TAXPAYER EXHIBIT
B2
February 23, 2010
Donald and Christine Wattson
446005

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EXHIBITS / AUTHORITY – HEARING – 2/23/10

APPEAL OF DONAL A. WATTSON and CHRISINE A. WATTSON

APPEAL CASE ID NO. 446005

Year	Additional Tax	Penalties
2001	$273,149.00	$54,629.80

1. CA Corp code secs. 16103 and 16807
2. Exhibit D - WAC K-1 1995
3. Exhibit E – WAC K-1 1996
4. Exhibit F – WAC FORM 565 Balance Sheet

16103. (a) Except as otherwise provided in subdivision (b), relations among the partners and between the partners and the partnership are governed by the partnership agreement. To the extent the partnership agreement does not otherwise provide, this chapter governs relations among the partners and between the partners and the partnership.

(b) The partnership agreement may not do any of the following:

(1) Vary the rights and duties under Section 16105 except to eliminate the duty to provide copies of statements to all of the partners.

(2) Unreasonably restrict the right of access to books and records under subdivision (b) of Section 16403, or the right to be furnished with information under subdivision (c) of Section 16403.

(3) Eliminate the duty of loyalty under subdivision (b) of Section 16404 or paragraph (3) of subdivision (b) of Section 16603, but, if not manifestly unreasonable, may do either of the following:

(A) The partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty.

(B) All of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty.

(4) Unreasonably reduce the duty of care under subdivision (c) of Section 16404 or paragraph (3) of subdivision (b) of Section 16603.

(5) Eliminate the obligation of good faith and fair dealing under subdivision (d) of Section 16404, but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable.

(6) Vary the power to dissociate as a partner under subdivision (a) Section 16602, except to require the notice under paragraph (1) of Section 16601 to be in writing.

(7) Vary the right of a court to expel a partner in the events specified in paragraph (5) of Section 16601.

(8) Vary the requirement to wind up the partnership business in cases specified in paragraph (4), (5), or (6) of Section 16801.

(9) Restrict rights of third parties under this chapter.

(10) Vary the law applicable to a registered limited liability partnership under subdivision (b) of Section 16106.

16807. (a) In winding up a partnership's business, the assets of the partnership, including the contributions of the partners required by this section, shall be applied to discharge its obligations to creditors, including, to the extent permitted by law, partners who are creditors. Any surplus shall be applied to pay in cash the net amount distributable to partners in accordance with their right to distributions under subdivision (b).

(b) Each partner is entitled to a settlement of all partnership accounts upon winding up the partnership business. In settling accounts among the partners, the profits and losses that result from the liquidation of the partnership assets shall be credited and charged to the partners' accounts. The partnership shall make a distribution to a partner in an amount equal to any excess of the credits over the charges in the partner's account. Except for registered limited liability partnerships and foreign limited liability partnerships, a partner shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner's account.

(c) If a partner fails to contribute the full amount that the partner is obligated to contribute under subdivision (b), all of the other partners shall contribute, in the proportions in which those partners share partnership losses, the additional amount necessary to satisfy the partnership obligations for which they are liable under Section 16306. A partner or partner's legal representative may recover from the other partners any contributions the partner makes to the extent the amount contributed exceeds that partner's share of the partnership obligations for which the partner is personally liable under Section 16306.

(d) After the settlement of accounts, each partner shall contribute, in the proportion in which the partner shares partnership losses, the amount necessary to satisfy partnership obligations that were not known at the time of the settlement and for which the partner is personally liable under Section 16306.

(e) The estate of a deceased partner is liable for the partner's obligation to contribute to the partnership.

(f) An assignee for the benefit of creditors of a partnership or a partner, or a person appointed by a court to represent creditors of a partnership or a partner, may enforce a partner's obligation to contribute to the partnership.

SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, Etc.

▶ See separate instructions.

For calendar year 1995 or tax year beginning ,1995, and ending ,19

OMB No. 1545-0099

1995

Partner's identifying [redacted]

Partnership's identifying number ▶33-0227232

Partner's name, address, and ZIP code
Donald A Wattson
[redacted]

Partnership's name, address, and ZIP code
The Wattson Arno Company
3600 Birch St., Suite 250
Newport Beach, CA 92660

A This partner is a ☒ general partner ☐ limited partner ☐ limited liability company member

B What type of entity is this partner? ▶ Individual

C Is this partner a ☒ domestic or a ☐ foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	65%	%
Loss sharing	65%	%
Ownership of capital	%	%

E IRS Center where partnership filed return: Fresno

F Partner's share of liabilities (see instructions):
Nonrecourse $
Qualified nonrecourse financing $
Other $ 3276933

G Tax shelter registration number ▶

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐

I Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065 Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d)
-4815136	562733	1043141	(45621)	-3254883

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1	-9597	See pages 5 and 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2	Net income (loss) from rental real estate activities ....See Line 25	2	-56950	
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):			
	a	Interest	4a	704	Sch. B, Part I, line 1
	b	Dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e	Net long-term capital gain (loss)	4e		Sch. D, line 13, col. (f) or (g)
	f	Other portfolio income (loss) (attach schedule)	4f		Enter on applicable line of your return.
	5	Guaranteed payments to partner	5	94536	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	6	Net gain (loss) under section 1231 (other than due to casualty or theft)	6	1096326	
	7	Other income (loss) (attach schedule)	7		Enter on applicable line of your return.
Deductions	8	Charitable contributions (see instructions)	8		Sch. A, line 15 or 16
	9	Section 179 expense deduction	9		See page 7 of Partner's Instructions for Schedule K-1 (Form 10
	10	Deductions related to portfolio income	10		
	11	Other deductions (attach schedule)	11		
Investment Interest	12 a	Interest expense on investment debts	12a		Form 4952, line 1
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)	704	See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
		(2) Investment expenses included on line 10 above	b(2)		
Credits	13 a	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
		(2) Other than on line 13b(1) for property placed in service before 1990	a(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
		(4) Other than on line 13b(3) for property placed in service after 1989	a(4)		
	b	Qualified rehabilitation expenditures related to rental real estate activities	13b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	c	Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities	13c		
	d	Credits related to other rental activities	13d		
	14	Other credits	14		

For Paperwork Reduction Act Notice, see instructions for Form 1065.

Schedule K-1 (Form 1065) 1995

KFA

Partner 1

EXHIBIT D

5

YEAR 1995

Partner's Share of Income, Deductions, Credits, etc.

CALIFORNIA SCHEDULE
K-1 (565)

	MONTH	DAY	YEAR		MONTH	DAY	YEAR
taxable or income year beginning	[redacted]	01	1995	, and ending	12	31	95

Partner's identifying number [redacted]

Partnership's FEIN 33-0227232

Partner's name, address, state and ZIP code

Donald A Wattson
[redacted]

Partnership's name, address, state and ZIP code

The Wattson Arno Company
3600 Birch St., Suite 250
Newport Beach, CA 92660

A Is this partner a: ☒ general partner; or ☐ limited partner?

B Partner's share of liabilities:
Nonrecourse ..... $
Qualified nonrecourse financing .... $
Other ..... $ 3276933

C What type of entity is this partner? ●
(1) ☒ Individual (4) ☐ Corporation (7) ☐ LLP
(2) ☐ S Corporation (5) ☐ Partnership (8) ☐ IRA/Keogh/SEP
(3) ☐ Estate/Trust (6) ☐ LLC

D Check here if this partnership is a publicly traded partnership as defined in IRC Section 469(k)(2) ..... ☐

E Enter partner's percentage of:

	(i) Before decrease or termination	(ii) End of year
Profit sharing	65% ●	%
Loss sharing	65% ●	%
Ownership of capital	% ●	%

F Tax shelter registration number

G Check here if this is: ●
☐ a final Schedule K-1 (565) ☐ an amended Schedule K-1 (565)

H Is this partner a foreign partner? ..... ● ☐ Yes ☒ No

I Is this partner a nonresident of California? ..... ▶ ☐ Yes ● ☒ No

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of line 3, line 4 and line 7 Form 565, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine column (a) through column (d))
-4815136	562733	1043140	(45621)	-3254884

Caution: Refer to Partner's Instructions for federal Schedule K-1 (1065) before entering information from this schedule on your tax return.

	(a) Distributive share item	(b) Amount from federal Sch. K-1 (1065)	(c) Adjustments	(d) Total amounts using CA law (Combine column (b) and Column (c))	(e) California source amounts and credits
Income (Loss)	1 Ordinary income (loss) from trade or business activities ...	-9597		● -9597	▶ -9597
	2 Net income (loss) from rental real estate activities ..... See Line 22	-56950	-566	● -57516	▶ -57516
	3 Net income (loss) from other rental activities				
	4 Portfolio income (loss):				
	a Interest	704		704	704
	b Dividends				
	c Royalties				
	d Net capital gain (loss)			●	▶
	e Other portfolio income (loss) Attach schedule				
	5 Guaranteed payments to partners	94536		● 94536	▶ 94536
	6 Net gain (loss) under IRC Section 1231 (other than due to casualty or theft)	1096326		● 1096326	▶ 1096326
	7 Other income (loss). Attach schedule			●	▶
Deduction	8 a Charitable contributions				
	b Political contributions				
	9 Expense deduction for recovery property (R&TC Sections 17252.5, 17265 and 17266 and IRC Section 179). Attach schedule				
	10 Deductions related to portfolio income. Attach schedule				
	11 Other deductions. Attach schedule				

Partner 1

EXHIBIT D (41)

SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

OMB No. 1545-0099

1996

For calendar year 1996 or tax year beginning ,1996, and ending ,19

Partner's identifying number ▶ [redacted]

Partnership's identifying number ▶ 33-0227232

Partner's name, address, and ZIP code
DONALD A WATTSON
[redacted]

Partnership's name, address, and ZIP code
THE WATTSON ARNO COMPANY
3600 BIRCH ST., SUITE 250
NEWPORT BEACH, CA 92660

A This partner is a ☒ general partner ☐ limited partner
☐ limited liability company member

B What type of entity is this partner? ▶ INDIVIDUAL

C Is this partner a ☒ domestic or a ☐ foreign partner?

D Enter partner's percentage of:

	(i) Before change or termination	(ii) End of year
Profit sharing	%	%
Loss sharing	%	%
Ownership of capital	%	%

E IRS Center where partnership filed return: FRESNO

F Partner's share of liabilities (see instructions):
Nonrecourse $
Qualified nonrecourse financing $
Other $

G Tax shelter registration number ▶

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐

I Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d)
-3254883		-2932	( )	-3257815

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities	1		See pages 5 and 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2 Net income (loss) from rental real estate activities	2		
	3 Net income (loss) from other rental activities	3		
	4 Portfolio income (loss):			
	a Interest	4a		Sch. B, Part I, line 1
	b Dividends	4b		Sch. B, Part II, line 5
	c Royalties	4c		Sch. E, Part I, line 4
	d Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f) or (g)
	e Net long-term capital gain (loss)	4e		Sch. D, line 13, col. (f) or (g)
	f Other portfolio income (loss) (attach schedule)	4f		Enter on applicable line of your return.
	5 Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	6 Net gain (loss) under section 1231 (other than due to casualty or theft)	6		
	7 Other income (loss) (attach schedule)	7		Enter on applicable line of your return.
Deductions	8 Charitable contributions (see instructions)	8		Sch. A, line 15 or 16
	9 Section 179 expense deduction	9		See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
	10 Deductions related to portfolio income	10		
	11 Other deductions (attach schedule)	11		
Investment Interest	12 a Interest expense on investment debts	12a		Form 4952, line 1
	b (1) Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
	(2) Investment expenses included on line 10 above	b(2)		
Credits	13 a Low-income housing credit:			
	(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
	(2) Other than on line 13a(1) for property placed in service before 1990	a(2)		
	(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
	(4) Other than on line 13a(3) for property placed in service after 1989	a(4)		
	b Qualified rehabilitation expenditures related to rental real estate activities	13b		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	c Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities	13c		
	d Credits related to other rental activities	13d		
	14 Other credits	14		

For Paperwork Reduction Act Notice, see instructions for Form 1065.

Schedule K-1 (Form 1065) 1996

KF

PARTNER 1 PAGE 2 NOT APPLICABLE

EXHIBIT E (6)

61

LSC
YEAR
1996

Partner's Share of Income, Deductions, Credits, etc.

CALIFORNIA SCHEDULE
K-1 (565)

For taxable or income year beginning MONTH 01 DAY 01 YEAR 1996, and ending MONTH 12 DAY 31 YEAR 96

Partner's identifying [redacted]

Partner's name, address, state and ZIP code

DONALD A WATTSON
[redacted]

Partnership's FEIN 33-0227232

Secretary of State file number

Partnership's name, address, state and ZIP code
THE WATTSON ARNO COMPANY
3600 BIRCH ST., SUITE 250
NEWPORT BEACH, CA 92660

A Is this partner a: ● (1) ☒ general partner; or (2) ☐ limited partner?

B Partner's share of liabilities:
Nonrecourse ..... $
Qualified nonrecourse financing .... $
Other ..... $

C What type of entity is this partner? ●
(1) ☒ Individual (4) ☐ Corporation (7) ☐ LLP
(2) ☐ S Corporation (5) ☐ General Partnership (8) ☐ IRA/Keogh/SEP
(3) ☐ Estate/Trust (6) ☐ LLC (9) ☐ Limited Partnership

D Check here if this partnership is a publicly traded partnership as defined in IRC Section 469(k)(2) ..... ☐

E Enter partner's percentage (without regard to special allocations) of:

	(i) Before decrease or termination	(ii) End of year
Profit sharing	%	● %
Loss sharing	%	● %
Ownership of capital	%	● %

F Tax shelter registration number

G Check here if this is: ●
(1) ☐ a final Schedule K-1 (565) (2) ☐ an amended Sch. K-1 (565)

H Is this partner a foreign partner? ..... ● ☐ Yes ☒ No

I Is this partner a nonresident of California? ..... ▶ ☐ Yes ● ☒ No

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of line 3, line 4 and line 7 Form 565, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine column (a) through column (d))
-3254883 A3		-2932 A3	( )	-3257815 A3

Caution: Refer to Partner's Instructions for federal Schedule K-1 (1065) before entering information from this schedule on your tax return.

	(a) Distributive share item	(b) Amount from federal Sch. K-1 (1065)	(c) Adjustments	(d) Total amounts using CA law (Combine column (b) and Column (c))	(e) California source amounts and credits
Income (Loss)	1 Ordinary income (loss) from trade or business activities			●	▶
	2 Net income (loss) from rental real estate activities			●	▶
	3 Net income (loss) from other rental activities				
	4 Portfolio income (loss):				
	a Interest			●	▶
	b Dividends			●	▶
	c Royalties			●	▶
	d Net capital gain (loss)			●	▶
	e Other portfolio income (loss) Attach schedule			●	▶
	5 Guaranteed payments to partners			●	▶
	6 Net gain (loss) under IRC Section 1231 (other than due to casualty or theft)			●	▶
	7 Other income (loss). Attach schedule			●	▶
Deductions	8 a Charitable contributions				
	b Political contributions				
	9 Expense deduction for recovery property (R&TC Sections 17252.5, 17265 and 17266, 17268 and IRC Section 179). Attach schedule				
	10 Deductions related to portfolio income. Attach schedule				
	11 Other deductions. Attach schedule				

EXHIBIT E (28) 21

WAC - 1999 - Form 565

THE WATTSON ARNO COMPANY

Schedule L Balance Sheets. See the instructions for Question N before completing Schedules L, M-1 and M-2. 33-0227232

Assets	Beginning of income year (a)	Beginning of income year (b)	End of income year (c)	End of income year (d)
1 Cash				
2 a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities				
6 Other current assets. Attach schedule				
7 Mortgage and real estate loans				
8 Other investments. Attach schedule	Stmt 3	-2,007,228.		-3,240,628.
9 a Buildings and other depreciable assets				
b Less accumulated depreciation	( )		( )	
10 a Depletable assets				
b Less accumulated depletion	( )		( )	
11 Land (net of any amortization)				
12 a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
13 Other assets. Attach schedule				
14 TOTAL assets		-2,007,228.		-3,240,628.
Liabilities and Capital				
15 Accounts payable				
16 Mortgages, notes, bonds payable in less than 1 year				
17 Other current liabilities. Attach schedule	Stmt 3	76,239.		77,750.
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more		1,540,446.		NONE
20 Other liabilities. Attach schedule				
21 Partners' capital accounts		-3,623,913.		-3,318,378.
22 TOTAL liabilities and capital		-2,007,228.		-3,240,628.

Schedule M-1 Reconciliation of Income per Books With Income per Return. Use total amount under California law.

1 Net income (loss) per books	305,535.	6 Income recorded on books this year not included on Schedule K, line 1 through line 7. Itemize: a Tax-exempt interest $	
2 Income included on Schedule K, line 1 through line 7, not recorded on books this year. Itemize		7 Deductions included on Schedule K, line 1 through line 12a and line 16a, not charged against book income this year. Itemize: a Depreciation $	
3 Guaranteed payments (other than health insurance)		8 Total of line 6 and line 7	
4 Expenses recorded on books this year not included on Schedule K, line 1 through line 12a and line 16a. Itemize: a Depreciation $ b Travel and entertainment $ c Limited partnership tax $		9 Income (loss) (Schedule K, line 23a). Subtract line 8 from line 5	305,535.
5 Total of line 1 through line 4	305,535.		

Schedule M-2 Analysis of Partners' Capital Accounts

1 Balance at beginning of year	-3,623,913.	6 Distributions: a Cash	
2 Capital contributed during year		b Property	
3 Net income (loss) per books	305,535.	7 Other decreases. Itemize	
4 Other increases. Itemize		8 Total of line 6 and line 7	
5 Total of line 1 through line 4	-3,318,378.	9 Balance at end of year. Subtract line 8 from line 5	-3,318,378.