

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
HARRY AND HILDA EISEN)

Appearances:

For Appellants: William N. Roth
Certified Public Accountant

For Respondent: Carl G. Knopke
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 Harry and Hilda Eisen against proposed assessments of additional personal income tax in the amounts of **\$3,995.06** and **\$10,155.53** for the years 1976 and 1977, respectively.

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Hilda Eisen is a party to this appeal solely because she filed joint personal income tax returns with Harry Eisen, her husband, for the years in issue. Accordingly, only the latter will hereinafter be referred to as "appellant."

Appellant is a partner in E & M Ranch, a farming partnership, and chief operating officer and fifty percent owner of Norco Ranch, Inc. (hereinafter referred to as "Norco"), a farming corporation. Prior to its incorporation, Norco was a sole proprietorship owned and operated by appellant. As its chief operating officer, appellant's duties consist of managing Norco's farming operations, a task to which he devotes substantially all of his time. In addition to dividends and the salary he is paid by Norco, appellant also receives bonuses from the corporation based on the success of its operations.

Upon examination of appellant's returns for the years in issue, respondent determined that partnership farm losses, the unrecognized portion of capital gains, and excess depreciation were items of preference income. Respondent also determined that the salary, bonus, and dividend income received by appellant from Norco during the years in issue was not income from the trade or business of farming for purposes of computing his net farm loss. Appellant protested respondent's latter determination, asserting that the salary, bonus, and dividend income received from Norco constituted income from farming which reduced the amount of his net farm loss preference income. After consideration of appellant's arguments, respondent affirmed the proposed assessments, resulting in this appeal.

The sole issue presented for determination is whether the salary, bonus, and dividend income received by appellant from Norco constituted income from the trade or business of farming for purposes of computing the amount of appellant's net farm loss preference income.

Revenue and Taxation Code section 17063,^{1/} subdivision (i), as it existed for the years in issue,^{2/}

^{1/} Hereinafter, all references are to the Revenue and Taxation Code unless otherwise indicated.

^{2/} AB 93 (Stats. 1979, Ch. 1168), operative for taxable years beginning on or after January 1, 1979, rewrote subdivision (i) of section 17063 as subdivision (h) and increased the excluded amounts thereunder.

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included as an item of tax preference income "[t]he amount of net farm loss in excess of fifteen thousand dollars (\$15,000) which is deducted from **nonfarm** income." The term "farm net loss" is defined by section 17064.7 as;

. . . .the amount by which the deductions allowed by this part which are directly connected with the **carrying on** of the trade or business of farming, exceed the gross income derived from such trade or business. (Emphasis added.)

Appellant argues that the income in issue is income from the trade or business of farming. Supporting this contention, he asserts, is Treasury Regulation § 1.162-1 which purportedly defines the term "trade or business" to include services performed as an employee. Additionally, at the oral hearing on this matter, appellant maintained that the income in issue would clearly have been farm income prior to the incorporation of Norco and that the mere incorporation of the business should not have the effect of changing the nature of the income he derived from its operation. After a careful review of the record on appeal and for the specific reasons set forth below, we conclude that the salary, bonus, and dividend income received by appellant as an employee and shareholder of Norco did not constitute income from the trade or business of farming for purposes of determining appellant's net farm loss tax preference income.

Former section 17063, subdivision (i), was intended as a replacement for former section 18220. While it changed the method of deterring tax motivated farm loss operations,, the focus of the new section, i.e., "farm net loss", remained the same **as that** of the section it replaced. Except for certain provisions not in issue here, section 17064.7 defines "farm net loss" in a **manner** identical to that of former section 18220, subdivision (e). Pursuant to respondent's regulation 19253,^{3/}

3/ In pertinent part, this regulation provides as follows:

In the absence of **regulations** of the Franchise Tax Board and unless otherwise specifically provided,. in cases where the Personal Income Tax Law conforms to the Internal Revenue Code, regulations under the Internal Revenue Code shall, insofar as possible, **govern the interpretation** of conforming state statutes

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regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section 18220 was patterned) governed the interpretation of the term "farm net loss" under former section 18220, subdivision (e). Given the successor relationship between section 17064.7 and former section 18220, subdivision (e), the Treasury regulations adopted pursuant to section 1251 of the Internal Revenue Code are applicable for purposes of interpreting the term "farm net loss" as it appears in section 17064.7.

Treasury Regulation § 1.1251-3(b) defines "farm net **loss**" as follows:

(b) . . .The term "farm net loss" means the amount by which--

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying **on of the trade or business of farming**. 'exceed

(ii) The gross income derived from such trade or business. (Emphasis added.)

Treasury Regulation § 1.1251-3(e)(1) defines the term "trade or business of farming" as follows:

. . . For purposes of section 1251, the term "**trade or business of farming**" includes any trade or business with respect to which the taxpayer may compute gross income under § 1.61-4, expenses under § 1.162-12, make an election under section 175, 180, **or 182**, or use an inventory method referred to in § 1.471-6. Such **term** does not include any activity not engaged in for profit within the meaning of section.183 and § 1.183-2.

According to the above, any taxpayer that may compute gross income under Treasury Regulation § 1.61-4 is engaged in the trade or business of **farming**. Treasury Regulation § 1.61-4 is identical to respondent's former regulation 17071(d). The **latter, operative** for the years in issue, designated as "farmers" "**[a]ll individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants . . .**" Similarly, California Administrative Code, title 18, regulation 17224(c) provides that "[a]

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taxpayer is engaged in the business of **farming** if he cultivates, operates, or manages a farm for gain or profit, either as owner **or tenant.**" Under neither regulation is an employee of a corporation engaged in the business of farming defined as either a "farmer" or as a "taxpayer engaged in the business of farming."

Federal Revenue Rulings interpreting Treasury **Regulation § 1.175-3** [the **substantive** federal equivalent of respondent's regulation 17224(c)] have determined that wages paid farm employees and fees paid to providers of customary farm services are to be excluded from the definition of gross income from farming. (See Rev. Rul. 65-280, 1965-2 Cum. Bull. 433; Rev. Rul. 77-105, 1977-1 Cum. Bull. 374.) Additionally, it has been determined that dividend income from a corporation engaged in the business of farming does not constitute income from farming to a shareholder of such a corporation. (Rev. Rul. 76-141, 1976-1 Cum. Bull. 381; see also Whipple v. Commissioner, **373 U.S. 193 [10 L.Ed.2d 288] (1963).**) In light of this analysis, appellant's contention that Treasury Regulation § 1.162-1 would include as farm income wages and dividends derived from a farming corporation is untenable. Moreover, it should be noted that Treasury Regulation § 1.162-1 merely provides for the deduction from gross income of the ordinary and necessary expenditures directly connected with a taxpayer's trade or business; it does not focus on what income shall be determined to have been derived from such a trade or business.

At the oral hearing on this matter, appellant argued that the salary, bonus, and dividend income in issue would have been considered gross income from farming had it not been for the incorporation of Norco and that the mere change in form of ownership should not have the effect of changing the nature of such income from farm income to non-farm income. We cannot agree. While it is true that in matters of tax **liability substance** is generally to be preferred to form, it is not correct to say that the form which a transaction takes is unimportant from the standpoint of tax liability. Indeed, in many instances, the form of a transaction is determinative of tax consequences. If a taxpayer, having a choice of methods for accomplishing an economic or business result-, pursues a particular means to accomplish his ends, he must abide by the tax consequences resulting from his choice of methods, even though had he made another choice the tax consequences would have been less severe or even nonexistent. (United States v.

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Cumberland Public Service Company, 338 U.S. 451 [94
L.Ed. 2511 (1950); Freeman v. Commissioner, 303 F.2d 580
(8th Cir. 1962); Barber United States, 215 F.2d 663
(8th Cir. 1954).)

For the reasons set forth above, respondent's
action in this matter will be sustained.-


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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 **HERC**BY 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 Harry and Hilda Eisen against proposed assessments of additional personal income tax in the amounts of **\$3,995.06** and **\$10,155.53** for the years 1976 and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 27th day **of October , 1981**, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Bennett and Mr. Nevins present.

 Ernest J. Dronenburg, Jr., Chairman

William M. Bennett, Member

Richard Nevins, Member

_____, Member

_____, Member