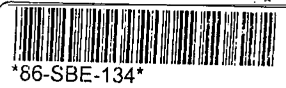

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal or')
) **No. 84A-865-GO**
INTERNATIONAL BAY CLUBS, INC.)

Appearances:

For Appellant: Robert O. Basmajian
Vice President

For Respondent: Terry L. Collins
Counsel

OPINION

This appeal is made pursuant to section **25666**[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of International Bay Clubs, Inc., against a proposed assessment of additional franchise tax in the amount of **$14,169.76** for the income year ended September 30, 1977.

1/ Unless otherwise specified, all section references **are** to sections of the Revenue and Taxation Code as in effect for the income year in issue.

The question presented is whether respondent properly computed the amount realized', if any, by appellant resulting from certain transactions involving Terrace Apartments.

Appellant, a California corporation on the accrual basis of accounting, is primarily engaged in developing and operating private clubs. On November 5, 1976, appellant sold its major asset, the Terrace Apartments, to a limited partnership, the Terrace Apartments Limited Partnership (hereinafter "Partnership") whose general partner was Oppenheimer Industries, Inc., and. whose limited partners were a group of physicians from the midwest. Pursuant to an agreement entitled "Contract for Assignment of Leasehold', Real and Personal Property Interest," the sales price was $10,000,000, to be paid as follows:

a. $175,000 upon signing of the sales contract.

b. Interest only on the unpaid balance of nonrecourse debt ($9,825,000) at 8 percent per annum until November 1, 1982.

c. Principal payments of $100,000 per year plus interest to be paid from November 1, 1983, to November 1, 1995.

d. The remaining unpaid balance was to come due 20 years after the date of closing. (App. Post-Hg. Memo., Ex. A. at 3-4.)

The Terrace Apartments were leased back to appellant for a period of six years. The lease was apparently a "triple net lease" in that appellant remained liable for operating expenses, taxes, existing debt, etc. (App. Post-Hg. Memo., Ex. C, sub-Ex. J.) By separate agreement dated November 5, 1976, appellant purchased, for $10, a right of first refusal to purchase the Terrace Apartments on or before November 5, 1982, from the Partnership. In spite of the fact that it was purchased for $10, the right of first refusal was valued by the parties under this agreement at $3,500,000. (Resp. Br., Ex. A at 3.)

In reporting the sale of the Terrace Apartments on its corporate franchise tax return for the income year ended September 30, 1977, appellant reduced the $10,000,000 selling price by the $3,500,000 ascribed to

the right of first refusal. This treatment resulted in a recognized loss of $596,692 to appellant on the sale. Appellant elected to have the installment method of reporting apply to the sale. (Resp. Post-Hq. Memo., Ex. B.)

Upon audit, respondent determined that the $3,500,000 had not "accrued" within the meaning of section 24681, and adjusted the above-referenced computation by adding back the $3,500,000.[2] This resulted in a gain realized of $903,308. The gain recognized, on the installment basis (based.upon a gross profit percentage of 29 percent and payment received of $175,000), was $50,750. (Resp. Post-Hg. Memo;, Ex. B.)[3] Accordingly, respondent disallowed the claimed loss and added the $50,750 to appellant's reported income. (Resp. Post-dq. Memo., Ex. C.) Appellant protested, but respondent affirmed its proposed assessment. Appellant filed this appeal.

On appeal, appellant argues that the right of first refusal was a "retained right" with an ascribed value of $3,500,000 and, therefore, that amount; of the gross salesprice would never be realized. (App. Reply Ltr., Sept. 18, 1984, at 1.) Appellant argues that if the right was exercised, it was to pay the Partnership $14,133,000 which was the $10,000,000 note plus cash approximately equaling the funds which it was to receive during the six-year period with interest. On the other hand, if the right was not exercised, the $10,000,000 note would be reduced by $3,500,000 so that only $6,500,000 would actually be received from the Partnership. (App. Reply Ltr., Sept. 18, 1984, at 1 and 2.) Appellant appears to additionally argue that the subject transaction might be more appropriately cast as a financing transaction rather than as a sale. (App. Reply

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2/ On audit, respondent initially understood that appellant had excluded the $3,500,000 because it had accrued that amount as an expense. As indicated below however, appellant subsequently contended that the $3,500,000 was not an accrued expense or loss, but that it was a "retained right." (App. Reply Ltr., Sept. 18, 1984, at 1.) Accordingly,- no discussion of the "accrual" issue is required.

3/ Respondent also adjusted appellant's return involving the restructure of debt. Appellant agrees that this adjustment was proper. (App. Ltr., Apr. 12, 1984, at 1.)

-Ltr., Sept. 18, 1984, at 2.) This second argument would have the effect that the $175,000 received-by appellant during the year at issue would not be deemed to be income to **it.** However, consistent treatment would require that tax advantages (e.g., depreciation) heretofore taken by the Partnership would be lost to it.[4] Respondent notes, however, that it has accepted the transactions as a sale as initially cast:by the parties. **(Resp.** Br. at **6.)** Woreover, respondent **reaffirms** that its treatment including the amount attributed to the right of first refusal as part of the amount realized is proper. (Resp. Post-Hg. Memo. at 11.)

Accordingly, in this appeal, we have two questions to address: (1).whether the subject transactions resulted, in fact, in a sale as opposed to a financing arrangement; and (2) if so, whether **respondent's characterization** of the **proceeds** of that sale is correct.

We note that while the Partnership and appellant were aware of the risk that the transactions might be recast by taxing authorities as a financing arrangement rather than as a sale, they clearly intended and arranged for the transfer to be treated as a sale. (Resp. Post-Hg. Memo., Ex. D at 9, **par. 10(a)(iii).)** The **escrow instructions accompanying the transfer clearly** envision a sale. The calculations of the offering prospectus made available to the limited partners are clearly based upon sale treatment. (Resp. Post-Hg. Memo., **Ex. D.)** And while the record does not indicate if the limited partners, in fact, treated the transaction as a sale to them, we consider it to be inconceivable that they would not. Accordingly, to treat the subject.- transaction as a financing arrangement as appellant now contends, rather than as a sale, would violate the general rule that a party'may not disavow the tax consequence of his own agreement. It is, of course, well settled that a party to an agreement "can challenge the tax consequences of his agreement as construed by the [taxing authority] only by adducing proof which in an action between the parties would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, **etc."** (Commissioner v. Danielson, 378 **F.2d** 771, 775 (3rd Cir. **1967).)** No such proof has been advanced by appellant in

4/ See Del **Cotto,** Sale and Leaseback: A Hollow Sound **When** Tapped? 37 Tax L. Rev. 1 (1981).

this appeal. Accordingly, we find that the agreement between the Partnership and appellant provides for a sale of Terrace Apartments and that appellant has not produced any evidence *which would alter that construction or alter the enforceability of the agreement. Therefore, we find that the subject transactions resulted in a sale.

Our second inquiry concerns the proper treatment by appellant of that sale. As indicated above, appellant argues that whether the right is exercised or not, it will not realize the full gross sales price of $10,000,000. In an April 22, 1985, letter, its accountant stated:

> In substance, the maximum amount which could ever be realized by [appellant] was $6,500,000. If the right of first refusal is not exercised, the $10,000,000 note would be reduced by $3,500,000 so that only $6,500,000 would actually be received from the sale. If the right was exercised, [appellant] would be required to pay the partnership $14,133,000. (Resp. Post-Hg. Memo., Ex. A at 2.)

However, it is clear that each of these mutually-exclusive possibilities would produce completely different effects on the parties. If the right is exercised, the Partnership would realize a long-term capital gain and appellant would reacquire the apartment at an increased basis. On the other hand, if the right is not exercised, the Partnership would realize ordinary income due to the discharge of its indebtedness and appellant would incur a complementary expenditure. In either case, the tax treatment to the parties and the effect of the right must wait until that right is exercised or not and any adjustment between the parties should properly be made at that time. 'Accordingly, any adjustment caused by the ultimate exercise or nonexercise of the right would properly realign the interests of the parties.[5/]

5/ While the Partnership is not before us in this matter and while 1977 may not now be an open year for it, consistency would require that, under appellant's theory, the Partnership's adjusted basis for depreciation should be $6,500,000 rather than $10,000,000. However, such an adjustment would violate the rule cited above in Commissioner v. Danielson, supra.

Any adjustment of the stated sales price of $10,000,000 in the year before us would be pure speculation. Based upon the facts presented, respondent's determination following the stated terms of sale and postponing any adjustment until the ultimate exercise or nonexercise of the right of first refusal is not only an accurate interpretation of the agreements submitted, but also allows for consistent treatment by both appellant and the Partnership. Moreover, it is well settled that respondent's determination is presumptively correct and appellant bears the burden of proving that it is incorrect., (Appeal of Coachmen Industries of California, Inc., Cal. St. Bd. of Equal., Dec. 3, 1985.) Nothing presented by appellant establishes respondent's determination is incorrect. Accordingly, respondent's action must be sustained.

Appeal of International Bay Clubs, Inc.

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 International Bay Clubs, Inc., against a proposed assessment of additional franchise tax in the amount of $14,169.76 for the income year ended September 30, 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day Of July , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

__________, Member

*For Kenenth Cory, per Government Code section 7.9