BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JERROLD and ALAYNE PRESSMAN)

For Appellants: Lewis S. Rosenthal
Certified Public Accountant

For Respondent: Bruce W. Walker
Chief Counsel

Kathleen M. Morris
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 Jerrold and Alayne Pressman against a proposed assessment of additional personal income tax in the amount of $626.81 for the year 1970.

The issue presented is whether failure to exercise an option to purchase a partnership business resulted in a capital loss or an ordinary loss.

In April of 1969 appellant Jerrold Pressman, a California resident, acquired an option to purchase the interest of all three partners in an existing general partnership known as Marx Brothers Fire Extinguishers. In consideration of $10,000 deposited in escrow, appellant obtained the right to purchase the partnership interests for $540,000, i.e., for $530,000 plus the $10,000 placed in escrow. The option agreement indicated that among the assets included were: (1) sufficient cash to pay outstanding liabilities, which liabilities 'would be assumed by appellant; (2) the accounts receivable, less a reasonable reserve for doubtful accounts; (3) other assets enumerated in the partnership's balance sheet (as of December 31, 1968), except for the land and building owned by the partnership; and (4) the partners' covenants not to compete for a period of three years.

On May 7, 1969, appellant contracted. with Firemaster, Inc., to sell all the assets of Marx Brothers Fire Extinguishers to that corporation for $575,000. The contract was to be in effect, however, only if Firemaster, Inc., had sufficient funds prior to consummation of any sale between the partnership and appellant.

Appellant was originally given until December 30, 1969 to exercise the option to purchase Marx Brothers Fire Extinguishers, but the period was subsequently extended through January of 1970. He allowed the option to lapse and thereby forfeited the $10,000 deposit. This was the first such option that appellant acquired from any business for the purpose of resale.

Appellants treated the loss of the deposit as a fully deductible ordinary loss on their 1970 personal income tax return. Respondent concluded, however, that the loss should be characterized as derived from the sale of capital assets, and, therefore, determined it was subject to the limitations imposed on the deductibility of capital losses. Consequently, respondent issued the proposed assessment.

Appellant explains that it was his- intention to purchase the business, not for the purpose of- owning and operating it, but for immediate resale at a profit. He contends,. therefore, that the transaction should'be. considered as equivalent to a purchase of inventory to

be immediately resold, and that the resulting loss from the lapsed option should be fully deductible as an ordinary loss.

A loss attributable to failure to exercise an option to buy property is considered as a loss from the sale or exchange of property having the same character as the property to which the option relates would have in the hands of the taxpayer, if it had been acquired by him. (Rev. & Tax. Code, § 18191, subd. (a).) The option is deemed to have been sold or exchanged on the date of its expiration. (Rev. & Tax. Code, § 18191, subd. (b).) 1/ There are identical provisions under federal law. (Int. Rev. Code of 1954, §§ 1234(a)(1), 1234(a)(2).)

Consequently, in determining the nature of such a loss, these provisions direct that the acquisition of the option must be treated as an actual acquisition of the underlying property to which the option relates. The optionee is deemed to have held the underlying property from the date of the option's acquisition to the date the option lapses. He is deemed to have "sold" the underlying property on the latter date, and the character of the property is determined by the character it would have had if so held by the optionee. (Charles M. Spindler, ¶ 63,202, P-H Memo. T.C. (1963).) Therefore, we must determine whether the underlying assets which were the subject of this option would have been characterized as capital assets if held by appellant from the date of the acquisition of the option to the date of its lapse.

Whether assets are capital assets or noncapital assets is expressly controlled by section 18161 of the California Revenue and Taxation Code, the provisions of which, insofar as applicable to our present question, are as follows:

> The term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

---

1/ Where a taxpayer is in the business of selling options this statutory rule is inapplicable. (See section 18191, subd. (d)(1), and section 18161, subd. (a).) The record, however, does not indicate that appellant was in such a business.

> (a) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business:
>
> (b) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 17208 to 17211.7, inclusive, or real property used in his trade or business;
>
> * * *
>
> (d) Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in subdivision (a).

Identical provisions are found under federal law. (Int. Rev. Code of 1954, § 1221, (1), (2) and (4).)

Whether property constitutes a capital asset is entirely a question of fact. (W. T. Thrift, Sr., 15 T.C. 366 (1950); Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956); Fidler v. Commissioner, 231 F.2d 138 (9th Cir. 1956); Appeal of Adolph and Bertha Kirschenmann, Cal. St. Bd. of Equal., June 6, 1961.) Respondent's determination of this factual question is presumed correct. Therefore the burden is on the appellant to prove that the determination is erroneous. (Van Suetendael v. Commissioner, 152 F.2d 654 (2d Cir. 1945); Estate of John C. Burns, ¶ 47,242 P-H Memo. T.C. (1947); Cohen v. Kelm, 119 F. Supp. 376 (D. Minn. 1953).)

For the reasons hereafter stated, we must conclude appellant has not established that respondent wrongfully characterized the assets in question as capital assets. Thus, appellant has not proven that the determination is erroneous.

First, appellant has made no showing that any of the assets which were the subject of this option constituted stock in trade or other property excluded from the term "capital asset" under subdivision (a) of section 18161, supra. In reaching this conclusion, we are aware it was likely that some of these assets were stock in trade of the partnership, and, consequently, "noncapital

assets" of that entity. We are not concerned, however, with the nature of the assets in the partnership's hands, but only with what their proper characterization would have been if in appellant's hands from the date of the acquisition of the option to the date of its lapse. (See Broadwell v. U.S., 30 Am. Fed. Tax R. 2d 72-5500 (E.D. N.C. 1972), affd., 476 F.2d 976 (4th Cir. 1973); see also Acro Manufacturing Co. v. Commissioner, 334 F.2d 40 (6th Cir. 1964), cert. den., 379 U.S. 887 [13 L. Ed. 2d 92] (1964); Seaboard Packing Co.v. U.S., 32 Am. Fed. Tax R. 2d 73-5009(D. Me. 1973); Estate of Jacques Ferber, 22 T.C. 261 (1954); Greenspon v. Commissioner, supra.)

In determining whether property at the time of sale constitutes property held primarily for sale in the ordinary course of a taxpayer's trade or business, and thereby excluded from the definition of a "capital asset" by subdivision- (a) of section 18161, the courts have adopted a number of well recognized tests. These important tests include: the reason for the taxpayer's acquisition and disposition of the property; continuity of sales or sales related activity over a period of time; number, frequency, and substantiality of sales; and the extent to which the owner or his agents engaged in sales activities by developing such property, soliciting customers and advertising. (W. T. Thrift, Sr., supra; Thomas E. Wood, 16 T.C. 213 (1951); Boomhower v. United States, 74 F. Supp. 997 (N.D. Iowa 1947); Greenspon v. Commissioner, supra; Appeal of Logan R. and Della M. Cotton, Cal. St. Bd. of Equal., Oct. 19, 1960; see also Horace S. Baker, ¶ 56,241 P-H Memo. T.C. (1956), affd., 248 F.2d 893 (5th Cir. 1957).)

When applying these tests, the courts have repeatedly held that even though property is acquired for the specific purpose of resale at a profit and is resold, if such sale and resale is an isolated transaction, or if such transactions are only infrequent and sporadic, a taxpayer is not carrying on a trade or business of selling such property. Consequently, in such circumstances, because the taxpayer is not carrying on a trade or business, the property is not embraced within the first exclusion (i.e., subdivision (a)) to the capital asset classification. (See, e.g., Phipps v. Commissioner, 54 F.2d 469 (2d Cir. 1931); Fidler v. Commissioner, supra; Thomas v. Commissioner, 254 F.2d 233 (5th Cir. 1958).)

For reasons already stated, we must treat appellant as purchasing the underlying assets, holding them for a period of time, and selling them. Appellant,, however, has simply made no showing that during this period

he was engaged in the business of selling property of the kind in question, in the business of selling-complete businesses, or in any other business in which assets which were the subject of this option would have been held by him primarily for sale. It is for these reasons we have concluded that subdivision (a) of section 18161 does not apply.

Second, appellant has made no showing that any of the assets in question would have constituted his depreciable business property, if in his hands during this period, and thus would be excluded from the term "capital asset" pursuant to subdivision (b), above, of section 18161. Undoubtedly some of the assets were depreciable business properties of the partnership. We, however, are again only concerned with the proper characterization of the property in the hands of appellant, and not its correct characterization in the hands of the partnership. Appellant simply has not proven that he was engaged in any trade or business in which depreciable business property of the partnership would have been used. (See Fidler v. Commissioner, supra.) On the contrary, it was his intention to purchase all of the assets for resale, and not for use in any trade or business. Thus, the exclusion from the term "capital asset" in subdivision (b) of section 18161 is inapplicable.

Third, while appellant is also deemed to have acquired the accounts receivable of the partnership when the option was acquired, and to have sold them when the option lapsed, it is obvious that these accounts were not "acquired" by the appellant in the ordinary course of any business conducted by him of selling property or rendering services. Thus, the exclusion from the term "capital asset" set forth in subdivision (d), above, of section 18161 does not apply. (See Acro Manufacturing Co. v. Commissioner, supra.)

Upon review of the entire record we must conclude, therefore, that respondent properly characterized the loss as a capital loss.

Appeal of Jerrold and Alayne Pressman

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Jerrold and Alayne Pressman against a proposed assessment of additional personal income tax in the amount of $626.81 for the year 1970, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of October, 1977, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member