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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

SCOTT L. SHAFER

OTA Case No. 18010886

Date Issued: July 26, 2019

OPINION

Representing the Parties:

For Appellant: Robert H. Sargent, Jr., Enrolled Agent

For Respondent: Veronica Long, Tax Counsel
Ciro Immordino, Tax Counsel IV

Office of Tax Appeals: William J. Stafford, Tax Counsel III

D. BRAMHALL, Administrative Law Judge: This appeal is made pursuant to Revenue and Taxation Code (R&TC) section 19045 from the actions of respondent Franchise Tax Board (FTB) proposing additional tax of $228,520, plus interest, for tax year 2007, and $156,878, plus interest, for tax year 2008.[1]

On April 25, 2019, Administrative Law Judges Douglas Bramhall, Kenneth Gast and Linda C. Cheng held an oral hearing in this matter in Los Angeles, California. When the hearing concluded, Administrative Law Judge Bramhall closed the record and the panel took the matter under submission.

ISSUES

1. In an Internal Revenue Code (IRC) section 1033[2] transaction by a partnership, must appellant partner recognize gain resulting from a distribution in excess of his basis in his partnership interest under Sections 731 and 752?
2. If so, is the partner tax liability an offset to the amount of partnership mortgage liability

[1] Appellant is not separately disputing the applicable interest.

[2] All further "Section" references are to the IRC, unless otherwise indicated. All "Regulation" references are to federal Treasury Regulations (Regulations), unless otherwise indicated.

relieved?

3. If gain is recognized, has appellant established error in FTB's computation of appellant's basis in his partnership interest?

4. Were the distributions by the partnership in 2008 made as a partner loan or as partnership distributions subject to Section 731?

FACTUAL FINDINGS

1. Taking the Fifth, LLC ("TT5") is a California limited liability company (LLC) owned, as of the beginning of the 2007 tax year, by Barry A. Beitler (72.5 percent), appellant (22.5 percent), and 1251 Playa Partners, LLC (5 percent). During the 2007 tax year, TT5 sold real property, under the threat or imminence of condemnation, to the City of Santa Monica ("City") for approximately $17.4 million with an adjusted basis of $4.146 million. On its 2007 California tax return, TT5 did not recognize the resulting gain of $13.254 million under the provisions of Section 1033. Using the proceeds of this sale, TT5 paid off mortgage indebtedness in the amount of $6,460,826 and made cash distributions to appellant of $2,115,405 in 2007.

2. Fifth & Arizona Investors, LLC ("Fifth/Arizona"), while having some common owners with TT5, is a separate California LLC owned, as of the beginning of the 2007 tax year, by Mr. Beitler (60 percent), appellant (15 percent), the Hild Family Trust (10 percent), and 1251 Playa Partners, LLC (15 percent). During the 2007 tax year, Fifth/Arizona sold certain real property, under the threat or imminence of condemnation, to the City for approximately $5 million with an adjusted basis of $3.1 million. On its 2007 California tax return, Fifth/Arizona did not recognize the resulting gain of $1.9 million under the provisions of Section 1033. Using the proceeds of this sale, Fifth/Arizona paid off mortgage indebtedness in the amount of $237,106 and made cash distributions to appellant of $93,054 in 2007.

3. Bayside Domination, LLC ("Bayside"), while having some common owners with TT5, is a California LLC owned, as of the beginning of the 2007 tax year, equally by Mr. Beitler (50 percent) and appellant (50 percent). During the 2007 tax year, Bayside sold certain real property under the threat or imminence of condemnation, to the City for approximately $3 million with an adjusted basis of $949,580. On its 2007 California tax return, Bayside did not recognize the resulting gain of $2.05 million under the provisions

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of Section 1033. Using the proceeds of this sale, Bayside paid off mortgage indebtedness in the amount of $1.5 million and made cash distributions to appellant of $68,620 in 2007.

4. By the end of the 2007 tax year, TT5, Fifth/Arizona, and Bayside were all owned by Mr. Beitler (66.67 percent) and appellant (33.33 percent).

5. In 2008, appellant also received three cash transfers totaling $1.6 million from TT5 that were not reported on his Schedule K-1 from TT5 nor on his 2008 individual California tax return. TT5 reported the transfers totaling $1.6 million as loans in its general ledger.

6. For all relevant tax years, each LLC was classified as a partnership for tax purposes.

7. For the 2007 tax year, appellant's outside basis in TT5 was zero, determined as follows:

Beginning capital 2007	-94,558
Share of TT5 debt	1,453,686
2007 beginning basis in TT5	1,359,128
2007 contributions to TT5	70,357
2007 income or loss of TT5	-105,526
Subtotal basis prior to distributions	1,323,959
Cash distributions in 2007	-2,115,405
Debt relief (deemed distributions)	-1,453,686
2007 distribution in excess of basis	-2,245,132
Ending outside basis	0

8. For the 2008 tax year, appellant's outside basis in TT5 was zero, determined as follows:

Beginning capital 2008	0
Share of TT5 debt	0
2008 beginning basis in TT5	0
2008 contributions to TT5	83
2008 income or loss of TT5	65,986
Subtotal basis prior to distributions	66,069
Cash distributions in 2008	-1,600,000
2008 distributions in excess of basis	-1,533,931

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Ending outside basis	0

9. For the 2007 tax year, appellant's outside basis in Fifth/Arizona was zero, determined as follows:

Beginning capital 2007	-83,907
Share of Fifth/Arizona debt	35,566
2007 beginning basis in Fifth/Arizona	-48,341
2007 contributions to Fifth/Arizona	94,705
2007 income or loss of Fifth/Arizona	-82,457
Subtotal basis prior to distributions	-36,093
Cash distributions in 2007	-93,054
Debt relief (deemed distributions)	-35,566
2007 distributions in excess of basis	-164,713
Ending outside basis	0

10. For the 2007 tax year, appellant's outside basis in Bayside was zero, determined as follows:

Beginning capital 2007	-91,409
Share of Bayside debt	750,000
2007 beginning basis in Bayside	658,591
2007 contributions to Bayside	5,250
2007 income or loss of Bayside	-87,545
Subtotal basis prior to distributions	576,296
Cash distributions in 2007	-68,620
Debt relief (deemed distributions)	-750,000
2007 distributions in excess of basis	-242,324
Ending outside basis	0

11. On October 20, 2017, Notices of Action (NOA) were issued, and based upon the basis determinations resulted in proposed additional tax of $228,520, plus applicable interest, for the 2007 tax year, and an additional tax of $156,878, plus applicable interest, for the 2008 tax year.

12. This timely appeal followed.

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DISCUSSION

Issue 1. In a Section 1033 transaction by a partnership, must appellant partner recognize gain resulting from distributions in excess of his basis in his partnership interest under Sections 731 and 752?

Section 1033(a) provides for the nonrecognition of gain where property has been involuntarily converted into money or unrelated property, and the taxpayer, within a certain period, acquires replacement property that is similar or related in service or use to the property so converted.[3] Condemned real property held for productive use in trade or business, or for investment, generally can be replaced by like-kind property, which is a less restrictive standard than the similar-use requirement for other involuntary conversions. (IRC, § 1033(g)(1); Regulation § 1.1033(g)-1(a); see also *Appeal of Estate of Howard W. Chase, et al*. (76-SBE-066) 1976 WL 4082.) A taxpayer must replace condemned real property held for productive use in trade or business, or for investment, within the period beginning with the condemnation and ending three years (two years if not condemnation of real property) after the close of the first taxable year in which any part of the gain is realized. (IRC, § 1033(g)(4).) In general, gain is realized as soon as the proceeds in excess of basis are received. (See *Wineberg v. Commissioner*, T.C. Memo. 1961-336, 1961 WL 4401.)

The application of Section 1033 rules to involuntary conversions of mortgaged property by individuals and corporations is relatively straightforward. However, the properties at issue were owned by LLC's taxable as partnerships so several partnership tax provisions are implicated in our analysis, including specifically Section 752(b).

Sections 752, 731 and 733 set forth the tax treatment of partnership distributions made to a partner, such as appellant.[4] Under Section 752(b), a decrease in a partner's share of partnership liabilities is treated as a distribution of money to that partner. Under Section 731(a)(1), nonliquidating distributions of money in excess of a partner's basis in the partnership interest will result in taxable gain to the partner. When partnership property is involuntarily converted and the partnership elects to defer recognition of gain under Section 1033, Sections 752 and 731

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[3] Section 1033 is generally incorporated into California law at R&TC section 18031.

[4] Sections 752, 731 and 733 are generally incorporated into California law at R&TC section 17851.

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also apply to determine a partner's individual tax consequences flowing from the transaction and from other partnership activity during the taxable year of the involuntary conversion.

Section 705(a) sets forth the rules for determining a partner's basis in a partnership interest. As relevant here, the rules provide that basis is equal to a partner's contribution to the partnership, plus taxable income, and less partnership losses and distributions from the partnership.[5] An alternative basis rule may be applied in unusual circumstances at the discretion of the Internal Revenue Service (IRS) commissioner under Regulation section 1.705-1(b).

In IRS Revenue Ruling (Rev. Rul.) 81-242, 1981-2 C.B. 147, mortgaged property owned by a partnership was involuntarily converted. The partnership elected to defer the recognition of gain until the property was replaced. Rev. Rul. 81-242 held that although gain was not recognized by the partnership in the year of the conversion, gain had to be recognized by each partner to the extent that the partner's proportionate share of the deemed distribution arising from payment of the mortgage exceeded the adjusted basis of the partner's interest in the partnership immediately before the deemed distribution. Rev. Rul. 81-242 reasoned that the decrease in liability on the condemnation was a deemed distribution of money to the partners and could not be netted against the subsequent increase in each partner's share of liability related to the replacement property because the involuntary conversion of the property and the later replacement of the property constituted two separate transactions.[6]

For each partnership (LLC) at issue, following the condemnation sales of the property in 2007, mortgage debt on each property was paid off, resulting in deemed distributions of money by reason of a reduction in appellant's share of partnership liabilities. (See IRC, § 752(b).) As of the end of 2007 and 2008, the record in this appeal reflects the acquisition of replacement property had not occurred.[7] To the extent Rev. Rul. 81-242 applies, such deemed distribution reduced appellant's basis in his three partnership interests, as did direct distributions of cash. Under Rev. Rul. 81-242, the increases in liabilities occurring on the purchase of the replacement

[5] Section 733 specifies a reduction in basis for partnership distributions of money.

[6] Rev. Rul. 2003-56, 2003-1 C.B. 985, cited by appellant, provides no relevant authority in this appeal in that it addresses only Section 1031 transactions. (See Regulation § 601.201 [the authority of a revenue ruling is limited to the facts and law relied upon].)

[7] Appellant has asserted that replacement property was acquired in 2011 and 2013 to complete the Section 1033 transaction.

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property is *not* netted against the reduction in liabilities occurring in connection with the condemnation because the condemnation and the replacement are separate transactions.

Appellant asserts[8] that the guidance provided in Rev. Rul. 81-242 is inconsistent with the policy underlying Section 1033, which allows, at the election of the partnership, nonrecognition of gain when partnership property is involuntarily converted. Further, appellant argues that the involuntary conversion of property, followed by an appropriate replacement within the meaning of Section 1033, should be considered a single transaction. Appellant reasons that they are for the purposes of determining basis and gain on the disposition of property, such that each partner may net the deemed distribution under Section 752(b) with the partner's share of any liability incurred by the partnership upon the acquisition of the replacement property under Regulation section 1.752-1(f). Alternatively, appellant argues that the property disposition and replacement transactions should be deemed a single transaction under a step-transaction theory. We disagree.[9]

Although Section 1033 addresses the partnership's nonrecognition treatment of gain regarding the involuntary conversion, it does not address the Section 752(b) issue. Under Section 752(b), a decrease in a partner's share of partnership liabilities is treated as a distribution of money to that partner. Under Section 731(a)(1), nonliquidating distributions of money in excess of a partner's basis in the partnership interest will result in taxable gain to the partner. When partnership property is involuntarily converted and the partnership elects to defer recognition of gain under Section 1033, Rev. Rul. 81-242 provides that gain may be recognized by the partner(s) individually, notwithstanding that the transaction qualifies as an involuntary conversion under Section 1033 to the partnership itself.

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[8] Appellant's appeal letter incorporates arguments contained in various articles, copies of which are attached as exhibits to appellant's appeal letter. For sake of brevity, we incorporate and summarize the relevant arguments as part of appellant's contentions on appeal.

[9] We acknowledge that after Rev. Rul. 81-242 was issued in 1981, the regulations were amended in 1991 to add Regulation section 1.752-1(f). This subsection provides that if, as a result of a *single* transaction, a partner incurs both an increase in the partner's share of partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership's liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership. We note, however, that Regulation section 1.752-1(f) only permits the netting of liabilities when they are part of the same transaction, and the examples reflect only simultaneous transactions, not when offsetting liabilities occur as a result of separate transactions. No authority has been cited, and we are aware of none, supporting the application of that regulation or the step-transaction doctrine to a Section 1033 transaction.

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For each of the three partnerships at issue, the decrease in partnership liability by payment of outstanding mortgage debt on the involuntary conversion was a deemed distribution of money to appellant and under the ruling cannot be netted against the subsequent increase in appellant's share of liability related to the replacement property because the involuntary conversion of the property and the later replacement of the property constitute two separate transactions. (Rev. Rul. 81-242.)

Appellant also asserts that after Rev. Rul. 81-242 was authored in 1981, the IRS issued Rev. Rul. 2003-56, which permits the netting of liabilities in a transaction under Section 1031. We note that the IRS based its decision in Rev. Rul. 2003-56 in part on Regulation section 1.1031(b)-1(c), which, as stated above, expressly provides for liability offset. Further, we note that Regulation section 1.1031(b)-1(c) was added to the Regulations in 1956, which was 25 years before Rev. Rul. 81-242 was adopted. Thus, when the IRS issued Rev. Rul. 81-242, the IRS knew of Regulation 1.1031(b)-1(c) but did not apply it to Section 1033. No similar regulation exists under Section 1033. In short, appellant fails to cite any authority that authorizes the offset of liability assumed and liability relief for purposes of determining the amount of money deemed received under Section 752 in a Section 1033 transaction by a partnership.

Finally, appellant makes a policy argument, contending that permitting the netting of liabilities under Section 1031, while disallowing liability netting under Section 1033, is "in error" and is inconsistent with the purpose of allowing deferral under Section 1033. In support, appellant notes that the authors of a leading treatise of the federal taxation partnerships state that "[i]t makes little sense for the [IRS] to grant deferral of a § 752(b) distribution of § 1031 exchanges, but not for § 1033 condemnations." (McKee, Nelson & Whitmore, *Federal Taxation of Partnerships and Partners* (4th ed. 2007 & Supp. 2016-1) ¶ 9.02(1)(c)(iii).) As additional support, appellant cites to an article written by FTB's counsel in this matter that argues the law should be changed to allow liability netting for partnerships under Section 1033. (Veronica Long, *Proposed Change To Allow Liability Netting For Partnerships Subject To Involuntary Conversion* (Ca. Tax Lawyer, October 2018, Vol. 27, No. 3).)

While one might agree the disparate treatment between two tax deferral provisions, Section 1031 and Section 1033, and even between partnership and individual transactions of the same type, present policy concerns, we note adequate differences in substance and purpose to warrant differences in tax consequences among the options available to a taxpayer. Because of

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the substantial time that partnerships have under Section 1033 to reinvest conversion proceeds, any attempt to maintain the partners' bases during the reinvestment period could have unintended consequences. For example, we note that the deadline for reinvestment of real property held for productive use in trade or business, or for investment, under Section 1033 is three years after the end of the tax year in which gain is first realized, which can be a considerably longer time than three years following a conversion because proceeds equal to adjusted basis generally must be received before the three-year deadline starts to run—and, furthermore, the deadline starts to run from the end of the tax year. (IRC, § 1033(a)(2), (g)(1) & (4).) In addition, taxpayers can obtain relief from the foregoing Section 1033 timing requirement on application to the IRS showing good cause. (IRC, § 1033(a)(2)(B)(ii); Regulation § 1.1033(a)-2(c)(3).) In comparison, Section 1031 imposes much more rigorous timing requirements—e.g., if replacement property is not acquired within the 45-day "identification period," a limited number of potential replacement properties must be identified within 45 days of the transfer of relinquished property and all replacement property must be acquired within 180 days of the transfer. (IRC, § 1031(a)(3).) Here, the long time periods that Section 1033 involuntary conversions can span might present significant administrative difficulties in accounting for a partner's basis during intervening years if liability netting were permitted. This is unlike a Section 1031 like-kind exchange, where an offsetting liability can only come from the same or next tax year.

Appellant next contends that disallowing partnership liability netting in involuntary conversions unfairly discriminates against partnerships. We note, however, that taxpayers are free to structure their business affairs in any manner they choose. In addition, appellant's assertion in this respect appears to be a constitutional issue, which cannot be ruled upon by the Office of Tax Appeals. (See *Appeals of Bailey* (92-SBE-001) 1992 WL 44503.)

The principal issue in this appeal appears to have no judicial history. The only interpretive authority on the subject that we are aware of is Rev. Rul. 81-242.[10] It is well settled that where

[10] Both Rev. Rul. 81-242 and Rev. Rul. 2003-56 have been in effect and remain unchanged for many years. Appellant suggested at the oral hearing that no cases have been decided on the issue before us because the IRS has abandoned the rule and does not enforce it. We find it more probable that since the results in this case are avoidable with adequate planning, taxpayers likely do not engage in such transactions. In any event, the Ninth Circuit Court of Appeals has, in appropriate circumstances, granted deference to IRS revenue rulings. We find the circumstances here are appropriate for us to grant such deference to Rev. Rul. 81-242. (See *Sewards v. Commissioner* (9th Cir. 2015) 785 F.3d 1331.)

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federal law and California law are the same, federal rulings and regulations dealing with the IRC are persuasive authority in interpreting the applicable California statute. (See *J.H. McKnight Ranch v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, fn. 1, citing *Calhoun v. Franchise Tax Bd.* (1978) 20 Cal.3d 881, 884.) Since California tax law conforms to the provisions at issue in Rev. Rul. 81-242, we opt to follow that interpretation. Accordingly, we find that appellant must be treated as realizing a cash distribution equal to his share of partnership mortgage liabilities paid off following the condemnation sales in 2007 and recognize any resulting gain from 2007 distributions.

In summary, appellant, a member of three LLCs that are taxable as partnerships, must recognize gain when mortgaged real property owned by the LLCs is involuntarily converted, even though the LLCs elected to defer the recognition of gain under Section 1033.

Issue 2. Given our finding above, is the partner tax liability an offset to the amount of partnership mortgage liability relieved?

Having found that appellant must recognize gain, we next determine the extent to which a partner tax liability resulting from the three partnerships' deferred Section 1033 gain may be netted against the mortgage liability in determining the deemed distribution to appellant.

Appellant contends that the deferred gain and resulting potential tax liability under Section 1033 constitutes a liability under Regulation section 1.752-1(a)(4)(i)[11] that can be netted against the amount of mortgage debt paid off by the partnership. We disagree.

Quite simply, as argued by FTB, obligations of a partnership addressed by the cited regulation only include "liabilities." If a tax obligation arises as a result of the Section 1033 transaction (and in this appeal, it was acknowledged that replacement property was timely acquired by the partnership after the appeal years), it would be an obligation of the partnership to report it, but not a liability of the partnership. Thus, there is no identified liability of the partnership to offset the mortgage debt, and no error in FTB's determination on this issue.

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[11] Regulation section 1.752-1(a)(4)(i) provides that a liability under Section 752 arises "only if, when and to the extent that incurring the obligations -

(A) Creates or increases the basis of any of the obligor's assets (including cash);
(B) Gives rise to an immediate deduction to the obligor; or
(C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital."

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Issue 3. If gain is recognized, has appellant established error in FTB's computation of appellant's basis in his partnership interest?

Appellant submitted alternative calculations representing adjustments to FTB's determination, as reflected in the factual findings above, of appellant's basis in his partnership interests for 2007 and 2008. Substantive items of difference include the following: (1) whether the deferred gain amounts should be deemed taxable income and thus increase appellant's basis in his partnership interests under Section 705(a); (2) whether the cash received by the partnership upon the condemnation sale closing creates additional basis for a partner; (3) whether the alternative basis rule under Section 705(b) should be applied to determine appellant's basis; and (4) whether the distributions to appellant in 2007 and 2008 were loans as opposed to distributions (an issue we discuss and resolve below).

As to whether the deferred gain should increase appellant's basis in his partnership interests under Section 705(a), we find the position inconsistent with controlling law. Appellant argues that since the Section 1033 transaction was not completed by the end of 2007 or 2008, the income realized on the sale is not recognized as taxable income but should nonetheless be considered taxable pending the completion of the exchange. Section 705(a) clearly identifies taxable income as the item that increases a partner's basis in the partnership interest. Appellant cites no authority supporting his position that the realized but unrecognized income arising under Section 1033 can be viewed as taxable income, and we are aware of none. Accordingly, we find that FTB did not err in omitting the deferred gain from appellant's basis determination.

Appellant also argues that since each partnership received unrestricted cash proceeds for the involuntary conversion transaction, each member's share of that cash increased the partner's basis in his interest. While a partnership has an inside basis in its assets that may impact a partner's capital account, changes in value or additions to those assets do not impact a partner's outside basis in the partnership interest. Only those items specified in Section 705(a) impact outside basis. Cash inflow that does not represent taxable income or tax-exempt income is not an item identified in Section 705(a) as impacting basis. Accordingly, we find that FTB did not err in omitting the cash from appellant's basis determination.

Regulation section 1.705-1(b) provides that, in certain cases, the adjusted basis of a partner's interest in a partnership may be determined by reference to the partner's share of the adjusted basis of the partnership property which would be distributable upon termination of the

partnership. The use of this alternative is restricted to situations where it is impractical to apply the general rule or where, in the opinion of the IRS Commissioner, it is reasonable to conclude that the results produced will not vary substantially from the result obtainable under the general rule. The facts presented in this appeal do not demonstrate any impracticality to the application of the general rule, and as proposed by appellant, the result would substantially vary from that obtained by application of the general rule. Accordingly, we find no authoritative basis to apply an alternative basis rule in this appeal.

In summary, we find that appellant has not established error in FTB's determination of appellant's basis in each of the three partnerships for 2007 or 2008.

Issue 4. Were the distributions by the partnership to appellant in 2008 made as a partner loan or as partnership distributions subject to Section 731?

As stated above, under Section 731(a)(1), nonliquidating distributions of money in excess of a partner's basis in the partnership interest will result in taxable gain to the partner. However, a loan by a partnership to a partner is not a distribution under Section 731, if, at the time the funds are transferred, the partner is under an obligation to repay the funds at a fixed date. (Regulation § 1.731-1(c)(2).) To determine whether a loan existed, courts generally consider the following non-exclusive objective factors: (1) whether the promise to repay is evidenced by a note or other instrument; (2) whether interest was charged; (3) whether there was a fixed schedule of repayments; (4) whether there was collateral; (5) whether repayments were made; (6) whether the borrower had a reasonable prospect of repayment and the lender had sufficient funds to transfer; and (7) whether the parties conducted themselves as if the transaction were a loan. (*Welch v. Commissioner* (9th Cir. 2000) 204 F.3d 1228; see also *Alterman Foods, Inc. v. United States* (5th Cir. 1979) 505 F.2d 873.) In the case of a transfer by a partnership to a partner, there will only be a loan where the partner is "under an unconditional and legally enforceable obligation to repay a sum at a certain determination date . . . at the time of the withdrawal of funds from the partnership." (Rev. Rul. 73-301, 1973-2 C.B. 215.) Transfers between related parties are examined with special scrutiny. (*Hubert Enterprises, Inc. v. Commissioner* (2005) 125 T.C. 72.)

Late in the appeal process, appellant presented a copy of an agreement dated August 31, 2007 (agreement), asserting that its terms establish that the formalities of a loan were observed

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and that appellant was under a legally enforceable obligation to repay the funds transferred to him in 2007 and 2008[12]. As such, the agreement is allegedly a de facto debt instrument.

Originally, no such documentation was provided during the course of FTB's examination and appellant's protest. Accordingly, FTB understandably viewed the distribution as taxable and not as a loan given the lack of substantiation. FTB replies to these new assertions regarding the agreement by noting that the advances were to carry no interest, had no fixed time for repayment,[13] and were in fact never repaid even though replacement property was subsequently acquired. We note that the completion of the Section 1033 transaction ended appellant's obligation to "replenish" partnership funds and thus terminated any obligation to repay the purported loan. Therefore, FTB reasserted its position that the distribution was a taxable event as no bona fide loan was created.

While the agreement entered into evidence is very difficult to read, we observe some additional terms that we can decipher.[14] The agreement calls for the deposit of net sale proceeds of the partnerships in "Mediation Accounts" (collectively designated the Mediation Account) held in each partnership name. Terms allow appellant to "draw upon the Mediation Account for any reason and provide that upon a request, a jointly signed check shall be delivered within 24 hours without condition or delay." We view these terms as negating any intention that the draws needed to be repaid. Further, the terms of a bona fide debt obligation must be unconditional, for a fixed sum, and repayable on a date certain. (See Rev. Rul. 73-301, *supra*.). Here, the draws are made without conditions, have no fixed sum identified, and are only contingently subject to "replenish[ment]." Accordingly, we find that no bona fide debt was created by either distribution made in 2007 or 2008.

HOLDINGS

1. Appellant must recognize gain resulting from distributions in excess of his basis in his partnership interest under Sections 731 and 752 in tax years 2007 and 2008.

[12] The issue for the 2008 tax year arises from a 2008 distribution from TT5. Appellant does assert, in the basis computations provided in rebuttal of FTB's basis determination, that the 2007 distributions were also loans.

[13] The agreement provides that in the event the parties do elect to complete the Section 1033 exchange and there are insufficient funds in the partnership accounts to acquire replacement property selected, each partner shall replenish the respective account pro rata based on their percentage ownership.

[14] At the appeal hearing, appellant presented a legible, prepared summary of certain terms in the agreement. We find that summary consistent with the copy of the original agreement.

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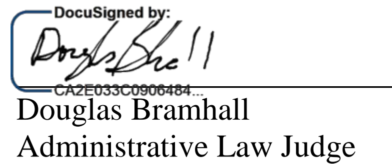
2. Appellant's deferred tax liability may not offset the amount of partnership mortgage liability relieved.
3. Appellant has not established error in FTB's computation of appellant's basis in his partnership interests for 2007 or 2008.
4. The distributions by the partnership in 2008 were not loans to appellant, but were partnership distributions subject to Section 731.

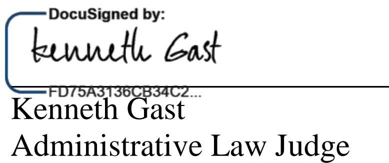
DISPOSITION

FTB's actions in denying appellant's protest of proposed assessments for tax years 2007 and 2008 are sustained.

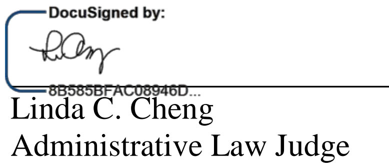


Douglas Bramhall
Administrative Law Judge

We concur:



Kenneth Gast
Administrative Law Judge



Linda C. Cheng
Administrative Law Judge