



F. Kanani and J. Abrams	2016	\$1,106,399
	2017	(\$35,250)
	2018	(\$139,551)

Office of Tax Appeals (OTA) Panel Members Veronica I. Long, Keith T. Long, and Seth Elsom held a virtual oral hearing for this matter on April 24, 2025. At the conclusion of the hearing, the record was closed. On April 25, 2025, the record was reopened to allow for the submission of additional evidence and briefing. On August 27, 2025, the record was closed and this matter was submitted for an Opinion pursuant to California Code of Regulations, title 18, section 30209(b).

ISSUES

1. Whether appellants must recognize taxable boot in relation to an Internal Revenue Code (IRC) section 1031 exchange.<sup>1</sup>
2. Whether appellants have demonstrated a basis to abate interest.

FACTUAL FINDINGS

1. EWV is a limited liability company (LLC) with three members; appellants A. Abady, S. Hashem, and F. Kanani.
2. In 2016, EWV obtained a loan for \$7.7 million and acquired property in Pasadena, California (Pasadena Property).

Exchange

3. On October 20, 2016, EWV's Qualified Intermediary (QI) sold the Pasadena Property for \$13.4 million.<sup>2</sup> The closing statement shows that the \$7.7 million loan was repaid from the proceeds, and the proceeds were used for miscellaneous sales expenses including title fees and escrow charges. The remaining \$5,045,107.83 of cash went to the QI.

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<sup>1</sup> Boot is defined as the money, debt relief, or the fair market value of other property received by the seller in an exchange in addition to replacement property. (*Appeal of Jacqueline Mairghread Patterson Trust*, 2021-OTA-187P.) Although an IRC section 1031 exchange allows for deferral of gain or loss, any boot received in the exchange is taxable in the year received. (*Ibid.*)

<sup>2</sup> The third-party buyer also paid miscellaneous expenses, including prorated taxes, totaling an additional \$197,992.56.

4. On December 15, 2016, the QI purchased real property in Renton, Washington (Renton Property) on EWV's behalf for \$54.5 million.<sup>3</sup> The closing statement reflected credit for a \$54 million loan from American National Insurance Company (ANIC), QI deposits totaling \$800,000, and a deposit of \$500,000 from A. Abady Trust. Debits on the closing statement included "New Loan Charges" from ANIC including:<sup>4</sup>
  - a. 1% Prepayment Fee to ANIC of \$540,000<sup>5</sup>
  - b. Tenant Improvement and Leasing Commission Escrow Fund to ANIC of \$2,993,099.35
  - c. Capital Improvement Escrow Fund to ANIC of \$1,500,000
5. EWV entered into two promissory notes with ANIC dated December 15, 2016; one for \$45.5 million (ANIC Loan 1) and the other for \$8.5 million (ANIC Loan 2), both secured by the Renton Property. The notes required EWV to pay ANIC a fee equal to 1% of the principal balance of both notes on or before the recording date of the Renton Property. Payment of the Prepayment Fee enabled EWV to prepay the promissory notes.
6. EWV entered into two agreements with ANIC, both dated December 15, 2016; a Tenant Improvement and Leasing Commission Escrow Agreement (TI Agreement) and a Capital Improvements Escrow Agreement (CapEx Agreement).

#### TI Agreement

7. The TI Agreement recitals required appellant to deposit \$993,099.35 of separate funds and \$2 million of loan funds into a TI Escrow Fund for the purpose of funding tenant improvements and leasing commissions on the Renton Property. The TI Escrow Fund would be held as collateral for the underlying loans and either disbursed to EWV, subject to certain restrictions, or applied against the promissory notes and ANIC's expenses incurred under the TI Agreement.

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<sup>3</sup> EWV formed a single member LLC (SMLLC) to hold the Renton property, called Renton Office Park, LLC, which is a disregarded entity for tax purposes. Accordingly, it will not be mentioned further in this Opinion.

<sup>4</sup> Appellants also paid other expenses of the exchange, including title charges, EWV's legal fees, and prorated property taxes, which are not in dispute.

<sup>5</sup> EWV also paid \$341,250 of ANIC's legal fees. This payment was not included in the closing statement.

8. Section 1(a) states that beginning February 15, 2017, and on the 15th of each succeeding month, EWV will deposit \$27,032 of additional funds into the TI Escrow Fund to be held by ANIC.
9. Section 1(c) states that the objective of the TI Escrow Fund is to provide EWV with a funding mechanism for approved tenant improvements and leasing commissions related to future leases, to provide ANIC with collateral and, in certain events, to provide ANIC with immediately available funds.
10. Section 1(d) instructs ANIC to hold the TI Escrow Fund in an unsegregated, non-interest-bearing account.
11. Section 3(a) states that the TI Escrow Fund may only be used for leasing commissions and tenant improvements. For a leasing commission to be disbursed, the lease must be “reasonably satisfactory” to ANIC and have an initial term of at least five years. For either tenant improvements or leasing commissions to be disbursed, ANIC must be notified in advance in writing. Disbursements must be made within ten days after ANIC’s receipt and approval, “not to be unreasonably withheld, conditioned, or delayed” of EWV’s request for disbursement, and after occurrence or satisfaction of subsections (b)-(e) (the “TI Escrow Disbursement Conditions”).
12. TI Escrow Disbursement Conditions:
  - a. Section 3(b) provides that disbursement shall be made only after EWV has delivered to ANIC a fully executed lease agreement that is “reasonably satisfactory” to ANIC.
  - b. Section 3(c) states that disbursements for leasing commissions may be made incrementally, with up to half of the commission disbursed on the execution of the lease and the remainder to be disbursed when the remaining TI Escrow Disbursement Conditions are satisfied. The subsection states no disbursement shall be made unless: EWV has demonstrated to ANIC’s satisfaction, “not to be unreasonably withheld,” that the tenant improvements were performed and completed; if required, EWV has delivered to ANIC a lien release for the work performed; if requested, photos of the work are provided to ANIC; EWV has paid ANICs reasonable attorney’s fees and expenses, if any, incurred in connection with the TI Escrow Fund; EWV delivers a certificate of occupancy to ANIC; with respect to final disbursements, that EWV has delivered an updated estoppel certificate from the applicable tenant in a form and manner reasonably satisfactory to ANIC; EWV delivers a subordination, non-disturbance, and attorney agreement reasonably

- acceptable to ANIC signed by the applicable tenant; and that the other requirements of Section 3(e) are met.
- c. Section 3(d) provides that no disbursement shall be made until EWV has paid ANIC's reasonable attorneys' fees and expenses, if any, incurred in connection with the TI Escrow Fund or TI Agreement.
  - d. Section 3(e) provides that no disbursements shall be made if at the time of the disbursement request, EWV is in default on its loans from ANIC or the requirements of Section 3 are not satisfied.
13. Section 3(f) provides that the \$953,099.35 portion of the TI Escrow Fund will be paid to, on behalf of, or for the benefit of a specific tenant for improvements in accordance with that tenant's existing lease under similar disbursement restrictions as stated in Section 3(c).
14. Section 4(c) provides that when the promissory notes are repaid, any remaining amount in the TI Escrow Fund will be paid to EWV.
15. Section 5 provides that ANIC may immediately draw on the TI Escrow Fund if certain circumstances occur (a "Draw Event"), such as if EWV is in default on the payment of the loans or otherwise breaches its contract with ANIC. If ANIC draws on the funds, it may apply the funds towards reasonable costs and expenses, repayment of the loan, and similar expenses. Section 5(c) states that it is the intention of EWV and ANIC that ANIC have the unconditional immediate right to draw on the TI Escrow Fund at any time if a Draw Event occurs.

#### CapEx Agreement

16. Many sections of the CapEx Agreement are substantially similar, if not identical, to the TI Agreement, including the recitals, Sections 1(c)-(d), 4(c), and 5.
17. The CapEx Agreement recitals provide that EWV will deposit \$1.5 million of the loan proceeds from ANIC into a CapEx Escrow Fund to be used for capital improvements and leasing commissions. The CapEx Escrow Fund would be held as collateral for the underlying loans and either disbursed to EWV or applied against the promissory notes and ANIC's expenses incurred under the CapEx Agreement.
18. Section 1(a) states that beginning February 15, 2017, and on the 15th of each succeeding month, EWV will deposit \$9,458 of additional funds into the CapEx Escrow Fund to be held by ANIC.

19. Section 3(a) states that disbursements from the CapEx Escrow Fund shall be made for only capital expenditures and must be: approved in writing in advance by ANIC in ANIC's "reasonable discretion, not to be unreasonably withheld, conditioned or delayed;" made only after EWV has demonstrated to ANIC's satisfaction, "not to be unreasonably withheld, conditioned or delayed" that the work has been completed in "good and workman-like manner;" if requested, EWV has delivered lien releases to ANIC; if requested, EWV has delivered such other reasonable information and documentation concerning progress and quality of the work performed; and if applicable, EWV has paid ANIC's attorneys fees incurred in connection with the CapEx Escrow Fund. ANIC's approval and consent must be in writing and disbursements shall be made within ten days of: receipt and approval by ANIC, "not to be unreasonably withheld, conditioned or delayed"; and occurrence or satisfaction of subsections (b)-(c) (the "CapEx Escrow Disbursement Conditions").
20. CapEx Escrow Disbursement Conditions:
  - a. Section 3(b) provides that no disbursement shall be made until EWV has paid ANIC's reasonable attorneys' fees and expenses, if any, incurred in connection with the CapEx Escrow Fund or CapEx Agreement.
  - b. Section 3(c) provides that no disbursements shall be made if at the time of the disbursement request, EWV is in default on its loans from ANIC or the requirements of Section 3 are not satisfied.

#### Tax Filings

21. EWV reported the exchange on Form 3840 and Form 8824. EWV reported that the relinquished property sold for \$13.4 million with \$542,009 of sales expenses. EWV reported an adjusted basis in the relinquished property of \$6,439,339, for a realized gain of \$6,418,652.
22. EWV reported the fair market value of the replacement property as \$54.5 million and adjusted basis in the relinquished property, net of amounts paid to the other party plus exchange expenses, of \$48,081,349, for a total deferred gain of \$6,418,561.

#### Procedural Matters

23. FTB issued EWV a Notice of Proposed Assessment (NPA) proposing to increase its income by \$5,531,998 based on receipt of taxable boot, resulting in additional LLC fees of \$9,290.

24. The proposed assessment flowed through to EWW's members, and appellants A. and M. Abady, S. and F. Hashem, and F. Kanani and J. Abrams received either NPAs or Notices of Proposed Adjusted Carryover Amounts (NPACAs) and a proposed reduction in claimed Passive Activity Losses (PALs), depending on their personal tax attributes and reporting.
25. Appellants protested the NPAs and NPACAs. FTB affirmed the notices and issued Notices of Action (NOAs). This timely appeal follows.

### DISCUSSION

In 2016, EWW exchanged the Pasadena Property for the Renton Property for \$54.5 million. EWW obtained loans for \$45.5 million and \$8.5 million. The parties agree that ANIC Loan 1 and at least \$4 million of ANIC Loan 2 were used towards the purchase. From here, the parties' views diverge. EWW contends ANIC Loan 2 was bifurcated; \$4 million went towards the purchase price and the remaining \$4.5 million was placed in the TI and CapEx Escrow Funds (collectively, "Escrow Funds") for future improvements and leasing commissions. Under EWW's approach, approximately \$5 million of the Pasadena Property's sales proceeds were invested in the Renton Property. FTB views the entire \$8.5 million of ANIC Loan 2 as going towards the purchase price and thus, views EWW as trading down in equity and directly or constructively receiving \$4.5 million of the Pasadena Property's sales proceeds. Thus, the dispute in this appeal is whether the following items constitute taxable boot to EWW: (1) the Escrow Funds, (2) the 1% Prepayment Fee to ANIC of \$540,000, and (3) the payment of \$341,250 of ANIC's legal fees. Appellants also request interest abatement.

Issue 1: Whether appellants must recognize taxable boot in relation to an IRC section 1031 exchange.

#### Burden of Proof

An FTB determination is generally presumed to be correct, and a taxpayer bears the burden of proving otherwise. (*Appeal of F.A.R. Investments, Inc. and Arciero & Sons, Inc.*, 2022-OTA-395P.) 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.) Generally, under IRC 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); *Appeals of Troublefree, LLC and Sutton*, 2024-OTA-078P.) Thus, under IRC section 1031(b), if a taxpayer exchanges like-kind property for other like-kind property and satisfies the general requirements of IRC section 1031, but also receives cash, the cash is taxable to the extent that the taxpayer realizes gain on the transaction.

#### Actual or Constructive Receipt of the Escrow Funds

Under IRC section 1031, a taxpayer generally has actual receipt when the taxpayer receives the money or property or its benefit. (Treas. Reg. § 1.1031(k)-1(f)(2).) A taxpayer has constructive receipt when the money or property is credited to the taxpayer’s account, set aside for the taxpayer, or made available so that the taxpayer can draw on it with notice. (*Ibid*; *Appeal of Lovinck Investments N.V., et al.*, 2021-OTA-294P.) However, a taxpayer does not have constructive receipt if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions. (Treas. Reg. § 1.1031(k)-1(f)(2).) Except as otherwise provided by the regulations to IRC section 1031, the determination of whether a taxpayer actually or constructively received money is made under the general rules of actual and constructive receipt. (*Ibid*.)

#### *Fredericks v. Commissioner*

The tax court considered the issues of actual and constructive receipt in the context of a like-kind exchange in *Fredericks v. Commissioner*, T.C. Memo. 1994-27 (*Fredericks*). In *Fredericks*, the taxpayer purchased Wildridge, an apartment complex, in 1980 using an 18-month wrap-around note. In late 1980, the taxpayer began looking for long-term financing to replace the wrap-around note. In 1981, the taxpayer entered into an option to buy another property, the Buellton property, from a third-party seller. In 1982, the taxpayer extended the option on the Buellton property and paid for the extension through his wholly-owned corporation. In April of 1983, the taxpayer signed a loan commitment letter with a bank to refinance the Wildridge wrap-around note. On May 27, 1983, the taxpayer signed a promissory note for \$6 million and executed a deed of trust in favor of the bank for the refinancing. On June 2, 1983, the loan transaction settled and the taxpayer received net loan proceeds in excess of \$2 million.

While the refinancing arrangement was ongoing, on May 20, 1983, the taxpayer entered into an agreement to sell Wildridge to a third-party buyer. The agreement required the buyer to: deposit \$200,000 into an escrow account with the title company, assume certain debt obligations, execute a promissory note and deed of trust in favor of the seller, and, at the close of escrow, pay the balance of the purchase price and the \$200,000 deposit held in escrow to the seller. The agreement permitted the taxpayer to first exchange Wildridge with his wholly-owned corporation which then sold the property to the buyer. The agreement provided that, in the event the sale did not occur, the escrow would terminate and the deposit would revert to the buyer. The buyer deposited \$200,000 into an escrow account with the title company the same day that the agreement was executed.

On June 10, 1983, the taxpayer entered into an agreement with his wholly-owned corporation to exchange Wildridge for the Buellton property. On June 27, 1983, the taxpayer and Wildridge's buyer agreed to amend their escrow instructions to direct the title company to release the \$200,000 deposit to the seller subject to the title company receiving a signed extension of the purchase agreement through July 29, 1983. The same day, the taxpayer conveyed Wildridge to his wholly-owned corporation in exchange for the Buellton property, and the corporation completed the pre-planned sale of Wildridge to the third-party buyer.<sup>6</sup> Three days after the property was conveyed to the buyer, the title company released the escrow proceeds to the taxpayer's wholly-owned corporation.

The IRS asserted that the taxpayer had actual or constructive receipt of the \$200,000 escrow account. The tax court determined there was no actual or constructive receipt of the \$200,000 of escrow funds. First, the Court determined that there was no actual receipt by the taxpayer because the funds were paid to the taxpayer's wholly-owned corporation, not the taxpayer himself. Second, the tax court determined there was no constructive receipt because there were substantial restrictions preventing the taxpayer from controlling the escrow funds. The restrictions included that: the parties agreed that if the transaction did not occur, the deposit would be returned to the buyer; the taxpayer could not unilaterally amend the escrow instructions because the buyer's agreement was necessary; and the deposit was not distributed until the property had been conveyed to the buyer.

The IRS further asserted that the taxpayer received boot in the form of the \$2 million of net loan proceeds the taxpayer received from refinancing Wildridge after it had executed the

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<sup>6</sup> In *Fredericks*, the taxpayer received the Buellton property from his wholly-owned corporation approximately three years after he initiated the like-kind exchange through the transfer of Wildridge to the corporation. Since *Fredericks*, IRC section 1031 has been amended to include certain time restrictions, which are not at issue in this appeal. (See IRC, § 1031(a)(3).)

sales contract with the third-party buyer. The tax court held that the taxpayer did not receive boot because IRC section 1031 relates only to funds received in an exchange, and the loan proceeds were not received as part of the exchange, but outside of it. The tax court declined to integrate the refinancing with the exchange because the taxpayer had a business reason to refinance the property, namely to replace the 18-month wrap-around note, and that taxpayer had been attempting to refinance the property since he obtained Wildridge in 1980.

*Garcia v. Commissioner*

The tax court considered constructive receipt of escrowed funds in *Garcia v. Commissioner* (1983) 80 T.C. 491 (*Garcia*). In *Garcia*, the tax court also held that there was no constructive receipt of escrow funds because there were substantial restrictions on the taxpayer's ability to control the funds including: the escrow agreement required the cooperation of both parties; under certain circumstances, the other party, but not the taxpayer, had the option to cancel the escrow agreement; and had the escrow agreement been canceled by the other party, the funds would be returned to the other party and not the taxpayer. Based on these restrictions, the tax court held that the taxpayer did not have a right to the escrowed funds until the escrow agreement's restrictions were satisfied. The tax court further reasoned that the fact that the escrowed funds were not transferred until the property transfers were complete supported that the funds had not been previously constructively received by the taxpayer.

*Klein v. Commissioner*

In contrast, the tax court held that the taxpayer had constructive receipt of escrow funds in *Klein v. Commissioner*, T.C. Memo 1993-491 (*Klein*). In *Klein*, the taxpayer entered into an agreement with a third-party buyer, the Smiths, to sell real property (Treehaven). The Smiths agreed to cooperate with the taxpayer's plan to execute a like-kind exchange by having the Smiths acquiring replacement property to exchange with the taxpayer for Treehaven. The taxpayer orally agreed with another party, the Murphys, to purchase their Neilsen property, using the sales proceeds from the Treehaven sale. On September 9, 1988, the taxpayer executed escrow instructions directing the title company to provide the sales proceeds from the Treehaven sale directly to the Murphys. The Murphys were not a party to the escrow agreement. On September 15, 1988, the taxpayer amended the escrow instructions and directed the title company to instead pay \$30,000 of sales proceeds to the Murphys, and the remaining proceeds to the taxpayer directly. On September 16, 1988, the Treehaven escrow closed and the title company paid \$30,000 of proceeds to the Murphys directly and the remainder to the taxpayer. The taxpayer delivered additional funds to the Murphys outside of

the escrow and acquired the Neilsen property. In holding that the Treehaven escrowed funds were constructively received by the taxpayer, the tax court reasoned that the taxpayer exercised unrestricted control over the funds in the Treehaven escrow. The Court stated that, at the “critical point in time,” when the Smiths deposited the funds into escrow, [the taxpayer] had control over the funds” because there was no evidence that the Smiths had placed any restrictions on the escrowed funds. This was evidenced by the taxpayer’s unilateral ability to alter the escrow instructions to direct partial payment to himself. The taxpayer’s exercise of power to alter the disposition of the escrow funds amounted to constructive receipt.

#### FTB Position

FTB asserts EWW had actual receipt of the Escrow Funds because they were held as collateral for EWW’s \$54 million of loans from ANIC and were used to pay loan costs. FTB contends that these facts establish that EWW received the economic benefit of the Escrow Funds, constituting actual receipt.

FTB also asserts EWW constructively received the Escrow Funds because: (1) the Escrow Funds were set aside for EWW’s benefit under Treasury Regulation section 1.1031(k)-1(f)(2); (2) the disbursement restrictions were not substantial because disbursement of the funds could not be “unreasonably withheld, conditioned, or delayed” by ANIC under Section 3 of the Agreements and Section 4(c) of the Agreements provide that any remaining funds would be paid to EWW; and (3) EWW had legal entitlement to the funds.

As support for their contention that EWW had legal entitlement to the Escrow Funds, FTB cites *Sullivan v. Commissioner*, T.C. Memo. 1999-341 (*Sullivan*), wherein the tax court held that a taxpayer had constructive receipt of a judgment award even though it was subject to restrictions.<sup>7</sup> In *Sullivan*, the tax court reasoned that the restrictions on the account only limited the taxpayer’s disposition of the judgement award and not the taxpayer’s legal entitlement to the award. FTB contends that appellant was similarly legally entitled to the Escrow Funds regardless of the disbursement restrictions because: the Escrow Funds functioned as a security deposit; ANIC could apply the Escrow Funds to EWW’s amount due in the event of a default event; and the amount of any remaining Escrow Funds after payment of the notes would be paid to EWW.

FTB asserts that Treasury Regulation section 1.1031-1(k)-1(g)(8) supports that EWW had constructive receipt of the Escrow Funds because in examples one through three of that

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<sup>7</sup> Notably, *Sullivan* does not involve a like-kind exchange but is cited by FTB for its analysis of the doctrine of constructive receipt.

regulation, constructive receipt turned on the escrow agreement's limitation on the taxpayer's ability to receive, pledge, borrow, or otherwise obtain the benefit of the funds, and the taxpayer's immediate, unrestricted right to receive the funds before receiving like-kind property. FTB asserts that EWV had constructive receipt of the Escrow Funds under this regulation because once the TI and CapEx Disbursement Conditions were met, EWV had a right to disbursement of the Escrow Funds.

FTB distinguishes this appeal from *Fredericks* on the basis that *Fredericks* dealt with a loan on relinquished property whereas this appeal concerns loans on replacement property. In *Fredericks*, the taxpayer refinanced the relinquished property after executing a contract to sell it. In this appeal, the loans concern the replacement property and the loans were obtained during the replacement period.

FTB analogizes this appeal to *Klein*, wherein the tax court held that a taxpayer's power to dispose of income was sufficient to cause constructive receipt. FTB states that, similar to *Klein*, EWV had the right to draw upon the escrow funds once the TI and CapEx Disbursement Conditions were met and therefore, EWV had constructive receipt.

FTB asserts that constructive receipt occurs if a taxpayer has *any* ability to obtain escrowed funds; the fact that funds may be subject to difficult or onerous conditions does not prevent constructive receipt. FTB cites to *Klein* to support this position.

#### Appellants' Position

In general, appellants do not contend that the Escrow Funds qualify as like-kind property for purposes of IRC section 1031. Instead, they contend that the Escrow Funds were part of a separate, unrelated loan intended for EWV to improve the property after acquisition. Appellants assert the Escrow Funds should be treated as post-closing borrowing—i.e., proceeds not received in connection with the exchange.

In response to FTB's contention regarding actual receipt, appellants assert that EWV did not have actual receipt because the cash was directly paid to ANIC during closing. The money was not received by EWV during escrow, and it was not received until disbursements were made from the Escrow Funds as the disbursement conditions became satisfied in later tax years far after the close of escrow.

In response to FTB's contention regarding constructive receipt, appellants contend EWV did not have constructive receipt because the Escrow Funds were for EWV to improve the property after acquisition and disbursement of the Escrow Funds was substantially restricted, similar to the facts and circumstances of *Fredericks* and *Garcia*. At the time the cash was

placed into the Escrow Funds, appellants allege that EWW had no ability to control the Escrow Funds or receive disbursements. Appellants contend that ANIC was not required to approve disbursements until EWW had satisfied numerous, onerous conditions contained in Section 3 of the Agreements. Appellants contend the fact that the Escrow Funds were not actually disbursed to EWW until far after, and in some cases years after, the close of escrow supports the contention that there was no constructive receipt, that the disbursement conditions were substantial, and that EWW did not have the unilateral ability to direct disbursements.

Appellants distinguish *Sullivan* on the basis that there, the taxpayer had legal entitlement to the funds and the only remaining question was whether the taxpayer used the funds himself or whether the funds went to his attorney or former spouse. Here, appellants assert the disbursement restrictions meant that EWW did not have legal entitlement to the Escrow Funds unless and until the disbursement restrictions were satisfied.

#### *Analysis of Actual Receipt*

It is undisputed that the Escrow Funds were not directly received by EWW. The question is whether EWW received the economic benefit of the Escrow Funds such that it had actual receipt pursuant to Treasury Regulation section 1.1034(k)-1(f)(2).

The TI and CapEx Agreements stated that the Escrow Funds would be held as collateral for the underlying loans and either disbursed to EWW or applied against the promissory notes and ANIC's expenses incurred under the Agreements. FTB urges OTA to consider the use of the Escrow Funds as collateral to secure the loans and their use to pay ANIC's expenses as actual receipt.<sup>8</sup> In respect to the use of the Escrow Funds as collateral, a review of the facts shows that the Renton Property itself secured the loans. FTB's position misinterprets the Draw Event provisions of the TI and CapEx Agreements, which only enable ANIC to draw on the Escrow Funds upon the occurrence of certain events, such as a loan default. FTB also contends that the Disbursement Conditions only applied to the Escrow Funds *after* the cash was placed into the Escrow Funds with ANIC, and EWW's ability to direct the cash to those accounts constitutes actual receipt. However, ANIC's provision of the loan required the cash to be placed in the Escrow Funds as a condition to ANIC's making of the loans. The placement of the loan proceeds into the Escrow Funds, as required by the loan agreements, supports that EWW did not have actual receipt of the cash. Thus, at the time of the exchange, EWW did not have actual receipt of the Escrow Funds.

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<sup>8</sup> EWW's payment of ANIC's expenses pursuant to the Agreements is discussed below.

Analysis of Constructive Receipt

As to FTB's first contention that the Escrow Funds were set aside for EWW's benefit pursuant to Treasury Regulation section 1.1031(k)-1(f)(2), a review of the facts show that the Escrow Funds were held in an unsegregated, non-interest bearing account. In addition, the Escrow Funds were not available for EWW's benefit because EWW's ability to draw on the cash was subject to Disbursement Conditions that must be met prior to disbursement.

Next, FTB contends the Disbursement Conditions were not substantial because disbursement of the Escrow Funds could not be "unreasonably withheld, conditioned, or delayed" by ANIC under Section 3 of the Agreements, and Section 4(c) of the Agreements provides that any remaining cash would be paid to EWW. However, this disbursement requirement occurs only *after* the Disbursement Conditions are satisfied. The fact that ANIC could not unreasonably withhold disbursement after the Disbursement Conditions were met does not lessen the restrictive nature of the Disbursement Conditions.

To the extent FTB contends there is constructive receipt if a taxpayer has *any* ability to obtain the Escrow Funds, even where the funds are subject to difficult or onerous restrictions, OTA finds this contention to be without merit. (See, e.g., Treas. Reg. § 1.1031(k)-1(f)(2); *Fredericks, supra*; *Garcia, supra*.)

The TI Escrow Disbursement Conditions required EWW to obtain and deliver tenant lease agreements of at least five years, perform tenant improvements, and, where required, to provide lien releases and photos of the work performed, and deliver a certificate of occupancy before any disbursement would be made. The CapEx Disbursement Conditions required EWW to make capital improvements that were approved in writing in advance by ANIC, to have the work completed in a "good and workman-like manner," and, where required, deliver lien releases and other documentation before any disbursement would be made.

To evaluate the substantiality of the Disbursement Conditions, we look to *Fredericks, Garcia, and Klein*. Similar to *Fredericks*, the Disbursement Conditions were a substantial restriction that prevented EWW from accessing the Escrow Funds, EWW could not unilaterally amend the TI and CapEx Agreements, and EWW could not obtain any disbursement until or unless the Disbursement Conditions were satisfied. Also similarly, EWW had a business reason to obtain the TI and CapEx Agreements, to complete tenant and capital improvements and provide for leasing commission for the Renton Property.

FTB attempts to distinguish *Fredericks* on the basis that in that case, the taxpayer encumbered its relinquished property prior to the exchange for a valid business purpose, whereas EWW encumbered the replacement property during the exchange. However, EWW's

access to the loan proceeds was restricted, and E WV had a valid business purpose for obtaining the loan, namely to provide for capital improvements and leasing commissions on the replacement property, and that it was a condition of the loan made by ANIC. Thus, OTA finds FTB's argument on this point unpersuasive.

Similar to *Garcia*, E WV did not have the ability to cancel the TI and CapEx Agreements and access the Escrow Funds. Also, similarly, the fact that the Escrow Funds were not in fact transferred to E WV until the Disbursement Conditions were met, in some cases, years after the close of escrow, supports that the Escrow Funds were not constructively received by E WV at the time of the exchange.

In *Klein*, the taxpayer constructively received funds because there was no evidence of restrictions on the escrowed funds, as evidenced by the taxpayer's ability to direct payment to himself. Unlike *Klein*, E WV was not able to direct payment to itself because disbursement of the Escrow Funds was subject to substantial restrictions. The fact that the Escrow Funds were not disbursed to E WV until far after the close of escrow supports this.

Finally, FTB asserts E WV had constructive receipt of the Escrow Funds because they were legally entitled to the funds, citing *Sullivan*. However, E WV's access to the Escrow Funds was subject to significant restrictions such that E WV only had the right to receive the funds once the Disbursement Conditions were met. The use of the Escrow Funds was earmarked for specific expenditures, including capital and tenant improvements and leasing commissions. E WV would only receive the remaining Escrow Funds, if any, upon the complete repayment of the promissory notes, totaling \$54 million. For these reasons, E WV's rights to the Escrow Funds fall short of the facts in *Sullivan*.<sup>9</sup>

Accordingly, OTA finds that E WV has shown error in FTB's determination by a preponderance of the evidence. E WV did not have actual or constructive receipt of the Escrow Funds.

### Exchange Expenses

The amount of boot received in a like-kind exchange, if any, is decreased by the taxpayer's exchange expenses. (*Blatt v. Commissioner*, T.C. Memo. 1994-48 (*Blatt*); Rev. Rul. 72-456, 1972-2 C.B. 468.) Exchange expenses are costs incurred in connection with an exchange under IRC section 1031, and include brokerage commissions, attorney's fees, and

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<sup>9</sup> In addition, to the extent any of these funds ultimately were used to pay off the balance of the loan proceeds, the ultimate result is a reduction of the loan amount because the escrow accounts were funded from the loan proceeds per TI and the CapEx Agreements.

deed preparation fees. (Rev. Rul. 72-456; IRS Pub. 544.) Exchange expense are not otherwise defined by statutes, regulations, or case law.<sup>10</sup>

Revenue Ruling 72-456 cites example 2 of Treasury Regulation section 1.1031(d)-2 as standing for the principle that money paid “in connection with an exchange” “is offset against money received in computing gain . . . and is also added in determining the basis of the acquired property.” It found that, as brokerage commissions were paid “in connection with” the exchange, the payment of the brokerage expenses reduced realized gain.

#### Appellants’ Position

EWV paid a 1% Prepayment Fee of \$540,000 to ANIC and \$341,250 of ANIC’s legal fees. EWV asserts that these payments are not taxable boot because: (1) payment was not made out of exchange funds but was merely a reduction in the loan amount, and (2) in the alternative that the payments are held to be made out of exchange funds, they are exchange expenses and do not result in taxable boot. EWV contends that payment of these items was required for EWV to obtain a loan to purchase replacement property and, but for payment of these expenses, EWV would not have been able to acquire the replacement property. EWV contends that *Blatt*, Rev. Rul. 72-456, and General Counsel Memorandum (GCM) 34895<sup>11</sup> support that expenses incurred in connection with the exchange are exchange expenses.

#### FTB Position

FTB asserts that the payments were non-exchange expenses that result in taxable boot because the expenses were incurred in connection with *financing* the exchange rather than the exchange itself. FTB states that exchange expenses incurred in either the disposition of relinquished or acquisition of replacement property do not result in boot where they are paid from exchange funds. FTB contends that items typically found on a closing statement such as

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<sup>10</sup> While Treasury Regulation section 1.1031(k)-1(g)(7) provides that a taxpayer will not be in actual or constructive receipt where certain transactional items related to an exchange are paid from exchange proceeds, the regulation does not address whether such transactional items are non-exchange expenses that constitute boot to an exchange.

<sup>11</sup> GCM 34895, dated June 5, 1972, analyzed the then-proposed Rev. Rul. 72-456, but does not provide guidance beyond that contained in the Revenue Ruling.

prorated rents, security deposits, mortgage interest, late charges, prepayment penalties, property taxes, and similar expenses are non-exchange expenses that result in taxable boot.<sup>12</sup>

### Analysis

EWV's closing statement from the purchase of the Renton Property shows the 1% Prepayment Fee of \$540,000 listed as a "Loan Charge" debit and reflects a credit for the \$54 million loan from ANIC. Thus, although EWV asserts that the Prepayment Fee resulted in a reduction of the loan amount, it does not appear that the loan was reduced by the payment of this fee. Under the terms of the promissory notes, the Prepayment Fee enabled EWV to prepay the loans, but it does not appear that the payment reduced the loan amount. In addition, it is not clear that the Prepayment Fee was made from the loan proceeds; payment may have been made from the deposit of exchange proceeds by the QI, or from the deposit made by the A. Abady Trust. Similarly, EWV has not shown that the payment of ANIC's legal fees resulted in a reduction of the loan amount, or that they were paid by solely with the loaned funds.

Next, OTA must consider whether the Prepayment Fee and payment of ANIC's legal fees are exchange expenses. There is no precedential authority clearly resolving this issue, and secondary authorities indicate it is a matter of some uncertainty. The American Bar Association (ABA) Section on Taxation has stated that: (1) "[l]oan fees, points, loan application fees, mortgage insurance, lender's title insurance, assumption fees and other costs related to the acquisition of a loan for the replacement property" should not be treated as exchange expenses because those costs are generally treated as part of the cost of obtaining a loan rather than the cost of obtaining the property, and (2) if such loan-related expenses are paid out of the exchange balance, they should constitute taxable boot. (ABA Tax Section's Report on Open Issues in Section 1031 Like-Kind Exchanges, July 14, 1995, Q-1 (*ABA Report*)). The ABA Report, however, does not constitute precedential legal authority.

Another secondary authority notes that, while IRS Form 8824 refers to "exchange expenses," it is "not further defined on IRS Form 8824 or its instructions, and there is no other authority on the issue." (Foster, *Tax-Free Exchanges* § 4:14, Oct. 2023.) It further states that "[i]t is generally assumed that exchange expenses . . . are costs that are typically: (1) treated as transactional costs and added to basis in a taxable sale; (2) non-deductible by a buyer, but capitalized and added to the basis of the property acquired; or (3) costs specifically related to

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<sup>12</sup> As support, FTB cites Private Letter Ruling (PLR) 8328011. In the PLR, the IRS treated expenses that were not related to an exchange, e.g., interest, late charges, fund deficit, pro rata rents, and rent deposits, as boot received by the taxpayer in the exchange. Notably, PLRs, Revenue Rulings, GCMs, and IRS Publications are not binding authority, but their reasoning may be found persuasive.

the fact that the transaction is an exchange, such as QI or EAT fees.” (*Ibid.*) It states that other items found on a closing statement, such as mortgage interest, are “probably not” exchange expenses. (*Ibid.*)

While the issue is not free from doubt, OTA finds FTB’s position and the logic of the ABA Report to be persuasive. Like loan fees, points, and loan application fees, the Prepayment Fee and payment of ANIC’s legal fees were costs incurred in obtaining financing.<sup>13</sup> By having these loan fees paid during the exchange from the proceeds of a loan secured by the Replacement Property, EWV obtained an economic gain from the Replacement Property before the exchange had closed.

In summary, OTA finds that EWV’s payment of a 1% Prepayment Fee in the amount of \$540,000 and ANIC’s legal expense in the amount of \$341,250 results in boot to EWV.

Issue 2: Whether appellants have demonstrated a basis to abate interest.

Appellants do not make any specific arguments for interest abatement and requested abatement based on the duration of the case in light of EWV’s cooperation with FTB.

The imposition of interest is mandatory. (R&TC, § 19101(a); *Appeal of Moy*, 2019-OTA-057P.) Interest is charged from the due date of the tax payment to the date the tax is paid. (R&TC, § 19101(a).) Interest is not a penalty but is compensation for the taxpayer’s use of money after it should have been paid to the state. (*Appeal of Moy, supra.*) There is no reasonable cause exception to the imposition of interest and interest can only be waived in certain limited situations when authorized by law. (*Ibid.*)

To obtain relief from interest, a taxpayer must qualify under R&TC sections 19104 (unreasonable error or delay), 19112 (extreme financial hardship), or 21012 (reasonable reliance on FTB’s written advice). (*Appeal of Moy, supra.*) However, OTA does not have jurisdiction to determine whether appellant is entitled to the abatement of interest under R&TC section 19112 and in addition, R&TC section 21012 is not relevant because FTB did not provide appellant with written advice. (*Ibid.*)

Under R&TC section 19104(a)(1), FTB may abate all or a part of any interest on a deficiency to the extent that interest is attributable in whole or in part to any unreasonable error or delay committed by FTB in the performance of a ministerial or managerial act. (R&TC, § 19104(a)(1).) OTA has jurisdiction to determine whether FTB’s denial of interest abatement under R&TC section 19104 was an abuse of discretion. (R&TC, § 19104(b)(2)(B); *Appeal of*

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<sup>13</sup> Notably, expenses incurred in connection with obtaining a loan for business properties are generally capitalized and may be deductible over the period of the loan.

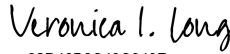
*Moy, supra.*) Here, appellants do not allege an error or delay occurred on the part of FTB and thus, relief is not available to appellants under R&TC section 19104(a)(1). Based on this, appellants have not established a basis to abate interest.<sup>14</sup>

HOLDINGS

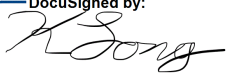
1. Appellants must recognize taxable boot for EWW’s payment of a 1% Prepayment Fee in the amount of \$540,000 and ANIC’s legal expense in the amount of \$341,250 in relation to an IRC section 1031 exchange but will not otherwise recognize taxable boot.
2. Appellants have not demonstrated a basis to abate interest. However, interest will be reduced and recalculated as a result of the reduction to the proposed assessment based on holding 1.


DISPOSITION

FTB’s determination is modified to reduce the amount of taxable boot to \$881,250. FTB’s denial of appellants’ request for interest abatement is sustained.

Signed by:  
  
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 Veronica I. Long  
 Administrative Law Judge

We concur:

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 Keith T. Long  
 Administrative Law Judge

Signed by:  
  
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 Seth Elsom  
 Hearing Officer

Date Issued: 11/26/2025

<sup>14</sup> The amount of interest will be reduced to reflect the reduced assessment of tax in accordance with this Opinion.