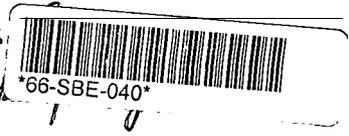


Stepped-up tax
re-acquired



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
ROBERTS FARMS; INC, }

Appearances:

For Appellant: John M. Fleharty,
Attorney at Law

For Respondent: A. Ben **Jacobson**,
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 protests of Roberts Farms, Inc., against proposed assessments of additional franchise tax in the amounts of \$17,952.45 and \$44.80 for the income years ended March 31, 1957, and 1958, respectively.

The question presented here is whether farm property sold in 1953 to a charitable trust and later acquired by the appellant corporation, Roberts Farms, Inc., received a stepped-up tax basis or whether that property retained the lower basis which it had when held by its original owners.

Hollis B. Roberts, in partnership with his wife, Manon, conducted a large farm operation in Kern County until April 1953, when they sold most of their farm property to the Sonnabend Foundation, a tax exempt charitable trust. Sonnabend agreed to pay \$2,250,000 for the property, subject to certain adjustments not pertinent here, It is undisputed that this was a fair and reasonable price,

Sonnabend made an immediate cash payment of \$300,000 and agreed to pay another \$300,000 out of the proceeds of the then growing crops, The balance of the purchase price was to be paid in annual installments of \$110,000 each, plus

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3 percent interest, No payment would become due, however, except to the extent of the net profits derived from the purchased property. Sonnabend's liability for payment of the purchase price and interest was limited to the assets acquired. The agreement provided that the entire purchase price was payable in any event within fifteen years, Sonnabend gave notes, secured by a deed of trust and chattel mortgage, for the unpaid balance of the purchase price.

Appellant corporation was formed to operate the purchased farm property, Employing Mr. Roberts as its president, appellant bought the growing crops and other personal property connected with the farming operation from Sonnabend, giving back secured notes. It also leased the land from Sonnabend for a five-year term.

Due to a drop in potato prices, earnings from the property fell below expectations and a dispute soon arose between Sonnabend and Roberts. Sonnabend contended that it was not obliged to pay certain preexisting liabilities assumed by it in connection with its purchase of the farm unless there were sufficient profits available from the operation,

In October 1954 a series of agreements were executed which relieved Sonnabend of all liability under the original agreement and transferred the farm property to appellant, In exchange, appellant gave Sonnabend a secured installment note for \$300,000 and assumed all of Sonnabend's obligations under the 1953 agreement. The amount due on the \$300,000 note was to be reduced to \$225,000 if paid by July 1, 1955, or \$250,000 if paid by July 1, 1956.

Appellant had no stockholders when it was formed in April 1953. A permit obtained from the California Corporations Commissioner in October 1953 authorized the issuance of stock to three individuals named by Sonnabend, but they refused to invest because of the dispute, In April 1954 M. B. McFarland, a prominent grower and former business associate of Roberts, purchased \$5,000 worth of appellant's stock and became its sole stockholder, In April 1956 McFarland sold his stock to Roberts for \$5,000, Roberts was appellant's sole stockholder during the years on appeal, the years-ended March 31, 1957, and 1958,

The tax basis to Mr. and Mrs. Roberts of the farm property sold in 1953 was \$1,159,509.03. Although the sales price exceeded this amount, the Roberts reported the sale on a cost recovery method under which no gain was to be recognized until they recovered their basis, As of 1964, the Roberts had not yet reported any gain on the sale.

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in 1957 and 1958, appellant sold some of the farm assets. To determine its basis for reporting gain, appellant used the amount of the note it gave and the liabilities it assumed when it acquired the farm. The Franchise Tax Board refused to allow appellant to use this basis.- Respondent reduced the basis 54 percent, to an amount equal to Mr. and Mrs. Roberts' original basis for the assets sold by appellant and increased the gain on the 1957 and 1958 sales accordingly.

Respondent also made adjustments relating to rental income and deductions for depreciation, travel, entertainment, and other expense items. Appellant contests these adjustments only to the extent that they are caused by the reduction in basis.

Section 24912 of the Revenue and Taxation Code provides the fundamental rule that the basis of property shall be its cost. It is undisputed that under ordinary circumstances, the cost of the assets appellant acquired would include the obligations it assumed. The Franchise Tax Board argues, however, that the general rule may not be applied in the present case,

Respondent states that the cost recovery method, used by the Roberts to report their gain on the 1953 sale is appropriate only where a high degree of contingency exists. It reasons that since the Roberts used the cost recovery method, Sonnabend's notes were contingent obligations. Citing a number of authorities for the proposition that a contingent obligation may not be included in the cost of acquiring property (Albany Car Wheel Co., 40 T.C. 831, aff'd, 333 F.2d 653; Lloyd H. Redford, 28 T.C. 773; Walter R. Hoblitzell, T.C. Memo., Dkt. No. 76348, Oct. 10, 1960; Rev. Rul. 55-675, 1955-2 Cum. Bull. 567), respondent argues that appellant's assumption of Sonnabend's obligation on the notes may not be used to increase the basis of the transferred farm property,

The authorities cited by respondent do not support its position. Those authorities dealt with situations where either the amount of the obligation was not fixed at the time of the sale or no obligation was to arise at all until a future event occurred. Sonnabend, on the other hand, agreed to pay a fixed sum within fifteen years. The sum was payable out of the profits from the property purchased and was secured by the property itself. There is no contention or evidence that the reasonably anticipated profits would not have equaled the obligation within fifteen years, that the property was not ample security, or that the sale and the agreed price were not bona fide. On the contrary, respondent states that the validity of a sale under circumstances similar to those before us has been recognized by federal courts (see Commissioner v. Brown, 380 U.S. 563 [14 L. Ed. 2d 75], and that the Roberts

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probably should have reported gain in the year of the sale to Sonnabend, Regardless of the reporting method used by the Roberts, we cannot find that the obligation assumed by appellant was so uncertain or contingent that it must be excluded from appellant's cost basis.

Respondent also argues that the Roberts rescinded the sale to Sonnabend and that the basis thereafter should be the same as before the sale,

Even assuming that a rescission occurred, the theory that the basis of the farm property remained the same as before the sale is not supported by any authority that we have discovered. The Roberts sold the property in one year and the purchaser transferred it to appellant in the following year. If the transfer to appellant were treated as a reacquisition by the Roberts due to a default in payment, then the basis of the property would be its fair market value, not its original basis, (Cal. Admin. Code, tit, 18, regs. 25291-25293(c) and 25291-25293(d).) There is no compelling reason why the result should be different merely because the return of the property is classified as a rescission.

The arguments presented to us do not establish any tenable grounds for reducing the basis used by appellant. Accordingly, we must reverse respondent's action insofar as it relates to the reduction in basis,

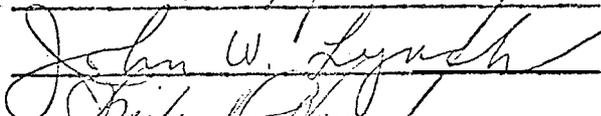
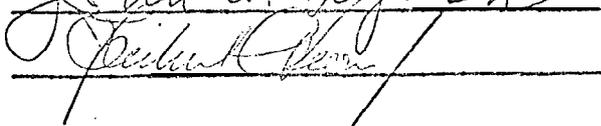
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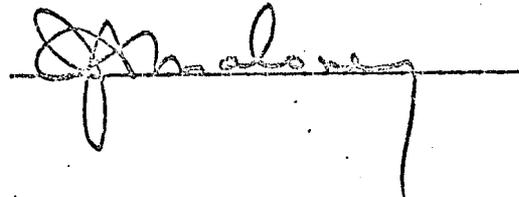
Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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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 protests of Roberts Farms, Inc., against proposed assessments of additional franchise tax in the amounts of \$17,952.45 and \$44.80 for the income years ended March 31, 1957, and 1958, respectively, be and the same is hereby reversed with respect to the basis of the property sold. In all other respects, to the extent not inconsistent with the foregoing, the action of the Franchise Tax Board is sustained.

Done at Pasadena, California, this 28th day of June, 1966, by the State Board of Equalization.

 _____, Chairman
 _____, Member
 _____, Member
_____, Member
_____, Member

Attest:  _____, Acting Secretary