BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-924-KP
PHILIP L. AND)
MADELEINE G. LAWTON)

For Appellants: Richard W. Konig
Attorney at Law

For Respondent: Elleene K. Tessier
Cdunsel

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 Philip L. and Madeleine G. Lawton against a proposed assessment of additional personal income tax in the amount of $1,931.52 for the year 1979.

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 issue presented by this appeal is whether appellants are entitled to deduct legal expenses they incurred in resisting an eminent domain action instituted by the City of Stockton.

Appellants are husband and wife. Prior to the appeal year, Mrs. Lawton owned a one-half interest in a parcel of real property in downtown Stockton. Apparently, Mrs. Lawton received rent proceeds from the movie theater located on that property. In 1973, the City of Stockton commenced eminent domain proceedings to acquire the property. Allegedly, the condemnation action was initiated for the benefit of a third-party.developer. Mrs. Lawton filed suit against the city challenging the condemnation proceedings on the ground that the taking of her property had no public purpose. Mrs. Lawton prevailed and the court ordered the city to terminate its condemnation proceedings in 1979,

Appellants deducted the legal expenses incurred in their battle with the City of Stockton to defeat the eminent domain action on their joint tax return they filed for 1979. Respondent audited that return and disallowed the deduction on the ground that the cost of defending or perfecting title to property is a nondeductible capital expenditure which must be added to the basis of the property, An appropriate assessment was issued. Appellants protested stating that their action against the city was not one in which title was defended, since the title to the property was undisputed, Respondent denied the protest and this appeal followed.

As respondent concedes the deductibility of the fees in all other respects, the only issue on appeal is whether the fees are capital expenditures or current expenses. Section 17202. provides for the deduction of all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Similar provision is made in section 17252 for the deduction of all ordinary and necessary expenses paid or incurred during the taxable year for the management, conservation, or maintenance of property held for the production of income, Section 17283 prohibits the deduction of capital expend-itures as current expenses. Sections 17202, 17252, and 17283 are virtually identical to, and were based upon, sections 162, 212, and 263, respectively; of the Internal Revenue Code, Therefore, federal cases interpreting the federal statutes are highly persuasive as to the interpretation of the

respective state statutes. (Andrews v. Franchise Tax Board, 275 Cal.App.2d 653 [80 Cal.Rptr. 403] (1969).)

In an effort to develop a uniform approach to decide the deductibility of expenses, the United States Supreme Court in United States v. Gilmore, 372 U.S. 39 [9 L.Ed.2d 570] (1963), formulated the so-called "origin and character" test. As stated by the court, the characterization of the expense:

> [D]epends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It does not depend on the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim . ... [S]uch a rule [based upon consequences to the taxpayer! would lead to capricious results. If two taxpayers are each sued for an automobile.accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstances of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or nonincome-producing property. We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation.
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> For these 'reasons, we resolve the conflict among the lower courts- . . . in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was . . . deductible or not . . . . (Emphasis original.)

(United States v. Gilmore, supra, 372 U.S. at 48-49.)

The United States Court of Appeals extended the application of the "origin and character" standard to the question of capital vs. noncapital expenses in Madden v. Commissioner, 514 F.2d 1149 (9th Cir. 1975), revd. 57 T.C. 513 (1972), cert. denied, 424 U.S. 912 [47 L.Ed.2d

3161 (1976). When faced with a factual situation almost identical to the one presently before us, the court in Madden reversed the tax court's finding that attorneys' fees were currently deductible with this reasoning:

> In looking to the origin and character of the litigation, however, we are compelled to treat the legal expenses as capital in nature. The underlying lawsuit did not arise out of taxpayers' business, but out of the need of a governmental agency for taxpayers' land. The public need presumably existed without regard to the consequences to taxpayers' business. The government was attempting to appropriate taxpayers' land and taxpayers were resisting that attempt.. Such a controversy is inherently related to the sale and acquisition of land, even though the ultimate sale, if one is made, is a forced sale. (Citations,)
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> [I]n Woodward, the Court noted that "[a] test based upon the taxpayer's 'purpose' in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions * * *." 397 U.S. at 577, 90 S.Ct. at 1306.
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> We believe that rejection of the "origin and character", standard in situations such as that in the instant case would result in allowing different taxpayers to characterize basically similar litigation in the manner that would have the most beneficial tax consequences to each. Although use of the "origin and character", standard aliows the governmental agency to determine unilaterally the nature of the litigation, and thus the tax consequences for the taxpayer, we do not think this phenomenon invalidates its application. The agency initiated the condemnation proceedings here for a tax-neutral purpose. Where this is so, there is no 'inherent unfairness to the taxpayer, Furthermore, all taxpayers with capital assets affected by the agency's action will be similarly treated. Finally, the element

of certainty, particularly desirable in tax law, is enhanced.

(Madden v. Commissioner, supra, 514 F.2d at 1151-1152.)

We find this reasoning persuasive and adopt the court of appeals' holding. We reach this conclusion despite appellants' argument that the condemnation proceedings were invoked for a reason other than a public purpose. Whether the reason behind the condemnation proceeding was fraud or collusion is not the issue. The fact remains that the proceedings were started for a tax-neutral purpose not related to the taxpayers' production of income or their business activities. As' such, this case falls squarely under the rationale of Madden.

Appellant's argument that the deductibility of attorneys' fees in a condemnation proceeding turns on the question of whether the condemnation action is for possession of property rather than an action for the taking of title to property misses the point. The Gilmore rationale eliminates the need to distinguish at what, point in the litigation, or under what theory! the attorneys' fees change from current expense to capital expenditure or vice-versa. (See Woodward v. Commissioner, 397 U.S. 572 (25 L.Ed. 2d 577] (1970).) Although separate causes of action based on separate legal theories, separate theories of recovery, and separate stages of litigation may be addressed or reached in a lawsuit challenging a condemnation, all of those issues and stages revolve around one central theme, the eminent domain action against the property. It is for that reason the court in Madden found there was no need to discuss whether attorneys' fees would be deductible if the action was defined as a defense of title or otherwise. (See Madden v. Commissioner, supra, 514 F.2d at 1150, fn. 4.) It is also that focus on the central issue which compels us to reject appellants* suggestion that we allow the deductibility of attorneys* fees in cases where the taxpayer prevails in a condemnation action, but do not allow their deductibility where the taxpayer fails. Such a capricious rule would fly in the face of the rationale established in Gilmore, Woodward, and Madden.

Finally, we note that by taking the above position, we reject the line of tax court cases cited by

appellants,[2] as those cases were decided prior to the court of appeals' decision in Madden. Since the Madden decision was rendered, the tax court itself has specifically rejected its decision in Reakirt v. Commissioner, 29 B.T.A. 1296 (1934), the former leading case in this area and the basis of appellants' argument, and has accepted the propriety of the "origin and character" standard enunciated in Madden as the proper test to determine the deductibility of attorneys' fees in the present context. (See Von Eafften v. Commissioner, 76 T.C. 831 (1981); see also Soelling v. Commissioner, 70 T.C. 1052 (1978); Iske v. Commissioner, ¶ 80,061 T.C.M. (P-H) (1980).)

For the above-stated reasons, respondent's action in this matter will be sustained.

2/ Reakirt v. Commissioner, 29 B.T.A. 1296 (1934); see also Charlie Sturgill Motor Co. v. Commissioner, ¶ 73,281 T.C.M. (P-H) (1973), which was based on the Reakirt rationale as expressed in the tax court case-den v. Commissioner, 57 T.C. 513 (1972), prior to the Ninth Circuit's reversal.

Appeal of Philip L. and Madeleine G. Lawton

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 Philip L. and Madeleine G. Lawton against a proposed assessment of additional personal income tax in the amount of $1,931.52 for the year 1979, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of September, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9