BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal)
)
of)
)
F. A. STEARNS, INC.)

Appearances:

For Appellant: F. A. Stearns, President of F. A. Stearns; *Inc.*

For Respondent: Burl D. Lack, Chief Counsel; Crawford H. Thomas; Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of F. A. Stearns, Inc. to a proposed assessment of additional franchise tax in the amount of $412.75 for the income year 1945.

Appellant, a California corporation, owned a beneficial interest in land in the State of Nevada which contained deposits of gypsum. The legal title to the property was in F. A. Stearns, its president. In 1936 it entered into an agreement with one C. A. Beall, relating to its interest in the land. The agreement, in the form of a letter from Appellant to Beall, provided in part:

> "Referring to our recent conversations concerning your taking a lease and bond on our gypsum property . . . . we make the following proposal:
>
> "We agree to convey to you all of our right title and interest in and to the above mentioned property, provided that you or your assigns pay the undersigned within five years from date-hereof the sum of Fifteen Thousand Dollars ($15,000.00)."

Appellant further agreed to place a deed in escrow when Beall paid the sum of $500.00, to be applied "on future royalties and/or said purchase price", the deed to be

delivered on payment of the full purchase price. Beall agreed to pay a royalty of 10 cents per ton on gypsum removed by him, with a minimum monthly royalty of $10.00 during the first year, $20.00 during the second, $30.00 during the third and $50.00 during the fourth and fifth years. These payments were to apply on the purchase price. Reports on development were to be provided Appellant and improvements connected with development were to become part of the property "securing the agreement." In case of default by Beall, he was to forfeit all rights and Appellant could retain royalties previously paid as rent, Other provisions are not relevant here.

For several years, Beall did considerable development work on the property and paid the minimum royalty required. In the latter part of 1938, having paid $450.00 in royalties, he requested that a deed be put in escrow. Appellant states that "Inasmuch as it then appeared that Mr. Beall meant business and intended to carry out the terms of the contract, the transaction was set up on Appellant's books as a sale." The sum of $10,326.45 was entered as profit therefrom in 1938 and the balance of the purchase price was entered as "Unrealized Profit Reserve." Although reporting an overall net loss, the sum was included on its return as income for that year. Beall continued the minimum payments until June, 1939 at which time having paid a total of $630.00 in royalties, he ceased operations and paid no more under the agreement. No further efforts were made by either party to perform or compel performance under its terms. In 1945, the year in which Appellant determined that the statute of limitations had tolled on any action to enforce the agreement, a bad debt deduction was claimed for the unpaid balance of the purchase price. In 1946 Mr. Stearns contracted to sell the property to Beall for $25,000.

The Franchise Tax Board disallowed the deduction in the amount of $9,858.18, which action is here on appeal.

Section 8(e) of the Bank and Corporation Franchise Tax Act (now Section 24121f of the Revenue and Taxation Code) provides for the deduction of debts which become worthless within the income year, This section is similar to, and based upon, Section 23(k) of the United States Internal Revenue Code, A deduction for a bad debt is allowable only if the obligation to pay is certain (Bercaw v. Commissioner, 165 Fed. 2d 521; Otis Boa11 Kent, T.C. Memo. Dec,, Docket No. 37332, December 31, 1953).

The agreement here involved is apparently common with respect to certain types of mining property to allow a potential buyer to test its worth before purchase and its terms create no more than a lease and option (Hammon Consolidated Gold Fields v.Powell, 40 Fed. 2d 317; Cook v. Enright, 134 Cal. 1; Waterman v. Banks, 144 U. S. 394; 55 Am. Jur. 496). An option can ripen into a sale or binding

contract of sale only by the optionee's acceptance of the offer, unconditionally as made, and within the time specified, which in this case would seem to require lack of default and full payment of the purchase price (Mariposa Commercial and Mining Company v. Peters, 215 Cal. 134; Caldwell v. Dalaray Mines, Inc., 68 Cal.App.2d 180; Baker Divide Mining Co. v. Maxfield, 83 Cal. App. 2d 241; Callisch v. Farnham, 83 Cal. App. 2d 427; White v. Bank of Hanford, 148 Cal. 552; 55 Am. Jur. 506, 507). Furthermore, it does not appear that Beall intended, by his actions, to accept the offer of sale, He apparently did not consider himself obligated to pay.

However, assuming a valid debt existed, since no contrary contention is made by the Franchise Tax Board, it nevertheless appears that Appellant suffered no loss permitting a deduction. If a sale were in fact made, Appellant retained its title as security for payment and was in this respect comparable to a mortgagee, On repossession the debt would be reducible by the value of the property (Commissioner v. Spreckels, 120 Fed. 2d 517). No showing of the value was made but since the property was subsequently sold for $25,000.00, we can only conclude that Appellant recovered property at least as valuable as the alleged worthless debt.

In view of the foregoing, we think it unnecessary to decide the contentions of the Franchise Tax Board that the debt did not become worthless in the year in which the deduction was claimed and that the source of the loss was not within California.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of F. A. Stearns, Inc., to a proposed assessment of additional fran-

chise tax in the amount of $412.75 for the income year 1945, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of February, 1954, by the State Board of Equalization.

Geo. R. Reilly, Chairman

Wm. G. Bonelli, Member

J. H. Quinn, Member

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_____ Member

ATTEST: Dixwell L. Pierce, Secretary