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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:

BRIAN N. KHOURY;

JASON B. KHOURY AND

LISA B. KHOURY;

NOELLE K. LUDWIG AND

TIMOTHY S. LUDWIG

HEARING SUMMARY

PERSONAL INCOME TAX APPEAL

Case No. 867810;

Case No. 867855;

Case No. 867874

Deficiency

Case No.	Year	Amount	Interest-based Penalty[1]	NEST Penalty[2]
867810	2006	$492,858.00	$164,127.94	$178,003.00
867855	2006	$501,883.00	$348,396.39	$181,263.00
867874	2006	$500,697.00	$166,738.43	$180,834.00

Representing the Parties:

For Appellants: Michael C. Hamersley, Esq., MBA

For Franchise Tax Board: Roman D. Johnston, Tax Counsel IV

[1] This penalty was imposed pursuant to R&TC section 19777. Unless otherwise stated, references to statutes and regulations refer to provisions in effect as of the tax year at issue (2006) and for purposes of this appeal.

[2] R&TC section 19774 imposes a penalty on noneconomic substance transactions. It is commonly referred to, and referred to herein, as the "NEST" penalty.

Questions: (1) Whether appellants' consent to the extension of the statute of limitations is valid and enforceable such that the Franchise Tax Board (FTB or respondent) timely issued its Notices of Proposed Assessment (NPAs).

(2) Whether appellants' installment sale transaction should be disallowed under the economic substance doctrine or other judicial standards.

(3) Whether Internal Revenue Code (IRC) section 453(e) applies to disallow installment sale treatment.

(4) Whether the partnership anti-abuse regulations apply to appellants' transaction.

(5) Whether the NEST penalty applies and, if it applies, whether it should be reduced to 20 percent on the basis of adequate disclosure.

(6) Whether the interest-based penalty applies.

(7) Whether interest suspension applies.

HEARING SUMMARY

Section 40 Appeal

This is an appeal in which R&TC section 40 (Section 40) applies. Therefore, within 120 days of the date the Board renders its decision in this matter, a written opinion must be published on the Board's website. Please see General Staff Comments under Issue 7 for a discussion of Section 40.

Background

General

Appellants Brian Khoury, Jason Khoury, and Noelle Ludwig (Siblings) are the adult children of Tawfiq N. and Richel G. Khoury (Grandparents or Khoury Parents).[3] Grandparents are the founders of the Pacific Scene Family of Companies (Pacific Scene), which is a group of family-owned real estate development and investment companies. (AL,[4] p. 11.)

[3] For simplicity, Brian, Jason, and Noelle will be referred to as appellants or the Siblings. However, Jason B. Khoury's spouse, Lisa B. Khoury, and Noelle K. Ludwig's spouse, Timothy S. Ludwig, are also a party to the appeal.

[4] Unless otherwise indicated, references to AL refer to the Appeal Letter of Brian N. Khoury, Case No. 867810. The appeal letters of the other appellants raise the same issues and arguments. The appeals were consolidated following the receipt of the appeal letters.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Transaction

In sum, in the transaction at issue, NBJ Associates L.P. (NBJ) sold its limited partnership interest in RSD Group L.P. (RSD or RSD Group) to Sundance-K, LP (Sundance-K) in return for an installment note (RSD Interest Sale).[5] Shortly after this sale, RSD sold the Club Pacifica Apartments in El Cajon, California to an unrelated third party (RSD Property Sale). (AL, pp. 11-17; Respondent's Opening Brief (ROB), pp. 3-10.)

To provide more background, on or about December 6, 2005, RSD contracted to sell the Club Pacifica Apartments. NBJ's share of the sale proceeds was projected to be $14,785,629. On or about January 3, 2016, the RSD Interest Sale occurred. In the RSD Interest Sale, NBJ sold its interest in RSD to Sundance-K in return for a $14,750,000 installment note issued by Sundance-K and $10,000 in cash. Of the $14,750,000 amount due on the note, $490,000 was due on February 1, 2006, and was paid on or about that date. The remaining $14,260,000 was due in thirty years, on January 3, 2036, with monthly interest-only payments of $60,000 (a five percent rate) due and paid beginning March 1, 2006. Pursuant to an IRC section 754 election, Sundance-K's share of the partnership's basis in the property was increased by $17,529,480.[6] On February 7, 2006, the RSD Property Sale closed. The gain and sale proceeds were allocated and subsequently distributed to the partners of RSD. As a result of the IRC section 754 election, Sundance-K, which now held the partnership interest that had formerly been held by NBJ, had $223,558 of allocated net gain (as compared to gain of $17,753,038 that would have been

[5] Appellants owned interests in NBJ, RSD, and Sundance-K as follows. Appellants each owned a 33 percent interest in NBJ. Loma Verde Inc. (LVI), an S corporation that was wholly owned by appellants, served as NBJ's general partner and held the remaining one percent interest in NBJ. Jason Khoury was the President of LVI. Appellants held an interest in RSD through NBJ and also through NBJ's other partners, which were Sundance Financial, Inc. (SFI), The First Kekale Corp. (Kekale or FKC), and The MFI Group LP (MFI). Appellants owned all of SFI and Kekale, which were S corporations. SFI was the general partner of Sundance-K and owned 20 percent of Sundance-K. Appellant Noelle Ludwig's husband, Tim Ludwig, was the President of SFI. The Khoury Family 1999 Irrevocable Trust (referred to by appellants as the 1999 Grandchildren Irrevocable Trust) owned an 80 percent limited partnership interest in Sundance-K. MFI's owners were its general partner SFI, which owned a 48 percent interest, the Grandparents (i.e., the Siblings' parents), who owned a 51.6 percent interest through a disregarded grantor trust, and LVI, which owned a 0.4 percent interest. Appellants held their ownership interests in the entities through disregarded grantor trusts. Charts of the ownership structure can be found at AL, Ex.'s X and XI, and ROB, Ex. Y, p. 15. It should be noted that the organizational diagram at ROB, Ex. Y, p. 15, does not include Sundance-K.

[6] Through IRC section 743(b), Sundance-K's proportionate share of the partnership's basis in its assets (i.e., Sundance-K's "inside" basis) was increased to equal Sundance-K's basis in the partnership interest. The effect of IRC section 743(b) is to treat a purchaser of a partnership interest as if the purchaser purchased an interest in the partnership's assets. It only affects the purchasing partner.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

1 allocated in the absence of the IRC section 754 election). On February 28, 2006, RSD distributed
2 $14,504,490 in proceeds from the RSD Property Sale to Sundance-K and, on February 28, 2006, it
3 distributed an additional $351,698 to Sundance-K. Sundance-K then used substantially all of the
4 proceeds to extend loans to other entities.[7] On and following March 1, 2006, Sundance-K paid the
5 $60,000 monthly interest-only payments which were due on the installment note, which NBJ reported as
6 taxable income. (AL, pp. 11-17; ROB, pp. 3-10.)

7 Audit and Protest[8]

8 The FTB's audit began in April 2009. Following the issuance of and responses to various
9 information document requests (IDRs), the FTB's auditors requested, and on May 27, 2011 received,
10 appellants' consent to an extension of the statute of limitations to October 15, 2012. In July of 2011, the
11 FTB advised appellants of its Voluntary Compliance Initiative 2 (VCI-2).[9] Under VCI-2, taxpayers
12 could obtain the removal of certain penalties if they paid tax and interest due by October 31, 2011.[10]
13 Following an August 9, 2011 meeting and additional discussions, appellants determined not participate
14 in VCI-2. (AL, pp. 2-5; ROB, pp. 9-10.)

15 On February 6, 2012, the FTB issued an audit issue presentation sheet (AIPS 1). On
16 March 12, 2012, appellants sent a response which raised due process and objectivity concerns and
17 included four declarations of fact.[11] On May 25, 2012, the FTB issued a second AIPS (AIPS 2).
18

19 [7] The other entities were Grossmont Partners, LP/Grossmont Co-Tenants (Grossmont), Legacy Building Services, Inc.
20 (LBS), KLH Land Holding, Inc. (KLH), and LVI. LVI owned a 14.4 percent interest in Grossmont Tenants and
Grossmont Partners, LP owned the remaining interest. SFI owned a 29.82246 percent capital interest in Grossmont Partners.
21 Respondent states that an unrelated third party owned the remaining capital interest in Grossmont Partners. The Siblings
each owned one-third of LBS. The Grandparents owned 25 percent of KLH. Jason Khoury's children's trust owned
22 25 percent of KLH, and Brian Khoury and his children's trust each owned 12.5 percent of KLH. (AL, pp. 15-16; ROB, pp.
8-9.)

23 [8] The parties' contentions provide further information and argument regarding the audit and protest and appellants' signing of
24 consents to extensions of the statute of limitations. (See AL, pp. 2-10, 17-20; ROB, pp. 9–10; Appellants' Reply Brief
(ARB), pp. 8-12; Appellants' Supplemental Brief as corrected and submitted Nov. 27, 2015 (ASB), pp. 2-3.)

25 [9] Staff requests that the FTB provide this notice (or the form of the notice if a copy is not available) as an additional exhibit
26 at least 14 days prior to the oral hearing date.

27 [10] See https://www.ftb.ca.gov/Voluntary_Compliance_Initiative_2/.

28 [11] The response can be found at Exhibit A of respondent's supplemental brief dated February 17, 2016. The declarations are
dated March 2, 2012 and can be found as Exhibits V, W, and X of respondent's opening brief.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Following additional discussions, on August 24, 2012, appellants signed a consent and waiver to extend the statute of limitations for assessment to November 15, 2012. As summarized below under the heading of "Contentions," appellants argue that the consent is invalid based on various grounds. (AL, pp. 5–7; ROB, p. 10, Ex.'s JJ, KK, and LL [consents], and Ex.'s MM [Aug. 12, 2012 letter], NN [July 23, 2012 email].)

On September 26, 2012, the FTB sent a third audit issue presentation sheet (AIPS 3) to appellants. AIPS 3 is sometimes referred to as the FTB's "Final Analysis." Appellants disagreed with AIPS 3 and filed a response on October 30, 2012. (AL, pp. 7-8.)

On November 7, 2012, respondent issued Notices of Proposed Assessments (NPAs) to appellants proposing the additional tax and penalties set forth on the first page of this Hearing Summary. The NPAs stated that deferred gain from the installment sale at issue was being disallowed and that the installment sale "had characteristics of an abusive tax shelter transaction."[12]

On January 7, 2013, appellants protested the NPAs. On January 30, 2013, after the involvement by the FTB Taxpayers Rights Advocate, the FTB issued a closing letter. On November 14, 2013, a protest hearing was held. On November 27, 2014, the FTB issued a preliminary determination letter (PDL) stating it would affirm the NPAs. On December 29, 2014, the FTB issued a final determination letter (FDL), and on January 6, 2015, the FTB Chief Counsel declined appellants' request for relief from the NEST penalty. On January 13, 2015, the FTB issued Notices of Action affirming the NPAs, and appellants filed timely appeals which were subsequently consolidated into this appeal.[13]

<u>ISSUE (1): Whether appellants' consent to the extension of the statute of limitations is valid and enforceable such that Franchise Tax Board (FTB or respondent) timely issued its NPAs.</u>

<u>Contentions – Issue (1)</u>

<u>Appeal Letter – Issue (1) – Procedural History</u>[14]

Appellants state that the FTB issued extensive IDRs, to which appellants fully and timely

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[12] AL, p. 8; Ex. II for Brian K. and Ex. II following ALs of Noelle K. L. and Timothy S. L., and Jason B. K. and Lisa B. K..

[13] AL, pp. 8-10, Ex's III [Jan. 7, 2013 protest], VI [Nov. 26, 2014 PDL], VII [Dec. 29, 2014 FDL], I [Brian N. K. NOA; other NOAs are substantively identical with only amounts differing].

[14] Appellants' description of the procedural history may also be relevant to its other arguments as well.

responded. Appellants state that they "graciously agreed" to the first extension of the statute of limitations in order to provide more time for the FTB auditors to review the facts. (AL, pp. 2-3.)

Appellants assert that, in July of 2011, without fully reviewing the information supplied by them, the FTB "advised the Taxpayers to self-assess and report the RSD Interest Sale as a BOB abusive tax shelter by participating in [VCI 2]."[15] Appellants state that they felt strongly that they had shown the transaction was not abusive and requested to meet with FTB auditors. Appellants argue that, during the August 9, 2011 meeting with the FTB auditors, the FTB lead auditor "admitted . . . that the facts at hand are very different from every other BOB transaction he had seen, particularly given the significant amount of gain reported and income taxes paid in 2006, the year of the transaction." Appellants contend that the FTB auditors advised that they would consult further with FTB attorney Michael Cornez and would then provide the taxpayers with a further explanation regarding the FTB's position. Appellants argue that the FTB auditors promised to provide the guidance by September 30, 2011 so that the taxpayers had time to prepare amended tax returns in time to meet the October 31, 2011 deadline for participation in VCI 2. (AL, p. 3.)

Appellants state that, on or about October 4, 2011, they were told that the "promised report would not be available until November 2011" which would be after the October 31, 2011 deadline for participation in VCI 2. Appellants argue that the auditors' "failure to provide the promised guidance . . . left the Taxpayers in a very precarious position." Appellants argue that they had to decide whether to irrevocably self-assess tax and participate in VCI 2 before the deadline, and thereby avoid associated penalties, when they thought they had demonstrated that the transaction was not an abusive tax shelter. Appellants contend that they determined that the Internal Revenue Service (IRS) would not treat the transaction as an abusive tax shelter and determined not to participate in VCI 2. Appellants further contend that they "provided references to federal authorities" supporting their position, including

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[15] See FTB Notice 2008-4 (Resolution of Bogus Optional Basis (BOB) Transactions and Certain Employee Stock Ownership Plan (ESOP) Transactions), June 6, 2008 [available at https://www.ftb.ca.gov/law/notices/2008/2008_4.pdf].

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

a GAO Tax Gap Report on 'IBOBs" and an IRS paper on Redemption BOBs.[16] Appellants allege that the FTB lead auditor stated in part that the documents were not authority that the FTB had to follow and indicated that the taxpayers would receive a standard AIPS regarding BOB transactions. (AL, pp. 4-5.)

Appellants assert that AIPS 1 alleged "that the RSD Interest Sale was a BOB abusive tax shelter." Appellants contend that AIPS 1 contained factual and legal errors and omitted material taxpayer-favorable facts, such as bank statements and favorable authorities. On March 12, 2012, appellants sent a response explaining why they disagreed with AIPS 1, "expressing grave concerns regarding the FTB auditors' lack of objectivity and due process . . . [,]" and providing declarations of fact. Appellants argue that the FTB began to "retreat" from its characterization of the transaction as a BOB and refer to the transaction as a "tax shelter of first impression." Appellants further assert that the FTB lead auditor advised appellants' representative that he would be "taking over as the lead auditor" and would shortly issue his own analysis. (AL, p. 5.)

Appellants state that AIPS 2 was issued on May 25, 2012, and it did not refer to the transaction as a BOB any longer. Appellants state that the FTB lead auditor requested a written response to AIPS 2, and the IDRs contained in it, within 30 days. Appellants allege that AIPS 2 had more errors and omissions than AIPS 1 and "contained significant evidence of bias and predetermined outcome." Appellants state that they requested clarification in writing regarding the status of AIPS 1 and raising issues with AIPS 2 but did not receive any such clarification. Appellants assert that AIPS 2 "gave no regard" to the declarations provided, reasoning that "declarations are not evidence" and do not have to be considered. (AL, pp. 5-6.)

Appellants argue that the FTB reviewing auditor recognized that AIPS 2 was deficient and advised appellants' representative that the FTB lead auditor would be drafting a Final Analysis (AIPS 3) that would replace AIPS 1 and AIPS 2. Appellants state that, on or about July of 2012, the FTB began requesting their consent to a four-month extension of the statute of limitations. Appellants state that they declined to agree to the extension due the additional delay and expense and explained

[16] A GAO report addressing iBOBs may be found at: http://www.gao.gov/assets/320/310180.html, and an IRS coordinated issue paper addressing the "Redemption Bogus Optional Basis Tax Shelter[,]" dated January 31, 2006, was published by *Tax Notes Today* on February 7, 2006, and can be found on Lexis at 2006 TNT 25-38. It appears to staff that these may be the reports referenced by appellants.

they had lost confidence in the FTB auditor's "ability to conduct an objective and fair review" and believed that the FTB was committed to issuing an NPA in any event. Appellants assert that, in response, "the FTB auditors made a number of verbal and written promises, representations and assurances to the contrary, including promises of taxpayer 'benefits' (e.g. no decision had been made on whether an NPA would [be] issued, AIPS 3 was intended to afford a "fresh look" and provide . . . independent review . . . prior to any decision being made . . .), in an effort to convince the Taxpayers to enter into an additional statute of limitations extension." Appellants argue that, relying on the promises and assurances of the FTB auditors, their representative conveyed a compromise offer of a 30-day extension of the statute of limitations, but subject to "a condition precedent requiring inspection of the FTB's 'Final Analysis' prior to signing the consent agreement." Appellants state that the FTB auditors "rejected this offer stating that such conditions could not be included in the boilerplate form consent agreements because FTB policies prohibit any alteration or modification to this form." (AL, pp. 6–7.)

Appellants argue that their representative "agreed to remove the condition precedent and blindly trust that the FTB auditors were true in their intentions and would keep their word regarding the timing and purpose of AIPS 3." Appellants state that the FTB shortened the extension to thirty additional days and that, "[b]ased on the representations, promises, and assurances made by the FTB auditors, the Taxpayers' representative executed this waiver on August 24, 2012[,]" extending the statute of limitations for assessment until November 15, 2012. Appellants allege that it subsequently became apparent from the statements and conduct of the auditors that they "had no intention of making good on the promises and assurances made to induce [appellants' agreement to the consent] and that their true purpose was for the sole benefit of the FTB auditors (i.e., to buy time they needed to purge AIPS 1 and AIPS 2 and support its intended NPA with AIPS 3 instead)." (AL, p. 7.)

Appellants assert that AIPS 3 also contained "numerous errors and omissions of fact and law." Appellants state that they advised the FTB that it contained "indisputable evidence demonstrating that it was drafted with the purpose of removing the facial evidence of predetermined outcome, bias, and auditor misconduct apparent in AIPS 1 and AIPS 2. Appellants further contend that AIPS 3 erroneously argued that Sundance-K was "newly formed in 2006 to facilitate the RSD Interest Sale" when the taxpayers had provided the FTB "with years of Sundance-K federal tax returns filed in

years prior to 2006." Appellants responded to AIPS 3 on October 30, 2012. (AL, pp. 7-8.)

Appellants assert that, although the FTB "had issued dozens of IDRs and received more than one thousand pages of information and documents[,]" it issued a "protective" or "naked" NPA containing only a brief two-paragraph explanation that the deferred gain on the installment sale was disallowed, that the installment sale had characteristics of an abusive tax shelter transaction and that the maximum 40 percent NEST penalty would be assessed because the transaction was not adequately disclosed. Appellants note that the NPA did not reference any other information or analysis and state that the NPA did not provide an explanation for how the basis, gain, tax, penalties, or interest was calculated. (AL, pp. 8-9.)

Appellants argue that the FTB lead auditor continued auditing and issuing IDRs following the NPA and assert that the auditor acknowledged the "naked" nature of the NPA and instructed the taxpayers to file a "bare bones" protest letter. Appellants argue that the lead auditor "blamed the Taxpayers and wrongfully attributed his delinquency to the Taxpayers' refusal to grant him the additional four-month statute of limitations consent agreement he had demanded." Appellants argue that they responded in their January 7, 2013 protest letter and argued that the auditors' conduct "negated any mutual assent or 'meeting of the minds' and rendered the 8/24/2012 SOL Consent Agreement invalid." Appellants assert that the FTB's January 30, 2013 "Closing Letter" reflected new theories of assessment. Appellants note that a protest hearing was held and state they expressed "fresh look" concerns regarding the involvement of Mr. Cornez because they had been told he had been involved in the audit. (AL, pp. 9-11.)

Appeal Letter – Issue (1) – Statute of Limitations

Appellants assert that the FTB's position is both legally and factually incorrect. Appellants note that Revenue and Taxation Code (R&TC) section 19067 provides that a taxpayer may consent in writing to extend the statute of limitations and that this provision is patterned after Internal Revenue Code (IRC) section 6501(c)(4). Appellants state that it is settled law that statute of limitations waivers are governed by contract law principles such as fraudulent inducement, coercion, and mutual assent, citing in a footnote *Schulman v. Commissioner* (1989) 93 T.C. 623 (*Schulman*), 639, *Kronish v. Commissioner* (1988) 90 T.C. 684 (*Kronish*), 693, *Huene v. Commissioner* (1989) T.C. Memo 1989-570

(*Huene*), *Robertson v. Commissioner*, T.C. Memo 1973-205 (*Robertson*), and numerous other cases. (AL, pp. 17-18, fn. 3.)

Appellants argue that the FTB "attempts to reframe" their "fraudulent inducement" and "meeting of the minds" arguments as simply a matter of whether the consent agreement included conditions. Appellants contend that the FTB erroneously argues that "the consent agreement is per se valid unless specific conditions are added to the agreement, notwithstanding facts and circumstances indicating the absence of mutual assent to the agreement (i.e., a 'meeting of the minds') and material misrepresentations of fact and deceptive conduct by the FTB auditors relating to the purpose, terms, benefit and expectations of the parties with respect to the consent agreement." Appellants argue that the FTB's view is based on "an invalid application of the parol evidence rule and/or an invalid assumption that the only express or implied term of an FTB consent agreement is the issuance of a protective NPA by the date in the agreement." (AL, pp. 18-19.)

Appellants further argue that the FTB's preliminary determination letter (PDL) "materially misstates the facts" with regard to the consent agreement. Appellants contend that the evidence does not support the FTB's "attempt to suggest that the Taxpayers' good faith gesture in agreeing to relinquish the request for [a] specific condition precedent and use of the word 'unconditional' in so doing can be reasonably interpreted as having intended to submit to a 'no holds barred' pattern of deception and waiver of all reasonable expectations regarding the conduct of the parties . . . or removal of all the expressed and implied terms, promises, obligations, and conditions inherent in the [agreement.]" (AL, p. 19.)

Appellants allege that, by arguing that the taxpayer understood and expressly stated that the waiver was unconditional, the FTB omits "highly relevant and contradictory contextual information" that is shown in their January 7, 2012 protest letter. Appellants state that the FTB incorrectly refers to an August 15, 2012 letter when it appears to be referring to correspondence dated August 22, 2012 which is included in their Exhibit XII. Appellants also point to their June 19, 2012 correspondence and "July 23 email" which are attached in their Exhibit XIII and to additional correspondence attached as Exhibit XIV. (AL, p. 19.)

Appellants assert that "[a]n examination of the contextual information and audit

correspondence . . . leaves no doubt": (1) that the consent agreement "was not 'unconditional' in the sense the protest hearing officer is suggesting[;]" (2) that there was "no mutual assent or 'meeting of the minds[;]'" and (3) that appellants would not have signed the consent agreement in the absence of the FTB's:

> coercive threats of improper and negative consequences from failure to sign a consent agreement or had the FTB auditors been truthful regarding (i) their intent to disavow and breach their express promises of taxpayer benefits or the implied promises inherent in every consent agreement, or (ii) their plans to open an audit of Sundance-K under false pretenses to continue the audit . . . and subject the Taxpayers to further undue burden and expense far beyond the agreed upon November 15, 2012 extension date, NPA issuance and protest filing.

Appellants argue that, as a result, the consent agreement is not valid. (AL, pp. 19 – 20.)

FTB's Opening Brief – Issue (1) – Statute of Limitations

The FTB states that, at the August 9, 2011 meeting, "[a]ppellants and Respondent's auditors communicated with each other regarding the transaction and the applicability of judicial doctrines." Pointing to its audit "PASS" event log, the FTB states that appellants' representative left a voicemail on September 27, 2011 indicating that appellants would not participate in VCI 2. The FTB states that its auditor confirmed the receipt of the message on September 30, 2011 and notified appellants that she would be out of the office, returning on October 31, 2011. Based on the foregoing, respondent concludes that ". . . whatever issues Appellants may have had concerning their participation in VCI 2 were resolved over one month prior to the end of the eligibility period." (ROB, p. 10.)

The FTB argues that the NPAs were timely under the statute of limitations as extended by the waivers. The FTB notes that each waiver states that it "will extend the period during which we may examine the return and issue a [NPA]." The FTB argues that "[p]rior to signing the Waivers of SOL, Appellants' representative had previously represented twice that the 30-day Waiver of SOL was unconditional[,]" citing the August 22, 2012 letter of appellants' counsel and his July 23, 2012 email. The FTB further argues that appellants "are fully aware that Respondent does not allow changes or modifications to the Waivers of SOL[,]" citing appellants' opening brief. (ROB, p. 10.)

The FTB disputes appellants' arguments that there was no "meeting of the minds" on the ground that the waivers of the statute of limitations (SOL) "were unconditional and were executed by

Appellants' representative." Respondent asserts that it "did not fraudulently induce or coerce the representative to sign the Waivers of SOL." Respondent further asserts that appellants' "dissatisfaction with the results or the occurrence of intervening events after execution of the Waivers of SOL does not equate to fraudulent inducement." (ROB, p. 11.)

Appellants' Reply Brief – Issue (1) – Statute of Limitations

Appellants argue that the FTB's description of events related to VCI 2 is inaccurate and misleading. Appellants contend that the FTB promised to provide "non-binding guidance on or before September 30, 2011 so as to allow the Taxpayers sufficient time to prepare amended tax returns by the October 31, 2011 participation deadline." Appellants further contend that the FTB auditors did not deliver "the VCI-2 BOB guidance they had promised, and that Appellants' communication of their decision to not to participate in VCI-2 was made only after being informed of the FTB junior auditor's vacation and that such FTB guidance would not be forthcoming in time to allow Appellants sufficient time to prepare amended tax returns by the October 31, 2011, participation deadline." (Appellants' Reply Brief (ARB), p. 7.)

Appellants argue that the consents to extend the statute of limitations were invalid on one or both of the following grounds. First, appellants argue that they were fraudulently induced into signing the consents as "[t]he FTB auditors' coercive tactics and exercise of undue influence in making improper threats to issue a protective NPA after years of auditing and contribute to Appellants increased costs of defending against the FTB's actions if appellants refused to sign . . . and/or lack of good faith and fair dealing in making false representations of fact regarding their true intentions and their true unilateral purpose and benefit . . . ." Second, appellants argue that there was no mutual assent or "meeting of the minds" regarding "the essential terms, purpose, and benefits [of the consent] given the FTB's apparent position that its understanding of Appellants' use of the term 'unconditional' was somehow intended or operated to negate all . . . expressed and implied duties, obligations and covenants of good faith and fair dealing . . . ." Appellant assert that, as was "promptly manifested" by the FTB's "conduct and written communications, the FTB's purported understanding of the term 'unconditional' was not shared by Appellants, nor would it be shared by . . . any reasonable person under the circumstances . . . ." (ARB, pp. 8-9.)

Appellants argue that they would not have signed the consent "in the absence of the FTB auditors' coercive threats" or if the auditors had been "truthful about their true intentions . . . or their intent to disavow, breach and frustrate the benefits the FTB represented and promised" to secure appellants' consent. Appellants further argue that the FTB "summarily concludes" that there was a "meeting of the minds" and no fraudulent inducement and note that the FTB "does not offer any legal authority . . . or any application of law to the facts . . . ." (ARB, p. 10.)

Appellants argue that the FTB appears to contend that appellants' use of the term "unconditional" and appellants' understanding that the FTB does not allow a modification of its boilerplate agreements "somehow evidences" a meeting of the minds. Appellants contend that the FTB's argument conflates "the principles of contractual conditions with the essential elements for contract formation" and is "troubling from a public policy perspective." Appellants assert that neither appellants nor any reasonable person would understand "unconditional" to mean waiving "all expectations of good faith and fair dealing." Appellants further assert that, if the FTB auditors shared the FTB's view of the meaning of "unconditional," then there was no meeting of the minds because the parties to the agreement attached different meanings to this "essential term." (ARB, pp. 11-12.)

<u>Appellants' Supplemental Brief – Issue (1) – Statute of Limitations</u>

Appellants argue that, despite all of their prior arguments regarding the invalidity of the consents, and their criticism of respondent's opening brief on this issue, "<u>[s]hockingly, [respondent's reply brief] is nonetheless completely silent with respect to this critical and dispositive threshold issue</u> . . . . [emphasis in original]." Appellants argue that ". . . the proper inference to be drawn . . . [is] that there is a fatal flaw in Respondent's argument on this dispositive issue." (ASB, pp. 2, 9.)

<u>Applicable Law – Issue (1) – Statute of Limitations</u>

In general, respondent must issue an NPA within four years of the date the taxpayer filed his or her California return. (Rev. & Tax. Code, § 19057.) Under R&TC section 19067, taxpayers may consent in writing to extending the statute of limitations for proposing an assessment.

In *Schulman*, *supra*, 93 T.C. 623, the taxpayer argued that his consent to extend the statute of limitations was limited. The taxpayer argued that, because the letter transmitting the consent form stated that the IRS needed further time to examine a particular return item, the consent was limited

to an examination of that item. The Tax Court ruled against the taxpayer and found that the consent was not restricted.

The Tax Court stated that, because the IRS provided a signed consent form and issued its assessment within the extension period, appellant had the burden of proof. The Tax Court explained that, although a consent is a waiver of a defense and not a contract, contract principles are important because the statute requires a written agreement and ". . . we look to the objective manifestations of mutual assent to determine the terms of such agreement." (*Schulman, supra*, 93 T.C. 623, 640.) At pages 639 to 641 of its opinion, the Tax Court provided the following overview of case law and principles:

> In cases where taxpayers executed consents in the belief that they were conditioned upon some event which had or would occur, but failed to reduce their understanding to a writing associated with the consent, we have found the consent to be valid and/or unrestricted. See [*Kronish*], *supra,* 90 T.C. 684; *Tallal v. Commissioner*, 77 T.C. 1291 (1981).
>
> In cases where we have granted relief from a consent which appeared valid and/or unrestricted on its face, we have looked to the documents which were forwarded by the taxpayer with the consent. In *Windfall Grain Co. v. Commissioner*, 23 B.T.A. 725 (1931), the restriction was contained in the taxpayer's letter transmitting the consent to respondent. Similarly, in *Smith v. Commissioner*, T.C. Memo. 1989-87, we held a consent invalid where respondent did not comply with a condition precedent explicitly stated in a taxpayer's letter transmitting the partially executed consent. In *Scheuerman v. Commissioner*, T.C. Memo. 1984-160, we determined, factually, that the taxpayer's letter transmitting the consent did not constitute a statement of conditions or restriction. These cases illustrate that there must be agreement between the parties.
>
> In a case, similar to this one, where the taxpayer relied upon the Commissioner's letter transmitting the consent to the taxpayer for execution, we held that a mistake as to the extension date in the Commissioner's transmittal letter did not support or justify a variance from the intent reflected by the date on the consent. *Marx v. Commissioner*, 13 T.C. 1099, 1104-1105 (1949). . . . In *Marx v. Commissioner*, *supra*, the Commissioner did not intend to communicate the "mistaken" date and there was no agreement between the parties, other than that reflected on the consent.
>
> In a case strikingly similar to this case, we found the consent to be unrestricted even though the Commissioner's transmittal letter contained specific reference to some, but not all, of the issues under consideration by the Commissioner. *Sager v. Commissioner*, T.C. Memo. 1988-193. . . . The taxpayer in *Sager v. Commissioner*, *supra*, was held to the unambiguous, unrestricted language of the consent, and we found, in spite of the transmittal, that the taxpayer was aware that the Commissioner was continuing to examine the Schedule C loss. There was, in fact, no agreement between the parties restricting or limiting the terms of the consent.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Examining the facts before it, the court found it "most telling" that the taxpayer did not modify the language of the written consent to reflect the alleged restriction on the scope of the consent. (*Id.* at p. 642.) The court found that consent was "complete and unambiguous on its face and represents the agreement of the parties." (*Ibid.*) The court stated that, although it might be argued that the transmittal letter conveyed terms of a proposed restriction, no such proposal was "intended, clearly communicated, or accepted by both parties." (*Ibid.*) Therefore, the court found that the statute of limitations remained open for all issues.

In *Kronish*, *supra*, 90 T.C. 684, the taxpayer argued a consent to extend the statute of limitations was invalid on the ground that there was no mutual assent to its terms and also that the IRS should be estopped from relying on the form due to alleged misrepresentations. The Tax Court found that the evidence did not show any misrepresentation or misleading silence, noting that there was no admissible evidence supporting the taxpayer's contentions of verbal misrepresentations. As a result, the court found that the taxpayer was bound by the terms of the consent.

In *Robertson*, *supra*, T.C. Memo 1973-205, the Tax Court found duress sufficient to invalidate a consent. In that case, the Tax Court found that the IRS agent had harassed the taxpayers, who were not represented by counsel and had no knowledge of IRS procedures, that the agent repeatedly called the taxpayers at home and at work (e.g., ten calls per week and three calls in one day) and failed to advise the taxpayers of the amount of the tax or the procedures available to contest the tax. The Tax Court determined that the harassment constituted duress because, considering the taxpayers' circumstances, the acts of the IRS agent were sufficient to overwhelm the free will of the taxpayers.

In *Huene*, *supra*, T.C. Memo 1989-570, the IRS sent the taxpayers a computer generated consent on Form 872A to extend the statute of limitations. Dr. Huene duplicated the typeface and created "a nearly exact duplicate form which he dubbed '872M'." (*Id.* at p. 6.) He then copied the text of the actual form to his new form "word for word" except that he added a new paragraph stating that the assessment could not exceed $50. (*Id.* at p. 9.) The changed language did not contain any additional marks or initials that would indicate that the language was changed. The Huenes signed the form and sent it to the IRS, which did not notice the changes and also signed the form. The Tax Court explained that the elements of fraud are (1) a false representation, (2) knowledge of its falsity, (3) intent

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

to deceive, (4) "actual and justifiable reliance", and (5) causing injury or prejudice. (*Id.* at p. 24.) The court found that Dr. Huene's conduct satisfied the elements of fraud and that he intended to deceive the IRS and induce its agents to sign the "Form 872M." (*Id.* at pp. 19, 24, 39.) The court therefore found that the "Form 872M" was invalid. However, it further held that Dr. Huene had intentionally deceived the IRS and that all of the elements required for equitable estoppel were present. As a result, it prohibited the Huenes from raising the invalidity of the consent as a defense, and therefore ruled in favor of the IRS.

In *Hubert v. IRS* (C.D.Cal. 1996) 1996 U.S. Dist. LEXIS 13657, 78 A.F.T.R.2d (RIA) 6535, a federal district court in California considered similar issues. The court stated that "[t]he cases reveal that, absent an agreement to alter the terms of the unilateral waiver embodied in the [consent form], the terms of the waiver control its scope." (*Id.* at p. 7.) The taxpayer believed that the consent only applied to certain issues, and exchanged letters with the IRS regarding the execution of the consent. The court found that "[i]f anything, the letters are ambiguous . . . and the evidence is that the parties attached materially different meanings to the letters . . . ." (*Id.* at p. 8.) The court therefore found that there was no agreement to restrict the scope of the consent form, and therefore held that the terms of the consent form controlled.

STAFF COMMENTS - ISSUE (1) – STATUTE OF LIMITATIONS

For ease of reference, staff notes that Exhibits XII, XIII, and XIV of appellants' appeal letter contain correspondence related to the consent.[17]

The consent form is clear and unambiguous on its face, and appellants were represented by counsel when they signed it. At the hearing, appellants have the burden of establishing that the FTB fraudulently induced them into signing the form or other defenses to the enforcement of the consent exist. As noted above, the Tax Court has found that, absent an agreement to alter the terms of a consent, the terms of the consent control its scope. (See, e.g., *Hubert, supra*, *Schulman*, *supra*.)

To prove fraudulent inducement, a party must show: (1) a false representation,

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[17] The consents at issue are dated August 23, 2012 (and signed August 24, 2012), and are attached as Exhibits JJ, KK and LL of respondent's opening brief. They are substantively identical and for simplicity are referred to as the consent. By their terms, they extended the statute of limitations to November 15, 2012. There were prior consents dated May 27, 2011 which had extended the statute of limitations to October 15, 2012. Appellants do not contest the validity of those prior consents.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

(2) knowledge of its falsity, (3) intent to deceive, (4) "actual and justifiable reliance", and (5) which causes injury or prejudice. (See *Huene, supra*.) Thus, to prevail on this argument, appellants would have to show that the FTB intentionally deceived them and by doing so caused them injury. Appellants argue that, if the FTB had disclosed all the relevant facts and not misrepresented its purposes, they would not have signed the consent. However, it is not evident to staff how signing the consent caused injury to appellants, as it only extended the statute of limitations by a month and, if appellants had not signed the consent, it appears that the FTB still would have issued NPAs proposing the tax and penalties at issue. Further, since appellants indicate that they researched the issue carefully prior to the VCI 2 deadline and still argue on appeal that the tax and penalties are not due, it appears unlikely they would have determined to participate in VCI 2 even if they had received a different AIPS analysis from the FTB.

With respect to appellants' allegations of coercion and "threats of improper and negative consequences,"[18] appellants should be prepared to identify at the oral hearing the evidence showing the alleged threats, that the alleged threats were improper, and that the threats were sufficient to overwhelm appellants' free will. (See *Robertson*, *supra*, T.C. Memo 1973-205.) Staff notes that, in *Hall v. Commissioner*, T.C. Memo 2013-93, at page 12, the Tax Court explained:

> The assertion by the Commissioner of an intention to pursue a legal remedy is not ordinarily considered duress, especially when the taxpayer has a lawyer and there is ample time for deliberation. See *United States v. Martin*, 274 F. Supp. 1002, 1005-1006 (E.D. Mo. 1967), aff'd, 411 F.2d 1164 (8th Cir. 1969). We have held duress does not exist when the Commissioner threatens to take legally authorized actions if a taxpayer does not sign Form 4549 [consent]. See *Zapara v. Commissioner*, 124 T.C. 223, 228 (2005), aff'd, 652 F.3d 1042 (9th Cir. 2011).

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[18] AL, pp. 19-20; ARB, p.10.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Issue (2): Whether appellants' installment sale transaction should be disallowed under the economic substance doctrine or other judicial standards.

Contentions – Issue (2)

Appeal Letter – Issue (2) – Background and Transactions[19]

Appellants first generally describe the ownership structure and history, and attach an organization chart as Exhibit X.[20] (AL, pp. 11-18.) Appellants emphasize that the Khoury Family 1999 Irrevocable Trust, which appellants refer to as the 1999 Grandchildren Irrevocable Trust, has owned an 80-percent limited partnership interest in Sundance-K since 1999. Appellants state that the trust was established by the Grandparents "for the primary purpose of providing for their grandchildren, who are the only non-contingent beneficiaries of the trust." Appellants state that the siblings are "remote contingent beneficiaries" of the trust. (AL, p. 12.)

Appellants state that Wells Fargo Bank is the independent third party trustee of the trust. Appellants note that the Khoury siblings are on the Investment Committee of the trust and can make a written request to the trustee regarding the purchase and sale of trust property, but argue that the trustee "has final say and sole discretion over all distributions of trust assets." Appellants further contend that the Siblings "have no control or discretion over trust distributions and no power to cause [the] distribution of any trust assets to any of the Khoury Siblings." Appellants state that the trust agreement permits the Trustee's use of trust assets for health-related emergencies or catastrophic events of the siblings or "in the unlikely event that all of the grandchildren predecease the Khoury Siblings." Appellants further state that trustee may make fully taxable distributions of trust assets for certain expenses personally paid by the siblings for the health and education expenses of the grandchildren. Appellants argue that, other than two fully taxable distributions totaling approximately $116,000 in 2007 and 2008 which were made to reimburse the siblings for educational expenses of the grandchildren, "none of the Khoury Siblings have ever[] received any distributions of trust assets" from the trust. (AL, pp. 12-13.)

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[19] Appellants' description of the transactions may also be relevant to their other arguments as well.

[20] A summary of the ownership structure is set forth above under Background prior to Issue (1).

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Appellants state that, prior to the RSD Property Sale, they consulted with their trusted advisor, Kenneth Van Damme II, CPA, "regarding their grave concerns and urgent need to prevent squandering and liability exposure, family squabbles, loss of family unity and lack of adequate cash flow for Pacific Scene businesses that would result from the winding up of RSD upon sale of the RSD Property and distribution of the sale proceeds . . . to the Khoury Siblings." Appellants contend that Mr. Van Damme first proposed "a highly leveraged triple net" transaction involving an IRC section 1031 exchange (which appellants refer to as the "NNN/1031 Proposal) to defer taxable gain, however, Jason Khoury "expressed disinterest in obtaining tax benefits and a preference for 'putting cash in [his] pockets.'" Also, appellants contend, the Grandparents expressed concern that the IRC section 1031 proposal "would not prevent the Khoury Siblings from gaining access to and squandering the liquidity produced from the RSD Property Sale." (AL, p. 13.)

Appellants argue that, in response to such concerns, Mr. Van Damme proposed the RSD Interest Sale. Mr. Van Damme explained that the RSD Interest Sale "would provide each of the Khoury Siblings with stable and measured monthly income of approximately $20,000 from the taxable installment payments made . . . while preserving liquidity needed by the businesses, would enable wealth transfer to the grandchildren in furtherance of Grandparents['] estate planning . . ." and advance the Siblings' "shared interest" in passing the family business to their children. Appellants state that the Grandparents agreed to the proposal and, on January 3, 2006, presented the decision to the Siblings. Appellants argue that the Siblings did not receive the news well but that after much "spirited debate and heartache" the siblings acquiesced to the plan. (AL, pp. 13-14.)

Appellants argue that the gain realized by RSD was properly allocated under the partnership agreement. Appellants further argue that, because RSD had an IRC section 754 election in place, RSD increased its inside tax adjusted basis in its assets as provided by IRC section 743(b). Appellants contend that the aggregate taxable gain reported by RSD was approximately $26.3 million and that the RSD partners paid approximately $4.5 million in state and federal tax as a result of the sale. Appellants further contend that "MFI, the general partner of RSD, which is owned by Grandparents, and LVI, the general partner of NBJ, both realized absolutely no tax benefits or tax savings from [the] consummation of the RSD Interest Sale because it had loss carryovers far in excess of likely income . . .

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

which were likely to expire unutilized[.]" Appellants state that the Grandparents "indirectly received approximately $4.6 million of cash proceeds . . . but had taxable gain . . . of approximately $11.5 million." (AL, p. 14.)

Appellants state that, on January 3, 2006, NBJ sold its limited partnership interest to Sundance-K for a total consideration of $14,760,000, which was made "in the form of two down payments totaling $500,000 and a thirty-year, 5 percent per annum promissory note calling for monthly installment payments of interest in the amount of nearly $60,000 to begin on March 1, 2006, and a balloon payment at maturity. Appellants indicate that the sale closed on February 7, 2006, with RSD receiving net proceeds of $30,630,000. Appellants state that the net proceeds were distributed by RSD "to its partners as follows: $14,856,188 to Sundance-K, $12,127,500 to MFI, $3,335,062 to SFI, and $306,250 to FKC." (AL, pp. 14-15 and Ex. XI [diagram illustrating sale structure].)

Appellants argue that, "[d]uring 2006 and 2007, Sundance-K invested substantially all of the $14,856,188 RSD Property Sale proceeds . . . by making interest bearing loans to four independent investment and operating entities: Grossmont Partners, LP/Grossmont Co-Tenants ("Grossmont"), Legacy Building Services, Inc. ("LBS"), KLH Land Holding, Inc. ("KLH"), and LVI." Appellants further argue that, from March 2006 to January 2007, Sundance-K loaned a total of $7,785,000 to Grossmont, which appellants state "is majority owned by an unrelated third party." Appellants assert that the loan was interest-only at a 10-percent interest rate with principal repaid at maturity, but that approximately $2.5 million was restructured in May of 2008 due to market conditions to reduce the interest payments to "5.5 percent per annum (and 4.5 percent interest accrued and payable at maturity)." Appellants state they also made a loan of $2,000,000 to LBS, which had a three-year maturity and initially accrued interest at 10 percent but also was restructured to reduce the interest rate in 2008. Similarly, appellants state that they extended loans totaling $3,004,000 to KLH and $1,900,000 to LVI, with a 10-year maturity and interest initially set at 10 percent but subsequently reduced. Appellants assert that LVI repaid its loan on December 31, 2007 and a new loan with the principal amount of $1,940,000 was made. (AL, pp. 15-16.)

Appellants argue that RSD continued to engage in activities following the RSD Interest Sale, including receiving $100,000 of interest income, performing an accounting and receiving "cash

flow from [a] hired management company and other miscellaneous items of income totaling approximately $54,500," paying approximately $50,000 in payroll as well as utility bills, professional fees, and other expenses, and making distributions to partners of $29.9 million and $725,000. Appellants further argue that, during 2007 and 2008, RSD earned interest income, collected income from the winding down of apartment operations, and paid professional fees and taxes. Appellants state that, after winding up its business affairs, RSD terminated its existence at the end of tax year 2008. (AL, pp. 16-17.)

Appeal Letter – Issue (2) – Economic Substance – *Roberts/Rushing*

Appellants note that respondent indicated it was applying the economic substance standards set forth in *Coltec Industries, Inc. v. United States* (Fed. Cir. 2006) 454 F.3d 1340 (*Coltec*) and *Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360. Appellants argue that *Casebeer, Coltec*, and similar cases involve sham transactions "intended to produce artificial and noneconomic losses and deductions," and apply an "Artificial Loss ESD Standard" that is "generally applicable only in cases involving tax losses and deductions." Appellants further argue that, even if this standard applied, it would not support the FTB's assessment "because, as the FTB acknowledges, the RSD Interest Sale would be disregarded for tax purposes and treated as if it never occurred." Appellants assert that "[t]he FTB provides no logical explanation as to how there could be an assessment of tax on NBJ's installment sale gain when it argues that [the] RSD Interest Sale giving rise to such gain must be disregarded for all tax purposes as if it never occurred." (AL, pp. 20-21.)

Appellants also contend that the FTB "unreasonably disregards and mischaracterizes" appellants' evidence showing nontax reasons for the sale and objective economic substance. Appellants state that the economic substance doctrine, including the statutory codification of the doctrine in IRC section 7701(o), "involves a two-pronged approach to determine whether the transaction producing the 'tax benefits' should be disregarded for tax purposes because (1) it was motivated solely by a desire to produce [a] tax loss ("*subjective economic substance"* or "business purpose"), or (2) it is noneconomic because no meaningful change in the economic position of the parties results therefrom ("*objective economic substance*") [appellants' emphasis]." (AL, p. 21.)

With regard to the first prong of the analysis, appellants argue that they have provided the

FTB "with significant and compelling evidence of nontax purposes . . . ." Appellants note that the FTB's protest hearing officer cited four factors for the officer's determination: that the installment sale contract occurred after the real property as contracted for sale, that the family "sought advice for family non-tax issues from a tax advisor . . . [,]" [that] "*neither NBJ Associates [LP] nor Sundance-K [LP] [both of which are passthrough entities] paid tax in 2006 on the gain* . . . [and] as explained below . . . I am unable to accept the business purposes set forth by the taxpayer as being valid. [appellants' emphasis]" Appellants argue that the hearing officer's analysis and arguments in its PDL misrepresents appellants' position, "freely substitutes his own business judgment for that of the actual business decisions made by [] experienced business professionals, and improperly discredits or altogether ignores taxpayer favorable facts provided to him regarding the substantial amount of tax paid and . . . lack of tax motivation for the RSD Interest Sale." (AL, p. 22.)

With regard to the second prong of the analysis (i.e., objective economic substance), appellants assert that the analysis set forth in the FTB's PDL "does not offer any discernible standard of objective economic substance ever applied by any court." Appellants contend that objective economic substance is shown by the "millions of dollars of nearly $60,000 monthly installment payments[,]" the benefits and burdens of ownership obtained by Sundance-K when it acquired the partnership interest, and the fact that NBJ was left with $60,000 monthly installment payments rather than the lump sum of $14.86 million of cash it would have received if the RSD Interest Sale had not occurred. Accordingly, appellants argue, the transaction "clearly resulted in a meaningful alteration of the economic position of both NBJ and Sundance-K . . . ." (AL, p. 22.)

Appellants contend that the transaction "is clearly not a sham transaction" based on the standard set forward in *Roberts v. Commissioner* (9th Cir. 1981) 643 F.2d 654 (*Roberts*). Appellants argue that, in *Roberts*, the Ninth Circuit applied the standard for evaluating related party installment sale that was set forth in *Rushing v. Commissioner* (5th Cir. 1971) 441 F.2d 593 (*Rushing*) and by the Board of Equalization in the *Appeal of Palmer C. and Norma K. Forsell*, 80-SBE-015, decided February 6, 1980. Under this standard, the focus is on ". . . whether the related party installment sale buyer is a mere 'conduit' or 'agent' of the related party seller or instead is an 'independent economic entity' such that prompt resale of the installment sale property does not place the related party seller in

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

the very same economic position as if the full proceeds of such resale had been received directly." Appellants contend that a review of a long line of cases applying this standard "make[s] clear" that the RSD Interest Sale had economic substance. (AL, pp. 22-23.)

Appellants contend that the FTB's FDL wrongly focuses on *Lustgarten v. Commissioner* (5th Cir. 1981) 639 F.2d 1208 (*Lustgarten*), which appellants assert is distinguishable and is one of the "very few government wins" in the long line of *Rushing* cases. Appellant argue that the FTB then "summarily moots" the *Rushing* cases by stating that the enactment of IRC section 453(e) ended the *Rushing* line of cases. Appellants further argue that, by doing so, the FTB ignores the legislative history which "indisputably refut[es]" the assertion that the cases no longer apply. (AL, pp. 23-24.)

Appellants assert that, under the *Rushing* analysis, the RSD Interest Sale has economic substance "because Sundance-K is an independent economic entity from NBJ and there is more than a significant non-tax motive for the RSD Interest Sale . . . ." Appellants further assert that the facts here are more taxpayer-favorable than those in the *Rushing* line of cases because there was no direct resale of the installment sale property and "the taxpayers in those cases prevailed notwithstanding . . . that the tax motivation for the installment sale far outweighed any nontax motivation." (AL, p. 24.)

Appellants contend that "Sundance-K is clearly an independent economic entity." Appellants further contend that, "unlike the taxpayer victories in the *Rushing* line of cases, the funds held by the installment sale buyer, Sundance-K, are separated from the installment sale seller by additional independent economic entities." On this basis, appellants contend that "the FTB would have to sham all of these independent economic entities in order to prevail . . . ." Appellants assert that ". . . neither NBJ (nor its owners) have obtained use of or access to any of Sundance-K's $14.86 million share" of the distributed sale proceeds. (AL, p. 24.)

<u>Respondent's Opening Brief – Issue (2) – Introduction and Background</u>[21]

Respondent summarizes that NBJ's owners learned that the sale of the property was going to generate a large amount of taxable income. As a result, respondent contends, NBJ's owners determined to sell a partnership interest to a related partnership in exchange for an unsecured note so

[21] The FTB's presentation of the factual circumstances may also be relevant to its other arguments as well.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

that "NBJ's owners could utilize the cash now, but avoid the tax liability on the unpaid portion of the promissory note for 30 years." Respondent argues that appellants claimed the tax result was "too good to be true" on the ground that it allowed appellants to possess, control, and enjoy $14.26 million of sale proceeds and "avoided paying income tax on the $14.26 million for at least 30 years." (ROB, pp. 1, 3.)

Respondent summarizes the ownership structure and transactions. Respondent notes that appellants each owned a 33 percent limited partnership interest in NBJ, and, through LVI, indirectly owned a one percent general partnership interest in NBJ. Respondent states that "[i]n addition to being on LVI's Board of Directors, Jason Khoury was LVI's President and CEO[,]" and Brian Khoury and Noelle Ludwig were Vice-Presidents. (ROB, p. 3.)

Respondent observes that Sundance-K purchased the RSD Interest and that SFI owned a 20 percent general partnership interest in Sundance-K. Respondent notes that SFI was equally owned by each appellant and that Noelle Ludwig's husband, Tim Ludwig, was the President of SFI. (ROB, p. 3.)

Respondent discusses at some length the Khoury Family 1999 Irrevocable Trust dated 7/28/1999, which respondent refers to as the Khoury Family Trust. Citing Article 1.1 of the trust, respondent states that the trust's purpose was "to financially assist Appellants with health emergencies and Appellants' descendants . . . with their 'health, education, support, maintenance, comfort, and welfare.'" Respondent argues that the intent of the Khoury Parents was to avoid the application of the generation-skipping transfer (GST) tax while taking into account gift and estate taxes. Respondent further argues that, in order to take advantage of the annual gift tax exclusion, appellants had a "Crummey Power" "to demand distributions from the trust based upon a . . . formula." (ROB, pp. 3-4.)

Respondent contends that the trustees "could apply as much of the net income and principal to any Appellant to assist one of them with a catastrophic illness or injury." Respondent asserts that "[b]ecause each Appellant had a contingent interest of 100 percent of the trust's income and principal, Appellants did not hold remote contingent interests in the Khoury Family Trust under the [IRC]." Respondent also states that, if the youngest of appellants turned 50 and there were no descendants "in being," then appellants were entitled to distributions in place of the descendants, and the descendants could receive as much of the net income and principal "as the trustees determined was

appropriate for their health, maintenance, education, support, welfare, and comfort." Respondent observes that appellants and the Khoury Parents served on the Investment Committee which determined investments. Respondent notes that the Khoury Parents determined who was on the Distribution Advisory Committee and selected themselves as the initial members. Respondent asserts that, "[w]hile the Distribution Advisory Committee only made 'recommendations' as to distributions, and left the determination to the trustee, the Investment Committee (i.e., the Khoury Parents and Appellants), 'acting by majority vote, could remove any Trustee, with or without cause.'" (ROB, pp. 4-5.)

Respondent states that the amount required to be distributed currently is included in the income of the beneficiaries whether it is distributed or not. Respondent further states that, for the 2008 tax year, the trust issued K-1s to appellants and appellants' children, with "blank" K-1s issued to appellants' children and Brian Khoury. Respondent observes that the K-1 issued to Jason Khoury "stated that he received a distribution of $60,939 and that he received 24.2892 percent" (of distributable net income of $250,889) and that Noelle Ludwig received $19,431. (ROB, pp. 5-6.)

Respondent describes the events leading up to the sale of RSD's property as follows. Respondent states that, in July of 2005, Tawfiq Khoury asked Mr. Van Damme several tax-related questions about selling the property. On July 29, 2005, Mr. Van Damme provided tax calculations for a hypothetical sale and recommended a transaction involving an IRC section 1031 exchange. On July 30, 2005, Jason Khoury said he would rather put cash in his pockets than try to avoid paying taxes or waiting for "a great 1031." On September 21, 2005, Noelle Ludwig's husband asked whether Mr. Van Damme had any "tax thoughts on the then-anticipated sale of the property. (ROB, pp. 6-7, Ex.'s O-R.)

Respondent states that, effective as of January 3, 2006, NBJ sold the RSD Interest for a total consideration of $14,760,000,with $10,000 payable "on the date hereof" and delivered with a check dated January 6, 2006. Respondent argues appellants asserted that the family met with Mr. Van Damme because they were worried about the cash proceeds being squandered. Respondent asserts that ". . . there were many steps involved before the cash proceeds would be able to be distributed to Appellants" as RSD would have to distribute the cash proceeds to NBJ which would then have to

distribute the cash to appellants who would then have to pay taxes. (ROB, p. 7.)

Respondent notes that RSD's IRC section 754 election reduced the taxable gain on the property sale that was allocable to Sundance-K by $17,529,480. Respondent also notes that RSD distributed $12,127,500 to the MFI Group, $14,856,177 to Sundance-K, $3,335,062 to SFI and $306,250 to FKC. Respondent states that, as of the start of the 2006 tax year, Sundance-K had a cash balance of $210 and nearly $2 million in investments in partnerships and LLCS. Respondent further states that, after RSD's distributions to Sundance-K, Sundance-K had a remaining investment of $117,306 in RSD, which, respondent argues, "is 0.08 percent of the total consideration that Sundance-K paid for the 48.51 percent interest ($14,760,000)." (ROB, p. 8.)

Respondent contends that Sundance-K "utilized substantially all of the $14,856,188 [it received] to make loans to NBJ's general partner, LVI, Legacy Building Services, Inc., KLH, and Grossmont Co-Tenants," providing promissory notes in support. Respondent notes that, absent the installment sale, NBJ would have received distributions from RSD and states that, within "about two weeks of RSD's distribution to Sundance-K, Sundance-K made a 10-year interest-only loan to NBJ's general partner, LVI, in the amount of $1,900,000 at 10 percent per annum due monthly and principal due at maturity." Respondent states that the terms were changed on September 1, 2007 so that interest would be paid at 5.5 percent per annum and accrued at 4.5 percent per annum. Respondent also states that on December 31, 2007, LVI repaid the loan, and Sundance-K "then immediately made a 10-year loan to LVI in the amount of $1,940,000. Respondent asserts that, by 2009, "Sundance-K's current profit from the loans went negative[,]" as in 2009, Sundance-K received $653,760 in interest income and paid $712,003 in interest expenses. (ROB, pp. 8-9.)

<u>Respondent's Opening Brief – Issue (2) – Economic Substance – *Roberts/Rushing*</u>

Respondent argues that "[t]he installment sale of the RSD Interest to Sundance-K with a nominal down payment and a 30-year interest-only note, in conjunction with an IRC section 754 basis step-up election, had no valid business purpose or economic substance . . . ." Respondent argues that appellants created the sale to generate a tax benefit, which is illegitimate, citing *Stobie Creek Investments LLC v. United States* (Ct. App. Fed. Cir. 2010) 608 F.3d 1366, 1375. (ROB, p. 11.)

Citing *WFC Holdings Corp. v. United States* (8th Cir. 2013) 728 F.3d 736, 742-743,

respondent argues that appellants' transaction must be disregarded if it was entered into without a valid business purpose in order to claim tax benefits not contemplated by a reasonable application of the IRC. Respondent argues that Congress could not have intended a result in which "NBJ's sale of its RSD Interest to a related partnership immediately prior to RSD's sale of its property in order to defer tax on $14.26 million out of $14.76 million of gain for 30 years when at the same time Appellants obtained control and enjoyment of the cash proceeds." (ROB, pp. 11-12.)

Respondent disputes appellants' contention that *Casebeer*, *supra*, 909 F.2d 1360 is inapplicable because it involved sham deductions, noting that the court in *Schering-Plough Corp. v. United States* (Dist. N.J. 2007) 651 F.Supp.2d 219 (*Schering-Plough*), 266, stated that "the particular mode of the tax benefit" is not important. Respondent argues that, under *Casebeer*, ". . . the taxpayer must demonstrate that it had a business purpose for engaging in the transaction other than tax avoidance and the transaction had economic substance beyond the mere creation of tax benefits." Respondent argues that, if either prong is not satisfied, then the tax benefits are disallowed. (ROB, p. 12.)

With regard to business purpose, respondent emphasizes that, under *Schering-Plough*, *supra*, "taxpayers must demonstrate that the business purpose existed at the time of the transaction and does not merely appear logical or make sense today." With regard to appellants' stated concern that the Khoury Parents wanted to prevent the squandering of the cash proceeds, respondent asserts that "[c]ash management itself is not a sufficient business purpose[,]" citing *Schering-Plough*, *supra*, 651 F.Supp.2d at 267. Respondent further asserts that Mr. Van Damme's recommendation of a triple net IRC section 1031 tax-deferral structure addressed none of the stated concerns of the Khoury Parents. Respondent argues that "[t]his is not surprising" because, rather than specializing in family disputes, Mr. Van Damme, in the words of promotional materials, "specializes in providing clients with innovative and new ideas in order to meet the clients' overall <u>tax goals</u>, such as §1031 structuring, <u>installment sales</u> . . . and more. [respondent's emphasis]" Respondent argues that Mr. Van Damme's emails and billings do not address the stated concerns about the squandering of assets "but illustrate significant concerns about tax liabilities." (ROB, pp. 12-13, Ex.'s PP, QQ.)

Respondent contends that "[b]oth RSD and Sundance-K have the same management ultimately making decisions." Respondent argues that, "[i]f the Khoury family was not comfortable

with RSD's management making the decisions for the cash proceeds," then structuring a transaction in which cash was distributed to Sundance-K would not resolve such concerns. (ROB, pp. 13-14.)

Respondent states that appellants argued that "interest rate arbitrage" was also a business purpose. Citing *Casebeer*, *supra*, 909 F.2d at 1364, respondent argues that appellants' lack of prior experience in this activity and their lack of any investigation into this activity weigh against a finding that it was a valid business purpose. Respondent further argues that appellants invoked this business purpose *ex ante* and that Sundance-K "did not act like an interest rate arbiter" when it modified interest terms so that interest payable was only 5.5 percent while interest accrued was 4.5 percent. Respondent states that, starting in 2009 and continuing into 2010, Sundance-K incurred a loss on its interest rate arbitrage as it paid more in interest than it received in interest from the loans it made. (ROB, pp. 14-15.)

Respondent disputes Brian Khoury's statement that one of appellants' motives arose from concerns regarding Jason Khoury's "very significant personal guarantees on real estate development loans[,]" quoting Brian Khoury's declaration at page five. Respondent argues that this argument "[does] not withstand scrutiny" because the sale proceeds did not have to be distributed "from RSD to NBJ and subsequently from NBJ to its partners, such as Appellants." In this connection, respondent observes that "[w]hen Sundance-K received the distribution from RSD, Sundance-K did not distribute the money to its partners, but made loans to related parties." (ROB, p. 15.)

Respondent also argues that "estate planning" was not the purpose of the transaction. Respondent contends that appellants caused Sundance-K to purchase the RSD Interest "without taking into consideration any discounts attributable to holding limited partnership interests." "Instead," respondent contends, "the purchase price was based [on] the amount necessary to eliminate RSD's gain allocable to NBJ's ownership interest in the RSD Property." Respondent asserts that "the parties had to execute a 'sale' in order to trigger IRC section 743 and RSD's step-up in basis in the RSD Property, thus eliminating an allocable portion of the gain in the RSD Property." Citing *Casebeer,* respondent argues that appellants' failure to make independent inquiries into the value of the limited partnership, and their failure to obtain a minority discount, cast doubt on their business purpose. Respondent contends that Sundance-K "substantially overpaid" for the partnership interest and by doing so inflated the tax benefit from RSD's increase in basis. (ROB, pp. 15-16, 20; see also ROB, p. 24.)

1 Respondent also disputes appellants' argument that their decision to forego an IRC
2 section 1031 transaction demonstrates that their chosen transaction had a business purpose. Respondent
3 argues that IRC section 1031 exchanges are more complex. Respondent states that appellants believed
4 that the real estate market was peaking and better opportunities would arise. For this reason, respondent
5 argues, appellants chose to sell the property "instead of exchanging it for other very highly priced real
6 estate." (ROB, pp. 16-17.)
7 Turning to the second prong of the economic substance analysis, respondent contends
8 that appellants' transaction did not have economic substance apart from tax benefits. Quoting
9 *ACM Partnership v. Commissioner* (3d Cir. 1999) 157 F.3d 231, 249, respondent argues that "although
10 taxpayers in several cases 'actually and objectively disposed of their property, the courts examined the
11 dispositions in their broader economic context and refused to recognize them for tax purposes where
12 other aspects of the taxpayers' transactions offset the consequences of the disposition, resulting in no
13 change in the taxpayer's economic position." Here, respondent argues that "NBJ's economic position
14 did not change" because "[i]nstead of having a distribution of $14.26 million directly from RSD, NBJ
15 had a $14.26 million promissory note from a related entity that then received the distribution from
16 RSD." (ROB, p. 17.)
17 Respondent asserts that the sale price of the RSD Interest was "based on the amount
18 needed to eliminate RSD's gain to be allocated to NBJ." Respondent argues that the monthly
19 installment payments do not demonstrate economic substance because the interest "on the $14.26
20 million is simply compensation for the time-lost value of money." Quoting *Schering-Plough*, *supra*,
21 651 F.Supp. at 267, respondent argues that "the use for which a disputed transaction is put is not
22 relevant in determining whether the transaction itself has sufficient substance." Respondent further
23 argues that, in the *Appeal of Alyn*, 2009-SBE-001, decided May 27, 2009 (*Alyn*), the Board found the
24 transaction at issue lacked substance even though Treasury Notes were borrowed and repaid according
25 to the parties' agreement. Respondent contends that "[t]he fact that NBJ chose to lend Sundance-K
26 $14.26 million, instead of making other investments with the $14.26 million, and Sundance-K made
27 payments on the note, does not equate to a finding that the transaction has economic substance." (ROB,
28 pp. 17-18.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Respondent argues that the NBJ/Sundance-K "promissory note lacked economic substance because the interest expense flowing through to Appellants . . . provided a tax benefit that offset the interest income that appellants were paying tax on [respondent's emphasis]." In fact, respondent argues, NBJ's general partner, LVI, paid interest "at 10 percent, at least initially, while at the same time being allocated taxable interest income on the 5 percent note between NBJ and Sundance-K." Respondent contends that LVI "did not agree to this transaction to lose 5 percent interest, but to reap the tax benefits." (ROB, p. 18.)

Respondent disputes appellants' contention that Sundance-K was an "independent economic entity." Respondent notes that appellants defined the term "Taxpayers" as including appellants, the Khoury Parents, and "all of the entities involved in the FTB audit . . . ." Respondent argues that "[i]nstead of allowing Sundance-K's general partner . . . to manage Sundance-K, Appellants represented that the Khoury Parents 'announced their decision to consummate the RSD Interest Sale prior to the RSD Property Sale." Respondent contends that, instead of arms'-length bargaining, appellants simply, in their words, "acquiesced to [the Khoury parents'] judgment . . . to further the continued future operations of Pacific Scene and its related entities." (ROB, pp. 18-19.)

Respondent disputes appellants' representation that neither NBJ nor its owners have used the funds distributed to Sundance-K. Respondent argues the evidence shows that "NBJ's owner 'obtained the use of' and 'access to' nearly $2 million within about two weeks of RSD's distribution . . ." when Sundance-K made a $1.9 million loan to LVI on March 14, 2006. (ROB, p. 19.)

Respondent also disputes appellants' argument that the payment of tax on interest from the note shows that interest income was 14.7 percent of the historic gain of $40.5 million realized on the sale of the property. Respondent argues that the associated tax is not from the principal payment of $14,260,000 but rather income from the "investment" of loan proceeds. Thus, respondent contends that the interest income is not a part of the amount realized on the transaction. Respondent further contends that, if NBJ had sold the partnership interest for cash, investment of that cash would also have generated a substantial gain but that this gain would be irrelevant to the analysis. (ROB, pp. 19-20.)

Respondent takes issue with appellants' referring to the Khoury Family Trust as the "1999 Grandchildren Irrevocable Trust." Respondent argues that the word "grandchildren" never

appears in the trust agreement. Respondent further argues that ". . . it is important to clarify that Sundance-K, and not the Family Khoury Trust, was the purchaser of the RSD Interest." Respondent contends that, instead of distributing substantial cash to the trust, Sundance-K "loaned the distribution proceeds to entities related to Appellants." Respondent also contends that the withdrawal rights of appellants allowed the use of the annual gift tax exclusion and caused appellants not to be remote contingent beneficiaries. (ROB, pp. 20-21.)

Respondent argues that the Khoury Family Trust made fully taxable distributions to Jason Khoury and Noelle Ludwig in 2007 and 2008 (totaling $80,370) but that "Jason Khoury and Noelle Ludwig did not receive K-1s due to reimbursements[,]" and that the income was required to be included in the gross income of the beneficiaries to whom the income was distributed. Respondent further argues that, since transfers made directly to education institutions "are free of gift taxes and the GST[,]" "[i]t is illogical to make a distribution out of earnings protected from the estate and gift tax [through the annual exclusion] to reimburse them for their children's tuition." Respondent also contends that, unlike the descendants, the Khoury Parents and appellants could remove the trustee at any time with or without cause, and that appellants, rather than appellants' descendants, received required distributions. Respondent argues, in the circumstances, appellants "failed to explain how their interests are contingent, but [the] Descendants' interests are not." (ROB, pp. 21-22.)

Respondent asserts that, during the audit, appellants asserted that the case law does not require a valid business purpose, citing a September 21, 2011 email. Respondent asserts that, having now conceded that a valid business purpose is necessary, appellants "now argue that the economic substance doctrine under Casebeer does not apply." Respondent characterizes appellants' argument that the *Rushing* test "has long been the standard for determining whether related party installment sales are sham transactions . . ." as an "unusual" argument. Respondent asserts that, by making this argument, appellants concede that there was a related party installment sale, and, if there was not a related party installment sale, *Rushing* would have no applicability. (ROB, pp. 22-23.)

Respondent also asserts that appellants "misread the significance of the *Rushing* case." Respondent argues that *Rushing* sets forth a test for when installment sales would be respected under which, quoting *Rushing*, *supra*, 441 F.2d at 598, ". . . the seller may not directly or indirectly have

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

control over the proceeds or possess the economic benefit therefrom." Respondent argues that "Congress did not like the courts' rule" and changed the law to prevent cases, such as *Rushing*, where installment treatment was allowed for stock that was sold to a related buyer and then liquidated. Respondent further argues that, in the legislative history, Congress "explicitly stated that the IRS could still argue that the sham transaction doctrine was applicable when appropriate." (ROB, p. 23.)

Respondent argues that *Rushing* "does not control" but that, even if it did, appellants would fail. Respondent notes that the court in Rushing stated that ". . . in order to receive the installment sale benefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." Here, respondent argues, appellants' wholly-owned S corporation was NBJ's general partner, and NBJ did not sell the RSD Interest "to a potentially independent party," such as the irrevocable trust in *Rushing*, but instead sold the RSD Interest to Sundance-K. Respondent notes that Sundance-K's general partner was SFI, for which Timothy Ludwig was president and appellants were the owners, and argues that Sundance-K's limited partner was an irrevocable trust in which appellants and their descendants were beneficiaries. Thus, respondent contends, appellants controlled and obtained the benefit of the proceeds through their control over the related entities. Respondent argues that the subsequent loan of nearly $2 million of proceeds to NBJ's general partner shows appellants' control and benefit over the proceeds. (ROB, p. 24.)

Appellants' Reply Brief – Issue (2) – Economic Substance – *Roberts/Rushing*

Appellants argue that the FTB's brief provides a misleading description of the facts by asserting (1) that appellants rather than the Grandparents sought the advice of Mr. Van Damme and (2) that appellants had "possession, control and enjoyment" of the proceeds based on the *Rushing* test. Appellants contend that the sworn declarations of appellants and Grandparents, and the direct testimony of Grandparents and Mr. Van Damme provided at protest, show that the Grandparents were the impetus for the RSD Interest Sale. Appellants assert that the FTB misleadingly represents that appellants initiated the sale because it knows that the Grandparents could not have been motivated by tax savings as the evidence "indisputably" establishes "that Grandparents actually had more taxable income and paid more federal and state income tax than they would have had the RSD Interest Sale not been consummated!" (ARB, pp. 3-5.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Appellants argue that the "too good to be true" legal standard advocated by the FTB "is an arbitrary and capricious standard that has been unambiguously rejected by the U.S. Supreme Court and now exists only in the mind of the FTB Tax Counsel."[22] Appellants further argue that the adoption of such a "nebulous" standard would leave taxpayers "with absolutely no certainty in planning their business affairs, and run afoul of the more than 80 year-old judicial doctrine recognizing the right of a citizen to organize and arrange one's business affairs in a manner that does [not] result in the maximum amount of taxes owed to the government."[23] (ARB, pp. 4-5.)

Appellants contend that, in addition to being contradicted by the evidence, the FTB's argument is flawed because the economic substance doctrine "cannot possibly result in the disallowance and deficiency shown on the 11/7/2012 NPAs." Appellants argue that, while the NPAs and NOAs disallowed NBJ's gain deferral on the installment sale, the FTB focuses on RSD, which is not referenced in the NPAs or NOAs, and RSD's gain on the RSD Property Sale. (ARB, pp. 12-13.)

Appellants argue that the application of the "Artificial Loss ESD [economic substance doctrine] Standard" or any other application of the economic substance doctrine "necessarily results in the transaction giving rise to the tax benefit (i.e., the RSD Interest Sale here) being disregarded and treated for all tax purposes as if it never occurred." Appellants contend that it "simply makes no sense" for the FTB to simultaneously apply the Artificial Loss ESD Standard to disregard the RSD Interest Sale "and yet fully tax the amount of gain on a sale that it successfully argued did not take place for tax purposes." Appellants argue that, while the Artificial Loss ESD Standard might have been relevant if the FTB had disallowed RSD's IRC section 754 basis adjustment, it is not relevant to the disallowance of the gain deferred on NBJ's installment sale. Appellants take issue with the FTB's citation to *Schering-Plough*, *supra*, 651 F.Supp.2d 219 arguing that it is factually distinguishable, and was "widely criticized by practitioners as not being relevant to the inquiry, and purged from the analysis by . . . *Merck & Co., Inc. v. U.S.* (3d Cir. 2011) 652 F.3d 475 . . . ." (ARB, pp. 13-14.)

Appellants contend that the documentary and testimonial evidence, including their sworn

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[22] In footnote 18, appellants cite in support *Gitlitz v. Commissioner* (2000) 531 U.S. 206, 213 (*Gitlitz*), *Coggin Auto. Corp. v. Commissioner* (11th Cir. 2002) 292 F.3d 1326, 1333-1334, and other cases.

[23] In footnote 19, appellants cite in support *Gregory v. Helvering* (2d Cir. 1934) 69 F.2d 809, 810 and other cases.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

affidavits, demonstrate that the RSD Interest Sale was motivated by (1) "a desire to preserve vital cash flow and protect assets of the family businesses . . . [,]" (2) estate planning goals, and (3) "a desire to preserve a sufficient level of family unity . . . ." Appellants argue that the FTB mischaracterizes their purposes by characterizing their objectives as "cash management" in its brief. Appellants argue that the "cash management" factual finding in *Schering-Plough*, *supra*, ". . . is confined to the facts of the case and surely does not stand for a general proposition that cash management 'does not count' as a business purpose." (ARB, pp. 14-15.)

Appellants contend that the FTB erroneously argues that appellants attempted to supplement their business purpose with an interest rate arbitrage purpose. Appellants argue that this is incorrect because the potential for profit from interest rate arbitrage and the estate planning purposes were noted by appellants "from the very earliest stage" of audit proceedings. Appellants further argue that the FTB's brief made "a factual finding that Sundance-K had no prior experience" in business and financial matters and that this finding "is wholly unsupported by any evidence." (ARB, pp. 15-16.)

Appellants take issue with the FTB's argument that declining to engage in an IRC section 1031 transaction demonstrates economic substance for the transaction at issue. Appellants argue that, as indicated in their declarations, the proposed IRC section 1031 transaction was "unacceptable because it failed to address Grandparents' nontax concerns and . . . motivations . . . ." (ARB, p. 17.)

Appellants also argue that the RSD Interest Sale "had [an] objective economic substance because it changed in a meaningful way (apart from tax savings) the economic position of the parties to this transaction." Appellants reiterate that the $500,000 in down payments and millions of dollars in monthly installment payments, as well as the benefits and burdens of ownership of the partnership interest which were obtained by Sundance-K, demonstrate an objective economic substance. Appellants argue that *ACM Partnership*, *supra*, is "highly distinguishable" because "[u]nlike in *ACM Partnership*, there are no other transactions present in the case at hand which offset, unwind, or undo the meaningful alteration of the economic position of the parties to the RSD Interest Sale." Appellants contend that *Alyn*, *supra*, is also distinguishable because it involved a "Son of Boss" transaction that "was one of the most widespread and abusive 'cookie cutter' abusive tax shelters in history." (ARB, p. 18.)

Appellants assert that the "tax benefit" and "independent economic entity" assertions

made by the FTB on page 18 of its opening brief "are factually inaccurate and irrelevant . . . ." Appellants argue that, when they discussed Sundance-K's "independent economic entity status[,]" their discussion "was simply to address the FTB's propensity . . . to improperly disregard (and effectively sham) all entities and treat them as a single economic entity." Appellants further argue that is "shameful" for the FTB to "improperly disregard the indisputable separate economic entity status of Sundance-K" by arguing that appellants' definition of "taxpayers" concedes that Sundance-K was not independent. Appellants contend that "Sundance-K's 'independent economic entity' status is highly relevant" to the discussion of the *Rushing*, *Roberts* and *Stewart* cases and that the FTB's brief "pretend[s]" the Ninth Circuit's *Roberts* and *Stewart* cases "simply do not exist." (ARB, pp. 18-19.)

Appellants argue that the FTB's assertions that NBJ's partner received cash from the RSD Property Sale proceeds "are factually inaccurate, grossly misleading, and irrelevant . . . ." Appellants contend that the $1.9 million loan from Sundance-K to LVI was "fully disclosed" at audit and protest and note that this loan and the other investments made by Sundance-K were also discussed in their appeal letter. Appellants argue that they are the owners of NBJ, not LVI, and that "[i]t remains a true statement that neither NBJ nor its owners, Appellants, have accessed the RSD Sale Proceeds . . . ."[24] (ARB, pp. 19-20.)

Appellants dispute the FTB's argument that the receipt of interest income is irrelevant. Appellants contend that "[t]he evidentiary value of the fact that the RSD partners reported, in the aggregate, approximately $23 million (56.7%) of the approximate $40.5 million of historic gain on the RSD Property in 2006, notwithstanding the consummation of the RSD Interest Sale, is highly relevant to [the] subjective economic substance (business purpose)." Appellants argue that "[t]here is no evidence to support FTB Tax Counsel's view that the purchase price . . . was somehow pegged to tax needs or tax benefits – because it is not true!" (ARB, p. 20.)

Appellants contend that the FTB's objections to referring to the 1999 Khoury Family Irrevocable Trust as the "1999 Grandchildren Irrevocable Trust" are "factually inaccurate, grossly

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[24] According to the diagram provided by appellants in response to respondent's audit findings, LVI is the general partner of NBJ and owns a one-percent interest in NBJ. (ROB, Ex. Y, p. 15.) In a September 9, 2015 letter to the Board Proceedings Division, appellants noted that they previously stipulated that LVI was the one percent general partner of NBJ, and stated that the statement that "LVI is not an owner of NBJ" was an error. (See RRB, Ex. O.)

misleading, and partially irrelevant . . . ." Appellants further contend that, by discussing this issue in its economic substance discussion, rather than in the discussion of the *Rushing* test, the FTB shows "a fundamental misunderstanding of the issues . . . ." Appellants explain that the grandchildren (appellants' children) "are the intended primary beneficiaries of [the] trust." Appellants argue that the Grandparents have referred to it as the grandchildren's trust and that appellants "are merely remote contingent beneficiaries." Appellants further argue that the fact that trust funds can be spent on two specific "actuarily remote events" (i.e., a catastrophic illness or all the grandchildren predeceasing appellants) "is entirely consistent with the characterization of Appellants as 'remote contingent beneficiaries.'" Appellants contend that the FTB Tax Counsel's judgments and argument regarding the gift tax exclusion, generation-skipping taxes and fund distributions and allocations "are inappropriate and troubling[,]" and "simply wrong." (ARB, p. 20.)

Appellants argue that the FTB falsely contends that they asserted at audit that a valid business purpose was not required. Appellants argue that the September 22, 2011 email referenced by the FTB is the best evidence of the falsity of the FTB's contentions, noting that the email is attached as Exhibit OO to respondent's opening brief. Appellants contend that the referenced email is an explanation by appellants' representative that the subjective prong of the economic substance test, "first espoused in *Rice's Toyota World Inc. v. Commissioner* (4th Cir. 1985) 752 F.2d 89, . . . requires a showing that the transaction . . . was motivated entirely by tax avoidance motivations and did not have any nontax purpose." (ARB, pp. 20-21.)

Respondent's Reply Brief – Issue (2) – Economic Substance – *Roberts/Rushing*

The FTB disputes appellants' argument that the FTB's "too good to be true" argument is not supported by law. The FTB argues that *Gitlitz*, *supra*, 531 U.S. 206, and the other cases cited by appellants on this point, are distinguishable because the cases involved transactions that had economic substance. The FTB quotes *Salem Financial v. United States* (Fed. Cir. 2015) 786 F.2d 932, 942: ". . . [the taxpayer's] argument that the inquiry begins and ends with the Code and regulations, if accepted, would largely eviscerate the common-law economic substance doctrine." Respondent notes that Treasury Regulation section 16662-3(b)(1)(ii) states that a penalty may be appropriate where a reasonable person would find a transaction "too good to be true" and that, in *Rovakat*, *LLC v.*

Commissioner, T.C. Memo 2011-225, the Tax Court "found problems with taxpayers 'blindly relying' on a professional opinion to support 'too good to be true' tax results." (Respondent's Reply Brief (RRB), pp. 3-4.)

Citing *Higgins v. Smith* (1940) 308 U.S. 473 (*Higgins*), 477-478, and the United States Supreme Court decision in *Gregory v. Helvering* (1935) 293 U.S. 465 (*Gregory*), respondent argues that tax agencies need to look at the true nature of transactions and disregard sham or unreal transactions. Respondent contends that in *Coltec*, *supra*, 454 F.3d 1340, the Court of Appeals for the Federal Circuit reversed the trial court, the Court of Federal Claims, which had raised a similar argument about the need for certainty in planning business affairs. Respondent argues that in *Coltec, supra*, 454 F.3d at 1352, the Court of Appeals "reminded the courts that, 'Over the last seventy years, the economic substance doctrine has required disregarding, for tax purposes, transactions that comply with the literal terms of the tax code but lack economic reality. [respondent's emphasis]" (RRB, pp. 5-8.)

Respondent asserts that appellants want the Board "to substitute the related party installment test in *Rushing* . . . , which was decided in 1971 and had already been overruled by the enactment of IRC section 453(e), for the economic substance substance doctrine, which existed nearly 50 years prior to *Rushing*." Respondent argues that neither *Rushing* nor *Roberts* provide the economic substance test here. Respondent further argues that, by looking to the transaction generating the tax benefits, appellants are acknowledging a principle of the economic substance analysis. (RRB, p. 8.)

Respondent disputes appellants' arguments regarding an "Artificial Loss ESD Standard." Respondent argues that it performed a Lexis search in the combined federal court cases database for "artificial loss economic substance doctrine" and found no results. Respondent contends that, "[r]egardless of the name chosen by Appellants, the economic substance doctrine applies to all transactions to disallow tax benefits improperly resulting from a transaction lacking economic substance or valid business purpose." (RRB, p. 9.)

Respondent argues that it is "not estopped" from arguing the economic substance doctrine. Respondent states that at protest appellants identified one of the issues as whether a sham transaction occurred and whether there was economic substance. Respondent argues that it presented economic substance arguments in its PDL and that its NOAs referenced the PDL and its FDL. (RRB,

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

pp. 10-11.)

Respondent also disputes appellants' objections to its citation of *Schering-Plough, supra*, 651 F.Supp.2d 219. Respondent notes that the Court of Appeals for the Third Circuit affirmed the District Court's determination and did not address the trial court's alternative conclusion that the transactions lacked economic substance. Respondent argues that the Third Circuit did not "purge" the economic substance doctrine and "did not find fault in or in any way criticize the District Court's application of the economic substance doctrine." Respondent further argues that appellants "provided no examples of any criticism of practitioners" and that the United States Tax Court has also cited to the District Court's economic substance analysis in *Schering-Plough*. (RRB, pp. 12-13.)

Respondent contends that appellants "provide no legal authority for their assertion that the economic substance doctrine does not apply because the 'tax benefit' here does not include deductions or losses." As an example, respondent discusses *Salty Brine I, Limited v. United States* (5th Cir. 2014) 761 F.3d 484. In that case, respondent argues, the court found that the transactions shifted assets from one set of controlled entities to another and applied the economic substance doctrine to disallow the taxpayers' claimed exclusion of income. Respondent states that, while the taxpayers argued that the court should only look at the initial transfer of a royalty interest, and not "the ultimate flowback" to the controlled entities, the court evaluated the whole transaction and determined that it lacked economic substance. Respondent argues that appellants' transaction is similar in that appellants "ultimately controlled every step in the scheme, and, pursuant to Appellants' control of Sundance-K, the money ended up with Appellants' entities." (RRB, pp. 13-14.)

Respondent contends that, contrary to appellants' arguments, "LVI's ownership of RSD and receipt of sale proceeds is significant." Respondent reiterates its argument that appellants erroneously represented that ". . . neither NBJ (nor its owners) have obtained use of or access to any of Sundance-K's $14.86 million share off the RSD Property Sale proceeds distributed to it." Respondent argues that appellants "characterized Respondent's correct statements as 'factually inaccurate, grossly misleading, and irrelevant . . . .'" Respondent argues that the fact that NBJ's owner received some of the sale proceeds "is a strong factor finding that the transaction lacked economic substance." Respondent contends that through "the abusive transaction, LVI was able to obtain use of the cash

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

without LVI or appellants having tax liability[,]" and further contends that, the receipt of cash by NBJ's owners shows that the entities "are not very independent." Respondent argues that, in a September 9, 2015 letter, appellants conceded that LVI was the general partner. Thus, respondent argues, what appellants "originally characterized as 'grossly misleading' Appellants now characterize as 'true.'" (RRB, pp. 15-16.)

Respondent contends that appellants are asking that the Board "disregard and, effectively, overrule judicial doctrines" formulated by the United States Supreme Court "to ensure that the tax effect of a transaction is not altered by transactions lacking in economic substance. Respondent cites *Gregory, supra*, 293 U.S. 465, *Higgins, supra*, 308 U.S. 473, and *Frank Lyon Co. v. United States* (*Frank Lyon Co.*) (1978) 435 U.S. 561, and argues that *Frank Lyon Co.* is "particularly compelling" because appellants "fail each criteria set out by the U.S. Supreme Court" in that case. Respondent notes that Supreme Court precedent is binding precedent and must be followed. (RRB, pp. 16-17.)

Respondent argues that the IRS relies on the economic substance doctrine in evaluating related party installment sales and that appellants incorrectly assert that the *Rushing* line of cases survived the enactment of IRC section 453(e). In support, respondent discusses *Bakersfield Energy Partners, LP v. Commissioner* (9th Cir. 2009) 568 F.3d 767 (*Bakersfield*). In *Bakersfield*, the parties used a combination of an IRC section 754 election and a related party installment sale to reduce their taxable gain, and the IRS argued that the installment sale should be disregarded as lacking in economic substance. The Tax Court held that the IRS adjustment was untimely so it did not reach the economic substance issue. Respondent contends that the IRS adjustments provide another example showing that the economic substance doctrine is not limited to losses and deductions and that the doctrine applies to related party installment sales. Also, respondent contends, the facts of *Bakersfield* show that the IRS characterized a transaction as lacking economic substance even though some partners paid tax. (RRB, pp. 18-19.)

Respondent argues that *Roberts*, *supra*, and *Stewart*, *supra*, are not applicable, and disputes appellants' assertion that the FTB has "pretend[ed] like these highly favorable cases simply do not exist." Respondent contends that the cases are not "highly favorable" and that it addressed *Roberts* and *Stewart* during protest. Respondent argues that IRC section 453(e) was enacted "to ensure that the

results and holdings in cases" such as *Roberts* and *Rushing*, *supra*, 441 F.2d 593, "would not occur again." Respondent further argues that "Congress never intended for IRC section 453(e) to supplant the economic substance doctrine. Respondent discusses the facts of *Rushing*, in which a father sold stock to an irrevocable trust, and argues that appellants rely on "outdated language" from a decision that the taxpayer my reap the tax advantages of installment sale treatment "if he actually carries through an installment sale," even though the transaction was designed to minimize tax. Respondent notes that IRC section 453(e) would prevent *Rushing* from occurring and that it is "illogical" to continue to use the *Rushing* test when IRC section 453(e) "overrides the courts' prior language regarding the freedom to engage in installment sales and prevents the type of installment sales that the courts previously allowed." Respondent makes similar points about *Roberts*, *supra*, which also involved a sale of stock to an irrevocable trust. Respondent further contends that the *Rushing* test and *Roberts* rule "were never established to deal with abusive transactions such as the one present here" and did not involve fact patterns in which gain was shifted to another entity to be taxed at a lower rate. (ROB, pp. 21-23.)

Respondent argues that NBJ improperly reported "the net capital gain from the recapture of its negative capital account in RSD and the $500,000 in initial payments from Sundance-K for the RSD Interest as <u>non-California source</u> [income]. [respondent's emphasis]" Respondent argues that, under this reporting, ". . . California may or may not receive the tax when the principal of the 30-year promissory note is paid to NBJ." Respondent argues that, because Sundance-K is a Wyoming limited partnership, with its 80 percent limited partner a South Dakota Irrevocable Trust, "[t]he abusive structure materially alters the taxation of the proceeds . . ." and attempts to change income from the sale of real property located in California to "income from a non-California source nonbusiness intangible asset." (ROB, pp. 23-25.)

Respondent contends that appellants have not addressed its legitimate concerns regarding the purported business purposes and the K-1s issued to appellants from the Khoury Family 1999 Irrevocable Trust. Respondent notes that the Senate Finance Committee, in discussing *Rushing* and *Roberts*, explained that "the committee believes that the application of the judicial decisions, involving corporate liquidations, to intra-family transfers of appreciated property has led to unwarranted tax avoidance by allowing the realization of appreciation within a related group without

the current payment of tax." (RRB, p. 30.)

Appellants' Supplemental Brief – Issue (2) – Economic Substance – *Roberts/Rushing*

Appellants argue that "the sham transaction and conduit doctrine approach . . . in *Rushing* . . . and adopted in modified form by the Ninth Circuit in *Roberts* and *Stewart*[25] (i.e., *Roberts'* Rule) is the relevant judicial doctrine to be applied . . . ." Appellants assert that the transaction is not a sham under that analysis because, appellants contend, ". . . NBJ does not have the requisite "control and benefit" over proceeds from a second disposition of the installment sale property as if it had sold the installment sale property itself. [appellants' emphasis]" Appellants argue that, even if Sundance-K had immediately sold the installment sale property, the transaction still would not be a sham because Sundance-K "is clearly an "*independent economic entity*" separate and distinct from NBJ . . . , which precludes the latter from having the requisite control and benefit of the proceeds from the former's prompt second disposition of the installment sale property . . . . [appellants' emphasis]." Appellants state that, unlike the taxpayers in *Rushing, Roberts, Stewart* and other cases which "were decided in the taxpayers' favor, the installment sale property here [is] not marketable securities, and the installment sale buyer here, Sundance-K (and its 80% owner, the 1999 Grandchildren Trust) is not a spouse, dependent, or newly created trust or other entity[] formed shortly before the installment sale and solely to facilitate the taxpayer's IRC § 453 installment sale treatment." (ASB, pp. 4-5.)

Appellants argue that respondent's position is that *Roberts* and *Rushing* "are wholly irrelevant . . . ." Appellants argue that this argument "that the economic substance doctrine supplants *Roberts* Rule and the *Rushing* Test flies in the face of the legislative history to IRC § 453(e) . . ." which indicates that "the sham transaction doctrine adopted in the *Rushing* line of cases survives and is to be applied . . . where the installment sale . . . passes muster under the statutory provisions of IRC § 453(e)[.]"[26] Appellants argue that respondent is inconsistent in arguing that Congress intended to disallow the results reached in the *Rushing* cases while also asserting that "the *Rushing* test and *Roberts*

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[25] *Stewart v. Commissioner* (9th Cir. 1984) 739 F.2d 411 (*Stewart*).

[26] In support, appellants quote Senate Report 96-100 (available at ROB, Ex. TT, page 21 [page 17 of the report]): "It is understood that the [installment sale provisions] are not intended to preclude the [IRS] from asserting the proper tax treatment of transactions that are shams."

rule were never established to deal with abusive transactions . . . [quoting ROB, p. 23].” Appellants further contend that respondent’s argument that appellants obtained “possession, control, and enjoyment” of the funds received by Sundance-K “apparently fails to realize” that *Rushing* and *Roberts* provide the applicable analysis. (ASB, pp. 5-6.)

Applicable Law – Issue (2) – Economic Substance – *Roberts/Rushing*

The Ninth Circuit applies the economic substance doctrine to determine if a transaction was a sham that should be disregarded for tax purposes. (*Casebeer*, *supra*, 909 F.2d at pp. 1362-1363.) In determining whether a transaction is a sham that lacks economic substance, the Ninth Circuit applies a two-pronged analysis considering: (1) whether the taxpayer has demonstrated a non-tax business purpose for the transaction (a subjective analysis); and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits (an objective analysis). (*Id.*) The Ninth Circuit has held that this test is not a “‘rigid two-step analysis,’” but instead a single inquiry into whether the transaction had any practical economic effects other than tax benefits.[27] (*Reddam v. Comm’r* (9th Cir. 2014) 755 F.3d 1051, 1058. See also *Casebeer*, *supra*, 909 F.2d at p. 1363; *Appeal of James A. Alyn and Lisa E. Alyn*, *supra*, 2009-SBE-00 [adopting *Casebeer*’s two-pronged analysis].) “The ultimate determination of whether a transaction lacks economic substance is a question of fact.” (*Hunter v. Comm’r*, T.C. Memo 2014-132, p. 15.)

In *Rushing, supra*, 441 F.2d 593, the taxpayers adopted a liquidation plan for two corporations and, shortly before the liquidation of the corporations, sold their stock in the corporations to an irrevocable trust in return for cash and installment notes. The issue was whether the taxpayers “should be treated as if they constructively received the entire liquidation dividend in the year of the liquidation or whether the sale and consequent distribution [of the liquidation proceeds] to the trusts insulates the taxpayers so that for tax purposes they are deemed to receive the payments representing their gain only as they receive the installment payments from the trusts.” (*Id.* at p. 597.)

The court stated that the taxpayer could reap the benefits of installment sale treatment, even if the transaction was designed for tax purposes, “if he actually carries through an installment sale .

[27] The definition of a “noneconomic substance transaction” for purposes of the NEST penalty applied by R&TC section 19774 is discussed under Issue (5), which addresses whether the NEST penalty applies.

. . ." (*Id.* at p. 598.) However, the court cautioned, a taxpayer may not receive installment sale treatment "if, through his machinations, he achieves in reality the same result as if he had immediately collected the full sales price, or, in our case, the full liquidation proceeds." (*Ibid.*) The court explained that, as it understood the test, ". . . the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom." (*Ibid.*)

Applying these principles, the court ruled in favor of the taxpayers, explaining:

> An autonomous entity controlled the proceeds, and no right of recapture inured to the benefit of the taxpayers. . . . the trustee was independent of the taxpayers' control. [footnote omitted[28]] Thus the intervening third party, the trustee, was neither a puppet nor an economic serf. The taxpayers retained no effective benefit or control over the liquidation dividend. Absent the possibility of control or recapture, the alienation of the stock cannot be hyphenated for tax purposes by merely labeling the transaction an assignment of income or constructive receipt. Here there was no possibility of recapture or control. The trustee was no alter ego of the taxpayers; it had independent duties and responsibilities to persons other than the taxpayers. The taxpayers' only effective means of obtaining the benefit of the liquidation proceeds was under the contract of sale with the trust[,] a contract which provided for payments to be made on the installment basis.

In *Roberts*, *supra*, 643 F.2d 654, the taxpayer sold stock to an irrevocable trust in return for installment notes, and the trust subsequently sold the stock received for cash. The Ninth Circuit followed the rationale and reasoning of *Rushing* and found in favor of the taxpayers. Like the court in *Rushing*, the Ninth Circuit emphasized that "[i]t cannot be denied that Taxpayer had no control over the trust or the trustees[,]" and "no way of reaching or controlling the trust corpus." (*Id.* at pp. 656-657.) In this respect, the Ninth Circuit noted, the facts before it were distinguishable from *Griffiths v. Commissioner* (1939) 308 U.S. 355, in which the intermediary and issuer of the installment note was a corporation that was wholly owned by the taxpayer. The court similarly distinguished *Williams v. United States* (5th Cir. 1981) 219 F.2d 523, in which the taxpayer-seller was the beneficiary of the bank escrow that received the cash, and *Lustgarten v. Commissioner* (5th Cir. 1981) 639 F.2d 1208, in which the sale proceeds were put in a trust account that "was not free from control of the taxpayer." (*Roberts*, *supra*, 643 F.2d 654, 656 and fn. 3.)

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[28] In its footnote 6, the court rejected the suggestion of the IRS that the trustee was not independent because the settlors could remove the trustee. The court found the right was "severely limited" as only a bank could be appointed as a replacement trustee.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

In *Shelton v. Commissioner* (1995) 105 T.C. 114 (*Shelton*), the Tax Court noted that IRC section 453(e) was enacted after *Rushing*, and it found that IRC section 453(e) was intended to reverse the result of cases such as *Rushing* in which stock was sold to a related buyer and then liquidated.[29] (*Id.* at p. 122.) However, in *Dobrich v. Commissioner*, T.C. Memo 1997-477 (*Dobrich*), which involved a tax year after the enactment of IRC section 453(e), the Tax Court cited *Rushing* and *Roberts*, at page 25, for the general principle that "[t]axpayers are not entitled to report gain under the installment method if they directly or indirectly control the sale proceeds or receive the economic benefit therefrom."[30]

STAFF COMMENTS – ISSUE (2) – ECONOMIC SUBSTANCE – *ROBERTS/RUSHING*

It appears to staff that both parties take overbroad positions. Contrary to respondent's argument on appeal, it appears to staff that IRC section 453(e) only reverses the result of *Roberts* and *Rushing* on facts where the statute is applicable. *Roberts* and *Rushing* focus on whether, as a practical matter, the sale proceeds are directly or indirectly controlled by the taxpayer and seller, and it appears to staff that this mode of analysis remains good law. To the extent that a transaction does not fall within IRC section 453(e), it could still be analyzed under the logic of *Roberts* and *Rushing*.

Contrary to appellants' arguments, or at least the implication of appellants' arguments, it appears to staff that the *Roberts* and *Rushing* line of cases are not the only relevant cases, and the economic substance doctrine is not limited to cases involving losses and deductions. When Congress enacted IRC section 453(e), it did not create a safe harbor for any transaction that was not covered by IRC section 453(e). As expressly noted in the legislative history, courts could still apply doctrines such as the economic substance doctrine, even when a transaction was not subject to IRC section 453(e).[31]

It appears to staff that, under a general economic substance analysis, as well as under the

[29] The facts and holding of Shelton are discussed in connection with Issue (3), below, regarding the application of IRC section 453(e). It is noted here only for its discussion of the intended effect of IRC section 453(e) on prior case law.

[30] See also *Estate of Silverman* (1992) 98 T.C. 54, at page 64, in which the IRS argued with respect to tax year after the enactment of IRC section 453(e) that installment sale treatment should not apply based on *Rushing*.

[31] As noted by appellants, Senate Report 96-100 stated that, "It is understood that the [installment sale provisions] are not intended to preclude the [IRS] from asserting the proper tax treatment of transactions that are shams." (See ASB, p. 6, fn. 11, and ROB, Ex. TT, page 21 [page 17 of the report].)

Roberts and Rushing line of cases, a critical inquiry will be whether appellants avoided the gain while retaining effective control of the sale proceeds, or, alternatively, whether the installment sale placed the gain from the ESD Property Sale out of their reach in an independent economic entity. If the sale proceeds were out of appellants' reach, it would tend to support appellants' stated purpose (among others) of avoiding the squandering of sale proceeds, and it would also tend to support appellants' argument that the transaction had objective economic substance. On the other hand, if appellants had effective control over the sale proceeds that went Sundance-K, it would tend to undermine one of appellants' stated business purposes, as well as appellants' argument that the transaction changed the actual economics of the situation.

Accordingly, at the hearing, the parties should be prepared to discuss further whether appellants retained effective control over the sale proceeds at the time the proceeds were received by Sundance-K. Appellants should be prepared to address the fact that appellants owned and controlled SFI, and SFI served as the general partner of Sundance-K. As the general partner, SFI would be responsible for managing and controlling Sundance-K.[32] While SFI only owned a 20 percent interest in Sundance-K, the 1999 Khoury Family Trust (a/k/a the 1999 Grandchildren Irrevocable Trust) owned the remaining interest as a limited partner and, as a limited partner, could not take part in management.

Brian N. Khoury's and Jason B. Khoury's affidavits state as one reason for the transaction that ". . . Noelle's husband [Tim Ludwig] had a history of failed business ventures, and I realized that my Parents wanted to protect their legacy for their grandchildren and not fully entrust it to Noelle's husband."[33] The affidavits also indicate that one of the motivations of the transaction was to prevent the cash proceeds from being squandered by one or more of the Siblings.[34] At the oral hearing, appellants should be prepared to address how it served these stated purposes to engage in a transaction in which the cash proceeds went to a limited partnership (Sundance-K) that was controlled by the Siblings through SFI, for which Tim Ludwig was the President.

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[32] Sundance-K was a Wyoming limited partnership. See http://soswy.state.wy.us/forms/publications/choiceisyours.pdf, p. 7 (summarizing that limited partners "must not manage in any capacity" and general partners "manage the enterprise").

[33] See ROB, Ex. V, p. 3, par. 10 [Brian N. Khoury declaration], and Ex. W, p. 3, par. 10 [Jason B. Khoury declaration].

[34] See *id.* and Ex. X, p. 3, par. 9 [Noelle K. Ludwig declaration].

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

At the hearing, the parties should be prepared to discuss appellants' argument that respondent is inconsistent because it is seeking to disregard the installment sale at the same time it is seeking to tax the gain on the installment sale. It appears to staff that, if the installment sale had not occurred or is disregarded, then there could not have been an IRC section 743 basis adjustment, and appellants would be taxable on their share of the gain from the RSD Property Sale through their interests in NBJ. (See ROB, Ex. A.)

Issue (3): Whether Internal Revenue Code IRC section 453(e) applies to disallow installment sale treatment.

Contentions – Issue (3)

Appeal Letter – Issue (3) – IRC Section 453(e)

Appellants state that they disagree with the FTB's "convoluted" related person analysis. Appellants argue that, based on a "tortured application of the attribution rules of IRC §318," the FTB concludes that "6.666 percent of stock hypothetically owned by [Sundance-K] (the installment sale buyer) can be attributed to each of the three Appellants (and further to [NBJ], the installment sale seller)." Appellants also argue that the FTB contends that Sundance-K is related to NBJ through IRC section 267(b), however, appellants argue that the explanation offered in the PDL "appears to rely entirely on a policy argument found in a temporary regulation that is aimed at the loss disallowance purpose of IRC Section 267(a), and beyond the 'related person' reference in IRC § 267(b) in IRC 453(f)." However, appellants argue that the "exhaustive debate" of this issue is "unwarranted given the more obvious inapplicability" of IRC section 453(e) on other grounds. (AL, pp. 25-27.)

Appellants argue that IRC section 453(e) "does not apply because there was no 'second disposition' of the installment sale property by Sundance-K within two years of the RSD Interest Sale." Appellants contend that the legislative history shows there must be a "direct" disposition of the property by Sundance-K and that no such disposition occurred. In footnote 70 of their appeal letter, appellants cite in support to IRS General Counsel Memorandum (GCM) 39662 (1987 GCM LEXIS 70). Appellants note that the GCM states that Congress initially proposed to deny installment sale treatment to any direct or indirect disposition to a related person but that "even the Treasury Department stated that 'the bill goes too far.'" (AL, pp. 26-27.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Appellants further argue that they did not have a "principal purpose of tax avoidance." Appellants contend that their prior summary of facts[35] shows that the RSD Interest Sale "was principally motivated by several nontax considerations and resulted in the payment of a significant amount of tax." Appellants state that it is not clear to them why the FTB believes a second disposition of the property occurred and argue that the FTB's PDL and FDL do not explain how the second disposition was principally motivated by tax avoidance. (AL, p. 27.)

Respondent's Opening Brief – Issue (3) – IRC Section 453(e)

Respondent notes that, under IRC section 453, the installment sale method provides that sellers can defer the payment of tax due as principal payments are received from the buyer. Respondent states that interest is always taxable. Respondent quotes *Shelton, supra*, 105 T.C. 114 (*Shelton*): "the purpose of the installment method of reporting income is to alleviate the hardship on taxpayers who would otherwise recognize the entire gain on a sale, but who did not have sufficient cash to pay the tax." Citing *Shelton* in support, respondent argues that the installment method "is not designed to allow a group of related parties to obtain access to and use cash from a sale while deferring the gain." (ROB, pp. 25-26.)

As background, respondent states that, under IRC section 453(e), "installment sale treatment does not apply . . . where a disposition took place between related persons and the related person disposes of the original property within two years." "Instead," respondent states, "the person first disposing of the property is treated as receiving the amount that the related person received at the time of the second disposition." Respondent notes that "[a] related person is defined as a person whose stock would be attributed under IRC section 318(a) (other than paragraph 4 of section 318(a)) to the original seller, or a person who bears a relationship pursuant to IRC section 267(b) to the original seller." Respondent notes that, under IRC section 453(e)(7), in order to avoid the application of the related person rules, "the taxpayer must establish that neither the first nor the second disposition of the property had a principal purpose of tax avoidance." (ROB, p. 26.)

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[35] Appellants' appeal letter sets forward a Statement of Facts at pages 11-17. Pages 13-15 of the appeal letter provide appellants' description of the events surrounding the RSD Property Sale and the RSD Interest Sale. Appellants' arguments regarding a business purpose are summarized herein under "Contentions" for Issue (2).

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Respondent argues that Sundance-K and NBJ are related parties under IRC section 453(f) through the application of IRC section 318(a) and are also related through the application of IRC section 267(b). Respondent first discusses the application of IRC section 318(a). (ROB, p. 27.)

Respondent argues that Sundance-K and NBJ are related under IRC section 318 because appellants, through their disregarded grantor trusts, have an ownership interest in each entity. Respondent contends that appellants have an interest in Sundance-K both through SFI, which owned 20 percent of Sundance-K, and through the Khoury Family Trust, which owned 80 percent of Sundance-K. With regard to appellants' interest in Sundance-K through SFI, respondent notes that S corporations, such as SFI, are treated as partnerships, and that IRC section 318(a)(2)(A) generally provides "that stock owned by a partnership is considered as owned proportionately by its partners." Thus, since each appellant owns 33.33 percent of SFI (through a disregarded grantor trust), and SFI owns 20 percent of Sundance-K, respondent contends each appellant is treated as owning 6.666 percent of Sundance-K's stock (i.e., 20 percent x 33.33 percent). With regard to appellants' interest in Sundance-K through the Khoury Family Trust, respondent states that, under IRC section 318(a)(2)(B)(i), stock owned by a trust is considered owned by the trust beneficiaries in proportion to their actuarial interest in the trust. Since the trustees can apply net income and principal to appellants in order to deal with illness or injury, respondent argues that appellants have an actuarial interest in the trust. (ROB, pp. 26-29.)

Respondent contends that appellants also have an interest in NBJ. Respondent argues that appellants have an interest in NBJ through NBJ's general partner, LVI, which owns a one percent general partner interest in NBJ, because each of appellants' disregarded grantor trusts owned a 33.33 percent interest in LVI. (ROB, pp. 29-30.)

Based on the foregoing, respondent argues that Sundance-K and NBJ are related parties under IRC section 318(a). Respondent further argues that NBJ and Sundance-K are also related under IRC section 267(b) because, under Temporary Treasury Regulation 1.267(a)-2T, partnerships with common owners are subject to "a disallowance of a loss or a deferral of a deduction pursuant to IRC section 267." Respondent contends as follows:

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

IRC section 267(b)(10) provides that [a] corporation and a partnership are related persons if the same persons own more than 50 percent in value of the outstanding stock of the corporation and more than 50 percent of the capital interests or profits interest in the partnership. Sundance-K's 20 percent partner, Sundance-K [sic][36], is owned by SFI, an S corporation. Pursuant to IRC section 267(c)(1), stock owned by a corporation is considered owned proportionately by its shareholders. SFI is 100 percent owned by Appellants' disregarded grantor trusts. NBJ is 99 percent owned by Appellants' disregarded grantor trusts. Thus, Sundance-K would be a related party to NBJ under the regulations to IRC section 267. [37] (ROB, pp. 31-32.)

Respondent argues that there was a second disposition of the property (the RSD Interest) within two years "when RSD made the distributions to Sundance-K in 2006." (ROB, p. 32.)

Respondent contends that, in *Shelton*, *supra,* 105 T.C. 114, "the Tax Court determined that that a liquidation of a corporation, which resulted in the realization of the appreciation in the value of the stock, constituted a disposition for purposes of IRC section 453(e)(1)." Respondent notes that the Tax Court, at page 121, quoted legislative history indicating that Congress was concerned about second dispositions that allowed cash to "flow[] into the related group." The Tax Court stated, at page 122, that the legislative history demonstrated that "Congress believed 'that the application of the judicial decisions, involving corporate liquidations, to intra-family transfers of appreciated property has led to unwarranted tax avoidance by allowing the realization of appreciation within a related group without the current payment of income tax.' [quoting the legislative history]" Respondent also states that, "The Tax Court also described how Congress's enactment of IRC section 453(e) was clearly designed to reverse the *Rushing* line of cases, where installment treatment was allowed for stock that was sold to a related buyer and then liquidated." Respondent notes that, after reviewing the statutory language and history, the Tax Court stated, at pages 122-123, "[t]his is a situation at which section 453(e) is aimed, to prevent the related group from cashing out the appreciation in the stock on a current basis while deferring recognition of gain." (ROB, pp. 32-34.)

Respondent contends that, "To provide the appearance that RSD continued to have [an]

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[36] It appears to staff that respondent's intent is to say that Sundance-K's general partner, SFI, an S corporation, owns 20 percent of Sundance-K.

[37] It is not clear to staff how the above explanation demonstrates that appellants would be deemed to own 50 percent or more of the capital or profits of Sundance-K. Although appellants, through their disregarded grantor trusts, own SFI, staff's understanding is that SFI only a 20 percent interest in Sundance-K, rather than an interest greater than 50 percent. Respondent should be prepared to clarify this at the hearing.

ongoing business, Appellants previously represented that Sundance-K still held the RSD Interest." "In reality," respondent argues, "RSD dissolved at the end of 2008." (ROB, p. 34.)

Respondent disputes appellants' contention that the legislative history shows that the related person must dispose of the installment property "directly." Respondent argues that the legislative history "supports an opposite conclusion[,]" citing a Senate Committee Report which stated that the application of cases involving corporate liquidations "to intra-family transfers of appreciated property has led to unwarranted tax avoidance . . . ." Respondent also cites *Shelton*, *supra*, and argues that its position is supported by the fact that IRC section 453(e)(4) expressly contemplates second dispositions other than sales and IRC section 453(e)(6)(B) provides exceptions for involuntary conversions. (ROB, p. 35.)

Respondent argues that appellants' argument misinterprets IRS GCM 39622. Respondent argues that initial proposals would have barred installment sales for any direct or indirect dispositions to a related person, without requiring a second disposition. However, respondent argues, as enacted, IRC section 453(e) "addressed the abuse upon the second disposition, the same abuse that is being addressed here." (ROB, pp. 35-36.)

Respondent further contends that appellants' argument that the second disposition must be "direct" does not make sense because, based on the dictionary definition of "directly" as "in a direct line or manner; straight," appellants' interpretation would mean that the legislators meant to require that the related person dispose of the property in a straight line. However, respondent contends, for the second disposition, ". . . there is no specific third party (such as a related person) that the legislators were concerned about." Also, respondent contends that appellants' argument "does not make grammatical sense" because, unlike the first disposition to a related party, "there is no prepositional phrase in section 453(e)(1)(B) to follow the terms "directly or indirectly." (ROB, pp. 36-37.)

<u>Appellants' Reply Brief – Issue (3) – IRC Section 453(e)</u>

Appellants first reiterate their argument that IRC section 453(e) cannot apply because "the documentary and testimonial evidence supports a finding that the RSD Interest Sale did not have a 'principal purpose of tax avoidance' . . . ." Second, appellants argue that there was no second disposition. (ARB, p. 23.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Appellants argue that *Shelton* is distinguishable because it involved a corporate liquidation which "is treated as [a] sale or exchange in complete redemption of the corporate stock in exchange for the distribution of the corporation's assets." In *Shelton*, appellants argue, the installment sale property was the corporate stock that was exchanged and redeemed in exchange for the corporation assets. Thus, appellants argue that *Shelton* involved a direct exchange of the corporate stock. Appellants contend that the facts here are distinguishable because the distribution of proceeds from the RSD Property Sale to Sundance-K was a non-liquidating distribution in which Sundance-K did not surrender its partnership interest in RSD. Appellants further argue that the FTB's legislative history arguments are "nonsensical" and "misleading" and state that they will "simply rely on SBE staff to read this material and see it for what it is." (ARB, pp. 23-24.)

Appellants also dispute the FTB's argument that Sundance-K and NBJ are related under IRC section 267(b) and IRC section 318(a). With regard to IRC section 267(b), appellants argue that, "The FTB's position rests entirely on an overriding of the statutory construct of IRC §453(f), and §267(b) to which it refers, through [an] improper application of an obsolete temporary treasury regulation, Treas. Reg. §1.267(a)-2T . . . ." Appellants argue that, even if the regulation were valid, it "is doubtful that the Treasury Department intended to authorize this regulation to be stretched far beyond its intended loss disallowance purpose in IRC §267(a) to be imported into . . . IRC §453 for the wholly different purpose of gain deferral." (ARB, p. 25.)

With regard to IRC section 318(a), appellants state that they ". . . have discovered several errors in the FTB's analysis and process; however, Appellants have also learned that the FTB may be correct with respect to one of the several paths it identified." Appellants further state that, "Although not free from doubt, Appellants now believe that it may actually be possible to attribute constructive ownership of a very small amount of hypothetically-owned stock from Sundance-K to NBJ under [R&TC section 318(a)]." However, appellants argue that the issue is moot because they had no principal purpose of tax evasion and there was no second disposition of property. (ARB, p. 25.)

Respondent's Reply Brief – Issue (3) – IRC section 453(e)

Respondent notes that appellants concede that "it may actually be possible" that NBJ and Sundance-K are related parties under IRC section 318(a). Respondent argues that NBJ reported on

its tax return that the sale of the RSD Interest was not to a related party and failed to provide pertinent information regarding the related party, Sundance-K, such as its name. Respondent argues that "[a]ccurate reporting of related party installment sales is critical, as it allows the tax agencies to monitor the transaction more closely." Respondent further argues that NBJ failed to report that RSD dissolved and should have reported that it disposed of the property and the date on which it disposed of the property by dissolving. Respondent contends that appellants' reporting of the installment sale on FTB Form 3805E "was patently incorrect" and that this undermines appellants' argument that there was adequate disclosure for purposes of penalty abatement. (RRB, pp. 25-27.)

Respondent further contends that appellants misrepresented that Sundance-K "still holds" its interest in RSD Group. Instead, respondent contends, appellants "quickly dissolved" RSD "when the two-year mark was hit (2008)." (RRB, p. 28.)

With regard to *Shelton*, *supra*, respondent argues that appellants erroneously contend that the crucial fact was that there was a complete liquidation and redemption of the corporate stock. Respondent contends that, if this fact was dispositive, "the Tax Court would not have reviewed the legislative history . . ." and "would not have examined the effect of the liquidation, which was to allow the related group to cash out the appreciation in the stock. [respondent's emphasis]" (RRB, p. 29.)

Respondent summarizes that "Sundance-K purchased the RSD Interest for $14,760,000, with $500,000 payable in the first year and $14,260,000 payable in 30 years." Respondent argues that, "The next month, Sundance-K received a $14,405,490 distribution, which was 98.3 percent of its initial investment of $14,760,000." Respondent argues that, although it was not called a liquidation, the distribution "had the effect of allowing the related group (NBJ and Sundance-K) to cash out the appreciation in the stock[,]" and therefore constituted a second disposition. (RRB, p. 29.)

Appellants' Supplemental Brief – Issue (3) – IRC Section 453(e)

Appellants argue that IRC section 453(e) requires the Board to make three factual findings: (1) that Sundance-K and NBJ are related persons under the statute; (2) that there was a second disposition of the RSD Interest within two years; and (3) that either the first or second disposition of the RSD Interest must have had a principal purpose of tax avoidance. With regard to the first issue, appellants state that the parties "disagree" on how IRC sections 267(b) and 318(a) apply.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Appellants state that "the parties continue to disagree with respect to both (1) the application of certain of the IRC §453(e) statutory provisions and (2) whether the actual facts and evidence . . . support the three factual findings required for the application of IRC §453(e)." (ASB, pp. 3-4.)

Additional Exhibits and Briefing – Issue (3) – IRC Section 453(e)

On December 11, 2015, respondent submitted a memorandum enclosing as additional exhibits a copy of IRC sections 453(f)(1)(A) and IRC section 318 and two secondary materials (excerpts from Warren Gorham & Lamont Treatise, *McKee, Nelson & Whitmire: Federal Taxation of Partnerships and Partners* (WGL Treatise), and Lisa M. Starczewski, *BNA Portfolio 565-3rd: Installment Sales*).

In a December 22, 2015 submission, appellants argue that the FTB's submission "clearly evidences an attempt to end-run your Board's briefing rules by submitting additional argumentation vicariously by way of secondary source commentary." Appellants note that respondent's memorandum directs the Board's attention to Subsection 14.04[6] on page 10 of Exhibit C (the WGL Treatise). Appellants argue that this is the "purported 'authority' on which [FTB counsel] is relying for his theory that *any infinitesimal amount of attributional stock ownership pursuant to the application of IRC §318 will suffice to establish 'related person' status under IRC §163(f)(1)(A)*. [appellants' emphasis]." Appellants object that the secondary source commentary is "not binding legal precedent or authority]," "speculative[,]" authored by an individual subject to criticism for issuance of "specious tax opinion letters to Enron[,]" ignores legislative history, "appears to be unaware of the referenced provision reflecting a Congressional intent to adopt a 50% minimum corporate stock ownership threshold . . . [,]" and "is inherently inconsistent with the common control policy concerns and approach of the related party installment sales . . . , as is clearly reflected in the 50% common control threshold of IRC §267(b) that is adopted . . . under IRC §453(f)(1)(B). [footnote omitted]" (Appellants' Dec. 22, 2015 Additional Brief, pp. 1-4.)

With respect to Exhibit D of respondent's submission, the BNA portfolio excerpt, appellants note that Sundance-K and NBJ "do not appear to bear any of the purported 'related person' relationships as restated and described by Ms. Starczewski." Appellants further object that in footnote 352 on page 1 of Exhibit D, Ms. Starczewski asserts that "the Code" "somehow includes brother-sister

familial attribution – notwithstanding her recognition that the referenced legislative history to IRC §453(e) states exactly the opposite. [appellants' emphasis]" Appellants argue "it is Ms. Starczewski, not Congress, who is mistaken." (Appellants' Dec. 22, 2015 Supplemental Brief, pp. 4-5.)

In response, the FTB argues that:

> The WGL Treatise affirmed the clear language of IRC sections 453(f)(1) and 318(a), stating that "[u]nder IRC § 318(a), stock owned by a partnership is attributed to all of its partners, and stock owned by any partner is attributed to the partnership. Thus, a partnership and all of its partners, regardless of how large or small their partnership interests may be, are related parties for purposes of § 453(e), and hence § 453(e) may have unexpectedly broad application in connection with installment sales involving partnerships." (Respondent's Feb. 17, 2016 Supplemental Brief, p. 1.)

Respondent argues that the Tax Court frequently relies on the WGL Treatise. Respondent further argues that appellants misread the legislative history in arguing that there was a Congressional intent to adopt a 50 percent minimum corporate stock threshold, as such a threshold only applies for corporations. Respondent also contends that appellants disregard attribution through the Khoury Family Trust and that, even if appellants had no actuarial interest in the trust, appellants would own the stock owned by their children through the application of IRC section 318(a)(1)(A)(iii). In sum, respondent argues, quoting IRC section 453(f)(1)(A), that: "Because Sundance-K is 'a person whose stock would be attributed under section 318(a) (other than paragraph 4 thereof) to the person first disposing of the property . . . ,' Sundance-K is a related person to [NBJ] . . . ." (Respondent's Feb. 17, 2016 Supplemental Brief, pp. 2-5.)

Applicable Law – Issue (3) – IRC Section 453(e)

In relevant part, IRC section 453(e)(1), provides as follows:

> . . . If – (A) any person disposes of property to a related person [as defined in IRC section 453(f)(1)] (hereinafter in this subsection referred to as the "first disposition"), and (B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the "second disposition"), then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

However, pursuant to IRC section 453(e)(7), the provision "shall not apply to a second disposition . . . if it is established to the satisfaction of the Secretary that neither the first disposition nor

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

the second disposition had as one of its principal purposes the avoidance of Federal income tax."

IRC section 453(f) defines a "related person" for purposes of IRC section 453(e) as:

> (A) a person whose stock would be attributed under section 318(a) . . . to the person first disposing of the property, or
>
> (B) a person who bears a relationship described in section 267(b) to the person first disposing of the property.

As relevant here, under IRC section 318(a):

(1) (family attribution) an individual is attributed the stock owned, directly or indirectly, by or for his spouse, children, grandchildren and parents (IRC section 318(a)(1));

(2) (attribution *from* partnerships, trusts, and S corporations[38]) stock owned, directly or indirectly, by or for a partnership or trust is considered owned proportionately by its partners, beneficiaries (in proportion to their actuarial interest in the trust), or shareholders (IRC section 318(a)(2)); and

(3) (attribution *to* partnerships, trusts, and S corporations) stock owned, directly or indirectly, by or for a partner, a beneficiary of a trust, or an S corporation is considered owned by the partnership, trust, or S corporation (IRC section 318(a)(3)).

In general, stock constructively owned by a person through the above rules is considered actually owned by that person such that the person's ownership can cause another person to also be considered the owner of the stock. However, pursuant to IRC section 318(a)(5)(B), stock constructively owned by a family member under IRC section 318(a)(1) above will not be considered owned by him or her for purposes of again applying IRC section 318(a)(1). Similarly, pursuant to IRC section 318(a)(5)(C), stock constructively owned by a partnership, S corporation, or trust under IRC section 318(a)(3) will not be considered as owned by it for purposes of applying IRC section 318(A)(2) to make another the constructive owner of such stock.

Pursuant to IRC section 318(a)(5), S corporations are treated like partnerships except in

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[38] As noted below, although S corporations are not included in the terms of IRC section 318(a)(2) & (3), S corporations are generally treated like partnerships pursuant to IRC section 318(a)(5) except for the purpose of determining whether stock in the S corporation is constructively owned by another.

determining whether stock in the S corporation is constructively owned by another person. Thus, for example, if an S corporation holds stock, its shareholders would also be deemed to own a proportionate share of the stock. However, in determining whether the stock of the S corporation itself is constructively owned by others, the partnership attribution rules would not apply.

As noted above, under IRC section 453(e) and (f), installment sale treatment is disallowed in certain circumstances in which the installment seller is related to the buyer under IRC section 318(a) or IRC section 267(a). IRC section 318(a) is summarized above. IRC section 267(a) disallows losses in sales between persons listed in IRC section 267(b). IRC 267(b) lists the following related persons:

> (1) Members of a family, as defined in subsection (c)(4);
>
> (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
>
> (3) Two corporations which are members of the same controlled group (as defined in subsection (f));
>
> (4) A grantor and a fiduciary of any trust;
>
> (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
>
> (6) A fiduciary of a trust and a beneficiary of such trust;
>
> (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
>
> (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
>
> (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
>
> (10) A corporation and a partnership if the same persons own—
> (A) more than 50 percent in value of the outstanding stock of the corporation, and
> (B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

IRC section 267(c) sets forth constructive ownership rules that apply for purposes of the ownership of stock under IRC section 267(b), and provides as follows:

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

In *Shelton, supra*, 105 T.C. 114, a taxpayer's wholly owned corporation, JMS Liquidating Corporation (JMS), sold the stock of El Paso Sand Products, Inc. (EPSP) to Wallington Corporation (Wallington), which was owned by the taxpayers' children and related trusts, in return for an installment note. Within two years, EPSP sold all of its assets, and the subsidiary and Wallington liquidated, with the proceeds being distributed to the Wallington shareholders. The court found that IRC section 453(e) applied because treating the liquidation of stock by a related party as a second disposition "comports with the language and legislative intent of section 453(e)." (*Id.* at p. 123.)

With regard to the language of IRC section 453(e), the Tax Court noted that amounts distributed in complete liquidation are treated as full payment in exchange for the stock, and such an exchange generally is treated as a disposition. (*Id.* at p. 119.) The Tax Court noted that the term "disposition" is used in IRC section 453(e) but is not defined. However, the Tax Court observed that some exceptions to IRC section 453(e) included dispositions that were not a sale or exchange.

With regard to the legislative history and purpose, the Tax Court noted that IRC section 453(e) was intended to reverse the result of cases involving liquidations, such as *Rushing*. (*Id.* at p. 122.) It summarized its reasoning as follows:

> In the instant case, cash and other property flowed into the related group when the assets of EPSP were sold and the stock of EPSP was liquidated. This is a situation at which section 453(e) is aimed, to prevent the related group from cashing out the appreciation in the stock on a current basis while deferring recognition of the gain. Accordingly, in this case, it seems clear that the liquidation had the effect of a second disposition within the meaning of section 453(e). (*Id.* at pp. 122-123.)

STAFF COMMENTS – ISSUE (3) – IRC SECTION 453(e)

It appears to staff that the installment sale seller (NBJ) is related to the buyer (Sundance-K) because both partnerships are directly or indirectly owned by the Siblings. Specifically, it appears to staff that, pursuant to IRC section 453(f), the "stock" [39] of Sundance-K would be attributed to NBJ under IRC section 318(a). First, Sundance-K's partner SFI actually owns stock of Sundance-K. Second, under IRC section 318(a)(2)(A) (which applies to shareholders of S corporations pursuant to IRC section 318(a)(5)(E)), the shareholders of SFI, the Siblings, constructively own a proportionate share (20 percent) of the Sundance-K stock owned by SFI. Third, under IRC section 318(a)(3), this stock in Sundance-K that is constructively owned by the Siblings is also constructively owned by NBJ because the Siblings, both directly and through LVI, are partners in NBJ.[40]

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[39] IRC section 453(f) defines a related party as a "person" whose "stock" would be attributed to the seller of the property under Section 318(a). Since IRC section 453 applies to partnerships and IRC section 7701(a)(1) defines "person" to include a partnership, it appears to staff that "stock" for this purpose would include a partnership interest. This conclusion is supported by the WGL Treatise which states that IRC section 318(a) would apply to installment sales between partnerships that share common owners. (See Respondent's Dec. 11, 2015 Additional Ex.'s, Ex. C, p. 10.)

[40] For simplicity, staff does not address here respondent's other arguments for attribution through the 1999 Khoury Family Trust and through the application of IRC section 267(b). As noted by respondent, there is no minimum percentage of stock that must be attributed for IRC section 453(f) to apply.

In staff's view, this result is consistent with the legislative purpose in that the Siblings appear to have control over both NBJ and Sundance-K (through LVI, in the case of NBJ, and through SFI, in the case of Sundance-K). In view of the legislative purpose of IRC section 453(e), it would be surprising if the provision did not cover second dispositions by an entity that was indirectly controlled by the same individuals that controlled the installment sale seller.

It therefore appears to staff that the critical issues under IRC section 453(e) will be: first, whether appellants have shown that neither the first disposition (the RSD Interest Sale) or the second (alleged) disposition (the transfer of proceeds from RSD to Sundance-K) had "as one of its principal purposes" the avoidance of tax; and, second, whether the transfer of proceeds from RSD to Sundance-K constituted a second "disposition" for purposes of IRC section 453(e). With regard to the latter issue, appellants should be prepared to address respondent's argument that, within a month of purchasing the RSD Interest, Sundance-K received a cash distribution of more than 98 percent of the its purchase price for the RSD Interest. The parties should be prepared to discuss *Shelton*, *supra*, and whether the distributions to Sundance-K were substantially equivalent to a liquidating distribution or other disposition for purposes of IRC section 453(e).

Issue (4): Whether partnership anti-abuse regulations apply to appellants' transaction.

Contentions

Appellants argue that the anti-abuse rules do not apply because "NBJ did not rely on any provision of Subchapter-K to obtain IRC §453 installment method reporting on the RSD Interest Sale that was disallowed by the 11/7/2012 NPA." Appellants argue that there is "no judicial authority" to support the view that the partnership anti-abuse rules apply simply because the installment sale property is a partnership interest or the buyer or seller is a partnership. Appellants further contend that "[t]he examples provided in Treas. Reg. §1.701-2 and IRS administrative guidance interpreting these regulations clearly do not support an expansive application of this very limited anti-abuse rule . . . ." Appellants argue that, even if the rules were to apply, the FTB would have to explain "a substantive recast alternative transaction" that better explains the economics of the transaction . . . ." (AL, p. 25.)

Respondent argues that, in order to be respected under Treasury Regulation section 1.701-2, a transaction must be (1) entered into for a substantial business purpose, (2) be respected under

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

substance-over-form principles, and (3) clearly reflect the partner's income. Respondent contends that the installment sale violates all three requirements. First, respondent contends, the transaction was not entered into for a substantial business purpose. Second, respondent contends that the transaction violated substance-over-form principles because it was structured as a purchase of a limited partnership interest "[y]et, in substance, Sundance-K was simply borrowing cash from NBJ in exchange for an unsecured interest-only 30-year promissory note." Third, respondent contends that the transaction did not clearly reflect NBJ's or Sundance-K's income because "[t]he parties utilized the partnership structure to improperly reduce NBJ's income." Respondent further contends that the IRC section 743 adjustment to the inside basis should be disallowed. (ROB, pp. 37-38.)

In response, appellants argue that the FTB's attempt to recast the transaction as "Sundance-K borrowing cash from NBJ" is both "patently improper" and "cannot possibly result in the disallowance and deficiency assessed on [the NPAs and NOAs] (i.e., disallowance of NBJ's deferral of gain . . . under IRC §453)." Appellants further argue that it is telling that the FTB attempts to disallow the IRC section 743 basis adjustment because it shows that the FTB misunderstands "the facts and the purpose of the provisions" and it addresses "abandoned BOB arguments, not NBJ's gain on RSD Interest Sale that appears on the [NPAs and NOAs]." Appellants also contend that the FTB's analysis does not recognize that the RSD Interest sale is not a transaction "between the partner and partnership" as is required under the regulations. Appellants argue that "[i]t speaks volumes that no judicial authority or administrative guidance is provided which would even remotely support such an application of these rules." In appellants' supplemental brief, appellants argue that the FTB's "complete silence and failure to offer any rebuttal whatsoever [in its reply brief]" shows that the FTB is incorrect. (ARB, pp. 25-26; ASB, p. 7.)

Applicable Law – Issue 4 – Partnership Anti-abuse Regulations

Treasury Regulation section 1.701-2 (the anti-abuse regulations) states that subchapter K is intended to allow taxpayers to conduct joint businesses flexibly without incurring an entity-level tax. It further states that:

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///

(a) . . . Implicit in the intent of subchapter K are the following requirements --
(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a *substantial business purpose*.
(2) *The form of each partnership transaction must be respected under substance over form principles*.
(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income (collectively, proper reflection of income). However, certain provisions of subchapter K and the regulations thereunder were adopted to promote administrative convenience and other policy objectives, with the recognition that the application of those provisions to a transaction could, in some circumstances, produce tax results that do not properly reflect income. Thus, the proper reflection of income requirement of this paragraph (a)(3) is treated as satisfied with respect to a transaction that satisfies paragraphs (a)(1) and (2) of this section to the extent that the application of such a provision to the transaction and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. . . .
(b) Application of subchapter K rules. . . . if a partnership is formed or availed of in connection with a transaction a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner that is inconsistent with the intent of subchapter K, the Commissioner can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K . . . .
(c) Facts and circumstances analysis; factors. Whether a partnership was formed or availed of with a principal purpose to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K is determined based on all of the facts and circumstances, including a comparison of the purported business purpose for a transaction and the claimed tax benefits resulting from the transaction. The factors set forth below may be indicative, but do not necessarily establish, that a partnership was used in such a manner. . . . Factors include:
(1) The present value of the partners' aggregate federal tax liability is substantially less than had the partners owned the partnership's assets and conducted the partnership's activities directly;
(2) The present value of the partners' aggregate federal tax liability is substantially less than would be the case if purportedly separate transactions that are designed to achieve a particular end result are integrated and treated as steps in a single transaction. For example, this analysis may indicate that it was contemplated that a partner who was necessary to achieve the intended tax results and whose interest in the partnership was liquidated or disposed of (in whole or in part) would be a partner only temporarily in order to provide the claimed tax benefits to the remaining partners;
(3) One or more partners who are necessary to achieve the claimed tax results either have a nominal interest in the partnership, are substantially protected from any risk of loss from the partnership's activities (through distribution preferences . . . or other arrangements), or have little or no participation in the profits from the partnership's activities other than a preferred return that is in the nature of a payment for the use of capital;

(4) Substantially all of the partners . . . are related (directly or in-directly) to one another;
(5) Partnership items are allocated in compliance with the literal language of §§ 1.704-1 and 1.704-2 but with results that are inconsistent with the purpose of section 704(b) and those regulations. . . . ;
(6) The benefits and burdens of ownership of property nominally contributed to the partnership are in substantial part retained (directly or indirectly) by the contributing partner (or a related party); or
(7) The benefits and burdens of ownership of partnership property are in substantial part shifted (directly or indirectly) to the distributee partner before or after the property is actually distributed to the distributee partner (or a related party).
(d) Examples. . . . [staff's emphasis]

STAFF COMMENTS – ISSUE (4) - PARTNERSHIP ANTI-ABUSE REGULATIONS

At the oral hearing, respondent should be prepared to address appellants' argument that the RSD Interest Sale is not a transaction between a partnership and a partner to which the anti-abuse regulations would apply. Respondent should also be prepared to elaborate on its argument that the use of an installment sale immediately prior to the RSD Property Sale did not clearly reflect NBJ's or Sundance-K's income because "[t]he parties utilized the partnership structure to improperly reduce NBJ's income." (ROB, p. 38.)

Issue (5): Whether the NEST penalty applies and, if it applies, whether it should be reduced to 20 percent on the basis of adequate disclosure.

Contentions

Referring back to their economic substance arguments, appellants argue that the NEST penalty does not apply because they had "a valid nontax California business purpose" such that the transaction had economic substance. Appellants further argue that the partnership anti-abuse regulations, IRC section 453(d) and other doctrines and provisions that do not involve an economic substance analysis cannot provide a basis for the imposition of the NEST penalty. Appellants further argue that, as they have previously explained to the FTB, the transaction was adequately disclosed "in both the 2006 tax returns and attached statements of both NBJ and RSD, and in the installment sale forms included in tax returns for subsequent years." Appellants therefore argue that any assessment of the penalty should be reduced to 20 percent pursuant to R&TC section 19774, subdivision (b)(1). (AL, pp. 27-28.)

Respondent notes that R&TC section 19774 imposes a penalty where a transaction lacks

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

economic substance and that the statute provides that a transaction "shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction." Respondent argues that the transaction lacks economic substance and that it is "also treated as lacking economic substance because Appellants have not demonstrated that they had a valid nontax California business purpose . . . ." (ROB, p. 38.)

Respondent argues that NBJ was faced with a gain on the sale of its property and took artificial steps to "deflect the partnership-level gain to a related entity, Sundance-K[,]" which, in turn, eliminated the gain through the application of IRC section 743. Respondent asserts that "[a]ppellants acknowledge that Sundance-K knew in advance that RSD intended to wind down after the sale of the RSD Property." Respondent further asserts that the purchase price was set without a valuation at a price designed to eliminate taxable gain. Respondent argues that appellants have not shown a valid nontax California business purpose and that ". . . the documents demonstrate that Van Damme was engaged to assist with tax planning." (ROB, pp. 38-39.)

With regard to whether the penalty should be reduced to 20 percent for adequate disclosure, respondent argues as follows:

> . . . Appellants did not disclose all of the relevant facts of the transaction. Appellants could not have made adequate disclosure as they were purportedly unaware that NBJ and Sundance-K were related persons. Tax returns and related documents filed to obtain the tax benefits do not qualify as adequate disclosure. Had the parties not completed the tax filings, Appellants would not have received tax benefits. (ROB, p. 39.)

In their reply brief, appellants argue that the FTB "ignores" the contrary information they have provided regarding nontax motivations and "essentially states that the RSD Interest Sale must have been tax motivated simply because the Khoury Family CPA offers tax planning services and he is the one who came up [with] the idea for the RSD Interest Sale . . . ." Appellants note that R&TC section 19774, subdivision (c)(2), requires a "disallowance or addition [that] is attributable to a transaction . . . that lacks economic substance . . ." and further states that "[a] transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction" or if any disallowance of benefits occurs because the transaction lacks economic substance under IRC section 7701(o) "relating to the clarification of

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

economic substance doctrine." Appellants argue that the RSD Interest Sale was "clearly motivated by a nontax business purpose" and also that the disallowance or addition shown in the NPAs and NOAs cannot result from any valid application of the doctrine or its codification in IRC section 7701(b). (ARB, pp. 27-28.)

Appellants further argue that the FTB's application of the adequate disclosure penalty reduction provision is "nonsensical." Appellants observe that R&TC section 19774, subdivision (b)(1), provides that the penalty will be reduced "with respect to the portion of any noneconomic substance transaction understatement to which the relevant facts affecting the tax treatment of the item are *adequately disclosed in the return or a statement attached to the return.* [appellants' emphasis]." Appellants argue that they have explained the disclosure of the RSD Interest Sale in both the 2006 tax returns and attached statements of RSD and NBJ as well as the subsequent reporting in installment sale forms for subsequent years. Appellants contend that the FTB summarily concludes that "the full facts" were not disclosed without explaining what additional disclosure was required. Appellants note that the FTB asserts that "[t]ax returns and related documents . . . do not qualify as adequate disclosure" but provides no authority for this "self-created rule of law" which "defies all logic and the plain language of the statute, and effectively reads R&TC §19774(b)(1) right out of the statute." Appellants question how, under the FTB's "that doesn't count" rule, any taxpayer could ever satisfy the requirements of R&TC section 19774(b)(1), which requires by its terms adequate disclosure "in the return or a statement attached to the return." (ARB, pp. 29-30.)

In its reply brief, respondent addresses the adequate disclosure issue in the context of its discussion of the related party rules of IRC section 453(e). Respondent argues that NBJ failed to report that RSD dissolved and should have reported that it disposed of the property and the date on which it disposed of the property by dissolving. Respondent argues that NBJ failed to check "YES" on FTB Form 3805E to indicate that the installment sale was between related persons. Respondent contends that appellants' reporting of the installment sale on FTB Form 3805E "was patently incorrect" and that this undermines appellants' argument that there was adequate disclosure for purposes of penalty abatement. (RRB, pp. 26-27.)

In appellants' supplemental brief, they argue that the FTB's reply brief failed to rebut or

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

otherwise respond to their NEST penalty arguments. Appellants argue the FTB's "complete silence and failure to offer any rebuttal whatsoever" indicates that the FTB's argument is incorrect. (ASB, p. 7.)

Applicable Law– Issue 5 – NEST Penalty

As in effect for this appeal (i.e., for notices mailed on or after March 24, 2011), R&TC section 19774 imposes the NEST penalty on any noneconomic substance transaction (NEST) understatement. The penalty is 40 percent of the amount of the NEST understatement except that the penalty is reduced to 20 percent "with respect to the portion of any [NEST] understatement with respect to which the relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return."

R&TC section 19774, subdivision (c)(2), provides as follows:

> A "noneconomic substance transaction" includes:
>
> (A) The disallowance of any loss, deduction or credit, or addition to income attributable to a determination that the disallowance or addition is attributable to a transaction or arrangement that lacks economic substance including a transaction or arrangement in which an entity is disregarded as lacking economic substance. A transaction shall be treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.
>
> (B) Any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, within the meaning of Section 7701(o) of the Internal Revenue Code, relating to clarification of economic substance doctrine, as added by Section 1409(a) of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152), except as otherwise provided.

R&TC section 19774, subdivision (c)(B)(i) and (ii), modify IRC section 7701(o) for California purposes. As modified by these provisions, IRC section 7701(o), provides as follows:

> (o) Clarification of economic substance doctrine
>
> (1) Application of doctrine. In the case of any transaction to which *the economic substance doctrine* is relevant, such transaction shall be treated as having economic substance *only if*—
>
> (A) the transaction changes in a meaningful way (apart from state income tax effects) the taxpayer's economic position, *and*
>
> (B) the taxpayer has a substantial purpose (apart from state income tax effects) for entering into such transaction.
>
> (2) Special rule where taxpayer relies on profit potential
>
> (A) In general. The potential for profit of a transaction shall be taken into account in determining whether the requirements of subparagraphs

(A) and (B) of paragraph (1) are met with respect to the transaction only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

. . .

(3) State and local tax benefits. For purposes of paragraph (1), any federal or local income tax effect which is related to a state income tax effect shall be treated in the same manner as a state income tax effect.

. . .

(5) . . . For purposes of this subsection—

(A) Economic substance doctrine[.] *The term "economic substance doctrine" means the common law doctrine under which tax benefits under subtitle A with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose*. [emphasis added by staff]

(B) Exception for personal transactions of individuals[.] In the case of an individual, paragraph (1) shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income.

(C) Determination of application of doctrine not affected[.] *The determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if this subsection had never been enacted*.

(D) Transaction. The term "transaction" includes a series of transactions. [staff's emphasis]

STAFF COMMENTS – ISSUE (5) - NEST PENALTY

If the Board determines that the transaction lacks economic substance under Issue (3), the NEST penalty will be applicable.

At the hearing, the parties should be prepared to discuss further whether the relevant facts were adequately disclosed in the return or statements attached to the return such that the penalty would be reduced from 40 percent to 20 percent. On page 39 of its opening brief, respondent states: "Tax returns and related documents filed to obtain the tax benefits do not qualify as adequate disclosure." This statement is incorrect. As noted by appellants, R&TC section 19774, subdivision (b)(1), expressly provides that the penalty shall be reduced if "the relevant facts affecting the tax treatment of the item are adequately disclosed in the return or a statement attached to the return." In light of this statutory language, respondent should be prepared to clarify its statement.

At the hearing, appellants should be prepared to address respondent's argument that

NBJ failed to put the FTB on notice of the potential application of IRC section 453(e) because it checked "no" in response to the question on Form 3805E as to whether the installment sale property was sold to a related party. (See RRB, pp. 26-27 and Ex. B at p. 1 [NBJ's Form 3805E].)

Issue (6): Whether the interest-based penalty applies.

Contentions

Appellants argue that the interest-based penalty does not apply because the RSD Interest Sale has economic substance such that it is not subject to the NEST penalty and not an abusive tax avoidance transaction (ATAT). Appellants contend that the alleged FTB "contact" regarding an ATAT was made in AIPS 1, "which alleges that the RSD Interest Sale is a BOB abusive tax shelter." Appellants argue that the FTB "now admits" that the transaction is not a BOB abusive tax shelter and further argue that AIPS 1 was subsequently withdrawn. (AL, pp. 28-29.)

Respondent notes that R&TC section 19777 imposes an interest-based penalty if the taxpayer has been contacted by the FTB regarding an ATAT and has a deficiency attributable to the transaction. Respondent further notes that R&TC section 19777 includes in the definition of ATAT "any transaction to which Section 19774 applies." The FTB argues that it "contacted RSD on April 28, 2009 and Appellants on February 6, 2012 regarding the abusive tax avoidance transaction [ATAT]." The FTB concludes that the interest-based penalty applies because appellants' deficiency is "attributable to the [abusive tax avoidance transaction]." (ROB, p. 40.)

In their reply brief, appellants state that they agree that a transaction that is subject to the NEST penalty would be subject to the interest-based penalty if the taxpayer has been contacted by the FTB regarding an ATAT. However, appellants dispute that the transaction was a noneconomic substance transaction for the reasons previously stated. Appellants also dispute that the FTB contacts referenced in its opening brief were contacts "regarding *the* [abusive tax avoidance transaction]" as asserted by the FTB. Appellants state that both the April 28, 2009 and February 6, 2012 contacts referenced by it relate to its "erroneous and abandoned" Bogus Optional Basis (BOB) allegations which sought to disallow the positive basis adjustment and assess a deficiency on RSD's gain on the RSD Property Sale. Appellants argue that neither of the contacts pertain to the disallowance of NBJ's deferral of gain under IRC section 453 or its gain on the RSD Interest Sale. Appellants also state that

the February 6, 2012 contact refers to AIPS 1 which was rescinded with the FTB's issuance of AIPS 3. (ARB, pp. 29-30.)

In their supplemental brief, appellants note that the FTB did not address the interest-based penalty in its reply brief and argues that the FTB's "complete silence and failure to offer any rebuttal" shows that the FTB is incorrect. (ASB, p. 8.)

Applicable Law – Issue (6) - Interest-based Penalty

As in effect for purposes of this appeal, R&TC section 19777 adds an interest-based penalty equal to 100 percent of the interest charged between the date the tax was due and the date of the NPA. R&TC section 19777, subdivision (a), requires that the taxpayer have been "contacted by the [FTB] regarding an abusive tax avoidance transaction [ATAT]." R&TC section 19777, subdivision (b), defines an "abusive tax avoidance transaction" as including, among other things, a transaction to which the NEST penalty applies.

STAFF COMMENTS – ISSUE (6) – INTEREST-BASED PENALTY

If the Board determines that the FTB contacted appellants regarding an ATAT and it determines the NEST penalty applies under Issue (5), then the interest-based penalty would apply. The FTB argues that notice was provided on April 28, 2009 and February 6, 2012 (AIPS 1). At least 14 days prior to the oral hearing date, the FTB should provide a copy of the notices as additional exhibits. At the hearing, respondent should be prepared to address appellants' argument that the FTB did not provide the required notice because the FTB's notices reflected its erroneous allegations that the transaction was a BOB transaction. Appellants should be prepared to address whether the documents were sufficient to put them on notice that the FTB viewed the transaction as abusive, even if the FTB's analysis of the transaction later changed.

Issue (7): Whether interest suspension applies.

Contentions

Appellants argue that, if the assessment were found to be valid, interest should be suspended pursuant to R&TC section 19116 "because the FTB failed to timely notice Appellant within the 'notification period' required by R&TC §19116." Appellants further argue that they have raised this issue previously but the FTB did not address it in its PDL, FDL, or its NOAs. Appellants further

argue that the FTB's conclusion that the transaction "is an ATAT as defined in R&TC §19777 because it is a NEST as defined in R&TC §19774 is erroneous." (AL, p. 29; ARB, p. 30.)

The FTB argues that R&TC section 19116, subdivision (d)(8),[41] provides that interest suspension does not apply to an ATAT. The FTB argues that appellants cannot obtain interest suspension because their transaction was an ATAT. (ROB, p. 40.)

In their supplemental brief, appellants note that the FTB did not address interest suspension in its reply brief and argues that the FTB's "complete silence and failure to offer any rebuttal" shows the FTB is incorrect. (ASB, p. 8.)

Applicable Law

R&TC section 19777, subdivision (d)(8), provides that interest suspension shall not apply to any "[a]ny interest, penalty, addition to tax, or additional amount relating to any [abusive tax avoidance transaction], as defined in Section 19777. . . ."

STAFF COMMENTS – ISSUE (7) – INTEREST SUSPENSION – SECTION 40

If the Board finds that the NEST penalty applies under Issue (5), then interest cannot be suspended. The FTB should be prepared to address whether interest suspension would apply if the Board found that the NEST penalty did not apply and that the transaction was not an ATAT.

Appellants argue that the FTB did not timely notice appellants within the notification period required by R&TC section 19116. However, the notice period is only relevant if R&TC section 19116 applies, and R&TC section 19116(d)(8) provides that R&TC section 19116 does not apply to ATATs.[42]

GENERAL STAFF COMMENTS

Additional Briefing

The briefing on this matter is voluminous and the briefing process has concluded unless

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[41] The FTB refers to R&TC section 19777, subdivision (c)(8), but this appears to staff to be a typographical error.

[42] Appellants also argue that the FTB's conclusion that the transaction "is an ATAT as defined in R&TC §19777 because it is a NEST as defined in R&TC §19774 is erroneous." (AL, p. 29; ARB, p. 30.) At the oral hearing, appellants should be prepared to clarify whether they contend that ATATs are eligible for interest suspension (and, if so, explain the basis for the argument and address R&TC section 19116, subdivision (d)) or whether they simply contend that the transaction at issue was not an ATAT.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

additional briefing is requested pursuant to California Code of Regulations, title 18, section (Rule) 5435. Therefore, the parties should not submit any further written argument unless additional briefing is requested pursuant to Rule 5435.

Additional Exhibits

Staff requests that, at least 14 days prior to the oral hearing, the FTB (or appellants) provide as additional exhibits a copy of AIPS 1, AIPS 2, AIPS 3, the July 2011 VCI-2 notice, and the April 28, 2009 notice referenced in its interest-based penalty arguments. Staff also requests that appellants (or the FTB) provide the March 12, 2013 declaration of the Grandparents (and any other declarations or affidavits that are not already in the appeal record). In addition, pursuant to Rule 5523.6, if either party has any additional evidence to present, it should provide the evidence to the Board Proceedings Division at least 14 days prior to the oral hearing. Evidence exhibits should be sent, with a copy to the other party, to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

Section 40

As noted above, this matter is subject to Revenue and Taxation Code section 40. Therefore, within 120 days from the date the Board's vote to decide the appeal becomes final, a written opinion (i.e., Summary Decision or Formal Opinion) must be published on the Board's website. (Cal. Code Regs., tit. 18, § 5552, subds. (b), (f).) The Board's vote to decide the appeal will become final 30 days following the date of the Board's vote. (Cal. Code Regs., tit. 18, § 5465, subd. (b).) No petition for rehearing may be filed following the Board's vote to determine the appeal after the rehearing. (Cal. Code Regs., tit. 18, § 5460, subd. (c)(2).)

Following the conclusion of this rehearing, if the Board votes to decide the appeal, but does not specify whether a Summary Decision or a Formal Opinion should be prepared, staff will expeditiously prepare a nonprecedential Summary Decision and submit it to the Board for consideration at a subsequent meeting. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(2).) Unless the Board directs otherwise, the proposed Summary Decision would not be confidential pending its consideration by the Board (Cal. Code Regs., tit. 18 § 5551, subd. (b)(5)); accordingly, it would be posted on the Public Agenda Notice for the meeting at which the Board will consider and vote on the

Summary Decision. If it wishes, the Board may hold its vote in abeyance until it has the opportunity to review the proposed Summary Decision. If the vote is held in abeyance, the proposed Summary Decision will be confidential until it is adopted by the Board. (Cal. Code Regs., tit. 18, § 5551, subd. (b)(5).)

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL