STATE OF CALIFORNIA

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June 5, 1997

The Honorable Bradley L. Jacobs
Orange County Assessor
Attention: Kathy Scott
6300 North Broadway Annex
Santa Ana, CA 92702

In Re: **Change in Ownership Under a 1031 Exchange/Holding Agreement**

Dear Ms. Scott:

This is in response to your telephone request on June 4, 1997, concerning the change in ownership consequences of IRC 1031 exchange transactions involving the transfer of real property from a "seller" by deed and/or agreement to a "straw man" (accomodator or nominee) with instructions requiring the "straw man" to transfer that property at some later date to a "buyer". Please see attached Eisenlauer Letters, 7/5/88, and 8/17/89, Bessent Letter 1/24/92, Cazadd Letter, 10/26/93, and Alonzo Letter, 6/28/94.

As you will note from the foregoing, the general application of the legal principle under Section 60, as interpreted by Rule 462.200(c), requires that the transfer of real property to a "straw man" in a transaction paralleling the IRC 1031 exchange provision does not include the transfer of any equitable or beneficial interest in the property. The "straw man," which may be a title company, a bank, or a broker functioning as an accomodator, merely holds "legal title" to the property, with the result that there is no change in ownership at this point. However, when the "straw man" subsequently transfers title to a buyer who receives the "present beneficial ownership" of the property per Section 60, there is a change in ownership and reappraisal at that time.

In regard to tracking and establishing the date of the change in ownership, taxpayers have the responsibility to notify the assessor (and to substantiate with the relevant documentary evidence) that a particular transfer is not a reappraisable event. Therefore, where there is language on the face of a deed indicating that the transfer may constitute the transfer of mere legal title to a "straw man," the assessor may wish to mail a change in ownership statement to both the transferor and transferee, and advise them that under the authority of the deed presumption in Rule 462.200 (b), the date on the deed will be used to establish the

change in ownership and reappraisal of the property, unless further information (including the existence of a holding agreement) are submitted, indicating that the transferor ("seller") is still the present beneficial owner of the property.

We have consistently advised that taxpayers claiming the benefit of an exception to change in ownership have the burden of establishing to the satisfaction of the assessor that they qualify for such treatment. In cases where formal recorded documents, such as deeds, fail to contain a complete explanation of a transaction, the assessor is entitled to require that the taxpayers establish by clear and convincing evidence that present beneficial ownership of the property did not (or did) transfer by such documents. Therefore, the assessor may demand a variety of instruments (change in ownership statement, agreements, tax returns, etc.) which demonstrate that only "legal title" to the property transferred and that the normal incidents of the "straw man" relationship under IRC 1031 were observed.

I hope this information has been responsive to your request. The views expressed in this letter are, of course, advisory only. Our intention is to provide timely, courteous and helpful responses to inquiries such as yours. Suggestions that help us to accomplish this objective are appreciated.

Very truly yours,

Kristine Cazadd
Senior Tax Counsel

KEC:sao

Enclosures

cc: Mr. James E. Speed, MIC: 63
Mr. Richard Johnson, MIC: 64
Mr. Larry Augusta, MIC: 82

State of California

Board of Equalization

Memorandum

To : Mr. Verne Walton

Date : July 5, 1988

From : Eric F. Eisenlauer by Richard H. Ochsner

Subject : Change in Ownership of Real Property via "Strawmen" under Internal Revenue Code Section 1031

This is in response to your memorandum of April 20, 1988 to Mr. Richard H. Ochsner in which you request our opinion whether a change in ownership occurred as a result of the following facts provided with your memorandum.

By an undated grant deed recorded November 26, 1986, Narragansett Trading, Inc. conveyed the subject real property to Andrew South. By an undated grant deed recorded one minute later, Andrew South conveyed the subject property to Raymond Aviles. By a grant deed dated November 21, 1986 and recorded at the same time, Raymond Aviles conveyed the subject property to Great Highway Associates, A California Limited Partnership. Each of the three deeds was acknowledged on November 21, 1986. Narragansett Trading, Inc. is a California Corporation which is wholly owned by Peter Dwares. Great Highway Associates was first formed as a general partnership in June 1983 with Peter Dwares, Amy Farris and Catherine Nelson as general partners. In September 1984, the aforementioned partners formed a limited partnership of the same name with Peter Dwares the general partner having an ownership interest of 80 percent and Amy Farris and Catherine Nelson limited partners each with an ownership interest of 10 percent. The Certificate of Limited Partnership recites that the limited partners contributed $20,000 to the capital of the partnership.

On April 15, 1985 Amy Farris assigned her 10 percent limited partnership interest to Peter Dwares. By grant deed dated April 15, 1985, Catherine Nelson conveyed an undivided one-tenth interest in real property located in San Francisco to Peter Dwares. Apparently, the acquisition of the same real property was the purpose for which the limited partnership was formed. On December 12, 1986, Peter Dwares executed another Certificate of Limited Partnership for Great Highway Associates. This was filed in the Office of the Secretary of State January 20, 1987. As of June 24, 1987, records of the Franchise Tax Board reflect Great Highway Associates as a partnership and include the names Peter Dwares and Amy Farris as partners.

Included with your memorandum was a copy of a document entitled "Delayed Exchange Agreement and Escrow Instructions" (hereafter referred to as the "Agreement") dated November 26, 1986. That document essentially provides for a deposit in escrow on or before November 26, 1986 of a grant deed of the subject property from Narragansett to Andrew South and for a deposit in escrow on or before May 26, 1987 of a grant deed of other real property from Andrew South to Narragansett. Paragraph 3 of the Agreement contemplates a sale of the subject property by South however no part of the sales proceeds are for his benefit. Escrow is to close on or before November 26, 1986. The Agreement recites Narragansett's intent to exchange the subject property for other real property under the terms of Internal Revenue Code section 1031. The Agreement further provides that Narragansett has until January 12, 1987 to locate other real property which would be acceptable in exchange for the subject property and to notify Andrew South thereof in writing. South would then purchase the other property (apparently from the proceeds of the sale of the subject property) and convey it to Narragansett. The Agreement contains other provisions which are not relevant to this discussion, however, it omits mention of a conveyance by Andrew South to Raymond Aviles or conveyance from Raymond Aviles to Great Highway Associates. Further, neither of the latter grantees is a party to the Agreement.

Peter Dwares contends that no change in ownership occurred as a result of the conveyances of the subject property because he owned 100 percent of Great Highway Associates and because intermediaries in the transaction Andy South and Raymond Aviles took title only for an instant under the provisions of Internal Revenue Code section 1031 which sets forth the rules for tax-free exchanges.

The first question raised by the foregoing facts is whether the conveyances to South and Aviles are changes in ownership. This depends upon whether there has been "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest" as required by Revenue and Taxation Code section 60.

In Alderson v. C.I.R. (1963) 317 F.2d 790, the Internal Revenue Service argued that the transaction there involved could not be construed as constituting an exchange for purposes of Internal Revenue Code section 1031 because of the failure of one of the participants in a multiparty exchange to hold a "real" interest in one of the properties sought to be exchanged. The court, relying on Mercantile Trust Company of Baltimore v. C.I.R. (1935) 32 B.T.A. 82 rejected that argument and held that there was no need to acquire a "real" interest in the property in question by assuming the benefits and burdens of ownership to make the exchange qualify under section 1031. The court stated at page 795:

> "The Mercantile case appears to hold that one need not assume the benefits and burdens of ownership in property before exchanging it but may properly acquire title solely for the purpose of exchange and accept title and transfer it in exchange for other like property, all as part of the same transaction with no resulting gain which is recognizable under Section 1002 of the Internal Revenue Code of 1954. (Emphasis in case.)

From the foregoing, it does not appear that for purposes of Internal Revenue Code section 1031 either South or Aviles were required to have any beneficial use of the subject real property. Moreover, from the facts presented, it appears that they were not intended to have any beneficial use of the subject property and that in fact they did not have any beneficial use of the property or any incident of ownership of the property other than the right to transfer its title. The deeds by which each acquired title and conveyed it were apparently executed the same day. South's role in the transaction was to accept title to the subject property and convey it in order to acquire other property to convey to Narragansett in exchange for the subject property in accordance with the Agreement. Aviles' complete role in the transaction is less clear. The facts show that he received title to the subject property from South and transferred it to Great Highway Associates. We assume that Aviles received the subject property subject to a contractual obligation to convey it to Great Highway Associates but we have not been provided with a copy of any agreement indicating that is the case. If our assumption is correct, however, we are of the view that the transfers to South and Aviles did not give them any beneficial use of the property and therefore are not changes in ownership as defined in Revenue and Taxation Code section 60.

Since Great Highway Associates unquestionably did receive a present fee interest in the subject real property including the beneficial use thereof as a result of the transfer from Aviles, such transfer was a change in ownership (see also section 61(i)) unless section 62(a)(2) applies. That section provides in relevant part that change in ownership shall not include "[a]ny transfer between an individual . . . and a legal entity or between legal entities, . . . which results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer . . . "

Having concluded above that beneficial ownership and use of the subject property was intended to and in fact did pass from Narragansett through South and Aviles to Great Highway Associates,

we are of the opinion that section 62(a)(2) should be applied as though the transfer was directly from Narragansett to Great Highway Associates. So viewed, the transfer to Great Highway Associates was not a change in ownership if Great Highway Associates was wholly owned by Peter Dwares as he contends it was.

Mr. Dwares apparently relies on the assignment by Amy Farris of her 10 percent limited partnership interest to him and the conveyance by Catherine Nelson of an undivided one-tenth interest in real property to him both of which apparently occurred on April 15, 1985. In our view, the conveyance of an undivided interest in real property doesn't clearly establish that Catherine Nelson relinquished her interest in the partnership. Moreover, approximately two weeks after the transfers in question, Mr. Dwares executed a Certificate of Limited Partnership for Great Highway Associates and filed it with the Secretary of State as required by Corporations Code section 15621 to form a limited partnership. Subparagraph (c) of that section provides that "[f]or all purposes, a copy of the certificate of limited partnership duly certified by the Secretary of State is conclusive evidence of the formation of a limited partnership and prima facie evidence of its existence." Since a limited partnership is one formed by two or more persons and has one or more general partners and one or more limited partners (Corporations Code section 15611(j)) the Certificate of Limited Partnership filed by Mr. Dwares creates a rebuttable presumption that Great Highway Associates is not wholly owned by Mr. Dwares. As indicated above, the records of the Franchise Tax Board corroborate this conclusion as of June 1987.

Accordingly, without clear proof that Mr. Dwares owned 100 percent of the capital and profits interests of Great Highway Associates at the time of the transfers in question we are reluctant to conclude that the transfer is excluded under section 62(a)(2).

If you have further questions regarding this matter, please let us know.

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cc: Mr. Gordon P. Adelman
Mr. Robert H. Gustafson