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9 **BOARD OF EQUALIZATION**

10 **STATE OF CALIFORNIA**

11 In the Matter of the Appeal of:

) **HEARING SUMMARY**

) **PERSONAL INCOME TAX APPEAL**

12 **RICHARD A. HALL**<sup>1</sup>

) Case No. 533898

13 Year  
14 2003

Deficiency  
Proposed Assessment  
\$157,185

15 Representing the Parties:

16 For Appellants:

A. Lavar Taylor, Attorney

17 For Franchise Tax Board:

Leah McElhatton, Tax Counsel

18  
19 **QUESTION:** Whether appellant has established that a \$1,476,000 distribution to appellant  
20 from appellant's partnership was a bona fide loan.

21 **HEARING SUMMARY**

22 Background

23 Appellant is a general partner owning a 45 percent profits and capital interest in Richard  
24 Hall, LP (RHLP), a limited partnership that owned the Copacabana Mobilehome Park (Copacabana  
25 property) in La Verne, California. The other two partners are David E. Rose with a 5 percent interest and  
26 Robert K. Ostengaard with a 50 percent interest. In February 2003, the City of LaVerne (city) adopted a  
27

28 <sup>1</sup> Appellant resides in Tustin, Orange County.

1 resolution determining that the Copacabana property was being acquired, pursuant to the city's  
2 condemnation authority and power, as necessary for the city's affordable housing purposes. The city also  
3 filed an eminent domain action against RHLP for the Copacabana property. In April 2003, RHLP sold  
4 the Copacabana property under threat of condemnation for \$8,000,000. (App. Op. Br., pp. 2-3; Resp. Op.  
5 Br., p. 1.)

6 The net proceeds from the sale were \$3,278,248 and the 2003 partnership return of RHLP  
7 reported \$3,681,000 as distributions to the partners from the proceeds of the sale. Appellant's 2003  
8 Schedule K-1 reported \$1,668,500 in distributions received in April 2003. Appellant executed a  
9 document titled "Demand Promissory Note" (Note) dated April 16, 2003 reciting that he promises to pay  
10 upon demand the principal sum of \$1,476,000 to RHLP. The Note provides that the loan amount was  
11 part of the consideration from the sale of the Copacabana property and that RHLP intended to reinvest  
12 the proceeds in a replacement property under the provisions of Internal Revenue Code (IRC) section  
13 1033. Unless previously demanded, the Note further provides that appellant is obligated to pay the  
14 principal amount of the Note at least two business days prior to the date RHLP reinvests the proceeds to  
15 acquire the replacement property. The Note did not provide for the accrual and payment of interest on  
16 the principal unless an amount due was not paid when due; in that event, appellant agreed to pay interest  
17 on the delinquent amount which was presumed to be the amount of damages for the late payment. The  
18 initial due date for the reinvestment was December 31, 2006, but RHLP requested and was granted  
19 extensions of the due date until December 31, 2010. (App. Op. Br., p. 3 and attachments; Resp. Op. Br.,  
20 pp. 1-2.)

21 In 2007, respondent examined the return of RHLP and issued a Notice of Proposed  
22 Assessment (NPA) dated February 3, 2009, which assessed additional tax on the amount transferred to  
23 appellant in excess of appellant's tax basis in RHLP. Appellant filed a timely protest of the NPA and  
24 respondent affirmed the NPA in a Notice of Action dated April 28, 2010. Appellant then filed this timely  
25 appeal.<sup>2</sup> (App. Op. Br., p. 2.)

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27  
28 <sup>2</sup> This matter was calendared for hearing at the December 2011 Board meeting but was deferred at appellant's request to  
allow him the opportunity to submit additional documentation showing that the IRC section 1033 exchange was completed  
and the partners repaid the distributed funds to RHLP. As discussed below, appellant and respondent submitted additional  
briefing concerning this additional documentation.

1           Contentions

2                   Appellant

3                   Shortly after the sale of the Copacabana property, appellant states that payments were  
4 made to the partners of RHL P out of the proceeds of the sale. Appellant further states that all partners  
5 were in full agreement that RHL P should reinvest the proceeds in a replacement property and that the  
6 funds distributed to them should be returned to RHL P to purchase the replacement property. Thus,  
7 appellant asserts that the partners understood that the transfers of the funds were loans to them which  
8 were documented as demand promissory notes. (App. Op. Br., p.3.)

9                   Appellant contends that the facts and circumstances show that the parties intended the  
10 payment as a loan and not as a capital account distribution. Appellant further contends that he was  
11 obligated to return the proceeds so RHL P could purchase a replacement property. Appellant also states  
12 that he remained a partner because he intended to participate through RHL P as an investor in the  
13 replacement property. Appellant asserts that the “general characteristics of a valid loan” must be  
14 considered and he presents the following “7 major characteristics”:

- 15           • Written unconditional obligation to pay on demand or at a reasonably close fixed maturity date -  
16           The Note is due on demand and if no demand is made it is due and payable at least two business  
17           days prior to the date of reinvestment which is a reasonably close, fixed maturity date.
- 18           • Existence of a sum certain – The Note has a face amount of \$1,476,000.
- 19           • Definite date of repayment (i.e., fixed maturity date) – The Note states that payment is due on  
20           demand or at least two days before the reinvestment date. The original due date, if not demanded  
21           earlier, was December 28, 2006, but extensions were granted to RHL P by the Internal Revenue  
22           Service. As they stated in affidavits provided with appellant’s opening brief, the partners also  
23           understood that the managing partner could determine an earlier maturity date.
- 24           • Repayment schedule and manner of repayment – The Note states that the entire principal is due  
25           on demand or due and payable at least two business days prior to the reinvestment date. A full  
26           payment at maturity is a common manner of repayment and constitutes a common repayment  
27           schedule. The fact that appellant has not made a repayment is consistent with the terms of the  
28           Note.

- 1 • Whether the loan is payable regardless of the debtor's income or lack of income – The Note  
2 provides for a repayment regardless of the debtor's income and appellant does not have the right  
3 to withhold a repayment due to income constraints.
- 4 • Fixed interest rate percentage – There is no fixed interest rate if the partner is not in default. The  
5 business reason for not charging interest is the pro-rata nature of the loans to the partners which  
6 were made so that each partner could make his own decision as to how the funds should be used  
7 until RHLP needed them. If interest were charged, it would have simply flowed to RHLP and  
8 then back to the individual partners. The failure to charge interest is not applicable under these  
9 circumstances because it is irrelevant to the partners' business deal. It is also noteworthy that, if  
10 interest is charged to a partner in default, it is not likely to be pro rata.
- 11 • Likelihood of repayment – The specific facts here indicate a very high likelihood of repayment as  
12 follows:
- 13 (a) Security for loan - The Note does not have “nonrecourse provisions” or limitations on  
14 collection efforts. Appellant is a high net worth individual and he understood the “full  
15 personal recourse nature of the loan and its maturity date.” For that reason, there was no  
16 need for appellant to pledge security or collateral.
- 17 (b) Expectation of repayment – The Note is a recourse liability and the other partners can  
18 compel RHLP to seek a repayment of the loan. There is also an incentive for appellant to  
19 repay the loan on time to ensure the deferral of income tax on the gain realized from the  
20 sale of the Copacabana property.
- 21 (c) Source of repayment – Appellant is a high net worth individual with sufficient resources  
22 to repay the loan.
- 23 (d) Arm's length business decision – RHLP made a prudent business decision to make loans  
24 to the partners and the partners engaged in business relationships with each other for many  
25 years and expected the other partners would repay the loans when due.  
26 (App. Op. Br., pp. 4-8.)

27 Appellant contends that respondent focuses on only four of the seven major characteristics  
28 and appellant takes issue with respondent's conclusions set forth in a letter dated April 14, 2010, as

1 follows:

- 2
- 3 • Fixed Maturity Date – Respondent erroneously argues that the loan has no fixed maturity date  
4 when it states that the replacement period may be extended pursuant to IRC section 1033(g)(4)  
5 and thus the extended period became an unspecified period of time. Appellant argues that the  
6 terms of the Note which is a loan from RHLP to a 45 percent interest partner and due on demand  
7 satisfies the fixed maturity date requirement. In addition, appellant asserts that the due date is  
8 controlled by factors that are not within appellant’s control. Appellant contends that the IRS  
9 extensions do not turn the loan term into an unspecified period of time and respondent’s argument  
10 makes no sense unless RHLP has the unilateral right to extend the time frame under IRC section  
11 1033 to acquire the replacement property.
  - 12 • Fixed Repayment Schedule – Respondent erroneously argues that there is no fixed repayment  
13 schedule because the exact date of repayment is unknown due to the extensions for acquiring the  
14 replacement property. A common feature of many loans is that they are due in full at maturity  
15 which constitutes a “fixed payment schedule”. Making a number of “fixed payments” is not a  
16 requirement for a valid loan. In addition, respondent appears to argue that there is no fixed  
17 repayment schedule due to the extensions which is the same reason that respondent contends there  
18 is no fixed maturity date. Because appellant has shown that a fixed maturity date exists,  
19 respondent’s argument makes no sense. Finally, neither RHLP nor appellant is able to control  
20 whether the IRS grants a request for an extension of time to acquire the replacement property.
  - 21 • Whether the loan was an arm’s length transaction – Respondent argues that RHLP did not benefit  
22 by distributing the funds and the Note was a loan from appellant to himself. RHLP did benefit  
23 from “the prudent business decision to loan the funds to the partners” which allowed each partner  
24 to individually invest funds and ensure that RHLP would be repaid timely.
  - 25 • Whether appellant is at risk indicating the existence of a recourse loan – Respondent focuses on  
26 an irrelevant aspect of partnership tax law pertaining to a partner’s tax basis with respect to  
27 partnership liabilities and the restoration of any capital account deficit. Here, the accounting item  
28 (i.e., the loan), is an asset of RHLP and not a liability. In addition, the loan from RHLP to  
appellant is recourse and appellant is at risk as set forth in appellant’s description of the seven

1 major characteristics above.

2 (App. Op. Br., pp. 8-12.)

3 Respondent

4 Respondent contends that appellant and the other partners made a distribution to him and  
5 labeled it as a loan “without the appropriate safeguards of a loan” whereas RHLP would have been better  
6 served by retaining the proceeds. Specifically, respondent contends that appellant acted “on both sides of  
7 the transaction” which indicates a taxable distribution. Notwithstanding the formalities observed by the  
8 partners, respondent asserts that the partners did not treat themselves as third-party borrowers because  
9 they did not require interest payments, evidence of the debtor’s financial status, a fixed maturity date, or a  
10 repayment schedule. In addition, because the amount of the payment was in proportion to appellant’s  
11 partnership interest, a third-party lender would not make a loan under such circumstances and the  
12 partners will not enforce a payment against themselves. (Resp. Op. Br., pp. 2-3.)

13 Rather than treating themselves as strangers on behalf of RHLP, respondent contends that  
14 the partners treated RHLP as an extension of themselves to the potential financial detriment of RHLP.  
15 Respondent contends that a bona fide creditor-debtor relationship did not exist because appellant is both a  
16 debtor and, as a partner, is a creditor and thus has made a loan to himself. For that reason, respondent  
17 asserts that the transaction merits closer scrutiny of the surrounding circumstances to determine whether  
18 the following factors support a finding that the parties truly intended a loan.

- 19 • Promissory Note as Evidence of Indebtedness – A promissory note is only a label and the focus  
20 should be on whether the partners treated themselves as strangers in the transaction. (Resp. Op.  
21 Br., p. 5.)
- 22 • Intent – The affidavits and unsupported assertions provided by appellant “can be equated to ‘self-  
23 serving declarations of intention to create a debt’” but “such empty declarations of subjective  
24 intent” do not alter the surrounding objective circumstances which may indicate that the  
25 partnership never intended that the distribution would be repaid. (Resp. Op. Br., pp. 5-6.)
- 26 • Interest Payments – The absence of a fixed interest rate and regular interest payments indicate a  
27 distribution rather than a loan. A true creditor requires the payment of interest, which is  
28 compensation for the use of money, and thus without interest payments a true creditor has no

1 incentive to make a loan. The absence of interest payments indicates that appellant was not  
2 treated as a stranger by the partnership and thus was not a bona fide debtor. In addition, the  
3 imposition of interest upon default is not the equivalent of a fixed interest rate and regular interest  
4 payments, whereby the creditor ensures the receipt of benefits for making the loan rather than  
5 benefitting only if the borrower defaults. (Resp. Op. Br., pp. 6-7.)

- 6 • Ensuring Repayment – A true creditor takes measures to ensure a repayment such as requiring  
7 security, examining the debtor’s ability to repay, enforcing the repayment upon default, and  
8 setting a fixed maturity date and a regular schedule of repayment. (Resp. Op. Br., p. 8.)
- 9 • Security Requirement – The requirement of security ensures the repayment of a loan and thus the  
10 absence of security indicates that the payments were distributions because appellant was not  
11 treated as a stranger. Regardless of whether appellant’s assets were put at risk, as appellant  
12 asserts, a true creditor would have required security because other creditors may have had claims  
13 to those assets superior to RHLP’s claim. Therefore, appellant was not treated as a stranger  
14 because no security was required to ensure a repayment. (Resp. Op. Br., p. 8.)
- 15 • Financial Ability to Repay – A bona fide creditor is typically concerned with a debtor’s ability to  
16 repay. Here, appellant has made assertions but has not provided any evidence that he is a “high  
17 net worth individual”. A true creditor would require evidence rather than unsupported assertions  
18 of a debtor’s financial status before loaning a substantial amount of money to a stranger. (Resp.  
19 Op. Br., p. 9.)
- 20 • Fixed Maturity Date – Here, the maturity date is not fixed because RHLP appears indifferent to  
21 the exact date of the repayment. In addition, repayment is contingent upon a condition, the  
22 reinvestment plan, that has suspended the obligation to repay as a result of the multiple  
23 extensions. The absence of a fixed maturity date indicates a distribution. (Resp. Op. Br., pp. 9-  
24 10.)
- 25 • Repayment Schedule – The purpose of a repayment schedule is to ensure the certainty of  
26 repayment and requiring the repayment of the full amount on a maturity date increases the risk of  
27 nonpayment. An agreement to make a lump sum repayment on demand is not a repayment  
28 schedule and even, if such an agreement constitutes a repayment schedule, that schedule is

1 unknown because there is no fixed maturity date. In support of this point, respondent cites *In re*  
2 *Cold Harbor Associates* (1997) 204 B.R. 904, in which the Bankruptcy Court held that a  
3 provision of a promissory note under which the debtor was obligated to make a repayment of the  
4 principal amount on demand did not constitute a loan repayment schedule. (Resp. Op. Br., pp.  
5 10-11.)

- 6 • Proportionate Ownership – Receipt of a payment proportionate to a partner’s interest in a  
7 partnership indicates a distribution. If a true debtor-creditor relationship existed, the amount of  
8 the loan would be established without regard to the debtor’s economic interest in the creditor  
9 entity. Respondent cites *Estate of Mixon v. U.S.* (5th Cir. 1972) 464 F.2d 394 in this regard.  
10 (Resp. Op. Br., pp. 11-12.)
- 11 • Right to Enforce Repayment – Evidence that a creditor would not enforce a repayment indicates  
12 that the payments were distributions. Here, a distribution can be “molded” into a tax-free loan  
13 because the partners make up the partnership and no partner would enforce a repayment of a loan  
14 against the other partners because each partner benefited from his nontaxable distribution. The  
15 partners chose to “loan” to debtors which increased the risk that the loan would not be repaid and  
16 the partners would no longer be acting on behalf of the partnership and the partners did not take  
17 the customary steps to ensure a repayment of the purported loan or to ensure the receipt of a  
18 benefit. (Resp. Op. Br., p. 12.)
- 19 • Ability to Obtain a Loan from an Outside Lender – Appellant would not be able to obtain a loan  
20 on the same terms from an outside lender. A true creditor would have either directly invested the  
21 proceeds pending an acquisition of a replacement property rather than the riskier option of  
22 lending them to a third-party to invest or, if the creditor did choose to lend the proceeds, the  
23 creditor would have taken steps to decrease the likelihood of default, such as security or a  
24 repayment schedule, and to ensure the receipt of a financial benefit by requiring interest  
25 payments. (Resp. Op. Br., pp. 12-13.)

26 Respondent concludes that partners have a duty to act in the best interests of the  
27 partnership but in this instance appellant and the other partners acted in a manner that put the proceeds at  
28 greater risk which could potentially harm RHL P. Respondent contends that the partners’ disregard of the

1 most beneficial option for RHL P, i.e., directly investing the proceeds for RHL P, worked to RHL P's  
2 detriment in two ways: (1) the partners did not take appropriate steps to ensure the repayment by  
3 requiring security and the other means stated above and (2) the partners did not ensure the receipt of a  
4 benefit for RHL P by requiring interest payments as a true creditor would have done. Finally, even  
5 though appellant asserts that each partner is relying indirectly on the other partners to repay their loans, it  
6 is just as plausible to assume that each partner is relying on the others not to repay. (Resp. Op. Br., pp.  
7 13-16.)

#### 8 Appellant's Reply

9 RHL P's election under IRC section 1033 is clear evidence of the intent to use the proceeds  
10 to acquire a replacement property. Thus, RHL P was not free to use the proceeds to make capital account  
11 distributions to appellant and the other partners. In addition, the partners had great incentive to avoid  
12 federal and state income tax liabilities by accomplishing an IRC section 1033 tax-deferred exchange.  
13 Thus, it was clear that the funds must be repaid to RHL P to acquire the replacement property and each  
14 partner willingly accepted the repayment obligation. (App. Reply Br., p. 6.)

15 Both substance and form support the existence of a bona fide debt because the debt was  
16 evidenced by the Notes and affidavits from the partners. In addition, appellant has shown all of the  
17 indicia of a loan including an unconditional obligation to pay on demand or at a reasonably close fixed  
18 maturity date, the existence of a sum certain, a definite date of repayment, a repayment schedule and the  
19 manner of repayment, a repayment required regardless of debtor's financial condition, and a high  
20 likelihood of repayment. The absence of a requirement to make regular interest payments was  
21 appropriate under the circumstances. (App. Reply Br., p. 6.)

22 Appellant further contends that respondent does not "adequately consider all of the actual  
23 facts and circumstances of the situation" and "does not make an orderly and logical examination of such  
24 facts and circumstances to determine if enough characteristics exist to have a valid loan." Appellant  
25 notes that the absence of one or more of the major characteristics does not necessarily demonstrate that a  
26 valid loan does not exist. Appellant asserts that RHL P's IRC section 1033 election on the 2003  
27 partnership return is objective evidence demonstrating that the partners intended the proceeds to be used  
28 to acquire a replacement property. Thus, there was no intent to distribute those funds without a

1 repayment obligation. Appellant further asserts that the payments were incorrectly reported as  
2 distributions on the 2003 return due to an “obvious miscommunication of the loans to the accountants”  
3 which should not be held against appellant. Appellant concludes that the obvious implication of its 1033  
4 election was that the payment was a loan that appellant needed to repay in a timely manner to purchase a  
5 replacement property. (App. Reply Br., pp. 5-6.)

6 In support of his contention that he is a “high net worth individual”, appellant attaches to  
7 his reply brief a document titled: “Personal Financial Statement, Addendum to Imperial Capital Bank,  
8 Commercial Loan Application” dated November 14, 2003, with an attached Consolidated Balance Sheet  
9 dated April 30, 2003, which shows total assets of \$58,617,986, total liabilities of \$33,493,910 and net  
10 worth of \$25,124,076. Appellant also takes issue with respondent’s position that appellant was not  
11 treated by RHLP as a stranger to the transaction. Specifically, appellant argues that respondent focuses  
12 primarily on the fact that RHLP did not “adequately underwrite” appellant before making the loan.  
13 However, appellant asserts that the RHLP partners have been doing business with each other for many  
14 years and are familiar with each other’s financial condition. Therefore, RHLP had knowledge of  
15 appellant’s high net worth, so security and additional collateral were unnecessary. In addition, appellant  
16 argues that the loans to the partners represented “the most prudent decision” RHLP could make under the  
17 circumstances because any other investment would have carried more risk. Finally, appellant asserts that  
18 respondent misses “the big picture” when it focuses on “the lack of some traditional formalities” because  
19 “it was the relationships that existed [between the partners] that rendered certain traditional formalities  
20 unnecessary” and the promises by all three partners to repay the loans were mutually dependent. (App.  
21 Reply Br., pp. 7-8.)

22 With respect to respondent’s citation of *In re Cold Harbor Associates, supra*, in support of  
23 its position that the absence of a repayment indicates a lump sum distribution, appellant argues that the  
24 case is distinguishable and does not support respondent’s position for the following reasons:

- 25 • This is a Bankruptcy Court case and one aspect of the case was whether certain limited partners  
26 made bona fide loans to their partnership.
- 27 • The lenders were the partners whereas in this appeal, the partnership, RHLP, is the lender.
- 28 • The promissory notes were simple “demand notes” with no specified maturity dates.

- 1 • Respondent misquotes the *In re Cold Harbor Associates* court’s finding and appellant contends  
2 that, under the facts and circumstances presented, “the court did not find the existence of  
3 formalities evidencing a method of repayment.”
- 4 • In *In re Cold Harbor Associates*, the only language on the notes referencing a repayment was  
5 “ON DEMAND” whereas in this appeal, the promissory note has “other language establishing a  
6 maturity date”.
- 7 (App. Reply Br., pp. 9-11.)

8 Appellant further argues that respondent incorrectly characterizes the loan transaction as a  
9 “loan to himself” because appellant held only a 45 percent partnership interest and the other partners  
10 would be significantly harmed if he failed to repay the loan. With respect to respondent’s argument that  
11 no outside creditor would make a loan under similar circumstances, appellant asserts that RHLF  
12 “received the benefits of placing its funds securely with high net worth borrowers who were highly  
13 motivated to timely repay the money.” Appellant acknowledges that “the payment of interest is usually  
14 one important aspect of a loan transaction”, but appellant contends that “it should be reduced in  
15 importance or even eliminated because of the total absence of economic substance in this situation  
16 (proportionate loans to partners) until there is a default (when interest should be and is charged in this  
17 case).” Appellant further notes that, in the case cited by respondent, *Estate of Mixon, supra*, the court  
18 found, under the facts presented, that the failure to require interest payments was insignificant. Finally,  
19 appellant asserts that major U.S. banks are making very large loans to the Federal Reserve at an interest  
20 rate of one quarter of one percent which amounts to a negative real interest rate. (App. Reply Br., pp. 11-  
21 12.)

22 Appellant takes issue with respondent’s conclusion that the transaction was not a bona fide  
23 loan based solely on the failure to require interest payments. Appellant also disputes respondent’s  
24 contention that the maturity date is not fixed and the repayment date will likely be extended each year  
25 because the “reinvestment date” has been extended each year. Appellant states that additional extensions  
26 must be approved by the IRS and appellant does not anticipate requesting an extension beyond year end  
27 2010. In addition, the partners were not, as respondent has stated, indifferent to the date of repayment  
28 because a timely repayment is essential to accomplish the IRC section 1033 transaction. (App. Reply

1 Br., pp. 12-13.)

2 Appellant asserts that respondent misplaces its reliance on *Estate of Mixon, supra*,  
3 because, in that case, the court considered whether payments by shareholders to a corporation were loans  
4 or capital contributions. By contrast, this appeal involves a partnership making loans to its partners with  
5 an obligation to repay those amounts. The fact that the loan amounts were proportionate to the partners'  
6 interests does not indicate a distribution rather than a loan. In that respect, appellant contends that  
7 respondent is "confusing old cases pertaining to corporate debt versus equity situations (and taxable  
8 corporate dividends versus loan repayments)." (App. Reply Br., pp. 13-14.)

9 Finally, with respect to respondent's position that RHL P and the other partners had no  
10 incentive to enforce a repayment, appellant argues that:

- 11 • He holds a minority partnership interest and the other partners looked out for their own best  
12 interests.
- 13 • Appellant was contractually bound to repay the loan and had a fiduciary duty to the partnership to  
14 enforce a repayment.
- 15 • Respondent's analysis is more applicable to a corporation's payment to a shareholder as a  
16 disguised dividend because a distribution by a partnership to a partner is only taxable to the extent  
17 it exceeds the partner's basis in the partnership.
- 18 • All three partners made mutually dependent promises to repay the loans so that any partner who  
19 did not default would have a strong incentive to seek enforcement.
- 20 • The loans were made to high net worth individuals who were very motivated to repay them.
- 21 • The customary steps to secure the loans were unnecessary and RHL P obtained a very significant  
22 benefit by receiving mutually dependent enforceable promises of repayment.

23 (App. Reply Br., pp. 14-16.)

24 Supplemental Briefing

25 On or about December 12, 2011, appellant notified the Board's Appeals Division that he  
26 had information showing that the IRC section 1033 exchange had been completed and all of the funds  
27 had been repaid to RHL P. By letter dated December 19, 2011, appellant provided the following  
28 supplemental information:

- 1 • A copy of a letter from the IRS to appellant dated February 2, 2011, requesting information as to  
2 whether RHLP acquired replacement property and, if so, the date of acquisition, the cost, and a  
3 description of the converted and replacement property. Appellant replied to the IRS by letter  
4 dated February 4, 2011, which states that RHLP acquired two replacement properties in  
5 November and December of 2010, describes the properties, and states the prices paid for them.
- 6 • A copy of a 2010 Form 565 (Partnership Return of Income) for RHLP with an attached statement  
7 explaining that RHLP acquired the two properties described above.
- 8 • A transfer activity report from the Bank of the West showing four transfers from “Richard Hall  
9 RHIP Acct” to “Richard Hall LP” in November and December of 2010 totaling \$1,504,000.

10 Appellant contends that this supplemental information demonstrates that respondent “incorrectly  
11 concluded that the loan to [appellant] was a capital account distribution.” (App. Add’l Information.)

12 After reviewing the information provided by appellant, by letter dated February 13, 2012,  
13 the Appeals Division requested that appellant provide additional information confirming that (1) the IRS  
14 determined that the acquisition of certain replacement properties qualified as a tax-deferred exchange  
15 under IRC section 1033, (2) the other two partners of RHLP transferred to RHLP the amounts specified  
16 in their promissory notes and (3) any other evidence to substantiate appellant’s claim that all  
17 requirements for a valid IRC section 1033 exchange were met. In a reply dated March 9, 2012, appellant  
18 provided the following documentation in response to each item above:

19 (1) Appellant refers to the correspondence between himself and the IRS attached to his December 19,  
20 2011 letter.

21 (2) A summary of transfers made in November and December of 2010 from the partners to RHLP.

22 (3) Appellant declines to provide any evidence because he believes that the information he already  
23 submitted adequately supports his position.

24 (App. Add’l Br. and exhibits.)

25 In a supplemental brief dated April 24, 2012, respondent states that appellant only  
26 provided a letter from the IRS requesting information about the acquisition of replacement property.  
27 Thus, respondent contends that appellant has failed to provide documentation confirming that the IRS  
28 determined that the acquisition of the properties met the requirements of an IRC section 1033 exchange.

1 Respondent further argues that appellant’s documentation shows transfers from the partners to RHL P but  
2 appellant has failed to show any connection between those transfers and the promissory notes.  
3 Respondent asserts that there was no repayment schedule and the total of the transfers was a different  
4 amount than that stated in the promissory note. In response to appellant’s characterization of the  
5 repayment schedule as an obligation to pay the entire principal upon demand, respondent notes that the  
6 partners transferred varying amounts of money on different days that totaled more than the sum certain  
7 due on the promissory note. Respondent further states that appellant’s assertion that the excess amounts  
8 should be treated as contributions of capital makes it difficult to identify the 2010 transfers as a  
9 repayment of a 2003 loan “without viewing how the transfers were labeled in the partnership’s books for  
10 financial accounting and tax purposes, such as which amounts reduced their liabilities and which amounts  
11 increased their ownership equity.” (Resp. Add’l Br.)

12 In his reply, appellant states that, even though he did not provide an IRS determination,  
13 the evidence shows he properly informed the IRS of the IRC section 1033 exchange transaction and the  
14 IRS “obviously chose not to challenge it.” With respect to the repayment documentation, appellant  
15 contends that respondent “demonstrates a wholly unreasonable approach to the information provided and  
16 the normal conduct of business.” Appellant states that he provided a detailed summary showing each  
17 deposit and how it was accounted for in the partnership’s books, as well as copies of bank statements and  
18 checks. Appellant further states that the partners repaid the loans and contributed additional cash as  
19 required. Finally, appellant takes issue with respondent’s statement that appellant “failed” to provide  
20 additional supporting information in response to the Appeals Division’s request. Appellant contends that  
21 the information he provided is “exhaustive support” for his position. (App. Add’l Reply Br.)

### 22 Applicable Law

23 It is well-settled that a presumption of correctness attends respondent’s determinations as  
24 to issues of fact and a taxpayer has the burden of proving error in such determinations. (*Appeal of Oscar*  
25 *D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) This presumption is a rebuttable one and will  
26 support a finding only in the absence of sufficient evidence to the contrary. (*Id.*) To overcome the  
27 presumed correctness of respondent’s findings as to issues of fact, a taxpayer must introduce credible  
28 evidence to support his assertions. When the taxpayer fails to support his assertions with such evidence,

1 respondent's determinations must be upheld. (*Id.*) A taxpayer's unsupported assertions are not sufficient  
2 to satisfy his burden of proof. (*Appeal of James C. and Monablanc A. Walshe*, 75-SBE-073, Oct. 20,  
3 1975.)

4 A transfer of money is a loan for federal income tax purposes if, at the time the funds were  
5 transferred, the transferee unconditionally intended to repay the money, and the transferor  
6 unconditionally intended to secure a repayment. (*Jones v. Comm'r*, T.C. Memo 1997-400.) With respect  
7 to a transfer from a corporation to a shareholder, "[m]ere declarations by the parties that they intend a  
8 certain transaction to constitute a loan [are] insufficient if [they] fail[] to meet more reliable indicia of  
9 debt which indicate the 'intrinsic economic nature of the transaction.'" (*Alterman Foods, Inc. v. U.S.*  
10 (5th Cir.1979) 505 F.2d 873, 877.)

11 In *In re Cold Harbor Associates, supra*, the question before the Bankruptcy Court was  
12 whether the transaction created a debt or equity relationship between the limited partners and their  
13 partnership. The court held that the primary factor to consider was whether the transaction "bears the  
14 earmarks of an arm's length negotiation" and the more it reflects such a negotiation, the more likely such  
15 a transaction is to be treated as a debt. (*Id.* at 915.) In making that determination, the court applied  
16 factors similar to those set forth below and placed the factors into two groups: those concerning "the  
17 formality of the alleged loan agreement" and those relating to "the financial situation of the [debtor] at  
18 the time the purported loan is made." With respect to the former group, the court held that the more  
19 specific and complete are the agreement terms, the more likely the transaction will appear to be a loan.  
20 With respect to the latter group, the court held that if the "investment" appears risky or the source of the  
21 repayment funds is unclear, the transaction looks more like an equity contribution. (*Id.* at 916.)

22 In that case, limited partners made advances to the partnership and held promissory notes  
23 for the repayment of those advances. The court found that the promissory notes "most properly reflect an  
24 equity contribution rather than a loan" because the notes were demand notes with no defined due date and  
25 no demand had been made. The court proceeded to analyze the other factors finding that some exhibited  
26 the formalities of a loan but, after weighing them against the other factors, the court concluded that the  
27 evidence was in favor of treating the advances as equity. (*Id.* at 917-919.)

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1 STAFF COMMENTS

2 In determining whether such a transfer to a shareholder should be treated as a loan, the  
3 courts have reviewed eleven factors and eight of those factors (restated below) are relevant in analyzing  
4 the transfer from RHL P to appellant. (*Jones v. Comm’r, supra*; see also *Alterman Foods, Inc. v. U.S.,*  
5 *supra.*) The various factors are not of equal significance and no single factor is controlling. (*Alterman*  
6 *Foods, Inc. v. U.S., supra* at 877.)

7 1. *The magnitude of the withdrawal and whether a ceiling existed to limit the amount*  
8 *advanced;*

9 Appellant has presented no information as to whether a ceiling existed on the amount  
10 RHL P could advance. Here, it appears that the amount of the advance was determined solely by the  
11 amount of the proceeds from the sale of the Copacabana property.

12 2. *How RHL P recorded the withdrawals on its books and records;*

13 According to appellant, the payment was recorded on RHL P’s balance sheet as a  
14 distribution rather than a loan but the balance sheet was later corrected. In addition, RHL P’s 2003  
15 partnership return reported the payment as a distribution to a partner and appellant’s Schedule K-1  
16 reported the receipt of \$1,668,500 as a partnership distribution. Appellant does not explain the  
17 inconsistency of its original reporting with the reporting position subsequently taken. Thus, the original  
18 accounting entries and tax reporting weigh in favor of finding a distribution rather than a loan.

19 3. *Whether appellant executed a promissory note;*

20 Appellant executed a document titled “Demand Promissory Note” for a principal sum of  
21 \$1,476,000 which recites that the principal amount is due and payable, unless demanded earlier, at least  
22 two business days prior to the date the principal amount is needed to acquire a replacement property.  
23 Thus, the note had no fixed schedule for a repayment and no date certain for a maturity. The Board has  
24 held that a written note is “less than significant” as a factor when the note has no fixed schedule for a  
25 repayment. (*Appeal of William R. and May R. Horn, 81-SBE-050, May 19, 1981.*) Thus, the executed  
26 note in this case appears not to be a significant factor supporting appellant’s position.

27 4. *Whether interest was paid or accrued;*

28 The note does not provide for the payment of interest on the principal amount. However,

1 appellant agrees to pay an amount based on a percentage of the principal if the principal is not repaid  
2 when due. Because it is common for lenders to charge and receive interest on actual loans, RHLP's  
3 failure to charge and collect interest for the term of the loan weighs in favor of finding that the payment  
4 was not a loan.

5 *5. Whether RHLP ever undertook to compel a repayment;*

6 There is no evidence in the record that RHLP sought a repayment of the amount  
7 transferred but appellant has provided documentation to show that in 2010 he transferred to RHLP funds  
8 in excess of the amount of the purported 2003 loan. In view of appellant's payment, the evidence is  
9 unclear as to whether RHLP undertook to compel a repayment or appellant transferred the funds  
10 voluntarily. Thus, this factor does not weigh in favor of either as a distribution or a loan.

11 *6. Whether security was given for the loan;*

12 Appellant states that he did not pledge security for the amount tendered because the terms  
13 of the Note provided that RHLP had a right to recourse from appellant who is a high net worth  
14 individual. The lack of any security for the loan weighs in favor of a finding that a distribution occurred.

15 *7. Whether appellant was in a financial position to repay;*

16 The Consolidated Balance Sheet attached to the Personal Financial Statement shows that  
17 appellant had a net worth of \$25,124,076 in 2003. Most of appellant's assets in the amount of  
18 \$58,617,986 appear to be investments, such as corporate equity and revenue bonds, and cash in the  
19 amount of \$644,029 appears to be the only liquid asset listed. Thus, the evidence is unclear as to whether  
20 appellant had the financial ability to repay \$1,476,000 upon demand at the time the Note was drawn up.

21 *8. Whether there was any indication appellant attempted to repay.*

22 Appellant presented evidence that he transferred amounts totaling \$1,504,000 in  
23 November and December of 2010 which he characterized as a full repayment of the loan amount of  
24 \$1,476,000 and a capital contribution of \$28,000. However, we note that the repayment occurred more  
25 than six years after the purported loan was made at the time when RHLP needed funds to acquire what  
26 appellant described as replacement properties. Furthermore, the factors discussed above do not clearly  
27 support a finding in favor of a bona fide loan. Thus, it is unclear whether the amount transferred in 2010  
28 was a repayment of a loan or whether the entire amount should be characterized as a capital contribution

1 by a partner.

2           The parties observed the formality of executing a promissory note contemporaneously  
3 with the disbursement of the payment to appellant which weighs in favor of a bona fide loan. However,  
4 the demand nature of the note and other provisions such as the absence of interest payments tend to  
5 lessen its reliability as evidence of a loan. In addition, as outlined above, there are several other factors  
6 that are either not determinative or are inconsistent with a loan and a debtor-creditor relationship.

7           At the hearing, appellant should be prepared to present any legal authority for his position  
8 that the “due on demand” provision of the promissory note constitutes a fixed maturity date and a fixed  
9 repayment schedule. Appellant should also be prepared to present any evidence to show that a third party  
10 would make a loan of this amount on similar terms, particularly with the lack of a security interest and  
11 without charging interest for the debtor’s use of the money.

12           Appellant should also be prepared to explain how RHL P’s intention to acquire a  
13 replacement property with the sale proceeds tends to prove a loan because such an intention is not one of  
14 the factors necessary for determining whether the parties intended to create a debtor-creditor relationship.  
15 Respondent should be prepared to address appellant’s argument that the 1033 election by RHL P clearly  
16 demonstrated that the advance was a loan, rather than a distribution, because a repayment was necessary  
17 to acquire the replacement property.

18           Pursuant to California Code of Regulations, title 18, section 5523.6, if either party has any  
19 additional evidence to present, it should be provided to the Board’s Board Proceedings Division at least  
20 14 days prior to the oral hearing.<sup>3</sup>

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27  
28 <sup>3</sup> Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of  
Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.