BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 79A-555-MW
ROSEGLEN CONSTRUCTION, INC.)

For Appellant: James T. Burnes
Attorney at Law

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Roseglen Construction, Inc., against proposed assessments of additional franchise tax in the amounts of $713.17, $3,955.69, and $45,786.94 for the income years ended June 30, 1963, February 29, 1964, and February 28, 1965, respectively.

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

Two questions are presented by this appeal: (1) whether appellant has shown that respondent's determinations for the income years ended in 1964 and 1965, which were based on federal audits, were erroneous, and (2) whether respondent properly disallowed appellant's claimed deduction of aircraft expenses and depreciation for the income year ended in 1963. The adjustments made by respondent which gave rise to proposed assessments for the income years 1963, 1964, and 1965, also resulted in franchise tax and penalty credits totaling $18,716.35 for the income year ended February 28, 1966.

Respondent received copies of federal audit reports regarding appellant's federal returns for the 1964, 1965, and 1966 income years. Respondent proposed assessments based on those federal audit changes which had corresponding effects on appellant's income subject to California franchise taxes. Respondent also conducted its own audit for the 1963 income year, resulting in the disallowance of aircraft expenses and depreciation similar to those disallowed in the federal audits for succeeding years. Appellant later reached a settlement with the Internal Revenue Service for a lesser federal tax liability, but respondent did not reduce the California tax assessed because it had not been shown that the settlement was the result of adjustments which had a corresponding effect on appellant's California liability.

Where respondent's adjustments are based on federal audits, the taxpayer must either concede the accuracy of the federal adjustments or state why they are in error. (Rev. & Tax. Code, § 25432.) Appellant has contested the various adjustments which respondent has made in accordance with the federal audit, and we will discuss these adjustments individually.

Capital Gain v. Ordinary Income

The federal audits disallowed capital gain treatment for several items, treating the gain as ordinary income. This federal adjustment, however, was not used by respondent as a basis for its state adjustments, since appellant did not take a capital gains deduction or exclusion on its state returns. Therefore, this, is not an issue before us.

Installment Reporting of Gains on Sale of 138-Acre Tract

On March 6, 1964, appellant sold a 138-acre parcel of land to El Toro Joint Venture (El Toro) for

$2,074,155. The sales agreement provided for a cash payment to appellant of $286,288.50 and a note, secured by a first deed of trust on the parcel, for $1,787,366.50. The agreement also required El Toro to purchase existing notes (the Loughridge notes) secured by the property, evidencing a $1,165,120 obligation of appellant incurred in its purchase of the parcel. El Toro obtained a loan from a third party, Mr. Berger, enabling it to purchase the parcel and the Loughridge notes. Mr. Berger received a note from El Toro secured by a first deed of trust on the parcel.

At the completion of the sale, El Toro owned the parcel and the Loughridge notes secured by the parcel. El Toro then owed appellant $1,787,366.50 and appellant owed El Toro $1,165,120, the amount of the Loughridge notes. El Toro also owed Mr. Berger some amount over $1,165,120 which was also secured by the parcel. The Loughridge notes were not canceled, but apparently the parties agreed that only the difference between the, Loughridge notes and the note carried back by appellant, i.e., $622,246.50, would be paid in cash to appellant, the remaining amounts to be reduced by offsetting credits. (Resp. Br., Ex. A, p. 16.)

The cash payment received by appellant, $286,288.50, was less than 30 percent of the selling price and appellant used the installment method to report the gain on the sale. Use of the installment method was disallowed by the Internal Revenue Service because it determined that appellant had received $1,165,120 in debt relief and, when that amount was added to the cash payment, total payments received in the year of sale exceeded 30 percent of the selling price.

Former section 24668 (added by Stats. 1955, ch. 938, § 20, p. 1625 and repealed by Stats. 1981, Ch. 336, § 19, p. 1494, operative for income years beginning on or after Jan. 1, 1981) allowed gain from the sale of real property to be reported on the installment method if payments in the income year of disposition (exclusive of evidence of indebtedness of the purchaser) did not exceed 30 percent of the selling price. This section was substantially similar to Internal Revenue Code section 453(b) (amended 1980), and interpretations of the federal statute are very persuasive in the interpretation and application of section 24668. (Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L.Ed. 510 (1941).) Because the installment sale provisions are an exception to the general rule as to the year for reporting income, they are to be strictly construed. (Sallies v. Commissioner, 83 T.C. 44, 53 (1984).) It is the substance of a transaction, not its form, which determines whether the transaction qualifies for installment sale treatment, and the taxpayer bears the burden of showing that. the substance and form are the same. (Connell v. Commissioner, ¶ 81,370 T.C.M. (P-H) (1981).)

Cancellation of a seller's indebtedness to a purchaser as partial consideration in an installment sale will be considered a payment received in the year of sale. (Riss v. Commissioner, 368 F.2d 965, 968 (10th Cir. 1966); Big "D" Development Corp. v. Commissioner, ¶ 71,148 T.C.M. (P-H) (1971).) Although mutual or cross debts between a seller and purchaser do not automatically cancel or reduce each other (Ricke v. Commissioner, 54 T.C. 680, 695 (1970), affd. 502 F.2d 748 (9th Cir. 1974); Connell v. Commissioner, supra), we find that, in substance, appellant's debt to El Toro on the Loughridge notes was canceled by El Toro's debt to appellant and this resulted in the receipt by appellant of more than 30 percent of the selling price in the year of sale.

These were not independent debts, which might not be set off against each other (Connell v. Commissioner, supra), but arose out of the same property and were "mutual debts contracted on the credit of each other." (United States v. Ingalls, 399 F.2d 143, 146 (5th Cir. 1968).) That these cross debts were to cancel each other is clear to us from the amount of the note given to appellant by El Toro. If the debts were not to cancel each other, that note would not have been in the amount of $1,787,366.50, but only in the amount of $622,246.50, the difference between the Loughridge notes and the amount owed by El Toro to appellant. In addition, El Toro had given notes to appellant and Mr. Berger which, unless the Loughridge notes and the note given to appellant canceled each other, substantially exceeded the value of the property. Finally, the record indicates that appellants had a specific agreement that the notes would cancel each other.

Appellant contends that there was a valid business reason for El Toro's acquisition of the notes without canceling them: to postpone the payment of a $100,000 real estate commission due upon appellant's payment of or release from liability on the Loughridge notes. Even though appellant intended to achieve a separate business purpose by the form of this transaction, the substance of the transaction, for installment sale purposes, was that appellant's 'debt was canceled.

Appellant also contends that, even if the debt was canceled, the note and trust deed given by El Toro to Mr. Berger was a new liability substituted in lieu of appellant's original liability. It argues that this was tantamount to an assumption of appellant's liability and that the assumption of a seller's liability does not constitute payment in the year of sale. The same argument was raised in Maddox v. Commissioner, 69 T.C. 854 (1978). The court found, as we do here, that there was no assumption either in form or in intent. We conclude that, in substance, appellant's debt on the Loughridge notes was canceled and it must be considered to have received more than 30 percent of the selling price in the year of sale, precluding the use of installment reporting.

Installment Reporting of Gains on Sale of Lots

Appellant owned two tracts of land financed by a blanket loan covering the property as a whole. The tracts were subdivided into lots and appellant sold the lots. Each purchaser of a lot obtained a new loan to finance the purchase price. Frequently, the purchaser obtained a loan from the lender carrying appellant's blanket loan. In these cases, the lender would reduce appellant's loan balance by the amount of the purchaser's loan proceeds at close of escrow.

The federal audit denied installment treatment based on the determination that the reductions in appellant's loan in these transactions were the equivalent of additional cash received in the year of sale. Appellant contends that in the year of each sale it received only the cash down payment, which was always less than 30 percent of the selling price, and, therefore, it was entitled to use installment reporting for the gain. It argues that the reductions in the blanket loan were not additional payments in the year of sale, but were substitutions of the purchasers' liabilities for appellant's and tantamount to assumptions of the existing mortgage.

As we mentioned previously, this argument was addressed and rejected in Maddox v. Commissioner, supra. On the basis of that case, we reject appellant's argument and conclude that appellant received more than 30 percent of the selling price of each lot in the year of sale. Therefore, appellant was not entitled to report the gain on the sales of these lots using the installment method.

Advertising Expenses

The accounting method historically used by appellant to deduct its advertising expenses for its real estate projects was to deduct those expenses in the years when the income to which such expenses related was realized. However, for the Palm Village project, appellant deducted the advertising expenses in 1964, when incurred, even though no income was realized from the project until later years. The federal audit, with which respondent agrees, stated that the advertising expenses for this project should have been deducted in accordance with appellant's usual method, that is, when income was realized, in order to clearly reflect income.

Subdivision (b) of section 24651 provides that if the method of accounting used by a taxpayer does not clearly reflect income, the Franchise Tax Board may prescribe the method of accounting to be used which it considers to clearly reflect income. Respondent, based on the federal audit report, determined that the method. used for the Palm Village advertising did not clearly reflect income and that the method historically used by appellant did clearly reflect income. In order to overcome respondent's determination, appellant must show that the method it used did clearly reflect its income in 1964. (Appeal of Western Outdoor Markets, Cal, St. Bd. of Equal., Jan. 4., 1972.) Appellant has not done so. Appellant states that the Commissioner of Corporations determined that, with regard to Palm Village, securities, rather than real estate, were being sold. We fail to see how this justifies a departure from appellant's normal. method of accounting. Appellant's argument that there was no distortion of income because the income to which the expenses related was realized in the immediately succeeding income year is of no avail, since it is the clear reflection of income on a yearly basis which matters.

Rent Deduction

This adjustment was not addressed by appellant in this appeal and we must conclude, therefore, that appellant has conceded this issue.

Abandonment Loss

'In the 1964 income year, appellant sold a parcel of land, with a basis of $5,000, to its sole shareholder for $5,000. The federal audit determined that, at the time of the sale, the land contained a building having an adjusted basis of $4,337.79, which was demolished subsequent to the sale. Appellant claimed a deduction in the amount of the building's basis as an abandonment loss, which was denied because of the determination thatappellant did not own the building at the time of the demolition. The respondent's determination, based on the federal audit report, is presumed to be correct. Appellant asserts that the building was demolished before the sale, but the journal entry submitted by appellant does not show when the property was sold or when the building was demolished. Appellant's unsupported assertions are insufficient to overcome the presumption of correctness which attached to respondent's determination.

Cost of Sales - Daynes Property

The federal audit disallowed appellant's deduction for income year 1964 of costs attributable to real estate it owned on Daynes Avenue because it determined that the property had been sold in the 1962 income year. Appellant agrees with this adjustment, but argues that it should be allowed the deduction for the 1963 income year, because, it contends, that is the year in which the property was sold. However, the journal entry which appellant has submitted does not show whether the property was sold in 1962 or 1963. Respondent's determination that the property was sold in 1962 is presumptively correct and appellant has not shown that the determination was wrong. Therefore, the deduction cannot be claimed for either income year 1963 or 1964.

Airplane Expenses and Depreciation

During the appeal years, appellant owned and operated an airplane for which it deducted operating expenses and depreciation. The federal audit disallowed these deductions because appellant did not substantiate the business purpose for the operation of the airplane.

Section 24343 allows as a deduction ordinary and necessary business expenses incurred in carrying on a trade or business, including travel expenses. Section 24349 allows a deduction for depreciation of property used in a trade or business. Appellant has attempted to substantiate the business use of the airplane by fuel and service records and affidavits of two employees. The fuel and service records show the dates of flights, the amount of fuel used, and the destinations of some of the flights. This, by itself, does not establish that the airplane was used in carrying on appellant's business. The affidavits state that the airplane was used, regularly and frequently, for business purposes, to transport corporate personnel and other people involved in appellant's projects to appellant's various project sites around California. Although specific information about particular flights has not been provided, we believe that there is sufficient evidence to conclude that the airplane was used, to some extent, for business purposes. We believe that this is an appropriate case for application of the "Cohan rule," which provides for an approximation of expenditures where it is clear that some amount was spent, but the taxpayer's records are so inadequate that it is impossible to determine with any accuracy just how much was spent for business purposes. (Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).) Under the circumstances, we find that appellant should be allowed to deduct 50 percent of the operating costs and depreciation for the airplane for each year.

Appeal of Roseglen Construction, Inc.

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 Roseglen Construction, Inc., against proposed assessments of additional franchise tax in the amounts of $713.17, $3,955.69, and $45,786.94 for the income years ended June 30, 1963, February 29, 1964, and February 28, 1965, be and the same is hereby modified in accordance with the foregoing opinion.

Done at Sacramento, California, this 10th day of June, 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