56-SBE-014

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JACMAR ORCHARDS, INC.)

Appearances:

For Appellant: Cy H. Lemaire, Attorney at Law

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 protests of Jacmar Orchards, Inc., to proposed assessments of additional franchise tax in the amounts of $5,299.24 and $2,800.48 for the taxable years ended March 31, 1950, and March 31, 1951, respectively, the tax for both years being measured by income of the year ended March 31, 1950.

On or about April 1, 1947 Mr. H. R. Minkoff acquired a tract of land suitable for sub&vision into residential lots. Shortly thereafter he entered into negotiations for the development of the tract with Mr. Mark Boyar, a builder, and other interested persons, As a result of these negotiations it was agreed that the group would organize a corporation to take over the land and construct homes thereon for sale to veterans. For his services in acquiring the land and setting up the project it was agreed among the incorporators that the corporation would pay Mr. Minkoff the sum of $100 per lot, an aggregate amount of $21,000, payable as lots were improved and sold,

Appellant was incorporated on May 2, 1949. Its authorized capital structure consisted of $225,000 in preferred stock, in which Mr. Minkoff invested $100,000, and $2,700 in common stock, in which he invested $400. The agreement to compensate Mr. Minkoff in the amount of $21,000 was ratified by Appellant at a meeting of its board of directors on May 12, 1949. Payment was made on March 6, 1950.

Appellant adopted a fiscal year ending on March 31. It filed its first return, stated to be on the cash receipts basis, for the period May 2, 1949, to March 31, 1950, On this return it reported sales of 81 homes. It paid a tax for the period covered by the return, and a prepayment of tax for the year ending March 31, 1951, measured by its net income from these sales. The reported sales were those in which the escrows had been closed and the deeds recorded.

On August 30, 1950, Appellant filed a' return for its second taxable year, This return, likewise stated to be on the cash receipts basis, covered the period April 1, 1950, to August 23, 1950, and included receipts from sales of the remaining 129 homes in the subdivision, It did not pay, any tax measured by income from these sales. On November 29, 1950, Appellant was dissolved.

Acting under Section 12(1) of the Bank and Corporation Franchise Tax Act (now Section 24651 of the Revenue and Taxation Code), the Franchise Tax Board recomputed Appellant's net income from all sales on a completed sale basis. On this basis it apportioned income from sales of 182 homes to the period ended March 31, 1950. The deficiency for the taxable year ended March 31, 1951, was determined on the basis that Appellant was taxable for that year under Section 13(k) of the Bank and Corporation Franchise Tax Act (now Section 23332 of the Revenue and Taxation Code), which governs the taxation of a dissolving corporation, As Appellant had done business for eight months of the year in which it dissolved, the Franchise Tax Board, acting under Section 13(k), measured the tax by 8/12ths of Appellant's revised net income for the preceding income period,

Under Appellant's method of operation a prospective purchaser of a home was required to sign an agreement to purchase, which was subject to approval by Appellant within 60 days, If the sale was subsequently disapproved by Appellant both it and the purchaser were relieved from all liability thereunder, Although down payments were not required, a forfeiture clause provided that upon cancellation by the purchaser "for any reason other than the Seller's failure to approve this sale or failure to obtain approval of 'GI' loan." , Appellant was authorized to retain as liquidated damages all sums paid by the purchaser.

The next step in the sales process was the execution by the purchaser of applications for a loan and for Veterans Administration approval, While these applications were pending Appellant completed the home, Upon completion the prospective purchaser was given occupancy under an agreement providing that he would pay Appellant monthly a sum to be computed by prorating the taxes, interest and insurance from date of occupancy and that "in the event loan fails to be approved by Veterans Administration, this Purchaser will vacate the premises immediately on Notice from Seller." Either before or after a prospective purchaser moved in, usually after, escrow instructions were signed by both parties.

The receipt by the escrow company of a commitment from the lending institution, with the approval of the Veterans Administration, was followed forthwith by issuance of a policy of title insurance and the recording of a deed, after which the escrow was closed. The interval between the signing of a purchase agreement and the close of escrow ran from three to eight months, Monthly payments under agreements for occupancy were computed to the date on which the deed was recorded.

In each of the 101 transactions in dispute the prospective purchaser had taken possession by March 31, 1950. In each transaction the escrow instructions had been signed by that date, In none of them, on that date, had the purchase agreement been approved by Appellant, the deed been recorded, or the escrow closed. Although admitting that legal title to the premises did not pass to the purchaser prior to March 31, 1950, the Franchise Tax Board contends that each transaction constituted a completed sale by that date because the purchaser had assumed the benefits and burdens of ownership. While not disputing the statement that acceptance by the purchaser of the benefits and burdens of ownership gives rise to a completed sale, the Appellant argues that in none of the disputed transactionshad such benefits and burdens passed to the purchaser prior to March 31, 1950.

Both parties agree that the benefits and burdens of ownership do not pass from seller to purchaser until all substantial contingencies have been eliminated, Appellant contends that there were substantial contingencies present here in that (1) the lending agency had yet to accept the prospective purchaser as a credit risk, (2) the Veterans Administration had to approve the prospective purchaser's eligibility for a loan guaranty, and (3) a policy of title insurance had to be obtained. The Franchise Tax Board denies that these were substantial contingencies and asserts that there was a reasonable certainty that the 101 transactions would be completed.

Although it appears that all of these transactions were later completed, we feel Appellant is correct in asserting that there were substantial contingencies present which had to become certain before the benefits and burdens of ownership passed to the purchaser, Certainly possession alone is not enough to pass the benefits and burdens of ownership to the possessor, As was said in In Re Chrisman, 35 F. Supp. 282, p. 283, "Occupancy of land, while awaiting delivery of instruments in escrow, does not give rise to any interest in it independent of the conditions of the escrow or contrary to it." And merely opening an escrow does not operate as a transfer of title nor as a transfer of the benefits and burdens of ownership, Holman v. Toten, 54 Cal. App. 2d 309. In these transactions, if the purchaser had failed to secure acceptance as a credit risk, or the approval of the Veterans Administration, he would have been required to vacate the premises, Where one has the benefits of ownership he cannot be required to vacate on the failure of a contingency. The escrow instrument provided that unless the necessary approvals were secured and a policy of title insurance issued within thirty days either party was free to withdraw without liability. Where one has the burdens of ownership he cannot withdraw from a transaction without liability upon the failure of contingencies, In Commissioner v. Segall, 114 Fed, 2d 706, the court said, at p. 710, that "A factor often considered [in determining whether a sale has been completed] is whether there has been such substantial performance of conditions precedent as imposes upon the purchaser an unconditional duty to pay." Where one may withdraw without liability upon the failure of a condition, as the parties, could here, it cannot be said that there is an unconditional duty to pay nor that the burdens of ownership have passed to the purchaser,

As we are unable to accept the contention of the Franchise Tax Board that the benefits and burdens of ownership had passed to the purchasers prior to March 31, 1950, we have concluded that income from the disputed sales is not includible in Appellant's income for the year ended March 31, 1950. But this does not mean that the income from these transactions escapes taxation.

As we have heretofore noted, Appellant paid its tax and the Franchise Tax Board issued its proposed deficiency assessment for the taxable year ended March 31, 1951, on the supposition that the tax for that year was to be computed under Section 13(k) of the Bank and Corporation Franchise Tax Act. In our opinion in the Appeal of Sacramento Valley Tractor-Company, decided May 5, 1953, we said that a commencing corporation with a first taxable year of less than 12 months which dissolved in its second taxable year was taxable for both years under Section 13(c) of the Act (now Section 23222 of the Revenue and Taxation Code),, Under Section 13(c) Appellant was subject to a tax for the period April 1, 1950, to November 29, 1950, the date of dissolution, measured by net income for that period. As the deficiency proposed to be assessed for this period, together with Appellant's prepayment of tax for its second taxable year, does not equal the correct amount of tax computed under Section 13(c), the action of the Franchise Tax Board in denying Appellant's protest to this assessment must be sustained.

In reaching the foregoing conclusion we have considered the 1949 amendment to subdivision (c) of Section 13, which was not in effect for the year in question in the Sacramento Valley Tractor appeal, This amendment, in the event of the dissolution of a commencing corporation in its second taxable year, permitted the proration of the prepayment of tax for that year if the prepayment was greater than the tax for the period preceding dissolution, It did not, in our opinion! preclude the taxation of such corporations under subdivision (c).

The second question presented in this appeal arises from the disallowance by the Franchise Tax Board of the deduction from gross income of the $21,000 paid to Mr. Minkoff and included by Appellant in its cost of land. The Franchise Tax Board contends that this payment was in consideration of Mr, Minkoff's large investment in Appellant's shares of stock and for that reason constituted a distribution of earnings and profits essentially equivalent to a dividend.

In support of its contention, the Franchise Tax Board has directed our attention to various Federal decisions in which payments made by a corporation out of its earnings or profits were construed to constitute dividends, even though they purported to be based upon a consideration and were not designated as dividends. Each of these cases turned on its particular facts, Common to all the cases, however, was an absence of consideration for the payments and the presence of an intent to distribute accumulated earnings and profits.

The fact that Mr. Minkoff made the largest single investment in Appellant's shares of stock has prompted us to examine this transaction closely, but even after such close examination the position of the Franchise Tax Board appears untenable. The uncontroverted evidence shows that the agreement between Mr. Minkoff and the other incorporators was made before the date of incorporation, The agreement was ratified by Appellant within ten days after its incorporation and before it had earned any profits, Although by the terms of the agreement payment to Mr. Minkoff was deferred until Appellant had realized sufficient income from which to make the payment, the obligation was not contingent upon Appellant's having net profits. Lastly, the payment was by way of compensation for services actually performed by Mr. Minkoff prior to the incorporation of Appellant, the benefits of which accrued to Appellant, The Franchise Tax Board has not suggested that these services were not worth the agreed compensation, or that the land acquired by Appellant as a result of Mr. Minkoff's activities was worth less than the purchase price plus the $21,000 paid to Mr. Minkoff. These facts clearly remove the payment in question from the scope of the authorities relied upon by the Franchise Tax Board,

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 protests of Jacmar Orchards, Inc., to proposed assessments of additional franchise tax in the amounts of $5,299.24 and $2,800.48 for the taxable years ended March 31, 1950, and March 31, 1951, respectively, be and the same is hereby modified as follows: the action of the Franchise Tax Board in including in income of the year ended March 31, 1950, receipts from sale of 101 homes and disallowing a deduction in that year in the amount of $21,000, is reversed; in all other respects the action of the Franchise Tax Board is hereby sustained,

Done at Sacramento, California, this 27th day cf November, 1956, by the State Board of Equalization,

Paul R. Leake, Chairman

J. H. Quinn, Member

Geo, R. Reilly, Member

Robert E. McDavid, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L, Pierce, Secretary