BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PAUL J. WIENER)

For Appellant: Charles D. Kimbell
Attorney at Law

For Respondent: John R. Akin
Counsel

OPINION

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 Paul J. Wiener against a proposed assessment of additional personal income tax in the amount of $28,557.47 for the year 1974.

Appeal of Paul J. Wiener

Appellant, a contractor, acquired two vacant parcels of land in Goleta,, California (Goleta lots), in 1970 and 1971, apparently planning to develop them for commercial use. In 1972 and 1973, the Goleta County Water District imposed-a moratorium on new hookups to the Goleta Water' District system. 'The moratorium affected. the Goleta lots, but did not preclude appellant from drilling a well, -as long as he had permission of the district.

In 1974, the Santa Barbara County Assessor's office reduced the appraised value of the Goleta lots from $86,500 to $33,500. Appellant states that in that year he decided that the property was not marketable and that he should abandon it. The property was written off his books in 1974 and property taxes due in December 1974 were not paid. The property was sold to the State in June 1975 for tax delinquency, and subsequently redeemed by appellant in October 1975. Appellant asserts that the redemption was due solely to a mistake. On his return for taxable year 1974, appellant claimed a loss deduction for the abandonment of these lots.

In 1974, appellant constructed 16 residential units in Visalia, California (Central Avenue Village). The project was oriqinally planned as an apartment complex, then changed to a condominium project. The condominiums did not sell, however, so appellant rented them as apartments. On his 1974 tax return, appellant claimed a loss deduction in an amount equal to 60 percent of the cost of improvements which were alleged to have been installed to enhance the project's potential sale as condominiums.

Appellant's wholly'owned corporation, Midtown Development Company (Midtown), constructed a 40-unit residential project in Visalia (Villa Sequoia), which also beqan as an apartment project. During construction, the plan was changed, first to a planned unit development, then to a condominium project. Ultimately, when the condominiums did not sell, the units were rented as apartments. Although appellant apparently owned the land on which the units were constructed, Midtown held title to the project during construction and at the time of the conversion from condominiums'to apartments. On his 1974 tax return, appellant claimed a loss deduction of $135,514 for the cost of converting Villa Sequoia to condominiums.

Appellant paid Midtown a management fee for personnel, equipment and overhead of the corporation which was used for his individual business ventures. In his brief, appellant states that the amount of $92,000, which was deducted on his 1974 return, was his best estimate of the value of these services. Payment to Midtown of that amount was ratified by Midtown's board of directors on June 14, 1976. During the federal -audit of appellant in 1976, the Internal Revenue Service ascertained that payments by appellant to Midtown were based on 10 percent of the costs of certain construction performed by Midtown for appellant. It was discovered in the federal audit that these costs had been miscomputed. The percentage rate applied to the correct costs yielded $72,000, $20,000 less than the amount claimed by appellant in his 1974 return.

Early in 1976, the Internal Revenue Service began an audit of appellant's personal income tax return for taxable year 1974. Appellant consented to the proposed federal tax deficiency assessment in February 1977. The federal adjustments disallowed appellant's claimed loss deductions for the Goleta lots, Central Avenue Village and Villa Sequoia, and $20,000 of the claimed expense deduction for fees paid to Midtown. His ordinary gain was decreased, his capital gain increased, and a net operating loss was carried back from taxable year 1975.

Respondent adjusted appellant's taxable income for 1974 in accordance with the adjustments of the federal audit report to the extent applicable under California law. Respondent issued a notice of proposed assessment, which appellant protested. Respondent denied appellant's protest, and this timely appeal followed.

Appellant questions only the disallowance of the loss and expense deductions. The issue to be decided is whether appellant has shown that respondent's proposed adjustments, which were based on the federal audit report, are incorrect.

Respondent's proposed assessment based on a federal audit report is presumed correct, and the burden is on the taxpayer to prove it erroneous. (Appeal of Ann Schifano, Cal. St. Bd. of Equal., Oct. 27, 1971; Appeal of James A. McAfee, Cal. St. Bd. of Equal., Feb. 3, 1977.) Furthermore, deductions are a matter of legislative grace, and the burden of proving the

right thereto is on the taxpayer. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348] (1934); Appeal of Ronald J. and Eileen Rachrach, Cal. St. Bd. of Equal., Feb. 6, 1980.)

Revenue and Taxation Code section 17206 and the requlations thereunder provide for personal income tax loss deductions. This section is substantiaily similar to section 165 of the Internal Revenue' Code of 1954 and its predecessor sections in previous Internal Revenue Codes. Accordingly, the interpretation of the federal section is very persuasive in the construction of the California section. (Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356, 360 [280 P.2d 893] (1955).)

Gpleta Lots

Commissioner v. McCarthy, 129 F.2d 84, 87 (7th Cir. 1942) states:

> The rule to be deduced from the "abandonment': cases, we think, is that a deduction should be permitted where there is not merely a shrinkage of value, but instead a complete elimination of all value, and the recognition by the owner that his property no longer has any utility or worth to him, by means of a specific act proving his abandonment of all interest in it, which act of abandonment must take place in the year in which the value has actually been extinguished.

Worthlessness, rather than mere shrinkage or fluctuation in value', is the standard set for determining whether there is a loss for tax purposes. (A. J. Industries, Inc. v. United States, 503 F.2d 660, 664 (9th Cir. 1974); John R. Thompson Co. v. United States, 338 F. Supp. 770, 774 (N.D. Ill. 1971).) The regulations and cases indicate that worthlessness may mean either absolute loss of all value of the property or total lack of useful value to the owner in his or her trade or business. (Cal. Admin. Code, tit. 18, § 17206, subd. (b)(1): Stanley Selig, ¶ 67,253 P-H Memo. T.C. (1967).)

Once a loss sufficient for tax purposes is established, the taxpayer must abandon the property for the loss to be deductible. This is done by demonstrating an intent to abandon and an affirmative act of

actual abandonment in the taxable year for which the deduction is claimed. (John R. Thompson Co., supra, at 777; Enid Ice and Fuel Co. v. United States, 142 F. Supp. 486, 487 (W.D. Okla. 1956).) "Neither mere intention alone nor mere non-use alone, is sufficient to accomplish abandonment." (Hummel v. United States, 227 F. Supp. 30, 32 (N.D. Cal. 1963).) Refusal to pay ad valorem property taxes when able to do so is not sufficient by itself to show abandonment. (Enid Ice and Fuel co., supra, at 488.)

The Goleta lots had not lost all value in 1974. They were assessed at $33,500 in that year.' Appellant asserts that "the marketability of this 'property was virtually destroyed" by the moratorium. Although the determination of loss of useful value is "a matter of sound business judgment" (A. J. Industries, Inc. v. United States, 388 F.2d 701, 704 (Ct. Cl. 1967), appellant presents no evidence showing this was "sound business judgment" rather than an arbitrary decision to take a deduction at that time.

Even assuming that appellant decided the property had lost all useful value to him based on sound business judgment, there was no act in 1974 sufficient to establish abandonment. The only acts which appellant points to supporting abandonment in that year are his writing off the property on his hooks and his failure to pay property taxes on the parcels that year. However, we cannot accord the former undue weight (see A. J. Industries, Inc., supra, at 712), and the effect of the latter is both insufficient and contradicted by appellant's later act of redemption of the lots.

We find, therefore, that appellant has not shown that respondent's adjustment was erroneous 'in regard to the disallowance of this deduction.

Central Avenue Village

Appellant claims an "abandonment loss" for 60 percent of the cost of improvements which he states were made solely in anticipation of the units selling as condominiums. He maintains that the improvements lost a portion of their useful value when the units were rented as apartments. Since the improvements are depreciable assets, any deduction must come under Revenue and Taxation Code section 17208. For depreciable property, a loss is allowed for the "retirement" of an asset, defined as "the permanent withdrawal of depreciable

property from use in the trade or business or in the production of income." (Cal. Admin. Code, tit. 18, reg. 17208(h), subd. (1).) No "permanent withdrawal" has occurred here, as appellant admits the improvements were used and, in fact, aided in maintaining a lower vacancy rate for the apartments. Consequently; appellant is not entitled to a deduction for these costs.

Villa Sequoia

Appellant claims a similar deduction for costs in connection with the Villa Sequoia units. Our decision regarding Central Avenue Village is equally applicable to Villa Sequoia. Additionally, respondent asserts, with no refutation from appellant, that at the time the claimed loss occurred, title to the project was in Midtown, not appellant. Obviously, appellant was not entitled to claim a deduction on his personal income tax return in connection with property which he did not then own.

Overhead Expense Deduction

Appellant has not met his burden of showing that the federal audit disallowance of $20,000 of appellant's claimed overhead expense deduction is erroneous. He contends only that the deduction claimed was his "best estimate" and that Midtown's board of directors ratified acceptance of that amount in 1976, almost two years after the payment was made. He does not refute, in any way, the method used by the Internal Revenue Service in computing the deductible amount. On these facts, we cannot say that appellant has shown respondent's determination to be erroneous.

For the reasons stated above, we sustain respondent's action.

Appeal of Paul J. Wiener

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Paul J. Wiener against a proposed assessment of additional personal income tax in the amount of $28,557.47 for the year 1974, be and the same is hereby sustained.

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

_____, Chairman

_____, Member

_____, Member

_____, Member

_____ Member