BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81A-266-MA
FREEMON AND DOROTHY THORPE)

Appearances:

For Appellants: Russell Tollefson
Certified Public Accountant

For Respondent; Kathleen M. Morris
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 Freemon and Dorothy Thorpe against proposed assessments of additional personal income tax in the amounts of $2,551.23, $4,928.03, $5,205.09, and $3,331.86 for the years 1974, 1975, 1976, and 1977, respectively.

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

The sale issue to be resolved in this appeal is whether appellants' claimed expenses were incurred in an activity entered into for profit.

Appellant-husband, Mr. Thorpe, is a wholesale distributor of beauty and barbershop supplies and resides with his wife in Pasadena, California. During the years at issue a substantial portion of appellants' income was derived from dividends and interest. In 1973, appellants purchased approximately 200 acres of Land Located in Palo Cedro. Appellants constructed buildings, corrals and barns in order to use the purchased property as a ranch. The ranch property was reflected in appellants' returns on Schedule C as a sole proprietorship known as "Thorpes TBS Properties" (Properties) with the principal business purpose stated as "investments." A separate entity, Thorpes TBS Ranch, Inc. (Ranch or the Corporation) was incorporated on December 7, 1973, and began doing business on January 1, 1974. Apparently, it was the Corporation, and not the sole proprietorship, Properties, which actually operated the Ranch.

During the years at issue the income and deductions shown on appellants' schedule C for their property were as follows:

	Gross Receipts or Sales	Depreciation	Other Expenses	Net Loss
1974	$ -0-	$19,177	$ 4,131	($23,308)
1975	$ 2,108	45,249	1,195	($44,336)
1976	$ 646	47,522	443	($47,319)
1977	$ 2,400	32,465	207	($30,352)

As appellants' schedule C indicates, most of the claimed losses consisted of depreciation of the above-mentioned property (building, corrals, barns, etc.) which they constructed on the Palo Cedros property in order that the property could he used by the Corporation as a ranch.

Respondent disallowed claimed losses on appellants' tax returns for the years at issue on the grounds appellants were not engaged in any activity far profit. Appellants argue that the expenses claimed (namely depreciation) were in connection with an activity entered into for profit, namely Thorpes TBS Properties and, thus, were properly deductible pursuant to section 17202. Respondent argues that the evidence presented by appellants

shows, however.- that appellants' activities did not constitute a trade or business but instead were "activities not engaged in for profit" as defined in section 17233.

Subsequent to the filing of this appeal, appellants provided respondent with a federal audit report which disallowed appellants' claimed expenses for 1977 and 1978 on their federal tax return. The basis of the federal disallowance was that appellants@ operation of Thorpes TBS Properties was not an activity entered into for profit.

Before addressing appellants' arguments, we note first that the Internal Revenue Service (IRS) has determined that the expenses incurred in connection with Thorpes TBS Properties were not for an activity entered into for profit. Appellants acquiesced in this determination. As such, the IRS disallowed the claimed losses for the appeal year 1977 under the terms of section 183 of the Internal Revenue Code, the counterpart to section 17233.

Section 18451 of the Revenue and Taxation Code provides, in part, that a taxpayer shall either concede the accuracy of a federal determination or state wherein it is erroneous. It is well settled that the burden is on the taxpayer to overcome the presumption of correctness that attaches to a federal determination. (Todd v. McColgan, 89 Cal.App.2d 509; 201 P.2d 414 (1949); Appeal of Bernard J. and Elia C. Smith, Cal. St. Bd. of Equal., Jan. 9, 1979.)

Appellants were simultaneously audited by the Internal Revenue Service on the same issue as disputed here. They conceded that they were not engaged in an' activity for profit at the federal level and this determination is binding upon the appellants unless they can demonstrate that the federal determination was erroneous. For the reasons stated below we conclude that appellants have not offered any evidence with which to overcome the presumption of correctness that attaches to a federal determination. Because the facts are essentially identical for all the years under appeal, the federal determination is persuasive for the earlier appeal years. That is, if appellants conceded that Thorpes TBS Properties was not an activity entered into for profit in 1977, in the absence of any contrary evidence, the same conclusion should be reached' for the years 1974 through 1976.

Appellants have the burden of establishing that they operated Thorpe TBS Properties primarily for profit-seeking purposes and not primarily for personal, recreational or other nonprofit purposes. (Appeal of Harold and Joyce E. Wilson, Cal. St. Bd. of Equal., Sept. 9, 1983) Whether an individual engages in an activity with the intention of making a profit is to be resolved on the basis of all the facts and circumstances (Golanty v. Commissioner, 72 T.C. 411, 425-426 (1979), affd. without pub. opn., 647 F.2d 170 (9th Cir. 1981).) In order to determine a taxpayer's primary purpose, the following factors are considered: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value: (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or losses with respect to the activity: (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. (See generally Treas. Reg. S 1.183-2(b) (1972).) 'Whether the property was acquired and held for the purpose of making a profit is a question of fact to be determined from all the facts and circumstances of the case. "No single factor is controlling but greater weight is to be given to objective facts than to the taxpayer's mere expression of intent." (Johnson v. Commissioner, 59 T.C. 791, 815 (1973).)

In their attempt to demonstrate that the expenses incurred were in connection with an activity entered into for profit, appellants have listed each of the relevant factors cited in Treasury Regulation S 1.183-2(b), supra, and have attempted to show how each ii applicable. In doing so, appellants argue that it was their intent to make a profit but have presented little or no objective facts to support this argument. Additionally, appellants implicitly ask that we consider the activities of Thorpes TBS Ranch, Inc., the corporation operating the ranch, and Thorpes TBS Properties, the proprietorship which owns the real property, as an integral unit. Herein lies the inherent weakness in appellants' argument. We cannot treat Ranch and Thorpes TBS Properties as a single entity. Ranch is a separate corporation and a separate taxable entity. As respondent correctly points out, appellants cannot piggyback Ranch's activities to that of their sole proprietorship in order

to establish that Thorpes TBS Properties was engaged in an activity entered into for profit. The question of whether it was proper for Thorpes TBS Properties to deduct the claimed expenses is the only issue which is before this Board. Thus, any arguments used by appellants which relate to Ranch's activities, and the expenses incurred in connection with the separate operation of that corporate entity known as Ranch, are irrelevant.

None of the other evidence presented by appellants leads to the conclusion that the operation was other than a passive investment. In fact, rather than buttressing appellants' argument that Properties was an activity entered into for profit, many of the factors they cite point only toward the conclusion that the property was a passive investment purchased for its potential increase in value as opposed to a profit-making activity. This, coupled with the fact that during the years at issue only a nominal rent was paid by Ranch for the use of the property and that appellants' primary source of income was from other passive investments, serves to negate a finding that Thorpes TBS Properties was an activity entered into for profit.

Finally, we note that Thorpes TBS Properties has suffered substantial losses throughout its existence and continues to suffer losses; therefore, profit'motive does not appear to be a prime motivating factor for appellants. While the absence of profit is not necessarily determinative of whether or not an activity was entered into for profit, the operation must be of such a nature that in good faith, 'the taxpayers could expect a profit. (Carkhuff v. Commissioner, 425 F.2d 1400 (6th Cir. 1970).) In this case, there is a strong indication that appellants' actions were motivated by a desire to shelter their substantial income. *In* fact, it appears that one of the reasons Ranch and Thorpes TBS Properties were kept separate was to allow appellants to shelter their substantial income because, otherwise the losses would serve no tax benefit.

For the reasons stated above, respondent's determination is sustained in all respects.

Appeal of Freemon and Dorothy Thorpe

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 Freemon and Dorothy Thorpe against proposed assessments of additional personal income tax in the amounts of $2,551.23, $4,928.03, $5,205.09, and $3,331.86 for the years 1974, 1975, 1976, and 1977, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of October, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

87-SBE-072-A

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) 81A-266-MA
Freemon and Dorothy Thorpe)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed November 5, 1987, by Freemon and Dorothy Thorpe 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 ordered that the petition be and the same is hereby denied and that our order of October 6, 1987, be and the same is hereby affirmed.

Done at Sacramento, California, this 3rd day of May, 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Carpenter and Mr. Collis present.

Ernest J. Dronenburg, Jr., Chairman

Paul Carpenter, Member

Conway H. Collis, Member

_____, Member

_____, Member