

1 Charles E. Potter, Jr.
2 Tax Counsel
3 Board of Equalization, Appeals Division
4 450 N Street, MIC: 85
5 PO Box 942879
6 Sacramento CA 95814¹

7 Attorney for the Appeals Division

8
9 **BOARD OF EQUALIZATION**
10 **STATE OF CALIFORNIA**

11 In the Matter of the Appeal of:) **HEARING SUMMARY³**
12) **CORPORATION INCOME TAX APPEAL**
13 **ROYAL HOUSING, INC.²**) Case No. 484677

	<u>Year</u>	<u>Proposed</u>
	2003	Assessment
		\$76,647.00

14
15 Representing the Parties:

16
17 For Appellant: Donald L. Feurzeig, Attorney

18 For Franchise Tax Board: David Gemmingen, Tax Counsel IV

19 ///
20
21

22 ¹ Any questions regarding this hearing summary may be directed to Grant S. Thompson, Tax Counsel IV (telephone:
23 (916) 322-2167).

24 ² Appellant appears to be located in Kensington, California, in Contra Costa County.

25 ³ The oral hearing was originally scheduled for March 23, 2010 and was deferred at respondent's request due to a scheduling
26 conflict. In a March 11, 2010 letter, appellant also requested the continuance of the hearing so it could respond to questions
27 raised in the hearing summary. The appeal was then scheduled for the July 13-15, 2010 oral hearing calendar. On July 8,
28 2010, appellant provided a letter, with declarations and copy of a recently decided Tax Court case, *Ringgold v.*
Commissioner, T.C. Memo 2010-103, stating the issues in this case were similar and requesting that the FTB address the
submission. The appeal was deferred from the August 24, 2010 calendar for further briefing in which Board staff requested
additional briefing from respondent to address appellant's July 8, 2010 submission and exhibits, including *Ringgold, supra*.
The appeal was then scheduled for the April 25, 2011 calendar, but was deferred at appellant's request due to a scheduling
conflict.

1 QUESTIONS: (1) Whether the gain on the sale of appellant's assets is subject to built-in gains (BIG)
2 tax pursuant to Revenue and Taxation Code (R&TC) section 23809, and if so,
3 what is the proper valuation of the assets for purposes of calculating the BIG tax.
4 (2) Whether appellant's built-in gains were properly limited with respect to the
5 taxable income and the net unrealized built-in gain limitations.

6 HEARING SUMMARY

7 Background

8 Appellant was a C corporation until January 1, 2003, when it elected to be treated as an
9 S corporation under Internal Revenue Code (IRC) section 1362⁴ (January 1, 2003). (Appellant's
10 Opening Brief (AOB) p. 1.) Prior to electing this status, appellant acquired an interest in 11 notes in
11 1997 from the Federal Deposit Insurance Corporation for \$540,000 (the Wrap Notes). (*Id.*) On
12 September 30, 2003, appellant reached a settlement that transferred its interest in the Wrap Notes.
13 Respondent determined that the gain from the September disposition was subject to BIG tax and issued a
14 Notice of Proposed Assessment (NPA) on December 18, 2006, which appellant subsequently protested.
15 At protest, respondent used the September 30, 2003 selling price of \$2,700,000 to determine the value of
16 the Wrap Notes as of January 1, 2003. Respondent concluded the built-in gain was \$1,925,520, which,
17 for reasons that will be discussed below, was subject to appellant's taxable income limitation of
18 \$1,033,339.⁵ After taking into consideration prior tax payments and the minimum tax, respondent
19 calculated the deficiency to be \$76,647 and issued a Notice of Action with the revised amount of tax as
20 noted above on February 27, 2009. This timely appeal followed.

21 Appellant's Contentions with Respect to Question (1) – The Valuation Issue

22 Appellant claims that the value of the Wrap Notes on January 1, 2003, was approximately
23 \$270,000. (AOB, p. 5.) Appellant contends it purchased the Wrap Notes in 1997 for \$540,000 from the
24 Federal Deposit Insurance Corporation. (AOB, p. 1.) Appellant states it subsequently realized that it
25 only purchased 37 percent of what it thought it originally purchased. (*Id.*) Citing *S.E.C. v. Sands*
26

27 ⁴ California generally conforms to the federal S corporation regime under R&TC section 23800 *et. seq.*

28 ⁵ It appears that this was the amount of net income originally reported. (*See* App. Reply Br., Exhibit A.)

1 (C. D. Cal. 1995) 902 F. Supp. 1149 (the 1995 *Sands* Case), appellant claims that the Wrap Notes in this
2 particular case were described as risky, highly speculative investments which posed valuation problems.
3 (*Id.*)

4 Appellant claims it was able to purchase the Wrap Notes due to a loan from American
5 Factor, LLC of \$400,000. (*Id.*) Upon receipt of payment of the Wrap Notes, the lender was to receive
6 75 percent of the payment until the loan was repaid, then 50 percent of each payment thereafter,
7 notwithstanding that the payments could exceed the \$400,000 face value of the loan. (*Id.*)

8 At the time of the S election on January 1, 2003, appellant claims there was ongoing
9 litigation between appellant and both Spencer Street Limited (Spencer) and Englewood Apartments Ltd.
10 (Englewood) regarding appellant's ownership rights to the Wrap Notes. (*Id.*) On July 24, 2002, the
11 parties to this litigation stipulated that there had been "intense and protracted settlement negotiations"
12 and there appeared a "reasonable likelihood of success" that formal mediation would resolve the issues.
13 (*Id.*) The mediation on September 19, 2002, did not resolve appellant's ownership in the Wrap Notes.
14 (*Id.* pp. 1-2.)

15 On June 9, 2003, appellant states that First Bancorp (Bancorp), with which Leonard
16 Sands was affiliated, sued appellant for fraud in the inducement, fraud and deceit, breach of contract and
17 conversion arising out of a contract between Bancorp and appellant on November 25, 1998, to jointly
18 pursue the parties' respective rights in the Wrap Notes. (AOB, p. 2.) Bancorp alleged that appellant
19 converted Bancorp's Wrap Notes. (*Id.*)

20 On September 30, 2003, the litigation between appellant and the Wilshire Group was
21 settled⁶ to resolve all disputes except the outstanding issues related to Bancorp (the Wilshire Group
22 Settlement). (*Id.*) Appellant states that Bancorp was an "unstable adversary" and did not settle with
23 appellant until November 4, 2005. (AOB, p. 2.) Appellant claims that until the Wilshire Group
24 Settlement, it was uncertain what its economic gains would be with respect to the Wrap Notes, since the
25 Wilshire Group disputed its ownership of the Wrap Notes. (*Id.*)

26 Included with appellant's *Ringgold* letter, appellant provided declarations, under penalty
27

28

⁶ This settlement included Spencer and Englewood.

1 of perjury, from (i) Michael Stein (dated May 23, 2010) (discussed below in connection with Mr. Stein's
2 valuation), (ii) Max Perry, in house general counsel of Wilshire Investments Corporation and its
3 affiliates, and (iii) E. Jay Gotfredson, an attorney engaged by Max Perry and Wilshire in connection
4 with the Wrap Notes.

5 Mr. Perry states there were several actions relating to the Wrap Notes, including:

- 6 1. *Royal Housing, Inc. v. Spencer Street Limited, et. al.*, Case no. SC057585;
- 7 2. *Royal Housing, Inc. v. Englewood Apartments, Ltd.*, Case no. SC057584;
- 8 3. *Community Preservation, Ltd. Partnership et al. v. Royal Housing Inc.* and related cross-
9 actions, Case no. SC069564;
- 10 4. *Wilshire Investments Corporation, et. al, v. Royal Housing, Inc., First Pacific Bancorp*, Case
11 no. SC059793

12 Mr. Perry states that discussion relating to a purchase of the project related to the Paine Note arose in
13 late 2000 or early 2001. Mr. Perry states that the parties achieved only limited success with a global
14 settlement, but did reach a settlement with the Paine Note in mid-2001, with litigation intensifying
15 thereafter until 2002, which culminated in a mediation on September 19, 2002, which then stalled in
16 early December 2002. Mr. Perry states that in May 2003, news was received that a new investment
17 group was willing to invest as a limited partner in San Martin Twin Towers (one of the projects subject
18 to the Wrap Notes). Based on this "favorable turn of events" and the likely payment of the RIWN based
19 on a successful sale of the property, Wilshire's management determined that settlement of the litigation
20 should be reinstated, which resulted in a final settlement agreement on September 30, 2003.

21 Mr. Gotfredson's declaration states, in part, that early in December 2002 settlement
22 discussions "stalled and looked like they were going no place and that no settlement would take place."
23 However, the declaration states that in May 2003, he was instructed to proceed with settlement
24 discussions, in light of the news that a new investor existed for the San Martin Twin Towers.
25 Mr. Gotfredson states that "there were a large number of factors, each difficult to weigh and assess,
26 which went into the calculus of arriving at settlement terms, even a sampling of which will give you a
27 sense of the complexity and speculativeness, and explain why an opportunity to realize value, and the
28 same time, to resolve difficulties and disputes, has very great value." Mr. Gotfredson's declaration

1 further describes the legal uncertainties with regard to the Wrap Notes, the lack of effective security, the
2 lack of a market and other difficulties associated with the Wrap Notes.

3 Appellant argues that events after January 1, 2003 (the date of the S corp election) were
4 not foreseeable and cannot be used to value the Wrap Notes. (AOB, p. 3.) Appellant asks: if the
5 settlement was foreseeable on January 1, 2003, then why would appellant “have spent \$400,634 in legal
6 fees during 2003?” (*Id.*) In its *Ringgold* letter, appellant argues that the “unexpected and unanticipated”
7 offer to buy San Martin, which is described in its declarations, constituted an unforeseeable event.
8 Appellant further argues that the *Ringgold* court agreed that the “unique circumstances” of the actual
9 buyer should be considered, and that Wilshire became “very motivated after the valuation date” which
10 resulted in a premium, as occurred in *Ringgold*. Appellant argues that the court in *Ringgold* considered
11 many factors, demonstrating that respondent errs by “relying entirely on the sales price . . . because the
12 factors that lead up to the sale were not present on the valuation date.”

13 Appellant, citing *Ithaca Trust Co. v. U.S.*, (1929) 279 U.S. 151, argues that reliance on
14 hindsight is not permissible in making valuation determinations.⁷ Appellant contends that events
15 subsequent to the date of valuation are not generally foreseeable as of the date of valuation, citing
16 *Garwood Irrigation Co. v. Comm’r* (2004) T.C. Memo 2004-195 (hereinafter, *Garwood*) and other
17 authorities.⁸

18 In appellant’s supplemental brief, appellant argues that *Gilford v. Comm’r*, (1987) 88
19 T.C. 38 has “striking similarities” to its case. Appellant argues that, in *Gilford*, the IRS did not
20 introduce any expert testimony, but instead relied on a \$24 per share sale price based on a merger
21 occurring within seven months of the valuation date. Appellant contends that the court found that the
22 taxpayer’s expert presented a *prima facie* case that the valuation was \$7.58 a share as of the valuation
23 date, which the IRS failed to rebut. Appellant argues that: he has provided two expert witnesses, while
24 the taxpayer in *Gilford* only provided one; the later sale in *Gilford* occurred less than seven months after
25

26 ⁷ In *Ithaca Trust*, the United States Supreme Court found that the value of a life estate (given to a spouse upon her husband’s
27 death) had to be calculated using mortality tables, not on a six month valuation based on the fact that the spouse died six
28 months later.

⁸ Appellant also cites *Jung v. Comm’r* (1993) 101 T.C. 412, 43; and *Hess v. Comm’r* (2003) T.C. Memo 2003-251.

1 the valuation date while the sale in this case occurred about nine months later; and that the court in
2 *Gilford* strongly suggested that valuation cases should be settled.

3 Appellant states it hired two expert appraisers in this case to value the Wrap Notes as of
4 January 1, 2003. (AOB, p. 5.) On February 12, 2007, Mr. James Biedenbender of BizValPlus, Inc.
5 valued the Wrap Notes as of January 1, 2003 to be approximately \$233,385 (the BizValPlus Valuation).⁹
6 On February 14, 2007, Mr. Michael Stein valued the Wrap Notes to be 50 percent of the original cost or
7 \$270,000. Mr. Stein stated in his valuation that as of January 1, 2003, based on his experience with
8 these types of instruments, he “would have paid up to 50% of Royal’s \$540,000 investment in the
9 RRWNS to acquire its interest, without Royal indemnifying me against claims by Bancorp.” (AOB,
10 Exhibit L, para. 11.) Mr. Stein stated that during 2003, he “received a copy of a consent decree between
11 various entities and individuals, including their principal, A. Bruce Rozet (“Rozet”), controlling the
12 debtor and HUD, as part of a plea bargain in a multi-count criminal case brought against these parties in
13 the federal district court in San Francisco.” (*Id.*, para. 10.) Mr. Stein stated that Rozet and his affiliates
14 were obligated to liquidate their interests in HUD projects and that, during the summer of 2003,
15 settlement discussions accelerated. Mr. Stein stated that the “main stumbling block at this time was the
16 demands of Bancorp to the debtor not to deal with Royal,” and that, as a result, part of the settlement
17 involved appellant indemnifying the debtors and their affiliates against claims by Bancorp.

18 In a later declaration dated May 23, 2010 (provided with appellant’s *Ringgold* letter),
19 Mr. Stein states:

20 What I valued is Royal’s (Appellant’s) real asset at that time—a claim in litigation against
21 Wilshire that was settled. I did not value a portfolio of undivided interest in the RIWNs
22 [Wrap] (Notes) on an arm’s length sale basis as no such sale could take place. No one
23 would purchase assets from a seller whose very title to the assets was the subject of
pending litigation. As of January 1, 2003[,] Wilshire had withdrawn from settlement
negotiations and was actively pursuing litigation in which it sought to determine that it
and not Royal owned the interest in the RIWNs.

24 As of January 1, 2003, Royal’s position in the litigation was precarious. Wilshire was
25 raising a number of claims to ownership of the RIWNs that Royal had minimal capacity
26 to oppose, including (a) that the original sale of the RIWNs to the bank and the Bancorp
27 had not been consummated and (b) that the sale if consummated had been rescinded and
(c) the FDIC improperly blocked Wilshire’s efforts to repurchase the RINWs. As to (a)
and (b) all of the percipient witnesses, including the bank and Bancorp’s original

28 ⁹ See AOB., Exhibit O.

1 attorneys, were either adverse parties or hostile. If Wilshire's position was sustained,
Appellant's RIWNs would be valueless.

2 Based on my experience, knowledge of the parties, and the litigation risks, I would have
3 recommended a settlement of the action for a net payment to my clients at that time of
\$250,000. This was the basis of my valuation which reflected the true value of what asset
4 Royal had on its books as of January 1, 2003.

5 (Appellant's *Ringgold* Letter, declaration of Mr. Stein, paragraphs 1-3.)

6 Appellant contends it "exhorted" respondent to hire a valuation expert in this case.

7 (AOB, p. 5-6.) According to appellant, these experts discounted the value of the Wrap Notes based
8 apparently in part on the outstanding litigation with the Wilshire Group and with Bancorp. (Appellant's
9 Reply Brief (ARB), p. 11, lines 11-13; AOB, Exhibit L, para 11; Exhibit O.)

10 Appellant further contends that the sale of the Paine Note was not indicative of the value
11 of the remainder of the Wrap Notes. (ARB, pp.11-12.) Appellant states that this note was the "jewel of
12 the portfolio" because it was located near downtown San Francisco. Appellant states that the only
13 reason it was able to sell this note was that Wilshire posted a \$1,000,000 bond to block a foreclosure,
14 which was in Wilshire's interest because it had a 75% interest in the wrap note. Appellant states the sale
15 of the Paine Note only reduced its inventory and thereby provides further evidence of the proof of the
16 \$270,000 valuation of the seven remaining notes. Appellant states that "[o]f the 11 properties that
17 appellant assumed it had purchased, Englewood had already been sold, Spencer Street refinanced and
18 another foreclosed, thereby leaving appellant with a half ownership in eight of the 11 wrap notes."¹⁰

19 Respondent's Contentions with Respect to Question (1) – The Valuation Issue

20 Respondent provided its version of the background of the Wrap Notes as follows. Prior
21 to appellant's acquisition of the Wrap Notes, the 1995 *Sands* Case involved a Securities and Exchange
22 Commission (SEC) lawsuit filed against Bancorp, Leonard Sands, and other individuals alleging
23 violation of federal securities laws. (Respondent's Opening Br. (ROB), p. 2.) One of the issues litigated
24 was Bancorp's acquisition and accounting for the Wrap Notes (which were later acquired by appellant).
25 (*Id.*) The SEC's case against Bancorp and Mr. Sands was in large part based on the SEC's position that
26

27
28 ¹⁰ In the body of its reply brief, appellant states there were seven remaining notes; however, footnote 10 of its reply brief
states that there were eight remaining. At the hearing, appellant may wish to clarify the record and state which property was
foreclosed.

1 Bancorp had improperly classified and disclosed the Wrap Notes in its (Bancorp's) financial statements.
2 (*Id.*) Thus, appellant's purchase of the Wrap Notes two years later was with full knowledge of the *Sands*
3 case involving Bancorp and the Wrap Notes.

4 According to respondent, the Federal Deposit Insurance Corporation Closing Statement
5 indicates that appellant purchased the Wrap Notes with a face amount of \$15,846,371 and a book value
6 of \$5,333,533 for \$539,999 on September 29, 1997. (ROB, p. 2-3.) The Notice of Loan Sale describes
7 the Wrap Notes as follows:

8 This pool of unique instruments and or investments entered into by the former bank in
9 eleven different limited partnerships; the form bank purchased varied percentage interest
10 and or vendor's interest in unsecured notes wrapped around HUD notes; the HUD notes
11 are secured with first trust deeds on apartment complexes in California, Nevada, Illinois,
12 Arkansas, Tennessee, and Puerto Rico; some refer to this transaction as a Residual
13 Receipt Note: the FDIC is selling its interest in these eleven residual receipt notes
14 wrapped around the HUD notes; the FDIC's interest is not real estate; in addition to this,
15 the pool does not contain typical notes, but, rather transaction agreements; it should be
16 noted that only copies of the agreements exist and that some of the documentation is
17 missing.¹¹

18 Respondent states that the Wrap Notes were originally held by a distressed financial
19 institution and sold by the FDIC in its capacity as liquidator and appellant took advantage of this
20 opportunity to make a bargain purchase of assets. (*Id.*) Respondent contends that appellant's citation to
21 the 1995 *Sands* case for the proposition that Wrap Notes had a problematic valuation history is belied by
22 appellant's decision to purchase the Wrap Notes in 1997 for approximately \$540,000. (ROB, p. 3-4.)
23 Respondent claims that as of 1997, appellant must have had an expectation that it would receive an
24 amount well in excess of this amount upon its disposition of the Wrap Notes; otherwise appellant would
25 not have made the purchase. (ROB, p. 3.)

26 Respondent also contends that appellant disposed of a single wrap note in 2001 (the Paine
27 Note) and obtained approximately \$400,000 with respect to this single disposition. (ROB, p. 4.)

28 Respondent claims that appellant's treatment with respect to this 2001 transaction belies appellant's
position for 2003. (*Id.*) Respondent claims that appellant did not report gain from the Paine Note, but
///

¹¹ See ROB, p. 3.

1 did reduce its basis in the remaining Wrap Notes from \$539,999 to \$59,999. (*Id.*)¹² Respondent states
2 that as a matter of consistency, for appellant to argue that there was no built-in gain (*i.e.*, a low valuation
3 as of January 1, 2003), appellant is clearly attempting to ignore its 2001 sale of the Paine Note and re-
4 utilize a substantial portion of its original cost basis (*i.e.*, the \$539,999 original cost) to obtain a double
5 deduction for the sale of the Wrap Notes in 2003. (*Id.*)

6 Respondent contends that the amount of built-in gain as of January 1, 2003 is best
7 determined from the amount realized on the sale of the Wrap Notes on September 30, 2003. (ROB, p.
8 5.) Respondent states that IRC section 1374(d)(3) provides a statutory presumption that gains on the
9 disposition of built-in gain assets during the 10 year period after January 1, 2003 are built-in gains,
10 unless the taxpayer can establish that the appreciation accrued after the conversion. (ROB, p. 6.)

11 Respondent contends that appellant has failed to demonstrate how the Wrap Notes increased 10 fold in
12 the matter of nine months (from the \$270,000 value purported by appellant as of January 1, 2003 to the
13 \$2,700,000 sale price on September 30, 2003). (*Id.*) Respondent contends that the best evidence of fair
14 market value is an actual sales price made in an arm's length transaction within a reasonable time before
15 or after the date for which a value is sought. (ROB, pp. 7 and 9.)

16 Respondent further contends that in determining the value of unlisted stocks actual sales
17 made in reasonable amounts at arm's length, in the normal course of business within a reasonable time
18 before or after the valuation date, are the best criteria of market value. In support, respondent citing
19 *Duncan Indus. v. Comm'r*, (1979) 73 T.C. 266, 276 (which cites *Fitts' Estate v. Comm'r*, (8th Cir. 1956)
20 237 F. 2d. 729), *Estate of Jung v. Comm'r* T.C. Memo. 1990-5; *Estate of Andrews v. Comm'r* (1982)
21 79 T.C. 938, 940; *Estate of Campbell v. Comm'r*, T.C. Memo. 1991-615 and *Morton v. Comm'r*,
22 T.C. Memo. 1997-166. (ROB, pp. 8-9.)

23 Respondent also contends that the formal appraisals submitted by appellant are lacking in
24 that neither adequately identifies the property they purport to value, the specific Wrap Notes at issue, or
25 appellant's interest in each of the Wrap Notes. (ROB, p. 10.) Respondent contends that the appraisals
26

27
28 ¹² In response to respondent's Paine Note basis contention, appellant states that the Paine note's basis was adopted by
appellant from respondent's hearing officer's computation, as shown on page 59 of the hearing officer's report. (App. Add.
Br., p. 7 and exhibit A.)

1 appear to be mere conjectures as to what, if anything, was truly being valued; that they are opinions of
2 value, but do not adequately demonstrate what that value pertains to. (*Id.*)

3 With regard to the BizValPlus Valuation, respondent argues as follows:

- 4 1. The valuation states that it would be tempting to look at the \$2,700,000 amount for valuation
5 purposes, but that it was precluded by the U.S. Tax Court from reviewing subsequent events.
6 However, respondent notes that the BizValPlus Valuation did look to 2001 and September 30,
7 2003 as the investment return period for its valuation (*i.e.*, the BizValPlus needed a period to use
8 for when a hypothetical investor would expect a return). (ROB, p. 11.) Respondent claims that
9 the BizValPlus Valuation did not “ignore” September 30, 2003 in its valuation methodology and
10 that it is selecting particular events (time dates in 2003), but ignoring other facts in 2003 (*i.e.*, the
11 actual sales price on September 30, 2003). (ROB, p. 12, lines 13-18.) Thus, respondent claims
12 the BizValPlus Valuation is a misleading estimate that ignores actual market results of 2003.
13 (ROB, p. 12, lines 19-23.)
- 14 2. Respondent claims the BizValPlus Valuation is flawed because it arrived at probabilities of
15 outcomes (Return Outcome) in the following manner: (ROB, p. 12-13; AOB, Exhibit O, p. 9
16 (unnumbered).)

Return Outcome	Probability	Value Result	Multiple	Concluded Value
\$ 59,999	5.00%	\$ 3,000	0.5	\$ 1,500
\$ 444,290	45.00%	\$ 199,930	0.5	\$ 99,965
\$ 1,029,157	45.00%	\$ 463,120	1.0	\$ 463,120
\$ 4,388,220	5.00%	\$ 219,410	0.5	\$ 109,570 ¹³

17
18
19
20
21
22 Respondent characterizes using the return amounts against these probability weightings as an
23 “unfounded utilization of arbitrary probabilities” that “ignore the true value” of the WRAP
24 Notes. (ROB, p. 13.) Respondent argues that the appraisal assigned “a probability of 95
25 percent” that the FMV was \$1,029,157, or “less than roughly one-third of the actual proceeds
26 realized months later, while still electing to use the actual October 2003 payoff date as the proper
27

28 ¹³ Board staff notes that \$219,410 times 0.5 equals \$109,705, not \$109,570 as indicated in the BizValPlus table.

1 time period for calculating the date an investment return would be expected. [emphasis in
2 original]” Respondent contends that this “lopsided allocation flies in the face” of the one sales
3 price of \$2,700,000 that occurred as of September 30, 2003. (*Id.*)

4 Respondent contends that both appraisals failed to fully account for the Paine Note sale in
5 2001. (*Id.*) Respondent indicates that the Closing Statement shows that this single wrap note (in which
6 appellant had only a 6.25 percent interest) brought in \$400,041 to appellant, an amount greater than all
7 the other Wrap Notes combined (as purportedly valued by appellant’s appraisers). (*Id.*) Respondent
8 contends that any subsequent valuation of the remaining Wrap Notes should discuss the factual historic
9 disposition of the Paine Note. (*Id.*)

10 With regard to the second valuation from Mr. Stein, respondent contends that it too relies
11 heavily on events occurring after January 1, 2003. (ROB, p. 14.) For example, at paragraph 8 of his
12 estimate, Mr. Stein referred to the June 2003 litigation that Bancorp commenced against appellant, and
13 he referred to the summer of 2003 litigation costs. (ROB, pp. 14-15.) Respondent contends that
14 Mr. Stein relied on litigation filed months after January 1, 2003 to value the Wrap Notes as of January 1,
15 2003. (*Id.*) Thus, respondent contends that Mr. Stein’s approach violates the very principle appellant is
16 arguing for in valuing the Wrap Notes; that it looked to events past January 1, 2003 to value the note.
17 (ROB, p. 15.)

18 Respondent contends that the Wilshire Group Settlement in September 2003 was
19 foreseeable. (ROB, p. 16.) Respondent contends that appellant previously argued that settlement was
20 unforeseeable and resulted from the unexpected settlement of criminal charges against Rozet occurring
21 in 2003 (i.e., after the valuation date). Respondent contends that criminal charges were, in fact, settled
22 in 2001, that the settlement included a time limit for Rozet and others to dispose of their interests and
23 that, as a consequence of the foregoing, settlement of the civil litigation was foreseeable on January 1,
24 2003. In support, respondent provides excerpts from Chapter 4 “Investigations” of the Office of
25 Inspector General’s Semiannual Report to Congress as of March 31, 2001 regarding the resolution of the
26 criminal charges.¹⁴ (ROB, pp. 16-17.) This report describes two corporations pleading guilty to
27

28 ¹⁴ See Resp. Opening Br., Exhibit G.

1 insurance fee kickback schemes related to low-income housing projects located throughout the country.
2 (ROB, p. 16, line 18.) Respondent indicates that this was a criminal prosecution presumably of the
3 Wilshire Group. (*Id.*, line 12.) According to this report, it appears that entities within the Wilshire
4 Group entered into criminal pleas which capped a 5-year investigation. (ROB, p. 17, line 21.)
5 Respondent thus contends that in 2001 it was clear that the Wilshire Group was facing criminal
6 prosecution and it was just a matter of time before the Wilshire Group would settle civil claims and
7 divest itself of the Wrap Notes. (ROB, p. 18, lines 5-9.) Mr. Rozet had to divest himself by March
8 2004, which meant that Mr. Rozet (*i.e.*, the Wilshire Group) had significant motivation to divest himself
9 of the Wrap Notes sometime in 2003. (ROB, p. 18-19.)

10 Respondent (citing *Estate of George C. Blount v. Comm'r et. al.*, TC Memo 2004-116)
11 contends that (1) the Board can reject an expert's opinion if it finds that it is contrary to the judgment the
12 court forms on the basis of its understanding of the record as a whole and (2) that expert testimony is no
13 more persuasive than the convincing nature of the reasons offered in support of the expert's testimony.
14 (Respondent's Reply Brief (RRB) p. 5.) For the reasons above, respondent contends that the expert
15 valuations are not persuasive and ignored relevant information before and after September 30, 2003.
16 (ROB, p. 18-19; RRB, p. 6.) Thus, respondent contends these expert valuations did not overcome the
17 presumed correctness of respondent's factual findings. (ROB, p. 18.)

18 Respondent contends that appellant's business behavior with respect to the Wrap Notes
19 belies its \$270,000 valuation. (RRB, p. 8-7.) Respondent states that appellant's claim of paying
20 \$834,657 in legal fees relating to securing its rights to the WRAP Notes, including \$465,574 after 2002,
21 strains common sense, if appellant believed the Wrap Notes were "nearly worthless," or at best,
22 \$270,000. (RRB, p. 8.)

23 With regard to appellant's *Ringgold* letter, respondent argues that *Ringgold* supports its
24 analysis in this appeal that an actual arm's length sale, occurring within a reasonable time before or after
25 the valuation date, is the best criteria of value. Respondent argues that the asset being valued in
26 *Ringgold*, an equity interest in a tiered partnership interest in a telecommunications enterprise, was
27 different from those in this appeal. Respondent asserts that, unlike the interest in a tiered partnership,
28 which involved potential capital calls and other issues not present in this appeal, the Wrap Notes provide

1 a fixed principal amount that provide by their terms a maximum amount that might ultimately be
2 realized.

3 Appellant's Contentions with Respect to Question (2) – The Taxable Income

4 NUBIG Limitations

5 Appellant contends that even if the sale of the Wrap Notes resulted in BIG tax, certain
6 limitations for the tax have been miscalculated by respondent.

7 Appellant's Taxable Income Limitation Calculation

8 Appellant contends that even if the value of the Wraps Notes is deemed to be \$2,700,000,
9 then under the taxable income limitation, the taxable net income from the sale of the Wrap Notes in
10 2003 was only \$830,972. (Appellant's Reply Brief, (ARB) p. 8.) Appellant calculated this limitation as
11 follows:¹⁵

Sales Price of Wrap Notes			\$2,700,000
Interest to American Factors			
Amount Received		\$1,202,464	
Loan Amount	\$400,000		
Received 2001	\$221,339	(\$178,661)	
Interest			(\$1,023,803)
Balance			\$1,676,197
Cost	\$539,999		
Paine Note	(\$95,709)		
Legal Fees	\$421,678		\$865,968
Profit on Notes			\$810,229
Other Form 100S Adjustments			(\$50,819)
Net income			\$759,410
Tax at 8.84%			\$67,132
Minimum Tax			\$800
Corrected Tax			\$67,932
Tax Previously Paid			(\$15,500)
Deficiency			\$52,432

12
13
14
15
16
17
18
19
20
21
22
23
24
25
26 Thus, appellant claims under respondent's valuation the total deficiency would only be \$52,432, when
27

28

¹⁵ *Id.* It is not clear from the appeal record why appellant contended in his heading on page 8 of its Reply Brief that the net income was only \$830,972, while the table presented a net income amount of \$759,410.

1 the proper income tax limitation is applied. (*Id.*)

2 Appellant's NUBIG Limitation Contention

3 Appellant contends that the theory of the NUBIG limitation is to limit the BIG amount to
4 an amount that cannot exceed the corporation's NUBIG, as if the corporation were liquidated. (ARB,
5 p. 9.) Appellant contends the value of the NUBIG is the amount by which the fair market value of all of
6 the assets of appellant, on January 1, 2003, exceeds the aggregate adjusted bases of such assets. (*Id.*)
7 Appellant contends that the only asset owned by it, other than the Wrap Notes, was a 10 percent interest
8 in Royal Apartments which had a basis of \$136,002. Appellant contends the value of Royal Apartments
9 after deducting the mortgage would be no more than \$250,000. (AOB, Exhibit N, p. 3.) Appellant
10 contends that in this hypothetical sale of all the assets, the amount realized would be reduced by the
11 amount appellant would pay as BIG tax and for the payment that would have to be made to American
12 Factor. Appellant contends that this is not a deduction for taxes, but simply reduces the amount realized
13 in the NUBIG computation, which is, in effect, a complete liquidation. (Appellant's Additional Brief
14 (AAB), p. 6.)

15 In support, appellant cites *Litchfield v. Comm'r*, TC Memo 2009-21 and *Jelke v. Comm'r*,
16 (11th Cir. 2007) 507 F.3d 1317, contending that both stand for the proposition that a capital gains
17 discount of 100 percent of the taxes was allowed.¹⁶ (ARB, p. 8.) Appellant contends that, in the
18 hypothetical sale of its assets, there would be an amount realized that would have to take into account
19 both the payment to American Factor and the corporate capital gains tax that would be paid by the
20 corporation upon sale or disposition of the assets. (ARB, p. 9.) Thus, under *Jelke*, appellant contends
21 that the capital gains tax reduced the value of the corporation due to the capital gains tax and that this
22 also holds true for an S corporation (under *Litchfield*), and that such taxes should reduce the value of the
23 corporation for NUBIG Limitation purposes. (*Id.*)

24 Appellant contends that the *Jelke* tax discount reduction rationale has been recognized
25 and approved by respondent's Settlement Bureau and respondent "has a duty to provide consistent
26 treatment to all of its citizens and allow the *Jelke* reduction in value." (ARB, pp. 9-10.)

27 _____
28 ¹⁶ In *Jelke* and *Litchfield*, the courts held that, for estate tax purposes, the value of S corporation stock could be reduced to
take into consideration taxes that would be imposed on a sale of the corporation's assets.

1 Respondent’s Contentions with Respect to Question (2) – The Taxable Income and
2 NUBIG Limitations

3 Respondent’s Taxable Income Limitation Contention

4 Respondent contends that appellant’s table above misrepresents reporting positions taken
5 by appellant in 2001. (Respondent’s Reply Brief (RRB), p. 6-7.) Respondent contends that appellant
6 erroneously introduced a basis of \$95,709 for the Paine Note. (RRB, p. 7.) Respondent contends that
7 appellant sold the Paine Note in 2001 and on the 2001 return, appellant offset its total basis in the Wrap
8 Notes by the amount of \$480,000 as a consequence of the Paine Note sale. (*Id.*) Thus, respondent
9 contends that appellant’s 2003 Paine Note basis calculation fails to take into consideration the \$480,000
10 of basis used to offset the amount realized on the 2001 disposition of the Paine Note. (*Id.*) Thus,
11 respondent contends that much of the original basis in the Wrap Notes was used in 2001 to reduce the
12 gain on the Paine Note. (*Id.*) Respondent argues that appellant has a duty of being consistent in its
13 reporting and not attempt to reduce its taxable income limitation by re-using its cost basis for the 2003
14 sale of the Wrap Notes. (*Id.*)

15 Respondent concedes that it originally failed to take into account the taxable income
16 limitation from 2003 and that as a result, at protest, respondent corrected this error by reducing the net
17 recognized built-in gain for 2003 from \$1,084,158 to \$1,033,339. (ROB, p. 19-20.)

18 Respondent’s NUBIG Limitation Contention

19 In respondent’s determination letter, respondent contends that it did not have sufficient
20 information to fully determine appellant’s NUBIG as of January 1, 2003, since respondent claimed not
21 to have sufficient information regarding the fair market value of appellant’s 10 percent interest in Royal
22 Apartments as of January 1, 2003. (Respondent’s Protest Determination Letter, pp. 3-4 (copy enclosed
23 as Exhibit N of AOB).) Respondent also claims that the “unrecorded” liability for federal and state
24 taxes on the hypothetical sale of the corporation as of January 1, 2003 cannot be taking into account for
25 purposes of calculating the NUBIG limitation. (ROB, p. 19.) Respondent contends that Treasury
26 Regulation section 1.1374-3(a)(2) provides that a reduction to NUBIG is allowed for a liability, but only
27 if the corporation would be allowed a deduction on payment of the liability. (*Id.*) Respondent contends
28 that since federal taxes are not deductible for federal or California purposes (Int. Rev. Code § 275(a)(1)

1 and Rev. & Tax. Code, § 24345), then they are not an “unrecorded liability” that can reduce NUBIG
2 under the regulations. (*Id.*) In other words, respondent contends that capital gains tax cannot be used
3 for NUBIG limitation purposes. (*Id.*)

4 Applicable Law

5 Background Regarding the BIG Tax

6 Since a C corporation is subject to a corporate level tax, if a C corporation acquires an
7 asset for \$100 (its original cost basis) and then later sells the asset for \$1,100, the gain on the sale would
8 be approximately \$1,000 (\$1,100 sales price minus \$100 basis). Assuming a federal corporate tax rate
9 of 35 percent, the corporation would owe federal tax of \$350 on the transaction (\$1,000 times 35 percent
10 (ignoring any federal deductions for state taxes)).¹⁷ If the corporation then distributed \$650 to its
11 shareholders, a second level of tax directly on the shareholders at the dividend rate¹⁸ would generally
12 apply. However, since S corporations are pass-through entities and are not subject to first level,
13 corporate federal income taxation,¹⁹ if the C corporation, just prior to selling the asset, elected
14 S corporation status, it could attempt to sell the asset as an S corporation and avoid the federal corporate
15 level of tax (i.e., the \$350 in tax).²⁰ Thus, by electing S corporation status, C corporations with assets
16 that have “built-in” gains prior to becoming an S corporation (the \$1,000 amount in this hypothetical)
17 could, in the absence of the BIG tax, avoid the C corporation tax by electing S corporation status and
18 then selling the assets with built-in gains. To avoid this, Congress instituted a BIG tax regime that is
19 imposed on unrealized gains that exist at the time a C corporation becomes an S corporation (the \$1,000
20 in the hypothetical above).

21 Definition of Realized Built-In Gain

22 A “recognized built-in gain” is any gain occurring within 10 years after an S corporation
23 election date that results from the sale of an asset owned prior to the S corporation election. The amount
24

25 ¹⁷ Assuming a California corporate tax rate of 8.84 percent, the corporation would also owe approximately \$88.40 on the
26 transaction.

27 ¹⁸ Assuming adequate earnings and profits existed within the corporation to support a dividend.

28 ¹⁹ S corporations for California purposes are subject to a lower corporate level tax rate of 1.5 percent.

²⁰ For California purposes, the \$1,000 would still be subject to a lower corporate tax rate of 1.5 percent, as mentioned above.

1 of the “recognized built-in gain” equals the excess of the “fair market value” of the asset over its basis at
2 the time the C corporation converted to S corporation status. (Int. Rev. Code § 1374(d)(3).)

3 Tax on Net Recognized Built-in Gain

4 For any taxable year within 10 years of electing S corporation status (the recognition
5 period), an S corporation is subject to tax on its net recognized built-in gain. (Int. Rev. Code § 1374(a);
6 Rev. & Tax. Code, § 23809.)

7 Limitations on Built-in Gain

8 A “recognized built-in gain” is any gain occurring within 10 years after an S corporation
9 election date that results from the sale of an asset owned prior to the S corporation election. (Int. Rev.
10 Code § 1374(d)(3). The amount of the “recognized built-in gain” equals the excess of the fair market
11 value of the asset over its basis at the time the C corporation converted to S corporation status.²¹ The
12 BIG tax is imposed only on the “net recognized built-in gain.” (Int. Rev. Code §§ 1374(a), 1374(c)(2);
13 Treas. Reg. § 1.1374-2(a)(3).) The “net recognized built-in gain” cannot be greater than:

- 14 a. *The Taxable Income Limitation:* the corporation’s taxable income as it would have
15 normally been calculated for a C corporation without regard to certain disallowed
16 deductions (Int. Rev. Code § 1374(d)(2); Treas. Reg. § 1.1374-2(a)(2).); or
17 b. *The Net Unrealized Built-in Gain Limitation:*²² the amount by which the
18 corporation’s net unrealized recognized built-in gain (hereafter NUBIG) exceeds its
19 net recognized built-in gain for all prior taxable years. The NUBIG is the total of five
20 items:
21 1. The amount the corporation would realize if it sold all of its assets on the first day
22 of the recognition period at fair market value to an unrelated party that assumed
23 all of the corporation’s liabilities.
24 2. The second item, which is subtracted, is any liability of the corporation that would
25 be included in the amount realized that would be allowed as a deduction to the
26

27 ²¹ The \$1,000 in the hypothetical example discussed previously would be “recognized built-in gain.”

28 ²² Int. Rev. Code § 1374(c)(2) and Treas. Reg. § 1.1374-2(a)(3).

1 corporation on payment.

2 3. The third item, which is subtracted, is the total adjusted basis of the corporation's
3 assets on the first day of the recognition period.

4 4. The fourth item, which does not appear applicable in this appeal, is IRC section
5 481 adjustments, which are either added or subtracted.

6 5. The fifth item, which does not appear applicable in this appeal, is any recognized
7 built-in loss that would not be allowed on the sale under IRC sections 382, 383 or
8 384. (See Treas. Reg. § 1.1374-3(a).)

9 Valuation

10 To determine the amount of "recognized built-in gain" for BIG tax purposes, the fair
11 market value (FMV) of the asset must be determined as of the S election. (Int. Rev. Code § 1374(d)(3).)
12 FMV is the price at which the property would change hands between a willing buyer and a willing
13 seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of
14 relevant facts. (*U.S. v. Cartwright*, (1973) 411 U.S. 546 ("The willing buyer-willing seller test of fair
15 market value is nearly as old as the federal income, estate, and gifts taxes themselves....").)

16 In *Ringgold, supra*, the United States Tax Court considered the valuation of an
17 S corporation's interest in a partnership. The court explained that the valuation of stock is "a question of
18 fact resolved on the basis of the entire record," citing *Ahmanson Found. v. United States*, 674 F.2d 761,
19 769 (9th Cir. 1981) and *Estate of Newhouse v. Comm'r*, 94 T.C. 193, 217 (1990). (*Ringgold, supra* at
20 p. 8.) The court further explained that "[i]n valuing unlisted securities, 'actual arm's length sales of such
21 stock in the normal course of business within a reasonable time before or after the valuation date are the
22 best criteria of market value[,]" citing *Estate of Andrews v. Comm'r*, 79 T.C. 938, 940 (1982) and *Estate*
23 *of Davis v. Comm'r*, 110 T.C. 530, 535 (1998). The court considered the testimony of the expert
24 witnesses submitted by the parties, and the later sale of the partnership interest, approximately eleven
25 months after the valuation date, for approximately \$5.2 million. After considering the timing of the sale,
26 the circumstances surrounding the sale and the testimony presented, it found the sale price to be
27 "probative, but not conclusive, evidence of the value of [the partnership interest] on the valuation date."
28 (*Id.* at p. 28.) As a result, the court concluded that the partnership asset had value as of the valuation

1 date of \$3,727,142, rather than the \$5.2 million value asserted by the government and the \$2.9 million
2 value asserted by the taxpayer.

3 *Garwood, supra*, provides another example of the legal analysis applicable in valuing an
4 asset of an S corporation for purposes of the BIG tax. In *Garwood*, the United States Tax Court valued
5 water rights that were sold by an S corporation. The government valued the water rights at \$76.6
6 million for purposes of its assessment, but its expert at trial concluded that the value was \$45.8 million.
7 The taxpayer had reported BIG tax based on a valuation of \$31.4 million and later argued at trial that the
8 value was \$10.7 million. The government argued that events occurring after the valuation date,
9 including the later sale of the taxpayer's irrigation assets for \$75 million, provided evidence supporting
10 its valuation determination. In contrast, the taxpayer argued that later events were not foreseeable by a
11 hypothetical willing buyer and seller. The court considered the testimony of the valuation experts and
12 all the surrounding circumstances and concluded in part that, while a later sale of the water assets was
13 reasonably foreseeable, the valuation reflected in the \$75 million purchase was "not sufficiently
14 predictable [as of the valuation date] to form the basis for valuation." (*Id.* at p. 43.) The court then
15 determined its own estimate of value, in part by adjusting the assumptions made by the expert witnesses,
16 and determined a FMV of approximately \$22.5 million.

17 Burden of Proof

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

27 Expert opinion is admissible if it will assist the trier of fact to understand evidence that
28 will determine the fact in issue. (*Frazer v. Comm'r*, (1992) 98 TC 554.) While expert opinions may be

1 helpful, a court is “not bound by these opinions and may reach a decision based on [its] own analysis of
2 all the evidence in the record.” (*Garwood, supra* at p. 23 [internal citations omitted].) In doing so, the
3 court may “accept or reject the opinion of an expert in its entirety, or it may be selective in the use of
4 any portion [of an opinion].” (*Id.* [internal citations omitted].)

5 STAFF COMMENTS

6 Question (1) - Valuation

7 Staff suggests that the parties be prepared to discuss the following items at the hearing.

- 8 1. Would a willing seller have parted with the Wrap Notes to a willing buyer on January 1, 2003,
9 for \$270,000 (appellant’s valuation), or would a willing buyer have purchased such assets for
10 \$2.7 million (respondent’s valuation)?
- 11 2. To what extent, if any, does the sales price of the Paine Note, and/or the September 30, 2003
12 settlement provide evidence of the value of Wrap Notes as of January 1, 2003? Did market
13 conditions, the foreseeability of the Wilshire Group settlement, the risk of Bancorp litigation,
14 etc., or any other relevant factors substantially alter the value of the Wrap Notes in the months
15 from January 1, 2003 to the September sale of the Wrap Notes? Respondent should be prepared
16 to address the three affidavits provided by appellant with its *Ringgold* letter dated July 6, 2010.
17 Did the acquisition of financing by a potential investor in San Martin Towers, in May 2003, or
18 other events occurring between January 1, 2003 and the date of the settlement, change the
19 valuation of the Wrap Notes in ways that could not have been foreseen?
- 20 3. The parties should be prepared to discuss the data, assumptions and methodologies used by
21 appellant’s experts. Respondent should be prepared to explain why it did not obtain its own
22 expert valuation.
- 23 a. The BizValPlus Valuation, for the purpose of calculating the BIG tax, includes a 43.84
24 percent discount for the incurrence of BIG tax. In support of such a discount, appellant
25 cites cases that take into account built-in gain in assets for the purpose of evaluating the
26 FMV of the *stock* of the corporation holding the assets. Staff is not aware of any case
27 stating that, in order to calculate the BIG tax on the sale of an S corporation’s *assets*, the
28 BIG tax should be deducted, and staff questions whether this is appropriate.

- 1 b. The BizValPlus Valuation states that it used four possible outcomes (\$59,999, \$444,290,
2 \$1,029,157 and \$4,388,220) in its appraisal and that “the values herein are book value or
3 book investment for [appellant] for the low value, total remaining book value of the notes
4 per the FDIC schedule after the initial collection, the value so obtained in final settlement
5 and finally, the value derived from applying the identical percentage used by the FDIC in
6 the bid process against the total book value of the RIWN’s (10.1246% times
7 [\$]4,388,220).” (AOB, exhibit O, p. 6 [unmarked].) Appellant should be prepared to
8 discuss further the source of these potential outcomes and the basis for the relative weight
9 given to each.
- 10 c. The largest possible outcome value, \$4,388,220, is equal to the value determined by
11 subtracting the Paine Note’s book value, as of the FDIC auction, from the total book
12 value of all the Wrap Notes (\$5,333,533 as shown in ROB, exhibit A). If appellant only
13 had seven or eight of the Wrap Notes remaining (see footnote 10 of this hearing summary
14 and footnote 10 and surrounding text of appellant’s reply brief), does the appraisal
15 inadvertently take into account the book value of Wrap Notes that had already been
16 disposed of or had no value?
- 17 d. Is it reasonable for the report to use appellant’s remaining investment in the Wrap Notes,
18 which the report states was \$59,999 after taking into account the American Factor loan,
19 and then reduce this amount by 50 percent? It appears to staff that if appellant initially
20 became a co-owner, with a 50% interest, its original investment amount and later returns
21 would already reflect that it only acquired a 50% interest. Similarly, appellant should be
22 prepared to clarify at the hearing how the \$444,290 potential outcome was calculated and
23 whether it is reasonable to apply a 50 percent discount to this \$444,290 outcome.
- 24 e. It appears that one of the valuation’s potential outcomes is a \$1,029,157 final settlement
25 amount. Appellant should be prepared to confirm at the hearing whether this amount is
26 based on net proceeds from the September 2003 settlement (after deducting legal fees and
27 payments of principal and interest to American Factor) and if so, discuss whether this is
28 indicative of the FMV of the Wrap Notes and consistent with appellant’s position that the

1 settlement was speculative and unforeseeable as of January 1, 2003.

2 f. How probative is the book value of the Wrap Notes, as listed in connection with the 1997
3 sale by the FDIC, in estimating their FMV as of January 1, 2003?

- 4 4. Could the actual FMV reasonably be determined to be between the values asserted by the parties
5 and, if so, what alternative methodologies might be considered? For example, could a value be
6 reasonably estimated by determining the percentage of the payoff amount (\$2.4 million) or book
7 value (\$945,313) of the Paine Note (based on the FDIC schedule) that was obtained on the sale
8 of that note, and multiplying that percentage (with any appropriate adjustments) by the total book
9 value or payoff amount of the remaining Wrap Notes?

10 Question (2) The Taxable Income and NUBIG Limitations

11 It appears to staff that respondent's assessment is based on a taxable income limitation of
12 \$1,033,339, and that this was the amount of net taxable income reported on appellant's tax return. The
13 parties should be prepared to confirm or clarify at the hearing whether this is the case. Any party
14 wishing to provide a different taxable income limitation should be prepared to explain how and why it
15 calculates a different taxable income amount from the amount previously calculated.

16 As noted above, staff is not aware of any authority for the deduction of potential BIG tax
17 by an S corporation in order to determine the amount of BIG tax. Similarly, staff is not aware of support
18 for such a deduction in the calculation of NUBIG. Treasury Regulation section 1.1374-3(a)(2) allows a
19 decrease in the amount realized for NUBIG purposes, "but only if the corporation would be allowed a
20 deduction on payment of the liability...." (Treas. Reg. § 1.1374-3(a)(2).) Although the payment of tax
21 by an S corporation may reduce the amount of pass-through income recognized by the S corporation's
22 shareholders, it appears to staff that an S corporation cannot deduct state and federal tax in order to
23 determine its own taxable income under California law. (See Rev. & Tax. Code section 24345.) At the
24 hearing, appellant should be prepared to discuss further its position in this regard.

25 Appellant also should be prepared to discuss, and if applicable provide supporting
26 documentation for, its basis and valuation determination with regard to Royal Apartments, its resulting
27 calculation of NUBIG and whether the NUBIG is less than built-in gain (and the net income limitation)
28 such that the NUBIG limitation would affect the calculation of tax. It appears that respondent has

1 reduced NUBIG by \$740,652 paid to American Factors. (See AOB, exhibit N, p. 6.) Respondent thus
2 calculates NUBIG as \$1,184,686²³ (\$2,700,000, reduced by appellant's \$774,480 basis and \$740,652
3 paid to American Factors). (*Id.* at p. 8.) Since the net income limitation amount is less than this
4 amount, the NUBIG calculation does not change the amount of tax due under respondent's calculations.

5 Other Comments

6 Staff notes that, while the period for briefing legal argument has now expired, the parties
7 may still submit additional documentary evidence, if they wish. If either party desires to submit any
8 such additional documentary evidence, it should be provided at least 14 days prior to the hearing.²⁴
9 Staff further notes that it has received a Board Member Inquiry and distributed it to the parties and
10 expects that the responses of the parties will be circulated shortly.

11 ///

12 ///

13 ///

14 Royal_Housing_cep

15

16

17

18

19

20

21

22

23

24

25

26

27

28

²³ It appears this amount should be \$1,184,868 based on the calculations above.

²⁴ 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).)