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10 **BOARD OF EQUALIZATION**
 11 **STATE OF CALIFORNIA**

12 In the Matter of the Consolidated Appeal of:) **HEARING SUMMARY**
 13) **PERSONAL INCOME TAX APPEAL**
 14) **DONALD R. DIAMOND AND**) Case No. 441030
 15) **JOAN B. DIAMOND**)
 16) **FRANK A. ARIES AND**) Case No. 464475
 17) **MARY LOU ARIES¹**)

18 Appellants' Diamond
 19 Proposed
 20 Assessment
 21 1999 \$199,804

22 Appellants' Aries
 23 Claim for Refund
 24 1999 \$154,047²

25 Representing the Parties:

26 For Appellants: Steven W. Phillips

27 ¹ Appellants reside in Tucson, Arizona.

28 ² 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.

Donald R. Diamond and Joan B. Diamond
Frank A. Aries and Mary Lou Aries

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1 For Franchise Tax Board:

Valerie G. Leclerc, Tax Counsel III
Renel Sapiandante, Tax Counsel III

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

7 HEARING SUMMARY

8 Background

9 Appellants Donald Diamond and Joan Diamond (Diamonds) and appellant Frank Aries³
10 formed Golden Gate Apartments (GGA), a limited partnership, in 1978 for the purpose of owning and
11 operating the Golden Gate Apartments (Apartments) located in San Francisco. The Diamonds held a 49
12 percent limited partner interest in GGA and Frank Aries held a 50 percent limited partner interest and a
13 1 percent general partner interest. In 1998, the City and County of San Francisco (City) notified GGA
14 that City was exercising its powers of eminent domain to convert the Apartments to a public use. On
15 December 1, 1998, GGA agreed to sell the Apartments to City for \$6,772,500 under threat of eminent
16 domain. (Resp. Op. Br. (Diamond), p. 1.)

17 On its 1999 federal partnership return (Form 1065), GGA elected to defer \$5,686,845 of
18 capital gain realized on the sale of the Apartments under IRC section 1033(a)(2) and Treasury
19 Regulations section 1.1033(a)-2(c). Between 1999 and 2002, GGA acquired as replacement properties:
20 150 acres of vacant land, membership interests in six limited liability companies, an interest in a limited
21 partnership and an interest in rental real property located in Scottsdale, Arizona (Scottsdale Property).
22 The total cost of the replacement properties was reported as \$7,912,508. (Resp. Op.Br. (Aries), p. 4.)

23 The Scottsdale Property was jointly purchased by GGA, appellants, Stratford American
24 Corp., DRD-97 Trust, and Auriga Properties, Inc. Immediately after the purchase transaction, the
25 parties contributed the Scottsdale Property to Scottsdale Thompson Peak, LLC (STP), a newly formed
26 Arizona LLC. STP is a single-asset LLC which was engaged in the business of owning, leasing,
27

28 ³ Frank Aries is a partner of GGA and filed the 1999 return as married filing jointly with his spouse, appellant Mary Lou Aries.

1 operating and maintaining the Scottsdale Property. In exchange for its interest in the property, GGA
2 received a 13 percent membership interest in STP. (Resp. Op. Br. (Diamond), p.2.)

3 On its 2002 California Partnership Return (Form 565), GGA reported the acquisition of
4 various replacement properties for purposes of qualifying for the deferral of taxation on its gain. During
5 an audit of GGA's 1999 taxable year, respondent determined that the Apartments had been sold under
6 threat of eminent domain as required by IRC section 1033. With respect to the properties other than the
7 Scottsdale Property, respondent determined that the 150 acres of vacant land qualified as a replacement
8 property under section 1033 but that the LLC and LP interests failed to qualify pursuant to subdivision
9 (a)(2) of IRC section 1031, which excludes an exchange of partnership interests from gain non-
10 recognition and the LLCs elected to be treated as partnerships. Thus, respondent determined that the
11 LLC and LP interests were not either "like-kind" to the property taken, i.e., the Apartments. Respondent
12 also determined that the LLC and LP interests did not qualify as "similar" properties because those
13 interests are intangible personal property, rather than real property interests. (Resp. Op. Br. (Aries), pp.
14 4-5.)

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

22 Respondent issued a Notice of Proposed Assessment (NPA) to appellants Diamond and
23 an NPA to appellants Aries on October 7, 2004. Appellants filed timely protests of the NPAs
24 contending that the acquisition of the LLC and LP interests and the interest in the Scottsdale Property
25 qualified as replacement properties under IRC section 1033. After considering appellants' protests,
26 respondent affirmed each NPA in a Notice of Action (NOA) dated January 2, 2008. The Diamonds
27 timely appealed the NOA. (Resp. Op. Br. (Diamond), p. 3.) The Aries paid the assessment and filed a
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Donald R. Diamond and Joan B. Diamond
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decision or opinion.

1 claim for refund for the entire amount⁴ which respondent denied. The Aries timely appealed
2 respondent's denial. (Resp. Op. Br. (Aries), p.6.)

3 Contentions

4 Appellants' Contentions⁵

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

15 Appellants further contend that *Magneson* has been cited with approval by the U.S. Tax
16 Court and the Ninth Circuit Court of Appeal and has been followed by the IRS and by state courts. In
17 addition, appellants maintain that the *Magneson* court's decision was based on its finding that the
18 taxpayer had met the "holding" requirement of IRC section 1031(a), because the taxpayer continued to
19 hold real property for investment or use in a trade or business. Appellants assert that, even though the
20 *Magneson* court referred to the application of the step transaction doctrine in dicta, the court did not base
21 its decision on that doctrine and thus the change to IRC section 1031 by the Deficit Reduction Act of
22 1984 did not legislatively overrule that decision. As support, appellants cite an Oregon Tax Court case,
23 *Louis E. Marks v. Department of Revenue* TC-MD 050715D (July 24, 2007), in which the court rejected
24

25 _____
26 ⁴ On appeal, the Aries have conceded that the LLC and LP interests did not qualify as replacement properties; the Diamonds
27 state that they are not appealing the Franchise Tax Board's proposed assessment with respect to the seven limited liability
28 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.

⁵ 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.

1 the argument that *Magneson* was effectively overruled by the amendment to IRC section 1031 made by
2 the Deficit Reduction Act of 1984. Appellants further assert that Congress has a long-held policy of
3 specifically identifying a case when it passes legislation that is intended to overrule that case. (App. Op.
4 Br., pp. 6-8.)

5 Respondent's Contentions

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

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

20 Respondent notes that generally a limited partner has no right to engage in the
21 partnership's business, which is consistent with California partnership law. Thus, respondent concludes
22 that STP's operating agreement transformed GGA's interest in the Scottsdale Property by delegating
23 day-to-day management of the Scottsdale Property to STP's manager. (Resp. Op. Br. (Diamond), p. 6.)
24 Respondent asserts that under California law an LLC member does not hold a direct ownership interest
25 in the LLC's assets and that under Arizona law property acquired by a partnership is owned by the
26 partnership and not by the individual partners. (Resp. Op. Br. (Aries), pp. 11-13.) By contributing the
27 Scottsdale Property interest to STP, respondent concludes that appellants through GGA altered their
28 "core rights of property ownership" and never had the benefit of these rights because they were

1 obligated to contribute the property to STP from its initial acquisition. Furthermore, respondent
2 concludes that GGA's withdrawal from STP would require the sale of the STP interest which is properly
3 classified as intangible personal property. (Resp. Op. Br. (Aries), p. 19.)

4 Respondent further states that *Magneson* is based on California Corporation Code section
5 15025 which was repealed and replaced by Corporations Code section 16501, effective January 1, 1999.
6 Respondent explains that former section 15025 provided that a partner was a co-owner of partnership
7 property as a tenant in partnership while section 16051 provides expressly that a partner is not a co-
8 owner of partnership property. Thus, respondent concludes that the *Magneson* holding has no
9 application and provides no support for appellants' position. Finally, respondent quotes language from
10 the *Magneson* decision limiting the holding to situations in which a taxpayer acquires like-kind property
11 "with the intent of contributing the acquired property to a partnership for a general partnership interest."
12 (Resp. Op. Br., pp. 17-18.) Respondent also contends that the *Marks* case may not be relied upon
13 because it was decided before the change in California law as well. (Resp. Op. Br., p. 20.)

14 Respondent contends that the transaction does not meet the requirements of IRC section
15 1033(a)(2)(A) because GGA did not purchase "similar property". That is, appellants owned the
16 replacement property through GGA's limited partner interest which the IRS has ruled does not qualify
17 for non-recognition treatment. (Resp. Op. Br. (Diamond), pp. 6-7.) Respondent further contends that a
18 membership interest in an LLC taxable as a partnership is intangible personal property, rather than real
19 property. Under the applicable Treasury Regulation, respondent asserts that exchanged property of a
20 different character, i.e., personal property, is not "like-kind" replacement property. Respondent notes
21 that the rules set forth in the applicable Treasury Regulations are evidence that a fundamental distinction
22 exists between real property and personal property. Respondent also cites *M.H.S. Company, Inc. v.*
23 *Commissioner* (1976) T.C. Memo 1976-165, aff'd 575 F.2d 1177, 1178 (6th Cir. 1978) (*M.H.S.*
24 *Company*) in which, respondent contends, the federal court held that an exchange of real property for an
25 interest in a joint venture which owned an otherwise qualifying replacement property did not qualify for
26 non-recognition treatment under IRC section 1033. Respondent asserts that the court concluded that the
27 partnership interest was not "like-kind" property within the meaning of IRC section 1033. (Resp. Op.
28 Br. (Aries), pp. 8-9.) Respondent notes that *Magneson* distinguished *M.H.S. Company* as involving

1 application of IRC section 1033 (rather than IRC section 1031 as in *Magneson*) so that *M.H.S. Company*
2 has not been affected by changes in California or Arizona law, changes in the IRC or the holding in
3 *Magneson*. (Resp. Op. Br. (Aries), pp. 20-21.)

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

11 In addition, with respect to appellants' intention to transfer the Scottsdale Property
12 interest to STP, respondent cites *Sandoval v. Commissioner* (2000) T.C. Memo 2000-189 (*Sandoval*) in
13 which the tax court found that a group of taxpayers had agreed prior to the purchase of a replacement
14 property to contribute the property to a partnership for partnership business purposes. As a result, the
15 court held that the taxpayers did not acquire qualifying replacement property for purposes of IRC
16 section 1033. The court also held that partnership property is owned by the partnership regardless of
17 whether the property is held in the name of the partnership or in the name of one or more partners.
18 Respondent also points out that in *Sandoval* the taxpayers had purchased the property and formed the
19 partnership on the same date. Respondent concludes that *Sandoval* stands for the proposition that an
20 exchange will not qualify for non-recognition even if the replacement real property is acquired first,
21 when there was a prior agreement to transfer the property to a partnership. (Resp. Op. Br. (Aries), pp.
22 15-17.)

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

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1 Appellants' Contentions on Reply

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

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

- 16 • In *Maloney v. Commissioner* (1989) 93 T.C. 89 (*Maloney*), a corporation completed an IRC
17 section 1031 exchange of property held for investment and then immediately liquidated pursuant
18 to IRC section 333 and distributed the replacement property to its shareholder. Based on
19 *Magneson*, the tax court held that the addition of another nontaxable transaction did not
20 disqualify the exchange for non-recognition of gain under IRC section 1031.
- 21 • In *Field Service Advice* (FSA) 199951004 (1999) the Chief Counsel’s Office of the IRS advised
22 an agent that it considers *Magneson* to be controlling so that the IRS is no longer following its
23 prior position that a prearranged transfer of replacement property means that a taxpayer no
24 longer holds the property for investment.
- 25 • Likewise, in FSA 1999-485 (1993) the IRS acknowledged that after *Magneson* it had not been
26 successful in arguing that property held for use in a trade or business did not qualify as “like-
27 kind” when such property was distributed from a partnership to its partner who then intended to
28 exchange them with another taxpayer rather than holding them for use in a trade or business.

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

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

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

26 Appellants further assert that the U.S. Supreme Court and lower federal courts have held
27 that a taxpayer has the legal right to structure business affairs in a manner most advantageous to the
28 taxpayer and so long as the transaction has substance the government has no authority to restructure the

1 transaction in a manner that increases the taxpayer's tax liability. (App. Second Reply Br., p. 5.)

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

10 Applicable Law

11 Federal Provisions

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

19 The regulation that interprets and implements IRC section 1033 with respect to property
20 taken by eminent domain, Treasury Regulation (Regulation) 1.1033-1(g)(1) (26 C.F.R. § 1.1033-
21 1(g)(1)), follows Regulation 1.1031(a)-1 for purposes of determining whether replacement property is
22 property of like-kind to the converted property. Subdivision (b) of Regulation 1.1031(a)-1(b) provides
23 that like-kind refers "to the nature or character of the property and not to its grade or quality. One kind
24 or class of property may not, under that section, be exchanged for property of a different kind or class".

25 Magneson v. Commissioner

26 In *Magneson, supra* the court of appeal held that the taxpayer must intend to hold the
27 property for investment at the time the exchange is consummated in order to qualify for non-recognition
28 under IRC section 1031. (*Id.* at 1493.) In that case, the taxpayers had a prearranged plan to transfer

1 their fee interest in real property in exchange for a tenancy-in-common interest in the qualifying
2 replacement property. Thereafter, on that same day, the taxpayers and the other tenant-in-common
3 transferred their real property interests to a limited partnership. In exchange for the property interest and
4 cash, the taxpayers became a general partner with a ten percent equity interest and a nine percent interest
5 in net profits and losses. The court concluded that the exchange qualified for non-recognition of gain
6 because the taxpayers continued to hold the property for investment “albeit in a different form of
7 ownership.” (*Id.* at 1492.)

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

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

28 In its analysis of continuing ownership, the court held that California state law controls in

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

14 M.H.S. Company v. Commissioner

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

22 Sandoval v. Commissioner

23 In *Sandoval*, the taxpayers sold real property under threat of condemnation and
24 contended that they purchased qualifying replacement real property and later created joint ventures to
25 manage the real property. Contrary to the taxpayers' characterization of the transaction, the court found
26 that the taxpayers first formed partnerships and that the partnerships acquired real property interests.
27 Because the taxpayers acquired partnership interests, rather than real property interests, the court held
28 that the exchange did not qualify for purposes of IRC section 1033.

1 Member’s Interest in LLC Property

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

11 Current Partnership Statutes

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

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

21 Sham Transaction and Step Transaction Doctrines

22 The “sham transaction” doctrine allows the taxing agency to disregard transactions that
23 lack economic substance beyond the creation of tax benefits. (*United States v. Consumer Life Ins. Co.*
24 (1977) 430 U.S. 725, 737; *Gregory v. Helvering* (1935) 293 U.S. 465, 470; *Knetsch v. United States*
25 (1960) 364 U.S. 361, 365.) A taxpayer must show that the transaction:

26 “. . . was not motivated or shaped solely by tax avoidance features that
27 have meaningless labels attached, [but instead] is compelled or
28 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.)

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

3 Similarly, the “step transaction doctrine” has been applied to determine whether the
4 transaction should be treated as a whole or whether each step of the transaction may stand alone. The
5 “step transaction doctrine” is a corollary of the general tax principle that the incidence of taxation
6 depends upon the substance of a transaction rather than its form. (*Comm’r v. Court Holding Co.* (1945)
7 324 U.S. 331.) The application of the doctrine involves a determination that

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

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

18 “The legal right of a taxpayer to decrease the amount of what otherwise
19 would be his taxes, or altogether avoid them, by means which the law
20 permits, cannot be doubted.” (*Gregory v. Helvering, supra*, 293 U.S. at p.
21 469.)

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

23 “. . . so long as some valid, non-tax business purpose partially motivated
24 the transfer, even if tax concerns also played a major role.” (*Estate of*
25 *Kluener v. Commissioner* (6th Cir. 1998) 154 F.3d 630.)

26 Staff Comments

27 The *Magneson* decision turned on whether the taxpayers “held” qualified replacement
28 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

1 co-owner with the other partners “as a tenant in partnership” of specific partnership property. In
2 addition, the court distinguished the ownership interest of a partner in real property contributed to a
3 partnership from that of a shareholder who, the court held, did not have a continuing ownership interest
4 in real property contributed to a corporation. (*Magneson, supra* at 1493.)

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

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

16 In its application of the step transaction doctrine, the *Magneson* court suggests that the
17 acquisition of a partnership interest in a partnership that owns qualified replacement property, rather
18 than a direct interest in the replacement property, qualifies under IRC section 1031(a). Thus, the court
19 indicates that *M.H.S. Company* and *Sandoval*, cases in which the tax court found that the taxpayers
20 acquired partnership interests, rather than fee interests in real property, were wrongly decided.

21 At the hearing, the parties should be prepared to discuss the effect of the *Magneson*
22 court’s holding on the application of the step transaction doctrine.

23 In the staff’s view, if the Board holds that *Magneson* is inapposite because current
24 Arizona law does not provide that a member of an LLC is a “co-owner” of LLC property in the same
25 manner as a partner under former Corporations Code section 15205, then the Board should decide the
26 issue of whether it is appropriate to apply the step transaction doctrine here. Therefore, the parties

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1 should be prepared at the hearing to discuss the step transaction doctrine and its applicability to these
2 facts.

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