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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:	OTA Case Nos. 19095264, 19095262
TROUBLEFREE, LLC; **D. SUTTON**	

OPINION

Representing the Parties:

For Appellants: Jeffrey W. Curcio, Attorney

For Respondent: John E. Yusin, Attorney[1]

For Office of Tax Appeals: Grant S. Thompson, Attorney

J. JOHNSON, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellants Troublefree, LLC (Troublefree) and D. Sutton (Sutton) appeal the respective actions of respondent Franchise Tax Board (FTB) proposing a limited liability company (LLC) fee of $6,000 for Troublefree for the 2012 tax year, and additional tax of $171,979 and $231,402, plus accrued interest, for Sutton for the 2011 and 2012 tax years, respectively.[2]

Appellants waived the right to an oral hearing and therefore the Office of Tax Appeals (OTA) decides this matter based on the written record.

[1] Mr. Yusin was a representative for the Franchise Tax Board (FTB) in this appeal, but he is no longer employed with FTB. Although he is currently employed with the Office of Tax Appeals (OTA) as an attorney, he has had no involvement with this appeal while at OTA.

[2] In its appeal, Troublefree listed the 2011 tax year as another year at issue, but there is no indication of a notice of action, denial of claim for refund, or other basis for jurisdiction for that year for Troublefree. Accordingly, only the above proposed actions are before the Office of Tax Appeals in this appeal.

ISSUE[3]

Whether, in a transaction properly qualifying under Internal Revenue Code (IRC) section 1031 (Section 1031), appellants must recognize taxable gain for the 2011 tax year with respect to a $1,972,683 net reduction in mortgage debt.

FACTUAL FINDINGS

1. Sutton was the sole member of Troublefree during 2011 and 2012.[4]
2. During 2011, Troublefree sold a commercial property (relinquished property) as part of a Section 1031 transaction. In 2012, as part of the same Section 1031 transaction, Troublefree acquired three replacement properties. The exchange was completed through a qualified intermediary.
3. Troublefree had an adjusted basis of $4,473,924 in the relinquished property, which it sold for $8,500,000. Pursuant to an agreement of the parties, a portion of the sales proceeds were used to repay two loans, a mortgage of $4,644,760 and another loan of $350,000 (totaling $4,994,760).
4. Troublefree purchased the replacement properties for an aggregate amount of $4,551,991. Troublefree financed the purchase through $3,022,077 in loans, with the remainder of the purchase price paid with sale proceeds from the relinquished property. Following the acquisition of the replacement properties, appellants received $1,688,795 in cash from the transaction.[5]
5. As noted above, appellants started the Section 1031 transaction with $4,994,760 of debt on the relinquished property. They ended the transaction with $3,022,077 of debt on the

[3] Troublefree's request for appeal included the amount of the LLC fee for the 2012 tax year. However, as it is undisputed that Troublefree received more than $1 million of cash boot in 2012, regardless of the outcome of the taxable gain at issue on appeal, the LLC fee was properly imposed. (See R&TC, § 17942(a) [imposing a $6,000 fee on LLCs with income of $1 million or more but less than $5 million].) Similarly, while Sutton included in her appeal 2012 as a year at issue, the only arguments provided on appeal relate to the mortgage debt issue which only pertains to the 2011 tax year. Appellants have not provided arguments objecting to the imposition of the LLC fee or the proposed assessment of additional tax for the 2012 tax year, both based on cash boot received in that year, and, finding both were properly assessed based on Troublefree's self-reporting, they will not be separately addressed further herein. References to "appellants" hereafter may refer to either or both appellants, as context provides, and specific references to a particular appellant will be made where appropriate.

[4] As a single member limited liability company, Troublefree is a disregarded entity for income tax purposes, with its taxable gain or loss flowing through to Sutton.

[5] This amount includes interest accrued on funds held by the exchange intermediary.

replacement properties. Thus, through the transaction, appellants obtained a net debt reduction of $1,972,683, which is the purported taxable gain at issue in this appeal.

Tax Reporting and Procedural Background

6. Appellants filed federal Forms 8824 reporting the Section 1031 transaction. They reported an adjusted basis in the relinquished property of $4,473,924, which FTB accepted. Appellants further reported cash received of $1,628,333 (net of exchange expenses) and a fair market value of $6,813,297 for the replacement properties for a total amount of cash and property received of $8,441,630. Subtracting their adjusted basis of $4,473,924 in the relinquished property from the $8,441,630 of cash and property received, they reported realized gain of $3,967,706. Appellants reported $1,628,333 in cash received as recognized gain (i.e., taxable "boot"[6]) and reported the remaining $2,339,373 of realized gain as deferred gain. Sutton reported $1,628,333 of cash received as taxable income on her 2011 tax return. She did not report any taxable income from the transaction on her 2012 tax return.

7. FTB's auditor found that appellants reduced their investment in exchange property by $1,815,430 of cash boot, which amount includes $45,470 of disallowed exchange expenses. The auditor further determined that, other than the additional income of $45,470 arising from disallowed exchange expenses, the cash boot should be reported in 2012. Thus, the auditor calculated $45,470 of cash boot for 2011 and $1,769,960 of cash boot for 2012. As Sutton had reported $1,628,333 of taxable boot on her 2011 tax return, while the auditor had determined cash boot of only $45,470 for the 2011 tax return, the auditor issued a Notice of Proposed Overpayment (NPO), dated June 2, 2015, to remove $1,582,863 of reported cash boot from the 2011 tax return (i.e., Sutton's reported $1,628,333 of taxable boot, less $45,470 of disallowed exchange expenses for 2011).

8. On June 2, 2015, the auditor also issued a Notice of Proposed Assessment (NPA) to Sutton for 2012 to add $3,742,643 of income to the 2012 tax year. This $3,742,643 amount was determined by adding the remaining cash boot of $1,769,960 ($1,815,430 of total cash boot, less the $45,470 of disallowed exchange expenses for 2011) and net

[6] In a transaction under Section 1031, "boot" generally refers to cash or other non-like-kind property that is received.

mortgage boot of $1,972,683 (which represents the difference between appellants' debt of $4,994,760 on the relinquished property and their debt of $3,022,077 on the replacement properties).

9. On July 31, 2015, Sutton protested the NPA and filed amended tax returns for 2011 and 2012. She agreed with the auditor's determination of $45,470 of taxable boot income for 2011. However, she disagreed with FTB's determination of taxable gain in 2012 arising from the net reduction in debt. She argued, as appellants argue on appeal, that the net debt reduction should reduce her basis in the replacement properties, rather than constituting taxable gain in 2011 or 2012.[7]

10. During protest, FTB's hearing officer determined that the net mortgage boot should have been reported for the 2011 tax year rather than for the 2012 tax year. As a result, FTB withdrew the NPO for 2011 and, on July 29, 2016, issued an NPA for 2011 that proposed to increase Sutton's 2011 income by the net mortgage boot. Sutton protested the NPA for 2011, again arguing that the net mortgage reduction does not create any taxable boot.

11. On July 27, 2016, FTB issued an NPA to Troublefree for 2012. It assessed the addition of an LLC fee of $6,000 as a result of the increase in Troublefree's income caused by the cash boot of $1,769,960.

12. On August 20, 2019, FTB issued three notices of action (NOAs).
    a. For 2011, FTB issued an NOA to Sutton affirming its NPA and proposing additional tax of $171,979, plus accrued interest. This NOA included the net mortgage boot.
    b. For 2012, FTB issued an NOA to Sutton revising its NPA. The NOA removed the net mortgage boot (which FTB included in the NOA for the 2011 tax year) and reduced Sutton's flow-through income from Troublefree from $3,742,643, the amount proposed in the NPA, to $1,828,555. This $1,828,555 amount is the amount of cash boot, net of expenses.[8] The NOA proposed additional tax of $231,402, plus accrued interest.
    c. For 2012, FTB also issued an NOA to Troublefree. The NOA affirmed the prior NPA, which assessed an additional LLC fee of $6,000 due to the increase in

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[7] She also raised arguments regarding the application of various carryovers of itemized deductions and passive losses. It appears FTB accepted these arguments and adjusted its determinations accordingly.

[8] The reduction in pass-through income does not precisely equal the $1,972,682 of net mortgage boot due primarily to adjustments in net operating losses.

Troublefree's income for 2012. FTB did not issue an NPA or NOA to Troublefree for the 2011 tax year.

13. Appellants then filed this timely appeal from the three NOAs issued by FTB. On appeal, appellants continue to argue that the net mortgage reduction does not create any taxable income for the years at issue.

DISCUSSION

To qualify for nonrecognition treatment under Section 1031, the following general requirements must be satisfied: (1) the transaction must be an exchange; (2) the exchange must involve like-kind properties; and (3) both the property transferred (the relinquished property) and the property received (the replacement property) must be held for a qualified purpose. (IRC, § 1031(a)(1)-(3).)[9] There is no dispute that these general requirements are met here.

Generally, under Section 1031(a)(1), no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for like-kind property which will be held for productive use in a trade or business or for investment. However, when a taxpayer receives money or other property in addition to like-kind property, gain is recognized to the extent of the money or other non-like-kind property received (commonly referred to as "boot"). (IRC, § 1031(b); see also Treas. Reg. §§ 1.1031(a)-1(a)(2), 1.1031(b)-1, 1.1031(k)-1(f).)

Thus, under IRC section 1031(b), if a taxpayer exchanges like-kind property for other like-kind property and satisfies the general requirements of Section 1031, but also receives cash, the cash is taxable to the extent that the taxpayer realizes gain on the transaction. For example, consider a taxpayer who exchanges unmortgaged property with a fair market value of $85 in which the taxpayer has a tax basis of $50 for unmortgaged property with a fair market value of $75 plus $10 of cash. The taxpayer has $35 of realized gain ($75 + $10 - $50 tax basis), but the $10 of cash received is recognized taxable boot and the remaining $25 of realized taxable gain is

[9] As relevant to the issues on appeal, FTB conforms to Section 1031 at R&TC section 18031 and will generally follow the related Treasury Regulations. (See R&TC, § 17024.5(d).) After the tax years on appeal, Section 1031 was amended to limit exchanges to exchanges of real property. (Pub.L. No. 115-97 (Dec. 22, 2017) 131 Stat. 2054; see also R&TC, § 18031.5 [generally conforming to this change for exchanges after January 10, 2019, for individuals exceeding certain income thresholds]; R&TC, § 24941.5 [generally conforming for exchanges by corporations after January 10, 2019].) For the tax years at issue, California conforms to the IRC as amended through January 1, 2009. (R&TC, § 17024.5(a)(1)(O).) All references to the IRC in this Opinion refer to the January 1, 2009 version.

deferred under Section 1031. (See Treas. Reg. § 1.1031(b)-1(b), Example 1.) The same result occurs if, instead of receiving $10 cash, the taxpayer receives other non-like-kind property, such as, for example, a share of stock with a fair market value of $10. In both cases, because the taxpayer received property in addition to like-kind property, the other property received is generally recognized and therefore taxable upon receipt (i.e., not deferred) to the extent that the taxpayer has realized gain on the transaction.

On appeal, appellants do not dispute FTB's determination of the amount of taxable cash boot received by appellants. Rather, appellants dispute FTB's determination that they received taxable mortgage boot due to the relief of debt. As discussed below, appellants assert that the reduction in mortgage indebtedness should reduce their basis in the replacement properties rather than constitute taxable boot from the exchange. Therefore, OTA must consider the effect of debt relief on a Section 1031 transaction.

To do so, OTA modifies the above example to provide that the relinquished property is subject to $10 of debt, while the replacement property is not subject to any debt. In the transaction, the parties agree that, instead of paying the taxpayer $10 in cash (or $10 of stock or other non-like-kind property), the other party will assume the $10 of debt. Treasury Regulation (Regulation) section 1.1031(b)-1(c) provides that if the consideration received by the taxpayer includes an assumption of debt, then the assumption of debt will be treated as if it were money or other non-like-kind property for purposes of IRC section 1031(b). (See also Treas. Reg. §§ 1.1031(d)-2, 1.1031(k)-1(j)(3), Example 5.) This same rule applies if, instead of directly assuming debt, the other party takes relinquished property that is subject to debt. Therefore, if a taxpayer exchanges property subject to $10 of debt in return for property that is not subject to any debt, the taxpayer will have $10 of taxable boot.

Similarly, if proceeds from the sale of relinquished property are used to pay off the taxpayer's debt (or debt that encumbers the relinquished property), the repayment would be treated as taxable boot. (*Barker v. Commissioner* (1980) 74 T.C. 555, 572 (*Barker*); see also IRS Private Letter Ruling No. 9853029 (Dec. 31, 1998).[10]) This makes sense because, regardless

[10] IRS Private Letter Rulings are generally applicable only to the taxpayer under consideration; however, ". . . where federal law and California law are the same, . . . rulings and regulations dealing with the IRC are persuasive authority in interpreting the California statue." (*J.H. McKnight Ranch, Inc. v. Franchise Tax Bd.* (2003) 110 Cal.App.4th 978, fn. 1.)

of whether the other party to the exchange assumes the debt, pays off the debt, or pays the taxpayer $10, the taxpayer is effectively $10 richer.

However, when proceeds from the sale of relinquished property are used to pay off debt that encumbers the relinquished property, a taxpayer can net this debt reduction with the amount of new debt undertaken by the taxpayer on the replacement property. (IRS Private Letter Ruling No. 9853029 (Dec. 31, 1998).) Regulations under Section 1031 recognize that, if a taxpayer is relieved of debt on the relinquished property but acquires replacement property that is subject to debt, then the debt on the replacement property also needs to be considered. (Treas. Reg. §§ 1.1031(b)-1(c), 1.1031(d)-2, Example 2, 1.1031(k)-1(j)(3), Example 5.) For example, if a taxpayer exchanges a property with $10 of debt in return for a property that also has $10 of debt, then the taxpayer has not obtained any net debt relief. Thus, the regulations provide that, to determine the amount of mortgage boot, any debt assumed by the buyer on the relinquished property will be offset by any debt assumed by the taxpayer on the replacement property.[11]

The same rules apply in a deferred exchange. Just as in a simultaneous exchange of property, any cash or other non-like-kind property received in a deferred exchange, as well as debt assumed, constitutes taxable boot up to the amount of the gain realized by the taxpayer in the transaction. (See Treas. Reg. §§ 1.1031(k)-1(j)(1) [generally providing that gain recognized in a deferred exchange is subject to “the rules of [S]ection 1031 and the regulations thereunder”], 1.1031(k)-1(j)(3), Examples 1 & 2.)

Moreover, just as in a simultaneous exchange, liabilities in a deferred exchange are netted in order to determine the amount of any taxable mortgage boot. (See Treas. Reg. § 1.1031(k)-1(j)(3), Example 5.) This same rule applies regardless of whether the buyer assumes the mortgage debt on the relinquished property or pays off the mortgage debt when it acquires the property. (*Barker*, *supra*, 74 T.C. 555, 572; see also IRS Private Letter Ruling No. 9853029 (Dec. 31, 1998).)

[11] Note that a like-kind exchange may involve the acquisition of multiple replacement properties, as is the situation in the facts of this appeal. The principal remains the same regardless of whether there are more than one replacement properties involved.

In Revenue Ruling 2003-56, 2003-1 C.B. 985, the IRS applies the foregoing rules in the context of a Section 1031 transaction that, like the transaction here, spanned two tax years. Consistent with the foregoing authorities, Revenue Ruling 2003-56 explains that any gain realized due to net debt relief is recognized in the first year of the transaction.[12]

Here, when appellants sold the relinquished property, $4,994,760 of the sale proceeds were applied to pay off the mortgage debt on the relinquished property. Appellants then acquired replacement properties subject to $3,022,077 of debt. The Section 1031 transaction thus reduced their debt by a net amount of $1,972,683.[13] Accordingly, under the foregoing authorities, FTB properly determined mortgage boot of $1,972,683. As appellants' realized gain exceeds the boot they received, the mortgage boot is taxable.

Appellants argue that the net mortgage boot is not taxable because the exchange spanned two taxable years and qualified as an installment sale. In support of their position, appellants point to Regulation section 1.1031(k)-1(j)(2) and Temporary Regulation section 15a.453-1(b)(3)(i).[14]

There are some circumstances where installment sale rules interact with regulations under Section 1031, but such circumstances are not present here. For example, if a taxpayer has a "bona fide" intent to complete a deferred exchange under Section 1031, and sells relinquished property at the end of a year, but then in the following year fails to complete the like-kind exchange, the taxpayer may be able to take advantage of installment sale rules to defer taxable gain to the second year. (See Treas. Reg. § 1.1031(k)-1(j)(2) & (vi), Example 3; 3 Mertens Law of Fed. Income Tax'n (2020) § 20B:64, Coordination of deferred exchange rules with installment

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[12] As the debt relief is received in the first tax year of the transaction, it is taxed in that year. If its requirements are satisfied, Section 1031 allows a taxpayer to defer gain to the extent the taxpayer receives like-kind property, but it does not allow the taxpayer to defer the recognition of gain to the extent of cash, debt relief, or other non-like-kind property received. Consistent with Revenue Ruling 2003-56 and the authorities outlined above, FTB's proposed assessment finds that the net debt relief is taxable in the 2011 tax year. As noted above, appellants argue that the net debt relief is not taxable in either the 2011 or 2012 tax year.

[13] For this purpose, an assumption of debt is treated the same as a transfer of property that is subject to debt. (See Treas. Reg. § 1.1031(b)-1(c) [requiring the netting of debt regardless of whether liabilities are assumed or property is taken subject to debt].)

[14] Appellants also provide a marked copy of former Proposed Regulation section 1.453-1(f) and appear to argue that it supports their position. However, prior to the tax years at issue, Proposed Regulation 1.453-1 was removed. (See Installment Method Reporting by Dealers in Personal Property, Treas. Dec. 8270, 54 Fed. Reg. 46375-01 (Nov. 3, 1989) 1989 WL 1110712.) Moreover, former Proposed Regulation section 1.453-1(f) applied to transactions in which the taxpayer receives an installment obligation from the other party to the exchange, which did not occur here.

sales rules.) Here, however, appellants timely completed their Section 1031 transaction, and there is no dispute that the transaction satisfied the general requirements of Section 1031.

Another situation where installment sale rules may be relevant to a Section 1031 transaction is where the buyer of the relinquished property pays part of the purchase price with a note or other obligation that provides for at least one payment to be received in a subsequent tax year. (See IRC, § 453(b)(1) [defining an installment sale as a disposition of property where at least one payment is to be received in a subsequent tax year].) In that situation, IRC section 453 and regulations thereunder may be relevant to determine the timing of the taxpayer's recognition of any taxable gain. (See Treas. Reg. § 1.1031(k)-1(j)(2)(ii) & (vi), Examples 2-6.) However, that situation also is not present here. In appellants' transaction, the buyer of the relinquished property paid the full amount of the purchase price in 2011.

Regulation section 1.1031(k)-1(j)(1) addresses the interaction of installment sale rules with Section 1031 and provides the following general rule:

> Except as otherwise provided, the amount of gain or loss recognized and the basis of property received in a deferred exchange is determined by applying the rules of section 1031 and the regulations thereunder. See sections 1.1031(b)-1, 1.1031(c)-1, 1.1031(d)-1, 1.1031(d)-1T, 1.1031(d)-2, and 1.1031(j)-1.

Thus, the general rule is that, in determining the amount of the gain and the basis of the property received, Section 1031 and the regulations thereunder apply, rather than IRC section 453 and regulations thereunder.

Regulation section 1.1031(k)-1(j)(2) then explains how the installment sale rules of IRC section 453 and Temporary Regulation section 15a.453-1(b)(3)(i) apply to deferred exchanges. Contrary to appellants' contention, neither Regulation section 1.1031(k)-1(j)(2) nor Temporary Regulation section 15a.453-1(b)(3)(i) applies here.

Regulation section 1.1031(k)-1(j)(2)(i) applies to situations where the acquiror of the relinquished property deposits cash to secure a promise to deliver replacement property.[15] It

[15] The regulation prevents the cash deposit from being treated as a payment for purposes of IRC section 453 during the exchange period, as long as the deposit is held in a qualified escrow account or qualified trust and the taxpayer does not have the ability to access or obtain the benefit of the deposit. Without the regulation, the installment sale rules could deem the taxpayer to have received a payment at the time the transferee secures its obligation with cash. (See Temp. Treas. Reg. § 15a.453-1(b)(3)(i) [generally providing that receipt of evidence of indebtedness that is secured by cash constitutes a payment for purposes of installment sale rules but noting the special rule provided by Regulation section 1.1031(i)-1(j)(2)(i)]; Treas. Dec. 8535, 59 Fed. Reg. 18747-01 (April 20, 1994) 1994 WL 16000355 [addressing the interplay between Section 1031 and IRC section 453].)

does not apply in this appeal because the transferee of the relinquished property did not deposit cash to secure an obligation to deliver replacement property. Moreover, Regulation section 1.1031(k)-1(j)(2)(i) does not address the repayment of debt with proceeds from the sale of the relinquished property or the netting of mortgage obligations. It is not relevant here.

Regulation section 1.1031(k)-1(j)(2)(ii) is also not relevant. It provides that a taxpayer's qualified intermediary will not be considered an agent of the taxpayer for purposes of the installment rules until the earlier of the end of the exchange period or such time as the taxpayer has the ability to obtain the benefit of the cash in the account. This rule prevents the application of installment sale rules from causing the taxpayer to be taxed when the exchange intermediary receives funds from the buyer of the relinquished property. (See Treas. Reg. § 1.1031(k)-1(j)(2)(vi), Example 2.)

FTB is not seeking to treat the qualified intermediary as an agent of the taxpayer or seeking to tax appellants on the exchange intermediary's receipt of funds. Rather, FTB is seeking to tax appellants on the net amount of debt relief they received when funds were removed from escrow to pay off appellants' debt. Therefore, Regulation section 1.1031(k)-1(j)(2)(ii) is not applicable here.

Regulation section 1.1031(k)-1(j)(2)(iii) generally provides that if a taxpayer uses a qualified intermediary and receives evidence of indebtedness of the transferee of the relinquished property, the taxpayer will be treated as if it received the evidence of indebtedness from the person acquiring the relinquished property. As noted previously, this rule may allow a taxpayer to take advantage of installment sale rules where the taxpayer receives a promissory note or other evidence of indebtedness of the buyer from the qualified intermediary. (See Treas. Reg. § 1.1031(k)-1(j)(vi), Example 4.) This provision is also inapplicable, because appellants did not receive a note or other evidence of indebtedness of the transferee.[16]

Appellants argue that the "qualifying indebtedness" provisions of Temporary Regulation section 15a.453-1(b)(3)(i) apply and allow Troublefree to reduce its basis instead of recognizing gain. However, Regulation section 1.1031(k)-1(j) explains the circumstances in which the

[16] The remaining provisions of Regulation section 1.1031(k)-1(j)(2) provide more detailed rules and examples regarding the operation of subparts (i) through (iii) of the regulation. Subpart (iv) requires that the taxpayer have a "bona fide" intent to enter into a deferred exchange in order to take advantage of subparts (i) and (ii). Subpart (v) explains that subparts (i) and (ii) do not apply if the relinquished property is disqualified property. Subpart (vi) then provides examples illustrating the operation of the provision.

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installment sale rules of IRC section 453 and Temporary Regulation section 15a.453-1(b)(3)(i) apply to deferred exchanges.[17] As discussed above, none of those circumstances are present here.[18]

Appellants contend that *Smalley v. Commissioner* (2001) 116 T.C. 450 (*Smalley*) supports their position. In *Smalley*, the taxpayers sold the relinquished property (timber cutting rights) in 1994, with the sale proceeds placed in a qualified escrow account and subsequently used to acquire replacement property (real property) in 1995. The IRS issued an assessment for the 1994 tax year, arguing that the replacement property was not like-kind property. The tax court found that it did not need to rule on the like-kind issue because the taxpayers had a bona fide intent to complete the exchange and therefore were not taxable *in 1994* on the proceeds that were placed in escrow, even if they received non-like-kind property in 1995.

Smalley provides no assistance to appellants. The Smalleys were not considered to have constructively received any proceeds during the year at issue because the proceeds were held, outside their reach, in an escrow account. Here, by contrast, $4,994,759 of sale proceeds were removed from escrow to pay off appellants' debt. Appellants therefore received an immediate economic benefit in the first year of the transaction, unlike the taxpayers in *Smalley*.

Appellants also argue that IRS Revenue Ruling 2003-56 only applies to partnerships. It is true that Revenue Ruling 2003-56 considers an exchange conducted by a partnership and therefore discusses partnership provisions that are not relevant here. However, the revenue ruling also discusses and applies more general provisions that apply to net debt relief received in a Section 1031 transaction, such as Section 1031(b) and Regulation section 1.1031(k)-1(j). While the allocation of the gain among the partners is not relevant in this appeal, the revenue ruling's determination that the partnership recognizes gain in the first year of the transaction to the extent of net debt relief is relevant and provides further support for FTB's determination.

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[17] Also, while not relevant here, Regulation section 1.1031(k)-1(g)(2)(i)(B) references Temporary Regulation section 15A.453-1(b)(3)(iii) in connection with the treatment of a standby letter of credit provided by a transferee.

[18] Moreover, Temporary Regulation section 15a.453-1(b)(3)(i) is inapplicable by its own terms. It states that, in determining the amount of any payment received in an installment sale transaction, the amount of "qualifying indebtedness" that is assumed by the buyer shall be included only to the extent that it exceeds the taxpayer's basis in the property. Here, the buyer did not assume any debt, and the exchange did not involve a note, installment payments, or other deferred consideration.

HOLDING

Appellants must recognize taxable gain for the 2011 tax year with respect to a $1,972,683 net reduction in mortgage debt.[19]

DISPOSITION

FTB's actions are sustained.

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John O Johnson
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John O. Johnson
Administrative Law Judge

We concur:

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Huy "Mike" Le
Administrative Law Judge

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Andrea L.H. Long
Administrative Law Judge

Date Issued: 11/30/2023

[19] As noted above, appellants have not provided arguments objecting to the imposition of the LLC fee or the proposed assessment of additional tax for the 2012 tax year, and, finding both were properly assessed, FTB's actions are sustained as to these amounts as well.