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2018 – OTA – 210
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18011715
SHARON MITCHELL	) Date Issued: August 2, 2018

OPINION

Representing the Parties:

For Appellant:	Christina Weed, Esq. Lisa Mendez, Esq.
For Respondent:	David Gemmingen, Attorney IV Ciro Immordino, Attorney IV Michael Cornez, Attorney V
For Office of Tax Appeals:	Tom Hudson, Tax Counsel III

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (RTC) section 19045, Sharon Mitchell (appellant) appeals an action by the Franchise Tax Board (FTB) determining $60,209 of additional tax and applicable interest for the 2007 tax year.

Office of Tax Appeals Administrative Law Judges Teresa A. Stanley, Alberto T. Rosas, and Michael F. Geary held an oral hearing in this matter on April 24, 2018. When the hearing concluded, OTA closed the record and took the matter under submission.

SUMMARY

Appellant held an interest in a general partnership (Con-Med), which owned one piece of land with a building located at 130 Tampico Way, Walnut Creek, California (the Property). Con-Med decided to sell its only holding and dissolve. Most of the partners wanted to cash out their investment, but two, appellant and her mother, wanted to keep their investment in real estate through a like-kind exchange under Internal Revenue Code (IRC) section 1031 (1031 exchange). To meet the diverse needs of the partners, arrangements were made for a sale of the Property, and Con-Med redeemed the partnership interests of those who wanted to remain

invested, distributing to them undivided tenant-in-common (TIC) interests in the Property. Those former partners later sold their interests when Con-Med sold its interest in the Property. Acting through a qualified exchange intermediary, appellant then reinvested the proceeds from the sale into like-kind property located in or near Sedona, Arizona. We hold that appellant's exchange was a valid 1031 exchange, which entitled her to defer the recognition of taxable gain.

ISSUE

Did appellant complete a 1031 exchange?[1]

FACTUAL FINDINGS

1. In 1991, appellant inherited a 10-percent interest in Con-Med, a general real estate partnership. There were between 15 and 17 partners in Con-Med during the relevant time. The Property was Con-Med's only holding.
2. The "Second Amended and Restated Partnership Agreement," as amended by a first amendment, (partnership agreement) was in effect at the time of the transactions at issue and it included the following provisions:
    a) The purpose of the partnership was to operate, lease and sell, transfer or exchange the Property. (Article II, para. 4.)
    b) The vote or agreement of a majority in interest of the partners was required to sell or exchange. (Article VI, para. 17.a.(4).)
    c) Con-Med operated on a cash basis. (Article VIII, para. 24.)
    d) The sale or other disposition of substantially all of the partnership's assets and the receipt in cash of the proceeds of the sale required dissolution of Con-Med and the wind-up of its affairs. (Article X, para. 42.b.)
    e) The managing partner had the exclusive authority to wind up the partnership's affairs and distribute its assets and to take any action authorized by law to do those things. (Article X, para. 43.b.)
3. According to an August 29, 1990 letter to Caroline Mitchell (appellant's mother) from a representative of the lessee of the Property, PTLA, Inc. (PTLA or lessee) proposed to

[1] The parties also presented argument and evidence on a second, contingent issue: if we found that appellant did not complete a 1031 exchange, we were to determine the correct basis for calculating her gain. Because we find, below, that appellant did complete a 1031 exchange, we need not address that issue.

either purchase the Property or restructure the ownership to include the lessee. The letter stated, in part, "we could collectively consider a [1031] exchange rather than a sale. An exchange would allow those of us that wish to defer capital gains taxes to do so. Those that want to be 'cashed out' would be free to do so[;] however[,] they would be responsible for capital gains tax on their interest."

4. According to a December 7, 2004 email from managing partner Mr. Tom Milner to the other Con-Med partners, Caroline Mitchell became a member of the executive board of Con-Med on or about that date.

5. According to Mr. Milner's declaration under penalty of perjury, Con-Med recognized by 2005 that it would probably have to sell the Property and that Con-Med would need a plan to accommodate partners who wanted to continue their investment in like-kind property, as well as those who wanted to cash out their investment.

6. In a July 22, 2005 email, Mr. Milner advised other Con-Med partners that there had been inquiries from at least one partner, Caroline Mitchell, regarding the procedure for structuring any sale to facilitate a valid 1031 exchange. Mr. Milner stated in the email that, if Con-Med sold the Property, some partners may cash out while others may choose to exchange their interests under IRC section 1031, and he concluded the email by stating, ". . . I will make sure that our lawyer, Richard Goodman, has us set up the mechanism correctly for any partners that wish to do a '1031 exchange' of the property."

7. Mr. Milner's July 27, 2005 email to Mr. Goodman stated that a number of the partners, particularly appellant and her mother, wanted to have their share of the sale proceeds deposited into an "exchange account." It also indicated that Mr. Goodman had previously indicated that "exchanging some partners into a new partnership while 'cashing out' others would be difficult."

8. On or about December 20, 2006, PTLA made an offer to Con-Med to buy the Property for $6 million. The offer indicates that the parties would cooperate if either party elected to do a 1031 exchange.

9. In a January 5, 2007 email, Mr. Milner confirmed an earlier telephone conference with the Con-Med partners, during which they had discussed the pending offer. Among other things, the email states that as many as three partners wanted to structure the transaction to allow them to complete a 1031 exchange of their respective partnership interests, and

that there was some concern that breaking up the partnership before close of escrow might allow one of the partners to prevent completion of the sale.

10. Con-Med's February 6, 2007 counteroffer priced the Property at $6.4 million.
11. PTLA's February 26, 2007 counteroffer included a modification to allow either party an option to extend the escrow for up to 60 days to facilitate a 1031 exchange. Con-Med accepted this counteroffer.
12. Mr. Milner's March 2, 2007 email to the Con-Med partners stated he accepted the last counteroffer, and explained there were several contingencies, including approval by the Con-Med partners by March 21, 2007. The email also stated that the August 31, 2007 escrow close date could be extended to facilitate a 1031 exchange, and that, if Con-Med's accountants approved, Mr. Milner would adopt a second amendment to the partnership agreement that would require dissolution of the partnership and distribution to the partners of undivided interests in the Property before the close of escrow.
13. A November 17, 2007 "Agreement of Redemption of Partnership Interests" (redemption agreement) states Con-Med authorized its managing partner to redeem appellant's and her mother's interests in Con-Med. Appellant was to relinquish her 10-percent interest in Con-Med and receive in return a 10-percent interest in the Property and $2,000 cash. Appellant's mother was to relinquish her 8-percent interest in Con-Med and receive in return an 8-percent interest in the Property and $1,600 cash.[2] In its acknowledgment of the Con-Med partnership agreement and amendment then in effect, the redemption agreement makes no reference to a second amendment to the partnership agreement (which would have required the dissolution of Con-Med prior to the close of escrow).
14. On November 20, 2007, Mr. Milner executed[3] a grant deed to transfer the undivided TIC interests in the Property to appellant and her mother as trustees of their respective revocable trusts.[4]
15. Pursuant to an "Exchange Agreement" and an "Assignment Agreement" dated November 26, 2007, and signed by appellant on November 28, 2007, First American Exchange

[2] The interests in the Property distributed to appellant and her mother were undivided interests as tenants-in-common (with each other and Con-Med).

[3] A notary public acknowledged Mr. Milner's signature on November 27, 2007.

[4] Later references will not indicate appellant's or her mother's status as trustee.

Company (American Exchange) assumed the role of qualified intermediary to provide exchange services and facilitate appellant's 1031 exchange. On November 28, 2007, PTLA, as general partner of Tampico Investors, LP (Tampico), acknowledged receipt of a copy of the Assignment Agreement.

16. Con-Med's grant deed to appellant and her mother was recorded on November 29, 2007.
17. On November 28, 2007, Con-Med, appellant, and her mother executed a grant deed to transfer a 19.7297-percent interest in the Property to Tampico, and an 80.2703-percent interest in the Property to Meadows Investors, LLC (Meadows).[5] This deed was recorded on November 30, 2007.
18. First American Title Insurance Company (the title company) provided escrow services to Con-Med, Caroline Mitchell, and appellant (collectively, the sellers), and to Tampico and Meadows (collectively, the buyers) in connection with the planned sale and exchange of the Property.
19. Mr. Goodman provided legal advice to the sellers regarding escrow and exchange services and 1031 exchange procedures.
20. The title company disbursed 10-percent of the net proceeds from the sale of the Property to American Exchange for the benefit of appellant. American Exchange deposited the funds into appellant's exchange account.
21. According to appellant's May 5, 2008 statement of account from American Exchange, the replacement property for the exchange was identified on January 1, 2008, and the purchase of that property was concluded by May 5, 2008.
22. On March 22, 2012, FTB issued a Notice of Proposed Assessment (NPA) to appellant. The notice informed appellant that, in FTB's view, the transaction at issue did not qualify as a 1031 exchange, that appellant's gain from Con-Med's sale of the Property must be recognized in 2007, that the gain further limited appellant's itemized deductions to the extent they no longer exceeded two percent of appellant's adjusted gross income, and that additional tax ($60,209), and interest, were due.
23. Appellant filed a timely protest of the NPA. On February 13, 2014, FTB issued appellant a Notice of Action affirming its determination. This timely appeal followed.

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[5] Evidence does not establish the relationship, if there was one, between Meadows and PTLA.

DISCUSSION

Did appellant complete a 1031 exchange?

As relevant to the issues presented here, IRC section 1031 allows the nonrecognition of gain or loss on the exchange of property held for investment or for productive use in a trade or business (relinquished property) for like-kind property held for the same purpose (replacement property). (IRC, § 1031(a)(1).)[6] The rationale for not recognizing gain or loss – for not viewing the exchange as a taxable event – is that the taxpayer is in the same economic position before and after the exchange; in other words, the taxpayer remains invested in the same kind of property. (*Magneson v. Commissioner* (9th Cir. 1985) 753 F.2d 1490, 1494 (*Magneson*); *Maloney v. Commissioner* (1989) 93 T.C. 89, 95-99 (*Maloney*); *Appeal of Rago Development, et al.* 2015-SBE-001, June 23, 2015.)[7] "[T]he courts have permitted taxpayers great latitude in structuring transactions[, and] . . . it is immaterial that the exchange was motivated by a wish to reduce taxes." (*Biggs v. Commissioner* (1978) 69 T.C. 905, 913-914, affd. (5th Cir. 1980) 632 F.2d 1171 (*Biggs*); See generally *Estate of Bartell v. Commissioner* (2016) 147 T.C. 140, 161-176[8] (*Bartell*) [in depth discussion of the requirements for a 1031 exchange].)

FTB argues that the transactions at issue did not satisfy the "exchange" requirement of section 1031 because appellant did not sell the Property. It contends Con-Med sold the Property.[9] In this regard, FTB contends that the tax consequences of the subject transaction should be determined by substance rather than form, by considering a series of interrelated transactions as component parts of an overall plan rather than by viewing each of them

[6] As relevant here, California conforms to IRC section 1031(a)(1).

[7] Precedential decisions of the State Board of Equalization (BOE) are viewable on the BOE website: http://www.boe.ca.gov/legal/legalopcont.htm.

[8] The Internal Revenue Service has issued an Action on Decision, indicating it does not agree with *Bartell* and will not follow it to the extent it holds that taxpayers that use accommodating parties outside the scope of Revenue Procedure 2000-37 have engaged in a 1031 exchange even if the taxpayer, rather than the accommodating party, acquires the benefits and burdens of ownership of the replacement property before the taxpayer transfers the relinquished property. (Action on Decision 2017-33 (Aug. 14, 2017) [2017 WL 3880328].) Here, the replacement property was not acquired before appellant transferred the relinquished property.

[9] FTB had previously argued that appellant also did not hold the Property for investment because Con-Med held appellant's interest during almost all of the time prior to the exchange, and she acquired her interest solely for the purpose of almost immediately transferring that interest to another person. It appears FTB has since abandoned this argument.

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separately.[10] FTB argues that the sale of the Property was negotiated entirely by Con-Med and that appellant held title to her 10-percent interest for a short time, during which she had none of the risks or benefits of direct ownership. It urges us to view appellant's redemption as an attempt by appellant to improperly delay recognition of substantial gain by merely acting as a conduit through which title passed from Con-Med to the buyers. FTB also contends that Con-Med's transfer of the 10-percent interest in the Property to appellant was an anticipatory assignment of Con-Med's income, which requires that we attribute all income from the sale to Con-Med.

Appellant argues that the subject transactions satisfied all requirements for a 1031 exchange. She alleges that she owned an interest in the Property, which she held for investment, and exchanged that interest for like-kind property, which she has since held for investment. Appellant further contends that her exchange precisely fits the rationale for allowing tax-deferred exchanges in that she did not cash out her investment in the Property, but rather, she remained in the same economic position (invested in real property) before and after the exchange. Appellant states that, due in large part to the knowledge and advocacy of her mother, Con-Med gave all partners an opportunity to structure the transaction to allow a valid 1031 exchange. Appellant acknowledges that she did not personally negotiate the sale or exchange of the Property. However, she argues there is no requirement that she do so, and she asserts that her mother, who shared appellant's interest in completing a 1031 exchange and had the authority to negotiate on appellant's behalf, was involved in the negotiations and was instrumental in negotiating an exchange option for the Con-Med partners.[11]

The evidence shows that appellant continuously held an interest in the Property for investment purposes and exchanged that interest for an interest in like-kind property. She held her general partnership interest in the Property for investment from 1991 until November 27, 2007, when Con-Med deeded the 10-percent interest in the Property to her. She held her TIC interest in the Property until she transferred it to the buyers. The fact that the form of her ownership changed, from owning the property through her general partnership interest to owning it directly, is of no real significance here. (See *Magneson*, *supra*, 753 F.2d, at pp. 1494-1495

[10] When applicable, this "step-transaction doctrine" requires that we base our findings regarding tax liabilityon a realistic view of the entire transaction, rather than on the integrated yet distinct steps of that transaction. (*Commissioner v. Clark* (1989) 489 U.S. 726, 738.)

[11] Appellant testified that she had given her mother a durable power-of-attorney, but she did not provide a copy. We make no finding regarding whether appellant's mother had appellant's power-of-attorney.

[holding that the contribution of the replacement property to a partnership in exchange for a general partnership interest was a continuation of the taxpayer's investment, unliquidated but in a modified form].) And, the fact that she held her TIC interest with the intent to exchange it for like-kind property is also immaterial. (See *Bolker v. Commissioner* (9th Cir. 1985) 760 F.2d 1039, 1045 (*Bolker*).) Finally, appellant transferred her entire investment in the Property to a qualified intermediary, which exchanged that investment for another, like-kind investment property. We find these actions met the requirements of section 1031.[12]

FTB does not appear to dispute that the various steps appellant and her partners took to transfer the Property met the requirements of section 1031. Rather, it urges us to look beyond the mere form, and to the substance of the transaction, which, FTB argues, was Con-Med's sale of the property. More precisely, it urges us to apply the step-transaction doctrine, examine the series of integrated transactions as a whole, and ignore the redemption and the transfers from Con-Med to appellant and from appellant to the buyers (the redemption and transfer process). FTB argues we should find that Con-Med sold 100 percent of the Property and, consequently, appellant's gain should be subject to tax because she did not exchange the Property; she was simply the recipient of cash from Con-Med's sale of the property. Consideration of this argument requires that we examine the history of appellant's investment.

The evidence establishes that as early as 1990, Caroline Mitchell and PTLA were discussing a 1031 exchange as a choice for the Con-Med partners. Some partners wanted to cash out their investment, while other partners wanted to remain invested in real estate. As a result, the Con-Med partners needed a plan to accommodate their varying investment goals. There were several instances during 2005 through 2007 where Tom Milner acknowledged a need for a plan that would allow Con-Med partners a 1031 exchange option, including one when he stated that he would make sure that Con-Med's lawyer correctly set up a mechanism for a 1031 exchange. The mechanism that the Con-Med partners decided upon was the redemption and transfer process. The partners who wanted to continue their investment in real estate would redeem their partnership interests for undivided TIC interests in the Property, and would join

[12] Con-Med's $2,000 cash payment to appellant was simply the balance of cash value in her capital account.

with Con-Med to transfer the Property to the buyers, using qualified intermediaries to complete a 1031 exchange.

We find nothing in section 1031, its implementing regulations, or the partnership agreement that prohibited Con-Med from redeeming a partner's share as part of a plan to facilitate a 1031 exchange. The redemption of 18 percent of the partnership shares (10 percent for appellant and 8 percent for Caroline Mitchell) was not a disposition of "substantially all of [Con-Med's] assets" that would have triggered a mandatory dissolution of Con-Med under Article X, para. 42.b, of the partnership agreement. However, it is clear from the evidence, and no one really disputes the fact, that the redemption was part of the plan to dispose of the Property and eventually dissolve the partnership and wind up its affairs. The redemption was the only reasonable way for Con-Med to dispose of its only asset while accommodating its partners' desires to either cash out or continue their investment in real estate. Mr. Milner had the authority under Article X, Paragraph 43.b. to take any action authorized by law to dissolve the partnership and wind up its affairs. The redemption and transfer process was within that authority.

The redemption was not complete until Con-Med transferred the undivided 10-percent interest in the Property to appellant. We see no legal obstacle to a transfer concurrent with the redemption agreement. However, Con-Med waited until November 27, 2007, or later to deliver the grant deed.[13] The evidence indicates the delay may have been to ease the concerns of the Con-Med partners who planned to cash out and were worried about appellant or her mother preventing completion of the deal. Regardless, execution of the grant deed was within Mr. Milner's authority as the managing partner, and the evidence shows the transfer was valid. Once this step was complete, only appellant could transfer her 10-percent interest in the Property.

Appellant held her interest in the Property until November 28, 2007, when the sellers executed the grant deeds to the buyers. According to FTB, this is the time during which appellant acted as a "mere conduit" for the passage of title from Con-Med to the buyers. But the grant deed from Con-Med to appellant was valid on its face, and it is prima facie evidence that appellant held title to a 10-percent interest in the Property for that brief period. The County Clerk recorded the grant deed on November 29, 2007, to update the chain of title.[14] FTB does

[13] The evidence does not show when Con-Med delivered the grant deed to appellant. The notary public did not acknowledge Mr. Milner's signature until November 27, 2007, and we infer from this that the deed was delivered that day or the next.

[14] A chain of title is the sequence of historical transfers of title to a property.

not argue otherwise. Instead, FTB argues, in effect, that the brief period of ownership is reason to ignore the transfer from Con-Med to appellant. We disagree.

Section 1031 does not require ownership of the relinquished property for any particular period of time, and 1031 exchanges have involved situations where title to the replacement property was held only briefly and only for the exchange. (See, e.g., *Alderson v. Commissioner* (9th Cir. 1963) 317 F.2d 790 (*Alderson*); *Barker v. Commissioner* (1980) 74 T.C. 555 (*Barker*); *Appeal of Continental Desert Properties, Inc.* 85-SBE-114, Oct. 9, 1985; *Mercantile Trust Co. of Baltimore v. Commissioner* (1935) 32 B.T.A. 82 (*Mercantile Trust*).) Furthermore, the courts have allowed simultaneous or immediate transfers of the replacement property following an exchange (see *Magneson*, *supra*; *Department of Revenue v. Marks* (Or. T.C. 2009) 20 OTR 35, 2009 WL 3617493), and the tax court has observed that, "A trade of property A for property B, both of like kind, may be preceded by a tax-free acquisition of property A at the front end, or succeeded by a tax-free transfer of property B at the back end." (*Maloney*, *supra*, 93 T.C., at p. 98.) FTB has cited no authority for the proposition that such title must be held for more than one day, or for any specific time period.

Commenting on the analysis by U.S. Board of Tax Appeals in the *Mercantile Trust* case, *supra*, the Ninth Circuit observed, with apparent approval, that "The *Mercantile* [*Trust*] case appears to hold that one need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title <u>solely for the purpose of exchange</u> and accept title and transfer it in exchange for other like property, all as a part of the same transaction with no resulting gain . . . ." (*Alderson*, *supra*, 317 F.2d at p. 795 [emphasis added].) As noted by the tax court in *Barker*, courts have generally shown an awareness of business and economic necessities when examining a 1031 exchange. (*Barker*, *supra*, 74 T.C. at pp. 562-563.) It was such business and economic necessities that caused appellant's exchange to be executed how and when it was.

The evidence shows that appellant obtained the TIC interest late in the process due primarily to the diverse plans the partners had for the proceeds of their respective investments, rather than due to any intent to avoid tax. Mr. Milner's January 5, 2007 email shows there were only a few partners who were interested in a 1031 exchange (exchanging partners), and at least some of the other 14 or more partners (cashing-out partners) expressed concerns about the risks of deeding interests to the exchanging partners before the close of escrow. The cashing-out

partners were worried that one of the exchanging partners could block the sale. If most of the Con-Med partners were worried about deeding interests in the property to two or three partners, they would have been even more reluctant to dissolve the partnership and distribute 17 interests in the Property before escrow closed. It is likely that the timing of the process was also based on other practical concerns. Con-Med functioned primarily through one person, Mr. Milner. Each redemption of a partnership share and distribution of a property interest would have further complicated management of the property. Therefore, valid business reasons appear to have prompted a redemption later in the process, instead of when the intent to exchange was first expressed years earlier.

FTB's reliance on Con-Med's role in the negotiations for the "sale" of the Property is misplaced. Con-Med's representative negotiated the sale *or exchange* of the property on behalf of its 17 partners. The fact that only Con-Med's name appears on counteroffers is simply a reflection of the state of the title to the Property at the time. The plan by some partners to do 1031 exchanges was known to all from the beginning, and everyone knew that the transfer of the Property may involve procedures and documents to allow the exchanges to occur.

We see no reason to ignore any step in the series of integrated transactions that resulted in appellant's exchange of the Property. FTB views the true nature of the transaction to be Con-Med's sale of the Property. But that view is incomplete. The evidence shows that the true nature of the transaction was never an outright sale by Con-Med. Appellant and her mother, at least, never wanted to cash out their investment in the Property. They wanted to remain invested in like-kind property and, with the cooperation of their partners, the buyers, and others, and careful planning, they were able to accomplish that legitimate goal. None of the steps we discuss above were meaningless, and, as already stated, each was necessary and had economic substance. In the end, every participant obtained what they wanted: Con-Med in fact dissolved, and those partners who chose to cash out presumably paid tax on their gains; the buyers purchased the Property; and appellant remained (and still remains) invested in like-kind property. We find that the circumstances do not require application of the step-transaction doctrine.

The cases on which FTB relies are distinguishable on their facts. *Commissioner of Internal Revenue v. Court Holding Co.* (1945) 324 U.S. 331 (*Court Holding*), which was not a section 1031 case, involved a corporation that owned apartments and negotiated a sale to a group of related buyers (the lessees and their sister and brother-in-law). There was an oral agreement

on the terms of the sale, but the corporation declined to reduce the agreement to writing when it realized it would owe substantial capital gains tax if the sale by the corporation was completed.[15] Instead of completing the sale, the corporation declared a "liquidating dividend" that resulted in the transfer of the apartments to the shareholders who then completed a sale to the lessees' sister on substantially the same terms. The tax court concluded that the liquidating dividend and transfer of the property were "mere formalities designed 'to make the transaction appear to be other than what it was'" for the sole purpose of avoiding the tax. (*Id*. at p. 333.) With one of three judges dissenting, the circuit court of appeals disagreed, "drawing different inferences from the record," and finding that the corporation's sale of the property had been called off, that there was no binding agreement by the corporation to sell the property, and that the sale by the former shareholders was a different transaction. (*Ibid*.) The Supreme Court reversed, and summarized the basis for the reversal as follows: "There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. [Citations omitted.] On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation." (*Id*. at pp. 333-334.)

That evidence before that tax court revealed circumstances far different than those presented here. In *Court Holding Co. v. Commissioner* (1943) 2 T.C. 531, the sole shareholders of a corporation orally agreed on behalf of the corporation to sell the property but at the last minute refused to sign a binding written contract of sale, not because they did not want the sale to happen on the agreed-upon terms, but because they wanted to permanently avoid substantial corporate income tax on the gain. There was evidence before the tax court of the shareholders' failure to observe corporate formalities. They intermingled funds, failed to maintain adequate business records, and accepted payments to the corporation as if they had been made to them as individuals. They also delayed corporate dissolution, apparently for the sole purpose of insulating the property from possible claims by their personal creditors. In essence, the tax court concluded that the corporate liquidation was designed to make a sale by the corporation to the buyers appear to be a sale by the former shareholders to the buyers, and it determined that the

[15] As noted by the court, the corporation's gains on the sale would have been taxable to it as ordinary income, but the corporation would have realized no taxable gain distributing its assets to the shareholders in partial or in complete liquidation, regardless of how much they may have appreciated in value since the corporation acquired them. (*Court Holding*, *supra*, 324 U.S. at p. 333, fn. 3.)

liquidating dividend was a sham to avoid corporate income tax, and on that basis upheld the assessment on the corporation.

The case before us does not involve a sham transaction or an attempt to improperly avoid taxes. It does not involve taxpayers who paid little attention to the formalities of corporate existence or record-keeping requirements. It involves the use of a series of reasonable, necessary, and integrated transactions to delay, not avoid, the recognition of gain, which section 1031 allows. There was no last-minute decision to change the parties to the sale. The sellers and buyers always understood that a 1031 exchange option was on the table.[16]

Kimbell-Diamond Milling Company (1950) 14 T.C. 74 (*Kimbell-Diamond*) is also not controlling here. There, Corporation A wanted to acquire the assets of Corporation B. Rather than buying the assets, Corporation A purchased all outstanding shares of Corporation B and immediately liquidated Corporation B to acquire its assets. The plan was to avoid taxes by disguising the nature and purpose of a series of transactions. As we state above, appellant was not trying to avoid taxes.[17] She simply wanted to remain invested in like-kind property, an activity encouraged by the delayed recognition of gain allowed by section 1031. However, because all Con-Med partners did not share her goal – some wanted to cash out their investment – the partnership and the partners used a series of integrated transactions to accomplish their diverse and legitimate goals. In *Kimbell-Diamond*, the form of the taxpayer's transaction was not compelled by business considerations and did not serve the purpose of the relevant statutory provisions. In contrast, the form of appellant's transaction was compelled by the varying goals of her business partners and consistent with the purpose of section 1031, which is to not recognize gain when the taxpayer maintains her investment in qualifying like-kind property.

FTB's reliance on *Chase v. Commissioner* (1989) 92 T.C. 874 (*Chase*) is also misplaced. *Chase* involved a limited partnership and a taxpayer who had the authority to control the timing and transactions to change the tax consequences. In contrast, appellant was a general partner who had no management control greater than her 10-percent interest allowed. Mr. Chase caused the limited partnership to "liquidate" his 46-percent limited partnership interest and deed an undivided interest in a partnership asset (apartments) to him in violation of the partnership

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[16] *Jones v. Grinnell* (10th Cir. 1950) 179 F.2d 873, also cited by FTB, is factually similar to *Court Holding* and not persuasive for the same reasons.

[17] Unlike the situations in *Court Holding* and *Kimbell-Diamond*, the Con-Med partners were not subject to entity-level taxes.

agreement. Appellant, on the other hand, worked with the managing partner, the partnership's attorney, and others to structure the sale of the Property to include the redemption and transfer process to allow her to do the 1031 exchange, all in a manner consistent with the partnership agreement. In *Chase*, the escrow payment to the trustee (for the benefit of the taxpayer) represented an allocation of Mr. Chase's share of total net proceeds in his capacity as a limited partner, and not as a straight allocation of his 46-percent interest. In the case before us, the escrow company disbursed 10 percent of the net proceeds from the sale to American Exchange on behalf of appellant, which is what we would expect for a 10-percent owner of the Property. As the facts demonstrate, Mr. Chase used his control of the partnership to manipulate the sale of a partnership asset to gain a tax advantage, while failing to act in a way that was consistent with the transaction forms he chose. On the other hand, appellant, who through no choice of her own was faced with the prospect of losing an investment property when she wanted to remain invested in that kind of property, worked with her partners, the buyers, and others to exchange one investment property for another.

Appellant cites cases that more closely resemble her situation. In *Magneson*, the court initially acknowledges that it may not be appropriate to collapse the steps of a transaction if the transaction could not have been achieved directly, and it observes that, "[b]etween two equally direct ways of achieving the same result, the Magnesons were free to choose the method which entailed the most tax advantages to them." (*Magneson*, *supra*, 753 F.2d at p. 1497.) Under the facts before us, we see only one realistic way the Con-Med partners could have achieved their goal of allowing some partners to cash out of their ownership interests in the Property while allowing other partners to continue their investment in real property: the one they used. FTB has not suggested another, and while one may exist, the Con-Med partners were not required to select a process that would maximize the tax.[18]

The Ninth Circuit Court of Appeals decided *Bolker* just a few months after it decided *Magneson*. Mr. Bolker was the sole shareholder of Crosby Corporation (Crosby), which owned real property in Montebello. He planned to develop the property and for tax purposes decided to liquidate the corporation and take ownership of the property. Before completing the process, though, Mr. Bolker decided to dispose of the property rather than developing it. On the day of

[18] We note that our conclusions in this opinion are based on the documentary evidence, appellant's testimony, and the law. We give no weight to the testimony of appellant's proffered expert, Jeff Krajewski.

the liquidation and transfer of the property to Mr. Bolker, he agreed to exchange the property, and several entities contracted to take part in a multi-party exchange through which one party would receive the Montebello property and Mr. Bolker would receive like-kind property. A little more than three months later, all transactions closed simultaneously, and Mr. Bolker reported the disposition of the Montebello property as a 1031 exchange.

The IRS made the same arguments in *Bolker* that FTB initially made here. It argued that Crosby exchanged the property, not Mr. Bolker, and that Mr. Bolker did not hold the relinquished property for investment. While *Bolker* did not address the IRS's argument based on the step-transaction doctrine (because the IRS failed to raise the argument in the lower court), its analysis of the section 1031 issue is revealing. The Ninth Circuit notes that the *Bolker* and *Magneson* tax court reasoned that if each transaction in a series of integrated transactions did not trigger a tax, the combination of transactions should not trigger a tax. It goes on to point out that, while its affirmance of *Magneson* recognized the importance of such continuity of investment, it was based on the conclusion that a purported 1031 exchange must satisfy the specific requirements of the statute. Ultimately, the court declared that, in the absence of controlling precedent, the plain language of the statute prevails. The court states its holding as follows:

> . . . if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is "holding" that property "for productive use in trade or business or for investment" within the meaning of section 1031(a). Under this formulation, the intent to exchange property for like-kind property satisfies the holding requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits. Bolker acquired the Montebello property with the intent to exchange it for like-kind property, and thus he held Montebello for investment under section 1031(a).

(760 F.2d at p. 1045 [emphasis in original].)

As we note above (citing *Maloney*, *supra*, 93 T.C. at p. 98), a taxpayer's 1031 exchange can be preceded by a tax-free acquisition of the relinquished property or followed by a tax-free transfer of the replacement property.[19] Here, appellant's 1031 exchange was preceded by a tax-free acquisition of the relinquished property. The redemption of her partnership interest in exchange for the TIC interest was not taxable. (IRC, § 731(a)(1).) Allowing the integration of

[19] *Bolker*, *supra*, 760 F.2d at p. 1044, also discusses the tax court's conclusion that if each step is entitled to nonrecognition treatment, the combination of the steps should be treated similarly if there is continuity of investment. However, while the appellate court did not specifically disagree with the tax court's analysis, it affirmed the tax court's decision because the taxpayer's actions satisfied the plain language of IRC section 1031.

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the steps as a 1031 exchange serves section 1031's purpose of promoting continuity of investment.

Finally, the evidence does not support FTB's argument that there was an anticipatory assignment of Con-Med's income. FTB has not explained how there could have been an improper assignment of income here, given that Con-Med, a partnership, was a pass-through entity. (See RTC, § 17851; IRC, § 701.) It did not owe taxes on its income. It reported its partners' net gains or losses, and each partner, in turn, reported the tax. In that sense, all its income and losses were properly "assigned" to the partners. FTB also has not cited a case to support its assertion that an anticipatory assignment can occur under our facts.[20] To the extent FTB is arguing that the redemption and transfer process was an improper anticipatory assignment because Con-Med "assigned" to appellant the right to receive proceeds from the sale of her 10-percent interest in the Property directly from the buyers, we have addressed that argument, above.

For the reasons stated above, we find that Con-Med did not sell 100 percent of the Property to the buyers, that appellant sold 10 percent of the Property to the buyers, and that appellant completed a 1031 exchange of her interest in the Property.

HOLDING

Appellant completed a 1031 exchange of her interest in the Property following Con-Med's redemption.

[20] *Salvatore v. Commissioner* (2d. Cir. 1970) 434 F.2d 600 is distinguishable because it did not involve a pass-through entity.

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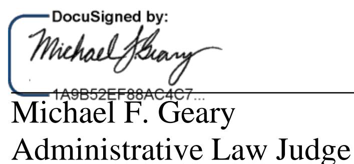
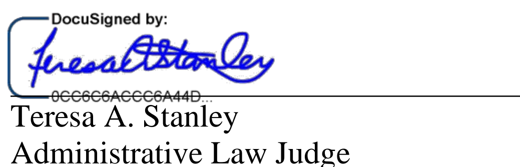
DISPOSITION

We reverse the action of the FTB in proposing an assessment of $60,209 of additional tax, plus applicable interest, for the 2007 tax year.



Michael F. Geary
Administrative Law Judge

I concur:



Teresa A. Stanley
Administrative Law Judge

DISSENTING OPINION

A. ROSAS, Administrative Law Judge: I respectfully dissent.

It is a well-accepted principle that application of tax laws depends on the substance of a transaction and not its form. (*Commissioner v. Court Holding Co.* (1945) 324 U.S. 331, 334 (*Court Holding*).) There is precedent, entrenched in this nation's tax laws for over 70 years, that a "sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title." (*Ibid.*) In a drop-and-swap transaction the "first question we must consider is who made the exchange . . . ." (*Bolker v. Commissioner* (1983) 81 T.C. 782, 794 [citation omitted], affd. (9th Cir. 1985) 760 F.2d 1039.) Grant deeds are not dispositive for tax purposes.[1] It is incorrect to suggest that certain types of forms, i.e., a redemption agreement followed by a grant deed, should be elevated over substance.[2]

Internal Revenue Code (IRC) section 1031[3] provides an exception from the general rule set forth in section 1001(c) requiring the current recognition of gain or loss realized upon the sale or exchange of property. Appellant has the burden of proving that she falls within section 1031's requirements. Appellant was a general partner in a partnership, and while "[a] taxpayer is free to adopt such organization for [her] affairs as [she] may choose . . . ," having chosen to hold a general partnership interest, "[she] must accept the tax disadvantages." (*Higgins v. Smith* (1940) 308 U.S. 473, 477.) As discussed below, appellant did not show that she satisfies the requirements of section 1031. Moreover, the evidence is clear that, for tax purposes, Con-Med Properties (Con-Med), a California general partnership, was the sole seller of the real property located at 130 Tampico Way in Walnut Creek, California (Property).

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[1] As discussed in this dissent, in many of the cases cited by the parties, the courts found that, regardless of whose name appeared on the deed, the sale was attributable to another person or entity for tax purposes. While grant deeds may control for purposes of property law and civil law, grant deeds are not rigidly binding for tax law. (See, e.g., *Frank Lyon Co. v. United States* (1978) 435 U.S. 561, 573 ["In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding"].)

[2] The substance-over-form doctrine originated in *Gregory v. Helvering* (1935) 293 U.S. 465, and courts have applied the doctrine to disallow tax benefits arising out of transactions the forms of which have differed from their substance. (See, e.g., *Commissioner v. CM Holdings* (3d Cir. 2002) 301 F.3d 96, 102 [noting that the rationale behind *Gregory* and its progeny is that "courts should not elevate form over substance by rewarding taxpayers who have engaged in transactions that lack any purpose save that of tax savings. The taxpayer has the burden of showing that the form of the transaction accurately reflects its substance . . ."].)

[3] As relevant to the issues here, California conforms to IRC section 1031 per Revenue and Taxation Code section 18031. Further statutory references are to the IRC, unless otherwise noted.

I. SUMMARY OF THE FACTS

In 2005, the Con-Med partners discussed selling the Property. Con-Med's managing partner advised that anyone interested in a section 1031 exchange should speak with their tax advisors.[4] Mr. Milner further advised that it was uncertain if a sale would occur, stating that it was a "big 'if'" whether the sale "comes to pass . . . ."

On December 14, 2006, PTLA presented Con-Med with an Agreement of Purchase and Sale (Purchase Agreement). The terms included a purchase price of $6 million and a closing date of May 31, 2007. With Con-Med's consent, PTLA could assign the agreement.[5] The Purchase Agreement included a provision that Con-Med and PTLA agreed to cooperate with each other if either of them chose to qualify for a section 1031 exchange. However, this provision does not include anything about Con-Med transferring a tenancy-in-common (TIC) interest[6] to appellant. The Purchase Agreement identified Con-Med as the sole owner and seller of the Property. Appellant is not listed or named in the Purchase Agreement.

On January 3, 2007, many Con-Med partners participated in a phone conference to discuss the pros and cons of PTLA's offer. Two days later, Mr. Milner emailed the partners to summarize the conference. He wrote that they "would have to break up the partnership into tenants-in-common" to allow some partners to do a section 1031 exchange. He explained there was a potential risk that one partner, after receiving a TIC interest, could "foul the deal" by changing his or her mind during escrow. In his affidavit, Mr. Milner stated that Con-Med "needed to put a plan in place to relinquish the property while allowing the partners to continue their investment if they wished." The plan contemplated that (a) Con-Med would dissolve

[4] Appellant consulted an attorney who, at one point in time, directed appellant to read an article he wrote about section 1031 exchanges. He explained that his article detailed the issues, problems, and risks relating to section 1031 exchanges such as appellant's. Appellant did not read this article.

[5] The evidence suggests Con-Med exercised this right of assignment. The buyer changed from PTLA to Tampico Investors LP and Meadows Investors LLC. This was all part of the same deal. "PTLA had changed into another entity to buy the property " appellant explained during her testimony, "they were calling themselves Tampico Investors and Meadow Investors, LLC."

[6] While the majority opinion refers to appellant's "interest," the opinion appears to make no distinction between appellant's partnership interest and her TIC interest. However, the distinction between these interests is important, because owning an interest in a general partnership that owns real property is not equivalent to owning a direct TIC interest in the underlying real property. (Corp. Code, § 16501.)

"immediately *prior* to Close of Escrow," and (b) each partner would receive a TIC interest in the Property. But, Con-Med abandoned this plan.[7]

Appellant's testimony gave background information about the partners' history: "The older people were all together, in 1969 when they made their original investment." Over the years, many original partners passed away, and their shares were inherited by others. This resulted in a "whole new generation of people who didn't know [appellant and her mother]."

Early on, when appellant and her mother informed the other partners of their intent to undertake a section 1031 exchange, many of the other partners were concerned that appellant and her mother could "spoil" the deal. Appellant testified that the other partners did not want appellant (or her mother) "muddying the waters." Appellant explained "there were a few sticking points" with the sale. "There were just a few points where it was looking like maybe this wasn't even going to happen," she testified, "and the last thing that . . . the last things these other members of the partnership wanted was to have a couple wildcards, as far as they could tell, running amuck. That was a concern, and that's why I remember that very specifically." It is important to understand this distrust; this background helps illustrate why appellant was not involved in the negotiations to sell the Property. Instead, Con-Med negotiated and closed the sale.

Mr. Milner wrote that he planned to present Con-Med's counter-offer to PTLA, but there is no indication that the counter-offer would be on behalf of both Con-Med and appellant. There is no evidence that Mr. Milner planned to discuss appellant's eventual sale of a TIC interest. The documentary evidence suggests Con-Med made a counter-offer dated January 12, 2007 (one week after Mr. Milner's email), and that PTLA made a counter-offer dated January 25, 2007. As part of these counter-offers, the price increased from $6 million to $6.2 million. The following month, Con-Med's counter-offer dated February 6, 2007, increased the price to $6.4 million, and it identified only Con-Med as the seller. Appellant was not involved in the negotiations.

PTLA made a counter-offer dated February 26, 2007, which amended the closing date to August 31, 2007, and added a provision allowing either Con-Med or PTLA the option to extend

[7] Instead of dissolving "immediately *prior* to Close of Escrow," Con-Med dissolved after escrow. Instead of each partner receiving a TIC interest in the property and selling their interests to the buyer, Con-Med stayed intact and only appellant and her mother received TIC interests in the property.

the closing for up to an additional 60 days to complete a section 1031 exchange.[8] The Purchase Agreement and counter-offers do not say anything about appellant's interest (partnership or TIC), about her being one of the sellers, or about her wanting to undertake a section 1031 exchange. There is no evidence that prior to November 28, 2007, PTLA knew about appellant, let alone her partnership or TIC interest, or her desire to undertake a section 1031 exchange.

From December 14, 2006, through the close of escrow, Con-Med received rent of $17,516 per month. Con-Med paid all expenses associated with the Property. Appellant did not pay any part of these expenses. Nor did the tenants pay directly to appellant any part of the rent.

On November 17, 2007, two weeks before close of escrow, the Con-Med partners executed a Redemption Agreement that, among other things, approved redemption of appellant's partnership interest and approved distribution to her of a 10-percent TIC interest in the Property. This agreement said Con-Med—and not appellant—was under contract to sell the Property.

The first deed granted appellant and her mother a 10-percent and 8-percent, respectively, undivided TIC interest in the Property (Grant Deed #1). The second deed transferred all interest in the Property from Con-Med, appellant, and appellant's mother to the buyers (Grant Deed #2).[9] Although both deeds included a pre-printed date of November 20, 2007, Mr. Milner's signatures, on behalf of Con-Med, were notarized in California on November 27, 2007—three days before close of escrow; and appellant's and her mother's signatures on Grant Deed #2 were notarized in Arizona on November 28, 2007.[10] Grant Deed #1 was recorded on November 29, 2007. Grant Deed #2 was recorded 24 hours later, on November 30, 2007. Thus, according to the documentation and notarizations, after Con-Med distributed a TIC interest to appellant via Grant Deed #1, just one day later appellant's signature on Grant Deed #2 was notarized, and Grant Deed #2 transferred that TIC interest to the buyers.

[8] Notwithstanding this added provision, there is no evidence that the option to extend the closing was a provision intended for appellant's benefit. The counter-offer makes no reference to appellant.

[9] All other terms of the Purchase Agreement and counter-offers stayed the same. For instance, the sales price remained at $6.4 million.

[10] Regardless of the pre-printed dates on the deeds, based on the locations and the dates of the notarizations, it is more likely than not that Mr. Milner signed the deeds on November 27th, whereas Appellant and her mother signed Grant Deed #2 on November 28th.

II. DISCUSSION

A. For Tax Purposes, Con-Med Sold the Property

1. Court Holding

In *Court Holding*, the Supreme Court set forth various legal principles—substance over form, assignment of income, sham transactions, and the step-transaction doctrine:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

(*Court Holding, supra,* 324 U.S. at p. 334, fns. omitted.)

Court Holding and its Supreme Court companion case, *United States v. Cumberland Public Service Co.* (1950) 338 U.S. 451 (*Cumberland*), dealt with whether a corporation was required to pay tax on gain from the sale of property that was first distributed in liquidation and then sold by the shareholders. Justice Black wrote both opinions. While both opinions applied the same legal principles, they reached different results because the cases involved different facts: *Court Holding* held for the government and *Cumberland* held for the taxpayer.[11]

The transaction in this appeal fits squarely within the rule laid down by the Supreme Court that a "sale by one person cannot be transformed for tax purposes into a sale by another . . . ." (*Court Holding*, *supra,* 324 U.S. at p. 334.)[12] However, in this appeal, the majority opinion dismisses this precedent. For example, the majority opinion points out that *Court Holding* is not a section 1031 exchange case, and the majority opinion attempts to distinguish *Court Holding* by focusing on the specific corporate transactions in that case. But,

[11] "Whoever negotiated the sale is irrelevant," appellant's counsel argued during oral hearing. These two Supreme Court cases prove that this argument is entirely without merit, because these cases show that the facts surrounding who negotiated the sale are extremely relevant.

[12] In *Court Holding*, a corporation negotiated the sale of its only asset, an apartment building. The shareholders sold on the precise terms the corporation had negotiated. The Supreme Court upheld the tax court's determination that the corporation, rather than the shareholders, had sold the building.

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courts have applied *Court Holding* to transactions involving section 1031 exchanges as well as to cases involving partnership transactions. (See, e.g., *Chase v. Commissioner* (1989) 92 T.C. 874, 881 (*Chase*).) The State Board of Equalization (SBE) has also cited *Court Holding* in cases involving section 1031 exchanges. (See, e.g., *Appeal of Brookfield Manor, Inc. et al.*, 89-SBE-002, Jan. 11, 1989 (*Brookfield Manor*).)

In this appeal, Con-Med was listed as the seller on the Purchase Agreement and counter-offers. Con-Med negotiated the sale. There is no evidence that PTLA was aware of appellant or her intent to undertake a section 1031 exchange. There is no evidence that Mr. Milner or appellant's mother negotiated with the buyers on appellant's behalf.[13] Eleven months after the Purchase Agreement, Con-Med redeemed appellant's partnership interest, and on November 27, 2007, Grant Deed #1 was notarized. Grant Deed #1 distributed to appellant a 10-percent undivided TIC interest in the Property. The next day, on the 28th, appellant's and her mother's signatures on Grant Deed #2 were notarized. Grant Deed #2 transferred all interest in the Property to the buyers. Escrow closed two days later on the 30th, and the Property sold on the precise terms Con-Med had negotiated.

In *Court Holding*, over a period of five months, Court Holding Co., a corporation holding title to real property, entered negotiations with the lessees for the sale of the property. Similarly, over a period of three months,[14] Con-Med, a general partnership holding title to real property, entered negotiations with PTLA, the lessee of the Property.

A sales contract was drawn up in *Court Holding*, with the corporation's former shareholders as sellers instead of the corporation. The new contract contained substantially the same terms that the corporation and lessees had agreed upon. Here, there is no evidence of any contract naming appellant as one of the sellers. There is no evidence that the Purchase Agreement and counter-offers were amended to add appellant as a seller. Appellant testified that the recording of Grant Deed #2 was a continuation in the process. The eventual sale was for

[13] In fact, based on the partners' distrust, it comes as no surprise that there is no evidence of appellant's involvement in the sale. She did not take part in discussions. She did not negotiate with PTLA. There is no evidence that the buyers were even aware of her or her intentions. The evidence shows Con-Med wanted to ensure that only the partnership conducted the negotiations, in order to avoid the complications and disputes that could arise if Con-Med disributed TIC interests to its partners and allowed the partners to jointly negotiate the sale.

[14] This three-month negotiation period runs from the Purchase Agreement and Sale dated December 14, 2006, through the counter-offer dated February 26, 2007.

substantially the same terms that Con-Med and PTLA had agreed upon, including the same sales price of $6.4 million.[15]

In *Court Holding*, three days after the contract was drawn up with the former shareholders, the sales transaction closed. Here, just one day after Grant Deed #1 was notarized, distributing a TIC interest to appellant, appellant's signature on Grant Deed #2 was notarized; and Grant Deed #2 transferred that TIC interest to the buyers. Escrow closed two days later. Based on the notarizations, Appellant held title to a 10-percent TIC interest in the Property for one day. Escrow closed under the same terms of the pre-arranged agreement. The majority states that they see only one realistic way for this sale to achieve appellant's and the other partners' goals—the way they used. However, there were other ways to structure the transaction, as appellant's own expert witness acknowledged.[16]

In *Court Holding*, the Supreme Court found that "the Tax Court was justified in attributing the gain from the sale to respondent corporation." (*Court Holding, supra,* 324 U.S. at p. 334.) Likewise, the evidence here is overwhelming that respondent was correct in attributing the sale of the Property to Con-Med for tax purposes. The facts in this appeal more closely resemble those from *Court Holding* than *Cumberland*. Yes, appellant and the majority are correct that *Court Holding* involved corporate transactions (not partnership transactions) and that *Court Holding* was not a section 1031 case. However, as noted previously, the case law is clear that *Court Holding* applies to transactions involving section 1031 exchanges as well as to partnerships and partners. (See, e.g., *Chase, supra*; and *Brookfield Manor, supra*.)[17]

[15] The differences were: (1) the seller changed from Con-Med (100%) to Con-Med (82%), appellant (10%), and appellant's mother (8%); (2) PTLA created two entities to hold title (Tampico Investor LP & Meadows Investors LLC); and (3) although there was an option to extend the closing date past August 31, 2007, by up to an additional 60 days, escrow closed approximately 90 days later, on November 30, 2007.

[16] For example, appellant's expert testified that he "would have attempted to drop her interest perhaps sooner than what actually took place." He also testified that he "would have made her a party to the contract at the onset, or subsequently by way of addendum to the purchase and sale agreement."

[17] One of the issues in *Brookfield Manor*, *supra*, was whether, under *Court Holding*, a section 1031 exchange was made by the corporation or by the individual shareholders. SBE determined that the corporation "took an active role in the exchange," that the corporation "negotiated the essence of the exchange" prior to its dissolution, and that, eventually, "the exchange was conducted under substantially the same terms" agreed to by the corporation and the buyer. There was no evidence that the shareholders "conducted any negotiations on their own behalf." SBE therefore found that the sale was properly imputed to the corporation.

2. Substance-Over-Form Doctrine

The *Chase* decision demonstrates that substance-over-form principles apply in the context of section 1031. In these section 1031 drop-and-swap cases, where the issue is who made the exchange, "[t]his question is one of fact." (*Bolker, supra,* 81 T.C. at p. 794 [citation omitted].) *Chase* is not factually distinguishable. Using the substance-over-form doctrine, the tax court found that although the partnership prepared a deed conveying an undivided interest in the property to the partner, the partner never acted as an owner, never paid any of the property's expenses, never received any of the rents from the property, and was not a party to the sales contract. Therefore, in substance, the partnership (not the partner) was treated as disposing of the property, while it was the partner (not the partnership) who acquired replacement like-kind property. Thus, neither the partnership nor the partner was involved in a valid like-kind exchange.

In the same way, appellant never acted as an owner, never paid any of the Property's expenses, never directly received any of the rents from the Property, and was not a party to the sales contract. From December 14, 2006, through the close of escrow, Con-Med received rent of $17,516 per month, and Con-Med paid all expenses associated with the Property. During this year-long period, appellant did not directly receive any rents and did not pay any expenses.

Moreover, the evidence suggests that even if appellant had wanted to be a party to the sales contract, the partners would not have allowed it. They were afraid of her "muddying the waters" for the rest of them. Thus, appellant was not listed in the sales contract, she was not involved in the negotiations, and it appears that the buyers were not even aware of her 10-percent TIC interest until the closing.

In *Chase*, the buyer did not negotiate with the Chases, and correspondence from the buyer did not indicate that the buyer knew that the Chases, as individuals, held any ownership interest in the apartments. In this appeal, the evidence is overwhelming that PTLA negotiated with Con-Med only; specifically, it negotiated with Con-Med's managing partner. PTLA did not negotiate with appellant, and the evidence does not indicate that the buyers even knew that appellant, as an individual, held any interest in the Property. In fact, appellant's expert witness testified that the earliest moment when the buyers could have known of appellant's interest was when the buyers signed the Acknowledgement of Receipt of a Copy of Assignment on November 28, 2007.

In *Chase*, the tax court also stated:

> There is no indication that any party to the sale believed that anyone other than JMI held title at the time of RWT's offer to purchase. Further, there is no evidence of negotiations by petitioners on behalf of themselves concerning the terms for the disposition of the Apartments. Also, petitioners never paid any of the operating costs of the Apartments or their share of the brokerage commission. Further, petitioners did not receive, or have credited to them, any of the Apartment's rental income.

(*Chase, supra,* 92 T.C. at pp. 881-882.) Likewise, in this appeal, there is no indication that the buyers believed that anyone other than Con-Med held title at the time PTLA executed the Purchase Agreement on December 12, 2006, or at the time PTLA executed the February 26, 2007 counter-offer. Further, there is no evidence of negotiations by appellant on her own behalf concerning the terms for the disposition of the Property. Also, appellant never paid any of the operating costs of the Property and did not receive, or have credited to her, any of the Property's rental income.

In *Chase*:

> Petitioners final argument regarding the substance issue is that JMI's general partners acted as petitioners' agents in negotiating the disposition of the John Muir Apartments to Traweek. This, petitioners argue, explains why they did not appear, individually, as parties in most of the documents to this transaction. We find petitioners' argument, in this regard, both self-serving and unsupported by the record.

(*Chase, supra,* 92 T.C. at p. 882.) Appellant's arguments are equally unsupported by the record.

For example, appellant argues that her mother was actively involved in the sales negotiations, that her mother represented appellant's interests in these negotiations, and that her mother would have informed the buyers of appellant's interest in the Property and role with the sale. This is pure speculation. There is no evidence appellant's mother represented appellant's interests in these negotiations. There is no evidence appellant's mother informed the buyers of appellant's interest in the Property or of appellant's role with the sale. There is no evidence appellant's mother informed the buyers that appellant would receive a 10-percent TIC interest in the Property, which appellant would subsequently sell to the buyers.[18]

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[18] Appellant was asked to provide any available records evidencing the negotiations and her mother's involvement, but appellant did not provide any.

Appellant testified that the February 26, 2007 counter-offer is evidence that the buyers knew she was going to do a section 1031 exchange. But this counter-offer only names Con-Med; it is silent about appellant holding a 10-percent partnership interest, about her holding a 10-percent TIC interest in the Property, about her being one of the sellers, or about her wanting to undertake a section 1031 exchange. However, appellant speculates that her mother "was pushing for this for so long and absolutely would have put herself front and center in that to make sure that they came to the table and agreed to it." This is pure speculation. Appellant was not present at these negotiations. There is no evidence of what appellant's mother said to the buyers, if anything. There is no documentary evidence that, during the negotiations, the buyers even knew of appellant's intentions.

The documentary evidence and testimony from appellant's expert witness suggests that November 28, 2007, was the earliest date the buyers were even made aware of appellant's ownership interest and her intentions. This is the same date when appellant's signature on Grant Deed #2 was notarized.

Appellant testified that her mother was her agent under a power of attorney (POA). Although appellant could not recall when the POA was executed, she testified that the POA "was in play" at the time of the negotiations. Appellant testified that she had a digital copy of the POA and that it was available on a cloud server, but she did not offer a copy of the POA. Nevertheless, a POA would not prove (1) that appellant's mother actually participated in any of the negotiations, (2) that her mother served as appellant's agent during these sale transactions, or (3) that the buyers were aware that appellant's mother served as her agent. The documentary evidence shows that appellant signed everything on her own behalf.[19] Her mother did not sign anything on appellant's behalf. Furthermore, there is no evidence that a copy of the POA was given to PTLA. There is no evidence appellant's mother negotiated any of the specific sales terms. There is no evidence PTLA was aware appellant's mother had a POA for appellant.

Chase held "that the substance over form doctrine applies and that, in substance, JMI disposed of the Apartments." (*Chase, supra,* 92 T.C. at p. 881.) "The substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." (*Id.* at p. 874, citing *Court Holding* and *Cumberland.*) In comparison, the form chosen by appellant—the redemption and the deeds signed, notarized, and

[19] Or that appellant signed as trustee of The Sharon Mitchell 1995 Revocable Trust.

recorded at the last minute, and the escrow settlement statement listing appellant as a "seller"—is a fiction that does not reflect the economic realities of the sales transaction. The evidence demonstrates that the substance-over-form doctrine applies and that, in substance, Con-Med disposed of 100 percent of the Property.

3. Assignment of Income

Salvatore v. Commissioner (2d Cir. 1970) 434 F.2d 600 (*Salvatore*) provides additional support for respondent's determination that Con-Med alone was the seller of the Property. In *Salvatore*, on July 24, 1963, Mrs. Salvatore (as seller) and Texaco (as buyer) signed a formal sale agreement. One month later, on August 28, 1963, she executed a warranty deed conveying a one-half interest to her children. On August 28 and 30, she and her children then conveyed their respective interests in the station to Texaco. All the deeds were filed at the recorder's office simultaneously. The Second Circuit Court of Appeals found substantial support for the tax court's conclusion that this was an improper assignment of income, explaining that "[t]he insubstantiality of the children's 'ownership,' which they acquired only on the understanding that they would reconvey, is further underscored by its fleeting duration- no more than a few hours on August 28 as to several of the children, and approximately two days in the case of a daughter living in Florida." (*Id.* at pp. 601-602.) Likewise, appellant acquired her 10-percent TIC interest in the Property for a fleeting duration.

In affirming the tax court, the court of appeals noted that the tax court "found that Mrs. Salvatore's children were only 'conduit(s) through which to pass title,' citing [*Court Holding*], and that Mrs. Salvatore alone, rather than she and her children, was the seller of the gas station." (*Salvatore, supra,* 434 F.2d at p. 601.) The evidence shows that the same is true for appellant. There is substantial support for the conclusion that Appellant was not a seller but a mere "conduit through which to pass title" to her 10-percent interest.

4. *Bolker*

In *Bolker, supra,* the tax court found that the early involvement by the corporation ended and that in both substance and form the exchange was made by the individual taxpayer rather than by the corporation.[20] The IRS appealed to the Ninth Circuit; however, the IRS did not

[20] The tax court stated: "Examining the record in the instant case, we find at most minimal corporate involvement in the negotiations and the exchange. While it is true that in 1969 Crosby entered into a sales

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contest the tax court's determination that Mr. Bolker rather than the corporation made the exchange. Instead, the IRS argued on appeal that Mr. Bolker lacked investment intent and did not hold the property for investment purposes.

The Ninth Circuit's decision in *Bolker* focused on section 1031's holding requirement, and it held that "the intent to exchange property for like-kind property satisfies the holding requirement, because it is not an intent to liquidate the investment or to use it for personal pursuits." (*Bolker*, *supra,* 760 F.2d at p. 1045.) However, although the intent to exchange property for like-kind property may satisfy the holding requirement, this intent to exchange property for like-kind property is not dispositive on the question of whether an exchange actually occurred. (*Bezdjian v. Commissioner,* T.C. Memo. 1987-140*,* affd. (9th Cir. 1988) 845 F.2d 217.) Therefore, before reaching an analysis on the holding requirement, the "first question we must consider is who made the exchange . . . ." (*Bolker, supra,* 81 T.C. at p. 794 [citation omitted].) Moreover, on the holding requirement issue, the majority opinion cites cases that are distinguishable, such as *Magneson v. Commissioner* (1983) 81 T.C. 767, affd. (9th Cir. 1985) 753 F.2d 1490 (*Magneson*),[21] and *Appeal of Rago Development Corp., et al.,* 2015-SBE-001, June 23, 2015 (*Rago*).[22]

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agreement with SCS for the precise parcel in question here, that contract was terminated upon SCS's failure to make payment of the balance of the purchase price. In no way can it be said that the events of 1972 were a continuation of the transaction which was agreed upon in 1969. As representatives of both Crosby and SCS testified, both parties were of the opinion that the prior deal was dead and that the subsequent negotiations started the bargaining process anew." (*Bolker*, *supra,* 81 T.C. at p. 800 [citations omitted].)

[21] *Magneson* involved a swap-and-drop rather than a drop-and-swap transaction, and the tax court's majority opinion focused on the holding requirement, specifically on whether the taxpayers met the requirement that the replacement property be held for investment or for productive use in a trade or business. The decision in *Magneson* is based on the rights of a general partner under former law, and in discussing the similarities between TIC interests and partnership interests, the Ninth Circuit cited former statutes. (*Magneson, supra,* 753 F.2d at p. 1495.) *Magneson* was decided when a tax-free exchange of partnership interests was permissible under section 1031, but section 1031(a)(2)(D) altered that rule. Additionally, *Magneson* was decided prior to the Uniform Partnership Act of 1994, and under the new law, a partner no longer has an interest in partnership property. (Corp. Code, § 16501.) Furthermore, *Magneson* did not address who is the seller for tax purposes.

[22] In *Rago,* several individuals relinquished separate properties and together acquired a replacement property as tenants-in-common. SBE discussed the step-transaction doctrine. Among other things, *Rago* did not address who is the seller for tax purposes, it involved a swap-and-drop, and it focused on the holding requirement of the replacement property. SBE found that the acquisition of the replacement property had real economic substance and legal significance because it exposed the taxpayers to real economic risks and entitled the taxpayers to any appreciation in the value of the property or income from the property. Among the factors given importance: the replacement property was held for seven (7) months prior to transferring it, and during that time the taxpayers "controlled the property, obtained the benefit of any increase in the value of the property, and would have suffered the economic effect if any in the value of the property or damage to the property." In the present appeal, appellant's

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Appellant argues that this appeal falls within the ambit of the Ninth Circuit's decision in *Bolker.* This argument is not persuasive because the facts of *Bolker* were far different than the facts here. Appellant wants to focus on the Ninth Circuit's decision in *Bolker*, while ignoring the tax court decision. But as the tax court pointed out, in a drop-and-swap transaction, the "first question we must consider is who made the exchange ......" (*Bolker*, *supra,* 81 T.C. at p. 794 [citation omitted].)

Unlike the facts in *Bolker*, where the individual taxpayer was actively involved in the sale negotiations, in this appeal there was no involvement from appellant in the negotiations. And her involvement in the overall sale transactions was minimal: she signed Grant Deed #2 soon after receiving her 10-percent TIC interest. Although appellant was eventually listed in Grant Deed #2 and the escrow settlement statement, this was not the result of a new contract. The contract—the Purchase Agreement and counter-offers—was not terminated. Appellant testified that the recording of Grant Deed #2 was a continuation and an additional step in the process. It was all part of the same transaction.[23] The recording of Grant Deed #2 was a consummation of the sales contract memorialized in the Purchase Agreement and counter-offers. This was the same deal.

In *Bolker*, the tax court pointed out the following:

> [A]fter Crosby's unsuccessful attempt to sell the property to SCS in 1969, Crosby ceased negotiating with SCS and all subsequent negotiations with SCS with respect to the property were conducted by petitioner in his own behalf. In fact, both the consideration and terms of the exchange that petitioner and SCS ultimately agreed upon were different from that included in the 1969 contract between Crosby and SCS.

(*Bolker*, *supra,* 81 T.C. at p. 802.)

The facts in this appeal are distinguishable from *Bolker*. In this appeal, Con-Med's attempt to sell the Property to PTLA was successful. Con-Med did not cease negotiating with

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ownership of a 10-percent TIC interest for a fleeting duration is significant; it is indicative of the lack of real economic substance and legal significance.

[23] At oral hearing, appellant was asked to explain whether the sale that closed on November 30, 2007, was a continuation of the deal between Con-Med and PTLA, or whether it represented a new deal. Appellant testified that it was all part of the same deal. "It's like putting one foot in front of the other," she explained. "You just plod your way through the purchase of a property. That's what I would say, is you do this, then you do this, then you sign that, then you file that." Appellant testified that the recording of Grant Deed #2 "would have simply been one sort of step of the thing." Grant Deed #2 and the close of escrow was a consummation of the deal between Con-Med and PTLA.

PTLA. There were no negotiations between appellant and the buyers regarding the Property. Both the consideration and terms of the sale were identical to the $6.4 million sales price and the terms included in the Purchase Agreement and counter-offers. Unlike the petitioner in *Bolker* who was free to negotiate on his own behalf, here, the majority of Con-Med partners feared that appellant could "spoil" the deal if she were given a TIC interest before there was an enforceable agreement with PTLA. Under those circumstances, appellant was in no position to negotiate.

In *Bolker*, the tax court concluded that "the evidence clearly establishes, and we find, that in substance the transaction with SCS was negotiated by petitioner and not by Crosby." (*Bolker, supra*, 81 T.C. at p. 801.) Here, on the other hand, the evidence clearly establishes that in substance Con-Med—not appellant—negotiated the sales transaction. Therefore, the evidence leads to but one conclusion: in substance, and for tax purposes, Con-Med sold the entire Property.

B. Con-Med Did Not Undertake a Section 1031 Exchange

Section 1031 requires an exchange. "Section 1031(a) requires that like-kind property be both given up and received in the 'exchange.'" (*Chase, supra,* 92 T.C. at p. 883.) Accordingly, because Con-Med sold the Property, section 1031(a) requires that Con-Med likewise receive the replacement property. As in *Chase*, Con-Med transferred the Property but did not receive like-kind property. In other words, Con-Med did not receive the replacement property in Arizona. Con-Med never held the Arizona property that was received by appellant as part of the purported exchange.

In *Chase*, the tax court concluded as follows:

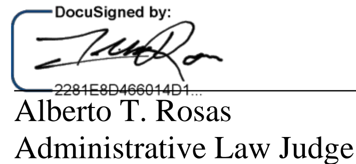
> Having concluded that JMI sold the entire interest in the Apartments, and that JMI did not act as petitioner's agent with respect to an undivided interest in such apartment, we hold that petitioners failed to 'exchange' like-kind property within the meaning of section 1031(a). Accordingly, petitioners are not entitled to the benefits of that section.

(*Chase, supra,* 92 T.C. at p. 883.)

In like manner, having concluded that Con-Med sold the entire Property, and that there is no evidence to prove that either Con-Med or appellant's mother acted as appellant's agent with respect to a 10-percent TIC interest in the Property, appellant did not exchange like-kind property within the meaning of section 1031(a).

III. CONCLUSION

A sale by one person (Con-Med) cannot be transformed into a sale by another (appellant). Con-Med sold 100 percent of the Property, for tax purposes. Based on the substance-over-form doctrine and the overwhelming evidence, which includes testimony from appellant and her expert witness, it is clear that appellant did not take part in the sale negotiations. There is no evidence that appellant's mother represented her in the negotiations. In addition, there is no evidence that the buyers even knew about appellant's 10-percent partnership or TIC interest prior to November 28, 2007. The evidence proves that only Con-Med was involved with the negotiations that led to the consummation of the sale, that Con-Med sold the entire Property for tax purposes, and that, accordingly, appellant could not have consummated a section 1031 exchange.



Alberto T. Rosas
Administrative Law Judge