86-SBE-202

BEFORE TEE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ENSIGN CLUB) No. 84R-955-GO

Appearances:

For Appellant: Bill Bertetta

For- Respondent: Patricia I. Hart
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 Ensign Club for refund of franchise tax in the amount of $4,041.06 for the income year ended January 31, 1978.

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.

The major issue in this matter is'whether and, to what extent, gain from the sale of appellant's real property during the year at issue should be recognized pursuant to the provisions of section 23732, subdivision (a)(2)(C).

Appellant is an organization exempt from taxation under section 23701g. Prior to and during the year at issue, appellant owned real property located at 751 47th Street in Oakland, California (hereinafter "47th Street property") which was used directly in the performance of its exempt function. On April 28, 1976, appellant purchased other real property located at 3318 Piedmont Avenue in Oakland, California (hereinafter "Piedmont property") which was also used directly in the performance of its exempt function. At the time of the purchase of the Piedmont property, the 47th Street property was listed for sale. However, due to zoning restrictions, poor location, and a depressed real estate market, the 47th Street property was not sold untii August 24, 1977, some 16 months after the purchase of the Piedmont property.

Appellant's tax return for fiscal year ended January 31, 1978, indicated that appellant realized a gain of $27,781 fros the sale of the 47th Street property (Resp. Br., Ex. B), but none of that gain was recognized. Upon audit,. respondent concluded that the sale was subject to taxation as "unrelated exempt function income" and assessed additional tax of $2,520.36. Appellant filed a protest dated July 8, 1982. However, appellant subsequently paid the amount assessed plus interes-t and filed this claim for refund. On March 21, 1984, respondent disallowed the refund and appellant filed this appeal.

On appeal, appellant initially argues that section 23732, subdivision (a)(2)(C), should apply to the sale so that the gain should not be recognized. In contrast, respondent contends that the transaction does not meet the stated requirements of section 23732, subdivision (a)(2)(C), and that:, accordingly, gain must be recognized.

This case, then, initiaily involves the construction of section 23732, subdivision (a)(2)(C) which provides, as follows:.

> If property used directly in the performance of the exempt function

> of an organization described in section 23701g or 23701i is sold by such organization, and within a period beginning one year before the date of such sale, and ending three years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property. For purposes of this subparagraph, the destruction in whole or in part; theft, seizure, requisition, or condemnation of property, shall be treated as the sale of such property and rules similar to the rules provided by Sections 18092, 18093, 18095, and 18100 shall apply.

While admitting that the transaction does not "readily fall" into the literal provision of that section since the 47th Street property was not sold within one year of the purchase of the Piedmont property, appellant argues that "[r]elief from the wooden time restrictions of the statute is certainly warranted, and clearly within the legislative intent." (App. protest letter, June 14, 1984, at 4.)

This nonrecognition provision has not previously been construed. However, the above statute is similar to its federal counterpart. (I.R.C. § 512 (a)(3)(D).) Accordingly, cases interpreting Internal Revenue Code section 512 (a) (3)(D) would be highly persuasive as to the proper. application of section 23732, subdivision (a)(2)(C). (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942); Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] cert. den.., 314 U.S. 636 [86 L.Ed 510 (1941); Union Oil Associates v. Johnson, 2 Cal.2d 727 [43 P.2d 291] (1935).)

To our knowledge, only one case has interpreted Internal Revenue Code section 512 (a)(3)(D). (Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985).) That case involved the interpretation of the phrase "organization's sales price." The Tax Court noted that the

starting point for interpreting a statute is the language of the statute, itself. (Rosewell v. LaSalle National Bank, 450 U.S. 503, 512 [67 L.Ed.2d 464] (1981); Consumer Product Safety Commission v. GTE Sylvania, 447 U.S. 102, 108 [64 L.Ed.2d 766] (1980).) Absent a clearly expressed legislative intention to the contrary, the language of a statute ordinarily must be regarded as conclusive. (United States v. Turkette-, 452 U.S. 576, 580 [69 L.Ed.2d 246] (1981); Consumer Product Safety Commission v. GTE Sylvania, supra, 447 U.S. at 108.)

The language of section 23732, subdivision (a) (2) (C), clearly provides that in order to qualify for nonrecognition treatment, the sale of the subject property must occur within a period of one year after the purchase of other property "used by such organization directly in the performance of its exempt function. ..." Appellant admits that the instant sale occurred 16 months after the purchase of the qualifying property, well beyond the statutory period of one year. Citing no authority, appellant nevertheless argues that unusual market conditions "dictate a liberal re-doing of the provision" to conform with the spirit of the statute, (App.'s protest letter June 14, 1984, at 4.)

The Senate Finance Committee provided the following explanation with respect to the exception of its tax on unrelated business taxable income codified in Internal Revenue Code section 512 (a)(3)(D):

> In addition, the committee's bill provides that the tax on investment income is not to apply to the gain on the sale of assets used by the organizations in the performance of their exempt functions to the extent the proceeds are reinvested in assets used for such purposes within a period beginning 1 year before the date of sale and ending three years after that date. This provision is to be implemented by rules similar to those provided where a taxpayer sells or exchanges his residence (sec. 1034). The committee believes that it is appropriate not to apply the tax on investment income in this case because the organization is merely reinvesting the funds formerly used for the benefit of its members in

> other types of assets to be used fur the same purpose. They are not being withdrawn for gain by the members of the organization. For example, where a social club sells its clubhouse and uses the entire proceeds to build or purchase a larger clubhouse, the gain on the sale will not be taxed if the proceeds are reinvested in the new clubhouse within three years.

(S. Rep. No. 552, 91st Cong., 1st Sess., reprinted in 196.9-3 C.B. 423, 470-471.)

Nothing. in the committee report pertinent to Internai Revenue Code section 512 (a) (3)(D) supports appellant's argument that the statutory time limits are other than specific. (*See* Tamarisk Country Club v. Commissioner, *supra.*) Accordingly, appellant's first argument must be rejected and the gain realized must be held to be "unrelated business taxable income" subject to tax.

This conclusion, however, does not end our inquiry. At the oral hearing and in subsequent briefs, appellant argues that its adjusted basis for computing gain was, in fact, greater than it had initially reported on its tax return, so that, in effect, it realized no gain on the sale of the 47th Street property. First, appellant argues that several of its members contributed their labor to the construction of the 47th Street building and that this labor, estimated to be $24,000 in value, must be added to its basis. (App. Post Hrng. Memo., Sept. 30, 1985.) Moreover, appellant argues that since it was an organization exempt from taxation, it *never* claimed depreciation so that the figure listed as accumulated depreciation of $15,134 on its tax return (Resp. Br., Ex. A) should be added back to its basis. (App. Post Hrng. Nemo., April 8, 1986.) Respondent answers that it has "trouble" with respect to the labor element of basis and argues that section 24916 requires that the property's basis must be reduced for "allowable depreciation" as opposed to depreciation actually allowed. (Resp. Post Hrng. Memo., May 1, 1986.)

We, likewise, have trouble with appellant's adjustments to basis with respect to the labor of its members. The basis of property acquired by purchase is its *cost*. (Rev. & *Tax.* Code § 24912). The cost of capital expenditures made to property during its holding period can also be added to basis. (Rev. & Tax. Code

§ 24916, subd. (a).) However, there is no indication that appellant incurred any cost for the labor of its members which it now claims should be added to the basis of the 47th Street property. Instead, it appears from the record that its members donated their labor to appellant. While the donee's basis for property acquired by gift is the same as the donor's basis (Rev. & Tax. Code § 24914, subd. (a),) it cannot be said that its members had any basis in their own labor. Accordingly, we must hold that appellant's claimed adjustment to the basis of the 47th Street property relating to the labor of its members is erroneous.

Appellant's second argument relating to the proper adjusted basis of the 47th Street property is also misplaced. In brief, appellant argues that while its tax return indicated that the cost basis of the property of $17,312 had been reduced by accumulated depreciation of $15,134, as an exempt organization it had, in fact, taken no deduction for such depreciation. Therefore, appellant argues, no depreciation was allowed and, accordingly, no adjustment to its basis is warranted when computing gain. Respondent answers that, pursuant to section 24916, basis is adjusted not for depreciation "allowed" but depreciation "allowable" so that "no special treatment [should be] given to property" held by a tax exempt organization. (Resp. Post Hrng. Memo., May 1, 1986, at 2.)

For federal purposes, it is clear that the basis of property must be decreased by the depreciation "allowed" to the extent that this depreciation resulted in tax benefit but "not less than the amount allowable." (I.R.C. § 1016 (a)(2)).[2] Moreover, Internal Revenue Code section 1016(a)(3) provides, in relevant part, that proper adjustment shall be made when such property was held by an organization not subject to tax. The legislative history of this provision provided the following explanation:

[2] Internal Revenue Code section 1016(a)(2) provides, in relevant part, that proper adjustment shall be made "for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount ... resulting ... in a reduction ... of the taxpayer's taxes ... but not less than the amount allowable. ..."

B. Depreciation sustained while property is used by a tax-exempt organization (sec. 1016)

Where a tax-exempt organization which has held a property for a number of years becomes taxable (as in the case of the application of the unrelated business income fax since the Revenue Act of 1950) questions have been raised as to what basis the property should have for purposes of computing depreciation for income-tax purposes. The alternatives available are the original cost of the property, its fair market value at the time the organization becomes. taxable, or its cost less depreciation and obsolescence which has taken place during the interval prior to the time when the organization becomes taxable.

The present code does not deal specifically with this problem. The rule presently followed by the Internal Revenue Service is the third alternative described. above. *Your* committee has endorsed the position taken by the Service by specifically providing in the new code that the basis of the property, for purposes of computing taxable income, is reduced for exhaustion, wear, tear, obsolescence, amortization, and depletion to the extent sustained during any period since 1913 when the property was held by an organization not subject to income taxation.

(H.R. Rep. No. 1337, 83rd Cong., 2nd. Sess., reprinted in 1954-3 U.S. Code Cong. & Ad. News 4105].)

Appellant argues that the same rationale should apply to the instant appeal to limit the adjustment for basis to the amount of depreciation taken or actually sustained by it rather than the amount allowable. The rationale of the federal statute, however, appears to be grounded upon the proposition that basis is reduced by depreciation allowed to the extent that such depreciation resulted in a tax benefit. (I.R.C. § 1016(a)(2); see footnote two cited above?. The short answer to appellant's argument is that neither this tax benefit principle nor the adjustment for organizations not subject to income taxation (I.R.C. § 1016(a) (3)(B)) is mandated by section 24916. Accordingly, we must hold

that the federal legislative history cited above is not relevant to the present inquiry and that respondent's interpretation of section 24916 outlined above is accurate.

Therefore, we hold that the respondent's action must be sustained.

Appeal of Ensign Club

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HERESY 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 Ensign Club for refund of franchise tax in the amount of $4,041.06 for the income year ended January 31, 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of December, 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