BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MARCUS AND MARCIA RUDNICK)

For Appellants: Louis J. Barbich
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 Marcus and Marcia Rudnick against proposed assessments of additional personal income tax in the amounts of $2,994.15 and $1,286.61 for the years 1976 and 1977, respectively.

Appellants filed joint California personal income tax returns for the years 1976 and 1977 in which they reported net farm losses of $351,313 and $68,330, respectively; those returns did not reflect items of net farm loss tax preference. Upon review of their returns, however, respondent concluded, pursuant to former section 17063, subdivision (i), of the Revenue and Taxation Code, that appellants had items of net farm loss tax preference for each of the years in issue in the amounts of their overall net farm losses in excess of $15,000. The subject proposed assessments were subsequently issued. Appellants protested respondent's action, arguing that net farm loss, if more than $15,000 in excess of nonfarm income, constitutes an item of tax preference only to the extent of nonfarm income. Appellants thereby computed that they had no item of net farm loss tax preference in 1976 and a total tax preference liability of only $320 in 1977. After consideration of appellants' protest, respondent affirmed the proposed assessments, thereby resulting in this appeal.

Section 17062 of the Revenue and Taxation Code provides, in pertinent part:

> In addition to the other taxes imposed by this part, there is hereby imposed ... taxes ... on the amount (if any) of the sum of the items of tax preference in excess of the amount of net business loss for the taxable year ....

During the year in issue, section 17063[1/] provided, in relevant part:

> For purposes of this chapter, the items of tax preference are:
>
> * * *
>
> (i) The amount of net farm loss in excess of fifteen thousand dollars ($15,000) which is deducted from nonfarm income. (Emphasis added.)

1/ 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.

Appellants contend that the emphasized portion of former section 17063, subdivision (i), should be interpreted as providing that net farm loss, if more than $15,000 in excess of nonfarm income, shall constitute an item of tax preference only to the extent of nonfarm income. The resolution of appellants' argument is the sole issue presented by this appeal.

Section 17062, the section setting forth the minimum tax on tax preference items, was enacted as part of a comprehensive legislative plan designed to conform California income tax law to the federal reforms enacted by the Tax Reform Act of 1969. (See Assem. Corn. on Rev. and Tax., Tax Reform: 1971; Detailed Explanation of AB 1215-1219 and ACA 44, As Amended May 20, 1971 (1971) p. 85,) The federal counterpart of section 17062, section 56 of the Internal Revenue Code of 1954, imposes a minimum tax on tax preference items. It was enacted to reduce the advantages derived from otherwise tax-free preference income and to insure that those receiving such preferences pay a share of the tax burden. (1969 U.S. Code Cong. & Ad. News 2143.)

The federal minimum tax on tax preference items is imposed only with respect to those preference items which actually produce a tax benefit. Similarly, as we observed in Appeal of Richard C. and Emily A. Biagi, decided May 4, 1976, the intent of the California Legislature in enacting 'section 17062 was to apply the minimum tax on items of tax preference only with respect to those preference items which actually produce a tax benefit; when items of tax preference do not produce a tax benefit, they are not subject to the minimum tax. (See also Appeal of Harold S. and Winifred L. Voegelin, Cal. St. Bd. of Equal., Feb. 3, 1977.)

In order that only those items of tax preference which actually produce a tax benefit be subject to the minimum tax on tax preference items, section 17062 was constructed so as to impose the minimum tax on the sum of the items of tax preference in excess of the amount of "net business loss." 2/ Accordingly, to

2/ The term "net business loss" is defined in section 77064.6 as follows:

> . . . the term "net business loss" means adjusted gross income (as defined in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net amount is a loss.

the extent of "net business loss," the tax benefit otherwise produced by the sum of the items of tax preference is neutralized. (Appeal of Richard C. and Emily A. Biagi, supra.)

Each of the items of tax preference set forth in section 17063 is used to determine a taxpayer's "net business loss." (See Rev. & Tax. Code, § 17064.6: Appeal of Richard C. and Emily A. Biagi, supra.) By deducting "net business loss" from the sum of the items of tax preference, the taxpayer is assured that only those preference items that have provided a tax benefit will be subject to the minimum tax on items of tax preference.- (Appeal of Paul B. and Mary E. Schmid, Cal. St. Bd. of Equal., April 6, 1977; Appeal of Richard C. and Emily A. Biagi, supra.)

In the Appeal of Dorsey H. and Barbara D. McLaughlin, decided by this board October 27, 1981, we addressed an issue identical to the one presented here, i.e., whether former section 17063, subdivision (i), should be interpreted as providing that net farm loss, if more than $15,000 in excess of nonfarm income, shall constitute an item of tax preference only to the extent of nonfarm income. The analysis used in that decision is equally applicable here:

> Appellants' application of former subdivision (i) of section 17063 thwarts the intent of the tax preference scheme by permitting them to deduct their net farm loss[3/] in excess of nonfarm income twice. By "offsetting" the amount of their nonfarm income with their net farm loss in excess of $15,000 for the purpose of arriving at the amount of their item of net farm loss tax preference, appellants have, in effect, **deducted the amount of**

3/ The term "farm net loss" is defined in section j-7064.7 as follows:

> . . . "farm net loss" means 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.

net farm loss in excess of nonfarm income from the total amount of their net farm loss tax preference item. The same amount (i.e., net farm loss in excess of nonfarm income) is then used again by appellants when they deduct "net business loss" from the sum of the items of tax preference to arrive at the amount of such items of tax preference which are subject to the preference tax. As noted earlier, net farm loss in excess of nonfarm income is included in "net business loss." Consequently, whereas section 17062 provides only for the deduction of "net business loss" from the sum of the items of tax preference in order to arrive at the amount of such items which have resulted in a tax benefit, appellants have also used a component of "net business loss" (i.e., net farm loss in excess of nonfarm income) in order to determine the amount of their net farm loss tax preference item.

As we held in the Appeal of Dorsey H. and Barbara D. McLaughlin, supra, the legislative history behind the enactment of the tax preference scheme supports our conclusion that appellants have misinterpreted the manner in which the minimum tax on items of tax preference is to be imposed. The Legislature's intent in imposing the minimum tax on items of tax preference was to tax those items of tax preference listed in section 17063 to the extent of tax benefits produced; this is determined by deducting a taxpayer's "net business loss" from the sum of the items of tax preference. (Appeal of Paul B. and Mary E. Schmid, supra; Appeal of Richard C. and Emily A. Biagi, supra.) Appellants' interpretation of former section 17063, subdivision (i), would frustrate that legislative intent by allowing a taxpayer to partially or completely escape the minimum tax on items of tax preference that did provide a tax benefit. It is an elementary rule of statutory interpretation that a statute must be construed with reference to the object sought to be accomplished so as to promote its general purpose or policy. (Dept. of Motor Vehicles v. Indus. Acc. Com., 14 Cal.2d 189 [93 P.2d 131] (1939); Candlestick Properties, Inc. v. San Francisco Bay Conservation Etc. Com., 11 Cal.App.3d 557 [89 Cal.Rptr. 897] (1970).) We have already observed that the Legislature intended to impose the minimum tax on those items of tax preference which produce a tax benefit; by frustrating that policy and shielding such items of tax preference from taxation, appellants'

interpretation of former section 17063, subdivision (i), is clearly inconsistent with that policy and cannot be sustained.

For the reasons set forth above, we must conclude that respondent properly computed appellants' items of net farm loss tax preference for the years in issue. In accordance with former section 17063, subdivision (i), respondent's computation imposes the preference tax only on the amount of nonfarm income, in excess of $15,000, which was sheltered from ordinary taxation by appellants' net farm losses. (Appeal of Dorsey H. and Barbara McLaughlin, supra.)

Appeal of Marcus and Marcia Rudnick

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 Marcus and Marcia Rudnick against proposed assessments of additional personal income tax in the amounts of $2,994.15 and $1,286.61 for the years 1976 and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of March , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Reilly, Mr. Dronenburg, Mr. Nevins and Mr. Cory present.

William M. Bennett, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Kenneth Cory, Member