John O. Johnson
Tax Counsel
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento, CA 95814
Tel: (916) 323-3140
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Consolidated Matter of the Appeals of: **SCOTT L. STRINGER AND** **IRENE STRINGER**[1]	**HEARING SUMMARY** **PERSONAL INCOME TAX APPEAL** Case Nos. 609814, 610020

Year	Proposed Assessments[2]
2005	$306,390
2005	$ 5,253

Representing the Parties:

For Appellants: G. Scott Haislet, Attorney

For Franchise Tax Board: David Gemmingen, Tax Counsel IV

QUESTION: Whether appellants have shown error in respondent's proposed assessment based on $3,000,000 in gain from property transactions, or whether such gain should be

---

[1] Appellants reside in Danville, Contra Costa County, California.

[2] Respondent issued two separate Notices of Action to appellants for the 2005 tax year, leading to two appeals to the Board by appellants. The first proposed assessment, represented as Case ID Number 609814 for $306,390, is based on the $3,000,000 of alleged gain from the disposition of property and related itemized deduction adjustments. The second proposed assessment, represented as Case ID Number 610020 for $5,253, is based on a $50,999 adjustment in Schedule E income. As discussed herein, appellants concede the $50,999 adjustment in Schedule E income. (App. Op. Br., Case ID No. 610020.)

deferred based on a "like-kind" exchange pursuant to Internal Revenue Code (IRC) section 1031.

HEARING SUMMARY

Background

Procedural Facts

Appellants reported a $3,000,000 gain deferral through a claimed like-kind exchange under IRC section 1031 on their 2005 tax return. Respondent (Franchise Tax Board or FTB) states that it reviewed the claimed like-kind exchange, and its auditor determined that the $3,000,000 gain was taxable compensation for appellants' efforts in putting together a land deal in Modesto, California, and therefore did not qualify for gain deferral under IRC section 1031. (Resp. Op. Br., p. 8.)[3] Respondent issued a Notice of Proposed Assessment (NPA) on October 11, 2010, adding the $3,000,000 in compensation to appellants' revised taxable income and adjusting $28,684 in itemized deductions.[4] (App. Op. Br., exhibit 2.) The additional tax assessment of $306,390 plus interest was affirmed in a Notice of Action (NOA) issued to appellants on March 26, 2012.

Respondent sent a second NPA on June 8, 2011, increasing appellants' income based on $95,633 in Schedule E income or loss relating to a partnership or S corporation, and $5,738 based on itemized deduction limitations. (App. Op. Br., Case ID No. 610020, exhibit 2.) Respondent issued the following NOA on March 26, 2012, revising the proposed assessment by removing the itemized deduction limitation adjustment and lowering the Schedule E income adjustment to $50,999, resulting in a proposed assessment of $5,253. (*Id.* at exhibit 1.)

This timely appeal followed. In their appeal letter, appellants concede the $5,253 proposed assessment represented by Case ID Number 610020.

Pre-purchase Background

Appellant-husband is the sole owner of Stringer Development Company (SDC), an

---

[3] Respondent provided the same opening brief to address both appeals. Appellants provided separate appeal letters to address each appeal issue. Unless specifically noted, references to Appellants' Opening Brief in this summary refer to their appeal letter for the first proposed assessment, Case Number 609814.

[4] Although not explained, the itemized deduction adjustment may be due to a phasing out of deductions based on the increase in income. Appellants originally reported taxable income of $443,533.

S corporation.[5] Respondent indicates that SDC had a longstanding reputation in Northern California by 2005 as a highly-regarded real property development entity, and appellant-husband is an expert in the land entitlement process, which is the legal method of obtaining approvals for the right to develop property for a particular use. (Resp. Op. Br., p. 8.) Respondent indicates that, over the course of several years, appellants formulated a development plan for two parcels of land, the Cramer and Rowe properties, collectively known as the Modesto Properties.[6] (Resp. Op. Br., p. 8.) Development of the property included securing options to purchase the land, developing the subdivision plan for the land, obtaining various permits, entitlement from various government oversight agencies, and other various tasks. Respondent states that appellants obtained the aid of the Monterey Development Group, LLC (MDG) and its affiliates to help with the development process. (*Ibid*.)

Appellants provide a purchase proposal letter with a date of May 9, 2003, stating an intent to purchase the Cramer property by appellant-husband "and/or its assignee." (App. Op. Br., exhibit 6.) The "Non-Binding Letter of Intent" gives a proposed purchase price for the property and defines the "Buyer" as "A to be formed Entity with [appellant-husband] as a principal." (*Ibid*.) The letter states that the buyer shall place a $50,000 deposit with escrow once a purchase and sale agreement is accepted by both parties. (*Id*. at exhibit 6, ¶¶ 5 and 8.) Appellants apparently never entered into a purchase and sale agreement, and it does not appear that they deposited any money to secure any right to purchase the Cramer or Rowe properties.

<u>Purchase and Sale of the Modesto Properties</u>

The parties disagree as to who gained property interests in the Modesto Properties. Appellants assert that they obtained property interests in the Cramer and Rowe properties in 2003 and 2004, respectively, while respondent asserts that appellants never obtained property interests in the Modesto Properties. (App. Op. Br., p. 3; Resp. Op. Br., p. 1, et. seq.) Although appellants do not disagree that a third party may have performed some of the actions, including receiving and transferring

[5] Appellants filed appeals jointly for the proposed assessments at issue. The business operations discussed were handled by appellant-husband, and references to appellants' actions in this summary generally refer to appellant-husband only.

[6] Appellants contend that they received the Cramer property in 2003 and the Rowe property in 2004, and sold them on March 3, 2005; whereas, respondent asserts that appellants never acquired a property interest in these properties, as discussed herein.

payment for the properties, they contend that the third party was acting as their qualified intermediary in a delayed like-kind exchange. (App. Op. Br., pp. 3-6.) Respondent contends that income received by appellants was compensation for years of work, and not income from any property interests in the properties sold. (Resp. Op. Br., pp. 8-9.)

On July 22, 2003, a couple of months after appellants' Non-Binding Letter of Intent, MDG entered into a purchase agreement (Cramer contract) for the Cramer parcel. A copy of the Cramer contract is not provided, but the parties provide documents exhibiting that MDG entered into this purchase contract as the sole buyer. (See App. Op. Br., exhibit 5; Resp. Op. Br., exhibit D, p. 1.) A third party buyer, "Rowe," entered into an agreement on January 27, 2004, the Vincent contract, to purchase specific land known as the Vincent parcel. (See Resp. Op. Br., exhibit A and D, p. 1.) The Vincent contract was then modified by a purchase agreement amendment (Rowe contract) on March 5, 2004, to assign a portion of Rowe's purchase interest in the Vincent parcel to MDG.[7] (*Id*. at exhibit A.) MDG subsequently sold its rights in the Cramer and Rowe contracts to its affiliate, MDG Capital Investors, Inc. (MDG Inc.), in a document dated November 8, 2004.[8] (*Id*. at exhibit C.) MDG Inc. entered into a Purchase and Sale Agreement, including escrow instructions, with William Lyon Homes, Inc. (Lyon Homes) on January 14, 2005. (*Id*. at exhibit D.) This agreement notes that MDG Inc. did not yet purchase the Modesto properties, but had the right to purchase those properties according to the Cramer and Rowe contracts. Respondent asserts that MDG Inc. then purchased and ultimately took title to the properties per the Cramer and Rowe contracts on March 2, 2005. (See *Id*. at pp. 8-9 and 20.) Respondent states that MDG Inc. sold the Modesto properties to Lyon Homes on March 3, 2005, the day after purchasing the properties. (*Ibid*.) Respondent provides a copy of MDG Inc.'s "Cost of sale" spreadsheet, dated March 3, 2005, listing the expenses (including purchase contracts) for the Modesto properties. (*Id*. at exhibit B.)

---

[7] The Rowe contract bears a signature date of March 7, 2004, but is referred to as the March 5, 2004 contract by appellants.

[8] MDG Inc. is described by the parties as a "successor in interest" to MDG as relating to the Modesto properties, and the parties do not appear to make a distinction between the actions taken by MDG (an LLC) and those of MDG Inc. (See Resp. Op. Br., p. 6.) For purposes of this summary, the actions of the two entities will be reported individually, accordingly to the facts available, but some actions attributable to MDG by the parties may have been performed by MDG Inc. Both parties may wish to discuss, or be prepared to discuss, whether there is a significant change in the effect of any action based on whether it was performed by MDG or MDG Inc.

Profits from the Modesto Properties Sale

Appellants provide a letter from MDG, with the title of "Nominee Interest" (Nominee Interest Letter) and signed November 19, 2004, received by appellant-husband and signed December 7, 2004.[9] (App. Op. Br., exhibit 5.) MDG states in this letter that it executed the Cramer and Rowe documents as the sole buyer on July 22, 2003, and March 5, 2004, respectively, but asserts that MDG and appellants "agreed in principle" that appellants would hold a "profits-only ownership interest as tenants in common in those [c]ontracts," in accordance with the terms as laid out in that letter. (*Id.* at p. 1.)

According to the Nominee Interest Letter, executed sixteen months after MDG executed the purchase agreement for the Cramer property, eight months after MDG executed the purchase agreement for the Rowe property, and nine days after MDG sold or assigned its rights in those contracts to MDG Inc., appellants held a 16.67 percent "profits interest" in the land contracts "and/or the underlying real property" upon disposition of the contracts or property by MDG to a third party not affiliated with MDG. (App. Op. Br., exhibit 5, ¶ 1.) This 16.67 percent profits interest is defined, generally, as the difference between the net sales price and MDG's expenses in connection with the contracts and property. (*Ibid.*) Although this letter purports to give appellants a tenancy-in-common status in the contracts and the underlying property, it specifies that this interest is solely in the profits from the sale of the property, and expressly states that appellants have no rights to possession or occupancy of the property. (*Id*. at ¶ 3.) MDG retained "sole and absolute control" over the property, including the timing and price of any sale and any assignment of rights under the contract or property. (*Id*. at ¶¶ 3 and 6.) The letter contemplates the possibility that appellants may not receive any compensation from the sale of the property, stating that appellants "will receive payment from [their] interest, **if at all**, only from proceeds of the sale" of the contracts or property [emphasis added]. (*Id.* at ¶ 5.) The Nominee Interest Letter provides that appellants are liable for a pro rata share of any liabilities, claims, costs, or expenses of any kind, and appellants are required to perform due diligence

[9] The Nominee Interest Letter describes the business intentions of MDG and appellants in relation to the Modesto properties' purchase, development, and distribution of proceeds. This letter was signed by the two parties after MDG transferred its rights in the purchase contracts for the Modesto properties to MDG Inc., and apparently prior to when MDG Inc. acquired title to the properties.

and other services for the benefit of the property as requested by MDG at no cost or expense to MDG for the purpose of improving the land (e.g., tentative development, mapping and planning, etc.). (*Id*. at ¶¶ 2 and 8.)

The Purchase and Sale Agreement states that MDG Inc. would purchase the Modesto Properties, including its purchase interest in the Vincent parcel according to the terms of the Vincent and Rowe contracts, and, through a lot line adjustment with the city, detach from the Vincent parcel the parcel assigned to MDG Inc. through the Rowe contract (i.e., the "Rowe parcel") and attach it instead to the Cramer parcel. Under the agreement, MDG Inc. was to then sell the Modesto Properties (i.e., Cramer and Rowe parcels without the remaining Vincent parcel) to Lyon Homes. (Resp. Op. Br., exhibit D, ¶¶ A-C and G.) The execution of the Purchase and Sale Agreement was completed on March 3, 2005. The final purchase price is listed as $30,064,600.[10] (*Id*. at exhibit D, p. 2, ¶ 3.) MDG Inc.'s calculated cost of sale, as reported to FTB on its tax return paperwork, totaled $28,828,884.86, and included $3,677,435.00 allocated to "Stringer" (i.e., appellant-husband).[11] (*Id.* at exhibit B.) The parties state that appellants received $677,435 of their payout in cash, which they included as taxable income on their tax return, and the remaining $3,000,000 was held for them by MDG Inc. (See App. Op. Br., pp. 3-4; Resp. Op. Br., p. 9.)

Appellants state that after the profits from the sale were attributed to them, they "completed the deferred exchange, identifying and acquiring timely a qualifying replacement property." (App. Op. Br., p. 6.) Respondent addresses the remaining $3,000,000 by stating that it was "disbursed under Appellants' direction to purchase real property for Appellants' personal benefit." (Resp. Op. Br., p. 9.) The parties focus on the Modesto Properties' transactions, and do not provide documents or discussion concerning the subsequent purchase beyond the statements above, but it appears appellants did not take possession of the $3,000,000, and MDG Inc. used the funds to purchase property on appellants' behalf, and appellants treated this purchase as replacement property in accordance with the alleged like-kind exchange.

---

[10] The typed purchase price of $30,750,000 is crossed out by hand and replaced with the above-listed amount and the explanation that the revised amount is the "final amount per escrow."

[11] Respondent states that MDG Inc. deducted this $3,677,435 "cost" attributed to appellants on its tax reporting.

Contentions

Appellants' Contentions

Appellants assert that they obtained interests in the Cramer property on May 5, 2003, when they executed the Non-Binding Letter of Intent, and obtained interests in the Rowe property at some point in 2004 after the Vincent contract and prior to Rowe contract when "[appellants] and Rowe agreed that Rowe would assign Rowe's interest of the [Vincent contract] to a party designated by [appellants]."[12] (App. Op. Br., pp. 4-5.) Appellants contend that they then "agreed with MDG that [appellants] would assign [appellants'] interests of the [Vincent contract] to MDG," and then Rowe assigned its interest in the Vincent property to MDG Inc. through the Rowe contract.[13] (*Id*. at pp. 3, 5.) Appellants assert that, in this fashion, they transferred their interests in the Modesto Properties to a co-ownership arrangement with MDG. (*Id*. at p. 11.) Appellants assert that they received $3,677,435 from the sale of the Modesto Properties on March 3, 2005, $3,000,000 of which was used to purchase replacement property under an alleged like-kind exchange. (*Id*. at p. 4.)

Appellants assert that the Nominee Interest Letter, issued and signed by MDG, acknowledges that appellants had a tenancy-in-common interest in the Modesto Properties and the real property contracts regarding the Modesto Properties. (App. Op. Br., p. 5, 8; citing Cal. Civil Code § 682.) Appellants contend that the Internal Revenue Service (IRS) "sustained with taxpayer's report of an exchange described by IRC § 1031 and did not require taxpayer to recognize $3,000,000 in compensation income as FTB has alleged." (*Id*. at pp. 6-7.) Appellants cite the *Starker, infra*, case for the proposition that contract rights are considered property for IRC section 1031 purposes. (*Id*. at p. 8; citing *Starker v. United States* (9th Cir. Or. 1979) 602 F.2d 1341.) Appellants contend that the "waiver of right of partition," the lack of possession of the Modesto Properties, and the delegation of property management and control included in the terms of the Nominee Interest Letter does not negate ownership for purposes of determining whether their interest was "property" for purposes of IRC 1031. (*Id*. at

---

[12] As noted above, the Non-Binding Letter of Intent bears a signature date of March 7, 2003. (App. Op. Br., exhibit 6.)

[13] In appellants' brief, they refer to the property interest ultimately assigned to and purchased by MDG Inc. from the Rowe and Vincent contracts as the Vincent property. For consistency purposes, this property is listed as the Rowe property in this summary, as it is referred to in the Purchase and Sale Agreement between MDG Inc. and Lyon Homes.

p. 9.) Appellants assert that MDG Inc. signed and executed the purchase and sale agreement with Lyon Homes acting on behalf of appellants, as evidenced by the Nominee Interest Letter, and the fact that appellants did not sign a deed, agreement, or other contract with Lyon Homes is not relevant. (*Id*. at p. 12.)

Appellants believe that respondent values the Modesto Properties at $3,000,000, and contends that this is in error, asserting that they obtained interests in the Cramer and Vincent properties in 2003 and 2004, respectively, when the value of the interests were significantly less than $3,000,000. (App. Op. Br., p. 13.) Appellants provide an example of a horse trainer who was given a horse as a $10 payment for compensation of work done, trains the horse to increase the value of the horse, the horse wins the Kentucky Derby, and the horse is sold for $1,000,010 and the $1,000,000 sale proceeds are put into a like-kind exchange purchase of another horse. (*Id*. at p. 13.) Appellants state that the trainer received $10 in ordinary income and another $1,000,000 in deferred gain. Appellants assert that this scenario is analogous to appellants' fact pattern in this appeal. Appellants concede that they must include taxable income for 2005 "upon acquisition of taxpayers' interest of the [Modesto properties]," but assert that this income should be close to zero, based on the fact that the Modesto properties were nearly worthless absent the assemblage and processing work that ensued after taxpayers obtained rights in those properties. (*Id*. at pp. 13-14.) Appellants contend that the value of the Modesto Property was only increased "after MDG (and [appellants]) acquired the right to purchase" the Rowe property and the Modesto Properties could be assembled. (*Id*. at p. 14.)

Appellants assert a third-party consultant would likely charge $12,000 per month for pre-acquisition processing for the development of each property. (App. Op. Br., p. 16.) Appellants contend that they provided these services for six months for the Cramer property (i.e., February 2003 through July 2003), and for five months for the Rowe property (i.e., November 2003 through March 2004). Therefore, appellants contend, the value of those services is $132,000 (i.e., 11 months at $12,000 per month). Appellants state that these services occurred prior to their acquisition of the properties. Appellants assert that the value of the Modesto Properties can then be determined by adding the value of the purchase contract or right to purchase, which they state is about zero, plus the cost of development activities, which is claimed as being $132,000 as stated above, and conclude that $132,000 of the

$677,435 portion of their payout was ordinary income (i.e., compensation income) with the remainder being gain. (*Id*. at pp. 16-17.) Appellants contend that the $3,000,000 was not taxable under the like-kind exchange theory. (*Id*. at p. 17.)

Appellants maintain that respondent has failed to make clear its determinations. Appellants assert "adjustments alleged by [the] NPA are incorrect because of the expiration of statute of limitations for the applicable year," that if the proposed assessment is sustained then "interest charges must be adjusted accordingly (i.e., reduced from those levels reflected in the NPA or the [NOA])," and that respondent "must recognize an increase in basis of the replacement property acquired in taxpayer[s'] exchange if the $3,000,000 is deemed compensation income.[14] (App. Op. Br., pp. 17-18.)

Respondent's Contentions

Respondent asserts that appellants must recognize $3,000,000 in additional compensation income for the 2005 tax year, since appellants received that income in 2005 as compensation for appellant-husband's services. (Resp. Op. Br., pp. 10-11; citing *Gamble v. Commissioner* (1980) 39 T.C.M. (CCH) 1030.) Respondent asserts that this treatment of the income received is consistent with the Nominee Interest Letter, and cites *Escher v. Commissioner* (discussed in the *Appeal of Haubiel*, 73-SBE-004, decided on January 16, 1973), in which the Court of Appeals for the Third Circuit determined that the taxpayer received compensation for his services as ordinary income and not capital gains from the sales proceeds of the stock when he received a percentage of the sale proceeds as compensation for past services. (*Id*. at p. 11; see *Escher v. Commisioner* (3d Cir. 1935) 78 F.2d 815.) Respondent contends that labor is not property that can be exchanged for wages or other compensation in a nontaxable transaction. (*Id*. at p. 12; citing *Casper v. Commissioner* (10th Cir. 1986) 805 F.2d 902; *Funk v. Commissioner* (8th Cir. 1982) 687 F.2d 264.)

Respondent discusses the duty of consistency, and asserts that appellants "cannot reshape facts at will." (*Ibid*; citing *Estate of Ashman v. Commissioner* (9th Cir. 2000) 231 F.3d 541.) Respondent notes that MDG Inc. deducted in full the $3,677,435 amount paid to appellants in

---

[14] Appellants provide these contentions at the conclusion of their opening brief, but have provided no explanation, supporting law, or evidence of their assertions made in regard to statute of limitations claims, interest abatement assertions, or increase in basis contentions. Appellants' contentions in these issues are not clear, and therefore this summary is not able to fully address these contentions.

accordance with the Nominee Interest Letter between MDG and appellants. (Resp. Op. Br., p. 13.) Respondent contends that the letter identifies appellant-husband's performance of services and sets agreed upon compensation of a fixed dollar percentage of the net sales price of identified assets controlled exclusively by MDG (or its affiliate). Respondent argues that, since MDG Inc. deducted the full $3,677,435 payment to appellants, appellants, under the duty of consistency, have an obligation to likewise treat that amount as income. (*Ibid*.) Respondent contends that appellants acknowledge they received compensation for work completed, but only concede $132,000, and the Nominee Interest Letter shows that both parties understood that the compensation amount was $3,677,435 (i.e., 16.67 percent of net sales proceeds) and not the "imaginary and uncorroborated $132,000 now proffered by Appellants." (*Id*. at p. 14.)

Respondent asserts that, if the Board were to determine that appellants' receipt of the profits interest in return for appellant-husband's services was something other than an exclusive cash entitlement, appellants must still recognize the $3,000,000 as taxable income. (Resp. Op. Br., p. 14.) Respondent cites Revenue Ruling 79-24, which provides examples of property or services taken as payment for services, and states that the fair market value of the property or services taken in payment must be included in income. (*Id*. at pp. 14-15; citing Rev. Rul. 79-24.) Respondent asserts that the fair market value of appellant-husband's services in regard to the Modesto Properties was established as 16.67 percent of the net sales proceeds, which was determined as $3,677,435, and must be included in income. (*Ibid*.)

Respondent asserts that appellants had at best contractual options with respect to the Modesto Properties, and no title or ownership interest in real property parcels MDG Inc. conveyed to Lyon Homes. (Resp. Op. Br., pp. 16-18.) Respondent alleges that appellants assigned any contractual rights to the Modesto Properties when they assigned their intangible contractual rights to MDG on or before July 22, 2003, and on March 5, 2004. (*Id*. at p. 1; citing App. Op. Br., at pp. 4-5.) Respondent contends that appellants' argument has been one of implication rather than substantiation. (*Id*. at p. 16.) Respondent asserts that appellants' horse trainer analogy is unpersuasive and inapplicable because, in the example, the horse trainer actually owns the horse early in the transaction, whereas appellants never owned the Modesto Properties. Respondent asserts that the Non-Binding Letter of Intent, proposing an intent to purchase the Cramer property, is merely a proposal to purchase property and lacks any obligation or option to purchase the property without further negotiation and a purchase and sale agreement. (*Id*. at p. 16.)

Respondent cites *Steiner v. Thexton*, in which the California Supreme Court held that, when a contract binds the seller to sell on specific terms, but leaves discretion to the other party to buy or not to buy, it constitutes simply an option contract, and not a real property purchase contract.[15] (*Id*. at p. 17; citing *Steiner v. Thexton* (2010) 48 Cal.4th 411.) Respondent contends that appellants never had an interest in the Modesto Properties, and merely an interest in the contractual and potential negotiating opportunities to buy the underlying parcels.[16] Respondent asserts that the option to acquire property does not equal ownership interests in the underlying property. (*Id*. at p. 18; citing *Appeal of Gene and Paul Ray*, 96-SBE-014, July 25, 1996.) Furthermore, respondent asserts that the ultimate sale of the Modesto Properties to Lyon Homes was a sale for the parcels of land, and are assets that are legally distinct than the contractual rights appellants claim to have owned. (*Id*. at p. 3.)

Respondent asserts that the burdens and benefits of property ownership were held by MDG Inc. at the time the property was conveyed to Lyon Homes. (Resp. Op. Br., p. 19.) Respondent asserts that the factors indicating ownership include legal title, the right of possession and control, treatment by the parties, the payment of property taxes, the risk of loss and damage, and benefits from the operation and sale of the property. (*Ibid*; citing *Grodt & McKay Realty Inc. v. Commissioner* (1981) 77 T.C. 1221; *Arevalo v. Commissioner* (5th Cir. 2006) 469 F.3d 436.) Respondent contends that a review of the terms in the Purchase and Sale Agreement between MDG Inc. and Lyon Homes in light of the factors above shows that appellants never had the benefits and burden of ownership over the Modesto Properties. Respondent also looks to the Nominee Interest Letter to show that appellants were specifically denied the right of possession and control over the Modesto Properties, appellants

---

[15] In *Steiner, supra*, the court ultimately determined that the potential buyers completed a partial performance of their bargained-for promise to seek a parcel split, which cured the initially illusory nature of the promise, and constituted sufficient consideration to render the option irrevocable.

[16] Respondent asserts that appellants had only an intangible contractual right, at best, for the properties that it assigned to MDG well prior to the purchase and sale of the properties. Respondent also asserts that appellants have not provided any documentation showing they had any rights as to the Rowe or Vincent parcels, and, conversely, the Rowe agreement gives rights from Rowe to MDG with no mention whatsoever of appellants or any rights they held. (Resp. Op. Br., p. 2.)

apparently never paid property taxes and related expenses, appellants had no equity in the properties, and appellants only enforceable relationship with respect to the properties contractually only arose after the properties were sold by MDG Inc. to Lyon Homes. (*Id*. at pp. 19-20.)

Respondent contends that appellants' asserted like-kind exchange fails because they never acquired the relinquished property with the intent to hold the relinquished property for productive use in a trade or business or for investment. (Resp. Op. Br., pp. 20-26.) Respondent asserts that, even if the Board determines that appellants had an interest in the Modesto Properties when they were sold to Lyon Homes, the properties were not acquired until March 2, 2005, and were acquired with the "contractual and transactionally-stepped structure and intent to immediately flip and sell those properties . . . the next day." At best, respondent argues, the Modesto Properties were acquired solely with the intent to immediately dispose or sell them, rather than with the intent to hold them for investment, as required under IRC section 1031. (*Id*. at p. 20.)

Respondent notes that the asset purchase agreement assigning the property option contracts from MDG to MDG Inc. specifically states that "Seller, as a matter of business policy and purpose, has resolved not to hold or **acquire** any properties for investment or development purposes in order to manage its historical and possible future liabilities," and that "**Seller wishes to divest itself of the Contracts in furtherance of Seller's intention not to hold or acquire any properties**." (Resp. Op. Br., pp. 20-21; citing Resp. Op. Br., exhibit C; emphasis added by respondent.) Respondent asserts that the relinquished property in a like-kind exchange must be held with the intent for investment, and not with an intention to sell the property. (*Id*. at p. 21; *Real Estate Corporation v. Commissioner* (1961) 35 T.C. 610, 615.) Respondent cites to a federal district court decision for the proposition that "property acquired for the purpose of completing an exchange is not considered to be held for productive use in a trade or business or for investment and, therefore, is ineligible for like-kind treatment." (*Id*. at p. 21; citing *Francis J. Barker II v. United States* (C.D. Ill. 1987) 668 F.Supp. 1199.) Respondent asserts that *Bolker*, where the like-kind exchange was found to be valid, differs factually because Mr. Bolker planned to acquire the property before he had any intention of exchanging it, and he actually held the property for three months. (Citing *Bolker v. Commissioner* (9th Cir. 1985) 760 F.2d 1039.) Respondent also notes that like-kind exchange treatment was denied in *Click v. Commissioner*, wherein the Tax

Court listed three requirements that must be satisfied: (1) the transaction must be an exchange; (2) the transaction must involve like-kind properties; and (3) both properties involved must be held either for productive use in a trade or business or for investment. (*Click v. Commissioner* (1982) 78 T.C. 225.) Respondent asserts that, like in *Click*, *supra*, the Modesto Properties in this appeal are not entitled to like-kind exchange because they were acquired with the intent to dispose of them immediately. (Resp. Op. Br., p. 24.)

Respondent asserts that appellants must prove they satisfied the requirements for a like-kind exchange to receive like-kind treatment. Respondent contends that appellants have not proven that they had an ownership interest in the Modesto Properties and, therefore, could not participate in or obtain the benefits of a deferred 1031 property exchange since they never conveyed the property. (Resp. Op. Br., p. 25.) Respondent alleges that appellants had a right to receive cash proceeds from MDG Inc.'s sale of the Modesto Properties, and at no time had a legal right to any real property, including any right to partition, occupy, encumber, or sell the land. (*Id.* at p. 5.) Respondent reasserts that an option to purchase land is not equivalent, for tax purposes, to the land underlying the option. (*Id.* at p. 25.) Respondent contends that deductions are a matter of legislative grace (*New Colonial Ice v. Helvering* (1934) 292 U.S. 435), respondent's determination that a deduction should be disallowed is presumed correct (*Welch v. Helvering* (1933) 290 U.S. 111), and appellants must prove their entitlement to the claimed deductions (*Appeal of Ambrose L. and Alice M. Gordos*, 82-SBE-062, Mar. 31, 1982). (*Ibid*.)

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*.) A taxpayer's failure to provide evidence within his or her control gives rise to a presumption that such evidence would be unfavorable to the taxpayer's case. (*Appeal of James C. Coleman Psychological Corporation, et al.*, 85-SBE-028, Apr. 9, 1985.)

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 the 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 is held for investment. (*Ibid*.)

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 p. 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 Revenue Ruling 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.[17] (*Bolker, supra,* at p. 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 Revenue Ruling 77-337 in the following two ways. First, the court stated that “the liquidation [in *Bolker*] 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. (*Bolker, supra*, 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 took 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

[17] Revenue Ruling 77-337 contemplates a prearranged transaction wherein a corporation (*X*) is liquidated to facilitate the transfer of a shopping center it held in a like-kind exchange by the corporation’s sole owner (*A*). The revenue ruling states that the transfer does not qualify for like-kind treatment because the property was received by *A* for the sole purpose of immediately exchanging the property, and the property was not held by *A* for productive use in a trade or business or for investment.

pursuing this position in litigation in view of the negative precedent.

In *Starker*, *supra*, a matter before the Tax Court, a father and his two children deeded land to a corporation in exchange for similarly-priced land to be determined later. The company was able to locate suitable parcels and transfer them to the family members over the course of the next couple of years, and the family members treated the transaction as a like-kind exchange. The 9th Circuit discussed whether the replacement property must be received immediately after the relinquished property is transferred. The court determined that the transfer must not be simultaneous, but, as stated in *Lincoln v. Commissioner*, there still must be, in fact, an exchange of property. (See *Lincoln v. Commissioner* (1998) 76 T.C.M. (CCH) 926.)

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 *Barker*, *supra*, a 1987 federal district court decision from Illinois, the taxpayer argued that the transaction did not constitute a like-kind exchange under IRC section 1031 for purposes of the investment credit calculation. The court distinguished *Bolker*, *supra*, since the taxpayer in *Barker* acquired the property for the express purpose of exchanging it and never held the property for significant time or use. The court reasoned that the analysis of Revenue Ruling 77-337 more properly applied to the facts and, therefore, determined that there was no like-kind exchange.

In *M.H.S. Company*, 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. (*M.H.S. Company v. Commissioner* (1976) T.C. Memo 1976-165 [35 T.C.M. 733], aff'd. 575 F.2d 1177, 1178 (6th Cir. 1978).) 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.[18]

Treasury Regulation section 1.1031(b)-2 provides safe harbors for like-kind exchanges involving qualified intermediaries. Treasury Regulation section 1.1031(k)-1(g) further defines the safe harbors, indicating that a qualified intermediary is not the agent of the taxpayer, and therefore the taxpayer is not in the constructive receipt of proceeds from a sale of property, but only if the agreement between the taxpayer and the intermediary expressly limits the taxpayer's right to receive or otherwise obtain the benefits of the income. That Treasury Regulation states that the taxpayer attempting a like-kind exchange and the intermediary must enter into an exchange agreement, and the qualified intermediary may acquire the relinquished property from the taxpayer, transfer that property for the replacement property, and then transfer the replacement property to the taxpayer. (Treas. Reg. § 1.1031(k)-1(g)(4)(iii).)

<u>Duty of Consistency</u>

The United States Supreme Court has held that ". . . while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not." (*Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.* (1974) 417 U.S. 134, 149.) The duty of consistency was discussed by the Ninth Circuit Court of Appeals in *Ashman v. Commissioner, supra,* 231 F. 3d 541, 543 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.

The Ninth Circuit identified the following three elements for meeting 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.

---

[18] IRC section 1033 allows for the nonrecognition of gain in like-kind exchanges when the relinquished property is property that is taken due to condemnation, seizure, or otherwise compulsorily or involuntarily converted.

(*Id*. at p. 546 [quoting *Herrington v. Comm'r* (5th Cir. 1988) 854 F.2d 755, 758 and citing additional authorities].)

STAFF COMMENTS

Appellants have the burden of proof. To prevail, appellants will need to show that they met the three requirements for a like-kind exchange. Primarily, appellants will need to show that they owned property rights in the Modesto Properties, which were allegedly exchanged for like-kind property. Appellants should be prepared to explain what documents show that they had an interest in the properties, and not merely the "profits" from the development and sale of the properties, and any documents supporting their contention that MDG acted as an intermediary. Appellants may wish to provide documents showing the purchase of the Modesto Properties by MDG Inc. on March 2, 2005, and the Cramer and Vincent purchase agreements dated July 22, 2003, and January 27, 2004, respectively. Appellants should also try to provide any documentation of their alleged agreement with Rowe regarding the assignment of Rowe's interest in the Vincent contract to a party designated by appellants (See App. Op. Br., pp. 4-5), as well as documentation of appellants agreement with MDG that appellants would assign its alleged rights to the Vincent property, through Rowe, to MDG Inc. Pursuant to California Code of Regulations, title 18, section 5523.6, if either party wishes to provide additional documentation, they should provide any additional evidence exhibits to this Board's Board Proceedings Division at least 14 days prior to the oral hearing.[19]

Appellants provide a Nominee Interest Letter, which uses the term "tenants in common," but applies that term to the Cramer and Rowe contracts, and states that appellants have a "profits-only ownership interest" in the net proceeds from the purchase and sale of the property involved in the contracts. The Nominee Interest Letter lists restrictions on appellants' rights, preventing appellants from any right of possession, risk of loss and damage, assignment or sale of the contracts or any interest in the contracts or land, and generally deny appellants of any burden and benefit of property ownership, other than a percentage of the net proceeds upon the sale of the land. Appellants should be prepared to discuss how this agreement with MDG shows that appellants had a property interest in the underlying property,

---

[19] Evidence exhibits should be sent to: Claudia Madrigal, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

and not merely an interest in a percent of net proceeds as compensation for the development and planning services provided. The parties should clarify whether appellants' ownership interests in the property, if any, was based on a joint venture with MDG and its successor; and whether, therefore, the analysis in *M.H.S. Company*, *supra*, applies to prevent appellants from claiming like-kind exchange treatment.

The parties should discuss when a property interest in the Modesto Properties was acquired by the entities involved in the transactions involved in this appeal. The parties should address whether the Non-Binding Letter of Intent created any property rights in the Cramer property, whether the alleged agreement between appellants and Rowe created any property rights in the Rowe or Vincent property, and whether the Cramer and Rowe purchase option contracts created any property interests; or, whether property rights were not attained until MDG Inc. exercised the contracts and purchased the properties on March 2, 2005. If property rights were not acquired until the Cramer and Rowe contracts or later, appellants should explain how they attained rights in the properties when they are not included in either contract or in the Purchase and Sale Agreement between MDG Inc. and Lyon Homes. Appellants should explain what rights they believe they had to the Cramer and Rowe properties after these properties were purchased on March 2, 2005, and prior to being sold on March 3, 2005.

Appellants contend that MDG acted as their qualified intermediary in the transactions at issue. According to Treasury Regulation section 1.1031(k)-1(g)(4)(iii), an intermediary may take possession of the relinquished property, make the exchange, and deliver the replacement property to the taxpayer. However, use of a qualified intermediary requires a written agreement between the taxpayer and the intermediary. Appellants should provide any such document between themselves and MDG. Appellants assert that MDG sold their property interests in the Modesto Properties, then used the proceeds to purchase replacement property. While it appears that MDG Inc. held $3,000,000 of appellants' share of the net sales proceeds of the Modesto Properties and possibly used it to purchase different property, there is no indication in the evidence that appellants at any time owned a property interest in the Modesto Properties or that they assigned this interest to MDG or MDG Inc. as an intermediary. Conversely, it appears from the record that appellants held an interest that was a profits-only 16.67 percent share of the net sale proceeds from the future sale of the properties as compensation for services rendered, and had no right to the actual parcels of land or any recourse should MDG Inc. never purchase the Modesto Properties and sell the properties to an unrelated party.

If appellants prove that they had a property interest worth at least $3,000,000 in the Modesto Properties when the properties were sold to Lyon Homes, appellants then need to support their contention that the property relinquished was held for a productive use in a trade or business or held for investment. It appears as though the fact pattern here is similar to the example in Revenue Ruling 77-337, wherein property was acquired for the sole purpose of divesting of the property. As in Revenue Ruling 77-337, actions taken before the property is acquired (e.g., lot line adjustments and other improvements) do not qualify a property as being held for productive use in trade or business or investment when these actions occur prior to acquisition. The parties should discuss how the Modesto Properties were held for productive use in a trade or business or investment between the time the properties were purchased on March 2, 2005, and when the properties were sold according to a prearranged plan on March 3, 2005, the following day. The parties should also discuss *Bolker*, and its affect on this appeal, keeping in mind that in *Bolker* the court found that the taxpayer held the property for three months, not just one day, and the taxpayer planned to acquire the property prior to any intention of exchanging it or liquidating it. The parties should discuss whether the analysis of *Barker* is more appropriate to the facts presented in this appeal.

Respondent should be prepared to discuss further its argument that the duty of consistency should foreclose appellants from arguing that the $3,000,000 in proceeds is deferred according to IRC section 1031 because MDG Inc. deducted the full $3,677,435 amount paid to appellants. 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.[20] Here, respondent appears to be arguing that the duty of consistency requires appellants to treat income in a manner similar to how a

---

[20] 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.

different taxpayer treated the amount paid. Respondent should explain how the duty of consistency applies here when appellants are not attempting to change the reporting of their income.[21]

Appellants provided at the conclusion of their only brief several short statements as contentions. Among these assertions, appellants state arguments relating to the statute of limitations, interest adjustments, and an increase in the basis for the replacement property. Appellants do not provide any discussion of these topics anywhere else in their brief, and provide no documents or further analysis of these issues. The NPA was issued on October 11, 2010, which is within the four-year statute of limitations if appellants filed their return between October 11, 2006, and the extended due date for the 2005 tax year of October 15, 2006. The parties should be prepared to state the filing date of the 2005 tax return, and whether there is a statute of limitations issue in this appeal. The interest abatement assertions are completely unsupported, and there is no specification as to what interest should be adjusted or how it should be adjusted.[22] The final issue, an increase in the basis for the replacement property, appears to be a question that has no effect on this tax year, and is not properly before the Board at this time. Should appellants wish to continue these contentions at the hearing, they must provide complete arguments with supporting law and evidence.

///

///

///

Stringer_jj

[21] Appellants have conceded on appeal that $132,000 of the $3,677,435 received should be treated as ordinary income, but contend that this amount is included in the $677,435 amount already reported as taxable income.

[22] Interest abatement under R&TC section 19104, generally, is only allowed when there is an interest accrual attributable to an unreasonable error or delay committed by respondent in the performance of a ministerial or managerial act. There has been no assertion of such an error or delay here.