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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
ESTHER KORMAN	Case No. 680322

Year	Proposed Assessment
2004	$293,037

Representing the Parties:

For Appellant: Bradley R. Marsh and C. Michelle Ferreira, Attorneys

For Franchise Tax Board: Ciro M. Immordino, Tax Counsel III

QUESTION: Whether a valid Internal Revenue Code (IRC) section 1031 exchange was executed such that appellant is not required to recognize pass-through gain from the sale of real property.[1]

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[1] As relevant to the issues in this appeal, California conforms to IRC section 1031.

HEARING SUMMARY

Factual Background

Metro Real Properties IV, LLC ("Metro") owned real property located at an address on Franklin Avenue in Los Angeles, California (the "Franklin Property"). Metro had two members: Ester Korman ("appellant") and Lieb Korman ("Mr. Korman"), with both members owning 50 percent interest in Metro. (Resp. Op. Br., p. 3, Exh. D.)

Sale of Franklin Property

In anticipation of a planned sale of the Franklin Property, Metro entered into an exchange agreement with Windsor Exchange Corporation ("Windsor"). Windsor would serve as the intermediary in a like-kind exchange of the Franklin property. The exchange agreement provided that the proceeds from the Franklin property sale are the "sole and exclusive property of Windsor" until the closing date of the exchange. On July 23, 2004, the Franklin Property was sold and proceeds of $5,933,965.38 sent to Windsor.[2] (Resp. Op. Br., p. 3, Exhs. E & F.)

On September 29, 2004, during the exchange period appellant and Mr. Korman signed an document labelled "AMENDMENT TO EXCHANGE AGREEMENT" with Windsor ("amendment"). The amendment reflected that appellant signed the amendment both in her individual capacity and as the "Member/Manager" of Metro. The amendment also reflected that Mr. Korman signed the amendment in his individual capacity. The amendment directed Windsor to distribute half of the Franklin Property sale proceeds to Mr. Korman. In accordance with appellant's instruction as managing member of Metro, Windsor distributed $2,972,776.71 of the sale proceeds to Mr. Korman. (Resp. Op. Br., pp. 3-4, Exhs. G & H.)

Arizona Properties

On September 1, 2004, a real estate purchase agreement was entered into between sellers and Tony LaRuffa, Jack Tiano, "and/or Permitted Assignee." The purchase agreement was for the following three real properties: (1) the Sierra Vista Apartments in Tucson, Arizona; (2) the Parkwood Apartments in Phoenix, Arizona; and (3) the Metro Village Apartments in Phoenix, Arizona

[2] According to the seller's escrow statement for the Franklin Property, Windsor's name was mistakenly listed as "Wilshire." This does not impact the issues in this appeal.

(together all three are referred to as the "Arizona Properties"). In an undated assignment document, Tony LaRuffa and Jack Tiano assigned 78.2279 percent of their interest in the purchase agreement to eight persons and entities, including a 37.9747 percent interest to Metro (together the "Assignees"). Tony LaRuffa and Jack Tiano retained a 21.7721 percent interest in the purchase agreement to buy the Arizona Properties. (Resp. Op. Br., pp. 4-5, Exhs. I & J.)

(1) <u>Sierra Vista Apartments</u>

An escrow statement provided that the Sierra Vista Apartments were purchased on November 30, 2004 by 3535 Sierra Vista Apartments, LLC ("Sierra LLC"). Neither Metro nor Windsor was listed as a purchaser of the real property on the escrow statement. The escrow statement listed a sales price of $8,775,000.00, a new loan of $6,852,000.00 and reflected that Windsor deposited $392,054.26 into escrow. The loan agreement for the $6,852,000 loan listed the sole borrower as Sierra LLC, with Anthony LaRuffa signing the loan document on behalf of Sierra LLC. Schedule B of the loan document is an amendment to extend the maturity date of the loan. Appellant, Ms. Korman, was a guarantor on the Sierra LLC loan. Neither Metro nor Windsor was listed as either a borrower or a guarantor on the Sierra LLC loan. (Resp. Op. Br., p. 5, Exhs. K & L.)

On November 30, 2004 at 5:30 pm, three documents were recorded simultaneously: (1) a deed which transferred the Sierra Vista Apartments from the seller to Sierra LLC and the Assignees, including a 37.9747 percent interest to Metro; (2) a deed transferring Metro's interest in the Sierra Vista Apartments to Sierra LLC; (3) a deed of trust between the lender and Sierra LLC which was secured by the entirety of the Sierra Vista Apartments. The deed of trust was only signed by Anthony LaRuffa on behalf of Sierra LLC. Section 21(a)(1) of the deed of trust disallowed a transfer of any interest in the Sierra Vista Apartments. According to the operating agreement of Sierra LLC, Metro received a member interest in Sierra LLC. (Resp. Op. Br., pp. 5-6, Exhs. M, N, O & P.)

(2) <u>Parkwood Apartments</u>

An escrow statement provided that the Parkwood Apartments were purchased on November 30, 2004, by 5656 Parkwood Apartments, LLC ("Parkwood LLC"). Neither Metro nor Windsor was listed as a purchaser on the escrow statement. The escrow statement listed a purchase price of $6,775,000.00, a new loan of $5,000,000.00 and reflected that Windsor deposited $734,109.33

into escrow. The Parkwood LLC loan agreement for the $5,000,000 loan listed the sole borrower as Parkwood LLC, with Anthony LaRuffa signing the loan document on behalf of Parkwood LLC. Appellant was a guarantor on the Parkwood LLC loan. Neither Metro nor Windsor was listed as either a borrower or guarantor on the Parkwood LLC loan. (Resp. Op. Br., p. 6, Exhs. Q & R.)

On November 30, 2004 at 4:57 pm, three documents were simultaneously recorded: (1) a deed which transferred the Parkwood Apartments from its seller to Parkwood LLC and the Assignees, including a 37.9747 percent interest to Metro; (2) a deed transferring Metro's interest in the Parkwood Apartments to Parkwood LLC; and (3) a deed of trust between the lender and Parkwood LLC which was secured the loan by the entirety of the Parkwood Apartments. The deed of trust was signed only by Anthony LaRuffa on behalf of Parkwood LLC. Section 21(a)(1) of the deed of trust disallowed a transfer of any interest in the Parkwood Apartments. According to the Parkwood LLC operating agreement, Metro received a membership interest in Parkwood LLC. (Resp. Op. Br., pp. 6-7, Exhs. S, T, U & V.)

(3) *Metro Village Apartments*

An escrow statement provided that the Metro Village Apartments were purchased on November 30, 2004, by 3106 Metro Apartments, LLC ("3106 Apartments LLC"). Neither Metro nor Windsor was listed as a purchaser on the Metro Village Apartments escrow statement. The escrow statement listed a purchase price of $13,870,000.00, an assumption of a loan of $10,067,811.72, and reflected that Windsor deposited $1,873,836.40 into escrow. The agreement for the assumed loan listed the sole transferee as 3106 Apartments LLC, with Anthony La Ruffa signing the loan document on behalf of 3106 Apartments LLC. Neither Metro nor Windsor was listed as a transferee. Appellant was a guarantor on the loan. Neither Metro nor Windsor was listed as either a borrower or guarantor on the loan. (Resp. Op. Br., p. 7, Exhs. W & X.)

On December 1, 2004 at 11:50 am, three documents were simultaneously recorded: (1) a deed which transferred the Metro Village Apartments from the seller to 3106 Apartments LLC and the Assignees, including a 37.9747 interest to Metro; (2) a deed which transferred Metro's interest in Metro Village Apartments to 3106 Apartments LLC; and (3) the assumption of loan document between the lender and 3106 Apartments LLC, which secured the loan by the entirety of Metro Village

Apartments. The assumption of loan document was signed by Anthony LaRuffa on behalf of 3106 Apartments LLC and the assignees, including appellant as an individual. According to 3106 Apartments LLC's operating agreement, Metro received a membership interest in 3106 Apartments LLC. (Resp. Op. Br., pp. 7-8, Exh. X, Y, Z, & AA.)

Procedural Background

Appellant timely filed her 2004 California tax return as a single individual, claiming IRC section 1031 exchange treatment for the pass through gain from the sale of the Franklin Property. Respondent subsequently disallowed the claimed like-kind exchange and issued a Notice of Proposed Assessment (NPA) dated November 6, 2009, in which respondent proposed to increase appellant's California taxable income by $3,150,940, resulting in additional tax of $293,037. The NPA stated that the claimed like-kind exchange did not qualify for non-recognition treatment because the property exchanged was not of like-kind since real property was exchanged for an LLC interest. Appellant protested the NPA. After review, respondent issued a Notice of Action (NOA) dated October 30, 2012, in which respondent affirmed the NPA. The NOA stated that the intermediary was an agent of the taxpayer and the taxpayer did not acquire like-kind property. This appeal then followed. (Resp. Op. Br., Exhs. A, B, & C.)

Contentions

Appellant's Appeal Letter

Appellant contends that she, through Metro, relinquished investment property in 2004 and exchanged that property for TIC interests in three separate, but similar investment properties in Arizona. Appellant contends that deeds reflecting these transactions were properly recorded and the exchange satisfied all the requirements under California and federal tax law for a valid exchange. Appellant contends that the new real property interests subsequently were transferred to three separate Arizona LLCs with other co-tenants in proportion to their respective ownership interests. Appellant indicates that she has been the managing member of each of these three Arizona LLCs since that transaction and contends that she continues to hold her LLC interest in these properties for investment purposes. Appellant contends that respondent improperly applied the substance-over-form and step transaction doctrines to this appeal. Appellant contends that the facts show that she exchanged real property for real property. Citing *Magneson v. Comm'r* (1985) 753 F.2d 1490 (*Magneson*), appellant contends that where real property interests were subsequently transferred into LLCs, these subsequent transfers are considered a "continuation of the investment." (Appeal Letter, pp. 1-2.)

Appellant further contends that respondent did not cite relevant authority for respondent's theory that appellant was not entitled to like-kind exchange treatment because one of the LLC partners making the exchanges was permitted by a third party trustee to withdraw from the partnership prior to the conclusion of the exchange. (Appeal Letter, pp. 3-4.)

Respondent's Opening Brief

Respondent contends that appellant must recognize the pass through gain from the sale of the Franklin property because Metro failed to complete a valid like kind exchange for the following four reasons.

1. Metro had actual receipt of the sale proceeds from the Franklin Property

Respondent contends that Metro was in actual receipt of the proceeds from the sale of the Franklin Property. Respondent acknowledges that Treasury Regulation section 1.1031(k)-1 allows taxpayers the benefit of a like kind exchange under IRC section 1031 when property is sold through an intermediary and that intermediary then uses the proceeds from the sale to purchase new property on behalf of the taxpayer as long as certain requirements are followed. Respondent contends that one of these requirements is that the taxpayer have no right or ability to access proceeds held by a qualified intermediary during an exchange, citing Treasury Regulation section 1.1031(k)-1(f)(1). Respondent further contends that courts have invalidated attempted like-kind exchanges where taxpayers actually or constructively received or had the ability to receive or benefit from the sale proceeds during an exchange, citing *Big Hong Ng v. Comm'r*, T.C. Memo. 1997-248, *Klein v. Comm'r* (1993) 66 T.C.M. 1115 (*Klein*), *Estate of Bowers v. Comm'r* (1990) 94 T.C. 582, *Maxwell v. U.S* (1988) 88-2 U.S. Tax Cas. 9560, and *Lee v. Comm'r*, T.C. Memo. 1986-294. (Resp. Op. Br., pp. 8-9.)

Respondent notes that Treasury Regulation section 1.1031(k)-1(g)(4)(i) provides a safe harbor that a qualified intermediary is not considered an agent of the taxpayer for purposes of IRC section 1031(a) under certain circumstances. Respondent contends that this safe harbor provision only applies if the agreement between the taxpayer and the qualified intermediary expressly limits the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary, citing Treasury Regulation section 1.1031(k)-1(g)(4)(ii). Respondent contends Treasury Regulation section 1.1031(k)-1(g)(6)(i) clarifies that the taxpayer must have no rights, except as provided in (g)(6)(ii) and (g)(6)(iii) of that section, to receive, pledge, borrow, or otherwise obtain the benefits of money or other property before the end of the exchange period.[3] (Resp. Op. Br., pp. 9-10.)

Respondent contends that Metro's ability to amend the exchange agreement in the middle of the attempted exchange and receive a distribution of $2,972,776.71 from Windsor demonstrates that Windsor did not comply with the requirement that Metro have no right to receive the sale proceeds. Respondent contends that the safe harbor does not apply to Windsor, with the result that Windsor is considered Metro's agent for all purposes, including attribution of control over the funds received when the Franklin property was sold. Respondent contends that since Windsor merely acted as a conduit for Metro, Windsor is Metro's agent under the United States Supreme Court factors discussed in *Comm'r v. Bollinger* (1988) 485 U.S. 340, 346-347.[4] Respondent contends that, as Windsor was Metro's agent and had actual receipt of the entire proceeds from the sale, Metro had actual receipt of the entire proceeds from the sale of the Franklin property. (Resp. Op. Br., pp. 10-11.)

2. Metro had constructive receipt of the sale proceeds from the Franklin Property

Respondent contends that Metro was in constructive receipt of the proceeds from the sale of the Franklin Property. Respondent notes that Treasury Regulation section 1.1031(k)-1(f)(2) provides that the taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of

[3] Respondent contends that these exceptions do not apply to the present appeal.

[4] "There is such a thing as a true corporate agent of an owner-principal, and the four indicia and two requirements of such status are known in federal income tax law as the 'six National Carbide factors': [1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent." *Commissioner v. Bollinger, supra.*

intent to draw is given. Citing *Klein*, *supra*, respondent contends that Metro's ability to disregard the exchange agreement and obtain almost $3 million in cash at its own discretion demonstrates Metro's ownership, enjoyment, and constructive receipt of the sale proceeds from the Franklin property. (Resp. Op. Br., pp. 11-12.)

Respondent contends that appellant is "not an innocent party who is being assessed tax with respect to a transaction out of her control." Respondent contends that, during the exchange period, appellant signed the disqualifying amendment to Metro's exchange agreement with Windsor on behalf of Metro as its managing member and in her own individual capacity. Respondent contends that Windsor complied with Metro's instructions and issued the funds to Mr. Korman in or around September 30, 2004, approximately two months prior to the purchase of the alleged replacement property. Respondent contends that Metro and Windsor disregarded the requirement in Treasury Regulation section 1.1031(k)-1(g)(6)(i) that Metro have no right to receive the sale proceeds. Respondent argues that Metro's ability to receive half of the sale proceeds demonstrates that Metro could have asked for and received the entirety of the exchange proceeds from Windsor. (Resp. Op. Br., p. 12.)

Respondent further contends that it was appellant's affirmative decision, as managing member of Metro, to violate both the terms of the exchange agreement and the law regarding like kind exchanges by directing Windsor to distribute 50 percent of the sale proceeds to Mr. Korman. Respondent contends that Metro's ability to access some of the exchange proceeds demonstrates that Metro could have accessed all of the exchange proceeds. Respondent further argues that constructive receipt is a venerated principle in tax law, citing *Corliss v. Bowers* (1930) 281 U.S. 376 in which the United States Supreme Court held that a taxpayer who retained the power to modify or revoke a trust was in constructive receipt of the trust income because he had the ability to access the money if he had so chosen. (Resp. Op. Br., pp. 13-14.)

3. Metro did not acquire replacement property

Respondent contends that, through the application of the substance-over-form doctrine, the Arizona LLCs, not Metro, bought the purchased properties. Respondent asserts that an alternative ground for disqualifying the exchange is that the same legal entity that sold the relinquished property did not acquire replacement property in a like kind exchange. Citing *Comm'r v. Court Holding Co.* (1945) 324 U.S. 331 (*Court Holding*), respondent asserts that the tax consequences depends on the substance of a transaction and the transaction must be viewed as a whole and each step, from the commencement of the negotiations to the consummation of the sale is relevant. Respondent further contends that the Board confirmed the appropriateness of applying the substance-over-form doctrine to disallow an attempted like-kind exchange in the *Appeals of Brookfield Manor, Inc., et. al*, 89-SBE-002, decided by the Board on January 11, 1989 (*Brookfield Manor*). (Resp. Op. Br., pp. 14-15.)

Respondent contends that the purchase of the Arizona Properties was momentarily structured to give the appearance that Metro purchased partial TIC interests in the Arizona Properties. Respondent notes that 78.2279 percent of the purchase agreement for the Arizona Properties was assigned to the Assignees and transitory deeds were recorded in the names of the Assignees, including Metro. Respondent contends that a review of all the documents recorded on the same day in the exchange, as well as the pertinent loan and escrow documents, demonstrates that the Arizona LLCs, not the Assignees, were the true purchasers of the Arizona Properties. Respondent notes that the assignment document purportedly purchasing the replacement Arizona properties is not dated and only signed by one of the eight assignees (not Metro or appellant). Respondent further contends that the assignment document assigns an interest in the purchase agreement to appellant, not Metro or Windsor.[5] Respondent argues that the same person disposing the property must receive the replacement property in order for an exchange to occur, citing *Chase v. Comm'r* (1989) 92 T.C. 874 (*Chase*). Respondent contends Metro never received the right to buy the Arizona Properties, and Metro is an entirely different taxpayer from appellant, to whom a portion of the purchase agreement was assigned. Respondent further contends that, while Metro attempted to salvage the exchange as a transitory owner of TICs related to the Arizona Properties, Metro was only recorded as a TIC owner in all three of the Arizona Properties for less than one minute in each case. Respondent contends that Metro's TIC interest was then immediately transferred to the Arizona LLCs, the intended property

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[5] It appears that Metro is listed as an assignee on the document.

owners of the respective Arizona Properties.[6] Respondent further contends that a review of the other documents concerning the purchase of the Arizona Properties show that Arizona LLCs were the actual purchasers of the Arizona Properties. Respondent notes that the total purchase price of the Arizona Properties was $29,420,000. Respondent contends that $21,919,811.72 of this amount was funded by loans undertaken by the Arizona LLCs, not Metro, and on which the Arizona LLCs were listed as the borrowers. Respondent observes that just signing a guarantee does not make the guarantor a principal on the loan or give the guarantor an ownership interest in the property upon which the note relates. Respondent however argues that the note was signed by appellant in her individual capacity and shows that Metro was not connected with the loans, even as a guarantor. (Resp. Op. Br., pp. 16-17.)

Respondent argues that no merit should be given to the position that loans are properly used to purchase property for persons and entities other than the intended borrowers because lenders in that situation would not have a security interest in the property purchased by the unintended buyer. Respondent points out that all three escrow statements for the purchase of the Arizona Properties list the Arizona LLCs as the sole purchasers and the loans to the Arizona LLCS were secured by 100 percent of the Arizona Properties. Respondent accordingly contends that the loan documents contemplated that the Arizona LLCs would be the purchasers of 100 percent of the Arizona Properties and should be treated as such for tax purposes. (Resp. Op. Br., p. 17.)

Respondent notes that, in the same minute that Metro's and the other supposed TIC buyers' deeds were recorded, the TIC interests in the Arizona Properties were then transferred to the Arizona LLCs. Respondent also notes that the deeds of trust which secured the loans were then recorded. Respondent asserts that this ordering was necessary for the appearance of formalities while still attempting to record the lender's deeds of trust secured by 100 percent of the Arizona Properties which could only be recorded after the Arizona LLCs owned 100 percent of those properties. Respondent argues that the manner of which the deeds were recorded is contradictory to what happened

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[6] Citing the Board's decision in *Brookfield Manor, supra*, respondent also contends that, under appellant's theory that Metro acquired TIC interests in the Arizona Properties, Metro is not considered to hold the TIC interests in the Arizona Properties for investment, as otherwise required by IRC section 1031(a)(1) since Metro immediately exchanged those TIC interests for membership interests in the Arizona LLCs, which constitute intangible personal property.

in substance and for tax purposes. Respondent contends that the Arizona LLCs were always the intended property owners and the loans necessary to buy the Arizona Properties were solely obtained by the Arizona LLCs and secured by the Arizona Properties. Respondent argues that appellant's claim of Metro having intermediary ownership in the Arizona Properties between the period when the loans were funded and the lenders' rights were secured is a distortion of the substance of the purchase transactions. Respondent contends that the act of recording the deeds in the names of the Assignees were mere formalities designed to make the transaction appear to be something other than what it was in order to avoid tax liability. Respondent asserts that, at best, Metro received an interest in the Arizona LLCs, which is specifically disallowed by IRC section 1031(a)(2)(D) for like kind treatment. (Resp. Op. Br., pp. 18-19.)

4. Metro received partnership interests which are not qualifying replacement property

Respondent contends the step transaction doctrine applies to this appeal and results in the determination that Metro received partnership interests in the Arizona LLCs rather than TIC interests in the Arizona LLCs, which do not constitute real property replacement property for the like-kind exchange treatment. Citing *Brown v. U.S.* (6th Cir. 1986) 782 F.2d 559,[7] respondent asserts that the circumstances in this appeal satisfy the end result and the interdependence tests and therefore the step transaction doctrine applies to this appeal. (Resp. Op. Br., pp. 19-20.)

As to the end result test, respondent contends that, based on appellant's claim, it is undisputed that Metro's alleged purchase of a TIC interest in the Arizona Properties and subsequent immediate contribution to the Arizona LLCs was part of a single intended transaction. Respondent contends that the end result test is satisfied and results in finding that Metro received LLC membership interests, intangible personal property that is not qualifying like kind property under IRC section 1031(a)(2)(D). Respondent contends that the receipt of this non-like kind property disqualifies Metro from like-kind exchange treatment. (Resp. Op. Br., p. 20.)

As to the interdependence test, respondent contends that this test is satisfied as Metro and the other Assignees purchased TIC interests in the Arizona Properties because the loan agreements

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[7] Staff notes that, following remand and further findings by the trial court, the Sixth Circuit Court of Appeals later held that the step transaction doctrine did not apply. (*Brown v. United States* (6th Cir. 1989) 868 F.2d 859.)

required the Arizona LLCs to own 100 percent of the Arizona Properties. Respondent contends that, as the circumstances satisfy the interdependence test, the anticipated and intended results of Metro's transaction were the receipt of LLC membership interests, intangible personal property that is not qualifying like kind property under IRC section 1031(a)(2)(D). Respondent further asserts that, at the end of the associated transactions, Metro's intangible ownership interests in any of the three LLCs could not be exchanged for real property in a qualifying 1031 exchange. Respondent asserts that this lack of reciprocity shows that the overall intended effect and consequences of this exchange does not qualify for tax deferral under IRC section 1031. (Resp. Op. Br., pp. 20-21.)

Respondent points to the Board's decision in the *Appeal of Sargent Industries*, 93-SBE-008, decided on April 22, 1993, in support of its position, noting that the Board determined that the step transaction doctrine is applicable where a taxpayer who entered into various transactions for the single purpose of reorganizing and restructuring itself and the transactions were part of a clearly defined plan with prearranged and required steps. Respondent also points to the Board's decision in the *Appeal of Chris-Craft Industries, Inc*., 68-SBE-011, decided on March 26, 1968, noting that the Board determined that the step transaction doctrine is applicable where a taxpayer engaged in a series of transactions that were carried out for the purpose from beginning to end of securing a loan to pay a corporate debt. (Resp. Op. Br., pp. 21-22.)

As to appellant's reliance on *Magneson*, *supra*, respondent contends that decision is based on now-repealed California Corporation Code section 15025.[8] Respondent further contends that subsequent to the law cited in *Magneson*, the Internal Revenue Code was amended to exclude interests in a partnership from qualifying property under IRC section 1031. As to the current law regarding California LLC interests, respondent contends that the California Legislature repealed California Corporation Code section 15025 in 1999 and immediately added California Corporations Code section 16501, which provides that a partner is not a co-owner or partnership property and has no interest in partnership property that can be transferred either voluntarily or involuntarily. Respondent asserts that the legislature intentionally reversed the law regarding a partner's interest in the property of

[8] Former California Corporations Code section 15025 provided that partners have an ownership interest in the property of the partnership.

a partnership. Respondent further notes that California Corporations Code section 17300 provides that a membership interest in an LLC constitutes personal property of the member and a member or assignee has no interest in specific LLC property. (Resp. Op. Br., p. 22.)

As to the current law regarding Arizona LLC interests, respondent notes that Arizona law provides a membership interest in an LLC constitutes personal property of the member, citing Arizona Revised Statutes section 29-732. Respondent further notes that Arizona law provides that property acquired by a partnership is property of the partnership and not of the partners individually, citing Arizona Revised Statutes section 29-1013. As such, respondent contends that Metro's ownership interest in the Arizona LLCs did not give Metro an ownership interest in the Arizona Properties held by Arizona LCCS and Metro merely owned an intangible personal property interest in the Arizona LLCs. (Resp. Op. Br., p. 23.)

As to the current law regarding IRC section 1031 and partnership interests, respondent contends that the *Magneson* court's decision was based on its understanding that a taxpayer could do a like kind exchange of real property for an interest in a partnership that owned real property. Respondent notes that, in 1984, Congress amended the Internal Revenue Code to exclude partnership interests from IRC section 1031. Respondent further points out the *Magneson* court qualified its own opinion by noting in its decision that, for transactions executed after July 18, 1984, Congress amended section 1031(a) to exclude the exchange of partnership interests. Respondent contends that Metro received membership interests in the Arizona LLCs which are excluded from IRC section 1031 treatment regardless of whether the Arizona LLCs owned real property. Respondent contends that, if Metro is considered to have purchased TIC interests in the Arizona properties, then Metro's attempted like kind exchange would also be disallowed under the step transaction doctrine. Respondent contends that, under the step transaction doctrine, Metro is considered to have exchanged real property for partnership interests, which are excluded from IRC section 1031 and are not like kind to real property. (Resp. Op. Br., pp. 23-26.)

<u>Appellant's Reply Brief</u>

Appellant contends that she and her father-in-law, Mr. Korman, planned to replace some rental units they held through Metro by using a like-kind exchange and engaged a property exchange facilitator to handle the sale, transfer, and swap of the property. Appellant states that Mr. Korman "suddenly and unreasonably decided" to withdraw from Metro and demanded the escrow funds to be paid to him. Citing California Corporations Code section 17252, appellant contends that Mr. Korman had the right to disengage from Metro and have his share of the investment returned to him. Appellant contends that, at the time of the withdrawal, the exchange was already in mid-stream as the sale proceeds were held by Windsor and the exchange agreement did not allow Mr. Korman to obtain those funds. Appellant contends that, under threat of a lawsuit, she allowed Mr. Korman to withdraw from Metro and Windsor distributed one-half of the funds to Mr. Korman. Appellant asserts, despite Mr. Korman's withdrawal, the exchange was completed by Windsor and appellant as Metro received the replacement property. (App. Reply Br., pp. 1-2.)

1. Metro and appellant did not have actual receipt of the sale proceeds from the Franklin Property

Appellant contends that she and Metro did not actually receive the sale proceeds from the Franklin Property. Appellant asserts that she, through Metro, properly completed the exchange despite Mr. Korman's withdrawal from the investment. Appellant contends that she did not benefit in any way by Mr. Korman's withdrawal and her economic position was unchanged. Citing Treasury Regulation section 1.1031(k)-1(f)(2), appellant contends that she did not improperly receive any exchange funds or the economic benefit of those funds at any point in time. Appellant contends that the exchange agreement between Metro and Windsor satisfied the requirements for the safe harbor provision, citing Treasury Regulation sections 1.1031(k)-1(g)(4)(i), 1.1031(k)-1(g)(4)(ii), and 1.1031(k)-1(g)(6). Appellant points out that the exchange agreement did not include a right by appellant, Mr. Korman, or Metro to obtain money or other property before the end of the exchange period, and instead, the agreement reserved all discretion in the exchange facilitator, Windsor.[9] (App. Reply Br., pp. 3-4.)

As to respondent's reliance on the September 29, 2004 document to support its position

[9] Appellant points to Section 6.2 of the exchange agreement which stated that there is no agency and Section 2.3 of the agreement which stated that all cash proceeds received by Windsor from the sale and any and all earnings thereon shall be under the control of Windsor. Appellant further points out that Section 4.1 of the agreement stated that Metro has no right to request or demand any disbursement or payment of cash from Windsor instead of exchange property.

that Windsor was an agent of Metro, appellant asserts that she and Mr. Korman signed a "hastily drafted document" stating that Mr. Korman left Metro, Mr. Korman assigned his rights to appellant, and that Windsor could pay Mr. Korman his share of the sale proceeds. Appellant contends that she, Mr. Korman, and Metro did not have any right to control how Windsor decided to send funds to Mr. Korman. Appellant further contends that the September 29, 2004 document is not an "amendment" to the June 21, 2004 exchange agreement as the September 29, 2004 document was not signed by Metro and Windsor, as required by Section 6.5 of the exchange agreement. Appellant asserts that Windsor distributed funds to Mr. Korman in its sole discretion and in its own self-interest under the threat of a lawsuit from Mr. Korman. Appellant asserts that Metro, now wholly owned by appellant, and Windsor consummated the exchange as outlined in the original exchange agreement. As such, appellant contends that that the safe harbor provision applies, Windsor was not an agent, and she and Metro did not have actual receipt of the sale proceeds from the Franklin Property. (App. Reply Br., pp. 4-5.)

2. *Metro and appellant did not have constructive receipt of the sale proceeds from the Franklin Property*

Appellant contends that the doctrine of constructive receipt should not apply in this appeal, citing *Griffith v. Comm'r* (1971) 35 T.C. 882. Appellant contends that neither she nor Metro realized any cash boot or received any other gain as a result of Mr. Korman's withdrawal, citing IRC section 1031(b). Appellant contends that Mr. Korman's receipt of his portion of the funds after his withdrawal from Metro was wholly unrelated to the exchange and in no way altered the exchange as it pertained to appellant and Metro. Appellant contends that Mr. Korman's actions and Windsor's decision should not affect her position as she had no right to control Mr. Korman or Windsor's actions. Appellant asserts that she could not legally control, request, or direct the funds held by Windsor and she did not have the ability to waive limitations or restrictions over the control of the funds. (App. Reply Br., p. 6.)

Appellant further contends that *Klein, supra,* has no application in this appeal. Appellant asserts that while the taxpayer in *Klein* obtained access to the sale proceeds by amending the agreement, the agreement in this appeal was not "effectively amended." Appellant asserts that the

September 29, 2004 document "simply recognized" that Mr. Korman withdrew from Metro and was entitled to his share of the membership interest under California law. Appellant asserts that the document did not allow her or Metro to obtain any portion of the proceeds and the remaining portion of the proceeds remained with Windsor. Appellant contends that substantial limitations existed in this appeal as the exchange agreement placed heavy restrictions on the transaction. (App. Reply Br., p. 7.)

Appellant contends that the present appeal is more akin to *Morton v. United States* (Ct. Fed. Cl., 2001) 107 AFTR 2d 2011-1963 (*Morton*), in which some of the sale proceeds in an attempted exchange were placed in a bank account of the taxpayer's business subsidiaries instead of with the escrow agent. Appellant notes that the *Morton* court did not have constructive receipt because he was bound by contract to not "receive, pledge, borrow, or otherwise obtain benefits of the Exchange Value." Appellant further points out that the *Morton* court reasoned that a taxpayer should not be penalized for another's mistake when the taxpayer took every step to cause a deferred like-kind exchange and the taxpayer did not have control over the mistaken actions of a third party. Appellant contends that, like *Morton*, she and Metro did not have any control over Mr. Korman or Windsor's action. (App. Reply Br., pp. 7-8.)

3. Metro and appellant properly acquired replacement properties

Appellant also contends that the exchange should not be disregarded using the substance-over-form or step transaction doctrines. Appellant contends that, contrary to respondent's position, the Ninth Circuit Court of Appeals in *Magneson* and courts in other related cases have held that subsequent transfers of acquired TIC interests into LLCs are entitled to IRC section 1031 exchange treatment. Appellant contends that the *Magneson* court declined to read into IRC section 1031 the requirement that a taxpayer continue to hold acquired property in the exact form of ownership in which it was acquired. Appellant contends that each of the replacement property interests were transferred into separate, single purpose LLCs treated as partnerships for federal tax purposes. Appellant contends that the LLCs more closely resemble the entities described in *Magneson* than a shareholder of a corporation. Appellant contends that she, as managing member of the LLCs, directs, manages, and controls the investment properties of the LLCs and has expansive authority, power, and discretion to make decisions regarding the properties. Appellant notes that the *Magneson* court did not opine on how LLCs would be treated with regards to IRC section 1031 exchanges (as LLCs did not exist at the time of its decision), but argues that the court's analysis is directly applicable to this appeal and supports finding that the replacement property was of like-kind. (App. Reply Br., pp. 8-9.)

Appellant contends that the fact that Metro (and appellant) decided to hold the replacement properties within the single purpose LLCs did not violate the holding requirement to treat the properties as continued investment in a trade or business or otherwise disqualify the like-kind exchange. Appellant contends that the Board should consider *Department of Revenue v. Marks* (2009) 20 OTC 35; 2009 Ore. Tax LEXIS 241 (*Marks*), in which the court held that the *Magneson* decision was applicable to a taxpayer's transfer of property held as TIC for replacement property that was immediately transferred to a partnership. Appellant points out that the court in *Marks* reasoned that the issue of whether there is continuity of investment versus a cashing out and the purpose of any partnership to which property received in an exchange is contributed is more important than the details of the state law rights as between co-tenants and partners. Appellant further contends that the IRS acknowledged that *Magneson* is precedential in Field Service Advice (FSA) 199951004 in which the IRS stated that, although it disagreed with the conclusion in *Magneson* and *Bolker v. Comm'r* (9th Cir. 1985) 760 F.2d 1039 (*Bolker*) that a taxpayer receives property subject to a prearranged agreement to immediately transfer the property holds the property for investment, it was no longer pursuing this position in light of the negative precedent. (App. Reply Br., pp. 10-11.)

4. The step transaction doctrine has no application in the present appeal

Appellant contends that the like-kind exchange in the present appeal is similar to that in *Magneson* in that multiple steps were taken and there was more than one way to reach the end result. Appellant contends that the *Magneson* court upheld the taxpayer's choice of completing the exchange by obtaining a property interest in the replacement property and later contributing that property into a partnership with other co-tenants because there was no more direct method to achieve the same result. Appellant contends that here there was no more direct method that could be used to execute the transaction. Appellant contends that, contrary to respondent's contention that the acquisition of replacement property and subsequent transfer involved a step with no valid business purpose, the owner needed to transfer the property to the LLCs in order to properly operate it and obtain financing. (App.

Reply Br., pp. 11-12.)

Appellant contends that respondent's position that appellant never held the benefits and burdens of ownerships and did not meet the holding requirement are essentially different ways of saying that the replacement property as not used in a trade or business or for investment. Citing *Magneson*, appellant contends that the central purpose of IRC section 1031(a) is to provide for non-recognition of gain on a transfer of property where the differences between the relinquished property and the replacement property are more formal than substantial and the new property is substantially a continuation of the old investment still unliquidated. Appellant contends that, as in *Magneson,* she continued to actively manage the property both before and after the exchange as she is an active managing member in each of the Arizona LLCs that hold the Arizona Properties. Appellant further contends that the benefits and burdens of ownership attach immediately upon transfer, citing *Dixon v. Eastown Realty Co.* (2nd Cir. 1951) 104 Cal.App.2d 260. (App. Reply Br., p. 12.)

Appellant further contends that *Bolker* is applicable here. Appellant notes that *Bolker* involved a distribution of relinquished property by a corporation liquidating to its shareholder, followed by an exchange of property by the shareholder for the replacement property. Appellant notes that the *Bolker* court, in upholding the exchange, held that if a taxpayer owns property which he does not intend to liquidate or use for personal pursuits, then the taxpayer is holding that property for productive use in a trade or business or for investment for purposes of IRC section 1031(a). Appellant emphasizes that the critical inquiry is whether the taxpayer's economic situation after the transfer is fundamentally the same as prior to the transfer. Appellant contends that her economic situation was fundamentally unchanged. (App. Reply Br., pp. 12-14.)

Respondent's Reply Brief

Respondent asserts that appellant changes the facts and misrepresents herself as the exchangor in her arguments. Respondent notes that the exchange agreement was signed only by Windsor and Metro, the relinquished property was held by Metro, not appellant, and all other documents in the attempted exchange reflect Metro as the exchangor. Respondent contends that Metro is the exchangor and it received a distribution to its member Mr. Korman. Respondent further contends that appellant misrepresents Metro's member, Mr. Korman, as engaged in a failed exchange separate from appellant's attempted exchange. Respondent contends that Metro is the only entity attempting a like-kind exchange, and it is improper for appellant to misrepresent that Metro's members, appellant and Mr. Korman, were the exchangors. Respondent reiterates that the attempted-like kind exchange is properly analyzed only at Metro's level, citing *McManus v. Comm'r* (1975) 65 T.C. 197.[10] Respondent further contends that appellant represents Metro as the exchangor when it benefits her such as when appellant contends that the replacement property was properly received. Respondent contends the law does not allow appellant pick and choose when Metro should be recognized as a separate legal entity, citing *Moline Properties, Inc. v. Comm'r* (1943) 319 U.S. 436.[11] Respondent contends that appellant cannot now attempt to abandon the LLC structure that she previously benefited from, nor ignore Metro's actual ownership of the Franklin Property. (Resp. Reply Br., pp. 1-5.)

1. Metro was in actual receipt of all proceeds from the sale of the Franklin Property

Respondent reiterates that appellant's arguments are based on the misrepresentation that appellant, not Metro, is the exchangor. Respondent reiterates that Metro is the entity attempting the like-kind exchange and appellant attempts to confuse the issue of actual receipt. Respondent contends that since Metro was able to ignore the exchange agreement's restrictions to receive the Franklin Property sale proceeds, the safe harbor does not apply. As to appellant's arguments that the exchange agreement limited Metro's right to receive the sale proceeds, the exchange agreement was not amended as it was not signed by Metro and Windsor, and Windsor exercised its own discretion to distribute the funds, respondent contends that these arguments are without merit. Respondent contends that the limitations in the Treasury Regulation would have no impact if a qualified intermediary could distribute cash to an exchangor upon the exchangor's request so long as the exchange agreement did not require the intermediary to make a distribution. Respondent contends appellant has cited no authority for its assertion and no courts have accepted appellant's flawed interpretation of the Treasury Regulation.

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[10] In *McManus v. Comm'r*, *supra*, the tax court held that, for purposes of determining the level at which an attempted exchange is analyzed, the appropriate level was at the partnership level, rather than the individual level, because the partners held themselves out as partners and the partners intended to carry out their business affairs as a partnership.

[11] In *Moline Properties, Inc. v. Comm'r*, *supra*, the United States Supreme Court (USSC) held that a taxpayer could not disregard the corporate form of his business organization unless such form was a sham or unreal. The USSC reasoned that, so long as there is a legitimate non-tax business purpose served by the selection of the corporate form and the entity engaged in sufficient business activity, the entity remains a separate taxable entity.

(Resp. Reply Br., pp. 5-6.)

Respondent contends that appellant's argument that a distribution resulting from a member of an exchangor exerting pressure or threatening a lawsuit against the qualified intermediary should not prevent like-kind exchange treatment has been rejected by courts, citing *Greene v. Comm'r* (1991) T.C. Memo. 1991-403 (*Greene*). Respondent contends that the *Greene* court held that a distribution to an exchangor is treated as a waiver of the restrictions against the exchangor's access to sale proceeds. As to appellant's contention that Windsor was not an agent of Metro based on the terms of the exchange agreement, respondent contends that agency for tax purposes is based on the actions of the parties, citing *Comm'r v. Bollinger*, *supra*. Respondent contends that the evidence shows that Metro, and its members, instructed Windsor to distribute funds and Windsor did so, which violated the requirement that a taxpayer have no right to receive, pledge, borrow, or obtain the benefits of the sale proceeds held in the exchange. (Resp. Reply Br., pp. 6-7.)

2. Metro had constructive receipt of all the sale proceeds from the Franklin Property

Respondent notes that because Windsor complied with Metro and appellant's instructions that half of the sale proceeds be distributed to Mr. Korman, Metro could have asked Windsor to distribute any amount. Respondent contends that, contrary to appellant's representation of the issue as being whether appellant had legal authority to control the funds, the issue is whether Metro was able to control, request and direct the funds held by Windsor. Respondent contends that Metro made a request for distribution of a portion of the funds and received such funds. Respondent further contends that appellant's arguments regarding *Klein*, *supra*, ignore Treasury Regulation section 1.1031(k)-(1)(f)(2) which provides that constructive receipt occurs "at the time the limitations or restrictions lapse, expire, or are waived." Respondent contends that Windsor waived the restrictions limiting Metro's ability to receive the sales proceeds at the time it acquiesced to Metro's instructions to distribute half of the sale proceeds to Metro's member. Respondent also contends that this appeal is akin to *Greene*, *supra*. Respondent contends that Windsor's willingness to ignore the restrictions in the exchange agreement was similar to the trustee in *Greene* who allowed Mr. Greene access to cash held in a trust. Respondent points out that the Tax Court in *Greene* held that the taxpayer had constructive receipt of the entire amount of the proceeds held in the trust based on its finding that none of

Mr. Greene's requests for advances were denied, delayed or modified by the trustee who was employed by Mr. Greene on an at will basis and who did not pose a substantial limitation to the taxpayer's access to funds. (Resp. Reply Br., pp. 8-10.)

Respondent further contends that, contrary to appellant's assertions, Windsor made it very clear that it was not exercising discretion when it distributed funds to Metro. Respondent points out the amendment prepared by Windsor included language clearly stating that Metro was instructing Windsor to distribute funds and agreed to indemnify Windsor from any negative tax consequences resulting from the distribution. Respondent contends that Windsor waived the exchange agreement's restrictions on Metro's access to the sale proceeds. As to appellant's reliance on *Morton*, *supra*, respondent contends that case dealt with an unintentional mistake whereas in this appeal appellant, Mr. Korman, Metro, and Windsor purposefully wired funds to Metro's member, Mr. Korman. As to appellant's contentions that neither she nor Metro bear any responsibility for the distribution, respondent contends that this is blatantly incorrect as appellant was the managing member of Metro and she instructed Windsor to distribute funds to Mr. Korman. Respondent further contends that appellant's brief contains an internal contradiction as appellant also contends that, with regard to the Arizona LLCs, she directed, managed and controlled the investment properties of the LLCs and had expansive authority, power, and discretion to make decisions regarding the properties. (Resp. Reply Br., pp. 10-12.)

3. The Arizona LLCs, not Metro, bought the purchased properties

Respondent contends that appellant's argument discussing whether the replacement property was valid replacement property does not address respondent's contentions that it was impossible for Metro to purchase the Arizona Properties. Respondent contends that it is impossible for Metro and the other buyers to purchase a 78 percent TIC interest that cost $23,405,639 with $7,500,000. Respondent notes that the Arizona LLCs paid $21,919,811 into the escrow account, but purportedly purchased 22 percent of the Arizona Properties that cost $6,400,000. Respondent further notes that the loan documents list the borrower as the Arizona LLCs and shows that the loans were secured by 100 percent of the Arizona Properties. Respondent maintains that the listing of Metro and others as the purchasers of 78 percent of the Arizona Properties was a façade and that, for tax purposes, the Arizona LLCs were the true purchaser of the Arizona Properties. As to appellant's contention that Metro transferred its TIC interest into the LLCs, respondent contends that this is not possible because Metro never had a TIC interest in the Arizona Properties to subsequently transfer. (Resp. Reply Br., pp. 12-14.)

Respondent further contends that appellant's discussion of the "holding" issue is not relevant in this appeal as respondent did not raise that issue. Respondent contends that the issues are whether the Arizona Properties were purchased by the Arizona LLCs and, even if the Arizona Properties were purchased by Metro as alleged by appellants, under the step transaction doctrine, Metro is treated as receiving interests in the Arizona LLCs. Respondent contends that these legal theories are separate from appellant's analysis of whether the "holding" requirement of IRC section 1031 is met when property received in a like-kind exchange is immediately transferred to a partnership. (Resp. Reply Br., pp. 14-15.)

4. Per the step transaction doctrine, Metro received partnership interests in the Arizona LLCs

Respondent reiterates that the end result test for the application of the step transaction doctrine was satisfied as Metro acknowledges that its alleged purchase of a TIC interest in the Arizona Properties and subsequent immediate transfer to the Arizona LLCs was part of a single intended transaction. Respondent contends that, contrary to appellant's contention that Metro took multiple necessary steps and there was no more direct way for Metro to accomplish its intent, appellant's analysis is flawed since Metro chose to make a one-step purchase of the interests in the Arizona LLCs into multiple steps and also because the steps appellant took were not necessary. Respondent contends that, although the regular course of escrow would have been for the Arizona LLCs to purchase the Arizona Properties and have the recorded deeds reflect that the Arizona LLCs as the purchaser, Metro added the additional steps of having the deeds for the Arizona Properties first reflect that the Arizona LLCs had 22 percent TIC interest and Metro and others had 78 percent TIC interest and simultaneously record a separate set of deeds transferring Metro and the other's 78 percent TIC interest to the Arizona LLCs so that the Arizona LLCs had 100 percent ownership in the Arizona Properties. (Resp. Reply Br., pp. 15-16.)

As to appellant's contention that these steps were necessary, respondent contends that these steps were unnecessary because the deeds could have initially been recorded 100 percent in the name of the Arizona LLCs. Citing *True v. United States* (1999) 190 F.3d 1165, respondent contends that if a taxpayer engages in a series of steps to get a specific result, he cannot request independent tax recognition of each step unless he shows that at the time he engaged in each step, its result was the intended end result in and of itself. Respondent contends that, otherwise, the series of steps should be collapsed and only give tax consideration to the intended result. Respondent asserts that the recording of a deed in the name of Metro was clearly not the intended end result, but a "transitory and instantaneous act" to give the appearance that Metro purchased TIC interests in the Arizona Properties. As to appellant's argument that there was a business need for the additional steps, respondent contends that the claimed business purpose cannot give vitality to a clearly superficial transaction of momentarily recording the deeds in Metro's name. Respondent further contends that the facts do not support the asserted business purchase of properly operating and obtaining financing for the Arizona Properties. Respondent asserts the best way to accomplish the alleged business purpose of transferring the Arizona Properties to the Arizona LLCs would be to record the Arizona Properties in the names of the Arizona LLCs initially. As to the alleged business purpose of obtaining funding, respondent contends all the funds to purchase the Arizona Properties had been obtained prior to the purchase. Respondent argues that choosing to record the two separate sets of deeds was a step that occurred after financing for the Arizona Properties had been funded and it had already been decided to have the Arizona LLCs hold the Arizona Properties. As such, respondent contends that funding was based on the Arizona LLCs purchasing the Arizona Properties as the loan documents all reflect that the Arizona LLCs were required to hold the Arizona Properties. (Resp. Reply Br., pp. 16-18.)

Respondent further contends that, as the Arizona Properties were held by the Arizona LLCs, the interdependence test of the step transaction doctrine is satisfied. Respondent contends that since the loan agreements providing most of the financing to purchase the Arizona Properties required the Arizona LLCs to hold the Arizona Properties, recording the deed in Metro's name only for an instant required that a subsequent deed to be recorded in the Arizona LLC's names to comply with lender requirements. Respondent contends that appellant has not even shown that recording the deed in Metro's name was allowed under the loan agreements. Citing *Brown v. U.S.* (6th Cir. 1986) 782 F.2d 559, respondent contends that Metro, in creating unnecessary steps by recording the deed in Metro's name and simultaneously recording the deed to the Arizona LLCs, did not take an equally direct way to the same result. Respondent further contends that the contrived step of recording the deed in Metro's name does not alter the economic reality of what really happened, i.e., the Arizona LLCs purchased the Arizona Properties. (Resp. Reply Br., pp. 18-19.)

As to appellant's contention that the substance-over-form doctrine should not apply in this appeal because the benefits and burdens of ownership and the holding requirement under IRC section 1031 are the same thing, respondent reiterates that there is no holding issue in this appeal and appellant's discussion and reliance on *Bolker*, *supra*, are irrelevant. Respondent reiterates that the issue being analyzed is whether the steps of momentarily recording a deed followed by an immediate transfer to the Arizona LLCs should be collapsed. Respondent emphasizes that the step transaction doctrine was not determinative in *Magneson* as the law at that time provided that real property could be exchanged for an interest in a partnership that held real property. Respondent contends that the law has since changed. Respondent contends that under current California law, a partner is no longer treated as holding an interest in the assets of a partnership and instead, a partner's interest in a partnership is now considered intangible personal property. (Resp. Reply Br., pp. 19-20.)

<u>Appellant's Supplemental Brief</u>

Appellant maintains that she, as managing member of Metro, completed the exchange and should be entitled to defer the gain. Appellant further asserts that the like-kind exchange should not be disregarded because, pursuant to a prearranged plan, a taxpayer transfers its real property interest into a legal entity after completing an otherwise proper exchange. Appellant contends that respondent has been aggressively auditing 1031 exchanges using the invalid "prearranged agreement" and "step transaction" arguments. (App. Supp. Br., pp. 1-2.)

Appellant reiterates that, in light of Mr. Korman's decision to withdraw from Metro and threat of litigation against her, Windsor, and Metro if he did not get his money, she "had no choice" but to acknowledge Mr. Korman's withdrawal and request that Mr. Korman be paid his share of the sale proceeds from Windsor. Appellant reiterates that the September 29, 2004 document is not an amendment to the exchange agreement between Metro and Windsor as it was not signed by both Windsor and Metro. Appellant reiterates that, despite the "defects" in the document, Windsor exercised its discretion in distributing funds to Mr. Korman. Appellant points out that the check was made out to Mr. Korman, not to Metro, and Mr. Korman paid California income taxes on the distribution. Appellant reiterates that she, as managing member of Metro, then completed the exchange as planned. Appellant reiterates that Metro contributed its TIC interest as part of a pre-arranged plan to separate single purpose LLCs and she, through Metro, became a managing member of each of the Arizona single purpose LLCs. (App. Supp. Br., pp. 3-5.)

As to respondent's actual receipt argument, appellant maintains that respondent's contentions have no merit. Appellant acknowledges that Mr. Korman, as a former member of Metro, received $2,972,776. Appellant however argues that the funds were not distributed to Metro and Metro did not distribute any funds to Mr. Korman. Appellant argues that Windsor unilaterally paid those funds to Mr. Korman in his individual capacity and neither Metro, nor any of its members, received the funds. Appellant further contends that, contrary to respondent's argument, Metro did not ignore the exchange agreement. Appellant contends that the proper analysis here is that Mr. Korman in his individual capacity received the funds after his withdrawal from the LLC. As such, appellant contends that she and Metro did not have actual receipt of the funds. (App. Supp. Br., pp. 5-6.)

As to respondent's constructive receipt argument, appellant disputes that respondent's representations that Metro disregarded the exchange agreement and Treasury Regulations and obtained almost $3 million in cash at its discretion. Appellant emphasizes that Mr. Korman, during the exchange period, suddenly and unreasonably demanded to withdraw from Metro and obtain the funds held by Windsor. Appellant reiterates that the September 29, 2004 document was not an amendment to the exchange agreement and contends that appellant's actions, individually and as managing member of Metro, did not "affirmatively affect or otherwise jeopardize" the exchange. Appellant argues that neither she nor Metro constructively received any proceeds as no funds were set aside for them, they did not have access to any funds, and they did not receive any benefit from Windsor's distribution. Appellant argues that when Mr. Korman received the distribution, he was no longer part of Metro, and therefore, he was not an exchangor. As such, appellant contends that respondent's reliance on *Greene*, *supra*, is misplaced and the appropriate authority is *Morton v. United States*, *supra*. Appellant contends that Windsor's decision to comply with her "acknowledgment" of Mr. Korman's departure from Metro and Mr. Korman's demand for payment does constitute constructive receipt by either appellant or Metro. Appellant maintains that Windsor's actions occurred after Mr. Korman had withdrawn from Metro, so Mr. Korman was not a member of Metro at the time of disbursement. Appellant further maintains that neither appellant nor Metro received, controlled, or had access to the funds released by Windsor. (App. Supp. Br., pp.6-8.)

Appellant disputes respondent's argument that Metro's ability to receive 50 percent of the sale proceeds demonstrates that it could access all of the exchange proceeds. Appellant argues that Metro did not receive 50 percent of the proceeds, and Windsor, under threat of a lawsuit, decided to "acquiesce" to Mr. Korman's demands. Appellant argues that it is unfair to characterize appellant's actions, either individually or as managing member of Metro, as anything but compliance with California law. With regard to respondent's argument that appellant misrepresents herself as the exchangor, appellant contends that respondent fails to recognize that the proposed assessment is directed at appellant. Appellant further contends that it is not inconsistent or inaccurate to refer to appellant as the controlling person in the exchange or the exchangor as Metro became a single-member LLC once Mr. Korman left Metro. (App. Supp. Br., pp. 8-9.)

As to respondent's substance-over-form and step transaction arguments, appellant contends that these are "essentially two versions of the same argument." Appellant emphasizes that IRC section 1031 requires a specific form and taxpayers should not be faulted for following the formal legal requirements of IRC section 1031 to complete these transactions. As such, appellant questions respondent's reliance on *Court Holding Co.*, *supra*, for the application of the substance-over-form doctrine. Appellant contends that she and Metro followed the prescribed form of an expressly permitted tax policy of Congress, and therefore the substance-over-form and the step transaction doctrines are not applicable. Citing *Tandy Corp. v. Comm'r* (1989) 92 T.C. 1165 in support of her position, appellant contends that the law allows taxpayers to participate in 1031 exchanges and the courts have repeatedly blessed the ability of taxpayers to complete their transaction by continuing the investment in a legal entity. Appellant further cites *Magneson*, *supra*, in support of her position, contending that the presence of a prearranged plan does not disallow 1031 exchange treatment. As to respondent's argument that the taxpayer's satisfaction the holding requirement was just a formality and the end goal was to acquire an LLC interest, appellant contends that the *Magneson* court addressed this argument and upheld the taxpayer's method because there was not a more direct method to achieve the same goal. Appellant contends that the *Magneson* court declined to apply the step transaction doctrine to 1031 exchanges. Appellant argues that the issue was whether the taxpayer continued to have an economic interest in essentially the same investment, regardless of the change in form of ownership, citing *Magneson*, *supra*, *Bolker*, *supra*, *Maloney v. Comm'r.* (1989) 93 T.C. 90, and *Marks*, *supra*. (App. Supp. Br., pp. 9-12.)

Appellant contends that, in substance and form, Metro held TIC interests in the Arizona Properties and subsequently transferred those interests to the Arizona LLCs. Appellant acknowledges that she guaranteed the loan, but argues that this fact is irrelevant to this appeal. Appellant contends that lenders often require owners of single member entities sign loan documents. Appellant further contends, as acknowledged by respondent, that a loan document is not dispositive as to ownership interest in the property upon which the loan document relates. Appellant also contends that, contrary to respondent's claim, the assignment document plainly assigned the purchase contract to Metro and appellant signed the document on behalf of Metro. Appellant further contends that, after the exchange, Metro transferred its TIC interests to the Arizona LLCs. Appellant also contends that, contrary to respondent's claims, it is possible to purchase $23,405,639 of property with $7,500,000 when the purchase is consummated with a loan to cover the balance. Accordingly, appellant contends that the substance and the form of this transaction is the same: Metro exchanged real property for real property and subsequently continued the investment, unliquidated as a result of a transfer to an LLC treated as a partnership where Metro was the managing member. (App. Supp. Br., pp. 12-14.)

Appellant also reiterates that the step transaction doctrine is expressly inapplicable under existing precedent, citing *Magneson*, *supra*, and *Marks*, *supra*. Appellant further points out that the court in *Brown v. U.S.* (6th Cir. 1986) 782 F.2d 559, noted that intent is a crucial element in the end result test for purposes of applying the step transaction doctrine. Appellant contends that Metro and appellant's intent was to use a TIC pooling structure to obtain replacement like-kind property.

Appellant contends there were business reasons for the approach taken by Metro that should not be ignored. (App. Supp. Br., pp. 14-16.)

<u>Applicable Law</u>

<u>Burden of Proof</u>

The FTB's determination is presumed correct and appellants have the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)

<u>IRC section 1031</u>

California law conforms to IRC section 1031 at R&TC sections 18031 and 24941. For a transfer of property to qualify for non-recognition of gain treatment under IRC section 1031, three general requirements must be satisfied: (1) the transaction must be an exchange; (2) the exchange must involve like-kind properties; and (3) both the property transferred (the *relinquished property*) and the property received (the *replacement property*) must be held for a qualified purpose. (Int.Rev. Code, § 1031(a)(1).) Property is held for a qualified purpose if it is held for a productive use in a trade or business or held for investment. (*Ibid*.)

IRC section 1031(a)(2) provides that the exchange of the following items will not qualify for the like-kind exchange treatment: (A) stock in trade or other property held primarily for sale; (B) stocks, bonds, or notes; (C) other securities or evidences of indebtedness or interest; (D) interests in a partnership; (E) certificates of trust or beneficial interests; or (F) choses in action.

Treasury Regulation section 1.1031(k)(1)-(f)(1) provides that, generally, a transfer of relinquished property in a deferred exchange is not a valid like-kind exchange under IRC section 1031 if, as part of the consideration, the taxpayer receives money or other property. In addition, in the case of a transfer of relinquished property in a deferred exchange, gain or loss may be recognized if the taxpayer actually or constructively receives money or other property before the taxpayer actually receives like-kind replacement property. (*Ibid*.) If the taxpayer actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property.

(*Ibid*.)

A taxpayer has actual receipt of money or property "at the time the taxpayer actually receives the money or property or receives the economic benefit of the money or property." (Treas. Reg., § 1.1031(k)(1)-(f)(2).) A taxpayer has constructive receipt of money or property "at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time or so that the taxpayer can draw upon it if notice of intention to draw is given." (*Ibid*.) The taxpayer is not in constructive receipt of money or property if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. (*Ibid*.) However, the taxpayer has constructive receipt of the money or property "at the time the limitations or restrictions lapse, expire, or are waived." (*Ibid*.) In addition, actual or constructive receipt of money or property by an agent of the taxpayer (determined without regard to paragraph (k) of this section[12]) is actual or constructive receipt by the taxpayer. (*Ibid*.)

Treasury Regulations section 1.1031(k)-1(g)(1) sets forth certain safe harbor provisions that, if applicable, results in a determination that the taxpayer is not in actual or constructive receipt of money or other property for purposes of IRC section 1031. As relevant to this appeal, Treasury Regulation section 1.1031(k)-1(g)(4)(i) provides a "qualified intermediary" safe harbor that allows a taxpayer to appoint a qualified intermediary to receive funds from the sale of property, and this intermediary will not be considered an agent of the taxpayer. A "qualified intermediary" is a person who is not the taxpayer or a "disqualified person," as defined in paragraph (k) of this section, and enters into a written agreement with the taxpayer (the exchange agreement) and, pursuant to the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer. (Treas. Reg., §1.1031(k)-1(g)(4)(iii).)

For this safe harbor provision to apply, the taxpayer must limit his rights to receive,

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[12] Treasury Regulation section 1.1031(k)-1(k) provides that a "disqualified person" includes an agent of the taxpayer at the time of the transaction, a family member of the taxpayer and other related persons.

pledge, borrow, or otherwise obtain the benefits of the money held by the intermediary.[13] (Treas. Reg., § 1.1031(k)-1(g)(4)(ii).) Further, this safe harbor provision ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. (Treas. Reg., § 1.1031(k)-1(g)(4)(vi).)

In *Klein*, *supra*, the taxpayer attempted to complete a 1031 exchange. The taxpayer entered into a contract with a buyer to purchase the taxpayer's real property. The taxpayer sought to purchase real property from a third party with the sale proceeds. The taxpayer amended the escrow instructions to give a portion of the sale proceeds to the third party. The court determined that because the taxpayer unilaterally exercised his power to alter the disposition of the sale proceeds in the escrow account demonstrated the taxpayer's ownership and enjoyment and demonstrated that the taxpayer had constructive receipt of the sale proceeds. The court accordingly determined that the taxpayer did not complete a valid exchange.

<u>Substance-over-Form Doctrine</u>

In *Court Holding*, *supra*, the Supreme Court explained that "[t]o permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." (*Court Holding*, *supra*, at 334. See also *Appeal of Larry and Rhoda Geisel*, 2007-SBE-02, Dec. 12, 2007.) In *Court Holding*, a corporation had entered into oral negotiations to sell its real property. Subsequently, after a down payment had been received, the controlling shareholders were advised that if the sale was consummated as structured, the corporation would incur a large tax liability. Consequently, the day after receiving this advice, the controlling shareholders dissolved the corporation and received the property as a result of the liquidation of the corporation. Three days later, the individuals sold the property.

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[13] Treasury Regulation sections 1.1031(k)-1(g)(6)(ii) and (iii) provide two limited exceptions to this requirement. First, the agreement may provide that if a taxpayer has not identified replacement property by the end of the identification period, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property at any time after the end of the identification period. (Treas. Reg., § 1.1031(k)-1(g)(6)(ii).) Second, the agreement may provide that if the taxpayer has identified replacement property, the taxpayer may have rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property upon or after: (A) the receipt by the taxpayer of all of the replacement property to which the taxpayer is entitled under the exchange agreement; or (B) the occurrence after the end of the identification period of a material and substantial contingency that relates to the deferred exchange, is provided for in writing, and is beyond the control of the taxpayer and of any "disqualified person", other than the person obligated to transfer the replacement property to the taxpayer. (Treas. Reg., § 1.1031(k)-1(g)(6)(iii).)

On the foregoing facts, the Court ruled that, in substance, the property was sold by the corporation. The Court explained that the transaction must be viewed as a whole, with each step considered, and that "[a] sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title." (*Court Holding*, *supra*, at 333.)

The application of the substance-over-form doctrine involves a determination of whether the substance of the transaction differs from its form or whether the form reflects what actually happened. (*Andantech L.L.C. v. Comm'r*, T.C. Memo. 2002-97; *Tracinda Corp. v. Comm'r* (1998) 111 T.C. 315, 326.)

In *Chase*, *supra*, a husband and wife sought to use IRC section 1031 to defer gain on the sale of an undivided interest in various apartments. The contract for the sale of the apartments reflected the partnership as the seller. The taxpayer-husband signed the contract as a general partner of the partnership, and there was no indication that the taxpayer-husband individually held any interest in the apartments. When it was certain that the sale would close, the taxpayer-husband caused the deed for an undivided interest, which had been executed shortly after the receipt of an initial offer to purchase the apartments, to be recorded. The partnership's share of the sale proceeds were not delivered to the exchange agent, but to the taxpayers in accordance with their partnership interests. In addition, the partnership, not the taxpayers, received rents and paid expenses related to the apartments.

Reviewing the above facts, the court noted that "[t]o qualify for nonrecognition, a taxpayer must satisfy each of the specific requirements as well as the underlying purpose of section 1031(a)[,]" citing *Bolker*, *supra*. (*Chase*, *supra*, at 881.) The court explained that "[t]he substance over form doctrine applies where the form chosen by the parties is a fiction that fails to reflect the economic realities of the transaction." (*Ibid.*) The court further explained that "'[t]ransactions, which did not vary, control, or change the flow of economic benefits, are dismissed from consideration[,]'" quoting *Higgins v. Smith*, 308 U.S. 473, 476 (1940). (*Ibid.*) Applying these principles, the court found that, in substance, the partnership sold the property, not the taxpayers. Therefore, the court ruled that the taxpayers did not participate in an exchange under IRC section 1031.

The Supreme Court has stated that where ". . . there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." (*Frank Lyon Co. v. United States* (1978) 435 U.S. 561, 583 - 584.) *Frank Lyon Co.* involved a sale and leaseback transaction that was structured in cooperation with federal banking authorities. Observing that "tax laws affect the shape of nearly every business transaction[,]" the Court found that the fact that favorable tax consequences were considered "is no reason for disallowing those consequences." (*Id.*, at 565.) On the facts before it, the Court respected the form in which the transaction was cast in large part because the taxpayer "exposed its very business well-being to [the] real and substantial risk [that loans secured by the property would not be repaid]." (*Id*. at 577.)

<u>Step Transaction Doctrine</u>

The Ninth Circuit Court of Appeals has explained that "[t]he step transaction doctrine is one of the many 'substance-over-form' doctrines in tax law." (*Linton v. United States* (9th Cir. 2011) 630 F.3d 1211, 1223.) Although the doctrine considers the substance over the form of the transaction, the taxpayer "is not bound to choose the pattern which will best pay the Treasury." (*Id.*, at 1224; see also *Magneson*, *supra*, at 1497 ["Between two equally direct ways of achieving the same result, the [taxpayers] were free to choose the method which entailed the most tax advantages to them."].)

Courts have generally used three alternative tests in determining whether to apply the step transaction doctrine: (i) the end result test; (ii) the interdependence test; and (iii) the binding commitment test. Generally, only one of the tests needs to be satisfied in order for the step transaction test to apply. (See, e.g., *Falconwood Corp. v. United States* (Fed. Cir. 2005) 422 F.3d 1339, 1349; *McMillin-BCED/Miramar Ranch North v. County of San Diego* (1995) 31 Cal.App.4th 545.)

In *Esmark, Inc. v. Commissioner* (T.C. 1988) 90 T.C. 171, 195, the court stated that:

> The existence of an overall plan does not alone, however, justify application of the step-transaction doctrine. Whether invoked as a result of the "binding commitment," "interdependence," or "end result" tests, the doctrine combines a series of individually meaningless steps into a single transaction. (See also *Linton*, *supra*, 1223 [quoting *Esmark, Inc.*].)

Under the end result test, "'purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.'" (*King Enterprises v. United States* (Ct. Cl. 1969) 418 F.2d 511, 516 [internal citation omitted].)

The interdependence test looks to each step of the transaction to see whether the legal effects of one of the steps seem fruitless without completion of the overall transaction. (*True v. United States*, *supra*, 190 F.3d at pp. 1175-1181.)[14] Application of the interdependence test will be unsuccessful if the steps have "reasoned economic justification standing alone," but the step transaction doctrine will apply if the only reasonable conclusion from the evidence is that the steps have "meaning only as part of the larger transaction." (*Id.*, at 1178 [quoting *Security Industrial Ins. Co. v. United States* (5th Cir. 1983) 702 F.2d 1234, 1246-1247].) The interdependence test states that the individual steps need to be "the type of business activity we would expect to see in a bona fide, arm's length business deal between unrelated parties," and make sense "standing alone without contemplation of the subsequent steps in the transaction." (*Id.*, at 1179.) Under this test, it may be "useful to compare the transactions in question with those we might usually expect to occur in otherwise bona fide business settings." (*Id.*, at 1176; see also *Linton*, *supra*, 1224 – 1225 [quoting *True*].).

The third step transaction test, the binding commitment test, is applicable to transactions where one step creates a binding commitment by the taxpayer to take a second action at a substantially later time. (*Id.* at p. 1175, fn. 8.) The Ninth Circuit has stated that the binding commitment test "only applies to transactions spanning several years." (*Linton*, *supra*, 1224 – 1225. See also *True*, 1175 [stating that "[t]he binding commitment test is seldom utilized . . . ."].)

<u>*Magneson v. Commissioner* (1985) 753 F.2d 1490</u>

Magneson, supra, was the first of two IRC section 1031 cases decided by the Ninth Circuit Court of Appeals in 1985. In *Magneson*, the issue presented was whether the acquisition of property in a like-kind exchange with the intention of contributing the property to a partnership

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[14] It should be noted that the court in *True* cautioned that it was using the step transaction doctrine to evaluate an overall sequence of transactions involving an IRC section 1031 exchange rather than invalidating an IRC section 1031 exchange. (*True*, 1180, fn. 14.)

satisfied the requirements of IRC section 1031. Pursuant to a pre-arranged plan, the taxpayers completed an exchange of property, and then, on the same day, contributed the property to a limited partnership, and in return became general partners of the limited partnership. The court found that the requirements of IRC section 1031 were satisfied and declined to apply the step transaction doctrine.

The court stated that "[t]he case law, the regulations, and the legislative history are . . . all in agreement that the basic reason for nonrecognition of gain or loss on transfers of property under sections 1031 and 721 [which permits nontaxable contributions to partnerships] is that the taxpayer's economic situation after the transfer is fundamentally the same as it was before the transfer; his money is still tied up in investment in the same kind of property." (*Magneson*, *supra*, 1494.) The court held that "this principle exactly describes the Magnesons' situation[,]" reasoning that the Magnesons only changed the form of their ownership from a tenancy in common to a partnership and they took no cash or non-like-kind property of the transaction. (*Ibid.*)

The court rejected the argument that the partnership interest received and the tenancy-in-common interest given up were so substantially different that the Magnesons could not be considered to have continued to hold the property for investment. In doing so, the court looked to California state law existing at that time and observed that a partner is co-owner with his partners and that general partners had the right to possess partnership property. The court stated that, while there are "significant distinctions" between a tenancy in common and a partnership interest, the distinctions are not controlling, and the taxpayers continued their investment interest when they held the property through their general partnership interest. (*Id.*,149 -1496.)

The court also rejected the argument of the IRS that step transaction doctrine should apply so that the transaction should be viewed as an exchange of real property in return for a partnership interest. The court found that the Magnesons could have structured their transaction differently, but there was no more direct method than the method actually used. As noted above, the court stated that "[b]etween two equally direct ways of achieving the same result, the Magnesons were free to choose the method which entailed the most tax advantages to them." (*Id.*, 1497.) The court further stated that, even if it did collapse the transaction, the transaction would still qualify under IRC section 1031, though it noted that Congress had recently amended the statute, for years after the years at issue in the case, to exclude exchanges of partnership interests. (*Id.*, 1497-1498, fn. 4.) The court concluded by stating that "a critical basis for [its] decision [was] that the partnership in this case had as its underlying assets property of like kind to the Magnesons' original property, and its purpose was to hold that property for investment." (*Id.*, 1498.) The court stated that its holding was limited to exchanges of property where the property is contributed in return for a general partnership interest. (*Ibid.*)

<u>*Bolker v. Commissioner* (9th Cir. 1985) 760 F.2d 1039</u>

Shortly after its decision in *Magneson, supra*, the Ninth Circuit issued its decision in *Bolker, supra*. In *Bolker*, "for tax purposes," the taxpayer liquidated his own wholly owned corporation, and received a distribution of real estate. On the same day as the liquidation, he contracted to exchange the distributed property for other like-kind property. The actual exchange took place three months later. The IRS argued that the corporation, not the individual taxpayer, exchanged the property. In the alternative, the IRS argued that the taxpayer did not hold the property for trade or business or investment. The trial court and the Ninth Circuit rejected these arguments. On appeal to the Ninth Circuit, the IRS also argued, for the first time, that the step transaction doctrine should apply, but the court stated it would not consider this argument because, as a general rule, it will not consider arguments that were not raised at trial.

The Ninth Circuit explained that in *Magneson* it based its decision "on our holding that the Magnesons intended to and did continue to hold the acquired property, the contribution to the partnership being a change in the form of ownership rather than the relinquishment of ownership." (*Id.*, 1044.) The court held that ". . . if a taxpayer owns property which he does not intend to liquidate or to use for personal pursuits, he is 'holding' that property 'for productive use in trade or business or for investment' within the meaning of section 1031(a)." (*Id.*, 1045.) Applying this holding, the court found that the intent to exchange a property does not disqualify a property from qualifying for like-kind treatment.

<u>*Maloney v. Commissioner* (1989) 93 T.C. 89</u>

In *Maloney*, the Tax Court considered whether the requirements of IRC section 1031 were satisfied on the following basic facts. The corporation entered into an agreement to exchange real property and, shortly before the exchange occurred, determined that it wished to liquidate and distribute the property following completion of the exchange. As a result, three days after the exchange, the corporation adopted a plan to liquidate and distribute the replacement property to its shareholder. The liquidation then occurred within a few weeks. Citing *Magneson* and *Bolker*, the tax court held that the addition of another nontaxable transaction did not disqualify the exchange for non-recognition of gain under IRC section 1031. The Tax Court found that *Magneson* was applicable because, in both *Magneson* and its case, property was exchanged for like-kind property. The court noted that, in *Magneson*, the exchange was followed by a tax-free transfer to a partnership, while in its case, the exchange *preceded* a tax-free liquidation. The court found that this "minor variation" did not warrant treating taxpayers in a "dramatically different" manner.

The court further stated that, even without *Magneson*, it believed the taxpayer's position was correct. It explained that, where a taxpayer surrenders stock in a corporation in a liquidation, and receives in return property owned by the corporation, ". . . he continues to have an economic interest in essentially the same investment, although there has been a change in the form of ownership." (*Id.*, 98-99.) The court stated "Section 1031 is designed to apply to these circumstances and to defer the recognition of gain where the 'taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture.'" (*Ibid.*)

<u>IRS Field Service Advice 199951004, December 24, 1999</u>[15]

The FSA reviewed a very complicated series of transactions. In summary, the taxpayer, a partnership, agreed to dissolve a partnership in which it held an investment, and then exchange certain of the properties received. The exchange intermediary then acquired the properties to be relinquished in the exchange. The owner of 97.5 percent of the taxpayer/partnership then acquired the replacement properties, directly or indirectly through another limited partnership, and agreed to exchange the properties with the exchange intermediary, which, in turn, agreed to transfer the replacement property to the taxpayer/partnership. The FSA stated that the details about one property ("Property 4") were

[15] An IRS Field Service Advice (FSA) is not citable as precedent. However, given that, as relevant to the issues on appeal, California law conforms to federal law with respect IRC section 1031, staff believes the FSA provides background that may be of interest.

unclear but there was evidence that the owner transferred the property to a LLC several years after the period in dispute.

The FSA stated that a substance over form analysis might be applied to find that, in substance, the taxpayer exchanged a partnership interest rather than like-kind real property. The FSA stated that the transactions were "convoluted" and all occurred on a single date. Further, the FSA found that the "ultimate result" was the disposal of the taxpayer's interest in the partnership, rather than the dissolution of the partnership. The FSA also found that the form of the transaction merited scrutiny due to ". . . the lack of a non-tax based advantage to either of the parties in the chosen structure of the transaction."

However, the FSA cautioned that "[w]hether the form of this transaction should be respected is a factual issue subject to the interpretive whims of the court[,]" citing *Bolker*, *supra*, and *Mason v. Commissioner*, T.C. Memo. 1988-273, aff'd 880 F.2d 420 (11th Cir. 1989).[16] The FSA recommended that the facts be more fully developed. The FSA also acquiesced to the Ninth Circuit's decisions in *Magneson* and *Bolker*, stating as follows:

> . . . we agree with you that the facts concerning whether Property 4 was actually transferred to Taxpayer and whether the exchange agreement met the requirements [under the regulations] should be developed further. We do not recommend pursuit of the argument that Taxpayer did not hold the property for investment within the meaning of section 1031(a). As you have noted, this position has been rejected on several occasions. [citing *Magneson v. Commissioner*, (9th Cir. 1985) 753 F.2d 1490, and *Bolker v. Commissioner*, *supra*.] **Although we disagree with the conclusion that a taxpayer that receives property subject to a prearranged agreement to immediately transfer the property holds the property for investment, we are no longer pursuing this position in litigation in view of the negative precedent.** [emphasis added]

Department of Revenue v. Marks (2009) 20 OTC 35; 2009 Ore. Tax LEXIS 241

In *Marks*, the taxpayers received replacement property in an IRC section 1031 exchange and immediately contributed it to a partnership. In its analysis, the court assumed that the transfer was the result of a pre-arranged plan. (*Id.*, 40, fn. 3.)

The Department argued that the taxpayers did not hold the property for investment and,

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[16] In *Mason*, the Tax Court allowed an IRC section 1031 exchange where it found that two partners received property in a partnership liquidation and then exchanged the properties distributed.

further, that the substance-over-form and step transaction doctrines should apply such that the taxpayers should be deemed to have received a partnership rather than like-kind property. The Department further argued that *Magneson* was distinguishable because (i) it pre-dated amendments to IRC section 1031 that prohibited exchanges of partnerships interests for partnership interests and (ii) *Magneson* relied on state partnership laws that did not reflect Oregon's current laws.

The court rejected all of the Department's arguments. Reviewing *Magneson*, *Bolker*, *Maloney*, and FSA 199951004, among other authorities, the court determined that the central rationale of *Magneson* was that the taxpayer continued his investment. The court noted that *Bolker* and *Maloney* followed *Magneson*, and reflected the same rationale. Citing legislative history and the plain language of the statute, it further found that the amendments to IRC section 1031 only prohibited exchanges of partnership interests for partnership interests, rather than prohibiting an exchange of real property that is followed by the contribution of that property to a partnership. With regard to the changed partnership laws, it found that the changes in the uniform partnership act did not alter the fact that the taxpayers essentially continued their investment in a new form.

With regard to the substance-over-form and step transaction doctrine, the court found that the steps taken reflected the substance of the transaction and were permitted. It stated as follows: "[t]he point of *Magneson* is that taxpayers may engage in IRC section 1031 transactions and then, pursuant to a pre-existing plan or intent, contribute replacement property to a partnership. . . . The department is not authorized or permitted to rearrange facts to produce a different transaction." (*Id.*, 52.) However, the court denied the defendants' motion for partial summary judgment in order to allow more factual development with regard to whether the partnership continued to hold the replacement property for investment.

STAFF COMMENTS

The parties dispute whether appellant or Metro is the exchangor of the Franklin Property. It appears to staff that the documents relating to the exchange reflect that Metro is the exchangor. The exchange agreement was made between Metro and Windsor and lists Metro as the exchangor. (Resp. Op. Br., Exh. E.) The amendment to the exchange agreement also lists Metro as the exchangor. (Resp. Op. Br., Exh. G.) The closing statement for the sale of the Franklin Property lists

Metro as the exchangor. (Resp. Op. Br., Exh. H.) The parties may want to discuss *Chase*, *supra*, and its implication as to the identity of the exchangor. It appears to staff that Metro is the exchangor and Metro must satisfy the requirements under IRC section 1031 for non-recognition of gain from the sale of the Franklin Property.

A critical issue on appeal is whether Metro had actual receipt of the proceeds from the sale of Franklin property. The Franklin Property was sold and the proceeds of $5,933,965.38 sent to Windsor. It is undisputed that Windsor distributed approximately half of the sale proceeds from the Franklin Property to Metro's member, Mr. Korman, prior to the purchase of the Arizona Properties. The closing statement indicates that "as per instructions" Windsor distributed a total of $2,972,776.71 (i.e.,$2,972,219.64 + $557.07) to Mr. Korman. (Resp. Op. Br., Exh. H.)

Generally, a transfer of relinquished property in a deferred exchange is not a valid like-kind exchange under IRC section 1031 if, as part of the consideration, the taxpayer receives money or other property. (Treas. Reg., § 1.1031(k)(1)-(f)(1).) If the taxpayer or her agent actually or constructively receives money or other property in the full amount of the consideration for the relinquished property before the taxpayer actually receives like-kind replacement property, the transaction will constitute a sale and not a deferred exchange, even though the taxpayer may ultimately receive like-kind replacement property. (*Ibid*.) Treasury Regulation section 1.1031(k)-1(g)(4)(i) provides a "qualified intermediary" safe harbor that allows a taxpayer to appoint a qualified intermediary to receive funds from the sale of property, and this intermediary will not be considered an agent of the taxpayer. To qualify for the safe harbor, the taxpayer must limit his rights to receive, pledge, borrow, or otherwise obtain the benefits of the money held by the intermediary. (Treas. Reg., § 1.1031(k)-1(g)(4)(ii).) This safe harbor provision ceases to apply at the time the taxpayer has an immediate ability or unrestricted right to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. (Treas. Reg., § 1.1031(k)-1(g)(4)(vi).)

Appellant contends that Mr. Korman in his individual capacity, and not appellant or Metro, received the funds after his withdrawal from the LLC. Appellant asserts that, under threat of litigation, Windsor unilaterally distributed the funds to Mr. Korman. Appellant asserts that Windsor distributed the funds to Mr. Korman after Mr. Korman had withdrawn from Metro, so Mr. Korman was not a member of Metro at the time of disbursement. Appellant further asserts that neither she nor Metro received, controlled, or had access to the funds released by Windsor. Appellant asserts that the September 29, 2004 amendment is not a valid amendment to the exchange agreement because it was not signed by Windsor and Metro as required by section 6.5 of the exchange agreement and therefore the September 29, 2004 amendment did not affect the restrictions in the exchange agreement. Staff notes that section 6.5 of the exchange agreement provides that "no supplement, modification or amendment to the exchange agreement shall be binding unless executed in writing by both parties." It appears that the parties to the exchange agreement are Metro and Windsor. Staff further notes that Mr. Korman and appellant (both individually and on behalf of Metro) signed the September 29, 2004 Amendment which directed Windsor to distribute funds to Mr. Korman. (Resp. Op. Br., Exh. G.) The September 29, 2004 Amendment also reflected that appellant, Metro, and Mr. Korman agreed to hold Windsor free and harmless from any negative tax consequences which they may incur as a result of Windsor's compliance with the instructions contained in the amendment. (*Id*.) In addition, the amendment was faxed from Windsor. (*Id*.) The parties will want to discuss whether Metro waived the restrictions once it directed Windsor to distribute the funds to Mr. Korman at Metro, appellant and Mr. Korman's direction. If the Board determines that Metro waived the restrictions, the safe harbor afforded to a qualified intermediary would not apply and, as Windsor had actual receipt of the Franklin Property sale proceeds and Windsor is Metro's agent, Metro would be treated as having actual receipt of the sale proceeds. If the Board determines that this occurred, respondent's action should be sustained, and all other issues would be moot.

With regard to respondent's substance-over-form and step transaction arguments, the parties should be prepared to address whether Metro purchased the replacement property. In this connection, the parties should be prepared to discuss *Chase, supra*. In *Chase,* the court looked to the economics of the transaction, and who negotiated and signed the purchase agreement, in order to determine who the actual purchaser was.

If either party has any additional evidence to present, they should provide their evidence to the Board Proceedings Division at least 14 days prior to the oral hearing pursuant to California Code

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of Regulations, title 18, section 5523.6.[17]

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[17] Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.