BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WILLIAM C. BURNS)

For Appellant: William C. Burns, in pro. per.

For Respondent: Kathleen M. Morris 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 William C. Burns against proposed assessments of additional personal income tax in the amounts of **$1,946.86**[1] and **$6,108.44** for the years 1976 and 1977, respectively.

1/ According to respondent, the correct amount for the taxable year 1976 should be **$1,874.86** since respondent allowed exemption credits of $58.00 when the correct amount of these credits was **$130.00.** Should it prevail, respondent has agreed to reduce the 1976 assessment accordingly.

Before proceeding to the merits of this appeal, we must dispose of a preliminary question. In his letter of January 14, 1983, appellant contends that this appeal should be dismissed in his favor because respondent failed to respond to certain arguments advanced by appellant in his opening brief. Appellant's position appears to be that under sections 5026 and 5028 of the Board of Equalization Hearing Procedure Regulations (Cal. Admin. Code, tit. 18, regs. 5026, 5028) respondent's failure to reply to certain issues within the requisite 30-day period acts as an admission that the arguments set forth are controlling and therefore the appeal should be dismissed. Appellant's reading of these sections is incorrect. Section 5026 allows the Franchise Tax Board 30 days in which to file a memorandum in support of its position. Section 5028 provides a procedure wherein the parties may file a stipulation of facts. Neither section requires respondent to respond to every issue raised by an appellant or risk conceding an unanswered issue. To impose such a requirement on respondent would be unduly burdensome and unnecessary when one issue can be dispositive of an entire appeal. In any event, the issues to which appellant refers are really subarguments of the sole issue in dispute in this appeal, which has been addressed by respondent. Accordingly, appellant's argument must be rejected.

Turning to the merits of this appeal, the sole issue presented is whether respondent properly computed appellant's net farm loss for the purpose of calculating the tax on tax preference items.

Appellant and his wife filed joint personal income tax returns for the years '1976 and 1977, reporting losses from farm activities on Schedule F of their returns and on various partnership returns. During the years 1976 and 1977, appellant paid interest on mortgages he had obtained on his farm property in the amounts of $34,333. and $44,910, respectively. The money from the mortgages was used to acquire more farm property and finance his farming enterprises. Appellant excluded the interest payments on the mortgages when he computed his tax preference income.

After an examination of the returns, respondent concluded that appellant had erroneously calculated his tax preference income in that he had not included the aforementioned interest payments in the computation of his net farm loss nor had he included his capital ga'ins as-a tax preference item. Respondent thereafter recomputed

appellant's tax preference income to include the interest payments and capital gains and issued notices of.proposed deficiency assessments.

Appellant protested respondent's action with respect to the inclusion of interest payments while conceding that the rest of its computation of the tax preference income was correct. On May 18, 1982, after due consideration, respondent affirmed its deficiency notices. Appellant filed a timely appeal on May 24, 1982.

Appellant contends that the "net farm loss" which must be reported includes only the amount by which deductions 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. He maintains that standard accounting principles support the position that interest is to be treated in a special indirect manner and that it is virtually unanimous practice to disassociate interest expense or income from normal expense categories associated with a business because such expense is not considered directly connected with the operating profit or loss of the entity. Appellant argues that the interest in question would be due and payable to the note holder whether or not farming was performed on the lands in question, and if farming was not practiced on the land in question, the interest would be fully deductible and would not then be considered a tax preference item. He contends that respondent's position is unreasonable discrimination against credit farmers and that the statutes concerning "farm net loss" are unnecessarily vague and subject to several interpretations. Finally, appellant requests that this board set aside its previous decisions on this issue.

Respondent contends that it properly computed appellant's net farm loss for the purpose of calculating the tax on preference items in accordance with previous decisions by this board.

The provisions of Revenue and Taxation Code section 17063, subdivision (i), in effect during the income years in question,!/ included as an item of tax

2/ For income years beginning on and after January 1, 1979, Assembly Bill 93 (Stats. 1979, ch. 1168) amended section 17063 to increase the excluded amounts thereunder. Subdivision (i) was rewritten as subdivision (h).

preference "[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 in 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.

The essence of appellant's argument is that the above-quoted portion of section 17064.7 is sufficiently narrow in scope so as to eliminate interest payment deductions from the computation of his farm loss tax preference. Appellant maintains that the interest payments are not "directly connected" with the carrying on of the trade or business of farming.

For interpretation of the term "farm net loss" as it is used in section 17064.7, we look to the Treasury regulations promulgated pursuant to section 1251 of the Internal Revenue Code.3/

Treasury Regulation § 1.1251-3(b)(1) defines the term "farm net loss" as follows:

> 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.)

3/ Section 17064.7 is the successor section to section 18220, subdivision (e). Except for certain provisions not applicable here, section 17064.7 defines "farm net loss" in the same manner as that of former section 18220, subdivision (e). Pursuant to the provisions of Title 18, California Administration Code, section 19253, the regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section 18220 was patterned) govern the interpretation of "farm net loss" under former section 18220, subdivision (e).

Section 62(1) of the Internal Revenue Code of 1954 (the equivalent of section 17072, subdivision (a)) provides that an expense attributable to a taxpayer's trade or business may be deducted by the taxpayer to arrive at adjusted gross income only if the connection between the expense and the trade or business is direct. When presented with this issue in the past, this board has concluded that interest payments are "directly connected" with the trade or business of farming. (See Appeal of James A. and Sheila L. Ortloff, Cal. St. Bd. of Equal., Feb. 1 1982; Appeal of Vincent 0. and Jovita L. Reyes, Cal. St'. Bd. of Equal., Nov. 16, 1981.)

The reasoning used in our previous decisions is equally applicable under the circumstances presented by the instant case in that the indebtedness from which the relevant interest deductions resulted had a direct causal relationship with appellant's farming activities. This relationship was established by the fact that the proceeds from the encumbrances were used by appellant to finance his farming enterprises and acquire more farm property. Appellant has presented no credible arguments which would cause this board to set aside, or distinguish, our previous decisions on this issue.

As we have in previous decisions, if we look to the legislative history behind the enactment of.section 62(1) of the Internal Revenue Code of 1954 and its predecessor section, section 22(n)(1) of the Internal Revenue Code of 1939, we find support for our conclusion that appellant's interest payments were directly related to his farming business. The legislative history reveals that Congress intended that interest and tax payments comparable to those in issue here would be deductible from a taxpayer's gross income to arrive at adjusted gross income if those expenses were incurred in a taxpayer's trade or business. In such a case, Congress observed, the interest and tax payments would be directly connected with the trade or business carried on by the taxpayer. The House of Representatives Report concluded that:

> taxes and interest are deductible in arriving at adjusted gross income only as they constitute expenditures attributable to a trade or business or to property from which rents or royalties are derived. The connection contemplated in this statute is a direct one rather than a remote one.

(H.R. Rep. No. 1365, 78th Cong. 2d Sess. (1944) [1944 Cum.Bull. 821, 8391.)

The above-quoted legislative history clearly reveals that interest payments on loan proceeds used in a taxpayer's trade or business are deductible from the taxpayer's gross income to arrive at adjusted gross income since they are expenses directly connected to the trade or business being carried on by the taxpayer. Similarly, we conclude that there existed a direct relationship between appellant's interest payments and his farming enterprise. (See United States v. Wharton, 207 F.2d 526 (5th Cir. 1953).) Accordingly, we must conclude that respondent properly determined that the subject deductions were includible in the calculation of appellant's item of net farm loss tax preference.

The other issues raised by appellant regarding unreasonable discrimination and statutory vagueness are without merit. For the reasons stated above, we sustain respondent's action, as modified.

Appeal of William C. Burns

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 William C. Burns against proposed assessments of additional personal income tax in the amounts of **$1,946.86** and **$6,108.44** for the years 1976 and 1977, respectively, be and the same is hereby modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 15th day of **September, 1983,** by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, **Member**

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9