BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
EDWARD C. AND CATHERINE LELOUIS )

Appearances:

For Appellants: Edward C. LeLouis, in pro. per.

For Respondent: Mark McEvilly
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 Edward C. and Catherine LeLouis against proposed assessments of additional personal income tax in the amounts of $1,777.28 and $2,250.28 for the years 1977 and 1978, respectively.

The issue presented by this appeal is whether appellants were engaged in the operation of the orange grove described below primarily for the production of income such that they were entitled to deduct certain expenses incurred with respect thereto during the years in issue.

Appellant-husband, an attorney, and appellant-wife, a nurse, are the owners of a 62-acre orange grove in Porterville, California. On their joint California personal income tax returns for the appeal years, appellants reported expenses of $32,301 and $19,085, respectively, from their orange grove operation; no income was derived from this activity. On their returns, appellants asserted that the reason for this lack of success was attributable to: (i) the failure of the grove's caretaker to properly care for the trees; and (ii) 'a shortage of water due to a severe drought.

Upon audit, respondent learned that appellants resided approximately 60 miles from their orange grove and that, during the years in issue, a woman had' been permitted to live on the grove rent-free in exchange for her services as a caretaker. While appellants acknowledge that they were aware that their caretaker. was failing to water the grove, they failed to remove her or to hire another caretaker. When appellant's caretaker later abandoned her position, appellants were unaware of her absence until so informed by a neighboring property owner three months later. Respondent also learned that approximately 25 acres of the grove could have been successfully farmed, but that appellants had neglected to do so.

As previously indicated, appellants assert that -their orange 'grove operation was unsuccessful because. a severe drought caused insufficient water to be available. Information obtained by respondent from the California Department of Water Resources reveals, however, that citrus farmers in the Porterville area were -permitted' 25 percent of their normal allotment of irrigation canal water in 1977, and that they were able to. compensate for the remaining loss by alternative actions, thereby permitting near normal water supplies. The aforementioned agency also indicated that the drought was broken by heavy rainstorms in the 1977-78 winter months.

Based upon the information acquired during its audit, respondent 'determined that appellant's operation. of the orange grove was not an activity engaged in for profit. Consequently, pursuant to section 17233 of the Revenue and Taxation Code,1/ respondent disallowed

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

the claimed expenses related to this activity. Apparently relying upon section 17202, appellants assert that the losses attributable to the subject activity are fully deductible. In relevant part, these two sections are set forth in the margin./

2/ Section 17233:

> (a) In the case of an activity engaged in by an individual, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this part except as provided in this section.
>
> (b) In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--
>
> (1) The deductions which would be allowable under this part for the taxable year without regard to whether or not such activity is engaged in for profit, and
>
> (2) A deduction equal to the amount of the deductions which would be allowable under this part for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).
>
> (c) For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under Section 17202....

Section 17202:

> (a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . .

These sections are substantially identical to Sections 183 and 162, respectively, of the Internal Revenue Code of 1954. Accordingly, federal case law is highly persuasive in interpreting the California statutes. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (195.

With regard to appellants' 1978 return, respondent also disallowed a claimed casualty loss deduction in the amount of $5,025.51, and $712.25 of a claimed $5,449 loss arising out, of appellants' investment in a beer parlor. Respondent. now concedes that appellants have substantiated thay they were entitled to the claimed casualty loss deduction. At the oral hearing conducted on this matter, appellants acknowledged that they lacked the documentation necessary to substantiate that portion of the claimed beer parlor loss disallowed by respondent. Therefore, in accordance with established- authority holding that the burden is on the taxpayer to show by competent evidence that he is entitled to any deductions claimed (Deputy v. du Pont, 308 U.S. 488 [84 L.Ed. 416] (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934), we must sustain respondent's action in this regard.

Ordinary and necessary expenses attributable to an activity not engaged in for profit are deductible only to the extent of gross income' derived therefrom less the amount of those deductions which are allowable whether or not the activity is engaged in for profit. (Rev. & Tax. Code, section 17233, subd. (b).) An activity not engaged in for profit is defined in section 17233, subdivision (c), as one'for which deductions under section 17202 or under subdivisions (a) or (b) of section 17252 are not allowable.

In deciding whether an activity is described in section 17233, the focus is on the objective with which the taxpayer entered into, and engaged in, the activity. If the taxpayer had a bona fide, even though unreasonable, objective of making a profit, the activity is not described in section 17233. (Edward Jasionowski, 66 T.C. -312, 321 (1976); Margit Sigray Bessenyey, 45 T.C. 261, 274 (1965), affd., 379 F.2d 252 (2d Cir. 1967), cert. den., 389. U.S. 931 [19 L.Ed.2d 283-J (1967).) The determination of the taxpayer's intent is to be based on "all the facts and circumstances" with, respect to the activity, with greater weight Placed on objective facts than on' the taxpayer's statement of intent. (Former Cal. Admin. Code, tit. 18, reg. 17233(b), subd. (a), repealed May 16, 1981; C. West Churchman, 68 T.C. 696, 701 (1977); Francis X. Benz, 63 T.C. 375, 382-384 (1974).) Whether a taxpayer engaged in an activity for the primary purpose of making a profit is a question of fact on which he bears the burden of proof. (Appeal of Clifford R. and Jean G. Barbee, Cal. St. Bd. of Equal., Dec. 15; 1976.)

Nine factors which are normally taken into account were listed in respondent's regulations promulgated pursuant to section 17233, subdivision (b). (Former Cal. Admin. Code, reg. 17233(b), repealed May 16, 1981; see also Treas. Reg. § 1.183-2(b).) Our decision in the instant appeal is founded upon a combination of several of these factors. These include substantial income from'other sources, the limited time and effort which appellants apparently devoted to the

operation of their orange grove, appellants' evident lack of expertise in conducting this activity, and commencement and continuation of the subject activity in a manner which does not reflect a profit motive.

During the years in issue, appellants reported income from other sources, including from their aforementioned occupations, of $58,860 in 1977 and $100,448 in 1978. As the amounts of respondent's proposed assessments illustrate, appellants partially recouped the losses incurred in the operation of the orange grove by offsetting those losses against their other income; thereby reducing their tax liability. The combination of the losses from the subject activity and substantial income from other sources may be an indication that the activity was not engaged in for profit. (Former Cal. Admin. Code, tit. 18, reg. 17233(b), subd. (b)(8), repealed May 16, 1981; Edward Jasionowski, supra; Joseph W. Johnson, Jr., 59 T.C. 791, 817 (1973), affd. on another issue, 495 F.2d 1079 (6th Cir. 1974), cert. den., 419 U.S. 1040 [42 L.Ed.2d 3173 (1974).)

A second factor is the minimal time and effort evidently expended by appellants on the operation of the orange grove. (Former Cal. Admin. Code, tit. 18, reg. 17233(b), subd. (b)(3), repealed May 16, 1981.) In view of their occupations, as well as their various investment activities, it is inconceivable that appellants could have devoted much personal time or effort to the operation of an orange grove located approximately 60 miles from their residence. Supporting this conclusion are: (i) appellants" failure to provide any substantiation documenting their personal efforts with regard to the activity in issue; and (ii) the fact that they were unaware for three months that the grove's caretaker had departed.

The manner in which appellants entered into the operation of their orange grove does not reflect any reliance on expertise or any knowledge of anticipated expenses. The record reveals that appellants had no, prior experience in citrus farming. Moreover, there is no indication that they prepared for this activity by study of the accepted business practices of citrus farming, or consulted with those knowledgeable of such practices. Considering these factors, we cannot conclude that appellants prepared for the subject activity by extensive study of accepted business practices, within the meaning of former regulation 17233(b), subdivision (b)(2).

Other factors similarly belie appellants' contention that their operation of the orange grove constituted an activity engaged in for profit. A separate bank account was not obtained; accounting records were not maintained, and there is no indication that insurance coverage was acquired. Finally, in the face of substantial losses and no revenue, appellants apparently did little to alter the operation of their grove. Specifically, appellants have failed to adequately explain the following: (i) why they never made an effort to farm the

approximately 25 acres which could have been productive: (ii) why an admittedly incompetent caretaker was left in charge of the grove's operation; and (iii) why they failed to obtain needed water when other farmers in the Porterville area managed to do so. In the aggregate, these factors constitute evidence of a manner of operation inconsistent with a profit motive. (Former Cal. Admin. Code, tit. 18, reg. 17233(b), subd. (b)(1), repealed May 76, 1981;' cf. C. West Churchman, supra.)

For the reasons set forth above, respondent's action 'in disallowing appellants' claimed expenses relating to their orange 'grove operation will be sustained.

**Appeal of Edward C. and Catherine LeLouis**

**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 Edward C. and Catherine LeLouis against proposed assessments of additional personal income tax in the amounts of $1,777.28 and $2,250.28 for the years 1977 and 1978, respectively, be and the same is hereby modified in accordance with respondent's concession regarding appellants' claimed casualty loss deduction in the amount of $5,025.51 for the year 1978. In all other respects, the action of the Franchise Tax Board is sustained.**

**Done at Sacramento, California,** this 17th day of November, 1982, by the State **Board of Equalization,** with Board Members Mr. **Bennett,** Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, **Chairman**

Conway H. Collis, **Member.**

Ernest J. Dronenburg, Jr., **Member**

Richard Nevins, **Member**

_____, **Member**

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ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed December 15, 1978, by Edward C. and Catherine **LeLouis** for rehearing of their appeal from the **action of** the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our our order of November 17, 1982, **be** and the same is hereby affirmed.

Done at Sacramento, California, this 3rdday **of** January 1983, by the State Board, of **Equalization, with** Board Members Mr. Bennett, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett, Chairman

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

_____, Member

_____, Member