BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)		
	) Nos.	84A-1145 and
ANDREW F. AND OPAL M. HOUSE AND)		84A-1146-GO
KENNETH G. AND		
MARJORIE L. HOUSER		

For Appellants: James L. Gray
Authorized Representative

For Respondent: Lorrie K. Inagaki
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Andrew F. and Opal M. House against a proposed assessment of additional personal income tax and penalty in the total amount of $403.57 for the year 1981 and on the protest of Kenneth G. and Marjorie L. Houser against a proposed assessment of additional personal income tax in the amount of $723.31 for the year 1981.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

The primary issue raised by these appeals is whether and to what extent gain realized in a tax-deferred exchange within the meaning of section 18081 must be recognized. As framed by the parties, the resolution of this issue, in turn, depends on whether appellants received more "boot" than they gave up in the exchange. 2/ Because of the identity of facts, issues, and legal principles involved in each case, the two appeals are consolidated for purposes of this opinion.

Section 18081 3/ provides, in part, that "[n]o gain or loss shall be recognized if property held for . . . investment . . . is exchanged solely for property of a like kind. . . ." Notwithstanding the word "solely" in section 18081, section 18081 may apply if at least some property meeting all the requirements of section 18081 is transferred in exchange for at least some other qualified property. In addition, that section may apply when nonqualified property or "boot" *is also* transferred and/or received. (Rev. & Tax. Code, § 18081, subd. (b).) Gain realized in such an exchange is recognized, but not in excess of the lesser of the gain realized on the exchange or the amount of the boot received. Boot is defined as the amount of money and fair market value of property other than money received. (Rev. & Tax. Code, § 18081, subd. (b),) The amount of boot received by a taxpayer in an otherwise qualifying exchange is considered to be reduced by the amount of boot given by the taxpayer to the other party. (See Treas. Reg. § 1.1031, subd. (d)-2, examples (1) and (2).)

For this purpose, the amount of any liability of a taxpayer assumed by the other party to the exchange or subject to which the other party acquired the taxpayer's property is considered to be money received by the taxpayer in the amount of such debt decrease. (Rev. & Tax. Code, § 18081, subd. (d).) On the other hand, the amount of any liability of the other party assumed by the taxpayer, or subject to which the taxpayer acquired the

2/ Appellants Andrew F. and Opal M. House have made no arguments with respect to the penalty assessed against them.

3/ Section 18081 is substantially similar to Internal Revenue Code section 1031.

other party's property is considered to be money paid by the taxpayer in the amount of such debt increase. (See Treas. Reg. § 1.1031, subd. (d)-2, example (2) for example of the netting procedures involving liabilities.)

In the instant appeals, the parties agree that the exchange of the properties described below qualifies as a tax-deferred exchange within the meaning of section 18081. The disagreement, as framed by the parties, however, arises with respect to inclusion or exclusion in the netting procedure of a $90,000 note purportedly created upon appellants' temporary acquisition of a mini-storage property subsequently exchanged in the qualifying exchange.

The record indicates that on August 14, 1981, appellants acquired a mini-storage property from David and Janice Hayes (hereinafter "Hayes") for a total consideration of $109,022.96. (Resp. Ex. A.) The closing statement for that transaction indicated that appellants assumed an existing loan of $19,022.96 and gave the Hayes $90,000 denoted in the statement as "deposit or earnest money" for the property. That same closing statement indicated that no new loan was executed with respect to the mini-storage property. (Resp. Ex. A, category 202.) However, the statement indicated that proceeds from the "earnest money" were used to pay off a mortgage on the property the principal balance of which was $87,000. (Resp. Ex. A, category 504.)

On August 24, 1981, appellants exchanged the newly acquired mini-storage property along with other properties which they owned for a property known as the Hogg Ranch which the Hayes owned. (Resp. Ex. B.) On their personal income tax returns for the year at issue, appellants reported the subject exchange as a tax-deferred "like-kind" exchange within the meaning of section 18081. In arriving at the amount of the liabilities assumed by them for netting purposes, appellants included $90,000 which they allege represents a $90,000 note for money advanced from a third party created upon their acquisition of the mini-storage property. In their July 30, 1984, protest letter, appellants allege that the Hayes required that the mini-storage [property] be purchased and subsequently exchanged for [their] property. As part of the agreement, the mortgage [created upon that acquisition] was to stay in appellants' names and "become part of the liability of exchanging into the new property." Inclusion of the note as a "liability assumed" by

appellants in the netting computation resulted in boot given exceeding boot received and, thus, in no gain being recognized to appellants with respect to the subject exchange. Upon audit, however, respondent determined that the subject $90,000 note should not be "considered a liability assumed for purpose of computing gain from the exchange ...." (Resp. Br. at 2.) Exclusion of the $90,000 from the netting computation resulted in the instant proposed assessments.

As framed by the parties, the primary issue would be whether or not the subject $90,000 note was the liability of the Hayes which appellants assumed in the exchange. As indicated above, the closing statement of the August 14, 1981, transaction indicates that no such new mortgage was created involving the mini-storage property. Accordingly, as thus framed, appellants would be unsuccessful in these appeals. However, a closer review of the underlying realities indicates another result. This review is easiest to explain by reviewing the computations submitted by appellants. (Resp. Ex. C.)

As indicated above, in a tax-deferred exchange involving boot, gain is recognized, but not in excess of the lesser of the gain realized in the exchange or the amount of the boot received. Thus, the focus of appellants' computations was to determine which item was less--gain realized or boot received. Respondent's Exhibit C, reproduced, in part, below shows that appellants' computations indicated that due to the mortgages of $196,531 purportedly assumed by appellants, boot was less than zero so that no gain was to be recognized. Respondent's Exhibit C, in relevant part, is as follows:

REALIZED GAIN

4.	Fair Market Value of Property Received	$300,000	
5.	Cash Received	-0-	
6.	Pair Market Value of Boot (Other Than Cash) Received	-0-	
7.	Mortgage Balance on Property Conveyed	151,532[4/]	
8.	Total Consideration Received		$451,532

4/ This figure includes the $19,022.92 mortgage on the the mini-storage property that was conveyed back to the Keyes.

LESS:

9. Adjusted Basis of Property Conveyed	$225,937		
10. Cash Given	11,214		
11. Adjusted Basis of Boot (Other Than Cash) Conveyed	-0-		
12. Mortgage Assumed on Property Received	196,531		
13. Exchange Expenses	10,794		
14. Total Consideration Given		$444,476	
15. Gain Realized on Exchange (line 8 less line 14)			$7,056

RECOGNIZED GAIN

CASH AND BOOT:

16. Cash and Boot (Other Than Cash) Received	$ -0-		
17. Cash and Boot (Other Than Cash) Conveyed	11,214		
18. Exchange Expenses	10,794		
19. Net Cash and Boot (Other Than Cash) Received		$ -0-	

MORTGAGE RELIEF:

20. Mortgage on Property Conveyed	$151,532		
21. Mortgage Assumed on Property Received	196,531		
22. Net Mortgage Relief		$ -0-	
23. Gain Recognized (line 20 less line 21)			$ -0-

The mortgages assumed noted as $196,531 in that exhibit consisted of mortgages assumed in the August 24, 1981, transaction of $106,531 and the subject $90,000 mortgage. As indicated above, the respondent correctly determined that the $90,000 mortgage was not a liability of Hayes which appellants assumed in the exchange. This conclusion would change the figure for line 21 of respondent's Exhibit C from $196,531 to $106,531 and result in net boot received by appellants being $45,001 rather than zero. (Resp. Ex. D.) In making its computation here, respondent made a similar adjustment to line 12 of respondent's Exhibit C which also represented the figure for mortgages assumed, which would indicate that gain

realized was $97,516[5] rather than $7,516 as originally computed by appellants. Accepting all of appellants' other figures[6] and making these two adjustments resulted in the instant assessment reflecting boot received to be the lesser figure of $45,001 which was added to appellants' incomes. (Resp. Ex. D.)

We have no quarrel with these two adjustments, as such. However, the record before us requires that one further adjustment to the computation be made. Clearly, the August 14, 1981, transaction and the August 24, 1981, exchange were part of the same transaction. In the first transaction by appellants, appellants advanced $90,000 in cash to acquire the mini-storage property. Thereafter, this same mini-storage was transferred back to the Hayes. Apparently, tne Hayes needed to clear up the financing of the mini-storage property and appellants advanced thera the money to do so. Accordingly, the two transfers appear to be contractually interdependent. (Brauer v. Commissioner, 74 T.C. 1134 (1980).) Moreover, it has been held that a transaction will qualify as a tax-deferred exchange if the taxpayer's transfer and receipt of property "were interdependent parts of an overall plan, the result of which was an exchange of like kind properties." (Biggs v. Commissioner, 69 T.C. 905, 914 (1978).) Respondent, however, would argue that in the August 14 transfer, appellants received the mini-storage property from the Hayes and the Hayes received only cash so that the August 14 transfer was a sale of the mini-storage property for cash. (Resp. Br. at 6.) Appellants

5/ In respondent's recomputation of the transaction, boot received is the lesser figure and therefore the figure upon which the assessments are based. (Resp. Ex. D.)

6/ It appears that appellants may have made a clerical mistake in transposing the adjusted basis for line nine of respondent's Exhibit C as $225,937 rather than $225,237. In its computation of gain realized, respondent used the $225,237 figure rather than the $225,937 figure which appellants had used. In addition, respondent used a figure of $10,974 for exchange expenses reflected in line 13 of its Exhibit C rather than $10,794 as appellants had done in this computation. These are minor discrepancies which may be resolved later.

would argue that the various transfers fit within the framework of section 18081.

In deciding such questions, the courts have looked to the substance of the transaction. (See Brauer v. Commissioner, supra, 74 T.C. at 1144.) In the instant case, the two transactions were no different than if the mini-storage property had not been transferred at all and appellants had instead added $90,000 to the August 24 exchange with the Hayes then clearing up the financing on the mini-storage property themselves. Indeed, without the understanding that the mini-storage would immediately be returned to the Hayes, it is unlikely that it would have been transferred to appellants at all. Clearly, the August 14 transaction was an "interdependent part" of the *overall plan' to exchange like-kind properties. Accordingly, we find that the two transactions were part of one nontaxable exchange and that appellants, in fact, advanced $90,000 to the exchange which requires a further adjustment. (See also discussion in Smith v. Commissioner, 537 F.2d 972 (8th Cir. 1976).) The adjustment required would be adding to line ten of respondent's Exhibit C $90,000 for this extra cash advanced by appellants. This increases that line from $11,214 to $101,214 and results in the figure for gain realized, using respondent's figures, being $7,516 rather than $97,576 as initially computed by respondent. Since, as indicated above, gain recognized in this transaction must be the lesser of gain realized (here $7,576) and boot received (here $45,001), our further adjustment requires the assessment be modified to reflect that the gain realized ($7,576) is the lesser figure limiting gain recognized.

Accordingly, respondent's determination must be modified in accordance with this conclusion.

Appeals of Andrew F. and Opal M. House
and Kenneth G. and Marjorie L. Houser

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 Andrew F. and Opal M. House against a proposed assessment of additional personal income tax and penalty in the total amount of $403.57 for the year 1981 and on the protest of Kenneth G. and Majorie Houser against a proposed assessment of additional personal income tax in the amount of $723.31 for the year 1981, be modified in accordance with this opinion.

Done at Sacramento, California, this 9th day of April , 1986, by the State Board of Equalization, 'with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Walter Harvey* , Member

, Member

*For Kenneth Cory, per Government Code section 7.9

BEFORE THE STATE BOARD OF EQUALIZATION

OF TBE STATE OF CALIFORNIA

In the Matter of the Appeals of)	
	) Nos. 84A-1145 and
ANDREW F. AND OPAL M. HOUSE AND)	84A-1146-GO
KENNETH G. AND	)
MARJORIE L. HOUSER	)

ORDER DENYING PETITION FOR REHEARING AND MODIFYING OPINION TO CORRECT COMPUTATIONAL ERRORS

In our original determination of this matter on April 9, 1986, we modified the action of the Franchise Tax Board concerning the computation of gain recognized in a like-kind exchange. In its petition for rehearing filed April 28, 1986, respondent argues, first, that our determination is erroneous in treating the August 14, 1981, transaction and the August 24, 1981, exchange as part of the same transaction; and, second, if not erroneous, our computations are not in accordance with that determination.

With respect to the first argument, there is no basis to contradict our initial holding. The two transactions were clearly part of the same plan. (Opinion at 7.) However, to effect that adjustment, the computations must treat the mini-storage property as not having been transferred at all. Accordingly, the computations must be further modified to exclude the $19,022.92 liability on the mini-storage property and the $109,023.00 reflecting appellants' adjusted basis in the mini-storage in the property conveyed category. As a result, respondent is correct with respect to the computational errors in our opinion.. Therefore, although respondent's petition must be denied, the text of our opinion of April 9, 1986, must be modified.

Accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of April 9, 1986, be and the same is hereby affirmed. Good cause appearing therefor, it is also hereby ordered that the text of our opinion of April 9, 1986, beginning on page seven of the original opinion, commencing with the words "The adjustment required would be adding," be and the same is hereby deleted and the following is hereby substituted:

> The adjustment required would be to add $90,000 to line ten of respondent's Exhibit C for the extra cash advanced by appellants, to delete the $19,022.92 reflecting the mortgage on the mini-storage from lines seven and 20 and to delete $109,023.00 reflecting the basis of the mini-storage from line nine as follows:
>
> **REALIZED GAIN**
>
4.	Pair Market Value of Property Received	$300,000	
5.	Cash Received	-0-	
6.	Fair Market Value of Root (Other Than Cash) Received	-0-	
7.	Mortgage Balance on Property Conveyed	132.509	
a.	Total Consideration Received		$432,509

LESS:

9.	Adjusted Basis of Property Conveyed	116,914		
10.	Cash Given	101,214		
11.	Adjusted Basis of Boot (Other Than Cash) Conveyed	-0-		
12.	Mortgage Assumed on Property Received	106,531		
13.	Exchange Expenses	10,794		
14.	Total Consideration Given		335,453	
15.	Gain Realized on Exchange (line 8 less line 14)			$97,056

The gain recognized would be calculated as follows:

RECOGNIZED GAIN

CASH AND BOOT:

16.	Cash and Boot (Other Than Cash) Received	$ -0-		
17.	Cash and Boot (Other Than Cash) Conveyed	101,214		
18.	Exchange Expenses	10,794		
19.	Net Cash and Boot (Other Than Cash) Received (line 16 less lines 17 and 18)		$ -0-	

MORTGAGE RELIEF:

20.	Mortgage on Property Conveyed	132,509		
21.	Mortgage Assumed on Property Received	106,531		
22.	Net Mortgage Relief (line 20 less line 21)		25,978	
23.	Gain Recognized (line 19 plus line 22)			$25,978

Based upon the above calculations, the lesser figure for recognition purposes, which is the lesser of the gain realized or the boot received, is the net mortgage relief of $25,978;. This, then, is the

amount of gain that must be recognized in this exchange. Respondent's determination must be so modified in accordance with this conclusion.

Done at Sacramento, California, this 7th day Of April , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman

Ernest J. Dronenburg, Jr. , Member

Paul Carpenter , Member

Anne Baker* , Member

, Member

*For Gray Davis, per Government Code section 7.9