BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JARESA FARMS, INC., NOW HARRIS FARMS, INC.)

For Appellant: John H. Baker
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Peter S. Pierson
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Jaresa Farms, Inc., now Harris Farms, Inc., against proposed assessments of additional franchise tax in the amounts of $1,930.47 and $3,623.94 for the income years ended March 31, 1959, and March 31, 1960, respectively.

Appellant, a California corporation, is engaged in farming land located in Arizona and in California. The California farming operation is conducted as a partnership under the name of J & J Ranch. Appellant has a one-half interest in the partnership and Clarence W. and Cornelia V. Jones have the other one-half interest.

In the early 1950's, the partnership purchased certain farming property near Firebaugh, California, for a price of $400 per acre. Gradually the saline water tables under portions of this property began to rise to the surface causing reduced productivity and decreasing the market value of the land. In order to restore the productivity, tile drains were installed to remove surface as well as subsurface salts through underground water diversion. In the type of soil involved, such drains normally achieve within five or ten years a salt

balance condition whereby the salt removed annually equals the quantity applied in the irrigation water. For tax purposes for the years in question, the cost of the tile drains was deducted from income as a current expense. However, respondent has determined that the cost should have been capitalized.

On April 25, 1958, appellant merged or consolidated with Jaresa Cotton Co., an Arizona corporation which opera-ted a farm, a service station, a motel, a cafe, and a curio shop. Thereafter, the same officers assisted in the management of both the J & J Ranch and the Arizona operations. All of the operations are financed through the personal guarantee of the president and principal stockholder, Mr. Jack Harris. For the years in question, appellant determined its California income by use of the three-factor allocation formula. Respondent determined that appellant's business within and without the state is not Unitary in nature and, accordingly, that the California income should be computed on a separate accounting basis.

The first issue presented in this case is whether the cost of contructing and installing the tile drains should be capitalized or allowed as a current expense deduction.

Section 24369 of the Revenue and Taxation Code provides:

> In the case of a taxpayer engaged in the business of farming, expenditures made for the purpose of soil and water conservation and the prevention of erosion of land used in farming shall be allowed as deductions. Under Section 24343. For the purposes of this section, the term "expenditures made for the purpose of soil and water conservation and the prevention of erosion" means expenditures for the treatment, moving, or cultivation of earth, including (but not limited to) leveling, grading and terracing, contour furrowing, the construction of diversion channels and drainage ditches, the control and protection of watercourses, outlets, and ponds, the planting and cultivation of cover and protective crops or windbreaks, the control of weeds and brush and other special or emergency cultivation and tillage; but such term does not include the purchase, construction, installation, or improvement of structures, appliances, and facilities made of masonry, concrete, tile, metal, or wood, such as tanks, reservoirs, pipes, conduits, canals, dams, wells, and pumps, which

> are subject to the allowance for depreciation provided in Sections 24349 to 24354, inclusive. For the purpose of this section, the term "land used in farming" means land used (prior to the expenditure for conservation made by the taxpayer) by the taxpayer or its tenant or the predecessor owner or its tenant for the production of crops, fruits, and similar agricultural products or for the sustenance of livestock,

Appellant contends that the tile drains were experimental since their effectiveness was uncertain. It urges that the cost of the drains is deductible either as a business expense under section 24343 of the Revenue and Taxation Code or as a soil and water conservation expense under section 24369. Respondent takes the position that section 24369 specifically precludes the deduction of the cost of the tile drains.

We conclude that the dost of the tile drains is not a currently deductible expense but must be capitalized. It is clear from section 24369 that the costs of installing tile facilities such as pipes, conduits, and canals, which are subject to an allowance for depreciation, do not qualify as deductible expenses under that section. The drains in question were installed as new structures with anticipated useful lives extending substantially beyond the year of installation. Even though there may have been some doubt as to their effectiveness, they are capital assets subject to allowances for depreciation, (Red Star Yeast & Products Co., 25 T.C. 321.) The status of the drains as depreciable property is substantiated by respondent's regulation which provides that:

> For example, expenditures in respect of depreciable property include those for materials, supplies, wages, fuel, hauling, and dirt moving for making structures such as tanks, reservoirs, pipes conduits, canals, dams, wells, or pumps composed of masonry, concrete, tile, metal, or wood. (Cal. Admin. Code, tit. 18, reg. 24369(b), subd. (2)(A).)

Although this regulation was adopted after the years here involved, it is a reasonable interpretation which does not conflict with any prior regulation.

The other question presented is whether appellant conducted a unitary business so that its entire income may properly be combined and allocated within and without the state by a formula method pursuant to section 25101 of the Revenue and Taxation Code, rather than by separate accounting.

The California Supreme Court has held that a unitary business exists *if* there is (1) *unity of* ownership, (2) Unity of operation evidenced by central purchasing, advertising, accounting, and management, and (3) unity *of* use in the centralized executive force and general system of operation; or, if the operation of the business within California contributes to or depends upon the operation of the business outside California. (Butler Bros. v. McColgan, 17 Cal. 2d 664 [111 P.2d 334], aff'd, 315 U.S. 501 [86 L. Ed. 991]; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472 [183 P.2d 16]; Superior Oil Co. v. Franchise Tax Board, 60 Cal. 2d 406 [34 Cal. Rptr. 545, 386 P.2d 33]; Honolulu Oil Corp. v. Franchise Tax Board, 60 Cal. 2d 417 [34 Cal. Rptr. 552, 386 P. 2d 40].)

In our opinion, the record in this matter does not establish the existence of a unitary business. Appellant's operations in California consists of a 50 percent interest in a farming partnership, while it operates in Arizona a variety of enterprises, including a farm. The same officers assist in the management of all of the operations and all of the operations are financed through the personal guarantee of the president and principal stockholder. Those features, however, *are to* be expected in almost any case where a closely held corporation operates a number of enterprises. They do not demonstrate in themselves that the various enterprises depend upon or contribute to each other or that the profit of each enterprise is materially affected by the operation of the other enterprises. Appellant's income from the California enterprise, therefore, should be determined by separate accounting and not by combining the income from all of the operations and allocating a portion of it to California by the formula method.

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,

Appeal of Jaresa Farms, Inc., now Harris Farms, Inc.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Jaresa Farms, Inc., now Harris Farms, Inc., against proposed assessments of additional franchise tax in the amounts of $1,930.47 and $3,623.94 for the income years ended March 31, 1959, and March 31, 1960, respectively, be and the same is hereby sustained,

Done at Sacramento, California, this 15th day of December, 1966, by the State Board of Equalization.

_____, Chairman

Paul R. Leake, Member

John W. Lynch, Member

Robert Crown, Member

_____, Member

ATTEST: _____, Secretary