BEFORE THE STATE OF CALIFORNIA

OFFICE OF TAX APPEALS

COUNTY OF SACRAMENTO

IN THE MATTER OF THE APPEAL OF:		
SILVERADO LODGING CO., LLC, and C.V. PATEL, K.C. PATEL, J.V. PATEL and J.A. PATEL,	CASE NO.	21047599 21047600 21047601
APPELLANTS.		

TRANSCRIPT OF PROCEEDINGS

Sacramento, California

Tuesday, August 15, 2023

Reported by:

Maria Esquivel-Parkinson,
CSR No. 10621, RPR

Job No.:
43169 OTA(B)

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TRANSCRIPT OF PROCEEDINGS, taken at Office of Tax Appeals, 400 R Street, Sacramento, California, commencing at 1:40 p.m. and concluding at 3:54 p.m. on Tuesday, August 15, 2023, reported by Maria Esquivel-Parkinson, CSR No 10621, RPR, a Certified Shorthand Reporter in and for the State of California.

APPEARANCES

PANEL MEMBERS:

Veronica Long, Lead ALJ

Mike Le

Tommy Leung

FOR THE APPELLANT:

Edward Kaplan, Attorney at Law

J.V. Patel, Taxpayer

C.V. Patel, Taxpayer

FOR THE CDTFA:

OFFICE OF TAX APPEALS
400 R Street
Sacramento, California
By: Marguerite Mosnier, Tax Counsel
Carolyn Kuduk, Tax Counsel

I N D E X

EXHIBITS

(Appellants' Exhibits 1 through 31 were admitted at page 6)

(FTB's Exhibits A through S were admitted at page 7)

TUESDAY, AUGUST 15, 2023

SACRAMENTO, CALIFORNIA

1:40 P.M.

ALJ LONG: We are opening the record in the consolidated appeals of Silverado, C.V. Patel, K.C. Patel, J.V. and J.A. Patel, OTA Case Nos. 21047599, 21047600, and 21046001 [sic]. This matter is being held before the Office of Tax Appeals. Today's date is Tuesday, August 15th, 2023, and the time is approximately 1:40 p.m.

My name is Veronica Long. And I am the lead administrative law judge for this appeal. With me today are Administrative Law Judges Mike Le and Tommy Leung. As a reminder, the Office of Tax Appeals is not a court. It's an independent appeals body. The office is staffed by tax experts and is independent of the State's tax agencies.

With that, please let me have the parties introduce themselves for the record starting with Appellants.

MR. KAPLAN: Edward Kaplan representing the Appellants.

APPELLANT JAG PATEL: Jag Patel.

APPELLANT CHAN PATEL: Chan Patel.

ALJ LONG: All right. Thank you.

Franchise Tax Board?

MS. MOSNIER: Marguerite Mosnier.

MS. KUDUK: Carolyn Kuduk.

ALJ LONG: All right. Thank you. As confirmed at our prehearing conference and in my minutes and orders following that conference, the issue to be decided in this appeal is whether Appellants have demonstrated that they met the exchange requirements of Internal Revenue Code Section 1031 to properly execute a tax-deferred like-kind exchange.

Next, I'd like to move on to the evidence in this appeal. Appellants submitted Exhibits 1 through 31. These exhibits were submitted by Appellant prior to the prehearing conference, and FTB indicated they did not have any objection to these exhibits. As such, Appellants' Exhibits 1 through 31 are now admitted and entered into the record.

(Appellants' Exhibits 1 through 31 admitted.)

ALJ LONG: FTB submitted Exhibits A through J prior to the prehearing conference and Exhibits K through S after the prehearing conference. Appellant indicated they do not have any objection to Exhibits A through J.

Appellants, do you have any objection to FTB's

Exhibits K through S?

MR. KAPLAN: No, we do not.

ALJ LONG: All right. Hearing no objection, FTB's Exhibits A through S are now admitted and entered into the record.

(FTB's Exhibits A through S admitted.)

ALJ LONG: Now, I'd like to go over the order of the proceedings today. In my minutes and orders I indicated that Appellants will have five minutes to make an opening statement, and then Franchise Tax Board will have five minutes to make an opening statement.

And then Appellants may begin their case presentation in chief, including witness testimony. And that will be for 50 minutes. At the conclusion of your case presentation, the panel will have the opportunity to ask questions. And at the conclusion of any witness testimony, FTB will have opportunity to ask questions regarding factual testimony. And then FTB will have 55 minutes for their presentation, and Appellant has reserved five minutes for rebuttal. With that, I think we're ready to begin.

Do you have any questions, either party?

MS. MOSNIER: None for Franchise Tax Board.

MR. KAPLAN: No, your Honor.

ALJ LONG: All right. And then I believe

Mr. -- is it Jag Patel?

APPELLANT JAG PATEL: Yes. Yes.

ALJ LONG: -- and, Mr. Chan Patel. My understanding is that you both intend to testify today; is that still correct?

MR. KAPLAN: It may very well be possible that only Jag testifies. To the extent that Chan's testimony is helpful or -- you know, he's certainly available to testify. If anyone has questions, he's available to respond to that. But essentially his testimony will be identical to that of his brother.

ALJ LONG: All right. Well, the reason I ask is because for the witness testimony to be weighed as evidence, I will need to swear the witnesses in. So I'm going to go ahead and swear in both Misters Patel so that they can both offer witness testimony.

So I will start with Mr. Jag Patel if you're ready. I'm going to ask you to please raise your right hand.

Do you swear or affirm to tell the truth, the whole truth and nothing but the truth?

APPELLANT JAG PATEL: I do.

ALJ LONG: Thank you, Mr. Patel.

And then, Mr. Chan Patel, if you're ready, I'll swear you in.

Mr. Patel, please raise your right hand.

Do you swear or affirm to tell the truth, the whole truth and nothing but the truth?

APPELLANT CHAN PATEL: Yes.

ALJ LONG: All right. Thank you, Mr. Patel. Appellants, you have five minutes to make your opening statement and you may begin whenever you are ready.

MR. KAPLAN: Thank you, your Honor.

OPENING STATEMENT

By MR. KAPLAN, Counsel for Appellant:

For ease of reference and not to be disrespectful to either of their wives or their full names since both of these are Patel brothers, I think it will be easiest if I refer to them as "Jag" and "Chan." Their respective wives are parties to these appeals insofar as they filed joint income tax returns with their husbands and their investments are held jointly amongst them. So when I refer to the two brothers, I am including their respective spouses with that. I don't think it will be confusing to anyone, but I just wanted to make that clear at the outset.

What we have here today on these consolidated cases involve the tale of investments made by two brothers and their wives. The single issue is whether the sale of their interests and acquisition of

replacement properties qualify for tax deferral under Section 1031.

Respondent argues that the form of the transactions do fully comply with their requirements for qualified exchanges. It argues, however, as it invariably does in a swap-and-drop context, that the true seller of the property interests were not the brothers but the LLC in which they owned membership interests. The facts and the law clearly show that Respondent's position is without merit and that Appellants' appeal should be granted.

In a Section 1031 transaction, the substance must be consistent with its form. There is no dispute about that. That is the case here. It might be helpful to review very briefly the historical chronology of the brothers' investments in the properties so that it can be understood how the property moved from one form into another form into another form to its eventually sale -- to its eventual sale.

The brothers initially acquired the property -- it's a hotel property located in Calistoga, California, which we'll continue to refer to simply as "the property." They acquired the property as tenants in common in the late 1980s. They operated the hotel as tenancy in common through approximately the middle of

the year 2001 at which time they established an LLC by the name of Silverado Lodging, LLC.

When Silverado was established, the brothers transferred, contributed their TIC interests in the property to Silverado in exchange for membership interest in Silverado. Nothing about their investment changed in any way, shape or form other than the formal title in which their investments were held. They were 50/50 partners, 50/50 tenants in common ownership at the outset. They remained 50/50 percent owners in the LLC.

The LLC operated the hotel as such from approximately 2001 when it was acquired until 2014 at which time the brothers decided to sell their -- sell the property and go their separate investment ways. Their families had been growing. Their children were joining their own respective business operations, and the notion of joint ownership amongst multiple families with multiple generations appeared a little problematic, and so they decided that it would be best if their investments were held separately.

They engaged the services of an attorney to assist them in the documentation of the sale. They knew they were both familiar with the requirements of Section 1031. They understood that if they wanted to separate their interests and still be able to qualify

for tax deferral that they would need to own those interests separately, and, therefore, they understood that it would need to be transferred out of the name of Silverado into their own respective ownership forms in one fashion or another.

During the time that Silverado was operating, each of the brothers had formed their own family limited partnership: One, JagJudy, Limited Partnership; the other one, ACT Enterprises, Limited Partnership.

In the middle of 2014 the brothers transferred their membership interests in Silverado, which they had held as -- initially as tenants in common. They transferred their membership interests directly into their respective partnerships so that now Silverado was owned 50/50 by JagJudy Limited Partnership and ACT Enterprises, Limited Partnership. The process of marketing the property for sale, the negotiations for its sale, all aspects related to its sale were performed by the two brothers individually.

One of the difficulties, I think, that exists here and that the Respondent has had a little difficulty either comprehending or accepting is the fact that as both members of Silverado and as partners in the members that owned Silverado the brothers wear a number of different hats during the course of all of this. It is

not necessarily readily apparent when they speak whether they are speaking on behalf of Silverado, whether they are speaking on behalf of themselves as individuals, or whether they are speaking on behalf of their partnerships. What is clear and what my brief questions eliciting testimony from the brothers will focus on is the fact that from the outset the intent to sell the property was coupled with the intent to separate from their brothers and their investment and that all actions were taken consistent with that intent and goal. The properties that -- the property was marketed. A purchase and sale agreement was entered into. It was entered into by Silverado Lodging signed by -- I don't recall if it was one or both of the members, but that will be reflected in the exhibit.

But at that time it had to be named -- the purchase and sale agreement had to be in the name of Silverado as Silverado was still the record owner of the property. It was understood by the listing broker, it was understood by the buyer, it was understood by the title company, it was understood by the exchange company, that was engaged to handle the exchange that the ultimate sale was going to be by the two partnerships representing themselves so that they could go their separate ways and do their own exchanges.

ALJ LONG: Mr. Kaplan, I hate to interrupt you. We've only allocated five minutes for opening statements, and we're a little past the five-minute mark. Would you like to wrap up your opening statement and save the remainder for your opening presentation?

MR. KAPLAN: I will -- I will -- I do tend to go on, as my children will tell you. No, I'm ready to wrap that up. I think that is essentially the history. I think that focuses on the key -- the key issue. And the one thing I had not covered but which is overlaying all of this is the overriding public policy behind Section 1031, which is to mandate deferral of any gain if, in fact, you have not cashed out of your investment. All that has changed here is the form in which the brothers held their investment. Their investment itself economically never changed at all. All the entities involved are flow-through entities. The only parties that ever reflect actual tax liabilities or the consequence of the income, expense, gain, or loss are the two brothers and their respective wives, regardless of whether it came through directly or came through via a K-1. And with that I will stop.

ALJ LONG: All right. Thank you, Mr. Kaplan.

FTB, you have five minutes for your opening statement. Whenever you're ready.

OPENING STATEMENT

By MARGUERITE MOSNIER, Tax Counsel:

Thank you. Good afternoon. Marguerite Mosnier and Carolyn Kuduk for Franchise Tax Board.

FTB's proposed assessments result from its determinations: First, that Silverado rather than the limited partnerships JagJudy and ACT Enterprises were the true sellers of the Silverado property; and second, that no Section 1031 transaction was completed and the Appellants were required to recognize gain from the sale.

The evidence in the record shows that Silverado owned the real property, that it negotiated the sale, that the limited partnerships played no part in the sale negotiations, that the sale was completed shortly after its terms were set, that the sale was completed along long terms negotiated by Silverado, and that the limited partnerships bore no burdens nor enjoyed any benefits of property ownership.

Applying well-settled law discussing the substance-over-form doctrine, including two precedential Office of Tax Appeals opinions to these facts, it's clear that the limited partnerships were not for tax purposes, the sellers of the property, and that they did not meet Section 1031 requirements to qualify for gain

deferral. The proposed assessments are, therefore, correct and should be sustained. Thank you.

ALJ LONG: All right. Thank you, FTB.

Appellants, you may begin your case presentation whenever you're ready. You have 50 minutes.

MR. KAPLAN: Thank you, your Honor.

PRESENTATION

BY EDWARD KAPLAN, Counsel for Appellants:

MR. KAPLAN: I would like to call at this time Jag Patel as a witness, and I'll direct my questions to him.

EXAMINATION

BY EDWARD KAPLAN, Counsel for Appellants:

Q. As you just heard, it is the Appellants' view that the negotiations and various documents related to the sale of the property because it was done in the name of Silverado was done by Silverado on its behalf. Is this something that reflects in your mind what your role was in the negotiations?

A. No. I think ever since we acquired the property a little bit later on when my son got involved, we decided that we were going to separate, and so we always were looking at us being separated out. When I say us, my family. And eventually when we decided to

sell, we were just looking at our families' interest first in the sale of the property.

Q. Was any consideration ever given to the continuation of Silverado at the time the sale was being discussed and negotiated?

A. Absolutely not, no.

Q. Did, in fact, Silverado dissolve shortly after the purchase and sale agreement was entered into?

A. Yes.

Q. At the time of the actual closing of the transaction in January of 2015, was Silverado still in existence?

A. No.

Q. Had it -- had it formally dissolved with the State of California?

A. Yes.

Q. Effective December 31, 2014?

A. Yes. I believe it was October 14.

Q. Okay. And prior to the -- prior to the dissolution of Silverado, had it transferred ownership interest in the property from itself distributed out to its two members, which at that time were JagJudy and ACT Enterprises?

A. Yes.

Q. Is -- who would be the appropriate party, the

appropriate person to negotiate a transaction on behalf of Silverado while it was in existence?

A. It was -- it was me.

Q. And who would have been the appropriate person to negotiate a transaction on behalf of, in your case, JagJudy Limited Partnership?

A. It was me.

Q. So it's not -- the fact that you were the one negotiating the transaction at a time when you were both a member of Silverado via your membership interest held by JagJudy or whether you were representing JagJudy, it would not necessarily be possible to determine that from -- from above, I guess?

A. No.

Q. Okay. During the -- during the stages of ownership, initially you and your brother as tenants in common, as members of Silverado, and as owners via your partnership interests in JagJudy and ACT, did the economics of your investment change in any manner?

A. No, no.

Q. Was it a 50/50 ownership with your brother every step of the way?

A. Yes.

Q. Is the only thing that changed the form that your investment held and not the amounts or how the

hotel was operated or anything other than the name?

A. Yes. No, I mean its just stayed the, you know, the same.

Q. So -- okay. Is -- what was the purpose of liquidating Silverado following the entering of the purchase and sale agreement?

A. The purpose was for us to go separate way.

Q. It served as Silverado was intended to go out of business without assets, without activity. There was no reason for it to continue to exist?

A. No.

Q. When Silverado was operating the property, did it engage the services of a management company?

A. Yes.

Q. And who handled the day-to-day paperwork, the payment of expenses and distributions of money and whatnot? Was that you or your brother, or was that all done by the management company?

A. Management company.

Q. At what point in time was the management company informed of your intent to market and hopefully sell the property?

A. Well, when we engaged a realtor to market the property, then we had to tell the management company.

Q. Okay. So they were throughout the time that

the sale was being -- that the property was being marketed and the sale was being negotiated and documented, the management company was well-aware of the impending sale?

A. Yes.

Q. Okay. And that it was about to essentially be out of a job unless it could negotiate with a new buyer?

A. Yes.

Q. Okay. And, the -- again, to repeat myself or repeated a question, the day-to-day expenses and bank account for Silverado were handled by whom?

A. The management company.

Q. Okay. So if a -- if an electric bill or water bill or maintenance bill of some type, who would -- who would make payment on -- on -- for those expenses?

A. Management company.

Q. Okay. So the bills would go to them and they would write -- they would write a check?

A. Yes.

Q. And from an account that was in the management company's name or in Silverado's name?

A. I believe it was joint.

Q. Okay.

ALJ LE: Excuse me. When you're asking the witness questions, please try to face the microphone.

Because when you face away from the microphone, your voice cuts off.

MR. KAPLAN: I'm sorry, your Honor.

With -- who -- who negotiated -- once the sale was completed, you engaged your exchange company to handle the receipt of the sale proceeds from the property as well as the acquisition of your replacement property; is that correct?

A. Yes. We had an accomodator.

(Reporter interrupted)

MR. KAPLAN: Yeah, an exchange accomodator.

And they were obviously aware of who was selling the property and who was buying the replacement property?

A. Yes.

Q. Okay. And there were no issues related to identification of the replacement properties or monies distributed out by the accomodator during the time they held the sale proceeds?

A. No.

Q. Okay. That -- so that would be consistent with the fact that Respondent has no issue with the involved transactions other than the determination of who should be treated as the true seller of the property? Is that --

A. Yes.

Q. Okay. Now, when -- actually, this is in the documents.

I don't think I have any further questions at this point. I would ask whether Respondent thinks it would be helpful if I essentially asked the same questions of Chan Patel or whether that can be foregone. It does not matter to me. I would not be asking any additional questions, and I certainly don't expect any different answers so ...

ALJ LONG: All right. I don't think that would be necessary.

Franchise Tax Board?

MS. MOSNIER: I think ultimately it's up to the Appellant to determine whether and which witnesses to call. We would note, though, if the Appellants would like to make an offer of proof that if Chan Patel testified, his testimony would be -- his responses to those same questions would be the same, FTB would accept that offer of proof no problem.

MR. KAPLAN: I will -- I will make such in the hopes to bring this to a speedier conclusion.

MS. MOSNIER: And no objection by FTB.

MR. KAPLAN: Thank you.

ALJ LONG: All right. Thank you. In that case

I'm going to move on to the opportunity for Franchise Tax Board and my co-panelists to ask questions of Mr. Jag Patel.

Franchise Tax Board, do you have any questions for the witness?

MS. MOSNIER: Thank you. No.

ALJ LONG: All right. Judge Leung, do you have questions for Mr. Jag Patel?

ALJ LEUNG: Yes, I do. Thank you, Judge Long.

EXAMINATION

BY TOMMY LEUNG, Administrative Law Judge:

Q. Good afternoon, Mr. Patel. Thank you for --

A. Good afternoon.

Q. -- coming.

A. Thank you.

Q. I want to go back to the beginning when Mr. Kaplan talked about the early days when Silverado was formed and then you and your brother owned the hotel. Now, when you created Silverado, you and your brother created an LLC and you took a 50 percent interest and your brother took a 50 percent interest; is that correct?

A. Yes.

Q. You were the only two members of that LLC?

A. Correct, yeah.

Q. Okay. Now, when you formed your limited partnership and your brother formed his limited partnership, who was your other -- who were your other partners in your limited partnership?

A. The limited partnership, it was a family partnership.

Q. Okay. But besides yourself, who else was --

A. My wife. My wife.

Q. Okay. Who was the general partner? Who was the limited partner?

A. I think we both were general partners, I believe.

Q. Okay.

A. I don't know the exact -- but it -- a family partnership. That's -- I think we have a document there, I believe.

MR. KAPLAN: I don't have that in front of me, but I believe it's in the documents, your Honor.

ALJ LEUNG: Okay.

MR. KAPLAN: The certificate of limited partnership establishing that -- that entity is in the documents, in the exhibits.

ALJ LEUNG: Thank you.

APPELLANT CHAN PATEL: Plus, our wives were limited partners as well as general partners.

Q. (BY ALJ LEUNG): Okay. So --
A. And also -- also, myself and my wife were limited and general.
Q. Okay. So basically, for both of those partnerships, husband and wife, and at least for you, Mr. Chan Patel, you and your wife were both limited and general partners?
APPELLANT CHAN PATEL: Yes. Yes.
ALJ LEUNG: Okay.
APPELLANT CHAN PATEL: And I believe Jag's would be the same, yeah.
Q. (BY ALJ LEUNG): Okay. At -- at the time when you gentlemen each owned 50 percent of the hotel, was that hotel owned by just you two gentlemen or were other -- were there other owners?
A. Just two of us.
ALJ LE: I'm going to interject again. Please make sure you're talking directly into the microphone as you're speaking. Thank you.
APPELLANT JAG PATEL: There were just two of us.
Q. (BY ALJ LEUNG): What about your wives? Were they -- did they also have an ownership interest in the hotel?
A. Well, the -- in the Silverado you mean?

(Reporter interrupted)

APPELLANT JAG PATEL: In the partnership, both of us.

Q. (BY ALJ LEUNG): Yes. But when you and your brother owned the hotel directly --

A. Correct. Yes.

Q. -- did your wife have any interest in the hotel -- own any interest in the hotel?

A. Yes. You mean by managing it, you mean?

Q. No. Ownership.

MR. KAPLAN: I don't want to -- certainly, I do not want to step on Jag's toes or try to answer for him, but in the grant deed that transferred the property from the two brothers into Silverado both of their respective wives were also listed as grantees -- or grantors rather. So it is husband/wife and husband/wife to Silverado.

ALJ LEUNG: Okay. And I think that's all I have for Mr. Patel. Thank you, sir.

Judge Long.

ALJ LONG: All right. Thank you.

Judge Le, do you have any questions for Mr. Patel?

ALJ LE: This is Judge Le. No questions at this time. Thank you.

ALJ LONG: All right. And with that, we will move on to Franchise Tax Board. Actually, let me -- Mr. -- I'm sorry.

Appellant, does that conclude your case presentation? Or do you have --

MR. KAPLAN: It does.

ALJ LONG: It does?

MR. KAPLAN: No, I have nothing further to add.

ALJ LONG: All right. Okay. I just wanted to confirm. Thank you.

In that case, Franchise Tax Board, we're ready for your case presentation. You have 55 minutes and may begin whenever you are ready.

MS. MOSNIER: Thank you.

Mic check. Ms. Parkinson, can you hear me?

THE REPORTER: (Indicates with head)

MS. MOSNIER: Thanks.

PRESENTATION

BY MARGUERITE MOSNIER, Counsel for FTB:

Good afternoon. Marguerite Mosnier for Franchise Tax Board. Silverado owned real property in California that was improved with a hotel. In May of 2014, Silverado entered into a listing agreement to sell that property and subsequently entered into a purchase and sale agreement to sell the property. Those would be

Exhibits 11 and 14.

Ten days before escrow closed a deed conveying Silverado's interest in the property was conveyed by tenant in common, or TIC, interests to its members, the two limited partnerships we've been discussing. That deed was recorded. The sale closed. The limited partnerships purchased other real property and reported Section 1031 exchanges and deferred gain from the sale of the Silverado property.

Following an audit, FTB determined that Silverado and not the limited partnerships was the true seller of the property, disallowed the 1031 exchange because the exchange requirement was not met, and proposed additional assessments, which should be affirmed.

We'd start with a discussion of the burden of proof. FTB's determination is presumed correct and it must be upheld unless a taxpayer establishes error through credible, competent, and relevant evidence.

I'd like to go over the nuts and bolts of Section 1031 for just a moment. Internal Revenue Code Section 1031 to which FTB generally conforms is an exception to the requirement that income must be recognized in the area it is received.

Generally speaking, a taxpayer must meet three

requirements to qualify for relief or gain deferral under Section 1031, and they are known as -- commonly known as the exchange requirement, the holding requirement, and the like-kind requirement. Only the exchange requirement is at issue. It is the Appellants' burden to show that the same taxpayer sold the relinquished property, which is the Silverado property, and purchased the replacement property. And the question of who was the true seller of the relinquished property is a question of fact.

This all turns on a doctrine we know as the substance-over-form doctrine. That doctrine was first enunciated and established by the Supreme Court almost a hundred years ago in Gregory vs. Helvering. It instructs that "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 is disregarded for tax purposes."

And in the hallmark case of Court Holding, a 1945 Supreme Court opinion, the court there applied that doctrine to disregard the form of a property sale. In that case a closely held corporation negotiated the terms for the sale of the property, and then before the sale closed determined it would suffer adverse consequence if it, rather than its shareholders, sold

the property. So it liquidated, transferred the property to its shareholders, who then completed the sale on the same terms as the corporation had negotiated. The Supreme Court affirmed the IRS's characterization of the corporation that should -- as the true seller for tax purposes and noted that the incidence of taxation depends on the substance of the transaction.

A few years later the Supreme Court applied that doctrine again and reached the opposite result in the Cumberland decision. In that case another closely held entity had approached a rival with an offer to sell its stock. No deal was reached, and that closely held entity then sold some property, dissolved and transferred remaining assets to its own shareholders.

Those shareholders independently, after the entity was truly dissolved, negotiated their own deal with that same rival to sell assets. And a couple of things the court focused on there to distinguish its determination as different from its determination in Court Holding were that in the first instance the entity was looking to sell its stock, and when its shareholders were negotiating with the same prospective purchaser, it was negotiating to sell assets. So there was different property that was the potential subject of a sale.

And secondly, the Court noted that the entity had dissolved completely. It was no longer in existence, nor did it own any property at the time the sale closed.

The next case that is relevant in the substance-over-form doctrine analysis is the tax court's decision in Chase vs. Commissioner in 1989. And in that case, the Court, again, determined that a partnership, rather than its partner, was the true seller for tax purposes even though it was the partnership whose name was -- excuse me -- even though it was the partner who had a TIC deed that was recorded shortly before escrow closed and who had not borne any burden, nor enjoyed any benefits of property ownership, nor had disclosed to the purchaser between the time the sale was negotiated and escrow closed the partner, rather than the partnership, actually held title to the property. Our state tax appeal agencies, previously the Board of Equalization and now the Office of Tax Appeals, also have precedential opinions that address this issue.

The Board of Equalization's opinion in Appeal of Brookfield Manor addressed facts very similar to those of Court Holding and reached a similar conclusion.

In Brookfield Manor, a corporation negotiated the sale of property, opened escrow, and then dissolved

and transferred the property to its shareholders via a TIC deed and the shareholders were substituted as the sellers in escrow and they completed the sale per the terms that the corporation had negotiated. The Board of Equalization used Court Holding principles and held that the corporation was the true seller for tax purposes.

And then we have two opinions from the Office of Tax Appeals. In the first Appeal of Kwon, which was issued in 2021 --

MS. MOSNIER: Yes.

ALJ LE: Excuse me. To the extent that case names are difficult to spell, if you can just spell it out for the stenographer, I think that would be helpful. Thank you.

MS. MOSNIER: Thank you.

ALJ LE: Thank you.

MS. MOSNIER: I should have remembered.

Yes. Appeal of Kwon is K-w-o-n, a 2021 opinion. The Office of Tax Appeals applied substance-over-form doctrine to determine who the true purchaser of replacement property was. And the OTA considered, among other things, the identification of the person who negotiated the purchase of the replacement property. And the corollary when we're talking about who really sold the relinquished property

would be the identification of who negotiated the sale of relinquished property. And OTA also considered the timing between the close of escrow and the transfer of the replacement property to the entity it ultimately determined was the true purchaser for exchange requirement purposes, and the corollary in the context of true seller analysis would be to consider the timing between the recording of the TIC deed and the close of escrow. So that was Kwon.

And then just last year the OTA issued FAR Investments, et al. -- I'll call it FAR Investments. The facts in that appeal are very similar to the facts in this appeal. The OTA applied the substance-over-form doctrine, Court Holding, Cumberland, Chase, and Brookfield Manor and concluded that the entity rather than the TIC holders were the true seller of relinquished property for tax purposes. And, importantly, the OTA enumerated a nonexclusive list of factors to consider in a substance-over-form analysis. They set out five factors in that opinion, and I'm going to go through them and analyze them based on the facts in this appeal.

The first factor to consider is whether the entity, here Silverado, took an active role in the sale and negotiated the essence of the sale. All evidence in

the record establishes that only Silverado had an active role in the sale and negotiated not only the essence but the whole of the sale.

We see first looking at Exhibit 11, which is a May 19, 2014 listing agreement to sell the property, it was -- the sellers listed as Silverado, and it was signed by Jag Patel, Mr. Patel, as a member of Silverado.

Exhibit M is Silverado's September 9, 2024 [sic] counterproposal for the sale of the property, and that was correspondence signed by Silverado's counsel.

Exhibit 14 is the original purchase and sale agreement. The seller is listed as Silverado. The signatures are by Jag Patel and by Chan Patel. Both designated -- designated as "authorized member" of the seller, which is Silverado.

After that, we have the first amendment to the purchase and sale agreement. It is in the record both as Exhibit 19 and as Exhibit N. Exhibit N is a copy that has signatures on behalf of Silverado. And Silverado there is listed as the seller. All terms of the original contract are confirmed, and it is signed by Mr. J. Patel and Chan Patel as Silverado's authorized members.

Exhibit 20, which is the assignment of the first amended purchase agreement, was executed November 30, 2014. It purports to sign -- to assign all of Silverado's rights in the purchase and sale agreement to the limited partnerships as of November 30, 2014. And we note that it incorrectly recites -- incorrectly recites that the relinquished property had already been deeded to the limited partnerships.

Exhibit 21 is the second amendment to the purchase and sale agreement. It is noted as being effective as of December 2, 2014. And it's noteworthy that pursuant to paragraph 2(f), the assignment of Silverado's interests in the purchase and sale agreement to the limited partnerships was not effective until the TIC deed was recorded.

And we see in Exhibit 22, which is a copy of the recorded TIC deed, it was not recorded until December 30, 2014. We also see in Section -- I think it is Section 5 of the second amendment -- Silverado remains liable and obligated to perform all the seller's terms, conditions, and covenants under the purchase and sale agreement. And all provisions of the original purchase and sale agreement are confirmed again in the second amendment.

So all these documents with Silverado's name

all over them with signatures by Mr. J. Patel and Mr. C. Patel individually as authorized members, not as general partners of the respected limited partnerships that purported to be the owners -- excuse me -- the members of Silverado.

And I note in that context that FTB's response or comment in its reply brief as to the capacity in which both Misters Patel would have been signing documents on behalf of Silverado June 30, 2014 the putative date of the transfer of their individual memberships to their respective limited partnerships, is based simply on technical understanding that once there has been that transfer, the signatures must have been on behalf of the respective limited partnerships. But, in fact, that is not what these documents I just discussed tell us. They tell us that they were executed as managing members. And we know that they could say that they weren't signed as general partners of their respective limited partnerships. In fact, they did so in the assignment of the first amended purchase and sale agreement, which is different from the first amendment to the purchase and sale agreement. It is Exhibit 20. The agreement was executed November 30, 2014. It was between Silverado as the assignor and the respective limited partnerships as the assignees, and as the

assignor Silverado, LLC, is listed and below that ACT Enterprises Limited Partnership member, by C. Patel, general partner, and by JagJudy Limited Partnership member, by J. Patel, general partner. So we know that they knew how to do it, but that is not the way they signed any other document related to purchase, sale, assumption, and assignment of rights and liabilities related to this transaction that are in the record. And all of this, even though Appellants say at one point that Silverado dissolved effective December 31st, 2014 -- and I believe Mr. Jag Patel might have testified -- I think maybe I heard him say October 14th, but maybe he was talking about "'14" as in 2014, I'm not sure. In reality, the facts and the evidence in the record are not consistent with a 10/31/2014 dissolution date, but they are consistent with two other statements the Appellants have made during the appeal.

In the Appellants' reply brief at page 5, the Appellants state that at no time did the brothers, meaning Mr. J. Patel and Mr. C. Patel, intend that Silverado would continue after the sale. So the implication there was that Silverado, in fact, would continue until the sale was concluded.

In the -- in Appellants' brief that was filed

September 26, 2022, a brief responding to OTA's request for additional briefing on page 5., the Appellants acknowledge -- or state that the dissolution did not occur until Silverado filed its certificate of cancellation on December 31, 2014.

So to answer the question whether the entity Silverado took an active role in sale and negotiated its essence, all documents in the file support the finding that it did, that only Silverado did.

The second factor that the OTA considered in its substance-over-form analysis in the FAR Investments case was whether the purported sellers, here the limited partnerships conducted any sale negotiations on their own. The record shows no substantive negotiations by limited partnerships although the second amendment to the purchase and sale agreement has a couple non substantive changes regarding extending the closing date and providing -- putting the -- amending the conditions under which -- the Silverado's obligations and rights under the sale agreement would be assigned to the limited partnerships. So neither of those affected the actual terms of the sale. And that would have been the limited partnerships' only involvement with any -- with any sale negotiations, which, as we see, were nonexistent.

And so not only were there no substantive negotiations between the limited partnerships and the purchasers the second amendment to the purchase and sale agreement, first, it confirms the terms of the original purchase and sale agreement, Section 5, and it confirms that Silverado remains obligated to perform all the sellers' responsibilities under the purchase and sale agreement. These facts are similar to the facts in the Chase case where there was no evidence of negotiations solely by TIC holders.

The third factor the OTA considered in the FAR Investments case was the amount of time that elapsed between the entity's negotiations and the final exchange. The latest document regarding -- that could evidence any negotiations that is in the record is the second amendment to the purchase and sale agreement, which is Exhibit 21. The effective date is listed as December 2nd, 2014, but we note that it was signed by the purchaser with a December 7th, 2014, date. Regardless which date you use though, there's no evidence in the record of any action by the limited partnerships between that date and the close of escrow about a month later on January 9th, 2015 that would have altered any terms of sale.

The fourth factor the OTA considered was

whether the sale was conducted under substantially the same terms as negotiated by the entity, by Silverado here. And we see that there were two amendments to the purchase and sale agreement. There was the first amendment, which is both Exhibit 19 and Exhibit N, but the limited partnerships were not a party to that agreement. And it had minor revisions, extended a closing date, adding email as a form of correspondence for notices.

The second amendment, Exhibit 21, as we discussed, has -- and to which the limited partnerships are a party has only non substantive changes. So what we see here when we are looking for any evidence that the limited partnerships participated meaningfully in the negotiations and consummation of the sale is that, in effect, their role was simply to step into the shoes of Silverado and complete the sale that Silverado had negotiated.

The final enumerated factor from the FAR Investments case is whether the purported sellers, here the limited partnerships, enjoyed the benefits and bore the burdens of property ownership. The record is devoid of evidence that the limited partnerships either enjoyed the benefits and/or discharged any burden of property ownership. The TIC deed was not fully executed until

December 8, 2014. It was not recorded until December 30, 2014.

Exhibit O shows payment coupons dated November 2014 and December 2014 from the lienholder. Those are addressed to Silverado.

Exhibit P is a Silverado bank statement for the month of January 2015. That could be the account that the Appellants referred to on page 3 of their September 26, '22 brief mentioning that the management company had a signatory authority for. And I believe Mr. Patel testified that he thought it might be a joint account. There is no corroborating evidence in the record on that point. The only documentary evidence is a bank statement in the name of Silverado. That is Exhibit P. And this document FTB argues would contradict the testimony that there was no activity at all by Silverado after it dissolved, and certainly we would say none after the sale, although there are transactions in that bank statement that postdate the close of the sale.

So it's very odd to see that Silverado had an active bank account in January of 2015 when it theoretically dissolved either on October 31st, 2014 which is the effective date of the dissolution set out in Exhibit 15, Section 1, or on December 31st, 2014,

which was the date the certificate of the cancellation was filed with the Secretary of State.

This was an active account. During that month it reflected 10 credit entries, a couple deposits, more than a dozen withdrawals, and 82 checks negotiated. And we note that there were electronic debit payments to pay the utility PG&E. If you would look at Exhibit R, page 5, there is a PG&E bill for $570.66, and if you look at Exhibit R, page 9, another PG&E bill for $436.67. You can match payments of those amounts that were made by Silverado during January 2015 on their bank statement, Exhibit P, page 2.

There is no evidence that the limited partnerships notified the lienholder, the holder or the issuer of property insurance. There is no documentary evidence to corroborate Mr. Patel's testimony that from the time -- I believe he testified the listing agreement was entered into that the management company was aware of the -- the transfer to the limited partnerships.

We note the TIC agreement, the tenant in common agreement, between the two limited partnerships that is dated October 31st, 2014 is in the record as Exhibit 16 is illusory because the limited partnerships had no interest in that property until December 8th, 2014 at the earliest, and as a public record until

December 30th, 2014.

And that would be the same with respect to the agreement that is the assumption of Silverado's debts and liabilities by the limited partnership. It is Exhibit 17. Because while dated October 31st, it was not effective until the property was distributed to the limited partnerships, and we know that that didn't happen until December.

And we note, too, that there is no evidence in the record that the limited partnerships paid any costs associated with their ownership of the property even during the few days that they had public record title to it. And that was similar to -- those facts were similar to the facts in the FAR Investment case. And the Appellants, apparently, in that case had argued that, Well, they were paid in escrow because they were debits to the -- in that case certain individual partners as put here the limited partnerships. And although it's really a very blurry copy of the escrow statement that's in the record, you can make out -- and I can't make out the amounts, but you can make out that there were some debit entries that appeared to be debits for property maintenance, maintenance costs, maybe pro rata tax for example. And so to the extent that they paid them, that's perhaps a little different from a voluntary

and proactive assumption to discharge those burdens of ownership.

As the OTA stated and discussed in the FAR Investments opinion, they didn't know. There was no certainty that those -- that the -- in that case, the underlying -- the purported sellers would have borne those costs absent the completion of the sale. And FTB submits that it would be -- it would be the same thing here.

And Appellants' failure to establish that the limited partnerships enjoyed the benefits and bore the burdens of property ownership is consistent with their statements during the appeal. In their opening brief on page 11, they say that the limited partnerships waited until they were reasonably assured the sale would occur before liquidating Silverado and having their membership interests converted to TIC interests. And in their September 26, 2022, brief on page 4, they acknowledged they had no right to the burdens or benefits of property ownership until December 30th, 2014.

So in sum, there is no evidence they bore burdens or enjoyed the benefits of their ownership of the property. And that's the end of the discussion for the five enumerated factors that were enumerated in the FAR Investments opinion. As I said, the facts of this

case are very similar to those in FAR Investments, and the FTB couldn't think of any other factors that would be appropriate to consider in addition to the five that were enumerated.

The Appellants' argument, that its economic interests never changed, although their form of ownership did and that that's sufficient to establish that they met the exchange requirement and the reliance on the decisions in Magneson, M-a-g-n-e-s-o-n vs. Commissioner, and In Appeal of Rago, R-a-g-o, Development, a Board of Equalization opinion, and in the Ninth Circuit's decision of Bolker, B-o-l-k-e-r, vs. Commissioner for that position, those arguments are unpersuasive.

As the Office of Tax Appeals noted in Footnote 20 of the Kwon opinion, those decisions address the holding requirement. They are not relevant to the exchange requirement. And while the Appellants have testified to their intent to go their separate ways after they -- I believe they said they entered into the listing agreement, intent itself is not determinative in a true seller substance-over-form doctrine analysis. The OTA -- longstanding cases indicate that, and the OTA said so itself. In the FAR Investments case on page 13, intent is not determinative. Furthermore, we give less

consideration to intent in this case where the purchase agreement negotiated and executed by the parties fails to implement such stated intent. FTB would submit that that analysis is appropriate on the facts of this case as well. The documents negotiated and set out in the record do not evidence an intent that is consistent with the way the membership and the signatures on behalf of Silverado are set out.

Additionally, as we've stated, there's just simply no evidence of any direct negotiations by the limited partnership in the partnerships' capacities at all. And so we get back to, you know, a well-worn legal principle which is that taxpayers may organize their affairs, their business affairs however they want, and that comes with both the benefits of operating however they want and it also comes with the burdens of operating in a manner that is inconsistent with the way they have structured their affairs. And for that, we would direct OTA also to page 13 of its opinion in FAR Investments at -- where it noted that 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.

So considering all this evidence, Silverado was, in substance, the seller of the property and the Appellants have not met their burden to show that they were the true seller, and, therefore, they have not met the exchange requirement that the seller of the relinquished property must also be the purchaser of the replacement property. Consequently, OTA should sustain the proposed assessments. Thank you. I'll be happy to address any questions.

ALJ LONG: All right. Thank you, Franchise Tax Board. Just to confirm, does that conclude your case presentation?

MS. MOSNIER: Yes.

ALJ LONG: All right. Thank you. I'm going to turn to my co-panelists to see if they have any questions.

I'm going to begin with Judge Leung. Do you have any questions for Franchise Tax Board?

ALJ LEUNG: Thank you, Judge Long. I think I'm going to hold off until Mr. Kaplan gets a chance to rebut, so thank you.

ALJ LONG: All right. Thank you.

Judge Le, do you have any questions for Franchise Tax Board?

ALJ LE: No questions at this time. Thank you.

ALJ LONG: All right. Franchise Tax Board, I also do not have any questions at this time.

Appellants, at this time I am going to let you begin your rebuttal, but I want to mention that because you had leftover time during your case presentation, I'm going to add that to your rebuttal, so that will give you 40 minutes to make your rebuttal.

At this time I want to check to -- Ms. Parkinson, would you like to take a 15-minute break?

THE REPORTER: No, I'm good.

ALJ LONG: All right. Does anybody need a break or we can continue on? All right. I'm going to go ahead and let us begin.

Appellants, you can begin 40 minutes when your rebuttal -- for your rebuttal whenever you're ready.

MR. KAPLAN: Thank you, your Honor. Hopefully, it won't take 40 minutes.

REBUTTAL ARGUMENT

BY EDWARD KAPLAN, Counsel for Appellants:

My first comment is "Wow." I note that the Respondent's argument is based almost exclusively on the forms of certain documents and not on the substance of the transaction respondent has accepted that the form followed by Appellants properly qualifies for Section 1031. So I find it a bit odd that while they

followed the form correctly, there are significant issues with the forms being used.

We need to look at the substance of the transaction if the form is correct, it can only be the substance of the transaction that could cause these exchanges to fail. The substance of the transaction, to quote from Court Holding, the substance over form doctrine is designed, and I quote, "to permit the true nature of a transaction to be disguised by mere formalisms which exist solely to alter tax liabilities would seriously impair the effective administration of the tax policies of Congress."

At no point have I heard Respondent address the question of what is the policy behind Section 1031. Section 1031 is not something that can be accomplished accidentally. Transactions have to be structured. Steps have to be taken to ensure compliance with Section 1031. Certain general tax principles are set aside that would not otherwise allow for exchange treatment.

The existence of an exchange accomodator, as long as certain restrictions are placed upon the ability to use the funds held by the accomodator, they will not treat the accomodator as the agent of the seller. In no other context in tax law would that be allowed except

within the structure of Section 1031. Why is it allowed in Section 1031? Because use of an accomodator restricting the funds from going to the seller is completely consistent with the policy behind Section 1031. The legislative history of Section 1031, it's been in existence for over 100 years unchanged in its policy.

Certain aspects of Section 1031 have changed. Certain properties are now no longer eligible for this treatment. Certain restrictions have been imposed, which essentially came post Starker -- S-t-a-r-k-e-r is the case name -- to allow for deferred exchanges. But the one factor that has never altered, never changed in the purpose of Section 1031 taken from the legislative history, if a taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.

The policy is also reflected in the Treasury Regulations at Section 1.1002-1(c). It discusses Section 1031 and other statutory provisions that deviate

from the general rule of current taxation and make clear that the underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated.

The form in which the brothers' investment was held did change. The investment did not change. At no time was any other taxpayer charged with income, expense, gain or loss whether it came via direct investment or whether it came via a K-1 issued by the LLC or via two K-1s. The first to the LLC, one of which came to them directly in the first half of twenty -- 2014. A second K-1 from the LLC was issued to cover the second half of 2014, which was issued to the two family partnerships. All of those numbers, the K-1s, the fact that it's done via an LLC or in a partnership, in terms of looking at the investment, these are essentially accounting vehicles.

The tax and burden, economic burden, always falls upon the two brothers. It flows to them, only to them. Their investment in the property is not changed at all. This is what 1031 says, not just deferral is available, but deferral is mandated. A taxpayer is not even allowed to choose to report a portion of the gain on an exchange. If an exchange is accomplished, the entire amount of the gain must be deferred.

There could be situations where you have a loss from some other activity where it could be fully absorbed by a portion of the gain. You cannot use that in a 1031 transaction. The entire amount of the gain must be deferred. The substance of the transaction is not the form of the transaction. The substance in a 1031 transaction is on the economics.

What has happened here to defeat the policy of Congress. What has been done that defies Congress's policy of making sure that if your investment has not been taken off the table, if it continues unchanged, reinvested into like-kind property, where is that policy being denied? It's denied in Respondent's position. Respondent's position has turned substance over form completely on its head. It makes no sense.

The substance of the transaction is the economics. You'll see it in assignment of income cases. Has this taxpayer earned money and somehow engaged in various transactions that shift the burden of that income earning to another taxpayer? Makes perfect sense. Substance over form should apply there. You're looking to who should bear the burden of tax on a particular transaction.

If the party -- if the -- the brothers had never put the property into an LLC and had simply sold

the property, any gain -- let's put 1031 aside -- any gain from that sale would be reported on their individual tax returns. If the LLC -- once the property is in the LLC, if the LLC had sold the property again with no Section 1031 transaction involved, a gain would result from that sale. And who would pay the tax on the gain from that sale? The brothers, not the LLC. The LLC is the form from which the gain flows through to the brothers, but in substance, how can you say this is the LLC's gain? The LLC is not a taxpayer. It is an entity. It's an entity that has a tax filing requirement, but it itself does not have a tax liability. That tax liability flows through to its members via K-1s.

The exact same thing is true with the partnerships. If the property had been distributed out to the partnerships, they sold the property exactly as was done but no reinvestment was made, who would bear the burden of the tax consequence on that gain? It wouldn't be the partnerships, per se. They are not taxpayers in the sense of incurring the cost, the burden of the tax liability. They're the vehicle through which the gain flows to the brothers. There is no other taxpayer in substance in any aspect of this transaction.

The form of ownership that the brothers held

this property in changed. Magneson and Bolker. Respondent loves to think that these cases have no relevance because their specific issue was in the intent in holding property. I seriously differ with that view.

In the first place, I do not understand how it is possible to determine that the form changes and yet the owner in that new form is still treated as having the intent in holding that property that they have held momentarily, that they have held it, they are holding it, for the exact same intent that it was held in prior to that transfer. How is it possible to be treated as holding a property for investment and yet not holding it for the purpose of being able to sell it? It makes absolutely no sense. The context of changing the form of the investment, you can't change the intent in holding an asset but somehow or another when it's sold, Oh, you aren't treat -- you -- you held it with the right intent, but you weren't the seller of it. I do not understand that.

Bolker. Bolker is an interesting case. If you read the Ninth Circuit opinion, the straight issue addressed is the intent in holding. Similar to Magneson. The factual underpinnings of those cases were different, but the issue before the Ninth Circuit was strictly the intent in holding. If you go back and read

the tax court opinion in Bolker from which the appeal came, the issue of who was the true seller was addressed in the tax court. If you read the tax court's opinion, you will find that the tax court, consistent with the intent in holding carrying over, held that the true seller was the same. The Internal Revenue Service did not appeal that issue. It appealed solely the intent in holding issue. Why? I cannot guess. That's -- that's their professional judgment. To my mind, they think the issue was so obvious they're not even going to appeal it. They dropped it.

This is similar to going back to Court Holding. This is in the briefs, and I don't want to belabor and repeat myself too terribly much. But the Court Holding opinion lays out the substance-over-form doctrine and why it's appropriate, certainly more appropriate in cases where, like in Court Holding, and where, like in Brookfield Manor, you have corporations and shareholders. Who the appropriate seller is in that context is very important. You have two separate taxpayers. Corporation has its tax liability; individual shareholders have their tax liabilities. They do not dovetail. They do not flow one through to the other as they do with LLCs and partnerships.

Court Holding, if you go back to the beginning,

go back to the original tax court opinion, the tax court opinion looked at the various facts and made a factual determination that on the facts in that case the corporation was going to be treated as the true seller and not the shareholder as the taxpayer in that case was advocating. Taxpayer appeals to the Fifth Circuit. The Fifth Circuit looks at exactly the same facts, makes its own independent determination that, no, in its view, the taxpayer, the shareholder, should be treated as the true seller and not the corporation. It reverses the tax court's holding.

Government appeals to the Supreme Court. The Supreme Court takes a look at the issue, does not make a determination on its own as to who the true seller is. Rather, it simply says, when you read the opinion and understand what it's talking about, it says the tax court is the trier of fact. They determined as a fact that the corporation should be the seller. The Fifth Circuit is not the trier of fact and has no business making its own independent determination. All it can -- is charged with -- all it has the authority to do is to determine whether or not there is sufficient facts to support the tax court's determination or whether it is so wholly without factual support that it demands reversal.

Supreme Court points out the facts that the tax court pointed out, not because it felt those were necessarily determinative but certainly with the -- with the view that they do support, they do offer sufficient support for the tax court's decision, and, therefore, there is no basis for the Fifth Circuit reversal. It acted well beyond its authority to make its own factual determination, and it goes back and reinstates the tax court opinion. It discusses the substance-over-form doctrine. Very important doctrine. Again, very important in a case as you have with Court Holding corporations and shareholders.

The facts it points out aren't necessarily determinative of how the Supreme Court would have held as to whether it was the corporation or the shareholder. It simply is an unknown. I don't think it makes any difference. The fact of the matter is Court Holding lays out the substance-over-form doctrine, which says you need to look at what is the intent of Congress. What is the policy behind congressional statutes and is what the taxpayer attempting to do a mechanism to circumvent those policies to achieve a result that is different and contrary to what Congress wants to have happen?

Congress with Section 1031 wants to defer gain

when your investment is not cashed out. When your investment continues undiminished in like-kind property, it wants you to defer gain. The brothers have made an investment. They continued that investment irrespective of the form in which the investment was held. They never cashed it out. There were no other investors that came in or out. It is the two of them with their respective wives throughout the entire process. It's the form of their investment that changed, not the substance.

There are issues that -- that Respondent made. You know, in particular I tried to jot down a few notes. There are too many to go over here, but one in particular, the second amendment to the -- to the purchase and sale agreement, Exhibit 21. Respondent points out that it specifically states the assignment is not effective until the grant deed is filed from Silverado to the -- to the family partnerships. Of course, it's not effective until then. How can it be effective before the partnerships actually are the formal owners of the property? Similar to how can anyone sign the purchase and sale agreement prior to the time they are record owners?

Silverado owned the property at the time the transaction was negotiated, at the time the sale was

worked out. It was worked out by the brothers on their own behalf using the names of Silverado because technically that was who held the property. You couldn't have a purchase and sale agreement under any other name. If Respondent is arguing that it is essential that the taxpayers distribute the property out before any negotiations are undertaken, that is an incredible burden put on normal commerce that is simply not required by Section 1031.

What happens if the sale isn't consummated? Not every contract where there's a purchase and sale agreement that's entered into is completed. Some of them fall apart. Respondent seems to require bank accounts need to be changed, leases need to be amended, lender approval needs to be acquired. Try to get lender approval of any -- of a change in ownership in less than six months' time. It's simply not possible. All of these things must be done. Change the bank account name, change -- get new checks, tell PG&E, you know, the account name needs to be changed. Do all of these things and you find out three months later sale didn't close. Now what do you do? You need to reverse everything. You want the limited liability protection of being in an LLC, you transfer everything back. You reamend things. You go back for lender approval again

saying, "Forget what we wanted you to do the first time. We want you to go back to the original loan." That's insanity, and it's not what Section 1031 requires.

Section 1031 has specific requirements. Look to the substance of it. Where is the investment? If a -- if a bill comes in addressed to Silverado in January of 2015, two weeks after it has formally dissolved with the State of California, does that mean Silverado shouldn't pay the bill or that the bill itself shouldn't be paid? The bill has to be paid. Maybe it's on a Silverado check. It's addressed to an account in Silverado's name. But in substance who's paying that bill? The brothers are paying it. The check is being written by the management company. I don't care who's writing the check. Who's paying the bill? The brothers are paying the bill. I don't care what name it comes in. That's not relevant to the substance of the transaction.

If you fail to notify a lender that you have transferred ownership of the property, perhaps you are in breach of that loan. I don't know. I don't think we have a copy of the loan in the record. But let's assume for purposes of argument that you have breached a loan covenant. Okay. So you're in breach of a contract. Lender has a right to sue. Let them. They're fully

paid before they even know there's an issue. As long as they're paid, they don't care. They don't care whether the check is written on a Silverado account or whether I write it on my own personal account. They want to be paid. As long as they're paid, they're happy.

Management company, they're about to lose their engagement. Their owner who has engaged them to operate the hotel is about to disappear. There's going to be a new owner. Sooner or later they're going to have to be told. Even if they're not told, so what? That's their problem. Maybe they find themselves going to work on a Monday going, "Wait a second. Who's paying us? We have a new" -- "there's no one there to pay us." That's a contractual issue. Doesn't change the substance of who made the investment. Doesn't change the question of whether or not there might have been a breach in the management agreement, which I don't believe there was in both in reality or in possibility. It's not relevant to the substance of the transaction when the substance looks to the question of who is the party that has made the investment that who bears the burden and reaps the rewards of every dollar in or out of that investment. That never changed.

That's what 1031 is about. That's what -- if you read Magneson and Bolker and Maloney and all of the

other cases, that's what they are about. The focus is on "Did the investment change?" If only the form changed, okay, it doesn't change your intent in holding it. Does that mean it changed everything else? I don't see how. That's kind of a leap of faith. The Ninth Circuit didn't say anything to the contrary. The Ninth Circuit answered the question that it was faced with. But if you ask yourself how is it possible for the Ninth Circuit's opinion in both Magneson and Bolker, how do you come up with that opinion and that view and its analysis that nothing changes if the form itself is the only thing that changes? How is that not relevant, even relevant to the issue of substance over form?

Respondent insists on burying its head in the sand. To put a little age on myself, it reminds me of Sergeant Schultz in Hogan's Heroes covering your ears, "I see nothing. I hear nothing." It's ludicrous. It's absolutely ludicrous. There is a reason that those cases have been out there for 40 years undiminished, unchallenged, unchanged. They are the law of the land.

We're within the Ninth Circuit. California does not have its own rules and laws for Section 1031. It's statutorily bound to follow federal law. It likes to make its own law. I'm a believer in negative inferences. Why has the IRS not brought any of the

cases that the FTB pursues? In my mind, they don't think there's an issue with it. I've been to innumerable conferences where they say, "We don't have a problem with it. If the FTB wants to go off on its own, it's free to do so." My personal view, the FTB should be talking to the State Legislature. It's not required to follow federal law. It can always choose to do something different.

The State Legislature, for whatever reason, I make no -- I have no clue as to the hows or whys. It has never even attempted to deviate from the federal rules of 1031. It's got the Franchise Tax Board constantly banging its head against the wall. Legislature seems unconcerned. They could solve the problem if they thought it was a problem. My sense is they don't.

Federal government certainly doesn't seem to have a problem with it. And I think it comes back to: What is the purpose and policy of 1031? If you got a change in the owners, you might have a different issue. If you've taken certain monies off the table, you might have a certain issue. If you've exchanged into property that is not completely like-kind, you might have an issue. Those aren't our facts. That's not this case. We haven't changed anything with our investment other

than the form in which it's held. And to say that that is in contradiction to what Congress intends, that that is somehow impairing the effective administration of congressional tax policies is completely backwards. It is completely backwards.

Talked about -- Respondent talked about certain case law. They, you know, the -- the responses to -- to response's view of case analysis has been covered at length in the briefs that have been submitted. I don't have a great deal more to say about that, but it -- it, you know, I will say one thing that I'm pretty certain was addressed in the briefs, but I'm not a hundred percent certain so I don't want to let this opportunity pass.

Respondent is correct that the intent to do a qualified 1031 exchange is not determinative of whether you have done one or not. Obviously not. People intend to do lots of things lots of times and they fail for one reason or another. But the intent to do a 1031 exchange is not irrelevant. It is -- it helps in this particular case as a perfect example. It shows on whose behalf the negotiations were done. The brothers intended to do a 1031 exchange. That intent in and of itself doesn't mean they did one. But when Respondent says there's no evidence that anyone other than Silverado negotiated the

deal, that is entirely inconsistent with what the evidence has been, what the testimony was.

If you have the intent to do an exchange and you understand both based on your personal knowledge and awareness of 1031 as well as having the benefit of a legal adviser helping you with the documentation throughout the process and an exchange accomodator involved throughout the process and a broker who understands Section 1031 and a title company that understands Section 1031, how is their intent not evidence of who was -- who was doing this deal? It's done in the name of Silverado because Silverado is the technical owner at that time. It is not done on behalf of Silverado. In substance, Silverado is not negotiating the deal.

I alluded to it earlier. The brothers wear multiple hats. You need to look at which hat they were wearing. In my personal view, I'm not sure it makes any difference because I think the only hat that's important is who made the investment and what happened to the investment. Wear any hat. Wear them both. Wear them all at the same time. I don't think that matters. But if you do think it matters, think about what hat they were wearing at every step of the way. At no time were they wearing Silverado's hat in the sense of doing this

transaction on Silverado's behalf.

Silverado was liquidated. Clearly it was never intended or expected to exist beyond their ownership of the property. Once it was clear that the property would, in fact, be sold, it no longer served a purpose. They liquidated it, they filed the appropriate papers with the State of California, they transferred, they assigned. They did all the things that a company -- a dissolution of an entity. Everything is consistent with that.

Again, going back to there's no evidence of who bore, you know, the benefits and burdens of ownership. Again, to repeat myself, the benefits and burdens of ownership were always 100 percent held by these two gentlemen sitting next to me and their respective wives. The benefits and burdens -- if you own it via an LLC, you may have some liability protection for your investment, but your benefits and burdens of ownership of the property, it's only your wallet that's affected, nobody else's. There is no LLC wallet. It all flows through.

I -- in my mind, I don't understand the complexity of the issue. I honestly don't. I think it's straightforward. I think it's very simple. When you have a situation as we have here -- no other parties

going in and out, no monies going in and out, all that's going -- property is being held this way, it goes into this entity, it goes into that entity, it's exchanged -- you're in the world of Section 1031. You defer your tax. And, again, it's deferral. It's not avoidance. You carry over your tax basis. This isn't a freebie in the sense of, "Oh, look," you know, "we never have" -- "we've done a tax-free deal." When you put the property into the LLC, you've changed the ownership. There's no tax owed on that contribution into the LLC. When you distribute the property out to the partnerships, there's no tax owed on that distribution, the liquidation of the LLC. It requires a -- a -- you know, the property itself to be disposed of. It's -- I -- I do not -- the benefit of deferral clearly screams loud and clear in the tax world that's what you want to do. You want to defer your tax obligation as long as possible. If the Code allows you a way to do it, you take advantage of it. That's what was done here.

Again, it's not tax avoidance. They do not -- the replacement properties that they each acquired, they do not get to depreciate those properties based on their purchase price. No. They get a carryover basis from the property they had held for twenty-plus years already. I've had clients who looked at numbers and go,

"You know, I don't want to do an exchange. I've depreciated my prior property down to zero already. I'd rather pay the tax and get my accelerated depreciation on my new property."

There is a cost to the deferral, and the cost is you're foregoing that increased depreciation deduction. It's a matter of economics. It's the way you want to handle your investments. It's as Respondent, you know, said, taxpayers are free to run their economic lives the way they see fit, and they bear the consequences of doing so. Everybody does their own analysis. But what we have here is, in my mind, simple and straightforward. And no investment was ever altered from these taxpayers. They sold one investment. They exchanged it entirely into new like-kind property. Respondent accepts that the form that was followed, in spite of all the problems with the various forms that they mentioned, the form was followed. That's what 1031 requires. That's what was done. And with that, I will put down my bully pulpit.

ALJ LONG: All right. Thank you, Appellants.

At this point I'm going to circle back to my co-panelists see if they have any questions.

Judge Leung, do you have any questions for either party?

ALJ LEUNG: Yes. Thank you, Judge Long.

EXAMINATION

BY TOMMY LEUNG, Administrative Law Judge:

Q. Mr. Kaplan, Franchise Tax Board seems to argue as part of its case that the OTA's decision in FAR Investments and the five factors should guide us in -- for the outcome of this appeal. Do you agree? Disagree? Tell me why, why not.

A. I am a very strong believer that the decision is incorrect both on factual basis as well as a legal basis. If you review the facts of the case and look at the exhibits, they do not support the opinion. The opinion discusses substance over form and yet, as is happening in this case, it exalts form over substance. In that case, the facts are there was a seller. There was a winery. There was real property affiliated with the winery as well as inventory and operating assets of the winery. The controlling owner of the winery, when they were approached from the outside by a prospective buyer, the -- the primary, the owner, insisted, I'm happy to sell, but only if we can do a Section 1031 transaction with respect to the real property. Don't really care about anything else, but I am not selling if I have to pay tax on the sale of the property.

The negotiations other than that, that was

accepted. The buyers understood it. The other TIC members understood it or LLC members understood it, and all were in agreement. The assets, the operating assets were different. They were not eligible for 1031 exchange treatment. And so no one was particularly focused on how that would -- would transpire. The only issue with respect to that was: How are you going to value it and is there going to be a mechanism for what happens if the buyer acquires your inventory and a month later they realize that a hundred thousand gallons of wine that is in barrels has gone bad and there needs to be a purchase price adjustment?

The parties entered into a seller substitution agreement prior to the time the purchase and sale agreement was entered into, a seller substitution agreement with respect to the property. Not with respect to the wine -- the inventory and operating assets, but the property was clearly carved out and was going to be handled in a separate transaction. The purchase and sale agreement is signed four days later. The purchase and sale agreement was not a good document. It was not particularly well-crafted. It did not carve out the real property. It said this is the only -- you know, this is the be-all and end-all of agreements, and we are selling the real property and the inventory and,

seemingly, in contradiction to what had been signed four days before from the parties.

Interestingly, if you go back and you look at the exhibit, there is no purchase price contained in that purchase and sale agreement that ultimately was exalted above everything else to form the rationale for the opinion. There was no purchase price in that document. It does say property and inventory, you know, is all being sold as one by the entity, but, again, inconsistent with what was signed by all the parties four days prior.

More importantly, completely inconsistent with the escrow instructions that were signed by all of the parties less than a week later, which clearly spelled out how much was being paid for the property, how that was being transferred and sold directly by the individual TIC members and not by the entity, and the remainder being covered by -- you know, the remainder being covered separately in the escrow agreement.

The only way I can -- and also I want to add there is nothing in the opinion that discusses the policy of 1031. It said that -- that the only evidence that the primary owner was involved in in the negotiations was with respect to insisting that, you know, it encompass a 1031 transaction, but he was not

involved in any of the other negotiations. I can't begin to tell you how absurd that is. He dictated everything. He did not care how you determined what the -- the purchase price adjustment formula might be if there were a problem with the winery, but clearly nothing was done at any stage by anybody other than with his approval.

There is absolutely no evidence that anybody else was involved in negotiations. The only thing that was ever specifically addressed in the testimony was his insistence with respect to the real property transfer. There was total silence with respect to every other aspect and, yet, the opinion notes that there's no evidence that he participated in anything other than. Well, there's no evidence that anybody else participated in it.

And then the opinion contains something that will eat at me until I die, which is it pointed to the number of versions of the purchase and sale agreement as evidence of how deeply and significantly this agreement was negotiated. And yet it still contains something that was not what the parties had actually agreed to. And so, therefore, because it was negotiated with 17 different versions of this document, that must be the document that is the be-all and end-all irrespective of

the fact that it's inconsistent to what was signed three days before and inconsistent with what was signed four days later.

I don't know how often you create documents yourself. The ones I am typing -- and I can't -- honest, I was not involved in those negotiations. I had nothing to do with that particular purchase and sale agreement. But I know that when I am typing up a document, I take a look at it and I start to make my edits, and if the only thing I change is I'm going to add a comma or I'm going to capitalize one word or I'm going to put a parenthetical, a defined term in, the minute I make that change, I click new version.

There is nothing of substance that changed in the document because there's a new version. It doesn't necessarily -- it could, but it certainly doesn't necessarily reflect this is a document going back and forth multiple times and people are, you know, agonizing over, you know, this provision or that provision. If you look at the document, it's clear nobody agonized over anything. It doesn't have a purchase price. It doesn't have any instructions as to how the property itself was going to be sold. It's -- it's not an opinion I'm favorable of, as you can well imagine.

And then in terms of -- in terms of the legal

errors, again, you know, I take great issue with the fact that it never asked the question: How is the substance changed by whichever one of these documents you choose to follow? The parties that had their investments, the ones who want -- and there was one party that was not interested in doing an exchange. They took their -- their share of the proceeds, paid tax on it, and moved on. Everybody else did an exchange. But there was no -- no analysis or even inquiry into the policy of 1031 and how is that policy violated by what has transpired here.

The only way I can begin to understand that opinion is by concluding that the problem was not in the substance, it was in the form. The document that said it was the be-all and end-all did not comport with the -- with what the parties were trying to do. They did not dot their i's correctly. They did not cross their t's correctly, and as a consequence, it's not that it was the substance that negated the form, it was the form simply didn't meet the requirements. I personally don't believe it, but it's the only way I can understand that opinion.

The Chase opinion, which was referred to here, also involves a situation unlike Court Holding and Brookfield Manor, not two separate -- not a Corporation

shareholder. Chase was strictly partnership partners. Chase is a fraud case. It has nothing to do with 1031. It has nothing to do with form over substance. It's a case where the deal had been done, fully negotiated. No one ever thought of doing anything other than having the partnership sell the property. Everybody was going to go their separate ways, pay tax. The general partner, the lightbulb goes off at the last minute after all the documents have been signed, they're in escrow, he changes the purchase and sale agreement unilaterally. The buyer doesn't know this. The other partners don't know this. It violates the very partnership agreement that he's the general partner of to allow him to carve his portion out as a TIC interest so that he can go off and do an exchange. Hadn't been thought about by anybody else, hadn't been discussed with anybody. He violates his own partnership agreement. He unilaterally changes a document. And the Court correctly determines: We're not going to allow that. You can't play games. You can structure things. You could have done it the right way had the lightbulb gone off sooner. But it didn't. But you can't come in, you know, under, you know, the cloak of darkness, move things around and say, "Oh, look. Here's what really happened," because it's not what really happened. Again, it's not a form --

it's not a substance over form case. To my mind, it's a fraud case. The Court was not going to allow this fraudulent action to be recognized. Wholly agree with the outcome.

The Kwon case also, you know, another case out of the OTA also to my reading is not a substance over form case. It's a failure of form case. In Kwon you had -- you clearly had a different party making the acquisition of the replacement property. It had paid -- they set up an entirely new entity with different owners and that new entity is the entity that made the down payment on the replacement property. And suddenly someone went, "Holy smokes. I think we screwed things up. We need to go back to square one and we need to correct this."

And the way they went about it, they went to the buyer and they said, "We'll give you a $100,000 to change the purchase and sale agreement," which was done. They paid the buyer a hundred thousand dollars to change the agreement. Unfortunately, it cost them an extra hundred thousand because the OTA didn't allow the exchange that they were trying to do. But, again, it was -- it was a failure of the form. You had an action by a third -- by another entity that was not the same, that was entirely inconsistent with an exchange. Why is

this entity putting money into their exchange? You can't do that. It's not an exchange. It's the form that failed. It's not the substance was off. I mean, the substance also was off, but it's because the form was off. Not our case. Our form fits our substance.

ALJ LEUNG: Okay.

MR. KAPLAN: Very long-winded answer. I'm sorry.

ALJ LEUNG: Thank you. Appreciate that.

Judge Long, I am done.

ALJ LONG: All right. Thank you, Judge Leung.

Judge Le, do you have questions for either party?

ALJ LE: Yes, I do.

EXAMINATION

BY MIKE LE, Administrative Law Judge:

Q. Question for Respondent here. Can you address Appellants' arguments that they -- I believe they're arguing that they satisfied the policy intent behind 1031 because they continued their investment.

A. Thank you. Congress as a policy wants to entitle taxpayers under particular circumstances to delay recognition of gain when property is sold. That's set out in 1031. That doesn't mean, though, that 1031 is an open-ended invitation for a taxpayer to sell

property and defer gain. There are specific requirements in Section 1031, and if they are not met, then ultimately the policy has not been realized or fulfilled.

For example, I believe Appellants did note that if you're going to exchange property for non like-kind property that that would frustrate the policy behind Section 1031. To the same extent -- because we know that one of the three general requirements of 1031 is the, quote, like-kind requirement. To the same extent, if a taxpayer held and sold property that it had not held for use in business or for investment, I think Appellants would agree that disallowing a claimed 1031 transaction on those facts would not frustrate the policy of Section 1031 because there is a holding requirement that has to be met. Well, there's one other requirement that has to be met and that is the exchange requirement.

And so if a taxpayer cannot establish that the taxpayer both sold the relinquished property and purchased the replacement property, which we know is a factual issue, then that taxpayer has not satisfied that specific statutory requirement and disallowing a Section 1031 transaction or a claimed transaction on those facts, likewise, would not frustrate the

congressional policy to allow gain deferral in certain fact patterns.

I think that the -- I don't think there is necessarily a quarrel between FTB and Appellants with respect to what a policy behind Section 1031 is. I think what we have is simply a dispute as to whether the facts establish that the requirements, the specific statutory requirements of Section 1031 have been met. Have I addressed your question?

Q. Yes. Thank you. Additional question. The Appellants argue that a FAR Investment and Kwon it's -- it deals with form. There's a form issue in those cases. Can you address that argument? So I believe Appellants are arguing that FAR Investment should not apply to this particular case because this particular case does not have a form issue.

A. FTB's reading of FAR Investments is that the OTA concluded that in substance the sales transaction was made by the entity rather than by the TIC holders. In this case, FTB is arguing that as a factual matter the substance of the transaction, the evidence in the record indicates that the substance of the transaction is that the entity -- Silverado and not the TIC holders, the limited partnerships -- sold the property.

So ultimately it is -- it is: What is the

substance of the transaction analysis? That is the substance-over-form doctrine. And the only way to determine what the real substance of the transaction, is, is to drill down into the -- onto the facts. And we have a precedential opinion here that tells us if we're trying to figure out who the true seller is -- and the parties here agree that the issue in this appeal is whether the Appellants have established that from their perspective it is the limited partnerships and not Silverado that is the true seller.

So ultimately, if we went by -- if we went by forms only, I think there would not -- there couldn't be a true seller or a true purchaser analysis because the substance-over-form doctrine is precisely a tax exception to following the very form in question. The grand deed that conveyed title to the property to this third party purchaser was signed, executed and signed by the limited partnerships. So the problem here is not with the form. The problem here is that the substance of the sale. The facts, the evidence in the record, indicates that the substance of the sale was that it was not made by the entities whose names appear on that grant deed. So to that extent, I think the issue here has simply been mischaracterized or misunderstood by Appellants. The problem here is not failure of forms.

The problem here is that the facts establish that the substance is different from what was reported on the forms.

ALJ LE: Thank you.

No further questions.

ALJ LONG: All right. I also have no further questions for either party. With that, I would like to just check with both parties.

Is there anything else either party would like to add before I end the hearing, any questions or concerns?

I'll begin with Franchise Tax Board.

MS. MOSNIER: Thank you for asking. No.

ALJ LONG: All right.

Appellants?

MR. KAPLAN: I just had one quick gratuitous comment --

ALJ LONG: All right. Go ahead.

MR. KAPLAN: -- to follow along after Respondent's response to Judge Le, and that is it's -- it's a very strange thing to me to say the problem isn't the form, it's the substance, but then you determine what the substance is by looking at the form. I don't understand it. If this panel can shed some light on that, it might make things easier form me. And with

that, I'm done.

ALJ LONG: All right. Thank you, Mr. Kaplan. With that, I think we're ready to conclude the hearing. I want to thank the parties for their presentations today. The panel of administrative law judges will meet and decide the case based on argument, testimony, and evidence in the record. We will issue our written decision no later than 100 days from today. The case is submitted and the record is now closed. This concludes our hearing calendar for today. Thank you, everyone.

(Conclusion of the proceedings at 3:54 p.m.)

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REPORTER'S CERTIFICATE

STATE OF CALIFORNIA)

COUNTY OF SACRAMENTO) ss.

I, MARIA ESQUIVEL-PARKINSON, do hereby certify that I am a Certified Shorthand Reporter, and that at the times and places shown I recorded verbatim in shorthand writing all the proceedings in the following described action completely and correctly to the best of my ability:

LOCATION: OFFICE OF TAX APPEALS
400 R Street, Suite 470
Sacramento, CA 95811
DATE: Tuesday, August 15, 2023
CASE: Silverado Lodging Co, LLC
Case Nos. 21047599, 21047600 and 21047601

I further certify that my said shorthand notes have been transcribed into typewriting, and that the foregoing pages 1 through 82 constitute an accurate and complete transcript of all my shorthand writing for the dates and matter specified.

I further certify that I have complied with CCP 237(a)(2) in that all personal juror identifying information has been redacted if applicable.

IN WITNESS WHEREOF, I have subscribed this certificate at Sacramento, California on this 4th day of September, 2023.

Maria Esquivel-Parkinson
CSR No. 10621, RPR

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