CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of:

BRIAN N. KHOURY;
JASON B. KHOURY AND
LISA B. KHOURY;
NOELLE K. LUDWIG AND
TIMOTHY S. LUDWIG

Oral hearing date: April 26, 2016
Decision rendered: May 26, 2016
Publication due by: September 23, 2016

Case No. 867810

Case No. 867855

Case No. 867874

Representing the Parties:

For Appellants: Michael C. Hamersley, Esq., MBA

For Franchise Tax Board: Roman D. Johnston, Tax Counsel IV

Counsel for the Board of Equalization: Grant S. Thompson, Tax Counsel IV

LEGAL ISSUE 1

Whether appellants' consent to the extension of the statute of limitations is valid such that the Franchise Tax Board (FTB or respondent) timely issued its Notices of Proposed Assessment.

PROCEDURAL BACKGROUND AND FINDINGS OF FACT

The FTB's audit began in April of 2009. In 2011, appellants consented to an extension of the statute of limitations. The FTB subsequently issued two audit issue presentation sheets. Appellants objected to the FTB analysis reflected in the audit issue presentation sheets and provided additional evidence and argument to the FTB.

In July of 2012, the FTB requested that appellants agree to a second extension of the statute of limitations. Appellants' counsel indicated that appellants were frustrated with the FTB's handling of

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

the audit and would only agree to an extension if the FTB first provided a further analysis to appellants. Following additional correspondence, appellants' counsel agreed that appellants would provide an unconditional extension of the statute of limitation.

On August 24, 2012, appellants signed a consent and waiver to extend the statute of limitations for an assessment to November 15, 2012. The signed consent was on a standard form, with no written alterations or conditions to the extension of the statute of limitations.

The FTB subsequently sent a third audit issue presentation sheet to appellants. Appellants again objected to the FTB's analysis.

On November 7, 2012, respondent issued Notices of Proposed Assessment to appellants proposing the additional tax and penalties at issue in this appeal. Following protest proceedings at the FTB, the FTB issued Notices of Action affirming its proposed assessments. Appellants timely appealed, and their appeals were consolidated into this appeal.

On appeal, appellants argued that the August 24, 2012 consent signed by them was invalid on various grounds, including fraudulent inducement and a lack of mutual assent.

APPLICABLE LAW

In general, respondent must issue a proposed assessment within four years of the date the taxpayer filed his or her California return. (Rev. & Tax. Code, § 19057.) Under Revenue and Taxation Code (R&TC) section 19067, taxpayers may consent in writing to extending the statute of limitations for proposing an assessment.

In *Schulman v. Commissioner* (1989) 93 T.C. 623 (*Schulman*), the taxpayer argued that his consent to extend the statute of limitations was limited. The taxpayer argued that, because the letter transmitting the consent form stated that the IRS needed further time to examine a particular return item, the consent was limited to an examination of that item. The Tax Court ruled against the taxpayer and found that the consent was not restricted.

The Tax Court stated that, because the IRS provided a signed consent form and issued its assessment within the extension period, appellant had the burden of proof. Examining the facts before it, the court found it "most telling" that the taxpayer did not modify the language of the written consent to reflect the alleged restriction on the scope of the consent. (*Id.* at p. 642.) The court found that the

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

consent was "complete and unambiguous on its face and represents the agreement of the parties." (*Ibid.*) The court stated that, although it might be argued that the transmittal letter conveyed terms of a proposed restriction, no such proposal was "intended, clearly communicated, or accepted by both parties." (*Ibid.*) Therefore, the court found that the statute of limitations remained open for all issues.

To prove fraudulent inducement, a party must show: (1) a false representation; (2) knowledge of its falsity; (3) an intent to deceive; (4) actual and justifiable reliance; and (5) that the actual and justifiable reliance causes injury or prejudice. (*Huene v. Commissioner* (1989) T.C. Memo. 1989-570.)

FURTHER FINDINGS OF FACT, ANALYSIS & DISPOSITION

As noted above, the Tax Court has found that, absent an agreement to alter the terms of a consent to extend the statute of limitations, the terms of the consent control its scope. (See, e.g., *Schulman*, *supra*, 93 T.C. 623.) Here, the consent form is clear and unambiguous on its face, and appellants were represented by counsel when they signed it. Although appellants' counsel initially stated that appellants would not sign the consent unless certain conditions were met, he later withdrew this condition. Accordingly, the consent contains no limitations or conditions. Moreover, appellants have failed to carry their burden of establishing that the FTB fraudulently induced them into signing the consent or that another defense to its enforcement exists. Accordingly, we find that appellants' consent to extend the statute of limitations is valid. As respondent issued its proposed assessments within the extended period provided by the consent, the proposed assessments were timely issued within the statute of limitations.

LEGAL ISSUE 2

Whether appellants' installment sale transaction should be disallowed under the economic substance doctrine or other judicial standards.

BACKGROUND AND FINDINGS OF FACT

Appellants Brian Khoury, Jason Khoury, and Noelle Ludwig (Siblings) are the adult children of Tawfiq N. and Richel G. Khoury (Grandparents).[1] Grandparents are the founders of the Pacific Scene Family of Companies (Pacific Scene), a group of family-owned real estate companies.

[1] Brian, Jason, and Noelle are sometimes referred to as the Siblings. Jason B. Khoury's spouse, Lisa B. Khoury, and Noelle K. Ludwig's spouse, Timothy S. Ludwig, are also appellants.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

In summary, in the transaction at issue, NBJ Associates L.P. (NBJ) sold its limited partnership interest in RSD Group L.P. (RSD) to Sundance-K, LP (Sundance-K) in return for $10,000 in cash and a $14,750,000 note (RSD Interest Sale).[2] Shortly after this sale, RSD sold the Club Pacifica Apartments in El Cajon, California (RSD Property) to an unrelated third party (RSD Property Sale).

To provide more background, on or about December 6, 2005, RSD contracted to sell the Club Pacifica Apartments. On or about January 3, 2006, NBJ sold its interest in RSD to Sundance-K in return or a $14,750,000 installment note issued by Sundance-K and $10,000 in cash. Of the $14,750,000 amount due on the note, $490,000 was due on February 1, 2006, and was paid on or about that date. The remaining $14,260,000 was due in thirty years, on January 3, 2036, with monthly interest-only payments of $60,000 (a five-percent rate) due and paid beginning March 1, 2006. Pursuant to an Internal Revenue Code (IRC)[3] section 754 election, Sundance-K's share of the partnership's basis in the property was increased by $17,529,480.[4] On February 7, 2006, the RSD Property Sale closed. The gain and sale proceeds were allocated and subsequently distributed to the partners of RSD. As a result of the IRC section 754 election, Sundance-K, which now held the partnership interest that had formerly been held by NBJ, had $223,558 of allocated net gain. On February 28, 2006, RSD distributed $14,504,490 in proceeds from the RSD Property Sale to Sundance-K and, on July 7, 2006, it distributed an additional $351,698 to Sundance-K. Sundance-K then used substantially all of the proceeds to extend interest-bearing loans to other entities. On and following March 1, 2006, Sundance-K paid the $60,000 monthly interest-only payments which were due on the installment note, which NBJ reported as taxable income.

---

[2] The Siblings each owned a 33-percent interest in NBJ. An S corporation that was wholly owned by the Siblings served as NBJ's general partner and held the remaining 1-percent interest in NBJ. Until the RSD Interest Sale, the Siblings held an interest in RSD through NBJ. The Siblings also held indirect interests in RSD through its other partners. The Khoury Family 1999 Irrevocable Trust, which was formed to benefit appellants' children, owned an 80-percent limited partnership interest in Sundance-K. The Siblings owned the general partner of Sundance-K, which owned the remaining interest in Sundance-K. The Siblings' interests were held through disregarded grantor trusts.

[3] As relevant to the issues on appeal, California law conforms to the IRC provisions discussed herein.

[4] Through IRC section 743(b), Sundance-K's proportionate share of the partnership's basis in its assets (i.e., Sundance-K's "inside" basis) was increased to equal Sundance-K's basis in the partnership interest. The effect of IRC section 743(b) is to treat a purchaser of a partnership interest as if the purchaser purchased an interest in the partnership's assets. Such treatment only affects the purchasing partner.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

APPLICABLE LAW

The United States Court of Appeals for the Ninth Circuit applies the economic substance doctrine to determine if a transaction was a sham that should be disregarded for tax purposes. (*Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360 (*Casebeer*).) In determining whether a transaction is a sham that lacks economic substance, the Ninth Circuit applies a two-pronged analysis considering: (1) whether the taxpayer has demonstrated a non-tax business purpose for the transaction (a subjective analysis); and (2) whether the taxpayer has shown that the transaction had economic substance beyond the creation of tax benefits (an objective analysis). (*Id.*) The Ninth Circuit has held that this test is not a "'rigid two-step analysis,' but rather a single inquiry into 'whether the transaction had any practical economic effects other than tax benefits.'" (*Reddam v. Comm'r* (9th Cir. 2014) 755 F.3d 1051, 1058 [quoting *Sacks v. Comm'r* (9th Cir. 1995) 69 F.3d 982, 988].)

In *Rushing v. Commissioner* (5th Cir. 1971) 441 F.2d 593 (*Rushing*), the taxpayers adopted a liquidation plan for two corporations and, before the liquidation of the corporations, sold their stock in the corporations to an irrevocable trust in return for cash and installment notes. The issue was whether the taxpayers "should be treated as if they constructively received the entire liquidation dividend in the year of the liquidation or whether the sale and consequent distribution [of the liquidation proceeds] to the trusts insulates the taxpayers so that for tax purposes they are deemed to receive the payments representing their gain only as they receive the installment payments from the trusts." (*Id.* at p. 597.)

The court stated that the taxpayer could reap the benefits of installment sale treatment, even if the transaction was designed for tax purposes, "if he actually carries through an installment sale . . . ." (*Rushing*, *supra*, 441 F.2d at p. 598.) However, the court cautioned, a taxpayer may not receive installment sale treatment "if, through his machinations, he achieves in reality the same result as if he had immediately collected the full sales price, or, in our case, the full liquidation proceeds." (*Ibid.*) The court ruled in favor of the taxpayers, explaining that "the trustee was independent of the taxpayer's control" and had "independent duties and responsibilities to persons other than the taxpayers." (*Ibid.*)

In *Roberts v. Commissioner* (9th Cir. 1981) 643 F.2d 654 (*Roberts*), the taxpayer sold stock to an irrevocable trust in return for installment notes, and the trust subsequently received the cash proceeds from the stock sales. Citing *Rushing*, the Ninth Circuit found in favor of the taxpayer,

explaining that the irrevocable trust was not a "mere conduit" for the taxpayer. (*Id.* at p. 657.) The Ninth Circuit further explained that the taxpayer had "no control over the trust or the trustees" and "had actually and effectively foregone the benefits [of the stock sales], electing instead to receive the use and enjoyment of the installment proceeds." [5] (*Ibid.*)

FURTHER FINDINGS OF FACT, ANALYSIS & DISPOSITION

Appellants established, through a preponderance of the evidence, that the transaction at issue had substantial nontax motivations and objective economic substance. In support of their position, appellants submitted declarations of the Siblings, the Grandparents, appellants' advisor and CPA, and from officers of Pacific Scene companies. We find that the declarations, and the testimony of the Siblings' grandfather Tawfiq N. Khoury (TNK) at the oral hearing, are credible and supported by corroborating evidence.

With regard to business purpose, the declarations and TNK's testimony establish that appellants entered into the transaction for estate planning purposes and to ensure that cash proceeds arriving from the RSD Property Sale were not squandered by the Siblings or their spouses. The record further shows that appellants' accountant suggested the use of a leveraged IRC section 1031 transaction that would have greatly reduced the amount of tax they owed for the year at issue. Instead of taking this path, appellants agreed to a transaction that resulted in significant amounts of tax being paid by appellants and the Grandparents. Appellants recognized taxable gain through their interest in NBJ when it received the initial principal payment in the installment note, and also recognized a share of the gain realized on the sale of the RSD Property through their interests in other entities investing in RSD. The Grandparents also recognized taxable gain due to their interest in another entity investing in RSD. Instead of seeking to avoid tax, appellants agreed to a transaction in which they and their parents incurred significant tax in the year at issue and would pay tax in the future as payments were made.

Through the transaction, proceeds from the RSD Property Sale that would have been received by an entity in which the Siblings owned a 99-percent interest (i.e., NBJ) were, instead, distributed to a

[5] In *Shelton v. Commissioner* (1995) 105 T.C. 114, the Tax Court noted that IRC section 453(e) was enacted after *Rushing* and was intended to reverse the result of cases such as *Rushing* in which stock was sold to a related buyer and then liquidated. (*Id*. at p. 122.) IRC section 453(e) is discussed below under Legal Issue 3.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

limited partnership (Sundance-K) in which an irrevocable family trust held an 80-percent economic interest. The trust had been established years prior to the transaction at issue to ensure a legacy for the children of the Siblings (i.e., TNK's grandchildren), and had an independent bank trustee. Through the use of the installment note, the transaction effectively placed the Siblings on an allowance and ensured that the sale proceeds attributable to the RSD Interest were invested for the benefit of the next generation. Thus, the structure of the transaction evidences the stated estate-planning motivation of setting aside funds for the next generation.

Appellants also demonstrated that the transaction had economic substance beyond the creation of tax benefits. Appellants and the entities involved in the transaction respected and followed the stated form of the transaction. For example, Sundance-K paid the stated interest shown on the installment sale note it provided to NBJ to obtain the RSD Interest. Appellants then reported their share of interest income received by NBJ from the installment note. Sundance-K invested substantially all of its share of the proceeds of the RSD Property Sale by extending loans to other entities. Although appellants owned direct or indirect interests in these other entities, the loans were formally executed and the recipients respected the terms of the loans and made required payments to Sundance-K. Respondent argued that appellants' ownership of the general partner of Sundance-K evidenced a lack of economic substance, but Sundance-K was a pre-existing and separate entity from NBJ with its own economic structure in which eighty percent of the profits and losses accrued to the benefit of the irrevocable trust. Moreover, the testimony and declarations establish that Sundance-K was professionally managed and, in practice, ultimately controlled by TNK. As a result, the transfer of the RSD Interest to Sundance-K changed the economic realities and was not a sham.

For similar reasons, the installment sale of the RSD Interest is valid under the analysis set forth in *Rushing*, *Roberts*, and similar cases. Rather than constituting a tax-motivated sale to an alter ego of NBJ or appellants, the installment sale of the RSD Interest constituted a sale to a separate economic entity that was managed for the benefit of an irrevocable trust with an independent trustee. The Grandparents, together with two unrelated professional Pacific Scene employees, served on the Board of Directors of the general partner of Sundance-K. Due to the Grandparents' effective control over appellants and Sundance-K, the need to preserve and grow assets for the beneficiaries of the irrevocable

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

trust (i.e., the Grandparents' grandchildren), and the oversight by professional managers of the affairs of Sundance-K, the practical effect of the installment sale, considering all of the facts and circumstances, was to ensure that Sundance-K's portion of the sale proceeds would be managed and grown for the benefit of the next generation.

Accordingly, we do not find a sufficient basis to disallow installment sale treatment based on judicial doctrines such as the economic substance doctrine or cases such as *Rushing* and *Roberts.*

LEGAL ISSUE 3

Whether IRC section 453(e) applies to disallow installment sale treatment.

APPLICABLE LAW

In relevant part, IRC section 453(e)(1), provides as follows:

> If –
>
> (A) any person disposes of property to a related person [as defined in IRC section 453(f)(1)] (hereinafter in this subsection referred to as the "first disposition"), and
>
> (B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the "second disposition"),
>
> then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

Thus, IRC section 453(e)(1) generally disallows installment sale treatment where there is a disposition of property ("first disposition") and, before all payments have been made for the property, the property is sold to a related party ("second disposition"). However, pursuant to IRC section 453(e)(7), the provision "shall not apply to a second disposition . . . if it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax." Also, pursuant to IRC section 453(e)(2)(A), and subject to exceptions that are not relevant here, installment sale treatment is only disallowed if the second disposition is "not more than 2 years after the date of the first disposition."

///

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

FINDINGS OF FACT, ANALYSIS & DISPOSITION

Respondent argued that, for purposes IRC section 453(e), there was an initial disposition of the RSD Interest by NBJ that was followed, within two years, by a second disposition of the RSD Interest to Sundance-K, which respondent contended was a related party. Respondent argued that the second disposition occurred when Sundance-K received distributions from RSD of its share of proceeds from the RSD Property Sale. Specifically, respondent asserted that, while the distributions from RSD were not called a liquidation of the RSD Interest, they constituted a disposition of the RSD Interest for purposes of IRC section 453(e) because they effectively allowed NBJ and Sundance-K to a "cash out" of appreciation that had occurred in the RSD Interest.

Even if we accepted all of the above arguments, and we do not,[6] IRC section 453(e) does not apply if appellants did not have as one of their principal purposes the avoidance of tax. Based on the findings of fact and analysis outlined in our discussion of business purpose under Legal Issue 2, we find that appellants did not have as one of their principal purposes the avoidance of tax. Consequently, IRC section 453(e) is not applicable, and we need not discuss further the issues of whether Sundance-K and NBJ were related or whether there was a second disposition of the RSD Interest for purposes of IRC section 453(e).

LEGAL ISSUE 4

Whether the partnership anti-abuse rule applies to appellants' transaction.

APPLICABLE LAW

Treasury Regulation section 1.701-2 (the anti-abuse rule) states that subchapter K of the Internal Revenue Code is intended to allow taxpayers to conduct joint businesses flexibly without incurring an entity-level tax.[7] Under Treasury Regulation section 1.701-2(b), the FTB can recast a transaction for tax purposes if a partnership is used in a transaction with a principal purpose to reduce tax in a manner

[6] We note that the distributions made by RSD did not result in a complete liquidation of the RSD Interest, and Sundance-K continued to hold the RSD Interest for at least two years. Consequently, it appears there was not a "disposition" of the RSD Interest within two years, as is required for the application of IRC section 453(e). As support for its position, respondent cited *Shelton v. Commissioner* (1995) 105 T.C. 114 (see, *supra*, fn. 5); however, that case is distinguishable because it involved a complete liquidation.

[7] Pursuant to R&TC section 17024.5, subdivision (d), federal regulations apply because, as relevant here, California law conforms to the relevant federal provisions.

that is inconsistent with "the intent of subchapter K." Treasury Regulation section 1.701-2(a) states that "the intent of subchapter K" requires that (1) the partnership is bona fide and the transaction has a substantial business purpose, (2) the form of the partnership transaction is respected under substance over form principles, and (3) the tax consequences under subchapter K of the Internal Revenue Code properly reflect the partners' economic agreement and income.

FINDINGS OF FACT, ANALYSIS & DISPOSITION

Based on the findings of fact and analysis outlined in our discussion of business purpose under Legal Issue 2, we find that the avoidance of tax was not a principal purpose of the sale of the RSD Interest. Accordingly, as the anti-abuse rule requires a principal purpose of tax avoidance, it is not applicable here.

Furthermore, the transaction satisfies the three requirements necessary to be consistent with "the intent of subchapter K." Both NBJ and Sundance-K were bona fide partnerships in which the partners shared in profits and losses, and, based on the findings and analysis under Legal Issue 2, we find that the transaction had substantial business purposes and economic substance. Accordingly, the first and second requirements to be consistent with the "intent of subchapter K" are satisfied.

The third requirement is that the tax consequences must accurately reflect the partners' economic agreement and income. Here, as the RSD Interest Sale had economic substance and qualified for installment sale treatment, NBJ is able to defer the recognition of gain. This result is consistent with the partners' economic agreement, their actual transactions, and their reporting of the installment sale, which all reflected the use of an installment note. It also accurately reflects each partner's income, as NBJ recognizes taxable gain when it receives principal payments and recognizes taxable income when interest payments were made on the installment note.

Respondent argues that the basis adjustment provided by IRC section 743(b), due to RSD's IRC section 754 election, should not be allowed. Respondent's argument appears to be based on the premise that the installment sale transaction and transfer of the RSD Interest should be disregarded so that there was no transfer of a partnership interest that would trigger a basis adjustment under IRC section 743(b). This argument fails because we reject respondent's premise that the installment sale of the RSD Interest should be disregarded.

Moreover, the basis adjustment properly reflects income. The gain that NBJ recognizes as a result of the RSD Interest reflects appreciation in the value of the RSD Property. Under the installment sale rules, NBJ is entitled to defer tax on this gain to the extent that the installment note defers the payment of principal. If Sundance-K did not receive a basis adjustment with respect to the share of the RSD Property attributable to the RSD Interest, appreciation in the RSD Property would *also* be taxed when the RSD Property was sold and Sundance-K recognized its share of gain from the sale of the RSD Property. [8] The IRC section 754 election, and resulting IRC section 743(b) basis adjustment, avoids this distortion and is consistent with the intent of subchapter K. (See Treas. Reg. § 1.701-2(d), example 9 ["Congress clearly recognized that if the section 754 election were not made, basis distortions may result."].)

CONCLUSION

Based on the findings and analysis above, appellants owe no additional tax for the year at issue. Consequently, interest and penalties that were imposed on the proposed additional tax do not apply and need not be considered further.

[8] This type of distortive tax result arises in the absence of an IRC section 754 election. While it is likely to be remedied when the buyer of the partnership interest ultimately disposes of the partnership interest, the application of IRC section 743(b) avoids the distortion in the first instance.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

ORDER

Pursuant to the analysis of the law and facts above, the Board ordered that the actions of the FTB on appellants' protests against the proposed assessments for the 2006 year be reversed. Adopted at Irvine, California, on this 14th day of July, 2016.

Fiona Ma ______________________, Chairwoman

Diane L. Harkey ________________, Member

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL