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**CALIFORNIA STATE BOARD OF EQUALIZATION**  
**FORMAL OPINION UNDER REVENUE AND TAXATION CODE SECTION 40**

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| In the Matter of the Consolidated Appeals of: | ) | <b>2015-SBE-001</b> |
| <b>RAGO DEVELOPMENT CORPORATION;</b>          | ) | Case No. 735761     |
| <b>LOUIS RAGO AND JUNE E. RAGO;</b>           | ) | Case No. 725839     |
| <b>MICHAEL J. SMITH AND LYNN M. SMITH;</b>    | ) | Case No. 725834     |
| <b>PAUL H. VERRIERE AND</b>                   | ) | Case No. 727493     |
| <b>PATRICIA R. VERRIERE;</b>                  | ) |                     |
| <b>FREDRICK M. WOOSTER AND</b>                | ) | Case No. 727483     |
| <b>MARY L. WOOSTER;</b>                       | ) |                     |
| <b>LOUIS LA TORRE</b>                         | ) | Case No. 633028     |
| <b>LIVING FAMILY TRUST;</b>                   | ) |                     |
| <b>MARTIN BRAMANTE AND</b>                    | ) | Case No. 632713     |
| <b>ESTATE OF VELIA BRAMANTE (DEC'D);</b>      | ) |                     |
| <b>FRANK SABELLA</b>                          | ) | Case No. 633944     |

Representing the Parties:

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|--|--|
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| For Franchise Tax Board:               | David Gemmingen, Tax Counsel IV  |
| Counsel for the Board of Equalization: | John O. Johnson, Tax Counsel III   |

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1 LEGAL ISSUE

2 Whether appellants have shown error in respondent's determination denying appellants'  
3 claimed deferral of gain pursuant to an attempted like-kind exchange under Internal Revenue Code  
4 (IRC) section 1031.<sup>1</sup>

5 FINDINGS OF FACT

6 The Bramante appellants<sup>2</sup> entered into an agreement with Consolidated Title Services (CTS) to  
7 perform a like-kind exchange on April 29, 2003, and sold apartments in San Rafael through their  
8 general partnership, Sonoma Bell Apartments, on May 1, 2003. The Rago appellants sold two adjacent  
9 properties in St. Helena, California, and entered into a separate like-kind exchange agreement with  
10 CTS, all during May of 2003. On June 2, 2003, both groups of appellants identified the Sand Creek  
11 Crossing shopping center as the replacement property for their like-kind exchanges.<sup>3</sup>

12 On June 2, 2003, all appellants entered into a loan agreement with Greenwich Capital Financial  
13 Products to obtain funds for the purchase of the Sand Creek Crossing property. The loan agreement  
14 provided that appellants would transfer their interests in the Sand Creek Crossing shopping center to a  
15 single-purpose limited liability company (LLC) no later than January 31, 2004. On June 30, 2003,  
16 appellants purchased the Sand Creek Crossing property through their qualified intermediary.  
17 Appellants held undivided interests in the property pursuant to a Tenants-In-Common Agreement. The  
18 property consisted of two parcels forming the Sand Creek Crossing shopping center and two adjacent  
19 parcels of undeveloped "pads." Appellants formed Sand Creek Crossing, LLC on January 23, 2004,

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22 <sup>1</sup> This consolidated appeal originally included interest abatement as an issue on appeal. Respondent subsequently agreed to  
23 abate the requested interest, and therefore interest abatement is no longer an issue on appeal.

24 <sup>2</sup> This appeal includes of two groups of taxpayers. The "Bramante" group consists of Louis La Torre Living Family Trust,  
25 Martin Bramante and Estate of Velia Bramante (Dec'd), and Frank Sabella. The remaining appellants are part of the  
26 "Rago" group.

27 <sup>3</sup> In addition to the like-kind exchange involving the Sand Creek Crossing property discussed herein, appellants in the Rago  
28 group also performed a like-kind exchange involving separate properties (the Rancho Adobe and Wachovia properties).  
Respondent originally denied tax-deferred treatment for this exchange, but subsequently conceded it was a valid like-kind  
exchange at the conclusion of respondent's administrative protest process. However, the Rago appellants' Notice of Action  
did not reflect this concession. Respondent confirmed at a pre-hearing conference that the like-kind exchange involving the  
Wachovia property qualified for IRC section 1031 treatment, and that the portion of the proposed assessment attributable to  
this exchange would be retracted.

1 and transferred the Sand Creek Crossing shopping center property to the LLC on January 31, 2004.<sup>4</sup>

2 Respondent audited appellants' 2003 tax year and determined that the attempted like-kind  
3 exchange failed based on various theories including partnership law and the substance over form  
4 doctrine.<sup>5</sup> Notices of Proposed Assessments (NPAs) were issued to the Rago appellants and to the  
5 Bramante appellants in March of 2008. Following protest hearings, respondent issued Notices of  
6 Action disallowing gain deferral under IRC section 1031 on the ground that, under the step transaction  
7 doctrine, appellants effectively exchanged real property for a partnership interest. Appellants then  
8 timely appealed.

9 APPLICABLE LAW AND RELATED CONTENTIONS

10 To qualify for nonrecognition treatment under IRC section 1031, the following general  
11 requirements must be satisfied: (1) the transaction must be an exchange; (2) the exchange must involve  
12 like-kind properties; and (3) both the property transferred (the relinquished property) and the property  
13 received (the replacement property) must be held for a qualified purpose. (Int.Rev. Code, § 1031(a)(1)-  
14 (3).)<sup>6</sup> Property is held for a qualified purpose if it is held for a productive use in a trade or business or  
15 held for investment. (*Ibid.*) IRC section 1031(a)(2)(D) provides that the exchange of interests in  
16 partnerships will not qualify for the like-kind exchange treatment.

17 Appellants contend that only the third requirement is at issue here, the holding requirement, and  
18 that the key to resolving this appeal is determining whether they held the replacement property for  
19 investment or productive use in a trade or business. The parties dispute whether the loan provision and  
20 subsequent transfer of the property to an LLC in accordance with that provision caused appellants to  
21 fail the holding requirement for the replacement property. Respondent also asserts that the step  
22 transaction doctrine should apply to treat appellants as if they had exchanged real property interests for  
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24 <sup>4</sup> Appellants also formed Sand Creek Crossing Pads, LLC on January 23, 2004, and transferred the pads portion of the  
25 property to this LLC on January 31, 2004. The loan provision only applied to the Sand Creek Crossing shopping center, and  
26 the parties on appeal focus on the potential effect of the contribution of that property to its respective LLC. For simplicity,  
27 references to the replacement property and LLC will refer to the shopping center property and Sand Creek Crossing, LLC.  
28 The legal conclusions herein are equally applicable to the contribution of the pads to the Sand Creek Crossing Pads, LLC.

<sup>5</sup> Respondent's protest officer would later reverse the audit determination regarding partnership law and find that the Sand Creek Crossing joint venture was, as appellants contended, a tenancy-in-common and not a disguised partnership.

<sup>6</sup> California conforms to IRC section 1031 pursuant to Revenue and Taxation Code sections 18031 and 24941.

1 interests in an LLC.

2       The determination of whether taxpayers meet the holding requirement (i.e., whether both the  
3 relinquished and replacement properties are held for productive use in a trade or business or held for  
4 investment) is a factual determination. The U.S. Tax Court and its precursor, the U.S. Board of  
5 Tax Appeals, have discussed the relevance of subsequent transfers and their effect on the holding  
6 requirement. The court has focused on the intent of the taxpayer by analyzing: (1) whether the  
7 taxpayer’s “mental state was such that it intended to hold the property received as investment”; and  
8 (2) whether, “given no tax problem, [the transaction] would almost certainly have been carried out in  
9 another way.” (*Regals Realty* (B.T.A. 1940) 43 B.T.A. 194, 208-209 [disallowing gain deferral where  
10 a corporation had a clear intention to sell replacement property and structured its transaction based on  
11 tax purposes].) The court has considered the taxpayers’ intent from the beginning of negotiating a  
12 property exchange and whether the taxpayers actually held the property for investment or used the  
13 property in their business for some time after acquisition. (*Wagensen v. Commissioner* (1980)  
14 74 T.C. 653 [allowing gain deferral where a rancher received land he used in his business for nine  
15 months before gifting it to his children, although the rancher considered the possibility of gifting land  
16 prior to the acquisition]; *Click v. Commissioner* (1982) 78 T.C. 225 [denying gain deferral where  
17 replacement property was held for seven months before gifting where the taxpayer’s primary intent at  
18 inception of exchange was to provide homes for her children].)

19       The Ninth Circuit Court of Appeals rendered two decisions in 1985 that addressed what are  
20 commonly known as the “swap and drop” and “drop and swap” fact patterns. In *Magneson v.*  
21 *Commissioner* (9th Cir. 1985) 753 F.2d 1490 (*Magneson*), pursuant to a pre-arranged plan, the  
22 taxpayers completed an exchange of property (“swap”), and then, on the same day, contributed the  
23 property to a limited partnership (“drop”), and in return became general partners of the limited  
24 partnership. The court stated that “[t]he case law, the regulations, and the legislative history are . . . all  
25 in agreement that the basic reason for nonrecognition of gain or loss on transfers of property under  
26 sections 1031 and 721 [which permits nontaxable contributions to partnerships] is that the taxpayer’s  
27 economic situation after the transfer is fundamentally the same as it was before the transfer: his money  
28 is still tied up in investment in the same kind of property,” and that “this principle exactly describes the

1 Magnesons’ situation[.]” reasoning that the Magnesons only changed the form of their ownership from  
2 a tenancy in common to a partnership and they took no cash or non-like-kind property out of the  
3 transaction. (*Magneson, supra*, 753 F.2d at p. 1494.) The court found that the requirements of IRC  
4 section 1031 were satisfied.

5 The court rejected the argument that the partnership interest received and the tenancy-in-  
6 common interest given up were so substantially different that the Magnesons could not be considered to  
7 have continued to hold the property for investment. In doing so, the court considered California state  
8 law existing at that time and observed that a partner is co-owner with his partners and that general  
9 partners had the right to possess partnership property. The court stated that, while there are “significant  
10 distinctions” between a tenancy in common and a partnership interest, the distinctions are not  
11 controlling, and the taxpayers continued their investment interest when they held the property through  
12 their general partnership interest. (*Magneson, supra*, 753 F.2d at pp. 1495-1496.)

13 The court stated that it may not be appropriate to apply the step transaction doctrine to view the  
14 transaction as an exchange of real property in return for a partnership interest. The court found that  
15 the Magnesons could have structured their transaction differently, but there was no more direct method  
16 than the method actually used. (*Magneson, supra*, 753 F.2d at p. 1497.) The court stated that, even if  
17 it did collapse the transaction, the transaction would still qualify under IRC section 1031, though it  
18 noted that Congress had recently amended the statute, for years after the years at issue in the case, to  
19 exclude exchanges of partnership interests. (*Id.* at pp. 1497-1498, fn. 4.) The court explained that “a  
20 critical basis for [its] decision [was] that the partnership in this case had as its underlying assets  
21 property of like kind to the Magnesons’ original property, and its purpose was to hold that property for  
22 investment.” (*Id.* at p. 1498.) The court stated that its holding was limited to exchanges of property  
23 where the property is contributed in return for a general partnership interest.<sup>7</sup> (*Ibid.*)

24 In *Bolker v. Commissioner* (9th Cir. 1985) 760 F.2d 1039 (*Bolker*), decided shortly after  
25 *Magneson*, the taxpayer liquidated his own wholly owned corporation, “for tax purposes,” and received  
26 a distribution of real estate. On the same day as the liquidation, he contracted to exchange the  
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28 <sup>7</sup> However, and as discussed below, subsequent court decisions have applied the rationale in *Magneson* to situations where property is transferred to or from entities other than general partnerships.

1 distributed property for other like-kind property. The actual exchange took place three months later.  
2 The Internal Revenue Service (IRS) argued that the corporation, not the individual taxpayer, exchanged  
3 the property. In the alternative, the IRS argued that the taxpayer did not hold the property for trade or  
4 business or investment. The trial court and the Ninth Circuit rejected these arguments.<sup>8</sup> The Ninth  
5 Circuit explained that in *Magneson* it based its decision “on our holding that the Magnesons intended to  
6 and did continue to hold the acquired property, the contribution to the partnership being a change in the  
7 form of ownership rather than the relinquishment of ownership.” (*Id.* at p. 1044.) The court held that  
8 “. . . if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he  
9 is ‘holding’ that property ‘for productive use in trade or business or for investment’ within the meaning  
10 of section 1031(a).” (*Id.* at p. 1045.) Applying this holding, the court found that the intent to exchange  
11 a property does not disqualify a property from satisfying the holding requirement.

12 In *Maloney v. Commissioner* (1989) 93 T.C. 89 (*Maloney*), the U.S. Tax Court followed the  
13 Ninth Circuit’s decisions in *Magneson* and *Bolker* and found that the addition of another nontaxable  
14 transaction (e.g., a tax-free contribution to a partnership or tax-free liquidation from a corporation) does  
15 not automatically disqualify an exchange for non-recognition of gain under IRC section 1031. On the  
16 facts before it, the court allowed gain deferral where a corporation completed an exchange and three  
17 days later initiated a distribution of the replacement property to the shareholder through a pre-planned  
18 liquidation. The court stated that, where a taxpayer surrenders stock in a corporation in a liquidation,  
19 and receives in return property owned by the corporation, “. . . he continues to have an economic  
20 interest in essentially the same investment, although there has been a change in the form of ownership.”  
21 (*Id.* at p. 98.) The court explained that IRC “Section 1031 is designed to apply to these circumstances  
22 and to defer the recognition of gain or loss where the taxpayer has not really ‘cashed in’ on the  
23 theoretical gain, or closed out a losing venture.” (*Ibid.*)

24 A more recent case discussing the requirements of IRC section 1031 comes from the  
25 Oregon Tax Court. (*Department of Revenue v. Marks* (Or. T.C. 2009) 20 OTR 35, 2009 Ore. Tax  
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27 <sup>8</sup> On appeal to the Ninth Circuit, the IRS also argued, for the first time, that the step transaction doctrine should apply, but  
28 the court stated it would not consider this argument because, as a general rule, it will not consider arguments that were not raised at trial.

1 LEXIS 241 (*Marks*.) While we are not bound by a decision of the Oregon Tax Court, the decision  
2 provides a thoughtful analysis of the relevant authorities and issues. In *Marks*, the taxpayers received  
3 replacement property in an IRC section 1031 exchange and immediately contributed it to a partnership.  
4 In its analysis, the court assumed that the transfer was the result of a pre-arranged plan. (*Id.* at p. 40,  
5 fn. 3.) The Oregon Department of Revenue argued that the taxpayers did not hold the property for  
6 investment and, further, that the substance over form and step transaction doctrines should apply such  
7 that the taxpayers should be deemed to have received a partnership rather than like-kind property. The  
8 Department further argued that *Magneson* was distinguishable because (i) it pre-dated amendments to  
9 IRC section 1031 that prohibited exchanges of partnerships interests for partnership interests and  
10 (ii) *Magneson* relied on state partnership laws that did not reflect Oregon’s current laws. The court  
11 rejected all of the Department’s arguments.

12       Reviewing *Magneson*, *Bolker*, and *Maloney*, among other authorities, the *Marks* court  
13 determined that the central rationale of *Magneson* was that the taxpayer continued his investment. The  
14 court noted that *Bolker* and *Maloney* followed *Magneson*, and reflected the same rationale. Citing  
15 legislative history and the plain language of the statute, it further found that the amendments to IRC  
16 section 1031 only prohibited exchanges of partnership interests for partnership interests, rather than  
17 prohibiting an exchange of real property that is followed by the contribution of that property to a  
18 partnership. With regard to the changed partnership laws, it found that the changes in the uniform  
19 partnership act did not alter the fact that the taxpayers essentially continued their investment in a new  
20 form. With regard to the step transaction doctrine, the court found that the steps taken reflected the  
21 substance of the transaction and were permitted. It stated as follows: “[t]he point of *Magneson* is that  
22 taxpayers may engage in IRC section 1031 transactions and then, pursuant to a pre-existing plan or  
23 intent, contribute replacement property to a partnership . . . . The department is not authorized or  
24 permitted to rearrange facts to produce a different transaction.” (*Marks, supra*, 20 OTR at p. 52.)

25       In sum, the development of case law on the holding requirement shows that the courts examine  
26 the intent of the taxpayers at the beginning of the exchange to determine whether there is an intent to  
27 hold replacement property for investment or use in a business or trade. The courts also find that the  
28 holding requirement can be met when there remains an economic interest in essentially the same

1 investment, despite a change in the form of ownership.

2 Respondent asserts that the step transaction doctrine, which is a substance over form doctrine,  
3 should apply here, so that appellants are treated as having exchanged the relinquished real property for  
4 partnership interests in Sand Creek Crossing, LLC, which ultimately held the alleged replacement  
5 property. The Ninth Circuit Court of Appeals has explained that, although the doctrine considers the  
6 substance over the form of the transaction, the taxpayer “is not bound to choose the pattern which will  
7 best pay the Treasury.” (*Linton v. United States* (9th Cir. 2011) 630 F.3d 1211, 1224 (*Linton*); see  
8 *Magneson, supra*, 753 F.2d at p. 1497 [“Between two equally direct ways of achieving the same result,  
9 the [taxpayers] were free to choose the method which entailed the most tax advantages to them.”].)  
10 The U.S. Tax Court has noted that “the doctrine combines a series of individually meaningless steps  
11 into a single transaction.” (*Esmark, Inc. v. Commissioner* (T.C. 1988) 90 T.C. 171, 195.)

12 Courts have generally used three alternative tests in determining whether to apply the step  
13 transaction doctrine: (i) the end result test; (ii) the interdependence test; and (iii) the binding  
14 commitment test. Generally, only one of the tests needs to be satisfied in order for the step transaction  
15 doctrine to apply. (See, e.g., *Falconwood Corp. v. United States* (Fed. Cir. 2005) 422 F.3d 1339,  
16 1349.)

17 Under the end result test, “purportedly separate transactions will be amalgamated into a single  
18 transaction when it appears that they were really component parts of a single transaction intended from  
19 the outset to be taken for the purpose of reaching the ultimate result.” (*King Enterprises v.*  
20 *United States* (Ct. Cl. 1969) 418 F.2d 511, 516 [internal citation omitted].)

21 The interdependence test looks to each step of the transaction to see whether the legal effects of  
22 one of the steps seem fruitless without completion of the overall transaction. (*True v. United States*  
23 (10th Cir. 1999) 190 F.3d 1165, 1175-1181 (*True*).)<sup>9</sup> Application of the interdependence test will be  
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25 <sup>9</sup> Respondent argues that *True* and *Crenshaw v. United States* (5th Cir. 1971) 450 F.2d 472 (*Crenshaw*) support its position  
26 that the step transaction doctrine should be applied to invalidate appellants’ IRC section 1031 exchange. We note that both  
27 cases applied the step transaction doctrine to disregard a complex series of transactions that could have been accomplished  
28 more directly. (See *True, supra*, 190 F.3d at p. 1179 [where the taxpayer used “a series of unnecessary exchanges and  
transfers” to obtain depreciation deductions]; *Crenshaw, supra*, 450 F.2d at p. 475 and fn. 5 [where the taxpayer used “a  
convoluted sequence of preplanned paper exchanges in place of a direct sale . . .”].) Neither case evaluated whether the  
specific requirements of IRC section 1031 were satisfied. (See *True, supra*, 190 F.3d at p. 1179, fn. 14; *Crenshaw, supra*,  
450 F.2d at p. 476, fn. 6.)



1 unsuccessful if the steps have “reasoned economic justification standing alone,” but the step transaction  
2 doctrine will apply if the only reasonable conclusion from the evidence is that the steps have “meaning  
3 only as part of the larger transaction.” (*Id.* at p. 1178 [quoting *Security Industrial Ins. Co. v.*  
4 *United States* (5th Cir. 1983) 702 F.2d 1234, 1246-1247].) The interdependence test states that the  
5 individual steps need to be “the type of business activity we would expect to see in a bona fide, arm’s  
6 length business deal between unrelated parties,” and make sense “standing alone without contemplation  
7 of the subsequent steps in the transaction.” (*Id.* at p. 1179.) Under this test, it may be “useful to  
8 compare the transactions in question with those we might usually expect to occur in otherwise bona  
9 fide business settings.” (*Id.* at p. 1176; see *Linton, supra*, 630 F.3d at pp. 1224-1225 [quoting *True*].)

10 The third step transaction test, the binding commitment test, is applicable to transactions where  
11 one step creates a binding commitment by the taxpayer to take a second action at a substantially later  
12 time. (*True, supra*, 190 F.3d at p. 1175, fn. 8.) The Ninth Circuit has stated that the binding  
13 commitment test “only applies to transactions spanning several years.”<sup>10</sup> (*Linton, supra*, 630 F.3d at  
14 pp. 1224-1225; see *True, supra*, 190 F.3d at p. 1175 [stating that “[t]he binding commitment test is  
15 seldom utilized . . .”].)

16 We note that, in this appeal, appellants held the replacement property for approximately seven  
17 months before transferring it to an LLC. In *Holman v. Commissioner* (2008) 130 T.C. 170 (*Holman*)  
18 and *Gross v. Commissioner*, T.C. Memo. 2008-221 (*Gross*), the Tax Court considered whether the step  
19 transaction doctrine should be applied with respect to a taxpayer’s contribution of stock to a partnership  
20 followed by the gifting of partnership interests. In *Holman*, the partnership held the stock for six days  
21 prior to the gifting of partnership interests. In *Gross*, the partnership held the stock for eleven days  
22 prior to the gifting of partnership interests. In each case, the court reviewed the facts under the step  
23 transaction doctrine to determine whether the transactions should instead be treated as direct gifts of  
24 stock to the children and thereby subject to the gift tax. The court held that the fluctuation of the price  
25 in the stock gave independent significance to the passage of time after the stock was contributed to the  
26 partnership and prior to the gifting of limited partnership interests to the children, and therefore the step  
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28 <sup>10</sup> As a result, the binding commitment test is inapplicable on the facts of this appeal.

1 transaction doctrine did not apply. In *Linton*, the Ninth Circuit Court of Appeals cited *Holman* and  
2 *Gross* approvingly, and found that, on the facts of that case, the placement of assets into an LLC did not  
3 demonstrate that the step transaction doctrine should apply. The Ninth Circuit explained that “[t]he  
4 placing of assets into a limited liability entity such as the LLC is an ordinary and objectively reasonable  
5 business activity that makes sense with or without any subsequent gift.” (*Linton, supra*, 630 F.3d at pp.  
6 1220, fn. 7, 1223, 1224.)

#### 7 ANALYSIS

8           There are two main issues of dispute on appeal: (1) whether the Sand Creek Crossing  
9 replacement property, which was received on June 30, 2003, was held for investment or productive use  
10 in a trade or business as required by IRC section 1031; and (2) whether the step transaction doctrine  
11 should be applied to treat appellants as receiving partnership interests in Sand Creek Crossing, LLC as  
12 their replacement property instead of the Sand Creek Crossing shopping center real property interests.

13           As discussed in the applicable law above, the holding period analysis considers whether the  
14 taxpayers intended to hold the real property received as an investment or for use in their trade or  
15 business. Here, appellants intended to acquire replacement property that would be held as investment.  
16 A lender required that appellants later transfer the replacement property to an LLC. This requirement  
17 was imposed for an independent business purpose, rather than for tax planning purposes. Appellants  
18 received the property as tenants in common and held the property for approximately seven months as  
19 tenants in common. During this period, they controlled the property, obtained the benefit of any  
20 increase in the value of the property, and would have suffered the economic effect of any decrease in  
21 the value of the property or damage to the property. Appellants subsequently transferred the property  
22 to a single-purpose LLC that they created. They were the sole members of the LLC, holding the same  
23 percentage interests as they held as tenants in common, and the property was held by their LLC as its  
24 sole operating asset. The contribution of the property to the LLC changed the form of appellants’  
25 investment in the property but did not significantly alter appellants’ continued economic investment in  
26 the property. (See *Maloney, supra*, 93 T.C. at pp. 98-99 [“. . . he continues to have an economic  
27 interest in essentially the same investment, although there has been a change in the form of  
28 ownership”].) This record demonstrates that appellants acquired the property with the intent to hold the

1 property as investment or for use in their business or trade.

2 Further, there is no evidence that appellants intended to gift, sell, or otherwise liquidate their  
3 replacement property upon receipt. As noted above, the courts (e.g., the *Magneson* and *Maloney*  
4 courts, among others) have found that a prearranged plan to transfer property to a different form of  
5 holding is not sufficient, by itself, to disqualify a claimed IRC section 1031 like-kind exchange where  
6 the taxpayer continues to maintain his or her investment interest in the property. Here, the evidence  
7 shows that appellants at all times held the replacement property for investment, first as tenants in  
8 common and then indefinitely through their LLC.

9 With regard to the step transaction doctrine, there is no indication that appellants artificially  
10 structured the transaction by adding unnecessary or meaningless steps. The acquisition of the property  
11 had real economic substance and legal significance, regardless of whether appellants later contributed  
12 the property to an LLC, as provided by the loan agreement, or refinanced the property before it was  
13 contributed to an LLC. As noted above, the acquisition of the property exposed appellants to real  
14 economic risks and conversely entitled appellants to any appreciation in the value of the property or  
15 income from the property. Rather than constituting an interim step that was meaningless or merely  
16 designed to facilitate appellants' later acquisition of an LLC interest, the acquisition of the property  
17 fulfilled appellants' fundamental intent to acquire an investment interest in the property. The later  
18 contribution of the property to the wholly owned LLC altered the form of appellants' ownership but did  
19 not alter appellants' fundamental objective to hold the property for investment.

20 When deciding whether the step transaction doctrine is applicable, the U.S. Tax Court looks for  
21 independent economic significance between steps. In both *Holman* and *Gross*, the court found that the  
22 period stock was held in a partnership before granting a share of that partnership to children was not  
23 insignificant due to the price fluctuation of the stock, and therefore this holding period should not be  
24 disregarded through application of the step transaction doctrine. Here, appellants acquired and held the  
25 Sand Creek Crossing shopping center property for a period of seven months as tenants in common prior  
26 to transferring the property to an LLC per the requirement of their loan. During this time, appellants  
27 bore the economic risks of value depreciation and physical damage, and also held the benefit of any  
28 increase in value. On the record before us, the acquisition of the replacement property as tenants in

1 common is “the type of business activity we would expect to see in a bona fide, arm’s length business  
2 deal between unrelated parties,” and makes sense “standing alone without contemplation of the  
3 subsequent” transfer to an LLC. (*True, supra*, 190 F.3d at p. 1179; see *Linton, supra*, 630 F.3d at p.  
4 1225 [“The Lintons’ creation and funding of the LLC enabled them to specify the terms of the LLC and  
5 contribute the desired amount and type of capital to it – reasonable and ordinary business activities.”].)

6 The foregoing record demonstrates that appellants conducted a valid exchange under IRC  
7 section 1031. As demonstrated by the above analysis of facts and law, the exchange was properly  
8 executed, the replacement property was held for investment purposes, and the later contribution of the  
9 property to appellants’ wholly owned LLC altered the form of appellants’ ownership but did not alter  
10 appellants’ fundamental objective to hold the property for investment. Furthermore, the step  
11 transaction doctrine does not apply to disregard appellants’ acquisition of the replacement property.

## 12 DISPOSITION

13 For the foregoing reasons, appellants’ appeals are granted.  
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ORDER

Pursuant to the analysis of the law and facts above, this Board ordered that the action of the Franchise Tax Board on appellants’ protests against the proposed assessments for 2003 be reversed, and the appeals be granted. Adopted at Culver City, California, this 23rd day of June, 2015.

Jerome E. Horton \_\_\_\_\_, Chairman\*

George Runner \_\_\_\_\_, Member

Fiona Ma \_\_\_\_\_, Member

Diane L. Harkey \_\_\_\_\_, Member

Yvette Stowers \_\_\_\_\_, Member\*<sup>†</sup>

\* Adopting the decision but not joining the vote to adopt the decision as a Formal Opinion based on the view that the highly fact-specific nature of the decision may limit its usefulness as a precedential decision to other taxpayers and factual situations.

<sup>†</sup> For Betty Yee, pursuant to Government Code section 7.9.