85-SBE-062

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OP CALIFORNIA

In the Matter of the Appeal of)
)
RICHARD A. KLOOS)

For Appellant: Richard A. Kloos, in pro. per.

For Respondent: Mary E. Olden Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Richard A. Kloos for refund of personal income tax in the amount of $169 for the year 1980.

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

The issue presented for our decision is whether appellant has shown that he was entitled to deduct a loss from his failure to exercise an option to buy residential property.

On November 1, 1979, appellant and his spouse executed a written lease agreement to rent a newly constructed residence in San Diego, California. Under the contract, the couple agreed to lease the residence for a one-year term beginning November 15, 1979, at a cost of $900 per month. In addition, pursuant to a lease rider, they paid $5,000 for an option to purchase the residence at any time during the lease term at a selling price of $150,000.

In the event that the option was exercised and the purchase transaction completed, the lease stipulated that'the purchase price of the option was applicable towards the sales price as a down payment. On the other hand, it was agreed that if the option was allowed to lapse upon the termination of the lease, the option cost was subject to forfeiture.

For the year 1980, appellant filed a -joint California income tax return with his spouse in which they claimed a renter's credit. On their schedule H, they declared that, on March 1, 1980, they lived in rented property in California which was their principal residence. For the address of this principal residence, appellant and his spouse gave the address of the San Diego home.

Two and one-half years later, in September 1983, appellant filed an amended return for 1980, requesting a tax refund. The alleged overpayment resulted from a newly claimed loss deduction of $5,000 from the lapse of the option to purchase the home. Respondent disallowed the deduction as a nondeductible personal loss and denied the refund claim. Appellant has appealed to this board for relief from respondent's action on its claim for refund.

In general, section 17206, subdivision (a), authorizes a deduction for any loss sustained during the taxable year which is not otherwise compensated for by insurance. In the case of an individual taxpayer, the deduction is limited to (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade-or business; and (3) certain casualty and theft losses in excess of $100. (Rev. & Tax. Code, § 17206, subd. (c).)

Similar provisions are found under federal law. (I.R.C. § 165(a) and (c).)

It is well settled that deductions are a matter of legislative grace, and the burden is on the taxpayer to show that he is entitled to the deduction claimed. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of James C. and Monablanche A. Walshe, Cal. St. Bd. of Equal., Oct. 20, 1975.) In support of the deductibility of his claimed loss, appellant contends in this appeal that he had only a profit motive in acquiring the option to purchase the residence. Appellant states that, at the time of the lease/option agreement, he was led to believe that the house would be worth substantially more in a year's time when construction of the whole residential project was completed. He claims that he intended to buy the home at that time and immediately sell it for a profit. Appellant explains that he and his wife did not plan on living in the residence but did so for the year- only because they could not afford to cover the negative cash flow from subletting the place. Finally, appellant states that he allowed the option to lapse in 1980 when it became apparent to him that the remaining planned development was not forthcoming and his own financial resources would not permit him to purchase the house at the agreed-upon sales price. Thus, it is appellant's position that the resultant loss from the lapsed option should be deductible as a loss from a transaction entered into for profit.

A loss attributable to the failure to exercise am option to buy property is considered to be a loss from the sale or exchange of property having the same character, in the hands of the taxpayer, as the property to which the option relates would have had if acquired by him. (Rev. & Tax. Code, § 18191, subd. (a); I.R.C. § 1234 (a)(1).) The option is deemed to have been sold or exchanged on the date of its expiration. (Rev. & Tax. Code, § 18191, subd. (b); I.R.C. § 1234(a)(2).) Thus, in determining the nature of such a loss, the acquisition and subsequent lapse of the option must be treated as a purchase and sale of the underlying property to which the option relates. (Appeal of Jerrold and Alayne Pressman, Cal. St. Bd. of Equal., Oct. 18, 1977; Spindler v. Commissioner, ¶ 63,202 T.C.M. (P-H) (1963).) In the instant appeal, appellant's loss from the lapsed option to purchase the San Diego residence must, therefore, be viewed as a loss from the sale of the residence.

Federal regulations, however, clearly provide that a loss sustained on the sale of residential property which was purchased by the taxpayer for his personal residence and used by him as such until the time of sale is not deductible. (Treas. Reg. § 1.165-9(a).) Because the record in the present appeal shows that appellant leased the San Diego residence and lived there until the lease and option expired, his claimed loss from its disposition will be disallowed unless he can prove his contention that the property was acquired for purposes of profit. (See Treas. Reg. § 1.1234-1(f) and (g)(2).)

Whether a particular transaction was entered into for profit is a question of fact on which the taxpayer bears the burden of proving that his primary intention was to make a profit. (Appeal of Clifford R. and Jean G. Barbee, Cal. St. Bd. of Equal., Dec. 15, 1976; Appeal of J. Perry and Sybil N. Yates, Cal. St. Bd. of Equal., Feb. 6, 1973; Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962), affg. 35 T.C. 221 (1960).) The taxpayer's expressions of intent, while relevant, are not controlling; rather, the taxpayer's motives must be discerned from all of the circumstances in the particular case. (Johnson, Jr. v. Commissioner, 59 T.C. 791 (1973); Appeal of Clifford R. and Jean G. Barbee, supra.) The primary focus in this inquiry is on the character of the property itself and the true. substance of the overall transaction. (Willis v. Commissioner, 736 F.2d 134 (4th Cir. 1984), revg. ¶ 83,180 T.C.M. (P-H) (1983).)

Here, we find that appellant has failed to show that he entered into the lease/option transaction to purchase the subject property with primarily a profit motive. That appellant acquired property that was residential in character, immediately occupied it, and continued to use it as his personal residence raises a strong presumption that the property-was acquired for use as a residence. (See Wilkes v. Commissioner, 17 T.C. 865 (1951).) Appellant's declaration that he planned to sell the house for a profit does not prove that his primary motive when he "purchased" the residence was profit-oriented, for the expectation of most home buyers is to realize a profit upon resale of their personal residence. (Meyer v. Commissioner, 34 T.C. 528 (1960); Kaczmarek v. Commissioner, ¶ 75,358 T.C.M. (P-H) (1975).)

Moreover, appellant's assertion that he did not plan on living in the house presumably means that he intended to sublet it. There were certainly no contractual restrictions in the lease against subletting the

residence. (Resp. Br., Ex. B.) Thus, it would appear that appellant had the opportunity during the course of his tenancy to convert the residence into a profit-making use. (See Treas. Reg. § 1.165-9(b); Xix v. Commissioner, ¶ 79,105 T.C.M. (P-H) (1979).) In response, appellant laments that he could not afford to sublet the house or to exercise the option to purchase it, "Taxation deals not with what was attempted to be done but with what was done." (Jeffries v. Commissioner, 158 F.2d 225, 226 (5th Cir. 1946), affg. 5 T.C. 1338 (1945).) Based on what he did, we cannot find that appellant's primary intention was to make a profit when he entered into the transaction in question. Accordingly, respondent's disallowance of the claimed loss deduction must be sustained.

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Richard **A.** Kloos for refund of personal income tax in the amount of $169 for the year 1980, 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.