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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	CORPORATION FRANCHISE TAX APPEAL
WEST COAST AGGREGATES, INC.	Case No. 446020[1]

Year	Proposed Assessment
2002	$444,886

Representing the Parties:

For Appellant: Richard DeAtley, West Coast Aggregates
Edmond E. Traille, CPA, Gallina LLP
Robert R. Rubin, Esq., Boutin Jones, Inc.

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

QUESTION: Whether appellant has shown respondent erred in determining the amount of appellant's built-in gains as of January 1, 2000.

[1] This appeal was originally scheduled as an oral hearing for the August 31, 2009 Board meeting. This matter was removed for further briefing to request that the parties address appellant's second appraisal, provide additional documentation if available, and clarify certain assumptions. After additional briefing was received, this appeal was deferred pending settlement negotiations from December of 2009 through July of 2011. This appeal was scheduled for the November 15-17, 2011 oral hearing calendar, and was further deferred due to a scheduling conflict with the taxpayer's representative. During this deferral period, supplemental briefing was provided by the parties, discussed herein.

HEARING SUMMARY

Background

Appellant West Coast Aggregates, Inc. (appellant) is a California corporation which was incorporated as a subchapter C corporation on September 27, 1989. Appellant's primary business has been aggregate mining since its incorporation. Appellant made an election as a subchapter S corporation effective January 1, 2000, and as an S corporation, appellant's taxable year for 2002 ended on December 31. On or about November 1, 1996, appellant entered into a lease agreement with Castro Valley Properties, Inc. (Castro Valley) for quarrying operations at the Freeman Quarry (also referred to as the Blue Stone Quarry).[2] Under the agreement, appellant intended to extract, crush, wash, stockpile, and sell sand, rock, fill, and dirt. Appellant was aware that all of these uses required governmental permits and appellant agreed to take reasonable steps to obtain the permits and approval of the Reclamation Plan as quickly as possible at its own expense. (Resp. Opening Br., pp. 1-2.)

The lease agreement provided that the ten-year term of the lease commenced ("commencement date") when appellant obtained all of the governmental permits and approvals necessary for appellant to commence business operations at the Freeman Quarry. Prior to the commencement of the ten-year term, appellant was required to pay option consideration to Castro Valley. At the time of agreement execution, appellant deposited $6,000 option consideration with Castro Valley which it held for 90 days while appellant determined whether it was feasible to operate a quarry. If appellant determined that it was feasible, Castro Valley would retain the $6,000 as consideration for its removal of Freeman Quarry from the market for a six-month period. Between the sixth month and ninth month following the execution of the lease, appellant agreed to pay Castro Valley $1,000 per month to keep Freeman Quarry off the market and for each month after the nine month period, but prior to the commencement of business operations, appellant agreed to pay $3,000 per month to keep the Freeman Quarry off the market. At any time prior to or after the commencement date, appellant could terminate the lease based upon a geotechnical engineer's report finding that quarrying at the Freeman Quarry was not commercially viable. (Resp. Opening Br., pp.2-3.)

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[2] References herein to the Freeman Quarry lease, property, interest, property interest, mining rights, and other related terms refer to the property rights bestowed upon appellant by this lease.

Once appellant commenced business operations, appellant was obligated to pay a minimum annual royalty to Castro Valley (but not prior to the date that appellant obtained all permits and governmental approvals of the Reclamation Plan which were necessary to allow appellant to conduct business operations). The annual royalty was a percentage of gross sales with a minimum annual amount which increased in specified years over the lease term. The agreement required appellant to wait until the commencement date to "install upon the Leased Premises such crushing and screening plants, all necessary buildings for equipment storage, office and weigh facilities, shop facilities, as well as any other improvements reasonably necessary for the efficient operation of Lessee's [appellant's] business operations upon the Leased Premises for the Permitted Uses." The agreement also granted appellant two options to renew the lease agreement for five years each, but after the initial ten year term Castro Valley could unilaterally terminate the agreement based on a good faith finding that appellant's operations interfered with development of the land. (Resp. Opening Br., pp. 3-4.)

After appellant entered into the lease agreement on November 1, 1996, it took action to obtain the necessary permits and approvals and submitted a draft Environmental Impact Report (EIR) in February of 1997. Appellant filed an Analysis and Compliance Document with the U.S. Army Corps of Engineers on July 8, 1998 and on August 5, 1998, the Santa Clara County Planning Commission voted to certify the EIR and grant the proposed use permit for twenty years. A newspaper article dated April 15, 1998, described appellant's plan to lease the property and operate a quarry for 20 years. Appellant received a use permit from Santa Clara County effective August 21, 1998, subject to two conditions: appellant would obtain and complete the Architectural and Site Approval conditions and appellant would obtain the final approval of the Reclamation Plan. Appellant received approval for the Reclamation Plan effective September 9, 1998. (Resp. Opening Br., pp. 4-5.)

Respondent asserts that prior to the end of 1998, for purposes of the lease, appellant obtained all permits and governmental approvals of the Reclamation Plan to permit it to conduct its business operations on the Freeman Quarry.[3] In 1998, appellant paid Castro Valley $50,000 as the minimum royalty payment and in 1999 appellant paid Castro Valley $56,250 as its minimum royalty

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[3] The parties dispute the date appellant acquired the necessary permits and approvals necessary to conduct its business operation, as discussed infra.

payment. In 2000 and 2001, appellant paid Castro Valley $69,594 and $308,027, respectively, which, according to the provisions of the lease agreement, were based on gross receipts of approximately $695,940 in 2000 and approximately $3,080,270 in 2001. According to inventory calculations that appellant provided to respondent, 182,531 tons of materials were produced in 2000 and 565,519 tons of materials were produced in 2001. (Resp. Opening Br., pp. 5-6.)

On March 30, 2000, the County of Santa Clara issued the final conditions of approval for appellant's grading permit to build an access road to the Freeman Quarry.[4] On January 17, 2002, appellant entered into a lease agreement with the State of California Department of Transportation (CalTrans) whereby CalTrans leased to appellant the right to use state highway property for a loading facility for $800 per year. On October 31, 2002, appellant sold its leasehold interest in the Freeman Quarry to Granite Construction Company (Granite)[5] and concurrently granted Granite an option to acquire the lease of the right to use CalTrans property. Appellant did not report any built-in gain from the sale of its interest in Freeman Quarry on its 2002 tax return. (Resp. Opening Br., p. 6.)

On August 13, 2004, respondent contacted appellant regarding the examination of its 2002 tax return and the sole issue arising from that examination is the amount of built-in gain arising from appellant's sale of its interest in Freeman Quarry on October 31, 2002. On April 29, 2005, appellant faxed respondent an undated appraisal of the leasehold interest in the Freeman Quarry as of January 1, 2000. The appraisal estimated that 7 million tons of materials were projected to be mined during the first ten years of the lease and used a discount period of 10 years (rather than 20 years) based on the possibility that Castro Valley would elect not to renew the lease at the end of ten years. Using a discount factor of 15 percent and the minimum annual royalty amounts for the ten-year period, the appraisal determined that the value of the lease was $234,000. After deducting costs incurred in

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[4] Although this final approval occurred after the S corporation election went into effect, both parties concur that it was reasonable to assume as of the election date that all permits necessary for the operation of the subject property would be obtained. (App. 2d Add'l Br., p. 2.)

[5] The parties disagree about the sale price. According to respondent, the sale price was $13,788,457.88, and according to appellant in its opening brief, the price was $10,793,174.00. (Resp. Opening Br., p. 6; App. Opening Br., p. 2.) In response to a request for additional briefing, appellant's appraiser states the total consideration paid to appellant by Granite for the interest in the Freeman Quarry was $13.9 million. (App. Add'l Br., exhibit, p. 2.) Respondent's additional brief, filed in reply to appellant's additional brief, restates the $13,788,457.88 sale price. (Resp. Add'l Br., pp. 2 & 3.)

developing the quarry, appellant reported no built-in gain. (Resp. Opening Br., pp. 6-7.)

Respondent determined the fair market value (FMV) of appellant's interest by primarily relying on the sales price and concluded that 100 percent of the net gain reported from the sale of the Freeman Quarry interest was built-in gain. After netting the gain and loss reported on appellant's 2002 return, respondent determined a net built-in gain amount of $9,231,036. Pursuant to the taxable income limitations of Internal Revenue Code (IRC) section 1374(d)(2), respondent determined that the built-in gain to be recognized in the 2002 tax year was $7,409,224. On April 26, 2006, respondent issued a Notice of Proposed Assessment (NPA) proposing assessment of additional tax of $654,975. The remaining built-in gain of $1,821,812 would be carried forward to future years. (Resp. Opening Br., pp. 7-8.)

Appellant timely protested the NPA. During the protest proceedings, respondent requested projections and budgets prepared prior to appellant entering into the lease, to which appellant stated it no longer employed the engineer who prepared the excavation estimates and that none of his reports were available. The protest hearing officer reduced the built-in gain by subtracting the value of goodwill and a customer list because the officer determined that those elements did not exist at the time of the S corporation election. The protest hearing officer also allowed a deduction for built-in gains tax against the S corporation tax. The adjustments reduced the net built-in gain amount of $9,231,036 to $6,061,110, a reduction of $3,260,000. (Resp. Op. Br., p. 8.) After these adjustments, respondent issued a Notice of Action (NOA) assessing $444,886 in additional tax. (App. Opening Br., exhibits.) Appellant filed this timely appeal.

<u>Contentions</u>

<u>Appellant's Contentions</u>

Appellant states that its first independent consultant, Cameron Adams, determined in his appraisal that the value of the Freeman Quarry lease and mining operations was $234,000 on January 1, 2000. (App. Opening Br., p. 2.) Appellant asserts there were start up costs of $653,845 through December 31, 1999, which resulted in a built-in loss of $418,845.[6] (App. Opening Br., p. 3; App. Reply

[6] It appears as though either the start up costs or calculated built-in gain loss number is off by one thousand dollars ($234,000 minus $653,845 equals -$419,845). (See App. Opening Br., p. 3.)

Br., p. 6.) Appellant subsequently engaged a second appraiser, Michael Cartwright, to conduct another appraisal and states that he also found the lease and associated mineral interests had no built-in gain as of the appraisal date, based on a value of negative $26,000. (App. Supp. Br., p. 2 & exhibit.)[7]

Appellant asserts there are at least four key factors for valuing a mining lease: 1) size of the resource or quantity of material available, 2) type and quality of the materials in the resource, 3) location of resource to market, and 4) existence of necessary operating permits and permit conditions. Appellant contends that the absence of one element can render a property of little or no value, and that Freeman Quarry had many elements missing or of an unknown or highly speculative nature. (App. Reply Br., p. 2.) Appellant states that some samples of material were not as high in quality as desired, and were rejected for use in one CalTrans project, but appellant does not provide any dates or details in this regard. (*Id*. at pp. 4-5.)

Appellant contends respondent's use of the subsequent sale in 2002 to determine the value of the property on January 1, 2000, is inconsistent with the statutes, regulations, and legal precedent. (App. Reply Br., p. 1.) Appellant makes two basic contentions: 1) the sale was not representative of the FMV at the date of sale because Granite paid a premium to integrate the property vertically into its road building and construction business, and 2) events subsequent to January 1, 2000, often unforeseeable, caused the value of the property to increase greatly, making the sale far too removed in both time and circumstances to be a reliable indicator of the FMV on the appraisal date. (App. Reply Br., p. 7.)

Appellant provides a report from Mr. Cartwright with its additional brief in response to the request for additional briefing, in which Mr. Cartwright describes Granite's business model and asserts the price paid by Granite was higher than the FMV because Granite was a strategic buyer or an investment value buyer. (App. Supp. Br., exhibit, pp. 4-7.) Appellant also asserts expenses of over $2,000,000 were incurred in the years following the appraisal date to establish access to the rock reserves, and reimbursement for those expenses is included in the sale price, causing the sale price to be higher than the FMV. (App. Opening Br., p. 4.)

Appellant contends events that occurred after January 1, 2000, greatly increased the value

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[7] Appellant states in its supplemental brief that it anticipates Mr. Cartwright will be available for testimony at the hearing.

of the property, including several events that were not foreseeable as of that date. These events include the following.

- The acquisition of the last permits and filings required to erect structures and begin the mining operation.[8] (App. Opening Br., p. 2; see also App. 2d Add'l Br., exhibits.)[9]
- The lease with CalTrans, entered into on January 17, 2002, had no value as of January 1, 2000. (App. Opening Br., p. 4.)
- The elimination of the right of the lessor to terminate the lease prematurely. (*Ibid*.)
- Appellant expended significant amounts of money to make the quarry a more desirable property (including over $2,000,000 from 2000 through 2002 to establish access to rock reserves). (*Ibid*.)
- Expenditures undertaken during the operation of the mine led to the enhancement of the value of the property by removing unwanted materials and opening the mining operation to more suitable and profitable materials for the subsequent buyer of the leasehold and minerals interest. (App. Supp. Br., p. 3.)

<u>Respondent's Contentions</u>

Respondent asserts there was realized built-in gain in the amount of $6,061,110 based on the 2002 sale of appellant's interest in the Freeman Quarry. Respondent started its calculation for built-in gain based on the sale price of $13,788,457.88 in 2002 and net gain of $9,321,110.00 as reported on appellant's 2002 tax return to allow full recognition of appellant's basis in the property. Respondent acknowledged there were changes from the valuation date to the sale date, and indicates it therefore applied a deduction of $3.26 million for goodwill and the customer list that was not present until after January 1, 2000. (Resp. Opening Br., pp. 16-17.) Respondent asserts appellant requests reductions for various items, including the value of the CalTrans lease, development costs, and liabilities, but has not

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[8] Appellant subsequently concedes that it was reasonable to assume as of the election date that all permits necessary for the operation of the subject property would be obtained. (App. 2d Add'l Br., p. 2.)

[9] Appellant's reply brief exhibits contain a letter from Freeman Associates, who provided project management services for the permitting phase of the Freeman Quarry project. The letter, dated December 20, 2008, lists five permit-related events that occurred after January 1, 2000, and as late as June 15, 2000. The letter seems to indicate that the permitting actions were all in process prior to January 1, 2000, but not all were fully completed by that date. The letter also indicates that mitigation work required by the permits was not fully completed until 2003.

provided sufficient documentation to prove the value of these items. (*Id*. at pp. 18-19.) Respondent asserts funds expended after the S corporation election effective date presumably increased appellant's basis in its interest in the Freeman Quarry, and therefore is included in the calculations since respondent began its calculations with the net gain on the sale. Respondent asserts that to allow appellant to deduct expenses from the built-in gains would equate to a double deduction. (Resp. Reply Br., p. 2.) Respondent contends appellant has the burden of proof to prove error in the assessment, and has not met this burden.

Respondent asserts the appraisals used by appellant undervalue appellant's property interest in Freeman Quarry. Respondent asserts a willing buyer and willing seller would consider the Use Permit and approval of the Reclamation Plan as valuable assets.[10] (Resp. Opening Br., p. 13.) Respondent asserts the Adams' appraisal is based on the minimum annual royalty amount, but a more accurate appraisal is available by basing the calculation on an estimate of the value of the predicted seven million tons of material to be mined during the first ten years. (*Id*. at p. 12.) Respondent contends Adams' appraisal should have taken into account the value of the quarry operations as a whole, and not just the value of the Freeman Quarry lease, as well as the two five-year options to extend the lease beyond the ten-year term. (*Id*. at pp. 14, 16.)

<u>Parties' Responses to Request for Additional Briefing</u>

By letter dated July 20, 2009, the Appeals Division requested additional information from the appellant as set forth below.

- *Whether appellant had an engineering study or report prepared prior to entering into the lease agreement.* Appellant states that it did not have an engineering study or report prepared. (App. 2d Add'l Br., p.3.)
- *Explain the substantial increase in value of the leasehold interest in view of the Appraisal's negative value of $26,000 as of January 1, 2000, as compared with the sale price of either $10*

[10] Respondent contends that since appellant paid $50,000 in minimum royalties in 1998, and since the minimum royalty payments did not begin according to the contract until all permits were acquired, appellant must have had all permits for operating the mining business in 1998. (Resp. Opening Br., p. 11.) Appellant provides documents that seem to dispute that assumption, and indicates the minimum royalty payments were made even though the permits were not acquired yet, partially to entice the lessor. (App. Reply Br., p. 4; App. Supp. Br., p. 4.)

million or $13 million in October of 2002. Appellant attaches a report prepared by Mr. Cartwright dated August 28, 2009, in which Mr. Cartwright asserts that as of January 1, 2000, "not all permitting and related studies had been completed." Mr. Cartwright further explains that as of the date of sale to Granite on October 31, 2002, the following events "materially and significantly increased the value of the Freeman Quarry" over the value on January 1, 2000: all environmental and other regulatory studies had been performed and accepted and permits had been issued and the mine had been in production, all necessary machinery and equipment had been installed and was operating, the rock resources and reserves had been increased and some deleterious areas of the planned mining operations had been identified.

In addition, Mr. Cartwright states that in Granite's purchase offer, "it appears that the annual tonnage is quite close to two times [appellant's] planned production and above the permitted production on 1 January 2000." Finally, Mr. Cartwright asserts that Granite used a capitalization rate of 12 percent which was significantly below, by 40 percent, the Recommended Benchmark Rate of the 2001 20 percent discount rate study for FMV determinations under the property tax laws, and was significantly below, by 20 percent, the 15 percent rate shown by actual market analysis of aggregate producing companies.

- *The Mineral Business Appraisal report dated March 31, 2009 (Appraisal), estimates production costs for aggregate material are 75 percent of the average aggregate sales price. Please provide detailed documentation to support that production cost estimate.* Mr. Cartwright states that he obtained the estimate by taking an average of the NOI to Revenue ratios from "eight appraisal engagements with properties comparable to the Freeman Quarry." He states that the identities of the companies is confidential and he notes that Granite only derives about 12 percent of its annual total revenue from sales to third parties which indicates that it was a strategic buyer, thus the price paid was not an indicator of FMV.
- *The Appraisal discounts appellant's net operating income (NOI) cash flows at 15 percent which "is in line with other startup quarry operations." Please provide detailed documentation to support the 15 percent discount rate.* Mr. Cartwright states that he took average adjusted

price/earnings ratios (P/E ratios) from a 1999 table of a published source and using one-half of the average P/E ratio as a risk adjusted single property NOI multiplier results in a value of 6.8. He explains that the inverse of the P/E ratio provides a capitalization rate, which in this instance is 15 percent.

- *The Appraisal assumed a stable long-term income profile suggesting an established business operation but uses a discount rate applicable to a start up operation suggesting a higher degree of risk than typically expected of an established operation. Please explain the apparent inconsistency in the model.* Mr. Cartwright states that it was a "poor turn of phrase" to use the term "start up" because that suggests that a lower discount rate should be used once NOI is stable. He states that the 2000 Benchmark Discount Rate for Aggregate Producers was obtained from a published source for 2001 used for fair market valuation of mining properties in California for property tax purposes. He also states that the 2000 Benchmark Discount Rate for Aggregate Producers for property tax purposes under Assessors' Handbook 560, *Assessment of Mining Properties*, was 22 percent which is about 1.5 times the discount rate derived from actual market data and, if used in this instance, would have significantly undervalued the Freeman Quarry and resulted in a value of a negative $606,000. (App. Add'l Br., attachment.)
- *In an article in the Gilroy Dispatch dated April 30, 2008, the project manager Verne Freeman is quoted as saying the Freeman Quarry "has produced one million tons of product each year and will last through 2017."* Appellant states that Mr. Freeman was never an employee of appellant and worked only as a third-party consultant and not as a project manager. (App. Add'l Br., p. 3.) Mr. Cartwright states that the amount quoted by Mr. Freeman "seem[s] to be in keeping with the general quantity of rock reserves and production level in Granite's purchase valuation letter." (App. Add'l Br., attachment.)

In its additional brief in reply to appellant's additional briefing and information, respondent takes issue with appellant's position and asserts that any prudent business would have exercised its option to terminate the lease agreement if it determined that the Freeman Quarry property was worth a negative $26,000 as of January 1, 2000, after investing $2 million in the quarry property. Respondent also contends that appellant contradicts itself by arguing that there was "substantial risk" that it might not obtain all permits necessary to operate the quarry whereas the Appraisal states that "it would seem to have been reasonably probable that as of 1 January 2000 that all necessary permits to mine, process and sell construction aggregate products would have been obtained." (Resp. Add'l Br., pp. 2-3.)

Respondent also contends that appellant has not adequately explained the substantial increase in value from appellant's opinion of a negative $26,000.00 value as of January 1, 2000, and the sales price of $13,788,457.88 in October of 2002. Respondent asserts that the events, such as the fact that the permitting and related studies had not been completed, cited as reasons by Mr. Cartwright in the response were in fact anticipated as of January 1, 2000 as described on page 5 of the Appraisal. Respondent further contends that even if Granite had been a strategic buyer, it would not have paid more than the fair market value of the property. In any event, respondent contends, IRC section 1374 requires that respondent calculate the built-in gain using the sale of the property and subsection (d)(3) provides a statutory presumption that gains on the sales or distributions of all assets of an S corporation during the recognition period are built-in gain unless the taxpayer can establish that appreciation accrued after the conversion. (Resp. Add'l Br., pp. 3-5.)

Respondent also takes issue with Mr. Cartwright's assertion that respondent incorrectly dismissed the royalty approach as an incorrect method of valuation by stating that the value of minimum royalty payments made to a landowner is part of the operating costs and not an indicator of the value of the leasehold interest. Respondent attaches a copy of the project assumptions prepared by Eaton Capital Corporation (Eaton) dated May 9, 2001, the third-party consultant that assisted appellant in the sale of the Freeman Quarry, and notes that Eaton included anticipated royalties paid to the landowner as part of the operating costs whereas the Appraisal added the anticipated royalties above and beyond the estimated operating costs of 75 percent of average aggregate sales. As a result, respondent contends that Mr. Cartwright concludes that NOI would actually be closer to 15 percent than 25 percent. (Resp. Add'l Br., pp. 5-6, Exhibit A.)

Respondent further cites the cost and revenue and production projections of Eaton as inconsistent with Mr. Cartwright's estimates performed in 2009 and argues that the Eaton projections made in 2001 are closer in time to the January 1, 2000, valuation date and therefore more reliable. With respect to Mr. Cartwright's assertion that the sale in October of 2002 was too far in the future to have been reasonably foreseeable on January 1, 2000, respondent notes that appellant made contact with Eaton in September 1999, prior to the S corporation election, regarding the sale of the entire business which would include the leasehold interest. (Resp. Add'l Br., p. 6.)

Respondent further argues that Mr. Cartwright inappropriately reduced the value of the leasehold interest by the start-up costs incurred prior to January 1, 2000. Specifically, respondent argues that Mr. Cartwright estimated capital expenses of $2.3 million in 1999 that reduced future operating income for the leasehold interest whereas one would expect capital expenditures to increase the value of an improved property. Thus, respondent concludes that, according to Mr. Cartwright's calculations, the more appellant spent on capital improvements, the less valuable the leasehold interest would become.

Respondent points to an article written by Mr. Cartwright in 1994, in which he discusses the three recognized approaches to value: the cost approach, the comparable sales approach and the income approach. Respondent notes that Mr. Cartwright makes the point that "the cost approach is an inappropriate method to use for estimating the value of a known mineral deposit" because "discovery and development costs usually bear no relationship to mineral property value." However, respondent points out that Mr. Cartwright utilized the capital expenses incurred prior to the S corporation election date to reduce the value of the leasehold interest. Respondent further notes that Mr. Cartwright describes five steps in the application of the income approach to value mineral properties but in the appraisal he does not discuss reducing NOI, the discounted NOI cash flow or reducing the cumulative discounted cash flow by the capital costs. (Resp. Add'l Br., pp. 7-9.)

Respondent states that, as a starting point, it used Mr. Cartwright's projections of the aggregate sales price of $6.90 per short ton and production costs of $5.20 per ton and increased those amounts by three percent a year to reflect that a market with reasonable knowledge of the relevant facts would not assume constant prices and costs. Respondent also states that it projected an annual production rate of one million tons from 2011 through 2018 based on the Eaton projections. Based on these figures, respondent states that the value of the leasehold interest on January 1, 2000 was $6,825,331 and after deducting start-up costs of $653,845, respondent arrived at a built-in gain amount of $6,171,486 which was then reduced to $6,061,110. (Resp. Add'l Br., pp. 9-10.)

In reply to respondent's additional briefing, appellant concedes that the Cartwright appraisal erred by inappropriately including capital expenses incurred prior to the January 1, 2000 valuation date. Appellant provides a revised discounted cash flow analysis resulting in a value determination of $916,000 for the leasehold interest as of January 1, 2000. Appellant also concedes that it is reasonable to assume that as of January 1, 2000, all permits necessary for the operation of the property would be obtained. (App. 2d Add'l Br., p.2.)

Appellant contends again that the purchase price paid by Granite is not indicative of FMV because Granite was a vertically integrated road builder and construction contractor. Specifically, appellant asserts that Granite consumes about half the aggregate it mines in its own business operations and, for that reason, Granite values a quarry based on how the property will contribute to its vertically integrated business. Appellant asserts that a quarry located close to a jobsite is significant advantage and would explain why Granite "paid such a high price for the subject property." Furthermore, appellant contends that the one-page Eaton projections are not reliable because it does not include capital expenses of $3 million, overhead charges of about $6.4 million, and equipment replacement costs of $2.8 million, between the valuation date and 2010. Appellant also contends that the document includes projections of annual production significantly higher than the projections set forth in the Appraisal. If the Eaton projections are based upon post-value date information, appellant maintains that would explain the increase in value between January 1, 2000 and the date of the sale. (App. 2d Add'l Br., p. 3.)

Appellant further states that the Appraisal projected 500,000 short tons of aggregate would be mined annually and total aggregate production over the economic life of the quarry would be 9,250,000. Appellant states that those projections were based on a Department of Fish and Game permit issued on April 5, 2000, the approved 1998 Reclamation Plan dated June 23, 1998, an air quality management permit to operate and the Santa Clara County use permit and related documents. Appellant contends that the production rates used by respondent exceed those amounts and are, therefore, illegal, unpermitted and hypothetical as of the value date. (App. 2d Add'l Br., p. 4.)

Appellant contends that respondent's implied discount rate in its spreadsheet (Resp. Add'l Br., exhibit F) varies and declines over time contrary to industry practice of utilizing a constant discount rate every year in a discounted cash flow analysis. Appellant asserts that the use of a higher rate in the early years of the analysis is illogical because risk increases over time. In addition, appellant argues that the spreadsheet includes about 6.5 million short tons of "hypothetical and unpermitted aggregate mineral reserves" which overstates the production amount, income realized and net present value. Finally, the royalty expense used in the spreadsheet is hypothetical and not based upon cash and the in-kind royalty payment in the lease agreement as of the valuation date and has the effect of increasing net present value. If the royalty expense figures are based on post valuation date information, appellant asserts that would explain the increase in value from the valuation date to the date of sale. (App. 2d Add'l Br., pp. 4-5.)

Appellant states that the Appraisal is based on revenue and expenses in constant dollars whereas respondent's value is based on 3 percent annual increases in revenue and expenses. Appellant further states that the use of constant dollars or "escalated" dollars is a matter of appraisal judgment and use of escalated dollars tends to overvalue a property unless appropriate adjustments are made to the discount rate. For that reason, appellant maintains that respondent's assertion that the Appraisal's use of constant dollars materially understated the net present value is erroneous. (App. 2d Add'l Br., p. 5.)

Finally, appellant contends that respondent's comparable sales approach value indicator is irrelevant because appellant failed to analyze the sale of the subject property 2 years and 10 months after the valuation date. Thus, appellant contends that respondent did not identify and value the variations in the property as of those two dates which renders the comparable sales approach of no use. (App. 2d Add'l Br., pp. 5-6.)

<u>Supplemental Briefing</u>

After this appeal was deferred from the November 15-17, 2011 oral hearing calendar, respondent provided exhibits and briefing to explain its justification and authority of the use of a declining discount rate and production amounts. (Resp. Oct. 28, 2011 Supp. Br.) Respondent asserts it utilized appellant's expert's formula, with more accurate projections, to arrive at the leasehold interest of the subject property, and refers to Mr. Cartwright's use of a declining discount rate. (*Id*. at p. 2 & exhibit A.) Respondent disagrees with Mr. Cartwright's subsequent claim that using a higher discount rate in the early years of a discounted cash flow analysis is illogical since the amount of unknowns and risk increase over time, and contends this contradiction further exemplifies appellant's inadequate attempts to support its position. (*Ibid*.) Respondent asserts appellant has provided three flawed appraisals containing non-reconcilable opinions of value, and has failed to sufficiently demonstrate that the gain from the October 31, 2002 sale of the leasehold interest exceeded the gain existing as of January 1, 2000. (Resp. Mar. 12, 2012 Supp. Br., p. 1.)

Respondent addresses appellant's contention that respondent's valuation used production amounts that exceed the legally allowable amounts under the available permits and the 1998 Reclamation Plan. Respondent asserts the quantity of quarry material available is an important factor for valuing the lease, and notes that appellant lists it as one of four key factors for valuing a mining lease. (Resp. Oct. 28, 2011 Supp. Br., p. 2.) Respondent contends the value of a mining lease is not limited to the amount of tons permitted to be mined by asserting that a mine with 100,000,000 tons of material available and a permit to mine 1,000 tons would have a leasehold interest worth "more than the 1,000 tons permitted because there is a tremendous amount of material available." (*Ibid*.)

Appellant contends that while mining reserves are an important factor in the valuation of a mineral interest, the legal limits on production can be even more important. (App. Jan. 13, 2012 Supp. Br., p. 3.) Appellant asserts the maximum probable annual production matters little toward the value of a mineral interest when the legal limits on production or reasonable expectation of quantity absorbed into the local construction aggregate market are substantially less than the arbitrary maximum theoretical physical production capability. Appellant contends it would be an appraisal misjudgment to project annual production numbers in excess of the legal limit unless there was reasonable belief that the legal limit would be increased, and there was no such reasonable belief here. Appellant asserts respondent's projected production levels exceed the production amount that could be expected to be produced and sold into the local market. (*Ibid*.)

Respondent contends appellant is incorrect in limiting the value of the leasehold interest based on the two-year permit, because (1) appellant would most likely not invest $2.4 million to obtain that $916,000 of value; (2) appellant's theory does not take into account a reasonable estimation of amounts to be mined for remaining years; and (3) the permits relied upon by appellant are for portable equipment used and it is highly unlikely the quarry would be mined for twenty years with portable equipment. (Resp. Mar. 12, 2012 Supp. Br., pp. 4-5.)

Respondent provides a revised schedule based upon an increase in the price of crushed stones at an annual rate of 7.6 percent and an annual inflation rate of 2.3 percent. (Resp. Oct. 28, 2011 Supp. Br., exhibit D.) Respondent increases the constant discount rate from 15 percent to 17.3 on account of inflation, and states the value of the leasehold interest in the Freeman Quarry under the revised calculations ($6,254,856) still exceeds respondent's originally calculated value of $6,061,110 as used for the purposes of calculating the built-in gains tax in the NOA, and therefore its action should be sustained. (*Id*. at pp. 2-3.)

Appellant disagrees with respondent's use of respondent's price escalator of 7.6 percent in addition to the 2.3 percent inflation and the constant discount rate of 17.3 percent. (App. Jan. 13, 2012 Supp. Br., pp. 3-4.) Appellant states that it may be appropriate to use an escalation factor in a discounted cash flow analysis if the appraiser finds it is reasonable to assume the price of a mineral will increase in the future. However, appellant asserts construction aggregate material is a commodity with a value that fluctuates based upon many factors but primarily local demand, and contends there was no reason to believe at the date of valuation that the value would increase by 7.6 percent per year for 19 years. (*Id*. at p. 4.) Appellant also states it is reasonable for an appraiser to take into account an inflation rate, such as the 2.3 percent, but appellant contends expenses would typically be expected to rise in accordance with price, if not faster. Therefore, appellant asserts respondent's use of two completely different and arbitrary inflation rates tends to overvalue mineral interests, and appellant's expert's use of the constant dollar discounted cash flow analysis is correct. (*Ibid*.)

Respondent asserts the 7.6 percent price escalator is based on Mr. Cartwright's data, following the trend from the five years leading up to the valuation date. (Resp. Mar. 12, 2012 Supp. Br., p. 6.) Respondent contends appellant incorrectly assumes expenses rise at the same pace as or faster than prices in the commodities market, and the general inflation rate of 2.3 is appropriate. (*Id*. at p. 7.)

Appellant asserts that respondent used the same constant discount rate as its expert, but appears to have used year 2000 as discount year 1, rather than year 1999 as was used in appellant's

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expert's original spreadsheet.[11] Therefore, appellant argues, respondent erroneously used the discount rate for year 2 in year 1 and repeated this error for each subsequent year. (App. Jan. 13, 2012 Supp. Br., p. 2.) Respondent disagrees, contending the 2000 tax year was properly discounted as year 1 since the valuation date is January 1, 2000. (Resp. Mar. 12, 2012 Supp. Br., p. 2.) Respondent asserts Mr. Cartwright improperly used 1999 in his first appraisal in order to arrive at a negative fair market value, and in his second appraisal used 2000 as the starting year but improperly added new expenses to the 2000 and 2001 tax years because he could not reduce the value by expenses incurred in 1999.[12] (*Id*. at p. 3.)

Appellant asserts that, regardless of the reasonably probable annual production rate, respondent still has to account for the capital cost and time required to construct a mining and processing facility capable of producing the anticipated production quantity. (App. Jan. 13, 2012 Supp. Br., p. 3.) In reply, respondent asserts appellant's claim that "…available historical information indicated that no such production facility was in place…" is ambiguous, as appellant should have known whether there was a production facility in place as of January 1, 2000, instead of relying on "available historical information." (Resp. Mar. 12, 2012 Supp. Br., p. 5.) Respondent notes that Mr. Cartwright's Summary Appraisal Report indicates there was already machinery in place for the mining process, and the facility costs were listed as 1999 expenses in his first appraisal. (*Ibid*.) Respondent asserts the expenses were moved to 2000 after Mr. Cartwright realized the calculation should begin with the year 2000. (*Id*. at p. 6.) Respondent contends appellant uses capital costs as a negative, but disregards the value of the buildings financed by the capital. In other words, if $500,000 in cash is used to create a building, appellant then has a building worth roughly $500,000 rather than that same amount in cash,

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[11] Previously, appellant argued that respondent incorrectly used a discount rate that varied over time. Appellant states this erroneous conclusion was the result of respondent using the wrong discount rate for the wrong years.

[12] Respondent addresses expenses added in Mr. Cartwright's second appraisal, including a $1,115,000 expense for a lawsuit over delivery of non-specification aggregate materials. Respondent asserts appellant would be the defendant in the lawsuit and not the leasehold; therefore, the leasehold interest would have no liability for any expenses as a result of appellant's behavior (i.e., the value of the leasehold interest would not be reduced). Respondent also asserts that appellant reduced the income by the settlement amount but never included the consideration received for the non-compliant aggregate in the prior year. Respondent also notes that appellant includes the full settlement amount for 2000 when the amount was unknown as of January 1, 2000, but then claims the 2002 sale amount is irrelevant to the value of the leasehold as of January 1, 2000, partly because it was unknown at the time. (Resp. Mar. 12, 2012 Supp. Br., p. 4.)

and there is essentially no loss of value. (*Ibid*.)

Applicable Law

Burden of Proof

It is well settled that a presumption of correctness attends respondent's determinations as to issues of fact and that an appellant has the burden of proving such determinations erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is, however, a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. Respondent's determination cannot, however, be successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent, and relevant evidence to the contrary. To overcome the presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible evidence to support his assertions. When the taxpayer fails to support his assertions with such evidence, respondent's determinations must be upheld. (*Ibid*.)

Expert opinion is admissible if it will assist the trier of fact to understand evidence that will determine the fact in issue. (*Frazee v. Comm'r* (1992) 98 TC 554.) While expert opinions may be helpful, a court is "not bound by these opinions and may reach a decision based on [its] own analysis of all the evidence in the record." (*Garwood Irrigation Co. v. Comm'r* (2004) T.C. Memo 2004-195, p. 23 [internal citations omitted].) In doing so, the court may "accept or reject the opinion of an expert in its entirety, or it may be selective in the use of any portion [of an opinion]." (*Ibid.* [internal citations omitted].)

Built-in Gain on a Conversion to a Subchapter S Corporation

Revenue and Taxation Code section 23809, which incorporates by reference IRC section 1374, imposes a corporate-level tax on built-in gains of an S corporation attributable to California sources. The tax is applied where a C corporation has converted to an S corporation and contributed assets to that converted S corporation and the S corporation later disposes of those assets within a defined recognition period. (Rev. & Tax. Code, § 23809; Int.Rev. Code, § 1374(a) & (d)(7).) Under IRC section 1374(a), if for any taxable year beginning in the recognition period,[13] an S corporation has a

[13] IRC section 1374(d)(7) defines the term "recognition period" as the 10-year period beginning with the first day of the first taxable year that the corporation was an S corporation.

net recognized built-in gain, a tax is imposed on the income of that corporation for that year which is essentially based on the highest tax rate for C corporations. A corporation's "net recognized built-in gain" is the excess of built-in gains over built-in losses that become recognized when a corporation disposes of assets during the recognition period.[14] (Int.Rev. Code, § 1374(d)(2), (3), & (4).)

IRC section 1374(d)(1) defines the term "net unrealized built-in gain" as the excess of the FMV of a corporation's assets at the beginning of its first taxable year as an S corporation over the aggregate adjusted basis of those assets at that time. That amount provides an upper limit on the amount of built-in gain that can be subject to tax. (Int.Rev. Code, § 1374(c)(2).)

Fair Market Value

To determine the amount of the built-in gain for tax purposes, the FMV of a corporation's assets must be determined as of the beginning of the first taxable year of the S corporation. (Int.Rev. Code, § 1374(d)(3).) FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. (*U.S. v. Cartwright* (1973) 411 U.S. 546; Treas. Reg. § 20.2031-1(b).) The willing buyer and the willing seller are hypothetical persons, rather than specific individuals or entities, and the individual characteristics of these hypothetical persons are not necessarily the same as the individual characteristics of the actual seller or the actual buyer. (*Estate of Curry v. United States* (7th Cir. 1983) 706 F.2d 1424, 1428.)

In *Ringgold v. Commissioner*, T.C. Memo 2010-103, the United States Tax Court considered the valuation of an S corporation's interest in a partnership for purposes of the built-in gains tax. The court explained that the valuation of stock is "a question of fact resolved on the basis of the entire record." (*Ringgold*, *supra*, at p. 8.) The court further explained that "[i]n valuing unlisted securities, 'actual arm's length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value'." (*Ringgold*, *supra*, at p. 9.)

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[14] Treasury Regulation section 1.1374-4 gives the example of a company that owns working interests in an oil and gas property but has not extracted any product at the time it makes the conversion from a C corporation to an S corporation. The example states that when the company subsequently begins working the interest and sells oil it produced, the sale does not result in a recognized built-in gain because at the time of conversion to an S corporation the company had only the working interest and not the oil itself (which had not yet been extracted). (Treas. Reg., § 1.1374-4(a)(3).) (See also Rev. Rul. 2001-50, 2001-2 C.B. 343.)

The court considered the testimony of the expert witnesses submitted by the parties, and the later sale of the partnership interest, approximately eleven months after the valuation date, for approximately $5.2 million. After considering the timing of the sale, the circumstances surrounding the sale, and the testimony presented, the court found the sale price to be “probative, but not conclusive, evidence of the value of [the partnership interest] on the valuation date.” (*Id.* at p. 28.) As a result, the court concluded that the partnership asset had a value as of the valuation date of approximately $3.7 million, rather than the $5.2 million value asserted by the Internal Revenue Service (IRS) or the $2.9 million value asserted by the taxpayer.

In *Garwood*, *supra*, the United States Tax Court valued water rights that were sold by an S corporation for purposes of the built-in gain tax. The IRS valued the water rights at $76.6 million for purposes of its assessment, but its expert at trial concluded that the value was $45.8 million. The taxpayer reported built-in gains tax based on a valuation of $31.4 million and later argued at trial that the value of the water rights was $10.7 million. The IRS argued that events occurring after the valuation date, including the later sale of the taxpayer’s irrigation assets for $75 million, provided evidence supporting its valuation determination. In contrast, the taxpayer argued that later events were not foreseeable by a hypothetical willing buyer and seller. The court considered the testimony of the valuation experts and all of the surrounding circumstances and concluded in part that, while a later sale of the water rights was reasonably foreseeable, the valuation reflected in the $75 million purchase price was “not sufficiently predictable [as of the valuation date] to form the basis for valuation.” (*Id.* at p. 43.) The court then determined its own estimate of value, in part by adjusting the assumptions made by the expert witnesses, and determined a FMV of approximately $22.5 million.

<u>STAFF COMMENTS</u>

Appellant has asserted that the FMV of the property interest on the appraisal date was $234,000, a negative $26,000, and most recently $916,000. Appellant should explain the reason for the three different values, and provide evidentiary and analytical support for its latest appraisal. Respondent argues the Board should disregard appellant’s appraisals based on their non-reconcilable opinions of value, yet also bases its valuation on certain information used in Mr. Cartwright’s appraisals (e.g., the 7.6 percent annual increase in the price of aggregate). Respondent should be prepared to explain the use of data or calculations borrowed from appellant's appraisals, showing why this information may be relied upon but the appraisal as a whole is not reliable. The parties should also be prepared to provide calculations of the tax based on this adjustment to appellant's opinion of FMV for the property.

Appellant lists several examples of possible conditions that may adversely affect the value of a mining leasehold interest, but does not indicate that any of the listed potential setbacks actually affected its business in a manner that would lower its value as of January 1, 2000. (App. Reply Br., pp. 2-3.) For example, appellant states that it was determined during 1998 and 1999 that the quality of materials in samples was not as high as hoped for, and briefly mentions litigation concerning CalTrans rejecting materials for one job. However, despite appellant's allegations about the inferior quality of the material and its suitability for a CalTrans project, staff notes that appellant's appraisals raise no concerns as to the suitability of the material for its intended purpose, and the Adams' appraisal even states that the material, after processing, will meet CalTrans specifications for asphalt concrete aggregates and road materials. (App. Opening Br., exhibit B, p. 1.) At the hearing, appellant may wish to present any additional evidence showing that the quality of the quarried materials would have a negative effect on the value of the leasehold interest.

Appellant also concedes that for the purposes of appraisals it is reasonable to assume that as of the valuation date all permits necessary for the operation of the business would be obtained, and does not assert there were any indications that it would suffer any significant setbacks to beginning its mining operation. (App. 2d Add'l Br., p. 2.) At the hearing, appellant may wish to clarify whether this concession affects its valuation position.

Appellant contends that the production amounts projected by respondent and used in its FMV calculation exceed the production amounts legally allowed under the permits and the 1998 Reclamation Plan. Appellant contends that respondent's valuation methodology which assumes quarry production in excess of the legally permitted limitation constitutes an error of appraisal judgment in the absence of a reasonable belief that the legal limit would be increased. Respondent contends that a mining leasehold interest with 100,000,000 tons of material available and a permit to mine 1,000 tons would have a value of "more than the 1,000 tons permitted because there is a tremendous amount of material available." Both parties should be prepared at the hearing to cite a recognized appraisal authority to support their respective positions.

In its 2d Additional Brief, appellant contends that the implied discount rate that respondent uses in its discounted cash flow analysis model declines over time which is contrary to industry practice of utilizing a constant discount rate every year. In its January 13, 2012 supplemental brief, appellant states that it incorrectly assumed that respondent used a fluctuating discount rate, but now realizes that respondent applied the wrong year's discount rate for each year. At the hearing, the parties should be prepared to support their contention regarding the correct discount rate for each year and identify the correct first year for applying the discount rate. In its 2d Additional Brief, appellant also contends the royalty expense used in respondent's FMV calculation is hypothetical and not based upon cash and in-kind royalty payment in the lease agreement as of the valuation date. At the hearing, appellant should be prepared to present evidence of and support for the royalty expense amounts that would have been known as of the valuation date. Respondent states Mr. Cartwright's Summary Appraisal Report indicates there was machinery in place for the mining process as of January 1, 2000, yet the second appraisal looks to historical data and assumes no production facility was in place. In view of this apparent inconsistency, appellant should be prepared to provide evidence of the actual mining and processing facility constructed as of the valuation date when appellant was in possession of the property. Appellant should also address respondent's contention that appellant's appraisal treats capital costs as negative value, but fails to include the value of buildings constructed with that capital.. Appellant should provide the value of such construction, and discuss whether it is appropriate to include such value in the overall valuation of the property.

Appellant should discuss why it invested and spent a large amount of money developing a property it states had a much lower appraised value as of January 1, 2000. Specifically, appellant should explain the reasons for investing $2,400,000 in a leasehold interest it claims had a value of $916,000 as of the valuation date, based largely on legal limitations on the production of aggregate.

Staff notes that, while the period for briefing legal argument has now expired, the parties may still submit additional documentary evidence, if they wish. If either party desires to submit any

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such additional documentary evidence, it should be provided at least 14 days prior to the hearing.[15]

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[15] Any additional evidence should be sent to Claudia Madrigal, Board Proceedings Division, Board of Equalization. P. O. Box 942879 MIC: 80, Sacramento, CA 94279-0080. (*See* Cal. Code Regs., tit. 18 § 5523.6, subd. (b).)