

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
 ) No. 18702  
Ronald F. and Catherine Boeddeker )  
 )

Representing the Parties:

For Appellants: Steven M. Danowitz  
Glenn Bystrom

For Respondent: Bradley Heller, Tax Counsel  
A. Kent Summers, Tax Counsel

Counsel for Board of Equalization: Charles D. Daly, Tax Counsel III

OPINION

This appeal is made pursuant to section 19045<sup>1</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Ronald F. and Catherine Boeddeker against a proposed assessment of additional personal income tax in the amount of \$1,403,751 for 1993. The issue in this appeal is whether appellants correctly excluded from appellants' gross income for the appeal year an amount equal to one-half of certain accrued but unpaid interest expenses that they had previously deducted.

Appellants were limited partners in a partnership that was one of a multi-tiered series of partnerships. The upper-tier partnership, HRW Limited Partnerships (HRW), a Hawaii limited partnership, owned a hotel in Hawaii that had an outstanding mortgage. HRW was an

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<sup>1</sup> Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.

accrual basis taxpayer that “passed through” to the lower-tier partnerships, and thus to appellants,

accrued but unpaid interest expense on the mortgage. Appellants state that they reported net taxable losses on each of their 1991 and 1992 tax returns that included interest expense on the hotel mortgage as well as other unspecified losses. Appellants further state that each of those tax returns reflected one-half of the net taxable losses on that return as net operating losses (NOL’s) to be carried forward to future taxable years.

During 1993, HRW restructured its mortgage in a manner that resulted in the cancellation of all accrued but unpaid interest and in the reduction of the principal amount owed to the lender. On its tax return for 1993, HRW treated the amount of cancelled interest and the amount of reduction of principal as cancellation of indebtedness income (CODI). On their 1993 tax return, appellants included their proportionate share of HRW’s CODI in gross income after making two adjustments. The first adjustment was that appellants reduced their proportionate amount of HRW’s CODI by an amount equal to one-half of the accrued but unpaid interest on the hotel mortgage that appellants reported on their 1991 and 1992 tax returns. The second adjustment was that appellants reduced their proportionate amount of HRW’s CODI by an amount equal to their “qualified real property business indebtedness” (QRPBI), as defined in Internal Revenue Code (IRC) section 108(c)(3). Appellants have conceded this second adjustment.<sup>2</sup> Upon review, respondent disallowed the first adjustment. After respondent denied appellants’ protest, this timely appeal followed.

The primary issue before the Board is this: Whether the tax benefit rule permits appellants to exclude from their gross income in the appeal year an amount equal to one-half of the accrued but unpaid interest expenses that appellants reported on their 1991 and 1992 tax returns. In order to effectively answer this question, this Board needs to consider a two step analysis: whether the tax benefit rule applies to appellants’ transaction related to the CODI income; and, if it does, then whether the tax benefit rule permits the exclusion of the amount at issue.

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<sup>2</sup> The second adjustment that respondent disallowed was the exclusion of the amount of appellants’ QRPBI that they had applied, under IRC section 108(c)(1), to reduce the basis of appellants’ “depreciable real property” that was unrelated to HRW’s hotel. Respondent did not disallow appellants’ exclusion of the amount of their QRPBI that appellants had applied to reduce the basis of their proportionate share of HRW’s hotel. Respondent states, and this Board agrees, that its reason for not disallowing the exclusion of that amount was that HRW had sold the hotel during 1993 and the excluded amount had already been taxed in the form of reduced basis.

### Tax Benefit Rule

Internal Revenue Code (IRC) section 111,<sup>3</sup> commonly known as the “tax benefit rule,” provides that gross income does not include income attributable to the recovery during a taxable year of any amount deducted in a prior taxable year if, and to the extent that, the deduction did not reduce the tax.

The United States Supreme Court provided a detailed analysis of the tax benefit rule in *Hillsboro National Bank v. Commissioner* (1983) 460 U.S. 370. The Ninth Circuit restated the Supreme Court’s analysis of the tax benefit rule as follows:

“The tax benefit rule has two components, a rule of inclusion and a rule of exclusion. The inclusion component of the rule requires the taxpayer to recognize income when an event occurs that is fundamentally inconsistent with the premise on which a deduction previously had been based. [Citation omitted.] The exclusionary aspect of the tax benefit rule requires a taxpayer to include income only to the extent that deduction gave rise to a tax benefit. [Citation omitted.]” (*Hudspeth v. Commissioner*, (9<sup>th</sup> Cir. 1990) 914 F.2d at pp. 1207-1212.)

In order for appellants to prevail, they must show that they met both the inclusionary and the exclusionary components of the tax benefit rule. We believe appellants have met their burden. At the hearing, respondent stated that appellants cannot use the tax benefit rule here because the “fundamental inconsistency” test had not been satisfied. However, respondent in its brief concedes that the “deduction of an interest expense accrual,” which is what we have in this case, “is fundamentally inconsistent with the subsequent forgiveness of the payment obligation,” which is exactly what the facts are in this case. (Resp. Reply Br., p. 3.) Therefore, by its concession, respondent agrees that the “inclusionary rule” component of the tax benefit rule is present.

As to the “exclusionary rule,” we note that before an amendment of IRC section 111 by Deficit Reduction Act of 1984 (DEFRA), if a previously deducted amount was recovered, section 111 provided for a “recovery exclusion” from gross income for an amount

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<sup>3</sup> Section 17131 incorporates Internal Revenue Code section 111 into California law.

equal to the portion of the deduction in the prior year that did not reduce taxes. (General Explanation of DEFRA, *supra*.) Although the particular “recovery exclusion” language was deleted, the underlying concept remains the same and is reflected in the existing regulations under IRC section 111. These regulations treat NOL carryovers as the equivalent of reducing taxes or, to say the same thing, providing a tax benefit in a prior year for purposes of calculating such a “recovery exclusion.” (See Treas. Reg., §§1.111-1(b)(1)-(2) 1.111-1(b)(3)(Example).) Because appellants received a tax benefit (in the form of NOL carryovers) for only one-half of the interest cancelled during the appeal year that was allocated to them, only that portion of the cancelled interest is properly included in their gross income for that year. The remaining one-half of the cancelled interest is a “recovery exclusion,” which is nontaxable. Consequently, the “exclusionary rule” component of the tax benefit rule is present.

The rationale of the tax benefit rule is that the taxpayer should be put in approximately the same after-tax position as if the correct amount had been deducted. (Staff of Joint Committee on Taxation, 98<sup>th</sup> Cong., 2d Sess., General Explanation of the Revenue Provisions of DEFRA, at p. 521.) Here, the rationale has been satisfied because only one-half of the accrued interest will be included in gross income and that amount exactly offsets the previously deducted interest that was included in the NOL carryovers. As a result, appellants are in the after-tax position as if the interest had never been deducted.

#### Tax Benefit Rule v. Net Operating Loss Carryover Limitations

Respondent next argues that even if the tax benefit rule otherwise applies the NOL carryover statute does not permit the exclusion of the amount at issue. As support for its position, appellants heavily rely upon *Hudspeth v. Commissioner*, *supra*, 914 F.2d 1207, *Rosenberg v. Commissioner* (1991) 96 T.C. 451, and the *Appeal of Gene and Donna F. Young* (94-SBE-017), decided by the Board on December 14, 1994. In those cases, the adjudicator commented that granting relief to the taxpayer under the tax benefit rule would, in effect, increase an NOL carryover in contradiction of an otherwise governing statute or create such a carryover without any statutory support. (See *Hudspeth v. Commissioner*, *supra*, 914 F.2d at p. 1212; *Rosenberg v. Commissioner*, *supra*, 96 T.C. at pp. 453-454; *Appeal of Gene and Donna F. Young*, *supra*.)

Respondent also contends that the application of the tax benefit rule to exclude that amount would be impermissibly inconsistent with the NOL carryover limits stated in R&TC section 17026, subdivision (b). Respondent takes the position that the result of the exclusion of the amount at issue is to violate the limits stated in R&TC section 17026, subdivision (b), by increasing, in effect, the NOL carryover by that amount.

IRC section 172(b) provides, in general, for NOL carrybacks and carryovers for a specified number of years to taxable years other than the taxable year in which the NOL occurred. IRC section 172(c) defines, with certain modifications, an NOL as the excess of deductions over gross income. Section 17276, subdivision (b), provided that the NOL carryover provisions of IRC section 172(b) shall be modified so that 50 percent of the entire NOL for any taxable year shall not be eligible for carryover to any subsequent taxable year.

We disagree with respondent on two counts. First, although respondent has placed great reliance upon the *Hudspeth*, *Rosenberg*, and *Young* cases, appellants correctly point out that the “fundamental inconsistency” test of *Hillsboro National Bank* was not satisfied, and therefore, the tax benefit rule did not apply, in any of those cases. As a result, those cases are of limited value in analyzing the relationship between the tax benefit rule and NOL carryovers. Consequently, we agree with appellants that the cases upon which respondent relies are not sufficiently on point to detract from our conclusion that only one-half of the cancelled interest allocable to appellants during the appeal year was properly included in their gross income for that year while the other half of that interest was properly excluded.

Secondly, Treasury Regulation section 1.111-1(b) explicitly takes into account NOL carryovers in its calculations when applying the tax benefit rule. We have followed that regulation in determining that only one-half of the cancelled interest at issue should be included in gross income, as only one-half of the subject interest reduced taxes by way of NOL carryovers due to the above-mentioned 50 percent limitation. Because we are aware of no authority that has invalidated the regulation, we disagree with respondent that our treatment of NOL carryovers in making that determination under the regulation somehow resulted in an improper increase in the amount of the NOL carryovers.

Accordingly, respondent’s action in this matter must be modified to reflect the foregoing opinion.

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Ronald F. and Catherine Boeddeker against a proposed assessment of additional personal income tax in the amount of \$1,403,751 for the year 1993 be and the same is hereby reversed with regard to respondent's inclusion in their gross income of one-half of the accrued but unpaid interest from HRW but is otherwise hereby sustained.

Done at Culver City, California, this 6<sup>th</sup> day of November, 2001, by the State Board of Equalization, with Board Members Mr. Parrish, Mr. Chiang, Mr. Klehs and \*Ms. Marcy Jo Mandel present.

Claude Parrish \_\_\_\_\_, Chairman

John Chiang \_\_\_\_\_, Member

Johan Klehs \_\_\_\_\_, Member

\* Ms. Marcy Jo Mandel \_\_\_\_\_, Member

\_\_\_\_\_, Member

\*For Kathleen Connell per Government code section 7.9.