

August 19, 2015

## **A NEW ERA IN REAL PROPERTY EXCHANGES IN CALIFORNIA**

Dear Clients and Friends:

Tax-deferred exchanges of commercial or investment real property are a common strategy for real estate owners. Federal courts have taken a pro-taxpayer approach in allowing taxpayers to structure these exchanges. California has not until recently. The June 23, 2015 opinion of the State Board of Equalization (*BOE*) in *Rago Development Corp. v. Franchise Tax Board* signals a shift in California towards a more taxpayer-friendly approach.

Internal Revenue Code section 1031 provides that in general a taxpayer may sell qualified real property and acquire other qualified real property without recognizing gain. To qualify under section 1031, the property sold and the property received must be of like kind and held for either (1) productive use in a trade or business or (2) investment. Real property in the United States is of like kind to all other domestic real property for purposes of section 1031.

Decisions in the federal courts allow a real property owner the benefits of section 1031 even if the owner later transfers the acquired real property into an entity. A United States Tax Court decision held that section 1031 applied to an exchange of real property by a corporation that distributed the acquired real property to its shareholder three days later. These transactions are commonly known as a “swap and drop” transactions; the taxpayer first swaps the relinquished property for other property and then drops the acquired property into an entity or from an entity to its owners.

California had no similar decisions until this year. This silence created uncertainty as to whether California would permit a swap and drop transaction; *Rago* is the first California decision permitting a swap and drop transaction.

The taxpayers in *Rago* sold commercial real property and acquired their interests in a shopping center, intending to defer the gain under section 1031. The taxpayers obtained a loan to fund the purchase, and the lender required that they transfer their interests in the shopping center into a single purpose limited liability company (LLC). The taxpayers completed the purchase and held their interests as tenants in common. Shortly before the seven-month deadline, they transferred their interests into a single purpose LLC to comply with the lender's requirement.

The Franchise Tax Board (*FTB*) determined that the sale did not qualify as a tax-deferred exchange for California income tax purposes. The *FTB* contended that the taxpayers had exchanged real property interests for an LLC interest. The *FTB* also argued that the taxpayers did not intend to hold their interests for business use or investment because they intended to transfer that real property into an LLC. The *BOE* rejected both arguments.

The *BOE* adopted the reasoning of the federal tax cases relating to section 1031 exchanges. The *BOE* determined that the taxpayers intended to qualify for section 1031 benefits, the transfer to the LLC was pursuant to a third-party lender's requirement, and the taxpayers continued their economic investment after the transfer. Moreover, the taxpayers bore the risk of loss and liability during the seven months they held the real property as tenants in common. The *BOE* concluded that the transaction qualified as a tax-deferred exchange under section 1031, and no gain was recognized on the sale.

The *BOE* decision in *Rago* brings California in line with federal law. We would be pleased to discuss section 1031 tax-deferred exchanges and the implications of the *Rago* decision with you in greater detail.

*Update:* Our May 2015 newsletter discussed the filing of the Report of Foreign Bank and Financial Accounts ("FBAR"). New law enacted on July 31, 2015 changed the filing date. Starting in 2017 the filing date for an FBAR is April 15, with a maximum six-month extension of time to file. The government may waive late-filing penalties if a taxpayer is required to file the FBAR for the first time.

Kind regards.

Very truly yours,

HARTOG & BAER  
A Professional Corporation



By: JOHN A. HARTOG