87-SBE-059

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BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 84A-373-PD
FRANKLIN E. AND	)	
SUZANNE H. SCUDDER	)	

For Appellants: Franklin E. Scudder, in pro per.

For Respondent: Karen D. Smith 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 Franklin E. and Suzanne H. Scudder against proposed assessments of additional personal income tax plus penalties in the amounts of $2,458.85 and $2,221.72, for the years 1976 and 1977, respectively, and of additional personal income tax of $4,009.53 for the year 1978.

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

At issue is whether respondent improperly (1) disallowed a theft loss deduction, (2) included a gain from the sale of a personal residence in its computation of tax preference income, and (3) disallowed losses claimed on corporation stock and tree farm properties.

Franklin E. and Suzanne H. Scudder are referred to herein as appellants since this appeal is of their joint assessment by respondent. Suzanne H Scudder died after this appeal was filed, so Franklin E. Scudder is referred to individually as the appellant.

On February 26, 1982, respondent issued notices of proposed assessment (NPAs) of additional income tax for 1976, 1977, and 1978 relating to the minimum tax on tax preference items resulting from large farm losses claimed by appellants during each of those years. Respondent also proposed additional assessment for the year 1978 because it disallowed a claimed Santa's Forest Corporation (hereafter "SFC" or "corporation") stock loss which did not qualify as a casualty or theft loss, and disallowed a loss attributable to real property interests received from SFC because the loss was not sustained in 1978. Respondent also assessed negligence penalties, which were abated prior to this appeal and penalties for failure to file returns, which were conceded during the course of this appeal.

Apparently, appellant does not now object to the portions of the assessments relating to tne minimum tax on tax preference items in the assessments for 1976 and 1978 and objects only to that portion of the minimum tax for 1977 which he believes was computed on the sale of appellants' personal residence in that year. Respondent denies having included the income from the sale of appellants' residence in the tax preference computation and has provided its computation of the minimum tax on tax preference items for 1977. It appears that the $14,796.05 gain from the sale of appellants' personal residence was included in the detailed listing of all appellants' long term capital gains reported, but only the $31,807 gain from the sale of 17.99 acres of land was actually included in respondent's computation as the amount of capital gains subject to tax preference for 1977. Thus, the $14,796.05 gain from the sale of the personal residence was not included in that computation.

Appellant's second objection is that respondent disallowed the theft loss deduction for 1977 which arose

out of the theft of personal property from a rented storage space in Santa Rosa. Respondent counters that it allowed the Santa Rosa garage theft loss in 1977 and that it only disallowed the claimed 1978 loss arising out of the SFC stock as not qualifying, inter alia, as a theft loss. The copy of the NPA for 1977 issued on February 26, 1982, and supplied by respondent does not contain any tax change relating to any disallowance for itemized deductions including, necessarily, itemized theft loss deductions. So it appears that respondent did not disallow whatever Santa Rosa garage theft deduction appellant may have claimed on the return for 1977.

Finally, appellant's only remaining objection is to respondent's disallowances of deductions claimed for 1978 reiating to SFC stock and to appellants' real property *interests* received from that corporation. Our understanding of the relevant facts is sketchy. Apparently, by the end of 1969, appellant was a shareholder in the corporation, which was located in' Waukesha, Wisconsin, and which had interests in stands of growing trees scattered throughout the Midwest. On January 10, 1970, appellant loaned the corporation $35,000. *On* May 7, 1979, the corporation conveyed its undivided one-fourth interest in 44.41 acres in Waterloo, Iowa (the "Waterloo asset") to appellant by quitclaim deed. That conveyance noted that the right, title, and interest which the corporation was conveying was solely that which it had derived from its agreement of October 16, 1968,' with the Production Credit Association (PCA); it did not specify the nature of that right, title, and interest. The conveyance noted that the consideration for the transfer had been paid in November 1969. The conveyance was filed for record on May 25, 1970. Additionally, on April 8, 1970, SFC granted appellant a security interest (not title) in its inventory of trees on the Deerfield Plantation in Illinois (the "Deerfield asset") as Security for the payment of the $35,000 appellant had loaned to SFC. The corporation agreed to pay appellant certain amounts if it should cut, remove, or sell part, or all, of those trees. There is no evidence that the security interest was ever perfected.

Appellant has provided an undated list of corporation assets available as security for proposed loans. The list valued the Waterloo asset at $220,000 for the land and trees and noted a PCA lien on it or for $65,000, a Morris Plan of Cedar Rapids second mortgage

for $50,000, and that Frank Scudder and Willard Croft had each purchased a 25-percent interest in that land and crop, together valued at $110,000. The list valued the Deerfield asset at $45,000 for the trees and $0.00 for the land, noted no encumberances or other interests, and listed $45,000 as the amount pledgeable on that property.

In May 1970, a petition for a Chapter X bankruptcy was filed for the corporation. In August 1971, the trustee in bankruptcy sold whatever interests the corporation had in the Waterloo and Deerfield assets, according to the trustee's attorney. That attorney also recalled that the Waterloo real estate had been sold under tax deeds or certificates.

In 1975, appellant engaged an Iowa attorney to protect his interests in the Waterloo and Deerfield assets. During 1977, that attorney allegedly told appellant that the abstract of title indicated that appellant had a valuable interest in the Waterloo asset and that the attorney was negotiating a sale of trees from the Deerfield asset. In February 1978, appellant was told that PCA had started legal proceedings to recover the value of its lien on the Waterloo property. In April 1978, appellant's Iowa attorney died. Upon the advice of his accountant, appellant decided not to hire another attorney to protect any interests he might have in the aforementioned property, but to abandon that effort and claim a loss.

Based upon the information related above, we must determine whether appellant has demonstrated that the claimed losses on the corporation's stock and on his interests in the Waterloo and Deerfield assets were deductible by him in 1978. It is well-settled that tax deductions are a matter of legislative grace and that the taxpayers bear the burden of proof that they are entitled to a particular deduction claimed. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of Joseph A. and Marion Fields, Cal. St. Bd. of Equal.,)

Section 17206 allows a deduction where certain types of property owned by the taxpayer become worthless during the taxable year and the loss is not compensated by insurance or otherwise. The deduction is allowed only if the property becomes worthless during the year the deduction is claimed. (Kirven v. Commissioner, ¶ 77,028

T.C.M. (P-H) (1977); Appeal of Everett R. and Cleo F. Shaw, Cal. St. Bd. of Equal., Apr. 6, 1961.) To take a loss on a property in a particular year, the taxpayer bears the burden of proving that the property had value at the beginning of that year and that it was rendered worthless, with no liquidating or potential value, during that year. (Boehm v. Commissioner, 326 U.S. 287 [90 L.Ed. 78) (1945); Mahler v. Commissioner, 119 F.2d 869 (2d Cir. 1941).)

In the case of appellant's corporation stock, there is no reason to conclude that the stock had any value after 1970, the year the corporation went bankrupt and the trustee was selling the corporation's assets. In any event, appellant admits that the stock became worthless as early as 1971, when any hopes of an anticipated merger terminated. So there is no reason to believe that the stock became worthless in 1978, the year appellants claimed the loss on the stock.

In the case of appellant's interests in the Waterloo and Deerfield assets, appellant's claimed deduction was based on his abandonment of those assets. But, again, a loss deduction must be supported by proof that the interests were abandoned because they became totally worthless during that year.

Apparently at some time in 1977, appellant's Iowa attorney advised appellant that his interests in the tree farm properties had some value. While that fact might suggest that appellant's property interests had value at the beginning of 1.978, it does not indicate what that value was, nor does it indicate that the property interest became worthless during that year. Furthermore, we have no other evidence that appellant's interests in those properties either had value at the beginning of 1978 or became worthless at some particular time in 1978. Appellant's 1978 decision not to incur any further attorney's fees to protect his interests does not demonstrate that those interests had become worthless at that time. Indeed, the available facts do not provide any basis upon

which we may reasonably conclude that appellant's interests in the tree farm properties had value at the beginning of 1978 and became valueless during that year, thereby entitling appellant to a loss deduction for 1978. 2/

Accordingly, we are unable to find that appellant has demonstrated error in respondent's assessments, and we must sustain respondent's actions, except as modified by its concession with respect to the penalties.

2/ Although it is not clear, appellant may be claiming a bad debt deduction (Rev. & Tax. Code, § 17207) for the $35,000 loan to the corporation which was secured by appellant's security interest in the Deerfield asset. If appellant is making such a claim it also must be rejected since a secured debt does not become worthless until the collateral security itself becomes worthless. (See, e.g., Appeal of Morlyn L. and Velma K. 'drown, Cal. St. Bd. of Equal., Oct. 27, 1964.)

Appeal of Franklin E. and Suzanne H. Scudder

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 EEREBY 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 Franklin E. and Suzanne H. Scudder against proposed assessments of additional personal income tax plus penalties in the amounts of $2,458.85 and $2,221.72, for the years 1976 and 1977, respectively, and of additional personal income tax of $4,009.53 for the year 1978, be and the same is hereby modified in accordance with the concession of respondent. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 28th day of July , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman

William M. Bennett , Member

Paul Carpenter , Member

Anne Baker* , Member

, Member

*For Gray Davis, per Government Code section 7.9

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BEFORE THE STATE BOARD OF EQUALIZATION

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In the Matter of the Appeal of)
) (No. 84A-373-PD
FRANKLIN E. AND)
SUZANNE H. SCUDDER)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed August 24, 1987, by Franklin E. Scudder for rehearing of their appeal from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby denied and that our order of July 28, 1987, be and the same is hereby affirmed.

Done at Sacramento, California, this 17th day of November, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Anne Baker*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9