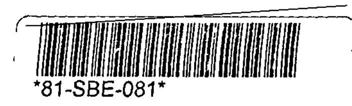
81-SBE-081

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
H. V. MANAGEMENT CORPORATION,)
TAXPAYER; ROBERT M. HAYNIE,)
ASSUMER AND/OR TRANSFEREE)

Appearances:

For Appellant: David L. Klott
Attorney at Law

For Respondent: Brian W. Toman
Counsel

O P I N I O N

This appeal was originally made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of H. V. Management Corporation, Taxpayer; Robert M. Haynie. Assumer and/or Transferee against a proposed assessment of additional franchise tax in the amount of $70,353.09 for the income year ended September 30, 1975. Subsequent to the filing of this appeal, appellant paid the proposed assessment in full. Accordingly, pursuant, to section 26078 of the Revenue and Taxation Code, this appeal is treated as an appeal from the denial of a claim for refund.

The issue for determination is whether H. V. Management Corporation (hereinafter referred to as "appellant") may properly take advantage of section 24310 of the Revenue and Taxation Code[1] so as to recover tax-free part of the gain realized on its sale of a partnership interest.

Appellant was incorporated under the laws of this state on October 6, 1972. Shortly thereafter; it acquired a one-third partnership interest in Silver Spur Associates, a California general partnership, with an investment of $5,203,082. Silver Spur Associates was involved in the development of a recreation-resort complex in Southern California. Appellant adopted a fiscal year ending September 30.

Construction delays and marketing difficulties caused the partnership to incur substantial losses. Consequently, on its return for the income year ended September 30, 1973, appellant reported a net loss of $286,693, $285,690 of which consisted of its one-third share of the partnership's ordinary loss and $1,003 of which was attributed to miscellaneous expenses. On its return for the income year ended September 30, 1974, appellant reported a net loss of $518,260, all of which represented its one-third share of the partnership's ordinary loss except for $17,470, which was attributed to miscellaneous expenses. Since appellant had no business activities or investments other than its one-third interest in Silver Spur Associates, it had no income to offset against the above described losses. Consequently, it derived no tax benefit from the significant losses it incurred during the income years ended September 30, 1973, and September 30, 1974.

In October 1974, appellant sold its one-third interest in Silver Spur Associates for $5,300,552 and reported a gain of $102,249 on its return for the income year ended September 30, 1975. In arriving at that gain, appellant excluded $781,701 of the $786,480 it had reported during the previous two income years as its losses resulting from its one-third share of the partnership's ordinary loss. Of the $102,249 reported as gain by appellant, $97,470 was reported as capital gain:

1/ Hereinafter, all references are to the Revenue and Taxation Code unless otherwise noted.

the balance of $4,779 was reported as ordinary income pursuant to sections 17911-17914.

Appellant claimed that the $781,701 exclusion was appropriate under the "tax benefit" rule and protested respondent's disallowance thereof. After considering appellant's contentions, respondent affirmed its decision on the-grounds that the holding and subsequent sale of appellant's partnership interest was not a single integrated transaction and that, consequently, appellant could not.use the "tax benefit" rule to offset past losses against the gain realized on the sale of the subject partnership interest.

An understanding of the development and current application of the "tax benefit" rule is indispensable in reaching a determination of the issue presented here.; Taxpayers who recover or collect items that have previously been deducted are ordinarily-taxed on the amount received unless the prior deduction was of no "tax benefit" because it did not reduce the taxpayer's tax liability. (1 Bittker, Federal Taxation of Income, Estates and Gifts (1981) p. 5-44.) Given the annual accounting concept,. the deduction of amounts that are'recovered in later years is a frequent occurrence. Creditors, for example, often deduct seemingly worthless claims but subsequently collect part or all of the debt when the debtor's financial status unexpectedly improves. While the courts have developed differing t'heories to explain the inclusion in income of a recovery that does not constitute an economic gain in the ordinary sense, these divergent views have in common the rationale that such a recovery is taxable because it is linked to a prior tax deduction which reduced the taxpayer's tax liability. (1 Bittker, supra, p. 5-47.) Conversely, where a recovery,. or portion thereof, has riot resulted in a prior tax benefit, it is excluded from income. (Plumb, The Tax Benefit Rule Today, 57 Hatv. L. Rev. 129 (1943).)

The tax benefit rule, while weli established today, originated from conflicting administrative rulings and court decisions. Originally, the Bureau of Internal Revenue (now the Internal Revenue Service) adopted a rule providing that if a debt had been charged off and had been allowable as a deduction, its later recovery was taxable even though no deduction had actually been claimed. (S.R. 2940, IV-1 Cum. Bull. 129 (1925).) The Board of Tax Appeals (now the United States Tax. Court) sustained the Bureau's position and upheld the

taxation of the recovery of a bad debt which had been deducted in a prior year, although the deduction produced no tax benefit. (Lake View Trust & Savings Bank, 27 B.T.A. 290 (1932).)

Later, however, the Bureau published a liberal ruling holding that a recovery of a bad debt, which had previously been charged off by a bank pursuant to the orders of bank examiners, should not be taxable unless the prior deduction had accomplished a reduction in tax liability. (G.C.M. 18525, 1937-1 Cum. Bull. 80.) Initially,, this tax benefit rule was rigidly confined to recoveries of debts involuntarily charged off by banks. (See I.T. 3172, 1938-1 Cum. Bull. 150.) In 1939, however, it was extended to recoveries of any bad debts by any taxpayer (G.C.M. 20854, 1939-1 (Part 1) Cum. Bull. 102), and soon thereafter to tax refunds as well. (I.T. 3278, 1939-f (Part 1) Cum. Bull. 76.)

A little over a year later, however, the Bureau revoked its rulings on the tax benefit rule, and held that recoveries of previously deducted bad debts and taxes should be taxable, irrespective of whether the deduction had resulted in a tax benefit. (G.C.M. 22163, 1940-2 Cum. Bull. 76 (bad debts): I.T. 3390, 1940-2 Cum. Bull. 68 (taxes).) Despite the change of position adopted by the Bureau, however, the Board of Tax Appeals continued to develop the tax benefit rule and applied it to many additional situations. Finally, Congress enacted section 116 of the Revenue Act of 1942 (currently section 111 of the Internal Revenue Code of 1954), which codified the tax benefit rule'to the extent that it provided for the exclusion from gross income of amounts, otherwise taxable, which were attributable to the recovery of bad debts, prior taxes, or amounts paid on account of tax delinquency, to the extent that the prior deduction of such items did not reduce the taxpayer's income tax liability. (56 Stat. 798, 812 (1942).)

The United States Supreme Court interpreted this section as not limiting the application of the tax benefit rule to those deductions specifically enumerated in the statute alone. (Dob'son v. Commissioner, 320 U.S. 489, 505-506 [88 L.Ed. 248] (1943).) Thereafter, the Treasury Department ruled that the tax benefit doctrine 'should apply to other losses, expenditures, and accruals made the basis of deductions from gross income, with the express exception of deductions with respect to depreciation, depletion, amortization, or amortizable bond

premiums. (Treas. Reg. 111, § 29.22(b)(12)-1 (1943) (later amended by T.D. 5454, 1945 Cum. Bull,. 68, now Treas. Reg. § 1.111-i (1956)).)

The application of the tax benefit rule is precluded where' the taxpayer merely seeks to take a second deduction rather than to prevent taxation of a recovery. Furthermore, if the events which give rise to the loss in the prior year and the recovery in the current year. do not constitute a single, integrated transaction,, the tax benefit rule has no application. (Sloane v. Commissioner, 188 F.2d 254 (6th Cir. 1951); Allen v. Trust Co. of Georgia, 180 F.2d 527 (5th Cir. 1950), cert. den., 340 U.S. 814 [95 L.Ed. 598] (1950); Capitol Coal Corp., 26 T.C. 1183 (1956), affd., 250 F.2d 361 (2d Cir. 1957).) Accordingly, proceeds from the sale in a subsequent tax period of stock accepted in total cancellation at a loss of a debt are includible in gross income despite the fact that no tax benefit was realized upon the loss in the year the stocks were received. (Allen v. Trust Co. of Georgia, supra.) Nor are receipts realized in a later year on property accepted in total release of a claim for prior embezzlement losses excluded from taxatio'n. (Waynesboro Knitting Co., 23 T.C. 404 (1954), affd., 225 F.2d 477 (3d. Cir. 1955).)

However, when there is such an interrelationship between the event giving rise to the loss and the event which constitutes recovery that they can be considered as parts of one and the same transaction,, the tax benefit rule is applicable. (Continental Ill. Nat. Bank, 69 T.C. 357 (1977); Sloane v. Commissioner, supra.) Neither the length of time between the loss and the recovery; nor the failure to attempt to deduct that loss in the year incurred, will preclude application of the rule in the later year of recovery. (Quincy Mining Co. v. United States, 156 F.Supp. 913 (Ct. Cl. 1957); Birmingham Terminal Co., 17 T.C. 1011 (1951).) Consequently, where an estate incurred expenses over an eight year period while an executor waited for a favorable market to take the estate out of bankruptcy, those carrying charges could be excluded from gross income in the year the subject property was sold, to the extent no tax. benefit was realized in the prior years. (Smyth v. Sullivan, 227 F.2d 12 (9th Cir. 1955).)

It may appear that application of the tax benefit rule will frequently conflict with the annual accounting concept. However, it must be noted that the

application of the rule was introduced for the purpose of eliminating some of the economic hardship inherent in a tax structure strictly adhering to annual tax periods, in order to reach a more equitable result. (See Lassen, The Tax Benefit Rule and Related Problems. 20 Taxes 473 (1942); Zysman, Income Derived from the Recovery of Deductions, 19 Taxes 29 (1941).) In any case, it must be remembered that the application of the rule 'depends in all cases upon facts sufficient'to give rise to a finding of a single integrated transaction.

The tax benefit rule is both a rule of inclusion and exclusion: recovery of an item previously deducted must be included in income; but that portion of the recovery not resulting in a prior tax benefit is excluded. As previously noted, the rule evolved judicially and administratively and has now been codified, as to certain items, in section-111 of the Internal Revenue Code. While focusing on the second aspect (exclusion), section 111 is predicated on the validity of the first aspect (inclusion). Although the rule has been partly absorbed in the statute, it has been expressly stated that the unabsorbed portion of the rule continues to apply. (Dobson v. Commissioner, supra; Alice Phelan Sullivan Corp. v. United States. 381 F.2d 399 (Ct. Cl. 1967); Mayfair Minerals, Inc., 56 T.C. 82 (1971), affd. per curiam, 456 F.2d 622 (5th Cir. 1972); Capitol Coal Corp., supra; Birmingham Terminal Co., supra.)

Section 24310, which codifies the tax benefit rule for California franchise tax purposes, is virtually identical to section 111 of the Internal Revenue Code insofar as pertinent to this appeal. It provides:

> (a) Gross income does not include income attributable to the recovery during the income year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.
>
> (b) For purposes of subsection (a)--
>
> (1) The term "bad debt" means a debt on account of the worthlessness or partial worthlessness of which a deduction was allowed for a prior income year.

> (2) The term "prior tax" means a tax on account of which a deduction or credit was allowed for a prior income year.
>
> (3) The term "delinquency amount" means an amount paid or accrued on account of which a deduction or credit was allowed for a prior. income year and which is attributable to failure to file return with respect to a tax, or pay a tax, within the time required by the law under which the tax is imposed, or to failure to file return with respect to a tax or pay a tax.
>
> (4) The term "recovery exclusion," with respect,to a bad debt,-prior tax, or delinquency amount, means the amount, determined in accordance with regulations prescribed by the Franchise Tax Board, of the deductions or credits'allowed, on account of such bad debt, prior tax, or delinquency amount, which did not result in a reduction of the taxpayer's tax under this part or corresponding provisions of prior tax laws, reduced by the amount excludable in previous income years with respect to such debt, tax or amount under this section.

As noted above, the Dobson decision extended the tax benefit rule beyond the confines of the statutes. Accordingly, the federal regulations were written so as to correspond with that decision. Respondent's regulation (Cal. Admin. Code, tit. 18, reg. 24310(a)), which is substantively identical to Treasury Regulation § 1.111-1, provides, in pertinent part:

> (a) General. Section 24310 provides that income attributable to the recovery during any income year of bad debts, prior taxes, and delinquency amounts shall be excluded from gross income to the extent of the "recovery exclusion" with respect to such items'. The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures,-and accruals made the basis of deductions from gross income for prior income years, including war losses referred to in Chapter.16, but not including deductions with respect to depreciation, depletion, amortization, or amortizable bond.

> premiums. The term "recovery exclusion" as used in this regulation means an amount equal to the 'portion of the bad debts, prior taxes, and delinquency amounts (the items specifically referred to in Section 24310), and of all other items subject to the rule of exclusion which, when deducted or credited for a prior income year, did not result in a reduction of any tax of the taxpayer under this part or corresponding provisions of prior tax laws.

For purposes of the instant appeal, it is imperative to understand why the basis of appellant's partnership interest was reduced by its distributive share of the partnership's losses. Section 17860, subdivision (a), provides, in relevant part:

> (a) The adjusted basis of a partner's 'interest in a partnership shall, except as provided in subsection (b), be the basis of such interest determined under Section 17882 (relating to contributions to a partnership) or Section 17902 (relating to transfers of partnership interests)--
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> * **
>
> (2) Decreased (but not below zero) by distributions by the partnership as provided in Section 17893 and by the sum of his distributive share for the taxable year and prior taxable years of--
>
> (A) Losses of the partnership; . . .

While appellant readily acknowledges that section 17860, subdivision (a)(2)(A), worked a reduction of its basis in the partnership, thereby resulting in a gain of $883,950 at the time of the sale of its partnership interest, it argues that section 24310, and the 'regulation promulgated pursuant thereto, permits it to offset its gain with its prior losses which did not result in 'any tax benefit. Appellant recognizes that the tax benefit rule\ as codified and interpreted by prior decisions and by respondent's regulations, does not permit a recovery exclusion for depreciation and amortization. Accordingly, it doe:; not dispute the franchise tax on $5,446 (representing $102 and $4,667 of partnership depreciation taken in 1973 and 1974,

respectively, and $667 of amortization taken in 1,974) in gain on the sale of its partnership interest.

As noted above, fundamental to the tax benefit rule is the requirement that both the recovery and the deduction result from a single integrated transaction. (Sloane v. Commissioner, supra; Allen v. 'Trust Co., supra.) Therefore, for example, in the case of a bad debt only the 'specific money or fair 'market value of property received constitutes a "recovery" 'for purposes of the tax benefit rule. Subsequent increments in the value of the 'property, or the' proceeds from its sale, are regarded as stemming from a new transaction. Even if the taxpayer receives, in full satisfaction of a 'debt, stock with a fair market value smaller than the amount owed, for 'tax benefit purposes the underlying debt is extinguisned. Consequently, gain on eventual sale of the stock, although no greater than the unpaid 'portion of the debt, cannot be excluded 'from gross income. (Allen v. Trust Co., supra.) Thus, under some circumstances, the single transaction requirement may present an obstacle to capital recoupment and frustrate the otherwise liberal intent of the tax benefit rule. (See The Tax Benefit Rule and the Loss Carryover Provisions of 'the 1954 Code, 67 Yale L.J. 1394 (1958).)

Appellant's argument that the tax benefit rule is applicable in this instance centers on its contention that to hold otherwise would be to impose a tax on capital. Appellant recognizes the existence and validity of the single integrated transaction.requirement and argues that the subject transaction is single and integrated since the investment loss represented a portion of its oriqi'nal capital investment an'd tha-t to tax its recovery of the investment loss which resulted in no tax benefit would be to impose a tax on capital., Appellant contends that its losses were directly related 'to, and integrated with, the gain on sale of its partnership interest since they reduced the measure o'f appellant's real gain by reducing,the basis of appellant% original investment; While it is clear that the- capital character of a deduction or adjustment does not preclude application of the tax benefit rule (Bertha A. Henry, 7 T.C. 228 (1946); Maurice A. Mittleman, 7 T.C. 1162 (1946); see also Tye, The Tax Benefit Doctrine Reexamined, 3 Tax L.Rev. 329 (1948)), there exists no precedential 'or statutory authority-supporting the proposition, that the tax benefit rule must be applied where not to do so would preclude capital recoupment. In fact, as previously noted. the courts have previously

held that the single transaction requirement may, under certain circumstances, present an obstacle to such recovery; (See, e.g., Allen v. Trust Co., supra; Capitol Coal Corporation, supra; see also Rich, The Tax Benefit Rule, 17 N.Y.U. Inst. on Fed. Tax. 257 (1959).)

We are not satisfied that there exist6 such a relationship between-the events which caused appellant's losses and the event which constituted the alleged "recovery" so that they can be considered as parts of one and the same transaction. We are convinced; on the contrary, that appellant's partnership interest, after the reduction in the basis thereof by operation of section 17860, subdivision (a)(2)(A), had acquired its own independent basis for future gain or loss. While not clearly identified by appellant, the expenses paid by the partnership which resulted in the reduction of appellant's original investment appear to have been similar to the carrying costs incurred by the taxpayer in Appeal of Percival M. and Katharine Scales, decided by this board May 7, 1963. In that case we determined that carrying costs of interest and taxes that did not qualify as sale expenses could not be used to offset gain upon sale of the subject property.. In Scales, the taxpayers were unable to trace the carrying costs to the gain realized upon sale because those costs had not been incurred while the subject property was being held for sale. (Cf. Smyth v. Sullivan, supra.) Here, appellant was not holding its partnership interest for sale while its basis was being reduced to reflect its distributive share of the partnership losses. Appellant has sought to distinguish our decision in the Scales case by noting that there the taxpayers' basis in their property was not reduced, whereas appellant's basis in its partnership interest was diminished to the extent of its distributive share of the partnership losses.

Initially, we note that, as previously mentioned, the mere fact that appellant may otherwise be prevented from recovering its original capital investment tax-free does not mandate use of the tax benefit rule to prevent such a result. Secondly, however, we observe that appellant's attempt to distinguish our decision-in Scales is misleading. In that case, the taxpayers did not reduce their basis in their real property so as to pay their carrying costs; the funds used for that purpose were additional out-of-pocket costs incurred by the taxpayers, However, had they sold a portion of their property to pay their carrying costs, they would have been in a situation identical to that of

appellant, i.e., their original basis in their property would have been reduced to the extent of the basis of the property sold. (Cal. Admin. Code, tit. 18, reg. 24271(d).) Nevertheless, our decision in that case would have remained the same because there still would not have existed the requisite relationship between the carrying costs incurred when the property was not held for sale and the subsequent sale. Our decision in Scales did not turn on the fact that the taxpayers' basis in their property remained unchanged.[2]

2/ One of the principal arguments advanced by appellant has been its contention that application of the tax benefit rule is required in this instance to prevent unequal application of the tax law to its detriment. To illustrate this proposition, appellant has presented us with a hypothetical example which allegedly demonstrates the manner in which the investment basis of a partner is adjusted in a manner different from that of an individual proprietor so as to mandate, under the circumstances presented here, application of the tax benefit rule.

Appellant's hypothesis compares an individual and a partner who have each purchased an investment with an original capital outlay of $500. Subsequently, each experiences excess operating losses of $300. Appellant alleges that the individual's investment basis remains at $500 despite the $300 in losses so that, if he later sells his investment for $500, he realizes no taxable gain on the sale. On the other hand, appellant states, the partner's investment basis, after the $300 in losses, is adjusted, by operation of section ~178.60, subdivision (a)(2)(A), to $200. Consequently, if the partner'later sells his investment for $500, he will experience a $300 taxable gain. To avoid this inequitable result,; appellant contends, application of the tax benefit rule is necessary to put the partner in the same economic position as the individual.

While appellant's argument has superficial appeal, it is based on the mistaken presumption that the individual, paying the $300 in losses through the sale of a portion of his original investment, would not experience a reduction in his investment basis; as with the partner, the individual's basis would also be reduced to $200. Appellant's hypothetical can be used to illustrate: an individual acquiring five acres of land for $100 per

While appellant contends that there exists a relationship between the. losses it incurred and its subsequent sale of. its partnership interest,, its argument is based solely on the grounds that the losses reduced the measure of its gain by reducing the basis-of its original investment. As we have demonstrated, this is entirely insufficient to show the type of relationship between the losses and--the subsequent recovery so that. the two events can be considered as parts.of one and the same transaction. Accordingly, we must conclude that 'appellant has failed to establish that it may take advantage of the tax benefit rule under the circumstances presented by this appeal and that respondent's action in this matter was correct.

2/ (Continued)
acre will have a basis of $500 in the property. If he subsequently sells three acres to pay a property tax assessment of $300, his basis in the land, contrary to appellant's assertion that it would remain unchanged, will be reduced to $200. (Cal. Admin. Code, tit. 18, reg. 24271, subd. (d).) Accordingly, the individual is placed in the same economic position as that of the partner whose investment basis is adjusted pursuant to section 17860, subdivision (a)(2)(A). Consequently, appellant's argument that the only manner in which both the individual and the partner can be placed in the same economic position is to permit the latter to use the tax benefit rule is inaccurate. Contrary to appellant's contention, application of the tax benefit rule in favor of the partner would actually place him in an advantageous economic position in relation to the individual.

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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board- in 'denying, the claim of H. V. Management Corporation; Taxpayer; Robert M. Haynie, Assumer and/or Transferee, for refund: of franchise tax in the amount. of $70,353.09 for the income year ended September 30, 1975, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day Of Juiy , 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