BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHARLES A. AND HANNAH E. MAC GREGOR)

For Appellants: Charles A. MacGregor, in pro. per.

For Respondent: Mark McEvilly
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 Charles A. and Hannah E. MacGregor against proposed assessments of additional personal income tax in the amounts of $433.60 and $372.18 for the years 1976 and 1977, respectively.

The two issues for determination are: (1) whether certain payments made by appellants were deductible rental expenses or partial payments of the purchase price for such property, and (2) whether expenses incurred by appellant-wife during a trip to France were deductible business expenses.

During the years at issue, appellants were employed in the Los Angeles area. In 1974, appellants purchased 22.5 acres of farmland in Edna Valley, San Luis Obispo County, California, for the purpose of establishing a vineyard. In September of 1975, in order to enlarge their vineyard activities, appellants executed an Agreement of Lease with Option to Purchase 124.5 additional acres of farmland on Orcutt Road in San Luis Obispo County ("the subject property"). Under the terms of this lease, appellants were to make eight annual payments of $25,000 denoted as rent commencing September 1, 1975. Moreover, appellants acquired an option to purchase the subject property for $79,000 exercisable from July 1,' 1983, through August 1, 1983, provided that all the terms of the lease had been complied with. The lease agreement further provided that appellants would not need the entire acreage immediately and that the lessor would have the use of all acreage until March of 1976, 100 acres until March of 1977, 75 acres until March of 1978, 50 acres until March of 1979, 25 acres until March of 1980, but none of the acres thereafter.

No income was earned from the vineyard activities associated with the property for either of the years at issue. Nevertheless, $25,000 was included among the expenses claimed for such activities in each year as a rental expense.

In September of 1976, appellants traveled to the Burgundy and Rhine regions of France, during which time educational sessions regarding wine making were given. The trip expenses, totaling $3,108.35, were substantiated by a diary kept by appellants, together with hotel, restaurant and airline receipts. On their 1976 personal income tax return, appellants claimed a deduction for traveling expenses for such trip.

Upon audit for the years at issue, respondent determined that the yearly payments of $25,000 denoted on the returns as "rent" should be disallowed since, in substance, the underlying transaction was a purchase rather than a lease. Accordingly, respondent determined that $5,834 of each $25,000 yearly payment was allocable to

deductible interest expense while the remainder of such yearly payment was allocable to nondeductible principal payments. Such determination reduced the amount of income subject to tax preference, but still resulted in a deficiency for the years at issue. Moreover, respondent determined that while appellant-husband had established the business-related nature of the classes regarding wine making, appellant-wife had not. Accordingly, respondent allowed the expenses incurred by appellant-husband on the trip (53%), but disallowed those expenses attributed to appellant-wife. Appellants protested the resulting assessments and respondent's denial of that protest led to this appeal.

Rental payments for the use of property employed in a trade or business are deductible if the taxpayer has not taken title or has no equity in such property. (Rev. & Tax. Code, § 17202, subd. (a)(3).) However, while an agreement may be cast in the form of a lease requiring rental payments, it may be, in substance, a sales contract so that the payments are, in reality, applied to the purchase price of the property. (Anthony J. Foyt, Jr. v. United States, 561 F.2d 599, 603 (5th Cir. 1977).) Thus, the precise problem posed here is the characterization of the payment made pursuant to the lease-option arrangement. Were they payments of rent or partial payments of the purchase price of the property?

To properly discern the true character of the payment, it is necessary to ascertain the intention of the parties as evidenced by the written agreements, interpreted in light of the specific facts and circumstances existing at the time of the agreement. (See Anthony J. Foyt, Jr., supra.) The courts have looked to various factors in ascertaining the substance of lease-option arrangements. Where the periodic payments exceed the current fair market rental value of the property and where the aggregate payments paid prior to the exercise of the option are disproportionately greater than the relatively small final amount required to acquire title, the payments are, in reality, being applied to the agreed purchase price of the property. (See Judson Mills, 11 T.C. 25 (1948).) Also important is whether the schedule of payments under the so-called lease was commensurate with the benefits derived by the lessee from occupancy and use. (Oesterreich v. Commissioner, 226 F.2d 798 (9th Cir. 1955).)

Appellants have presented an appraisal which suggests that the fair market rental of the subject

property averaged $200 per acre per year over the life of the eight-year lease. This, appellants assert, would indicate that the $25,000 per year payment equaled fair market rent for the subject 124.5 acre parcel. However, as indicated above, during the majority of 1976, appellants used only approximately 25 acres of the subject property. The remainder was used by the lessor. Likewise, during the majority of 1977, appellants used only approximately 50 acres of the subject property. Viewed in this light, the yearly payments, both during the years at issue and during the life of the so-called lease, appear to be excessive even if a fair market rent of $200 per acre per year was accepted. Moreover, the benefits derived by the lessee were clearly not commensurate with the schedule of payments made under the so-called lease. As appellants used progressively more land toward the end of the lease, the per-acre per-year rent actually decreased. In view of the foregoing, we cannot accept the valuation suggested by appellants', appraisal as being fair market rent. In this regard, we find the case of Breece Veneer & Panel Co. v. Commissioner, 232 F.2d 319 (7th Cir. 1956), cited by appellants, to be distinguishable from the instant case since that case found the payment at issue there to be a "fair rental" payment.

Moreover, the periodic payments in the instant case represent over 250 percent of the option price. Accordingly, we find that aggregate payments paid prior to the time the option was to be exercisable would be disproportionately greater than the final amount required to take title. Thus, based on the record before us, we must conclude that it was the intent of the parties that the periodic payments denoted as rent would apply to the purchase price. We are further impressed with what appears to be appellants' economic obligation to buy the land. (M & W Gear Company v. Commissioner, 446 F.2d 841, 846 (7th Cir. 1971).) That is, appellants planted vineyards which would take several years to mature and produce grapes. Clearly, numerous expenditures were made for leasehold improvements which would not be recoverable to a lessee and, in our opinion, would be inconsistent with appellants' claim that prior to the exercise of the option to purchase, they had no intention to acquire an equity in the land.

In light of the foregoing, and upon consideration of the record as a whole, we are convinced that through the annual payments denoted as "rent," appellants were, in fact, acquiring a substantial equity in the property. Accordingly, we hold that respondent properly disallowed the claimed deduction as rental payments.

Next, we turn to the expenses associated with the trip to France. It is, of course, a fundamental principle of tax law that deductions are matters of legislative grace and that taxpayers have the burden of clearly showing their right to the deductions they claim. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348]; Appeal of Jack and Jacoba Turryer Cal. St. Bd. of Equal., 6, 1973.) According to the notice of proposed assessment, appellant-wife's expenses incurred during the trip were disallowed because such expenses were found not to be undertaken primarily for the purpose of maintaining or improving skills required in her employment or other trade or business. (Rev. & Tax. Code, § 17202.) Appellants have provided no proof of the business purpose of any of the wife's expenditures on the trip. Indeed, nothing in the record indicates that appellant-wife, a psychiatrist, is involved in any way with the vineyard operations. Accordingly, we are compelled to conclude that appellants have failed to prove that they are entitled to deduct any expenditures associated with appellant-wife's trip to France.

Appeal of Charles A. and Hannah E. MacGregor

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 Charles A. and Hannah E. MacGregor against proposed assessments of additional personal income tax in the amounts of $433.60 and $372.18 for the years 1976 and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of February , 1984, 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