



BEFORE THE STATE **BOARD** OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
MAURICE F. AND MARY D. CORREIA )

Appearances:

For Appellants: **Henry W. Blue**  
Attorney at Law

For Respondent: Kendall E. Kinyon  
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the actions' of the Franchise Tax Board on the protests of Maurice F. and Mary D. Correia against proposed assessments of additional personal income tax in the amounts of **\$6,416.12** and **\$20,977.00** for the year 1974.

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During 1974, appellants sold their interest in Ocean Fisheries, Inc., realizing a capital gain of \$655,030. Their other reportable gross income for that year was approximately \$75,000. In 1971, their gross income had been reported as approximately \$75,000, and in both 1972 and 1973, approximately \$95,000.

In December 1974, appellants purchased a shopping center for \$815,000. They made a cash down payment of \$165,000 and gave the seller a note for \$650,000 which was secured by a trust deed on the shopping center. The escrow instructions for the transaction provided that the interest which would accrue during 1975, amounting to \$58,324, should be deposited in the escrow and prepaid at close of escrow. The escrow closing statement, dated December 31, 1974, showed that the prepayment was in fact made. Interest for other years was not to be prepaid.

Appellants also entered into a cattle-raising arrangement in December 1974, with **the 3-D Cattle** Company, Inc. ("3-D"); Appellants were to finance the purchase and costs of raising a number of beef calves, which were to be sold the following summer with appellants receiving the proceeds. The cattle were purchased on December 10, 1974. 3-D was to be responsible for the actual raising **and selling** of the cattle, charging appellants yardage as well as other raising costs such as food, medicine, and delivery costs. This arrangement was financed in part by a \$200,000 line of credit which appellants obtained from the Bank of America ("the bank"). The credit line was to remain open until December 1, 1975, with interest, at 1 **1/4%** over the bank's prime lending rate, payable monthly. Appellants signed a demand note dated December 5, 1974, which provided for the monthly interest payments to begin January 1, 1975. The bank allowed appellants to prepay up to \$10,000 **of the** interest which would accrue in 1975. This was apparently done at appellants' request, the bank's manager stating in a letter dated December 20, 1974 that the bank would "need to post this prepayment by December 31 to give [appellants] the tax advantage . . . ." On December 30, 1974, appellants' prepayment **of \$10,000** of interest was entered on the bank's loan ledger.

On December 20, 1974, 3-D received a draft from the bank in the amount of \$180,700, which was

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charged against appellants' line of credit.- This was to pay for 1,300 tons of **feed apparently** bought from 3-D. None of this feed was consumed in 1974 and approximately five percent of it remained unused at the time the cattle were sold in 1975.

On their California personal income tax return for 1974, appellants, as cash basis taxpayers., claimed deductions for the two interest prepayments of \$58,324 and \$10,000 and for the \$180,700 cost of the cattle feed. Respondent examined the return, reallocated the shopping center interest prepayment to 1975, and issued a proposed assessment of **\$6,416.12** for 1974. Appellants protested this assessment. Respondent, after a reexamination of the return, denied the protest, and issued another assessment for \$20,977 reflecting the reallocation of the cattle-feed expenses and line-of-credit interest to 1975. The protest on the second assessment was also denied, resulting in the present appeal.

The issue presented as to both assessments is whether appellants are entitled to deduct in 1974 certain expenses **prepaid** in that year. Appellants take the position that, as cash basis taxpayers, they are entitled to take deductions for interest and business expenses in the year paid, **i.e.** 1974.

Respondent, however, contends that allowing these prepayments to be deducted in 1974 would materially distort appellants' income for that year. It maintains that the deductions were properly reallocated to 1975, when the interest liability was actually incurred and the feed was consumed, pursuant to its authority under Revenue and Taxation Code section 17561(b). Additionally, respondent asserts that the interest expenditures have not been shown to be deductible payments rather **than mere** refundable deposits, which are not deductible.

As a general rule, a deduction is properly taken in the "taxable year which is the proper taxable year under the method of accounting used in computing taxable income." (Rev. & Tax. Code, **§ 17591, subd. (a).**), Taxable **income is** to be computed "under the method of accounting on the basis of which the taxpayer **regularly** computes his income in keeping his books." (Rev. & Tax. Code **§ 17561, subd. (a):**) .-The regulation accompanying section 17591 states:

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Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. (Cal. Admin. Code, tit. 18, reg. 17591, subd. (a)(1).)

Our inquiry then is directed to whether appellants' expenditures fall within these general rules or are to be treated differently under some exception to the general rules.

The Prepaid Interest<sup>1/</sup>

Revenue and Taxation Code section 17203(a) allows deductions for "all interest paid or accrued within the taxable year on indebtedness." Basic to a finding of deductibility in the case of a cash basis taxpayer, is the requirement that the interest be paid in the taxable year. If unearned prepaid interest is refundable, the expenditure is considered a deposit rather than a payment, and therefore not deductible until the period to which it applies. (S. Rex Lewis, 65 T.C. 625, 630 (1975); Andrew A. Sandor, 62 T.C. 469, 482-483 (1974), affd. 536 F.2d 874 (9th Cir. 1976).)

It is well settled that respondent's determination is presumed **correct**, and the burden is on the taxpayer to show that it is erroneous. (Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 414] (1949).) Moreover, deductions are a matter of legislative grace, and the taxpayer bears the burden of showing **his** right thereto. (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.) Appellants have never addressed the issue of payment versus deposit, **either** in their reply brief or at oral hearing. However, after close examination of what is admittedly a deficient record, we believe that

<sup>1/</sup> Revenue and Taxation Code section 17595 now requires cash method taxpayers in most instances to deduct prepaid interest over the period of the loan. However, this section only applies to amounts paid in taxable years beginning after December 31, 1976, so it is not determinative of the issue for the year before us in this appeal.

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the payments here might well be characterized as deposits.

This is most evident with the line of credit which was granted appellants by the bank. A **line** of credit differs from an ordinary loan in that, although there is a maximum amount of principal which may be outstanding at any time, there is no lump sum given to the debtor when he signs the promissory note. **Over** the time during which the line of credit remains open, the debtor **may actually** use only a small amount of the credit available to him **or**, by making occasional principal payments so that the maximum amount is never exceeded at any one time, borrow a total amount 'which is several times more than the maximum. 'Because there are varying amounts borrowed for varying periods of time, it is impossible to know, until the 'line of credit is terminated, how much, if any, interest is payable. This uncertainty is exacerbated in this case because the interest rate itself varied in accordance with the bank's prime lending rate. On **December 30, 1974**, neither appellants nor the bank **could have** known how much, if **indeed** any, of the amount prepaid would become **payable.**<sup>2/</sup> **We find** it extremely difficult to describe an expenditure made in anticipation of money being loaned in the future as "interest paid" as that term is used in Revenue and Taxation Code section 17203.

Additionally, we note that prepayment of principal was not only allowed, but required. The terms of the line of credit include a provision that "[a]ll proceeds of cattle sales are to be applied directly to [appellants'] indebtedness . . . ." With no evidence to the contrary, we must assume that any unearned interest resulting from such prepayments of principal would be

<sup>2/</sup> Although it appears that the line of credit was **drawn** upon in 1974, appellants have not shown the amount of interest which may have been attributable to any amount borrowed in that year, so we must assume that the entire amount prepaid was attributable to interest for 1975.

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refunded to appellants. In light of all these factors, the **\$10,000** paid by appellants to the bank on December 30, 1974, could not be anything other than a deposit. Respondent's allocation of the payment to the year when the money was actually loaned and the interest liability actually incurred, is quite clearly proper.

A close review of the record in regard to the shopping center interest provides us with no useful information on this issue. Appellants have not provided us with the slightest information regarding the terms of the note, and **this** failure on their part must bear heavily against them. (Appeal of Janice Rule, Cal. St. Bd. of Equal., Oct. 6, 1976.) Although appellants apparently feel that they need- not respond to any issues not specifically raised in the notices 'of proposed assessment, we have not been shown by them, nor have we encountered otherwise, any authority to that effect. We can see no possible unfairness to appellants in this, since not only did respondent clearly state this issue as an alternative argument in its brief, but it is also often a fundamental inquiry in the tax court cases in this area. (See, 'e.g., S. Rex Lewis, supra; Andrew A. Sandor, supra.)

We find that appellants have failed to show that either of the **"interest prepayments"** made in 1974 were not simply deposits to be applied to interest to be incurred in the **future and** subject to refund upon prepayment of the principal. Having so found, we need not consider whether the prepayments caused a material distortion of income. Respondent's action in disallowing the deductions in 1974 and allocating them to 1975 must therefore be sustained.

The Prepaid Cattle-Feed Expense?/

The allowance of a deduction for this **\$180,700** expenditure in 1974, respondent contends, would materially

3/ Revenue and Taxation Code section **17599.1**, operative **for** taxable years beginning in 1977 and thereafter, limits feed expense deductions of "farming syndicates\*\* to the taxable year when consumed. Despite respondent's suggestion to the contrary, we do not believe that this section has any applicability to the year before us or to individual taxpayers in general. (See Kenneth H. Van Raden, **71 T.C. 1083, 1106 (1979).**)

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distort appellants' income. The timing of the expenditure, its relation to appellants' income, and the lack of a demonstrated business purpose for the expenditure are the reasons given for respondent's position. Appellants assert that they have shown a business purpose for the prepayment since the maximum price was **thereby fixed and a guaranteed supply** obtained.

The parties have 'structured their arguments around the criteria for deductibility' of prepaid feed expenses set forth in Revenue Ruling 75-152, 1975-1 Cumulative Bulletin 144.<sup>4/</sup> Clearly, revenue rulings do not have the 'force and effect of Treasury Department regulations, and **they are not binding** on the courts. (Andrew A. Sandor, supra, 62 T.C. at 481-482.) However, some courts have analyzed this issue in the context of this ruling (see, e.g., Kenneth H. Van Raden, 71 T.C. 1083 (1979), app. pending 9th Cir.; Clement v. United States, 580 F.2d 422 (Ct. Cl. 1978); Dunn v. United States, 468 F.Supp. 991 (S.D.N.Y. 1979)) and the parties **here** have done so as well; We therefore find it appropriate to use Revenue Ruling 75-152 as a guide for our analysis.

This ruling imposes three conditions 'for the deductibility of prepaid feed expenses:' (1) the expenditure **must be-** for the purchase of feed rather than a deposit, (2) the prepayment must be **made for** a business purpose and not **merely for** tax avoidance, and (3) the deduction must not result in a **material distortion** of income. Neither party having raised the question of **whether** the expenditure was a deposit, we do not consider that issue in this appeal.

The second criterion; **that the prepayment** must have a business purpose and not be merely for tax avoidance, is contested by the parties. Generally, the ruling states, the cases which have allowed such

<sup>4/</sup> Revenue Ruling 75-152 has been superseded by Revenue Ruling 79-229, 1979-2 Cumulative Bulletin 210. However, since the parties **have not** referred to this new ruling and it merely restates and amplifies the 'previous ruling, we refer here only to Revenue Ruling 75-152.

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deductions have found that the taxpayers acquired, or had a reasonable **expectation** of acquiring, some business benefit from the prepayment of expenses. The revenue ruling provides some examples of business **benefit**, such as the fixing of maximum prices,, securing an assured supply of feed, or securing preferential **treatment** in anticipation of a feed shortage. Consideration is also given to whether the prepayment was a condition imposed by the seller and whether such condition was meaningful. Since a business purpose clearly exists for the purchase of feed by a livestock raiser, the business purpose test of the revenue ruling must be directed to the timing of the expenditure. Although we question the propriety of such a test for timing, it is unnecessary for us to address the issue, since we find the business purpose requirement of the ruling to be met in this appeal. 5/

Appellants state that their prepayment fixed the maximum price for the feed and guaranteed the **supply**. They also submitted a statement of Mr. Fairbank, who is identified as the person who purchased the cattle and feed on **behalf** of the appellants. Mr. Fairbank stated **that** feed prices had been going up in the **fall** of 1974 and he advised appellants to purchase feed in the fall before **prices** increased further. Unfortunately, he **said**, feed **prices** declined in January 1975 and continued to **decline** throughout that year- He also indicated that the prepayment helped to guarantee the feed supply for appellants' cattle, that his practice was to purchase feed in the fall for use the following year if market conditions indicated that prices would increase, and that he knew prepayment for feed was a common practice in the locale of the feed lot. Given this uncontested evidence, we believe that appellants have shown they had a reasonable expectation of receiving some business benefit as a result of the timing

5/ See the discussion of this matter and relevant citations in the Appeal of Verne D. and Joanne O. Freeman, decided this day.

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of the prepayment. We also believe that **tax avoidance** was a motive; **but** cannot say that the prepayment was made merely for tax avoidance. Therefore, the **second test** of the revenue ruling is satisfied.

The third criterion in Revenue Ruling 75-152 is that the deduction **must not** result in a material distortion of **income**. The material **distortion of income test** is based on section 446(b) of the Internal Revenue Code of **1954 and its predecessors** in previous federal revenue acts. Revenue and **Taxation Code** section 17561(b) is virtually identical to Internal Revenue Code section 446(b). Therefore, federal case law is highly persuasive in determining the correct interpretation of the California- section. (**Holmes v. McColgan**, 17 Cal.2d 426, 430 [110 P.2d 428] (1941); **Meany v. McColgan**, 49 Cal.App.2d 203, 209 [121 P.2d 45] (1942).)

Section -17561(b) provides:

If no method of accounting has been **regularly** used by the taxpayer, or if the method **used** does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Franchise Tax Board, does clearly reflect income.

This section allows respondent broad discretion to modify a taxpayer's method of accounting to ensure a clear reflection of income, and respondent's determination will not be interfered with absent a showing of abuse of that discretion. (**Clement v. United States**, *supra*, 580 F.2d at 430.)

Respondent makes essentially the same argument in this case that it made with regard to a prepaid cattlefeed expense in the Appeal of Verne D. and Joanne O. Freeman, decided this day. The argument is that the timing and large amount of the prepayment result in a material distortion of income and it is within respondent's discretion, therefore, to reallocate the expense deduction pursuant to section 17561(b).

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We rejected respondent's argument in the Freeman appeal and must do so in this case as well. In Freeman we were- persuaded by the reasoning of the tax court in- the case of Kenneth H.: Van Raden, supra, which held that where a livestock raiser consistently uses the cash method of accounting; a substantial legitimate business purpose will satisfy the material distortion of income: test. This conclusion is based on the several statute's and regulations which accord special treatment to farmers, specifically allow.-ing them to. use the cash. method: of accounting:...

We find: this analysis to be controlling in this case.. Appellants, have consistently used the cash method of accounting and we conclude that they have shown a sufficiently substantial, and legitimate business purpose for the prepayment to satisfy the material distortion of income test as enunciated- in Van Raden. Therefore,, we- find that respondent has.. abused its discretion' in applying subdivision (b) of section.17561 in this. case..-

For the reasons discussed above,, respondent's action in regard, to the cattle-feed expense deduction must be reversed..

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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 actions of the Franchise Tax Board on the protests of Maurice F. and Mary D. Correia against proposed assessments of additional personal income tax in the amounts of **\$6,416.12** and **\$20,977.00** for the year 1974, are hereby modified to reflect the allowance of the prepaid cattle-feed expense deduction. In all other respects **the** actions of the Franchise Tax Board are sustained.

Done at Sacramento, California, this 23rd day of June, 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett and Mr. Nevins present.

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