2024-OTA-465
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **S.W.S. REALTY, LLC;** **M. SHORAKA;** **K. SHORAKA;** **S. SHORAKA;** **B. SHORAKA;** **S. SHIDFAR; AND** **J. VARJAVAND**	OTA Case Nos. 21088351, 21088354, 21088356, 21088359, 21088360, 21088361

OPINION

Representing the Parties:

For Appellants: David W. Riley, Attorney

For Respondent: Carolyn Kuduk, Tax Counsel III
Marguerite Mosnier, Tax Counsel IV

For Office of Tax Appeals: Nguyen Dang, Tax Counsel III

V. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, S.W.S. Realty, LLC, M. and K. Shoraka,[1] S. Shoraka, B. Shoraka, S. Shidfar, and J. Varjavand (appellants) appeal the following six actions by the Franchise Tax Board (respondent) for the 2010 tax year proposing, respectively: (1) an additional LLC fee and tax totaling $5,790; (2) additional tax of $135,178; (3) additional tax of $50,302; (4) additional tax of $124,122; (5) additional tax of $260,092; (6) additional tax of $172,291; and applicable interest.

Office of Tax Appeals (OTA) Administrative Law Judges Veronica I. Long, John O. Johnson, and Eddy Y.H. Lam held an oral hearing for this matter in Cerritos, California, on June 6, 2023. At the conclusion of the hearing, the record was closed and this matter was submitted for an opinion.

[1] M. and K. Shoraka were married and filed a joint California income tax return for the 2010 tax year.

ISSUE

Whether S.W.S. Realty, LLC's disposition of real property located at Slauson Avenue qualifies for nonrecognition treatment pursuant to Internal Revenue Code (IRC) section 1031.

FACTUAL FINDINGS

1. S.W.S. Realty, LLC (SWS) and T.W.S Realty, LLC (TWS) were flow-through entities commonly owned by M. and K. Shoraka, S. Shoraka, B. Shoraka, S. Shidfar, and J. Varjavand (members).
2. SWS held real property located at Slauson Avenue (Slauson Property).
3. TWS held real property located at North Brand Boulevard (Brand Property).
4. As of December 1, 2009, the Brand Property was encumbered by a debt of $8,949,549.18 (Loan).
5. The Loan had an original maturity date of January 1, 2010.
6. On December 23, 2009, the Loan maturity date was extended to March 1, 2010.
7. On May 19, 2010, the Loan maturity date was again extended to December 1, 2010.[2]
8. On May 26, 2010, SWS engaged a qualified intermediary (QI) for the purposes of executing a tax-deferred, like-kind exchange (Exchange).
9. SWS subsequently transferred the Slauson Property to the QI, and on June 16, 2010, the QI completed the sale of the Slauson Property by transferring the property to a third party for $13 million.
10. After taking into account an adjusted basis of $1,525,831 and closing costs of $238,741, the sale of the Slauson Property resulted in a realized gain of over $11 million.[3]
11. A portion of the proceeds from the sale of the Slauson Property was used to pay off the Loan.
12. On June 17, 2010, SWS identified the Brand Property as the replacement property.
13. On November 30, 2010, SWS acquired the Brand Property from TWS for $14,000,000 through the use of the QI.

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[2] TWS also obtained an option to further extend the maturity date to December 1, 2011, but this option appears to have been removed in a following modification.

[3] In 2012, SWS received an additional $2.6 million in connection with its sale of the Slauson Property, which was reported on its return for that year.

14. Respondent determined that at the time of sale, TWS had an adjusted basis in the Brand Property of $19,221,106.[4]
15. SWS filed its 2010 California LLC return treating the disposition of the Slauson Property as qualifying for partial nonrecognition treatment pursuant to IRC section 1031 and recognizing only $2,551,547 in gain from the sale of the property.
16. Respondent determined that the Exchange did not qualify for nonrecognition treatment because it was structured to avoid the anti-abuse provisions of IRC section 1031(f), which pertains to exchanges of like-kind property between "related persons."
17. Accordingly, respondent issued a Notice of Proposed Assessment (NPA) to SWS increasing its total income to include all the gain realized from the sale of the Slauson Property.[5]
18. Respondent also issued NPAs to the members of SWS for the additional flow-through income resulting from this adjustment.
19. Appellants protested the NPAs and respondent issued Notices of Action affirming its denial of non-recognition treatment for the Exchange.[6]
20. This timely appeal followed.
21. In its opening brief, appellants requested interest abatement for the period September 3, 2015, through February 10, 2020, and, in response, respondent conceded to abate interest for the period September 28, 2015, through February 18, 2019.

DISCUSSION

California generally conforms to IRC section 1031, which is a tax deferral provision pertaining to like-kind exchanges of property held for productive use in a trade or business or for investment (1031 exchange). (R&TC, § 24941.) When the requirements of IRC section 1031 are met, gain or loss realized from the disposition of property relinquished is deferred until such

[4] TWS reported an adjusted basis in the Brand Property of $23,398,888 less depreciation of $1,778,894.

[5] Respondent further determined that SWS had underreported the gain realized from the Exchange by $189,118.

[6] During their protest, appellants argued, and respondent conceded, that the unreported gain from the Exchange should be reduced to $162,225.

time as the property received is disposed of.[7] To preserve the relinquished property's built-in gain or loss for later recognition, the taxpayer must take a carryover basis in the replacement property, increased by any gain required to be recognized and decreased by any money received. (IRC, § 1031(d).) The reason for nonrecognition treatment in a 1031 exchange is that the newly acquired property is viewed as merely a continuation of the taxpayer's prior investment, as opposed to the disposition of one investment for another. (*Commissioner v. P.G. Lake, Inc.* (1958) 356 U.S. 260, 268.)

When a 1031 exchange involves related persons, a two-year holding requirement beginning from the date of the last transfer generally applies to the property received by the taxpayer from a related person or transferred by the taxpayer to a related person. (IRC, § 1031(f)(1).) "Related persons" include, among other things, two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profit interests.[8] (IRC, §§ 1031(f)(3), 267(b), 707(b)(1)(B).) Congress imposed this limitation to curb what it perceived were abuses of 1031 exchanges by related persons to reduce or avoid the recognition of gain or accelerate a loss, on the anticipated sale of property following an exchange. (See *Teruya Bros., Ltd. v. Commissioner* (9th Cir. 2009) 580 F.3d 1038, 1044-1045 (*Teruya Bros.*); see also H.R. No. 101-247, 101st Cong., 1st Sess., p. 1340 (1989) ["if a related party exchange is followed shortly thereafter by a disposition of the property, the related parties have, in effect, 'cashed out' of the investment, and the original exchange should not be accorded nonrecognition treatment"].)

For example, assume Individual A (A) owns Property 1, which has a basis of $1 and a fair market value of $10. A desires to sell Property 1. A's wholly-owned Corporation C (C) owns Property 2 which has a basis of $8 and is worth $10. A and C, who are related persons, complete a 1031 exchange in which C acquires Property 1 in exchange for Property 2. C subsequently sells Property 1. While an outright sale of Property 1 by A would have resulted in $9 of taxable gain, after the 1031 exchange with A, C takes a carryover basis of $8 in Property 1, thereby reducing the taxable gain on the sale of Property 1 to $2 (a $7 difference). Because C is wholly-owned by A, any benefit obtained by C also benefits A. The end result is

[7] Gain must be recognized to the extent that the taxpayer does not receive like-kind property in exchange or cashes out of the investment. (IRC, § 1031(b); Treas. Reg. § 1.1031(b)-1(b).)

[8] It is undisputed that SWS and TWS are related persons within the meaning of this section.

that by engaging in a related party exchange, A has effectively cashed out of Property 1 and deferred $7 of gain.[9] However, the above limitation provided by IRC section 1031(f)(1) does not apply where property in a 1031 exchange is transferred to, or received from, a qualified intermediary. (See IRC, § 1031(f)(1); *Teruya Bros.*, *supra*, 580 F.3d 1038.) As occurred here, qualified intermediaries are commonly employed to facilitate a non-simultaneous 1031 exchange by acquiring the relinquished property from the taxpayer, transferring the relinquished property, acquiring the replacement property, and transferring the replacement property to the taxpayer. (Treas. Reg. § 1.1031(k)-1(g)(4)(iii).) The qualified intermediary is not considered the agent of the taxpayer in a 1031 exchange. (Treas. Reg. § 1.1031(k)-1(g)(4)(i).) Hence, the use of a qualified intermediary means that property in a 1031 exchange is not directly transferred to, or received from, a related person.

To prevent taxpayers from utilizing qualified intermediaries to circumvent the limitations imposed by Congress on related party exchanges, subsection (f)(4) of IRC section 1031 specifies that nonrecognition treatment shall not apply to *any exchange* which is part of a transaction or series of transactions structured to avoid the purposes of IRC section 1031(f). (See also *Teruya Bros.*, *supra*, 580 F.3d 1038, 1045.)

Assume that, in the prior example, instead of C selling Property 1, A sold the property through a qualified intermediary in a non-simultaneous 1031 exchange. No transfer of property occurs between A and C directly. A relinquishes Property 1 to a qualified intermediary who sells the property to a third party. Using the proceeds from the sale of Property 1, the qualified intermediary purchases Property 2 from C and transfers it to A as replacement property. C recognizes $2 of gain on the sale of Property 2 and A defers $9 of gain from the sale of Property 1, resulting in a $7 net tax benefit compared to a direct sale of Property 1. Thus, without the application of subsection (f)(4), by using a qualified intermediary, A and C avoid the limitation set forth in IRC section 1031(f)(1) and obtain tax benefits similar to those of the preceding example.

In determining whether a transaction has been structured to avoid the purposes of IRC section 1031(f), federal courts have compared the actual tax consequences of the transaction to the taxpayer and the related party in the aggregate, to those which would have resulted from a direct sale of the relinquished property by the taxpayer. (See, e.g., *Teruya Bros.*, *supra*, 580 F.3d

[9] This hypothetical transaction would not be allowed where subsection (f)(1) is appropriately applied.

1038, and *Ocmulgee Fields, Inc. v. Commissioner* (11th Cir. 2010) 613 F.3d 1360 (*Ocmulgee Fields*).) As in the preceding examples, where the hypothetical tax from a direct sale of the relinquished property is substantially less than the related parties' aggregate tax resulting from a 1031 exchange, the courts have found the transaction to have been structured to avoid the purposes of IRC section 1031(f). (*Teruya Bros.*, *supra*, 580 F.3d 1038; *Ocmulgee Fields*, *supra*, 613 F.3d 1360.)

Nevertheless, a related party exchange may receive nonrecognition treatment if the taxpayer establishes that neither the exchange nor the disposition of the property received in the exchange had, as one of its principal purposes, the avoidance of federal income tax. (IRC, § 1031(f)(2)(C); see also *Teruya Bros*., *supra*, 580 F.3d 1038, 1047.)

Appellants take issue with respondent's determination that the Exchange should be denied non-recognition treatment due to the application of IRC section 1031(f)(4). Appellants argue the Exchange was not motivated by tax considerations, but instead was undertaken solely to obtain the funds necessary to pay off the Loan prior to the impending maturity date and to avoid a foreclosure of the Brand Property by the lender. Appellants further contend that the Exchange did not result in any tax benefits to SWS or TWS in the aggregate, as evidenced by the fact that defaulting on the Loan would have resulted in a lower tax burden and the Exchange was not a prohibited basis-shifting transaction involving a subsequent disposition of property.

Alternatively, appellants argue that should the Exchange be denied nonrecognition treatment, SWS's basis in the Brand Property should also be increased to reflect its acquisition costs, which would generate additional depreciation deductions of $31,370 for the 2010 tax year and $253,846 for the subsequent tax years through 2021.

When compared to a direct sale of the Slauson Property, the Exchange provided significant tax benefits for both SWS and TWS. SWS deferred $8.6 million in gain from the sale of the Slauson Property and recognized only $2.5 million in gain. The sale of the Brand Property accelerated the recognition of an over $5 million built-in loss for TWS. In contrast, had SWS merely sold the Slauson Property outright, SWS would have been forced to recognize the entire realized gain of over $11 million. The use of a qualified intermediary, therefore, allowed the common owners of SWS and TWS to cash out of their investment in the Slauson Property without full recognition of the resulting gain and to accelerate the recognition of the built-in loss on the Brand Property. These facts indicate that the Exchange was structured to avoid the purposes of IRC section 1031(f). (*Teruya Bros.*, *supra*, 580 F.3d 1038; *Ocmulgee Fields*, *supra*, 613 F.3d 1360.)

Appellants' contentions are unavailing because they fail to address whether the Exchange provided significant tax benefits as compared to a direct sale of the Slauson Property, which is the relevant inquiry under subsection (f)(4). (*Teruya Bros.*, *supra*, 580 F.3d 1038; *Ocmulgee Fields*, *supra*, 613 F.3d 1360.) Even if SWS and TWS could have obtained more favorable tax benefits by allowing the lender to foreclose on the Brand Property, this has no bearing on whether the Exchange provided a tax-advantaged method for appellants to dispose of the Slauson Property. Nor is it relevant, for purposes of subsection (f)(4), that SWS and TWS did not directly swap properties in a basis-shifting exchange prior to disposing of the Slauson Property. (*Malulani Group v. Commissioner* T.C. Memo. 2016-209, affd. (9th Cir. 2019) 771 Fed.Appx. 800 [substantial tax benefits obtained through a related party exchange may demonstrate the presence of a tax-avoidance purpose despite the lack of basis shifting].)

In addition, appellants' stated purpose for disposing of the Slauson Property is insufficient to show that the Exchange itself did not have a tax avoidance purpose. Obtaining the proceeds necessary to repay the Loan required only the disposition of the Slauson Property—and not the subsequent Brand Property acquisition. The record contains no evidence to suggest that once the Loan had been fully paid, the transfer of the Brand Property between two commonly owned entities had any meaningful economic effect or served any useful business purpose for appellants or TWS.

Based on the substantial tax benefits received from the Exchange as compared to a direct sale of the Slauson Property and appellants' failure to establish that the Exchange did not have a tax avoidance purpose, OTA finds that the Exchange should not be accorded nonrecognition treatment pursuant to IRC section 1031(f)(4).

Finally, appellants are correct that absent nonrecognition treatment, SWS's basis in the Brand Property is a higher cost basis (IRC, § 1012(a); R&TC, § 18031), thus entitling SWS to an increased depreciation deduction. The parties agree that the amount of increased depreciation that should be allowed is equal to one and a half months of depreciation of the building less amount of depreciation reported on the original return. The parties agree that 33.78 percent of the property's $14 million dollar basis is allocated to the building, and this amount is divided by

468 months to arrive at $19,809 of depreciation per month.[10] Respondent's proposed assessment for the 2010 tax year failed to account for this item and therefore the proposed assessment should be modified to allow an increased depreciation deduction in the amount of $18,070.[11]

To the extent that an increase in the Brand Property's depreciable basis results in an overpayment of tax for appellants' subsequent tax years, any claims for refund or credit with respect to these overpayments must be filed within the statute of limitations prescribed by R&TC section 19306.[12] Regardless, OTA's jurisdiction in this appeal is limited to appellants' 2010 tax year liabilities. (See Cal. Code Regs., tit. 18, § 30104(a)(1).) Consequently, OTA will not address this contention any further.

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[10] The parties agree on the formula to compute the amount of increased depreciation deduction but arrived at different results. This difference appears to be based on appellants' mathematical error in the amount of basis allocated to the building, however appellants' brief states that 33.78 percent of the $14 million basis is allocable to the land, which is in agreement with FTB. Therefore, OTA will use the remaining 66.22 percent, $9,278,800, as the basis in the building for purposes of computing the increased depreciation deduction.

[11] $19,809 per month depreciation multiplied by 1.5 is $29,714, less the previously reported depreciation of $11,644, results in a $18,070 additional depreciation deduction.

[12] R&TC section 19306(a) provides that no credit or refund shall be allowed unless a claim for refund is filed within one of the following three periods: (1) four years from the date the return was filed, if the return was timely filed within the extended filing period pursuant to an extension of time to file; (2) four years from the due date prescribed for filing the return (determined without regard to any extension of time for filing the return); or (3) one year from the date of the overpayment.

HOLDING

SWS's disposition of the Slauson Property does not qualify for nonrecognition treatment pursuant to IRC section 1031.

DISPOSITION

Respondent's action is modified per its concession on appeal to abate interest for September 28, 2015, through February 18, 2019. As described above, respondent's proposed assessment shall be further reduced to account for an $18,070 increase in the Brand Property's depreciable basis to reflect OTA's finding that the Exchange does not qualify for nonrecognition treatment. Respondent's actions are otherwise sustained.

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Veronica I. Long
Administrative Law Judge

We concur:

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John O. Johnson
Administrative Law Judge

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Eddy Y.H. Lam
Administrative Law Judge

Date Issued: 1/25/2024