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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEALS;
	CORPORATION FRANCHISE TAX APPEAL
EMERSON PROPERTIES, INC.;	Case No. 871652
STANLEY R. EMERSON AND	
KATHLEEN EMERSON;	Case No. 871809
CHRISTOPHER B. EMERSON AND	
VALERIE M. WADE;	Case No. 871819
DALE R. EMERSON AND	
CAROLYN K. EMERSON;	Case No. 871825
MICHAEL EMERSON AND	
MARLA NOVO;	Case No. 871826
PATRICK EMERSON;	Case No. 871832
CRAIG J. COOMBS AND	
TRICIA EMERSON	Case No. 871833

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Case No.	Year	Proposed Assessment
871652	2008	$17,870
871809	2008	$37,895[1]
871819	2008	$1,845
871825	2008	$27,434
871826	2008	$481
871832	2008	$1,841
871833	2008	$2,950

Representing the Parties:

For Appellants: Silvio Reggiardo III, Downey Brand LLP

For Franchise Tax Board: Carolyn S. Kuduk, Tax Counsel

QUESTION: Whether appellants have shown error in respondent's determination of additional taxable boot income from a like-kind exchange under Internal Revenue Code (IRC) section 1031.

HEARING SUMMARY

Background

On December 11, 2006, Emerson Properties, Inc. (Emerson Properties), an S Corporation, entered into an Agreement for Purchase and Sale of Real Property (Sales Agreement) to sell farm land located in Oakley, California (Oakley property), for an initial price of $21 million.[2] (Resp. Op. Br., exhibit A.) The Sales Agreement required the buyer to provide a deposit for the Oakley property originally set at $1 million, then increased by $1 million in the third amendment to the Sales

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[1] The proposed assessment for Case ID Number 871809 included a $7,579 accuracy-related penalty and other adjustments based on federal adjustments made by the Internal Revenue Service to appellants' 2008 tax liability in addition to additional flow-through gain from Emerson Properties, Inc. Appellants appealed the total additional tax of $37,895, but did not include the accuracy-related penalty as part of their appeal. (Appeal Letter, Case ID No. 871809.)

[2] The Sales Agreement provides an entry date of November 2006 on the first page, but is referenced in the first amendment as being entered into on December 11, 2006. (Resp. Op. Br., exhibit A, pp. 1 & 37.) The second amendment is dated February 6, 2007, and the quitclaim deed is dated as February 2007. (*Id*. at exhibit A, pp. 39 & 53.) A third amendment was filed on March 14, 2008, and a fourth amendment was entered into on July 15, 2008. (*Id*. at exhibits E & F.) The actual closing date of the sale appears to be August 29, 2008. (See *Id*. at exhibit H.)

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Agreement, and increased again by $500,000 in the fourth amendment to ultimately equal $2.5 million.[3] (*Id*. at p. 2 & exhibits A, p. 2, E, p. 4 & F, p. 2.) The third amendment also adjusted the purchase price from $21 million to $13 million. (*Id*. at exhibit E, p. 3.)

The Sales Agreement included language in contemplation of Emerson Properties conducting a tax deferred exchange pursuant to IRC section 1031, with the Oakley property constituting the relinquished property and the payment at closing to be directed to a qualified intermediary. (Resp. Op. Br., exhibit A, p. 24.) The section of the Sales Agreement pertaining to the early deposit, including the relevant portions of the third and fourth amendments to the Sales Agreement increasing such deposit (entered into on March 14, 2008, and July 15, 2008, respectively), do not provide any language contemplating a tax deferred exchange, and instead dictate that the deposit funds shall be released directly to Emerson Properties once deposited in escrow and prior to the closing of the sale. (*Id*. at exhibits A, p. 2, E, p. 4 & F, p. 2; see *Id*. at exhibit I, p. 2 [$2,006,837.93 "Option money retained by seller"].)

On July 15, 2008, Emerson Properties entered into an exchange agreement with First American Exchange Company (qualified intermediary). (Resp. Op. Br., exhibit J.) Through the agreement, Emerson Properties assigned its rights to the Oakley property to the qualified intermediary pursuant to the goal of performing a like-kind exchange within the requirements of IRC section 1031, including the requirement that Emerson Properties would not receive any portion of the proceeds from the sale of the relinquished property until the exchange concluded. The Oakley property was sold on August 29, 2008, for $13,313,837. (See *Id*. at exhibit H.) The closing statements for the buyer and seller both list $2,006,838 of early deposit funds retained by Emerson Properties and to be applied toward the purchase price of the Oakley property.[4] (*Id*. at exhibits H & I.) The seller's closing

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[3] Emerson Properties received $1 million of deposit funds on February 12, 2007, and a second $1 million deposit on March 31, 2008. (Resp. Op. Br., exhibit D.) Emerson Properties' transaction schedule, dated as of December 31, 2008, shows the two $1 million deposits. (*Ibid*.) The third deposit of $500,000, which should have been received in either July or August of 2008, is reflected as early release funds released to the qualified intermediary in the closing statement for the seller. (*Id*. at exhibit H.)

[4] The deposit clauses in the Sales Agreement and amendments stated that the deposit amounts were to include all interest accrued on the deposits while they were temporarily held in escrow, which accounts for the additional $6,838. (Resp. Op. Br., exhibit A, p. 2; *Id*. at exhibit D.)

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statement also reflects $500,000 of early release funds released to the qualified intermediary. (*Id*. at exhibit H.)

From the time of the receipt of the approximately $2 million in early release deposit funds through the closing of the sale of the relinquished property, Emerson Properties had "unfettered" use of the down payment funds. (App. Op. Br., p. 2.) On November 3, 2008, Emerson Properties transferred $1 million directly to Empire West Title Agency to the escrow account for the purchase of the replacement property. (*Ibid*; see Resp. Op. Br., exhibit I.) At no time did the qualified intermediary have possession of any portion of the approximately $2 million in early release deposit funds. (App. Op. Br., p. 2.) On November 4, 2008, Emerson Properties purchased replacement property in Arizona (Arizona property) for $16,750,000. (Resp. Op. Br., exhibit L.)

Emerson Properties filed a timely 2008 California tax return and included a federal Form 8824 reporting a like-kind exchange. (Resp. Op. Br., exhibits N & O.) The Form 8824 reported a like-kind exchange in 2008 of the Oakley property for the Arizona property with a realized gain on the transaction equal to cash received of $808,712, and deferred gain of $11,244,464. (*Id*. at exhibit O, pp., 1-2.) Respondent audited Emerson Properties' return and determined that Emerson Properties should have reported an additional $1,198,126 of taxable boot from its IRC section 1031 like-kind exchange. Respondent did not otherwise challenge the tax-deferred treatment of the like-kind exchange. (*Id*. at p. 6 & exhibit Q.) Accordingly, respondent determined that there was an understatement of Emerson Properties' 1.5 percent corporate level tax resulting in a deficiency for Emerson Properties of $17,870, plus deficiencies based on flow through capital gain income to Emerson Properties shareholders (i.e., appellants).[5] (*Ibid*.) Respondent issued Notices of Proposed Assessments (NPAs) to appellants on November 27, 2012.[6] (*Id*. at exhibit R.)

Appellants protested the NPAs, and after a protest period, respondent issued a position letter reasserting its finding that the transaction included additional taxable boot not reported. (Resp.

[5] One shareholder of Emerson Properties with a 2.5 percent interest did not protest the assessment and therefore is not a party to this appeal. (See Resp. Op. Br., p. 6, fn. 35.)

[6] Previous to the issuance of these NPAs, respondent issued an NPA on February 28, 2012, for the 2008 tax year to the appellants for Case ID Number 871809 based on federal adjustments, as discussed in footnote 1. (Resp. Op. Br., exhibit R, pp. 15-16.)

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Op. Br., exhibit S.) The position letter made a minor adjustment to remove the $6,838 of interest income from calculation of taxable boot after discovering that this amount may have already been included in Emerson Properties' tax return as taxable interest, and thereby reduced the additional cash boot from $1,198,126 to $1,191,288.[7] (*Id*. at exhibit S, p. 2.) Respondent issued Notices of Action to appellants in April 2015, upholding the NPAs with the minor adjustment. (Appeal Letters attachments; Resp. Op. Br., exhibit T.) These timely appeals followed.

Contentions

Appellants' Contentions

Appellants contend that the threshold issue in this appeal involves the character of the down payment funds for income tax purposes, and that this appeal is all about the application of IRC section 1031(b) and the extent of Emerson Properties' taxable boot. (App. Op. Br., p. 1; App. Supp. Br., p. 2.) Appellants assert that the down payments were option consideration, referencing *Estate of Franklin v. Commissioner* (1975) 64 T.C. 752, 763, *aff'd on other grounds*, (9th Cir. 1976) 544 F.2d 1045. (App. Op. Br., p. 1-4.) Appellants contend that gains from property transactions are considered gross income, under IRC section 61(a)(3), and calculated under IRC section 1001 as the amount realized minus the adjusted basis of the property transferred. Appellants assert that Revenue Ruling 78-182 provides that options are taxed at the time the option lapses, is exercised, or is cancelled, regardless of whether the optioner has unfettered use of the funds. Appellants assert that the open transaction doctrine provides that tax is deferred for certain income, such as option payments, when it is unknown how the funds will ultimately be treated for tax purposes. (App. Reply Br., p. 6; see *Burnet v. Logan* (1931) 283 U.S. 404 (*Burnet*).)

Appellants contend that the option payment is "rolled into" the IRC section 1001 calculation on the gain from the sale of property if the option is exercised. Therefore, appellants assert that if the option is exercised then the option consideration will roll into the option property transaction

[7] The $6,838 in interest that accrued on the early deposit payments was received by Emerson Properties as part of the deposit payments and pursuant to the Sales Agreement and amendments. Respondent contends that this interest amount is similarly treated as part of the purchase price for the relinquished property and applies the same analysis to the interest as it applies to the early release deposit amounts. (See, e.g., Resp. Reply Br., p. 15.) However, because Emerson Properties appears to have reported the interest as taxable interest on its tax return, the proposed assessment does not include additional tax for the $6,838 in interest, and this amount is not directly at issue in this appeal.

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rather than be analyzed as a separate transaction, and will be part of the nonrecognition transaction if the larger transaction falls within IRC section 1031. (*Id*. at pp. 4-5.)

Appellants contend that respondent attempts to somehow tie Emerson Properties' unfettered use of deposits before the closing of the sale into constructive receipt of the deposits during the exchange period. Appellants assert that Regulation section 1.1031(k)-1(a) contains the rules regarding actual and constructive receipt of money or property, and that the regulation focuses on the impact of such receipt during the exchange period, but not before that time. Therefore, appellants assert, Emerson Properties' receipt of the deposits before the exchange period has no impact on this appeal. (App. Op. Br., pp. 5-6.) Appellants contend that had Emerson Properties took possession of the $2 million of deposits at the closing of the sale of the relinquished property, then Emerson Properties would have had taxable boot due to the actual receipt of funds during the exchange period. (App. Supp. Br., pp. 2, 4.) Appellants state that respondent attempts to assert that the deposit funds somehow were converted from option payments to sale proceeds at the closing of the sale for the relinquished property, but from Emerson Properties' perspective, nothing changed with regard to the deposit payments as of the closing. (*Id*. at pp. 2-3.)

Appellants reference *Starker v. United States* (9th Cir. 1979) 602 F.2d 1341 (*Starker*), citing the court's consideration of "the long line of cases liberally construing [IRC] section 1031" and the court's decision allowing a deferred exchange despite a lack of statutory authority at the time. Appellants contend that Emerson Properties satisfied the purpose of the like-kind exchange provisions by continuing its investment in real property, except to the extent of deposits it did not in fact transfer into the escrow. Appellants assert that respondent's proposed assessments would not only be inconsistent with the Code and regulations, but also with the theory behind IRC section 1031. (App. Op. Br., p. 6.) Appellants contend that respondent provides misleading discussions and suggestions that Emerson Properties conducted a sale and reinvestment, but assert that this appeal does not involve a sale and reinvestment but instead a like-kind exchange under IRC section 1031. (App. Reply Br., p. 2.)

Appellants contend that if there is any legal authority on point for the facts of this appeal,

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addressing the use of option payments during a deferred exchange,[8] neither appellants nor respondent have found it.[9] Appellants assert, therefore, that the only way to approach the issue is to analyze general tax principles, practical tax administration issues, and Ninth Circuit authorities regarding like-kind exchanges. (App. Op. Br., p. 7; App Reply Br., p. 4.) Appellants restate IRC section 1001 and 1031, concluding that both sections require a closed property transaction and, prior to such a transaction, neither statute applies. Appellants contend that when option funds are used to acquire replacement property in a like-kind exchange, they should be treated as exchange acquisition funds, just like exchange intermediary cash used for that purpose. Appellants contend that, as stated in *Starker*, there is no regulatory "complex web of formal and substantive requirements" for IRC section 1031 exchanges, and the section is intended to prevent "the inequity . . . of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort."[10] Appellants assert that replacement property acquisition funds need not come exclusively from a qualified intermediary, citing *Alderson v. Commissioner* (9th Cir. 1963) 317 F.2d 790. (App. Op. Br., p. 7.) Appellants contend there is no federal or California authority indicating whether, how, or when a taxpayer in Emerson Properties' position should transfer deposit funds to a qualified intermediary. (App. Reply Br. pp. 4-5; App. Supp. Br., p. 3.)

Appellants assert that respondent is attempting to have the Board create a tax event at the closing of the sale of the relinquished property, but respondent provides no legal authority of any kind. (App. Reply Br., p. 6; App. Supp. Br., p. 4.) Appellants contend that respondent is essentially attempting to draft federal tax law and then apply that law for purposes of this dispute. Appellants assert

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[8] Appellants state on appeal that the qualified intermediary held most of the exchange funds but never held the deposits. (App. Reply Br., p. 1.) However, it appears as though the third and final deposit amount of $500,000 was received by the qualified intermediary, not Emerson Properties, and was placed into escrow for the purchase of the replacement property directly by the qualified intermediary. (See Resp. Op. Br., exhibit H.) Emerson Properties reported this deposit as being part of its IRC section 1031 like-kind exchange and deferred tax on this amount. Accordingly, it appears as though Emerson Properties found that IRC section 1031 did apply to those deposit funds.

[9] Appellants contend that the authorities cited by respondent are inapposite to this appeal. In particular, appellants contend that Revenue Ruling 84-121 is distinguishable because in that ruling the taxpayer kept the option payments. (App. Supp. Br., pp. 3-4.)

[10] At the hearing, appellants should be prepared to address whether the early release deposit funds of approximately $2 million, to which Emerson Properties had unfettered use of for over a year and a half as to $1 million and five months as to the other $1 million, constitutes gain that is "tied up," as contemplated in *Starker*.

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that Congress could have precluded the use of option or deposit payments in like-kind exchanges, imposing taxation at a particular point (referencing as examples IRC sections 311(b) and 336(a) relating to deemed corporate distributions), but contend that this issue has not been address by Congress, the Treasury, or the IRS. (App. Reply Br., pp. 6-7.)

Appellants assert that the statement in Treasury Regulation section 1.1002-1 that IRC section 1031 is to be "strictly construed" does not control in the Ninth Circuit, and instead a liberal construction applies. (App. Reply Br., pp. 9-10.) Appellants contend that the Ninth Circuit has liberally applied a change in form rather than substance of investment rationale in approaching like-kind exchanges, citing *Starker*; *Magneson v. Commissioner* (1985) 753 F.2d 1490; and *Bolker v. Commissioner* (1985) 760 F.2d 1039.[11] Appellants assert that Emerson Properties' early release deposits came from the relinquished property and were invested in the replacement property in a like-kind exchange; asserting that only the form of investment changed. Appellants contend the Ninth Circuit's change in form of investment rationale applies in this case. (App. Reply Br., pp. 8-9.)

Appellants contend that this appeal raises interesting tax administration issues for the State. Appellants assert that significant exchange transactions often follow from options, and those option payments often get rolled into exchanges. Appellants contend that their tax treatment should be consistent with efficient tax law administration, and market participants should not be surprised by an attack on transactions that routinely occur. Appellants point to the lack of cases at the federal level or Revenue Rulings on this subject, and assert that the State of California should carefully consider whether to mount an attack in this sort of case with a potential reach well beyond the California borders. (App. Op. Br., p. 8.)

Appellants state that it may seem counterintuitive that Emerson Properties should not be taxed on funds it received prior to the exchange and actually held during the exchange period when the

[11] Appellants note that, in *Starker*, *supra*, 602 F.2d 1341, 1352, the Ninth Circuit questioned the applicability of Treasury Regulation section 1.1002-1's rule of strict construction in light of the case law. However, staff notes that the Ninth Circuit also stated that, if ". . . taxpayers sell their property for cash and reinvest that cash in like-kind property, they cannot enjoy the section's benefits, even if the reinvestment takes place just a few days after the sale." (*Starker*, *supra*, p. 1352.) In *Magneson*, the Ninth Circuit declined to apply Treasury Regulation section 1.1002-1 in a way that would require the taxpayer to hold the acquired property "in the exact form of ownership in which it was acquired." (*Magneson*, *supra*, 753 F.2d at pp.1496-1497.)

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funds would have been taxable had Emerson Properties received funds the qualified intermediary held, and that allowing some of the deposits to be deferred as to taxation despite actual possession by Emerson Properties might or might not feel right, but appellants assert that the feel of the tax result is irrelevant here. (App. Reply Br., p. 5.)

Respondent's Contentions

Respondent asserts that the $2 million in deposits, plus the $6,838 of interest on those deposits, became part of the sale proceeds when Emerson Properties sold the Oakley property on August 29, 2008. Respondent contends that the option was exercised when the property was sold, under appellants' open transaction theory, and the option payments were rolled into the purchase price of the Oakley property at that time. Respondent cites Revenue Ruling 84-121 to show that option payments are taxable at the closing of the option. Respondent asserts that the open transaction doctrine does not apply to the deposits after the Oakley property's escrow closed because the character of the deposits were then determined and constituted sale proceeds. (Resp. Op. Br., pp. 8-11; see also Resp. Reply Br., pp. 10-13.) Respondent asserts that gain or loss from an option is taxable when an option is exercised. (Resp. Reply Br., p. 16.)

Respondent contends that gain or loss from the sale or exchange of property generally must be recognized pursuant to IRC section 1001(c). Respondent asserts that IRC section 1031 provides an exception to this general rule, but contends that property (including cash) received by the taxpayer not held by an intermediary or where the taxpayer has unrestricted right to the funds is taxable boot under IRC section 1031(b). Respondent contends that Treasury Regulation section 1.1002-1(b) states that exceptions, like the exception provided by IRC section 1031, are to be strictly construed. Respondent does not dispute that Emerson Properties completed a like-kind exchange, but asserts that Emerson Properties had actual receipt of the deposit funds during the exchange period, and therefore those amounts are taxable. (Resp. Op. Br., pp. 11-12.) Respondent contends that there is no requirement that cash be received by the taxpayer from the qualified intermediary for it to constitute boot, as alleged by appellants. (Resp. Reply Br., p. 14; see App. Reply Br., p. 5.)

Respondent contends that appellants' arguments are contradicted by the facts. Respondent notes that Emerson Properties reported as taxable boot $808,712 of the deposit funds that

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were not ultimately paid toward the purchase of the replacement property, which contradicts appellants' arguments that the $2 million in deposit funds were received prior to the sale of the relinquished property and therefore do not fall under the provisions of IRC section 1031(b). Respondent refers again to Revenue Ruling 84-121, in which an option payment received prior to the closing of the sale on the property was considered taxable boot under IRC section 1031(b). Respondent states that Emerson Properties' exchange agreement acknowledged that Emerson Properties was not to receive any of the exchange funds, and the receipt of exchange proceeds could constitute taxable boot. Respondent contends that $500,000 in early release deposit funds were sent straight to the qualified intermediary, and that these funds are not taxable boot because Emerson Properties did not receive the funds itself, whereas it took actual receipt of the other approximately $2 million of early release deposit funds. (Resp. Op. Br., pp. 12-15.)

Respondent asserts in its reply brief that, regardless of when Emerson Properties took possession of the approximately $2 million in early release deposit funds, it is undisputed that it had actual receipt of the funds during the exchange period. Respondent asserts that Treasury Regulation 1.1031(k)-1 allows for deferred like-kind exchanges, but only if specific requirements are met, including the provision providing that money or property actually received by taxpayers is not entitled to tax deferred treatment. Respondent contends that there is no legal support for appellants' position that sale proceeds actually received as cash prior to the closing of the sale on the relinquished property is somehow outside of the IRC section 1031 exchange and therefore not taxable. (Resp. Reply Br., pp. 1-4.) Respondent asserts that the proper analysis is to see whether appellants had actual receipt of money at any time during the exchange before replacement property is received. (*Id*. at p. 6.) Respondent contends that once Emerson Properties took possession of the cash, it had boot and must pay taxes on it, and it cannot escape taxation by then using the cash in their possession as part of the purchase price of the replacement property. (*Id*. at p. 4.) Respondent asserts it does not matter whether Emerson Properties received cash before the sale of the relinquished property, only that it received it prior to the acquisition of the replacement property. Respondent cites as similar examples cases wherein taxpayers received cash before an exchange began by refinancing property, and the cash received was deemed to be taxable boot under IRC section 1031(b). (*Id*. at p. 8; *Long v. Commissioner* (1981) 77

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T.C. 1045; *Garcia v. Commissioner* (1983) 80 T.C. 491; *Behrens v. Commissioner* (1985) T.C. Memo 1985-195; *Fredericks v. Commissioner* (1994) T.C. Memo 1994-27.)

Respondent contends that appellants misunderstand the fundamentals of IRC sections 1001 and 1031 when they assert there is a conflict between the sections and coin the new term "hybrid like-kind exchange." (Resp. Reply Br., p. 7; see App. Op. Br., p. 2.) Respondent asserts that IRC section 1001 provides for when gain from the sale of property is "realized," and states that such realized gain shall be "recognized" unless an exception such as that provided by IRC section 1031 applies. Therefore, respondent asserts, IRC sections 1001 and 1031 work in harmony. Respondent goes on to assert that IRC section 1031(b) carves out an exception to IRC section 1031(a)(1), and Treasury Regulation sections 1.1031(b)-1, 1.1031(d)-1, and 1.1031(d)-2 provide that the amount of gain to be recognized is essentially the amount of boot received up to the total amount of gain realized. (Resp. Reply Br., pp. 7-8.)

Respondent provides a reply to appellants' contention that there is no federal or California authority indicating whether, how, or when a taxpayer in Emerson Properties' position should transfer deposit or option payments to a qualified intermediary when the relinquished property is to be transferred. (Resp. Reply Br., p. 9; see App. Reply Br., p. 4.) Respondent contends that a taxpayer can use a qualified escrow account, as defined in Treasury Regulation section 1.1031(k)-1(g)(3), to avoid being in actual or constructive receipt. Respondent notes that Emerson Properties had the third deposit amount of $500,000 sent straight to its qualified intermediary to avoid taxable boot. (Resp. Reply Br., pp. 10-11.)

Respondent disagrees with appellants' contention that Emerson Properties adhered to the spirit of IRC section 1031. Respondent contends that Emerson Properties' actual receipt of cash proceeds from the sale of the relinquished property violates one of the most established principles of like-kind exchanges, citing *Klein v. Commissioner* (1993) T.C. Memo 1993-491 (*Klein*). Respondent asserts that, with regard to the $2 million early release deposits, Emerson Properties did not exchange property for property because of the receipt of the cash. Respondent contends that *Starker* is distinguishable because the taxpayers in that appeal never received cash, whereas Emerson Properties had actual receipt of sale proceeds. Respondent quotes the decision in *Starker* wherein it discusses other

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failed like-kind exchanges and stated, "[t]he formal transfers of cash to and from the taxpayer's hands defeated the attempt to fit the exchange within section 1031." Respondent contends that Emerson Properties is not allowed to both take actual receipt of cash and also get IRC section 1031 exchange deferral treatment. (Resp. Op. Br., pp. 15-17; *Starker, supra*, 602 F.2d at fn. 11.)

Applicable Law

Burden of Proof

Respondent has the initial burden of showing that its proposed assessment is reasonable and rational. Once this burden is met, respondent's determination is presumed correct and an appellant has the burden of proving it to be wrong. (*Todd v McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Richard Byrd*, 84-SBE-167, Dec. 13, 1984.)

Property Sale Proceeds and Option Payments

Internal Revenue Code (IRC) section 61(a)(3) includes gains derived from dealings in property in its definition of gross income. IRC section 1001(a) provides that the gain from the sale of property shall be the excess of the amount realized over the adjusted basis. Some exceptions apply to defer the recognition of gain for tax purposes, such as the exception provided for by IRC section 1031.

The U.S. Supreme Court in *Burnet v. Logan, supra*, 283 U.S. 404, stated generally that the income tax law is concerned only with realized losses and realized gain. Accordingly, and pursuant to IRC section 1234, gain or loss on an option is realized when the option lapses, expires, is exercised, transferred, or otherwise terminates. (See *Virginia Iron Coal & Coke Co. v. Commissioner* (1938) 37 B.T.A. 195.)

IRC section 1031 & "Boot"

California conforms to IRC section 1031 at R&TC sections 18031 and 24941. To qualify for nonrecognition treatment under IRC section 1031, the following 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)-(3).)

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

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1031(a) if, as part of the consideration, the taxpayer receives money or other property. However, such a transfer, if otherwise qualified, will be within the provisions of IRC section 1031(b) or 1031(c). IRC section 1031(b) provides, generally, that when a like-kind exchange also includes other property or money in addition to the property permitted to be received without recognition of gain, then any gain will not be deferred to the extent of the money or other property received (referred to as "boot").

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. (Treas. Reg. § 1.1031(k)-1(f)(1).) 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*.)

A taxpayer may defer recognition of gain in a deferred exchange only through the use of a safe harbor. Money or property actually or constructively received by the taxpayer outside of the safe harbor must be recognized. (Treas. Reg. § 1.1031(k)-1(g).) Treasury Regulation section 1.1031(k)-1(g)(4) provides the rules for using the safe harbor of a qualified intermediary for deferred exchanges. Section 1.1031(k)-1(g)(4)(vii) states that a taxpayer may receive money directly from a party to the exchange without affecting the safe harbor as long as the money does not come from a qualified intermediary. While this money would not disqualify the safe harbor, it would still be considered boot. (See Treas. Reg. § 1.1031(k)-1(g)(8) example 1.) Even if money is reinvested in replacement property after being received (actually or constructively) from the sale of relinquished property, it will not be allowed IRC section 1031 tax-deferral treatment if it was not done through use of a safe harbor. (See *Klein*.)

Revenue Ruling 84-121 discussed the tax treatment to the buyer and seller of an option to buy real property that was relinquished as part of a like-kind exchange. The property seller granted the potential purchaser for 5x dollars an option to buy the subject property for 100x dollars (either

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using cash or exchanging like-kind property). The purchaser exercised the option and transferred other real property worth 100x in exchange for the subject property. The Revenue Ruling reviewed the transaction under IRC sections 1001 and 1031, and found that the exchange of properties qualified as a like-kind exchange as to the seller of the property, but, in accordance with IRC section 1031(b), the 5x dollar option payment constituted taxable boot to the seller.

STAFF COMMENTS

Deferred like-kind exchanges are made possible through the use of one of the safe harbors enumerated in Treasury Regulation section 1.1031(k)-1(g). Emerson Properties made use of one of those safe harbors, a qualified intermediary, when it conducted the like-kind exchange at issue in this appeal. However, appellants assert that a portion of the approximately $2 million in early release deposit funds, which were never held by the qualified intermediary, should also qualify for tax deferral under IRC section 1031. Appellants should be prepared to explain how these deposit funds qualify for IRC section 1031 treatment when it appears as though they were not transferred in accordance to any of the safe harbors provided in the Treasury Regulation.[12]

It appears to staff that the above question, regarding how the funds qualify for safe harbor treatment, is dispositive. However, staff discusses below the other questions raised by the parties such as whether the nature of the funds prior to the closing of the sale on the relinquished property caused them to be an exception (i.e., via the open transaction doctrine) to the exception (i.e., Treasury Regulation section 1.1031(k)-1(f)(2)) of an exception (i.e., IRC section 1031(b)).

Appellants argument appears to be that, because Emerson Properties received the cash as early release deposit funds prior to the closing of the exchange or sale of the relinquished property, it should not be treated as boot, or at least that Emerson Properties should have an avenue to decide to include those funds in its tax-deferred like-kind exchange by contributing them toward the purchase price of the replacement property at a later date. Appellants contend that the open transaction doctrine

[12] In this connection, appellants should also be prepared to explain further how, under the statute and regulations, the receipt of cash prior to an exchange should not constitute taxable boot when, unless a taxpayer satisfies all the safe harbor requirements, the receipt of cash during an exchange would constitute taxable boot (or potentially disqualify the transaction altogether from exchange treatment). Under the statute and regulations, why should a taxpayer who receives cash prior to the exchange be in a better position than a taxpayer who receives cash during the exchange?

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keeps the option money from being taxable, even after the sale of the relinquished property closed, that the cash cannot be considered taxable boot under the regulations because it was received prior to the exchange rather than during the exchange and from the qualified intermediary, and, ultimately, that there is no controlling law on this issue and therefore the Board should apply IRC section 1031 liberally and in favor of the taxpayer.

Respondent asserts that the early release funds represent money in actual receipt of Emerson Properties during the exchange, having never been held by the qualified intermediary, and therefore must be considered taxable boot and outside of the exception provided for in IRC section 1031 and the accompanying regulations allowing for a deferred exchange. Respondent contends that the law is clear, and supports its position.

Staff questions appellants' position that there is no controlling law, as existing law under IRC section 1031 and regulations thereunder do not appear to staff to allow an exchanger to receive and control cash on a tax-deferred basis, except in narrowly defined circumstances which are not present here. As appellants appear to acknowledge, there is no IRC section 1031 case law or regulation supporting appellants' position regarding option money. California law requires that respondent and the Board follow federal regulations where, as is the case here, California's statute conforms to the federal statute. (Rev. & Tax. Code, § 17024.5, subd. (d).) Accordingly, it appears to staff that the Board must follow the applicable federal IRC section 1031 regulations, which only allow the tax-deferred receipt of cash in certain narrowly defined circumstances.

Emerson Properties had unfettered access and actual receipt of the approximately $2 million at issue prior to the acquisition of the replacement property. Although Emerson Properties received these funds prior to relinquishing the Oakley property, which is typically the beginning of the exchange process, the deposits appear to constitute money "received in exchange" for the relinquished property since the deposits were part of the sale price for the Oakley property (Int.Rev. Code, § 1031(b)), the deposits were certainly money that was received "before [Emerson Properties] actually receive[d] like-kind replacement property" (Treas. Reg. § 1.1031(k)-1(f)), and Emerson Properties "receive[d] the economic benefit of the money" since it was in its actual possession during the exchange period (*Id*. at § 1.1031(k)-1(f)(2)). Appellants should be prepared to explain how the early release

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deposits of which Emerson Properties had actual possession of during the exchange period and were contractually defined as compensation for the sale of the relinquished property do not constitute taxable boot when viewed under the IRC and Treasury Regulations. Appellants should also be prepared to address how sale proceeds actually held by a taxpayer would qualify for IRC section 1031 tax deferral when money never received but only made available to the taxpayer (i.e., constructive receipt) does not qualify. (*Ibid*; see *Id*. at § 1.1031(k)-1(j)(3) examples.)

Appellants contend that had Emerson Properties took possession of the $2 million of deposits at the closing of the sale of the relinquished property, then Emerson Properties would have had taxable boot due to the actual receipt of funds during the exchange period. (App. Supp. Br., pp. 2, 4.) The parties should be prepared to discuss the nature of the deposit funds at the time of the closing on the relinquished property. In particular, the parties may wish to discuss whether the exercising of an option causes the option payments to become realized, pursuant to *Burnet* and IRC section 1234, and whether at the time the option was exercised on the relinquished property the deposit funds constituted sale proceeds in the possession of Emerson Properties.

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