BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PAUL AND MELBA ABRAMS)

Appearances:

For Appellants: Paul Abrams, in pro. per.

For Respondent: Brian W. Toman
Counsel

O P I N I O N

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 Paul and Melba Abrams against a proposed assessment of additional personal income tax in the amount of $7,948.72 for the year 1971.

The issues presented are: (1) whether respondent properly disallowed a casualty loss deduction claimed by appellants on their 1971 return, and (2) whether respondent properly computed appellants' preference income tax liability for the year 1971.

Casualtys s

During 1971 appellants owned a shopping center located in the San Fernando Valley, California. The center consisted of two adjacent buildings which appellants leased to retail businesses. On February 9, 1971, the two buildings were severely damaged as a result of a major earthquake. Thereafter, during the period from April 15, 1971, to December 31, 1971, several aftershocks occurred in the general vicinity of appellants' shopping center,.

On their 1970 California personal income tax return, appellants claimed a casualty loss in the amount of $236,058. 1/ The loss, which was allowed by respondent, represents the decline in fair market value of appellants' buildings caused by the February 9, 1971, earthquake. On their 1971 return, appellants claimed another casualty loss of $82,532, representing the alleged decline in fair market value of the buildings caused by the aftershocks. Respondent disallowed that loss on 'the ground that appellants failed to prove the aftershocks caused actual physical damage to their buildings.

Section 17206 of the Revenue and Taxation Code permits the deduction of "any loss sustained during the taxable year and not compensated for by insurance or otherwise." However, a loss is deductible under this section only if evidenced by a closed and completed transaction, or otherwise fixed by an identifiable event. (Cal.

1/ Apparently, the initial earthquake constituted a "disaster" within the meaning of section 17206.5 of the Revenue and Taxation Code. Pursuant to that section, a taxpayer may elect to report a disaster loss in the taxable year immediately preceding the taxable year in which the disaster occurred.

Admin. Code, tit. 18, reg. 17206(a), subd. (2).) With respect to casualty losses, it is well settled that a taxpayer does not sustain a deductible casualty loss merely because the market value of his property decreases. (J. G. Boswell Co. v. Commissioner, 302 F.2d 682, 685-686 (9th Cir. 1962); Squirt Co., 51 T.C. 543 (1969), affd., 423 F.2d 710 (9th Cir. 1970); Clarence A. Peterson, 30 T.C. 660, 665 (1958); Appeal of Kathryne Beynon, Deceased, Cal. St. Bd. of Equal., April 22, 1975.) While such a decrease may be a loss in the economic sense, the loss is not sustained for tax purposes until it is fixed by some identifiable event, such as permanent physical damage to the property, or its sale or permanent abandonment. (Squirt Co., supra, 51 T.C. at 547; Harvey Pulvers, 48 T.C. 245 (1967), affd., 407 F.2d 838 (9th Cir. 1969); Citizens Bank of Weston, 28 T.C. 717, 721 (1957), affd., 252 F.2d 425 (4th Cir. 1958).)

The record on appeal contains no direct evidence, other than the general assertion of appellants, that the shopping center sustained permanent physical damage as a result of the aftershocks. In support of the claimed deduction, appellants submitted an appraisal report which was prepared for them on March 24, 1972. However, the report fails to establish whether, or to what extent, appellants' property sustained permanent physical damage due to the aftershocks. Moreover, it is not clear from the report that the values used by the appraiser for determining the extent of loss represent the actual fair market values of the property immediately before and immediately after the aftershocks. Finally, the report fails to describe the effects of any general market decline which may have affected undamaged portions of the shopping center. Consequently, we do not accept the appraisal report as reliable evidence of a deductible casualty loss. (See Cal. Admin. Code, tit. 18, reg. 17206(g), subds. (1) (B) and (2) (A).)

We recognize that, due to the nature of aftershocks and their close proximity to the initial earthquake, a taxpayer whose property is affected by such a casualty may find it difficult to establish the extent of permanent physical damage attributable to the aftershocks. However, we are also aware that appellants were allowed a $236,058 casualty loss deduction in connection with the initial earthquake. Appellants bear the burden of proving that any additional casualty loss deduction for the aftershocks accurately reflects the extent of permanent physical damage caused by such casualty. (Clapp v. Commissioner, 321

F.2d 12 (9th Cir. 1963); Appeal of Felix and Annabelle Chappellet, Cal. St. Bd. of Equal., June 2, 1969.) Since appellants have failed to meet their burden of proof in this regard, we must sustain respondent's action in disallowing the 1971 casualty loss deduction.

Preference Income Tax

Section 17062 of the Revenue and Taxation Code, 2/ in effect December 8, 1971, provides in pertinent part:

> In addition to the other taxes imposed by this part, there is hereby imposed ... a tax equal to 2.5 percent of the amount (if any) by which the sum of the items of tax preference in excess of thirty thousand dollars ($30,000) is greater than the amount of net business loss for the taxable year. (Emphasis added.) 3/

Section 17063 describes the items of tax preference which are subject to the preference income tax. Among the items listed are: accelerated depreciation on certain real and personal property in excess of straight-line depreciation: percentage depletion in excess of the basis of the property involved: and capital gains to the extent they are accorded preferential tax treatment. (See Rev. & Tax. Code, § 17063, subds. (b), (c), (e), (f) and (h), respectively.)

Section 17064.6 defines the term "net business loss" as "adjusted gross income (as defined in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net amount is a loss." As originally enacted in 1972, section 17064.6 did not contain the words "only if such net amount is a loss." (Stats. 1972, ch. 1065, § 1.6, p. 1980.) Those words were added by amendment in 1973. (Stats. 1973, ch. 655, § 1, p. 1204.)

2/ Hereinafter, all references are to the Revenue and Taxation Code unless otherwise indicated.

3/ Section 17062 was amended in 1975 to include a new tax rate schedule and to reduce the $30,000 exclusion to $4,000. (Stats. 1975, ch. 1033, § 1, p. 2434.) However, the changes have no bearing on the outcome of this appeal.

On their 1971 return appellants reported a total of $191,075 of items of tax preference in excess of the $30,000 statutory exclusion. For convenience, the amount of tax preference items in excess of the $30,000 statutory exclusion shall be referred to as excess preference income. In computing the tax imposed by section 17062, appellants reduced their excess preference income by a purported "net business loss" in the amount of $144,710. The purported "net business loss" consisted of a $122,736 net loss incurred by appellant husband in connection with his profession, a $21,819 net loss incurred by appellants in connection with their rental property, and a $155 net partnership loss. Appellants reported adjusted gross income of $52,881 on their 1971 return.,

Respondent recomputed the tax on appellants' excess preference income without allowing an offset against such income for the purported "net business loss." It is respondent's position that appellants did not incur a "net business loss", as that term is defined in section 17064.6, because their adjusted gross income less the deductions allowed by section 17252 (relating to expenses for production of income) did not amount to a net loss. Appellants, on the other hand, contend that the definition of "net business loss" set forth in section 17064.6 is not applicable for purposes of computing the preference income tax for taxable years prior to 1972. In the alternative, appellants contend that their 1971 adjusted gross income less the deductions allowed by section 17252 did in fact amount to a net loss, and that such net loss completely offsets their excess preference income.

The issue and arguments raised by appellants in connection with their primary contention are substantially similar to those addressed by this board in the Appeal of Richard C. and Emily A. Biagi, decided May 4, 1976. On the basis of our decision in Biagi, and for the reasons stated therein, we must reject appellants' argument that the definition of "net business loss" set forth in section 17064.6 is not applicable for purposes of computing their 1971 preference income tax liability. (See also Appeal of Robert S. and Barbara J. McAlister, Cal. St. Bd. of Equal., April 6, 1977.)

Appellants' alternative argument involves the proper method of computing their "net business loss" pursuant to section 17064.6. As indicated above, "net business loss" is defined in section 17064.6 as the difference between "adjusted gross income (as defined in Section 17072)' and "the deductions allowed by Section

17252 (relating to expenses for production of income)," if such net amount is a loss. However, appellants interpret the term "net business loss" to mean adjusted gross income less all deductions which are directly or indirectly related to the production of income, including business expenses, and expenses attributable to property held for the production of rents. Applying this interpretation to their own situation, appellants assert that they incurred a "net business loss" in 1971 equal to their adjusted gross income of $52,881 less the sum of $143,252 of business expenses and $205,269 of expenses attributable to their rental property. Thus, appellants claim they are entitled to completely offset their $191,075 of excess preference income with a "net business loss" of $295,640.

While section 17064.6 is not a model of statutory clarity, we think it is clear that appellants have misconstrued the formula set forth in that section for computing the "net business loss". Under appellants' view, as will be explained in greater detail below, taxpayers engaged in either a trade or business or in income producing activities related to rental property would be allowed, in computing the "net business loss", "double" deductions for expenses attributable to such activities. It is our opinion that the Legislature never intended the "net business loss" offset to reflect such "double" deductions. To the contrary, we believe that appellants' construction of the statute in question would lead to complete frustration of the very purpose for which the tax on preference income was enacted.

In the discussion which follows we shall first establish the general legislative purpose for the enactment of both the tax on preference income and the "net business loss" offset allowed in computing the tax. Next we shall examine the operative effect of the "net business loss' offset and its relationship to the achievement of the legislative purpose. Finally, we shall demonstrate why the legislative purpose would be frustrated if appellants' construction of the term "net business loss" were adopted.

In the Appeal of Richard C. and Emily A. Biagi, supra, we reviewed the legislative history of the federal and state taxes on items of tax preference and determined that the purpose of those legislative acts was to reduce the advantages derived from otherwise tax-free preference income and to insure that those receiving such preferences pay a share of the tax burden. We also noted that the legislation was intended to impose the preference income

tax only with respect to those preference items which actually produce a tax benefit; to the extent that items of tax preference do not produce a tax benefit, they are not subject to the preference income tax. (See Appeal of Harold S. and Winifred L. Voegelin, Cal. St. Bd. of Equal., F'eb. 3, 1977.)

In computing the tax on preference income an offset against the items of tax preference is allowed to the extent of the taxpayer's "net business loss". In essence, the purpose for the "net business loss" offset is to identify that portion of the taxpayer's preference income which has not resulted in an actual tax benefit. The following example illustrates the manner in which the "net business loss" offset achieves this purpose:

Example

Assume that a taxpayer with gross income of $100,000 is entitled to a $120,000 depreciation deduction of which $60,000 represents accelerated depreciation. Assume also that the taxpayer has no items of tax preference other than the accelerated depreciation. If the taxpayer is entitled to no other deductions in arriving at adjusted gross income, the taxpayer's adjusted gross income would be computed as follows:

Gross Income	$100,000
Less:	
Depreciation	120,000
Adjusted Gross Income	($20,000)

Since the taxpayer's only item of tax preference is the accelerated depreciation, the taxpayer's excess preference income is equal to $30,000 ($60,000 minus the $30,000 statutory exclusion). Absent a "net business loss" offset, the section 17062 tax would be imposed upon the entire $30,000 of excess preference income. However, the taxpayer's excess preference income has produced a tax benefit only to the extent of $10,000, since the taxpayer's adjusted gross income falls below zero after the deduction of that amount. Thus, by defining "net business loss" in terms of the extent to which adjusted gross income represents a net loss, the Legislature has achieved the intended result of imposing the tax on excess preference income only to the extent that such income produces a tax benefit. 4/

4/ Evidence that Congress intended to achieve a similar result with respect to the federal tax on preference (Cont.)

Returning to the definition of "net business loss" contained in section 17064.6, we observe that the computation of the offset takes into account not only adjusted gross income but also "the deductions allowed by Section 17252 (relating to expenses for production of income)." Adjusted gross income is defined in section 17072 as gross income less certain deductions, including in part:

> (a) The deductions ... which are attributable to a trade or business ....
>
> * * *
>
> (d) The deductions allowed ... by Section 17252 (relating to expenses for production of income) .. . which are attributable to property held for the production of rents or royalties. (Emphasis added.)

It is important to note that while section 17252, in general, permits the itemized deduction from adjusted gross income of all expenses incurred for the production or collection of income, it is only those section 17252 deductions attributable to property held for the production of rents or royalties which are allowed in computing adjusted gross income. Thus, if the Legislature had not included the phrase "less the deductions allowed by Section 17252 (relating to expenses for production of income)" within the definition of "net business loss", taxpayers engaged only in income producing activities not related to property held for the production of rents or royalties would be unable to reduce their excess preference income by the amount of such income which failed to produce an actual tax benefit.

4/ (Continued from page 7.)
income is contained in section 58(h) of the Internal Revenue Code of 1954. Section 58(h) provides that "[t]he Secretary shall prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's [ordinary income] tax ...." The regulations referred to in section 58(h) are currently in the form of proposed regulations. (See Proposed Treas. Reg. § 1.57-4, P-H Fed. Tax Serv. Par. 65,255.)

We believe that by including the phrase "less the deductions allowed by Section 17252 (relating to expenses for production of income)" in the definition of "net business loss" the Legislature merely intended, for purposes of the preference income tax, to put taxpayers engaged in income producing activities not related to property held for the production of rents or royalties on an equal footing with those taxpayers engaged either in a trade or business or in income producing activities related to property held for the production of rents or royalties. This result is effectively achieved if the phrase under consideration is interpreted to mean only those section 17252 deductions (relating to expenses for production of income) not already reflected in adjusted gross income. Furthermore, such interpretation is the only one which is consistent with the legislative intent that the "net business loss" offset be directly related to the extent to which excess preference income produces a tax benefit.

Under appellant's view, the phrase "less the deductions allowed by Section 17252 (relating to expenses for production of income)" refers to all deductions related to the production or collection of income, including trade or business expenses as well as all section 17252 deductions. If this interpretation were accepted, a taxpayer engaged either in a trade or business or in an income producing activity related to the production of rents and royalties would be allowed, in computing the "net business loss" offset, a "double" deduction for the expenses incurred in connection with such activity. Specifically, the taxpayer would be allowed to deduct such expenses once in computing adjusted gross income and again in computing "the deductions allowed by Section 17252." However, if the "net business loss" offset reflected such "double" deductions, it would no longer be directly related to the extent to which excess preference income produces a tax benefit. Instead, certain taxpayers with substantial excess preference income would be able to completely escape the preference income tax even though the excess preference income significantly reduced their ordinary income tax liability. This is precisely the result which would be reached in the instant appeal if we were to accept appellants' construction of the phrase in question.

The record on appeal indicates that in 1971 appellants' adjusted gross income less the deductions allowed by section 17252 (relating to expenses for production of income) did not amount to a net loss. Accordingly, we conclude that appellants did not experience a "net business loss" in 1971 and therefore, that respondent properly computed appellants' 1971 preference income tax liability.

Appeal of **Paul** and Melba Abrams

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 Paui and Melba Abrams against a proposed assessment of additional personal income tax in the amount of **$7,948.72** for the year i971, be and the same is hereby sustained.

Done at Sacramento, California, this 11th day of **January, 1978, by the State Board of** Equalization.

_____, **Chairman**

_____, **Member**

_____, **Member**

_____, **Member**

_____, **Member**