62-SBE-013

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BILTMORE HOMES, INC.)

Appearances:

For Appellant: David Uzel, Certified Public Accountant

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 Biltmore Homes, Inc., against proposed assessments of additional franchise tax in the amounts of $92.73, $115.20, 977.96, $201.43 and $358.38 for the taxable years 1953, 1954, 1955, 1956 and 1957, respectively.

Appellant is a California corporation which has been engaged in the ownership, construction and operation of real estate since 1946, primarily constructing homes and developing real property. All of its stock, at all times pertinent to this appeal, has been owned by Sydney M. Taper.

In 1949, Mr. Taper and his wife purchased real property in Beverly Hills for $70,018.49. In order to have a home suited to their own tastes, they extensively rebuilt the existing improvements at a cost of $77,386.93 and installed furnishings costing an additional $54,953.37. This work was completed in 1951.

On November 30, 1951, they obtained an opinion from a real estate agent that the maximum rental value of the home, if leased furnished for from three to five years, would be $15,000 per year and that a fair rental value would be $12,000 per year.

On December 31, 1951, the Tapers conveyed their home to Appellant at their cost, $202,358.79, and then leased it back for a five-year term at an annual rental of $12,000. The lease obligated the Appellant corporation to keep the premises, including the furnishings, in good condition, to replace any articles worn out or damaged by fair wear and tear or accidentally destroyed, to pay all utility bills, including telephone expense, and to employ regular help to attend to the gardens, tennis court and swimming pool.

The financial results of the lease during the income years involved are shown in the following table:

	1952	1953	1954	1955	1956
Rental income	$12,000.00	$12,000.00	$12,000.00	$12,000..00'	$12,000.00
Rental expenses (incl. ppty. tax)	5,673.57	6,177.99	5,240.88	7,746.69	11,670.25
Depreciation	8,644.66	8,701.88	8,708.04	9,289.23	9,289.22
Net losses	$2,318.23	$2,879.87	$1,948.92	$5,035.92	$8,959.47

After the five-year term the monthly rental was increased to $1,200 as the result of a new appraisal. On August 1, 1958, because of the addition of two rooms and a bath to the home, the rental was raised an additional $250 per month. Appellant reported a loss on the lease of $4,762.62 for the income year 1957, a profit of $896.73 for 1958 and a loss of $541.10 for 1959.

The Franchise Tax Board takes the position that the sale and leaseback was not an arm's-length transaction and that its tax effect should be nullified by treating the losses as non-deductible dividends distributed to Appellant's sole stockholder, Mr. Taper.

For tax purposes, a transaction between closely related parties demands special scrutiny to determine whether it has substance. Thus, a transfer of assets from a stockholder to his corporation may be disregarded if the transfer has no business purpose and is made only to reduce tax liability. (Higgins v. Smith, 308 U.S. 473.) Upon the same principle, a sale and lease-back (W. H. Armston Co. v. Commissioner, 188 F.2d 531) or a lease (58th St. Plaza Theatre v. Commissioner, 195 F.2d 724) may also be ignored.

It is difficult to believe that Appellant would have entered into a sale and leaseback with a stranger on the terms that it did with its sole stockholder, Mr. Taper. Appellant, or more realistically, Mr. Taper, was experienced in real estate matters. It is hardly credible that it or he could not have foreseen that the corporation would sustain substantial losses as a result of the transaction.

Appellant points to the increased rentals at the end of the initial five-year term as evidence of the good faith of the arrangement. The facts, however, show continued losses to Appellant following the increases except for one year when a profit of $896.73 was realized. The existence of continued losses after the adjustment, except for a meager return in one year of less than one-half of one percent on Appellant's investment, detracts rather than adds to Appellant's claim of good faith.

In attempting to establish that Appellant gained a business advantage from the sale and leaseback, it is argued that Appellant did not really suffer an economic loss because, aside from the factor of depreciation, it realized profits. Depreciation, it is claimed, is only a 'theoretical loss when values are actually appreciating,

Assuming that a valid business purpose could be found in purchasing property and leasing it back at an apparent loss, solely to benefit from appreciation in the value of the property, there is no evidence before us to establish the fact or extent of any appreciation in the value of the property here involved. The facts before us show that the rents received by Appellant were insufficient to meet expenses, recover its investment and realize a fair return.

Appellant also advances the contention that the tax benefit to Mr. Taper would have been greater if he had retained the home himself. Appellant's computations show that the reduction in Mr. Taper's personal income tax had he kept the house would have exceeded the reduction in Appellant's franchise tax arising from itsclaimed losses under the sale and leaseback. The computations reflect the tax benefit that Mr. Taper would receive by deducting property taxes in his comparatively high personal income tax bracket.

Appellant's approach ignores the double advantage of reducing both the corporate and the personal taxes. Mr. Taper was receiving the use and enjoyment of the property and benefiting from the payment of what would otherwise be personal, nondeductible items, without making an equivalent return to Appellant. At least to the extent of the losses claimed by Appellant, Mr. Taper was effectively drawing income from Appellant without paying personal income taxes upon it.

None of the cases cited by Appellant is inconsistent with the position of the Franchise Tax Board. Appellant places particular reliance upon <u>Sun Properties, Inc. v. United States</u>, 220 F.2d 171. That case dealt with a sale by a stockholder to his corporation at a profit, the corporation thus obtaining a higher basis for depreciation. Clearly, the case is distinguishable. The court, in fact, expressly recognized a significant difference between the case before it and a sale and leaseback.

In our opinion, the transaction before us was designed solely to avoid taxes and had no valid business purpose. By disallowing any deduction of the alleged losses by the corporation, Respondent has properly eliminated the tax advantages of the arrangement.

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 Biltmore Homes, Inc., against proposed assessments of additional franchise tax in the amounts of $92.73, $115.20, $77.96, $201.43 and $358.38 for the taxable years 195.3, 1954, 1955, 1956 and 1957, respectively, be and the same is hereby sustained.

Done at Pasadena, California, this 26th day of February, 1962, by the State Board of Equalization.

George R. Reilly, Chairman

John W. Lynch, Member

Paul R. Leake, Member

Richard Nevins, Member

_______________, Member

ATTEST: Dixwell L. Pierce, Secretary