

were interconnected by a roofed, two-story breezeway with second-floor walkways. The three pods were referred to as Buildings A, B, and C (collectively referred to as the Buildings). The center pod, Building B, contained all the electrical, communication and data utilities and public restrooms for all three pods. The Clinton property was served by a single water meter and a single electric meter located in Building B.

2. The Clinton property was subject to a mortgage requiring R. Mitchell to pay monthly installments of approximately \$10,000.
3. On January 31, 2017, R. Mitchell leased for five years the Clinton property to a charitable organization, Helping Others Pursue Excellence (HOPE). The lease required HOPE to pay a monthly base rent,¹ plus operating costs, including insurance, property taxes, and utilities. In consideration for an initial rent-free period of six months, HOPE agreed to make certain improvements to the Clinton property, including the installation of an elevator in compliance with the Americans with Disability Act of 1990. The lease granted HOPE the option to purchase the Clinton property for \$3.3 million during the first 12 months of the lease, subject to R. Mitchell's donation of \$700,000 of the purchase price to HOPE.
4. In April of 2017, a storm caused the Clinton property to flood, resulting in damage to all three buildings. During the storm, hail blocked a drain on the roof of Building B, causing water to accumulate on the roof and the roof to collapse. Building B became structurally unsound after the roof collapsed, which caused damage to the first story ceiling, the second story floor, and at least one wall. Due to the flood damage, HOPE vacated Buildings B and C but continued to occupy Building A, even though it sustained damage.
5. After the storm, R. Mitchell contacted his insurance company and sought funds to repair the damage. R. Mitchell did not receive any payment from the insurance company for approximately one year from the date of the storm.
6. While R. Mitchell sought funds from the insurance company, the copper wiring in Building B and the air conditioning units from all three Buildings were damaged or stolen. HOPE, which employed approximately three employees, continued to occupy Building A. Building A contained a single en-suite restroom and had no central air conditioning after the rooftop unit was stolen.

¹ The monthly base rent was \$15,000 for February 1, 2017, through January 31, 2019, \$17,500 for February 1, 2019, through January 31, 2020, \$20,000 for February 1, 2020, through January 31, 2021, and \$22,500 for February 1, 2021, through January 31, 2022.

7. HOPE did not pay rent or operating costs to R. Mitchell. R. Mitchell continued to pay the costs of ownership of the Clinton property, including mortgage payments and property taxes.
8. The insurance company refused to pay R. Mitchell the actual cost to reconstruct the Clinton property. Instead, R. Mitchell received total insurance proceeds of \$1,751,780 for the depreciated value of the Clinton Property due to the storm.
9. On June 4, 2018, R. Mitchell and HOPE executed a contract for R. Mitchell to sell the Clinton property to HOPE in consideration for a first deed of trust of \$2 million.
10. On July 30, 2018, R. Mitchell purchased real property located in Monterey, California (the Monterey property) for \$10.1 million, which he financed in part with the promissory note of \$2 million that he received from HOPE.
11. Appellants filed federal and California returns for the 2018 tax year. On federal Form 8824, Like-Kind Exchanges, appellants reported a like-kind exchange under IRC section 1031 of the Clinton property for the Monterey property with a recognized gain of \$1,991,807 and a deferred gain of \$1,677,710. However, on federal Form 6252, Installment Sale Income, appellants treated the sale of the Clinton property as an installment sale and included recognized gain of only \$1 from the sale of the Clinton property in their 2018 reported gross income.² On their California return, appellants reported a total tax of \$39,053 and after claiming payments of \$40,144, they claimed an overpaid tax of \$1,091.
12. FTB audited appellants' California return. At audit, appellants explained that they intended to rely on IRC section 1033, rather than IRC section 1031, to defer gain from the sale of the Clinton property. FTB disallowed the claimed nonrecognition of gain from the sale of the Clinton property under IRC section 1033.
13. FTB issued a Notice of Proposed Assessment (NPA) dated November 21, 2022, which increased appellants' reported taxable income by \$957,694 for the adjusted recognized gain of \$957,694 from the sale of the Clinton property and disallowed claimed itemized deductions of \$57,385 based on the revision to appellants' federal adjusted gross income. The NPA proposed additional tax of \$120,437, plus interest.
14. Appellants protested the NPA.
15. FTB issued a Notice of Action dated June 14, 2024, affirming the NPA.
16. This timely appeal followed.

² On federal Forms 6252 and 8824, appellants reported that they acquired the Clinton property on April 1, 2005, and they sold it on July 25, 2018.

17. At the October 8, 2025 oral hearing, appellant R. Mitchell provided testimony. Appellant R. Mitchell testified to the following:
- The Clinton Property was on a single parcel with one address for all three Buildings. The Buildings shared a single parking lot. The Buildings were leased to a single tenant, HOPE, pursuant to a single lease agreement.
 - HOPE leased the Clinton Property mainly to use Building B as a training center to assist people in gaining employment.
 - The Buildings shared a common area, located in Building B, which contained restrooms and utilities, including water, gas, and electric. All utilities that came into the Clinton Property did so through Building B. The main breakers for these utilities were also located in Building B. Roof access to all three Buildings was in Building B. Access to the HVAC systems for the Buildings was accessible only through the roof access in Building B.
 - Buildings A and C each had a single bathroom, each with a single toilet and sink.
 - Appellants owned the Clinton Property subject to a mortgage in the amount of approximately \$2 million, with monthly payments of \$10,000. Appellants paid insurance costs of approximately \$12,000 per year and property taxes of approximately \$24,000 per year.
 - After the loss event, HOPE continued to occupy Building A without paying rent in the hope that it would deter vagrants from damaging the Clinton Property. Nevertheless, vagrants stripped the copper from Building B and destroyed the three HVAC units that provided air conditioning for each Building.
 - HOPE had three employees that used the single bathroom in Building A and used a portable air conditioning unit.
 - After the loss event, appellants sought bids to repair the Clinton Property. Based on the bids, R. Mitchell estimated it would cost approximately \$1 million in excess of insurance proceeds to repair the Clinton Property.
 - Appellants did not receive funds from their insurer until approximately 15 months after the loss event.
 - R. Mitchell was unable to fund the additional \$1 million repair cost personally and considered obtaining a second mortgage. However, he was informed by his banker that the property would not provide adequate security for a second mortgage. R. Mitchell reasoned that based on the current cost of ownership and projected rental income, even if he could obtain a second mortgage on the

Clinton Property, the rental income would not be enough to service a second mortgage.

- Appellants sold the property to HOPE.
- Appellants had previously entered into like-kind exchanges under IRC section 1031 and testified that if they had known that FTB would disallow their involuntary conversion, they could have easily carried out a valid like-kind exchange.

18. At the October 8, 2025 oral hearing, W. McFeeters, the project manager tasked with evaluating and overseeing the bids obtained to repair or rebuild the Clinton property, provided testimony. Mr. McFeeters testified to the following:

- Damage to Building B included the collapse of all trusses, bowing of outside windows, and water damage and mold throughout the Building. Mr. McFeeters stated that he was unable to enter Building B because the extent of the damage made the site dangerous.
- Mr. McFeeters solicited bids for repair of the Building on appellants' behalf. Some bids included a bid for partial demolition to determine the extent of the damage. If the partial demolition determined that the damage was too extensive, appellants would then incur the cost of complete demolition of Building B in addition to the cost of the partial demolition.
- Based on the cost of partial demolition, Mr. McFeeters determined it would be more cost-effective to rebuild rather than do partial construction. Mr. McFeeters advised appellants to obtain bids to rebuild Building B in addition to demolition and removing asbestos and mold.
- Mr. McFeeters stated that construction costs, and lumber in particular, were high at the time and that it was difficult to obtain bids, and that the bids were only good for a period of time because of increasing costs.

DISCUSSION

FTB's determinations are presumed correct, and a taxpayer has the burden of proving error. (*Appeal of F.A.R. Investments, Inc. and Arciero & Sons, Inc.*, 2022-OTA-395P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) FTB's determinations must be upheld in the absence of credible, competent, and relevant evidence

showing that they are incorrect. (*Ibid.*) The burden of proof requires proof by a preponderance of the evidence. (Cal. Code Regs., tit. 18, § 30219(b).)

IRC section 1033³ is an exception to the general rule requiring recognition of gain or loss on the sale or exchanged of property. (See IRC, § 1001(c); Treas. Reg. § 1.1002-1(a); R&TC, § 18031.) IRC section 1033 provides for nonrecognition of gain where property has been involuntarily converted into money or unrelated property, and the taxpayer, within a certain time period, acquires replacement property that is similar or related in service or use to the property so converted. IRC section 1033 should be liberally construed to “relieve the taxpayer of unanticipated tax liability arising from involuntary conversion of his property.” (*Davis v. U.S.* (9th Cir. 1979) 589 F.2d 446, 450 (*Davis*); *Filippini v. U.S.* (9th Cir. 1963) 318 F.2d 841, 844 cert. denied (1963) 375 U.S. 922.)

Masser v. Commissioner

The Tax Court considered whether the involuntary conversion of one property can cause a related property to also qualify for involuntary conversion gain deferral in *Masser v. Commissioner* (1958) 30 T.C. 741 (*Masser*). In *Masser*, the taxpayer owned and operated an interstate trucking business and purchased two pieces of property located across the street from one another. One property had a building used as an office, bunkhouse, and for the loading and unloading of trucks. The second property was used for truck parking pending loading and unloading. The parking area was involuntarily converted as a result of threat of condemnation. The taxpayer sought to continue the business, but the only available property for parking was located a mile and a half away from the remaining property. The taxpayer determined that it would be economically impractical to continue to operate the remaining property with this parking lot because the distance would entail considerable expense for labor, result in traffic hazards and cargo thefts, delay deliveries, and present problems with traffic management. The taxpayer sold the remaining property and used the proceeds from both properties to buy replacement property suited for similar use as a truck terminal.

The Tax Court reasoned that “[t]axation is eminently practical [...] and that a relief provision ‘should be liberally construed to effectuate its purpose’.” (*Masser, supra*, at p. 746, citing *Massillon-Cleveland-Akron Sign Co.* (1979) 15 T.C. 79, 83.). The Court looked at the proximity of the two properties, that they were acquired to be used as a single economic unit, that they were operated as a single economic unit and, only after one property was involuntarily converted, the taxpayer exercised good business judgement to sell the remaining property and

³ California generally conforms to IRC section 1033 pursuant to R&TC section 18031.

invested the proceeds from both properties into similar replacement property. The Tax Court held that where two properties are used in a taxpayer's business as an economic unit and one property is involuntarily converted, with the result that continuation of the taxpayer's business on the remaining property is impractical such that the taxpayer in the exercise of good business judgement sells the remaining property, the transaction as a whole constitutes an involuntary conversion within the meaning of IRC section 1033.⁴

Revenue Ruling 78-377

In Revenue Ruling 78-377, the IRS considered application of *Masser* to a taxpayer who owned a shopping center that was partially destroyed by fire. While the destroyed portion was untenable, the tenants in the undamaged part of the property continued occupancy. The taxpayer decided not to reconstruct the destroyed portion and sold the shopping center. The IRS stated that the sale could only qualify for IRC section 1033 nonrecognition treatment where (1) the converted property could not be reasonably or adequately replaced; and (2) there is a substantial economic relationship between the converted property and the property sold such that they constituted one economic unit.⁵ The IRS further determined that a substantial economic relationship occurs only where the sold property could not practically have been used without replacement of the converted property. In the Ruling, the IRS decided that the fire-damaged portion of the shopping center could have been replaced and the undamaged portion used without the fire-damaged portion, and thus, the sale did not qualify under *Masser*.

C.G. Willis v. Commissioner

IRC section 1033 does not apply to defer the recognition of gain if the taxpayer's damaged property can be repaired economically and restored to usefulness for its intended business purpose. In *C.G. Willis, Inc. v. Commissioner* (1964) 41 T.C. 468 (*Willis*), a taxpayer owned a ship that was hit by a submerged object, which breached its hull, and the engine room took in water that required stoppage of the machinery. Rather than repairing the ship, the owner sold the partially damaged vessel and received insurance proceeds, which it used to purchase a barge. The owner claimed that the barge was similar or related in service or use to the ship. The Tax Court found that the ship was repairable, and that the sale of the unrepaired ship was the result of the owner's voluntary "business decision that the money equivalent of the

⁴ *Masser* considered IRC section 112(f)(1) of the IRC of 1939, which is the predecessor to the current IRC section 1033.

⁵ Revenue Ruling 59-361, 1959-2 C.B. 183.

unrepaired ship would serve its business interests better.” The Tax Court thus denied the owner’s claim for nonrecognition of gain under IRC section 1033. The Tax Court stated that involuntary conversion within the meaning of IRC section 1033(a) means that “the taxpayer’s property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes.” (*Id.* at p. 475.)

Analysis

The issue in this appeal is whether appellants’ sale of the Clinton property qualifies for nonrecognition treatment under IRC section 1033. Appellants contend the Clinton property was involuntarily converted by the April 2017 storm and that their sale qualifies for IRC section 1033 nonrecognition. FTB contends that: although Building B was destroyed by the storm, the sale of the Clinton property does not qualify for IRC section 1033 because: (1) Buildings A, B, and C were not an economic unit; (2) appellants’ sale of the Clinton Property was not involuntary; and (3) continued use of the property was not impractical.⁶

(1) Economic Unit

Appellants contend that the Clinton property was operated as a single economic unit because: the Clinton property was purchased, financed, and sold as a single transaction; the property was leased to a single tenant, HOPE, under a single lease; Buildings A and C could not have been used without Building B because the Clinton property was designed, constructed, and operated as a single unit comprised of three pods physically connected to each other via hallways and roofs; the main restrooms servicing all three Buildings were in Building B; the electrical service, communications service, and data service for all three Buildings were situated within Building B; and the HVAC units for all three Buildings were only accessible through the roof access point in Building B.

Appellants contend that Buildings A and C could not be occupied without being redesigned and modified to make them independent structures with each of them having new bathrooms, a new utility room, and new electrical, telephone, and data service. Appellants contend that if the demolition and reconstruction of Building B were to commence, Buildings A and C would be rendered uninhabitable at least until Building B were completely reconstructed or Buildings A and C were redesigned and reconstructed. For these reasons, appellants argue that R. Mitchell could not have negotiated a new lease for Buildings A and C.

⁶ FTB does not dispute that the proceeds from the sale of the Clinton property were used to acquire qualified replacement property within the requisite period as required by IRC section 1033.

Appellants note that in *Masser, supra*, at p. 749, the Tax Court held that if a taxpayer acquired two parcels of real property “practically adjacent to each other” for the purpose of being used and were used in the taxpayer’s business as an economic unit, the taxpayer’s sale of the second parcel would be deemed an involuntary conversion after the first parcel was involuntarily converted if it was apparent that the continuation of the taxpayer’s business on the second parcel was impractical “in the taxpayer’s exercise of good business judgment.” Appellants assert that, rather than being located on three parcels of real property “practically adjacent to each other,” as was the case in *Masser*, the Clinton property was a single legal parcel of real property with a single address.

FTB argues that R. Mitchell did not use the Clinton property as a single economic unit. FTB contends that appellants have failed to establish that the operation of Buildings A and C was dependent entirely on Building B for electrical, communications, and data utilities, as well as for access to restrooms. FTB notes that Building A contained a small bathroom. FTB contends that, because Building B was not demolished, it is irrelevant whether Buildings A and C would be uninhabitable if Building B were demolished. FTB also contends that R. Mitchell continued to operate a leasing business on the Clinton property after Building B was damaged because he continued to lease Buildings A and C to HOPE, and appellants claimed expenses related to the Clinton property on their 2018 return despite the lack of rental income.

Appellants have demonstrated that the Clinton Property was operated as a single economic unit in R. Mitchell’s leasing business. Appellants have established through witness testimony and documentary evidence that: Buildings A, B, and C were interconnected; the utilities, including water, gas, and electric for the property, were located in Building B; roof access to the Clinton property was located in Building B; the Clinton property was a single parcel with one address; the Clinton property was leased to a single lessor in a single lease agreement; and that the Clinton property was sold as a single property to a single buyer. In *Masser*, the taxpayer operated two pieces of property that were operated as a single unit although they were across the street from one another. Here, the Buildings are located on a single piece of property, are interconnected and reliant upon Building B, and appellants’ lease agreement, which encompassed all three Buildings, shows the Buildings were operated as a single property.

These facts are distinguishable from Revenue Ruling 78-377, wherein a shopping center was partially destroyed by fire. There, the tenants of the undamaged portion of the shopping center were able to continue their occupancy. Here, while HOPE was able to occupy Buildings A and C, it did so at a considerable disadvantage and lacked access to the utility mains, public

restrooms, and roof access, and would be forced to abandon their tenancy in the event that Building B was demolished for repair because the utilities for Buildings A and C were located within Building B. Accordingly, appellants have established that they operated the Clinton property as a single economic unit, and Buildings A, B, and C had a substantial economic relationship.

(2) Involuntary Conversion

Appellants contend that the Clinton property was involuntarily converted as a result of the April 2017 storm. Appellants cite to *Davis, supra*, for the contention that IRC section 1033 is a relief provision that should be liberally construed. Appellants provided testimony that repairing the Clinton property would require appellants to raise approximately \$1 million of funds in addition to insurance proceeds, that appellants were unable to raise these funds, and that even if appellants had been able to raise the funds, repair of Building B would render Buildings A and C untenable during repair. Appellants contend that in *Masser, supra*, the taxpayer's sale of two properties was considered an involuntary conversion because continuation of the business on the remaining property was impractical "*in the taxpayer's exercise of good business judgement.*" (*Masser, supra*, at p. 747, italics added.) Here, appellants contend that they similarly used their good business judgment to determine that continuation of the leasing business was not feasible.

Appellants distinguish their case from *Willis* on factual grounds. First, the taxpayer in *Willis* chose to sell the damaged ship because purchasing a barge with the proceeds would be more profitable. Second, in *Willis*, the taxpayer had the choice between selling or receiving 87-99% of the cost of repair from their insurer. Here, appellants recovered only 59-70% of the cost of repair from their insurer and would be required to provide approximately \$1 million of additional funds to repair the Clinton property.

FTB does not dispute that Building B was severely damaged but contends that the sale of the Clinton property was nonetheless voluntary because appellants could have repaired the property. FTB contends that where a taxpayer has a choice to repair or sell property, the sale cannot qualify for nonrecognition treatment under IRC section 1033. FTB cites to *Willis, supra*, at p. 474, for this contention.

In *Willis*, the Tax Court stated that IRC section 1033 did not apply where the owner had a choice "of keeping the property or converting or selling it." (*Willis, supra*, at p. 474.) In *Willis*, the taxpayer made several attempts to dispose of the ship prior to the casualty event, the ship was not in use at the time, and the taxpayer decided that the money equivalent of the ship

would better serve the taxpayer's business interests than a repaired ship. In holding that the property did not qualify for nonrecognition under IRC section 1033, the Court reasoned that involuntary conversion means "that the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes." (*Willis*, *supra*, at p. 476.) Based on the facts and circumstances of that case, the Court determined that the sale of the ship did not amount to a "forcible taking" of the taxpayer's property. (*Ibid.*)

In this case, R. Mitchell testified that he intended to repair the Clinton property and only considered selling it when the cost of repair became prohibitive. Unlike *Willis*, R. Mitchell immediately used the Clinton property in his leasing business and intended to continue operating the leasing business at the Clinton property, as evidenced by witness testimony and the lease agreement. The casualty event of the storm was an event outside appellants' control that rendered the Clinton property no longer useful or available to appellants because the cost to repair the property was not economically feasible. Unlike *Willis*, there is no evidence appellants made prior attempts to dispose of the property, and appellants have provided witness testimony that their insurance proceeds were insufficient to allow for repair. On this basis, appellants' case is distinguishable from *Willis*. Further, IRC section 1033 applies when "property (as a result of its destruction in whole or in part [...]) is compulsorily or involuntarily converted." (IRC, § 1033(a).) Thus, although the plain language of IRC section 1033 includes nonrecognition of gain for *partial* destruction of property, FTB's interpretation of *Willis* would permit application of the section only in the instance of *irreparable* harm.

FTB's interpretation of *Willis* would have the result that no involuntary conversion caused by a casualty event may qualify for IRC section 1033 if the property is repairable, regardless of the severity of the damage or cost of repair. OTA finds this contention counter to the plain language of IRC section 1033, which applies to property that is involuntarily converted "in whole or in part,"⁷ and the well-settled principle that IRC section 1033 should be liberally construed to "relieve the taxpayer of unanticipated tax liability arising from involuntary conversion of his property." (*Davis*, *supra*, at p. 450; *Filippini v. U.S.*, *supra*, 318 F.2d 841.) Accordingly, appellants have established that the Clinton property was involuntarily converted.

(3) Continuation of the Business was Impractical

Appellants contend that continuing to lease the Clinton property was impractical after the storm because R. Mitchell received insufficient insurance proceeds to cover the cost of repair and would be forced to invest approximately \$1 million of additional funds, which he did not

⁷ IRC section 1033(a).

have. Even in the event that appellants raised the funds, repair of Building B would render Buildings A and C untenable during repair. During this time, appellants were required to continue making monthly mortgage payments of approximately \$10,000 and paying property taxes of approximately \$2,000 per month. Appellants contend that under *Masser*, appellants need only demonstrate that continuing the business is impractical in appellants' good business judgement. (*Masser, supra*, at p. 747.)

FTB asserts that the continuation of R. Mitchell's leasing business on the Clinton property was not impractical. FTB asserts that in *Masser, supra*, at p. 741, the Tax Court found that continuation of the business was impractical because considerations including expense, danger, harm to customer relations, and traffic issues, but did not state that a decrease in profits or minor inconvenience constitutes impracticability. FTB asserts that appellants have not established that Buildings A and C would be without power, communications, data utilities, or restrooms in the event that Building B were demolished and that regardless, appellants did not demolish Building B but sold the property. FTB further contends that after Building B was damaged, R. Mitchell allowed HOPE to occupy Buildings A and C without paying rent, rather than negotiating a new lease with HOPE that may have obligated HOPE to pay many of the operating expenses.

Appellants have established by witness testimony that Buildings A and C relied upon Building B for utilities, including water, gas, and electric for the property, and public restrooms, and that in the event appellants had repaired Building B, it would render Buildings A and C unusable during the repair. Appellants have further established that repair of Building B was economically unfeasible.


As stated in *Masser*, "[t]axation is eminently practical [...] and that a relief provision 'should be liberally construed to effectuate its purpose'." (*Masser, supra*, at p. 746, citing *Massillon-Cleveland-Akron Sign Co., supra*, 15 T.C. at p. 83.). The Tax Court in *Masser* stated that the taxpayer's continued operation would be "economically impractical" because, among other considerations, continued operation of the taxpayer's business would have "entailed considerable direct expense." (*Masser, supra*, at p. 746.) Based on this, OTA finds that economic considerations may render continued business operation impractical. Further, this interpretation comports with the liberal interpretation of IRC section 1033 required under *Davis*. Appellants have established that continuation of R. Mitchell's leasing business of the Clinton property would be economically impractical. For the foregoing reasons, appellants have demonstrated entitlement to IRC section 1033 treatment for the sale of the Clinton property.

HOLDING

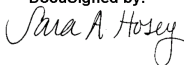
Appellants are entitled to nonrecognition of the gain from the sale of the Clinton property under IRC section 1033.


DISPOSITION

FTB's action is reversed.

Signed by:

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Veronica I. Long
Administrative Law Judge

We concur:

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Sara A. Hosey
Administrative Law Judge

Signed by:

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Seth Elsom
Hearing Officer

Date Issued: 1/13/2026