BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of

BOYS INCORPORATED OF AMERICA

Appearances:

For Appellant: Arthur H. Kent and Valentine Brookes, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel; James W. Hamilton, 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 Boys Incorporated of America to proposed assessments of additional franchise tax in the amounts of $13,600.75 for each of the taxable years ended May 31, 1955, and May 31, 1956, the tax for both years being measured by income of the year ended May 31, 1955.

Appellant, a nonprofit Delaware corporation, was organized on June 7, 1954. Its certificate of incorporation, a copy of which was filed in California with the Secretary of State on July 22, 1954, stated that its purposes were to undertake, promote, develop and carry on charitable and related activities, to make donations, gifts, contributions or loans for charitable and related purposes, and thus to "build better boys" and combat juvenile delinquency among boys. On July 23, 1954, pursuant to Section 23701 of the Revenue and Taxation Code, Appellant applied for exemption from taxes imposed under the Bank and Corporation Tax Law. In completing the application for exemption Appellant supplied the following information:

* * *

5. State fully all activities in which the organization is presently engaged or in which it will engage on the granting of the certificate of exemption. -- Establish and maintain centers for boys providing for athletic,

vocational training, study and other recreational activities.

6. State all sources from which the organization's income is or will be derived. -- From gifts and donations to the corporation and from the income resulting from the corporation's investment of such funds.

7. Specify purposes for which funds are or will be expended. -- To establish and maintain the recreational centers for boys referred to above.

* * *

On July 26, 1954, the Franchise Tax Board issued a ruling that Appellant was a tax exempt organization of the class outlined under Section 23701d of the Revenue and Taxation Code, which provides that:

> "Corporations organized and operated exclusively for religious, charitable, scientific, literary-, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation."

Also on July 26, 1954, Appellant acquired from the Del Mar Turf Club under an instrument entitled "ASSIGNMENT AND GRANT DEED," certain property rights in the horse racing facilities at Del Mar, California. Pertinent provisions of the instrument are hereinafter quoted:

> "... DEL MAR TURF CLUB, a California corporation, for and in consideration of the sum of Two Hundred. Fifty Thousand Dollars ($250,000), does by these presents, assign, transfer, set over, grant and deliver unto BOYS INCORPORATED OF

AMERICA, a Delaware corporation, the following described contracts, rights, estates, interests and real property, to-wit:

"(a) That certain Franchise Agreement ... for the rental of certain horse racing facilities in the County of San Diego in the vicinity of Del Mar, California, by and between the Twenty-second District Agricultural Association and Del Mar Turf Club . . . extended by various agreements to December 31, 1969, . . . and all rights, titles, interests and estates thereunder or incident thereto, as well as all rights, titles, interests and estates of Del Mar Turf Club under any and all other contracts and agreements subsisting between Del Mar Turf Club and the Twenty-second District Agricultural Association; subject, however, to the terms and provisions of that certain Sub-Franchise Agreement mentioned in the succeeding paragraph hereof;

"(b) That certain Sub-Franchise Agreement entered into on the 26th day of July, 1954, by and between the said Del Mar Turf Club and Operating Company, a California corporation, wherein the said Del Mar Turf Club sub-leased and sub-let unto the said Operating Company the horse racing facilities under and covered by the Franchise Agreement Extension for the period of years to expire on December 30, 1969, together with all rights thereunder or incident thereto; subject, however, to the exceptions,and reservations hereinafter set forth;

* * *

"(e) The lien and all and singular the rights, privileges, powers and benefits held by and to accrue to Del Mar Turf Club under that certain Collateral Pledge Agreement dated the 26th day of July, 1954, executed and delivered by the stockholders of Operating Company unto Del-Mar Turf Club to secure and enforce payment and performance by Operating Company of all and singular its obligations and undertakings under the aforesaid Sub-Franchise Agreement;

* * *

"TO HAVE AND TO HOLD unto the said BOYS INCORPORATED OF AMERICA, its successors and assigns . . . for and during the remainder of the term of said instruments, together with all and singular all rights, titles, interests, estates and benefits thereunder or incident thereto; SUBJECT, nevertheless, to the rents, covenants, conditions and provisions therein mentioned and to the exceptions and reservations herein set forth ...

"The aforesaid consideration of $250,000 is paid and payable as follows: The sum of $5,000 in cash upon the execution and delivery of this instrument ... and the balance of $245,000 is evidenced by a certain promissory note of even date herewith in the principal sum of $245,000, bearing interest at the rate of six per cent (6%) per annum on the balance of principal and interest from time to time unpaid, with principal and interest due on or before eleven (11) years from the date of issue ... and the payment of the indebtedness evidenced by said note is secured by a certain Trust Deed of even date covering that certain real property hereinabove described in paragraph (f) and is further and additionally secured by a certain Pledge Agree-

ment of even date, executed and delivered by BOYS INCORPORATED OF AMERICA unto Del Mar Turf Club, covering, pledging and hypothecating all and singular the leasehold estates, contracts, rights, titles and interests herein assigned and conveyed to BOYS INCORPORATED OF AMERICA.

"It is further understood and agreed, and as part of the consideration for the execution of this Assignment and Grant Deed, Del Mar Turf Club hereby excepts and reserves to itself, its successors and assigns, the rentals to accrue and to be derived--from and under the aforesaid Sub-Franchise Agreement, and therein referred to as 'additional rental', ..for a maximum period of ten (10) years from the date hereof, or until Del Mar Turf Club, its successors or assigns, has received in cash from such rentals herein excepted and reserved the full net sum of One Million Seven Hundred Eighty Thousand Dollars ($1,780,000), plus an amount equal to interest at the rate of Six per cent (6%) per annum on the declining balance of said sum, whichever occurs first; and in order: to secure unto Del Mar Turf Club the rentals herein excepted and reserved, BOYS INCORPORATED OF AMERICA by its acceptance of this Assignment and Grant Deed agrees and binds and obligates itself, upon written request therefor by Del Mar Turf Club, its successors or assigns, to, in good faith and with reasonable diligence, take such steps, perform such acts and deeds, and exercise such rights, privileges and powers, under the aforesaid Sub-Franchise Agreement . . . and/or Collateral Pledge Agreement, as may be provided or permitted thereunder or at law or in equity, reasonably necessary or appropriate to preserve, protect, enforce and secure unto Del Mar Turf Club, its successors and assigns, the said rentals and the payment thereof; provided that BOYS INCORPORATED OF AMERICA shall not be compelled or required hereby to take any such step, perform any such act or deed, or exercise any such right, privilege or

> power, or prosecute or defend any suit in respect thereof, unless and until indemnified to its satisfaction against loss, cost, liability and expense.
>
> "Operating Company, its successors and assigns, is hereby authorized and directed to pay direct to Del Mar Turf Club, its successors and assigns, all rentals payable under the aforesaid Sub-Franchise Agreement, and therein referred to as 'additional rental', as and when the same become due and payable until it has been given written notice that the right of Del Mar Turf Club to receive such rentals reserved hereunder has been satisfied and discharged.
>
> * * *

Operating Company, the corporation referred to in the Assignment and Grant Deed, was formed on July 12, 1954, by Mr. Eugene L. Stockwell, Secretary and Treasurer of the Del Mar Turf Club, who also became the Secretary and Treasurer of the new corporation, and his two secretaries.- It has issued 20 shares of stock at a par value of $1,000 each.

The Sub-Franchise Agreement under which Operating Company assumed operation of the race track was entered into by Del Mar Turf Club and Operating Company on July 26, 1954, and on the same day was assigned by the Club to Appellant under the Assignment and Grant Deed described above. Under the Sub-Franchise Agreement, Operating Company agreed to pay to the Club 90 percent of the net profits from the operating of the track or $250,000 annually, whichever amount is greater. (During the preceding seven years, the Club's average annual net income from operating the track was in excess of $500,000.)

Operating Company agreed to conduct racing meets for the number of days and of the character previously conducted by the Club and to pay directly to the Agricultural Association the rentals due under the Franchise Agreement. The agreement prohibited Operating Company from engaging in any business other than conducting and operating horse racing meets at Del Mar Track without the consent of the Club; restricted the amount of dividends and salaries it could pay, debts that it could incur and loans that it could make; limited payment of purses and breeders' fees

to amounts substantially similar to those previously and customarily paid by the Club; prescribed the amounts and types of insurance required to be carried by Operating Company, including coverage for employees' dishonesty, forgery and business interruption; and prohibited it from assigning the agreement or subletting the premises without the consent of the Club.

Operating Company assumed and agreed to observe and perform the Club's obligations under its agreement with various unions, together with contracts of employment with certain named individuals. The Club assigned to Operating Company advance rentals previously paid to the Agricultural Association in the amount of $257,401, which sum was to be repaid by Operating Company as it became entitled to withhold such advances from rents subsequently accruing to the Agricultural Association.

For purposes of the Sub-Franchise Agreement net profit is determined by deducting from gross income of Operating Company, without regard to source, the amounts reasonably required and expended in carrying out the agreement. The deductions allowed may include, but are not limited to, items listed in the agreement. Items expressly allowed include rentals paid to the Agricultural Association, interest on money borrowed, amounts expended for equipment not subject to depreciation, amortization and depreciation charges, personal property taxes, licenses and corporate franchise taxes paid to the State of California.

Operating Company agreed not to issue additional shares of stock without the consent of the Club. By a concurrent Collateral Pledge Agreement the stockholders of Operating Company pledged all of their stock to the Club and delivered irrevocable proxies granting the Club, or its assignee, the right to vote all of the stock upon default.

The Sub-Franchise Agreement and the Assignment and Grant Deed were steps in a complex series of transactions culminating in the acquisition by Appellant of the Club's leasehold interest in the Del Mar track and the liquidation of the Club. A cash sum was distributed to the Club's shareholders, all of the remaining assets of the Club were transferred to a newly created trust, certificates of beneficial interest in the trust were distributed to the Club's shareholders, the certificates were made immediately redeemable at face value by still another company created for that purpose, and the Club ceased doing business on July 26, 1954. It does not appear that Appellant was owned or controlled in common with other parties to this series of transactions.

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Appellant filed an information return for its fiscal year ended May 31, 1955, stating that during the year it had received no gross income. In each of its fiscal years ending in 1955 and 1956, Appellant made contributions in the amount of $75,000 to charitable organizations out of borrowed funds. The organizations thus aided by Appellant were Boys Club of San Diego, Inc., a nonprofit California corporation affiliated with Boys Club of America, and Devil Pups, Inc., a California organization which carried on a summer camp program for underprivileged boys. By March 31, 1960, Appellant had contributed a total of $427,072.28 to those and similar organizations. Appellant did not establish and maintain any centers for boys and did not carry on any religious, charitable, scientific, literary or educational program during the years in question, other than contributing borrowed funds to the aforementioned organizations.

After reviewing the documents relating to the transactions hereinabove described, the Franchise Tax Board concluded that Appellant had acquired by purchase the Club's entire interest in the income producing properties and that the amounts which were agreed to be paid by Operating Company directly to the Club were a part of the purchase price. The--Franchise Tax Board, accordingly, determined that the amount of $340,018.70 paid by Operating Company to the Club during the income year ended May 31, 1955, constituted income attributable to and constructively received by Appellant. It also determined that Appellant was not organized and, operated exclusively for charitable purposes,, but primarily for the purpose of liquidating its own indebtedness, and hence its franchise tax exemption was revoked ab initio. Since Appellant is a commencing corporation, its tax for the taxable year 1956 is also measured by net income for the income year ended May 31, 1955.

Appellant contends that the Club's right to receive the specified rentals' was retained, never passed to Appellant and thus could not produce any income attributable to Appellant. Appellant also contends that its tax-exempt status should be restored because of the charitable contributions which it made during the years in question. It maintains that such debts as it actually incurred in acquiring its interest in the race track facilities and in obtaining funds for charitable contributions may be paid out of income without destroying its tax-exempt status.

The parties have not cited, and we have not discovered any case in which a court has determined the tax

consequences flowing from a document wherein a lessee of real property has conveyed his entire interest in the leasehold, in partial consideration for which is reserved a fixed amount of money, with interest on a declining balance, to be paid from the net profits of operations on the property. No exact parallel may be drawn with cases such as Thomas v. Perkins, 301 U.S. 655, and Anderson v. Helvering, 310 U.S. 404, which have been cited to us. These cases, involving sales of oil leases with reservations of portions of the proceeds of production, turn upon the question of whether the sellers retained interests in "oil in place," a factor which has no precise counterpart here. It may be stated as a general rule, however, that income from property is taxable to the owner of the property. Thus, in determining whether the income in question is attributable to Appellant, the controlling question in this case, as in sales of other types of property, is whether Appellant acquired the property interest that produced the income. (Moore v. Commissioner, 124 Fed. 2d 991; McCulley Ashlock, 18 T.C. 405; Vermont Transit Co. Inc, 19 T.C. 1040, aff'd. 218 Fed. 2d 468 cert. den., 349 U.S. 945; 2 Lexington Ave. Corp., 26 T.C. 816.)

A close reading of the Assignment and Grant Deed indicates that the Club transferred to Appellant all of its property rights in the race track facilities, except the right to receive the specified payments from Operating Company. The amounts thus to be received, accordingly, were to accrue from interests which were sold and transferred to Appellant. That the so-called exception and reservation of rentals by the Club did not carve out an income-producing interest for retention by it, is further established by the provisions (1) authorizing and directing the Operating Company to pay the specified percentage of net profits to the Club and (2) binding and obligating Appellant, upon the Club's request, to do whatever was necessary and proper under the assigned instruments to secure payment of the specified amounts to the Club. If the Club had retained the interest upon which such profits were to accrue, it could have claimed and captured the amount thereof without any authorization and assistance from Appellant. Except for Appellant's dominion or control over the interest from which the profits were to accrue, such authorization or assistance would have been of no avail.

Appellant's agreement "as part of the consideration for the execution of this Assignment and Grant Deed?? that the Club was entitled--to receive specified payments, coupled with the authorization and direction to Operating Company to make such payments directly to the Club, seems clearly to

indicate that (1) the price of the property rights sold and transferred to Appellant by the Assignment and Grant Deed included the "full net sum" of $1,780,000, with interest upon the declining balance thereof, and (2) the mandatory payments to be made to the club by Operating Company were intended to secure to the Club its recovery of the purchase price. Even if no more than the minimum annual payments of $1250,000 "to accrue and to be derived from and under the aforesaid Sub-Franchise Agreement?? over a period of ten years were paid to the Club, the total sum ($2,500,000) would have equaled or exceeded $1,780,000 plus interest at 6 percent per annum on the declining balance of that sum.

Unlike the seller in McCulley Ashlock (supra), a case upon which Appellant leans heavily, the Club did not retain legal ownership and possession of income producing property. It did not retain control of such property and unfettered command of itsearnings. To the contrary, it transferred to Appellant all of its interest in the income producing property, including its right to enforce the obligations of Operating Company under the Sub-Franchise Agreement. Appellant owned the-property interest and benefited by the application of the income against the purchase price. We conclude, accordingly, that the income was property attributed to Appellant."

Under Section 23734 of the Revenue and Taxation Code, net income in excess of $1,000 received by an otherwise exempt corporation from a business unrelated to the charitable purposes of the corporation (aside from the fact that the income may be used for the charitable purposes), is subject to tax. Section 23732(c) excepts rents received from real property (including personal property leased with the real property) from the definition of "unrelated business net income," but Bank and Corporation Tax Regulation 23732(h)(b) provides, in part, that:

> "Whether a particular item of income falls within any of the exceptions, additions, and limitations provided in Sections 23732a to 23732h, inclusive, shall be determined by all the facts and circumstances of each case. For example, if a payment termed 'rent' by the parties is in fact a return of profits by a person operating the property for the benefit of the tax-exempt organization or is a share of the profits retained by such organization as a partner or a joint venturer, such payment is not within the exception for rent ..."

Upon consideration of the terms of the Sub-Franchise Agreement and of all the facts and circumstances of the relationship betweenthe Club, Operating Company and Appellant, we are convinced that the Sub-Franchise Agreement, although cast in the form of a sublease, is in substance an operating agreement entered into for the purpose of returning to Appellant the profit from horse racing at the Del Mar track.

That Operating Company was organized and entered into the Sub-Franchise Agreement for the purpose of operating the Del Mar track for Appellant is clear. Both the organization of the Operating Company and the, execution of the Sub-Franchise Agreement were but steps leading to the acquisition of the Club's lease of the racing facilities by Appellant. The organizer and Secretary-Treasurer of Operating Company was Mr. Stockwell, Secretary-Treasurer of the Club, On the very day of the execution of the Sub-Franchise Agreement it was assigned by the Club, together with the underlying lease from the Agricultural Association, to Appellant. Further illumination of the background and purpose of the operating arrangements is furnished by the testimony of Mr. Stockwell before a legislative subcommittee, in which he stated that "... the people behind this transaction were so anxious that they be able to operate the first year for the purpose and benefit of Boys, Incorporated, that they asked us to rush this thing through as fast as we could . .." (1955 Report of Subcommittee of Assembly Interim Committee on Governmental Efficiency and Economy, page 90.)

Under the terms of the Sub-Franchise Agreement Operating Company is prohibited from issuing additional shares of stock. It is precluded, without the consent 'of Appellant, from engaging in any business other than conducting and operating horse racing meets at Del Mar. Gross income from all sources must be included in the computation of net profits to be divided pursuant to the Sub-Franchise Agreement. Dividends and salaries payable by, loans to and indebtedness of Operating Company are restricted. In computing net profits, deductions are allowed for interest on money borrowed by Operating Company, the cost of additional nondepreciable equipment, amortization of indebtedness, and depreciation of additional capital equipment purchased by Operating Company.

In our opinion, these and other provisions of the Sub-Franchise Agreement, together with the receipt of 90% of the net profits by Appellant, are sufficient to establish that it is an operating arrangement for the benefit of Appellant, rather than a lease. (See Webster Corp., 25 TC 55, aff'd. 240 Fed. 2d 164.) Our conclusion that the amounts

constructively received by Appellant did not constitute rents is fortified by the concurrent Collateral Pledge Agreement and irrevocable proxies executed and delivered by the stockholders of Operating Company. By these instruments Appellant has the means, upon default, to take over the control of Operating Company itself, as distinguished from the repossession of the racing facilities. This device is entirely foreign to the concept of a lease of property. Its purpose, quite obviously, is to permit Appellant, in the event of default, to continue to receive operating profits in the form of exempt "rents."

We have concluded that if Appellant is otherwise exempt under Section 23701 of the Code, the amounts designated as rents in the Sub-Franchise Agreement constitute taxable income from an unrelated business. We are also of the opinion, however, that the income in question, even though considered as rent, would be subject to tax.

Appellant's tax exempt status under Section 23701d of the Code is qualified by Section 23737 as follows:

> "23737. In the case of any organization described in Section 23701d to which this article is applicable, if the amounts accumulated out of income during the taxable year or any prior taxable year and not-actually-paid out by the end of the taxable year--
>
> (a) Are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for such organization's exemption under Section 23701d; or
>
> (b) Are used to a substantial degree for purposes or functions other than those constituting the basis for such organization's exemption under Section 23701d, or
>
> (c) Are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function, constituting the

basis for such organization's exemption under Section 23701d,

exemptions under Section 23701d shall be denied for the taxable year.

The aforesaid Sections 23701d and 23737 are substantially the same as Sections 101(6) and 3814, respectively, of the Internal Revenue Code of 1939. Under the latter sections it has been held that a charitable organization is accumulating income if it uses its income to retire an indebtedness incurred in the acquisition of income-producing property, even though the organization has no liability whatsoever for payment of the unpaid balance except out of the property acquired. (Rev. Rul. 54-420, CB 1954-2, p. 128.) During the years here involved, Appellant devoted all of its income to the retirement of such an indebtedness. Although its application for tax exemption was based upon a proposed program of establishing and maintaining recreation centers for boys, none of the income accumulated by it has been devoted to that purpose during the taxable years in question. Under these circumstances Section 23737 requires the denial of the claimed exemption.

The case of A. Shiffman, 32 T.C. No. 99, cited by Appellant, does not compel a different conclusion. There, the corporation in question paid substantial amounts for charitable purposes from its own income in addition to paying a debt incurred in purchasing property;--We have also considered the case of Ohio Furnace Co., 25 T. C. 179. That case is distinguishable since it was decided before the existence of Section 3814 of the Internal Revenue Code of 1939, relating to unreasonable accumulations.

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,

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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 in denying the protests of Boys Incorporated of America to proposed assessments of additional franchise tax in the amounts of $13,600.75 for each of the taxable years ended May 31,1955, and May 31, 1956, be, and the same is hereby sustained.

Done at San Diego, California, this 24th day of June, 1960, by the State Board of Equalization.

John W. Lynch, Chairman

Richard Nevins, Member

Paul R. Leake, Member

George R. Reilly, Member

Alan Cranston, Member

ATTEST: Dixwell L. Pierce, Secretary