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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of: **GERALD J. MARCIL AND** **CAROL L. MARCIL**	**REHEARING SUMMARY** **PERSONAL INCOME TAX APPEAL** Case No. 458832

Proposed Assessment

Year	Tax	Penalty
2001	$307,466	$14,591.81[1]

Representing the Parties:

For Appellants: Layton L. Pace

For Franchise Tax Board: Valerie G. Leclerc, Tax Counsel III

QUESTION: Whether appellants' limited partnership satisfied the requirements for a "like-kind" exchange pursuant to Internal Revenue Code (IRC) section 1031.

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[1] The penalty is a post-amnesty penalty and is not argued in the petition for rehearing, although appellants note that they are not conceding any portion of the assessment. (App. Reh. Op. Br., p. 1.) In staff's view, the Board lacks jurisdiction over the penalty as it has not yet become final. (Rev. & Tax. Code, § 19777.5, subds. (d) & (e).)

HEARING SUMMARY

Prior Hearing

On June 21, 2011, the Board held an oral hearing in this matter and, on June 22, 2011, it determined that the Franchise Tax Board (FTB or respondent) properly determined that the sale and purchase of the subject properties did not qualify as a like-kind exchange pursuant to Internal Revenue Code section 1031.[2] Appellants then filed a petition for rehearing, which the Board granted on November 15, 2011.

Overview

Please note that the Staff Comments section of this hearing summary provides a timeline of events described below.

Hollywood Vista Apts, Ltd. (HVA), a limited partnership, sold certain real property located on North Vista in Los Angeles (the "Vista property" and the "relinquished property" in this appeal) on November 14, 2001. The sale was conducted through Asset Preservation, Inc. ("API"), a qualified intermediary for IRC section 1031 exchanges.[3] Appellants Gerald J. Marcil and Carol L. Marcil each owned a 49.5 percent interest in HVA and together owned 99 percent of HVA, with Woodglen Apt. LLC (Woodglen), the general partner of HVA, owning the remaining 1 percent interest.[4] Appellants also owned 50 percent each of Woodglen.

Through HVA, appellants realized gain of $3,048,644 on the sale of the Vista property. Appellants argue that tax on this gain should be deferred under IRC section 1031 on the basis that the sale of the Vista property was part of a qualified "reverse" exchange by HVA in which HVA first acquired replacement property for the Vista property through API (the qualified exchange intermediary). The claimed replacement property is a 60 percent undivided interest in certain property located on

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[2] A transcript of the hearing is available at: http://www.boe.ca.gov/meetings/transcripts/20110621B1.txt. Staff's hearing summary for the prior oral hearing is available at: http://www.boe.ca.gov/meetings/pdf/hearingsummaries/B_Marcil_Gerald_J_And_Carol_L_458832_Sum.pdf. The prior hearing summary is also attached as Exhibit A, as both parties incorporate their prior arguments and evidence by reference.

[3] API used an affiliate API Properties Corporation, which is referred to as "EAT" in some prior briefing. For simplicity, this Rehearing Summary will refer to API.

[4] A fourth partner, Carol Taylor, withdrew from the partnership immediately prior to the sale.

Manchester Boulevard (the "Manchester property").

The Manchester property was acquired as follows. Manchester Development, LLC ("MD, LLC") had a contract to purchase the Manchester property. A grant deed recorded October 24, 2001, transferred a 60 percent interest in the property (the "replacement property") to Lava Rock Eighty LLC ("Lava Rock"), which was a disregarded entity for tax purposes and had been formed by API to facilitate the acquisition of the property. The same October 24, 2001 grant deed conveyed the remaining 40 percent of the Manchester property to MD, LLC.

API transferred the 60 percent undivided interest in the Manchester property to HVA on November 20, 2001 (i.e., about a week after the sale of the Vista property). This was technically accomplished by transferring API's interest in Lava Rock, which held the replacement property, to HVA. Respondent contends that HVA then distributed the replacement property to Mr. Marcil by conveying its interest in Lava Rock to him; appellants dispute this and argue that HVA continued to hold the replacement property until December 15, 2001.

A grant deed dated December 15, 2001 (and apparently recorded March 18, 2002), transferred the 60 percent interest in the replacement property from Lava Rock to MD, LLC. Mr. Marcil appears to have owned at least a 50 percent membership interest in MD, LLC after the transactions, with the remaining interest held by a third party (John Walsh).

As more fully described below, respondent contends that HVA failed to hold the replacement property for investment purposes as required by IRC section 1031. Appellants contend HVA merged into MD, LLC for tax purposes so that HVA, for tax purposes, continued to hold the property. Appellants also contend that, even if there was a distribution of the replacement property to Mr. Marcil (which appellants dispute), a later tax-free contribution of the property from Mr. Marcil to MD, LLC should not disqualify the exchange.

<u>Detailed Background</u>

In 1987, appellants acquired the Vista property (the claimed exchanged property) as tenants in common. In January 1998, HVA was formed to hold and to manage the Vista property and to offer that property for sale. Prior to the transactions at issue, HVA had another partner, Carina Taylor, but her interest was terminated prior to the transactions at issue. (Resp. Orig. Op. Br., p. 1 and p. 4.)

On May 9, 2001, Mr. Marcil and a real estate broker, John Walsh, formed MD, LLC to acquire and to develop the Manchester property (the claimed replacement property). According to operating agreement of MD, LLC, Mr. Marcil held a 50 percent economic interest and a 60 percent voting interest and Mr. Walsh held a 50 percent economic interest and a 40 percent voting interest. (Resp. Orig. Op. Br., exhibit A, p. 27.) Appellants contended at the prior oral hearing, and contend in briefing on rehearing, that, in reality, they had only a "small interest" (less than two percent) in MD, LLC between October 24, 2001 and December 15, 2001, as the entity had not yet been funded. (App. Op. Br. on Reh., p. 2.)

On May 16, 2001, MD, LLC entered into an agreement to purchase the Manchester property for $8,000,000 with an expected closing date of July 24, 2001. The title company prepared a draft grant deed dated July 19, 2001, naming MD, LLC as the sole grantee of the Manchester property. The operating agreement for MD, LLC, effective May 29, 2001, provided that the purpose of MD, LLC was to construct 200 apartment units on the Manchester property. On August 8, 2001, HVA entered into an agreement to sell the Vista property for a price of $5,600,000. Ms. Taylor subsequently terminated her partnership interest in HVA. (Resp. Orig. Op. Br., p. 5, exhibit G.)

On August 24, 2001, HVA entered into an exchange agreement with API, the qualified intermediary, by which HVA assigned its rights to sell the Vista property to API, with the understanding that API would sell the Vista property and acquire a replacement property. While the Vista property was in escrow, MD, LLC was in the process of acquiring the Manchester property. In an amendment to the purchase agreement, dated September 26, 2001, a provision was added to allow the intended buyer, MD, LLC, to consummate a tax-deferred exchange with the closing date extended to October 23, 2001. (Resp. Orig. Op. Br., p. 6.)

On September 24, 2001, Lava Rock was organized by API to purchase the Manchester property as the replacement property for HVA's like-kind exchange. As of that date, the Manchester property was still subject to a contract of sale to MD, LLC. To facilitate HVA's like-kind exchange, an Exchange Accommodation Agreement was entered into between HVA and Lava Rock on October 17, 2001. The agreement provided that HVA, as the exchanger, desired to acquire the Manchester property as the replacement property and Lava Rock, as the exchange accommodator, would acquire and hold the

Manchester property until the transfer could be completed. On October 18, 2001, HVA purportedly assigned its rights to purchase the Manchester property to Lava Rock for the IRC section 1031 exchange.[5] (Resp. Orig. Op. Br., p. 7.)

On October 24, 2001, a grant deed was recorded stating that the Manchester property was being transferred from the seller to MD, LLC, but noting in a footnote that 60 percent of the Manchester property was transferred to Lava Rock (the disregarded entity that had been formed by API to hold the property) and 40 percent of the property to MD, LLC. (Resp. Orig. Op. Br., p. 8, exhibit I.)

API sold the Vista property on November 14, 2001. API assigned and transferred its 100 percent membership interest in Lava Rock to HVA on November 20, 2001, and because Lava Rock was a disregarded entity for income tax purposes, HVA thereby held the assets of Lava Rock which consisted of the 60 percent tenancy in common interest in the Manchester property. According to respondent, HVA assigned its 100 percent membership interest in Lava Rock to Mr. Marcil; however, appellants dispute this.[6] (See App. Orig. Op. Br., p. 3.; Resp. Orig. Op. Br., p. 8 and exhibits B and C.)

By grant deed dated December 15, 2001, Lava Rock transferred its 60 percent interest in the Manchester property to MD, LLC and, MD, LLC thereby held title to a 100 percent fee simple interest in the Manchester property.[7] MD, LLC's year end trial balance as of December 31, 2001, shows a 60 percent land contribution from Mr. Marcil and a 40 percent land contribution from Mr. Walsh. On December 31, 2001, HVA filed a certificate of dissolution with the California Secretary of State (SOS) and HVA's year end trial balance as of December 31, 2001, shows a property distribution in the amount of $1,801,073.22 to Mr. Marcil. (Resp. Orig. Op. Br., p. 8 and exhibits E, L and N.)

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[5] Respondent questions whether HVA had any rights to assign, since the purchase agreement was with MD, LLC rather than HVA.

[6] The assignment is not dated (with a handwritten note stating "Do not Date"); the certificate of amendment memorializing the transfer is also not dated but was filed with the Secretary of State on October 23, 2002. A print-out, apparently from the Nevada Secretary of State, lists Mr. Marcil as a partner and the numbers 112801, which respondent states refers to November 28, 2001. Respondent also points to, among other things, a trial balance sheet showing a distribution by HVA to Mr. Marcil, the fact that Mr. Marcil's 2001 tax return showed an interest in Lava Rock, and that Mr. Marcil's prior accountant indicated that a distribution occurred. However, appellants dispute this, arguing that it is inconsistent with a December 15, 2001 grant deed, which was signed by HVA on behalf of Lava Rock, conveying the 60 percent interest in the Manchester property from Lava Rock to MD, LLC. Appellants further argue that other Secretary of State documentation, which shows only HVA as a member, also includes the 112801 number. (See App. Orig. Reply Br., p. 6 and exhibit 3.)

[7] As noted above, exhibit D of respondent's original opening brief appears to show a recording date of March 18, 2002.

Respondent issued a Notice of Proposed Assessment (NPA) to appellants that included gain from the sale of the Vista property. Appellants filed a timely protest of the NPA and a protest hearing was held. Respondent subsequently affirmed the NPA and issued a Notice of Action from which this timely appeal was made. (Resp. Orig. Op. Br., p. 10.)

Contentions

Appellants' Opening Brief on Rehearing

Appellants summarize the facts follows:

A. On November 14, 2001, HVA sold its rental apartment building (i.e., the Vista property).

B. At that time, each appellant owned a 49.5 percent limited partnership interest in HVA, and each owned 50 percent of Woodglen, which owned a one percent general partnership interest in HVA.

C. On November 20, 2001, HVA intended to defer the gain by receiving a 60 percent interest in the Manchester property. Appellants note that respondent conceded at the oral hearing that HVA would have completed a valid exchange at this point if it had not engaged in further transactions with MD, LLC, which appellants later define (in F., below) as the Post-Exchange Transactions.

D. MD, LLC owned the remaining 40 percent interest in the Manchester property, which it acquired on October 24, 2001.

E. From approximately October 24, 2001 until December 15, 2001, appellants owned, as community property, "a small interest (i.e., less than 2% interest) in MD, LLC . . . ." John Walsh owned almost all of MD, LLC during that period because "he contributed almost all of the funds used to buy the 40% interest in the Manchester property." Appellants state that respondent erroneously asserts that they owned 50 percent of MD, LLC during this period "because of the initial paperwork." Appellants contend that appellants and Mr. Walsh had changed their financial arrangements so that appellants would buy a 60 percent interest in the Manchester property through HVA and Mr. Walsh would buy the remaining 40 percent interest through MD, LLC.

F. On December 15, 2001, HVA conveyed its 60 percent interest in the Manchester property to MD, LLC by a recorded grant deed, which appellants attach as exhibit 2 of their opening brief. Appellants argue that respondent seems to ignore the effect of the grant deed. On December 21, 2001, HVA filed a certificate of cancellation. Appellants describe these transactions, the conveyance to MD, LLC and cancellation of HVA, as the "Post-Exchange Transactions."

G. Appellants argue that the Post-Exchange Transactions were designed to save the annual franchise tax and other filing and administrative costs and that they combined HVA into MD, LLC, rather than combining MD, LLC into HVA, to save the Manchester name since the property was located on Manchester Avenue. Appellants argue that they gained no income tax advantage from the Post-Exchange transactions, which appellants describe as "completely separate and independent transactions from the purchase of the Manchester property."

H. Lava Rock, rather than HVA, held legal title to the 60 percent interest in the Manchester property, however Lava Rock was a disregarded entity for income tax purposes such that its involvement has no impact on the tax analysis. Appellants contend that Lava Rock's role confused respondent, and that, in the fall of 2002, appellants terminated Lava Rock's existence since it no longer owned any assets.

(App. Reh. Op. Br., pp. 1 – 3.)

Appellants assert that, in order to resolve whether a valid exchange occurred, only two sub-issues must be resolved: first, whether "HVA continue[d] to exist as a partnership for income tax purposes even though it filed a certificate of cancellation with the California Secretary of State[,]" and, second, whether HVA "sufficiently [held] the replacement property for an investment purpose to complete properly the [exchange] even if HVA did not continue to exist for income tax purposes." (App. Reh. Op. Br., pp. 3 – 4.)

Appellants' Arguments that HVA Continued to Exist for Tax Purposes

With regard to whether HVA continued to exist as a partnership for income tax purposes, appellants point to Revenue Ruling 77-548.[8] Appellants argue that, since no California law, regulation or guidance mandates deviating from Revenue Ruling 77-548, it must be followed as set forth in FTB

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[8] In the ruling, ten general partnerships, which were equally owned by two individuals, would accomplish a merger by a transfer of assets and liabilities of nine partnerships to the largest partnership in exchange for interests in that partnership which were then distributed to the two partners. After the transaction, the two individuals would own a 50 percent interest in remaining partnership. The ruling determined that, because the larger partnership contributed the most assets to the resulting partnership, it will be considered the surviving partnership for tax purposes.

Information Letter 2010-5.[9] (App. Reh. Op. Br., p. 4 and exhibit 3.)

Appellants argue that Private Letter Ruling 200339039 demonstrates that Revenue Ruling 77-458 is directly on point. In that private letter ruling, six partnerships contributed their assets to a newly formed LLC and then liquidated. Appellants note that the private letter ruling found that the partnership contributing the assets with the greatest value survived for income tax purposes. Appellants note that the private letter ruling does not require complying with state merger statutes and contend that it does not require that any of the partners "own any specific percentages in the LLC or that they even remain as owners of the LLC, so long as two partners, A and B, continue to own more than 50% of the disappearing and resulting partnerships." (App. Reh. Op. Br., p. 4 and exhibit 4.)

Appellants argue that respondent cites "NO authority for its position that a written plan of merger, compliance with the merger provisions of the California Corporations Code . . . or similar formalities is required for HVA to continue under IRC section 708(b)(2)(A)." (Emphasis in original.) Appellants state that, at the prior oral hearing, respondent "recanted that two partnerships need to statutorily merge" in contrast to the "cornerstone" of respondent's contentions in its original opening brief that a formal statutory merger is required. (App. Reh. Op. Br., pp. 4 – 5.)

Appellants state that the partnership termination provisions of IRC section 708 are not elective. In that respect, appellants contend, the IRC section 708 provisions are similar to the change in ownership provisions of R&TC section 60 *et seq*., in that a change of ownership for property tax purposes automatically occurs if a person gains ownership of more than 50 percent of the capital and profits interest in a partnership holding real property. (App. Reh. Op. Br., p. 5.)

As further support for their contention that HVA continued in existence for tax purposes, appellants cite Revenue Ruling 2000-5.[10] Appellants contend this ruling makes clear that "[a] merger is a matter of federal tax law, not state corporate law." (App. Reh. Op. Br., p. 5, exhibit 5.)

Appellants argue that Carol Marcil owned an interest in MD, LLC through her

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[9] The letter states as follows: "Where the [R&TC] conforms to the [IRC], federal administrative guidance applicable to the IRC shall, insofar as possible, govern the interpretation of conforming state statutes, with due account for state terminology, state effective dates, and other obvious differences between state and federal law."

[10] This ruling described two merger transactions that sought to qualify as IRC section 368(a)(1)(A) reorganizations and determined that the transactions did not so qualify, even though the transactions constituted mergers under state law.

community property ownership of the 60 percent ownership held by "the Marcils" in MD, LLC. In support, appellants provide Revenue Rulings 77-137[11] and 79-124[12]. Appellants contend that these rulings show that Mrs. Marcil did not need to sign the operating agreement of MD, LLC to own a partnership interest in MD, LLC for income tax purposes. Appellants also cite in support BOE Letter to Assessors 85-33,[13] which appellants contend confirms that Mrs. Marcil "is to be treated as separately owning her half of the 60% community property interest in MD,LLC." As a result, appellants argue that each of the Marcils owned 30 percent of the Manchester property through HVA before the Post-Exchange Transactions and 30 percent of the Manchester property as partners of MD, LLC after the Post-Exchange Transactions. Appellants argue that, just like the equal owners in PLR 200339039, they owned more than 50 percent of MD, LLC, and this majority ownership caused HVA to continue to exist for income tax purposes, regardless of whether the Marcils owned 50.1 percent or 100 percent. (App. Reh. Op. Br., pp. 5 – 6 and exhibits 5 - 8.)

Appellants also provide an affidavit from Mrs. Marcil in which she states, among other things, that she did not intend to give up any ownership interest in HVA or its assets, and was not concerned if Mr. Marcil was named as a member of MD, LLC as long as she held a community property interest. (App. Reh. Op. Br., p. 5 and exhibit 6.)

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[11] Revenue Ruling 77-137 found that an assignee acquiring substantially all control over a limited partner's interest is treated as a substituted limited partner for income tax purposes, even though the assignee did not become a nominal partner under local law. The ruling noted that the partnership agreement provided that a partner could assign the assigning partner's right to share in profits, losses and distributions to which the assigning partner would have been entitled. Since the assignee received these economic rights, the assigning partner was treated as a partner for income tax purposes, even though not the nominal partner under state law.

[12] Revenue Ruling 79-124 considered a situation in which individual "A" was a member of a partnership. Under state law, A's interest was held as community property by A and A's spouse "B". The ruling found that, on the death of A, A's one-half of the community property interest went to the estate. B's share of the partnership interest was held to have been acquired from A at A's death. The ruling found that, for purposes of IRC section 743(b) (which provides for an election to adjust the basis of partnership property upon a transfer of a partnership interest), the entire partnership interest originally owned by A was considered to have been transferred.

[13] This letter states that for purposes of change in ownership under the property tax provisions of the Revenue and Taxation Code, where property is acquired as "community property," it should be treated, in the opinion of staff, in the same manner as if title was taken as "joint tenants." The letter references Letter No. 83/17, which is included in appellants' exhibit 8, and which states that a husband and a wife holding interests as joint tenants should be considered as each owning 50 percent of the ownership interests in question. The letter adds that "[t]he fact they are married cannot be used to attribute the ownership of one spouse to that of the other so as to find one spouse has directly and indirectly acquired more than 50% ownership in a legal entity."

Appellants dispute respondent's argument that the ownership interests in MD, LLC do not suggest a valid merger. Appellants state that respondent's argument assumes that the Marcils owned 50 percent of MD, LLC before the Post-Exchange Transactions. Appellants contend this is incorrect, as evidenced by prior testimony from Mr. Marcil that the Marcils owned only a small interest in MD, LLC prior to the transactions. Appellants contend this fact is known by respondent from closing statements, general ledgers and tax returns. In support, appellants note accounting records showing the Marcils receiving capital account credit for $1,356,300, versus $904,200 for Mr. Walsh (i.e., 60 percent and 40 percent, respectively). (App. Reh. Op. Br., p. 6 and exhibits 9 and 10.)

Appellants also dispute respondent's argument, made at the prior oral hearing, regarding Revenue Ruling 90-17.[14] Appellants contend that the ruling "says nothing about partners needing to receive certain percentages in the resulting partnership for a merger . . . to occur." Appellants argue that, on the contrary, Revenue Ruling 90-17 only states that a merger or consolidation occurs if the partners "own more than 50% of the interests in the resulting partnership." (App. Reh. Op. Br., p. 6.)

Appellants' Arguments Regarding Whether HVA Sufficiently Held the Manchester property for an Investment Purpose Even If HVA Did Not Continue to Exist

Appellants state that respondent has conceded in its brief at the prior oral hearing that, but for the Post-Exchange Transactions, appellants satisfied the requirements of IRC section 1031. Appellants argue that the Post-Exchange Transactions should not invalidate the exchange because the substance of the transactions is that appellants owned a 60 percent interest in real property owned through a partnership before the exchange and continued to own a 60 percent interest in the same property through the same partnership after the transactions. (App. Reh. Op. Br., pp. 6-7.)

Citing *Bolker v. Comm'r* (9th Cir. 1985) 760 F.2d 1039 (*Bolker*) and *Maloney v. Comm'r* (1989) 93 T.C. 89 (*Maloney*), and referencing arguments in the original briefing, appellants argue that "changing the mere form of ownership, which occurred when Appellants converted their state law

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[14] Revenue Ruling 90-17 involved a merger of three partnerships that was accomplished by the merging partnerships contributing their assets to the resulting partnership in exchange for an interest in the resulting partnership, which interests were then distributed to the partners of the merging partnerships. Staff notes that, on the facts described, each partner received an interest in the resulting partnership in accordance with the percentage of the resulting partnership's assets that were effectively contributed by the partner through the partner's interest in the contributing partnership. However, as noted by appellants, the ruling does not expressly state this as a requirement.

ownership of partnership interests in HVA into state law ownership of membership interests in MD, LLC, does not violate the requirements of IRC Section 1031." Appellants contend that there is no time limit for which a taxpayer must retain replacement property, that HVA retained ownership from November 20, 2001 until December 15, 2001, and that it would have retained it longer if the $800 franchise tax was not fast approaching. Appellants argue that the Post-Exchange Transactions did not "cash out" appellants or change the use of the Manchester property. (App. Reh. Op. Br., p. 7.)

Appellants further argue that the "uncontroverted testimony" of Mr. Marcil is that HVA and MD, LLC combined after the completion of the like-kind exchange and only combined to save administrative costs. Appellants contend that the exchange and the Post-Exchange Transactions were not mutually dependent on other steps and were separate transactions that should be given their own separate tax effect. (App. Reh. Op. Br., p. 7.)

<u>Respondent's Brief on Rehearing</u>

Respondent first argues that contemporaneous documents prepared by Mr. Marcil as managing member of MD, LLC "establish conclusively" that the terms of appellants' deal did not materially change between May and November 2001 to reduce appellants' interest in MD, LLC to less than two percent. Respondent further argues that the petition for rehearing satisfied none of the grounds for a rehearing, and appellants merely repeat their prior arguments. (Resp. Reh. Br., pp. 1 -2.)

Respondent incorporates its prior briefing and "respectfully requests that your Board fully review Respondent's prior submissions to your Board . . . , as the positions that Appellants maintain are so vital to support a rehearing were conclusively addressed by Respondent in its briefings before the appeal." Respondent contends that appellants "ignore the legal principles behind Revenue Ruling 79-124," as discussed previously by respondent, that "a person can have a community property interest yet still not be a member or partner of an entity taxable as a partnership." Respondent reiterates that Carol Marcil held an independent partnership interest in HVA and, if appellants' merger theory were correct, she should have emerged with an ownership interest in MD, LLC. (Resp. Reh. Br., p. 2.)

Respondent again argues that documentation signed by Mr. Marcil confirmed his 50+ percent ownership interest in MD, LLC commencing in May 2001 and never at the 2 to 4 percent range which respondent states is now claimed. Respondent states that, at oral argument, "for the first time ever" appellants took the new and "completely unsubstantiated position" that Mr. Marcil owned less than four percent of MD, LLC between May and November 2001. (Resp. Reh. Br., p. 2.)

Respondent argues that the duty of consistency applies and should prevent appellants from changing their position, citing *Estate of Ashman v. Comm'r* (9th Cir. 2000) 231 F.3d 541, 546 (*Ashman*).[15] Respondent quotes extensively from *Ashman,* noting that the decision states that the duty of consistency is "hauntingly similar" to the concept of "judicial estoppel," which "'precludes a party from gaining an advantage by taking one position, and then seeking a second advantage by taking an incompatible position." (Quoting *Ashman*, *supra*, p. 546.) Respondent notes that *Ashman* stated that ". . . the duty of consistency not only reflects basic fairness, but also shows a proper regard for the administration of justice and the dignity of the law." (Quoting *Ashman*, *supra*, p. 543.) Respondent summarizes its duty of consistency argument as follows:

> Your Board should not allow taxpayers to supply Respondent with multiple documents during the audit that provide material evidence as to their ownership of the entities in question, have Respondent and your Board rely on those documents for purposes of determining the correct amount of tax, and then, when Respondent has successfully utilized that evidence to demonstrate the correctness of its determination and the lack of a merger of the partnerships, abandon those facts in a an unsubstantiated manner, with the hopes of constructing a new factual basis and legal theory to salvage an otherwise inevitable defeat.

(Resp. Reh. Br., pp. 2 – 3.)

Respondent argues that appellants' erroneously cite as support revenue rulings whose examples of mergers concern partnerships with the same ownership interests. Respondent contends that appellants cannot explain Revenue Ruling 90-17, which demonstrates the ownership changes that should occur when different owners are present and different partnerships merge, which result in proportionate changes in percentage ownership of the surviving entity. Further, respondent contends such ownership changes would occur where third parties engaged in a transaction reflecting economic realities and their own self-interest. (Resp. Reh. Br., p. 4.)

Respondent takes issue with appellants' position that Mrs. Marcil did not need to be a

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[15] Respondent's footnote 5 notes that MD, LLC's Restated Operating Agreement, entered into as of September 1, 2002, states that the members made equal capital contributions to MD, LLC, while appellants argue on rehearing that the members made unequal capital contributions.

named member of MD, LLC to own a partnership interest in the LLC. Respondent contends that Mrs. Marcil should have received an actual partnership interest if MD, LLC and HVA had merged. Respondent contends that appellants erroneously rely on Revenue Ruling 79-124, which "specifically provides that Spouse B, like Mrs. Marcil . . . , *was not* a partner in the partnership (in this case MD LLC), notwithstanding a community property interest in that property." Respondent notes that Mrs. Marcil had no voting rights and acknowledged she was not a member by signing a Spousal Consent. Respondent further contends that Revenue Ruling 77-137 does not address a situation involving spousal rights under community property law and is inapplicable. Respondent asserts that appellants are therefore incorrect to assert that Mrs. Marcil "owned 30% of MD LLC as a partner of HVA before the Post-Exchange Transaction . . . ." (Resp. Reh. Br., p. 5 and exhibit B.)

Respondent compares the original May 2001 MD, LLC Operating Agreement, with its amended Operating Agreement, effective September 1, 2002, and argues that "[a]ppellants' ownership in MD LLC did not change, as previously demonstrated, as it should have had a merger occurred, as explained by Revenue Ruling 90-17, which clarified by its terms Revenue Ruling 77-548 . . . ."[16] Respondent further states that Mr. Marcil signed a May 9, 2001 Certificate of Interest showing that Mr. Marcil held a 50 percent interest in MD, LLC.[17](Resp. Reh. Br., p. 5 and exhibits A and C.)

Respondent quotes *Ashman, supra,* as providing the following elements for application of the duty of consistency:

> (1) A representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. **The taxpayer is estopped to assert the contrary**. (*Ashman, supra*, p. 545 [emphasis supplied by respondent].)

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[16] Staff notes that the May 2001 Operating Agreement, attached as respondent's exhibit C, shows a 50 percent member interest and a 60 percent voting interest held by Mr. Marcil, while the amended Operating Agreement, effective September 1, 2002, attached as respondent's exhibit A, shows Mr. Marcil owning a 60 percent (as opposed to a 50 percent) member interest and a 60 percent voting interest.

[17] Staff notes that the May 9, 2001 Certificate of Interest, which is respondent's exhibit D, states that Mr. Marcil was the "record holder of a 60 percent [rather than 50 percent] fully paid and nonassessable share of MD, LLC.

Respondent asserts that "[e]quitable estoppel prevents any party from profiting from an action that induced reliance in another party." Respondent then sets forth the "elements of estoppel" as: "(1) there must be false representation or wrongful misleading silence (either a 50% or a 2% ownership interest in MD LLC); (2) the error must originate in a statement of fact . . . ; (3) the one claiming the benefit of estoppel must not know the true facts; and (4) that same person must be adversely affected by the acts or statements of the one against whom estoppel is claimed. [citations omitted]." Respondent contends that "noticeably, the duty of consistency does not require that there be a false representation or misleading silence." Instead, respondent asserts, the Ninth Circuit "has long applied a loose standard," which respondent states is based on 'the principle that no one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong'[,]" quoting *Ashman, supra*, page 543. Respondent further quotes *Cluck v. Commissioner* (1995) 105 T.C. 324, p. 545, which stated that the duty of consistency "contributes to our self-reporting system of taxation" and that allowing disavowal of prior representations "would invite similar intentional deceit" by other taxpayers. (Resp. Reh. Br., p. 6.)

Respondent notes that California Corporations Code section 17300 provides that a membership interest in a LLC is "personal property of the member" and "[a] member or assignee has no interest in specific limited liability company property." Respondent also cites *Denevi v. LGCC, LLC et al.* (2004) 121 Cal.App.4th 1211, 1214 and *Bartlome v. State Farm Fire and Casualty Company* (1989) 208 Cal.App.3d 1235, 1240, 1243, for the same point. Respondent contends that, based on these authorities, Mrs. Marcil's claim that she owns a portion of the Manchester property "is not germane to the resolution of this appeal, nor does it relate to HVA's independent obligation to satisfy all of IRC section 1031's exchange requirements. (Resp. Reh. Br., pp. 6 – 7.)

Respondent quotes *Appeal of Sierra Pacific Industries*, 94-SBE-002, decided January 5, 1994, which states in part that taxpayers ". . . are bound by the tax consequences of [their choice of form], whether contemplated or not, and they may not enjoy the benefits of some other path they might have chosen to follow, but did not." (Citing *Don E. Williams Co. v. Comm'r* (1977) 429 U.S. 569, *Comm'r v. National Alfalfa Dehydrating* (1974) 417 U.S. 134.) (Resp. Reh. Br., p. 7.)

Respondent contends that ". . . [a]ppellants effectively did 'cash out' of HVA, as they used the cash proceeds from HVA's sale of its apartment building to fund their separate, pre-existing and independent personal obligation to satisfy their capital contribution obligation to MD, LLC." In this connection, respondent notes that MD, LLC, not HVA, contracted to purchase the Manchester property in May 2001, stating that this occurred "long before" HVA sold or considered selling its property. Respondent notes that the last amendment to the purchase agreement extended MD, LLC's closing date to October 23, 2001, and contends that MD, LLC was not accomplishing a section 1031 exchange. Respondent further contends that HVA "effectively served as the Marcils' agent and conduit to fund their personal obligation to MD LLC . . ." and that HVA was terminated in order to insulate MD, LLC's assets from any liabilities that HVA might have had. Respondent argues that appellants had no business intent of merging the two entities, due to potential liability concerns, such as possible mold at the HVA apartments. (Resp. Reh. Br., p. 7.)

Respondent contends that MD, LLC did not assign its right to purchase any of the Manchester property to HVA until October 18, 2001. Respondent argues that HVA's lack of any purchase right is "demonstrated by the purported Assignment of Real Property Purchase Agreement between HVA and [Lava Rock], where the 'canned' assignment agreement provides a clear space for the date of the Real Property Purchase agreement, to allow its identification by referencing to its date of entry, but that date was left blank . . . as there never was a real property purchase agreement between [HVA and the sellers of the Manchester property] . . . ."[18] Respondent contends that "HVA had nothing to assign to Lava Rock" and that "HVA's holding of the Manchester property was transitory at best, done on behalf of Mr. Marcil, and . . . HVA failed to satisfy the 'holding requirement' of IRC section 1031(a)(1)." (Resp. Reh. Br., p. 8.)

In conclusion, respondent contends that, while Mr. Marcil and HVA "may have undertaken some actions that they claim demonstrate intent to accomplish a valid exchange, when all the documents and actions and ownership interests and positions are reviewed, intent is not enough and HVA did not accomplish a valid 1031 exchange[,]" citing *Bezdjian v. Commissioner* (9th Cir. 1988) 845 F.2d 217, affirming T.C. Memo. 1987-140. Respondent further argues that:

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[18] This document is attached to respondent's brief as exhibit F. The agreement references an agreement between HVA (as assignor) and Lava Rock (as assignee) for the acquisition of a 60 percent interest in the Manchester property, and references a purchase agreement, with the date left blank, between HVA and the third party sellers of the Manchester property.

> [t]o condone Appellants' material change in facts at this stage of the determination of their tax invites [a] chaotic environment, where Respondent's and your Board's audit and review process are effectively rendered not only meaningless, but which allows a taxpayer to recraft facts and ignore prior representations and documentation, once Respondent's legal arguments substantiating the taxpayer's true tax obligations have been provided to the taxpayer and your Board.

(Resp. Reh. Br., pp. 8 – 9.)

Appellants' Reply Brief on Rehearing

Appellants set forth four contentions in their reply brief. First, appellants contend that no California statutory merger is required and that respondent conceded this point at the oral hearing. Appellants note that respondent's brief incorporates its prior briefing, which contended that a statutory merger was required, so respondent presumably still maintains the position. In support of their position, appellants provides an excerpt from a 2011 New York University Tax Institute article, which states that "nuances of state law" do not govern partnership mergers, rather it is an issue of whether there has been a combination of entity "by whatever methods the parties choose." (App. Reh. Reply Br., pp. 1 – 2.)

Second, appellants contend that Mrs. Marcil did not need to sign the MD, LLC operating agreement or be a named member because she held her interest as community property. Appellants contend that IRC section 708 only requires that appellants collectively owned more than 50 percent of the partnership after the combination. With regard to respondent's argument that the facts of Revenue Ruling 90-17 involved maintenance of relative percentage interests, appellants argue that the ruling only recites the basic law, which does not require the same interests, and further that respondent erroneously "seizes upon facts and then attempts to assert them as evidence of non-existent tax law." (App. Reh. Reply Br., p. 2.)

Appellants reiterate their arguments regarding Revenue Ruling 79-124 and Revenue Ruling 77-137 and contend that respondent wrongly "equates being a 'partner' for state corporate law purposes with being a 'partner' for income tax purposes." Appellants provide a copy of Revenue Ruling 58-243, which they note states: "The fact that a husband and wife cannot legally be partners under state law does not necessarily prevent recognition of such a partnership for Federal income tax purposes." (App. Reh. Reply Br., p. 2.)

Third, appellants contend there is no duty of consistency issue. Appellants note that

Ashman, *supra*, involved circumstances where, in the 1990 tax year, the taxpayer failed to report taxable gain despite missing the deadline to rollover retirement funds. However, in 1993, the taxpayer received additional distributions which she did not report on the theory that since she had failed to timely rollover the 1990 funds, the amount should have been taxable in 1990 (rather than 1993). However, the statute of limitations had run on the 1990 tax year. (App. Reh. Reply Br., p. 3.)

Contrasting *Ashman*, *supra*, appellants contend that they and Mr. Walsh did not form MD, LLC until May 2001 and they "never filed any tax returns or took any positions with the [FTB] that reported their ownership of MD, LLC before the consolidation with HVA." In addition, appellants state that they "did not obtain a tax benefit from such a position." (App. Reh. Reply Br., p. 3.)

Appellants contend that respondent erroneously relies on *Cluck v. Comm'r* (1995) 105 T.C. 324 because it "applied the duty of consistency to prevent the taxpayer from using a different tax basis for income tax purposes than the agreed upon value used for estate tax purposes." Appellants note that the *Cluck* decision stated that the duty of consistency prevented a taxpayer "from taking one position one year and a contrary position in a later year after the limitations period has run for the first year." Appellants state that, in contrast, they did not take a position with regard to their interest in MD, LLC, "let the statute of limitations run, and then assert that they really owned a different percentage interest in MD, LLC in a later tax year." (App. Reh. Reply Br., p. 3.)

Fourth, appellants contend that HVA satisfied the requirements of IRC section 1031. Appellants argue that the FTB conceded at oral hearing that, but for the Post-Exchange Transactions, HVA satisfied the requirements of IRC section 1031. Appellants further contend that, at this stage, respondent cannot "assert that HVA failed to complete its like-kind exchange for other than how HVA combined into MD, LLC. (App. Reh. Reply Br., p. 4.)

Appellants further argue that they did not "cash out" HVA. Instead, appellants contend, "HVA brought its 60% undivided interest in the Manchester property with its own money from the sale of its own property that HVA had held for years." Moreover, appellants contend, HVA continued to own the property until it conveyed the property to MD, LLC by grant deed on December 15, 2001. (*Id.*)

Appellants reiterate that, although MD, LLC signed documents to buy 100 percent of the Manchester property, the transaction was modified "so that HVA would buy a 60% undivided interest in the Manchester property." Appellants contend that the deal modifications "did not cause Appellants to receive money from the sale of HVA's real property, cause HVA to buy personal use or non-like-kind property with the sale proceeds, or make HVA combine into MD, LLC." (*Id.*)

Appellants argue that IRC section 1031 did not require HVA to hold its interest in the property for any specified period of time. Appellants further contend the *Bolker* and *Maloney* cases recognize that "changing the mere form of ownership" is not cashing out and that, here, they continued to own the like-kind real estate "through a 'tax' partnership before and after all of the transactions." (App. Reh. Reply Br., p. 5.)

Applicable Law

Burden of Proof

It is well settled that a presumption of correctness attends respondent's determinations as to issues of fact and that an appellant has the burden of proving such determinations erroneous. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is, however, a rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary. (*Appeal of Oscar D. and Agatha E. Seltzer*, *supra*.) To overcome the presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible evidence to support his assertions. When the taxpayer fails to support his assertions with such evidence, respondent's determinations must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, *supra*.)

IRC section 1031

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*.)

Statutory Partnership Merger Requirements

The Uniform Partnership Act of 1994 (Act), which is adopted and codified in Corp. Code sections 16100 and following sections, sets forth the statutory provisions for a merger of a limited partnership and "another business entity", such as a LLC, under California law. (Corp. Code, § 16910.) With respect to form, Corp. Code section 16911 provides, in relevant part, that "[e]ach partnership and other business entity which desires to merge shall approve an agreement of merger. The agreement of merger shall be approved by the number or percentage of partners specified for merger in the partnership agreement of the constituent partnership." Such an agreement is required, in part, to state "the terms and conditions of the merger", "[t]he name and place of organization of the surviving partnership or surviving other business entity, and of each disappearing partnership and disappearing other business entity", and "[t]he manner of converting the partnership interests of each of the constituent partnerships into interests or other securities of the surviving partnership or surviving other business entity . . ."

In the event the surviving entity is a domestic partnership or a domestic other business entity, the merger proceedings with respect to that partnership or other business entity and any domestic disappearing partnership shall conform to the provisions of the Act governing the merger of domestic partnerships. (Corp. Code, § 16913, subd. (b).) Under those circumstances, a certificate of merger is required to be filed with the SOS (Corp. Code, §§ 16913, subd. (c) and 16915, subd. (b)) and, unless a future effective date is provided in the certificate of merger, the merger is effective upon the filing of the certificate of merger. (Corp. Code, § 16912, subd. (a)(2).)

<u>IRC section 708 and Applicable Treasury Regulation Provisions</u>

IRC section 708(a) provides that an existing partnership shall be considered as continuing if it is not terminated. For purposes of subsection (a), subsection (b) provides that "(A) a partnership shall be considered as terminated only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits." However, if two or more partnerships are merged or consolidated, "the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership." (Int. Rev. Code, § 708(b)(2)(A); Treas. Reg. § 1.708-1(c)(1).)

In addition, unless the IRS Commissioner permits otherwise, the resulting partnership can be considered "the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated." The resulting partnership is required to file a return for the taxable year of the merging or consolidating partnership that states that the resulting partnership is a continuation of such merging or consolidating partnership. The return is also required to retain the EIN of the partnership that is continuing, and to include the names, addresses, and EINs of the other merged or consolidated partnerships. Finally, the return shall include the respective distributive shares of the partners for the periods prior to and including the date of the merger or consolidation and subsequent to the date of merger or consolidation. (Treas. Reg. § 1.708-1(c)(2).)

With respect to the form of a merger or consolidation, Treas. Reg. section 1.708-1(c)(3) provides that:

> When two or more partnerships merge or consolidate into one partnership under the applicable jurisdictional law without undertaking a form for the merger or consolidation, or undertake a form for the merger or consolidation that is not [an assets-up merger] described in paragraph (c)(3)(ii) of this section, any merged or consolidated partnership that is considered terminated under paragraph (c)(1) of this section is treated as undertaking the assets-over form for Federal income tax purposes. Under the assets-over form, the merged or consolidated partnership that is considered terminated under paragraph (c)(1) of this section contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership.

<u>Community Property Interest</u>

With respect to a spouse's community property interest in the other spouse's partnership interest, the non-partner spouse is entitled only to the rights of a transferee and does not become a partner or acquire any of the partner-spouse's management rights. (*Business Organizations with Tax Planning* PART 3 Partnerships: Formation, Operation, Dissolution, Chapter 19 Rights of Partners in Partnership Property § 19.04.)

Section 503 of the Revised Uniform Partnership Act (RUPA) titled "Transfer of Partner's Transferable Interest" provides in subsection (d) "Upon transfer, the transferor retains the rights and duties of a partner other than the interest in distributions transferred." Comment 4 to section 503 explains that:

> Subsection (d) is new. It makes clear that unless otherwise agreed the partner whose interest is transferred retains all of the rights and duties of a partner, other than the right

> to receive distributions. That means the transferor is entitled to participate in the management of the partnership and remains personally liable for all partnership obligations, unless and until he withdraws as a partner, is expelled under Section 601(4)(ii), or is otherwise dissociated under Section 601.
>
> A divorced spouse of a partner who is awarded rights in the partner's partnership interest as part of a property settlement is entitled only to the rights of a transferee. The spouse may instead be granted a money judgment in the amount of the property award, enforceable by a charging order in the same manner as any other money judgment against a partner. In neither case, however, would the spouse become a partner by virtue of the property settlement or succeed to any of the partner's management rights. *See, e.g., Warren v. Warren*, 12 Ark. App. 260, 675 S.W.2d 371 (1984).

For purposes of this discussion, Corp. Code section 16503 conforms in all respects to RUPA section 503.

Case Law

In *Bolker*, the Ninth Circuit expressly dealt with the holding requirement and set forth a legal standard (at least as applicable to the facts of that case) for establishing whether a taxpayer exchanging property received as a distribution has satisfied the qualified use requirement with respect to the relinquished property. The taxpayer was the sole shareholder of a corporation that owned valuable land suitable for development. For tax purposes associated with the anticipated development of the land, the taxpayer decided to liquidate the corporation and distribute the land to himself. However, before the corporation carried out the liquidation, problems in financing convinced the taxpayer to dispose of the land rather than developing it himself. On the very same day that the liquidation occurred, the taxpayer entered into an agreement to exchange the land received for like-kind property. Subsequently, the exchange took place three months later and the taxpayer claimed that the exchange qualified under IRC section 1031. (*Bolker, supra*, at 1040.)

After reviewing the above transactions, the IRS argued that, because the taxpayer acquired the property with the intent and an almost immediate contractual obligation to exchange it, the taxpayer did not satisfy the qualified use requirement of IRC section 1031. Upon appeal, the Ninth Circuit rejected that view, noting that any such rule "would be nonsense as applied to the property given up, because at the time of the exchange the taxpayer's intent in every case is to give up the property." (*Bolker*, *supra*, at 1043.) The court held that if it were to adopt the IRS's understanding of the rule then "[n]o exchange could qualify." (*Ibid*.) Instead, the court concluded that, "the intent to exchange property for like-kind property satisfies the holding requirement, because it is *not* an intent to liquidate the investment or to use it for personal pursuits." (*Id.* at 1045.)

Recognizing that the facts in *Bolker* seemed similar to the facts in Rev. Rul. 77-337, the court first noted that revenue rulings are not controlling law—i.e., revenue rulings are not binding authority, although such rulings are entitled to consideration as a body of experience and informed judgment. (*Id.* at 1043; see also *Richards v. United States* (9th Cir. 1981) 683 F.2d 1219, 1224). Next, the court distinguished the facts in *Bolker* from the facts in Rev. Rul. 77-337 in the following two ways. First, the court stated that "the liquidation was planned before any intention to exchange the properties arose, not to facilitate an exchange." (*Bolker v. Commissioner*, at 1043.) Second, the court noted that the taxpayer actually held the property for three months. (*Id.* at 1043.)

The court refused to address whether the step-transaction doctrine applied to the facts in *Bolker* because the IRS raised the issue for the first time on appeal and the record in that respect may not have been fully developed in the lower court proceeding. (*Id.* at 1042.) Finally, it should be noted that when the matter was before the Tax Court, the Tax Court refused to apply the substance-over-form doctrine because it found "*at most* minimal corporate involvement in the negotiations and the exchange." (*Bolker v. Commissioner*, 81 T.C. 782, 800 [emphasis in original].)

Fourteen years after the Ninth Circuit issued its decision in *Bolker v. Commissioner*, *supra*, the IRS issued FSA 199951004 (Dec. 24, 1999), in which the IRS declined to pursue the position it had taken in *Bolker*, stating:

> 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.

In *Mason v. Commissioner*, T.C. Memo 1988-273, decided June 27, 1988, a case decided after *Bolker*, the Tax Court allowed an IRC section 1031 exchange where two partners received property in a partnership liquidation, and then immediately exchanged the property. The Tax Court did not specifically address the holding requirement.

In *Maloney*, a corporation completed an IRC section 1031 exchange of property held for investment and then immediately liquidated pursuant to IRC section 333 and distributed the replacement property to its shareholder. Based on *Magneson, supra* 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.

In *M.H.S. Company, supra*, the taxpayers owned real property in Tennessee that was taken in a condemnation action by the state and the taxpayers invested the proceeds in a joint venture which acquired replacement real property. The court found that the joint venture constituted a partnership and held that, under Tennessee law, property acquired with partnership funds is partnership property unless a contrary intention appears. Because a partnership interest was classified as personalty under Tennessee law, the court concluded that the taxpayers had not engaged in an exchange of like-kind property and that IRC section 1033 was inapplicable.

Substance-over-Form Doctrine

The substance-over-form doctrine provides that the form of an agreement or transaction does not control its substance. In short, the doctrine stands for the policy that to permit the nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. (See *C.I.R. v. Court Holding Co*. (1945) 324 U.S. 331 (*Court Holding*); *Appeal of Brookfield Manor, Inc*., 89-SBE-002, Jan. 1, 1989.) The substance-over-form doctrine was applied by the U.S. Supreme Court in *Court Holding* in which a corporation had entered into oral negotiations to sell its real property. (*Id.* at 333.) After the corporation had entered into the oral negotiations and a down payment was made, the controlling shareholders discovered that if the sale was consummated as structured, the corporation would incur a large tax liability. Consequently, the controlling shareholders dissolved the corporation, distributed the property to themselves, and sold the property as individuals. In ruling that the sale was properly attributed to the corporation, the U.S. Supreme Court held that:

> . . . the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. . . . To permit the true nature of the transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the . . . administration of the tax policies of Congress. (*Court Holding*,at 334.)

In *Chase v. Commissioner* (1989) 92 T.C. 874 (*Chase*), the taxpayers sought to use IRC section 1031 to defer gain on the sale of an undivided interest in various apartments. The tax court, however, applied the substance-over-form doctrine and concluded that the substance of the taxpayers' purported sale of an undivided interest in the apartments was a sale by the partnership. (*Id.* at 883.) In that case, the contract for sale of the apartments reflected the partnership as the seller. (*Id*. at 877.) 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. (*Ibid*.) When it was certain that the sale would close, the taxpayer-husband caused a deed to be recorded transferring legal title to the purported exchange property to him. (*Id*. at 878-879.) The taxpayers claimed that they (not the partnership) sold the undivided interest. The tax court disallowed the transaction under IRC section 1031, concluding that the undivided interest was sold by the partnership, not the taxpayers. (*Ibid*.)

<u>Duty of Consistency</u>

The duty of consistency was discussed by the Ninth Circuit Court of Appeals in *Ashman*, *supra*, as follows:

> While it is true that income taxes are intended to be settled and paid annually each year standing to itself, and that omissions, mistakes and frauds are generally to be rectified as of the year they occurred, this and other courts have recognized that a taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction.

(*Ashman*, *supra*, at p. 543 [citations omitted].)

In *Ashman*, the Ninth Circuit noted that the duty of consistency has the following elements:

> (1) A representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner. If this test is met, the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary.

(*Id.* at p. 545 [citations omitted].)

<u>STAFF COMMENTS</u>

At the hearing, respondent should be prepared to clarify whether it contends that a formal

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state law merger of partnerships is required in order to complete an effective merger for tax purposes.[19] If so, respondent should be prepared to discuss the New York University Annual Institute on Federal Taxation article[20] provided by appellants and McKee, Nelson and Whitmire, *Federal Taxation of Partnerships and Partners*, Vol. 2, 4th ed., paragraph 13.06, which provides that the IRS has treated IRC section 708(b)(2)(A) (the partnership merger provision) "as widely applicable to any form of transaction whereby the businesses of two or more partnerships are combined into a single partnership, regardless of the form of the transaction and regardless of whether it happens to be called a 'merger' or 'consolidation' under state law."[21] In the opinion of staff, a formal state law statutory merger is not required in order to complete a merger of partnerships for tax purposes.

Respondent should be prepared to discuss further its argument that the duty of consistency should foreclose Mr. Marcil from arguing, as he did during the prior hearing, that he only owned a small (less than two percent) interest in MD, LLC prior to its receipt of the Manchester property because the entity had not yet been fully funded and the business deal had changed. In applying the duty of consistency, the Ninth Circuit Court of Appeals has required an attempt by the taxpayer, after the statute of limitations has run on a prior tax year, to change a representation made in the prior tax year for which the statute of limitations has run, in a manner that disadvantages the government in the later tax year being adjudicated.[22] Here, respondent appears to be arguing for application of the duty of consistency where the disputed facts and allegedly changed representation both concern the same tax year, 2001, which is the year that is at issue in this appeal.

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[19] Respondent asserted this position in the original hearing, but appeared to modify or withdraw the position during the prior oral hearing. It does not expressly argue this position in rehearing briefing, however its rehearing brief incorporates by reference all of its prior briefing.

[20] Breitstone & Hirschfeld, *Tax Consequences of Partnership Mergers* (2011) 69-5 New York University Annual Institute on Federal Taxation § 5.04. Relevant portions of the article are attached as exhibit 1 of appellants' reply brief on rehearing.

[21] Relevant portions of the treatise are attached as exhibit 4 to appellants' opening brief in the original briefing. Respondent discussed this treatise at page 10 of its reply brief filed prior to the original hearing in this matter.

[22] See *Ashman*, *supra*, at p. 545; see also *Janis v. Comm'r* (9th Cir. 2006) 461 F.3d 1080, 1086 (quoting *Ashman* at p. 543: "[A] taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction[,]" and applying the requirement of a change in position after the statute of limitations has run.

Appellants have the burden of proof, and, in weighing the evidence, the Board will want to consider respondent's argument that appellants' presentation of the facts has been inconsistent and is contradicted by the evidence in the record. In this connection, appellants will want to discuss, among other things:

- why the operating agreement of MD, LLC was not amended to reflect Mr. Marcil's purported interest of less than two percent in MD, LLC prior to December 15, 2001 (the date of the deed transferring the 60 percent interest to MD, LLC), as alleged by appellants;
- why the purchase agreement for the Manchester property was not amended to show HVA as the acquirer of a 60 percent undivided interest in the Manchester property, instead of showing MD, LLC as the acquirer of all of the property; and
- why the partnership returns filed by MD, LLC continued to use its tax identification number, rather than using the identification number of HVA as the purported continuing entity.

Respondent should be prepared to address *Maloney*, *supra*, and appellants' argument that, regardless of whether HVA continued in existence, the substance of the transactions is that appellants owned rental property through a partnership prior to the transactions and after the transactions continued to own rental property through a partnership, thus maintaining a continuity of investment interest in like-kind property.

Chase, *supra*, suggests that, where the economic reality and history of a transaction shows a sale of property by a partnership, a transfer of the property to a partner shortly before the planned sale cannot cause the sale to be deemed to have been made by the partner for purposes of IRC section 1031. Appellants will want to discuss further whether the relatively brief assignment of a 60 percent undivided interest in the Manchester property to HVA, when the acquisition agreement for the property always listed MD, LLC as the buyer for all of the property and MD, LLC ultimately acquired all of the property, should be respected as an acquisition of property by HVA for purposes of IRC section 1031.

<u>Timeline</u>

The following sets forth staff's understanding of the timing of key events, with relevant disputed issues noted. The parties are encouraged to note any areas of disagreement with the timeline below at the rehearing.

Date	Event(s)
May 2001	MD, LLC is formed by Mr. Marcil and John Walsh, and contracts to buy the Manchester property. At this time, its operating agreement shows Mr. Marcil owning a 50% member interest and a 60% voting interest in MD, LLC. However, a Certificate of Interest shows Mr. Marcil as the "record holder of a 60 percent [rather than 50 percent] fully paid and nonassessable share" of MD, LLC.
June 2001	HVA considers selling the Vista property. When the property is sold, Mr. Marcil and Mrs. Marcil each own a 49.5% interest in HVA, with the remaining 1% interest held by Woodglen, an LLC that is equally owned, 50% each, by Mr. and Mrs. Marcil. (Immediately prior to the sale, the interest of another partner of HVA, Ms. Taylor, is terminated, leading to the foregoing ownership interests.)
July 2001	As part of the purchase contract for the Manchester property, a draft grant deed is prepared and attached to the contract, which contemplates the Manchester property being transferred to MD, LLC. (Resp. Orig. Op. Br., Exhibit G, p. 44.)
August 8, 2001	HVA enters into an agreement to sell the Vista property.
August 22, 2001	HVA enters into an exchange agreement with API (the exchange intermediary).
September 24, 2001	API forms Lava Rock LLC (a disregarded entity for tax purposes) to acquire the Manchester property.
September 28, 2001	MD, LLC extends the closing date to purchase the Manchester property to October 23, 2001.

Date	Event(s)
October 17, 2001	An Exchange Accommodation Agreement is entered into between HVA and Lava Rock.
October 18, 2001	HVA purportedly assigns its right to purchase 60% of the Manchester property to Lava Rock (which is then held by API). The FTB contends HVA had nothing to assign at this time since MD, LLC, rather than HVA, was the buyer under the purchase agreement for the Manchester property.
October 24, 2001	A deed is recorded transferring a 60% interest in the Manchester property to Lava Rock (which is then still held by API) and 40% of the property to MD, LLC. The deed, which had simply listed MD, LLC as the transferee, is modified by adding a footnote showing the 60/40 split between Lava Rock and MD, LLC.
October 24, 2001 to December 15, 2001	Appellants argue on rehearing, and argued during the prior oral hearing, that during this period Mr. Marcil (and Mrs. Marcil through her community property interest) owned a less than 2% interest in MD, LLC, due to a change in business arrangement with John Walsh (the other partner in MD, LLC).
November 14, 2001	API sells the Vista property (on behalf of HVA).
November 20, 2001	API transfers Lava Rock, which at that time holds a 60% interest in the Manchester property, to HVA. At the prior oral hearing, the FTB appeared to agree that, but for later transactions, a valid IRC section 1031 exchange would have occurred as of this date, if HVA had not engaged in later transactions (which transactions appellants refer to as the "Post-Exchange Transactions").
Between November 20, 2001 and November 28, 2001	The FTB contends that, during this period, HVA distributed Lava Rock (which then held a 60% interest in the Manchester property) to Mr. Marcil. Appellants dispute this and further argue that even if such a distribution occurred it should not disqualify the exchange as a qualified IRC section 1031 exchange.

Date	Event(s)
November 28, 2001 to December 15, 2001	As noted above, the parties dispute who held Lava Rock (which at this time held a 60% interest in the Manchester Property) during this period.
December 15, 2001	This is the date of a grant deed from Lava Rock transferring a 60% interest in the Manchester property to MD, LLC. The FTB has provided a copy of the grant deed which suggests the deed was not recorded until March 18, 2002. The FTB contends that as of December 15, 2001, Lava Rock was held by Mr. Marcil (since, as noted above, the FTB believes that HVA distributed Lava Rock to Mr. Marcil between November 20, 2001 and November 28, 2001). Appellants contend that as of December 15, 2001, Lava Rock was still held by HVA, and that the conveyance by HVA to MD, LLC, followed by the dissolution of HVA, constituted a merger for tax purposes. Once MD, LLC received a 60% interest, it owned 100% of the Manchester property, since it had acquired a 40% interest on October 24, 2001.
December 26, 2001	HVA files a certificate of cancellation and dissolution, which is effective December 31, 2001.
March 18, 2002	As noted above, the FTB has provided a copy of the December 15, 2001 grant deed (transferring the Manchester property to MD, LLC) which appears to show that the deed was recorded on this date.
September 2002	MD, LLC's operating agreement, as amended and restated effective on this date, shows Mr. Marcil owning a 60% (while the May 2001 operating agreement had shown a 50% interest) member interest and 60% voting interest. Lava Rock merges into MD, LLC.

EXHIBIT A

PRIOR HEARING SUMMARY

[Please see attached.]