 appraisals are highly probative because, absent documentation of actual costs, the next best evidence  
27 would be reproduction cost, "adjusted for existing structures and changes in construction costs during  
28 the same time period, as determined by a highly qualified professional, who inspected the home and the

1 grounds close in time to when the actual construction took place, and is familiar with the nuances of the  
2 Montecito market.” (Resp. 2d Supp. Reply Br., pp. 14-15, exh. F.)

3 Respondent states that Mr. Harding affirms that he did not try to determine the actual cost  
4 of custom-fabricated features such as molding and ironwork but he states that he considered the quality  
5 of materials and workmanship in determining the reproduction value. Given Mr. Harding’s experience  
6 and knowledge of the trades in the Montecito area, respondent asserts that there is not likely to be much  
7 difference between the reproduction cost and actual cost. Respondent further asserts that this  
8 methodology is more reliable than Mr. Williams’s approach because he failed to consider the quality and  
9 quantity of materials and the skill of the trades employed. Although Mr. Harding states that his  
10 reproduction cost determination does not include the costs of demolition and site improvement,  
11 respondent states that these costs are known and relatively small. (Resp. 2d Supp. Reply Br., p. 15,  
12 exhs. A and F.)

13 Respondent notes that Mr. Harding “makes much of the difference between reproduction  
14 cost and replacement cost” as used by Mr. Kruckenberg. Respondent acknowledges the difference  
15 between the two valuation methods as the former meaning the cost of building an exact replica which  
16 may include obsolete features and may not comply with building codes and the latter meaning the cost  
17 of “a substitute for the building being appraised” which uses modern materials and meets all  
18 construction codes. Respondent asserts that in this case the difference between “reproduction cost” and  
19 “replacement cost” is minimal because Garden Lane was built on the existing foundation and first floor  
20 framing and presumably the construction complied with all building codes and used materials that were  
21 available within months or a few years of construction. Thus, respondent argues that the methodology  
22 for determining reproduction cost and replacement cost for Garden Lane would be similar within this  
23 period as opposed to a home built in the 1880s which would have been constructed with materials and  
24 techniques not currently available and probably would not comply with modern building codes. (Resp.  
25 2d Supp. Reply Br., pp. 15-16, exh F.)

26 Respondent contends that some portions of Mr. Harding’s declaration are incorrect. For  
27 example, he states that Mr. Kruckenberg made “invalid assumptions”, without fully identifying those  
28 assumptions, about the meaning of parts of his appraisal. Respondent asserts that the only assumptions

1 made by Mr. Kruckenberg, which are not disputed by Mr. Harding, were that Mr. Harding is qualified to  
2 determine reproduction cost and that Mr. Harding's reproduction cost opinions were accurate. In  
3 response to Mr. Harding's criticism of Mr. Kruckenberg's methodology, respondent contends that the  
4 methodology was sound because at the time he provided his opinion only the 2003 appraisal was  
5 available and adjustments were required to account for the substantial increase in construction costs  
6 from the year in which the construction was completed. Respondent further contends that any  
7 complaints about the methodology are now moot because the 1999 and 2001 appraisals are now part of  
8 this record, and more accurately reflect the range of the costs to build an exact duplicate of Garden Lane.  
9 (Resp. 2d Supp. Reply Br., pp. 16-17, exh. F.)

10 Respondent asserts that appellants' flowchart which they claim proves a "minimum basis  
11 of \$8.243 million" merely confuses matters even further. Respondent states that the diagram purports to  
12 show evidence of \$5.385 million in construction costs but that amount is based on disputed assertions  
13 and not supported by the evidence. Respondent states that it addressed the attestations in prior briefing  
14 but it is important to note that amounts quoted in the attestations are from unknown sources. Thus, the  
15 attestations are not credible evidence and cannot be used to increase appellants' basis for the reasons  
16 discussed in respondent's supplemental brief dated November 12, 2013. Respondent also notes that the  
17 flowchart references ledgers purportedly created from accounts used by Bruce Sweet but that the ledger  
18 without corroborating documentation does not constitute incontrovertible evidence because the amounts  
19 may have already been reflected in the Quick Books itemized Categories report that appellants provided  
20 during protest as amounts paid from the construction loan attached as exhibit K to respondent's  
21 supplemental brief. Respondent asserts that the ledger is "persuasive evidence" that "Mr. Sweet likely  
22 had charge of bank accounts that received \$3.2 million in deposits" and note that respondent's allowance  
23 of \$4.3 million in construction costs exceeds that amount by \$1.3 million. (Resp. 2d Supp. Reply Br.,  
24 pp. 17-18, exh. G.)

25 Respondent argues that the Cohan rule requires taxpayers to prove an entitlement to  
26 every claimed expense and what appellants refer to as "nitpicking" is "actually respondent's thorough  
27 review of the claimed expenses in order to ascertain which costs were actually incurred and, if so, how  
28 much may be allowed." Respondent further argues that it has already established that, contrary to

1 Mr. Williams's report, the existing foundation and framing were utilized, the guest house was never  
2 built, and a master bathroom was not added in 2002 and 2003. Respondent adds that it is clear from the  
3 attestations that Mr. Sweet did not receive fees, profit, and overhead of nearly \$1 million as estimated in  
4 Mr. Williams's report and that there were no change order and upgrades in the amount of \$1 million as  
5 stated in the report. Respondent also asserts that appellants were unable to provide sufficient supporting  
6 evidence but that respondent allowed over \$4.3 million in construction expenses in light of appellants'  
7 claim that the documents were lost and based on ledgers and other accounting records even though it  
8 was difficult or impossible to determine whether amounts were double-counted. However, respondent  
9 concludes that, when considering the additional evidence such as the appraisals, it is clear that the  
10 amount allowed is a reasonable estimate of basis. (Resp. 2d Supp. Reply Br., pp. 18-19)

11 Respondent contends that "appellants persist in the absurd argument that the burden of  
12 proof has shifted to respondent because respondent made adjustments at appeal that were favorable to  
13 appellants." Respondent further contends that, if appellants were correct in this argument, the burden of  
14 proof "would reward taxpayers for withholding information or providing incorrect information during  
15 audit and protest in order to later argue error in the assessment." Respondent asserts that discussion of  
16 the burden of proof is not relevant at this point because both parties have produced some documentary  
17 evidence thereby satisfying their respective burdens of production and "ultimately the Board will  
18 determine which party is supported by the weight of that evidence." (Resp. 2d Supp. Reply Br., p. 19.)

19 Respondent asserts that appellants attempt to disparage Mr. Kruckenberg by asserting  
20 that he was engaged in a tax dispute but note that the irony of this position is that all appellants  
21 appearing before this Board are engaged in a tax dispute. Respondent contends that the fact that a  
22 taxpayer disagrees with a taxing authority does not make that person any less credible. Furthermore,  
23 respondent states that Mr. Kruckenberg has resolved his tax dispute and appellants' information is  
24 outdated and irrelevant. (Resp. 2d Supp. Reply Br., p. 20.)

#### 25 Applicable Law

#### 26 Burden of Proof

27 The FTB's determination of tax is presumed to be correct, and a taxpayer has the burden  
28 of proving error. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Aaron and Eloise Magidow*,

1 82-SBE-274, Nov. 17, 1982.) This presumption is a rebuttable one and will support a finding only in the  
2 absence of sufficient evidence to the contrary. (*Appeal of George H. and Sky Williams et al.*,  
3 82-SBE-018, Jan. 5, 1982.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of  
4 proof. (*Appeal of Aaron and Eloise Magidow, supra.*) Respondent's determination is not evidence to be  
5 weighed against the taxpayer's evidence and the presumption disappears once evidence that would  
6 support a contrary finding is submitted. The effect of the presumption is to place the burden of going  
7 forward with the evidence on the taxpayer. (*Appeal of Robert L. Webber, supra.*)

#### 8 Gain on the Sale of the Properties

9 IRC section 1001 provides that the gain on the sale of property shall be the excess of the  
10 amount realized over the adjusted basis as defined in IRC section 1011.<sup>7</sup> IRC section 1011 provides that  
11 the adjusted basis for determining the gain from the sale of property shall be the property's initial basis  
12 (determined under section 1012 or other applicable sections of that subchapter) with adjustments as  
13 provided in IRC section 1016. Under IRC section 1016, the property's initial basis must be adjusted for  
14 capital expenses and capital recoveries. Capital expenses, such as the cost of capital improvements  
15 made to the property, increase the initial basis and capital recoveries, such as deductions for  
16 depreciation, reduce the initial basis so that on the date of disposition the adjusted basis reflects the  
17 unrecovered cost or other basis of the property. (Int.Rev. Code, § 1016(a).) These expenditures are  
18 distinguishable from expenditures for the ordinary repair and maintenance of the property, which are  
19 neither capitalized nor added to the initial basis. The latter expenditures are deductible in the current  
20 taxable year if such expenditures are related to business or income-producing property. (Int.Rev. Code,  
21 §§ 162 and 212; Rev. & Tax Code, § 17201.)

#### 22 The Cohan Rule

23 In *Cohan v. Commissioner* (2nd Cir. 1930) 39 F.2d 840, the famous theatrical producer,  
24 George M. Cohan, testified at trial that he had spent substantial sums of money travelling and  
25 entertaining actors, employees, and drama critics in furtherance of his theatrical production business. He  
26 could not substantiate by records the actual amounts of such expenditures but instead estimated the  
27

28 <sup>7</sup> California conforms to IRC sections 1001 and 1011-1016 pursuant to R&TC section 18031.

1 amounts in his testimony. The Board of Tax Appeals found that Cohan had made substantial  
2 expenditures and that those expenditures were allowable expenses, but denied any deductions on the  
3 ground that, in the absence of details, it was impossible to determine his actual expenses. On appeal, the  
4 Second Circuit Court of Appeal held that where a taxpayer has established that he or she has incurred an  
5 expense for which a deduction may properly be claimed, but is unable to document the exact amount of  
6 the expense, a court may make a reasonable estimate of the deduction in certain circumstances, “bearing  
7 heavily” against the taxpayer whose inexactitude is of his/her own making. This holding is referred to as  
8 the Cohan rule. (*Cohan v. Commissioner, supra.*) For a court to estimate the amount of an expense under  
9 the Cohan rule, the court must have some basis upon which an estimate may be made. (*Vanicek v.*  
10 *Commissioner* (1985) 85 T.C. 731, 742, 743.) Without such a basis, any allowance would amount to  
11 unguided largesse. (*Williams v. United States, supra*, at 560-561.)

#### 12 Reproduction Cost

13           Reproduction cost is “the estimated cost to construct, at current prices as of the effective  
14 date of the appraisal, an exact duplicate or replica of the building being appraised, using the same  
15 materials, construction standards, design, layout, and quality of workmanship and embodying all the  
16 deficiencies, superadequacy and obsolescence of the original building.” (The Dictionary of Real Estate  
17 Appraisal (5th Ed.), Appraisal Institute, 2010.) This variation of the cost approach is of limited  
18 usefulness because it is frequently not possible or desirable to duplicate an existing property, due either  
19 to the lack of certain materials or trade skills, or to the functional obsolescence of an older property. The  
20 difficulty of using reproduction cost increases as a property ages. (Assessors’ Handbook section 501,  
21 *Basic Appraisal* (Jan. 2002), p. 76.)

#### 22 STAFF COMMENTS

23           As stated in detail above, respondent contends that its adjusted basis determination of  
24 \$6,671,112 is supported by Mr. Kruckenberg’s analysis and the Harding appraisals and respondent has  
25 allowed the deduction of additional selling expenses of \$79,826. Appellants contends Mr. Williams’s  
26 revised report which determined a minimum cost of construction of \$9,783,783.20 and the original cost  
27 of the property of \$2,858,126 support the adjusted basis \$13,526,000 reported on the 2005 return. At the  
28 hearing, the parties should confirm whether these amounts are correct.

1 In the Appeal Letter, appellants state that the construction was “so extensive that it took  
2 two years to complete” but in the opening brief they state that, in 2002 through 2003, a detached garage  
3 was remodeled with the addition of a second floor guest house, and in the main house an addition of a  
4 second story master bathroom, a conservatory in the rear, and a master closet expansion.” The record  
5 reflects that, at least, some of the construction described during the 2002-2003 period did not occur.  
6 Appellants also state that Craig Szabo is confident of the adjusted basis computations performed by his  
7 staff. At the hearing, appellants should be prepared to discuss whether Mr. Szabo’s staff made their  
8 computations based on the assumption that the project was completed in 1999 or that construction was  
9 ongoing until or through 2003. Also, appellants should explain, if they have such information, the reason  
10 or reasons Mr. Szabo was confident of the adjusted basis computations performed by his staff.

11 Mr. Williams appears to have overseen the construction loan from 1997 through 1999 but  
12 did not rely on his actual knowledge and contemporaneous documentation for that period. At the  
13 hearing, appellants should be prepared to explain why Mr. Williams did not use his actual cost data for  
14 Garden Lane in determining the costs of construction.

15 Appellants cite the website Zillow.com as the source for their claim that average home  
16 values in Montecito during the relevant period from 1997 to 2005 rose between 0 percent and  
17 100 percent. Based on that claim, appellants assert respondent’s estimate of the adjusted basis for  
18 Garden Lane is too low because the sale price of \$25 million would have yielded a return in excess of  
19 300 percent. The Appeals Division notes that a database published by the California Association of  
20 Realtors lists monthly median home prices for each county in California from January 1990 through  
21 May 2015. The database shows median home prices in Santa Barbara County for calendar year 1997  
22 ranging from \$225,223 to \$296,299 and for calendar year 2005 ranging \$625,000 to \$796,875. Thus,  
23 according to that data, median home values rose between 211 percent and 354 percent in Santa Barbara  
24 County during that period. At the hearing, appellants should be prepared to provide the source of the  
25 Zillow.com home price data if such information is available.

26 Appellants argue that Mr. Williams’s methodology considers “actual construction costs  
27 of similar projects at or around the same time frame” and “assumes that homes of approximately the  
28 same size, quality, and features built in the same community around the same time will, on average,

1 have approximately the same door budget, the same window budget, etc.” Appellants assert that  
2 Mr. Williams’s methodology is identical to the comparable sales approach to value but in  
3 Mr. Williams’s analysis, the “transactions” are construction projects with the construction costs being  
4 considered. However, the Appeals Division notes that the comparable sales approach is a method of  
5 determining fair market value rather than actual costs, the issue in this appeal. At the hearing, appellants  
6 should be prepared to present any authority that supports the use of Mr. Williams’s methodology to  
7 determine actual construction costs or which demonstrates the validity of his method for that purpose.

8 In their second supplemental reply brief, appellants assert that Mr. Williams performed  
9 an analysis “using costs of comparable projects as a guide” and all of those comparable projects  
10 “retained some portion of the structure sufficient to qualify them as remodels.” However,  
11 Mr. Williams’s report estimates \$152,850 for concrete and Mr. Williams maintained that this amount is  
12 an appropriate cost for an entirely new foundation. Mr. Williams’s report also estimates \$307,000 for  
13 rough framing and \$300,000 for “rough lumber” and Mr. Williams stated that these amounts are  
14 appropriate for new framing of an entire house. At the hearing, appellants should be prepared to  
15 reconcile the statement that the “comparable projects” used in Mr. Williams’s analysis “retained some  
16 portion of the structure sufficient to qualify them as remodels” with Mr. Williams’s cost estimates for an  
17 entirely new foundation and new framing of an entire house.

18 Mr. Kruckenberg adjusted the Harding Appraisal reproduction cost by estimated  
19 percentages applied to the costs determined by Mr. Williams but appellants contend that no connection  
20 can be shown between those costs. At the hearing, respondent should be prepared to explain the nature  
21 of Mr. Kruckenberg’s adjustments and his rationale for the amount and type of the adjustments.

22 Because it appears that Mr. Harding was not provided with a copy of Mr. Williams’s  
23 report prior to making his declaration, respondent contends that the absence of that report ensured that  
24 Mr. Harding’s opinion would be skewed. At the hearing, appellants should be prepared to explain  
25 whether Mr. Harding was provided with a copy of Mr. Williams’s report to evaluate and compare with  
26 Mr. Kruckenberg’s opinion of the costs of construction. If not, appellants should explain why  
27 Mr. Williams’s report was not provided to Mr. Harding and whether Mr. Harding is familiar with  
28 Mr. Williams’s methodology. Respondent should be prepared to explain how the absence of

1 Mr. Williams's report would skew Mr. Harding's opinion.

2 **Issue (2) Whether appellants have established reasonable cause for the abatement of the penalty**  
3 **for failure to furnish information.**

4 Contentions

5 Appellants' Contentions

6 Appellants contend that the regulations prohibit the imposition of the penalty for failure to  
7 furnish information pursuant to R&TC section 19133. Specifically, appellants argue that the regulations  
8 permit the imposition of the penalty only in cases of unfiled, false or fraudulent returns which did not  
9 occur here. Appellants further argue that the auditor and the protest hearing officer ignored the  
10 regulation and that "this case demonstrates why the regulation is subject to abuse with respect to general  
11 information requests, and reflects wise policy." (Appeal Letter, pp. 7-8; App. Op. Br., pp. 24-25.)

12 Appellants contend that the auditor's demands were arbitrary, capricious, and  
13 unreasonable. Appellants state that the information document request (IDR) included a demand for  
14 appellants' tax return which had been filed and was in respondent's possession. Appellants contend that  
15 the government cannot compel a taxpayer to produce documents already in the government's  
16 possession, citing *U.S. v. Powell* (1964) 379 U.S. 48, 57-58. Appellants also state that the IDR  
17 demanded the statements and other items, not in existence, be prepared and provided, presumably for the  
18 convenience of the auditor. Appellants contend that a taxpayer need not prepare or produce documents  
19 that do not exist, citing *U.S. v. Davey* (2d Cir. 1976) 543 F.2d 996 and *U.S. v. Brown* (6th Cir. 1976)  
20 536 F.2d 117. (Appeal Letter, p. 8; App. Op. Br., pp. 25-26.)

21 Appellants contend that 20 days is a short period of time to provide a response to the  
22 IDR, especially when the taxpayer is a professional with many clients and responsibilities and did not  
23 possess much of the information demanded. Appellants further contend that the auditor did not comply  
24 with Regulation 19032, subdivision (a)(3), by working together with appellants' representative to make  
25 "relevant and reasonable" information requests. Rather, appellants contend that the auditor made  
26 unreasonable demands and gave an unreasonable amount of time for reply. Appellants also refer to IRC  
27 section 7605 which requires that the time for complying with such a request must be reasonable.  
28 Appellants also argue that the auditor "may have been trying to establish his power and authority, and

1 asserted a penalty as retribution for a perceived lack of respect.” Appellants assert that such motives are  
2 inappropriate and misplaced. Finally, appellants state that appellants’ representative did not have the  
3 records requested but sought to obtain them from other professionals. However, only a portion of the  
4 records could be located which was communicated to the auditor. Appellants state that ultimately the  
5 available information was provided and appellants’ representative is still in the process of assembling  
6 information from other sources. (Appeal Letter, pp. 9-10; App. Op. Br., pp. 26-27.)

### 7 Respondent’s Contentions

8 Respondent states that it first contacted appellants by letter dated July 5, 2007, about an  
9 income tax examination of their 2003, 2004, and 2005 tax year returns and requested additional  
10 information, including information about the sale of Garden Lane. When appellants did not reply to this  
11 letter, respondent states that it sent follow-up letters dated July 31, 2007, August 22, 2007, September 6,  
12 2007, and October 5, 2007, notifying appellants of the examination and requesting the information  
13 relating to the Garden Lane sale. When appellants failed to respond, respondent states that it issued a  
14 formal demand letter on November 2, 2007, requesting additional information about the Garden Lane  
15 sale. Respondent states that, on November 27, 2007, appellants responded to the request for information  
16 for tax years 2003 and 2004 but deferred the information request for 2005 to another accountant.  
17 Thereafter, respondent states that it gave appellants four extensions of the time to respond to the  
18 November 2, 2007 formal demand letter. Respondent states that, on October 9, 2008, respondent sent a  
19 final demand letter outlining the numerous attempts to obtain information about the Garden Lane sale, a  
20 computation of the adjusted basis, and a computation of the penalty for failure to furnish information.  
21 (Resp. Op. Br., pp. 2-3, exhs. A, B and C; App. Op. Br., exhs. 9, 11, 12, 13, 14, 15, 16)

22 Respondent states that appellants appear to confuse the penalty for the failure to furnish  
23 information with the penalty for failure to file a return upon demand (demand penalty) which are both  
24 found under R&TC section 19133 and that appellants cite the regulatory provision applicable to the  
25 demand penalty. However, respondent asserts that the demand penalty is not in issue here and that  
26 regulatory provision has no bearing on the imposition of the failure to furnish information penalty.  
27 Respondent further asserts that appellants provide no support to show that respondent acted in an  
28 arbitrary, capricious, and unreasonable manner and respondent had no access to receipts and invoices for

1 the Garden Lane construction. Respondent notes that, when appellants provided information at protest  
2 and appeal, respondent made adjustments in appellants' favor and did so because respondent did not  
3 previously have such information in its possession. (Resp. Op. Br., pp. 10-11.)

4 Respondent contends that appellants provide no substantiation for their claim that the  
5 penalty was imposed as "retribution for a perceived lack of respect." With respect to appellants'  
6 argument that the penalty should be abated because the delays were due to reasonable cause, respondent  
7 notes that it allowed appellants more than a year to respond to its requests for information and thus  
8 appellants' contention that they were given an unreasonable amount of time to reply has no merit.  
9 Finally, respondent maintains that the inability to find or compile information does not constitute  
10 reasonable cause that would support an abatement of the penalty, citing the *Appeal of William T. and*  
11 *Joy P. Orr* (68-SBE-010), decided on February 5, 1968.

#### 12 Appellants' Reply Brief

13 Appellants take issue with respondent's statement of the facts as follows:

- 14 • The fact that a schedule to appellants' 2005 return which computed the gain from the sale of  
15 Garden Lane was not received by respondent is not attributable to appellants or their  
16 accountants, as respondent suggests. Boulevard Management filed the return electronically and  
17 had no control over the information collected by respondent or how it was stored and  
18 reconstructed. Contrary to respondent's assertion, it appears that respondent's system may  
19 intentionally ignore supplemental pages and schedules "and focus only on the capture of  
20 numbers, not disclosures or explanations."
- 21 • Regarding the notice of examination and the request for information, respondent's letter did not  
22 request information and the IDR was served concurrently, which is clearly inconsistent with  
23 respondent's own regulations.
- 24 • Although it appears the examiner did not receive all information requested by October 5, 2007,  
25 the record shows that "at least by some time in October, 2007, the examiner was indeed having  
26 conversations with [appellants'] representative." Appellants acknowledge that respondent sent  
27 the final request for information letter dated November 2, 2007, but appellants object to the  
28 suggestion that the formal demand resulted from appellants' failure to respond because the

1 evidence shows that the examiner had discussions with appellants' accountant.

- 2 • Respondent's statement that appellants "deferred the information request for the 2005 taxable  
3 year to another accountant" mischaracterizes the evidence because Boulevard requested and was  
4 waiting for Szabo to send documentation as to the adjusted basis.
- 5 • The requests for extensions demonstrate that appellants' accountant was attempting to find and  
6 provide the requested documents and believed the documents could be located if allowed  
7 sufficient time. The letter are dated in 2008 rather than 2007 and "[i]f any are properly dated  
8 2008, they occurred after Respondent had already determined to assess the penalty, and therefore  
9 such delay could not have been the reason for asserting the penalty."
- 10 • Respondent mischaracterizes the October 9, 2008 letter as a final demand but it was an  
11 examination report with the examiner's conclusions.
- 12 • The evidence does not establish a causal link between a "lack of documentation" and the  
13 issuance of the NPA which was the result of a "determination of deficiency" and not "frustration  
14 over missing documents (unless Respondent concedes the invalidity of the notice)", citing *Scar*  
15 *v. Commissioner* (9th Cir. 1986) 814 F.2d 1363 and *Wertin v. Franchise Tax Bd.* (1998)  
16 68 Cal.App.4th 961.
- 17 • The statements about what occurred at protest are irrelevant and argumentative.  
18 (App. Reply Br., pp. 3-6, exhs. 4, 9, 10, 15, 16, 16A and 107-100; Resp. Op. Br., exhs. A and B.)

19 Applicable Law

20 R&TC section 19133 provides that, if any taxpayer fails or refuses to furnish any  
21 information requested in writing by the FTB or fails or refuses to make and file a return upon notice  
22 and demand by the FTB, then, unless the failure is due to reasonable cause and not willful neglect, the  
23 FTB may add a penalty of 25 percent of the amount of tax determined pursuant to R&TC section 19087  
24 or of any tax deficiency assessed by the FTB concerning the assessment of which the information or  
25 return was required. To establish reasonable cause for waiving the penalty, a taxpayer must show that  
26 the failure to reply to the request for information occurred despite the exercise of ordinary business care  
27 and prudence. (*Appeal of Stephen C. Bieneman*, 82-SBE-148, July 26, 1982.) The taxpayer's reason for  
28 failing to respond to the request for information must be such that an ordinarily intelligent and prudent

1 businessperson would have acted similarly under the circumstances. (*Appeal of Eugene C. Findley*,  
2 86-SBE-091, May 6, 1986.) Unless a taxpayer provides credible and competent evidence to support her  
3 claim of reasonable cause, the penalty will not be abated. (*Appeal of Michael J. and*  
4 *Diane M. Halaburka*, 85-SBE-025, Apr. 9, 1985.)

#### 5 STAFF COMMENTS

6 Appellants assert that the formal demand did not result from appellants' failure to  
7 respond because the evidence shows that the examiner had discussions with appellants' accountant. At  
8 the hearing, the parties should be prepared to discuss whether the information provided by appellants'  
9 accountant was responsive to the information requests. Appellants should also be prepared to describe  
10 the efforts made by them or their representatives to obtain the requested information from Mr. Szabo  
11 during the period for which they requested extensions.

#### 12 Additional Evidence

13 Pursuant to California Code of Regulations, title 18, section 5523.6, if the parties have  
14 any additional evidence that they want the Board to consider, the parties should provide their additional  
15 evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.<sup>8</sup>

#### 16 Section 40

17 As noted above, this matter is subject to Revenue and Taxation Code section 40.  
18 Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written  
19 opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website.  
20 (Cal. Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become  
21 final 30 days following the date of the Board's vote, except when a petition for rehearing is filed within  
22 that period.<sup>9</sup> (Cal. Code Regs., tit. 18, § 5460, subd. (a).)

23 Following the conclusion of this hearing, if the Board votes to decide the appeal, but  
24 does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will  
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26 <sup>8</sup> Evidence exhibits should be sent to: Khaaliq A. Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of  
27 Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.

28 <sup>9</sup> If a petition for rehearing is filed, the Board's decision will not become final, and no written opinion under Section 40 will  
be considered until after the petition for rehearing is resolved.

1 expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for  
2 consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board  
3 directs otherwise, the proposed Summary Decision would not be confidential pending its consideration  
4 by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the  
5 Public Agenda Notice for the meeting at which the Board will consider and vote on the Summary  
6 Decision.

7           A taxpayer may request that the Board hold in abeyance its vote to decide the appeal so  
8 the taxpayer may review the Board’s written opinion prior to the expiration of the 30-day period for the  
9 filing of a petition for rehearing. If the vote is held in abeyance, the proposed Summary Decision will  
10 be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).) Any  
11 request that the Board’s vote be held in abeyance should be made in writing to the Board Proceedings  
12 Division prior to the hearing or as part of oral argument at the hearing. Any such request would then be  
13 considered by the Board during its deliberations on the appeal.

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