BEFORE TEE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-1863-MW
ROBERT V. AND SUE ANTLE)

Appearances:

For Appellants: Wayne Nichols
Certified Public Accountant

For Respondent: David Lew
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Robert V. and Sue Antle against a proposed assessment of additional personal income tax in the amount of $14,633 for the year 1980.

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

The question presented by this appeal is whether respondent properly determined appellants' preference tax income for 1980.

On their 1980 California personal income tax return, appellants reported a farm net loss of $348,486 as their only item of tax preference. In computing their farm net loss, they had subtracted from the total loss amount Mr. Antle's $210,064 salary from a farming corporation. They also reduced their tax preference income by the amount of tax benefit which they lost by not being able to include charitable contributions in their itemized deductions because of the limits on such deductions and by not being able to use their exemption credits because they had negative taxable income.

Respondent audited appellants' return and recomputed their tax on preference income by (1) including in the farm net loss Mr. Antle's salary from the farming corporation, (2) including $130,257 in preference income attributable to itemized deductions in excess of 60 percent of adjusted gross income (AGI) as reported on appellants' return, and (3) denying appellants' reduction of preference income attributable to the lost tax benefit from the unused charitable contributions and exemption contributions and exemption credits. Based on these adjustments, respondent issued a notice of proposed assessment increasing appellants' tax on preference income. Appellants have conceded the correctness of respondent's inclusion of Mr. Antle's salary in the farm net loss amount. However, they contend that no excess itemized deductions should be included in preference income and that their preference income should be reduced by the amount of tax benefit lost by their nondeductible charitable contributions and unused exemption credits.

Section 17062 imposes a tax on preference income in excess of net business loss for the taxable year. The amount of excess itemized deductions is included as an item of tax preference, (Rev. & Tax. Code, § 17063, subd. (a).) This preference item is the amount by which total itemized deductions, excluding the deductions for taxes, medical expenses, casualty losses, and inheritance taxes on income in respect of a decedent, exceeds 60 percent of adjusted gross income as reduced by the same excluded deductions. (Rev. & Tax.. Code, § 17063.2, subd. (a).)

The preference tax is imposed in order to reduce the advantage derived from the preferential tax

treatment accorded certain items of income and deduction and to ensure that those who are able to take advantage of this preferential tax treatment pay a share of the tax burden. (Appeal of Richard C. and Emily A. Biagi, Cal. St. Bd. of Equal., May 4, 1976.) However, this tax was only intended to be imposed on items of tax preference to the extent that they actually produce a tax benefit. (Appeal of Martin S. Ryan, Cal. St. Bd. of Equal., Nov. 14, 1979.) This "tax benefit rule" was added to the California tax preference statutes in 1977 by subdivision (f) of section 17064.5. (Stats. 1977, ch. 1079, § 20, p. 3307.) Subdivision (f) stated:

> The Franchise Tax Board 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 tax under this chapter for any taxable years.

The same provision had been added to the federal statutes imposing tax on preference income as Internal Revenue Code § 58(h), effective for taxable years beginning after December 31, 1975. (P.L. 94-455, § 301(d)(3), 90 Stat. 1520, 1553 (1976).)

The Franchise Tax Board promulgated a regulation pursuant to subdivision (f) of section 17064.5 in 1982, making it applicable to taxable years beginning on or after January 1, 1979. (Cal. Admin. Code, tit. 18, reg. 17064.5.) The substantive provisions of this regulation state:

> (a) In determining the extent to which a taxpayer's tax preference items reduce such taxpayer's tax, all nonpreference deductions will be considered to be taken into account first, followed by preference items of deduction.
>
> (b) The items of tax preference . .. shall be reduced by an amount equal to the taxpayer's, negative taxable income, except to the extent previously reduced by the taxpayer's net business loss" as defined'in .. . Section 117064.6.
>
> (c) The'phrase "reduction of the taxpayer's tax" as used in . . . Section 17064.5(f) means the reduction of tax liability

without regard to the effect of allowable tax credits.

Appellants contend that, because of the tax benefit rule, they had no excess itemized deductions subject to the preference tax. They base this contention on Revenue Ruling 80-226 (1980-2 C.R. 26) which provides steps to be followed in computing the tax benefit limitation on preference income as required by Internal Revenue Code § 58(h). Following the procedures of this revenue ruling, no amount of appellants' itemized deductions are includible in their tax preference income as excess itemized deductions. Respondent contends that the federal revenue ruling is inapplicable because there is a state regulation, regulation 17064.5, supra, which deals with the application of the tax benefit rule.

Substantially the same arguments are made in the Appeal of the Estate Anna Cogswell, decided this day. In that appeal, we considered respondent's regulation 17064.5 and determined that Revenue Ruling 80-226 did not conflict with it, but was a reasonable application of subdivision (a) of that regulation. We concluded, therefore, that the revenue ruling procedure was appropriate for determining the tax benefit limitation on tax preference income. Based on the revenue ruling procedures, we conclude that appellants are correct in contending that no amount of their itemized deductions are subject to the tax on preference income.

Respondent also disallowed appellants' reduction of their tax preference income by the amount of the charitable contributions which they made.in 1980, but were unable to claim as an itemized deduction because of the limitation on contribution deductions found in section 17215.2/ Appellants argue that Revenue Ruling 80-226 allows them to reduce their preference income subject to the preference tax by the amount of items which do not produce a tax benefit. They contend that under the revenue ruling formula for determining their

2/ Section 17215 provides that contributions are allowed as deductions only to the extent of 20 percent of a taxpayer's adjusted gross income. Appellants' adjusted gross income as reported on their return was a negative amount, 20 percent of which is zero. Therefore, none of their charitable contributions were allowable as deductions in 1980.

"preference exclusion," their adjusted gross income is increased to a positive amount and 20 percent of that amount exceeds the amount of their charitable contributions. Therefore, they treated their contributions as if they were deductible and added them to their claimed itemized deductions. This increased the amount of the preference exclusion computed under the revenue ruling and thereby reduced the amount of their preference income subject to the preference tax.

We believe that appellants are in error. Their charitable contributions can have no effect on their items of tax preference because they were not allowed or allowable as itemized deductions. (Rev. & Tax. Code, § 17215.) The "preference exclusion" computed under Revenue Ruling 80-226 consists, in part, of "itemized deductions to the extent of 60 percent of adjusted gross income computed without regard to deductions which are preference items . ..." (1980-2 C.B. at 27.) The significant part of this phrase is "itemized deductions." If an item is not an itemized deduction, as appellants' contribution amount was not, it does not go into the computation of the preference exclusion. This does not conflict with the legislative intent regarding the tax benefit rule, since the question involved in the application of that rule is not whether appellants received a tax benefit from their contribution, but whether they received a tax benefit from an allowable deduction. We must conclude, therefore, that appellants were not entitled to reduce their preference income by the amount of their nondeductible charitable contributions.

Appellants also contend that, since their exemption credits did not reduce their tax since they had negative taxable income, they should be allowed to reduce their tax preference income by the amount of income which would have been offset by the credits had they been able to use them. Respondent states that its disallowance of appellants' reduction was proper because of subdivision (c) of regulation 17064.5 which provides that the amount of tax benefit from preference items is to be determined "without regard to the effect of allowable tax credits."

Appellants argue that the restriction regarding use of tax credits is not found in subdivision (f) of section 17064.5. Although tax credits are not specifically referred to in that statute, it does provide that adjustment to preference income is to be made where 'the tax treatment giving rise to [items of tax preference] will not result in" a tax benefit. (Rev.-C Tax. Code,

§ 17064.5, subd. (f).) The exemption credits do not "give rise to" items of tax preference since they reduce tax liability directly, rather than reduce taxable income. Therefore, respondent's regulationdoes appear to conform to the statute.

Regulation 17064.5 was promulgated in 1982 and appellants argue that it should not apply retroactively. The regulation, however, was specifically made applicable to taxable years beginning on or after Yanuary 1, 1979, and this retroactive application was clearly within the authority of the Franchise Tax Board. (Rev. & Tax. Code, § 19253.) In any case, since the regulation appears to conform to the statute, the result would presumably be the same even if the regulation did not exist. Therefore, appellants were not entitled to consider credits in determining their preference income subject to the preference tax.

For the reasons stated above, we find that respondent's action must be modified to limit appellants' preference income subject to the preference tax to the amount determined in accordance with Revenue Ruling 80-226. However, respondent's action in disallowing the reductions which appellants made to preference income based on their charitable contributions and exemption credits must be sustained.

Appeal of Robert V. and Sue Antle

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 Robert V. and Sue Antle against a proposed assessment of additional personal income tax in the amount of $14,633 for the year 1980, be and the same is hereby modified in accordance with the provisions of Revenue Ruling 80-226. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 9th day of April, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

_____, Member

_____, Member

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF, CALIFORNIA

In the Matter of the Appeal Of)
) 82A-1863 MW
Robert V. and Sue Antle)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed May 3, 1986, by the Franchise Tax Board for rehearing of the appeal of Robert V. and Sue Antle, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is. hereby denied and fhat our order of April 9, 1386, be and the same is hereby affirmed.

Done at Sacramento, California, this 19th day of November, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9