

**OFFICE OF TAX APPEALS**  
**STATE OF CALIFORNIA**

In the Matter of the Appeal of: ) OTA Case No. 18010922  
**LA PALOMA NEVADA TRUST** )  
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**OPINION**

Representing the Parties:

For Appellant: R. Todd Luoma, Attorney  
For Respondent: Sonia D. Woodruff, Tax Counsel IV  
Carolyn S. Kuduk, Tax Counsel III

S. HOSEY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, La Paloma Nevada Trust (Trust or appellant) appeals an action by respondent Franchise Tax Board (FTB) proposing \$240,023.00 of additional tax, an accuracy-related penalty of \$48,004.60, and applicable interest, for the 2009 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Sara A. Hosey, Huy “Mike” Le, and Tommy Leung held an oral hearing for this matter in Sacramento, California, on May 24, 2022. At the conclusion of the hearing, the record was closed and this matter was submitted for decision.

**ISSUES**

1. Whether appellant established that the property was held for investment to satisfy the qualified purpose requirement for a tax-free exchange, pursuant to Internal Revenue Code (IRC) section 1031.
2. Whether appellant established that the accuracy-related penalty should be abated.

### FACTUAL FINDINGS

1. The Trust was created on July 20, 2006, by grantors B. and P. Burger (the Burgers or grantors), to hold title to land they purchased on La Paloma Road, Los Altos Hills, California (Los Altos property) on March 27, 1998.<sup>1</sup> The Los Altos property comprised the trust res.
2. The Burgers<sup>2</sup> used the Los Altos property to collateralize a \$3 million adjustable-rate mortgage with an initial rate of 5.5 percent to finance construction of a residence on the property on June 10, 2005.<sup>3</sup> The Burgers obtained a \$500,000 equity line on the Los Altos property on October 13, 2005.
3. While the Trust is irrevocable, the grantors retained veto authority over distributions by the trustee and retained the right to substitute property of equivalent value to reacquire trust property. Mr. Bayliss, a certified public accountant, was appointed trustee, and the grantors named themselves and their two adult children as beneficiaries. According to the Trust declaration, the purpose of the Trust was to benefit the beneficiaries while attempting to protect the trust property from the claims of creditors. Another purpose was to reduce or eliminate wealth-transfer taxes on trust assets and on the beneficiaries and grantors. The Trust instrument encourages the liberal use and enjoyment of the assets free of charge to aid the beneficiaries and disfavors the outright distribution of assets.
4. The \$3 million security instrument required the Burgers to “occupy, establish, and use the Property as Borrower’s principal residence within 60 days after the execution of this Security Instrument.” The homeowner insurance policy in the name of B. and P. Burger

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<sup>1</sup> As appellant initially represented to FTB that it was in fact a grantor trust rather than a non-grantor trust as claimed on its 2009 California Fiduciary Income Tax Return, FTB also issued an identical NPA to the grantors as individuals. During protest, FTB accepted appellant’s statements that the Trust is actually a non-grantor trust subject to filing requirements and FTB withdrew the NPA issued to the grantors in their individual capacity. Because the Trust is a complex trust that is not wholly owned by the grantors, we agree that the Trust had a filing requirement and is the appropriate party to be assessed with additional tax.

<sup>2</sup> The Burgers each signed the Wells Fargo Bank note as trustees of the Burger Family Trust for the benefit of themselves as borrowers.

<sup>3</sup> Both FTB and appellant’s briefs have a statement about the Los Altos property being transferred out of the “trust” for purpose of financing the \$3 million mortgage and then back into the “trust,” but the statement is unclear because the grantors obtained the financing in 2005 and created the Trust in 2006. The declaration of trust includes an effective date of July 20, 2006.

- lists 2005 as the date of construction of the 4,000 square-foot home and January 2006 as the move-in date.
5. In correspondence with FTB, Mr. Bayliss explained that the home was completed on May 13, 2005, the pool completed on April 3, 2007, and landscaping installed through 2009. Mr. Bayliss stated that the Burgers did not occupy the Los Altos property as a residence, but occupied it only in relation to construction and kept their primary residence in Glenbrook, Nevada on the shores of Lake Tahoe. According to Mr. Bayliss, Mr. Burger was an experienced investor who believed that the Burgers could purchase the lot, build a turnkey house, and sell it for a profit.
  6. The grantors as individuals executed a sales agreement on June 16, 2009, to sell the Los Altos property for \$7 million. The sales agreement provided the grantors with approximately 30 days to continue occupying the property at no charge and to complete the agreed repairs to the property. The basis in the Los Altos property was \$4,259,849.<sup>4</sup>
  7. The Trust entered into an exchange agreement on June 24, 2009, with the Asset Exchange Company. Mr. Bayliss, as trustee, signed both the exchange agreement and the escrow instructions.
  8. The Trust purchased two commercial properties on August 7, 2009: Carson City, Nevada for \$5,875,000 and Sparks, Nevada (the Nevada properties) for \$759,000. Mr. Bayliss, as trustee, signed the escrow instructions.
  9. The Trust filed a federal Form 8824 (Like-Kind Exchanges) listing the exchange of the two replacement Nevada properties for the relinquished Los Altos property for the 2009 tax year. The combined fair market value of the replacement properties was \$6,651,265 and the adjusted basis of the Los Altos relinquished property was \$4,259,849, with realized gain of \$2,391,416. On the 2009 Form 541 California Fiduciary Income Tax Return (trust return), the Trust deferred the gain attributable to the sale of the relinquished Los Altos property pursuant to an Internal Revenue Code (IRC) section 1031 exchange and reported rental income of \$154,888 for the Carson City property.

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<sup>4</sup> Mr. Bayliss wrote in a letter that the basis was approximately \$4,600,000, but “[b]ecause much of the records were lost, we rounded our estimate down to \$4,250,000 when we prepared the tax return.”

10. FTB audited<sup>5</sup> the Trust in 2013 and determined the tax-deferred exchange was flawed, because the relinquished Los Altos property lacked the qualified purpose requirement of IRC section 1031. Appellant protested and maintained that the grantors, and then the Trust, purchased and developed the relinquished Los Altos property with an investment purpose and not as a residence.
11. Appellant provided a handwritten reconstruction of dates by grantor P. Burger where construction-related activities occurred at the relinquished Los Altos property from 2007-2009 and the dates of the grantors' stay at the property. The total days on the "reconstructed" calendar in 2007 was 52. The grantors maintained they worked on the home or coordinated activities performed at the home, including: security and lighting system installation, hardwood floor repair, pool work and inspection, construction of an outdoor kitchen, and fencing construction on those dates. The reconstructed calendar indicates the grantors spent time in Tahoe and traveled to Europe and Wisconsin. In 2008, the grantors indicate they spent 40 days at the relinquished Los Altos property, and time in Tahoe, Wisconsin, Africa, Los Angeles, New York and Alaska. In 2009, the grantors indicated they spent 36 days at the property from January to July, prior to the execution of the sales agreement in June.
12. Appellant provided a description of the property created by an agent engaged to market the property, photographs of the interior and exterior, receipts and invoices for work on the property including landscaping, gate design, hardwood floor repair, and designs for stained glass, an outdoor kitchen and pool.
13. FTB issued a Notice of Proposed Assessment (NPA), finding a capital gain of \$2,391,416.00, and a total tax of \$240,023.00, and an accuracy-related penalty of \$48,004.60, plus applicable interest.
14. Appellant protested the NPA. After review, FTB issued a Notice of Action affirming the NPA. This timely appeal followed.

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<sup>5</sup> The IRS did not audit the transaction.

## DISCUSSION

Issue 1: Whether appellant established that the property was held for investment to satisfy the qualified purpose requirement for a tax-free exchange, pursuant to IRC section 1031.

FTB’s determination is presumed correct, and appellant has the burden of proving it to be wrong. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) Generally, a taxpayer must recognize the entire amount of gain or loss realized upon the sale or exchange of property unless a specific statutory provision provides otherwise. (R&TC, § 18031; IRC, §1001; Treas. Reg. § 1.1002-1(a).) For the year at issue here, California conforms to IRC section 1031 at R&TC sections 18031 and 24941. For a transfer of property to qualify for non-recognition of gain treatment under IRC section 1031: 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).) Such transactions or series of transactions are commonly referred to as “like-kind exchanges.” To constitute a tax-deferred exchange, the transaction must be a transfer of property for property, rather than a transfer of property for money. (Treas. Reg. § 1.1031(k)-1(a).)

Also known as the “holding requirement,” a qualified purpose means both the relinquished and the replacement property are held for productive use in a trade or business or for investment. (IRC, § 1031(a)(1).) Neither the IRC nor the Treasury Regulations define the phrase, “held for productive use in a trade or business or for investment.” The Ninth Circuit Court of Appeals used the ordinary meaning of the terms and found the holding requirement satisfied when the taxpayer never intended to liquidate the property or make personal use of it. (*Bolker v. Commissioner* (9th Cir. 1985) 760 F.2d 1039, 1044-1045.)

Whether the taxpayer meets the holding requirement is a factual determination. (*Appeals of Rago Development Corporation, et al.* (2015-SBE-001) 2015 WL 10553154.) “It is a taxpayer’s primary purpose in holding the properties that counts.” (*Moore v. Commissioner*, T.C. Memo. 2007-134.) The intention at the time of the exchange is the determining factor for holding purpose. (*Neal T. Baker Enterprises, Inc. v. Commissioner* (1998) T.C. Memo. 1998-302.) “Contemporaneous facts, not self-serving testimony given years later, are important in establishing intent.” (*Ibid.*)

An unrented home used for residential purposes and held with the “mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the

taxpayer uses the property as a residence.” (*Moore v. Commissioner, supra* [Properties used as vacation retreats ineligible for 1031 tax deferral treatment].) Where a taxpayer seeks only the profit from the appreciation of the property during the time of occupancy as a personal residence, the property cannot be deemed “held for the production of income[.]” (*Ibid.*, citation omitted.) “[I]f the anticipation of eventually selling the house at a profit were in itself sufficient to establish that the property was held with a profit-making intent, rare indeed would be the homeowner who purchased a home several years ago who could not make the same claim.” (*Jasionowski v. Commissioner* (1976) 66 T.C. 312, 323.) Use of the property solely as a personal residence is antithetical to its being held for investment. (*Starker v. United States* (9th Cir. 1979) 602 F.2d 1341, 1350-1351.) The taxpayer carries the burden to establish the requisite holding purpose exists. (*Click v. Commissioner* (1982) 78 T.C. 225, 231.)

Whether the Trust met the holding requirement for the Los Altos Hills relinquished property is the only issue in this case regarding the validity of the IRC section 1031 exchange.<sup>6</sup> FTB asserts that the trust grantors primarily used the property for their own personal use, thus disqualifying the property for tax deferral treatment of IRC section 1031. FTB relies upon *Moore, supra*, for the proposition that the home was used for vacation or personal use and not an investment property that satisfied the holding requirement. FTB argues that the grantors continued to personally use the property for two years before selling the property, between the time the pool was constructed in 2007 and the property sold in 2009, and that the grantors have not provided details about how much time they occupied the Los Altos property. FTB argues that the Trust never rented the property as evidence of the grantors’ personal use of the property.

Appellant argues that the grantors purchased the Los Altos property in 1998 with the intention of holding it for investment purposes, which they did prior to transferring it to the Trust in 2006. Appellant argues the property continued to be held for investment purposes as development occurred. Appellant argues that any personal use of the Los Altos property was in service of enhancing the property investment. Appellant argues that its trustee, Mr. Bayliss, arranged for the property to be developed, determined when it would be sold, selected the replacement properties, and engaged the intermediary. Appellant provided documents to

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<sup>6</sup> Neither party disputes the replacement Nevada properties were identified within 45 days and received within 180 days, nor that the replacement Nevada properties satisfied the holding requirement. (IRC, § 1031(a)(1)-(3).)

demonstrate the amount of work completed at the property to show that the property was not ready for sale until 2009 to maximize their investment.

However, the documents provided by appellant do not show that the property was held by the Trust for investment purposes. First, the grantors possessed the ultimate authority to determine whether the Los Altos property would be sold and that the property was the sum of the trust res. The Trust instrument contained language advising the trustee to provide the trust beneficiaries (the grantors and their issue) with the liberal use and enjoyment of trust property (free of charge) rather than making distributions of trust assets or investments. The grantors employed this language to direct the trustee to apply the Trust property very specifically: for the personal comfort and enjoyment of the beneficiaries rather than for the production of income.

Next, the receipts and correspondence provided by appellant demonstrate that the invoices and correspondence were in the grantors' names personally. The homeowner insurance document indicates that occupancy occurred in 2006. While appellant argues that the receipts for work indicate that the home construction continued until 2009, OTA finds the argument unpersuasive. According to the security instrument signed by the grantors, they agreed to treat the property as a principal residence. Further, the 2009 sales agreement which permitted the Burgers to continue to occupy the property after the sale at no cost for approximately 30 days supports a finding that the Burgers used the property as a residence. The handwritten timeline of the grantors' use of the Los Altos property shows a pattern of visiting the property and visiting multiple locations around the U.S. and trips to Africa, which is consistent with FTB's position that the Los Altos Hills property was treated for personal use akin to a vacation property. Likewise, the grantors retained the ability to take back control of the property from the Trust by the terms of the trust documents, so their personal use of the property was further protected by the governing trust documents.

Even if the reconstructed schedule demonstrates an investment purpose, which we do not believe it does, it is not contemporaneous, making it more akin to disfavored testimony given years later, the type not given weight to establish intent. (*Neal T. Baker Enterprises v. Commissioner, supra.*) Finally, the invoices for landscaping and decorative objects and photographs of the residence fail to establish the proposition appellant asserts - that the property was not ready for sale until 2009 - particularly when occupancy began in 2006.

Appellant has failed to satisfy the holding requirement for the relinquished property. Consequently, the requirements for a tax-free exchange of properties under IRC section 1031 are not met.

Issue 2: Whether appellant established that the accuracy-related penalty should be abated.

FTB imposed an accuracy-related penalty based on the determination that the sale did not qualify for tax-deferred treatment. R&TC section 19164 provides for an accuracy-related penalty determined in accordance with IRC section 6662. The penalty of 20 percent of the underpayment is imposed where the underpayment of tax is due to, as relevant here, any substantial understatement of income tax.<sup>7</sup> (IRC, § 6662(b)(2).) “Substantial understatement of income tax” exists when the understatement exceeds the greater of either 10 percent of the tax required to be shown on the return or \$5,000. (IRC, § 6662(d)(1)(A).)

The understatement is reduced by that portion of the understatement which is attributable to an item: (1) for which there is or was substantial authority, (2) for which the position was adequately disclosed in the tax return (or a statement attached to the return) and there is a reasonable basis for treatment of the item, or (3) for which there is reasonable cause for the understatement and the taxpayer acted in good faith. (IRC, §§ 6662(d)(2)(B), 6664(c)(1); R&TC, § 19164(d).)

The substantial authority standard is defined in Treasury Regulation section 1.6662-4(d) as an objective standard involving an analysis of the law and the application of the law to relevant facts. The substantial authority standard is less stringent than the “more likely than not” standard, but more stringent than the “reasonable basis” standard used for analyzing whether an underpayment is due to negligence or disregard of rules or regulations. (Treas. Reg. § 1.6662-4(d)(2).) Substantial authority for the tax treatment of an item exists only if the weight of authorities supporting the treatment is substantial *in relation* to the weight of authorities supporting a contrary treatment. (Treas. Reg. § 1.6662-4(d)(3)(i) (italics added).) Because it is an objective standard, the taxpayer’s belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment. (*Ibid.*)

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<sup>7</sup> Neither party disputes the amount of accuracy-related penalty on the NOA is properly calculated as \$48,004.60 (i.e., 20 percent x \$240,023.00).

The weight of an authority is evaluated considering the relevance, persuasiveness, and type of document providing the authority. (Treas. Reg. § 1.6662-4(d)(3)(ii).) Except under certain circumstances not relevant here, an exclusive list is provided for the purpose of determining whether there is substantial authority for the tax treatment of an item. (Treas. Reg. § 1.6662-4(d)(3)(iii).) Opinions rendered by tax professionals are not listed authority. (*Ibid.*) Substantial authority for the tax treatment of an item is determined at the time the return containing the item is filed, or on the last day of the taxable year to which the return relates. (Treas. Reg. § 1.6662-4(d)(3)(iv)(C).)

With regard to the accuracy-related penalty for 2009, appellant argues that it did not report the income because of reasonable reliance on professional advice from tax professionals. However, appellant fails to provide any details or supporting evidence regarding the source or content of the professional advice. It appears the trustee of the Trust at the time of the exchange, Mr. Bayliss, is a Certified Public Accountant who relied upon his own knowledge in setting up the 1031 exchange. However, we have no opinion from the trustee on what other authority he relied upon at the time the return was filed. Furthermore, appellant has not shown that the substantial authority for the tax treatment was substantial in relation to the weight of authorities supporting a contrary treatment. Therefore, appellant has not shown cause for abatement of the accuracy-related penalty.

HOLDINGS

1. Appellant failed to establish that the property was held for investment to satisfy the qualified purpose requirement for a tax-free exchange, pursuant to IRC section 1031.
2. Appellant failed to establish that the accuracy-related penalty should be abated for reasonable cause.

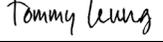
DISPOSITION

FTB’s action is sustained in full.

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 Sara A. Hosey  
 Administrative Law Judge

We concur:

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 Huy “Mike” Le  
 Administrative Law Judge

DocuSigned by:  
  
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 Tommy Leung  
 Administrative Law Judge

Date Issued: 8/29/2022