

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
WARDE E. AND JANICE N. GRENNER)

For Appellants: Harvey D. Tack
Attorney at Law

For Responaent: Bruce W. Walker
Chief Counsel

David M. Hinman
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 Warde E. and, , Janice N. Grenner against proposed assessments of additional psrsonal income tax in the amounts of \$3,990.32 and \$3,378.51 for the years 1970 and 1972, respectively.

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The issues presented by this appeal are the following: (i) whether certain amounts deducted from appellants' commission checks in repayment of their indebtedness to a trust fund are includable in their gross income; and (ii) whether the gain realized on the transfer of certain assets and liabilities to appellants' newly formed corporation was properly characterized by appellants as capital, rather than ordinary, gain.'

Appellants were the proprietors of an insurance agency during the years in issue. In connection with their business, appellant-husband acted as administrator of a trust fund administered on behalf of The Office Machine Dealers Association, and underwritten by the Fireman's Fund American Insurance Companies ("Fireman's Fund"). In the course of administering the trust fund, appellants became indebted to the fund in an amount in excess of \$70,000. Appellants subsequently made arrangements with Fireman's Fund to repay the amount due the trust fund with commissions payable to them by Fireman's Fund. In accordance with this agreement, Fireman's Fund withheld \$42,000 in commissions payable to appellants, and paid that amount to the trust fund. Appellants did not report the \$42,000 on their 1970 joint California personal income tax return. Upon audit, however, respondent determined that the subject amount constituted gross income to appellants.

In 1972, appellants contributed their sole proprietorship to a newly formed corporation and received corporate stock in return. Appellants transferred cash, receivables, prepaid expenses, furniture, and fixtures with a total book value of \$42,722.97 to the corporation; the liabilities transferred had a total book value of \$103,951.22. Appellants reported this transaction on their 1972 return as an exchange coming under the provisions of Revenue and Taxation Code section 17431,^{1/} the California counterpart to section 351 of the Internal Revenue Code of 1954. In accordance with the provisions of section 17440, subdivision (c), appellants reported the excess of liabilities assumed by the corporation over the adjusted basis of the assets transferred. Appellants reported this gain as capital gain on assets, held more than, five years, thereby taking only 50 percent of the gain into account for, purposes of computing their taxable income. Upon audit, respondent determined that the above mentioned assets did not come within the definition of the term "capital asset" as such term is defined in section 18161, and disallowed the capital gain treatment claimed by appellants. Appellants protested respondent's actions for both the appeal years; upon consideration of appellants' protests, respondent sustained its actions, thereby resulting in this appeal.

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

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The first issue presented by this appeal is whether the \$42,000 in commission income paid to the trust fund on appellants' behalf constituted gross income to appellants. While appellants argue that they are not subject to income tax liability on this amount, they have not set forth any authority, nor is this board aware of any, that supports such a position. The law is clear in this regard; in pertinent part, section 17071 provides as follows:

(a) . . . gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

It is well established that, for income tax purposes, income is taxed to the party who earns it, and such liability may not be avoided through an anticipatory assignment of the income. (United States v. Basye, 410 U.S. 441 [35 L.Ed.2d 412] (1973); see also Lucas v. Earl, 281 U.S. 111 [74 L.Ed. 73 '11 (1930).) Accordingly, we must conclude that the commission income paid to the trust fund on appellants' behalf constituted gross income to appellants.

The second issue presented by this appeal concerns appellants' treatment of the gain realized from the aforementioned transfer of certain assets and liabilities to the newly formed corporation in 1972. As noted above-, appellants transferred cash, receivables, prepaid expenses, furniture, and fixtures to the corporation. Respondent contends that these items do not constitute capital assets and that appellants improperly reported the gain from this transaction as capital, rather than ordinary, gain. On the basis of the record of this appeal, we must conclude that respondent's action be sustained.

Section 17440, subdivision (c)(1), provides as follows:

In the case of an exchange to which Section 17431 applies, if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

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In relevant part, section 18161 provides as follows:

For the purposes of this part, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--

(a) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(b) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in Sections 17208 to 17211.7, inclusive, or real property used in his trade or business;

* * *

(d) Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in subdivision (a).

None of the items transferred by appellants to the corporation in 1972 constituted capital assets. Cash and prepaid expenses are transferred at face value and cannot result in either a gain or loss. Accounts receivable are, specifically excluded from the term "capital asset" by subdivision (d) of section 18161; finally, furniture and fixtures constitute depreciable assets, and the gain therefrom is treated as ordinary gain pursuant to the provisions of section 18201. Therefore, respondent properly determined that the gain realized from the subject transfer of assets and liabilities to the corporation resulted in ordinary, rather than capital, gain.

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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 action of the Franchise Tax Board on the protest of Warde E. and Janice N. Grenner against proposed assessments of additional personal income tax in the amounts of \$3,990.32 and \$3,378.51 for the years 1970 and 1972, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this day 7th Of December , 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett Chairman

Ernest J. Dronenburg, Jr. Member

Richard Nevins, Member

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_____, Member