85-SBE-050

BEFORE. THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNXA

In the Matter of the Appeal of)
)
FRANK V. AND GERTRUDE AMARAL)

For Appellants: Donald F. Linsteadt
Certified Public Accountant

For Respondent: James C. Stewart
Counsel

O P I N I O N

'This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Frank V. and Gertrude Amaral against proposed assessments of additional personal income tax in the amounts of **$5,039.02, $1,214.68,** and **$1,534.06** for the years 1977, 1978, and 1979, respectively.

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

Appeal of Frank V. and Gertrude Amaral

The issues for determination are (1) whether appellants have demonstrated that they are entitled to a claimed demolition loss for the removal of fencing in 1977, and (2) whether appellants have demonstrated that they are entitled to claimed deductions for costs of a land survey in 1978 and 1979.

FENCING

On September 29, 1976, Frank V. Amaral (hereinafter "appellant") acquired a 669 acre dairy farm for a bid of $505,000 at a court probate sale. The farm, near Gustine, California, included land, houses, barns, and fences. The existing farm tenant, who-was operating a Grade B dairy, had the right to use the property through February 1977. The tenant had been paying an annual rent of $27,000 for the use of the farm,

Immediately after acquiring the property, appellants offered to renew the lease of the property to the existing tenant at an annual rent of $50,000. The tenant was willing to continue leasing at $27,000, but he refused appellants' $50,000 offer, and vacated the property at the end of February 1977.

Appellants had been advised that part of the land was sour and not good for anything. Shortly after acquiring the property, appellants employed an engineering firm to survey the land and prepare a plan for a subsurface drainage system to rid the land of sour spots. Over 100 holes were drilled and soil samples taken to develop the drainage plan, which was completed on December 27, 1976. After the tenant vacated at the end of February 1977, appellants removed all the fencing in order to complete the tile drainage system. After that system was installed, appellants rented the property to appellant's corporation to raise row crops.

On appellants' 1977 tax return, appellants reported that the farm had been acquired on January 1, 1977, that houses and barns on the property cost $98,000, and the fences around the property cost $75,000. Depreciation of $3,125 was taken on the fences, and the balance of the cost of the fencing was claimed as an abandonment loss.

Based upon the Merced County Assessor's estimated allocation ratio (.0442) of improvements to total assessed value of the property, respondent adjusted the basis of the fencing from $75,000 to $22,321, and after

allowing $930 in depreciation, disallowed $50,484 of the claimed abandonment loss. After a proposed assessment was issued, appellant protested.

During the protest, appellant contended that his original allocation between improvements and land had been realistic and conservative. Appellant furnished a letter from the Merced County Assessor which stated that the fencing was not included in the assessor's estimated allocation of improvements. Appellant also contended that he purchased the land with the intent of having continued dairy operations. Appellant stated that he found that the farm could not be leased as it was for a reasonable return, and that it could not be improved to operate as a Grade A dairy without prohibitive cost.

In October 1974, appellant had purchased another dairy farm in Merced County, immediately discontinued dairy operations, and engaged his corporation.to raise row crops on that land. Neither appellant nor his corporation had any experience in dairy operations. Appellant, who lists his occupation as that of lumberman, owns a corporation mainly engaged in cutting timber. In the past, appellant has subdivided land and sold lots, and he owns timberland.

After the protest hearing, respondent withdrew the original proposed assessment and issued a revised proposed assessment disallowing all of the abandonment loss and most of the claimed depreciation deduction. Appellant protested the new proposed assessment. After considering the information submitted in appellants' protest, the proposed assessment was affirmed and appellant appealed.

Section 17206 provided in part: "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise." This section was patterned after section 165 of the Internal Revenue Code. Accordingly, interpretations of that section of the Internal Revenue Code are persuasive of the proper interpretation of section 17206. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941).) Treasury Regulation section 1.165-3 explains the application of section 165 to the demolition of buildings and contains the intention test. The regulation states that, with one exception not relevant to this appeal, no deduction will be allowed under section 165(a)

on account of the demolition of old buildings when in the course of a trade or business or in a transaction entered into for profit the real property upon which the buildings were situated was purchased with the intention of demolishing those buildings.

The principles applicable to the demolition of buildings are suitable for questions involving the demolition of fencing. The regulation explains that the loss will be allowed under section 165, when the intention to demolish the property was formed after acquisition. Whether the real property was purchased with the intention of demolishing the structures or whether the demolition of the structures occurred as the result of a plan formed later is a question of fact. The *answer* to that question cannot be the result of an inference drawn from one fact or circumstance, but must be a result of a consideration of all relevant facts and circumstances. The regulation lists five different examples of facts and circumstances which might suggest that the intention to demolish existed at the time of acquisition, The four apparently relevant to this case are:

> (i) A short delay between the date of acquisition and the date of demolition;
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> (ii) Evidence of prohibitive remodeling costs determined at the time of acquisition;
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> * * *
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> (iv) Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or
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> (v) Inability at the time of acquisition to realize a reasonable income from the buildings.

(Treas. Reg. § 1.165-3(c)(2).)

In this case: (i) the fences were removed shortly after the land was acquired and the hold-over tenant had vacated; (ii) the appellant stated that prohibitive costs would have been incurred in upgrading the dairy operation from Grade B to Grade A status; (iii) the existing fencing and soil conditions were incompatible with a row crop operation; and (iv) appellant was unable to find a dairy operator who would pay a rent appellant

felt was a reasonable amount in relation to his investment.

The regulation lists ten different facts or circumstances which might suggest that the intention to demolish was formed after acquisition of the property. The only one apparently relevant to this *case* is: "(vii) Discovery of latent structural defects in the buildings after their acquisition; . . ." (Treas. Reg. § 1-165-3(c) (2).) Appellant states that he discovered the sour nature of the land after the hold-over tenant had vacated, Respondent has suggested, however, that it is unreasonable to believe that any person would bid $505,000 for such agricultural property without having assured themselves of a fair knowledge of the nature and conditions of the property beforehand. Additionally, we note that appellant's previous experience had been in lumbering and row crop operations, and that a dairy operation he had acquired earlier had been immediately converted to a row crop operation.

From all these facts, we can only conclude that appellants stated expectation of renting out the property in the dairy configuration while waiting for the land to appreciate is outweighed by other, objective facts and circumstances which indicate that the land was purchased with the intention of adapting the land to row crops, which necessitated demolishing the fences. Accordingly, we must conclude that appellant has not demonstrated that he is entitled to the disallowed fencing deduction.

SURVEY

Appellants owned several large tracts of Nevada County timber land, which had been surveyed for title purposes and had its boundaries established before appellants@ purchase. Because of the passage of time and the nature of the area, the boundaries of the land were no longer marked clearly. The U.S. Forest Service intended to harvest timber on its land which adjoined appellants* land. En order that appellants* timber not be harvested by mistake, appellants agreed with the Forest Service that their boundaries should be surveyed and clearly marked. The Forest Service agreed to reimburse the appellants for 40 percent of the cost. Part of the survey was completed in 1978, and appellants paid the survey cost of $11,840. The balance of the survey was completed in 1949, and appellants paid the surveyor $13,944. In 1980, the Forest Service reimbursed appellants $10,107.

On appellants' tax returns for 1978 and 1979, they deducted surveying costs in connection with the survey of timber land in the amounts of $11,840 and $13,944, respectively. In 1980, the taxpayer included in income reimbursement of $10,107, the Forest Service's share of the survey costs.

On audit, respondent determined that the useful life of the survey extended beyond the year of the survey and concluded that the survey costs must be capitalized. Therefore, proposed assessments were issued which were protested by appellants.

Appellants' position is that surveying and remarking the boundaries of forest land of the type owned by appellants is a recurring expense. Appellants rely on Brier Hill Collieries v. Commissioner, 12 B.T.A. 500 (1928), as authority supporting their position that surveys are deductible when they are not incurred for the purpose of establishing or defending title to property.

Section 17283, which was concerned with which items are and are not deductible expenses, stated in pertinent part: "No deduction shall be allowed for -- (a) Any amount paid out for . . . permanent improvements or betterments made to increase the value of any property . . . ." That section was similar to section 263(a) of the Internal Revenue Code, so interpretations of section 263(a) are persuasive as to the interpretation of section 17283. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941).)

The distinction between capital expenditures and deductible business expenses is generally found in differences between the extent and permanency of the benefit derived from the outlay. (Louisiana Land & Exploration Co. v. Commissioner, 7 T.C. 507 (1946).) The benefit from a business expense is generally realized and exhausted within a year, and the expense is often said to be recurring in nature, But an expenditure is of a capital nature where it results in the taxpayer's acquisition or retention of a capital asset, or in the improvement or development of a capital asset in such a way that the benefit of the expenditure is enjoyed over a comparatively lengthy period of time.

Thus, costs of development, such as plat mapping and subdividing a tract of land held for sale, must be capitalized and treated as an adjustment of the

taxpayer's basis for that property. (Louisiana Land & Exploration Co. v. Commissioner, supra.) Similarly, costs incurred to protect, defend, or correct title to real property are considered a part of the cost of that property and must be capitalized rather than expensed, (Vincent Johnson v. Commissioner, ¶ 55,247 T.C.M. (P-H) (1955).) The rationale is that such activities generally benefit-the owner of the property for a number of years, perhaps as long or longer than the time the property is owned by the person who incurred those expenses,

In this appeal; appellant relies on Brier Hill Collieries, supra, which held that certain resurveying and marking expenses incurred by the owner were properly deductible. In Brier Hill, the taxpayer owned a large acreage of wild, mountainous Tennessee land of difficult access. The land, which bore timber an3 bituminous coal deposits, had been surveyed a long time before 1918, but the marks had since been obliterated. In 1918 and 1919, the taxpayer had that land resurveyed and its boundaries remarked in order to prevent the loss of land by adverse possession. Under Tennessee law, adverse possession under color of title for seven years passed title. The Commissioner of Internal Revenue disallowed deductions for the costs of resurveying and remarking on the basis that they were costs of defending title to the property. Without analysis the Board of Tax Appeals concluded simply that those costs were not costs of defending title but were ordinary and necessary expenses incurred in protecting the taxpayer's property and so were deductible expenses.

In this appeal, the purpose of the resurvey and remarking was to protect the timber on that land from future harvest by government contractors working adjacent government land. There is no evidence that those survey markers might soon be obliterated or that the survey protection from government timber contractors is only a short-term necessity. Accordingly, we cannot conclude that these survey costs are properly considered to be recurring. So these survey costs may not be deducted and can only be capitalized.

For the reasons set forth above, respondent's action will be sustained.

Appeal of Frank V. and Gertrude Amaral

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 Frank V. and Gertrude Amaral against proposed assessments of additional personal income tax in the amounts of $5,039.02, $1,214.68, and $1,534.06 for the years 1977, 1978, and 1979, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 25th day of June, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

William M. Bennett, Member

Richard Nevins, Member

____________________, Member