OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011375
PETER PAU AND SUSANNA PAU	)
	) Date Issued: May 7, 2019
	)
	)

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants:	Edwin P. Antolin, Attorney
For Respondent:	Carolyn S. Kuduk, Tax Counsel III
Office of Tax Appeals:	Mai C. Tran, Tax Counsel IV

J. JOHNSON, Administrative Law Judge: On December 11, 2017, the Board of Equalization (BOE) held an oral hearing on this matter. After considering the arguments and evidence presented, the BOE sustained the proposed assessment of respondent Franchise Tax Board in the amount of $2,278,306 in additional tax, plus applicable interest, for the 2007 tax year. By letter dated January 10, 2018, appellants filed this timely petition for rehearing pursuant to California Revenue and Taxation Code (R&TC) section 19048. Upon consideration of appellant's petition for rehearing, we conclude that the grounds set forth therein do not constitute good cause for a new hearing.

Good cause for a new hearing may be shown where one of the following grounds exists, and the rights of the complaining party are materially affected: 1) irregularity in the proceedings before the BOE by which the party was prevented from having a fair consideration of its case; 2) accident or surprise, which ordinary prudence could not have guarded against; 3) newly discovered evidence, material for the party making the petition for rehearing, which the party could not, with reasonable diligence, have discovered and produced prior to the decision of the appeal; 4) insufficiency of the evidence to justify the decision, or the decision is against law; or

5) error in law. (Cal. Code of Regs., tit. 18, § 30604;[1] *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654; *Appeal of Do*, 2018-OTA-002P, Mar. 22, 2018.)

BACKGROUND

On their 2007 tax returns, appellants reported two like-kind exchanges (the Tantau and Wolfe transactions) pursuant to Internal Revenue Code (IRC) section 1031. IRC section 1031 requires that the same taxpayer that relinquishes property in a like-kind exchange also receive the replacement property in the exchange. (Treas. Reg. § 1.1002-1(d); *Chase v. Commissioner* (1989) 92 T.C. 874.) The properties were held by the partnerships. The partnerships entered into sales agreements to sell the properties. Appellant-husband owned an interest in the partnerships and, through other limited liability companies (LLCs), served as manager of the partnerships. According to the form of the transactions, on the day the properties were sold, partial interests in the properties (or entities holding the properties) were distributed, with the result that appellant-husband obtained an interest in a portion of the properties which he then reported as IRC section 1031 exchanges.

Respondent determined that each transaction failed as an exchange. Respondent determined that the partnerships, not appellant-husband, were the true sellers of the relinquished properties. In addition, respondent determined that appellant-husband did not receive the replacement property in the Tantau transaction because the replacement property was received by an LLC which had more than one member and was treated as a partnership, rather than by appellant-husband through a single-member disregarded entity.

In their briefs and at oral argument, appellants argued that appellant-husband was the seller of the relinquished properties and appellant-husband, through a disregarded entity, received the replacement properties. Appellants further argued that the LLC that received the replacement property in the Tantau transaction should be treated as a disregarded entity such that appellant-husband should be treated as receiving the replacement property directly.

The BOE determined that appellants did not show that they were entitled to treat the Tantau and Wolfe transactions as IRC section 1031 exchanges. The BOE determined that the partnerships, not appellant-husband, were the true sellers of the properties. Further, the BOE

[1] Appellants' petition for rehearing was filed with the Office of Tax Appeals while its emergency regulations were in effect. However, the relevant section of the permanent regulations, cited above and currently in effect, are substantially similar to the corresponding section of the emergency regulations, and therefore the changeover has no substantive effect on the analysis herein.

determined that the entity that received the replacement property in the Tantau transaction may not be treated as a disregarded entity owned by appellant-husband.

DISCUSSION

In their petition for rehearing, appellants contend that their petition should be granted because there was an irregularity in the proceedings, there is insufficient evidence to justify the BOE's decision, and the BOE's decision is against law. We consider each argument in turn.

1. Whether there was an irregularity in the proceedings

Courts have defined an irregularity in the proceedings as "an overt act of the trial court, jury, or adverse party, violative of the right to a fair and impartial trial, amounting to misconduct," (*Gray v. Robinson* (1939) 33 Cal.App.2d 177, 182), and as "[a]ny departure by the court from the due and orderly method of disposition of an action by which the substantial rights of a party have been materially affected." (*Gay v. Torrance* (1904) 145 Cal. 144, 149.) Courts have also required, in addition to identifying such an irregularity, that appellants show they were ignorant of the facts constituting the irregularity prior to the court's decision, "since it is settled that a party may not remain quiet, taking his chances upon a favorable verdict, and, after a verdict against him, raise a point of which he knew and could have raised during the progress of the [proceedings]." (*Gray v. Robinson, supra,* 33 Cal.App.2d at p. 183.)

Appellants argue that the BOE failed to address whether the tax liability was properly assessed on appellant-husband personally, instead of being assessed on the individual partners of the partnership. Appellants contend that the failure to address this issue is an irregularity in the proceedings that warrants a rehearing. Appellants' argument is without basis. Respondent's assessment is based on appellant-husband's distributive share of the partnership's gain from the sale of the two properties. Further, appellants made this argument in the briefs and there is no evidence that the BOE did not consider it.

As for appellants' assertions that the BOE failed to grasp the complex legal issues of this appeal and that this appeal was beyond the normal scope of appeals previously decided by the BOE, we note that appellants have not provided any evidence of this purported failure. Further, we note that the BOE has addressed these legal issues in prior appeals, including the BOE's

precedential opinion in the *Appeal of Brookfield Manor, Inc. et al.*, 89-SBE-002 (1989 WL 37900) Jan. 11, 1989 (*Brookfield Manor*), as well as an unpublished non-precedential decision.[2]

As for appellants' contention that they did not have enough time to present their appeal due to their change in counsel, appellants fail to provide any explanation of how this could have prevented appellants from having a fair consideration of its case. Appellants changed counsel prior to filing their reply brief. Appellants requested and were given multiple deadline extensions and allowed additional pages beyond the limits set by the regulations within which to file their reply brief. Appellants also submitted a response to respondent's reply brief. As such, appellants were provided ample opportunity to present their case after they changed their representation. Further, appellants did not request or express a need for additional time either prior to or at the hearing.

Appellants further contend that their appeal is subject to the written decision requirement in R&TC section 40, and that the lack of a written decision is an irregularity in the proceedings. Written decisions pursuant to R&TC section 40 were issued by the BOE *after* the conclusion of the petition for rehearing process. Therefore, appellants would not have received a written opinion until after the conclusion of this petition for rehearing process, not before it, and therefore this argument does not show an irregularity in the proceedings.[3] Accordingly, we find that there was no irregularity in the proceedings that prevented appellants from having a fair consideration of its case, and a rehearing is not warranted on this basis.

2. Whether there is insufficient evidence to justify the decision

When examining whether a petition for rehearing should be granted, such petition "shall not be granted upon the ground of insufficiency of the evidence to justify the [decision], . . . unless after weighing the evidence the [Office of Tax Appeals] is convinced from the entire

[2] The Board issued a nonprecedential summary decision in the *Appeal of Michael A. Giurbino and Suzanne E. Giurbino* (Case No. 861813) on November 29, 2016.

[3] Appellants assert that a rehearing must be granted to enable the Office of Tax Appeals to write an opinion on this appeal, pursuant to R&TC section 40. However, any statutory requirements placed upon the Office of Tax Appeals for issuing a written appeal in this matter are satisfied by this Opinion on Petition for Rehearing.

record, including reasonable inferences therefrom, that the [panel] clearly should have reached a different [decision]." (Code Civ. Proc., § 657.)[4]

Here, there was sufficient evidence in the record to justify the BOE's decision. In determining whether the substance-over-form doctrine should be applied to disregard the transfer of legal title of the properties from the partnership to the partners prior to the sale of the properties to third parties, the BOE considered who negotiated the sale and who held the benefits and burdens of ownership prior to the sale of the properties. (See generally, *Commissioner v. Court Holding Co.* (1945) 324 U.S. 331 (*Court Holding*); *Bolker v. Commissioner* (1983) 81 T.C. 782 (*Bolker*); *Chase v. Commissioner* (1989) 92 T.C. 874 (*Chase*); *Brookfield Manor*, *supra*.) The evidence in the record includes the sales agreements and subsequent documents related to the sale. In the Tantau transaction, the sales agreement and subsequent documents related to the sale were signed by the partnership. Prior to the sale, the partnership made distributions which resulted in appellant-husband being the sole owner of the partnership (a single-member LLC at that point) and the other partners receiving partial property interests. The evidence shows that, on the same day that the escrow on the Tantau transaction closed, two grant deeds were recorded. The first deed transferred interests in the Tantau property pursuant to the terms of the distribution agreement, which left the partnership (now wholly owned by appellant-husband) retaining a partial interest in the Tantau properties. The second deed transferred the Tantau properties to the third-party buyers. The sale took place under the terms and the amount listed in the sales agreement signed by the partnership. In addition, the loan documents reflected that the property was owned by the partnership prior to the sale to the third party. Further, the partnership's tax return, and not appellants' tax returns, reported rents and expenses from the property. Thus, the evidence supports finding that the benefits and burdens of ownership did not transfer to appellants prior to the sale.

Similarly, in the Wolfe transaction, the sales agreement and subsequent sales-related documents were signed by the partnership. Prior to the sale, the partnership executed a distribution agreement withdrawing all partners, including appellant-husband (through his indirect interest), from the partnership in exchange for partial property interests in the Wolfe property. Once escrow closed on the Wolfe transaction, two grant deeds were recorded. The

[4] In *Appeal of Wilson Development, Inc.*, *supra*, the BOE largely adopted the aforementioned grounds for granting a rehearing, including the ground of an insufficiency of evidence to justify the decision, from Code of Civil Procedure section 657, which sets forth the grounds for a new trial in a California trial court.

first grant deed transferred the interests in the Wolfe property pursuant to the terms of the distribution agreement. The second grant deed transferred the Wolfe property to the third-party buyers. The sale took place under the terms set by the partnership with the recording of the transfer from the partnership to appellants occurring the day after the sale of the Wolfe property.

Appellants contend that, with respect to the Wolfe transaction, the BOE's decision ignores the fact that distribution occurred after the original sales agreement lapsed. However, the partnership and the third-party buyer linked the subsequent sales documents as amendments to the original sales agreement, and the last amendment specifically included a ratification of the original sales agreement, which revived the original sales agreement. Appellants also admitted that the partners were required to sell their interests in the Wolfe property consistent with the terms of the sale negotiated by the partnership. In addition, the loan documents reflected that the property was owned by the partnership. Further, the partnership's tax return, and not appellants' tax returns, reported rents and expenses from the property which shows that the benefits and burdens of ownership did not transfer to appellants prior to the sale. The evidence in the record, viewed in a light most favorable to the BOE's decision, supports a finding that the partnerships were the true sellers of the properties because the partnerships signed the sales agreements, the deeds distributing interests were only recorded after the sale was imminent, and the partnership retained the benefits and burdens of owning the properties until the sale to the third party closed.

Appellants' contention that the LLC acquiring the replacement property in the Tantau transaction should be treated as a partnership, and not as appellant-husband's single member LLC, is not supported by the evidence in the record. Appellants contend the loan documents for the replacement property show that the alleged non-appellant partner in the LLC was simply a creditor who held a security interest in the entity for collateral to secure the loan. The BOE considered the partnership tax return for the entity, wherein the entity reported three members, and the entity's operating agreement, wherein the members agreed to acquire, hold, improve, lease, operate and dispose of the replacement property for investment and for the production of income from the replacement property. The operating agreement also indicated that the members, other than appellant-husband, made initial contributions of $5 million to the entity and would make additional contributions to fund capital improvements and other specified items related to the replacement property. Further, the entity maintained its own books and records. Viewing the evidence in a light most favorable to the BOE's decision, the evidence supports

finding that the LLC that acquired the replacement property in the Tantau transaction had more than one member and should be treated as a partnership.

Appellants essentially argue that the BOE weighed the evidence incorrectly against them. However, the relevant inquiry for purposes of a petition for rehearing is not one which involves a weighing of the evidence, but rather is a question of whether there is evidence which, if given its fullest effect, is legally sufficient to support the decision. (See *Mosekian v. Ginsberg* (1932) 122 Cal.App. 774, 777; *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906 (*Sanchez-Corea*).) In light of the above discussion, we find that the evidence supports the BOE's decision finding that the Tantau and Wolfe transactions did not qualify as IRC section 1031 exchanges. Therefore, a rehearing is not warranted on this basis.

3. Whether the decision is contrary to law

The question of whether the decision is contrary to law (or against law) is not one which involves a weighing of the evidence, but instead requires a finding that the decision is "unsupported by any substantial evidence." (*Sanchez-Corea, supra*, 38 Cal. 3d at p. 906.) This requires a review of the decision to "indulge in all legitimate and reasonable inferences" to uphold the decision. (*Id.* at p. 907.) The relevant question is not over the quality or nature of the reasoning behind the decision, but whether the decision can or cannot be valid according to the law. (*Appeal of NASSCO Holdings, Inc*. (2010-SBE-001) 2010 WL 5626976.)

Here, substantial evidence supports the finding that the BOE's decision was not contrary to law. Appellants make the same arguments on petition for rehearing that they made during briefing and oral argument on the original appeal. The BOE's decision followed the legal reasoning in *Court Holding, supra, Bolker, supra*, *Chase, supra*, and *Brookfield Manor, supra*, by determining that the sellers of the Tantau and Wolfe properties were the entities, not appellants. Further, appellants' contention that the sales agreement signed by the partnership in the Wolfe transaction was terminated prior to the ultimate sale of the property is contradicted by the evidence in the record and appellants' admission that they were bound by the contract to sell the property as negotiated by the partnership.

In addition, there is substantial evidence to support the finding that the LLC that acquired the replacement property in the Tantau transaction should not be treated as a disregarded entity. The BOE's decision is consistent with Treasury Regulation section 301.7701-2(a), which provides that, if an LLC has two or more owners, the LLC is treated as either a partnership or as

an association which is taxed as a corporation. The BOE followed the legal precedent set by *Commissioner v. Culbertson* (1949) 337 U.S. 733 in determining that the entity should be treated as a partnership based on all the facts and circumstances. As noted above, the record reflects that the LLC filed partnership tax returns in which the LLC reported three members and the members agreed in the LLC's operating agreement to acquire and invest in the replacement property for the production of income. As such, there is substantial evidence to support the finding that the LLC should be treated as a partnership, rather than a disregarded entity.

Based on the discussion above, and under the standard of review provided for in *Sanchez-Corea, supra*, *Appeal of Wilson Development, Inc., supra*, and *Appeal of Do, supra*, we find that the BOE's decision is not contrary to law and a rehearing is therefore not warranted on this basis.

CONCLUSION

Appellants have not shown good cause for a new hearing under the *Appeal of Wilson Development, Inc., supra*, and California Code of Regulations, title 18, section 30604, for obtaining a rehearing. Therefore, appellants' request for a rehearing is denied.

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John O. Johnson
Administrative Law Judge

We concur:

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