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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

Representing the Parties:

For Appellants:	Barry L. Guterman, Esq. Edward I. Kaplan, Esq.
For Respondent:	Carolyn S. Kuduk, Tax Counsel III Marguerite Mosnier, Tax Counsel V
For Office of Tax Appeals:	William J. Stafford, Tax Counsel III

J. LAMBERT, Administrative Law Judge: This consolidated appeal is made pursuant to section 19045 of the Revenue and Taxation Code (R&TC) from the actions of respondent Franchise Tax Board (FTB) proposing: (1) additional tax of $296,609, plus applicable interest, for appellant F.A.R. Investments, Inc. (FAR) for the tax year ending June 30, 2008; and (2) additional tax of $685,862, plus applicable interest, for appellant Arciero & Sons, Inc. (ASI) for the tax year ending March 31, 2008.

Administrative Law Judges Josh Lambert, Cheryl L. Akin, and Huy "Mike" Le held an oral hearing via videoconference for this matter on July 28, 2021. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUE

Whether appellants have shown error in FTB's determination denying appellants' claimed deferral of gain from like-kind exchanges under Internal Revenue Code (IRC) section 1031.

FACTUAL FINDINGS

1. Appellants were indirect owners in Arciero Wine Group, LLC (AWG), a limited liability company that is taxed as a partnership for California income tax purposes. AWG owned and operated a winery in Paso Robles, California, which grew, harvested, distilled, marketed, distributed, and sold wine products throughout the world.
2. AWG had two members: (1) Young's Holdings, Inc. (YHI) which held a 8.96 percent membership interest; and (2) Arciero Winery (Winery GP), a California general partnership, which held a 91.04 percent membership interest.
3. In turn, Winery GP had four partners: (1) KV, a 5 percent general partner; (2) appellant FAR, a 22.64 percent general partner; (3) appellant ASI, a 53.31 percent general partner; and (4) PA, a 19.05 percent general partner.[1] ASI's owners included Mr. Arciero Jr. (30 percent) and FAR (40 percent). FAR's owners included Mr. Arciero Jr. (8.4 percent) and Mr. Arciero Sr. (55 percent).[2] Mr. Arciero Sr. and Mr. Arciero Jr. were the principal officers of ASI and FAR. In addition, Mr. Arciero Sr., Mr. Arciero Jr., PA, and KV were all involved in the management and operations of AWG in various roles.
4. AWG's real property included buildings, offices, a gift shop, land, and approximately 40 acres of vineyards in Paso Robles, California (collectively the Paso Property). AWG's assets also included equipment (principally production machinery and wine barrels) and wine inventory.
5. In 2007, AWG received an unsolicited offer from Sapphire Advisors, LLC (SAL) to purchase AWG. Appellants participated in the negotiations with SAL through appellants' attorney (Attorney), who was also the attorney of KV, PA, and AWG. During the negotiations, appellants usually communicated their negotiation terms to Attorney, who in turn, communicated those terms to SAL. SAL initially proposed structuring the transaction as a purchase of AWG's membership interests. As the negotiations

[1] KV and PA are individuals and are referred to by their initials.

[2] Specifically, ASI was owned by: (1) Mr. Arciero Jr. (30 percent); (2) AA (30 percent); and (3) FAR (40 percent). FAR was owned by: (1) Mr. Arciero Jr. (8.4 percent); (2) AA (8.4 percent); (3) Mr. Arciero Sr. (55 percent); and (4) five others with a 5.6 percent ownership each. AA is an individual and is referred to by initials.

progressed, the proposed purchase evolved into a purchase of AWG's assets directly from AWG.[3]

6. Appellants and the other indirect owners of AWG, KV and PA, (hereinafter collectively Purported Sellers or individually Purported Exchanger) wanted to defer recognition of gains on sale of the Paso Property through use of like-kind exchanges under the provisions of IRC section 1031 (1031 Exchanges). But the other direct owner of AWG, YHI, wanted to cash out its investment in AWG. AWG and SAL were each aware of Purported Sellers' desires to defer gains through the use of 1031 Exchanges.
7. On or before July 23, 2007, SAL substituted Sapphire Wines, LLC as the intended buyer (Buyer) in the negotiations regarding the sale and purchase of AWG's assets.
8. Also on July 23, 2007, each Purported Exchanger entered into a separate exchange agreement (Exchange Agreement) with CPA Exchange Corp., a qualified intermediary (QI), wherein the Purported Exchanger expressed its/his intention of exchanging a real property interest that the Purported Exchanger intended to acquire in the near future. In turn, QI agreed to help facilitate the proposed 1031 Exchange.
9. In addition, each Purported Exchanger entered into a separate agreement (Seller Substitution Agreement) with Buyer on July 23, 2007, wherein the Purported Exchanger expressed its/his intention of exchanging the Paso Property, and in turn, Buyer agreed to cooperate with the proposed 1031 Exchange. Each Seller Substitution Agreement substituted QI for the Purported Exchanger as seller of the Paso Property.[4] The Seller Substitution Agreements were signed by each Purported Exchanger, CPA Exchange Corp. (by Mr. Silva, president), and Buyer.
10. Next on July 27, 2007, AWG and Buyer signed an asset purchase agreement (Asset Purchase Agreement), whereby AWG agreed to sell, and Buyer agreed to purchase,

[3] On or before June 19, 2007, SAL prepared and provided a draft Interest Purchase Agreement which provided for the purchase of 100 percent of Winery GP's and YHI's membership interests in AWG by SAL. This agreement was never executed by the parties. Instead, after further negotiations, the sale was converted into a sale of most of AWG's assets (including the Paso Property) directly from AWG. On or before June 30, 2007, SAL prepared and provided a draft Asset Purchase Agreement. AWG and SAL ultimately executed an Asset Purchase Agreement on July 27, 2007. The details of this agreement are discussed below in Findings of Fact numbers 10 and 11.

[4] Each Seller Substitution Agreement reflected the Purported Exchanger rather than AWG as the "TRUE SELLER" of the Paso Property. On the date the Seller Substitution Agreements were executed on July 23, 2007, each Purported Exchanger had not yet acquired its/his interest in the Paso Property from AWG.

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AWG's assets for $23.75 million, which consisted of $4 million for inventory, $1 million for equipment, and $18.75 million for the Paso Property.[5]

11. The Asset Purchase Agreement stated that: (1) AWG had the "requisite power and authority" to enter into such agreement, (2) the Asset Purchase Agreement "constitute[ed] the entire agreement among the parties" and "supersed[ed] all prior agreements, understandings, negotiations, and discussions," and (3) AWG had "good and marketable" title to the inventory, equipment, and the Paso Property. There were approximately 17 draft versions of a purchase or sale agreement circulated among Attorney, AWG, Purported Sellers (including appellants), and Buyer (or Buyer's predecessor, SAL) prior to the execution of the Asset Purchase Agreement, from June 2007 to its signing on July 27, 2007.
12. On July 31, 2007, AWG signed and delivered a single grant deed (Paso Deed) to the escrow agent for recording, by which AWG conveyed tenancy-in-common (TIC) interests in the Paso Property to each Purported Exchanger, as well as to YHI, in proportion to their respective direct or indirect ownership percentages in AWG.[6] Also on July 31, 2007, each Purported Exchanger and YHI, then signed and delivered to the escrow agent a second deed which conveyed their respective TIC interests in the Paso Property to Buyer (TIC Holders' Deed).
13. On August 2, 2007, each Purported Exchanger, as well as YHI, signed escrow instructions which stated, in part, "These escrow instructions are not intended to amend, supersede or modify the prior Asset Purchase Agreement By and Between Arciero Wine Group, LLC [i.e., AWG] and Sapphire Wines, LLC [i.e., Buyer] . . . ." At closing, Buyer deposited funds into escrow. The escrow agent then recorded both the Paso Deed and the TIC Holders' Deed on August 2, 2007.
14. In accordance with the escrow instructions, the escrow agent transferred each Purported Exchanger's proportionate share of net disposition proceeds (i.e., net of mortgage liens, accrued mortgage interest, prorated property taxes, escrow fees, etc.) related to the Paso Property to QI. In contrast, the escrow agent transferred YHI's proportionate share of net disposition proceeds related to the Paso Property to YHI directly. At closing, the escrow

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[5] At the time of the sale, the Paso Property was encumbered by a mortgage and a revolving credit line note.

[6] The TIC holders did not enter into a written tenants-in-common agreement.

agent also transferred net proceeds related to the disposition of AWG's inventory and equipment directly to AWG, subject to a possible audit valuation adjustment after the close of escrow due to Buyer's anticipated completion of its audit of AWG's inventory.

15. Purported Sellers and YHI did not pay any operating expenses, such as utility expenses, property maintenance expenses, or insurance expenses for the Paso Property in relation to the three-day period commencing on July 31, 2007, and ending on August 2, 2007, during which they purportedly held the property as tenants-in-common. Instead, AWG paid those expenses and claimed them on its 2007 California LLC income tax return.
16. Mortgage interest expense and prorated property taxes for the period from July 1 to August 2, 2007, plus closing costs, were deducted from Purported Sellers' and YHI's share of the closing proceeds.[7]
17. Purported Sellers and YHI did not notify the Paso Property's mortgage holder or its insurance carrier when the Paso Deed was executed and delivered to the escrow agent on July 31, 2007.
18. Appellants timely identified and acquired separate replacement properties with the assistance of QI.
19. Approximately five months after the close of escrow, AWG filed a complaint against Buyer in California Superior Court, asserting that Buyer's self-determined audit valuation adjustment in relation to AWG's inventory was unwarranted. Although the complaint does not specifically focus on the Paso Property, paragraph 5 of the complaint contains a statement that "On or about July 27, 2007, Arciero [i.e., AWG] and Sapphire [i.e., Buyer] entered into an Asset Purchase Agreement under which Arciero agreed to sell and Sapphire agreed to buy, substantially all of the assets of Arciero's wine business …."[8]
20. Subsequently, appellants filed California income tax returns, claiming deferral of gains under IRC section 1031.
21. During audit, FTB denied 1031 Exchange treatment and issued Notices of Proposed Assessments (NPA) to each appellant, which they timely protested.

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[7] AWG received the "Balance of Inventory consideration" totaling $99,401.03.

[8] Various items, such as memorabilia and framed pictures, were excluded from the Asset Purchase Agreement.

22. Following protest, FTB issued a Notice of Action (NOA) to FAR for its tax year ending June 30, 2008, revising the additional tax proposed per the NPA to $296,609. FTB also issued an NOA to ASI for its tax year ending March 31, 2008, revising the additional tax proposed per the NPA to $685,862.
23. In response, appellants filed this timely appeal.

DISCUSSION

Burden of Proof

An FTB determination is generally presumed to be correct, and a taxpayer bears the burden of proving otherwise. (*Appeal of GEF Operating, Inc*., 2020-OTA-057P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid*.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid*.)

IRC section 1031

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,[9] 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); 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).)[10]

"Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only." (Treas. Reg. § 1.1002-1(d).) IRC "[s]ection 1031(a) requires that like-kind property be both given up

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

[10] For the years at issue, nonrecognition treatment shall not apply to stock-in-trade or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action. (IRC, § 1031(a)(2)(A)-(F) [effective to December 21, 2017. Effective December 22, 2017, IRC section 1031(a)(1) was amended to state it applies to "real property" only].)

and received in the 'exchange.'"[11] (*Chase v. Commissioner* (1989) 92 T.C. 874, 883 (*Chase*).) The basic question of who in reality was the seller in the transaction is a question of fact. (*Waltham Netoco Theatres, Inc. v. Commissioner* (1968) 401 F.2d 333, 334 (*Waltham*); see also *Bolker v. Commissioner* (1983) 81 T.C. 782, 794 (*Bolker*).)

Substance-Over-Form Doctrine

The United States Supreme Court established the substance-over-form doctrine in *Gregory v. Helvering* (1939) 293 U.S. 465. If the substance of the transaction fails to satisfy the intent of the statute, then the form of the transaction that gave rise to the tax effect will be disregarded for tax purposes. (*Id*. at p. 470.) The substance-over-form doctrine has been applied to determine the "true seller" of property for tax purposes, as illustrated below.

Court Holding

The substance-over-form doctrine was applied by the United States Supreme Court in *Commissioner v. Court Holding Co*. (1945) 324 U.S. 331 (*Court Holding*), in which a closely held corporation entered into oral negotiations to sell its real property. (*Id*. at p. 333.) After the corporation entered into the oral negotiations and a down payment was made, the controlling shareholders discovered that if the sale was consummated as structured, the corporation would incur a large tax liability. Consequently, the controlling shareholders declared a liquidating dividend followed by the transfer of legal title of the property to themselves. The shareholders then signed a sales contract as owners of the property with substantially the same terms and conditions previously agreed upon by the buyer and the corporation. Three days after the liquidating dividend, the property was conveyed to the buyer. (*Ibid*.) In ruling that the sale was properly attributed to the corporation, the Supreme Court stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to

[11] In other words, generally the same taxpayer that relinquishes property in a 1031 Exchange must also receive the replacement property in the exchange to satisfy the exchange requirement under IRC section 1031. The IRS has considered limited exceptions, such as with regard to disregarded entities, that are not relevant here.

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> be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

(*Id*. at p. 334.)

<u>Cumberland</u>

Five years after deciding *Court Holding*, the United States Supreme Court reached a different result in *United States v Cumberland Public Service Co*. (1950) 338 U.S. 451 (*Cumberland*). In that case, shareholders of a closely held power company realized that the company could not compete with a new rival utility company and attempted to negotiate the sale of their stock in the company to the rival. That offer was rejected, and a counteroffer was made by the competitor to instead buy certain assets of the company. This counteroffer was rejected, based on its negative tax implications. Instead, the corporation transferred the assets to its shareholders in partial liquidation. The remaining assets were sold, and the corporation dissolved. The shareholders then executed the previously contemplated sale to the power company. The IRS then sought to treat the income as being received by the company under the theory that the shareholders were mere conduits for the sale. (*Id*. at p. 452-453.)

The Court, however, determined that, this in case, the substance-over-form doctrine did not warrant a recharacterization of the shareholders' sale as a sale by the corporation. The Court noted, in contrast to *Court Holding*, the corporation never negotiated for the terms of the sale at issue and "that at no time did the corporation plan to make the sale [of the assets] itself." (*Cumberland*, *supra*, 338 U.S. at p. 453.) The Court also determined that the company's activities and existence were genuinely ended by the dissolution and liquidation prior to the sale. The Court noted that its decision in *Court Holding* did "not mean that a corporation can be taxed even when the sale has been made by its stockholders following a genuine liquidation and dissolution." (*Id*. at p. 454.)

<u>Chase</u>

In *Chase*, *supra*, 92 T.C. 874, the tax court applied the substance-over-form doctrine to determine who was the seller of real property in an attempted 1031 Exchange – a partnership or the taxpayers who were the partners in that partnership. The taxpayers, a husband and wife, sought to employ IRC section 1031 to defer gain on the sale of an apartment building. The tax court, however, applied the substance-over-form doctrine and concluded that the substance of the

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taxpayers' purported sale of an undivided interest in the apartments was a sale by the partnership. (*Id*. at p. 883.) First, the contract for the sale of the apartments reflected the partnership as the seller. (*Id*. at p. 877.) Second, the taxpayer-husband signed the contract as a general partner of the partnership, and there was no indication that he individually held any interest in the apartments. (*Ibid*.) Furthermore, when it was certain that the sale would close, the taxpayer-husband caused the deed for an undivided interest in the property (which had been executed shortly after the receipt of an initial offer to purchase the apartments) to be recorded. (*Id*. at p. 877.) Finally, from the time the taxpayers received the deed to the apartments, until the date the sale was closed, the partnership and not the taxpayers received the rents and paid the expenses related to the apartments. (*Id*. at p. 878-879.)

Reviewing the above facts, the tax court explained, "[t]he substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." (*Chase*, *supra*, at p. 881, citing *Court Holding*, *supra*, and *Cumberland*, *supra*.) The tax court further explained, "Transactions, which did not vary, control, or change the flow of economic benefits, are dismissed from consideration." (*Ibid*., quoting *Higgins v. Smith* (1940) 308 U.S. 473, 476.) Applying these principles, the tax court found that in substance, the partnership rather than the taxpayers sold the property. The tax court further noted that the partnership did not complete a 1031 Exchange since it did not acquire replacement properties. Therefore, the tax court held that the taxpayers did not participate in a 1031 Exchange. (*Chase*, *supra*, at p. 882-883.)

<u>Brookfield Manor</u>

In the Board of Equalization's (BOE) precedential opinion in *Appeal of Brookfield Manor, Inc., et al*. (89-SBE-002) 1989 WL 37900 (*Brookfield Manor*), the BOE addressed whether property in an attempted 1031 Exchange was sold by appellant Brookfield Manor, Inc. (Brookfield) or instead, by the individual appellant shareholders of Brookfield.[12]

In August of 1978, Brookfield negotiated with a third party to exchange its mobile home park for an unspecified piece of property, and then proceeded to open an escrow for the transaction on August 22, 1978. On September 14, 1978, escrow was adjusted to replace

[12] BOE is the Office of Tax Appeals' (OTA) predecessor and precedential opinions from the BOE may be cited by OTA as precedential authority unless OTA removes the precedential status of that opinion. (Cal. Code Regs., tit. 18, § 30504.)

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Brookfield's name with the names of its shareholders and to specify a medical building as the replacement property. Brookfield next adopted a plan for liquidation on September 27, 1978, then purported to distribute its mobile home park to its shareholders on or before October 28, 1978, and finally dissolved three days later. The properties were then exchanged on November 9, 1978.

To address the issue of who was the true seller of the relinquished property, the BOE applied the principles in *Court Holding*, finding that it was factually similar. Following the principle set forth in *Court Holding*, the BOE found that Brookfield took an active role in the sale and negotiated the essence of the sale prior to dissolution; the sale was conducted under substantially the same terms as negotiated by Brookfield; there was no evidence that the individual taxpayers conducted any negotiations on their own behalf with the third party; and very little time elapsed between the corporate negotiations and the final exchange. Based on the foregoing circumstances, the BOE determined that the sale was properly attributed to Brookfield, not the individual shareholders.

Analysis of Exchange Requirement

At issue in this appeal is whether the exchange requirement of IRC section 1031(a) was satisfied.[13] FTB contends that the transaction at hand does not satisfy the exchange requirement because AWG was the true seller of the Paso Property, as evidenced by the Asset Purchase Agreement which listed AWG as the sole seller. Appellants argue that, in both form and substance, appellants (and the other TIC holders) were the true sellers of the Paso Property.[14] Specifically, appellants contend that there was a bifurcated sale: one, a sale of inventory and

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[13] The parties agree that both the like-kind and holding requirements have been met in this case.

[14] In support of their arguments, appellants cite *Appeal of Mitchell*, 2018-OTA-210, a nonprecedential opinion of OTA, and, in response, FTB cites *Appeal of Giurbino* (Nov. 29, 2016) 2016 WL 10005734, which is a nonprecedential summary decision of the BOE. However, a decision may not be expressly relied upon as precedent unless it is designated as a precedential decision by the agency. (See Cal. Code Regs., tit. 18, § 30502(b); Gov. Code, § 11425.60(a).) As such, we do not discuss these cases or the parties' arguments based on these cases further.

In addition, FTB incorrectly suggests that OTA should not follow the majority of any opinion, (which would include both nonprecedential and precedential opinions), where there is not a unanimous agreement by the panel of three administrative law judges. A nonprecedential opinion has no precedential weight, but nevertheless may be found to be persuasive, even if there is no unanimous decision. Additionally, the majority decision of a precedential opinion is given precedential weight, regardless of a dissent or concurrence, which are not afforded any precedential weight. (See, e.g., *People v. Lopez* (2012) 55 Cal.4th 569, 585 ["dissenting opinions are not binding precedent"]; see also *Wall v. Sonora Union High School Dist.* (1966) 240 Cal.App.2d 870, 872.)

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assets by AWG, and two, a sale of the Paso Property by the Purported Sellers, including appellants. Appellants contend that the Asset Purchase Agreement is "primarily concerned with the sale of AWG's wine inventory" and that there is "virtually nothing there related to the Paso Property."[15] Appellants contend that the separate sale of the Paso Property by appellants is evidenced by the Seller Substitution Agreements, which state that the Buyer acknowledges and agrees to cooperate with a substitution of QI for Purported Sellers, including appellants, (named "True Sellers" in the Seller Substitution Agreements) as the sellers of the Paso Property.

Appellants argue that the designation of AWG's name in the Asset Purchase Agreement should not control our determination as to who was the seller of the Paso Property because appellants always "intended" to complete 1031 Exchanges, and appellants' intent was known to AWG and Buyer (including Buyer's predecessor, SAL). Appellants assert that in "everyone's mind, buyer, sellers…everyone understood that the property was not part of the asset sale with respect to what AWG was doing."[16] Appellants also assert that "[e]veryone knew that piece [the Paso Property] was already moved out. And that's what the Seller Substitution Agreements from three or four days before said."[17] In addition, appellants provide witness testimony from Mr. Arciero, Jr. and Mr. Silva, the CPA who assisted in the transaction. The witnesses testified as to the circumstances and planning surrounding the transaction to ensure 1031 Exchanges were completed, and that the sale would not have occurred in the absence of 1031 Exchange eligibility.[18]

FTB, on its part, cites to *Bezdijan v. Commissioner* (1988) 845 F.2d 217, 218 (*Bezdijan*), for the proposition that intent is "irrelevant" to the exchange requirement. However, *Bezdijan* only states that "[t]he fact that the Bezdijans intended the Broadway parcel to replace the El Camino property in their holdings does not render their transactions an exchange." (*Id*. at

[15] Hearing Transcript, page 52, lines 8-10.

[16] Hearing Transcript, page 52, lines 10-13.

[17] Hearing Transcript, page 52, lines 13-16.

[18] Mr. Silva stated that it was a planned "drop and swap." Two typical approaches to a 1031 Exchange are a "drop and swap" transaction and "swap and drop" transaction. "Drop and swap" transactions are typically when a partnership distributes the relinquished property before the exchange. In contrast, a "swap and drop" transaction is when the property is contributed to the entity after the exchange.

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p. 218.)[19] While intent alone may not be determinative, it may be considered and can be relevant. This is because the "transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant." (*Court Holding*, *supra*, 324 U.S. at p. 334.) As stated by the United States Supreme Court in *Cumberland*, *supra*, 338 U.S. at fn. 3: "[I]n resolving such questions as who made a sale, fact-finding tribunals in tax cases can consider motives, intent, and conduct in addition to what appears in written instruments used by parties to control rights as among themselves." (*Cumberland*, *supra*, 338 U.S. at fn. 3.)[20]

While the appeal record does, in fact, indicate an intent to carry out 1031 Exchanges, the Asset Purchase Agreement contradicts the existence of a bifurcated sale, as it names AWG as the sole seller of the Paso Property and provides no indication of either the 1031 Exchanges or the separate sale of the Paso Property by Purported Sellers in place of AWG. Furthermore, the Asset Purchase Agreement specifically indicates that the assets sold includes the Paso Property, such as the winery buildings, offices, and land. The assets to be excluded from the purchase are specifically identified in the agreement and only include items such as memorabilia and framed pictures. In addition, the Asset Purchase Agreement states that it "constitute[ed] the entire agreement among the parties" and "supersed[ed] all prior agreements, understandings, negotiations, and discussions." These terms contradict the Seller Substitution Agreements, signed four days prior, and are inconsistent with appellants' contention that the Asset Purchase

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[19] We note that *Bezdijan* involved whether there was a sale or exchange and that similar cases hold that intent may be considered, but is not determinative. (See also *Smith v. Commissioner* (1976) 537 F.2d 972, fn. 2 ["Even though intent is a consideration, it is not controlling"]; *Garcia v. Commissioner* (1983) 80 T.C. 491, 498 ["Intent alone does not determine tax consequences" but "has received deference where parties have acted consistently therewith"]; see also *Carlton v. United States* (1967) 385 F.2d 238, 243.)

[20] See also *Rust Communications Group, Inc. v. United States* (1990) 20 Cl.Ct. 392, 398 ["Under *Cumberland* and *Court Holding*, this court must consider the subjective intentions cited by plaintiffs as well as the actual conduct of negotiations and written documents relied on by defendant"].

Agreement and Seller Substitution Agreements should be examined together as representing a bifurcated sale.[21]

As stated above, intent is not determinative; furthermore, we give less consideration to intent in this case where the Asset Purchase Agreement negotiated and executed by the parties fails to implement such stated intent. Here, there is no separate agreement to sell the Paso Property by Purported Sellers. In addition, the Asset Purchase Agreement was not amended to reflect that there were, in fact, two transactions; a bifurcated sale of the Paso Property by appellants and separate sale of the other assets and inventory by AWG.[22] And the Seller Substitution Agreements only purport to substitute QI for Purported Sellers as the seller of the Paso Property – there are no separate agreements substituting Purported Sellers for AWG as sellers of the Paso Property.[23]

While a taxpayer is free to organize its affairs as it chooses, nevertheless, once having done so, it must accept the tax consequences of its choice whether contemplated or not and may not enjoy the benefit of some other route it might have chosen to follow but did not. (*Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149.) A taxing agency may look through the form of a transaction to its substance (*Gregory v. Helvering*, *supra*, 293 U.S. 465); in contrast, "the taxpayer may have less freedom than the [taxing agency] to ignore the transactional form that [it] has adopted." (*Estate of Durkin v. Commissioner*, 99 T.C. 561, 571, citing *Bolger v. Commissioner* (1973) 59 T.C. 760, 767 fn. 4.) While appellants contend that a bifurcated sale was both intended and effectuated, the Asset Purchase Agreement

[21] Appellants had sufficient time to review the terms of the Asset Purchase Agreement and should have been aware that the Seller Substitution Agreements would be superseded by the terms of the subsequently executed Asset Purchase Agreement. Those terms were included in the June 19, 2007 draft Interest Purchase Agreement and June 30, 2007 draft Asset Purchase Agreement, and draft versions of the agreement circulated among the parties, including appellants, from June 2007 to the signing of the Asset Purchase Agreement on July 27, 2007. In addition, according to the declaration of KV, "[w]hile [Mr. Arciero] Sr., [Mr. Arciero] Jr., [PA], and [KV] jointly participated, managed and directed the overall business operations of the company, all major decisions, expenditures and investments were collectively discussed and required their agreement before implementation."

[22] There is email correspondence dated July 18, 2007, from Mr. Silva to Attorney, stating that "[e]ach partner will be doing their own exchange…I do believe it has to be mentioned in the agreement with the buyers so that they will cooperate." The record does not include evidence to explain why the Asset Purchase Agreement was not revised or amended to reflect a sale of the Paso Property by Purported Sellers in place of AWG.

[23] Appellants assert that, while all involved were aware it was a bifurcated sale, the lack of evidence is due to a "poor job of documenting." (Hearing Transcript, page 67, lines 15-16.)

executed with an independent, third-party buyer reflects a single sale by AWG of most of its assets, including the Paso Property.

On the other hand, the record includes the Seller Substitution Agreements and escrow instructions, which were adhered to in completing the transactions in accordance with appellants intent to complete 1031 Exchanges. Similarly, AWG issued a single grant deed which purportedly transferred TIC interests in the Paso Property to each Purported Exchanger and YHI, who then deeded their respective TIC interests in the Paso Property to Buyer.[24] However, we note that a transfer of title by grant deed does not necessarily control whether the true seller for tax purposes was AWG or appellants. (*Chase*, *supra*, 92 T.C. 874 at pp. 881 ["Although the general partners of JMI caused JMI to prepare a deed conveying … the Apartments to petitioners, at no time did petitioners act as owners except in their roles as partners of JMI"].) We also note that the escrow instructions state it is "not intended to amend, supersede or modify the prior Asset Purchase Agreement…."[25]

Appellants assert that, "[i]f you look at everything here, there is one piece that does not fit perfectly into the jigsaw puzzle. It's the Asset Purchase Agreement. If the Asset Purchase Agreement obliterates all the other facts and circumstances . . . now we're back to form trumps substance … It's necessary to look at everything."[26] Given that there are inconsistencies with the Asset Purchase Agreement and how the transaction was implemented, we agree that this transaction should be viewed as a whole in order to determine whether, in substance, appellants were the true sellers. In *Brookfield Manor*, the BOE considered whether the substance-over-form doctrine should be applied in similar circumstances to determine whether to disregard the transfer of legal title of the property from a corporation to its shareholders prior to the sale of the

[24] These actions are consistent with Mr. Silva's statement to Attorney in an email dated July 20, 2007, that to complete the 1031 Exchanges, "it is required that [AWG] deed out the real estate into the names of the partners involved…."

[25] The escrow instructions also state: "The parties agree that the Exchanger's conveyance of the property is not conditioned upon qualification of this escrow under Section 1031, and that the property shall be conveyed regardless of the ultimate tax effect on any transaction pursuant to this escrow."

[26] Hearing Transcript page 68, lines 8-12.

property to a third party.[27] Accordingly, we will examine whether the substance-over-form doctrine should be applied in this case.

Application of Substance-over-Form Doctrine

In determining whether the substance of the transaction differs from the form chosen by appellants – such that the transaction should be characterized as a sale by AWG, we apply factors which the courts and BOE have previously utilized in similar circumstances. Such factors include, but are not limited to: (1) whether AWG took an active role in the sale and negotiated the essence of the sale; (2) whether the Purported Sellers conducted any negotiations on their own behalf with the buyer; (3) the time elapsed between AWG's negotiations and the final exchange; (4) whether the sale was conducted under substantially the same terms as negotiated by AWG; and (5) whether the Purported Sellers received the benefits and burdens of ownership of the property. (*Brookfield Manor*, *supra*; *Chase*, *supra*.)

Negotiations by AWG

In examining the extent that AWG or appellants, on their own behalf, were involved in negotiations for the sale of the Paso Property, we note that appellants were partners of Winery GP, which held a 91.04 percent membership interest in AWG. Additionally, shareholders of appellants, such as Mr. Arciero Sr. and Mr. Arciero Jr., were directly involved in the management of AWG. Furthermore, Attorney and Mr. Silva, a CPA, represented both appellants and AWG.

As noted in *Bolker*, *supra*, 81 T.C. 782, 799, the earlier decisions in *Court Holding* and *Cumberland* "created a situation where the tax consequences were dependent upon the resolution of often indistinct facts as to whether the negotiations leading to the sale had been conducted by the corporation or by the shareholders." (*Id*., at p. 799, citing *Central Tablet Manufacturing Co. v. United States* (1974) 417 U.S. 673, 680.) However, the court noted, "the sale cannot be attributed to the corporation unless the corporation has, while still the owner of the property, carried on negotiations looking toward a sale of the property, and in most cases the negotiations must have culminated in some sort of sales agreement or understanding so it can be said the later

[27] When courts have decided to examine whether a taxpayer has shown that substance should trump form, the taxpayer has been held to a higher burden than the taxing agency. (See, e.g., *Glacier State Elec. Supply Co. v. Commissioner* (1983) 80 T.C. 1047, 1053.)

transfer by the stockholders was actually pursuant to the earlier bargain struck by the corporation – and the dissolution and distribution in kind was merely a device employed to carry out the corporation's agreement or understanding." (*Bolker*, *supra*, 81 T.C. 782, 799, citing *Merkra Holding Co. Inc. v. Commissioner* (1956) 27 T.C. 82, 92; see also *Hines v. United States* (5th Cir. 1973) 477 F.2d 1063.)

Here, the evidence indicates that AWG took an active role in the sale and negotiated the essential terms and conditions of the sale of the Paso Property.[28] In addition, AWG was named as the sole seller of the Paso Property in the Asset Purchase Agreement and prior drafts included in the appeal record contain notations and comments on the terms of the agreement by Attorney that are unrelated to the 1031 Exchanges. There is no indication in the records that the notations were done on behalf of appellants or that appellants negotiated the terms on their own behalf.

In an email dated July 17, 2007, from Mr. Silva to Attorney, Mr. Silva states: "I'm not sure if anyone has mentioned this to you, but the selling parties want to do a 1031 Exchange on the portion of the selling price that is allocated to the real estate." This email demonstrates that Attorney was informed of the proposed 1031 Exchanges 10 days before the agreement was signed, which is subsequent to his review of the terms of the sale of AWG's assets.[29] The June 19, 2007 draft Interest Purchase Agreement initially provided for the purchase of 100 percent of Winery Group's and YHI's membership interests directly from Winery Group in AWG and the June 30, 2007 draft Asset Purchase Agreement provided for the purchase of essentially all of AWG's assets directly from AWG in a single sales transaction. In finalizing the transaction as a single sale of substantially of AWG's assets, there were extensive negotiations regarding the terms and conditions of the transaction including the price of AWG's inventory. This evidence indicates that the negotiations for the Paso Property were completed primarily on behalf of AWG, not appellants.

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[28] In a May 1, 2007 email, KV communicated the original offer, which was to "include the current winery parcel/assets …[and] existing winery inventory to be purchased at cost." The Asset Purchase Agreement ultimately executed by AWG and SAL on July 27, 2007, evidences this primary objective of the sale.

[29] This includes Attorney's review of the draft Interest Purchase Agreement prepared and provided by SAL on or before June 19, 2007, and the draft Asset Purchase Agreement prepared and provided by SAL on or before June 30, 2007, as well as any other draft agreements not specifically in the record which were prepared and provided to Attorney before the July 17, 2007 email from Mr. Silva.

Negotiations by Purported Sellers (Including Appellants) on Their Own Behalf

The appeal record demonstrates that appellants participated in negotiations with Buyer (or its predecessor, SAL) with regard to the 1031 Exchanges, through Mr. Silva and Attorney, with the goal of implementing separate 1031 Exchanges, as evidenced by the Seller Substitution Agreements and email correspondence, consistent with the above discussion detailing appellants intent. However, there is no evidence that appellants were involved in active and independent negotiations with Buyer with respect to any contract terms relating to the Paso Property. (See *Chase*, *supra*, at p. 882 ["there is no evidence of negotiations by petitioners on behalf of themselves concerning the terms for the disposition of the Apartments"].) Appellants' negotiations appear to revolve around the process of implementing the 1031 Exchanges rather than the terms of the sale of the Paso Property owned by AWG (or any other property owned by AWG, such as equipment and inventory); the correspondence in the record indicates discussions among the Purported Sellers relating only to the 1031 Exchanges and the allocation of their payouts.[30]

Specifically, email correspondence on July 17, 2007, and July 18, 2007, indicates discussion of the proposed 1031 Exchanges, and Mr. Silva states in his declaration that the plan was raised and agreed on July 17, 2007, or shortly before, at a meeting with Mr. Arciero Sr., Mr. Arciero Jr., PA, and KV. Mr. Silva states that "[Mr. Arciero Sr.] was probably the only one at that meeting that was familiar with [like-kind exchanges]."[31] In addition, Mr. Silva states in his declaration that the concept of a "like-kind exchange, was unknown to [Mr. Arciero Jr.] and [KV]." Therefore, it appears that only Mr. Arciero Sr. and PA understood what a 1031 Exchange was prior to the July 17, 2007 meeting. And as stated above, the plan to implement 1031 Exchanges was raised and agreed upon at the July 17, 2007 meeting. However, extensive negotiations had already taken place prior to that date, as indicated by the June 19, 2007, and

[30] Email correspondence on May 1, 2007, informed the Purported Sellers of the offer to buy the Paso Property, and in the same email it is raised that they would be seeking tax planning as to the distribution of proceeds. However, this not demonstrate that the Purported Sellers were aware they would be negotiating on their own behalf and selling the property themselves, as it was not until the July 17, 2007 meeting that the plan to implement a 1031 Exchange was raised and agreed upon.

[31] Hearing Transcript, page 20, lines 15-17.

June 30, 2007 draft agreements in the record.[32] As a result, the evidence shows that the essential terms of the agreement had already been substantially negotiated by the time the 1031 Exchange proposal was raised and agreed to by the Purported Sellers on July 17, 2007.

The evidence further shows that, after the Seller Substitution Agreements were signed, appellants were only involved in negotiations with respect to implementation of the 1031 Exchanges and not as to the terms of the sale of the Paso Property. This indicates that the substance of the transaction is consistent with the Asset Purchase Agreement which identifies AWG as the sole seller of the property. Therefore, the evidence demonstrates that it was AWG and not appellants that were actively involved in negotiations related to the essential terms of the sale. (*Waltham*, *supra*, 401 F.2d 333, 335 ["It was only after that consultation that the sale by petitioner's stockholders was suggested. By that time, however, the deal with Clevite for the sale of the real estate had been struck and only the formalities of the transaction remained"].)

Substantially the Same Terms and Agreements

The prior drafts of the sales agreements in the record do not include terms where appellants are named as the sellers of the Paso Property.[33] Furthermore, there is email correspondence dated July 18, 2007, from Mr. Silva to Attorney, stating that "[e]ach partner will be doing their own exchange…I do believe it has to be mentioned in the agreement with the buyers so that they will cooperate." However, that email was nine days before signing the final agreement, and there is no evidence of any sales agreements that name the Purported Sellers as the sellers of the Paso Property, even though there were approximately 17 versions of the agreement being circulated among Attorney, Purported Sellers (including appellants), and Buyer (or Buyer's predecessor, SAL).

As noted above, the Asset Purchase Agreement states that it supersedes all prior agreements, understandings, negotiations, and discussions, including the prior executed Exchange and Seller Substitution Agreements. In addition, there were no amendments made to

[32] The June 19, 2007 draft lists Winery GP and YHI as the sellers of their membership interests in AWG, but the agreement was converted to Asset Purchase Agreement with AWG listed as the seller of its assets in the next, June 30, 2007 draft. There is a notation by Attorney on June 19, 2007 draft that raised the question: "The selling entity should be the LLC [AWG]?"

[33] As previously mentioned, the June 19, 2007 draft lists Winery GP and YHI as the sellers of their membership interests in AWG, but the agreement was converted to an Asset Purchase agreement with AWG listed as the seller of its assets in a subsequent draft dated June 30, 2007.

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the Asset Purchase Agreement to make it consistent with the Exchange and Seller Substitution Agreements, such as by substituting appellants as the sellers of the Paso Property. Appellants do not provide any evidence showing that the terms of the agreement were substantially modified after the Seller Substitution Agreements were signed on July 23, 2007. Rather, the evidence indicates that the terms of the agreement as to the Paso Property were substantially in place prior to the execution of the Seller Substitution Agreements. Therefore, the sale was conducted under substantially the same terms and conditions as negotiated by AWG.

Time Elapsed

Email correspondence on July 17, 2007, and July 18, 2007, indicates discussion of the proposed 1031 Exchanges, and Mr. Silva states in his declaration that the plan was raised and agreed to on July 17, 2007, or shortly before. (See *Rust Communications Group, Inc. v. United States* (1990) 20 Cl.Ct. 392, 397 ["The timing of conduct is also important. The trial court must consider the point at which the corporation chose to sell assets through shareholders"].) However, extensive negotiations had taken place prior to that date, as demonstrated by the prior draft agreements in the record. There was a short period of time between the negotiations by AWG and the Seller Substitution Agreements dated July 23, 2007, and the execution of the Asset Purchase Agreement on July 27, 2007. In addition, the sale of the Paso Property closed on August 2, 2007, and the deeds conveying the Paso Property to the Purported Sellers by AWG are dated July 30, 2007, and were recorded on August 2, 2007.[34] Given the brief time frame, plus the lack of evidence that appellants were involved in the negotiations of the Paso Property on their own behalf or that the terms were substantially changed after the Seller Substitution Agreements, it appears that appellants merely stepped into the shoes of AWG after the sale was already negotiated, agreed upon, and pending closing.[35]

[34] See *Chase*, *supra*, 92 T.C. 874, 881 ["Petitioners were deeded an undivided interest at the time of the first offer because it appeared that a sale was imminent. [W]hen this sale failed to close, however, petitioners' deed remained unrecorded until shortly before the disposition in question"].

[35] See *Martin Ice Cream Co. v. Commissioner* (1998) 110 T.C. 189, 212 ["when a corporation negotiates all the terms and conditions of a sale of its assets, and then, at the last minute, distributes assets to its shareholders and the shareholders' names are conveniently inserted as sellers; the substance of the negotiations will prevail, and the corporation will be regarded as the seller"].

Burdens and Benefits of Ownership

In *Chase*, *supra*, the court examined whether the taxpayers bore the benefits and burdens of ownership of the property, finding that they "never paid any of the operating costs of the Apartments or their share of the brokerage commission. Further, petitioners did not receive, or have credited to them, any of the Apartment's rental income." (*Id*. at p. 882.) In this case, appellants were conveyed the deeds on July 30, 2007, and the sale closed shortly thereafter on August 2, 2007. While this is a short period of time, we may examine any evidence indicating whether AWG or appellants bore any benefits and burdens of ownership of the Paso Property.[36]

In determining whether the benefits and burdens of ownership have passed to a purchaser, certain factors have often been considered, including, but not limited to: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether any equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. (*Grodt & McKay Realty, Inc. v. Commissioner* (1981) 77 T.C. 1221, 1237.)

AWG paid the operating expenses of the Paso Property including utility expenses, property maintenance expenses, and insurance expenses for the Paso Property until the sale closed on August 2, 2007.[37] However, 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. AWG claimed operational expenses associated with operating the property on its 2007 California LLC income tax return, as well as mortgage interest and property tax paid.[38]

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[36] The Seller Substitution Agreements state that "No 'Qualified Intermediary' shall appear on the chain of title."

[37] Mr. Silva states that the operational expenses of AWG were not allocated to the Purported Sellers because the pro rata shares for these expenses of $2,076 was immaterial.

[38] Appellants note that the members' proportionate shares of those amounts were reflected on their individual member return Schedules K-1 issued by AWG for same tax year.

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The property taxes and mortgage interest were paid out of the sales proceeds; however, there is no evidence that, but for the closing of the sale, there was any obligation on Purported Sellers and YHI to pay these expenses, or any other expenses, including those which were not reimbursed, during the three days that they held title to the property. In addition, prior to closing, Purported Sellers and YHI did not notify the Paso Property's mortgage holder or its insurance carrier of the pending sale or of the transfer of the deed to them by AWG.[39] Therefore, the evidence does not indicate that the burdens and benefits shifted from AWG to appellants at the time the deed was conveyed.[40] And there is no evidence indicating that appellants acted as the owners or held themselves out as the owners of the Paso Property after the deed was conveyed to them by AWG.[41] (*Chase v. Commissioner*, *supra*, 92 T.C. at p. 881 ["at no time did petitioners act as owners except in their roles as partners of JMI"].)

After considering all the evidence in the record we hold that, in substance, AWG was the seller of the Paso Property, and appellants have not shown that they have satisfied the exchange requirement of IRC section 1031(a).

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[39] Purported Sellers and YHI also did not enter into loan assumption agreements for the loans attached to the Paso Property.

[40] See *Wells Fargo & Co. and Subsidiaries v. United States* (2010) 91 Fed.CL. 35, 76, citing *Kwiat v. Commissioner*, T.C. Memo. 1992-433 ["the issue is whether the 'transaction, as it stands at the time in question, sufficiently shifts the benefits and burdens of ownership'…"].

[41] We also note that, AWG's complaint filed against Buyer on December 28, 2007, states that AWG sold "substantially all" of AWG's assets to Buyer under the terms of the Asset Purchase Agreement.

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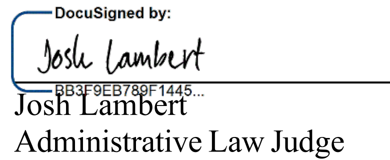
HOLDING

Appellants have not shown error in FTB's determination denying appellants' claimed deferral of gain from the1031 Exchanges.[42]

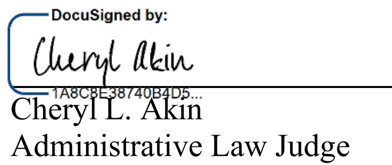
DISPOSITION

FTB's actions are sustained.

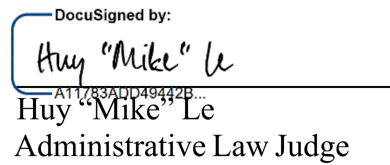


Josh Lambert
Administrative Law Judge

We concur:



Cheryl L. Akin
Administrative Law Judge



Huy "Mike" Le
Administrative Law Judge

Date Issued: 11/2/2021

[42] The second issue in this appeal is whether gain from the sale of the property should be attributed to AWG pursuant to an assignment of income theory. Because we find that appellants have not shown that the exchange requirement was met, there is no need to address the second issue.