BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
KATHERINE M. ROCKHOLD)

Appearances:

For Appellant: David K. Tone, Attorney at Law.

For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; Harrison Harkins, Associate Tax Counsel.

OPINION

This appeal is made pursuant to Section 19 of the Personal Income Tax Act (Chapter 329, Statutes of 1935, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Katherine M. Rockhold to a proposed assessment of additional tax for the year ended December 31, 1935, in the amount of $805.10.

During the year 1935 the Appellant paid taxes on certain property located in Cook County, Illinois, and also paid interest on real estate loans secured by that property. In computing her tax for that year she treated the amounts so paid as deductions from gross income. The Commissioner disallowed $4,385.45 of the deduction for interest and $17,063.11 of the deduction for taxes on the ground that these amounts represented obligations incurred prior to January 1, 1935, which, under Article 36 of the Regulations Relating to the Personal Income Tax Act of 1935, did not constitute allowable deductions even though Appellant computed her net income upon the basis of cash receipts and disbursements. The taxes disallowed were for the years 1931 to 1934, inclusive. The interest disallowed was for periods prior to 1935; e. g., in the case of an interest payment made in 1935 for the period July 1, 1934, to June 30, 1935, the Commissioner disallowed one-half of the amount paid as applicable to the period from July 1, 1934, to December 31, 1934, even though the entire amount was not due until 1935.

The Appellant maintains that Article 36 is invalid because it is contrary to the provisions of the Personal Income Tax Act of 1935, and that even if it is otherwise valid, it cannot affect the computation of taxes for the year 1935 since the Regulations were not prescribed until February 26, 1936. The

Appellant also cites an Illinois Statute (Ill. Rev. Statutes, 1937, State Bar Assn. Ed., pp. 2648-2650) under the provisions of which taxes for the years 1933 and 1934 did not become delinquent until January 1, 1935, and subsequent dates? and contends that by reason of this circumstance the deduction of the Illinois taxes for these years is not prohibited by Article 36, even if that Regulation is otherwise applicable to the year 1935.

The relevant provisions of the Personal Income Tax Act are as follows:

> sec. 2. For the purposes of this act and unless otherwise required by the context--
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> (j) the words "paid *or* incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this act.
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> Sec. 8. In computing net income there shall be allowed as deductions:
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> ******
>
> (b) All interest paid or accrued within the taxable year on indebtedness of the taxpayer; ...
>
> (c) Taxes or licenses paid or accrued during the taxable year ...
>
> Sec. 16. (a) The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books for such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income ...
>
> ******
>
> (d) The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the methods of accounting permitted under subsection (a) of this section, any such amounts are to be properly accounted for as of a different period ...
>
> (e) The deductions and credits provided for in this

> act shall be taken for the taxable year in which "paid or accrued" *or* "paid or incurred"? dependent upon the method of accounting upon the basis of which the net income is computed, unless in order clearly to reflect the income the deductions or credits should be taken as of a different period ...
>
> Sec. 36. This act ... shall apply to the net income of persons taxable hereunder received or accrued on and after January 1, 1935.
>
> Article 36-1 of the Commissioner's Regulations provides as follows:
>
> Ordinarily, a taxpayer reporting on the cash receipts and disbursements basis must report all income received during his taxable year even though accrued in a prior year and may deduct all amounts paid during such year, even though incurred in a prior year. However, income accrued prior to January 1, 1935, is not taxable and need not be reported, even though the income is received on or after that date and even though the taxpayer reports on the cash receipts and disbursements basis. Thus, salaries and other compensation for personal services earned in 1934 or prior years, for example, is not taxable even though received in 1935 or subsequently. Furthermore, obligations incurred prior to January 1, 1935, may not be deducted, even though paid on *or* after that date by a taxpayer reporting on the cash receipts and disbursements basis. Thus, delinquent taxes for years prior to 1935, rentals, salaries or other business expenses incurred in 1934 or prior years are not deductible, even though paid in 1935 or subsequently.

It is apparent that under the provisions of Section 16 the Commissioner is vested with considerable discretion and may require that, for the purposes of the Act, income be computed according to a method different from that employed in keeping the books of the taxpayer. Comparable provisions of the Federal income tax statutes have been so construed by the United States Supreme Court. See Lucas v. American Code Co., 280 U. S. 445, 449; Brown v. Helvering, 291 U. S. 193, 203. Consequently, any practice or regulation adopted by him in this connection should not be rejected unless clearly unlawful. Lucas v. American Code Co., supra.

In referring to methods of accounting the statutory provisions quoted above clearly contemplate the two systems of reporting that have been developed and received recognition in the administration of the Federal income tax laws, namely, the so-called "cash receipts and disbursements" and the "accrual" methods. See Aluminum Castings Co. v. Routzahn, 282 U. S.

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
EBBA SEDGWICK)

Appearances:

For Appellant: Boyle & Wood and Ebba Sedgwick appearing on her own behalf.
For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. hrditto, Franchise Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 19 of the Personal Income Tax Act (Chapter 329, Ststutes of 1935, as amended) from the action of the Franchise Tax *Commissioner in* overruling the protest of Ebba Sedgwick to a proposed assessment of additional tax in the amount of $366.36 for the taxable year ended December 31, 1936.

In her return of income for the year 1936 the Appellant deducted from gross income the amount of $13,800 as a loss resulting from the foreclosure sale of certain property acquired by her for profit. The Commissioner recognized that the loss was sustained, but limited the amount thereof to $2,000 upon the ground that it constituted. a capital loss within the meaning of Section 7(e) of the Personal Income Tax Act as enacted in 1935.

Section 7(e) then provided that gain or loss from sales or exchanges of capital assets should be taken into account as provided by Section 117 of the Federal Revenue Act of 1934 and incorporated that Section by reference. Since the time of the filing of this appeal the Supreme Court of the United States has held that losses arising from foreclosure sales of property acquired for profit are deductible for purposes of the Federal income tax only to the limited extent provided by Section 117(d) of the 1934 Act. Helvering v. Hammel, 311 U. S. 504; Electro-Chemical Engraving Company v. Commissioner of Internal Revenue, 311 U. S. 513. These decisions are entitled to great weight in the interpretation of the California Act (Meanley v. McColgan, 49 Cal, App. (2d) 203, 209) and require in our opinion that the action of the Commissioner be sustained.

Appeal of **Ebba** Sedgwick

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 that the action of **Chas. J. McColgan,** Franchise Tax Commissioner, in overruling the protest of **Ebba** Sedgwick to **a** proposed assessment of additional tax in the amount of $366.36 for the **taxable** year ended December 31, 1936, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
George R. Reilly, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
SOUTHERN INDUSTRIAL LOAN COMPANY)

Appearances:

For Appellant: Huntington P. Bledsoe, Attorney at Law.

For Respondent: James J. Arditto, Acting Assistant Franchise Tax Commissioner; Crawford H. Thomas and Irving Perluss, Assistant Tax Counsel.

O P I N I O N

These appeals are made pursuant to Sections 25 and 27 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of the Southern Industrial Loan Company to a proposed assessment of an additional tax in the amount of $1,104.82 and in denying the claims for refund of said company in the amount of $3,477.50, respectively, for the taxable year ended December 31, 1941.

The question presented by this appeal is identical with that involved in the Appeal of Central Industrial Loan Company, this day decided by us. On the basis of the authorities set forth in our opinion in that matter, the action of the Commissioner in this appeal must be reversed.

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 that the actions of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Southern Industrial Loan Company to a proposed assessment of additional tax in the amount of $1,104.82 and in denying the claims for refund of said company in the amount of $3,477.50 for the taxable year ended December 31, 1941, pursuant to Chapter 13, Statutes of 1929, as amended, be and the same are hereby reversed. Said rulings are hereby set aside and the said Commissioner is hereby directed to refund to said Southern Industrial Loan Company the amount of tax overpaid by it for the taxable year ended December 31, 1341, the amount of the overpayment

to be determined by the exlusion from the gross income of said company of the amount of the service charges paid to it on the renewal of its loans and the acceptance of the adjustments to the income, to any extent to which such adjustments may be material in the computation of net income, made in the Commissioner's proposed assessment of additional tax.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

R. E. Collins, Chairman
George R. Reilly, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of Appeal of)
)
STANDARD FLOUR COMPANY)

Appearances:

For Appellant: R. L. Beezer and E. J. O'Laughlin.

For Respondent: W.M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel, Hebard P. Smith, Assistant Tax Counsel.

O P I N I O N

This appeal is made pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Standard Flour Company to a proposed assessment of. additional tax in the amount of $136.05 for the taxable year ended December 31, 1938, based upon the income of the company for the year ended December 31, 1937.

Section 8(c) of the Bank and Corporation Franchise Tax Act authorizes the deduction from gross income of taxes paid or accrued during the income year "...other than taxes on or according to or measured by income or profits paid or accrued within the income year imposed by the authority of (1) the Government of the United States..."

This appeal arises from the disallowance by the Commissioner of a deduction from gross income claimed by the Appellant for taxes paid under the "windfall" tax provisions of Section 501(a) of Title III of the Revenue Act of 1936. The language of Section 501(a) imposes a tax upon "net income" arising from specified sources. See I. T. 3025, XV-2 C. B. 82. Such tax, therefore, is not deductible under the express provisions of Section 8(c) of the Bank and Corporation Franchise Tax Act.

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 that the action

of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Standard Flour Company to a proposed assessment of $136.05 for the taxable year ended December 31, 1938, based upon the income of said corporation for the year ended December 31, 1937, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

Ivan C. Sperbeck, Member
Wm. G. Bonelli, Member
George R. Reilly, Member

ATTEST: Dixwell L. Pierce, Secretary

92. It has been recognized that the accrual basis of reporting is the more scientific and that it more accurately reflects the actual gains and profits of each period than does the cash receipts and- disbursements basis. *See* 1 Paul and Mertens, Law of Federal Income Taxation, 548; Magill, Taxable Income, 165; United States v. Anderson, 269 U. S. 422.

In the case of many types of taxpayers such distortion of annual income as may be caused by the use of the cash basis is relatively slight, ordinarily resulting only in the income affected being taxed in one year rather than another and not justifying the requirement that the accrual method be followed by all taxpayers, See Magill, supra, 166. In cases, however, in which large items of income or expense earned or incurred prior to January 1, 1935, were not received or paid, respectively, until on or after that date, it is obvious that the unrestricted use of the cash basis would have an important bearing on the aggregate amount of income subject to the tax, and would often cause particular individuals to be unduly favored or discriminated against. *Thus,* in the instant matter, if the Appellant should be allowed to deduct the delinquent taxes she will be favored over the great mass of taxpayers who paid their taxes and other expenses during the years in which they fell due. Conversely, taxpayers, who as a result of unusual circumstances did not receive until 1935 large amounts earned by them and falling due prior thereto, would bear a disproportionately heavy tax burden if they were compelled to include such items in their 1935 incomes.

We are of the opinion that as a means of eliminating or alleviating this condition the Commissioner was justified in providing in Article 36 of the Regulations, that income accrued and expenses incurred prior to January 1, 1935, should not be considered in the computation of net income under the Act.

On the basis of statutory provisions similar to Section 16, the Court of Appeals of Kentucky in Reeves v. Turner, 289 Ky. 426, 158 S. W. (2d) 978, upheld the action of the Department of Revenue of that State in disallowing the deduction in a return of income for 1936 of a taxpayer on a cash basis of the amount of a Federal income tax payment made in 1936. The Federal tax was based on income earned prior to 1935 and should have been paid prior to the effective date of the state tax act. Although the factual situations involved in that action and in the instant case are not identical, the tax there in question having been due in a year prior to that *in* which it was paid whereas the amounts for which deductions were here disallowed were in part at least due in the year in which paid, it is to be observed nevertheless that the Court denied to a taxpayer reporting on a cash basis a deduction for a tax paid during the year and stated that "The true income of appellees for the year in question was not reflected where such a deduction was made."

While it is contended that Article 36-1 is contrary to the express provisions of Section 36 of the Act, we do not find in the provisions of that Section any language compelling the conclusion that taxpayers keeping their accounts on the cash basis may or must report all their income and deductions on that basis. The Section states merely that the Act "shall apply to . . . net income . . . received or accrued on and after January 1, 1935", cash or the accrual method be used in computing the net income subject to the tax. We are, accordingly, unwilling to conclude that Section 36 was intended as a limitation upon the discretion vested in the Commissioner by Section 16 of the Act. Since the provisions of the Act did not give the Appellant any unequivocal right to take the deductions in question, the fact that Article 36-1 was not prescribed until February 26, 1936, does not present any obstacle to its application in computing taxes for the year 1935.

There remains for consideration only the question whether the taxes and interest represent obligations incurred prior to January 1, 1935, within the meaning of Article 36. Inasmuch as the taxes were imposed for 1934 and prior years, and became liens upon the property on the first day of April of the respective years for which they were imposed (Ill. Rev. Statutes, 1937, State Bar Assn. Ed. p. 2648), no possible basis appears upon which they may be regarded as having accrued or been incurred in a subsequent year. The fact that the taxes for 1933 and 1934 did not become delinquent until on or after January 1, 1935, is immaterial. An obligation "accrues" or is "incurred" at the time the liability is created (United States v. Anderson, 269 U. S. 422) and not at the time when payment is required. A like conclusion must be reached with rsgard to the interest, which for both income tax and accounting purposes is regarded as accruing ratablu over the period of the loan, regardless of the date when it is due. Higginbotham-Bailey-Logan Co. v. Commissioner, 8B. T. A. 566, 577; Jamison v. Commissioner 18 B. T. A. 399,404; Montgomery, Auditing Theory and Practice (5th Ed., 1934) 347.

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 that the action of Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of Katherine M. Rockhold to a proposed assessment of additional tax in the amount of $805.10 for the year ended December 31, 1935, be and the same is hereby sustained.

Done at Sacramento, California, this 2nd day of December, 1942, by the State Board of Equalization.

R. E, Collins, Chairman
George R. Reilly, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierece, Secretary