

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of  
BERNARD B. AND DOROTHY HOWARD

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Appeals and Review Office  
FRANCHISE TAX BOARD

Appearances:

For Appellant: Marvin Goodson, Attorney at Law

For Respondent: F. Edward Caine, Associate Tax 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 protests of Bernard B. and Dorothy Howard to proposed assessments of additional personal income tax in the amounts of \$2,046.88, \$2,158.04 and \$1,084.68 for the years 1952, 1953 and 1954, respectively.

Prior to 1950, Appellants were residents of Michigan and in that year they became residents of California. Thereafter, they received notices of deficiency in Federal income tax based upon their income for the years 1944, 1945 and 1946. Appellants contested the asserted deficiencies and in doing so they incurred liabilities for legal and accounting fees. In 1952, they settled the tax dispute by agreeing to pay approximately \$250,000 in tax, plus interest. They paid \$12,174.00 in 1952, and \$4,004.40 in 1953 for the legal and accounting fees. They also paid the sums of \$34,122.23, \$31,772.83 and \$18,000.25 in the years 1952, 1953 and 1954, respectively, as interest on the Federal tax.. Appellants were on the cash basis of reporting their income and expenses.

The issue presented is whether Appellants may deduct the amounts they paid for the legal and accounting fees and for the interest in computing their California taxes for the years in which the amounts were paid.

During the years in question, Section 17351 of the Revenue and Taxation Code provided, in part, as follows:

"In computing net income no deductions shall in any case be allowed in respect of:

\* \* \*

(e) Any amount otherwise allowable as a deduction which is allocable to one or more classes of

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income (whether or not any amount of income of that class or classes is received or accrued) wholly exempt from the taxes imposed by this part."

In a recent opinion involving facts substantially identical to those now before us with respect to legal and accounting fees, we held that the above-quoted section prohibited the deduction of the fees because they were allocable to exempt income. (Appeal of Hyman H. and Gertrude Klein, Cal. St. Bd. of Equal., November 15, 1960 (CCH State Tax Rep., Cal., Par. 201-638), (P-H State and Loc. Tax Serv., Cal., Par. 58,174).) In that case, the point was not the main issue and was disposed of very briefly. We shall enlarge upon our reasoning here.

It is undisputed that the income of the Appellants on which the Federal tax was asserted, income derived before Appellants became residents of California, was exempt from the California personal income tax. It is equally clear that the Federal income tax is "allocable" to that income. (James F. Curtis, 3 T.C. 648; George W. P. Heffelfinger, 5 T.C. 985; Mary A. Marsman, 18 T.C. 1, aff'd, 205 F. 2d 335, 216 F. 2d 77, cert. denied 348 U.S. 943.) Concededly, a particular deduction may be related to exempt income in a degree so remote that it should not be considered as "allocable" to the exempt income within the meaning of the above-quoted section. We do not believe, however, that such a degree of remoteness is present in the case of the legal and accounting fees here involved. Since those fees are so directly related to the Federal tax, and thus to the exempt income, the fees are not deductible.

Turning now to the interest expense, Section 17304 of the Revenue and Taxation Code allowed a deduction generally for interest paid, but prohibited a deduction for interest "to the extent that it is connected with income not taxable under this part."

Having found that the legal and accounting fees are allocable to the exempt income through a relationship with the Federal tax upon that income, it necessarily follows that the interest paid on the Federal tax is "connected" with the exempt income. If a difference is discernible in this respect between the fees and the interest, it is that the interest is even more closely related to the Federal tax and thus to the exempt income. It must be concluded that the interest expense is not deductible.

The results that we have reached make it unnecessary to consider a further contention by the Franchise Tax Board that former Section 17566 of the Revenue and Taxation Code prohibited

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the deduction of the fees and interest because they had "accrued" within the meaning of that section before Appellants became residents of California.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Bernard B. and Dorothy Howard to proposed assessments of additional personal income tax in the amounts of \$2,046.88, \$2,158.04 and \$1,084.68 for the years 1952, 1953 and 1954, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of March, 1961, by the State Board of Equalization.

John W. Lynch, Chairman

Paul R. Leake\_\_\_\_\_, Member

Richard Nevins\_\_\_\_\_, Member

Geo. R. Reilly\_\_\_\_\_, Member

Member

ATTEST: Dixwell L. Pierce, Secretary