OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Claim for Reimbursement of: **S. MITCHELL**	OTA Case No. 21017158

OPINION ON CLAIM FOR REIMBURSEMENT

Representing the Parties:

For Claimant:	Christina Weed, Attorney Diana Lopez, Attorney
For Franchise Tax Board:	Marguerite E. Mosnier, Attorney V Carolyn S. Kuduk, Tax Counsel III
Office of Tax Appeals:	Grant Thompson, Tax Counsel V

M. GEARY, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 21013, S. Mitchell (claimant) requests an order requiring respondent Franchise Tax Board (FTB) to reimburse claimant for fees and expenses incurred in connection with an underlying appeal, *Appeal of Mitchell*, 2020-OTA-000.5, which the Office of Tax Appeals (OTA) decided in claimant's favor.

OTA Administrative Law Judges Cheryl L. Akin, Michael F. Geary, and Sara A. Hosey held an oral hearing for this matter in Sacramento, California, on October 18, 2022. At the conclusion of the hearing, the parties submitted the matter for decision and OTA closed the record.

ISSUES

1. Is claimant entitled to reimbursement for fees and expenses incurred in connection with the underlying appeal?[1]
2. If claimant is entitled to reimbursement for fees and expenses related to the underlying appeal, what shall be the amount of that reimbursement?

FACTUAL FINDINGS

1. Claimant held a 10-percent interest in a general partnership (Con-Med), which owned improved real property (the property).
2. By 2005 it became apparent to the partners that Con-Med would probably have to sell the property and that Con-Med would need a plan to accommodate both partners who wanted to continue their investments in like-kind property and those who wanted to cash out their investments. To that end, the managing partner assured the other partners that the sale would be structured to allow those who wished to remain invested in like-kind property to complete an exchange under Internal Revenue Code (IRC) section 1031 (a 1031 exchange).[2]
3. A potential buyer (Buyer) made an offer to Con-Med to buy the property for $6 million. The offer indicates that the parties would cooperate if either party elected to do a 1031 exchange.
4. Within weeks of the offer, it was known that as many as three partners wanted to structure the transaction to allow them to complete a 1031 exchange (and thus remain invested in like-kind property), and that there was some concern that breaking up the partnership before close of escrow might allow one of the partners to prevent completion of the sale.
5. Con-Med made a counteroffer at $6.4 million.

[1] Claimant had argued that OTA has jurisdiction to consider her claim for reimbursement under R&TC section 19717 and Code of Civil Procedure (CCP) section 1028.5. Neither of those statutes applies to the facts described below. At the hearing, the parties agreed to the issues as stated here. (See also Cal. Code Regs., tit. 18, § 30701, et seq.)

[2] IRC section 1031 allows the nonrecognition of gain or loss on the exchange of property held for investment or for productive use in a trade or business (relinquished property) for like-kind property held for the same purpose (replacement property).

6. Buyer's subsequent counteroffer included a modification to allow either party an option to extend the escrow for up to 60 days to facilitate a 1031 exchange. Con-Med accepted this counteroffer.
7. On March 2, 2007, the managing partner informed the other partners that he accepted the last counteroffer, and explained there were several contingencies, including approval by the Con-Med partners by March 21, 2007. The email also stated that the August 31, 2007 escrow close date could be extended to facilitate a 1031 exchange, and that, if Con-Med's accountants approved, the managing partner would adopt a second amendment to the partnership agreement that would require dissolution of the partnership and distribution to the partners of undivided interests in the property before the close of escrow.
8. On November 17, 2007, the Con-Med partners authorized the managing partner to redeem claimant's partnership interest in exchange for a 10-percent interest in the property plus $2,000. In its acknowledgment of the Con-Med partnership agreement and amendment then in effect, the redemption agreement makes no reference to a second amendment to the partnership agreement, which would have required the dissolution of Con-Med prior to the close of escrow.
9. On or about November 20, 2007, the managing partner executed a grant deed to transfer an undivided 10-percent tenant-in-common interest in the property to claimant.
10. Pursuant to an "Exchange Agreement" and an "Assignment Agreement" dated November 26, 2007, and signed by claimant on November 28, 2007, First American Exchange Company (American Exchange) assumed the role of qualified intermediary to provide exchange services and facilitate claimant's 1031 exchange. On November 28, 2007, Buyer acknowledged receipt of a copy of the Assignment Agreement.
11. On November 28, 2007, Con-Med, claimant, and one other similarly minded former partner executed grant deeds to two entities: one was an entity of which Buyer was a general partner, and the other was an entity that had not been previously identified.
12. The grant deed to claimant was recorded on November 29, 2007.
13. The title company disbursed 10 percent of the net proceeds from the sale of the property to American Exchange for the benefit of claimant. American Exchange deposited the funds into claimant's exchange account.

14. The replacement property for the exchange was identified on January 1, 2008, and the purchase of that property was concluded by May 5, 2008.
15. Following an audit, FTB issued a Notice of Proposed Assessment (NPA) to claimant, dated March 22, 2012, disallowing the reported 1031 exchange. On May 18, 2012, claimant protested the NPA.
16. Following protest proceedings, FTB issued a Notice of Action, dated February 13, 2014, affirming the NPA. Claimant's timely appeal followed.
17. After the oral hearing, OTA ruled, in a split opinion, that the transactions qualified as a 1031 exchange. The dissenting opinion found that FTB correctly determined that Con-Med, not claimant, sold the relinquished property and that claimant therefore did not accomplish a 1031 exchange.
18. FTB's petition for rehearing was also denied in a split opinion.
19. This timely claim for reimbursement followed.

DISCUSSION

Issue 1: Is claimant entitled to reimbursement for fees and expenses incurred in connection with the underlying appeal?

Taxpayers are entitled to be reimbursed for reasonable fees and expenses related to an appeal before OTA if the taxpayer files a claim with OTA and if OTA determines, in its sole discretion, that the action taken by FTB staff was unreasonable. (R&TC, § 21013(a).) In its analysis, OTA must consider whether FTB has established that its position in the appeal was substantially justified. (R&TC, § 21013(b)(1).) The words "substantially justified" are not defined in R&TC section 21013, and the parties have not cited to any authority defining or construing the words as used in R&TC section 21013. However, the same words are used in R&TC section 19717, which addresses the right of a prevailing party to recover litigation expenses incurred in a civil court proceeding regarding the determination, collection, or refund of any tax, interest, or penalty under the Franchise and Income Tax Laws (R&TC, Division 2, Part 10.2). The courts have construed the words "substantially justified" (as they appear in R&TC section 19717) to mean that FTB's position has a reasonable basis in law and in fact (*Fujitsu IT Holdings, Inc. v. Franchise Tax Bd.* (2004) 120 Cal.App.4th 459, 487) or is one about

which reasonable minds could differ (*Lennane v. Franchise Tax Bd*. (1996) 51 Cal.App.4th 1180, 1188–1189).

The crux of claimant's position is that the validity of the disallowed 1031 exchange is obvious and that such validity was obvious from the beginning to FTB, which nevertheless vigorously and repeatedly took positions on that issue that were not substantially justified. Claimant argues that the uncontroverted evidence adduced at hearing clearly demonstrated that fact, and that she is therefore entitled to reimbursement for the substantial fees and other expenses incurred.[3] However, claimant does not limit the claim to fees and expenses incurred as a result of FTB's arguments against the validity of the 1031 exchange. Claimant also asserts that FTB staff took the following other actions that were unreasonable: delaying the appeal, changing its position on the issues, taking an unreasonably aggressive position given the relatively small amount at issue,[4] and violating claimant's taxpayers' rights by choosing to maintain its untenable position for a period of over ten years.

FTB contends that the law regarding the requirements for a valid exchange under IRC section 1031 is well established, that it correctly applied that law to the facts shown by the evidence, and that, on the basis of that analysis, it found that claimant did not complete a valid 1031 exchange. It argues that its disallowance of the claimed tax-deferred exchange had a reasonable basis in law and fact and that reasonable minds could, and did in fact, differ, as shown by the dissenting opinion. On these bases, FTB argues that its positions in the underlying appeal were at all times substantially justified.

Claimant's position in the underlying appeal was not as strong as described in claimant's arguments. Similar circumstances had previously led courts and OTA's predecessor[5] to disallow claimed 1031 exchanges by former owners of an entity (shareholders, partners, members, etc.) where the evidence showed that the entity (corporation, partnership, limited liability company, etc.) and not the claiming individual(s), actually sold the relinquished property and/or acquired the replacement property. (See, e.g., *Chase v. Commissioner* (1989) 92 T.C. 874; *In the matter*

[3] The claim is for $115,261.87 in reimbursable expenses, consisting of attorney's fees ($93,709.50), paralegal fees ($2,594.50), expert witness fees ($18,017.00), and other costs ($940.87).

[4] The amount in controversy does not always dictate the intensity of the advocacy. This is perhaps truer of a taxing agency than other litigants. OTA will not further address this argument.

[5] Prior to January 1, 2018, the adjudicatory functions now performed by OTA were performed by the State Board of Equalization.

of the Appeal of Brookfield Manor, Inc. et al. (89-SBE-002) 1989 WL 37900.) These and other authorities provided reasonable support for FTB's position in the underlying appeal. Furthermore, OTA has since published a precedential Opinion confirming that these authorities remain controlling. (*Appeal of Kwon, et al.*, 2021-OTA-296P.) FTB has a statutory duty to examine tax returns and determine the correct amount of tax. (R&TC, § 19032; *Dicon Fiberoptics, Inc. v. Franchise Tax Board* (2012) 53 Cal.4th 1227, 1234-1235.). FTB's challenges in the underlying appeal were reasonable steps to fulfill that responsibility.

The fact that two of the three administrative law judges who heard the underlying appeal concluded that the particular facts established by the evidence provided a basis upon which to distinguish the authorities favoring FTB does not establish that FTB's position lacked substantial justification. If there is a conclusion to be drawn from the fact that the Opinion in the underlying appeal was not unanimous, it would be that reasonable minds did differ. Accordingly, OTA finds that FTB did not maintain unreasonable positions in the underlying appeal regarding the validity of the 1031 exchange.

Regarding claimant's contention that FTB staff took other unreasonable actions (delays, changing positions, and violations of taxpayers' rights), although there is nothing in R&TC section 21013 that clearly limits reimbursement claims to the contested legal and factual issues the parties intend to submit for decision, claimant's contentions regarding these other alleged actions lack legal and evidentiary substance and are too general to warrant reimbursement. Claimant referred to these other actions in briefing, and she mentioned alleged delays in oral argument; but claimant did not specifically attribute fees or expenses to any of these alleged actions, and it at least appears that the allegations were more to provide context than to provide a basis for reimbursement. To the extent claimant intended to base the claim to reimbursement on these other actions, that claim is also rejected. If claimant contends that FTB's arguments in support of its disallowance of the claimed 1031 exchange were unreasonable and therefore resulted in unreasonable delay and violated claimant's taxpayers' rights, that argument's premise has already been rejected, above. Claimant has cited no authority for its argument that FTB was prohibited from refining or otherwise changing its arguments during the appeals process, and OTA is aware of no such authority. Finally, while the record shows that claimant's appeal has a long history dating back to at least March 2014, with multiple briefs filed by both parties over a period of years, claimant does not identify any specific delays or causes for delays attributable to

FTB. Section 21013(b)(1) indicates that FTB has the burden of proving that "its position in the appeal was substantially justified," but FTB cannot be required to defend itself against vague allegations regarding unjustified actions or failures to act. As the above findings are dispositive of the claim, OTA does not reach the second issue.

HOLDING

Claimant is not entitled to reimbursement for fees and expenses incurred in connection with the underlying appeal.

DISPOSITION

Claimant's claim for reimbursement of fees and expenses is denied.

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Michael F. Geary
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Michael F. Geary
Administrative Law Judge

We concur:

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Sara A. Hosey
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Sara A. Hosey
Administrative Law Judge

DocuSigned by:
Cheryl L. Akin
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Cheryl L. Akin
Administrative Law Judge

Dated: 1/17/2023