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OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:	)	OTA Case Nos. 21047599, 21047600, 2104601
SILVERADO LODGING CO., LLC AND	)	
C.V. PATEL,	)	
K.C. PATEL,	)	
J.V. PATEL,	)	
J.A. PATEL	)	

OPINION

Representing the Parties:

For Appellants: Edward I. Kaplan, Attorney

For Respondent: Marguerite Mosnier, Attorney
Carolyn S. Kuduk, Attorney

V. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, Silverado Lodging Co., LLC (Silverado), C.V. and K.C. Patel, and J.V. and J.A. Patel (appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $827,751, a late payment penalty of $2,948, and applicable interest, for the 2015 tax year.[1]

Office of Tax Appeals (OTA) Administrative Law Judges Veronica I. Long, Huy "Mike" Le, and Tommy Leung held an oral hearing for this matter in Sacramento, California, on August 15, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

[1] Silverado LLC fee and annual tax totaling $12,590; C.V. and K.C. Patel tax $439,983; J.V. and J.A. Patel tax $375,178. FTB in its supplemental brief agreed to abate the late payment penalty against Silverado; thus, OTA will not discuss this issue further.

ISSUE

Whether appellants have demonstrated that they met the exchange requirement of Internal Revenue Code (IRC) section 1031 to properly execute a tax-deferred like-kind exchange.

FACTUAL FINDINGS

1. Silverado was organized in 1998 by C.V. Patel and J.V. Patel (appellant-brothers), who were its original members. Through Silverado, appellant-brothers each held a 50 percent tenancy-in-common interest in a hotel located in Calistoga, California (subject property), and operated it until its sale in 2015.
2. In May 2013, Silverado entered into a contract with Broughton Hotel Management, LLC (Broughton), for Broughton to provide management and operating services for the subject property.
3. In May 2014, Silverado listed the subject property for sale.
4. On June 30, 2014, appellant-brothers transferred their respective membership interests in Silverado to their separately-owned partnerships: ACT Enterprises, L.P. (ACT), owned by C.V. and K.C. Patel; and JagJudy, L.P. (JagJudy), owned by J.V. and J.A. Patel.
5. On September 10, 2014, Silverado entered into an agreement with Calistoga Hotel Group, LP (Calistoga) to sell the subject property to Calistoga. Appellant-brothers signed for Silverado as "authorized members."
6. On October 31, 2014, J.V. Patel signed the Assumption of Debts and Liabilities of Silverado Lodging Co., LLC, as managing member of Silverado. The Assumption of Debts and Liabilities stated that the assumption was "to be effective as of the time of distribution of these assets to the Undersigned, and… includes all further expenses of liquidation of the LLC to the extent that they are unpaid at the Date of Dissolution."
7. Also on October 31, 2014, appellant-brothers executed the Agreement for Dissolution and Winding Up of Silverado and the Conveyance and Assignment of Silverado's outstanding shares on behalf of ACT and JagJudy. ACT and JagJudy agreed in writing to hold the subject property as tenants in common.

8. On November 5, 2014, the Agreement for Sale of the subject property was subsequently amended (First Amendment) and appellant-brothers signed for Silverado in their capacities as members of their respective partnerships, ACT and JagJudy.
9. On November 30, 2014, Silverado assigned its rights, interests, and obligations under the sales agreement to ACT and JagJudy.
10. On December 2, 2014, the Agreement for Sale of the subject property was amended again (Second Amendment) and signed by appellant-brothers as members of their respective partnerships, ACT and JagJudy. The Second Amendment referred to ACT and JagJudy as the "New Seller" and expressed appellants' plan to use the subject property as a relinquished property as part of an IRC Section 1031 like-kind exchange. Silverado assigned its right, title, interest, and obligations under the sales agreement to ACT and JagJudy but remained liable and obligated to perform all the terms, conditions, and covenants as "seller." The assignment was to be effective upon the recording of the grant deed of the subject property.
11. In early December 2014, appellant-brothers executed a grant deed on behalf of Silverado, conveying a 50 percent interest each to ACT and JagJudy for the real property on which the hotel was located. The grant deed was recorded by the Napa County Recorder's Office on December 30, 2014.
12. Upon the distribution of the subject property to ACT and JagJudy on December 30, 2014, Broughton continued to oversee the operations of the hotel pursuant to its management agreement with Silverado, and appellants state in their briefing that "JagJudy and ACT were not direct parties to Silverado's contractual obligations and their assumption of those obligations did not serve to relieve Silverado from its obligations to those providers. . . . [and] Silverado's distribution of the [subject] Property did not allow it to walk away from its obligations."
13. On December 31, 2014, Silverado filed a Certificate of Cancellation with the California Secretary of State, signed by appellant-brother C.V. Patel as the "Managing Member."
14. On January 6, 2015, ACT and JagJudy executed separate agreements with Orexco for IRC Section 1031 like-kind exchanges.
15. On January 9, 2015, escrow closed and the sale of the subject property was complete.

16. Between December 30, 2014 (the day the subject property was distributed to ACT and JagJudy) and January 9, 2015 (the day the sales transaction was complete), ACT and JagJudy fulfilled their obligations for the existing debts and expenses of the subject property by paying for the property taxes, loan repayments, transfer tax, and service contracts as credits to the buyer Calistoga on the Closing Statement of the sales transaction. The sales proceeds were used to pay off mortgage and construction loans on the subject property. No other expenses were paid during the 10-day period, nor do appellants claim receipt of any income from the subject property.

Tax Returns

17. On September 3, 2015, Silverado filed its final 2014 California Limited Liability Company Return of Income (Form 568) reporting equal distributions of shares to ACT and JagJudy on Schedule L, resulting in $0 in assets and liabilities at the end of the taxable year. However, on line M ("Was there a distribution of property or a transfer of an LLC interest during the taxable year?"), Silverado checked the "no" box. On appeal, appellants contend that they checked the box in error.
18. Subsequently, ACT and JagJudy filed 2015 California income tax returns, claiming deferral of gains under IRC section 1031 (Form 3840). Silverado did not file a 2015 income tax return.

Procedural History

19. Following an audit, on December 6, 2019, and December 10, 2019, FTB issued Notices of Proposed Assessment (NPAs) allocating the $7,530,388.00 gain from the sale of the subject property to Silverado, which caused gain to flow through to appellants in the amount of $3,624,460.00 to C.V. Patel and K.C. Patel, and $3,710,127.00 to flow through to J. V. Patel and J. A. Patel. The NPAs proposed additional tax assessments of $458,812.00 to appellants C.V. Patel and K.C. Patel, and $475,332.00 to J.V. Patel and J.A. Patel. FTB also issued an NPA to Silverado proposing an LLC fee of $11,790.00, annual tax of $800.00, and a late payment penalty of $2,947.50 for a total of $15,537.50.

20. Appellants timely protested and on March 12, 2021, FTB issued Notices of Action showing proposed assessments of additional tax of $439,983.00[2] to C.V. and K.C. Patel, $375,178.00[3] to J.V. and J.A. Patel, and $15,537.50 to Silverado.
21. On April 12, 2021, appellants filed this timely consolidated appeal. On appeal, FTB agreed to abate the proposed late filing penalty of $2,947.50 imposed on Silverado.

DISCUSSION

Burden of Proof

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

IRC section 1031

IRC section 1031 is an exception to the general rule requiring recognition of gain or loss upon the sale or exchange of property. (See IRC, § 1001(c); Treas. Reg. § 1.1002-1(a); R&TC, §§ 18031, 24902.) To qualify for nonrecognition treatment under IRC section 1031,[4] three general requirements must be satisfied: (1) the transaction must be an exchange (exchange requirement); (2) the exchange must involve like-kind properties (like-kind requirement); and (3) both the property transferred (the relinquished property) and the property received (the replacement property) must be held for a qualified purpose (holding requirement). (IRC, § 1031(a)(1)-(3).)

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

[2] The NOA reduced the amount of flow-through income from $3,740,127 to $3,012,155, and further reduced this amount by $55,067.

[3] The NOA reduced the amount of flow-through income from $3,624,460 to $3,623,623, and further reduced this amount by $140,734.

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

received in the 'exchange."[5] (*Chase v. Commissioner* (1989) 92 T.C. 874, 883 (*Chase*).) The basic question of who in reality was the seller in the transaction is a question of fact. (*Waltham Netoco Theatres, Inc. v. Commissioner* (1968) 401 F.2d 333, 334–335; see also *Bolker v. Commissioner* (1983) 81 T.C. 782, 794.)

<u>Substance Over Form Doctrine</u>

Generally, the substance of a transaction will be prioritized over its form. (See *Eisner v. Macomber* (1920) 252 U.S. 189; *Southern Pacific Co. v. Lowe* (1918) 247 U.S. 330) In the seminal case of *Gregory v. Helvering* (2nd Cir. 1934) 69 F.2d 809, *affd.* (1939) 293 U.S. 465, Judge Learned Hand stated that the defect in the taxpayer's attempted transaction was that it was not what it purported to be (in that case, a reorganization) because the transaction was not part of the conduct of the business by either party involved, and so, when viewed as a whole, constituted a sham. (*Gregory v. Helvering, supra*, 69 F.2d 809, 811.) The substance over form doctrine states that if the substance of a transaction fails to satisfy the plain intent of the statute, then the form of the transaction that gave rise to the tax effect will be disregarded for tax purposes. (*Gregory v. Helvering, supra*, 293 U.S. 465, 470.) Holding otherwise "would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." (*Ibid*.)

<u>*Court Holding*</u>

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

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

property was conveyed to the buyer. (*Ibid.*) In ruling that the sale was properly attributed to the corporation, the Supreme Court stated:

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

(*Id*. at p. 334.)

<u>*Cumberland*</u>

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

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

even when the sale has been made by its stockholders following a genuine liquidation and dissolution." (*Id.* at p. 454.)

<u>*Chase*</u>

In *Chase*, *supra*, 92 T.C. 874, the tax court applied the substance over form doctrine to determine whether the seller of an apartment building in an attempted 1031 exchange was a partnership, or the individual partners of the partnership. The taxpayers, a husband and wife, sought to employ IRC section 1031 to defer gain on the sale of the apartment building. The tax court applied the substance over form doctrine and concluded that the substance of the taxpayers' purported sale of an undivided interest in the apartment building was a sale by the partnership. (*Id.* at p. 883.) First, the contract for the sale of the apartment building reflected the partnership as the seller. (*Id.* at p. 877.) Second, the taxpayer-husband signed the contract as a general partner of the partnership, and there was no indication that he individually held any interest in the apartment building. (*Ibid.*) Further, when it was certain that the sale would close, the taxpayer-husband caused the deed for an undivided interest in the apartment building (which had been executed shortly after the receipt of an initial offer to purchase the apartments) to be recorded. (*Id.* at p. 877.) Finally, from the time the taxpayers received the deed to the apartment building, until the date the sale was closed, the partnership and not the taxpayers received the rents and paid the expenses related to the apartments. (*Id.* at pp. 878-879.)

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

Brookfield Manor

In the Board of Equalization's (BOE) precedential opinion in *Appeal of Brookfield Manor, Inc., et al*. (89-SBE-002) 1989 WL 37900 (*Brookfield Manor*), the BOE addressed whether property in an attempted 1031 Exchange was sold by appellant Brookfield Manor, Inc. (Brookfield) or instead, by the individual appellant shareholders of Brookfield.[6]

In August of 1978, Brookfield negotiated with a third party to exchange its mobile home park for an unspecified piece of property and proceeded to open an escrow for the transaction on August 22, 1978. On September 14, 1978, escrow was amended to replace Brookfield's name with the names of its shareholders and to specify a medical building as the replacement property. Brookfield adopted a plan for liquidation on September 27, 1978, purported to distribute its mobile home park to its shareholders on or before October 28, 1978, and dissolved three days later. The properties were exchanged on November 9, 1978.

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

Kwon

In the OTA's precedential opinion, *Appeals of Kwon, et al.*, 2021-OTA-296P (*Kwon*), the substance over form doctrine analysis was applied to determine the buyer of replacement property in a 1031 exchange. The original buyer on the sales contract was Galleria, but prior to the execution of the sales contract, "KMC" and three additional investors paid the seller a $100,000 modification fee to be substituted in as the new buyers. The purchase closed less than one month following the buyer substitution. OTA concluded that the original named buyer "Galleria," not KMC, was the true buyer who acquired the replacement property because:

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

Galleria was the buyer that initially negotiated the purchase; KMC and the three investors were only substituted in after the essential terms of the sale had been agreed upon and shortly before the purchase closed; Galleria paid the initial $2 million deposit into escrow for the purchase; Galleria paid the expenses associated with the purchase of the replacement property such as the exchange fee, title fees, and broker commissions; and KMC and the three investors failed to pay any of the operating expenses of the replacement property as owners.

FAR Investments

In *Appeal of F.A.R. Investments, Inc. and Arciero & Sons, Inc.*, 2022-OTA-395P (*FAR Investments*), OTA performed a similar analysis in a precedential opinion. The taxpayers were indirect owners of "AWG," an LLC, which owned a winery. After receiving an offer to purchase the winery, AWG entered into negotiations with the buyer and an asset purchase agreement was drafted. To enable its partners (the taxpayers) to conduct 1031 exchanges, AWG's partners entered into seller substitution agreements with the buyer to list themselves, rather than AWG, as the seller of the property. However, after executing the substitution agreements, AWG and the buyer executed an asset purchase agreement superseding all prior agreements under the same terms they had previously negotiated. On the day escrow closed, AWG executed and recorded a deed conveying the property to its partners as tenants-in-common, and simultaneously the partners executed and recorded a deed conveying their tenant-in-common interests to the buyer. AWG's partners then acquired separate replacement properties and claimed that they had conducted a 1031 exchange.

OTA found that, while the record indicated an intent to carry out a 1031 exchange, the purchase agreement named AWG as the sole seller of the winery. In holding that AWG was the true seller of the winery, OTA determined that: the negotiations were completed primarily on behalf of AWG, not its partners as individuals; although the partners were involved in negotiations with respect to the 1031 exchanges, AWG was actively involved in negotiations related to the essential terms of the sale; the sale was conducted under substantially the same terms and conditions as negotiated by AWG; given the brief time frame, the partners merely stepped into the shoes of AWG after the sale was already negotiated, agreed upon, and pending closing; and the burdens and benefits of ownership did not shift from AWG to the partners at the time the deeds were conveyed, and the partners never acted as the owners or held themselves out as the owners of the winery after the deeds were conveyed to them. Therefore, OTA held that, in

substance, AWG was the true seller of the winery, and the partners as individuals were not entitled to the claimed deferral of gain from the purported 1031 exchanges.

Analysis of Exchange Requirement

The issue in this appeal is whether the exchange requirement of IRC section 1031(a) was satisfied.[7] Appellants assert that Silverado's partners, ACT and JagJudy, were the sellers of the property in both form and substance. Specifically, appellants contend the partners as tenants-in-common (TIC) sold the property and completed a 1031 exchange.

FTB does not dispute that the partners, ACT and JagJudy as TIC holders, were the sellers in form, but instead contends that the sale is nonetheless attributable to Silverado because Silverado was the seller in substance of the property. FTB contends that the transaction does not satisfy the exchange requirement because Silverado was the true seller of the property, and Silverado did not obtain replacement property to complete an exchange.

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

Negotiations by Silverado

The substance over form inquiry begins with examining the extent to which Silverado or appellants, on their own behalf, were involved in negotiations for the sale of the property. As noted above, the court in *Bolker v. Commissioner*, *supra*, stated, "the sale cannot be attributed to the corporation unless the corporation has, while still the owner of the property, carried on negotiations looking toward a sale of the property, and in most cases the negotiations must have culminated in some sort of sales agreement or understanding so it can be said the later transfer by the stockholders was actually pursuant to the earlier bargain struck by the corporation – and the

[7] The parties agree that both the like-kind and holding requirements have been met.

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

Here, the evidence indicates that from the sale listing in May 2014 until the Second Amendment to the sales agreement on December 2, 2014, Silverado was the official seller and took an active role in the sale and negotiated the essential terms and conditions of the sale of the property. Other than the assignment of Silverado's rights to appellants and the reference to appellants' plan to execute a Section 1031 exchange, the terms of the Second Amendment remained the same as the initial agreement and the first amendment. This evidence indicates that the negotiations for the sale of the property were completed primarily on behalf of Silverado, not appellants. As in *Kwon*, appellants replaced the original seller, Silverado, in the final sales agreement approximately one month prior to the close of escrow in early January 2015. In other words, appellants merely "stepped into the shoes" of Silverado after the essential terms of the sale had been negotiated.

<u>Negotiations by Purported Sellers on Their Own Behalf</u>

The appeal record demonstrates that approximately one month prior to the closing of the sale, appellants added a provision reflecting their intent to use the subject property as the relinquished property in a 1031 exchange. To accomplish this transaction, appellants also added an assignment clause replacing Silverado with ACT and JagJudy as the sellers. However, there is no evidence that appellants actively and independently negotiated with Calistoga with respect to any contractual terms relating to the subject property. (See *Chase*, *supra*, at p. 882 ["there is no evidence of negotiations by petitioners on behalf of themselves concerning the terms for the disposition of the Apartments"].) In other words, the evidence shows that appellants were only involved in negotiations with respect to implementation of the 1031 exchange and the seller assignment, not as to the essential terms of the sale of the subject property, which remained unchanged from the initial sales agreement. Therefore, Silverado, not appellants, was actively involved in negotiations related to the essential terms of the sale.

Substantially the Same Terms and Agreements

Appellants do not provide evidence showing that the terms of the agreement were substantially modified after the initial sales agreement dated September 10, 2014. Rather, the evidence indicates that although appellants replaced Silverado as the seller, the terms of the agreement were substantially unchanged in the subsequent amendments and through the execution of the sale**.** Therefore, the sale was conducted under substantially the same terms and conditions as negotiated by Silverado.

Time Elapsed

The record shows that approximately one month prior to the closing of escrow, appellants executed a grant deed transferring ownership of the subject property from Silverado to ACT and JagJudy, and the deed was recorded on December 30, 2014, a mere 10 days before the sale was complete. Because the assignment of Silverado's rights, title, and obligations to ACT and JagJudy did not take effect until the grant deed was recorded, ACT and JagJudy did not step into Silverado's shoes until 10 days before the closing of escrow. As in *Kwon*, wherein the appellants replaced Galleria as the buyer 17 days before the purchase was complete, the time elapsed here between ACT and JagJudy taking over Silverado's place was minimal. Given the brief time frame, the lack of evidence that appellants were involved in the negotiations of the subject property on their own behalf, and that the terms were substantially unchanged in the amended agreements, it appears that the individual partners as TIC holders merely stepped into the shoes of Silverado after the sale was already negotiated, agreed upon, and escrow was all but certain to close.

Burdens and Benefits of Ownership

In *Chase*, *supra*, the court examined whether the taxpayers bore the benefits and burdens of ownership of the property, finding that they "never paid any of the operating costs of the Apartments or their share of the brokerage commission. Further, petitioners did not receive, or have credited to them, any of the Apartment's rental income." (*Id*. at p. 882.) In this case, appellants were conveyed the deeds on December 30, 2014, and the sale closed shortly thereafter

on January 9, 2015. In this 10 days' time, we must determine whether Silverado or appellants bore any benefits and burdens of ownership of the subject property.

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

In the instant appeal, the recording of the grant deed of the subject property on December 30, 2014, indicates that legal title passed to ACT and JagJudy. ACT and JagJudy, upon executing the sale of the subject property, paid the property taxes, loan payments, transfer tax, and service contracts through credits for those expenses to Calistoga in the Closing Statement. However, ACT and JagJudy admittedly did not pay any other expenses during the 10-day period during which they owned the subject property, nor do they claim to have collected any revenues from the operation of the property. In fact, appellants stated that Broughton continued to provide management services during this time as obligated under the management contract with Silverado. Significantly, according to appellants, because ACT and JagJudy's rights and obligations relating to the subject property were contractually assigned, their assumption of those rights and obligations did not relieve Silverado from its obligations to perform under its contracts with service providers, including loan repayments, insurance policies, services agreements. In other words, the parties treated the relationship as that of assignor and assignee, or tenant and sub-tenant, and as such, Silverado still bore the risk of loss or damage to the subject property.

There is also no evidence indicating that ACT and JagJudy acted as the owners or held themselves out as the owners of the property after the deed was conveyed to them by Silverado. (*Chase v. Commissioner*, *supra*, 92 T.C. at p. 881 ["at no time did petitioners act as owners except in their roles as partners of JMI"].) Therefore, the burdens and benefits did not truly shift from Silverado to ACT and JagJudy during the 10 days prior to the closing of escrow.

Regardless of appellants' expressed intent in the Second Amendment to execute a 1031 exchange, the fact that ACT and JagJudy did not assume the burdens and benefits of ownership demonstrates that Silverado was the true seller of the subject property. (See *FAR Investments*, *supra*.)

<u>Continuity of Investment and Choice of Entity</u>

Appellants assert that, in substance, they continued their investment and they analogize the distribution the property from Silverado to appellants' separately held entities as a type of accounting vehicle for appellants to continue their investment. Appellants contend that they continued their investment in like-kind property and, therefore, they satisfy the requirements for a like-kind exchange pursuant to *Magneson v. Commissioner* (9th Cir. 1985) 753 F.2d 1490 (*Magneson*) and *Bolker v. Commissioner* (9th Cir. 1985) 760 F.2d 1039 (*Bolker*). Appellants assert that disallowing their attempted exchange would violate the intent of IRC section 1031, which is to defer taxation where sales proceeds of certain investments are reinvested in like-kind property.

The holdings in *Magneson* and *Bolker* address the holding requirement of IRC section 1031, which is not at issue in this appeal. The issue in this appeal is whether the exchange requirement of IRC section 1031 has been met. (See *Kwon*, *supra* at footnote 20 ["because the holding requirement is not at issue in this appeal, these cases [including *Magneson* and *Bolker*] will not be addressed or discussed further"].)

Appellants contend that, in substance, appellant-brothers were always the true owners of the property through their various business entities. However, the substance over form doctrine is not available to appellants. Courts have generally held that the substance over form doctrine is not available to taxpayers and that a "'taxpayer may not escape the tax consequences of a business arrangement which he made upon the asserted ground that the arrangement was fictional.'" (*Maletis v. U.S.* (9th Cir. 1952) 200 F.2d 97, quoting *Love v. U.S.* (Ct. Cl. 1951) 96 F.Supp. 919.) With few exceptions, the longstanding rule is that "the taxpayer does not have the same freedom to disregard the form [of a transaction] he has chosen, as does the government." (*W.E. Hall Co. v. FTB* (1968) 260 Cal.App.2d 179, 194.)

Appellants' choice to conduct affairs through various business entities is not analogous to an accounting vehicle. The choice of business entity carries with it certain advantages and disadvantages and once a taxpayer makes such an election, they are bound by their choice.

(*Moline Properties v. Commissioner* (1943) 319 U.S. 436, 439 (*Moline*); *Maletis, supra*.) Similar to *Moline*, wherein taxpayers elected to operate their business as a corporation and then urged the court to view the corporation as a "mere figmentary agent which should be disregarded in the assessment of taxes," (*Id* at p. 438), this panel declines to view appellants' choice of entity as a mere accounting vehicle.

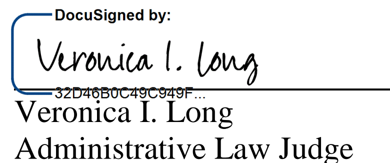
After considering all the evidence in the record, this panel finds that, in substance, Silverado was the seller of the property, and appellants have not shown that they have satisfied the exchange requirement of IRC section 1031(a).

HOLDING

Appellants have not demonstrated that they met the exchange requirement of IRC section 1031 to properly execute a tax-deferred like-kind exchange.

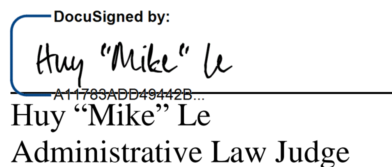
DISPOSITION

FTB's actions, including abatement of the late payment penalty on appeal, are sustained.

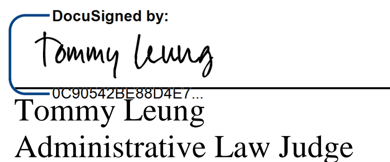


Veronica I. Long
Administrative Law Judge

We concur:



Huy "Mike" Le
Administrative Law Judge



Tommy Leung
Administrative Law Judge

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