



BEFORE THE STATE BOARD OF **EQUALIZATION**
OF **THE** STATE OF CALIFORNIA

In the **Matter** of **the** Appeal of)
PETER LAVALLE)

For Appellant: John E. **DeSantis**
Certified Public Accountant

For Respondent: Mary E. Olden
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the **Revenue** and Taxation Code from the action of the Franchise Tax Board on the protest of Peter **Lavalle** against a proposed assessment of additional personal income tax in the amount of **\$5,547.72** for **the** year 1978.

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The sole issue presented is whether in a like-kind exchange, otherwise within the tax deferral provisions of Revenue and Taxation Code section 18081, boot was given by appellant upon his assumption of an alleged liability which could be netted against a mortgage assumed by the transferor of the property exchanged by appellant.

On January 21, 1978, appellant exchanged an apartment house in San Francisco with an adjusted basis of \$87,983 for unimproved land in Sacramento owned by Earl D. Ancker. At the time of the exchange, the apartment house was valued at \$220,000 (see appellant's exhibit "A") and was mortgaged in the amount of \$108,622 while the unimproved land was owned free and clear by Ancker. The escrow documents prepared for the exchange indicate that the unimproved land received by appellant was valued at \$115,000 and that closing costs amounted to \$9,988. Relying upon the tax deferral provisions of Revenue and Taxation Code section 18081, appellant reported no gain on the exchange on his personal income tax return for 1978.

Revenue and Taxation Code section 18081, subdivision (a), provides, in part, that "[n]o gain or loss shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind" However) money or property other than "like-kind" property received in a section 18081 exchange is treated as boot under section 18081, subdivision (b)^{1/}, and gain must be recognized to that extent. Where property transferred by a taxpayer is subject to a mortgage, the amount of that mortgage is treated as boot received by the taxpayer. (Treas. Reg. § 1.1031(b)-1(c).)

^{1/} Revenue and Taxation Code section 18081 is substantially identical to its federal counterpart, section 1031 of the Internal Revenue Code. Therefore, "decisions interpreting the federal law furnish a guide in construction of the state act." (Douglas v. State of California, 48 Cal.App.2d 835, 838 [120 P.2d 927] (1942); see also, Appeal of Glenn A. and Sandra Garcia, Cal. St. Bd. of Equal., Feb. 2, 1976.) Moreover, as there are now no regulations of the Franchise Tax Board interpreting section 18081, pursuant to the authority of section 19253 of the Revenue and Taxation Code, regulations under section 1031 of the Internal Revenue Code would govern the interpretation of the conforming state statute.

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Based upon the above data, respondent determined that the subject exchange qualified for section 18081 treatment but that the mortgage of \$108,622 assumed by Ancker was boot received by appellant and that this sum, less closing costs of \$9,988, or a total of \$98,634, must be recognized as gain by appellant in the year of exchange. Notwithstanding these facts, appellant contends that as part of the exchange he assumed a contract to put in sewers and streets (hereinafter "improvement contract") on the Sacramento property and that this contract should be treated as a liability of Ancker's assumed by appellant which, in turn, should be netted against the mortgage on the property assumed by Ancker. Appellant valued that improvement contract at \$116,000 which, according to his computations, resulted in no net boot received by him and, therefore, no recognition of gain.

Respondent, of course, disagrees with appellant's position. First, respondent contends that the improvement contract was not a liability of Ancker's at all, but an agreement which appellant himself had entered into and, as such, appellant did not assume a liability of Ancker's for netting purposes. Secondly, respondent contends that, even if the improvement contract had been negotiated by Ancker prior to the exchange, it was not the kind of liability which could be netted against the mortgage assumed by Ancker. Respondent contends that liabilities which can be netted are limited to "existing mortgages on the properties-transferred."

Section 18081 speaks in terms of boot received but does not speak of boot given.^{2/} However, the regulations clearly allow the netting of boot in certain circumstances. (Treas. Reg. § 1.1031(b)-1(c); Treas. Reg. § 1.1031(d)-2, examples (1) and (2).) For example,

[w]hen there are mortgages on both sides of the exchange, the mortgages are netted and the difference becomes, for the purpose of determining how much gain is to be recognized, the 'money or other property' received by the

^{2/} For these purposes, it is customary to describe a taxpayer who assumes a liability or accepts property subject to a liability as one who gives boot, and one whose liability is assumed or who transfers property subject to a liability as one who receives boot.

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party transferring the property with the larger mortgage.

(Earlene T. Barker, 74 T.C. 555, 569 (1980).)

Unlike Treasury regulation section 1.453-4(c), Treasury regulation section 1.1031(d)-2 does not expressly refer to mortgage liabilities, but instead refers to "any liabilities of the taxpayer assumed." However, it seems axiomatic that such a liability must be a bona fide liability of the taxpayer and not a mere sham. While no documentation of the improvement contract itself has been provided us, an addendum to the exchange indicates that prior to the date of the exchange, appellant (and not Ancker) contracted with one Charles Amato "to construct off-site improvements for" the Sacramento property. Accordingly, the record presented us indicates that the improvement contract was not entered into by **Ancker** but by appellant so that even if a true liability had been created, such "liability" was the appellant's and not Ancker's. Furthermore, at the date of the exchange, no work had been done and presumably no benefits conferred **so** that at that time any "liability" arising from such contract appears to be illusory.

The implausibility of appellant's position is highlighted by a brief review of the facts. Appellant would have us believe that Ancker exchanged his Sacramento property having a fair market value of \$115,000 against which were alleged **liabilities** of \$116,000 (i.e., the **improvement** contract) for appellant's San Francisco property having a fair market value of \$220,000 against which were mortgage liabilities of \$108,622. Pursuant to appellant's, **theory**, Ancker exchanged a property with a negative equity of \$1,000 for one with a positive equity of \$111,378. Not only does this position contradict the economic reality of the subject exchange; but it borders upon the alchemist's legendary dream of turning base metals into gold,

Therefore, based upon the above, we find that upon the subject exchange, appellant did not assume a bona fide liability of Ancker and that no netting resulted. Accordingly, respondent's action must be sustained.

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O R D E R

Pursuant ~~to~~the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Peter Lavallo against a proposed assessment of additional personal income tax in the amount of **\$5,547.72** for the year 1978, be and the same is hereby sustained,

Done at Sacramento, California, this 5th day Of February , 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Bennett, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr. , Chairman

William M. Bennett . , Member

Richard Nevins_____ , Member

Walter Harvey*_____ , Membe r

_____ , Member

*For Kenneth Cory, per Government Code section 7.9