BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HOWARD E. AND KAREN R. FOSTER)

For Appellants: Howard E. Foster,
in pro. per.

For Respondent: Eric J. Coffill
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 Howard E. and Karen R. Foster against proposed assessments of additional personal income tax in the amounts of $1,227.40, $1,129.00, and $1,920.04 for the years 1978, 1979, and 1980, 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.

The question presented for decision is whether appellants are entitled to deduct various losses incurred by appellants' purchase of a sculpture moid for the work "Here Lies Crazy Horse" and the right to produce 25 sculpture pieces therefrom.

Appellant[2/] is an investment counselor by profession. On December 20, 1978, he purchased from artist Fritz White for a total purchase price of $49,100 *a mold to be used for the casting of an original issue of sculpture known as 'Here Lies Crazy Horse' . . . ." (Resp. Br., Ex. K.) The purchase price was payable $5,401 in cash upon closing and the remaining $43,699 by the execution of a seven-year nonrecourse promissory note bearing interest at the rate of six percent per year. The principal and interest of such note were to be payable only out of the gross revenues realized by appellant from the sale of sculptures produced from the mold and the only security for such note was a first lien upon the mold itself. The purchase agreement also provided that appellant could utilize the mold for the production of not more than 25 pieces of sculpture.

At the same time as he entered into the purchase agreement, appellant also entered into a management agreement with Griffin Gallery, Ltd. of Denver, Colorado, for the production and sale of pieces of sculpture to be produced from the mold. (Resp. Br., Ex. L.) The agreement provided that appellant agreed to employ the gallery, which was purportedly in the business of arranging for the production and sale of original sculptures, to "utilize its best efforts to arrange for and supervise the production of the Sculpture and to sell at wholesale or retail the Sculpture." (Resp. Br., Ex. L.) Furthermore, the agreement provided that the pieces were to be offered for sale at wholesale for not less than $2,000 per piece and at retail for not less than $3,000 per piece. Appellant was also required to pay the gallery $510 for the production of one piece of the sculpture, which was to be delivered to and held by the gallery to facilitate the sale of the sculpture.

2/ Karen Foster is a party to this appeal only because she filed a joint return with her husband Howard. Accordingly, all references to "appellant" are to appellant Howard E. Foster.

Appellant was also furnished with a memorandum dated October 1, 1978, which summarized the investment potential surrounding the purchase of the mold, (Resp. Br., Ex. M.) That memorandum noted that Fritz White, the creator of the sculpture, was a well-known western sculptor and a member of the Cowboy Artists of America. In order to generate working capital, the memorandum indicated, White had agreed to sell molds of his issues to investors, such as appellant, who would assume financial responsibility for casting and marketing the sculptures. The memorandum stated that such purchase by investors would "(i) furnish them with a favorable investment return, (ii) involve them in the collecting of fine art and (iii) provide unique tax shelter benefits." (Resp. Br., Ex. M.) Indeed, these tax shelter benefits were deemed to be so "unique" that a chart outlining the tax effect of various projected sales for an investor in the SO--percent bracket was attached to the memorandum. (Resp. Br., Ex. N.) Not only did the gallery fail to sell any sculptures during the years at issue, but as of December 1983, no sculpture had been sold, (Resp. Br., Ex. P.)

On his income tax returns for 1978, 1979, and 1980, appellant claimed business losses of $10,952.85, $11,044.90, and $8,042.76, respectively, arising from the purchase of the sculpture mold, Specifically, appellant claimed depreciation deductions of $10,442.85,[3] $11,044.90, and $7,889.20 for 1978, 1979, and 1980, respectively, calculated by using a basis in the mold of $49,100, the double declining balance method of depreciation and a seven-year useful life. In addition, appellant claimed casting costs of $510 in 1978 and an operating expense of $153.56 in 1980, Upon audit, respondent disallowed all the claimed'losses. Respondent contends that appellant is not entitled to deduct the losses because (1) no depreciation can be taken on the portion of the sculpture mold's basis represented by the nonrecourse liability since that liability did not represent an actual investment in the property, (2) the other deductions claimed and the cost basis reflected by the cash payment are precluded from being deducted by section 17233 since the activity relating to the sculpture mold was not one engaged in for profit and (3) to the extent any depreciation is found to be allowable, the amount of

3/ The figure includes $4,000 of additional first-year depreciation allowed by section 17213.

depreciation for the taxable year 1978 was calculated improperly. 4/

We will deal first with the issue concerning the nonrecourse note. The basis for depreciable property is its cost. (Rev. & Tax. Code, §§ 17211, 18041, 18042.) Generally, the cost of property includes the amount of a liability assumed by the buyer. (Crane v. Commissioner, 331 U.S. 1 [91 L.Ed. 1301] (1947).) A nonrecourse note can be included in the cost basis of an asset even if the liability is secured only by the asset transferred. (Mayerson v. Commissioner, 47 T.C. 340 (1966).) However, depreciation must be based on an actual investment in property to be deductible. (Narver v. Commissioner, 75

4/ Respondent contends that this appeal concerns an "abusive tax shelter." The term "tax shelter" has recently been defined by the Internal Revenue Service as an investment which has as a significant or intended feature for federal income or excise tax purposes either (i) deductions in excess of income from the investment being available in any year to reduce income from other sources in that year, or (ii) credits in excess of the tax attributable to the income from the investment being available in any year to offset taxes on income from other sources in that year. ("Guidelines for Providing Opinions on Tax Shelter Offerings," Treasury Department Final Regulations, 31 CFR, Part 10.33 (pub. in Federal Register Feb. 23, 1984; CCH Standard Federal Tax Reports, No. 10, Extra Edition, Feb. 23, 19.84.) Internal Revenue Service Commissioner Roscoe L. Egger, has outlined the distinction between abusive and nonabusive tax shelters as follows:

> Nonabusive tax shelters involve transactions with legitimate economic reality, where the economic benefits outweigh the tax benefits. Such shelters seek to deter or minimize taxes.
>
> Abusive tax shelters involve- transactions with little or no economic reality, inflated appraisals, unrealistic allocations, etc., where the claimed tax benefits are disproportionate to the economic benefits. Such shelters typically seek to evade taxes.

(Egger, Warning: Abusive Tax Shelters Can be Hazardous, 68 A.B.A. J. 1674, 1674 (1982).)

T.C. 53 (1980), affd. per curiam, 670 F.2d 855 (9th Cir. 1982).) Accordingly, the determinative factual question is whether appellant acquired an interest in the sculpture mold sufficient to allow him to take depreciation deductions for the basis reflected by the subject note. This, of course, is essentially a question of substance versus form. As the Supreme Court stated in Helvering v. F. & R. Lazarus & Co., 308 U.S. 252, 255 (84 L.Ed. 226) (1939), "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." As indicated above, depreciation is based OR actual investment in the property. Accordingly, in essence, we must determine whether appellant may treat the subject nonrecourse liability as a bona fide debt. There are various approaches which may be *taken* in answering this question. (Fox v. Commissioner, 80 T.C. 972 (1983).)

One approach, originating in Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975), indicates that where the stated purchase price of the property securing the note exceeds a reasonable estimate of the property's existing fair market value, no actual investment exists as to the excess since the purchaser would be acquiring no equity in the property by making payments and therefore would have no economic incentive to pay off the note. (See also Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1984).) An alternate test in this line of cases holds that when the principal amount of the note exceeds the value of the property, the debt will not be recognized. (Hager v. Commissioner, 76 T.C. 759, 773-774 (1981).) Since, as indicated below, both the purchase price and the principal amount of the nonrecourse debt unreasonably exceed the fair market value of the sculpture mold package, we do not decide which test is appropriate on the facts of this appeal. (See discussion in Odend'hal v. Commissioner, 80 T.C. 588, 604 *n.* 7 (1983); Fox v. Commissioner, supra, 80 T.C. at 1019 n. 21; accord, Appeal of Harold and Joyce E. Wilson, Cal. St. Bd. of Equal., Sept. 15, 1983.)

The evidence submitted by appellant to value the sculpture mold package consisted only of his own statements of value "[b]ased on discussions with people in the art field" (Resp. Br., Ex. R) and based upon retail prices "determined by Griffin Gallery based on historical information on the actual selling prices of other pieces of sculpture produced by Fritz White."

(Resp. Br., Ex. P.) No formal appraisal of the subject sculpture mold package had ever been made. Indeed, it may well be that the market value of an object of art such as "Here. Lies Crazy Horse" is too speculative for precise valuation. Accordingly, under either the purchase price test or the principal amount of the note test, we would find that appellant has failed'to carry his burden of proving that he had an actual investment in the nonrecourse note. (Appeal of Harold and Joyce E. Wilson, supra.)

Another line of cases more closely addresses the problem of bona fide loans where the sole security for such loans is a speculative asset with an undeterminable value at the time of purchase. This line of decisions holds that highly contingent or speculative obligations are not recognized for tax purposes until the uncertainty surrounding them is resolved. (CRC Corp. v. Commissioner, 693 F.2d 281 (3rd Cir. 1982), revg. on other grounds, Brountas v. Commissioner, 73 T.C. 491 (1979); Denver & Rio Grande Western R.R. Co. v. United States, 505 F.2d 1266 (Ct.Cl. 1974); Lemery v. Commissioner, 52 T.C. 367, 377-378 (1969), affd. on another issue, 451 F.2d 173 (9th Cir. 1971); Inter-City Television Film Corp. v. Commissioner, 43 T.C. 270, 287 (1964).) For example, in Lemery, the tax court held that an obligation to pay $444,335.17 of the $1,131,000 stated purchase price of a business only out of future "net profits" was too contingent to be included in the buyer's amortizeable basis. Also, in Denver & Rio Grande Western R.R. Co., the court of claims refused to allow the taxpayer to include in its basis an obligation to repay customer advances payable only out of the taxpayer's revenues from shipping above a certain annual tonnage during each of the following'ten years. Similarly, in Inter-City Television Film Corp., the tax court stated that a $1,250,000 obligation to a seller of certain television and movie exhibition rights, payable only out of various percentages of gross receipts in excess of $2,400,000, was not part of the buyer's cost basis in such rights. (See also Reali v. Commissioner, ¶ 84,427 T.C.M. (P-H) (1984).)

In the instant appeal, we find the nonrecourse note given by appellant to be at least as contingent as the notes given in CRC Corp., Inter-City Television Film Corp. and Lemery. Despite a feeble attempt by appellant to put a value on the sculpture mold, we think that like the publishing rights acquired in Fox v. Commissioner, supra, this is a case where no objective

fair market value was determinable for the sculpture mold as of the date of purchase.5/ We have noted above the disappointing sales of completed sculptures. Indeed, during the years at issue, none had been sold either at the retail or wholesale level. As repayment of the note and interest was to be made only out of gross sales of completed sculptures, to say that the subject nonrecourse note secured by the sculpture mold was 'contingent and speculative" is a major understatement. Accordingly, we hold that the subject nonrecourse note cannot be recognized for depreciation purposes.

The next question is whether appellant is entitled to deduct depreciation attributable to the cash paid for the sculpture mold, together with the casting costs of $510 in 1978 and an operating expense of $153.56 in 1980. It is respondent's position that appellant did not engage in this activity with the intention of making a profit. Accordingly, respondent argues that appellant is entitled to deduct expenses only to the extent allowable under section 17233.6/

Section 17233 provides, in relevant part, that if an individual's activity is "not engaged in for profit," only those deductions allowable regardless of a profit objective (e.g., taxes or interest) may be allowed.7/

5/ As indicated in Fox v. Commissioner, supra, 80 T.C. at 1020, the two lines of cases (i.e., Estate of Franklin and CRC Corp.) are not so much competing as they are complementary.

6/ It is interesting to note that some recent tax court cases have held that the 'for profit" issue can be entirely dispositive in disallowing all deductions for abusive tax shelter cases. (Jaros v. Commissioner, ¶ 85,031 T.C.M. (P-B) (1985).)

7/ As we stated in Appeal of Harold and Joyce E. Wilson, supra, depreciation must also run the section 17233 gauntlet. Section 17208 allows a depreciation deduction for property used in a trade or business, or property held for the production of income. Appellant deducted depreciation as an expense incurred in a trade or business. The words "trade or business@ for depreciation purposes in section 17208 have been interpreted in a manner consistent with the words @trade or business" expenses as used in section 17202. (Brannen v. Commissioner, 78 T.C. 471, 501 n. 7 (1982).) The test for determining

Accordingly, the disputed deductions noted above are allowable only if appellant had an actua-1 and good faith profit objective for engaging in those activities. (Appeal of Paul J. and Rosemary Henneberry, Cal. St. Bd. of Equal., May 21, 1980; Appeal of F. Seth and Lee J. Brown, Cal. St. Bd. of Equal., Aug. 16, 1979.) The taxpayer's expectation of profit need not be a reasonable one, but there must be a good faith objective.of making a profit. (Allen v. Commissioner, 72 T.C. 28 (1979).) Of course, whether the activities were engaged in primarily for such profit-seeking motives is a question of fact upon which the taxpayer has the burden of proof, (Appeal of Guy E. and Dorothy Hatfield, Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of Clifford R. and Jean G. Barbee, Cal. St. Bd. of Equal., Dec. 15, 1976.) Greater weight is to be given to objective facts rather than to the taxpayer's mere statements of his intent. (Jaros v. Commissioner, supra.) The regulations 8/ provide a fist of factors relevant in determininu whether a taxpayer has the requisite profit motive. While all facts and circumstances with respect to the activity are to be taken into account, no one factor is controlling in making this determination. (Treas. Reg. § 1.183-2(b).)

Among the factors which normally should be taken into consideration are the following: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity; (7) the amount of occasional profits, if any, which are earned;- (8) the financial status of the taxpayer; and (9) the elements of personal pleasure or recreation.

7/ (Continued)
whether an individual is carrying on a trade or business is whether the individual's primary purpose and intention in engaging in the activity is to make a profit.

8/ As section 17233 conforms to Internal Revenue Code section 183 and since there are now no regulations of the Franchise Tax Board in this area, the regulations under section 183 of the Internal Revenue Code govern the interpretation of section 17233. (Cal. Admin. Code, tit. 18, reg. 19253.)

In his January 26, 1983, appeal to this board, appellant has maintained that his activities surrounding the mold were engaged in for profit. However, the only support for his position is the statements made in that appeal in which he stated that since 1978, Griffin Gallery had expended considerable time, effort and expense in the promotion and marketing of Fritz White sculptures. However, after an extensive examination of the record, it is clear to us that, in fact, his activities were not engaged in for profit.

Appellant has made no showing that the sculpture activity was carried on in a businesslike manner. In spite of the fact that no revenues were realized, no changes of operating methods, adoption of new techniques. or abandonment of unprofitable methods indicative of an intent to improve profitability were instituted. (Treas. Reg. § 1.183-2(b)(1).) Moreover, the record does not indicate that appellant possessed any expertise in art and no evidence has been offered that would establish that his advisors, Griffin Gallery, possessed the requisite expertise. (Treas. Reg. § 1.183-2(b)(2).) In addition, there has been no showing that either appellant or Griffin Gallery expended any significant time or effort in promoting the sculpture activity. (Treas. Reg. § 1.183-2(b)(3).) Accordingly, in light of the fact that no sales of the sculpture had been made from 1978 through 1983 and because of the potential tax benefits envisioned by appellant (Flowers v. Commissioner, 80 T.C. 914 (1983)), the conclusion is unescapable that this venture was not entered into for profit.

Consequently, respondent's action must be sustained. Because of our disposition of the first two issues raised by respondent, it is unnecessary to discuss the third issue raised.

Appeal of Howard E. and Karen R. Foster

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 a-nd Taxation Code, that the action of the Franchise Tax Board on the protest of Howard E. and Karen R. Foster against proposed assessments of additional personal income tax in the amounts of $1,227.40, $1,129.00, and $1,920.04 for the years 1978, 1979, and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 25th day of June , 1985, by the Stake 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