



87-SBE-014

BEFORE **THE** STATE BOARD OF EQUALIZATION  
OF **THE** STATE **OF** CALIFORNIA

In the Matter of the Appeal of )  
  ) **No. 83J-319-MW**  
JAMES **E.** CROCKETT                  )

For Appellant: Thomas R. Helfand  
  Attorney at Law

For Respondent: David **Lew**  
  **Counsel**

**O P I N I O N**

This **appeal** is made pursuant to section **18646<sup>1/</sup>** of the Revenue and Taxation Code from the action of the Franchise Tax **Board** in denying the petition of James **H. Crockett for reassessment** of a jeopardy assessment **of** personal income tax in the amount of **\$46,018.33** for the year 1978.

1/ Unless otherwise specified, all section references **are** to sections of the Revenue and Taxation Code as in effect for the year in issue.

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The question presented by this appeal is whether appellant's transfer of real property qualified as a tax-free like-kind **exchange** under section 18081.<sup>2/</sup>

In 1978, appellant, **who was** then a California resident, owned several **apartment complexes in San Diego**. In anticipation of relocating to Texas, appellant entered into an agreement with a **Hr. Gillingwater (Gillingwater)** of Houston, Texas, in which appellant agreed to purchase from Gillingwater an apartment complex in Austin. The contract called for a purchase price **of \$5.6 million**, with \$750,000 to be paid in cash.

The cash part of the price was to be furid by appellant's transfer to Gillingwater of some or all of appellant's California property. Gillingwater would then **sell the property and deysit the proceeds in an escrow** account in a Texas bank. When the **accumulated** proceeds were sufficient **to meet the cash portion of the purchase price**, appellant **would** notify the bank to release the funds to **Gillingwater and the Texas** property would be conveyed to appellant. The written agreement specified that the intent of the parties **was to effect** a tax-free like-kind **exchange of** properties. The parties also entered into **an addendum** in which appellant agreed to hold Gillingwater **"harmless from any liability or responsibility, and the transactions shall be at no cost to Barry Gillingwater."** (**Resp. Ex. C.**) The addendum **was** also **made** part of all the **escrows covering** the California properties **transferred to** Gillingwater and the purchasers **of those properties were to agree** to release Gillingwater **f tom** responsibility.

Pursuant to the written agreement, appellant transferred **to Gilliagwater** title to seven of his California properties. **All were** sold between June and September 1978, to third parties, and the proceeds were

<sup>2/</sup> Section 18081 was repealed by A9 36 (Stats- 1983, **ch. 488, § 62, p. 1926**), **operative** for taxable years beginning on or **after** January 1, 1983. Internal Revenue Code (**I.R.C.**) section 1031, which is the federal **counter-**part of section 18081, now **governs** like-kind exchanges. (Rev. & Tax. Code, **§18031** (added by **AB 36**, Stats, 1983, **ch. 488, § 63, p. 1926**)). Interpretations of **I.R.C.** section 1031 are highly persuasive in the **proper** interpretation of section 18081. (**Meanley v. McColgan**, 49 **Cal.App.2d** 203, 209 [**121 P.2d 45**] (1942).)

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deposited in the escrow account. Appellant located purchasers for the properties and negotiated the sales. Apparently, the properties were transferred to Gillingwater only after purchasers had been found for them. Gillingwater signed the documents necessary to complete the sales. When **sufficient** funds had accumulated in the account, appellant directed their release to Gillingwater. Gillingwater conveyed the Texas property to appellant in 1979 and appellant moved to Texas in that year.

The sales of the California properties resulted in gain totaling \$428,415. Appellant did not file a California return for 1978. When appellant still failed to file a **return** after notice and demand, the Franchise Tax Board (**FTB**) issued an immediate jeopardy assessment based on **the gain** from the sale of the California properties, which the FTB had determined did not arise from a tax-free exchange. Penalties were also imposed for failure to file a timely return, failure to file after notice and demand, and fraud. Appellant filed a petition for reassessment, stating that the sales of the California properties were part of a tax-free exchange and the gain was not recognized for income tax purposes. In this appeal from the **FTB's** action denying appellant's petition, appellant apparently does not contest the penalties.

Section 18081, subdivision (a), and I.R.C. section 1031(a), provided that no gain or loss is to be recognized if qualifying property is exchanged solely for property of *a* like-kind. If money or other property ("boot") is also received in an **exchange**, gain is recognized to the extent of the boot. (Rev. & Tax. Code, former § 18081, **subd. (b)**; I.R.C § 1031(b),) We are concerned here only with the **requirement** that there be an exchange of like-kind properties, as distinguished from a cash sale of property by the appellant and a reinvestment of the proceeds in other property.

While adhering to "the **well** established principle that the substance of a transaction, rather than the form in which it is cast, ordinarily determines its tax consequences" (**Briggs v. Commissioner**, 69 T.C. 905, 914 (1978), **affd.**, **632 F.2d 1171** (5th Cir. 1980)), courts have recognized that there are some difficulties in applying this principle when determining whether or not a tax-free exchange has taken place:

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The "exchange" requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. In a sense, the **substance of** a transaction in which the taxpayer sells property and immediately reinvests the proceeds in like-kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash. [Citation.] Yet, if the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must, at least on occasion, engender different results. Accord, Starker v. United States, 602 **F.2d** 1341, 1352 (9th Cir. 1979).

(Barker v. Commissioner, 74 **T.C.** 555, 561 (1980).)

Taxpayers have been accorded wide latitude by the courts in structuring transactions which qualify as exchanges under I.R.C. section 1031. (Swaim v. United States, 651 **F.2d** 1066, 1069 (5th Cir. 1981); Biggs v. Commissioner, supra, 69 T.C. at 913.)<sup>3/</sup> when the parties have clearly intended a tax-free exchange, and the final result of an integrated plan is an exchange of like-kind property, with no cash, other than boot, actually being received by the taxpayer (even if, at the time of the agreement, there was a possibility that cash could be received), the transaction will qualify under I.R.C. section 1031. (See Starker v. United States, 602 **F.2d** 1341, 1354 (9th Cir. 1979); Garcia v. Commissioner,

<sup>3/</sup> Variations of the so-called "three-corner" exchange have been held to be qualifying § 1031 exchanges in numerous cases. (Biggs v. Commissioner, supra, 69 T.C. at 913.)

In such a transaction, the taxpayer desires to exchange, rather than to sell, his property. However, the potential buyer of the taxpayer's property owns no **property** the taxpayer wishes to receive in exchange. Therefore, the buyer purchases other suitable property from a third party and then exchanges it for the property held by the taxpayer.

(Biggs v. Commissioner, supra.)

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80 T.C. 491, 498-499 (1983); Biggs v. Commissioner, supra, 69 T.C. at 914; Coupe v. Commissioner, 52 T.C. 394, 409 (1969).) A transaction qualifies under I.R.C. section 1031 even though the person with whom the taxpayer exchanges his property sells the property immediately after acquisition, (Barker v. Commissioner, supra, 74 T.C. at 562; see also Mays v. Campbell, 246 F.Supp. 375 (N.D. Tex, 1965).) However, a qualifying exchange does not take place if a third (or fourth) party, acting as agent for the taxpayer, purchases property which the taxpayer wants and exchanges that property for the taxpayer's property, since, in essence, the taxpayer will have merely made an exchange with himself. (Biggs v. Commissioner, supra, 632 F.2d at 1178; Coupe v. Commissioner, supra, 52 T.C. at 406; Mercantile Trust Co. of Baltimore, et-al. v. Commissioner, 32 B.T.A. 82, d5 (1935).)

The FTB's sole contention is that Gillingwater sold the California properties conveyed to him by appellant as appellant's agent, that the sales must, therefore, be attributed to appellant, and that a tax-free exchange did not take place because appellant gave money (the proceeds from the sales) instead of property in exchange for Gillingwater's property. The bases for the FTB's conclusion that Gillingwater was appellant's agent appear to be the agreement appellant made holding Gillingwater harmless from any liability or cost in connection with the sales, the activities of appellant in securing purchasers for the California properties and negotiating the contracts for sale, its conclusion that the purchasers of those properties could look to appellant, rather than Gillingwater, for specific performance of their contracts, and its conclusion that Gillingwater never assumed the burdens of ownership of the properties. After examining the record and the law in this area, we cannot agree with that FTB's characterization of Gillingwater as appellant's agent.

The FTB has not cited, and we have not found, any authority for the proposition that a hold-harmless agreement creates an agency relationship. Nor do we believe that appellant's activities in negotiating the sales made Gillingwater into his agent. Taxpayers who have selected property to be received in an exchange, negotiated for acquisition of the property by a second or third party to the transaction, and even advanced money for the purchase price of the property to be acquired by exchange have not been denied section 1031 nonrecognition treatment where the result was an exchange of like-kind

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properties. (See Biggs v. Commissioner, supra, 69 T.C. at 913-914, and cases cited therein.) The FTB has not presented us with any reason why appellant should be treated any differently from the taxpayers just mentioned simply because he entered into the **arrangements** for Gillingwater's sale of the **California** properties. (Cf. Mays v. Campbell, supra.)

The **FTB's specific performance** argument is based upon language in Revenue **Ruling 77-297, 1977-2 C.B. 304**. In the revenue ruling, **A wished** to exchange his ranch for another ranch, and **3** wished to acquire **A's** ranch. **A** found a suitable ranch, **owned** by **C**, to receive in exchange for his ranch, and **B** agreed to purchase **C's** ranch and exchange it for **A's** ranch. The ruling stated, "**C** could not look to **A** for specific performance on the **contract, thus, B was not acting as A's agent in the purchase of [C's ranch].**" The FTB **concludes** that **third-party** purchasers of the **California** property which appellant conveyed to Gillingwater **could look** to appellant for specific **performance** of their contracts and, therefore, Gillingwater was appellant's agent.

As the FTB acknowledges, ~~the~~ statement in the revenue ruling is merely the position of the Internal Revenue Service. There is absolutely no legal authority cited by the Internal Revenue **Service** or the FTB to support the proposition that **3** is **A's** agent merely because a third party could look to **A** for specific performance of a contract between **3** and the third party. Rather, it appears that the **remedy of** specific performance is a result, not a cause, of an agency relationship between **A** and **B**. (See 58 **Cal.Jur.3d**, Specific Performance, **§ 46**.) Without a prior determination that Gillingwater was appellant's agent, we do not see how the third-party purchasers could look **to** appellant for specific performance, since he no **longer** had legal title to the property. Therefore, this line of argument does nothing to bolster the **FTB's contention** that Gillingwater was appellant's agent.

The **FTB's** contention ~~that~~ Gillingwater did not assume the burdens of ownership **along** with legal title to the California properties, even if **true**, does nothing to show that he was appellant's agent in selling the properties.

**[O]ne need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire**

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title solely for the purpose of exchange  
and accept title and transfer **it in**  
exchange for other like property ....

(Alderson v. Commissioner, 317 F.2d 790, 795 (9th Cir.  
1963).)

Similarly, we do not believe that **the** alleged failure of  
Gillingwater to assume the burdens of ownership before  
selling the California properties, even if true, provides  
a basis for denying section 1031 treatment of this  
transaction.

In accord with the liberal trend of the **courts**  
in this area, we must conclude that the transactions  
involved in this appeal were all \*part of an integrated  
**plan intended** to effectuate an exchange of like kind  
properties, the substantive result of which was an  
exchange within the meaning of section 1031." (Wiggs  
Commissioner, supra, 69 T.C. at 914-915.) The action of  
the **FTB, therefore,** must be reversed.

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ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY. ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the petition of James H. Crockett for reassessment of a jeopardy assessment of personal income tax in the amount of \$46,018.33 for the year 1978, be and the same is hereby reversed.

Done at Sacramento, California, this 3rd day of March , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman  
William M. Bennett , Member  
Paul Carpenter , Member  
Anne Baker\* , Member  
\_\_\_\_\_ , Member

\*For Gray Davis, per Government Code section 7.9