2021 – OTA – 023
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:	) OTA Case Nos. 18053084, 18073451
HUA QING ENTERPRISE LLC AND S. LAU	)

OPINION

Representing the Parties:

For Appellants: Jenny Wang, Attorney

For Respondent: Veronica Long, Tax Counsel

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

A. LONG, Administrative Law Judge: These consolidated appeals are made pursuant to section 19045 of the Revenue and Taxation Code (R&TC) from the actions of respondent Franchise Tax Board (FTB) on (i) appellant Hua Qing Enterprise LLC's (HQE) protest of a proposed assessment of a limited liability company (LLC) fee of $11,790, plus applicable interest, for the 2010 tax year; and (ii) appellant S. Lau's (Lau) protest of a proposed assessment of $990,565 in additional tax, plus applicable interest, for the 2010 tax year.

Administrative Law Judges Andrea L.H. Long, John O. Johnson, and Kenneth Gast held an oral hearing via videoconference for this matter on August 18, 2020, which was originally scheduled to be heard in Cerritos, California. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUE

Whether HQE acquired replacement property in a like-kind exchange with the requisite intent to hold for investment or for use in a trade or business.

FACTUAL FINDINGS

Background

1. Lau is the founder and sole member of HQE, which is a single-member LLC that is disregarded for income tax purposes.
2. In early 2010, HQE exchanged a warehouse property located in Rancho Cucamonga, California, for two replacement properties.[1] The first replacement property was a residential property, and the second replacement property (hereafter the Diamond Bar Property) was three parcels of land in a five-parcel development located in Diamond Bar, California, that was being developed by Millennium Diamond Road Partners, LLC (MDRP).
3. During FTB's audit, FTB determined that the exchange of the first replacement property qualified for deferral of gain under Internal Revenue Code (IRC) section 1031, to which California generally conforms under R&TC section 18031. In contrast, FTB determined that the exchange of the Diamond Bar Property (the second replacement property) did not qualify for deferral of gain because the Diamond Bar Property had been acquired and held primarily for sale. Therefore, FTB concluded that Lau, the sole member of HQE (a disregarded entity), must recognize and pay tax on capital gain of $10,518,820, and HQE must separately pay an LLC fee on that gain.
4. Based on the foregoing, FTB issued a Notice of Proposed Assessment (NPA) to Lau proposing additional tax of $990,565, plus applicable interest. FTB also issued an NPA to HQE proposing an LLC fee of $11,790, plus applicable interest.
5. In response, appellants filed timely protests, asserting that HQE acquired the Diamond Bar Property for long-term investment and had not formed an intent to sell the Diamond Bar Property at the time such property was acquired.[2]
6. After reviewing the matter, FTB affirmed the NPAs in separate Notices of Actions. Appellants filed this timely consolidated appeal.

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[1] Between 2007 and early 2010, HQE's sole business consisted of leasing the Rancho Cucamonga warehouse property.

[2] As noted above, HQE is a single member LLC and therefore is disregarded for income tax purposes. For sake of simplicity, we shall refer to HQE as the owner of the Diamond Bar Property.

Additional Facts

7. From 2006 through 2009, MDRP performed numerous activities to prepare the five-parcel development. For example, in 2006, MDRP obtained city approval of the development's tentative map. In 2007, MDRP received a water quality certification, and later in 2008, MDRP filed a preliminary public report with the California Department of Real Estate.

8. On November 30, 2009, an appraisal report for the five-parcel development was prepared for MDRP's lender, Preferred Bank. The appraisal report stated that the highest and best use of the five-parcel development "as planned" was a residential development, and that eight of the 48 lots in the development (four of which are located in the Diamond Bar Property) had been presold.

9. As part of the 2009 appraisal, the appraiser interviewed D. Cheng, a real estate agent in Diamond Bar, who stated that she had a group of buyers already set up and she was only waiting for grading of the development to begin to put sales into escrow. It was also noted by the appraiser that Cheng was under the impression that she would be able to sell all 48 lots in only six to nine months.

10. On December 4, 2009, four days after the date of the 2009 appraisal, HQE, as the buyer, entered into a purchase agreement with MDRP, as the seller, to buy the Diamond Bar Property for $13 million (Purchase Agreement).

11. The Purchase Agreement required MDRP to develop the three parcels, to provide HQE with a detailed budget, and to "start substantial construction" of improvements by December 31, 2010, or pay HQE a $500,000 penalty. A schedule of improvements and an estimate of improvement costs were included as an exhibit to the Purchase Agreement.

12. On January 23, 2010, HQE and MDRP entered into a first amended purchase agreement for purchase of the Diamond Bar Property, increasing the purchase price to $18 million (First Amended Purchase Agreement).

13. Section 13(c) of the First Amended Purchase Agreement states that HQE would purchase an additional parcel of land from the five-parcel development from MDRP for $5 million, and that MDRP would use the $5 million "only for the purpose of developing the Land before it can be legally sold in individual lots to a third party........"

14. Section 14 of the First Amended Purchase Agreement required that (i) MDRP "start substantial construction" of improvements by December 31, 2010, or pay HQE a $500,000 penalty; and (ii) all improvements be completed by December 31, 2010.
15. On May 6, 2010, HQE entered into a loan agreement (Loan Agreement) with Preferred Bank. The loan amount was for $7,600,000 with an initial maturity date of April 8, 2012, and an extended maturity date of October 8, 2012. The Loan Agreement required that HQE provide monthly progress reports on the development. Additionally, the promissory note with Preferred Bank stated that Preferred Bank was agreeing to make the loan to HQE based upon HQE's creditworthiness, and expertise in "owning, developing and operating the real estate property covered by the Deed of Trust........"
16. Escrow for the Diamond Bar Property closed on May 7, 2010.
17. On February 25, 2012, a reappraisal report for the development of the five-parcel development was prepared at the request of Preferred Bank. The 2012 reappraisal stated that the eight presold lots, which had been previously mentioned in the 2009 appraisal, were included in the cash flow analysis of the 2012 reappraisal.
18. On June 12, 2012, HQE and MDRP entered into an amendment to the First Amended Purchase Agreement (First Amendment to the First Amended Purchase Agreement), which stated that HQE would forego the $500,000 penalty that was listed in the First Amended Purchase Agreement, but that MDRP would complete all development improvements by October 31, 2013, or pay HQE a penalty of $1 million.
19. Between 2010 and 2013, 74 bi-weekly meetings were held by MDRP. Topics discussed included: improvements (and lack thereof); MDRP's commitment to complete the improvements as scheduled; and plans to design and market homes to be located on each of the 48 lots.
20. The meeting minutes indicate that HQE regularly authorized wire transfers from HQE's bank account to MDRP's bank account.
21. On February 12, 2012, HQE ordered 950 catalogs to advertise the individual lots for sale. The cover pages of the catalogs state that the development is a "Joint Development" by HQE and MDRP.
22. In August of 2013, HQE and MDRP jointly refinanced the Preferred Bank loans with a loan from the Bank of Sinopac. The new loan was for $20 million.

23. During a Diamond Bar City Council meeting on February 2, 2016, public comments by community members were made against the development.

24. As of the date of the hearing for this matter, HQE still owns the Diamond Bar Property.

DISCUSSION

I. Applicable Law

R&TC section 17942 imposes an LLC fee based on the total California source income of LLCs that are doing business in California. As relevant to this appeal, if the total income from all sources derived from or attributable to California is $5 million or more, the LLC fee is $11,790.

California law conforms to IRC section 1031 at R&TC section 18031.[3] For an exchange of property to qualify for nonrecognition of gain treatment under IRC section 1031, three general requirements must be satisfied: (1) the transaction must be an exchange; (2) the exchange must involve like-kind properties; and (3) both the property transferred (i.e., the relinquished property) and the property received (i.e., the replacement property) must be held for a productive use in a trade or business or held for investment. (IRC, § 1031(a)(1).) As relevant here, however, the nonrecognition treatment of IRC section 1031(a) does not apply to any exchange of property "held primarily for sale." (IRC, § 1031(a)(2)(A); *Black v. Commissioner* (1960) 35 T.C. 90, 96; *Neal T. Baker Enterprises, Inc. v. Commissioner*, T.C. Memo. 1998-302 (*Baker Enterprises*).)

The test of whether property is held for investment (thus qualifying for nonrecognition treatment) or held primarily for sale (thus disqualifying from nonrecognition treatment) is applied at the time of the exchange. (*Bolker v. Commissioner* (1983) 81 T.C. 782, 804, affd. (9th Cir. 1985) 760 F.2d 1039.) A taxpayer's conduct before and after an exchange can help a court determine the taxpayer's intent at the time of the exchange. (*Adams v. Commissioner*, T.C. Memo. 2013-7.) A taxpayer has the burden of proving that it had the requisite intent. (*Click v. Commissioner* (1982) 78 T.C. 225, 231.) Unsupported assertions cannot satisfy a taxpayer's burden of proof. (*Appeal of Wright Capital Holdings LLC*, 2019-OTA-219P.)

For purposes of IRC section 1031, neither the IRC nor Treasury Regulations specifically define held "for investment." (*Baker Enterprises*, *supra*, at p. *7.) The Treasury Regulations

[3] For the 2010 tax year, California conforms to the January 1, 2009 version of the IRC. (R&TC, § 17024.5(a)(1)(O).)

provide, however, that "[u]nproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale." (Treas. Reg. § 1.1031(a)-1(b).)

Similarly, for purposes of IRC section 1031, neither the IRC nor Treasury Regulations define "held primarily for sale." (*Baker Enterprises*, *supra*, at p. *7.) Whether property is "held primarily for sale" is a question of fact. (*Ibid*.) In the context of IRC section 1221,[4] the United States Supreme Court has held that the term "primarily" means "of first importance" or "principally." (*Malat v. Riddell* (1966) 383 U.S. 569, 572.)

Courts have acknowledged, however, that IRC section 1221 applies a different standard than IRC section 1031. (*Black v. Commissioner*, *supra*, 35 T.C. 90, 96; *Baker Enterprises*, *supra*, at p. *7.) IRC section 1221 excludes from the term "capital asset" property "held by the taxpayer primarily for sale *to customers in the ordinary course of [its] trade or business*." (IRC, § 1221(a)(1), italics added.) Unlike IRC section 1221, IRC section 1031 omits the phrase "to customers in the ordinary course of [its] trade or business." Because IRC section 1031(a)(2)(A) deals only with property "held primarily for sale," this is the only requirement for the applicability of the exception to nonrecognition treatment provided by IRC section 1031. (*Baker Enterprises*, *supra*, at p. *7; see also *Black v. Commissioner*, *supra*, 35 T.C. 90, 96.)

In analyzing the term "primarily for sale" in IRC section 1031 cases, courts have referenced the following factors established in IRC section 1221 cases:

(1) the purpose for which the property was initially acquired;
(2) the purpose for which the property was subsequently held;
(3) the extent to which improvements, if any, were made to the property by the taxpayer;
(4) the frequency, number, and continuity of sales;
(5) the extent and nature of the transactions involved;
(6) the ordinary business of the taxpayer;
(7) the extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property;
(8) the listing of property with brokers; and
(9) the purpose for which the property was held at the time of sale.

[4] IRC section 1221 (incorporated by R&TC section 18151) defines capital assets to include property held by the taxpayer, except those specifically listed in the statute.

(*Baker Enterprises*, *supra*, at p. *7, citing *Maddux Construction Co. v. Commissioner* (1970) 54 T.C. 1278, 1284; see also *Paullus v. Commissioner*, T.C. Memo. 1996-419.) None of the factors are conclusive standing alone, but rather all of the factors taken as a whole govern. (*Baker Enterprises*, *supra*, at p. *7.)

In determining whether property is "held primarily for sale" under IRC section 1031, the factors presented in IRC section 1221 cases (as set forth above) provide guidance in making the applicable determination, but for IRC section 1031 purposes, courts are not concerned with factors analyzing whether the property was sold "to customers in the ordinary course of . . . business" or whether the property was held in the taxpayer's "trade or business." (*Baker Enterprises*, *supra*, at p. *7.) As a result, the exclusion of "property held primarily for sale" from nonrecognition treatment in IRC section 1031(a)(1) is broader than the exception to capital gain treatment in IRC section 1221; the exception under IRC section 1031(a)(1) does not require the taxpayer to hold the replacement property for sale in the ordinary course of business but rather just hold the property for sale, whether or not connected with its business. (*Ibid*.)

II. Analysis

Appellants contend that HQE acquired the Diamond Bar Property for investment purposes, thereby qualifying its exchange for nonrecognition treatment under IRC section 1031. Specifically, appellants assert that HQE's intentions at the time of acquisition were to provide financing to MDRP and to hold the Diamond Bar Property for subsequent appreciation over a substantial period of time. We note that HQE's intentions are, of course, subjective and thus are, in some sense, not truly known to us. Accordingly, we must look to the circumstances surrounding HQE's acquisition of the Diamond Bar Property, and from those circumstances determine whether HQE acquired such property "for investment," or alternatively, "primarily for sale."

A. Contemporaneous Documents

Contemporaneous facts are important in establishing intent for IRC section 1031 purposes. (*Baker Enterprises*, *supra*, at p. *9.) Here, contemporaneous documents indicate that HQE acquired the Diamond Bar Property primarily for sale.

First, when HQE acquired the Diamond Bar Property, eight of the 48 lots in the development—four of which were located within the Diamond Bar Property itself—had been “presold” via contracts that were contingent on development of the project. The fact that lots had been presold when HQE acquired the Diamond Bar Property is evidence that HQE acquired the Diamond Bar Property primarily for sale. Appellants argue, however, that sales of the presold lots occurred between December 2008 and July 2009, and because HQE did not purchase the Diamond Bar Property until May 2010, the presold lots should not be attributed to HQE. Appellants also contend that “subsequent to the First Amended Purchase Agreement, all of the pre-sale lot transactions . . . [had] been reversed and cancelled.” However, the Purchase Agreement specifically mentions that MDRP would deliver to HQE “any deposit paid by third parties on the pre-sale of the lots” on the Diamond Bar Property, indicating that HQE assumed the obligations and benefits from the presold lots. HQE’s obligation to transfer the property to the purchasers of the presold lots is evidence that, at minimum, the presold lots were likely received primarily for sale. (See *Griffin v. Commissioner* (1967) 49 T.C. 253.) Moreover, the fact that the sales were reversed and cancelled, without any evidence as to why the sales were reversed and cancelled, may indicate that HQE’s intent to sell the property may have been frustrated, rather than proof that they did not intend to sell the property from the outset.

Next, HQE acquired the Diamond Bar Property under an agreement that required MDRP to “start substantial construction” of improvements by December 31, 2010, or pay HQE a penalty of $500,000. We believe, at a minimum, the $500,000 penalty is evidence that timely development of the Diamond Bar Property was a significant concern to HQE because it would lead to a timely sale.

Also, HQE’s loan with Preferred Bank had an initial maturity date of April 8, 2012, with an extended maturity date of October 8, 2012, which was only approximately two and a half years after acquiring the Diamond Bar Property, and that as part of the loan, HQE was required to provide the bank with monthly progress reports on development of the project. Additionally, the promissory note with Preferred Bank states that Preferred Bank agreed to make the loan to HQE based upon HQE’s creditworthiness, and expertise in “owning, developing and operating the real estate property covered by the Deed of Trust . . . .” Here, the relatively short term of the loan (approximately two years), combined with the requirement for monthly progress reports on development of the project and Preferred Bank’s basis for giving the loan, support a finding that HQE acquired the Diamond Bar Property primarily for sale.

Finally, shortly before HQE acquired the Diamond Bar Property, the appraiser had discussions with a real estate agent, Cheng, who stated that she already had a group of buyers set up to purchase lots and she was only waiting for grading of the development to begin to put sales into escrow. Cheng's statements may have been overly optimistic and, standing alone, would not prove that HQE acquired the Diamond Bar Property primarily for sale. However, when considered with the rest of the record, the statements support a finding that HQE acquired the Diamond Bar Property primarily for sale.

B. Subsequent Events

Events occurring after HQE acquired the Diamond Bar Property also support a finding that HQE acquired such property primarily for sale.

First, the 2012 reappraisal specifically included the eight presold lots in its cash flow analysis, which could support a finding that the eight presold lots had not been cancelled as of 2012. As mentioned above, the fact that lots had been presold when HQE acquired the Diamond Bar Property is evidence that HQE acquired the Diamond Bar Property primarily for sale. Again, appellants have not provided any documentation relating to when and why the cancellations occurred. Also, as noted previously, unexpected cancellations of contracts are not inconsistent with an intent to sell the property.

Next, the First Amendment to the First Amended Purchase Agreement is dated June 12, 2012, and it stated that MDRP must complete all development improvements by October 31, 2013, or be subject to a penalty of $1 million. As stated above with the $500,000 penalty, we believe, at a minimum, this $1 million penalty is evidence that timely development of the Diamond Bar Property was a significant concern to HQE.

Also, HQE ordered 950 catalogs, which advertised the 48 individual lots for sale. The cover pages of the catalogs state that the project is a "Joint Development" by HQE and MDRP. Appellants argue that MDRP created the catalogs to generate interest from third parties to raise money in order to keep up with loan payments. Regardless of MDRP or HQE's intent to generate sales, the solicitation for bids in 2012, when combined with all other evidence, support a finding that HQE acquired the Diamond Bar Property primarily for sale.

Next, after HQE acquired the Diamond Bar Property in 2010, MDRP held 74 bi-weekly meetings, wherein topics discussed included the progress of development improvements and plans to design and market homes on the 48 individual lots. The meeting minutes indicate that

HQE regularly authorized wire transfers of funds from HQE's bank account to MDRP's bank account to pay for development improvements. Appellants argue that HQE's role with MDRP and the Diamond Bar Property was akin to a passive investor whose purpose was to merely provide a source of financing for MDRP. Appellants contend that their role was similar to Preferred Bank, which also had money tied up in the investment (i.e., the Diamond Bar Property), and attended the bi-weekly meetings with HQE. However, the laws pertaining to an IRC section 1031 transaction do not make a distinction between a "passive investor" or someone who is actively selling the property. Additionally, the Diamond Bar Property was owned by HQE, not MDRP. While the meeting minutes themselves do not prove HQE's intent at the time of acquisition in 2010, they are objective evidence that, when combined with all the other documentation, support a finding that HQE acquired the Diamond Bar Property primarily for sale.

Appellants assert, however, that the length of time property is held is the second-most important factor in considering intent—and appellants state that HQE has held the Diamond Bar Property since 2010. Appellants argue that HQE desired to hold the Diamond Bar Property for investment and considered selling such property as a whole (with grading and improvements) when market conditions were desirable. While the length of time property is held is an important factor in considering intent (see *Baker Enterprises*, *supra*, T.C. Memo. 1998-302), the above-listed factors, taken as a whole, indicate that HQE acquired the Diamond Bar Property primarily for sale, rather than for investment. Appellants' intent to sell the property may have been frustrated by economic conditions[5] or community opposition,[6] but appellants have not shown that they intended to hold the property for investment at the time of the exchange. "The fact that land was held for many years does not, by itself, establish an intention to hold the property for investment rather than sale." (*Id.* At p. *15.)

In summary, the analysis of all the facts and circumstances in this case indicate that appellants acquired the Diamond Bar Property primarily for sale. At the time of the exchange,

[5] Appellants state that there was a declining value trend of existing property within the country between January 2008, through the November 30, 2009 appraisal report. Appellants stated at the oral hearing that the economic decline was evidenced by a 10.93 percent decrease in property value over a six-month period between May and November 2009.

[6] Significant and long-lasting legal action was taken against HQE that prevented appellants from accessing the Diamond Bar Property for development from 2013 through 2017.

HQE: (1) assumed the obligations of the presold lots on the Diamond Bar Property, which is indicative of an intent to develop and sell these four lots and the rest of the Diamond Bar Property; (2) required MDRP to begin substantial construction, or be subject to a substantial penalty; (3) obtained a $7.6 million short-term loan from Preferred Bank, which required monthly progress updates by HQE; and (4) received an optimistic appraisal from a realtor who stated that she already had buyers ready once the land was graded for development. These facts, along with the subsequent events that took place, indicate that HQE intended to hold the property primarily for sale.

HOLDING

Appellants have failed to demonstrate that HQE acquired replacement property in a like-kind exchange with the requisite intent to hold for investment or for use in a trade or business.

DISPOSITION

FTB's actions are sustained.

DocuSigned by:
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Andrea L.H. Long
Administrative Law Judge

We concur:

DocuSigned by:
873D9797B9E64E1...
John O. Johnson
Administrative Law Judge

DocuSigned by:
CF2E977BFB79472...
Kenneth Gast
Administrative Law Judge

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