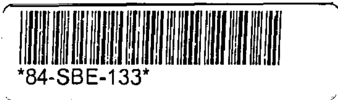


BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
WILLIAM J. AND MARIAN P. McBRIDE )

For Appellants: William J. McBride,
in pro. per.

For Respondent: Charlotte Meisel
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 J. and Marian P. McBride against a proposed assessment of additional personal income tax in the amount of $2,447 for the year 1979.

Appeal of William J. and Marian P. McBride

This appeal raises several questions. concerning the proper method of computing tax on appellants' 1979 tax preference income pursuant to section 17062 of the Revenue and Taxation Code.

Section 17062, in effect during the year at issue, provided in pertinent part:

> In addition to the- other taxes imposed by this part, there is hereby imposed . .. taxes . . . on the amount (if any) of the sum of the items of tax preference in excess of the amount of net business loss for the taxable year. ...

The term "net business loss" is defined in section 17064.6 as "adjusted gross income (as defined in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net amount is a loss.." Appellants computed the section 17062 tax on their 1979 items of tax preference as follows:

| | |
|---|---|
| Items of tax preference: | |
| Adjusted itemized deductions | $ 632.78 |
| Accelerated depreciation | 1,020.22 |
| Excess depletion | 541.00 |
| Nontaxable capital gains | 31,385.16 |
| Intangible drilling costs | 27,855.27 |
| Total items of tax preference | 61,434.43 |
| Less net business loss | 67,390.74 |
| Total tax preference income | (5,956.31) |
| Taxable tax preference income | $ 0 |

After conducting an audit of appellants' 1979 return, respondent increased the amount of the items of tax preference and recomputed the amount of net business loss as follows:

| | | |
|---|---|---|
| Total items of tax preference reported on return | | $61,434.43 |
| Increase of tax preference items (intangible drilling costs) | | 68,489.74 |
| Revised total items of tax preference | | 129,924.17 |
| Less net business loss | | |
| Adjusted gross income on return | (46,387.36) | |
| Less section 17252 expense | 16,053.38 | |
| | | (62,446.74) |
| Total tax preference income | | 67,483.43 |
| Less statutory exemption | | 8,000.00 |
| Taxable tax preference income as revised | | $59,483.43 |

This revision resulted in a tax on tax preference items of $2,447. Appellants protested the resulting assessment, and respondent's denial of that protest led to this appeal.

There appears to be no disagreement between the parties with respect to the total dollar amount of the total tax preference items, i.e., $129,924.17. Indeed, respondent's primary computations of the tax on tax preference items are based upon the figures supplied by appellants. The main disagreement arises from appellants' attempt to limit the inclusion of such items of tax preference, contending that they have received no "tax benefit" from $68,489.74 of such tax preference items. Drawing upon the well-settled principle that the tax on preference income should not be imposed where such income has failed to produce an actual tax benefit (Appeal of James R. and Jane M. Bancroft, Cal. St. Bd. of Equal., Jan. 11, 1978; Appeal of Richard C. and Emily A. Biagi, Cal. St. Bd. of Equal., May 4, 1976), appellants' Schedule P ("Minimum Tax on Preference Income") and attached statements purport "to minimize the minimum tax on preference income" by first excluding this $68,489.74 from the computation. However, there is simply no statutory authority for excluding such items from the tax preference computation in such manner.

While we agree with appellants' root assertion that the tax on preference income should not be imposed where such income has failed to produce an actual tax benefit, we believe tnat the Legislature achieved exactly this result by including in section 17062 an offset against tax preference income equal to the "net business loss." (See Appeal of James R. and Jane M. Bancroft, supra; Appeal of Robert S. and Barbara J. McAlister, Cal. St. Bd. of Equal., April 6, 1977.) The relationship between the "net business loss" and the tax preference income may best be illustrated by referring to the particular facts of the instant appeal.

The record on appeal indicates that appellants received gross income of $64,509.69 in 1979. Appellants' proper adjusted gross income would be a negative $65,570.48 (gross income of $64,509.69 less partnership losses of $129,927.17 and other losses of $156). Reducing adjusted gross income (i.e., negative $65,570.48) by the deductions allowed by section 17252 (i.e., $16,053.38) results in a net business loss of $81,623.86. (See Rev. & Tax. Code, § 17064.6.) The $146,133.55 difference between appellants' gross income and the net business. loss represents the'sum of three separate categories of deductions: (1) deductions, other than those which constitute items of tax preference allowed by section 17202 in computing adjusted gross income--$156; (2) "the deductions allowed by section 17252 (relating to expenses for production of income"--agreed, as being $16,053.38; and (3) the items of-tax preference--$129,924.17. Since there is no advantage, under California law, associated with a negative adjusted gross income, the portion of appellants' items of tax preference equal to their net business loss produce no tax benefit. Pursuant to sections 17062 and 17064.6, the first two categories reduced appellants' gross income by $16,209.38, while the items in the last category reduced appellants' gross income by an additional $129,924.17, resulting in a net business loss of $81,623.86. Therefore, appellants are entitled to offset that amount (i.e. $81,623.86), their "net business loss," against their items of tax preference (i.e. $129,924.17) in computing the tax imposed by section 17062 upon the amount of tax preference income in excess of net business loss (i.e. $48,300.31). Clearly to this extent, but only to this extent, appellants have received an actual tax benefit and the tax on preference income should be imposed.

As indicated above, our conclusion that the proper amount of tax preference income in excess of net business loss is $48,300.31, differs from respondent's conclusion that this sum should be $67,483.43. Our review of respondent's figures indicates that respondent has made a computational error by using $110,741.06 for the items of tax preference rather than $129,924.17 in determining adjusted gross income. Accordingly, based upon the foregoing discussion, respondent's determination must be modified.

Appeal of William J. and Marian P. McBride

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 William J. and Marian P. McBride against a proposed assessment of additional personal income tax in the amount of $2,447 for the year 1979, be and the same is hereby modified in accordance with the opinion of the board. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 12th day of September, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis and Mr. Bennett present.

Richard Nevins, Chairman

Ernest J. Dronenburg, Jr., Member

Conway H. Collis, Member

William M. Bennett, Member

________________, Member

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 81A-1336-GO
WILLIAM J. AND )
MARIAN P. MCBRIDE )

For Appellants: William J. McBride, in pro. per.

For Respondent: Charlotte Meisel Counsel

DENIAL OF PETITION FOR REHEARING AND MODIFICATION OF OPINION AND ORDER

In our original determination of this matter on September 12, 1984, we modified the action of the Franchise Tax Board concerning the computation of tax on appellants' tax preference income pursuant to Revenue and Taxation Code section 17062,[1] In that determination, we held that while the Franchise Tax Board was correct in its imposition of the tax, its computation was erroneous. Upon rehearing, both appellants and respondent dispute our determination. We have withheld

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

determination on the petition for rehearing for consideration of two appeals which 'we thought might bear on the resolution of this petition. (See Appeal of Estate of Anna Cogswell, Cal. St. Bd. of Equal., April 9, 1986, rehg. dec., _____ and Appeal of Robert V. and Sue Antle, Cal. St. Bd. of Equal., April 9, 1986, rehg. den., . . .) However, neither Cogswell nor Antle controls the outcome this petition.

The basis of appellants' dispute is straightforward; yet intricate, The starting point fur appellants' position is their agreement with our reference to the "well-settled principle that the tax on preference income should not be imposed where such income has failed to produce an actual tax benefit, . . ." (App. *Pet,* for Rehg. at 1.) However, appellants disagree that this result is obtained by including an offset against tax preference income equal to the "net business loss." Appellants begin their attack by reviewing the interplay between the exemption credit and the use of the tax preference items as follows:

> Specifically, on our Form 540 tax return we have an exemption credit of $54. Thus, according to the tax table we could have a taxable income of $4,950 which would result in a tax table tax of $53, and the $54 exemption credit would then be subtracted from this $53 tax, resulting in zero tax on line 47. Therefore, there is no need for us to. use any more deductions than are necessary to *reduce* our taxable income to $4,950. On the other hand, the application of the net business loss offset against tax preference income as described on page 4 of the Opinion has the effect of requiring us to reduce our taxable income to zero, thereby forcing us to use $4,950 of deductions which are not necessary and which produce no tax benefit. The idea of forcing us to use deductions which provide no tax benefit and which we do not wish to use, and then taxing these deductions, is truly preposterous.

(App. Pet. for Rehg. at 1.)

Appellants' second major attack on our determination centers upon the interplay between the tax rates on taxable income (Rev. & Tax, Code, § 17041) and the tax rates on preference income (Rev. & Tax, Code, § 17062)

with the tax benefit principle cited above. Because the total amount due from appellants is made up of the regular tax and the tax on tax preference items, appellants demonstrate that "trial and error computations" indicate that if they take fewer deductions and thereby increase the regular tax which they owe, their tax on tax preference items would be reduced and the total sum owed would be reduced. Accordingly, appellants argue that the statutory approach which we used to compute the amount of tax on tax preference items they owed actually results in a larger total liability and thereby also violates the tax benefit principle cited above.

Lastly, appellants note that further "trial and error computations" are required in order for them to fully utilize income averaging provided by sections 18241 et seq., which will minimize their total liability further and, thereby, fully comply with the tax benefit principle.

After thorough consideration, we conclude that appellants' understanding of the tax benefit rule, and, derivatively, their arguments are erroneous. To demonstrate this, we must carefully review the tax benefit rule and the statutes and regulations involved. The tax benefit rule is both a rule of inclusion in income and exclusion from income. In its broadest application, the rule provides that the "recovery of an item previously deducted must be included in income [while] that portion of the recovery not resulting in a prior tax benefit is excluded." (Putoma Corp. v. Commissioner, 66 T.C. 652, 664, fn. 10 (1976).) A classic example of the application of the tax benefit rule is a claim against a taxpayer such as a local property tax which is deducted when paid but recovered in part when subsequent events establish that the taxpayer paid more than he actually owed. In such a situation, the taxpayer "is ordinarily taxed on the amount received unless the prior deduction was of no 'tax benefit' because it did not reduce his tax liability." (Bittker and Kanner, The Tax Benefit Rule, 26 UCLA L.Rev. 265 (1978).)

The rule has been modified as to certain items in sections 17144 and 17145 and, for example, in single-issue statutes such as in section 17064.5, subdivision (f), dealing with items of tax preference. Section 17064.5, subdivision (f), provides:

> The Franchise Tax Board shall prescribe regulations under which items of tax preference

> shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax under this chapter for any taxable years,

Before reviewing the regulation promulgated by the Franchise Tax Board pursuant to the authority of section 17064.5, subdivision (f), it should be noted that the tax benefit rule, as judicially developed, does not mandate that the least amount of tax be paid, While the Court of Claims, at one point, adopted an "exact tax benefit" rule under which the recovery was taxed at the rate that was applicable to the deduction (Perry v. United States, 160 F.Supp. 270 (Ct. Cl. 1958)), that court later overruled its decision and accepted the prevailing judicial view that the recovery is to be taxed at whatever rate is in effect for the year of receipt.. (Alice Phelan Sullivan Corporation v. United States, 381 F.2d 399 (Ct. Cl. 1967).) Accordingly, drawing from the property tax example cited above, if the general rate of tax or the taxpayer's marginal tax rate is lower when the taxpayer claims the local property tax as a deduction than when he recovered such payments, inclusion in income in the year of recovery as required by the tax benefit rule would result in a greater total tax being paid,

With this discussion in mind, we must review appellants' arguments in view of the applicable regulation. Regulation section 17064.5 entitled "Adjustment to Items of Tax Preference Where No Tax Reduction Results" provides as follows:

> (a) In determining the extent to which a taxpayer's tax preference items reduce such taxpayer's tax, all nonpreference deductions will be considered to be taken into account first, followed by preference items of deduction.
>
> (b) The items of tax preference computed under Division 2, Part 10, Chapter 2.1, Revenue and Taxation Code, beginning with Section 17062, shall be reduced by an amount equal to the taxpayer's negative taxable income, except to the extent previously reduced by the taxpayer's 'net business loss' as defined in Revenue and Taxation Code Section 17064.6.
>
> (c) The phrase 'reduction of the tax-payer's tax' as used in Revenue and Taxation

Code Section 17064.5(f) means the reduction of tax liability without regard to the effect of allowable tax credits.

(d) This regulation shall apply to taxable years beginning on or after January 1, 1979.

That portion of appellants' first argument relating to the interplay between the exemption credit a-nd the use of tax preference items is directly addressed by subdivision (c) of regulation 17064.5. As indicated above, appellants' contention is that with the exemption credit of $54, there is no benefit to them for reducing their income below $4,950, However, as noted above, subdivison (c) of regulation 17064.5, provides that "[t]he phrase 'reduction of the taxpayer's tax' as used in Revenue and Taxation Code section 17064.5 (f) means the reduction of tax liability withaut regard to the effect of allowable tax credits." Accordingly, it is clear that the application of the tax benefit rule of section 17064.5, subdivision (f), applies to taxable income without regard to the exemption credit of $54. Therefore, based upon a reading of the statute, as amplified by the regulation, this portion of appellants' first argument is without merit. The remaining portion of appellants' final argument -- that appellants should not now be forced to use deductions which produce no tax benefit -- is addressed below.

As indicated above-, the primary basis of appellants' remaining major attacks against our determination is that "trial and error" computations result in less total tax being paid by them than our determination provides. Appellants appear to contend that our determination properly follows the applicable statute[2/] but that such statute violates the tax benefit principle. However, as discussed above, the tax benefit rule does not require that the least amount of tax be paid. (Alice Phelan Sullivan Corporation v. United States, supra.) Accordingly, the wellspring of appellants' remaining arguments actually appears to be

2/ Nevertheless, appellants contend that "the applicable law is invalid . . . ." (See appellants' December 14, 1984, letter to Glenn L. Rigby.) The precise basis of appellants' contention is not clear but appears to be only that their interpretation of the tax benefit rule overrides the clear reading of the statute.

contrary to the tax benefit rule. Moreover, since no provisions regarding the regular tax appear in the regulations, the interplay between the marginal tax rate of the regular tax and the tax on Preference items or the effect of tax averaging is irrelevant and does not undercut the tax benefit rule. (See, e.g., Cal, Admin. Code, tit. 18, reg. 17064.5, subd. (a).) In any case, the basis for our holding with respect to the tax on preference income is firmly grounded upon the clear reading of section 17064.5, subdivision (f), and the regulation which it authorizes. More fundamentally, the linchpin of appellants' remaining argument is the proposition that, in computing the tax on tax preference items, they should not now be forced to take deductions on their regular tax. As indicated above, appellants argue that their "total tax ... would be less. if we took less deductions." (App. Pet. for Rehg. at 2). The bulk of the deductions taken by appellants in the year at issue relate to intangible drilling costs. Their tax return indicates that of the $110,741.06 in deductions claimed for partnership losses, at least $96,345.01 relate to intangible drilling costs. (Resp. Br., Exs. B and C.)[3] Section 17283, subdivision (c), provides that the Franchise Tax Board shall prescribe regulations which grant the option of deducting as expenses in the year incurred or of recovering such costs through depletion in future years. Since section 17283, subdivision (c), conforms to Internal Revenue Section 263(c) and since there are now no regulations of the Franchise Tax Board in this area, the regulations under section 263(c) of the Internal Revenue Code govern the interpretation of section 17283, subdivision (c). (Appeal of William C. and Jane J. Kellogg, Cal, St. Rd. of Equal., June 25, 1985.) Treasury Regulation section 1.253(c)-1, in turn, provides that the rules relating to this option are governed by Treasury Regulation section 1.612-4. The manner of making the election to deduct intangible drilling expense or to capitalize them is outlined in Treasury Regulation section 1.612-4(d), which provides:

> (d) Manner of making election. The option granted in paragraph (a) of this section to charge intangible drilling and development costs to expense may be exercised by claiming

3/ In addition to these deductions, appellants claimed $16,052.28 in itemized deductions (Resp. Br., Ex. B).

> intangible drilling and development costs as a deduction on the taxpayer's return for the first taxable year in which the taxpayer pays or incurs such costs; no formal statement is necessary. If- the taxpayer fails to deduct such costs as expenses in such return, he shall be deemed to have elected to recover such costs through depletion to the extent that they are not represented by physical property, and through depreciation to the extent that they are represented by physical property.

Appellants clearly claimed the subject intangible drilling costs as deductions on their tax return, (See Resp. Br,, Ex. A, line 18c; Ex. C.) Accordingly, appellants elected to take those deductions in 1979 in compliance with Treasury Regulation section 1.612.4(d) rather than to capitalize such expenditures. Moreover, Treasury Regulation section 1.612-4(e) provides that any such "election shall be binding upon the taxpayer for the first taxable year for which it is effective and for all subsequent taxable years." Accordingly, appellants' election to deduct the subject intangible drilling *costs* in 1979 is binding upon them and there is no basis now to change what they have done for tax preference purposes. In addition, with respect to the remaining identifiable itemized deductions claimed, appellants submit a very general theory to the effect that, at this time, they should be allowed to adjust certain unspecified deductions which they claimed on their 1979 tax return filed on April 1, 1980, in order to minimize their tax on tax preference items. Suffice it to say, in this proceeding, and in the absence of special allegations, or an amended' return, we must conclude that appellants either have failed to raise the tax question in a timely manner, or have failed to carry their burden of proof. (See also our discussion of "trial and error" computations, supra.)

For this reason set forth above, we hold that appellants' dispute with our determinatian is without merit.

The basis of respondent's dispute with our determination is also straightforward, Respondent contends we have made a computational error by using

$129,724.17 for items of partnership losses rather than $110,741.06 as it had done. This resulted in our computation having a larger negative adjusted gross income and, therefore, a larger net business loss than it had computed. After further reflection, it is clear that respondent's computation, rather than ours, is statutorily correct. As indicated in our determination, section 17062, in effect during the year at issue, provides that the tax on tax preference items is imposed upon "the amount (if any) of the sum of the items of tax preference in excess of the amount of net business loss for the taxable year ...." In turn, the term "net business loss" is defined in section 17064.6 as "adjusted gross income (as defined in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net income is a loss." Relying upon the figures provided in appellants' return-for the year at issue, respondent correctly computed the following tax on tax preference items:

| | | |
|---|---|---|
| Total items of tax preference | | $129,924.17 |
| Less net business loss: | | |
| Adjusted gross income on return | (46,387.36) | |
| Less section 17252 expenses | 16,053.38 | |
| | | (62,440.74) |
| Total tax preference income | | 67,483.43 |
| Less statutory exemption | | 8,000.00 |
| Taxable tax preference income as revised | | $59,483.43 |

As a result, respondent is correct and our opinion and order of September 12, 1984, must be so modified.

Appeal of William J. and Marian P. McBride

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HERESY 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 J. and Marian P. McBride against a proposed assessment of additional personal income tax in the amount of $2,447 for the year 1979, be and the same is hereby sustained. Our order of September 12, 1484, is hereby modified accordingly.

Good cause appearing therefor, it is hereby ordered that the two full paragraphs beginning on page four of the original opinion, beginning with the words, "The record on appeal,". be and the same are hereby deleted and the following be substituted:

> The record on appeal indicates that appellants received gross income of $64,509.69 in 1979. Appellants' proper adjusted gross income would be a negative $46,387.37 (gross income of $64,509.69 less partnership losses of $110,741.06 and. other losses of $156). Reducing adjusted gross income (i.e., negative $46,387.37) by the deductions allowed by section 17252 (i.e., $16,053.38) results in a net business loss of $62,440.75. (See Rev. & Tax. Code, § 17064.6.) The $126,950.44 difference between appellants' gross income and the net business loss represents the sum of three separate categories of deductions: (1) deductions, other than those which constitute items of tax preference, allowed by section 17202 in computing adjusted grass income--$156; (2) "the deductions allowed by section 17252 (relating to expenses for production of income"--agreed as being $16,053.38; and (3) the items of tax preference--$110,741.06. Since there is no advantage, under California law,. associated with a negative adjusted gross income, the portion of appellants' items of tax preference equal to their net business. loss produce no tax benefit. Pursuant to sections 17062 and 17064.6, the first two categories reduced appellants' gross income by $16,209.38, while the items in the last

category reduced appellants' gross income by an additional $110,741.06, resulting in a net business loss of $62,440.75. Therefore, appellants are entitled to offset that amount (i.e., $62,440.75), their "net business loss," against their items of tax preference (i.e., $129,924.17) in computing the tax imposed by section 17062 upon the amount of tax preference income in excess of net business loss (i.e., $67,483.43). Clearly to this extent, but only to this extent, appellants have received an actual tax benefit and the tax on preference income should be imposed.

Accordingly, respondent's action in this matter must be affirmed.

Done at Sacramento, California, this 19th day of November, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9