

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
 )  
FRED AND BARBARA BAUMGARTNER )

For Appellants: Fred Baumgartner,  
in pro. per.  
For Respondent: James C. Stewart  
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 Fred and Barbara Baumgartner against proposed assessments of additional personal income tax in the amounts of \$405.36, \$625.82, \$931.17 and **\$1,600.36** for the years 1973, 1974, 1975 and 1976, respectively.

Appeal of Fred and Barbara Baumgartner

The sole issue presented is whether respondent properly disallowed certain interest expense deductions claimed by appellants for the years in question.

During the appeal years, appellants resided in Los Angeles, California; where Mr. Baumgartner was employed by Pan-American World Airways, Inc. as a traffic representative.' On the joint personal income tax returns which they filed for those years, appellants reported as income Mr. Baumgartner's wages and small amounts of interest. Among the itemized deductions claimed for each year were the following, which were identified as accrued interest owed to creditors in Switzerland:

<u>Taxable Year</u>	<u>Interest Expense Deduction</u>
1973	<b>\$15,800</b>
1974	16,300
1975	18,980
1976	25,000

After deducting these amounts, plus their other itemized deductions, appellants reported no tax liability for 1973, 1974 and 1975, and a tax liability of \$10.52 for 1976. Upon audit, respondent disallowed the claimed accrued interest deductions for lack of substantiation. That **action** gave rise to this appeal.

Appellants allege that during the period from 1939 through 1943, Mr. Baumgartner borrowed money from various Swiss creditors for the purpose of buying stocks and land located in Switzerland. According to appellants, those investments in Switzerland were sold in 1949. Appellants state that none of the borrowed funds were ever repaid, and it appears that no interest on those "loans" was ever actually paid. Appellants allege that through the years since the purported loans were created, interest accruing at the rate of 6 percent per annum has merely been added to principal. They state that such accrued interest **totalled** \$234,607 by the end of 1976. The interest expense deductions here in question represent portions of that "accrued interest." Appellants contend they are accrual basis taxpayers and that, as such, they were entitled to deduct those amounts in computing their tax liability for the years in question.

## Appeal of Fred and Barbara Baumgartner

It is a fundamental principle of tax law that deductions are matters of legislative grace and the taxpayer bears the burden of proving he is **entitled to** deductions claimed. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of William W. and Marjorie L. Beacom, Cal. St. Bd. of **Equal.**, Oct. 6, 1976.) Under the California Personal **Income Tax Law**, the deductibility of interest expenses is governed by section 17203 of the Revenue and Taxation Code which provides, in subdivision (a), "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Identical language is contained in section 163(a) of the Internal Revenue Code of 1954.

The accrued interest expense deductions claimed by appellants herein present numerous problems. To mention only a few, we note that appellants have failed to establish the existence of an indebtedness or of any obligation on their part to pay interest thereon, both of which are essential to the deductibility of interest under section 17203 of the Revenue and Taxation Code and under the federal income tax law. (See David W. Bernstein, ¶ 75,253 P-H Memo. T.C. (1975).) No documentation of the alleged loans has been submitted by appellants. Their apparent failure over a forty-year period ever to have made any payment of principal or interest suggests strongly that no bona fide indebtedness existed. **Certainly** none has been proven.

Even if the alleged loans had been substantiated, further difficulties arise with respect to appellants' use of the accrual method of accounting only with respect to the interest expense deductions claimed on their returns for the appeal years. A review of those returns indicates that appellants reported their income and all other deductions on a cash basis. As a general rule, taxpayers utilizing the cash receipts and disbursements method of accounting must deduct expenditures in the year in which they are actually paid. (Helvering v. Price, 309 U.S. 409 [84 L.Ed. 836] (1940); Clinton H. Mitchell, 42 T.C. 953 (1964); William A. Clarke, ¶ 46,002 P-H Memo. T.C. (1946); see Cal. Admin. Code, tit. 18, reg. 17591, subd. (a)(1).) Appellants herein have not established that they ever paid any interest on the purported loans from Swiss creditors.

Furthermore, appellants admit that they only began deducting the amounts of accrued interest in 1973, after they "learned that this could be done." Presumably their returns for earlier years were completed on a

Appeal of Fred and Barbara Baumgartner

cash basis. Any change in their accounting method would have required the prior consent of respondent (Rev. & Tax. Code, § 17561, subd. (e)), and no such consent was ever sought or obtained by appellants.

Since appellants have failed to supply even the most meager proof that they were entitled to the accrued interest expense deductions claimed, respondent's disallowance of those deductions 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 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 protests of Fred and Barbara Baumgartner against proposed assessments of additional personal income tax in the amounts of \$405.36, **\$625.82, \$931.17 and \$1,600.36** for the years 1973, 1974, 1975 and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of ~~October~~ , **1980**, by the State Board of Equalization, with **Members Nevins, Reilly, Dronenburg and Bennett** present.

Richard Nevins , Chairman  
George R. Reilly , Member  
Ernest J. Dronenburg, Jr. , Member  
William M. Bennett , Member  
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