80-SBE-163

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
EDWIN L. TERRY RAY.)

Appearances:

For Appellant: F. N. Gilbert
Tax Consultant

Marie Ray
Executrix of Appellant's Estate

For Respondent: James T. Philbin
Counsel

OPINION

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code[1] from the action of the Franchise Tax Board on the protest of Edwin L. Terry Ray against a proposed assessment of additional personal income tax in the amount of $728.90 for the year 1972. Respondent now concedes that the amount of tax liability should be reduced to $710.15. Appellant died after the filing of this appeal. Therefore, Marie Ray, his widow and executrix of his estate, is the real party in interest.

[1] Statutory references are to the Revenue and Taxation Code unless otherwise indicated.

The issues presented are: (1) whether appellant incurred liability for the tax on preference income, and, if so, (2) whether this liability has been properly computed.

Appellant was a real estate broker and during 1972 operated a real estate consulting business. He was then also engaged in the business of farming. The farm consisted of a 160-acre citrus fruit orchard. For several years prior to 1972 he had operated it at a loss. In 1972 he sustained another net loss from this activity in the amount of $9,318.27. Appellant and his ex-wife Helen, during their marriage, jointly owned the property, apparently as joint tenants. The property was encumbered with a deed of trust 'which secured a debt in the principal amount of $250,000.00[2]

Helen obtained a, divorce in 1969, and pursuant to the divorce decree, she and appellant each retained an undivided one-half interest in the farm property, but as tenants in common. The entire property continued to constitute security for the $250,000.00 obligation. By the beginning of the year 1972, interest payments were past due on the loan and back taxes were owed on the property.

Appellant arranged to have a portion of this property zoned for business use inasmuch as he felt that the property was suitable for a shopping center. In 1972, Mr. Seymour Lazar was interested in subdividing and reselling it. Lazar first purchased Helen's undivided one-half interest. Pursuant to Lazar's agreement with her, she received $20,000.00 as a cash payment. Appellant was not a party to this transaction, nor involved in these prior negotiations.

Lazar offered to purchase appellant's one-half interest under the same arrangement as that with Helen. Appellant refused that 'specific offer. Ultimately, an agreement was reached between appellant and' Lazar providing for the transfer. Pursuant to their contract, appellant received $5,000.00 as a cash payment and Lazar also agreed to pay appellant 10 percent of any net profit-derived from his resale of the property. There

[2] The record does not establish whether or not Helen Gas also personally liable' for the $250,000.00 debt.

were also provisions whereby appellant received an immediate loan,, and was the payee of a promissory note evidencing that Lazar was to make an additional loan to appellant in 1973.

Under his separate agreements with Helen and appellant, Lazar did not personally assume liability for any portion of the outstanding $250,000.00 debt or past due interest and taxes.' However, as a consequence of these two separate transfers, he received the entire property which constituted the security for payment of that obligation.

Because Lazar did not pay the money he promised to lend appellant in 1973, appellant filed suit. Lazar also countered with a suit, asserting that appellant was guilty of misrepresentation. The record does not disclose the subsequent events relating to these proceedings.

Lazar sold the farm property to a foreign corporation-located outside the United States. Appellant did not receive any further payment from him. Because of appellant's default in loan payments, foreclosure proceedings were brought. Since appellant was liable for the indebtedness, it appears that a deficiency judgment against appellant was also sought. Appellant, however, was hopelessly insolvent.

Appellant had intended to bring additional legal action against Lazar to rescind the sale, or obtain other appropriate relief, but this step was thwarted by appellant's poor financial condition, Lazar's residence in a foreign country, and the circumstance that the two subsequent purchasers of the property were also located in a foreign country.

On his 1972 state income tax return, appellant reported a $118,312.64 net long-'term capital gain from. the sale of his one-half undivided interest in the farm property. Appellant reported the transaction as if a sum equal to cash of $25,000.00, plus the entire amount of the indebtedness ($250,000.00), less certain deductions, including those for commissions and attorney fees, constituted the net selling price, which was computed to be $165,435.58. From that calculated price he deducted his basis in his one-half interest of the property ($47,122.94) to arrive at a net gain of $118,312.64. After offsetting short-term capital losses totaling $1,500.00, he showed a net total capital gain of $116,812.64 on his return.

Pursuant to the then applicable law, one-half of that capital gain was excluded from recognized income, for state income tax purposes. Therefore, appellant reported recognized net capital gain of $58,406.32 for 1972. Against this amount and oil royalty net income of $27.30, appellant offset the aforementioned farm loss ($9,318.27) and a loss from his operation of the real estate consultant business ($8,270.36). He then computed his adjusted gross income to be $40,844.96. Appellant also showed itemized deductions on his return totaling $51,634.67. Consequently, he reported a net loss for the year 1972 of $10,789.71, and concluded that he did not incur any state income tax liability.

In addition to the regular personal income tax, however, California also imposes a "minimum tax" on "tax preferences." The intent is to impose some tax on taxpayers who benefit substantially from various forms of income or deductions which receive favorable tax treatment under the regular income tax rules. The unrecognized portion of net capital gain is considered one such item of tax preference subject to a tax on preference income. (§§ 17062, 17063, (f) & (g).)

Section 17062, in effect December 8, 1971, provided-, in pertinent part:

> In addition to other taxes imposed by this part, there is hereby imposed ... a tax equal to 2.5 percent of the amount (if any) by which the sum of the items of tax preference in excess of thirty thousand dollars ($30,000) is greater than the amount of net business loss for the taxable year.,

Because of appellant's reported net capital gain, respondent has concluded that appellant had an item of tax preference of $58,406.32, and thus tax preference income of $28,406.32 in excess of the $30,000.00 statutory exemption that was applicable for the year 1972. Respondent also determined, that appellant did not incur any "net business loss," within the meaning of section 17062, for 1972, which would have further reduced the item of excess preference income. Therefore, applying the 2.5 percent preference income tax rate to the computed excess $28,406.32 item of tax preference income, respondent has determined that appellant incurred a preference income tax liability of $710.15 for that year. Respondent contends appellant's representative has not established that any adjustment should be made to reduce liability below $710.15.

Appellant's representative explains that the transfer of appellant's one-half interest in the farm property was incorrectly reported on the 1972 return. He points out that the error was discovered shortly after completing the return. Furthermore, he states that he and appellant were unaware of the minimum.tax on items of tax preference income, and since the return, as completed, established that appellant incurred a substantial net loss for the year, they did not deem it necessary to correct this erroneously reported transaction.

After thoroughly reviewing the record in this appeal, and considering the several contentions made by appellant's representative, we conclude that a substantial adjustment should be made in arriving at the amount of appellant's preference income tax liability for the following reasons. First, the record supports the contention of appellant's representative that it was through error the reported selling price included a sum equal to the amount of the $250,000.00 indebtedness, less certain deductions not pertinent here. Second, when Helen transferred her undivided one-half interest, Lazar became a tenant in common of the property with appellant. Therefore, in that prior transaction, Lazar received from her an undivided one-half interest in the property that continued.to be encumbered by the $250,000.00 debt. Consequently, the transfer of her encumbered interest to Lazar resulted in as real benefit to her as if Lazar had actually assumed one-half of that outstanding obligation; it was not of significance that Lazar did not assume any personal liability for the obl igat ion. (Crane v. Commissioner, 331 U.S. 1 [91 L.Ed. 13011 (1947).) Therefore, she received an amount equal to one-half of the amount of the debt ($125,000.00), plus $20,000.00, as consideration. 3/

3/ Appellant's representative has explained that in preparing Helen's 1972 return he showed $125,000.00, representing one-half of the amount of the debt, as part of the consideration she received.

Thereafter, when appellant transferred his undivided, but encumbered one-half interest, he likewise received as consideration for his sale not only a cash payment, but an amount equal to one-half the principal sum of the debt ($125,000.00). Again, in view of the Crane decision, the fact that Lazar did not personally assume liability for the debt, or any portion thereof! is simply not relevant. In addition, both parties agree, and the record supports a. finding,, that $5,000.00, not $25,000.00, was the cash consideration received by appellant. Thus, the total consideration received by appellant was in the amount of $130,000.00.

After considering appellant's other contentions, the record still does not establish that any further reduction in the selling price should be made. First, notwithstanding any contractual breach or misrepresentation by. Lazar, we find that there was nevertheless a sale, rather than a transaction void at its inception. Second, the sale was not a "like kind" exchange for which.gain is not recognized. Third, there was no "net business loss" under the facts of this case to be deducted from the item of tax preference. (Appeal of Paul and Melba Abrams, Cal. St. Bd. of Equal., Jan.' 11, 1978.)

Therefore, we have determined that appellant realized consideration as a consequence of the transfer. of his undivided one-half interest in the amount of $130,000.00. Consequently, after deductions for selling commissions and attorney fees ($11,950.00), and for his basis ($47,122.94), he received a net gain from the sale of $70,927.06, which resulted in a recognized gain of $35,463.53. After subtracting the recognized portion of the short-term net capital losses ($750.00), the net gain is established as $34,713.53. From this amount, the $30,000.00 statutory exemption is deducted, leaving excess tax preference income of $4,713.53, which when subjected to the 2.5 percent'income preference tax; results in a tax liability of $117.83.

For the reasons stated above, the tax liability should be reduced to $117.83.

Appeal of Edwin L. Terry Ray

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 Edwin L. Terry Ray against a proposed assessment of additional personal income tax in the amount of $728.90 for the year 1972, be and the same is hereby revised in accordance with the views expressed in this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 9th day of December, 1980, by the State Board of Equalization, with Members Nevins, Bennett, Reilly and Dronenburg present.

Richard Nevins, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

____________________, Member