BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WESTERN ORBIS COMPANY)

Appearances :

For Appellant: Melvin H. Malat
Attorney at Law

For Respondent: Jack E. Cordon
Supervising Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Western Orbis Company against a proposed assessment of additional franchise tax in the amount of $120,314.33 for the income year ended June 30, 1965.

Appellant Western Orbis Company is a Delaware corporation having its commercial domicile in California. Together with its subsidiary companies, appellant has been engaged in a unitary real estate development business which, under different

names, has been in existence since 1960. Since the nominal changes are not material for our purposes, and for convenience, we shall refer to appellant as though it had existed and had participated in all the events leading up to this appeal.

One of appellant's developments was the Barrington Plaza, a 712-unit apartment complex consisting of three high -rise buildings located in West Los Angeles. The project was completed in 1962 at a cost in excess of $20,000,000, and was financed by a trust deed loan from John Hancock Mutual Life Insurance Company. The loan was insured by the Federal Housing Administration (FHA) pursuant to section 220 of the National Housing Act as part of an urban renewal program. From the time the Barrington Plaza was opened for occupancy in 1962, due to the low occupancy rate, rental income was never enough to service the FHA insured mortgage.. Consequently, appellant obtained a moratorium on the payments from John Hancock, with the required approval of the FHA. This moratorium was renewed three times and was finally due to expire on April 30, 1965. By that date, unpaid interest exceeded $2,000,000. When this amount was added to the $18,000,000 principal amount of the mortgage, FHA's liability to John Hancock, in the event of a default, was increased to more than $20,000,000.

During1964 appellant unsuccessfully sought a buyer for the Barrington Plaza. Early in 1965, however, an Ohio investor expressed an interest in forming a limited partnership to acquire the Barrington Plaza. On January 13, 1965, an agreement to exchange the project for several parcels of real property located in Ohio, and other consideration, was executed between appellant and the partnership, known as **Barrington'** Plaza Enterprises (BPE). On January 15, 1965, the parties opened an escrow in California.

An express condition to performance under the agreement was approval of the transfer by the FHA as required by the National Housing Act and by FHA regulations. Therefore, immediately after execution of the agreement, an "Application for Transfer of Physical Assets" was filed with the FHA requesting preliminary approval of the transfer. The appropriate FHA regulations explained how to prepare the application and listed the documents required to be submitted therewith. The regulations also provided that preliminary approval authorized consummation of the transfer, including the execution and recording of the essential documentation. "Final"

approval of the transfer was contingent only on compliance with the terms of the preliminary approval within 60 days, compliance to be established by submission of the items listed on the application. Among other requirements for obtaining "final approval", the parties were required to submit a final title policy or attorney's opinion showing that good title had vested in the purchaser, and an attorney's opinion showing that the transaction had been legally consummated. It was also provided that the parties agreed to take any steps necessary to reconvey the property if the terms of the preliminary approval were not complied with within 60 days unless an extension was granted.

The FHA, on April 8, 1965, granted preliminary approval contingent on six specified administrative and legal conditions. These conditions were either met, or waived, by that date.

On April 15, 1965, title to all real property involved in the transaction was transferred, the deeds recorded, the escrow closed, and the parties to the exchange entered into possession of their respective new properties. There were no restrictions on appellant's use or disposition of the Ohio properties received in exchange for the Barrington Plaza. However, notwithstanding the absence of such restrictions, appellant refrained from taking any definitive action concerning the Ohio properties pending final FHA approval.

One of the conditions of the FHA's preliminary approval was appellant's payment, simultaneously with the transfer of title,, of $81,394.69 to be applied to the delinquent mortgage interest. Subsequent to preliminary approval, the FHA discovered that $29,323.87 of the amount paid had been improperly made from project rental income and so advised appellant on June 3, 1965. Thereafter, by letter dated July 1, 1965, the FHA informed appellant that final approval of the transfer would not be given until corrective action was taken. Apparently the necessary action was taken, since the FHA granted final approval on October 21, 1965. The record contains no indication of any other discrepancy in the performance of the conditions of the preliminary approval which might have delayed or prevented final approval.

Between April 1965 and April 1966, the relations between appellant and BPE were less than amicable. Under the terms of the

original exchange agreement between the partnership and appellant, BPE was to receive all of Barrington Plaza's accounts receivable and was to assume payment of all the accounts payable. The exchange agreement also provided that BPE would assume certain lease-purchase agreements for the acquisition of furniture and air conditioning equipment which appellant had placed in the apart - ments in an effort to increase the occupancy rate. The total cost was in excess of $500,000 and the aggregate monthly payments were approximately $15,000. According to the terms of the agreement, however, BPE was obligated to make the payments on these obliga - tions only so long as they owned the Barrington Plaza. Both before and after the preliminary approval by FHA, disputes arose over the allocation of the accounts receivable and accounts payable. Furthermore, due to the difficulties encountered in managing the Barrington Plaza, resulting in a continued low occupancy rate, BPE defaulted on the lease-purchase obligations it had assumed. As a result of BPE's default on these obligations, appellant was required to pay in excess of $100,000 to various creditors.

Because of these disputes and BPE's default, appellant attached BPE's bank account and commenced a legal action for damages in February 1966. During the course of the action BPE cross -complained for damages, alleging fraud, breach of contract, and conspiracy in connection with the basic exchange agreement. Although BPE threatened, upon occasion, to seek rescission of the exchange it never took any affirmative action to do so. After substantial negotiations, the disputes between the parties were settled, and the legal actions dismissed by written agreement executed on April 27, 1966.

BPE failed to make any payments to John Hancock as required under the-terms of the transfer agreement. Therefore, John Hancock instituted foreclosure proceedings in November 1965. On June 2, 1966, the property was foreclosed by John Hancock. As a result of the default and foreclosure, the FHA was required to pay $20,758,413.68 to John Hancock.

When appellant filed its federal and state tax returns for the income year ended June 30, 1965, it acknowledged the fact that the properties had been exchanged on April 15, 1965, resulting in a gain of $2,193,793.73. However, appellant did not report the gain as income for that year since it considered the exchange still

executory in view of the possibility that the FHA might withhold. final approval and the further possibility that BPE might seek to rescind the transaction.

For state purposes, appellant subsequently reported the gain from the transfer of the property on its. return for the income year ended June 30, 1966. However, due to offsetting losses, appellant paid only the minimum tax for that year.

Although appellant also reported the gain on its federal return for the income year ended June 30, 1966, the Internal Revenue Service determined that appellant had realized the gain on April 15, 1965, when deeds were recorded, escrow was closed, and BPE went into possession of the Barrington Plaza. Accordingly, the Internal Revenue Service made the appropriate adjustments to appellant's return for that year. However, due to a large net operating loss carryback from the income year ended June 30, 1966, the federal adjustment resulted in no tax deficiency. Appellant did expressly agree to pay interest on the amount of tax which would have been due except for the net operating loss carryback in accordance with **applicable federal law. (See** Int. **Rev. Code of 1954,** § 6601(e)(1); **Treas. Reg.** § 301.6601-1(e)(1).)

Thereafter, respondent made corresponding adjustments for California purposes. However, since California law does not provide for net operating loss carrybacks, a large deficiency resulted for the income year ended June 30, 1965. Appellant protested the proposed assessment of additional franchise tax. The protest was denied and this appeal followed.

The sole issue for determination is whether the gain realized on the transfer of the Barrington Plaza should have been recognized during the income year ended June 30, 1965, as maintained by respondent, or during the following income year as appellant contends.

Initially, we note that a deficiency assessment issued by respondent on the basis of a federal audit report is presumed to be correct, and the burden is on the taxpayer to show that it is incorrect. (Todd v. McColgan, 89 Cal. App. 2d 509 [201 P. 2d 414]; Appeal of Jackson Appliance, Inc., Cal. St. Bd. of Equal., Nov. 6; 1970.) **In opposition to this principle, appellant maintains that it** agreed to the federal adjustment without admitting to the validity of the deficiency which gave rise to the adjustment. Appellant points out that, since the net operating loss carryback wiped out the

deficiency leaving only a relatively insignificant amount of interest due, sound business judgment required a speedy settlement with the federal authorities. Regardless of what motivated appellant's agreement with the Internal Revenue Service, the fact remains that it did agree to the adjustment. In a similar matter, where the federal adjustment did not result in substantial federal tax liability because of a net operating loss carryback, we held that the presumption of correctness attached to the assessment. (Appeal of Jackson Appliance, Inc., supra.) Nevertheless, since appellant does challenge the propriety of the adjustment we will consider the merits of the question,

Before a gain is taxable, there must be a reasonable certainty that the transaction giving rise to the gain will be completed. A substantial contingency must not remain. In general, a sale of real property occurs when a deed passes or when, in accordance with the intention of the parties to make a conveyance, the purchaser acquires possession of the property along with the benefits and burdens of ownership. (See, e.g., Consolidated Gas & Equipment Co. of America, 35 T. C. 675; A. T. Newell Realty Co., 53 T. C. 130; J. T. Wurtsbaugh, 8 T. C. 183; Wendell v. Commissioner, 326 F. 2d 600.) Taxable gain from the acquisition or disposition of property is realized when the last step is taken by which the owner **obtains fruition of the economic gain which has accrued to him.** (**Feinberg v. Commissioner, 377** F. 2d 21.)

In line with these principles respondent argues that appellant realized the gain on the exchange of properties during the income year ended June 30, 1965. On April 8, 1965, the FHA granted preliminary approval. All conditions to that approval were met or waived by that date. Preliminary approval authorized consummation of the transfer, including the execution and recording of the essential documents. In accordance with this authorization, on April 15, 1965, the property was transferred, the deeds recorded, escrow closed, and possession was transferred. Respondent concluded that the transfer took place at that time.

In opposition to respondent's determination, appellant contends that the sale was not consummated until the following income year since substantial contingencies to the completion of the transaction existed until that time. Specifically, appellant urges that its treatment of the gain was proper because of the threat of

rescission by BPE and the necessity for final FHA approval before the sale could be consummated. Since final approval was not granted by the FHA until October 1965, and the threat of rescission by BPE was not removed until March 1966, appellant maintains that the transaction was not completed until that time. Therefore, appellant concludes, the gain was properly recognizable in the income year ended June 30, 1966. We shall consider each of appellant's contentions separately.

We first consider appellant's contention that BPE threatened to bring an action for rescission of the exchange, thus presenting a substantial contingency to the consummation of the transaction. As we have noted above, the record merely indicates that, on occasion, BPE threatened to rescind the transaction. At no time did BPE ever take positive action to do so. Furthermore, even if BPE had commenced an action for rescission, such act would not have prevented the realization of gain by appellant at the closing of escrow under the facts of this case. (Karl Hope, 55 T. C. 1020.)

In Hope,' the Tax Court held that the filing of a suit for rescission by the seller of shares of stock within the taxable year, of the sale did not justify failure to recognize gain from the challenged sale, even though the taxpayer held the proceeds of the sale pending the outcome of the suit. Appellant attempts to distinguish the Hope case by the fact that, in that case, it was the seller who instituted the action for rescission, whereas, in the instant matter it was the purchaser who threatened rescission. We are not persuaded by appellant's distinction, especially since in the Hope case there was, in fact, an action to rescind, while in this matter there was nothing more than threats to do so. Accordingly, we find that the mere threats by BPE to bring an action to rescind the exchange did not constitute a substantial contingency that would prevent the recognition of the gain from the exchange during appellant's income year ended June 30, 1965. (See Frost Lumber Industries, Inc. v. Commissioner, 128 F.2d 693; Appeal of Chapman Manor, Inc., Cal. St. Bd. of Equal., April 20, 1960; Appeal of Colima Homes, Inc., Cal. St. Bd. of Equal., Nov. 27, 1956.)

Next, we consider appellant's assertion that the delay in final approval by FHA constituted a substantial contingency which prevented completion of the sale until final approval was granted in October 1965.

Appellant argues that final approval from the FHA was a condition precedent to the consummation of the sale and not merely a ministerial act. However, we note that preliminary approval by the FHA is given after receipt of legal clearance by the appropriate FHA officials. It is preliminary approval that authorizes consummation of the transfer. Final approval is granted after a review of the transaction to insure that any changes requested in issuing preliminary approval were made. From this we can conclude that it was preliminary approval, and not final approval, that was a condition precedent to the consummation of the transfer.

After the FHA issued its preliminary approval the only contingency preventing the immediate issuance of final approval was appellant's misapplication of $29,323.87 of project funds. Once this contingency was corrected by appellant, final approval was granted. It is inconceivable that appellant would have forsaken a gain of over $2,000,000 by failing to satisfy this sole remaining condition imposed by the FHA for granting final approval.

Appellant has alleged other factors which, it contends, establishes that there was a substantial contingency that FHA would refuse to render its final approval, thus necessitating a reconveyance of the Barrington Plaza and defeating the transaction. In its argument appellant relies on testimony presented to a subcommittee of the United States Senate investigating the FHA's handling of certain projects. (See Investigation Into FHA Multiple Dwelling Projects (S. Rep. No. 369, 90th Cong., 1st Sess. 1967).) It is true that testimony before the subcommittee indicates that foreclosure was a distinct possibility if appellant retained the Barrington Plaza. In fact, both the FHA and John Hancock had agreed that no further extensions of the moratorium would be granted to appellant. However, the testimony also indicates that in order to avoid its liability as insurer of the mortgage, the FHA was highly desirous that the ownership of the project change hands. Thus, the FHA's only hope of escaping liability was to insure that final approval was granted as soon as possible, with the hope that BPE could profitably manage the Barrington Plaza and service the loan.

It should be clearly understood that we do not deny that the FHA had both the right and the power to deny final, approval, under appropriate circumstances, thereby requiring a reconveyance of the properties. However, in this matter we find that the delay in

granting final FHA approval did not constitute a substantial. contingency which prevented the recognition, in appellant's income year ended June 30, 1965, of the gain realized on the exchange.,. (See Frost Lumber Industries, Inc. v. Commissioner, supra; Appeal of Chapman Manor, Inc., supra; Appeal of Colima Homes, Inc., supra; see also William M. Davey, 30 B.T. A. 837.)

Appellant has cited a number of cases in support of its position. (See Morton v. Commissioner, 104 F. 2d 534; Edward and John Burke, Ltd. ,3 T. C. 1031; The Foundation Co., 14 T. C. 1333; Bundeson v. Harrison, 34 Am. Fed. Tax R. 1611; Soanes V. Commissioner,. 2d 747 ; Daniel Rosenthal, 32 T. C. 225; Doyle v. Commissioner, 110, F. 2d 157; Baird v. United States, 65 F. 2d 911, cert. denied, 290 U.S. 690 [78 L. Ed. 594]; Webb Press Co., 3 B.T.A. 247.) We have reviewed the cited authorities and do not find them persuasive.

The first four cases cited above concerned the proper year in which a loss was deductible, not when gain was taxable. Taxable gain is realized when the taxpayer has unrestricted use of the sales proceeds even though there is some uncertainty whether he will retain them. A loss, on the other hand, is not deductible until the fact and amount of the loss becomes fixed and definite. (Compare Karl Hope, supra, with Morton v. Commissioner, supra.)

Both Doyle v. Commissioner, supra, and Baird v. United States, supra, were concerned with executory contracts. The contract with which we are concerned in the instant matter was an executed contract, not an executory contract. Thus, these cases are clearly distinguishable. (See Karl Hope, supra.)

The cases of Webb Press Co., supra, and Daniel Rosenthal, supra, concerned conditions precedent which were not performed, thus defeating the transaction. In the present appeal, the condition precedent, preliminary FHA approval, was performed. Accordingly, those cases cannot be considered as authoritative.

The court, in Soanes v. Commissioner, supra, did consider a contract of sale which was subject to the approval of a government agency. However, the nature of that approval was not comparable to the preliminary and final approval used by the FHA where title and possession pass upon preliminary approval and

final approval is contingent only on compliance with the conditions of the preliminary approval. Therefore, we do not find Soanes v. Commissioner, supra, persuasive.

In conclusion, we find that the gain from the exchange of the Barrington Plaza was properly includible in appellant's income for the income year ended June 30, 1965. Accordingly, respondent's action in this matter must be sustained.

ORDER

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Western Orbis Company against a proposed assessment of additional franchise tax in the amount of $120,314.33 for the income year ended June 30, 1965, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of August, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary