BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JERRY N. SCHNEIDER)

Appearances:

For Appellant: Robert **T.** Gilleran
Attorney at Law

For Respondent: James T. **Philbin**
Supervising 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 Jerry N. Schneider against a proposed assessment of additional personal income tax in the amount of **$10,878.40** for the year 1971.

In 1968, while still in high school, appellant started his first company, Creative Systems, to sell his electronic inventions and discarded telephone equipment which he had repaired. He continued and expanded his wholesale telephone equipment business during 1970 and 1971, while majoring in electronics engineering in college. During this time, he learned enough about Western Electric Company's automatic ordering system to enable him to order telephone equipment from that company without paying for it by making it appear that the order had come from internal telephone company sources. Sometime during 1971, appellant began obtaining new telephone equipment from Pacific Telephone Company (Pacific) throuqh such illeqal means. The equipment was then sold to others or back to the telephone company.

Appellant's unlawful activity continued until his arrest in early 1972. He pleaded guilty on May 15, 1972, to a charge of grand theft, served a short term in a correctional institution, and paid a $500.00 fine. Pacific instituted a civil suit in which final judgment was entered November 26, 1974. The order in that suit stated that appellant had stolen equipment valued at $214,649.63, equipment valued at $73,452.81 had been returned, and appellant was liable to Pacific in the amount of $141,196.82 for compensatory damages, Pacific agreed not to execute on the judgment if appellant made sixty equal monthly payments of $141.50, beginning on December 1, 1974, for &total of $8,490.00. In the absence of default, this would fully satisfy the judgment. Appellant was also ordered to assign to Pacific his accounts receivable from the sale of the stolen equipment, amounting 'to $32,000.00, and a $42,000.00 leqal claim he had against an embezzling employee.

On July 6, 1972, appellant filed a California personal income tax return for 1971 reporting net income of $144,902.00 and a tax of $13,675.20. However, no remittance was sent. On April 30, 1973, an amended return was filed showing a net loss of $32,671.00 and no tax for 1971. The major reason for this result was a business expense deduction for appellant's liability to Pacific in the amount of $136,623.00.

The Internal Revenue Service audited appellant's returns for 1970, 1971 and 1972. Appellant agreed to the final federal report adjustments, consisting of an additional $11,982.00 in business income, disallowance of the $136,623.00 deduction for appellant's claimed liability to Pacific, and a 1972 net

operating loss (NOL) which was carried back to 1970 and 1971. The NOL carryback reduced appellant's 197-1 federal income tax liability from $84,396.40 to $26,360.50.

Subsequently, respondent issued a notice of proposed assessment (NPA) on the basis of the final federal action. It adjusted appellant's original 1971 return by adding $11,982.00 to business income, but, since California does not provide for the carryback of net operating losses, no adjustment was made for the 1972 loss. Respondent disallowed the $136,623.00 business expense deduction, but did allow the exclusion of appellant's $40,950.00 closing inventory. The NPA stated the tax liability as $10,878.40. After this appeal was filed, respondent discovered that the amount was misstated due to a clerical error, and should be reduced to $10,848.40.

The issue presented by this appeal is whether respondent's determination, based on federal audit adjustments to the extent applicable under California law, was proper.

Appellant does not dispute the inapplicability of NOL carrybacks in determininq.California income tax. Therefore, we need only decide whether appellant has overcome the presumption that the federal adjustments increasing his 1971 income and disallowing the business expense deduction in 1971 for his reimbursements to Pacific were correct.

In resolving these issues, we are guided by the well-established rule that respondent's proposed assessment, based on federal action, is presumed correct, and the burden is on appellant to show that it is erroneous. (Appeal of Ronald J. and Eileen Bachrach, Cal. St. Bd. of Equal., Feb. 6, 1980; Appeal of Nicholas H. Obritsch,, Cal. St. Bd. of Equal., Feb. 17, 1959.)

Appellant asserts that he should not be bound by the federal adjustments since they were only agreed to because the net effect was a reduction in tax due to the availability of the NOL carryback. This assertion, however, has no bearing on whether the adjustments were correct, but only explains appellant's motivation for the agreement. It is not sufficient to overcome the presumption of the propriety of respondent's determination. (See-Appeal of Tool Research-and Engineering Corporation, Cal. St. Bd. of Equal., Dec. 17, 1974, and

Appeal of Robert J. and Evelyn A. Johnston, Cal. St. Bd. of Equal., April 22 1975.) Appellant has not presented any evidence to indicate that his gross income for 1971 should not be increased by the amount determined in the federal action, so we find that the adjustment should stand.

Appellant's main argument centers, around the disallowance of a deduction for the amounts he was ordered to repay in 1974. Appellant's tax returns for 1971 indicate that he used the accrual method of accounting. Respondent has presented no evidence to dispute appellant's entitlement to use this method.

Appellant contends that his liability for reimbursement to Pacific accrued at the time he stole the equipment, and therefore, the amounts repaid are deductible in that *year.* He draws a parallel between his situation and that of a purchaser of equipment whose liability for payment to the seller accrues when the goods are purchased.

The regulations under Revenue and Taxation Code section 17591 provide that under the accrual method of accounting , liabilities are deductible in the year in which all events have occurred which fix the fact of the liability and the amount thereof can be determined with reasonable accuracy. (Cal. Admin. Code, tit. 18, reg. 17591, subd. (a)(2).) This statute and regulation are the same as the provisions of Internal Revenue Code section 461 and Treasury Regulations section 1,461-l (a) (2). Therefore, the federal case law is persuasive in the interpretation of the California section and its regulations. (Holmes v. McColgan, 17 Cal. 2d 426 [110 P.2d 428] (1941).)

"[T]he all events test is designed to protect tax revenues by ' [insuring] that the taxpayer will not take deductions for expenditures that might never occur. . . .'" (Mooney Aircraft, Inc. v. United States, 420 F.2d 400, 406 (5th Cir. 1969).) As long as there are any contingencies relating to a liability, it cannot be accrued for purposes of a tax deduction. (Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 188 L. Ed. 270] (1944); ABKCO Industries, Inc. v. Commissioner, *482* F.2d 150, 151 (3rd Cir. 1973).)

Contrary to appellant's assertion, his situation is unlike that of a purchaser. A purchaser has a fixed agreement with the seller at the time the property

is purchased that the seller will be paid. Further events may alter the payment in some respects, but all events have occurred to fix the fact of the liability at the time of purchase. A thief, on the other hand, obtains property with no intention or expectation of paying the victim for it. (See Moore v. United States, 412 F.2d 974, 979-983 (5th Cir. 1960).) If the thief or the theft were never discovered, the thief's liability would never be established. In 1971, appellant's theft had not even been discovered. His liability at that time was contingent, and therefore not deductible.

The question of when appellant would be entitled to deduct reimbursement payments is not before us, so we do not address that issue.

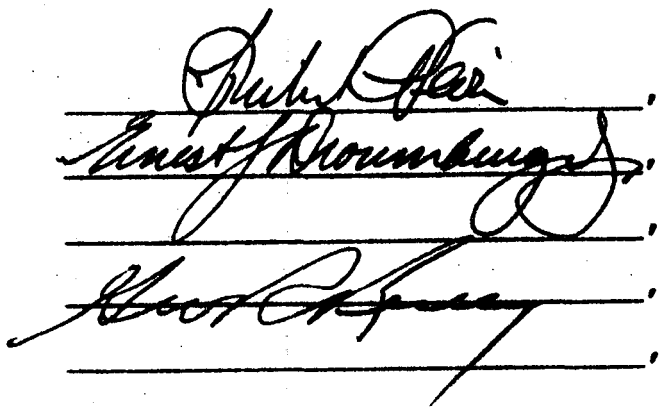
Appellant presents several other arguments in support of allowing the deduction in 1971, but we do not find any of them convincing. Therefore, we sustain respondent's action.

ORDER.

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 Jerry N. Schneider against a proposed assessment of additional personal income tax is hereby modified to reflect the correct amount of $10,848.40 for the year 1971. In all other respects, the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 1st day of August, 1980, by the State Board of Equalization.



_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member