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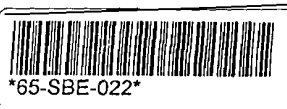

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

...

In the Matter of the Appeal of)
)
DAVID E. AND DOLLY BRIGHT)

Appearances:

For Appellants: Jack W. Nakell
Certified Public Accountant

For Respondent: Burl D. Lack
Chief 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 David E. and Dolly Bright against proposed assessments of additional personal income tax in the, amounts of $240.59, $3,124.13, $1,033.78, $137.91 and $2,297.35 for the years 1952, 1954, 1955, 1956 and 1958, respectively. The only assessments actually in dispute are in the amounts of $428.34, $307.47 and $900.00 for the years 1954, 1955 and 1958, respectively.

On the ground that appellants had become residents of California on July 1, 1948, the Franchise Tax Board, in a previous matter, issued assessments for unpaid personal income taxes against appellants for the period of July 1, 1948, to June 30, 1951. Appellants contested the proposed deficiency assessments and this board held, in the Appeal of David E. Bright and Dolly D. Bright, Cal, St. Bd. of Equal,, July 22, 1958, that they did not become residents of this state until July 1, 1951, In prosecuting their appeal, appellants

incurred certain legal and auditing fees, paying $7,139.00 in 1954 and $15,000.00 in 1958. Appellants claimed these amounts as deductions on their California personal income tax returns for the years in which the amounts were paid.

Appellant David E. Bright owned 50 percent of the outstanding stock of Whitney Industries, Inc., a foreign corporation which had no connection with the State of California. That corporation. was liquidated in 1949 and Mr. Bright received one-half of the corporate assets as a liquidating dividend. In 1954 the Commissioner of Internal Revenue determined that additional federal income taxes of $15,423.96 and $37,674.79 were due on the corporation's income for the years 1948 and 1949, respectively. In 1955, under the transferee liability provisions of the Internal Revenue Code, Mr. Bright, as a transferee, paid one-half of the taxes assessed plus interest. Of the amount paid as interest, $5,124.50 accrued after July 1, 1951, the date appellants became California residents. Appellant's' claimed the full amount of, interest paid on the federal assessment, $7,644.79, as a deduction on their 1955 California personal income tax return.

The Franchise Tax Board disallowed the 1954 and 1958 deductions claimed by appellants for the legal and audit fees incurred in resisting the California assessments on their income for the period July 1, 1948, to June 30, 1951.

Section 17285 of the Revenue and Taxation Code (formerly section 17351, subdivision (c)) provides, in part:

> No deductions shall be allowed for -
>
> (a) Any amount otherwise allowable as a deduction which is allocable to one or more classes of income other than interest (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, ...

It is undisputed that but for section 17285, appellants would, be entitled to deduct the fees in question. The

issue is whether such fees are "allocable" to appellants' income for the period July 1, 1948, to June 30, 1951. That income was exempt from California's personal income tax since appellants were nonresidents.

The Tax Court has held that an income tax imposed upon income which was exempt from tax by the United States was "allocable" to such income, for the purposes of a federal provision comparable to section 17285. (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 [99 L. Ed. 738].) Following the reasoning of these cases, we have held that legal and accounting fees incurred in the determination of an income tax are so directly related to such tax that they too are allocable to the underlying income. (Appeal of Hyman H. and Gertrude Klein, Cal. St, Bd. of Equal., Nov. 15, 1960; Appeal of Bernard B. and Dorothy Howard, Cal. St. Bd. of Equal., March 7, 1961; Appeal of William S. and Betty V. Jack, Cal: St. Bd. of Equal., May 17, 1962.)

While the above appeals dealt with fees incurred in the determination of federal taxes, we see no Logical basis for departing from this rule merely because the instant expenses were incurred in determining a California tax. The relationship between the cost of determining a tax and the income on which that tax is based does not vary according to the jurisdiction making the assessment. If the costs of litigating a federal income tax question are allocable to the income which gave rise to the disputed assessment, the costs of litigating a state income tax question are no less allocable to the income on which the state tax is based.

Respondent's regulation interpreting section 17252, the section which allows a deduction for expenses paid in connection with the determination of any tax, provides in part:

> (1) Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, ... are deductible if the expenses accrued after the taxpayer became a resident of this

> State, or if such expenses are attributable to income which has a source within this State. See Sections 17225 and 17596.... (Cal. Admin. Code, tit. 18, reg. 17252.)

At first blush, the regulation appears to require that we reverse the action of the Franchise Tax Board. The regulation itself, however, states that a deduction under section 17252 is subject to the restrictions in sections 17281 through 17298. (Cal. Admin. Code, tit. 18, reg. '17252, subd. (e).) Section 17285 also states that its restrictions are applicable to "any amount otherwise allowable as a deduction." The question of whether expenses are "allocable" to exempt income within the meaning of the overriding provisions of 'section 17285 is not reached by the regulation.

We conclude that section 17285 prohibits the deduction of appellants' legal and audit fees.

The Franchise Tax Board also disallowed the 1955 deduction for interest on the federal assessment based on the corporation's income, pursuant to section 17203, That section provides that while a deduction shall be allowed for all interest paid within the taxable year on indebtedness, no deduction shall be allowed "to the extent that it is connected with income not taxable under this part." Respondent contends that since the federal assessments arose from income untaxed by this state, the interest paid on those assessments falls within the limitation contained in section 17203. We are fully in agreement with that reasoning.

> 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....(Appeal of Bernard B. and Dorothy Howard, supra, Cal. St. Bd. of Equal., March 7, 1961.)

The fact that here the federal tax was imposed on the corporation's income rather than appellants' income matters not, for so long as the income is nontaxable, interest "connected" with such income is nondeductible. (Cf. James F. Curtis, 3 T.C. 648, 651.)

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 protest of David E. and Dolly Bright against proposed assessments of additional personal income tax in the amounts of $240.59, $3,124.13, $1,033.78, $137.91 and $2,297.35 for the years 1952, 1954, 1955, 1956 and 1958, respectively, be and the same is hereby sustained.

Done at Pasadena, California, this 28th day of June, 1965, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary