BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
UNITED STATES U-DRIVE)

Appearances:

For Appellant: Harold F. Lang,
Certified Public Accountant

For Respondent: Lawrence C. Counts,
Assistant Counsel

O P I N I O N

This appeal is made pursuant to section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of United States U-Drive for refund of franchise tax in the amounts of $1,548.31 and $1,098.22 for the income years ended July 31, 1960, and July 31, 1963, respectively.

Appellant was incorporated under California Law on July 29, 1959. Shortly thereafter it commenced its business of leasing and renting motor vehicles to customers in Santa Ana, California, and the surrounding area. By July 31, 1963, appellant's operating fleet had grown to consist of approximately 450 vehicles.

During 1963 appellant ran into financial difficulties. Negotiations with a local bank for financing were unsuccessful, and on September 12, 1963, appellant sold all its lease and rental vehicles and equipment and discontinued operations. Appellant was dissolved on July 29, 1964.

In the course of its business, appellant collected a deposit from each of its customers. That amount was received with the understanding that at the end of the lease period it would be refunded to the customer, in full or in part, unless needed by appellant to repair the leased vehicle or unless the customer wished to purchase the vehicle and to apply that deposit against its price.

The first issue raised by this appeal concerns whether such "customer deposits" collected by appellant during its income year ended July 31, 1960, which totalled $23,249.33, constituted income to appellant in that year. Appellant contends they did not, since the deposits were subject to refund and they were not used by appellant in the operation of its business during that year. Respondent argues that the deposits received during the year ended July 31, 1960, were properly includible in income for that same year, because those amounts were received by appellant under claim of right.

As stated by respondent, it is well established that if a taxpayer receives funds under a claim of right, without restriction as to their disposition, such funds are includible in income in the year of receipt, even though it may subsequently turn out that the taxpayer is obliged to repay all or a portion of the amount received. (North American Oil Consolidated v. Burnet, 286 U.S. 417 [76 L. Ed. 1197]; Healy v. Commissioner, 345 U.S. 278 [97 L. Ed. 1007].) It is also the law, however, that if a sum of money is deposited by a lessee to secure his performance under a lease it is not taxable to the lessor in the year of receipt, even though the fund is deposited with the lessor instead of in escrow, and the lessor has temporary use of the money. (John Mantell, 17 T.C. 1143; Estate of George E. Barker, 13 B.T.A. 562.) We believe the "customer deposits" in the instant case fall into this latter category.

At the time appellant received a deposit from a leasing customer it was understood by both parties that the deposit would be returned to the customer when his lease expired, unless needed for repairs or unless the customer wished to apply it on the purchase price of the vehicle. Until one of those future contingent events occurred, the customer had a right to have that deposit eventually refunded to him. This situation is distinguishable from the claim of right cases relied on by respondent in which the taxpayer claims complete

ownership of the funds when they are received., 'and then, at some later date and as a result of subsequent events, it is determined that he is not entitled to retain all or a portion of such funds.

We therefore conclude that the "customer deposits" in question did not constitute income-to appellant in the year in which they were received.

The second question raised by this appeal concerns . the reasonableness of the depreciation deduction claimed by appellant for vehicles which it had purchased during the income year ended July 31, 1963, and which it had on hand at the end of that period.

From the date it commenced doing business until May 1961 appellant depreciated the vehicles which it held for lease or rental by the straight-line method, based upon a three-year useful life and a 15 percent salvage value. Appellant's monthly depreciation on that basis amounted to 2.36 percent of the original cost of the vehicles. In May 1961 appellant revised the estimated salvage value upwards with respect to vehicles purchased after that date. From then until July 21, 1963, appellant depreciated its vehicles on a three-year straight-line basis, with monthly depreciation on its books of 1.95 percent of cost.

Appellant customarily purchased the vehicles which it held for lease and rental when they were new, and sold them from 20 to 24 months later. Capital gains realized by appellant on vehicles sold during the income year ended July 31, 1963, and preceding years were as follows:

Income Year Ended	A-verage Unit Cost	Average Gain Per Vehicle
7-31-60	$2,456	$250
7-31-61	2,606	93
7-31-62	2,883	252
7-31-63	3,115	256

Although net capital gains were realized In each year, ($12,995, $12,520, $45,617, and $59,647 for the income years ended July 31, 1960, 1961, 1962, and 1963, respectively) losses were sustained on the sale of some individual, vehicles.

In its franchise tax return for the income year ended July 31, 1963, appellant computed the depreciation allowance on the vehicles which it had purchased during that income year on a three-year straight-line basis, using a lower salvage value of 10 percent of original cost. This resulted in monthly depreciation of 2.50 percent of cost. No change was made in the depreciation deductions claimed on the vehicles still on hand which had been purchased in earlier income years.

The downward adjustment made by appellant in the estimated salvage value of vehicles purchased during the period from August 1, 1962, through July 31, 1963, resulted in an increased depreciation-deduction for that year in the amount of $35,625.26, and caused appellant to report a net loss of $18,603.74 for the income year ended July 31, 1963. Respondent's disallowance of that increased deduction gave rise to this appeal.

Section 24349, subdivision (a) of the Revenue and Taxation Code allows as a depreciation deduction "a reasonable allowance for the exhaustion, wear and tear" of property used in the trade or business. Respondent's regulations describe a reasonable allowance as:

> ... that amount which should be set aside for the income year in accordance with a reasonably consistent plan ...so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property. (Cal. Admin. Code, tit. 18, § 24349 (a).)

Respondent contends that, under this test, the increased depreciation deduction claimed by appellant for the income year ended July 31, 1963, was unreasonable, since appellant's vehicles were already being overdepreciated at the lower depreciation rates used in prior years.

Appellant argues that the adjustment which it made in the estimated salvage value of all cars on hand which had been purchased during the income year ended July 31, 1963,

was necessitated by general business conditions.-and by changes in the automobile market which rendered prior depreciation allowances inadequate. Appellant states that the auto leasing business had become increasingly competitive in the Los Angeles area since 1960, and that, as a result, the resale price of used fleet cars had been depressed. In support of its contention appellant submitted documentary evidence tending to prove that the automobile leasing industry as a whole had felt the impact of these changed business conditions, and indicating that such changes were being reflected in lower salvage values and resulting higher depreciation rates than had prevailed in prior years. In the industry as a whole, average monthly depreciation deductions in 1953 amounted to 2.44 percent of the cost of the rental vehicle,

The majority of the vehicles sold by appellant in the income years ended July 31, 1960, 1961, and 1962 had been depreciated on a three-year straight-line basis, with a 15 percent salvage value, the formula followed by appellant in the case of vehicles purchased prior to Nay 1951.. Net capital gains were realized in each year at that rate of depreciation.

Since appellant customarily held its vehicles for from 20 to 24 months, a substantial percentage of the vehicles sold during the income year ended July 31, 1953, must have been purchased after the May 1951 change in the rate of depreciation, from 2.36 percent per month to 1.95 percent per month. Notwithstanding the lower depreciation rates which were this-being applied to a large number of the vehicles sold, aggregate net capital gains in the amount of $59,647, or an average gain per vehicle of $255, were still realized on the sale of vehicles during the income year ended July 31,1963. This aggregate figure and the unit figure are both.higher than in any previous year.

The United States Supreme Court has recently observed, with reference to comparable federal legislation, that tke legislative intent behind the depreciation allowance was not to make taxpayers a profit thereby, but merely to protect them from loss. (Massey Motors, Inc. v. United States, 364 U.S. 92, 131 [4 L. Ed, 2d 1592].) In spite of the depressed automobile market. which existed during the income year ended July 21, 1963,and the lower depreciation rates being applied to a large number of the vehicles sold during that year, appellant

still realized substantial net capital gains. Even if the market continued to decline, a sizeable margin still existed before any loss on vehicle sales would be felt by appellant.

Under the circumstances before us, we are not persuaded that it was reasonable for appellant to lower its estimate of salvage value on vehicles purchased during the income year ended July 31, 1963, thereby increasing the rate of depreciation to 2.50 percent per month. We conclude that respondent's action in this matter must be sustained.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the claim of United States U-Drive for refund of franchise tax in the amount of $1,548.31 for the income year ended July 31, 1960, be-and the same is hereby reversed.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED, pursuant to section **26077** of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the claim of United States U-Drive for refund of franchise tax in the amount of $1,098.22 for the income year ended July **31, 1963**, be and the same is hereby sustained.

Done at Sacramento, California, this 23rd day of November, 1966, by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member

ATTEST: , Secretary