Drop and Swap: Opinion of Petition for Rehearing: In the Matter of the Appeal of Sharon Mitchell, OTA Case No. 18011715 (1/28/20) California Office of Tax Appeals

In this opinion, the California Office of Tax Appeals ("OTA") denies a Petition for Rehearing made by the California Franchise Tax Board ("FTB"). The opinion involves the 2018 OTA decision finding for the taxpayer, Sharon Mitchell, in a drop and swap exchange. The FTB requested a rehearing of the 2018 opinion based on several arguments, but the principal argument was OTA made an error in law by not applying the substance-over-form or *Court Holding* doctrine to disallow the drop and swap. In this 2020 decision, OTA again finds for the taxpayer and denies the FTB's petition for a new hearing.

Background: Mitchell is a classic "drop and swap". Mitchell held an interest in a general partnership that owned a building in Walnut Creek, CA. The partnership wanted to sell this building. The other partners did not want the partnership to distribute a tenancy-in-common (TIC) interest to the taxpayer prior to entering into a sale agreement because of the risk the taxpayer might hold up the sale. Therefore, the partnership alone negotiated and entered into the sale agreement with the buyer. The taxpayer's interest in the partnership was redeemed for a TIC interest in the property three (3) days before the closing of the property to the ultimate buyer. The deed creating the TIC was not recorded until after the taxpayer had signed the deed transferring the property to the buyer.

2018 Opinion. In the original hearing, the FTB argued that the partnership was the seller of the property and not taxpayer due to substance-over-form and step transaction principles. However, a 2 to 1 majority of the OTA found that the last-minute change in ownership form was of no real significance, relying on the *Magneson* case. The majority reasoned that the taxpayer wanted to continue her investment in real estate through an exchange while the other partners wanted to cash out, and the redemption of her general partnership interest was necessary to achieve this goal. Further, the redemption was later in the sale process for valid business reasons. OTA distinguished the holding from *Chase* because the partnership interest redemption in that case was in contravention of the partnership agreement, and Chase's share of the sales proceeds was based on this distributive share as a partner. The dissenting judge in the 2018 opinion argued that the substance-over-form doctrine should be applied to disallow the exchange.

2020 Opinion. The 2020 opinion, like the 2018 opinion, was a 2 to 1 decision, with the same judges, both the majority and dissent, sticking to their original conclusions. The majority opinion states that it did not ignore the *Court Holding* doctrine but found that the facts in the Mitchell exchange were materially different than in *Court Holding.* The taxpayer met all the requirements for a valid exchange and did not disguise the transaction by "mere formalisms". The taxpayer did what she thought was required "to navigate the still largely uncharted and obviously treacherous path from owning real property through a partnership interest to direct ownership of a property that successfully results in a valid 1031 exchange." The majority further stated that "the parties engaged in a series of reasonable, necessary, and integrated transactions to accomplish a 1031 exchange. There was no last-minute decision to change the parties at sale."

Comment: This is a highly favorable opinion for this taxpayer. However, it should be relied upon with caution. A subsequent drop and swap opinion, *Pau,* was decided by a different set of three

judges at OTA, and they reached a different conclusion in a 3-0 decision and found the exchange to be invalid. The facts in *Mitchell* and *Pau* differ somewhat. The principal difference in *Mitchell* seems to be the evidence that the taxpayer requested to structure a 1031 exchange early in the sale negotiation, even though the partnership alone negotiated and signed the sale agreement with the buyer. From this difference, it can be surmised that if the TIC will not be created until the closing of the relinquished property, the taxpayer should have early and well-documented evidence of an intent to do a drop and swap.

The most significant difference in the outcomes between *Mitchell* and *Pau* appears to be whether the judges believe it is appropriate to apply the substance-over-form doctrine in a drop and swap situation. In most situations, the TIC cannot be created until the closing is imminent. This is due to lender prohibitions, fear of a TIC owner holding up the sale, or perhaps the taxpayer was simply unaware of the tax law is this area. Is it acceptable to create a TIC prior to closing solely in order to create an exchangeable interest in these situations? The majority in *Mitchell* clearly believes that it is, especially if the taxpayer expressed an interest in an exchange early in the sale process. The contrary view, asserted by the FTB, is that the exchange is doomed by the choice of a partnership tax structure once the partnership enters into (or perhaps begins negotiating) the sale agreement for the relinquished property. Reasonable judicial minds apparently disagree on this issue, as shown by the *Mitchell and Pau* decisions, as well as the other cases and rulings in the drop and swap and swap and drop areas.