



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
J. H. MCKNIGHT RANCH, INC.) **No. 85R-76-MW**

Appearances:

For Appellant: John A. **Marta**
Certified Public Accountant

For Respondent: Grace Lawson
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a.), 1 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of J. H. **McKnight** Ranch, Inc., for refund of franchise tax in the amount of \$25,645 for the income year ended November 30, 1981.

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

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The question presented by this appeal is whether appellant must report advances it received as income.

Appellant, a rice grower, contracted with Comet Rice of California, Inc. (Comet) (formerly United Rice Growers and Millers), for the purchase of appellant's rice crops. Upon delivery of the rice to Comet, an advance was made to appellant of 90% of the gross crop value based on the amount of rice delivered as shown by warehouse receipts. The contract provided for final settlement to be made by December of the following year.

In appellant's income year ended November 30, 1981, the original bill of sale, dated November 6, 1981, showed that Comet paid appellant for **104,841.00** cwt of rice. Before the end of that month, however, Comet discovered that, because of its clerical error in recording the amount of rice **received from** appellant, the amount of rice delivered was overstated by **39,693.49** cwt. **Based** on this incorrect weight, appellant had been advanced \$267,138 more than it was entitled to. The error was reported to appellant and, before the fiscal year end, appellant and Comet agreed that appellant would repay the overpayment, with interest, after Comet **provided appellant** with an accounting of the overpayment amount and related interest. The invoice from Comet accounting for the **overpayment and interest was apparently received on** February 10, 1982, and appellant repaid Comet, with interest, on February 11, 1982. On that same date, appellant and Comet executed a new bill of sale, reflecting the correct weight of rice delivered, to replace the previous erroneous one.

Appellant originally reported the \$267,138 overpayment as income for the 1981 income year. Later, it filed an amended return for that year, excluding the **amount of the overpayment and claiming a refund.** Respondent denied the refund and appellant filed this appeal.

Appellant does not deny that it sold its rice crop to Comet, but contends that the overpayment it received was for nonexistent rice and should not be included in income for the 1981 income year, but should be treated as a loan which it repaid with interest in the following year. Respondent argues that appellant received **the overpayment under a claim of right during the income year and the amount must be included in income in that year and deducted in the following year, when repaid.**

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The claim of right doctrine holds that if a taxpayer receives property under an unrestricted claim of right, he has received income which is included in gross income in the year of receipt even if the taxpayer is required to return the property or its equivalent in a later year. (North American Oil Consolidated v. Burnet, 286 U.S. 417, 424 [76 L.Ed. 1197] (1932).) If the taxpayer is subsequently adjudged liable to return the property, he may deduct the amount in the year of repayment. (United States v. Lesoine, 203 F.2d 123, 126 (9th Cir. 1953).) This rule is based on the necessity of giving finality to the annual accounting period and on recognition of the impracticability of compelling the taxing agency to determine when a taxpayer's claim is without legal warrant. (United States v. Lesoine, supra.) An exception to the rule is not created simply because a taxpayer is mistaken as to the validity of his claim. (United States v. Lewis, 340 U.S. 590, 591 [95 L.Ed. 560] (1951).)

However, the courts have created some exceptions to the claim of right doctrine. Several courts have held that an exception exists when the taxpayer discovers a mistaken overpayment, renounces his claim to it, and recognizes his obligation for repayment, all in the same taxable accounting period. (United States v. Merrill, 211 F.2d 297, 304 (9th Cir. 1954); Gaddy v. Commissioner, 38 T.C. 943, 949 (1962), revd. in part on other grds., 344 F.2d 460 (5th Cir. 1965); contra, Quinn v. Commissioner, 524 F.2d 617 (7th cir. 1975).) 'In such a situation, there is no need for the taxing agency to determine the merits of any claim, since that has been resolved by the interested parties. (United States v. Merrill, supra.)

We believe that this appeal falls squarely within this exception to the claim of right doctrine. The error made by Comet in overstating the rice delivered and overpaying appellant was discovered, and the discovery communicated to appellant, before the fiscal year end. The record shows that appellant acknowledged the overpayment and its obligation to repay and made arrangements with Comet for repayment before the fiscal year end. Although respondent has doubted the truth of this state of facts, it has presented no evidence to contradict it and we find the record convincing on this matter.

Under these circumstances, we find that appellant did not hold the overpayment under a claim of right through the end of fiscal 1981, as alleged by respondent,

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but had abandoned its claim before the end of the year. By the arrangement made between appellant and Comet, the overpayment must be considered to have been converted to a loan. This loan was, in fact, repaid in the next **year**, with interest, in accordance with the agreement reached by appellant and Comet.

Based on the foregoing, we must reverse **the** action of the Franchise **Tax** Board.

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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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of J. H. McKnight Ranch, Inc., for refund **of** franchise tax in the amount of \$25,645 for the income year ended November 30, 1981, be and the same is hereby reversed.

Done at Sacramento, California, this 29th day of July , 1986, **by** the State Board of Equalization, with Board Members Mr. Nevins, Mr. Bennett, Mr. **Dronenburg** and Mr. Harvey present.

_____	, Chairman
William M. Bennett	, Member
Ernest J. Dronenburg, Jr.	, Member
Walter Harvey*	. Member
_____	Member

*For Kenneth Cory, per Government Code section 7.9