BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In **the** Matter of the Appeal of)
)
JOHN E. AND AMET Z. NEWLAND)

Appearances:

For Appellants: VerLyn N. Jensen
Attorney 'at Law

For Respondent: Paul J. Petrozzi
Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of John E. and Amet **Z.** Newland against proposed assessments of additional personal income tax in the amounts of $630. 11, $1, 120. 69, $1, 577. 83 and $1, 492. 13 for **the** years 1966, 1967, 1968 and 1969, respectively.

John and Amet Newland are both physicians practicing in Santa Ana. They own parcels of real property in various parts of southern California, and have appealed a decision of the Franchise Tax Board denying or reducing claimed deductions for depreciation and expenses on some of those parcels. Two issues are presented: First, whether a beach house owned by appellants is "property held for the production of income"; and second, whether respondent's determination of the bases of certain rental houses and orchards is correct.

I

In 1964 appellants bought a beach house in San Clemente **for** $60,000.~. The property is located approximately 35 miles from Santa Ana, where appellants maintain their permanent residence, and was purchased solely for personal use. During the next year appellants occupied the house only four nights, however, because they were out of the country during most of the summer and early fall. Appellants state that they realized this pattern of use would continue in the foreseeable future, and therefore decided in 1966 to put the property up for rent.

The beach house has one bedroom and one inside bath. Because of its limited size, appellants allegedly could not receive a sufficient return on their investment if the house were offered for rent as a permanent residence, and they decided instead to rent it to vacationers by the week. They listed it on that basis with two realty agencies, apparently asking $250.00 per week and $75.00 to $100.00 for weekends during season, and $150.00 per week during the off -season. They also claim to have advertised in newspapers in California, Utah, and Arizona, as well as nationally via the Riker Bulletin and the Professional Exchange. Respondent disagrees with this latter claim, and states that appellants advertised only in 1969 in a medical jourhal.

Appellants' efforts. to rent the property met with little success. The house is located on a bluff some distance from the beach, and is therefore undesirable to most vacationers. A garage adjacent to the house was rented in 1966 and again in 1968, but the house itself was rented oniy for a short time in 1969. Throughout

this period appellants continued to use the property occasionally for personal recreation. They allege that they stayed overnight in the house less than a dozen times, but the record does not disclose how often they spent the day at their beach property.

Appellants realized a total of $700.00 from rental of the beach property during the appeal years. On their California personal income tax returns for those years, they claimed a total of $20,252.88 in deductions for expenses and depreciation on the house. Respondent disallowed the deductions in full becauseit determined that the beach house was not held for the production of income. We have concluded that this determination was correct, and therefore sustain respondent's action.

Revenue and Taxation Code section 17252, subdivision (b), authorizes a deduction for ordinary and necessary expenses "[f]or the management, conservation, or maintenance of property held for the production of income;. .." Similarly, subdivision (a) of section 37208 authorizes "as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear" of such property. These deductions are not allowed, 'however, on property held primarily for the personal use and enjoyment of its owners. (Kanter v. United States, 31 Am. Fed. Tax R. 2d 73-973, aff'd, 33 Am. Fed. Tax R. 2d 74-534.) Appellants admit that the beach property was purchased solely for personal use, but maintain that it was converted to property held to produce income in 1966, when they decided to list it for rent. We disagree.

Appellants' position is that the test to determine whether there has been a conversion to income producing purposes is whether the property was offered for rent in a reasonable manner. Offers to rent, however, are not conclusive. In determining whether property formerly held for personal use has been converted to income producing purposes, "[t]he key question. .. is the purpose or intention of the taxpayer in light of all the facts and circumstances. " (Frank A. Newcornbe, 54 T. C. 1298, 1303; Lowry v. United States, 384 F. Supp. 2.57.) It must appear that the property was held primarily to produce income, and offers to rent are only one factor to be considered. (Kanter v. United States, supra; Frank A. Newcombe, supra.) Other relevant

factors include whether the property was available for personal use by its owners (Rumsey v. Commissioner, 82 F.2d 158, 159-160, cert. denied, 299 U. S. 552 [81 L. Ed. 406]), whether the property is recreational in character (see May v. Commissioner, 299 F. 2d 72.5, 727), and whether the taxpayer could in good faith have expected to realize a gain from holding the property. (Carkhuff v. Commissioner, 425 F. 2d 1400, 1404; Charles W. Robinson, 'I'. C. Memo. ,Oct. 29, 1973.)

Applying these standards, we have concluded that appellants did not hold the beach property primarily to produce income. The beach house was unoccupied throughout most of the period in question. While appellants claim that they seldom stnycd overnight there, the fact remains that they did sometimes use the property for personal recreational purposes, and that it was available for such use whenever they 'desired. Appellants' attempts to rent the house are of little significance. It was offered to rent only on a weekly basis, and occasional rentals would not interfere with appellants' use of the property. Moreover, they admit that there was little or no market for vacation rentals. We question whether appellants, who seem to be experienced in real estate matters, could have expected that the income from incidental rentals would ever exceed the expense of maintaining the property. Under these circumstances the most that can be said is that appellants held the property for personal recreational purposes, and sought to offset the resulting expense by occasional rentals. Appellants arc therefore not entitled to the claimed deductions for expenses and depreciation. (Kanter v. United States, supra.)

II

Appellants also own parcels of real property in Riverside and Goleta, California, and have claimed depreciation deductions for rental houses and orchards located on these parcels. Respondent determined that appellants had overestimated the value of the depreciable assets and underestimated the value of the lands. It therefore concluded that the basis which appellants had allocated to each depreciable asset was excessive, and reduced the claimed deductions accordingly.

The Goleta property: Appellants purchased this property from Mr. Newland's parents in 1965, assuming an $80,000.00 first trust deed on the parcel. There are four houses and a walnut grove with 46 trees on the land. Three of the houses are held out for rent, while the fourth is occupied by Mr. Newland's parents. The parents take care of the orchard, and receive in return any proceeds from the sale of walnuts.

The houses are small and range in age from 21 to 36 years. The older three are allegedly insured for $8,000.00 each, and the newer one for $10,000.00. Appellants state that the houses were rented for $75.00 to $80.00 per month prior to purchase and $90.00 to $100.00 per month thereafter. They apparently used $26,000.00 as the total basis for all four houses, allegedly calculated by multiplying the projected yearly income from the houses by an estimated remaining useful life of five years for the older houses and 20 years for the newer one.

Appellants computed the basis of the walnut grove as follows: An assumed yearly production of 400 pounds per tree was multiplied by the wholesale price of $.25 per pound, giving a projected yearly income of $100.00 per tree. They multiplied this figure by 46 (the number of trees), and again by a five year estimated useful life, which resulted in a total projected income of $23,000.00. They used this amount as the basis of the grove, and state that it was intended' to include the salvage value of the trees as well as the projected yield from walnuts.

The county assessor determined that for property.tax purposes the walnut grove had no value, and relying on his report respondent concluded that the grove's basis should be zero. The assessor also assigned 4.39 percent of the total assessed value to the houses. Applying this ratio to an $80,000.00 purchase price, respondent determined that the maximum allowable basis for the houses should be $3,512.00.

The Riverside property: In 1968 appellants bought a house and an adjacent orange grove in Riverside for $75,124.00. Apparently $53,518.00 of the purchase price was allocated to the orchard property and the remainder to the lot containing the house.

The house is a two-story frame building with a garage, two sheds and a machine shop. Its age and condition are not described in the record. It was allegedly rented for $1,500.00 per year prior to the purchase, and for $1,650.00 per year in 1971 and 1972. Appellants claim that it is insured for $20,000.00, and that a local realtor appraised it at $15,500.00. They calculated its basis to be $14,000.00, apparently by multiplying a projected yearly income by a ten-year estimated remaining useful life.

There are 2,200 orange trees in the orchard, which appellants allege are from 10 to 15 years old. The production records of the previous owner indicate that the orange grove returned a net profit of $25,075.07 over the five years immediately prior to the purchase, or about $2.28 per tree per year. Appellants calculated the basis of each tree to be $20.00. Apparently this figure was arrived at by multiplying the approximate yearly yield by an estimated useful life of ten years. At the hearing on this case, appellants' representative stated that in a settlement agreement with the Internal Revenue Service, the basis of the orchard was fixed at $12.00 per tree. He was requested to submit a copy of this agreement after the hearing, but did not do so.

The county assessor attributed only 3.3 percent of the value of the parcel to the orange trees, apparently because the previous owner of the orange grove had allowed it to run down. Applying this ratio to the purchase price, respondent determined that the orchard's maximum allowable basis should be $1,766.00, or about $.80 per tree. The assessor also allocated 37.05 percent of the value of the adjacent property to the house, and respondent determined accordingly that its basis for depreciation could'not exceed $8,005.00.

We must decide whether respondent's adjustments to the depreciation bases claimed by appellants were correct. As a general rule the basis of property for depreciation purposes is its adjusted cost. (Rev. & Tax. Code, §§ 17211, 18041, 18042.) Where depreciable and nondepreciable assets, such as land and improvements, are purchased together for a lump sum, the purchase price must be allocated between each type of asset. In such a case, the regulations provide that "... the basis for depreciation cannot exceed an amount which bears the same proportion

to the lump sum as the value of the depreciable property at [the time of purchase]. " (Cal. Admin. Code, tit. 18, reg. 17208(e).) The taxpayer bears the burden of proving that the depreciation basis of property is greater than respondent's determination. (Appeal of William H. and Donnalie W. McPherson, Cal. St. Bd. of Equal., May 9, 1968: Robert Earl Walsh, T. C. Memo., June 24, 1974.) To carry this burden he must not only show that respondent's determination is erroneous, but also must produce evidence from which a proper determination may be made. (Lightsey v. Commissioner, 63 F. 2d 254, 255.)

With respect to the orange grove in Riverside, appellants have shown that respondent's determination is erroneous. The production records of the previous owner show that each tree had netted over $2.00 per year in prior years, and respondent's valuation of $. 80 per tree is therefore clearly too low. In light of the county assessor's conclusion that the grove was run down, however, we cannot conclude that at the time of purchase the trees could have been expected to continue earning that high a profit over their remaining useful lives. Accordingly, we cannot accept appellants' valuation of $20.00 per tree. From the available evidence, we find $22,000.00, or $10.00 per tree, to be the reasonable value of the orange grove for purposes of computing its depreciation basis.

Appellants have failed to carry their burden of proof with regard to the remaining property. They argue generally that the methods they used to determine the bases of the various assets are reasonable, and that the county assessors' valuations are too low. They have introduced no evidence, however, to support their allegations concerning the income potential, replacement cost and insurance values of the various properties in question, and without such evidence we are unable to determine whether appellants' -computations are correct. The county assessors' determinations are the only competent evidence of value in the record. Such valuations, while they may be too low to establish the correct value of real estate as a whole, are competent evidence of the relative value of land and improvements. (2554-58 Creston Corp. , 40 T. C. 932, 940 n. 5; Offshore Operations Trust, T. C. Memo., Sept. 24, 1973.) In the absence of any evidence to the contrary, we must conclude that respondent's determinations based on the county assessors' valuations are correct. (Appeal of Kung Wo Co. , Inc. , Cal. St. Bd. of Equal. , May 5, 1953.)

Appeal of John E. and Amet Z. Newland

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 John E. and Amet Z. Newland against proposed assessments of additional personal income tax in the amounts of $630.11, $1, 120.69, $1,577.83 and $1,492.13 for the years 1966, 1967, 1968 and 1969, respectively, be modified pursuant to the views expressed in this opinion. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 17th day of September, 1975, by the State Board of Equalization;

John W. Lynch, Chairman

George R. Reilly, Member

Richard Nevins, Member

_____, Member

_____, Member.

ATTEST: Ernest J. Dunlop Secretary