BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PAUL AND NANCY FALKENSTEIN)

For Appellants: Roland S. Woodruff
Attorney at Law

For Respondent: James C. Stewart
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Paul and Nancy Falkenstein against a proposed assessment of additional personal income tax in the amount of $13,591.17 for the year 1365.

Appeal of Paul and Nancy Falkenstein

During 1965 and 1966, Mr. Falkenstein (hereinafter referred to as "appellant") was a partner in a joint venture known as "Casper and Falkenstein" {C&F), which owned and operated a thoroughbred racing stable. In August 1965, C&F purchased a 3/4 interest in a colt named Bold Bidder.

On November 30, 1965, C&F executed an agreement (the agreement) with one John R. Gaines, the owner of a thoroughbred breeding farm. In the agreement, C&F leased Bold Bidder to Mr. Gaines for a period of five years, commencing December 1965, with annual lease payments of $105,000 payable in'quarterly installments. The agreement granted to Mr. Gaines an irrevocable option to purchase C&F's interest in Bold Bidder for $448,750. The option could be exercised during March 1966 by delivery of the full purchase price to C&F. In January 1966, Mr. Gaines made the first rental payment of $26,250. In March 1966, he exercised the option, and C&F transferred title to the horse to him.

On its partnership return for 1966, C&E' reported that the sale occurred in 1966 and that- the gain was long-term capital gain. As a result of an audit of C&F's 1965 and 1966 tax returns, the Internal Revenue Service determined that Bold Bidder was actually sold to Mr. Gaines in November 1965 and that the entire gain was realized in 1965. For the years in issue, Internal Revenue Code section 1222 defined short--term capital gain as gain from the sale of a capital asset held less than six months. Since C&F had not held the colt for six months as of November, the Internal Revenue Service determined the partnership's gain to be short-term capital gain. It adjusted'appellants' 1965 personal income tax return to include the capital gain from the sale. Also, it adjusted their 1966 return by disallowing the deduction claimed for depreciation of the horse and by removing from their taxable income the amount appellants reported having received as lease payments for Bold Bidder. In addition, the Internal Revenue Service adjusted appellants' 1963 and 1964 returns to reflect changes in the net operating loss carrybacks, investment credit carryovers, and investment credit carrybacks claimed for those years. Appellants protested the adjustments made to their 1965 return and eventually filed a petition in the United States Tax Court. The tax court action was dismissed at appellants' request when the Internal Revenue Service agreed to reduce the assessment by one-half.

Respondent received notice of the federal audit and determined that the adjustments made to appellants' 1963 and 1964 returns were not applicable to their California returns. It determined, however, that the adjustments for the year 1965 were applicable to their state return since, until its repeal in 1972, Revenue and Taxation Code section 18162 was identical to Internal Revenue Code section 1222. Respondent also determined that the federal adjustments to appellants' 1966 return were applicable to their state return. The 1966 adjustments resulted in a decrease in appellants' taxable income for that year and were not disputed by appellants. Respondent issued a proposed assessment of additional tax for 1965 and reaffirmed it after appellants' protest, giving rise to this appeal.

The sole issue for determination is whether the agreement between C&F and John R. Gaines was properly characterized, for tax purposes, as a sales agreement or a lease with an option to purchase.

A determination by respondent which is based upon a federal audit report is presumed correct, and the taxpayer must either concede that it is correct or bear the burden of proving that it is incorrect. (Rev. & Tax. Code, § 18451; Appeal of Herman D. and Russell Mae Jones, Cal. St. Bd. of Equal., April 10, 1979.) Respondent's position is that appellants have not met their burden of proof since they have not produced evidence indicating that the adjustments by the Internal Revenue Service for 1965 were erroneous. However, appellants have produced a copy of the agreement and an affidavit signed by Mr. Gaines, the buyer of Bold Bidder. Appellants claim this evidence proves that the sale occurred in March 1966 rather than in November 1965. Since some evidence in support of appellants' position has been presented, this board must examine it to ascertain whether this evidence supports a finding contrary to respondent's determination. (Appeal of Janice Rule, Cal. St. Bd. of Equal., Oct. 6, 1976.) The only issue raised by appellants is whether the agreement is properly treated as a sales agreement or a lease with option. Apparently, appellants do not dispute the Internal Revenue Service's conclusion that, if the agreement is treated as a sales agreement, the gain was realized in 1965 and is taxable as short-term capital gain.

Substance rather than form determines the tax effects of a transaction. (Gregory v. Helvering, 293

U.S. 465 [79 L.Ed. 596] (1934).) In order to determine the substance of a transaction, we must ascertain the parties' intentions by examining the circumstances existing at the time the agreement was entered into and determine the agreement's practical effect by examining its legal provisions and the economics of the transaction. (George S. Lensing, ¶ 61,268 P-B Memo. T.C. (1961): Truman Bowen, 12 T.C. 446 (1949).) A lease with an option to purchase is properly treated as a sale if the parties to the agreement intended that a sale ultimately be consummated and if, at the time the agreement was made, there was no logical or economic reason for the lessee to refrain from exercising the option. (Karl R. Martin, 44 T.C. 731 (1965), affd., 379 F.2d 282 (6th Cir. 1967); Truman Bowen, supra.)

Although-the agreement is in the form of a lease with option, we conclude that it is, in substance., a sales agreement. Therefore, it is properly characterized, for tax purposes, as a sales agreement.

The circumstances surrounding the execution of the agreement reveal that both C&F and Mr. Gaines intended the transaction to culminate in a sale. Mr. Gaines' affidavi-t states that he originally intended. to purchase Bold Bidder and leased him only because C&F was unwilling to enter into an outright sale. Appellants explain that C&F was unwilling to sell the horse in 1965 because its gain from a sale at that time would have been short-term capital gain. To avoid that result, the transaction was cast in the form of a lease with: an option to purchase, which was exercisable in March, immediately after'the expiration of C&F's six-month holding period.

The agreement itself also indicates the parties' intention to ultimately consummate a sale. One factor indicating that a lease with an option is, in substance, a-sale is the transfer to the "lessee" of those burdens of ownership which are not normally transferred to a lessee under a lease agreement,

In the instant appeal, Mr. Gaines assumed substantially all the burdens of ownership when he received‘possession of Bold Bidder in November 1965. The- ag-reement required him not only to obtain full mortality insurance on the horse, but also to assume the risk of any loss, damage, or injury to the animal not covered by such insurance. In addition, Mr. Gaines was responsible for the payment of any ad valorem taxes assessed upon the horse. The transfer of these burdens of ownership have been held to be indicative of a sale, rather than a lease, of property. (Karl R. Martin, supra; Lemon v. United States, 115 F.Supp. 573 (W.D. Va. 1953).)

Finally, the economics of this transaction indicate that a sale, rather than a lease, was intended. A transaction in the form of a lease with option is treated as a sale if the economics are such that, at the time the agreement was executed, it is reasonable to infer that the option would be exercised. (George S. Lensing, a .) Thus, in-cases where the agreement provided that the lessee could purchase the property at the end of the lease term for a nominal amount, courts have consistently treated the transactions as conditional sales for tax purposes. (Truman Bowen, supra.) Similarly, where the payments pursuant to the lease were identical in amount and timing to the payments due after exercise of the option, the transaction was held to be a sale. (Karl R. Martin, supra.) However, when the amount due varies significantly according to whether or not the option is exercised, the lease with option has economic substance and is properly treated as a lease. (Estate of Adam Holzwarth, ¶ 65,304 P-H Memo. T.C. (1965).) - -

In the instant appeal, if Mr. Gaines failed to exercise the option, he was required to make lease payments totaling $525,000 over five years. If he exercised the option, he was required to pay a total of only $475,000, that is, the $448,750 purchase price, payable in March 1966, and the $26,250 rent, payable for the period prior to the exercise of the option. Appellants argue that there was a question as to whether or not Mr. Gaines would exercise the option. Because of this, they conclude that the option had economic substance. They stress the statement in Mr. Gaines' affidavit that the lease with option was acceptable to him because he would be able to see Bold Bidder race for six months before deciding whether or not to exercise the option; if Bold Bidder had not raced well during that six-month period, the "option might very well have not been exercised." We find this statement unconvincing. Once Mr. Gaines executed the agreement, he was unconditionally obligated to pay $525,000 and to bear the burdens of ownership for five years. His only other choice was to pay $50,000 less and obtain complete ownership of the horse. Assuming that the horse's useful life, first as a race horse and later as a stud, exceeded five years, it is clear that ownership was more beneficial than the lease-hold interest. Mr. Gaines could obtain the more significant benefits of ownership, and save $50,000, by exercising the option. Furthermore, there was no disadvantage to exercising the option since Mr. Gaines was already obligated to bear the burdens of ownership. Under these circumstances, we find that it was reasonable to assume that Mr. Gaines would exercise the option and obtain the benefits of ownership. Therefore, we conclude that the agreement was, in reality, a sales contract and that the sole reason for casting the agreement in the form of a lease with an option was to attempt to convert the gain to long-term capital gain by delaying passage of title until the six-month holding period had expired. It follows that appellants realized short-term capital gain on the sale of Bold Bidder.

For the foregoing reasons, the action of respondent must be sustained.

Appeal of Paul and Nancy Falkenstein

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Paul and Nancy Falkenstein, against a proposed assessment of additional personal income tax in the amount of $13,591.17 for the year 1965, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of February, 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Conway H. Collis, Wember

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

______________, Member