BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 87A-1535-SS
JAMES D. AND HELEN WITHERSPOON)

Appearances:

For Appellant: Kenneth H. Wennergren
Attorney at Law

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 James D. and Helen Witherspoon against proposed assessments of additional personal income tax in the amounts of $2,091, $3,180 and $4,396 for the years 1983, 1984, and 1985, respectively.

The question presented in this appeal is whether the accelerated depreciation appellants claimed on storage containers supplied to customers of their Port-A-Star business is an item of tax preference.

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

On their income tax returns for the appeal years, appellants deducted depreciation on non-recovery property in excess of straight line depreciation. The property was portable security storage boxes rented by appellants' business, Port-A-Stor, to construction contractor customers on a minimum 30 to 60-day, open-ended basis. Respondent.Franchise Tax Board recalculated appellants' tax liability for the appeal years to include a preference tax on the excess depreciation, and appellants protested.

Section 17062 provides for an additional tax on items of tax preference. Section 17063 lists the items of tax preference, including the excess over straight line depreciation on 'each item of section 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) which is subject to a lease ...." (Emphasis added.) Appellants point to Treasury Regulation section 1.57-1(c)(1) as limiting the definition of "lease' in both Revenue and Taxation Code section 17063 and its federal analogue, I.R.C. section 57(a)(3), to "net leases", leases for which less than 15 percent of gross rental income is deducted in maintenance. expenses (I.R.C. section 162) or for which the lessor is guaranteed a return. Appellants claim that their Port-A-Stor operation does not meet the criteria for "net leases" and therefore the excess depreciation should not be subject to preference tax.

The Franchise Tax Board responds that in 1977 the California Legislature amended section 17063 to conform to the Federal Tax Reform Act of 1976 and specifically eliminated the restriction of preference tax to net leases, thereby broadening it to include accelerated depreciation on "personal property subject to any kind of lease." (See Senate Report No. 94-938 (Part 1), 94th Cong. 2d Sess. 111, reprinted in 1976 U.S. Code Cong. & Ad. News 3546.) Respondent asserts that the Treasury regulation cited by appellant had simply not been conformed to the 1976 change in the statute and that, due to its inconsistency with the unambiguous language of the revised statute, it must be disregarded. We agree with respondent, despite the recent Seventh Circuit case of Freesen v. Commissioner, 798 F.2d 195 (1986), where the court held that "the commissioner's own regulations' limit the term "lease" in I.R.C. section 57(a)(3) to "net lease". We note that the Freesen court, in determining that "[f]or the purposes of section 57(a)(3) ... a 'lease' is a 'net lease' and not anything else" (798 F.2d 195 at 203) failed to make any mention of the language in the Senate Report on the 1976 Tax Reform Act cited by respondent, where elimination of the modifier "net" was explained as intended to expand the preference tax to accelerated depreciation on personal property subject to any kind of lease.

It appears to us that the Treasury regulation cited by appellants and the Freesen court, then, rather than restricting the term "lease' to "net lease" as held by the court, is rather an obsolete modifier to the pre-1976 statute, standing in clear conflict with the revised statute. Consequently, we reject appellants' argument that the accelerated depreciation on its containers is not an item of tax preference.

In the alternative, appellants contend that, rather than a simple "lease", the contract with their customers constitutes a "personal service' because they also provide transportation of the storage containers and custom installation of racks and shelves. As a result, argue appellants, they meet the 'service' exception to the application of I.R.C. section 57(a)(3) and therefore no portion of the accelerated depreciation is subject to the tax preference calculation. In support of their contention, appellants cite to the U.S. Court of Claims case of Xerox Corporation v. U. S., 656 F.2d 659 (1981). As noted by respondent, however, the Xerox case is wholly distinguishable on the facts and law. The relevant legal issue in Xerox was whether Xerox could claim the investment tax credit under I.R.C. sections 48(a)(4) and (5) and 38 for copy machines leased to governmental units and tax-exempt organizations. The Court of Claims concluded that certain express provisions in the Xerox rental agreements, imposing on Xerox risk of loss and exclusive responsibility for maintenance, repairs and training of customer personnel, made the substance of the agreements more service than lease oriented. The court also based its decision on consideration of the purpose of the investment credit legislation - stimulation of production - and the exclusion for leases to governmental units. The court's determination that allowance of the credit would not run afoul of the congressional purpose behind the credit was based on facts peculiar to the specific arrangements between Xerox and its customers.

Respondent cites to several private letter rulings which deal with the service/lease issue specifically in relation to the preference tax. (See Priv. Ltr. Rul. 8223009 (1982) & 8410010 (1984).) These rulings - more directly on point than the Xerox case - indicate that the IRS will look to the "primary business function" of a taxpayer and whether the services are "incidental to" that function. We agree with the Franchise Tax Board that appellants have offered inadequate* substantiation for their contention that their contracts with their customers are primarily service arrangements.

For the reasons stated above, the action of the Franchise Tax Board must be sustained.

Appeal of James D. and Helen Witherspoon

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 James D. and Helen Witherspoon against proposed assessments of additional personal income tax in the amounts of $2,091, $3,180, and $4,396 for the years 1983, 1984, and 1985, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 11th day of May, 1989, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Collis, Mr. Bennett and Mr. Davies present.

Paul Carpenter, Chairman

Conway H. Collis, Member

William M. Bennett, Member

John Davies*, Member

, Member

*For Gray Davis, per Government Code section 7.9