The California Office of Tax Appeals Hands Taxpayers a Partial Victory in a Like-Kind Exchange Case

By Robert S. Horwitz

Sec. 1031(a) of the Internal Revenue Code provides that no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged for like-kind property to be held either for productive use in a trade or business or for investment.[1] The purpose of section 1031 is to defer the recognition of gain or loss on transactions in which, although in theory the taxpayer may have realized a gain or loss, his economic situation is in substance the same after the transaction as it was before the transaction. H. Rept. No. 704, 73d Cong., 2d Sess. (1934); *Jordan Marsh Co. v. Commissioner*, 269 F.2d 453, 455-456 (2d Cir. 1959).

If the taxpayer receives, in addition to like-kind property, money or other property ("boot"), any gain is recognized up to the amount of money and the value of other property received. Sec. 1031(b). If a taxpayer is relieved of liabilities as part of a 1031 exchange, the amount of the liabilities relieved is taxable boot. Treas. Reg. sec. 1.1031(d)-2. If, as part of the transaction, the taxpayer receives funds from a party financing the acquisition of the replacement property, the funds received are considered taxable boot. *Behrens v. Commissioner*, T.C. Memo. 1985-195.

In *Consolidated Appeal of EWV*, et al., 2026-OTA-080P, the California Office of Tax Appeals addressed the issue of whether funds paid into escrow accounts constituted taxable boot.

Background Facts

EWV, LLC, is a limited liability company with three members, A. Abady, S. Hashem, and F. Kanani. In 2016, EWV purchased property in Pasadena financed by a $7.7 million loan. Its Qualified Intermediary (QI) sold the Pasadena property on October 20, 2016, for $13.4 million. After repaying the loan and various sale expenses, the QI had $5.045 million in cash.

On December 15, 2015, the QI purchased replacement property in Renton, WA for $54.4 million for EWV. The purchase was funded by two loans from American National Insurance Company (ANIC), one in the amount of $45.5 million and the other in the amount of $8.5 million, for a total of $54 million in loans. All of the $45.5 million loan

[1]For exchanges completed after December 31, 2017, sec. 1031 only applies to real property held for productive use in a trade or business or for investment.

and $4 million of the $8.5 million loan went toward the purchase of the property. The remaining $4.5 million of the $8.5 million loan was placed in two escrow accounts.[2] One escrow account was established under a Tenant Improvement and Leasing Commission Escrow Agreement (TI Agreement) and the other was established under a Capital Improvements Escrow Agreement (CapEx Agreement).

The TI Agreement and the CapEx Agreement contained a number of provisions, including:

> The TI Agreement required EWV to deposit $2 million of loan funds and $993,099 of separate funds into the TI escrow account to fund tenant improvements and leasing commissions. To obtain funds from the TI escrow account EWV was required to obtain and deliver tenant lease agreements of at least 5-years duration, make tenant improvements and provide lien releases and photos of the work performed and deliver certificates of occupancy. The $993,099 of separate funds were to fund tenant improvements for an existing tenant. EWV was required to deposit, bimonthly, $27,000 into the TI escrow account. When the notes were repaid, any balance remaining in the escrow accounts were to be paid to EWV. In the event of a default, ANIC could immediately draw down the funds in the TI escrow account.
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> The CapEx Agreement required EWV to deposit $1.5 million of the loan proceeds into a CapEx escrow fund, to be used for capital improvements. All capital improvements had to be improved in writing in advance by ANIC. Disbursements were at ANIC's "reasonable discretion," which could not be unreasonably withheld, after EWV demonstrated that the work was completed in a good workman-like manner and required documentation was delivered to ANIC. EWV was required to deposit, bimonthly, $9,458 into the CapEx escrow account. When the notes were repaid, any balance remaining in the escrow accounts were to be paid to EWV. In the event of a default, ANIC could immediately draw down the funds in the CapEx escrow account.
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> Both the TI and CapEx Agreements provided (a) that the funds in the escrow accounts were additional collateral for the loans and (b) that no disbursements could be made until EWV paid ANIC's legal fees incurred in connection with the agreement.

[2] The remainder of the $54 million purchase price was from the funds remaining from sale of the Pasadena property.

The closing statement for the Renton property reflected that $2,993,099 of loan funds were disbursed to the TI escrow account, $1.5 million were disbursed to the CapEx account, $540,000 went to pay ANIC a 1% prepayment fee, and $341,250 was disbursed to pay ANIC's attorney fees.

The FTB claimed that the funds placed in the escrow accounts, together with a prepayment fee and ANIC's attorney fees, were boot taxable to EWV and its members. It issued Notices of Proposed Assessment (NPAs) asserting the following deficiencies for 2016:

EWV	**A. Abady**	**S. Hashem**	**F. Kanani**
$9,290	$280,938	$2,212,799	$1,106,399[3]

Positions of the Parties on Funds in the Escrow Accounts

> The FTB claimed that EWV had actually received the escrow funds because they were held as additional collateral and could be used to pay loan costs. In the alternate it argued that the funds in the escrow accounts were constructively received by EWV because the funds were set aside for EWV's benefit and could be disbursed to EWV without substantial restrictions.

Under Treas. Reg. sec. 1031(k)-1(f)(2), boot is constructively received in a 1031 exchange if money or property is

a. Credited to the taxpayer's account,
b. Set aside for the taxpayer, or
c. Made available for the taxpayer to draw down upon written notice.

There is no constructive receipt if the taxpayer's right to the funds is subject to substantial limitations or restrictions.

EWV claimed that the escrow funds were part of a separate loan and thus not received as part of a like-kind exchange. Even if the escrow funds were part of the same loan, there was no actual receipt because the cash was paid to ANIC at closing and not received by EWV until later years when stipulated conditions were satisfied. It further argued that there was no constructive receipt of the escrow funds because disbursement of those funds was substantially restricted.

OTA Holds that the Escrowed Funds Were Not Taxable Boot

The OTA examined three Tax Court decisions dealing with constructive receipt in a 1031 exchange: *Fredricks v. Commissioner*, T.C. Memo 1994-27, *Garcia v. Commissioner*, 80

[3] NPAs were issued to Hashem and Kanani for 2017 and 2018 showing reductions in income for both years.

T.C. 491 (1983), and *Klein v. Commissioner*, TCM 1993-491. In *Fredricks*, the taxpayer conveyed an apartment building to his wholly-owned corporation, which sold the property and purchased like-kind property. As part of the sale, the purchaser of the apartments deposited $200,000 into an escrow account. The deposit was to be returned in the event the transaction was not consummated or the corporation defaulted. The IRS argued that the taxpayer actually or constructively received the $200,000. The Tax Court held there was no actual receipt because the corporation received the $200,000 and there was no constructive receipt because the disbursement of the funds was subject to substantial restrictions.

Garcia involved an integrated exchange with four parties, three properties and several escrow agreements. The property the taxpayers exchanged was subject to liabilities. The replacement property was subject to an almost identical amount of liabilities. The IRS claimed that the taxpayers had boot equal to the amount of liabilities to which the exchanged property was subject. The Tax Court rejected the argument since the liabilities the exchanged property was subject to were offset by the liabilities assumed by the taxpayers.

In *Klein*, the taxpayer sold property and had the funds placed in an escrow account that he had set up and whose conditions he had the ability to unilaterally alter. He subsequently used the escrow funds to purchase another property. He did not report gain on the sale, claiming the sale of the old property and purchase of the new property constituted a 1031 exchange. The Tax Court held that the taxpayer at all times had control of the escrow funds and constructively received those funds since he had the unlimited power to alter the escrow instructions and have the funds paid to himself.

The OTA rejected the FTB's position on actual receipt since the funds were paid into escrow as a condition to ANIC making the loans, ANIC could only draw on the escrowed funds in the event of default and EWV could not draw on the funds until the occurrence of certain conditions.

The OTA held that there was no constructive receipt of the funds in the CapEx account or the TI account because there were substantial conditions that had to be met before EWV was entitled to disbursement of those funds.

<u>The OTA Holds that EWV Constructively Received the Prepayment Fee, and the Funds Used to Pay ANIC's Legal Fees</u>

Normally, costs incurred in effectuating a like-kind exchange are not considered boot. EVW argued that the 1% prepayment fee and ANIC's attorney fees were similar to exchange expenses. The FTB argued that the prepayment fee and ANIC attorney fees were paid as part of the exchange but were paid for the loan. Stating that the issue was "not free from doubt," and there were no cases, regulations or revenue rulings on the issue, the OTA looked to a secondary source, the ABA Taxation Section's Report on *Open Issues in Section 1031 Exchanges*. The report concluded that fees related to a loan to acquire replacement property are not fees incurred for purposes of an exchange and thus should be treated as boot. Finding the ABA Report persuasive, the OTA held that the prepayment fee and ANIC's attorney fees were taxable boot.

Conclusion

The like-kind exchange provisions were first enacted as part of the Revenue Act of 1921, 42 Stat. 227. The concept behind tax-free like-kind exchanges is easy to grasp. The statute and regulations as they have evolved over time are complex, including those concerning the concept of boot. A taxpayer who is going to do a like-kind exchange, especially involving borrowed funds that are used to acquire replacement property, should consult with a qualified tax attorney who is versed in like-kind exchanges to ensure that there are no costly surprises in the form of taxable boot.

The EWV opinion shows that in a case involving a transaction between unrelated parties the OTA will carefully analyze the transaction documents to determine the proper tax treatment of the transaction.

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