BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85A-126-MA
JESSE A. AND PATRICIA E. NIMOCKS)
)

For Appellant: John E. Chilton
Certified Public Accountant

For Respondent: B. (Bill) S. Heir, 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 Jesse A. and Patricia E. Nimocks against proposed assessments of additional personal income tax in the amounts of $5,152.80, $3,263.00, $1,796.00, and $490.00 for the years 1979, 1980, 1981, and 1982, 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 issues in this appeal are whether respondent correctly determined the amount appellants were "at risk" within the meaning of section 17599[2/] and whether certain partnership distributions were in excess of appellants' adjusted basis in their partnership interest.

During the years at issue; appellants each owned a 13-percent limited partnership interest in Happy Hands Publishing Company (Partnership), a Texas limited partnership. Partnership is engaged in the business of publishing magazines for sale to the general public. Its two largest publications are "Needlecraft for Today" and "Needle and Thread." The primary effort to acquire subscribers is undertaken on Partnership's behalf by Publishers' Clearing House, which solicits subscribers for many publications.

Partnership was formed in 1977 and commenced business operations in 1978. According to the limited partnership agreement (Agreement) appellants' initial capital contribution totaled $260. The initial Agreement, in effect during each of the years at issue, provided that other than the initial capital contributions, "the limited partners shall not be required to make any additional capital contributions." Except for their' liability to loan money to the Partnership, the liability of the limited partners is limited to the amount of each limited partner's actual capital contribution. The agreement further provides that:

> after the General Partner has loaned the Partnership $100,000 ... and after the Partnership has expended this $100,000, the General Partner may demand ... that Patricia E. Nimocks and Jesse A. Nimocks loan the Partnership all or part of the total sum of $100,000. The proceeds of any such loans shall be used exclusively for the purpose of satisfying the Partnership's' liabilities to Publishers' Clearing House ....

Under the original agreement, the Partnership could not demand such loans after December 3, 1979. This cut-off date was later extended in the five amendments to the original agreement. The Agreement also gave appellants

2/ This section was repealed in 1983 but was in effect for the years in question.

> [The] option to purchase additional Limited Partnership interests from the other Limited Partner at the rate of one percent (1%) for every two thousand dollars ($2,000.00) loaned to the Partnership, at a purchase 'price of ten dollars ($10.00) per one percent (1%) interest to be paid to the other Limited Partner not required to make loans . . . ."

According to the evidence. provided, the aforementioned loan provisions 'were intended merely as a reassurance to Publishers' Clearing House (PCH) that PCH's risk would be minimal. In fact, during the years at issue appellants were'never called upon to make any loans to the Partnership.

During each of the years at issue the Partnership reported losses. On their California individual income tax returns, appellants deducted a partnership loss of $75,554 in 1978. In 1979, appellants deducted a partnership loss of $36,780, apparently representing what they perceived to be their "at. risk" amount. Appellants did not deduct any partnership losses in 1980, 1981, or 1982.

In 1979, appellants began receiving cash distributions from the Partnership. Their distributions were as follows:

1979		$ 43,206
1980		64,650
1981		66,3000
1982		200,226
	Total	$374,382

The Partnership sold many three-year subscriptions and elected under Internal Revenue Code section 455 (the equivalent to Revenue and Taxation Code section 17583) to include the prepaid' subscription income in gross income for the taxable years during which the liability to furnish or deliver magazines exists, i.e., ratably over a three-year period. Appellants have acknowledged that Partnership distributions received were from income earned ratably over'1979, 1980, and 1981. During the protest hearing appellants stated that 75 percent of the subscription income is recognized within one year and the other 25 percent is recognized over three years. However, during the audit appellants stated that all of the subscriptions were three-year subscriptions. .

Following an audit, respondent determined that. appellants were not "at risk" with respect to the 1979 loss deduction and that during 1979, 1980, 1981, and 1982, appellants received Partnership distributions exceeding their adjusted basis in their Partnership interest, and, therefore, were subject to tax.21

The first issue to be decided is the extent of appellants' loss deduction for the 1979 tax year. Appellants argue that they were "at risk" not only in the amount of their $260 cash contribution but also for the face amount of their loan obligation of $100,000. Respondent contends that the loan obligation was, at best, a contingent obligation and thus appellants should not be considered to be "at risk" for more than their $260 actual cash contribution.

Section 17599 permits deductions incurred in an activity to be applied freely against the income generated by that activity and intervenes only when a taxpayer attempts to use a loss incurred in a covered activity to reduce income from other sources. Section 17599, subdivision (b), provides that the amount of loss allocable to a covered activity is limited to the amount-that a taxpayer has "at risk." Section 17599 is substantially similar to section 465 of the Internal Revenue Code. Consequently, interpretations of the federal statute are relevant to the correct interpretation of the state statute. (Andrews v. Franchise Tax Board, 275, Cal.App.2d 653 [80 Cal.Rptr. 4031 (1969).) The purpose of the "at risk" limitations is to prevent individual investors from deducting "losses generated by.tax sheltering activities, to the extent the losses exceed the amount of actual investment the taxpayer has placed at risk in the transaction." (S. Rep; No. 938, 94th Cong., 2nd Sess. (1976) [1976 U.S. Code Cong & Ad. News 34821.)

Appellants argue that by virtue of the Partnership loan provisions they were "at risk" for the total amount they were obligated to loan. They equate the loan provision to that of a contribution of cash, property or qualified borrowing. However, appellants ignore the fact that they were never required' to make the loans in

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3/ Appellants have presented evidence'that the $200,000 distribution in 1982 was a loan that was repaid. Accordingly, respondent excluded this $200,000 amount 'from its calculations.

question. The Internal Revenue Service's proposed regulations issued under section 465 state that any money contributed by partners pursuant to a partnership agreement is not considered an amount "at risk" until such time as a contribution is actually made. (Treas. Reg. § 1.465-22(a) (1975) (proposed).) While we recognize that the Service's proposed regulations are not authoritative, we do find the logic contained therein compelling and indicative of the proper interpretation to be given the statute. There has been no showing that appellants undertook more than a future commitment to make loans to the partnership. As such, respondent correctly determined that appellants' loss deduction for 1979 was limited by the amount of cash appellants actually had "at risk" in the venture, not including the amount they might or might not have been called upon to loan.

The second issue presented for our consideration is whether certain partnership distributions to appellants exceeded the adjusted basis in their partnership interest.

Appellants argue that the payments in question should not be considered distributions until the last day of the partnership's taxable year in which such payments are included in the computation of its taxable income. Appellants cite an IRS Private Letter, Ruling (No. 7935073, Jan. 26, 1978), which held that where progress payments received by a partnership are not includable by it under the completed contract method of accounting, the payments when withdrawn are not to be treated as distributions until the last day of the partnership taxable year in which the partnership includes such payments. Respondent contends that even if the rationale of the cited Private Letter Ruling is applied to prepaid subscription income (rather than a construction contract), appellants are subject to tax on the partnership distributions because there has been no showing that more than 25 percent of the subscription income was reportable ratably over three years.4/ We agree there has been no evidence presented

4/ As noted above, appellants have presented contradictory statements as to the extent of subscription income attributable-to the three-year subscriptions. Respondent determined that 75 percent of the subscription payments must be recognized in the year payments were received by the partnership. No evidence has been provided that more than 25 percent of the subscription income was reportable ratably over three years. At any rate, even if the election were made, the partnership was required to include at least one-third of the three-year subscription income each year.

which would support appellants' position. Because the partnership is required to include the subscription payments in its income, the rationale of the IRS ruling does not apply.

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

Appeal of Jesse A. and Patricia E. Nimocks

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 Jesse A. and Patricia E. Nimocks against proposed assessments of additional personal income tax in the amounts of $5,152.80, $3,263.00, $1,796.00, and $490.00 for the years 1979, 1980, 1981, and 1982, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of April, 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Collis, and Mr. Davies present.

Ernest J. Dronenburg, Jr., Chairman

Conway H. Collis, Member

John Davies*, Member

__________, Member

__________, Member

*For Gray Davis, per Government Code section 7.9