Louis A. Ambrose
Tax Counsel IV
Board of Equalization, Appeals Division
450 N Street, MIC: 85
PO Box 942879
Sacramento CA 95814
Tel: (916) 445-5580
Fax: (916) 324-2618

Attorney for the Appeals Division

BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeal of:	**HEARING SUMMARY**[2]
	PERSONAL INCOME TAX APPEAL
DONALD R. DIAMOND AND	Case No. 441030
JOAN B. DIAMOND	
FRANK A. ARIES AND	Case No. 464475
MARY LOU ARIES[1]	

Year	Appellants' Diamond Proposed Assessment
1999	$199,804

Year	Appellants' Aries Claim for Refund
1999	$154,047[3]

[1] Appellants reside in Tucson, Arizona.

[2] The oral hearing on this appeal was originally scheduled for the September 2009 Board meeting but was deferred for further review and additional briefing at Board Member request. After additional briefing was completed, the hearing was rescheduled for the June 2010 Board meeting but postponed until the October 2010 Board meeting at the appellants' request.

[3] Respondent explains that the refund amount originally claimed by the Aries ($260,088) has been adjusted to reflect their concession of tax for certain interests acquired in limited liability companies and a limited partnership. (Resp. Op. Br., p.1, fn. 1.) Respondent should be prepared at the oral hearing to explain how it arrived at this figure.

Representing the Parties:

For Appellants: Steven W. Phillips

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

QUESTION: Whether the acquisition of an interest in a qualified replacement property by appellants' partnership and immediate transfer of that interest to a limited liability company (LLC) qualifies as a "like-kind" exchange pursuant to Internal Revenue Code (IRC) section 1033.

HEARING SUMMARY

Background

Appellants Donald Diamond and Joan Diamond (Diamonds) and appellant Frank Aries[4] formed Golden Gate Apartments (GGA), a limited partnership, in 1978 for the purpose of owning and operating the Golden Gate Apartments (Apartments) located in San Francisco. The Diamonds held a 49 percent limited partner interest in GGA and Frank Aries held a 50 percent limited partner interest and a 1 percent general partner interest. In 1998, the City and County of San Francisco (City) notified GGA that City was exercising its powers of eminent domain to convert the Apartments to a public use. On December 1, 1998, GGA agreed to sell the Apartments to City for $6,772,500 under threat of eminent domain. (Resp. Op. Br. (Diamond), p. 1.)

On its 1999 federal partnership return (Form 1065), GGA elected to defer $5,686,845 of capital gain realized on the sale of the Apartments under IRC section 1033(a)(2) and Treasury Regulations section 1.1033(a)-2(c). Between 1999 and 2002, GGA acquired as replacement properties: 150 acres of vacant land, membership interests in six limited liability companies, an interest in a limited partnership and an interest in rental real property located in Scottsdale, Arizona (Scottsdale Property). The total cost of the replacement properties was reported as $7,912,508. (Resp. Op. Br. (Aries), p. 4.)

The Scottsdale Property was jointly purchased by GGA, appellants, Stratford American Corp., DRD-97 Trust, and Auriga Properties, Inc. as tenants-in-common on December 11, 2002.

---

[4] Frank Aries is a partner of GGA and filed the 1999 return as married filing jointly with his spouse, appellant Mary Lou Aries.

Allianz of America, Inc. (Allianz), the lender on the Scottsdale Property, required the tenants-in-common to transfer their interests in the Scottsdale Property to a new single-asset, limited liability company (LLC). Immediately after the purchase transaction, the parties contributed the Scottsdale Property to Scottsdale Thompson Peak, LLC (STP), a newly-formed Arizona LLC. STP is a single-asset LLC which was formed for the purpose of owning, leasing, operating and maintaining the Scottsdale Property. In exchange for its interest in the property, GGA received a 13 percent membership interest in STP. (Resp. Op. Br. (Diamond), p. 2.)

On its 2002 California Partnership Return (Form 565), GGA reported the acquisition of various replacement properties for purposes of qualifying for the deferral of taxation on its gain. During an audit of GGA's 1999 taxable year, respondent determined that the Apartments had been sold under threat of eminent domain as required by IRC section 1033. With respect to the properties other than the Scottsdale Property, respondent determined that the 150 acres of vacant land qualified as a replacement property under section 1033 but that the LLC and LP interests failed to qualify pursuant to subdivision (a)(2) of IRC section 1031, which excludes an exchange of partnership interests from gain non-recognition and the LLCs elected to be treated as partnerships. Thus, respondent determined that the LLC and LP interests were not "like-kind" to the property taken, i.e., the Apartments. Respondent also determined that the LLC and LP interests did not qualify as "similar" properties because those interests are intangible personal property, rather than real property interests. (Resp. Op. Br. (Aries), pp. 4-5.)

With respect to the Scottsdale Property, respondent applied the step transaction doctrine and determined that GGA's purchase of the interest in the Scottsdale Property "was formulaic and transitory" and that GGA entered into that transaction with the intention of acquiring a membership interest in STP. Respondent collapsed the steps taken and treated the transaction as if GGA acquired a membership interest in STP. Because STP elected to be taxed as a partnership, respondent determined that the acquisition of the membership interest did not qualify as a replacement property under IRC sections 1031 and 1033. (Resp. Op. Br. (Aries), p. 5.)

Respondent issued a Notice of Proposed Assessment (NPA) to appellants Diamond and an NPA to appellants Aries on October 7, 2004. Appellants filed timely protests of the NPAs contending that the acquisition of the LLC and LP interests and the interest in the Scottsdale Property qualified as replacement properties under IRC section 1033. After considering appellants' protests, respondent affirmed each NPA in Notices of Action (NOA) dated January 2, 2008. The Diamonds timely appealed the NOA issued to them. (Resp. Op. Br. (Diamond), p. 3.) The Aries's paid the assessment and filed a claim for refund for the entire amount[5] which respondent denied. The Aries's timely appealed respondent's denial. (Resp. Op. Br. (Aries), p. 6.)

Contentions

Appellants' Contentions[6]

Appellants contend that the interest in the Scottsdale Property acquired by GGA was a qualified replacement property which complies with the requirements of IRC section 1033 and that the conveyance of that interest to STP was not a disqualifying event. In support of their position, appellants cite *Magneson v. Commissioner* (9th Cir. 1985) 753 F.2d 1490 (*Magneson*), a case with "virtually identical" facts to this appeal, in which the Court of Appeal held that property acquired in a "like-kind" exchange under IRC section 1031(a) and immediately transferred to a limited partnership in exchange for a partnership interest qualified for non-recognition of gain under that section. Appellants contend that respondent mischaracterizes the transaction as an exchange of a partnership interest. Appellants assert that GGA exchanged a fee interest in the Apartments for an undivided interest in the Scottsdale Property followed by a capital contribution to STP. (App. Op. Br., pp. 4-5.)

Appellants further contend that *Magneson* has been cited with approval by the U.S. Tax Court and the Ninth Circuit Court of Appeal and has been followed by the IRS and by state courts. In addition, appellants maintain that the *Magneson* court's decision was based on its finding that the taxpayer had met the "holding" requirement of IRC section 1031(a), because the taxpayer continued to hold real property for investment or use in a trade or business. Appellants assert that, even though the *Magneson* court referred to the application of the step transaction doctrine in dicta, the court did not base

---

[5] On appeal, the Aries have conceded that the LLC and LP interests did not qualify as replacement properties; the Diamonds state that they are not appealing the Franchise Tax Board's proposed assessment with respect to the seven limited liability companies. (See the Diamonds Appeal letter dated January 29, 2008, which is incorporated into the Aries' appeal at section 1.2 of the Aries appeal letter dated September 2, 2008.) Therefore, the only issue on appeal is whether the portion of the gain used to purchase the Scottsdale Property qualifies for non-recognition under IRC section 1033.

[6] Appellants state that, with the exception of their respective GGA interests, the facts of each of these appeals is identical and that the Aries' opening brief incorporates the Diamond's opening brief.

its decision on that doctrine and thus the change to IRC section 1031 by the Deficit Reduction Act of 1984 did not legislatively overrule that decision. As support, appellants cite an Oregon Tax Court case, *Louis E. Marks v. Department of Revenue* TC-MD 050715D (July 24, 2007), in which the court rejected the argument that *Magneson* was effectively overruled by the amendment to IRC section 1031 made by the Deficit Reduction Act of 1984. Appellants further assert that Congress has a long-held policy of specifically identifying a case when it passes legislation that is intended to overrule that case. (App. Op. Br., pp. 6-8.)

<u>Respondent's Contentions</u>

Respondent concedes that GGA's direct acquisition of an interest in the Scottsdale Property qualified as a like-kind exchange but contends that this Board should not recognize that acquisition because GGA made a pre-arranged transfer of the Scottsdale Property interest to STP. Respondent contends that IRC section 1033(g) does not apply where a taxpayer intends upon acquisition of a replacement property to transfer that replacement property to a third party, such as STP, in exchange for an LLC interest. (Resp. Op. Br. (Diamond), p. 4.)

Respondent asserts that the court in *Magneson* applied California law to reach its conclusion that the taxpayer "continued to own like-kind investment property, albeit in a different form of ownership." Respondent notes that the taxpayer in *Magneson* received a general partner interest which, the court held, did not significantly affect the amount of control or nature of the underlying investment. By contrast, respondent states that GGA momentarily held a tenancy-in-common interest in the Scottsdale Property but that the exchange for the STP interest significantly altered GGA's ownership rights because STP elected tax treatment as a partnership and, thus, GGA held a limited partner interest in STP. (Resp. Op. Br. (Diamond), pp. 5-6.)

Respondent notes that generally a limited partner has no right to engage in the partnership's business, which is consistent with California partnership law. Thus, respondent concludes that STP's operating agreement transformed GGA's interest in the Scottsdale Property by delegating day-to-day management of the Scottsdale Property to STP's manager. (Resp. Op. Br. (Diamond), p. 6.) Respondent asserts that under California law an LLC member does not hold a direct ownership interest in the LLC's assets and that under Arizona law property acquired by a partnership is owned by the partnership and not by the individual partners. (Resp. Op. Br. (Aries), pp. 11-13.) By contributing the Scottsdale Property interest to STP, respondent concludes that appellants through GGA altered their "core rights of property ownership" and never had the benefit of these rights because they were obligated to contribute the property to STP from its initial acquisition. Furthermore, respondent concludes that GGA's withdrawal from STP would require the sale of the STP interest which is properly classified as intangible personal property. (Resp. Op. Br. (Aries), p. 19.)

Respondent further states that *Magneson* is based on California Corporation Code section 15025 which was repealed and replaced by Corporations Code section 16501, effective January 1, 1999. Respondent explains that former section 15025 provided that a partner was a co-owner of partnership property as a tenant in partnership, while section 16051 provides expressly that a partner is not a co-owner of partnership property. Thus, respondent concludes that the *Magneson* holding has no application and provides no support for appellants' position. Finally, respondent quotes language from the *Magneson* decision which limits the holding to situations in which a taxpayer acquires like-kind property "with the intent of contributing the acquired property to a partnership for a general partnership interest." (Resp. Op. Br., pp. 17-18.) Respondent also contends that the *Marks* case may not be relied upon because it was decided before the change in California law as well. (Resp. Op. Br., p. 20.)

Respondent contends that the transaction does not meet the requirements of IRC section 1033(a)(2)(A) because GGA did not purchase "similar property". That is, appellants owned the replacement property through GGA's limited partner interest which the IRS has ruled does not qualify for non-recognition treatment. (Resp. Op. Br. (Diamond), pp. 6-7.) Respondent further contends that a membership interest in an LLC taxable as a partnership is intangible personal property, rather than real property. Under the applicable Treasury Regulation, respondent asserts that exchanged property of a different character, i.e., personal property, is not "like-kind" replacement property. Respondent notes that the rules set forth in the applicable Treasury Regulations are evidence that a fundamental distinction exists between real property and personal property. Respondent also cites *M.H.S. Company, Inc. v. Commissioner* (1976) T.C. Memo 1976-165, aff'd 575 F.2d 1177, 1178 (6th Cir. 1978) (*M.H.S. Company*) in which, respondent contends, the federal court held that an exchange of real property for an interest in a joint venture which owned an otherwise qualifying replacement property did not qualify for non-recognition treatment under IRC section 1033. Respondent asserts that the court concluded that the partnership interest was not "like-kind" property within the meaning of IRC section 1033. (Resp. Op. Br. (Aries), pp. 8-9.) Respondent notes that *Magneson* distinguished *M.H.S. Company* as involving the application of IRC section 1033 (rather than IRC section 1031 as in *Magneson*) so that *M.H.S. Company* has not been affected by changes in California or Arizona law, changes in the IRC or the holding in *Magneson*. (Resp. Op. Br. (Aries), pp. 20-21.)

Respondent believes that the circumstances of the transaction are appropriate for application of the step transaction doctrine, because the steps taken by appellants were in substance interrelated, interdependent, and intended from the outset to reach an ultimate result. Respondent states that GGA's title to the interest in the Scottsdale Property was transient and was never intended to vest in GGA. In addition, appellants concede that, prior to acquisition, they intended to immediately transfer the real property interest to STP which was part of GGA's revised investment strategy of holding LLC and LP interests, rather than property interests. (Resp. Op. Br. (Aries), p. 9-10.)

In addition, with respect to appellants' intention to transfer the Scottsdale Property interest to STP, respondent cites *Sandoval v. Commissioner* (2000) T.C. Memo 2000-189 (*Sandoval*) in which the Tax Court found that a group of taxpayers had agreed prior to the purchase of a replacement property to contribute the property to a partnership for partnership business purposes. As a result, the court held that the taxpayers did not acquire qualifying replacement property for purposes of IRC section 1033. The court also held that partnership property is owned by the partnership regardless of whether the property is held in the name of the partnership or in the name of one or more partners. Respondent also points out that in *Sandoval* the taxpayers had purchased the property and formed the partnership on the same date. Respondent concludes that *Sandoval* stands for the proposition that an exchange will not qualify for non-recognition even if the replacement real property is acquired first, when there was a prior agreement to transfer the property to a partnership. (Resp. Op. Br. (Aries), pp. 15-17.)

Respondent rejects appellants' assertion that a partnership interest is disqualified as replacement property only when the exchange involves both the relinquishment and acquisition of partnership interests. Respondent cites *Sandoval* for the proposition that a transaction involving relinquished real property in exchange for an interest in a partnership that holds like-kind replacement real property is disqualified under IRC section 1033. (Resp. Op. Br. (Aries), p. 19.)

Appellants' Contentions on Reply

Appellants maintain that the "linchpin" of this appeal is the *Magneson* case which respondent "attempts to minimize" by reading "a complex web of formal and substantive requirements into the Code." Appellants assert that in *Magneson* the Tax Court rejected arguments identical to those made by respondent. Additionally, appellants argue that the *Magneson* court did not base its decision on former Corporations Code section 15025. Rather, appellants assert that the court's view was that the "significant distinctions" between the ownership rights of a tenant-in-common and the rights of a partner were not a controlling element in determining whether the taxpayer had a continuity of investment in like-kind replacement property. Appellants point to the court's statement that the "holding for investment" requirement is satisfied if at the time of the exchange the taxpayer intends to contribute the property to a partnership and the partnership's purpose is to hold the property for investment even though the taxpayer as a partner has limited alienability rights with respect to the property. (App. Second Reply Br., p. 1 and pp. 9-11.)

Appellants cite case law and IRS guidance following *Magneson* as support for their position as follows:

- In *Maloney v. Commissioner* (1989) 93 T.C. 89 (*Maloney*), a corporation completed an IRC section 1031 exchange of property held for investment and then immediately liquidated pursuant to IRC section 333 and distributed the replacement property to its shareholder. Based on *Magneson,* the tax court held that the addition of another nontaxable transaction did not disqualify the exchange for non-recognition of gain under IRC section 1031.
- In *Field Service Advice* (FSA) 199951004 (1999), the Chief Counsel's Office of the IRS advised an agent that it considers *Magneson* to be controlling so that the IRS is no longer following its prior position that a prearranged transfer of replacement property means that a taxpayer no longer holds the property for investment.
- Likewise, in FSA 1999-485 (1993), the IRS acknowledged that after *Magneson* it had not been successful in arguing that property held for use in a trade or business did not qualify as "like-

kind" when such property was distributed from a partnership to its partner who then intended to exchange them with another taxpayer rather than holding them for use in a trade or business.

- In *Louis E. Marks v. Department of Revenue* TC-MD 050715D (July 24, 2007), the Oregon Tax Court rejected the same argument that respondent makes in this appeal relying on *Maloney* and affirming that *Magneson* remains good law despite the addition of IRC section 1031(a)(2)(D). (App. Second Reply Br., pp. 13-16.)

Appellants distinguish *M.H.S. Company*, which respondent relies upon, from the facts in this appeal by pointing out that in *M.H.S. Company* the condemnation proceeds were not paid directly to the sellers of the replacement real property, but instead, were invested in the joint-venture bank account and the joint-venture's bank account was used by the joint venture to pay for the real property. Appellants maintain that it was on that basis that the court held that the taxpayer did not qualify for non-recognition of gain under IRC section 1033. Appellants assert that the facts in this appeal show that GGA directly purchased an interest in the Scottsdale Property. Furthermore, appellants state that the court in *Magneson* also distinguished *M.H.S. Company* on the foregoing basis. Finally, appellants contend that the facts in *Sandoval*, which respondent also relies upon, are similar to the facts in *M.H.S. Company* and so that decision is distinguishable as well. (App. Second Reply Br., pp. 16-19.)

Appellants dismiss respondent's characterization of the replacement property as an LLC membership interest, i.e., intangible personal property, as irrelevant because GGA directly acquired like-kind replacement real property. Moreover, appellants contend that respondent's position ignores the *Magneson* decision in which the court held that a transaction such as the one at issue in this appeal did not disqualify a taxpayer from the non-recognition of gain under IRC section 1031. (App. Second Reply Br., pp. 20-21.) With respect to the step transaction doctrine, appellants contend that the test articulated by the court in *Magneson* is applicable. There, the court held that in order to apply the step transaction doctrine "it must be readily apparent that the transaction could have been achieved directly." According to appellants, as in *Magneson*, any alternative to the transaction in issue would have involved the same number of steps to achieve the same result so that, under the holding in *Magneson*, the step transaction doctrine should not be applied. (App. Second Reply Br., pp. 22-24.)

Appellants further assert that the U.S. Supreme Court and lower federal courts have held that a taxpayer has the legal right to structure business affairs in a manner most advantageous to the taxpayer and so long as the transaction has substance the government has no authority to restructure the transaction in a manner that increases the taxpayer's tax liability. (App. Second Reply Br., p. 5.)

Appellants state that they had a valid business reason for the structure of the transaction and, thus, the right to the beneficial tax treatment of acquiring a qualified replacement property, i.e., a tenant-in-common interest in the Scottsdale Property, and then transferring that interest to STP. Appellants reject respondent's argument that appellants' concession that the LLC and LP interests were not qualified replacement properties shows that the transaction at issue does not qualify. Appellants distinguish the Scottsdale Property transaction as an acquisition of a real property interest and subsequent exchange for a LLC interest – two distinct transactions without tax effect – rather than the acquisition of a legal entity ownership interest. (App. Second Reply Br., pp. 6-7.)

Request for Additional Briefing

In a letter dated October 28, 2009, the Appeals Division requested that the parties provide additional briefing to discuss the application of the step transaction doctrine with respect to the three alternative tests developed by case law, the timing of the subject transactions on the same day in light of specific gift tax cases, and whether the immediate transfer of the tenancy-in-common interest to STP and the Allianz requirement that the property be held by a single-member entity are sufficient to trigger the application of the step transaction doctrine.

Appellants' Additional Briefing

Appellants maintain that none of the three alternative tests is applicable and appellants' position is consistent with governing case law in which the courts have held that the step transaction doctrine is not applicable. Specifically, appellants assert that the courts have held that "the form of the transaction, and not the motivation of the taxpayer, must be followed because IRC section 1031 is mandatory, not elective and if there is an exchange of like-kind property, no gain or loss is recognized." (App. Add. Br., p. 2.) In support of their position, appellants cite *Alderson v. Commissioner* (9th Cir. 1963) 317 F.2d 790, where the court held that a transaction in which like-kind property was acquired by the buyer of the taxpayer's property for the sole purpose of immediately transferring it to the taxpayers in exchange for the relinquished property should be respected for income tax purposes. There, the court viewed the exchange of deeds between the parties as sufficient to meet the requirements of IRC section 1031. (App. Add. Br., pp. 2-3.)

Appellants cite *Magneson, supra,* and contend that the court rejected the IRS's argument that the step transaction doctrine was applicable under circumstances "virtually identical" to the facts presented here. Appellants note that the court specifically held that even if the step-transaction doctrine were applied, the transaction would still qualify under IRC section 1031(a). Appellants also cite *Maloney, supra,* in which the court held that an intermediate exchange of property to a corporation which then immediately liquidated and transferred the property in a non-taxable distribution to its sole shareholder did not disqualify the entire transaction under IRC section 1031(a). (App. Add. Br., pp. 3-4.)

Finally, appellants cite an "opinion of the Oregon Tax Court, Regular Division in *Louis E. Marks and Marie Y. Marks* (*Marks*)" in which the facts "are virtually the same" as the facts in *Magneson* and the facts presented in this appeal. Attached to appellants' additional brief is an Order Denying Defendants' Motion for Partial Summary Judgment in which the tax court concludes that "while [the] taxpayers are entitled to the benefit of the *Magneson* rationale", the factual record needs further development to determine whether the subject transaction meets the requirements of IRC section 1031(a). Appellants explain that in *Marks* the tax court held that the steps taken by the taxpayers "pursuant to a pre-existing plan or intent [to] contribute replacement property to a partnership" was permitted under IRC section 1031(a). Appellants argue that in both *Marks* and *Magneson* "the crucial question in a section 1031(a) analysis is continuity of investment in like-kind property" and that holding property in a partnership is a continuance of that investment. Thus, appellants submit that the Board will agree that, for purposes of IRC section 1031(a), GGA continued its investment in the subject property after contributing the property to STP. Appellants also make the same arguments, which they raise above, that *Magneson* remains good law despite the addition of IRC section 1031(a)(2)(D) and the change in state law regarding the control by partners of partnership property. (App. Add. Br., pp. 4-6.)

With respect to the gift tax cases referenced in the additional briefing request letter, appellants contend that those cases are irrelevant because they concern the federal transfer tax and not a like-kind exchange. Appellants repeat their contention that the only relevant cases presented are

Alderson, *Magneson*, and *Maloney*. Appellants further maintain that the step-transaction doctrine is not applicable because there was a valid business purpose for structuring the transaction as the parties did. Appellants cite *Frank Lyon Co. v. United States* (1978) 435 U.S. 561 for the proposition that the government should respect a transaction with economic substance which is not undertaken for the purpose of tax avoidance. Appellants maintain that the facts presented in this appeal show that GGA transferred the tenancy-in-common interest to STP because the terms of the loan agreement with Allianz required that the property be held by a single-asset entity. Thus, appellants contend that the transaction was motivated only by the valid business reasons of Allianz. Appellants cite *True v. U.S.* (10th Cir. 1999) 190 F.3d 1165, in which the court properly applied the step transaction doctrine and distinguishes the facts presented here on the basis that the steps taken by the taxpayers in that case were not dictated by a third party for valid business reasons but were instead taken by the taxpayers to achieve a favorable tax result. (App. Add. Br., pp. 7-10.)

In reply to respondent's additional briefing, appellants contend that the authorities relied on by respondent do not involve the acquisition of like-kind property whereas the cases involving the acquisition of like-kind properties support appellants' position. Appellants argue that the latter cases stand for the principle that IRC section 1031, as a mandatory section, must be applied according to its terms regardless of whether the exchange is transitory. Appellants further argue that the transitory nature of the exchange does not matter because the cases make clear that an intent to hold property carries over when the property is distributed from or contributed to a legal entity. (App. 2d Add. Br., pp. 1-2.)

Appellants contend that respondent mischaracterizes the *Magneson* court's holding by focusing on a portion of the decision that only buttressed the court's reason for not applying the step transaction doctrine. There, the court assumed *arguendo* that even if the transaction was viewed as a transfer of a fee interest for a partnership interest, it still qualified under IRC section 1031(a). Appellants also notes that the court discussed cases involving transfers of partnership interests to distinguish the facts in that case from the case relied upon by the IRS, *Estate of Meyer v. Commissioner* (9th Cir. 1974) 503 F.2d 556. Appellant further notes that in a footnote in *Magneson* the court characterized the amendment to IRC section 1031(a) as "aimed primarily at forbidding a tax-free exchange of 'burned-out' tax shelter partnership interests" and that in *Marks* the court held that IRC section 1031(a) excludes the "exchange of" partnership interests from like-kind exchange treatment but not the "exchange for" a partnership interest. Finally, appellants contend that the structuring of the transaction to satisfy the lender's requirements demonstrates that this was "a genuine multi-party transaction with economic substance that was compelled by business realities and that was imbued with tax-independent considerations". For that reason, appellants contend that the Board should honor "the allocation of rights and duties effectuated by the parties." (App. 2d Add. Br., pp. 2-5.)

<u>Respondent's Additional Briefing</u>

Respondent argues that the step transaction doctrine is applicable here under any of the tests. Respondent first distinguishes *Magneson, supra,* arguing that in that case the issue was the holding requirement under IRC section 1031(a) whereas in this appeal the issue is whether appellants obtained like-kind qualifying property. Additionally, respondent argues that *Magneson* limited the holding of that case to situations in which the taxpayer exchanges property for like-kind property with the intent of contributing the acquired property to a partnership for a general partnership interest. Respondent also repeats arguments made above regarding the state of California partnership law at the time *Magneson* was decided. Respondent also argues that the *Magneson* court "favorably acknowledged that the step transaction doctrine could be applicable in a series of transactions involving a like-kind exchange" by noting that "a transaction should be 'viewed as a whole' to determine the ultimate result of the transaction." Furthermore, respondent contends, allowing a taxpayer to rely on third-party lending conditions to excuse like-kind property requirements would effectively "remove statutory criteria and policy considerations from the Legislature." (Resp. Add. Br., pp. 5-7.)

As further evidence that the transaction does not qualify, respondent asserts that appellants would not be able to exchange their STP interests, which are intangible personal property, for real property pursuant to IRC section 1031. Respondent argues that the facts presented are the converse of that situation and, on that basis, the Board should determine that the subject transaction does not qualify under IRC section 1033. Respondent also contends that the district court's reasoning in *Heckerman v. U.S.,* 2009 U.S. District Lexis 65746, is applicable here. In *Heckerman,* the court held that a transfer of cash by the taxpayers to their "Investments LLC" and a transfer by gift of Family LLC units on the same day to their children's trusts was part of an integrated transaction intended to pass cash to their children in a tax advantaged form. In its analysis, the court determined that the transactions satisfied both the end result test because they were part of a pre-arranged plan and the interdependence test because the taxpayers took those steps solely for the tax benefit. Similarly, respondent contends that in these appeals GGA and STP had a pre-arranged plan to acquire the real property and immediately contribute it to STP. Respondent concludes that the three-step transaction doctrine tests apply to the transaction in issue here. (Resp. Add. Br., pp. 8-13.)

In response to the question posed in the letter requesting additional briefing, respondent asserts that application of the step transaction doctrine is appropriate when the steps occur on the same day. Respondent states that the step transaction doctrine focuses on the substance of the transaction rather than its form and is applicable to determine both the gift tax and income tax consequences of business transactions. Respondent notes that in *Linton v. U.S.* (2009) 638 F.Supp. 1277, the court distinguished two other recent cases in which the court held that the step transaction doctrine was not applicable because in those cases the passage of several days between steps may have been "indicative of a change in circumstances that gives independent significance" to the steps involved. However, respondent contends that the steps involved in these appeals occurred on the same day and had no independent significance and, thus, the step transaction doctrine applies. (Resp. Add. Br., pp. 14-16.)

Respondent also contends that the conditions of the loan from Allianz are sufficient to invoke the application of the step transaction doctrine. Because the lender required the property to be held in a single-asset entity, respondent argues that all three tests were satisfied because the parties agreed that the property interest would be held (except for a brief period as a tenancy in common) by STP. Respondent cites three Board formal decisions (*Appeal of Gustav S. and Stell Gossick*, 65-SBE-008, April 5, 1965; *Appeal of Western Icee Corp.*, 80-SBE-001, January 8, 1980; *Appeal of Chris-Craft Industries, Inc.*, 68-SBE-011, March 26, 1968) holding that the test for determining the applicability of the step transaction doctrine is whether the series of steps is so interdependent that the legal relations created by one transaction would have been fruitless without the completion of the series. In that regard, respondent notes that GGA and the other members of STP had a prearranged plan by which GGA was compelled to contribute its tenancy in common interest to STP. Thus, respondent contends that the entire series of steps must be viewed a single transaction. (Resp. Add. Br., pp. 17-18.)

Respondent argues that these appeals are distinguishable from *Marks, supra,* because here the Board is called upon to decide whether the replacement property is like-kind whereas in *Marks, supra*, the court considered whether the taxpayers were holding the property as an investment. Respondent also contends that, contrary to appellants' contention, the holding in *Marks, supra,* does not indicate that the amendment to IRC section 1031(a)(2)(D) had no effect on the *Magneson* decision because in *Marks, supra,* the court failed to address the issue of how an exchange of real property for a partnership interest would meet the like-kind test. Respondent cites *Sandoval* which respondent argues is more on point and holds that an exchange of a fee interest in real property for a partnership interest does not qualify as a like-kind exchange. (Resp. Add. Br., pp. 18-19.)

Applicable Law

Federal Provisions

IRC section 1033, which is incorporated by Revenue and Taxation Code section 18301, provides in relevant part that when property is compulsorily or involuntarily converted into money (for example, as a result of the exercise of eminent domain) and the taxpayer replaces the converted property by purchasing "other property similar or related in service or use to the property so converted, or purchases stock in the acquisition of control of a corporation owning such other property" within a specified period, then, at the taxpayer's election, any gain shall be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

The regulation that interprets and implements IRC section 1033 with respect to property taken by eminent domain, Treasury Regulation (Regulation) 1.1033-1(g)(1) (26 C.F.R. § 1.1033-1(g)(1)), follows Regulation 1.1031(a)-1 for purposes of determining whether replacement property is property of like-kind to the converted property. Subdivision (b) of Regulation 1.1031(a)-1(b) provides that like-kind refers "to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class".

Magneson v. Commissioner

In *Magneson, supra,* the court of appeal held that the taxpayer must intend to hold the property for investment at the time the exchange is consummated in order to qualify for non-recognition under IRC section 1031. (*Id.* at p. 1493.) In that case, the taxpayers had a prearranged plan to transfer their fee interest in real property in exchange for a tenancy-in-common interest in the qualifying replacement property. Thereafter, on that same day, the taxpayers and the other tenant-in-common transferred their real property interests to a limited partnership. In exchange for the property interest and cash, the taxpayers became a general partner with a ten percent equity interest and a nine percent interest in net profits and losses. The court concluded that the exchange qualified for non-recognition of gain because the taxpayers continued to hold the property for investment "albeit in a different form of ownership." (*Id.* at p. 1492.)

The *Magneson* court rejected an IRS revenue ruling in which the gain from an exchange involving qualified replacement property that was thereafter transferred to a controlled corporation in exchange for stock did not qualify for non-recognition treatment. In rejecting the applicability of that revenue ruling, the court distinguished the transfer of a real property interest to a corporation from a transfer to a partnership by first noting that a corporation is a "distinct entity, apart from its shareholders, whereas a partnership is an association of its partner-investors." In that respect, shareholders have no ownership interest in the corporation's assets and have no control over the daily management of the corporation. Thus, a taxpayer who transfers real property to a corporation relinquishes ownership and control while a taxpayer who transfers to a partnership in exchange for a general partner's interest retains both ownership and control. Secondly, the court observed that a non-taxable transfer to a corporation under IRC section 351 results in an exchange of property for stock which is not eligible for non-recognition under IRC section 1031. However, the court noted, there is no such prohibition on an exchange for partnership interests. (*Id.* at p. 1493.)

With respect to the purpose behind IRC sections 721 and 1031, the court cited case law, Treasury Regulations, and legislative history to support its view that the basic reason for non-recognition of gain or loss on transfers of property under those sections is that the taxpayer's economic situation after the transfer is fundamentally the same before the transfer. Applying this principle to the facts before it, the court found that that the taxpayers had simply changed their form of ownership from a tenancy-in-common to a partnership through which they still own the real property, and they had not taken cash or other non like-kind property out of the transaction. (*Id.* at p. 1494.)

In its analysis of continuing ownership, the court held that California state law controls in the determination of the taxpayers' legal interest in the property. The court cited former Corporations Code section 15025 which provided that a partner is a co-owner with the other partners as a tenant in partnership of specific partnership property and that "a general partner has the right to possess partnership property for the purposes of the partnership", although a general partner is not vested with title. (Corp. Code, § 15025(2)(a).) Unlike a tenancy-in-common interest, the court acknowledged that a partner's interest in partnership property is not assignable without concurrent assignment by all other partners, is not subject to attachment (except for partnership debt) and is not subject to marital property rights. (Corp. Code, § 15025(2)(b), (c) & (e).) (*Id.* at p. 1495.) However, the court dismissed as irrelevant the fact that the taxpayers, as partners, did not have a right of alienation in the property "[b]ecause the whole premise of section 1031(a) is that the taxpayer's intent is *not to alienate* the property." The court held that even those "significant distinctions" are not controlling in determining the "held for investment" issue because the taxpayers, as partners, continued to own an interest in the property with the right to possess and control the property. (*Id.* at pp. 1495 -1496.)

<u>M.H.S. Company v. Commissioner</u>

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

<u>Sandoval v. Commissioner</u>

In *Sandoval,* the taxpayers sold real property under threat of condemnation and contended that they first purchased qualifying replacement real property and later created joint ventures to manage the real property. Contrary to the characterization of the transaction by the taxpayers in *Sandoval,* the court found that the taxpayers first formed the joint ventures, the joint ventures acquired the real property interests and the taxpayers acquired interests in the joint ventures rather than real property interests. Therefore, the court held that the exchange did not qualify for purposes of IRC section 1033.

Member's Interest in LLC Property

Under Arizona law, "[u]nless the articles of organization provide that management of the limited liability company is vested in one or more managers, management of the limited liability company is vested in the members, subject to any provision in an operating agreement restricting or enlarging the management rights or responsibilities of one or more members or classes of members. (Az. Rev. Stats., § 29-681.) Real property and personal property owned or purchased by a limited liability company may be held, owned and conveyed in the name of the limited liability company. (Az. Rev. Stats., § 29-653, para. A.) An interest in a limited liability company is personal property and, except as provided in an operating agreement or article 11 of this chapter, may be assigned in whole or in part. (Az. Rev. Stats., § 29-732, para. A.)

Current Partnership Statutes

Under California law, Corporations Code section 16501 provides that "[a] partner is not a co-owner of partnership property and has no interest in partnership property that can be transferred, either voluntarily or involuntarily." Corporations Code section 16401, subdivision (f) provides that "[e]ach partner has equal rights in the management and conduct of the partnership business." Subdivision (g) of that section provides that "[a] partner may use or possess partnership property only on behalf of the partnership."

Corporations Code section 16502 provides that "[t]he only transferable interest of a partner in the partnership is the partner's share of the profits and losses of the partnership and the partner's right to receive distributions. The interest is personal property." The Arizona statutory provisions are identical. (Ariz. Rev. Stat. §§ 29-1031, 29-1041 and 29-1042 (2009).)

Sham Transaction and Step Transaction Doctrines

The "sham transaction" doctrine allows the taxing agency to disregard transactions that lack economic substance beyond the creation of tax benefits. (*United States v. Consumer Life Ins. Co*. (1977) 430 U.S. 725, 737; *Gregory v. Helvering* (1935) 293 U.S. 465, 470; *Knetsch v. United States* (1960) 364 U.S. 361, 365.) A taxpayer must show that the transaction:

> "… was not motivated or shaped solely by tax avoidance features that have meaningless labels attached, [but instead] is compelled or encouraged by business or regulatory realities, and has economic substance independent of the apparent tax shelter potential." (*Anagnostom v. Commissioner*, T.C. Memo 94-334, citing *Frank Lyon Co. v. United States* (1978) 435 U.S. 561.)

In *Rice's Toyota World, Inc. v. Commissioner* (1983) 81 T.C. 184 (rev'd in part by 752 F.2d 89), the Tax Court stated that there must be a threshold level of economic substance or a non-tax business purpose.

In the *Appeal of James A. Alyn and Lisa E. Alyn* (2009-SBE-001), decided May 27, 2009, the Board followed the approach of the Ninth Circuit Court of Appeals in *Casebeer v. Commissioner* (9th Cir. 1990) 909 F.2d 1360 ("*Casebeer*"), deciding whether a so-called "Son of Boss" tax shelter[7] transaction met the requirements of the sham transaction doctrine. In *Casebeer*, the Ninth Circuit upheld the tax court's determination that certain "sale-and-leaseback" transactions were sham transactions based on consideration of the taxpayer's subjective business motivation and the objective economic substance of the transactions.

The "step transaction doctrine" has been applied to determine whether the transaction should be treated as a whole or whether each step of the transaction may stand alone. The "step transaction doctrine" is a corollary of the general tax principle that the incidence of taxation depends upon the substance of a transaction rather than its form. (*Comm'r v. Court Holding Co.* (1945) 324 U.S. 331.) The application of the doctrine involves a determination that

> "… interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus 'linking together all interdependent steps with legal or business significance, rather than taking them in isolation,' federal tax liability may be based 'on a realistic view of the entire transaction.'" (*Commissioner v. Clark* (1989) 489 U.S. 726, 738, quoting 1 B. Bittker, Federal Taxation of Income, Estates and Gifts, ¶ 4.3.5, p. 4-52 (1981).)

The idea of disregarding transactions that lack economic substance, as embodied by the "sham transaction" and "step transaction" doctrines, is balanced by the right of taxpayers to structure transactions to legally avoid taxes. The United States Supreme Court has held:

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law

[7] A Son of Boss transaction is a variation of an older tax shelter called BOSS which is an acronym for a "bonds and options sales strategy."

> permits, cannot be doubted." (*Gregory v. Helvering, supra*, 293 U.S. at p. 469.)

Likewise, the Sixth Circuit has stated that taxpayers may structure their transactions as they wish:

> "In determining whether a valid, non-tax business purpose partially motivated a transaction, courts should examine all the facts and circumstances**.** . . . Therefore, a shareholder may use [IRC section 351] so long as some valid, non-tax business purpose partially motivated the transfer, even if tax concerns also played a major role." (*Estate of Kluener v. Commissioner* (6th Cir. 1998) 154 F.3d 630, 634.)

Courts have generally used one of three alternative tests in applying the step transaction doctrine: (i) the binding commitment test; (ii) the end result test; and (iii) the interdependence test. As the court explained in *Linton, supra*, he binding commitment test collapses a series of transactions into one "if, at the time the first step is entered into, there was a binding commitment to undertake the later step." The end result test focuses on whether the "series of formally separate steps are really pre-arranged parts of a single transaction intended from the outset to reach the ultimate result." The interdependence test inquires whether, "on a reasonable interpretation of objective facts," the steps were "so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series" of transactions. The question is whether "any one step would have been undertaken except in contemplation of the other integrating acts." (*Linton, supra* at p. 1288.)

<u>Linton v. U.S.</u>

In *Linton, supra*, the taxpayers contributed assets to a limited liability company (LLC) and thereafter transferred LLC interests by gift to their children's trusts. The court held that the transaction satisfied all three of the step transaction tests. The binding commitment test was met because the taxpayers executed binding trust agreements and gift documents at the same time they took the first step of contributing assets to the LLC. The end result test was met because the taxpayers had a subjective intent to convey as much property as possible to their children while minimizing their gift tax liability, and thus designed a scheme consisting of "pre-arranged parts of a single transaction." The interdependence test was met because the taxpayers would not have undertaken one or more of the steps absent their "contemplation of the other integrating acts". In that regard, the court found that the taxpayers would not have contributed assets to the LLC if the transfer of the LLC interests would not have resulted in an anticipated 40% to 49% discount in gift taxes.

STAFF COMMENTS

The *Magneson* decision turned on whether the taxpayers "held" qualified replacement property for productive use in a trade or business or for investment within the meaning of IRC section 1031(a) after they had transferred their interest in the property in exchange for a general partner's interest. The court held that, in the application of federal tax statutes, state law controls in determining the nature of the legal interest the taxpayer holds in the property sought to be taxed. On that basis, the court made a finding that the taxpayers in *Magneson* had "simply changed their form of ownership", pursuant to the existing state statute, Corporations Code section 15205, which described a partner as a co-owner with the other partners "as a tenant in partnership" of specific partnership property. In addition, the court distinguished the ownership interest of a partner in real property contributed to a partnership from that of a shareholder who, the court held, did not have a continuing ownership interest in real property contributed to a corporation. (*Magneson, supra* at p.1493.)

The *Magneson* court also held that even if the transaction is viewed as an exchange of a real property interest for a partnership interest for purposes of applying the step transaction doctrine, the transaction would still qualify under IRC section 1031(a) because a fee owner and a general partner have "very similar" rights of management and control in property. Thus, the court concluded that the taxpayers, as general partners, were "the managers of their investment" just as they were when they owned a fee simple interest in the exchanged real property. Under current Arizona law, however, a partner is not a co-owner of partnership property unlike the taxpayers in *Magneson*.

At the hearing, the parties should be prepared to discuss the extent to which the *Magneson* court relied on the specific "co-owner" language in former Corporations Code section 15205 as the basis for its decision and whether under the current Arizona statutes a member of an LLC has comparable rights of ownership and control in property owned by the LLC.

In its discussion concerning application of the step transaction doctrine, the *Magneson* court held that the acquisition of a partnership interest in a partnership that owns qualified replacement property, rather than a direct interest in the replacement property, qualifies under IRC section 1031(a). At the hearing, the parties should be prepared to discuss the effect of this aspect of the *Magneson* decision on the application of the step transaction doctrine here.

In the staff's view, if the Board holds that *Magneson* is inapposite because current Arizona law does not provide that a member of an LLC is a "co-owner" of LLC property in the same manner as a partner under former Corporations Code section 15205, then the Board should decide the issue of whether it is appropriate to apply the step transaction doctrine here. In that regard, while recognizing that appellants were free to structure their transaction as they wished, in order to avoid application of the step transaction doctrine, appellants must show that the transaction was motivated by business or regulatory realities rather than solely for the purpose of tax avoidance. At the hearing, parties should be prepared to discuss whether the steps in this transaction were interrelated in such a manner that each step may not be considered independently of the overall transaction.

///

///

///

AriesDiamond_la