



Appeal of Harold S. and Winifred L. Voegelin

Appellants, Harold S. and Winifred L. Voegelin, filed a joint California personal income tax return for the year 1972 wherein they reported an actual net loss of \$564,219 on the sale of capital assets held for not more than one year and an actual net gain of \$116,797 on the sale of capital assets held more than five years. Accordingly, appellants' 1972 capital asset transactions resulted in an actual total net capital loss of \$447,422 (\$564,219 - \$116,797). However, as will be explained below, appellants were entitled to claim a total net capital loss of \$505,820 in 1972 by virtue of the preferential tax treatment accorded capital gains pursuant to section 18162.5 of the Revenue and Taxation Code.

The sole issue presented by this appeal is whether the '\$58,398 difference between **appellants'** actual total net capital loss for 1972 and the total net capital **loss** recognized by virtue of section 181'62.5 constitutes an item of tax preference subject to the tax on preference income imposed by **section 17062 of** the Revenue and Taxation Code. As the issue presented is one of first impression before this board, our resolution of the appeal is prefaced with an analysis of the various **statutory** provisions that define or delimit the tax on **preference** income in situations **involving capital** asset transactions.

Section 17062 **of** the Revenue and Taxation Code, in effect December 8, 1971, imposes a special tax on certain items of income and deduction that are accorded preferential tax treatment under California's Personal Income **Tax Law**. For example, in defining the various items of tax preference subject to the tax imposed by section **17062**, section 17063 refers to: accelerated depreciation on certain real and personal property in excess of straight-line depreciation; percentage depletion in excess of the basis of the **'property** involved; and, commencing in 1976, excess **"net farm loss"** deductible from **nonfarm** income. (See Rev. & Tax. Code, § 17063, subds. **(b), (c), (e), and (i)**, respectively.) Section 17063 also contains two separate provisions which refer to the preferential tax treatment accorded capital gains as an item of tax preference subject to the tax imposed by section 17062. (**Rev. & Tax. Code, § 17063, subds. (f) and (h) .**)

Subdivision **(f)** of section 17063 defines as **an** item of tax preference the preferential tax treatment **that**

Appeal of Harold S. and Winifred L. Voegelin

was accorded capital gains in taxable years beginning prior to January 1, 1972. In computing taxable income for such years, individual taxpayers were allowed to deduct from gross income 50 percent of the amount by which their net long-term capital gains exceeded their net short-term capital losses. (Rev. & Tax. Code, §§ 18151, 18162, repealed by Stats. 1972, ch. 1150.) Subdivision (f) of section 17063 defines as an item of tax preference "[a]n amount equal to one-half of the amount by which net **long-term** capital gain exceeds the net short-term capital **loss.**"<sup>1/</sup> Accordingly, subdivision (f) subjects to the tax on preference income the portion of capital gains not included in taxable income by virtue of the capital gains deduction that was in effect for taxable years beginning prior to January 1, 1972.

Subdivision (h) of section 17063, on the other hand, deals with the preferential tax treatment accorded capital gains for taxable years beginning on or after January 1, 1972. For such **years**, with the enactment of section 18162.5 of the Revenue and Taxation Code and the repeal of the **above** described capital gains deduction, California established a new method for according capital gains preferential tax treatment. Specifically, section 18162.5 provides:

(a) In the case of any taxpayer, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing taxable income:

<sup>1/</sup> Subdivision (f) of section 17063 is applicable with respect to "taxable years beginning after December 31, 1970, and ending on or before November 30, 1972." (Rev. & Tax. Code, § 17063, subd. (h).)

Appeal of Harold S. and Winifred L. Voegelin

(1) One hundred percent if the capital asset has been held for not more than **one** year:

(2) Sixty-five percent if the capital asset has been held for more than one year but not more than five years:

(3) Fifty percent if the **capital asset** has been held more than five years.<sup>2/</sup>

The following two examples demonstrate the operation and effect of section 18162.5:

Example 1

Assume that a taxpayer with a taxable year beginning January 1, 1972, realizes actual "1-year" **capital gains** totaling \$5,000, actual "1-to-5 year" **capital gains** totaling \$3,000, and actual "S-year" capital losses totaling \$1,000. The taxpayer's total net capital gain would be computed under section 18162.5 as **follows**:

	<u>Actual</u> Gain or LOSS		<u>\$ 18162.5</u> Gain or Loss
"1-year" <b>gain</b> .....	\$5,000	x 100% =	\$5,000
"1-to-5 year" gain.....	3,000	x 65% =	1,950
"S-year" <b>loss</b> .....	(1,000)	x 50% =	( 500)
Total gain	<u>\$7,000</u>		<u>\$6,450</u>

Pursuant to section 18162.5, the taxpayer would account for a total net capital gain of \$6,450, rather than the realized or actual total net capital gain of \$7,000, in computing his 1972 taxable income.

<sup>2/</sup> Hereinafter, the capital gains and losses referred to in section 18162.5 will be described, according to the corresponding holding period, as "1-year", "1-to-5-year", or "S-year" capital gains or losses, respectively.

Appeal of Harold S. and Winifred L. Voegelin

Example 2

Assume that a taxpayer with a taxable year beginning January 1, 1972, realizes "1-year" capital losses totaling \$5,000, "1-to-5 year" capital gains totaling \$3,000, and "5-year" capital gains totaling \$1,000. The section 18162.5 total net capital loss would be computed as follows:

	<u>Actual</u> <u>Gain or Loss</u>		<u>§ 18162.5</u> <u>Gain or Loss</u>
"1-year" loss.....	(\$5,000)	x 100%	= (\$5,000)
"1-to-5 year" gain.....	3,000	x 65%	= 1,950
"5-year" gain.....	1,000	x 50%	= 500
Total loss	<u>(\$1,000)</u>		<u>(\$2,550)</u>

Pursuant to section 18162.5, the taxpayer would account for a total net capital loss of \$2,550, rather than the actual total net capital loss of \$1,000, in computing his 1972 taxable income.

As indicated, section 18162.5 results in preferential tax treatment for certain capital gains by providing for a specified percentage reduction in the amount of such gains taken into account in computing taxable income. Accordingly, subdivision (h) of section 17063 designates as an item of tax preference the preferential tax treatment accorded capital gains by virtue of section 18162.5. Specifically, subdivision (h) provides, in pertinent part:

For taxable years beginning after December 31, 1971, the amount of the tax preference income with respect to capital gains shall be an amount (but not below zero) equal to the difference between (1) the taxpayer's total net capital gains and losses (determined without regard to any capital loss carryover) for the taxable year, and (2) the taxpayer's net capital gains and losses recognized by virtue of Section 18162.5 for the same taxable year.

Appeal of Harold S. and Winifred L. Voegelin

Applying subdivision (h) to the examples set forth above, we find that the taxpayer in Example 1 experienced or realized tax preference income in the amount of \$550, since that amount represents the difference between the taxpayer's \$7,000 actual total net capital gains and the \$6,450 total net capital gains recognized by virtue of section 18162.5. By the same token, the taxpayer in Example 2, according to subdivision (h), experienced or realized tax preference income in the amount of \$1,550, since that amount represents the difference between the taxpayer's \$1,000 actual total net capital losses and the \$2,550 total net capital losses recognized by virtue of section 18162.5. It is important to note that in both examples the tax preference income arose by virtue of the artificial decrease in the taxpayer's actual capital gains.

The instant appeal presents a factual situation analogous to that set forth in Example 2. In 1972, appellants realized an actual total net capital loss of \$447,422 on their capital asset transactions. Yet, by virtue of section 18162.5, as shown below, appellants were entitled to claim a total net capital loss of \$505,820.

	<u>Actual</u> Gain or Loss		<u>§ 18162.5</u> Gain or Loss
"1-year" loss.....	(\$564,219)	x 100% =	(\$564,219)
"5-year" gain.....	116,797	x 50% =	<u>58,398</u>
Total loss	<u>(\$447,422)</u>		<u>(\$505,820)</u>

The difference between appellant's actual total net capital loss in 1972 and the net capital loss recognized by virtue of section 18162.5 is \$58,398. The narrow question presented for our resolution is whether that amount constitutes an item of tax preference as defined in subdivision (h) of section 17063.

Appellants take the position that subdivision (h) of section 1706'3, like its predecessor, subdivision (f), does not and was not intended to identify or define tax preference income in situations where the taxpayer's total capital losses exceed his total capital gains. Under such

Appeal of Harold S. and Winifred L. Voegelin

circumstances, appellant's argue, the taxpayer receives no immediate tax benefit as a result of his capital asset transactions, since the resulting total net capital loss is, for the most part, of value only as a capital loss carryover to subsequent years. (See Rev. & Tax. Code, § 18152.) Therefore, appellants conclude, such a taxpayer receives no tax preference "income" and should not be held liable for the tax imposed by section 17062.

It is our opinion that appellants' position is based upon an erroneous construction of the language contained in subdivision (h) of section 17063. Subdivision (h) identifies tax preference income only in situations where the operation of section 18162.5 results in an artificial decrease in a taxpayer's realized capital gains: if a taxpayer realizes only capital losses in the taxable year, or if the capital gains which he realizes are solely "1-year" gains accounted for at 100 percent, ~~the taxpayer~~ has no preference income under subdivision (h).<sup>3/</sup> Moreover, if the operation of section 18162.5 causes an artificial reduction of a taxpayer's realized capital losses *as well* as his realized capital gains (see Example 1, supra), the tax preference income identified by subdivision (h) is, in effect, limited to the amount by which the total reduction in actual ~~net~~ capital gains exceeds the total reduction in actual net capital losses. Thus, it seems clear that subdivision (h) was designed to define tax preference income with respect to capital gains in terms of the total section 18162.5 reduction in the taxpayer's realized capital gains, with an offset allowed for any section 18162.5 reduction in the taxpayer's realized capital

<sup>3/</sup> In such situations, the difference between the taxpayer's actual total net capital gain or loss and the total net capital gain or loss recognized by virtue of section 18162.5 will always be an amount equal to or below zero. such amounts are expressly excluded from the definition of tax preference income contained in subdivision (h) of section 17063.

Appeal of Harold S. and Winifred L. Voegelin

**losses-**, regardless of whether or not the **taxpayer's** total net capital losses exceed his total net capital gains. Finally, subdivision (h) contains no language which suggests that the Legislature intended to postpone or exclude the tax on preference items in cases such as the instant appeal where the section 18162.5 reduction in capital gains ultimately produces a potential as opposed to an immediate tax benefit. While postponement of the preference tax in **such** cases might be appropriate as a matter of tax policy<sup>4/</sup>, resolution of this appeal must be based upon the plain **language** of the statute in question. (See Appeal of Chester A. Rowland, Cal. St. Bd. of Equal., Oct. 21, 1975.)

For the reasons stated above, we conclude that the preferential tax treatment accorded appellants' 1972 capital gains by 'virtue of section 18162.5, **represented** as \$58,398 pursuant to the express terms of **subdivision (h)** of section **17063, constitutes** an item of tax preference, subject to the special tax imposed by section 17062. Consequently, respondent's action in this matter must be sustained.

<sup>4/</sup> At the federal level, for example, provision is made **for** postponement of the preference tax in cases where the taxpayer has a net operating loss carryover attributable in part to items of tax preference. (See Int. Rev. Code of 1954; **§ 56(b).**)

