BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
EDSIDE BLDG. CO., ET AL.)

Appearances:

For Appellants: Nathan Schwartz, Certified Public Accountant

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Appellants to proposed assessments of additional franchise tax as follows:

Appellant	Taxable Year Ended	Amount
Edside Bldg. Co., Arthur E. Edmunds, Assumer	2-28-55	$ 703.91
	2-29-56	703.91
	2-28-57	1,365.98
Halside Bldg. Co., Harold Hirsh, Assumer	2-28-55	770.95
	2-29-56	770.95
	2-28-57	1,496.07
Bernside Bldg. Co., Bernadine Edmunds, Assumer	2-28-55	703.91
	2-29-56	703.91
	2-28-57	1,365.98
Silside Bldg. Co., Sylvia Hirsch, Assumer	2-28-55	770.95
	2-29-56	770.95
	2-28-57	1,496.07

The two questions involved are (1) the year in which income from certain sales should have been reported and (2) the amount of unreported income from installment sales that should have been included in the measure of tax for Appellants' final taxable year.

The several Appellants were incorporated in California in March, 1954, for the purpose of engaging in real estate development. In order to carry out that purpose, they formed a partnership with another corporation, Ebster Bldg. Co. The partnership did business under the name of Edside Bldg. Co. Each Appellant adopted a fiscal year ending on the last day of February and reported its distributive share of the partnership's income

accrued as of the preceding October 31, when the partnership's fiscal year ended. Upon its formation, the partnership acquired a tract of land consisting of 126 lots. It then obtained construction loans and had individual homes built on the lots, By March, 1956, the 126 homes were sold, partnership assets were liquidated and the partnership was dissolved. Appellants were dissolved on April 3, 1956.

While some of the homes were sold outright, 74 were sold under agreements of sale providing for monthly installment payments to the seller. An installment sale was made in the event the buyer could not make the total down payment required by the lender involved. In such a case, the buyer and seller jointly executed a note to the lender for the maximum loan obtainable. The partnership reported the installment sales by the installment method, treating as income that proportion of each installment payment which the anticipated profit on the particular sale bore to the total contract price, and reported the other sales on the accrual basis.

In either type of sale, upon making an initial cash deposit, the home buyer was required to execute a sales deposit receipt setting forth terms of the transaction. The terms included these:

> Buyer shall perform Buyer's part of this purchase and accept possession of premises immediately upon Buyer being notified that the premises are ready for occupancy. Seller to furnish title policy.... Current taxes and insurance shall be prorated to date of possession. Buyer to assume and qualify for 1st Trust Deed.

When the house neared completion, the buyer signed a sales agreement and loan application as required by the seller, paid or arranged to pay (on or before the date of possession) the balance of his total cash down payment, which was $4,500 in the case of an installment sale and $7,000 in the case of an outright sale, and then awaited the seller's notification that his home was ready for occupancy. The seller gave such notification after the loan, arranged by the seller, was approved by the lender. Shortly thereafter, the seller sent the document pertaining to the transaction to the office of the title company serving as escrow agent; and upon receipt of the loan proceeds, the title company recorded the appropriate conveyance, issued its title policy and closed the escrow.

As of October 31, 1954, escrows on 73 homes had been closed. In 4.2 instances where escrows had not yet been closed, loans had been approved and the home buyers already had taken possession.

These escrows were closed in the following month - 35 of them on November 5, 1954. Escrows on all 126 homes were closed by February 9, 1955.

As of October 31, 1955, the partnership's books reflected an unrealized gross profit of $220,185.70 on its installment sales. In winding up itsaffairs the partnership, on March 15, 1956, sold all its installment co&tracts at a discount of $83,186.46.

In reporting its income for the year ended October 31, 1954, the partnership accounted for sales of 73 homes only. Sales of the 42 homes with escrows still pending were reported for the following fiscal year. Appellants, in reporting their distributive shares of partnership income, attributed gain from the latter 42 sales to their fiscal year ended February 29, 1956, rather than the year ended February 28, 1955.

The Franchise Tax Board determined that the aforesaid 4.2 homes were sold during the partnership's fiscal year ended October 31, 1954. Thus, it increased the income of each Appellant for the year ended February 28, 1955, and correspondingly decreased their respective incomes for the following fiscal year. In addition, since the entire income from the installment sales had not been reported prior to the year in which Appellants were dissolved, the Franchise Tax Board, acting under Section 24672 of the Revenue and Taxation Code, determined that the partnership's unrealized gross profit of $220,185.70 as of October 31, 1955, should be included according to their distributive shares thereof, in the measure of Appellants? franchise taxes for their final taxable year.

Appellants contend that income from sale of the aforesaid 42 homes was properly returned in the partnership's fiscal year ended October 31, 1955. In essence, their position is that until new trust deeds were recorded and title policies were issued, the loan proceeds for consummating, the sales were not irrevocably committed; that until the loan proceeds were actually paid over, a substantial condition to completion of the sales remained to be satisfied; that neither party to any of the sales transactions considered them binding until the foregoing events occurred; and that, therefore, the sales in question were not completed for tax purposes prior to the closing of the escrows involved.

The prepayment feature of the franchise tax law gives rise to special provisions for commencing and dissolving corporations. Thus, the tax on each Appellant for both the first and second taxable years, the years ended in 1955 and 1956, respectively, are to be measured by the income of the first year. (Rev. & Tax. Code, $23222; 18 Cal. Adm. Code, §§23221-23226.) Aside from special

provisions regarding installment sales, the tax for the third and final "year," a short period of approximately one month in this case, is to be measured by a correspondingly reduced portion of the income of the second year. (Rev. & Tax. Code, §23332.) Broadly stated, the income from installment sales is to be included in full in the measure of the tax for the final year, except that a reduction based on the short period of the final year is to be permitted as to sales that were made within the preceding year. (Rev. & Tax. Code, $24672.) It is because of these provisions that it is to the advantage of each Appellant to place a greaternumber of both installment sales and outright sales in the second year than in the first year.

In so far as the completion of sales is concerned, the facts in this matter are substantially identical with those considered by us in Appeal of Chapman Manor, Inc., April 20, 1960, 3 CCH State Tax. Rep. Cal. Par. 201-537; 2 P-H State & Local Tax Serv. Cal. Par. 13,220 We there held that the sales price accrued to the vendor after the buyer's loan application had been approved, the down payment had been made, possession had been transferred and all that remained to be done was to obtain title insurance, formally transfer title and close the escrow. As we stated in that appeal, the controlling principle is that a sale of realty is complete and the gain is includible in income when the buyer has assumed the burdens and benefits of ownership and no substantial contingencies remain to be satisfied. (Commissioner v. Union Pac. R.R., 86 F. 2d 637; Frost Lumber Industries, Inc. v. Commissioner, 128 F. 2d 693; Harris Trust & Sav. Bank, 24 B.T.A. 498; Standard Lumber Co., 28 B.T.A. 352.)

Appellants argue that the lender might have withdrawn its approval of the loan if the buyer's credit became impaired and that mechanics' liens might have prevented the issuance of title insurance. These contingencies were very remote. There was in fact no express provision permitting the lender to withdraw its approval. Moreover, the buyer had made a substantial down payment before taking possession and the house constituted security for the loan, With respect to title insurance, Appellants had recently acquired the realty and knew the condition of their title. Mechanics' liens were an unlikely impediment since Appellants had obtained a construction loan covering the bulk of the construction costs. There is no indication that Appellants were in such financial condition that unpaid mechanics' liens were at all probable.

It is our opinion that the burdens and benefits of ownership passed to a buyer when he took possession and that Appellants' right to the purchase price was subject to no substantial contingency thereafter. Therefore, we conclude that the sales of the 42homesin question were completed by October 31, 1954.

Appellants' second contention involves the interpretation of Section 24672 of the Revenue and Taxation Code, whose pertinent part provides as follows:

> (a) Where a taxpayer elects to report income from the sale or other disposition of property as provided in this article, and the entire income therefrom has not been reported prior to the year that the taxpayer ceases to be subject to the tax measured by net income imposed under Chapter 2 or Chapter 3 of [the Bank and Corporation Tax Law], the unreported income shall be included in the measure of the tax for the last year in which the taxpayer is subject to the tax measured by net income imposed under [the aforesaid chapters]....

In the Appellants' view, this provision is to be qualified by Section 24670 of the Code, which provides, in part, as follows:

> (a) If an installment obligation is satisfied at other than its face value . . . gain or loss shall result to the extent of the difference between the basis of the obligation and ...
>
> (1) The amount realized in the case of . . . a sale . . . .
>
> * * *
>
> Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

Appellants contend that the amount of unreported income from the partnership's installment sales to be included in the measure of the tax for their final taxable year, should be determined from the amount actually realized from sales of the installment contracts in March, 1956, rather than from anticipated gross profit which had not been reported prior to their final year. They contend that the "unreported income" could be no more than $136,999.24, since the installment contracts were sold at a discount of $83,186.46.

The question was answered by us in Appeal of Contractors Investment Co., Jan. 5, 1961, 3 CCH State Tax Rep. Cal. Par. 201-676, P-H State & Local Tax Serv. Cal. Par. 13,240. As we there stated, the above statutory provisions may be given effect so as to harmonize with and complement one another. Applying them here, the discount on the sale of the installment contracts

in Appellants' final year must be taken into consideration, with the result that the "unreported income" as determined by the Franchise Tax Board must be reduced by $83,186.46.

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 HEREEY CRDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Appellants to proposed assessments of additional franchise tax as follows:

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	2-28-57	1,496.07

be and the same is hereby modified in accordance with the views expressed in the aforesaid Opinion.

Done at Sacramento, California, this 6th day of November, 1961, by the State Board of Equalization.

John W. Lynch, Chairman
Paul R. Leake, Member
Geo. R. Reilly, Member
_____, Member
_____, Member

ATTEST: Dixwell L. Pierce, Secretary