



BEFORE **THE** STATE BOARD OF EQUALIZATION
OF **THE** STATE OF CALIFORNIA

In the Matter of the Appeal of)
JAMES R. **AND** **CHRYL** A. WATSON) No. **83A-763-VN**

For- Appellants: Richard **J. Albrecht**
Attorney at Law

For Respondent: Eric **J. Coffill**
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 James **R.** and **Chryl A.** Watson against a proposed assessment of additional personal income tax in the amount of \$5,279 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.

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The sole issue presented for our decision is whether **appellants** have shown error in respondent's determination to reduce their claimed depreciation deductions for the year 1980.

Appellants, husband and wife, own three office buildings in the Bay City Center, a business and retail shopping center located on Pacific Coast highway in the City of Seal Beach, County of Orange. Building A has 10,375 square feet of floor space while Buildings C and D contain a total of 19,670 square feet in floor area. Appellants constructed these two-story buildings in 1980 at a cost in excess of \$2 million.

On their joint California personal income tax return for 1980, **appellants** claimed first year **depreciation** deductions of \$36,504 for Building A and \$71,494 for Buildings C and D. The latter two buildings were treated as a single unit. They calculated the depreciation deductions under the straight line, component method, whereby the buildings were divided into their **various** component **parts** and different useful lives were estimated for **the** shell and such other components of the structures,

Upon audit, the Franchise Tax Board determined that the depreciation deductions claimed by appellants with respect to their office buildings were excessive due to the short useful lives that appellants had assigned to the buildings' components. Respondent redetermined the useful lives of the components based, in part, upon the guidelines set forth in Revenue Procedure 62-21, 1962-2 C.B. 418, which includes recommended depreciable lives for the structural shell and all integral parts of office buildings. Respondent thereupon issued a deficiency assessment that reflected the disallowance of \$13,325 of the depreciation expense claimed for Building A and \$29,305 of the depreciation expense claimed for Buildings C and D.

The useful lives that appellants employed in their 1980 return to depreciate the component parts of their buildings and the useful lives that respondent determined to be proper are as follows:

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Bay City Center Building A

| <u>Components</u> | <u>Useful Life Used By Appellants</u> | <u>Useful Life Determined By Respondent</u> |
|--|---|---|
| Shell | 49 | 45 |
| Thermal & Moisture | 10 | 45 |
| Finishes | 20 | 20 |
| Elevator | | 20 |
| Mechanical-Plumbing, Air | 12 | 45 |
| Electrical | 20 | 45 |
| Tenant Improvements | 10 | 29 |
| Leasing Commissions | 5 | 5 |
| Onsite-Parking Lot, Landscaping | 15 | 30 |
| Offsite-Sidewalks, Lights | | 45 |
| Construction Period Interest | 8 | 10 |

Bay City Center Buildings C & D

| | | |
|--|----|----|
| Shell | 40 | 45 |
| Thermal & Moisture | 10 | 35 |
| Finishes | 10 | 20 |
| Elevator | 20 | 20 |
| Mechanical-Plumbing, Air | 12 | 45 |
| Electrical | 20 | 45 |
| Tenant Improvements | 10 | 20 |
| Leasing Commissions | 5 | 5 |
| Onsite-Parking Lot, Landscaping | 15 | 30 |
| Offsite-Sidewalks, Lights | 40 | 45 |
| Construction Period Interest | 8 | 10 |

As the two schedules indicate, respondent increased the useful lives of 9 of the 11 components in each of appellants' buildings. In particular, respondent determined that the useful life of the shell, thermal-moisture, electrical, plumbing, and air conditioning of the structures was 45 years.

Section 17208 provides for the deduction of a reasonable allowance for the exhaustion, wear and tear, including a reasonable allowance for obsolescence, of property used in a trade or business or held for the production of income. This section is derived from and is substantially similar to Internal Revenue Code section

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167. Therefore, the interpretation and effect given the federal provisions by the federal courts and administrative bodies are relevant in determining the proper construction of the California statute. (Heanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); see Appeal of John 2. and Diane W. Mraz, Cal. St. Bd. of Equal., July 26, 1976, and the **cases cited** therein.)

The amount of a depreciation deduction is based, -in part, upon an estimate of the useful life of the subject property. The useful life of an asset is not necessarily the useful life inherent in the property but the period of time over which the asset may reasonably be expected to be useful to the taxpayer in the production of his income. (**Treas. Reg. § 1.167(a)-1(b).**) This period is to be determined by reference to the taxpayer's experience with similar property, taking into account present conditions and probable **future** developments. **The** regulation further provides:

Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal **progress** of the art, economic changes, inventions and current development within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions **peculiar** to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination.

The determination of an asset's **useful** life and the reasonableness of a taxpayer's depreciation deductions are questions of fact. (Casey v. Commissioner, 38 T.C.

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357 (1962).) Respondent's determination as to the proper depreciation allowance for the year in question carries with it a presumption of correctness, and the burden of proving the determination to be incorrect lies with the taxpayer. (Dunn v. Commissioner, 42 T.C. 490, 494 (1964); Appeal of Continental Lodge, Cal. St. Bd. of Equal., May 10, 1967.)

In the-present matter, appellants contend that the longer useful lives which the Franchise Tax Board deemed to be appropriate are not reasonable because they do not take into consideration the obsolescence of the buildings. During the audit phase of these proceedings in 1982, appellants commissioned a professional real estate appraiser to prepare a component depreciation schedule for their office-buildings in order to lend support to their 1980 deductions. First, the appraiser **concluded that** the buildings were functionally obsolete when they were **completed** in 1980 due to their "super adequacy" which he said was evidenced by the architectural design and special details not usually found in two-story office buildings. Specifically, the appraiser cited **such "super -adequate"** details as the elevators, excessive plumbing, excessive exterior wall area due to the inordinate number of **corners**, pop-out windows, rock veneer treatment, and roof overhangs. Because the cost to construct appellants' office buildings greatly exceeded the cost to build similar office space, the appraiser found that appellants were required to charge higher than market rental **rents to obtain a fair return** on their investment. Consequently, appellants experienced a high turnover of tenants as well as a high **vacancy rate in their properties.**

Second, the appraiser reasoned that the high rental rates and the attendant tenant problems at appellants' office buildings would cause economic obsolescence. Since the asking rent in the buildings was 22 percent higher than the market rent in the area for similar office space, the appraiser postulated the composite useful life of the buildings should be 22 percent less than the admittedly normal 45-year useful life of office buildings. In other words, the composite useful life of the buildings should be 35 years. Appellants submit that this calculation supports the shorter useful lives that they claimed on their 1980 depreciation schedules.

Federal regulations provide that obsolescence should be considered when determining useful life if it

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will render the asset economically useless to the taxpayer, regardless of its physical condition:

The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its **physical condition**. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and **other** like changes, and **legislative** or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. . . .

(Treas. Reg. § 1.167(a)-9.)

Whereas the depreciation deduction is essentially based on wear and tear, obsolescence is an allowance resting on disuse rather than use. (Dunn v. Commissioner, supra.) It permits a taxpayer to recover the cost of an asset where the depreciation deduction for wear and tear is insufficient to restore its basis because the estimated life has been shortened by reason of the asset having been rendered useless for its original function. (Zimmerman v. Commissioner, 67 T.C. 94, 107-108 (1976).)

Since obsolescence is defined in terms of uselessness to the **taxpayer, appellants** must establish with reasonable certainty that their property is becoming obsolete and will be obsolete: that is, appellants must prove what the normal useful lives of the office buildings' components are and that the office **buildings** will have little or no value prior to the end of these normal useful lives. (Dunn v. Commissioner, supra, 42

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T.C. at 494.) The mere reduction or absence of earnings and profits is not sufficient to sustain an **allowance** for obsolescence. (Detroit & Windsor Ferry Co. v. Woodworth, 115 **F.2d** 795 (6th Cir. 1940).) Nor are declining values due to economic conditions. (State Line & Sullivan R. Co. v. Phillips, 98 **F.2d** 651 (3d Cir. 1938), cert. den., 305 U.S. 635 [83 **L.Ed** 4081 (1938).) Overexpansion or other similar management decisions will not support a claim for obsolescence. (Real Estate-Land Title & Trust Co. v. United States, 309 U.S. 13 [84 **L.Ed** 5421 (1940).) **Rather**, appellant must show that the properties in question are or will be affected by economic conditions that will result in their being abandoned at a date prior to the end of their useful lives. (University City, -Inc. v. Commissioner, ¶ 79,198 **T.C.M.** (P-H) (1979).)

Here, we are **compelled** to find that appellants have failed to sufficiently prove their **claims** of obsolescence to warrant assignation of the shorter useful lives to their office buildings. First, their initial argument that the properties were functionally obsolete when first constructed is unsound. There is no reason to suppose, much less any evidence, that the buildings' were rendered useless **by** the number of amenities or architectural design elements in the buildings or that appellants intended to abandon the buildings as obsolete when construction was completed in 1980. Appellants have no basis for asserting obsolescence at that early juncture where they themselves made the management decisions to build the elaborate structures and thus created the very conditions that purportedly made the buildings useless. (Dunn v. Commissioner, supra, 42 T.C. at 495; Appeal of Darr and Patricia Jobe, Cal. St. Bd. of Equal., July 7, 1967.) **Moreover**, since we have noted above that declining values due to economic conditions cannot support a claim **for** obsolescence, it is clear that appellants' properties would not be useless for the function that they were built for merely because the buildings were more costly to build and thus more valuable than other office buildings.

Second, we must likewise reject appellants' mathematical formulation that their office buildings will **be** economically obsolete after 35 years. while their appraiser has conceded that the buildings have normal useful lives in excess of 45 years if properly maintained, appellants have not explained why the useful lives of the buildings and the components therein would be any shorter due to the higher rent schedules there. The rent that appellants chose to establish for their

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buildings undoubtedly had an effect on the vacancy rate as well as on their margin of profit, but it is settled that any loss in economic advantage due to competition is insufficient to support a finding of obsolescence.

(University City, Inc. v. Commissioner, supra.) Here, appellants' attempt to quantify their claim of obsolescence based on so-called "rental loss" must fail, for it is based on an **unfounded supposition** that non-competitive rental prices have the effect of shortening the number of years-that the buildings can function profitably in use.

"An **allowance** cannot be made for obsolescence merely because it is the taxpayer's opinion that the property may become obsolete at some later date," (University City, Inc. v. Commissioner, supra, ¶ 79,198 T.C.M. (P-H) at 79-789 (1979).) Thus, appellants have not established with reasonable certainty that their office buildings will become obsolete before the end of their normal **45-year useful** lives.

Based on the foregoing, we conclude that appellants **have** not met their burden of overturning respondent's determination of the appropriate useful lives for the components of their office buildings. Accordingly, respondent's action in this matter will be sustained.

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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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of James R. and Chryl A. Watson against a proposed assessment of additional personal income tax in the amount of \$5,273 for the year 1980, be and the same is hereby sustained.

Done at Sacramento, California, this 20th day of August ~~1986~~, by the State Board of Equalization, with Board **Members** Mr. Nevins, Mr. Collis, Mr. Bennett and Mr. Harvey present.

| | |
|--------------------|------------|
| Richard Nevins | , Chairman |
| Conway H. Collis | , Member |
| William M. Bennett | , Member |
| Walter Harvey* | , Member |
| _____ | , Member |

*For Kenneth Cory, per Government Code section 7.9

Miller



STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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September 11, 1986

TO: HOLDERS OF THE OPINIONS FROM THE
STATE BOARD OF EQUALIZATION

FROM: ROBERT J. BRENNER

SUBJECT: VOLUMES XXXVI and XXXVII OF THE OPINIONS FROM
THE STATE BOARD OF EQUALIZATION.

Attached are opinions and an updated table of cases related to franchise and income tax appeals decided recently by the State Board of Equalization. These are to be filed in Volume XXXVII.

Also attached are revised pages 264 and 265 to be filed in Volume XXXVI.

For your information, the Board of Equalization Opinions are available on Lexis and PHINet data systems. On Lexis, they are located in the Fedtax, Cal, or States Libraries, in the CALSBE file. On PHINet, they are located under CATX on the main menu.

RJB:lm

Attachments