OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **F.A.R. INVESTMENTS, INC. AND ARCIERO & SONS, INC.**	OTA Case Nos. 19125618 & 19125619

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: Barry L. Guterman, Esq.
Edward I. Kaplan, Esq.

For Respondent: Carolyn S. Kuduk, Tax Counsel III

J. LAMBERT, Administrative Law Judge: On November 2, 2021, the Office of Tax Appeals (OTA) issued an Opinion in which OTA sustained the determination of respondent Franchise Tax Board (FTB) denying the claimed deferral of gain by F.A.R. Investments, Inc. and Arciero & Sons, Inc. (appellants) from like-kind exchanges under Internal Revenue Code (IRC) section 1031. Appellants filed a timely petition for rehearing (PFR) under Revenue and Taxation Code (R&TC) section 19048.

A rehearing may be granted where one of the following six grounds exists, and the substantial rights of the filing party are materially affected: (1) an irregularity in the appeal proceedings, that occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise that occurred during the appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the filing party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6).)

Appellants contend that a rehearing should be granted on the grounds that the Opinion is contrary to law and that there is insufficient evidence to justify the Opinion. The question of whether the Opinion is contrary to law is not one which involves a weighing of the evidence, but

instead, requires a finding that the Opinion is "unsupported by any substantial evidence"; that is, the record would justify a directed verdict against the prevailing party. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.)[1] This requires a review of the Opinion in a manner most favorable to the prevailing party and indulging in all legitimate and reasonable inferences to uphold the Opinion if possible. (*Id*. at p. 907.) The question before OTA on a PFR does not involve examining the quality or nature of the reasoning behind OTA's Opinion, but whether that Opinion can be valid according to the law. (*Appeal of NASSCO Holdings, Inc*. (2010-SBE-001) 2010 WL 5626976.)

To find that there is an insufficiency of evidence to justify the Opinion, OTA must find that, after weighing the evidence in the record, including reasonable inferences based on that evidence, OTA clearly should have reached a different opinion. (*Appeals of Swat-Fame, Inc*., *et al.*, 2020-OTA-045P.)

The issue in the Opinion was whether appellants have shown error in FTB's determination denying their claimed deferral of gain from like-kind exchanges under IRC section 1031.[2] 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); Treas. Reg. § 1.1002-1(a); R&TC, §§ 18031, 24902.) To qualify for nonrecognition treatment under IRC section 1031, three general requirements must be satisfied: (1) the transaction must be an exchange (exchange requirement); (2) the exchange must involve like-kind properties (like-kind requirement);[3] and (3) both the property transferred (the relinquished property) and the property received (the replacement property) must be held for a qualified purpose (holding requirement). (IRC, § 1031(a)(1)-(3).)

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[1] California Code of Regulations, title 18, (Regulation) section 30604 is essentially based upon the provisions of California Civil Code of Procedure (CCP) section 657. (See *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654 [State Board of Equalization (BOE) utilizes CCP section 657 in determining grounds for rehearing]; *Appeal of Do*, 2018-OTA-002P [OTA adopts BOE's grounds for rehearing].) Therefore, the language of CCP section 657 and case law pertaining to the operation of the statute provide guidance in interpreting the provisions contained in Regulation section 30604.

[2] California applies IRC section 1031 per R&TC sections 18031 and 24941, except as otherwise provided.

[3] IRC "[s]ection 1031(a) requires that like-kind property be both given up and received in the 'exchange.'" (*Chase v. Commissioner* (1989) 92 T.C. 874, 883.) In other words, generally the same taxpayer that relinquishes property in an IRC section 1031 exchange must also receive the replacement property in the exchange to satisfy the exchange requirement. While there are limited exceptions, such as where the exchange property is sold or acquired by a disregarded entity, these exceptions are not relevant or applicable here.

Appellants argue that OTA's Opinion incorrectly held that they were not the true sellers of the real property: a winery, which included buildings, offices, a gift shop, land, and approximately 40 acres of vineyards in Paso Robles, California (collectively the Paso Property). Appellants argue that the Opinion incorrectly held that the true seller of the Paso Property was Arciero Wine Group, LLC (AWG), a limited liability company taxed as a partnership for California income tax purposes, of which appellants were indirect owners. Appellants assert that the Asset Purchase Agreement for the Paso Property between AWG and the buyer primarily concerned the sale of inventory and equipment and did not contain the essential terms for the sale of the Paso Property.[4] Appellants assert that AWG's (rather appellants') signature was necessary for the transfer of the inventory and equipment, which is why AWG was reflected as the seller in the Asset Purchase Agreement. Appellants further assert that the terms for the sale of the Paso Property were in seller substitution agreements and escrow instructions, instead. Accordingly, appellants contend that, because they were the true sellers of the Paso Property, they satisfied the exchange requirement of IRC section 1031(a).

In applying the substance over form doctrine to determine the true seller of the Paso Property, OTA addressed various factors considered in *Commissioner v. Court Holding Co*. (1945) 324 U.S. 331, *Chase v. Commissioner* (1989) 92 T.C. 874, and *Appeal of Brookfield Manor, Inc., et al*., (89-SBE-002) 1989 WL 37900. *Chase v. Commissioner*, *supra*, 92 T.C. 874, and *Appeal of Brookfield Manor, Inc.*, *et al*., *supra*, addressed the exchange requirement of IRC section 1031(a). OTA examined the extent to which AWG or the purported sellers of the Paso Property (including appellants) were involved in negotiations, whether the sale was conducted under substantially the same terms as negotiated by AWG, the time that elapsed between AWG's negotiations and the final exchange, and whether the purported sellers received the benefits and burdens of ownership of the Paso Property.[5] The Opinion found that the terms of the Asset Purchase Agreement as negotiated primarily by AWG were substantially in place prior to the execution of the seller substitution agreements, and that very little time elapsed between the negotiations by AWG, the seller substitution agreements executed on July 23, 2007, and the

[4] The "Paso Property" at issue in this appeal includes only the winery's real property. The parties agree that the related winery equipment and inventory were sold directly by AWG to the buyer.

[5] Appellants assert that the Opinion relied almost exclusively on the Asset Purchase Agreement. However, the Opinion also addressed the circumstances surrounding the transaction, not just the Asset Purchase Agreement.

execution of the Asset Purchase Agreement on July 27, 2007. The Opinion also found that the evidence did not indicate that the burdens and benefits of ownership of the Paso Property had shifted to appellants when they received title from AWG.[6]

However, appellants argue that the Opinion is contrary to *Appeals of Kwon, et al*., 2021-OTA-296P (*Kwon*),[7] which addressed whether the appellants in that case were the true purchasers of property for purposes of the exchange requirement of IRC section 1031(a).[8] Appellants assert that, unlike in *Kwon*, there was no modification fee paid to the seller in order to permit the substitution of the buyers. However, in *Kwon*, the modification fee was addressed to support the conclusion that substantial negotiations had taken place prior to the substitution of the new buyers. As discussed in *Kwon*, in considering who was the true seller of the property under the substance over form doctrine, the courts have found it important to consider whether the subsequent sale of the property by the shareholder or partner was conducted under substantially the same terms as the prior negotiation by the corporation or partnership, citing *Commissioner v. Court Holding Co*., *supra*, 324 U.S. at p. 334. Appellants provide the same or similar arguments as they did during the original briefing and hearing. As described above, OTA previously considered these arguments and evidence in making its determination. Appellants' dissatisfaction with the Opinion, and their attempt to reargue the same points, are not proper grounds for reconsideration. (*Appeal of Graham and Smith*, 2018-OTA-154P.)

Appellants also contend that the Opinion is contrary to law because it did not consider *Magneson v. Commissioner* (1985) 735 F.2d 1490 (*Magneson*) and *Bolker v. Commissioner* (9th Cir. 1985) 766 F.2d 1039 (*Bolker*). Appellants contend that they had a continuity of investment in like-kind property and, therefore, they satisfy the requirements for a like-kind

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[6] Appellants assert that the Opinion incorrectly stated that appellants did not pay for any expenses during the time they were tenants in common in the Paso Property, including mortgage payments and property taxes which were deducted from the sale proceeds. However, the Opinion stated that "AWG was reimbursed for some costs, such as mortgage interest expenses and property taxes, from July 1 to August 2, plus closing costs, which were deducted from Purported Sellers' and YHI's share of the closing proceeds [Purported Sellers includes appellants; YHI is Young's Holdings, Inc., the other member of AWG]."

[7] *Kwon* became precedential shortly after the underlying Opinion was issued for this appeal and was not directly addressed in the Opinion; however, *Kwon* addresses the same or similar factors and case law at issue in this matter.

[8] *Kwon*, states that "[w]hile *Court Holding* dealt with a *sale* of property and the transaction at issue in this appeal is the *purchase* of property, we conclude that the analysis remains the same." (Italics in original.)

exchange, pursuant to those cases. However, those cases only addressed whether the holding requirement of IRC section 1031 had been satisfied, whereas the issue in this appeal was the exchange requirement. The Opinion examined the exchange requirement, which required identification of the true seller of the Paso Property. Similarly, OTA declined to consider *Magneson* and *Bolker* in *Kwon*, because those cases only addressed whether the holding requirement of IRC section 1031 had been satisfied, whereas the issue in *Kwon* was the exchange requirement. (*Kwon*, *supra* at footnote 20 ["because the holding requirement is not at issue in this appeal, these cases [including *Magneson* and *Bolker*] will not be addressed or discussed further"].) As a result, it was not contrary to law that the Opinion declined to address or discuss *Magneson* and *Bolker*.[9] In addition, appellants have not shown that the Opinion clearly should have reached a different result. (See *Appeals of Swat-Fame, Inc.*, *et al.*, *supra*.)

Therefore, appellants have not shown that there is insufficient evidence to justify the Opinion or that the Opinion is contrary to law. Accordingly, we find that appellants failed to establish that a rehearing is warranted, and the PFR is denied.

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Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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Sara A. Hosey
Administrative Law Judge

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John O Johnson
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John O. Johnson
Administrative Law Judge

Date Issued: 10/18/2022

[9] In the Opinion, OTA cited to the United States Tax Court's opinion, *Bolker v. Commissioner* (1983) 81 T.C. 782. In that case, both the exchange and holding requirement were at issue, and that case was cited in the Opinion for purposes of evaluating the exchange requirement. The Ninth Circuit opinion cited by appellants, *Bolker*, *supra*, 766 F.2d 1039, addressed only the holding requirement, and was not addressed or discussed in the Opinion.