OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeals of: **LOVINCK INVESTMENTS N.V. AND STAR PROSPECT INTERNATIONAL LIMITED**	OTA Case Nos. 19095228, 19095246

OPINION

Representing the Parties:

For Appellants: John J. O'Neill, Esq.

For Respondent: Kim L. Akin, Specialist

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

T. LEUNG, 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 appellants' protests against proposed assessments.[1]

Appellants waived their respective rights to an oral hearing and, therefore, these appeals are being decided on the written record.

ISSUES

1. Whether appellants' limited partnership must recognize additional taxable income from the sale of relinquished property in a failed[2] like-kind exchange.
2. Whether the accuracy-related penalties were properly imposed.

[1] The Notice of Action (NOA) issued to appellant Lovinck Investment N.V. ("Lovinck") for the taxable year ended (TYE) June 30, 2012, imposed additional tax of $1,005,550 and an accuracy-related penalty of $201,110. The NOA issued to appellant Star Prospect International Limited ("Star Prospect") for the TYE May 31, 2012, imposed additional tax of $430,950 and an accuracy-related penalty of $86,190. Each NOA stated that interest would accrue on any unpaid additional tax, measured from the due date of the original return.

[2] For purposes of this appeal, it is undisputed that the exchange failed to qualify for deferral of gain under Internal Revenue Code (IRC) section 1031.

FACTUAL FINDINGS

1. Appellants were limited partners in 900 Folsom Street Partnership (FSP), a California limited partnership, which owned property on Folsom Street in San Francisco, California (the “Folsom Property” or “Relinquished Property”).[3] Appellants have since dissolved.
2. In 2011, FSP agreed to sell the Folsom Property to an unrelated third-party named 900 Folsom Street, LLC, a Delaware limited liability company (“Buyer”).
3. Appellants attempted to defer recognition of gain on FSP’s sale of the Folsom Property through use of a like-kind exchange under the provisions of IRC section 1031, and took the following action in December 2011:
    a. First, FSP and Buyer signed an asset purchase agreement (“Asset Purchase Agreement”), whereby FSP agreed to sell, and Buyer agreed to purchase, the Folsom Property for $19.5 million;
    b. Shortly afterwards, FSP entered into an exchange agreement with Independent Exchange Services, Inc., a qualified intermediary (hereinafter “QI”), wherein FSP expressed its intention of exchanging the Folsom Property, and in turn, QI agreed to help facilitate the proposed IRC section 1031 exchange. On the same day, FSP entered into a separate agreement with QI wherein FSP assigned its rights under the Asset Purchase Agreement to QI;
    c. At about the same time, Buyer signed an undated document titled “Notice of Contract Assignment and Buyer’s Acknowledgement,” wherein Buyer acknowledged that QI would participate in the proposed IRC section 1031 exchange;
    d. At close of escrow on that same day, FSP deeded the Folsom Property to Buyer;
    e. The closing escrow statement prepared by North American Title Insurance Company, Inc. (Title) for sale of the Folsom Property set forth a sales price of $19.5 million and no mortgages on such property. After escrow fees were paid, $19,217,751 was disbursed, at FSP’s direction, to QI; and

[3] FSP’s partners at the time the Folsom Property was sold were as follows: AGI Capital Group, Inc, which was the sole general partner and held a zero percent profits interest; Lovinck, which was a limited partner and held a 70 percent profits interest; and Star Prospect, which was a limited partner and held a 30 percent profits interests.

f. After escrow closed, FSP identified replacement property located in Antioch, California ("Replacement Property"), which was owned by a related entity named 2005 San Jose, LLC. Later, QI acquired the Replacement Property and transferred it to FSP, as well as paying off at least $16,250,000 of the more than $23 million debt owed to Lender and secured by the Replacement Property. Subsequently, Lender lent $16.5 million to FSP, which was secured by the Replacement Property.[4]

4. Appellants admit that the exchange failed to qualify under IRC section 1031 because it violated the related party rules of IRC section 1031(f), as 2005 San Jose, LLC was related to FSP and/or FSP's owners/affiliates.

5. The sale of the Folsom Property was reported by FSP on its 2011 return as a taxable sale. However, when calculating the amount of gain on sale of the Folsom Property, FSP utilized a sales price of $3.25 million, which was the fair market value (FMV) of the Replacement Property, instead of $19.5 million, which was the sales price listed in the Asset Purchase Agreement. Specifically, FSP calculated taxable gain on sale of the Folsom Property as follows:

Sales Price:	$3,250,000
Cost Basis (plus selling expenses):	$2,733,905
Gain:	$ 516,095

6. Upon audit, FTB determined that FSP's use of the $3.25 million sales price was incorrect, as it ignored the sales price of $19.5 million that is set forth in the Asset Purchase Agreement. FTB calculated taxable gain on the sale of the Folsom Property as follows:

Sales Price:	$19,500,000
Adjusted Basis (plus selling expenses):	$ 2,733,905
Recognized Gain:	$16,766,095

7. Due to appellants' status as limited partners in FSP, gain was allocated to them pursuant to R&TC section 24271(b) and IRC sections 704 and 702 in accordance with appellants' respective profits interests.

[4] The record indicates that these loan proceeds were then used to partially finance the buy-out of appellants' principals; FSP received a note receivable to represent this financing on its books.

8. FTB issued a Notice of Proposed Assessment (NPA) to Lovinck for Lovinck's TYE June 30, 2012, which imposed an additional tax of $1,005,550 and a 40 percent noneconomic substance transaction (NEST) penalty of $402,220.15. FTB also issued an NPA to Star Prospect in relation to Star Prospect's TYE May 31, 2012, which imposed an additional tax of $430,950 and a 40 percent NEST penalty of $172,379.88. Each NPA stated that interest would accrue on any unpaid additional tax, measured from the due date of the original return. Appellants protested.
9. Following the protest proceedings, FTB issued an NOA to Lovinck for Lovinck's TYE June 30, 2012, which imposed an additional tax of $1,005,550 and a reduced 20 percent accuracy-related penalty of $201,110. Also, FTB issued an NOA to Star Prospect in relation to Star Prospect's TYE May 31, 2012, which imposed an additional tax of $430,950 and a reduced 20 percent accuracy-related penalty of $86,190. Each NOA stated that interest would accrue on any unpaid additional tax, measured from the due date of the original return.

DISCUSSION

Issue 1: Whether appellants' limited partnership must recognize additional taxable income from the sale of the Relinquished Property.

Burden of Proof

FTB's determination is generally presumed to be correct, and the taxpayer bears the burden of proving otherwise. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

IRC section 1031

"[T]axpayers must recognize gains or losses realized from the disposition of property in the year of realization. See 26 U.S.C. § 1001(c). [However], in a so-called 'section 1031' exchange, gain realized on the exchange of like-kind property held for productive business use or investment need not be recognized until the acquired property is finally disposed of." (*Teruya Brothers Ltd. v. Commissioner* (9th Cir. 2009) 580 F.3d 1038, 1042 (*Teruya*).) Simply put, IRC section 1031 is an exception to the general rule requiring recognition of gain or loss upon the sale or exchange of property. (See IRC, § 1001(c).) As relevant to the issues here, California conforms to IRC section 1031 at R&TC sections 18031 and 24941. To qualify for nonrecognition 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 (the relinquished property) and the property received (the replacement property) must be held for a qualified purpose. (IRC, § 1031(a)(1)-(3).) IRC section 1031 will not apply if the transaction is structured to avoid the statute's provisions restricting exchanges between related persons. (IRC, § 1031(f)(4).)

Tax can "not be escaped by anticipatory arrangements and contracts however skillfully devised . . . [and] no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew . . . ." (*Lucas v. Earl* (1930) 281 U.S. 111, 115.) Under the IRC section 1031 rules, a taxpayer generally has actual receipt of money when the taxpayer receives the money or property or its benefit. (Treas. Reg. § 1.1031(k)-1(f)(2).) A taxpayer has constructive receipt of money when the money or property is credited to the taxpayer's account, set aside for the taxpayer, or made available so that the taxpayer can draw on it with notice. (*Ibid.*) Even where the taxpayer has no actual or constructive receipt of money or property, actual or constructive receipt by the taxpayer's *agent* is imputed to the taxpayer. (*Ibid.*)

The Treasury Regulations, however, create a safe harbor to shield section 1031 exchangers from constructive receipt of funds. (Treas. Reg. § 1.1031(k)-1(g)(4)(i).) Under the safe harbor, a qualified intermediary is not considered the agent of the taxpayer for purposes of section 1031(a) and, therefore, can transfer money and property without the taxpayer being deemed to have actual or constructive receipt of funds. (*Id.*) The safe harbor provides, in part:

> In the case of a taxpayer's transfer of relinquished property involving a qualified intermediary, the qualified intermediary is *not considered the agent of the taxpayer for purposes of section 1031(a)*. In such a case, the taxpayer's transfer of relinquished property and subsequent receipt of like-kind replacement property is treated as an exchange, and the determination of whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property is made as if the qualified intermediary is not the agent of the taxpayer. (Treas. Reg. § 1.1031(k)-1(g)(4)(i), emphasis added.)

The safe harbor disappears, however, the moment the taxpayer has an "immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money . . . held by the qualified intermediary." (Treas. Reg. § 1.1031(k)-1(g)(4)(vi).)

Analysis

It is undisputed that the purported exchange failed to qualify as a like-kind exchange under the provisions of IRC section 1031. Furthermore, because appellants failed to show that the exchange was not structured to avoid the related party restrictions, the entirety of IRC section 1031 is not applicable, including the safe harbor provisions for qualified intermediaries. (See IRC, § 1031(f)(4).)[5] The issue for us to decide is the extent to which FSP must recognize taxable income from its sale of the Folsom Property.

Once IRC section 1031 is inapplicable, the general recognition rule under IRC section 1001(c) is triggered. In addition, the Treasury Regulations provide that a taxpayer must treat a section 1031 exchange as a sale if the taxpayer has constructive receipt of the replacement property funds. (See Treas. Reg. § 1.1031(k)-1(f)(1).) FSP has not completed a like-kind exchange, and under any IRC section other than section 1031, QI is considered FSP's agent. Simply put, appellants cannot "dock" at the IRC section 1031 safe harbor once they admit that the transactions at issue do not qualify as an IRC section 1031 exchange. Moreover, FSP was able to control and direct Title and QI with respect to the use of the \$19.5 million received from the sale of the Folsom Property. Accordingly, Title's and QI's receipt of funds from the sale of the Folsom Property is imputed to FSP (see *Lucas v. Earl*, *supra*) and, therefore, FSP must pay tax on the difference between (1) the \$19.5 million sales price set forth in the Asset Purchase Agreement and (2) FSP's adjusted basis in the Folsom Property at the time of sale (plus selling expenses), which totaled \$2,733,905.[6] (See IRC, § 1001(a), (c).)

[5] It is noted that while appellants admit that the exchange does not qualify for IRC section 1031 treatment because of the involvement of related parties, they also do not appear to address whether these transactions were structured to avoid the prohibition against the use of related parties. Based on our reading of and comparison with *Teruya* and *Ocmulgee* (*Ocmulgee Fields, Inc. v. Commissioner* (11th Cir. 2010) 613 F.3d 1360) cases, we believe IRC section 1031(f)(4) applies.

[6] Pursuant to the terms of the agreements between FSP and QI, QI transferred net funds of \$19,217,751 (i.e., \$19.5 million less selling expenses) in accordance to the directions of FSP.

Appellants contend, however, that FSP is required to calculate gain on the failed 1031 exchange using the amount realized of $3.25 million, which is the FMV of the Replacement Property, citing *Teruya* and Revenue Ruling 2002-83.[7] We disagree.

Teruya affirmed the IRS's determination that a particular related party exchange did not qualify for non-recognition treatment under IRC section 1031, and its holding confirms that appellants' attempted related party exchange also failed to so qualify. Given that IRC section 1031 does not apply, the general recognition rule set forth in IRC section 1001(c) controls the outcome of this appeal. Furthermore, the *Teruya* court did not use the FMV of the replacement property to compute the taxpayer's gain, but started its gain computation using the amount realized from the sale of the relinquished property.[8]

In light of the *Teruya* and *Ocmulgee* decisions, Revenue Ruling 2002-83 is not persuasive. Appellants rely on the final paragraph of that revenue ruling, which states:

> A's exchange of property with QI, therefore, is part of a transaction structured to avoid the purposes of IRC section 1031(f) and, under IRC section 1031(f)(4), the non-recognition provisions of section 1031 do not apply to the exchange between A and QI. A's exchange of Property 1 for Property 2 is treated as a taxable transaction. Under section 1001(a), A has gain of $100x, the difference between A's amount realized on the exchange ($150x, fair market value of Property 2) and A's adjusted basis in the property exchanged ($50x).

In the revenue ruling, the FMV of Property 1 and Property 2 are the same, which is not the case in these appeals. The ruling simply identifies that the amount received in the example is $150x, the amount realized by A which coincides with the FMVs of Property 1 and Property 2. The revenue ruling does not establish that the realized gain on a failed IRC section 1031 exchange is always the difference between the FMV of the replacement property and the basis of the relinquished property.[9] Clearly, when the FMVs of the relinquished property and the replacement property are different, the amount realized is the amount paid for the replacement property. (See *Teruya*, *supra*, and *Ocmulgee*, *supra*.)

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[7] 2002-49 I.R.B. 927.

[8] Accord, *Ocmulgee*, *supra*. Ironically, in *Teruya*, the replacement properties had a higher FMV than the amount realized from the sales of the relinquished properties.

[9] See *Ocmulgee*, *supra* (gain realized from a failed related party IRC section 1031 exchange was calculated by using the difference between the sales price of the relinquished property and its basis).

In summary, QI's receipt of funds from the sale of the Folsom Property is imputed to FSP and, therefore, FSP must recognize taxable income on the difference between (1) the $19.5 million sales price set forth in the Asset Purchase Agreement and (2) FSP's adjusted basis in the Folsom Property at the time of sale (plus selling expenses), which totaled $2,733,905. (IRC, § 1001(a), (c).)

Issue 2: Whether the accuracy-related penalties were properly imposed.

R&TC section 19164, which generally incorporates the provisions of IRC section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty applies to the portion of the underpayment attributable to (1) negligence or disregard of rules and regulations, or (2) any substantial understatement of income tax. (IRC, § 6662(b).)

FTB imposed accuracy-related penalties on the basis of appellants' substantial understatements. For an individual, there is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or $5,000. (IRC, § 6662(d)(1).)

Here, Lovinck should have reported a California tax of $1,045,057 and understated its tax by $1,005,550. Star Prospect should have reported a California tax of $440,435 and understated its tax by $430,950. Accordingly, the understatements were substantial.[10]

The penalties may be reduced or abated if appellants can show (1) there is substantial authority for appellants' reporting position, (2) the position was adequately disclosed in the tax return (or a statement attached to the return)[11] and there is a reasonable basis for treatment of the item, or (3) that they acted in good faith and had reasonable cause for the understatement.[12] (IRC, §§ 6662(d)(2)(B), 6664(c)(1); R&TC, § 19164(d); Cal. Code Regs., tit. 18, § 19164(a).)

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[10] The NOAs reduced the amount of the proposed assessment by removing the 40 percent NEST penalties and imposing the 20 percent accuracy-related penalties. Here, the substantial understatements constitute prima facie evidence that the penalties were properly imposed.

[11] To qualify as an adequate disclosure, Treasury Regulations generally require that the taxpayer disclose the details of his or her position on either a Federal Form 8275, a Form 8275-R, or a qualified amended return. (Treas. Reg. § 1.6662-4(f).) The record does not show that appellants adequately disclosed their reliance on *Teruya* and Revenue Ruling 2002-83.

[12] A determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis and depends on the pertinent facts and circumstances, including the taxpayer's efforts to assess the proper tax liability, the taxpayer's knowledge and experience, and the extent to which the taxpayer relied on the advice of a tax professional. (Treas. Reg. § 1.6664-4(b)(1).)

On appeal, appellants have not raised any specific arguments concerning the accuracy-related penalties, and we see no basis to abate or reduce the penalties.[13] As discussed above, *Teruya* and *Ocmulgee* contradict appellants' position. In addition, we are not aware of any authority that supports appellants' position. We therefore find that appellants' position is not supported by substantial authority or a reasonable basis. Accordingly, there is no basis to waive the penalties.

Moreover, the record does not show reasonable cause for the understatements.[14] The record does not indicate that appellants received or reasonably relied on advice from an attorney or another tax professional that gain could be calculated using an amount realized of $3.25 million despite the fact the Relinquished Property was sold for $19.5 million in a failed IRC section 1031 exchange.

[13] We note, however, that the last page of appellants' opening brief states, in part, "as an aside . . . the [IRS] previously audited the exchange and related transaction at issue and decided not to assess any additional taxes, interest or penalties." The record does not include evidence of an IRS determination or the basis for any such determination. The record here shows that the penalties were properly imposed, and we are not bound by any federal determination. (See *Appeal of Der Wienerschnitzel International, Inc.* (79-SBE-063) 1979 WL 4104.)

[14] We therefore need not address whether appellants acted in good faith.

HOLDINGS

Appellants must recognize additional taxable income from the sale of the Relinquished Property in accordance with the discussion above. The accuracy-related penalties were properly imposed.

DISPOSITION

FTB's actions are sustained in full.

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Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

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John O Johnson
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John O. Johnson
Administrative Law Judge

DocuSigned by:
Sara A Hosey
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Administrative Law Judge

Date Issued: 6/2/2021