BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DOUGLASS-PACIFIC CORPORATION)

Appearances:

For Appellant: Kenneth L. Saunders

For Respondent: Robert L. Koehler
Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Douglass-Pacific Corporation against proposed assessments of additional franchise tax in the amounts of $5,804.55 and $5,603.25 for the income year 1973 and the income year ended September 30, 1974, respectively.

The primary question for decision is whether in an amended return appellant may retroactively capitalize items which it previously had deducted as expenses. A related issue concerns the propriety Of certain interest expense deductions claimed by appellant in its returns for the income years in question.

Appellant is a California corporation formed in 1965 for the purpose of developing and selling residential real property. The corporation was relatively inactive until late 1971, when it purchased land, a trailer field office, office furniture and a vehicle. There is no indication that any property development began in 1971.

Appellant keeps its books and computes income using an accrual method of accounting. In its California franchise tax return for the income year 1971 it deducted taxes ($1,065.00) and interest charges on loans ($2,358.00) as expenses. Appellant began developing the property in 1972, and in its tax return for that income year it again deducted real property taxes ($19,490.00) and interest charges ($189,762.00), as well as market research expenses ($2,914.00). Appellant received no tax benefit from those deductions in income year 1972, however, since it already operated at a loss in that year and paid only the minimum tax of $200.00.

Thereafter appellant employed a new firm of certified public accountants to handle its tax affairs. In the balance sheet filed with its franchise tax return for income year 1973, appellant reported the value of its total assets as of January 1, 1973, to be $212,166.00 greater than the closing figure as of December 31, 1972, reported in the balance sheet accompanying its return for income year 1972. The increased value appeared in appellant's stated investments in "land and residential development," and the increase equalled the total of the amounts of real property taxes, interest, and market research expenses that appellant had deducted in its return for income year 1972. In its return for income year 1973, appellant deducted certain taxes, interest, loan fees and legal fees accrued in that year. It also claimed as a deduction $70,645.00 of the interest expense ($189,762.00) it had deducted for the income year 1972, stating in explanation of that deduction, "Interest

expensed for federal purposes and capitalized for California in prior periods. Now expensed for books and California." As a result of these deductions, appellant's net income for income year 1973 was reduced to $1,699.00. Similarly, in its return for the income year ended September 30, 1974,[1/] appellant deducted another $63,227.00 of the interest expense deduction of $189,762.00 which it had claimed in its return for the income year 1972, reporting a net income for that income year of $1,253.53.

On October 28, 1975, respondent issued notices of proposed assessment of additional franchise tax for the income year 1973 and the income year ended September 30, 1974, based upon its disallowance of the interest expense deductionsclaimed in appellant's returns for those years in the amounts of $70,645.00 and $63,227.00, respectively. Appellant protested and, after being advised that respondent intended to affirm those deficiency assessments, appellant filed an amended return for income year 1972, in which it stated its election to capitalize the $212,166.00 of taxes, interest and market research expenses it had deducted in its original return for that year. Thereafter, respondent affirmed its proposed assessments for both years, and this timely appeal followed.

Section 24421 of the Revenue and Taxation Code provides:

> In computing "net income" of taxpayers under this part, no deduction shall be allowed for the items specified in this article.

One of the items specified as nondeductible is described in section 24426 as follows:

> Amounts paid or accrued for such taxes and carrying charges as, under regulations prescribed by the Franchise Tax Board, are chargeable to capital account with respect to property, if the taxpayer elects, in accordance with such regulations,, to treat such taxes or charges as so chargeable.

1/ Appellant had requested and received respondent's permission to change its annual accounting period from a calendar year to a fiscal year ending September 30.

This section is substantially identical to section 266 of the Internal Revenue Code of 1954.

Respondent's implementing regulation provides generally that in the case of real property the taxpayer may elect, in accordance with subsection (3) of the regulation, to capitalize certain taxes and carrying charges which are otherwise expressly deductible under article 1 of chapter 7 of the Revenue and Taxation Code. (Cal. Admin. Code, tit. 18, reg. 24426(a).) With respect to the manner in which such an election must be exercised, respondent's regulation provides, in subsection (3):

> (C) If the taxpayer elects to capitalize an item or items under this regulation, such election shall be exercised by filing with the original return for the year for which the election is made a statement indicating the item or items (whether with respect to the same project or different projects) which the taxpayer elects to treat as chargeable to capital account. ... (Emphasis added.)

Substantially identical language is contained in the comparable federal regulation. (Treas. Reg. § 1.266-1 (c)(3).)

It is not disputed that the taxes, interest, and market research expenses which appellant deducted in its original franchise tax return for the income year 1972 were items of a type which could have been capitalized under the above provisions. Respondent contends, however, that the language of its regulation is specific in requiring that the election to capitalize such taxes and carrying charges be exercised with the taxpayer's original return, and that appellant's attempted election by an amended return filed in 1975 for income year 1972 was therefore untimely and cannot be given effect.

In Appeal of Citizens Development Corporation, decided on July 31, 1973, we were called upon to determine whether respondent had properly computed the amount of gain realized by the taxpayer on a transfer of property. In that case, respondent refused to include in the basis of the property being transferred certain carrying charges which the taxpayer had originally deducted in returns filed for previous years but subsequently elected to capitalize on amended returns for those years. We

sustained respondent's action, stating:

> Here appellant deducted the charges in question on its original returns and, of course, did not file statements indicating its election to capitalize such charges. Such omission was fatal, Appellant cannot now change its position by electing to capitalize carrying charges. by amended returns. Therefore, we conclude that where a taxpayer fails to file the required statement of election to capitalize appropriate carrying charges with its original return for the year in which the election is made it is precluded from electing to capitalize such charges by amended return in a later year. ...

In reaching that conclusion we relied on a line of cases interpreting the comparable federal regulation and holding that the election to capitalize taxes and carrying charges must be made on the original return, in accordance with the clear language of the regulation. (See Kentucky Utilities Co. v. Glenn, 394 F.2d 631 (6th Cir. 1968); Oklahoma Gas & Electric Co. v. United States, 289 F. Supp. 98 (W.D. Okla. 1968); Estate of George Stamos, 55 T.C. 468 (1970); cf. Rev. Rul. 70-539, 1970-2 Cum. Bull. 70.) Respondent's regulation and the authorities cited above require a similar decision here, and we therefore agree with respondent that appellant's attempted election to capitalize taxes, interest, and market research expenses in an amended return filed for income year 1972 was untimely and cannot be given effect,

Appellant's deduction in its returns for income year 1973 and the income year ended September 30, 1974, of interest expense deductions accrued in 1972 was also improper. As a general rule, income is to be computed for tax purposes under the method of accounting by which the taxpayer regularly reflects its business transactions and, once the taxpayer has elected a permissible form of accounting, it is bound thereby unless it secures the consent of respondent to compute income by a different method. (Rev, & Tax. Code, § 24651, subds. (a) and (e).) In the instant case, appellant kept its books and computed income by an accrual method of accounting. Under

general accounting principles, accrual method taxpayers are allowed to deduct expenses in the income year in which all the events have occurred which establish the fact of the liability giving rise to such deduction, and the amount thereof can be determined with reasonable accuracy. (Cal. Admin. Code, tit. 18, reg. 24651, subd. (c)(1)(B).)

As we noted earlier, by exercising a timely election appellant could have capitalized the interest expenses in question. Instead, appellant deducted those expenses in its original return for the income year 1972. It has not been shown that those interest expenses accrued in any income year other than 1972 and, although appellant received no tax benefit from their deduction in that year, it clearly cannot deduct those identical interest expenses in returns filed for subsequent income years.

For the reasons stated above, respondent's action in this matter must 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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Douglass-Pacific Corporation against proposed assessments of additional franchise tax in the amounts of $5,804.55 and $5,603.25 for the income year 1973 and the income year ended September 30, 1974, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 16 day of August, 1979, by the State Board of Equalization.

William M. Bennett, Chairman

Richard Nevins, Member

Geo. R. Reilly, Member

_____, Member

_____, Member