BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 82A-286
CONTINENTAL DESERT	)	
PROPERTIES, INC.	)	

For Appellant: R. Tully Ramsaur, Jr.
Certified Public Accountant

For Respondent: Donald C. McKenzie
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Continental Desert Properties, Inc., against proposed assessments of additional franchise tax plus penalties in the total amounts of $1,061, $9,316, and $4,856 for the years 1977, 1978, and 1979, respectively.

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

The two major issues presented are (1) whether the acquisition by Continental Desert Properties, Inc. (hereinafter "Continental") of a Santa Barbara residence qualified as a tax-free "like kind" exchange within the meaning of section 24941;[2/] and (2) whether Continental should be allowed to deduct depreciation for the Santa Barbara residence.

During the years at issue, Gene Glick, a real estate developer, along with his wife Elaine, were the sole shareholders of Continental. Continental held ownership interests in several real properties, including two which were located in the desert (hereinafter referred to as "desert properties"). In 1978, the Glicks became interested in acquiring a residence in Santa Barbara. In order to accomplish this, appellant and the owners of the Santa Barbara residence entered into an agreement, the relevant portions of which follow:

> 1. The parties hereto mutually agree and acknowledge that this exchange is intended to be in performance of Section 1031 of the I.R.S. code as a tax deferred exchange for the benefit of Owner of [the Santa Barbara residence]. It is further acknowledged that proper legal and accounting advice from a competent authority in such matters has been obtained by said party, outside of this escrow; Owner of [the desert properties], Realtor and escrow agent shall assume no liability and/or responsibility as to the same.
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> * * *
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> 3. This escrow is subject to successful re-sale of [the desert properties] during this escrow period and said re-sales must close concurrently with this escrow. It is acknowledged by all parties that Owner of [the Santa Barbara property] shall bear none of the costs or expenses involved in connection with the sale escrows for the re-sale of [the desert properties] of whatever kind or nature, specifically including, but not limited to, title fees or escrow expense, policy of title insurance, recording fees, transfer taxes,

2/ Section 24941 is substantially similar to Internal Revenue Code section 1031.

> appraisal or credit report fees, real estate brokers' fees and commissions or otherwise. In this regard it is hereby agreed that no costs, fees or expenses shall be chargeable to Owner of [the Santa Barbara property] whether or not said escrow shall close.
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> 4. Owner of [the desert properties] hereby agrees that all of such costs and expenses shall be chargeable to them and they hereby agree to indemnify Owner of [the Santa Barbara property] free and harmless on account thereof.
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> * * *
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> 6. The parties hereto further acknowledge that the Owner of [the Santa Barbara property] has never inspected [the desert properties] and assumes no responsibility therefor. Owner of [the desert properties] does hereby agree to indemnify and hold harmless Owner of [the Santa Barbara property] from any and all obligations, warranties (expressed or implied) or representations which Owner of [the Santa Barbara property] may assume or agree to as "seller" in re-sale of [the desert properties].
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> * * *
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> 8. Should this 1031 tax deferred exchange fail to consummate then the Owner of [the desert properties] herein reserves the right to purchase [the Santa Barbara property] at a purchase price of $612,500.00 by paying $200,000.00 downpayment and having the seller take back a purchase money Note and Deed of Trust for $412,500.00 to be payable interest only at 10% per annum for a period of five years with additional terms to be agreed upon. (Exhibit A-3.)

The computations for such exchange were noted thereon as follows:

	PARCEL "A"	PARCEL "B"	PARCEL "C"[3]
Title Company liability	$525,000	$612,500	$825,000
Existing Trust Deed	300,000		350,000
" " "			105,000
Equity	225,000	612,500	370,000
60% of equity Parcel "C"			222,000
Approx re-sale costs to be deducted from equities	25,000		22,000
Approx Net equities	200,000		200,000
Purchase money deed of trust taken back by owner of Parcel "B"		212,500	
Balanced equities	200,000	400,000	200,000

Pursuant to the agreement, during escrow, the subject properties were exchanged, the desert properties were thereupon sold to an unrelated third party for cash, and the original owner of the Santa Barbara residence was cashed out.

After the acquisition of the Santa Barbara residence by Continental, the Glicks and their family moved in. Apparently the Glicks made no actual rental payments to Continental for their use of the residence, but instead allegedly reduced the dollar amount of certain purported loans made to the corporation.

Upon audit, respondent determined that the acquisition of the Santa Barbara residence by Continental did not qualify as a tax-free exchange and, consequently, treated the disposition of the desert property by Continental as a sale. In addition, respondent determined that Continental's depreciation of that residence should be disallowed. Denial of appellant's protest of those issues led to this appeal.

A. ACQUISITION OF SANTA BARBARA RESIDENCE

On appeal, respondent argues that no exchange took place, but that a sale was actually consummated.

3/ For purposes of this computation, the Santa Barbara residence is denoted as Parcel "B" and the desert properties are denoted as Parcel "A" and Parcel "C".

Respondent notes that the agreement provided that the owner of the Santa Barbara residence was to receive all cash. Moreover, even if a cash buyer for the desert properties was not secured, Continental retained an option to pay cash for the Santa Barbara residence. (Resp. Br. at 4.)

As indicated above, the statutory provision for nonrecognition is section 24941. On this issue, the determinative question for section 24941 treatment is the requirement that there be an exchange of like-kind properties as distinguished from a cash sale.[4] The tax court in Barker v. Commissioner, 74 T.C. 555, 561 (1980), recently outlined the problem generally faced in this area as follows:

> The 'exchange' requirement poses an analytical problem because it runs headlong into the familiar tax law maxim that the substance of a transaction controls over form. . . . [I]f the exchange requirement is to have any significance at all, the perhaps formalistic difference between the two types of transactions must, at least on occasion, engender different results. Accord, Starker v. United States, 602 F.2d 1341, 1352 (9th Cir. 1979).

In the typical case involving multiple-party transactions, the taxpayer has property which another person wants to acquire for cash. The taxpayer, in turn, wants to acquire another parcel of property. Rather than selling his property for cash, being taxed on any gain and then reinvesting the proceeds in the desired property, a tax-free like-kind exchange is effected whereby the person with whom the taxpayer exchanges the property first purchases the property wanted by the taxpayer. Accordingly, multiple parties must be involved in the transaction.[5]

4/ Respondent has not contended that the subject properties were not "like kind."

5/ As can be seen, the substance of a transaction in which the taxpayer sells the property and immediately reinvests the proceeds in like-kind property is not much different from the substance of a transaction in which two parcels are exchanged without cash.

In such situations, the courts have held there is nothing inherent in a multiple-party exchange that necessarily acts as a bar to tax-free exchange treatment. (Mercantile Trust Co. of Baltimore, et al. v. Commissioner, 32 B.T.A. 82 (1935); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963), revg. 38 T.C. 215 (1962); Starker v. United States, supra; Rev. Rul. 75-291, 1975-2 C.B. 332.) Moreover, it is not fatal to tax-free treatment that the person with whom the taxpayer exchanges his property immediately sells the newly acquired property. In such situations exchange treatment is deemed proper if:

> [E]ach of the contractual arrangements between the parties was a mutually interdependent part of an integrated plan; each transaction was contingent upon the successful completion of the other transactions; and the transactions were to be completed simultaneously.

(Barker v. Commissioner, supra, 74 T.C. at 564-565.)

This appeal involves the obverse situation from the typical case described above. In the instant case, Continental wanted to acquire the Santa Barbara residence, the owner of which wanted cash. However, Continental desired to exchange the desert properties for the Santa Barbara residence rather than to pay cash. To effect the transaction and to preserve the exchange treatment (i.e. between the desert properties and the Santa Barbara residence), a third-party was found who would purchase the desert properties for cash during the escrow period. (Resp. Br., Ex. A-3, par. 3.) The record indicates that this mutually integrated plan was, in fact, completed simultaneously during the escrow period. Accordingly, based on the record before us, we must find that a tax-free exchange did, in fact, result. Indeed, there is nothing in the record that would indicate that Continental received, even momentarily, any cash. Moreover, we find Continental's retention of the right to purchase the Santa Barbara residence for cash not to be in any way detrimental in its claim here. First, the transaction that would trigger tax recognition for Continental here is not the purchase of the Santa Barbara residence, but the sale of the desert properties. Retention of an option to purchase the residence for cash would have no direct relationship to any sale of the desert properties. Second, the possibility of a sale, should an exchange not be achieved, has been held not to be fatal to finding that an exchange did, in fact, occur. (Garcia v.

Commissioner, 80 T.C. 491, 498 (1983); Mercantile Trust Co. of Baltimore v. Commissioner, supra.)

Accordingly, respondent's determination on this issue must be reversed.

B. DEPRECIATION

On appeal, respondent also contends that Continental should not be allowed to deduct depreciation of the Santa Barbara residence since it was occupied on a rent-free basis. Appellant argues that if rental value of the residence is taxed to the sole shareholders as a constructive dividend, they have, in fact, paid rent and the depreciation deduction should be allowed.[6]

Section 24349 allows a depreciation deduction for property used in the trade or business or property held for the production of income.[7] Property that is occupied on a rent-free basis is not held for the production of income. (Odom v. Commissioner, ¶ 79,053 T.C.M. (P-H) (1979).) Moreover, receipt of a dividend by a shareholder cannot be construed as income to a corporation. Accordingly, based upon the record before us, we find that respondent's determination on this issue must be sustained.

Finally, we note that in 1977, respondent disallowed certain deductions claimed by appellant for the payment of personal expenses of its sole shareholders Appellant has offered no argument on this issue. Accordingly, based on appellant's failure to carry its burden of proof (see New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934)), respondent's determination must be upheld.

For the reasons noted above, respondent's determination must be modified.

6/ We have held in the companion to this appeal, the Appeal of Gene and Elaine Glick, decided this day, that the Glicks' use of the Santa Barbara residence was a constructive dividend to them.

7/ Appellant apparently makes no claim that the residence was used in its trade or business.

Appeal of Continental Desert Properties, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Continental Desert Properties, Inc., against proposed assessments of additional franchise tax plus penalties in the total amounts of $1,061, $9,316, and $4,856 for the years 1977, 1978, and 1979, respectively, be and the same is hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 9th day of October, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9