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SHOP TALK

To Drop or Not to Drop? California Creates a Conundrum

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@katten.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

It's been almost 100 years since Congress approved non-recognition treatment for so-called like-kind exchanges of qualifying property, but unanswered questions remain as to qualification for its benefits. Section 1031(a)(1) is deceptively simple: no gain or loss is recognized on the exchange of specified property held for productive use in a trade or business or for investment if the property received is of a like kind and is held either for productive use in a trade or business or for investment. But neither the Congress of 1921 nor the Congress of 2020 has addressed the question of qualification of Drop and Swap exchanges, and for decades taxpayers and their representatives have been gingerly tiptoeing through the potentially applicable tax law (and lore). A degree of certainty exists starting the day the statute of limitations expires; before that, as Borat would say, "ehh, not so much."

Our well-respected colleague and like-kind exchange legend Lou Weller, of Weller Partners LLP, Sausalito, California, a fellow member of the Editorial Board of the JOURNAL OF TAXATION, most recently contributed to *Shop Talk* his insight and helpful comments in connection with a potential indirect attack by California's state taxing agency, the Franchise Tax Board (FTB), on Drop and Swap exchanges (and Swap and Drop exchanges, which are another animal altogether and beyond the scope of this article). See Shop Talk, "FTB Attempts to Use Qualified Intermediaries to Enforce its View of the Law," 131 JTAX 36 (December 2019). Lou has been scrupulously reading the tea leaves on like-kind exchanges for many years. Lou is particularly fond of California tea, and graciously reports to our readers on a mixed bag of leaves-in the form of two recent California cases having conflicting results; but can they be reconciled? Lou writes:

"As most readers know, Section 1031 requires that an entity taxpayer that sells real property and wants to convert the sale into a like-kind exchange must itself complete the exchange by acquiring replacement property. Where the seller is a partnership (or is treated as one for income tax purposes), one of the most common scenarios presented to tax planners is the desire of partners to separate following a sale

rather than stay together and have the selling entity itself complete the exchange. To facilitate this, a technique referred to as 'Drop and Swap' is often suggested, involving a pre-sale distribution of undivided tenancy-in-common interests in property by a partnership to some or all of its partners, allowing each recipient partner (now a tenant-in-common) to separately exchange or sell its fractional interest.

The following discussion addresses recent state-level consideration of Drop and Swap transactions where inconsistent results were reached by different panels of judges from California's Office of Tax Appeals (OTA). But before describing the cases and their OTA outcomes, a brief introduction to tax issues raised by the Drop and Swap transaction is in order.

Drop and Swap transactions have become common and most tax practitioners would agree that they will successfully allow taxpayers to separately pursue sale or exchange treatment on sale of former partnership property if the taxpayers (1) cause the Drop to occur before the property is listed for sale, and (2) make certain that all of the formalities of the Drop are followed, i.e., there is an actual conveyance, any transfer taxes are paid, lenders are informed and an appropriate tenancy-in-common agreement is entered into by the parties (again with all of these steps being taken before the property is listed for sale).

Unfortunately, this kind of careful advance planning is the exception rather than the norm. Typically, negotiation of the sale has occurred before the partners decide that some but not all want exchange treatment and attempt the Drop into tenant-in-common ownership. In these cases, the key question is

whether the sale is attributable to the partnership under the assignment of income theory represented by the venerable Supreme Court opinion in *Court Holding v. Commissioner*, 33 AFTR 593, 324 U.S. 331 (1945). The creation of the tenancy-in-common relationship among former partners also gives rise to the questions of whether the partnership has really divested itself of ownership or whether a new partnership has been created among the tenants-in-common. In addition, from a Section 1031 perspective, the question arises whether the new co-owners hold their interests for the required 'trade or business or investment purposes' if at the time of receipt they have already formed a plan to sell the interests.

Statistics have consistently indicated that more like-kind exchanges involve California property or California taxpayers than are associated with any other state. While the issues described above apply to all Drop and Swap transactions, nowhere are they under more intense scrutiny than in California. California tax filings are made pursuant to a separate California income tax regime, which does not always follow the Internal Revenue Code. California has one of the highest marginal state tax rates in the nation and there is no state preferential rate for capital gains, so state tax due on recognized capital gains is generally at least 50% of the applicable federal tax. For a number of years, FTB has made review of like-kind exchanges a focus of audit activity, and while no reliable statistics are available, it seems clear from practitioners that the incidence of audits of like-kind exchanges, particularly Drop and Swap transactions, is far higher in California than in any other state or by the Internal Revenue Service.

FTB also feels free to assert its own interpretations of applicable principles, even though California tax law incorporates Section 1031 and applicable federal law and precedent for both individuals and business entities.

A recent change in California's tax administrative system has put a spotlight on the FTB's position regarding the Drop and Swap transaction and has created unfortunate confusion for taxpayers and their advisors. The change occurred in 2018, when jurisdiction over appeals from adverse FTB audit conclusions was shifted from an elected five-member body, the State Board of Equalization (SBE), to a newly created quasi-judicial body, the OTA, made up of a group of administrative law judges with tax backgrounds who hear cases in panels of three. The political backstory for this change is fascinating, but not the subject of the present discussion. What is important to understand is that taxpayers had historically fared rather poorly before SBE in challenges of FTB actions regarding like-kind exchanges, including a 2016 SBE decision sustaining FTB's denial of exchange treatment in a Drop and Swap transaction (*Appeal of Michael Giurbino*, SBE Case 861813) largely on *Court Holding* grounds. However, *Giurbino* involved rather messy facts-such as taxpayers' initial concession that a sale rather than exchange had occurred and initial reporting of a sale transaction by the selling partnership, with parties seeking to amend their returns four years later. Many practitioners hoped that since the OTA judges had tax backgrounds, issues involving technical interpretation of tax law, including like-kind exchange issues, might be more equitably addressed by OTA panels. However, this was countered by the realization that a significant majority of the initially appointed OTA judges were previously employed by state taxing agencies, including FTB and SBE.

This is the background to the seemingly conflicting outcomes in two recent OTA decisions involving Drop and Swap transactions: *Appeal of Sharon Mitchell,* OTA Case 18011715, and *Appeal of Peter & Susanne Pau*, SBE Case 959931, OTA Case 18011375. Let's briefly lay out the facts in the two cases and their outcomes.

Sharon Mitchell's mother Caroline had been a partner in Con-Med, a general partnership, since before 1991, when Sharon became a partner. Con-Med owned a single piece of commercial property. The tenant of the property had expressed interest in buying the property as early as 1990 and stated it would cooperate in allowing some partners to do Section 1031 exchanges, but nothing occurred until 2005, when Con-Med's managing partner concluded that it would need to sell the property and started to explore ways in which some partners could cash out and others could exchange their interests.

There is no indication in the OTA recitation of the facts that the property was subject to a mortgage or that there were any tenants other than the buyer.

Approximately 18 months later, in December 2006, the tenant made an offer to buy the property from Con-Med. In discussions among the partners about the offer, at least three indicated an interest in doing separate exchanges. Ultimately, Con-Med made a counteroffer and the parties then agreed to enter into a purchase agreement. The Con-Med managing partner continually advised the other partners that he was exploring ways to permit separate exchanges to be conducted by them.

Closing of the sale did not take place for eight months. Ten days before transfer of the property to the buyer, Con-Med executed an agreement authorizing the managing partner to redeem the interests of Sharon and Caroline Mitchell in return for distributions of undivided interests in the property and three days later deeds to those interests were executed and, apparently, delivered but not immediately recorded.

One week later, Sharon entered into an Exchange Agreement with a qualified intermediary. In the space of the next four days, the deeds were recorded, the sale to the buyer closed, and Sharon's 10% share of proceeds went to the qualified intermediary.

FTB denied exchange treatment to Sharon primarily on the grounds that: (1) as in *Court Holding*, the seller of the property was the pre-Drop entity Con-Med and Sharon was a conduit for Con-Med, and (2) she did not become owner of an interest in the property sufficient to overcome assignment of income principles requiring that the sale consequences be attributed to Con-Med.

Sharon's appeal of the FTB decision was originally made to SBE, but when jurisdiction over income tax matters passed to OTA on January 1, 2018, the Mitchell appeal followed and was heard by a three-judge OTA panel in April 2018. In one of the first reported OTA

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decisions, in August 2018, the OTA panel's opinion was released. On a 2-1 vote, the panel sided with Sharon, determining that the form of the transaction should be respected: a distribution of a direct interest in the property to her, followed by her disposition of that interest in a qualifying like-kind exchange. The panel rejected the need to treat Con-Med as seller of the entire property or the FTB's arguments that the last minute nature of the redemption should result in rejection of the transfer of an interest in the property to Sharon under the step transaction doctrine, stating 'we see no reason to ignore any step in the series of integrated transactions that resulted in [Sharon's] exchange of the Property.' Other than favorably citing the Ninth Circuit's decision in *Magneson*, 55 AFTR 2d 85-911, 753 F.2d 1490 (CA-9, 1985), the OTA's opinion does not seem to focus on the fact that Con-Med was a general partnership, not a limited liability company or limited partnership.

One aspect of OTA procedure immediately came into play. This is the right of either party to an OTA appeal to request a rehearing within 30 days following issuance of a panel's adverse opinion. The request is made to the same panel that heard the matter and issued the initial opinion. In this case, the FTB did make such a request in September 2018. There is no required time in which the panel must respond to the request, so Sharon, FTB, their counsel and others in the practitioner community waited through the balance of 2018 and all of 2019 for the OTA to act. Ultimately, in January 2020, the panel rejected the FTB's argument that the original opinion was wrong on the law, on the same 2-1 vote as in the opinion. Result-the taxpayer victory in the *Mitchell* opinion stands. However, as with U.S. Tax Court opinions, OTA opinions come in two varieties-"precedential" (akin to a reviewed opinion) and "non-precedential" (akin to a memorandum opinion). As issued, and now as final, the opinion in *Mitchell*

is labeled non-precedential.

At almost the same time as the *Mitchell* case was being considered, reconsidered and decided, taxpayers in another Drop and Swap case sought relief from an unfavorable SBE decision rendered in late 2017, just as the SBE's jurisdiction over income tax appeals was coming to an end. Consequently, the petition for rehearing fell into OTA jurisdiction. In the *Pau* appeal, two different exchanges were at issue. In the first, Mr. Pau was a member of a limited liability company (Moulds CPP LLC) that acquired multiple parcels of real property in 2006. The properties were subject to a mortgage containing due-on-transfer provisions and a property management agreement. Approximately six months later, Moulds CPP LLC contracted to sell all the properties at a substantial profit. In January 2007, the company entered into a Distribution Agreement to redeem Pau by transferring an interest in the properties to him and delivered deeds to this effect. Two days later these deeds were recorded, as were deeds to the buyer of the property. Pau then utilized a newly formed limited liability company owned by him and two other parties to acquire replacement property.

In the second exchange considered in the Pau appeal, the taxpayer owned 49.75% of a limited liability company (CHA) that owned a property in Silicon Valley. The property was subject to a mortgage also containing typical due-on-transfer provisions and to a management agreement. In February 2007, CHA entered into a contract to sell the property. Closing was delayed, but in a two-day period in July 2007, CHA entered into a Distribution Agreement to transfer an interest in the property to taxpayer, delivered a deed purporting to do this, and recorded both the deed to the taxpayer and deeds transferring the property to the buyer on the next day.

The Paus reported both transactions as like-kind exchanges on their 2007 returns. On audit, FTB challenged qualification of both and the Paus initially conceded non-qualification in the course of their protest (appeal) of the FTB Notice of Proposed Assessment, which was ongoing in late 2014 and then 2015. They apparently then hired a new tax representative and recanted on their concession, taking the position that the exchanges were valid. This led to denial by FTB and their appeal to SBE.

SBE wholly adopted the FTB assertion that the two LLCs were the sellers of the properties under a substance over form application of the *Court Holding* doctrine. It also concluded that the first exchange failed to qualify under Section 1031 since the replacement property was not acquired by the taxpayer, but by a separate entity taxed as a partnership-a conclusion which appears completely correct.

The OTA panel, faced with a petition for rehearing filed by the taxpayer, likewise had little trouble confirming application of the *Court Holding* substance over form principle in denying the taxpayer's request to honor the nominal form of either transaction as an exchange of Pau's distributed tenant-in-common interest. This was a unanimous 3-0 conclusion. It has also been labeled by OTA as non-precedential.

What are we to make of these decisions? In one, the key FTB *Court Holding* argument is explicitly dismissed, while in the other it is adopted. The difference seems to be the advance nature of the decision to Drop in *Mitchell* and the long-expressed desire of the Mitchells to structure the Con-Med

disposition as separate exchanges by them, compared to the last-minute actions by Pau, since in all three transactions at issue, an entity entered into binding purchase and sale agreements that governed the ultimate dispositions. In some ways, this mirrors the conclusions of the Tax Court in its non-safe harbor reverse exchange case, *Bartell*, 147 TC 140 (2016), where the Court expressed a view that taxpayers' intent to exchange was given significant weight in Section 1031 cases, and that in some ways Section 1031 relies on turning off substance-over-form concepts, as exchanges are largely form driven. (For more on *Bartell*, see Weller, Lipton, Cullen, Grilli, and Renchen, "Tax Court Finally Unveils Reverse Exchange Principle in *Bartell*, But Stay Tuned," 125 JTAX 96 (November 2016); Shop Talk, "Living with *Bartell* Uncertainty," 127 JTAX 238 (November 2017).) Quoting the Tax Court's opinion in *Biggs v. Commissioner*, 69 TC 905 , 913-914 (1978), *aff'd* 632 F.2d 1171 (CA-5, 1980),

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the majority opinion in *Mitchell* recites, '[T]he courts have permitted taxpayers great latitude in structuring transactions[, and]... it is immaterial that the exchange was motivated by a wish to reduce taxes.'

The core element seems to be the *Mitchell* panel's conclusion that the Con-Med managing partner negotiated sale of its property 'on behalf of the partnership and its 17 partners so they could determine whether they wished to become tenants in common and exchange their interests rather than cashing out.' This parallels the U.S. Supreme Court analysis in *Cumberland Public Service Co. v. Commissioner*, 38 AFTR 978, 338 U.S. 451 (1950), which strangely seems to have been ignored by the parties and the majority panel, being cited only in the dissenting opinion.

While they are mentioned in the *Pau* opinions from SBE and OTA, the existence of mortgages with due-on-transfer clauses that are violated by Drop transactions does not seem overly important to the analysis. Why does it matter that, in *Mitchell*, there is no mention of a property management agreement while this is called out in the *Pau* opinion? Nor, apparently, were formal tenant-in-common agreements created in any of these transactions. Are these simply cases of judges responding to sympathetic (mother and daughter Mitchell) versus unsympathetic petitioners who play fast and loose (Pau), in one case selling relinquished property for a large profit six months after acquiring it? Did the Paus' initial concession at their protest that their exchanges failed affect the outcome or is it just a matter of more effective counsel in one case versus the other?

While SBE and OTA in *Pau* point out that the taxpayer never reported any income or expenses from property operations (hard to do with one or two days of ownership), this was not considered by the panel in *Mitchell.* In fact, the panel expressly says that duration of ownership is not relevant to the question of whether relinquished property qualified for exchange treatment, citing a number of cases, including *Magneson* and *Maloney*, 93 TC 89 (1989).

It should be noted that FTB apparently abandoned any argument in *Mitchell* relating to application of the so-called qualified use requirement of Section 1031: that relinquished and replacement properties must be held by the exchanging taxpayer 'for trade or business or investment.' Advisors should be aware that public pronouncements by FTB officials have generally confirmed the FTB's lack of inclination to pursue

this issue in Drop and Swap cases.

In the end, it is hard to reach a conclusion about when a Drop and Swap transaction undertaken involving California property or a California taxpayer after a partnership signs an agreement to sell property will be allowed by FTB. *Pau* suggests that a last-minute decision to undertake these transactions is dangerous. But *Mitchell* gives hope to those who are able to put at least a little daylight between the Drop and the Swap. It also shows the importance of individual partners demonstrating intent to exchange early and as often as possible before a property sale. Unfortunately, whether the OTA will ultimately attempt to reconcile these conflicting decisions is anyone's guess."

We thank Lou Weller for his insights on the confusing application of the Drop and Swap rules by California tax bodies. As always, we welcome our readers' comments.

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