

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
KRANDILL MORTGAGE AND INVESTMENT CO,)

Appearances:

For Appellant: Rainey and Blum, Attorneys 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 the Krandill Mortgage and Investment Co, to proposed assessments of additional franchise tax in the amounts of \$899.32 and \$384.40 for the income years 1944 and 1945, respectively.

Appellant was incorporated in California in 1933 and has been engaged in the building and investment business in this State since that year. Its stock is owned one-half by Richard S. Diller and his wife and one-half by Herman Kranz and his wife, all of whom are residents of California. The operations of the corporation prior to the period in question had not been profitable. On January 1, 1944, it had accumulated a deficit of \$3,663.05 and had a net worth of about \$22,000.

Kranz and Diller were both actively engaged in the construction business. For some years prior to the transaction in controversy they had been associated in a partnership known as the Krandill Company, in which each owned a half interest,

Early in 1944, Kranz and Diller decided to purchase and subdivide certain land, to build houses thereon, and to sell the houses to the general public on the installment basis, To carry out thfs plan they arranged for the construction of the houses by Appellant. The original purpose of this arrangement was to limit the personal liability of Kranz and Diller and to enable them to prepare individual and partnership financial statements free of liabilities arising from the construction project,

Before the execution of any agreement it became apparent that Appellant could not obtain financing for the construction of the houses unless Kranz and Diller loaned Appellant substantial sums of money and

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made certain guarantees, On April 28, 1944, a contract providing for the construction of the homes was entered into between Appellant and Kranz and Diller, as partners, in which it was agreed that Appellant would "sell" and the partnership would "purchase" 200 single residences at "\$150 above cost" and 15 double homes at "\$250 each, over and above cost". It was further agreed that Kranz and Diller would (1) advance up to \$150,000 as working capital and as a guarantee that they would "purchase" all of the houses to be built, (2) personally guarantee the bank making the construction loans against any and all liens, (3) post their personal bond for completion of the houses, and (4) assume personal responsibility for all material and labor costs.

Subsequent to the execution of the agreement, Kranz and Diller transferred to Appellant, without cost, the land upon which the houses were to be constructed, The bond and other guarantees called for by the agreement were furnished by Kranz and Diller. They also advanced working capital and on December 31, 1944, Appellant was indebted to Kranz and Diller in the amount of \$260,613.45. They did not charge and Appellant did not pay any interest for the use of these funds.

It its returns for the year in question Appellant reported only the contract fees received from its construction activities, rather than a gross sales price less cost of construction. For the income year 1944, Appellant reported a gross profit of \$29,000 from this source, and other income consisting principally of rents, together aggregating \$37,513.49. Administrative and overhead expenses in the amount of \$35,863.04 were claimed as deductions leaving a reported net income of \$1,650.45. For the income year 1945, Appellant reported gross income of \$14,197.38, of which \$12,878.18 represented gross profits derived from its contract with Kranz and Diller, Administrative and overhead expenses claimed as deductions aggregated \$1,371.62.

In all, 222 homes were constructed in the development of the tract. As the homes were completed they, with the lots upon which they were constructed, were deeded to the Krandill Company, the partnership composed of Krane and Diller. The Krandill Company paid Appellant the sum of the direct costs of construction and the amount above cost provided for in the contract. The partnership sold the homes on the installment basis. No evidence has been offered by either party as respects the sale price of the homes to the public.

Acting on the assumption that administrative and overhead expenses were reimbursable under the contract with Kranz and Diller the Franchise Tax Board increased Appellant's net income by the amount of \$26,438.27 for the income year 1944, and \$11,272.37 for the income year 1945. These amounts represented the share of Appellant's aggregate overhead expenses estimated by the Franchise Tax Board to be attributable to the construction of the homes. The Franchise Tax Board has apparently since concluded that overhead expenses were not reimbursable under the contract as it now

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relies on the second paragraph of Section 14 of the Bank and Corporation Franchise Tax Act (now Section 25103 of the Revenue and Taxation Code) in support of the proposed **assessments**. That paragraph provided as follows:

"In the case of a corporation doing business within the meaning of this act, whether under agreement or otherwise, in such manner as either directly or indirectly to benefit the members or stockholders of the corporation, or any of them, or any person or persons, directly or **indirectly** interested in such business, by rendering services of any nature whatsoever, or acquiring or disposing of its products or the goods or **commodities** in which it deals, at less than a fair price therefor, the commissioner, in order to prevent evasion of taxes ~~as~~ clearly to reflect the income of such corporation, may require a report of such facts as he deems **necessary**, and may determine the amount which shall be deemed to be the entire net income allocable to this State of the business of such corporation for the calendar or fiscal year, and compute the tax upon such net **income**. In determining the **entire** net income the commissioner shall have regard to the fair profits which, but for any agreement, arrangement, or **understanding**, might be or could have been obtained from dealing in such products, goods or **commodities**."

The Franchise Tax Board does not attack the transaction in question as a sham or subterfuge. Its position, rather, is that the quoted provisions of Section 14 require that a fair profit to Appellant must be **determined** without regard to the value of the financial aid and services it received from the Krandill Company, or from **Kranz and Diller** individually. These contributions to the project were substantial, consisting of furnishing without cost the land upon which to build **the** houses, a loan in excess of \$250,000 without interest, and their guarantee of completion of the project and payment of all material and labor costs.

We do not agree that Section 14 (*supra*) required the Franchise Tax Board to determine the fairness of the profit received by Appellant without giving consideration to the value of the services rendered by the partners. In the absence of a claim that the transaction in question lacked substance, or was entered into solely for purposes of tax avoidance, we think that the substantial obligations undertaken by the partners under the contract must be treated as consideration given by them in **determining** the question of fair profit. Seminole Flavor Co. v. Commissioner, 4 T. C. 1215, 1233. Net income reported by Appellant for the income year 1944 was equivalent to a return of seven percent of ~~its~~ net worth, For the income year 1945 reported net income represented

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a return of approximately six percent on net worth, Considering the transaction in question in its entirety, we are of the opinion that the claim that Appellant received less than a fair price for the houses it constructed has been rebutted by the facts.

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 ORDER, 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 Krandill Mortgage and Investment Co. to proposed assessments of additional franchise tax in the amounts of \$899.32 and \$384.40 for the income years 1944 and 1945, respectively, be and the same is hereby reversed.

Done at San Francisco, California, this 29th day of Dec., 1958, by the State Board of Equalization*

George R. Reilly, Chairman

Robert E. McDavid, Member

Paul R. Leake, Member

J. H. Quinn, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L. Pierce, Secretary