OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

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

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: David W. Riley, Attorney

For Respondent: Carolyn S. Kuduk, Attorney

V. LONG, Administrative Law Judge: On January 25, 2024, the Office of Tax Appeals (OTA) issued an Opinion modifying the action of respondent Franchise Tax Board (FTB) for the 2010 tax year.

In the Opinion, OTA modified FTB's proposed assessment per FTB's concession on appeal to abate interest from September 28, 2015, through February 18, 2019, and to reduce M. and K. Shoraka, S. Shoraka, B. Shoraka, S. Shidfar, J. Varjavand, and S.W.S. Realty, LLC's (appellants') proposed assessment to account for an $18,070 increase in the basis of the property located at Brand Boulevard (Brand Property). The Opinion otherwise sustained FTB's proposed assessment. Appellants timely filed a petition for rehearing (petition) under Revenue and Taxation Code (R&TC) section 19048. Upon consideration of appellants' petition, OTA concludes they have not established a basis for rehearing.

OTA may grant a rehearing where one of the following grounds is met and materially affects the substantial rights of the party seeking a rehearing: (1) an irregularity in the proceedings that prevented the fair consideration of the appeal; (2) an accident or surprise that occurred, which ordinary caution could not have prevented; (3) newly discovered, material

evidence, which the filing party could not have reasonably discovered and provided prior to issuance of the written opinion; (4) insufficient evidence to justify the written opinion; (5) the opinion is contrary to law; or (6) an error in law that occurred during the appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6).)

In this case, 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. SWS held property on Slauson Avenue (Slauson Property) while TWS held the Brand Property. As of December 1, 2009, the Brand Property was encumbered by a debt in excess of $8,900,000 with a maturity date of January 1, 2010, which was extended to March 1, 2010, and then again to December 1, 2010. On May 26, 2010, SWS engaged a qualified intermediary (QI) to execute a like-kind exchange. SWS transferred the Slauson Property to the QI and, on June 16, 2010, the QI completed the sale of the Slauson Property by transferring it to a third party for $13 million. After taking into account basis and closing costs, the sale resulted in over $11 million of gain. A portion of these proceeds were used to pay off the loan encumbering the Brand Property.

On June 17, 2010, SWS identified the Brand Property as the replacement property and, on November 30, 2010, SWS acquired the property from TWS for $14 million. SWS filed its 2010 California return and claimed like-kind exchange treatment under Internal Revenue Code (IRC) section 1031[1] and recognized $2,551,547 of gain. FTB determined that the transaction did not qualify for nonrecognition because it was structured to avoid the anti-abuse provisions of IRC section 1031(f) pertaining to exchanges between related persons.

IRC section 1031(f)(4) 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). In determining whether a transaction has been structured to avoid the purpose 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. (*Teruya Bros., Ltd. v. Commissioner* (9th Cir. 2009) 580 F.3d 1038 (*Teruya*); *Ocmulgee Fields, Inc. v. Commissioner* (11th Cir. 2010) 613 F.3d 1360 (*Ocmulgee*).) Nevertheless, a related party exchange may receive nonrecognition treatment if the taxpayer establishes that neither the exchange nor the

[1] California generally conforms to IRC section 1031 pursuant to R&TC section 24941.

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).)

To determine whether the transaction was structured to avoid IRC section 1031(f), the Opinion compared the tax consequences of SWS's attempted like-kind exchange to an outright sale of the Slauson Property. In determining that the attempted changes provided significant tax benefits for SWS and TWS, the Opinion reasoned that SWS deferred $8.6 million in gain from the sale of the Slauson Property and recognized only $2.5 million in gain, and the sale of the Brand Property accelerated the recognition of a $5 million built-in loss for TWS. The Opinion stated that, 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 Opinion then determined that the use of the QI 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 accelerated the recognition of the built-in loss on the Brand Property. For this reason, the Opinion determined that the attempted like-kind exchange was structured to avoid the purpose of IRC section 1031(f) and should not be accorded nonrecognition treatment.

Appellants assert that there was insufficient evidence to justify the opinion, that the Opinion was contrary to law, and that the Opinion contained errors of law. OTA will address each of these assertions in turn.

Insufficiency of Evidence or Contrary to Law

California Code Regulations, title 18, section 30604(a)(4)-(5) provides that a rehearing may be granted on two distinct grounds of insufficiency of the evidence to justify the opinion, or the opinion is contrary to law. (*Appeal of Swat-Fame Inc., et al.*, 2020-OTA-045P.) To find that there is an insufficiency of evidence to justify the opinion, OTA must find that, after weighing the evidence in the record, including reasonable inferences based on that evidence, the panel clearly should have reached a different opinion. (*Ibid.*) To find that the opinion is contrary to law, OTA must determine whether the opinion is "unsupported by any substantial evidence." (*Ibid.*, citing *Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906 (*Sanchez-Corea*).[2])

[2] As provided in *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654, it is appropriate for OTA to look to Code of Civil Procedure section 657 and applicable caselaw as relevant guidance in determining whether a ground has been met to grant a new hearing.

This requires a review of the opinion to indulge in "all legitimate and reasonable inferences" to uphold the opinion. (*Ibid.*, citing *Sanchez-Corea, supra*, at p. 907.)

Appellants assert that there was insufficient evidence to justify the Opinion and that the Opinion was contrary to law because the facts of appellants' exchange are similar to Revenue Ruling 2002-83. Revenue Ruling 2002-83 provides that a taxpayer who transfers relinquished property to a QI in exchange for replacement property formerly owned by a related party is not entitled to nonrecognition treatment under IRC section 1031 if, as a part of the transaction, the related party receives cash or other non-like-kind property for the replacement property. Appellants assert that, because TWS received a promissory note for monthly payments rather than a cash payment, the transaction does not violate the revenue ruling because appellants did not "cash out" of their investment.

Appellants' literal reading of the term "cash out" is unavailing; to "cash out" of an investment means to liquidate or dispose of an asset or investment,[3] and does not require receipt of cash. A review of the Opinion shows that its determination is supported by substantial evidence in the record. Accordingly, appellants have not established that there was insufficient evidence to justify the Opinion or that the Opinion is contrary to law.

Errors in Law

California Code Regulations, title 18, section 30604(a)(6) provides that a rehearing may be granted where there is an error in law in the OTA appeals hearing or proceeding. A claim on a petition for rehearing that that there was an error in law is a claim of a procedural wrong. (*Appeal of Swat-Fame Inc., et al., supra*.) For example, courts have found an error in law occurred when there was an erroneous ruling on the admission or rejection of evidence.[4]

Appellants contend that the Opinion erred as a matter of law by incorrectly stating that TWS received a $5,000,000 deductible loss on the sale of the Brand Property. However, this contention cannot constitute an error in law because it is not an assertion of a procedural wrong. Accordingly, it will instead be addressed as a contention that the Opinion is contrary to law. To find that the opinion is contrary to law, OTA must determine whether the opinion is

[3] See, e.g., *North Central Rental & Leasing, LLC ex rel. Butler v. U.S.* (8th Cir. 2015) 779 F.3d 738.

[4] *Nakamura v. Los Angeles Gas & Elec. Corp.* (1934) 137 Cal.App. 487.

"unsupported by any substantial evidence." (*Appeal of Swat-Fame Inc., et al.*, *supra*., citing *Sanchez-Corea*, *supra*.)

The Opinion compared the attempted exchange to the tax consequences of a direct sale of the Slauson Property and determined that the attempted exchange accelerated the recognition of over a $5 million built-in loss for TWS. This is because at the time of sale, TWS had an adjusted basis in the Brand Property of over $19 million, and SWS paid $14 million for the Brand Property through the QI. While IRC section 267(a) does not permit deductions as a result of the exchange of property between related taxpayers, the loss is preserved against future gain because the property will have a carryover basis in the hands of SWS. (See IRC, § 267(d).) Accordingly, appellants have not established that the Opinion is unsupported by substantial evidence.

Appellants also contend that the Opinion erred as a matter of law by citing to *Teruya* and *Ocmulgee* for the proposition that, when evaluating whether a transaction has been structured to avoid IRC section 1031(f), federal courts compare the tax consequences of a transaction to the taxpayer and the related party in the aggregate to the consequences that would have resulted from a direct sale.[5] Appellants contend that *Teruya* and *Ocmulgee* did not use this language, but instead used "common sense" to determine that there was a tax benefit, and that the Opinion did not identify a tax benefit from appellants' attempted transaction.

The Opinion compared the tax consequences of a transaction to the taxpayer and the related party in the aggregate to the consequences that would have resulted from a direct sale, and found that the use of a QI, 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. Based on this, appellants have not established that the Opinion was unsupported by any substantial evidence.

[5] As with appellants' previous contention, this contention cannot constitute an error in law because it is not an assertion of a procedural wrong. Accordingly, OTA will evaluate the contention to determine whether the Opinion is contrary to law.

Accordingly, OTA finds that appellants have not established a basis for rehearing.

Signed by:
Veronica I. Long
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Veronica I. Long
Administrative Law Judge

We concur:

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Andrew Wong
Administrative Law Judge

DocuSigned by:
Lissett Cervantes
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For Sara A. Hosey
Administrative Law Judge

Date Issued: 8/9/2024