BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

in the **Matter** of the Appeal of	)	
	)	No. **82A-1222**
HARRY AND ELEANOR H. **GONICK**	)	

For Appellants: Harry **Gonick**
Attorney at Law

For Respondent: David Lew
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 Harry and Eleanor H. **Gonick** against a proposed assessment of additional personal income tax in the amount of $1,045 for the year 1978.

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 on appeal is whether appellants may properly exclude investment interest expenses from their excess itemized deductions subject to the tax on preference income.

Appellants, husband and wife, filed a joint tax return for 1978. The return reflected itemized deductions in excess of $75,000 and capital gains in excess of $31,000. The majority of the itemized deductions were interest payments made by appellants. on two stock portfolio margin accounts and a mortgage on income-producing real property- While apparently conceding that a portion of their capital gains may have been subject to preference tax, appellants did not file a Form 540, schedule P, "Tax on Preference Income," because they assumed that their investment interest expenses were not subject to preference tax treatment.

Upon review of appellants' return, respondent determined that they should have reported the above-described items as being subject to the preference tax. Appellants were assessed accordingly and this appeal followed.

Sections 17062 and 17062.2 imposed an additional tax on taxpayers filing jointly whose sum of tax preference items in excess of any net business loss was over $8,000.

Section 17063, subdivision (a), described the item of tax preference relevant to this appeal as "[a]n amount equal to the excess itemized deductions for the taxable year (as determined under Section 17063.2)." Section 17063.2, subdivision (a), stated that:

> For purposes of subdivision (a) of Section 17063, the amount of excess itemized deductions for any taxable year is the amount by which the sum of the deductions for the taxable year other than--
>
> (1) Deductions allowable in arriving at ad'justed gross income,
>
> (2) The standard deduction provided by Section 17171,
>
> (3) The deduction for medical, dental, etc., expenses'provided by' Sections 17253 to 17258, inclusive, and

> (4 The deduction for casualty losses described in Section 17206(b)(3), exceeds 60 percent (but does not exceed 100 percent) of the taxpayer's adjusted gross income for the taxable year.

In the Appeal of Richard C. and Emily A. Biagi, decided by this board on May 4, 1976, we reviewed the legislative history of the federal and state items of tax preference and determined that the purpose of those legislative acts was to reduce the advantages derived from otherwise tax-free income and to insure that those receiving such preferences paid a share of the tax burden.

Appellants dispute the inclusion of investment expenses as an item of tax preference for a number of reasons. First, appellants argue that section 17252 is made applicable to the preference tax as an offset against preference tax items through section 17064.6. Section 17252 stated, in part, that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year -- (a) For the production or collection of income; ..." Since the expenses paid by appellants were necessary for the production of income, appellants contend that those expenses should be excluded from the items of tax preference.

As pointed out by respondent, section 17252's only effect on the preference tax is its role in section 17064.6's definition of "net business loss." (Rev. & Tax. Code, § 17064.6; see also Appeal of Harold A. and Doris C. Rockwell, Cal. St. Bd. of Equal., Mar. 30, 1981.) If there is no "net business loss," section 17252 has no bearing on preference tax items. Appellants admit that their investment income exceeded their expenses in producing that income and that no "net business loss" was realized. Accordingly, section 17252 has no bearing on this appeal.

Secondly, appellants argue that since their net investment income exceeds their investment interest expenses for the year in question, there is no "excess investment interest" to include as an item of preference. In support of this proposition, appellants cite section 17064 as controlling. Section 17064, subdivision (a), stated that for the purpose of section 17063, "excess investment interest" is that amount by which the invest-

ment interest expenses exceeded the net investment income for the taxable year.

Respondent correctly notes that appellants have based their argument on a statute which was not applicable to the appeal year. When enacted in 1971, section 17063, subdivision (a), included as an item of tax preference the "amount of excess investment interest . . . as determined under section 17064." (Stats. 1971, 1st Ex. Sess. 1971, ch. 1, § 16, p. 4901.) Section 17063, subdivision (g), enacted that same year, stated that "[s]ubdivision (a) of this section, relating to excess investment interest, shall apply only to taxable years beginning before January 1, 1972." (Emphasis added.) Subsequently, section 17063 was amended in 1977 to delete the original version of subdivision (a) and substitute the version in effect during the appeal year which defined the items of tax preference to include an "amount equal to the excess itemized deductions for the taxable year. (as determined under Section 17063.2)." (Stats. 1977, ch. 1079, § 17, p. 3304.) In essence, section 17063, subdivision (a), went from being a statute which listed one specific item subject to preference taxation (excess investment interest), to a statute which generally included all itemized deductions as being subject to the preference tax. Only a few select deductions were exempted. (Rev. & Tax. Code, § 17063.2.) Under the amended section 17063, subdivision (a), interest deductions, such as those in question before us, clearly became items of tax preference. As a result, section 17064 became surplusage under California's tax law and it was only by oversight that it remained in the Revenue and Taxation Code until 1983 when it was repealed without reference to another code section. (Stats. 1983, ch. 235, § 3, p. 646.)

It is essential to realize that deductions from income create items of tax preference. This is why one of the fundamental preference tax rules is that personal deductions used to arrive at taxable income may not be used to offset tax preference income. (Appeal of Harold A. and Doris C. Rockwell, supra.) Therefore, as appellants listed their investment interest expenses as personal deductions, and the expenses were not exempted from being an item of tax preference under section 17063.2, those same expenses are includible as an item subject to the tax on preference income.

Finally appellants make a number of constitutional arguments against the inclusion of interest expenses as a tax preference item and against the tax

itself. With respect to these contentions we defer to our well-established policy of abstention from deciding constitutional questions in appeals involving deficiency assessments. (Appeal of Martin S. Ryan, Cal. St. Bd. of Equal., Nov. 14, 1979.)

Consequently, despite appellants' arguments to the contrary, respondent has shown that appellants' investment interest expense deductions are items of tax preference. Accordingly, respondent's action in this matter will be sustained.

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 Harry and Eleanor H. Gonick against a proposed assessment of additional personal income tax in the amount of $1,045 for the year 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of September, 1985, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

Ernest J. Dronenburg, Jr., Chairman

Richard Nevins, Member

Walter Harvey*, Member

_____, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9