BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DANT INVESTMENT CORPORATION)

Appearances:

For Appellant: Donald D. Roberts
Attorney at Law

John Carter
Attorney at Law

For Respondent: Marvin J. Halpern
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 protest of Dant Investment Corporation against a proposed assessment of additional franchise tax in the amount of $7,085.26 for the income year 1967.

Appeal of Dant Investment Corporation

The issue for our consideration is whether the entire December 31, 1967, balance in appellant's "Termination Payment Escrow Account" accrued as income to appellant in its income year 1967 and was therefore taxable to it for that period.

In the period under appeal, appellant was an accrual method California taxpayer which filed its franchise tax returns on a calendar year basis. Its principal business activity was renting real estate.' During the first few months of 1967, appellant commenced negotiations for the sale of one of its properties located in downtown San Francisco to the California Jones Company, and on May 15, 1967, the sale was consummated. The Agreement of Purchase and Sale (hereafter: "agreement"), provided for a sales price of $4,400,000, payable partly in cash, partly by a promissory note, and partly by the buyer's assumption of two existing mortgages on the property. Additionally, and of particular importance here, the agreement stipulated that the termination dates of certain leases on the subject property which were entered into by appellant during 1967 and which did not expire until 1968 or later, were not taken into consideration in determining the purchase price of the property. According to appellant, it entered into these leases during the course of the negotiations with the buyer, but did not inform the buyer of tneir existence until most of the terms of the agreement had been formalized.

Upon learning of the leases, the buyer allegedly wanted to abandon the agreement and not go through with the transaction or, alternatively, to obtain a price reduction since the buyer's alleged purpose in acquiring the property was demolition of the existing structures and redevelopment of the property, to commence in early 1968. Appellant, not wishing either to renegotiate terms already agreed upon or to lose the sale, persuaded the buyer that establishment of a "Termination Payment Escrow Account" (hereafter TPEA) would satisfy both parties. Provision for such an account was thereafter included in the agreement.

Under the terms of the agreement, appellant was required to deposit $109,677 of the purchase price in the TPEA. This amount represented the rental receipts due under the leases for the period May 1, 1967, through

June 30, 1970. The alleged purpose of the TPEA was to reimburse the buyer for costs it might incur with respect to the tenants in the event the buyer prematurely terminated the leases. The agreement permitted appellant to replace the cash in the TPEA with marketable securities of equal value and entitled it to all interest or dividends earned by the deposits. To the extent that the terms of the leases lapsed or expired without the buyer having to pay for their termination, the agreement set forth a formula whereby appellant was allowed on July 1 of each year following the sale to permanently withdraw such funds as were no longer needed for possible lease termination payments. The TPEA was to terminate on June 30, 1970, with any remaining balance payable to appellant. Since the buyer did not, in fact, incur any lease termination damages before June 30, 1970, appellant withdrew the entire $109,677 as follows: July 1, 1967--$8,459; July 1, 1968--$64,717; July 1, 1969-- $25,101; and July 1, 1970--$11,400. The amount withdrawn from the TPEA each year was included as income on the franchise tax return filed by appellant for the year of withdrawal.

On its franchise tax return for the income year 1967, appellant reported the gross sales price for determining gain from the sale of the subject property to be $4,298,782. This figure was computed by subtracting the balance in the TPEA on December 31, 1967, of $101,218 ($109,677 minus the July 1, 1967, withdrawal of $8,459) from the $4,400,000 purchase price listed in the agreement. After auditing this return, respondent determined that the $101,218 should have been accrued and reported as income by appellant for 1967. A deficiency assessment was proposed based on the unreported amount. Appellant's protest against the proposed assessment was denied by respondent, which gave rise to this timely appeal.

Appellant concedes that its 1967 return should have reported the amount of income in the TPEA to which it became entitled as of December 31, 1967. Thus, in addition to the $8,459 withdrawn on July 1, 1967, which appellant reported on its 1967 return, it now concedes that any amount due it from the account for the period July 1 through December 31, 1967, should also have been reported on that return. Appellant contends that all funds in the TPEA relating to subsequent years were properly reported on the returns corresponding to the year of their receipt. According to appellant, to have reported the entire beginning balance in the TPEA on its 1967 return would have constituted a serious distortion of income, since there was no way of knowing in 1967 how much of the money would ultimately belong to it. Appellant maintains that at the time of the purchase the buyer fully intended to commence redevelopment of the property in 1968, and that only an unanticipated gloomy economic picture that year prevented it from doing so.

Respondent, on the other hand, contends that all events fixing appellant's right to the entire purchase price of $4,400,000 had occurred on or before May 15, 1967, and, therefore, all money placed in the TPEA accrued as income to appellant during its income year 1967. In support of its position, respondent points out that all conditions for sale of the property were met on or before May 15, 1967, the entire purchase price was paid on that date, and as of that date title to the property and all other incidents of its ownership were transferred to the buyer. Respondent argues that the mere fact that a small portion of the purchase price was deposited in the TPEA subject to defeasance in the event the buyer had to settle with appellant's previous tenants did not alter appellant's fixed right to the entire purchase price on the date of the sale.

We agree with respondent. Under the accrual method of accounting it is the right to receive income and not its actual receipt which determines the year in which it accrues as gross income. (Spring City Foundry Co. v. Commissioner, 292 U.S. 182 [78 L. Ed. 1200] (1934); Appeal of Alum Rock Development Co., Cal. St. Bd. of Equal., Dec. 29, 1958.) In the instant case, appellant's right to the full purchase price was fixed on the day of the sale, i.e., title and all other incidents of ownership were transferred to the buyer in exchange for payment of $4,400,000. No other performance was required of appellant other than the deposit of a portion of the purchase price in the TPEA. The effect of this deposit was to guarantee the buyer against damages it might incur in removing tenants which had been installed by appellant without the buyer's approval during the course of negotiations for sale of the property. Appellant's right to receive interest on the deposit, its right to replace the money with securities, and itsunqualified right to the entire deposit in the event the buyer incurred no' damages, all indicate appellant had fixed rights to the funds in 1967, the year of their deposit.

A similar factual situation was before the tax court in Federal Development Co., 18 B.T.A. 971 (1930). In that case property occupied by a tenant under a lease was sold in 1919, the seller (who was an accrual method taxpayer) agreeing to secure the surrender of the premises by the tenant on a specified date during the following year. To this end, the buyer retained a portion of the purchase price as a guarantee of the seller's performance. In 1920 the retained amount, plus interest and less a small sum representing damages incurred as a result of the tenant holding over, was paid to the seller. The court found that the profit represented by the entire purchase price was taxable to the seller in 1919, the year of the sale. In reaching this result the court stated:

> "The retaining of this amount [by the buyer] was a use of it as funds of the petitioner [seller] in carrying out the latter's obligation to make a deposit. The sum was held from that time forward as money belonging to petitioner, interest being paid the latter for the time it was held. The fact that one who sells property guarantees the purchaser against some contingency arising in a future year and makes a deposit as security for the guarantee does not lessen by the amount of the guarantee or the amount of the deposit the profit which he had made on the sale. If in such case the happening guaranteed against takes place in the following year and a portion of the deposit is in consequence lost, the result is one affecting income for that year to the extent of the loss." (18 B.T.A. at 978)

The approach adopted by the court in the above cited case has been utilized in other more recent cases (see, e.g., Key Homes, Inc., 30 T.C. 109 (1958); Commissioner v. Hansen, 360 U.S. 446 [3 L. Ed. 2d 1360] (1959); Consolidated Gas and Equipment Co. of America, 35 T.C. 675 (1961); Bolling v. Commissioner, 357 F.2d 3 (8th Cir. 1966)), and we find this approach to be compelling here.

Appellant's approach, on the other hand, is unpersuasive. With but one exception, all cases cited by appellant involved cash basis and not accrual basis taxpayers. The one case cited by appellant involving an accrual basis taxpayer was Cleveland Trinidad Paving Co., 20 B.T.A. 772 (1930). However, as pointed out in respondent's brief, the facts of that case are clearly distinguishable from those herein since in that case the income in question was contingently earned, whereas here the income in question was earned unconditionally upon consummation of the sale. (See Key Homes, Inc., supra.)

Based on the foregoing we must conclude, as did respondent, that the entire December 31, 1967, balance in the Termination Payment Escrow Account accrued as income to appellant in its income year 1967 and was therefore properly subject to tax for that year.

Appeal of Dant Investment Corporation

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Dant Investment Corporation against a proposed assessment of additional franchise tax in the amount of $7,085.26 for the income year 1967, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of March , 1977, by the State Board of Equalization.

William M. Bennett, Chairman

George R. Reilly, Member

Richard Nevins, Member

________________, Member

________________, Member

ATTEST: W. W. Dunlop, Executive Secret'ry