BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CONTINENTAL LODGE)

Appearances:

For Appellant: William Grohne and
Harrison H. Simpson, of
Webb & Webb
Certified Public Accountants

For Respondent: A. Ben Jacobson
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 protest of Continental Lodge against proposed assessments of additional franchise tax in the amounts of $1,075.86, $1,075.86, $1,827.03, and $1,514.33 for the taxable years ended March 31, 1960, 1961, 1962, and 1964, respectively.

Appellant was incorporated under California law on March 31, 1958. In March 1959 it completed construction and commenced operation of a motel located at the corner of Filbert Street and Van Ness Avenue in San Francisco, called the "Continental Lodge." The motel is a three-story frame building constructed on a concrete foundation with metal beam supports. It contains 235 rooms, a restaurant and bar. The cost basis of the building itself upon its completion in 1959 was approximately $650,000.

All of appellant's stock is held by two individuals, Charles Schonfeld (67.5 percent), and Sidney Schonfeld (32.5 percent). Charles is the president of appellant, Sidney its secretary-treasurer, and the board of directors is composed of these two men and Charles* wife, Helga.

Appeal of Continental Lodge

The first issue raised by this appeal concerns the propriety of depreciation deductions claimed by appellant on the Continental Lodge building.

Section 24349 of the Revenue and Taxation Code allows as a depreciation deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--(1) Of property used in the trade or business." The annual allowance for depreciation is based in part on an estimate of the property's useful life, i.e., the period over which the asset may reasonably be expected to be useful to the taxpayer in its trade or business. (Cal. Admin. Code, tit. 18, reg. 24349(a), subd. (2).

In its franchise tax returns for the years on appeal appellant depreciated the motel building itself by the double declining balance method on the basis of an estimated useful life of 25 years. Other building components, such as furniture and equipment, heating and lighting systems, neon signs, elevators, and bar equipment, were depreciated on the bases of shorter useful lives.

Although it accepted the shorter useful lives estimated by appellant for the motel's component parts, respondent determined that the proper estimated useful life of the motel building itself was 50 years. This determination was based upon figures contained in Bulletin F of the Internal Revenue Service (Bulletin F, "Estimated Useful Lives and Depreciation Rates" (Revised, Jan. 1942)), which supplied the federal authorities with guideline estimates of useful lives for various types of depreciable property. Fifty years was there stated to be considered a reasonable useful life for an apartment or hotel building of standard or sound construction. As a result of respondent's determination, 50 percent of the building depreciation deductions claimed by appellant were disallowed.

Appellant contends that it reasonably computed depreciation on the motel building on the basis of a 25-year useful life because: (1) The Continental Lodge is located in a rapidly developing area; (2) It occupies the largest single piece of property (about one-third of a city block) on its side of Van Ness Avenue, and that property is zoned for a building of any height; (3) In 25 years or less the Continental Lodge will no longer be a first-rate motel because of changes which will occur in architectural styles and the facilities offered by motels, and it will then be more economical to erect a taller and more modern office or apartment building than to continue to operate the motel. Appellant also states that it understands the motel site is

a potential freeway route. In support of its contentions appellant submitted letters from two San Francisco banks, both of which indicate that motel and other special-purpose property loans by those banks were generally limited to a lo-year maturity..

. As under federal law, the taxing authority's determination as to the proper depreciation allowance carries with it a presumption of correctness and the burden of showing the determination to be incorrect is on the taxpayer. (Hotel De Soto Co., T.C. Memo., Dkt. No. 3215, April 25, 1945; Appeal of Frank Miratti, Inc., Cal. St. Bd. of Equal., July 23, 1953; Appeal of Address Unknown, Inc., Cal. St. Bd. of Equal., May 5, 1953.) In the instant case the bulk of the evidence introduced by appellant consists of appellant's own unsupported statements of its contentions. The letters from two San Francisco banks do not prove respondent's determination incorrect, for the conclusions stated in those letters reflect bank lending policies rather than any true appraisal of the economic useful life of the motel.

In addition, appellant's position rests entirely on events which may happen and circumstances which may exist at some future indefinite time. The obsolescence which appellant predicts is something more than normal obsolescence, and the likelihood that it will occur must be shown to be more than a mere probability. (Lassen Lumber & Box Co. v. Blair, 27 F.2d 17.) In our opinion appellant has failed to introduce evidence sufficient to overturn respondent's determination as to the appropriate estimated useful life of the motel building.

The second issue raised by this appeal is whether certain automobile, travel and business promotion expenses paid by appellant were properly deducted by appellant as ordinary and necessary business expenses of the corporation.

Charles and Sidney Schonfeld reside about 15 miles from the motel. During the years on appeal there was limited office space at the motel and therefore the Schonfelds both did some work at home. Each used an automobile owned by appellant to drive back and forth from his home to the motel, although both men also had automobiles of their own. The annual mileage put on each car owned by appellant was approximately 18,000 miles, and appellant estimates that one half of that amount, or about 9,000 miles per car, was attributable to trips between residences and the motel. In its returns for the years in question appellant claimed expense deductions which included payments made for parking, gas, oil and repairs to the two automobiles driven by the Schonfelds, and depreciation on those cars.

Appellant also deducted amounts designated as business promotion expenses. This category of expenses allegedly included minor petty cash expenditures, meals consumed by employees of the motel, and monthly amounts ranging from $50 to $100 which the manager of the lodge was authorized to spend on favors to guests, such as flowers, meals, and drinks.

Another claimed expense item, designated as guest parking expense, was for amounts paid to a service station near the motel for the privilege of parking motel customers' cars at the station when. the motel parking lot was filled.

In each year on appeal respondent disallowed approximately 75 percent of the expense deductions claimed for depreciation, travel, auto maintenance, guest parking and business promotion on the ground that appellant had failed to substantiate the expenditures as ordinary and necessary business expenses. Respondent treated the disallowed amounts as nondeductible distributions of corporate earnings to the stockholders.

In September 1960 Charles Schonfeld and his wife, Helga, made a trip to Europe. Appellant contends that their main purpose in making the trip was to personally inspect German linens for possible purchase for use in the motel. Ultimately they decided that the purchases would be uneconomical by the time shipping costs and duties were paid. While in Berlin they also attended a convention of manufacturers of hotel supplies. Their trip lasted three weeks, and appellant estimates that Mr. and Mrs.. Charles Schonfeld spent ten days of that time on motel business. The total cost of the trip was approximately $5,000, and of that amount appellant deducted $2,233 (the travel fares of husband and wife and living expenses of $25 per day for twenty days). Respondent disallowed the entire deduction on the ground that the trip was primarily for the personal benefit of Charles and Helga Schonfeld and that the cost of the trip was thus not an ordinary and necessary expense of appellant's business.

On several earlier occasions this board has been faced with the problem of determining whether expenses incurred by a stockholder of a closely held corporation and paid by the corporation were properly deductible by the corporation as ordinary and necessary business expenses, or whether those disbursements constituted distributions for the personal benefit of the stockholders and were thus in the nature of nondeductible dividends taxable as income to the stockholders. (Appeal of Simpson's, Inc., Cal. St. Bd. of Equal;, Feb. 3, 1965; Appeal of A. K. Thanos Co., Cal. St. Ed. of Equal., Nov. 13, 1962; Appeal of National Envelope Corp Cal. St. Bd. of Equal., Nov. 7, 1961.) As in those decision;, appellant has failed to produce evidence which justifies any change in respondent's determination.

The expenses incurred by the Schonfelds in driving back and forth from their homes to the motel were clearly of a personal nature, notwithstanding appellant's allegation that each stockholder did work in his own home. (See Larry N. Kutchinski, T.C. Memo., Dkt. No. 5680-63, March 1, 1965.) Though it may be that the automobiles owned by the corporation were used for business purposes to some extent, there is nothing in the record that establishes that that business use was more than 25 percent of the total use. The record similarly is lacking in specific evidence as to the amounts allegedly spent for promotional purposes.

We also agree with respondent that appellant has failed to show that the European trip taken by Charles and Helga Schonfeld in September 1960 was anything other than a vacation for the Schonfelds during which minor and-incidental business matters were tended to.

Another question which was originally raised by this appeal, involving the deductibility by appellant of amounts paid to its shareholders to reimburse them for their uninsured medical expenses, was conceded by appellant prior to the hearing, and is therefore no longer in issue.

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Continental Lodge against 'proposed assessments' of additional franchise tax in the amounts of $1,075.86, $1,075.86, $1,827.03, and $1,514.33 for the taxable years ended March 31, 1960, 1961, 1962, and 1964, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of May, 1967, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary