BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WALTER E. AND GLADYS M. SHERBONDY)

For Appellant: Mr. R. A. Harrison

For Respondent: Bruce W. Walker
Chief Counsel

Jeffrey M. Vesely
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 Walter E. and Gladys M. Sherbondy against proposed assessments of additional personal income tax in the amounts of $191.60, $185.38, $184.84, and $383.54 for the years 1972, 1973, 1974, and 1975, respectively.

Subsequent to the filing of this appeal, respondent revised its computation of appellants' tax liability for the year 1975. The net effect of respondent's adjustment is a reduction of the total of the proposed assessments for the years 1972, 1973, 1974,' and 1.975, from $945.36 to $413.07.

During the years on appeal, appellants resided in Newport Beach, California. In 1971 appellants acquired a parcel of land located in the Sierra National Forest approximately forty miles northeast of Fresno, California and over 250 miles from their Newport Beach residence. Appellants constructed a house on the land and began renting the house in 1972. The area surrounding appellants' Sierra house features various outdoor activities, including boating, fishing, horseback riding, and snow skiing.

During the years on appeal, appellants advertised the availability of their Sierra house by placing a notice on bulletin boards at Mr. Sherbondy's place of employment and by distributing copies of the notice to friends. Appellants did not advertise the house in any newspaper, and they did not employ the services of a rental agent. According to an occupancy schedule submitted by appellants, the Sierra house was rented a total of thirty-nine days during the period from January 1972 to September 1975, and it was occupied by appellants a total of eighteen days during that period. Appellants sold the house in September, 1975.

On their joint California personal income tax returns for the years in question, appellants reported rental receipts and losses from their Sierra house as follows:

Year	Receipts	Expenses	Net Loss
1972	$400	$7,380	$6,980
1973	475	6,766	6,291
1974	1 5 0	6,081	5,931'
1975	7 5	4 , 0 6 6	3,991

The expenses listed above include depreciation.

After conducting an audit of appellants' returns, respondent determined that appellants' ownership of the Sierra house was not an activity engaged in for profit. Consequently, respondent disallowed the claimed expenses to the extent they exceeded the limitations imposed by section 17233 of the Revenue and Taxation Code. Appellants claim that the expenses are fully deductible under sections 17208 and 17252 of the Revenue and Taxation Code. In relevant part, these three sections are set forth in the margin. 1/

Focusing on subsection (c) of section 17233, the disposition of this appeal turns on the question whether appellants' acquisition and holding of the Sierra house constituted an activity engaged in for profit. Specifically, in order to prevail, appellants must establish that they acquired and held the house primarily for profit-seeking purposes, and not primarily for personal recreational or other nonprofit motives. (Joseph W. Johnson, Jr., 59 T.C. 791, 814 (1973); Benjamin Gettler, et al., ¶ 75,087 P-H Memo. T.C. (1975); Appeal of Clifford R. and Jean G. Barbee, Cal. St. Bd. of Equal., Dec. 15, 1976.)

1/ Section 17233:

(a) In the case of an activity engaged in by an individual, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this part except as provided in this section.

(b) In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--

(1) The deductions which would be allowable under this part for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) A deduction equal to the amount of the deductions which would be allowable under this part for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(continued on next page)

Whether property is held for the primary purpose of making a profit is a question of fact on which the taxpayer bears the burden of proof. (Appeal of Clifford R. and Jean G. Barbee, supra.) The absence of actual profit is not determinative, but the activity must be of such a nature that the taxpayer had a good faith expectation of profit. (Carkhuff v. Commissioner, 425 F.2d 1400 (6th Cir. 1970); Joseph W. Johnson, Jr., supra.) Also, the taxpayer's expression of subjective intent is not controlling. Rather, the taxpayer's motives must be determined from all the relevant facts and circumstances. (Joseph W. Johnson, Jr., supra; Appeal of Clifford R. and Jean G. Barbee, supra.)

1/ (cont'd.)

> (c) For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable ... under subdivision (a) or (b) of section 17252.

Section 17208:

> (a) There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)--
>
> * * *
>
> (2) Of property held for the production of income.

Section 17252:

> In the case of an individual, 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;
>
> (b) For the management, conservation, or maintenance of property held for the production of income ....

These sections are substantially identical to sections 183, 167, and 212, respectively, of the Internal Revenue Code of 1954.

Appellants have submitted very little evidence in support of the claim that they acquired and held the Sierra house for the primary purpose of making a profit. However, the record on appeal does disclose several factors which tend to discount the claim.

First, it is reasonable to expect that one who plans to purchase property for rental purposes will conduct a prepurchase investigation of the profit-making potential of the property, especially where resort property is involved. (See Monfore v. United States, 40 Am. Fed. Tax R.2d 5338, 5345 (1977).) In the instant case. however, the record indicates that appellants conducted no preliminary investigation of the profitability of rental property in the vicinity of the Sierra house.

Evidence of profit motive is also sometimes found in a taxpayer's use of expert advice and services in acquiring and operating rental property. (See, e.g., Ida Meredith, 65 T.C. 34 (1975); Monfore v. United States, supra; Appeal of Ivan S. and Judith A. Fucilla, Cal. St. Bd. of Equal., March 2 1977.) During the four years of their ownership of the Sierra house, appellants incurred net losses ranging from $4,066 in 1975 to $7,380 in 1972. Despite these consistently large losses, appellants failed to seek the advice or services of local real estate or rental agents, and their efforts with respect to advertising and promoting rental of the house remained minimal. The consistent pattern of losses reported by appellants becomes particularly significant in light of appellants' failure to take any action to convert the losses into Profits. (See Monfore v. United States, supra; Appeal of Clifford R. and Jean G. Barbee, supra.)

Finally, it should be noted that the Sierra house was available for appellants' personal recreational use for all but thirty-nine days of the four year period in question. Although appellants' actual use of the Sierra house might be described as minimal, the recreational character of the property and its availability for appellants' personal use are clearly factors which must be considered in determining appellants' primary purpose for acquiring and holding the property. (See Frank A. Newcombe, 54 T.C. 1298, 1300 (1970); Benjamin Gettler, et al., supra.)

Appellants contend that in deciding whether or not they intended to make a profit we must also consider the production of prospective income resulting from the capital appreciation of the Sierra house. While it is generally true that property held for capital appreciation can qualify as property "held for the production of income"-, (Cal. Admin, Code, tit:. 18, reg. 17252, subd. (c); Appeal of Ivan S. and Judith A. Fucilla, supra.), the burden rests with appellants to prove that anticipation of capital appreciation was the primary, motive for their acquisition and holding of the Sierra house. (See Marvin Eisenstein, ¶ 78,095 P-H Memo. T.C. (1978).) Appellants have presented no evidence on this point. We recognize that appellants hoped to realize a capital gain on the sale of the Sierra house, and the record indicates that appellants sold the house for a substantial profit. These facts alone, however, do not establish that appellants' primary purpose for holding the property was to realize such profit. (See' Marvin Eisenstein, supra; Appeal of Ivan S. and Judith A. Fucilla, supra.)

On the basis of the record before us, we must conclude that appellants have failed to sustain their burden of proving that they acquired and held the Sierra house for the primary purpose of making a profit, and not primarily for personal recreational or other nonprofit motives.

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 Walter E. and Gladys M. Sherbondy against proposed assessments of additional personal income tax in the amounts of $191.60, $185.38, $184.84, and $383.54 for the years 1972, 1973, 1974, and 1975, be and the same is hereby modified to reflect the Franchise Tax Board's reduction of the total amount Of the proposed assessments from $945.36 to $413.07. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 10th day of April, 1979, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member