BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
TERRY E. AND PENNY A. PETERSON)

For Appellants: Philip L. Nadler
Attorney at Law

For Respondent: Kathleen M. Morris
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 Terry E. and Penny A. Peterson against a proposed assessment of additional personal income tax in the amount of $406.07 for the year 1974.

Appeal of Terry E. and Penny A. Peterson

In 1974 appellant-husband, hereafter referred to as appellant, invested along with others in properties known respectively as the 'Citrus Center!' and "Los **Banos**" properties. Both of these properties were purchased from a syndicator known as M. J. Grady and Associates,, Inc.

On his 1974 personal income tax return, appellant deducted the total of **$3,781.50** with respect to the 10 acre Citrus Center property located in San Bernardino County and **$12,835.56** with respect to the 930 acre Los Banos property located in **Merced** County for expenses, i. e., escrow costs, loan fees, management fees, feasibility study costs,etc. Respondent thereafter requested information regarding the claimed expenses in order to determine if the deductions were proper. Appellant responded to the request for information by stating that he was in effect defrauded by M. J. Grady and Associates through the misrepresentations of the syndicator concerning each of the two properties: to wit, the Citrus Center property was alleged to be commercially zoned, when in fact it was an orange grove and zoned for agricultural use, and the Los **Banos** property, purchased with the intent that it be operated as a farm, was in actuality, unsuitable for this purpose because of its location outside a water boundary.

Appellant contended that as a consequence of the above representations, M. **J.** Grady and Associates were being investigated by the Securities and Exchange Commission and the California Department of Corporations, as well as being investigated for fraud by an attorney hired by appellant. Appellant further contended that since fraud had been committed, his expenses should be allowed as a current expense deduction.

Respondent disallowed the costs in question, except the prepaid interest, on the ground that such costs constituted capital expenditures. It is respondent's position that such expenses can only be recouped upon the sale or other disposition of property. In the case of the Citrus Center property, which was allowed to be foreclosed in June 1975, respondent **determined that** the foreclosure constituted a disposition of property for income tax purposes. Accordingly, appellant was advised to file an amended return for 1975 and claim a capital loss in that year.

With respect to the Los Banos property, respondent determined that the expenses were properly disallowed. This appeal followed.

The issue for decision is whether respondent acted properly in disallowing expenses paid by appellants to acquire land on the basis that such expenses constituted capital expenditures.

It is a fundamental principle of income tax law that amounts paid to acquire real property or to improve it represent capital expenditures to be added to the basis of the property, rather than ordinary and necessary expenses which are deductible on a current basis. (See Appeal of *George S.* and Mabel L. Duke, Cal. St. Bd. of Equal., Nov. 6, 1967.) Generally, the cost of property represents its basis (Rev. & Tax. Code, § 18042) which is subtracted from the amount received at a later sale or exchange of that property in order to determine gain or loss on the transaction. (Rev. & Tax. Code, § 18031.)

Appellant concedes that this is a basic rule of law, but contends that an exception should be made in this instance because of the alleged fraud on the part of the seller. We do not agree.

A taxpayer is allowed a deduction for losses by theft of property not connected with a trade of business (after a $100 exclusion), if not compensated for by insurance or otherwise. (Rev. and Tax. Code, § 17206, subds. (a) & (c)(3).) However, this section is not applicable in this instance because it appears that the expenditures were made with respect to acquisition costs and the elements of a theft have not been established.

Appellant paid the subject money for certain acquisition costs and fees. A finding of theft requires, among other things, that the property (or money) involved be shown to have been improperly taken and to have been appropriated to the use of a perpetrator. (See e.g. Appeal of Orlo E., Jr. and Marian M. Brown, Cal. St. Bd. of Equal., May 4, 1976.) The money involved herein was paid to business entities for the normal costs associated with the acquisition of real property. This was the purpose for which appellant had agreed the money would be spent. Moreover, it has not

been demonstrated that the expenditures made in regard to acquisition costs and fees were misappropriated. We therefore conclude that no theft has been established with respect to the expenditures at issue.

On the basis of the foregoing, it is our determination that no impropriety has been shown with regard to respondent's disallowance of the expenses claimed by appellant. Respondent's actions must therefore 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 protest of Terry E. and Penny A. Peterson against a proposed assessment of additional personal income tax in the amount of $406.07 for the year 1974, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of July, 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