BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
TOOLEY HOTELS, INC.)

Appearances:

For Appellant: George G. Witter and Myron E. Harpole, 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 Tooley Hotels, Inc,, against proposed assessments of additional franchise tax in the amounts of $1,849.70 for each of the taxable years ended January 31, 1947, and 1948, measured by income for the year ended January 31, 1947.

In 1940 the Eli P, Clark Estate, Inc., leased a hotel in Los Angeles known as the Hotel Clark to the Hotel Clark Operating Company for a term ending August 31, 1952. Rental was based on a percentage of receipts with an annual minimum of $25,000. The lessor was to be responsible for taxes and insurance up to $25,000 annually, For the first four years the lessor was to advance all rental receipts in excess of the minimum up to a total of $40,000 toward improvements. The lessee was then to repay the sum advanced in seven yearly installments, Other relatively minor provisions for improvement were made,

On June 14, 1944, the lease was amended to provide for higher percentage rental and that:

> "...the Lessor hereby consents that said Lease of August 29, 1940, as hereby amended, may be assigned to W. L. Tooley, provided said W. L. Tooley shall prior to such assignment and prior to August 31, 1944, have executed and delivered to the Lessor an acceptance of said assignment and an assumption of all of the covenants and conditions on the part of the Lessee to be performed in words and figures as follows:
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> 'I hereby accept the assignment from Hotel Clark Operating Company of that certain Lease

> executed by Eli P. Clark Estate, Inc., as lessor and Hotel Clark Operating Company, as lessee, under date of the 29th day of August, 1940, as amended under date of June 14, 1944, and covering the premises commonly known as the Hotel Clark, and do hereby agree to be bound by and perform all of tho terms, covenants and conditions of said Lease on the part of the Lessee to be performed, and do hereby agree that said Lease shall not be assignable by me, or by operation of law, and that I will not sublet said premises, or any part thereof, nor assign nor attempt to assign, said lease or mortgage or hypothecate the same, without the written consent of the Lessor first had and obtained...."

On the same date the Eli F, Clark Estate, Inc., extended to the Hotel Clark Operating Company by a separate document in the form of a letter, an option to renew the lease at a still higher percentage rental if the Broadway Department Store renewed its lease and for the same period but not beyond January 31, 1961, The Broadway Department Store had leased a portion of the hotel property and adjoining property. The option stated in part:

> "This option is personal to you and shall not be assigned except that if said Lease of August 29, 1940, be assigned to W. L. Tooley as provided for in the Amendment to said Lease, then you may assign this option to him upon his executing and delivering to us an agreement to accept this option upon the terms and conditions therein stated, and not to further assign the same."

Three days later Mr. Tooley executed an acceptance of an assignment of the lease in the exact words specified in the amendment for such acceptance.

A partnership known as "Tooley Hotels", composed of Mr. Tooley and others, purchased all of the stock of the Hotel Clark Operating Company for $600,000 plus the net value of its assets and on August 31, 1944, the Hotel Clark Operating Company executed an assignment in the following words:

> "The undersigned, Hotel Clark Operating Company, a California corporation, hereby assigns, transfers and sets over unto W. L. Tooley, all of the lessee's right, title and interest in and to that certain lease dated August 29, 1940, between Eli P. Clark Estate, Inc., a corporation, as lessor, and the undersigned corporation as lessee of those certain

> premises commonly known as 'Hotel Clark,' Los Angeles, California, as amended by that certain amendment to lease and letter agreement amending lease, both of which are dated June 14, 1944, between Eli P. Clark Estate, Inc. and the undersigned."

The assignment was executed by Mr. Tooley as president of the Hotel Clark Operating Company and by its secretary, It is not claimed that Mr. Tooley himself paid any consideration for this assignment,

It is alleged by the Appellant that in September, 1944, Mr. Tooley, with the consent of the lessor, executed a sub-lease to the partnership for a term ending July 30, 1952. The Hotel Clark Operating Company was dissolved in October, 1944. The partnership operated the hotel until February, 1946, when it transferred its assets in a nontaxable exchange to the Appellant, Tooley Hotels, Inc. Mr. Tooley was the principal stockholder of the Appellant.

In March, 1948, Broadway Department Store extended its lease to December 31, 1961, Appellant states that in 1950 an attempt was made to exercise the option in question, However, sometime prior thereto William H. Simon and Mike Lyman had acquired the interest of the previous lessor, Eli P. Clark Estate, The new lessors contended that Mr. Tooley did not hold an option to renew because he had never executed and delivered to the previous lessor an agreement to accept an assignment of the option as specified in the instrument granting the option to the Hotel Clark Operating Company, Appellant states that legal advice sought by it confirmed the position of Simon and Lyman.

On August 15, 1950, Mr. Tooley entered into a new agreement with Messrs. Simon and Lyman. This agreement recited that Mr. Tooley had properly obtained and exercised the renewal option. The lease was extended to January 31, 1961. The minimum rental was raised from $25,000 to $75,000 annually and maximum annual expenditures to be made by the lessors for taxes and fire insurance were raised in the same amounts for the remainder of the original term and the renewal period. The percentage rental was to be paid monthly rather than semi-annually and the agreement made it clear that the percentage rental was to be based upon all space rentals, As additional consideration Simon and Lyman were given $1,500 in settlement of a lawsuit, Appellant states that it was surprised to find that Mr. Tooley did not hold the option and that the less favorable terms of the new agreement were consented to only because of this fact, On August 17, 1950, Mr. Tooley assigned the new lease to the Appellant with the consent of the lessors.

For the income year ended January 31, 1947, the Appellant contends that it should be allowed a deduction for amortization of the lease based on the original term. The Franchise Tax Board has taken the position that the cost of the lease should be amortized over the remainder of the original term plus the renewal period.

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Section 24343 of the Revenue and Taxation Code (formerly Section 8(a) of the Bank and Corporation Franchise Tax Act) allows as deductions all the ordinary and necessary expenses paid or incurred during the income year in carrying on business, including rentals or other payments required to be made as a condition to the continued use or possession for business purposes of property to which the taxpayer has not taken or is not taking title or in which it has no equity, This provision is substantially the same as that in Section 23(a) of the Internal Revenue Code of 1939.

The regulations of the Franchise Tax Board provided in part:

> "If a leashold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in its return an aliauot part of such sum each year, based on the number of-years the lease has to run.
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> "In cases in which the lease contains an unexercised option of renewal, the matter of spreading such depreciation or amortization over the term of the original lease, together with the renewal period or periods, depends upon the facts in the particular case. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease, or the cost or other basis of the improvements shall be spread only over the number of years the lease has to run, without taking into account any right of renewal." (Titlo.18, Cal. Admin. Code Reg, 24121a(7).)

This language is idcntical to that in the Federal regulations (Regs. 111, Sec. 2923(a)-10 and corresponding section in Regs. 118). The second paragraph was added to the Federal regulations by T.D. 4957, December 6, 19390 (1939-2 C.B. 87.)

It is conceded that the right of Mr. Tooley to the option should be imputed to the Appellant, The question presented is whether it was reasonable certain at the termination of the income year ended January 31, 1947, that the lease would be renewed. There are essentially two factors upon which the renewal depended, First, whether Broadway Department Stores would renew its lease of a portion of the property for the full term and second, whether Appellant would then exercise the option for renewal of the lease on the portion of the property it occupied.

The Appellant has cited several cases in support of its position, the moat directly in point on its facts being Strand Amusement Co..

3 B.T.A. 770. In that case renewal of a sublease was conditioned upon renewal of the primary lease,, The position of the Commissioner that amortization of the sublease should be based upon the original term was upheld without discussion of the likelihood of renewal by the Prime lessee. This case was decided before the clarification of Regs. 111, Sec. 29.23(a)-10 by T.D.4957. In Morris Nachman, 12 T.C. 1204, aff'd. 191 Fed, 2d 934, the court stated:

> "Some of the uncertainty and confusion which the decided cases presented before 1939 have now been allayed by the incorporation of T.D. 4957.....in respondent's regulations....It is there generally provided that where the facts show that the lease has been renewed, or that there is reasonable certainty that the lease will be renewed., the period should encompass not only the original term of the lease, but the renewal period,"

In view of the regulation in this State to the same effect as that in the Federal regulations, one factor that must be considered is whether it was reasonably certain that the Broadway Department Store would renew its lease,

The Broadway Department Store is one of the oldest and largest department stores in downtown Los Angeles. It occupies two buildings adjoining the property of the Hotel Clark, One, an eight story building, was leased from February 1, 1913, to January 31, 1961, with an option to renew to January 31, 1986, The other, a ten story building, was leased from January 1, 1923, to January 31, 1961, with an option to renew to January 31, 1986,

In addition, Broadway occupies the largest part of the ground floor of the hotel and an adjacent parking lot, This entire portion was leased by Broadway from September 3, 1913, to December 31, 1932, In 1926 the lease was extended to December 31, 1952. During the year ended January 31, 1947, the year in question, it held an option to renew to December 31, 1961, This option was exercised in March, 1948. This is the renewal upon which the option of the Appellant was dependent. The lease of this property gave to Broadway its only entrance and street frontage on Hill Street, It also gave Broadway an entrance next to the Hotel Clark and directly across the street from interurban bus and rail connections. This lease allowed the public to use the store as a passageway connecting with three streets of the block occupied by the store, It also provided parking facilities.

It is clear from the facts presented that the portion of the Hotel Clark property leased by Broadway was important to the store. It was possible, as the Appellant has pointed out, that the store might gain a Hill Street entrance by other means, that the store might purchase the Hotel Clark, that it might give up the Hill Street entrance or even go out of business entirely, Nevertheless, in view of the long period

of prior occupancy by the store, the fact that a previous option was exercised by the store, the apparent importance of this lease to the store and the fact that the store had leases on adjoining property to January 31, 1961, with options to renew to January 31, 1986, it appears to have been reasonably certain at the end of the income year in question that it would renew this lease for the full term and continue an integrated store operation,

From the facts presented, it appears that the Tooley interests were reasonably certain in their own minds that Broadway would renew its lease and that they would then exercise their own option. The Tooley interests paid $500,000 to the Hotel Clark Operating Company for the lease. At the time this amount was paid the original lease was to expire in eight years, while with the option, the lease could be extended to a period of over sixteen years, Although it would require a high income level to recoup this investment over the remaining eight years of the original period, we have been presented with no evidence to indicate that anticipated revenues would be sufficient to permit such rapid recovery, together with a reasonable profit, That the amount of the investment is important in determining the time over which the amortization should be made is, of course, obvious, (Morris Nachman (supra); Alamo Broadcasting Company Inc., 15 T. C. 534.) There is no testimony or direct allegation that renewal was not considered reasonably certain by the Tooley interests at the end of the year in question, To the contrary, the improvement program under the original lease, the submission to higher percentage payments in 1944, the acquisition of the option in 1944, and the bonus paid for the lease, all lead to the inference that the Tooley interests regarded the hotel operation as desirable and intended to exercise the option.

The Appellant leans heavily on its contention that the option was not available to it or to Mr, Tooley. This contention is based on the fact that Mr. Tooley had not executed and delivered an agreement to accept an assignment of the option as prescribed in the instrument in which the option was originally granted to the Hotel Clark Operating Company.

Only the facts known to the taxpayer at the end of the year are relevant in determining his right to a deduction for depreciation for that year (Leonard Refineries, Inc., 11 T, C, 1000), At the end of the year in question the Appellant believed that through Mr. Tooley it held the option, The fact that Simon and Lyman in a later year seized upon a technicality to claim that Mr. Tooley did not hold the option was not expected by the Tooley interests. We do not believe that this possibility, not even considered in the year in question, may now influence the amount of the deduction for amortization in that year. No doubt the validity of many leases and options is subject to question on technical grounds, and yet amortization is taken upon the assumption that they are valid or that the defect will not be exploited. In Commissioner v. Pittsburgh Union Stock Yards Co., 46 Fed, 2d 646, the taxpayer held a privilege of renewal conditioned upon the lessee's exercising the option by writing prior to the expiration of the original lease. No notice in writing of an election to exercise the option was given within

the stipulated time, but a renewal was granted shortly thereafter and occupation by the lessee was continuous. Despite the technical loss of the option the court held there that the value should be exhausted over the original term plus the renewal period, Moreover, Appellant and its lessor in their subsequent agreement specifically stated that the option here in question had been properly assigned,

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 2.5667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Tooley Hotels, Inc., to proposed assessments of additional franchise tax in the amounts of $1,849.70 for each of the taxable years ended January 31, 1947, and 1948, be and the same is hereby sustained.

Done at San Francisco, California, this 29th day of December, 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