

After the parties submitted additional briefing, the record was closed and this matter was submitted for decision.

ISSUES⁴

1. Whether the sale of a limited liability company (LLC) membership interest should be disregarded for tax purposes under the economic substance doctrine.
2. Whether appellants are entitled to claim a business loss deduction pursuant to Internal Revenue Code (IRC) section 165 on the sale of real property.

FACTUAL FINDINGS

1. As of January 1, 2010, appellant B. Richards (Richards) owned 100 percent of Nottingham Gate Lone Star W, LLC, a Texas LLC (Nottingham), through his revocable living trust. Nottingham was a disregarded entity for income tax purposes.
2. Nottingham owned a 372-unit apartment complex located in Houston, Texas (the Property), which it purchased in March 2007 for \$11,780,000.
3. After purchasing the Property, Richards learned that the seller fraudulently misrepresented the Property's rental income and occupancy rate.
4. Richards subsequently requested relief from the note holder, Bank of America. In July 2010, Bank of America canceled a portion of the note and issued a Form 1099-C, *Cancellation of Debt*, to Nottingham for \$5,657,551.75.⁵
5. On August 3, 2010, Nottingham listed the Property for sale.
6. Nottingham received an offer to purchase the Property from an individual named Kumar. On November 15, 2010, after a brief due diligence period, Kumar determined that the Property was not acceptable to him and terminated the agreement.

⁴ At the prehearing conference, appellants stated that a third issue on appeal is whether income from cancellation of debt should be excluded from income under Internal Revenue Code (IRC) section 108. However, at the hearing, appellants clarified that they are not asserting that IRC section 108 applies. Rather, they claim that the sale of the LLC interest was not solely tax-motivated because appellant B. Richards could have elected to apply IRC section 108 instead of selling the LLC interest. Accordingly, OTA need not address, as a separate issue, whether IRC section 108 applies in this appeal.

⁵ Appellants asserts that Bank of America canceled a portion of the debt because Richards had relied upon Countrywide (the former note holder, later acquired by Bank of America) to "perform proper due diligence" on its approval of the original purchase loan. The record does not contain documents supporting this claim.

Asset Sales Agreement

7. On or about November 17, 2010, Nottingham received a letter of intent to purchase the Property from an individual named Premji. Richards signed the letter of intent.
8. On or about December 7, 2010, Nottingham and Premji entered into a Purchase and Sale Agreement (Asset Sales Agreement), whereby Premji agreed to purchase the Property for \$5,460,000. The Asset Sales Agreement noted that the Property had fire damage and that Premji's purchase of the Property was subject to lender approval. Richards signed the Asset Sales Agreement on behalf of Nottingham.
9. A "Critical Dates Memorandum" clarified that the escrow closing date was "[t]he earlier of 15 days following the receipt of Lender Approval but not later than March 9, 2011."

Membership Sales Agreement

10. On December 10, 2010, three days after the Asset Sales Agreement was executed, Richards signed a Sale, Transfer, and Assignment of Membership Interest Agreement (Membership Sales Agreement) with appellant G. Hecker (Hecker), his business partner in other transactions, whereby Hecker agreed to purchase Richards' 100 percent LLC interest in Nottingham.⁶
11. The purchase price from the Membership Sales Agreement was primarily structured as follows: (1) the Property would remain subject to Bank of America's mortgage, which at the time totaled \$3,634,385; (2) if Hecker sold the Property on or before June 10, 2011, for a sales price of \$4,485,000 or less, the net proceeds would be paid to Richards; (3) if Hecker sold the Property on or before June 10, 2011, for a price greater than \$4,485,000, the net proceeds in excess of \$4,485,000 would be paid to Hecker; and (4) if Hecker sold the Property after June 10, 2011, all net proceeds would be paid to Hecker.
12. In a June 30, 2014 letter, appellants' CPA stated that the purchase price was structured to protect Richards from "losing the profit of the Premji sale should it close."

⁶ The record contains a Texas Franchise Tax Public Information Report (PIR) for Nottingham signed by Hecker as manager on December 22, 2010. The PIR names an entity called Jiro Incorporated as a member. The Membership Sales Agreement does not reference Jiro Incorporated.

Amendments to the Asset Sales Agreement

13. On December 27, 2010, Nottingham and Premji executed an amendment to the Asset Sales Agreement, which stated that the Property's purchase price is \$5,285,000 (a reduction of \$175,000 from \$5,460,000). Hecker signed the first amendment on behalf of Nottingham.
14. On February 1, 2011, Nottingham and Premji executed a second amendment to the Asset Sales Agreement, which stated that Premji would receive an \$800,000 credit at closing, but that Nottingham would retain all rights to any fire insurance proceeds in exchange. Hecker signed the second amendment on behalf of Nottingham.
15. On February 4, 2011, Nottingham and Premji executed a third amendment to the Asset Sales Agreement, which stated that the Property's purchase price would be reduced to \$4,485,000, but that Premji would no longer receive a credit of \$800,000 at closing. Hecker signed the third amendment on behalf of Nottingham.

Negotiations During the Sale of the Property

16. From December 21, 2010, through February 3, 2011, Richards and his attorney sent numerous emails to the escrow company and Premji's attorney regarding the transaction, including emails concerning price reductions, the condition of the Property, rent rolls, and closing costs. Hecker was not copied on those emails.

Close of Escrow

17. On February 7, 2011, escrow closed on the sale of the Property for a sales price of \$4,485,000.
18. After paying off the Bank of America debt, and satisfying other transaction fees and costs, net proceeds of \$640,461.41 were wired to Nottingham's Wells Fargo Bank account. The net proceeds of \$640,461.41 were then transferred to Richards.

Tax Filing and Procedural History: Richards and G. Cariste

19. On their joint 2010 California Resident Income Tax Return (Form 540), Richards and G. Cariste reported cancellation of debt (COD) income of \$5,657,552 and a loss of \$8,410,207 from the sale of a building (even though the loss was from the sale of the LLC interest, not the Property).

20. On their joint 2011 California Resident Income Tax Return, Hecker and J. Hecker reported a gain of \$71,899 from the sale of the Property and a loss of \$260,163 related to the rental of the Property.
21. On audit, FTB determined that Richards' sale of the LLC interest to Hecker lacked economic substance. FTB issued a Notice of Proposed Assessment (NPA) to appellants Richards and G. Cariste, proposing additional tax of \$601,416 and a NEST penalty of \$312,860, plus applicable interest, for the 2010 tax year. Richards and G. Cariste filed a timely protest. FTB affirmed the NPA in a Notice of Action (NOA). This timely appeal followed.⁷
22. FTB issued an NPA to Hecker and J. Hecker, proposing additional tax of \$12,079, plus applicable interest, for the 2011 tax year. Hecker and J. Hecker filed a timely protest. FTB affirmed the NPA in an NOA. This timely appeal followed.

Lawsuit In Texas Court

23. After filing this appeal in August 2020, on February 4, 2021, Hecker filed a lawsuit against Richards in the District Court of Harris County, Texas, seeking a declaration clarifying title to the Property. The Texas court determined on summary judgment that under Texas civil law, the sale of the LLC interest to Hecker in 2010 was: (1) a valid business transaction, (2) resulted from arms-length negotiations, (3) supported by adequate consideration to both parties, (4) consummated on commercially reasonable business terms, (5) for a valid business purpose, and (6) is not subject to being set aside based on the facts or applicable law.

DISCUSSION

Issue 1: Whether the sale of an LLC membership interest should be disregarded for tax purposes under the economic substance doctrine.

FTB's determination is generally presumed to be correct, and a taxpayer bears the burden of proving otherwise. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Bindley*,

⁷ Per footnote 1, FTB agrees to waive the NEST penalty and not to impose the accuracy-related penalty.

2019-OTA-179P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of Bindley, supra.*)

The economic substance and sham transaction doctrines are judicial doctrines developed to prevent a taxpayer from reaping tax benefits from a transaction that lacks economic substance. (See *Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360 (*Casebeer*); *Appeal of La Rosa Capital Resources, Inc.*, 2020-OTA-220P.) There are two types of shams: a sham in fact and a sham in substance. A sham in fact is a transaction that never occurred, while a sham in substance is a transaction that occurred but lacks the substance its form represents. (*Kirchman v. Commissioner* (11th Cir. 1989) 862 F.2d 1486, 1492.) In determining whether a transaction is a sham, courts have developed a two-part analysis: (1) whether the taxpayer has demonstrated a business purpose for engaging in the transaction other than tax avoidance; and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits. (*Casebeer, supra*, 909 F.2d at p. 1363; *Appeal of Alyn* (2009-SBE-001) 2009 WL 2340393.) This is not a rigid two-step analysis, but rather factors that are weighed to determine whether the transaction had any practical economic effects other than the creation of tax losses. (*Casebeer, supra*, 909 F.2d at p. 1363.)⁸

The business purpose factor involves an examination of the subjective factors that motivated the taxpayer to engage in the transaction at issue. (*Casebeer, supra*, 909 F.2d at p. 1364.) The economic substance factor looks at whether the substance of a transaction reflects its form and involves an examination of whether the transaction was objectively capable of creating a profit or affecting the taxpayer's financial situation. (*Id.* at p. 1365.)

The transaction to be analyzed is the one that gave rise to the alleged tax benefit. (*Coltec Industries, Inc. v. United States* (Fed. Cir. 2006) 454 F.3d 1340, 1356.) A lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance. (*Id.* at p. 1355.) A taxpayer bears the burden of proving that the transaction has economic substance. (*Ibid.*)

⁸ Appellants contend that IRC section 7701(o) created a new standard for determining whether a transaction lacks economic substance. However, IRC section 7701(o) expressly defines "economic substance doctrine" as the "common law doctrine under which tax benefits . . . with respect to a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose." Because IRC section 7701(o) defines economic substance doctrine as the common law doctrine, IRC section 7701(o) does not replace or modify the common law doctrine used to analyze whether a transaction lacks economic substance. IRC section 7701(o) applies only to the penalty provision in R&TC section 19774.

Here, on December 6, 2020, Richards signed an Asset Sales Agreement on behalf of Nottingham (a wholly owned and disregarded LLC) to sell the Property to Premji. The sale of the Property was subject to lender approval. As stated in the Critical Dates Memorandum, the sale was likely to close in 2011, the following tax year. Three days after signing the Asset Sales Agreement, Richards sold his interest in Nottingham to Hecker, his business partner, at a loss. The loss offset Richards' COD income in 2010. The question before OTA is whether the sale of the LLC interest lacked economic substance. The answer depends on who in substance, and not simply in form, made the sale of the Property to Premji.

There is an extensive body of case law holding that in certain circumstances the transfer of property followed by a sale will be treated for tax purposes as a sale by the transferor. For example, in *Commissioner v. Court Holding Co.* (1945) 324 U.S. 331 (*Court Holding Co.*), the taxpayers wound up their corporation, transferred the corporation's sole asset, an apartment building, to themselves as a liquidating dividend, then sold the building to a third party. The United States Supreme Court upheld the Tax Court's finding that, in a real-world economic sense, the corporation sold the building directly to the buyer. (*Id.* at pp. 333-34.)

In *U.S. v. Cumberland Public Service Co.* (1950) 338 U.S. 451, the United States Supreme Court clarified its decision in *Court Holding Co.* as follows:

[In *Court Holding Co.*,] the corporation had negotiated for sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corporation purported to "call off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the corporation. The terms of purchase were substantially those of the previous oral agreement. One thousand dollars already paid to the corporation was applied as part payment of the purchase price. The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidation was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability.

(*Id.* at pp. 453-54.)

Here, like in *Court Holding Co.*, Richards continued to negotiate the sale of the Property with Premji and Premji's representatives after selling his interest in his wholly owned and disregarded LLC to his partner Hecker. For example, in an email dated February 3, 2011, Richards wrote "[h]ere is the proof of payment for prop[erty] taxes. Also you need to credit me

on the closing statement for 1/2 the prepayment penalty and debit buyer.” (Emphasis added.) Hecker was not copied on those emails. In addition, the transaction closed for \$4.485 million, the exact amount that would determine if Hecker, the transferee owner of the LLC interest, earned a profit on the sale of the Property. Indeed, appellants’ CPA stated in a letter dated June 30, 2014, that the purchase price was structured to protect Richards from “losing the profit of the Premji sale should it close.” Based on these facts, OTA finds that the sale of the LLC interest lacked economic substance with respect to the sale of the Property to Premji.

With respect to the Texas court’s holding on summary judgment that the transaction had a valid business reason under Texas civil law, the court’s holding does not determine how the transaction should be treated for California tax purposes. California can apply tax law according to the substance of the transaction. (See, e.g., *Furman v. Commissioner* (1966) 45 T.C. 360, 364 [“a finding of validity under state Law, however, does not mean that the trust will necessarily be recognized for tax purposes”].)

Accordingly, OTA finds that, with respect to the sale of the Property to Premji, the sale of the LLC interest should be disregarded for tax purposes.

Issue 2: Whether appellants are entitled to claim a business loss deduction pursuant to IRC section 165 on the sale of real property.

Income tax deductions are a matter of legislative grace, and a taxpayer who claims a deduction has the burden of proving by competent evidence that he or she is entitled to that deduction. (*Appeal of Silver*, 2022-OTA-408P.) To meet that burden, a taxpayer must point to an applicable statute and show by credible evidence that the transactions in question come within its terms. (*Appeal of Jindal*, 2019-OTA-372P.) Unsupported assertions cannot satisfy a taxpayer’s burden of proof. (*Appeal of Silver*, *supra*.)

IRC section 165(a)⁹ provides, in part, that “there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.”

Section 165(c) limits an individual’s deduction for losses pursuant to Section 165(a) to:

(1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses of property not connected

⁹ IRC section 165 is generally incorporated into California law at R&TC sections 17201(a), 17204, and 17207 through 17207.14.

with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Appellants Richards and G. Cariste have failed to provide any evidence to substantiate that IRC section 165 applies. Their unsupported assertions cannot satisfy their burden of proof. (*Appeal of Jindal, supra.*) Therefore, appellants Richards and G. Cariste have not demonstrated that they are entitled to report a loss under IRC section 165.¹⁰

HOLDINGS

1. The sale of an LLC membership interest should be disregarded for tax purposes under the economic substance doctrine.
2. Appellants are not entitled to claim a business loss deduction pursuant to IRC section 165 on the sale of real property.

DISPOSITION

FTB's actions are sustained, as modified to abate the NEST penalty for the 2011 tax year, consistent with FTB's concession on appeal.

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Ovsep Akopchikyan

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Ovsep Akopchikyan
Administrative Law Judge

We concur:

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Asaf Kletter

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Asaf Kletter
Administrative Law Judge

DocuSigned by:

Eddy Y.H. Lam

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Eddy Y.H. Lam
Administrative Law Judge

Dated: 3/18/2024

¹⁰ To the extent appellants raise other arguments that this Opinion does not specifically address, this panel has reviewed those arguments and considers them unpersuasive.