

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 214

June 24, 1958

TRANSFER OF PROPERTY: SALE OR EXCHANGE OR LEASE WITH OPTION TO PURCHASE

Syllabus:

Whether a transfer of property is a sale or exchange or a lease with an option to purchase must be determined by the application substantive law. If it is a sale the purchaser may take depreciation on the property regardless of the manner in which he is to pay the purchase price.

In September, 1949 X Hotel was sold to X Hotel Company, a partnership. At the time of the sale seller was indebted to A Co., a Saving and Loan Association. Seller transferred the property by grant deed to the taxpayer-partnership, X Hotel Company, who gave A Co. a promissory note for the purchase price of X Hotel and secured it by a trust deed on the property. The taxpayer made no down payment and the promissory note is to be paid in three payments, 15% in 1964, 15% in 1974 and the balance in 1979. The promissory note called for 4 1/2% interest, however, only 2% of this was guaranteed by the partnership and this was the total extent of their personal liability. The note set up an involved method of payment of the interest and principal from 25% of the gross receipts. Since 1949 there have been few years, if any, that A Co. has received more than the minimum guarantee of the 2% interest, however, during these years taxpayer has taken depreciation at approximately three times the amount of the guaranteed payment. Advice is requested whether taxpayer may take depreciation on the hotel property.

The question of whether the transaction was a sale or exchange or a lease with an option to purchase is determinative of the issue involved. Title passed directly from the seller to the taxpayer with a trust deed to A Co. as security for payment of the promissory note. Except for the right to take possession of the property in case of a default A Co. has no reversionary interest in the property. It is well settled that an interest in the reversion is necessary to the relationship of landlord and tenant (Erving v Goodman Company Bank, 171 Cal. 559) and this principle has been relied upon in tax matters concerning sale v lease questions. A. B. Watson, 24 BTA 466. This situation is no different than where a taxpayer purchases property subject to a mortgage which he does not assume and the amount of the mortgage is included in his basis. Crane v Comm., 331 US 1. The fact that the partners are not personally liable in the event of a deficiency resulting from a mortgage foreclosure is not sufficient to hold the transaction not a sale as the Code of Civil Procedure, Section 580b prevents the collection of such a deficiency judgment. Consequently, the taxpayer may depreciate the amount of the note, which was his purchase price, regardless of the method in which the parties agreed for payment of the purchase price.