84-SBE-020

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WALTER O. AND BARBARA S. HANSEN)

Appearances:

For Appellants: George M. Lewellen
Certified Public Accountant

For Respondent: James C. Stewart
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 Walter O. and Barbara S. Hansen against a proposed assessment of additional personal income tax in the amount of $450.33 for the year 1976.

The issue presented is whether certain losses connected with leasing farm property should be included in items of tax preference.

Appellants leased certain farm land- to their controlled corporation, Straight Arrow Construction, Inc. (Straight Arrow) for the raising of crops and livestock. As rent, appellants received an undivided one-half interest in all crops, *except* alfalfa and hay raised on the land, and one-half of the amount derived from the raising of livestock on the land.

On their joint California tax return for 1979, appellants reported a $21,354 loss in connection with the rental to Straight Arrow.' They did not compute or pay any preference tax. Upon audit, respondent determined that the loss was an item of tax preference, combined it with an unrelated farm loss incurred during that year, and calculated appellants' preference tax. It issued a proposed assessment of additional tax in the amount in issue. Appellants objected to the proposed assessment on the grounds that the loss incurred in connection with the rental of farm land to Straight Arrow was not net farm loss. Respondent affirmed tne proposed assessment after considering appellants' protest. This timely appeal was filed.

In addition to other taxes imposed under the Personal Income Tax Law (Rev. & Tax. Code, §§ 17001-19452), section 17062 imposes a tax on the amount by which the taxpayer's items of tax preference exceed his net business loss. Included in the items of tax preference is the amount of net farm loss in excess of a specified amount which is deducted from nonfarm income. (Rev. & Tax. Code, § 17063, former subd. (i) (now subd. (h).) Farm net loss is defined 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." (Rev. & Tax. Code, § 17064.7.)

Section 17064.7 of the Revenue and Taxation Code does not contain a definition of "the trade or business of farming," and respondent has not issued regulations interpreting the phrase. However, this board has announced a general policy of using the definition of that phrase found in federal regulations issued under section 1251 of the Internal Revenue Code. (Appeals of Donald S. and Maxine Chuck, Cal. St. Bd. of Equal., Oct. 27, 1981.) This policy is based on the fact that

although section 17063, subdivision (i), and Internal Revenue Code section 1251 employ different methods, they have the identical focus, "net farm loss," and the identical purpose, to deter the use of farm loss to shelter large amounts of nonfarm income. Under these circumstances, except where the California Legislature has indicated a contrary intent (see Appeal of Edward P. and Jeanette F. Freidberg, Cal. St. Bd. of Equal., Jan. 17, 1984), we believe that the Legislature intended that the definition of "trade or business of farming" used in section 17063, subdivision (i), be the same as the definition used in Internal Revenue Code section 1251.

Treasury Regulation section 1.1251-3(e)(1) defines the "trade or business of farming" as including:

> 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.

Section 175 of the Internal Revenue Code allows taxpayers engaged in the trade or business of farming to deduct certain expenditures for soil and water conservation which would otherwise not be deductible. The regulations under that section specify that "[f]or the purpose of section 175, a taxpayer who receives a rental (either in cash or in kind) which is based upon farm production is engaged in the business of farming." (Treas. Reg. § 1.175-3.)

Respondent's position is that since appellants receive rental based upon farm production, they may make an election under section 175, and are thus engaged in farming for purposes of both section 1251 of the Internal Revenue Code and section 17063, subdivision (i), of the Revenue and Taxation Code.

Appellants first argue that since Treasury Regulation section 1.175-3 contains the phrase "for the purpose of section 175," it was intended to apply only to section 175 of the Internal Revenue Code and has no relevance to section 1251. This argument is without merit since it overlooks the fact that the regulations under 1251 specify that if a taxpayer may make an election under section 175, he is in the trade or business of farming for purposes of section 1251.

Appellants also contend that they are not taxpayers who may make an election under section 175 because they did not incur any expenditures for soil and water and, indeed, were prohibited from making such expenditures by the lease with Straight Arrow. We cannot agree. We believe that since Treasury Regulation § 1.1251-3 (e)(1) uses the word "may" it only requires that the taxpayer be one of those who, under the terms of section 175 and the regulations thereunder, might make an election under that section if the required expenditure were made. Appellants fall within that group since they received rental based on farm production. They were therefore engaged in the trade or business of farming for purposes of section 1251 of the Internal Revenue Code and, accordingly, for purposes of section 17063, subdivision (i), of the Revenue and Taxation Code. Thus, respondent was correct in concluding that the amount by which the deductions incurred in connection with the lease to Straight Arrow exceeded income was net farm loss.

Appellants contend that even if they kere engaged in the trade or business of farming, deductions for interest on loans connected with the leased land and property taxes on the leased land were not expenses directly connected with that trade or business. Appellants' position is identical to that taken by the taxpayers in the Appeal of Vincent O. and Jovita L. Reyes, decided by this board November 16, 1981. In the Reyes opinion, we rejected appellants' position and held that interest and taxes paid in connection with the farming business are properly included in the calculation of farm net loss under section 17064.7 of the Revenue and Taxation Code. Appellants have presented no reason for us to alter our decision in the Reyes appeal. We therefore conclude that this issue must be decided in respondent's favor.

For the above reasons, respondent's action must be sustained.

Appeal of Walter O. and Barbara S. Hansen

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 Walter O. and Barbara S. Hansen against a proposed assessment of additional personal income tax in the amount of $450.33 for the year 1976, be and the same is hereby sustained..

Done at Sacramento, California, this 31st day of January, 1981, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9