BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ROBERT J. AND VERA CORT)

Appearances:

For Appellants: Daniel F. Reidy
Attorney at Law

For Respondent: Jean Harrison Ogrod
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert J. and Vera Cort against a proposed assessment of additional personal income tax in the amount of $2,675.25 for the year 1976.

The sole question presented by this appeal is whether respondent Franchise Tax Board properly applied section 17299 of the Revenue and Taxation Code so as to disallow certain expense deductions claimed by appellants in their 1976 tax return with respect to rental property owned by them which had been determined to be substandard housing. The issue is one not previously decided by this board.

Since 1968 appellants have owned the building located at 1360-1380 Howard Street in San Francisco, California. Historically, the five-story concrete and steel structure has been used for manufacturing purposes and as a warehouse. In 1971 appellants leased the entire building for a term of five years to a single lessee, Project ONE, an unincorporated nonprofit association. According to appellants, the property was zoned for office or commercial usage and the original lease with Project ONE was a standard form commercial lease. Project ONE, in turn, subleased space to various tenants, including a number of sculptors, painters, musicians and other artists, who set up their studios in the building. Those subtenants erected partitions and modified portions of the building to suit their 'needs. They also added cooking and sleeping facilities to their work spaces and thereafter lived in the building, apparently sharing community kitchens and bathrooms. Thus, the building became one of mixed commercial and residential uses.

Sometime in 1975 the San Francisco Bureau of Building Inspection (BBI) inspected appellants' Howard Street property and determined that, as it was being used, the building constituted housing which was in violation of certain health, safety'and/or building codes. After receiving notice of the violations, appellants allege that they promptly contacted the officers of Project ONE and directed them to make appropriate repairs. They contend Project ONE personnel commenced a repair program, but the scheduled repairs were only partially completed.

Early in December of 1975, the BBI inspected the building again and determined that the code violations continued. On December 18, 1975, it issued a notice of noncompliance to appellants, advising them that unless the substandard condition of their Howard Street rental housing property was corrected within ten days, or an appeal was filed with the Abatement Appeals Board of the BBI within that same period, a copy of the notice of noncompliance would be sent to respondent, pursuant to the provisions of section 17299 of the California Revenue and Taxation Code. The BBI also informed appellants of

the tax consequences of its being obliged to notify respondent of their noncompliance.

Appellants did not file an appeal with the Abatement Appeals Board, nor did they correct the substandard condition of the building within the time prescribed. The BBI therefore mailed a copy of the notice of noncompliance to respondent. As of December 31, 1976, respondent had not been notified that the property had been brought to a condition of compliance.

Upon examination of appellants' 1976 California personal income tax return, respondent noted that in that year they reported gross rental income in the amount of $63,580.00 from the Howard Street property. In that return they also claimed deductions for interest, taxes and depreciation relating to the property in the total amount of $24,323.00. Respondent's disallowance of those deductions resulted in the proposed assessment of additional tax here in issue.

During the year on appeal, section 17299 of the Revenue and Taxation Code, which was added to the Personal Income Tax Law in 1974, 1/ provided, in pertinent part, as follows:

> (a) Notwithstanding any other provisions in this part to the contrary, in the case of a taxpayer who derives rental income from substandard housing located in this state, no deduction shall be allowed for interest, taxes, depreciation or amortization paid or incurred in the taxable year with respect to such substandard housing, except as provided in subdivision (c).
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> (b) Substandard housing means housing which (1) has been determined by a state or local government regulatory agency to violate state law or local codes dealing with health, safety, or building: and (2) after written notice of violation by the regulatory agency has not been brought to a condition of compliance within six monthsafter the date of the

1/ A companion provision, enacted at the same time, is to be found in the Bank and Corporation Tax Law (Rev. & Tax. Code, § 24436.5).

notice or the time prescribed in the notice, whichever period is later: or on which good faith efforts for compliance have not been commenced, as determined by the regulatory agency. The regulatory agency may, for good cause shown, extend the compliance date prescribed in a violation notice.

(c) When the period specified in subdivision (b) has expired without compliance, the regulatory agency shall mail to the taxpayer a notice of noncompliance. The notice of noncompliance shall be in such form and shall include such information as may be prescribed by the Franchise Tax Board, shall be mailed by certified mail to the taxpayer at his last known address, and shall advise the taxpayer (1) of an intent to notify the Franchise Tax Board of such noncompliance within 10 days unless an appeal is filed, (2) where an appeal may be filed, and (3) a general description of the tax consequences of such filing with the Franchise Tax Board. Appeals shall be made to the same body and in the same manner as appeals from other actions of the regulatory agency. If no appeal is made within 10 days or after disposition of the appeal if the regulatory agency is sustained, the regulatory agency shall notify the Franchise Tax Board of such noncompliance. No deduction shall be allowed for the items provided in subdivision (a) from the date of the notice of noncompliance until the date the regulatory agency determines that the substandard housing has been brought to a condition of compliance. The regulatory agency shall mail to the Franchise Tax Board and the taxpayer a notice of compliance, which notice shall be in such form and include such information as may be prescribed by the Franchise Tax Board. In the event the period of noncompliance does not cover an entire taxable year, the deductions shall be denied at the rate of one-twelfth for each full month during the period of noncompliance.

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Appellants argue vigorously that respondent improperly applied the above quoted section so as to deny them their claimed deductions in 1976 of interest, taxes,

and depreciation related to the building located at 1360-1380 Howard Street. In this regard, they contend that the BBI incorrectly determined that the building constituted "substandard housing" appropriate for referral to respondent under the provisions of section 17299. Appellants urge that they never intended to rent the building for residential purposes when they entered into the initial commercial lease with Project ONE. They argue that their income was derived from that commercial lease, not from rental housing, and that any residential use of the property was the total responsibility of Project ONE and its subtenants. 2/ Appellants also contend that the legislative purpose of section 17299 is not furthered by applying it against them, since they are not slum landlords exploiting residential tenants. Finally, they argue that, in anv event, they qualify for the exception contained in subsection (b) of section 17299, since good faith efforts for compliance were commenced in a timely fashion by their lessee, Project ONE.

2/ Although appellants allege they never intended to rent the building for residential purposes, there is evidence in the record to indicate that they were quite aware of, and perhaps even promoted, such usage. For example, in a renegotiated lease of the same building executed by appellants and Project ONE on November 18, 1974, it is stated that the property was being leased by Project ONE for the purpose of conducting therein "[a]lternative urban living systems, research and experimentation." A covenant (#25) contained in that lease agreement suggests that it was the intention of Project ONE to attempt to make housing use of the premises, presumably through a zoning change. In addition, a newspaper article appearing in the October 4, 1978, issue of the San Francisco Examiner featured the artists' usage of the building on Howard Street and the tax problems appellants were having as a result of the BBI's determination that the property constituted substandard housing. The author of that article characterized appellants as community-minded landlords who were making the space available at low rents to some sixty artists as a contribution to the artistic life of the City of San Francisco.

Respondent contends that the administration of section 17299 is a two-stage process, the first to be carried out by the state or local regulatory agency, and the second by respondent. It urges that once the state or local regulatory agency makes its determination that housing is substandard, as defined in subdivision (b) of the section, and notifies respondent of that determination, respondent cannot second-guess that agency's determination. Respondent argues that upon receipt of a notice of noncompliance from the regulatory agency, respondent's only duty under the provisions of section 17299 is to ascertain whether the taxpayer received rental income from the housing which has been determined to be substandard and, if so, to disallow any deductions claimed for taxes, interest, depreciation or amortization relating to that property. Respondent contends that in this case it did just as section 17299 mandates when it' disallowed the entire deductions claimed by appellants in their 1976 return for interest, taxes, and depreciation relating to the Howard Street property.

We do not believe it is necessary to discuss the other arguments offered by respondent in response to appellants' contentions, since we are in total agreement with respondent's interpretation of how section 17299 is to be administered. The language of that section quite clearly requires the determination that property constitutes substandard housing to be made solely by the regulatory agency, be it state or local. No discretion is placed either in respondent or in this board to review that determination. Similarly, the statute plainly places in the regulatory agency the responsibility of determining whether or not good faith efforts for compliance have been commenced within the required time, so as to remove the property from the definition of substandard housing. Again, no authority is given to respondent or to this board to second-guess the regulatory agency in that determination..

In accordance with the provisions of subdivision (c) of section 17299, the notice of noncompliance issued to appellants by the BBI advised them of their right to appeal and where such an appeal should be filed. It also warned them of the tax consequences of their failure to either file an appeal within ten days or bring the property into a condition of compliance within that same period. For reasons unknown to us, appellants chose not to file an appeal with their local Abatement Appeals Board. 'However, that certainly would have been the proper forum for the presentation of all of the arguments

which they have directed to us in this appeal. Nor did appellants correct the substandard conditions within the required time. The BBI therefore notified respondent of appellants' noncompliance, as it was required to do under the provisions of section 17299.

In due course, respondent did what it was required to do, and all it was authorized to do, under that section. It had received a copy of the notice of noncompliance, dated December 18, 1975, and, as of the end of 1976, it had not been advised by the BBI that appellants' Howard Street property had been brought into compliance. Upon examining appellants' 1976 tax return, respondent determined that appellants had derived rental income from that property in 1976, and that they did claim deductions of interest, taxes, and depreciation relating to the property. As mandated by section 17299, respondent therefore disallowed those deductions in their entirety. That action was in complete conformity with the law and 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 I'S 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 Robert J. and Vera Cort against a proposed assessment of additional personal income tax in the amount of $2,675.25 for the year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 21st day of May, 1980, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member