BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHARLES H. AND NORMA L. ANDREWS)

Appearances:

For Appellants: Roger A. Pott
Attorney at Law

For Respondent: John D. Schell
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Charles H. and Norma L. Andrews against proposed assessments of additional personal income tax and penalties in the total amounts of $107.47, $946.62, $4,185.84, and $778.50 for the years 1962, 1963, 1964, and 1965, respectively. Subsequent to the filing of this appeal, respondent Franchise Tax Board agreed to eliminate the penalties originally imposed for the years 1964 and 1965. As a result of that action, the amounts in issue for those years are reduced to $3,986.51 for 1964 and $741.43 for 1965.

The assessments of personal income tax here involved arose out of appellants' purchase and subsequent sale of two separate tracts of real property. The primary issue presented in each case is whether appellants held the property for more than six months, causing the gain which they realized upon its sale to be "long-term capital gain" within the meaning of section 18162 of the Revenue and Taxation Code.

Appellants are residents of Ojai, California. They filed joint tax returns for each of the years in

question. Since Mrs. Andrews was not directly involved in the property transactions at issue, Mr. Andrews will be referred to generally hereafter as appellant.

THE OJAI PROPERTY

During 1959 appellant was employed as vice president and sales manager of a title insurance company in Ventura, California. In September of 1959 he began negotiating to purchase approximately 550 acres of real property located on Sulphur Mountain in the Ojai Valley. In November 1959, the owner of that property, Helen Y. Fagan, accepted appellant's purchase offer of $62,000, plus payment of the broker's sales commission.

On December 12, 1959, escrow instructions constituting a contract were executed by both parties. Those instructions provided that the total purchase price was to be paid as follows: $3,000 into escrow to be paid to the broker as a commission, $1,000 to the seller outside of escrow, and an additional $14,000 into escrow on or before the date it closed. Appellant was to execute and deliver into escrow his promissory note for the balance of the purchase price, $47,000, secured by a deed of trust. That loan was to bear interest at the rate of 6 percent per annum from close of escrow, and appellant was to pay principal and interest in monthly installments of $600 or more, beginning July 1, 1960, and continuing until the loan was paid in full. The purchase price included two houses as well as all farming equipment located on the property. The escrow instructions provided that the buyer was to have immediate possession of the premises. It was further agreed that taxes and insurance would be prorated to close of escrow. The escrow agreement provided for a 90-day period in which to complete and close the transaction.

In accordance with the terms of the escrow instructions appellant paid the $1,000 to the seller outside of escrow, and he and his family moved some furniture in and went into possession of the Ojai property on or about December 12, 1959. Thereafter appellants spent a portion of their time there, using the property primarily as a weekend retreat. On December 15, 1959, an unsigned grant deed in favor of appellant was deposited in escrow, along with appellant's installment note dated December 12, 1959, promising to pay Mrs. Fagan $47,000 in accordance with the terms set forth in the escrow instructions. The unpaid principal was to bear interest from March 16, 1960.

After taking possession of the property appellant allegedly did certain repairs on the property at his own expense. At the oral hearing he testified that in January or February of 1960 he plowed fifty acres of the land and planted oats. He also stated that he had moved several horses and cows onto the land during this period of possession prior to the close of escrow.

On March 8, 1960, the escrow officer handling this transaction sent the unsigned grant deed to Mrs. Fagan at her residence in Manhattan Beach, California, requesting that she sign and return it. On March 10, 1960, Mrs. Fagan signed the deed before a notary public. Appellant paid $14,000 into escrow on March 15, 1960, and the escrow closed on March 16, 1960. According to the closing statement, taxes and insurance were prorated to March 16, 1960. The title insurance policy insuring appellant was dated March 16, 1960, and the deed to the property as well as the deed of trust securing the purchase price were recorded on that date.

By grant deed dated August 31, 1960, appellant sold 500 acres of the Ojai property to Luckywood Corporation and one Phil A. Stevens for $150,000. The escrow in that transaction was closed on September 13, 1960, although taxes and insurance were prorated to September 8, 1960. Appellant retained possession of the remaining 50 acres after September 13, 1960.

THE LAFAYETTE PROPERTY

On June 12, 1963, appellant paid $10,000 to Burton Valley Terrace, Inc., for an option to purchase approximately 100 acres of real property located in Lafayette, California. The agreement was drafted on an "Option to Purchase Real Estate" form recommended by the Oakland Real Estate Board. The option was for one year. and it provided that if appellant chose to exercise it, he could apply the $10,000 option price to the purchase price of $100,000, or $1,000 an acre. The agreement also provided that in the event appellant decided to buy the property he could either pay the balance of the purchase price in cash, at no interest, or he could make three equal annual installments of $30,000, the unpaid balance to bear interest at 6 percent from the date of the first installment.

In July 1963, appellant hired an engineering firm to survey the Lafayette property. It proved to

consist of only 91.3 acres rather than the supposed 100, and the price was subsequently adjusted accordingly. That same summer appellant negotiated the sale of an easement on the Lafayette property to Pacific Gas and Electric Company. While he held the option to buy the property, appellant also granted a lease to Cable-Vision for space upon which to erect a master antenna, and signed a grazing agreement with a cattle owner allowing the Lafayette property to be. used as pasture. In all instances Burton Valley Terrace, Inc., either co-signed the agreements or acquiesced in the transactions between appellant and third parties.

In a letter dated June 10, 1964, to Burton Valley Terrace, Inc. , appellant stated in part:

> Under the terms of my option to purchase what was originally considered 100 acres owned by Burton Valley Terrace, but which turned out to be 91.3 acres, at a price of $1000 per acre, I have elected to exercise the option which expires June 12, 1964, under the second of the two options -- that is, to pay one-third of the remaining balance at this time, with the unpaid balance to bear six per cent (6%) interest from the date of the first installment.
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> One-third of the remaining balance, which is $81,300, is enclosed herewith in the amount of $27,100.

A deed to the Lafayette property was executed in favor of appellant on October 1, 1964. During that month of October, appellant set up an escrow for transfer of the Same property to one Hodgkin. The deed to appellant from Burton Valley Terrace, Inc., was recorded on October 28, '1964, the same day that the transaction between appellant and Hodgkin was closed.

On their tax returns appellants reported the gain realized from the sales of the Ojai and Lafayette properties on the installment basis. Each transaction was treated by. appellants as having resulted in long-term capital gain from. the sale of a capital asset. · Respondent determined that the disposition of both properties had resulted in short-term capital gain since appellants had not held either tract of real property for a full six months prior to the sale. (Rev., & Tax. Code, § 18162, subd. (a).)

The Internal' Revenue Service had audited appellants for the taxable years 1962 and 1963. The revenue. agent's report, issued July 20, 1964, made numerous upward adjustments to appellants' reported income for those years, none of which were related to the question of short or long-term capital gain with respect to the Ojai and Lafayette transactions. The Internal Revenue Service also imposed a 5 percent negligence penalty on appellant for each year, pursuant to section 6653(a) of the Internal Revenue Code of 1954. Appellant expressly agreed to the federal adjustments, including penalties. The facts regarding the 0 jai and Lafayette transactions were discovered by respondent's auditors after receipt of the notice of federal audit, and respondent 's additional assessments for the years in question issued October 13, 1967, were based upon the agreed federal adjustments for 1962 and 1963, plus the short-term gain treatment of the Ojai and Lafayette land transactions. On July 22, 1968, subsequent to respondent's action, the Internal Revenue Service issued supplemental assessments of federal income tax for 1964 and subsequent years, the earlier years being barred by the statute of 'limitations.

Section 18162 of the Revenue and Taxation Code provides , in relevant part:

* * *

> (a) The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than six months? if and to the extent such gain is taken into account in computing gross income.
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> * * *
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> (c) The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than six months, if and to the extent such gain is taken into account in computing gross income. (Emphasis added.)

The word "held", as used in the above provisions, and as applied to the acquisition of real property, is not defined in the code but case law interpreting similar federal legislation has provided some guidelines. In McFeely v. Commissioner, 296 U.S. 102 [80 L. Ed. 83], the United States Supreme Court stated:

> In common understanding to hold property is to own it. In order to own or hold, one must acquire. The date of acquisition is, then, that from which to compute the duration of ownership or the length of holding....

Once the date of acquisition of real property is determined, the holding period is computed by excluding the day of acquisition and including the date of disposition of the property. (Cecil Sims, B.T.A. Memo., Jan. 31, 1942; I.T. 3287, 1939-1 (Part 1) Cum. Bull. 138.) The minimum holding requirement has been strictly construed by the federal courts. Long-term capital gain treatment was denied a taxpayer who held property for one day less than the required statutory period. (E. T. Weir, 10 T.C. 996, aff'd, 173 F.2d 222. See also Harriet M. Hooper, 26 B.T.A. 758.)

Respondent found that appellant's holding period for the Ojai property commenced on March 17, 1960, the day after the close of escrow in his purchase of the property, and ended no later than September 13, 1960, the day escrow closed and title to the 500 acres was transferred to Luckywood Corporation and Phil A. Stevens. By respondent's calculations, appellant had held the property for several days less than the required "more than six months." Appellant contends that as of December 12, 1959, he became a buyer in possession of the Ojai property under an unconditional contract of sale. He argues that by virtue of his possession of the property he assumed sufficient benefits and burdens of ownership to cause his holding period to commence.

Under California law, in property transactions involving escrows, legal title to real property does not pass to the grantee until full performance of the terms of the escrow agreement. (Love v. White, 56 Cal. 2d 192 [14 Cal. Rptr. 442, 363 P.2d 482].) For purposes of determining when a purchaser's holding period begins, however, the federal courts have recognized that a transfer of legal title under state law is not always required. With respect to real property which is the subject of an unconditional contract of sale, they have stated that the holding period begins on the day following that on which legal title passes or on the day following that on which delivery of possession is made and the benefits and burdens or incidents of ownership are acquired in a closed transaction, whichever date is earlier. (Boykin v. Commissioner, 344 F.2d 889; Ted F. Merrill,

40 T.C. 66, aff'd per curiam, 336 F.2d 771 (9 Cir. 1964); Rev. Rul. 54-607, 1954-2 Cum. Bull. 177).

We agree with the federal courts that the commencement of the holding period is not always dependent on the transfer of legal title to the buyer. In the absence of such legal ownership, however, we believe that in order for a buyer's holding period to begin, he must not only be in possession of the property but during this period of possession he must also be paying for the ordinary costs of real property ownership, i.e. property taxes, fire and liability insurance, and interest on the unpaid portion of the purchase price. In both the Merrill and Boykin cases, cited, above, the buyer in possession had expressly assumed these obligations of ownership as of the date of possession. In the instant appeal, all of those items were prorated to the close of escrow. We therefore must sustain respondent's determination that the appellant's holding period of the Ojai property did not begin until March 17, 1960, the day following the close of escrow, and his gain upon sale of that property was therefore subject to short-term capital gain treatment.

With respect to the Lafayette property, respondent concluded that appellant's holding period commenced no earlier than June 11, 1964, the day after he exercised his option to purchase the Lafayette property, and ended on October 28, 1964, the date the escrow closed on his sale of that property to Hodgkin, thereby constituting a period of substantially less than six months. Appellant contends that the "Option to Purchase Real Estate" which he was granted by Burton Valley Terrace, Inc., on June 12, 1963, was really a contract of sale and that his holding period of the Lafayette property therefore commenced on June 12, 1963. We cannot agree with appellant's contention.

Whether a written instrument is a contract of sale or only an option to purchase does not depend solely on any particular phraseology; but rather on the intention of the parties to the agreement as evidenced by its terms and all surrounding circumstances. The language of the instrument is important, however, in determining that intent. The critical test is whether the optionee has an obligation to buy, so that specific performance would lie against him in the event he refused to do so. (People v. Ocean Shore R.R. Co., 90 Cal. App. 2d 464 [203 P.2d 579].)

The wording of the "Option to Purchase Real Estate" granted to appellant on June 12, 1963, is totally indicative of an option, not a contract of sale. By the terms of that instrument appellant received nothing more than a right to purchase the Lafayette property within the specified time; Since no obligation to buy was imposed upon him, the agreement would not be specifically enforceable by the optionor, Burton Valley Terrace, Inc.,. as it was simply an option to buy. The surrounding circumstances are consistent with this conclusion. In various pieces of correspondence appellant referred to his option to buy the property. Perhaps the strongest evidence of the intent of the parties is appellant's letter of June, 10, 1964, in which he stated that he was electing to exercise the option, and enclosed one-third of the remaining purchase price. It is quite clear that. the holding period of one holding an option to purchase real property cannot commence earlier than the date on which the option is exercised. (Helvering v. San Joaquin Fruit & Investment Co., 297 U.S. 496 [80 L. Ed. 824].) We therefore must sustain respondent in its determination on this issue.

Lastly, appellant argues that the 5 percent negligence penalties imposed by respondent for the years in question were improper. As was stated at the opening of this opinion, respondent has agreed to cancel the penalties originally assessed for 1964 and 1965. The remaining penalties for 1962 and 1963 were based upon similar penalties imposed by the Internal Revenue Service and agreed to by appellant at the federal level. The penalties arose from the disallowance of a number of federal income tax deductions claimed by appellants in their returns for 1962 and 1963, all of which were totally unrelated to the question of whether appellant had realized short or long-term gain on disposition of the Ojai and Lafayette properties. Appellant has provided us with no evidence or arguments that these unrelated federal adjustments and penalties were improper. The state law relating to each adjustment-and to the negligence penalty is essentially identical to the federal law. We therefore see no justification for overturning respondent's imposition of the 5 percent negligence penalties for 1962 and 1963.

Appeal of Charles H. and Norma L. Andrews

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 Charles H. and Norma L. Andrews against proposed assessments of additional personal income tax and penalties in the total amounts of $107.47, $946.62, $4,185.84, and $778.50 for the years 1962, 1963, 1964, and 1965 be modified by the cancellation of the negligence penalties imposed for 1964 and 1965. In all other respects the action of the Franchise Tax Board is hereby sustained.

Done at Pasadena, California, this 21st day of June, 1971, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary