BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
GERALD H. AND DOROTHY A. BENSE)

For Appellants: Gerald H. Bense, in pro. per.

For Respondent: Bruce W. Walker
Chief Counsel

Jeffrey M. Vesely
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Gerald H. and Dorothy A. Bense against proposed assessments of additional personal income tax in the amounts of $2,292.68 and $4,668.79 for the years 1969 and 1970, respectively.

This appeal presents the following two issues for determination which concern appellants' disposition of one-half of their partnership interest in 1969 and the remaining one-half interest in 1970:

1. Did respondent properly include in the amount realized on both sales the amount by which appellants' share of the partnership liabilities were reduced?

2. Did respondent properly attribute part of the amount realized on the 1970 sale to appellants' interest in the partnership's "unrealized receivables"?.

From November 1963 until December 31, 1967, appellants owned a 40 percent interest in the Whittier Square Partnership (Whittier), a real estate partnership. On that date appellants sold 25 percent of their 40 percent partnership interest, or 10 percent of the entire partnership, for $82,000.00. The propriety of appellants reporting of the income from that sale is not in question in this appeal.

On July 1, 1969, appellants sold 50 percent of their remaining interest in Whittier, or 15 percent of the entire partnership, for $50,000.00 to James L. Spivey, who was not a member of the partnership prior to the sale. On their California personal income tax return for 1969, appellants, reported the gain from the sale to Spivey as a $50,000.00 long-term capital gain ($50,000.00 gross sales price less zero basis). As the result of an audit, respondent concluded that the amount realized from the sale by appellants should have been increased by their'share of the partnership liabilities of which they were relieved. Such liabilities amounted to $270,000.00 which represented 50 percent of their share of Whittier's liabilities as 'of the date of sale. Respondent used 50 percent since appellants sold 50 percent of their interest in the partnership; Respondent's resulting determination of appellants' gain from the sale was as follows:

Selling price:	
Cash received	$ 50,000.00
Share of appellants' partnership liabilities relieved	270,000.00
Total selling price	$320,000.00
Less: Adjusted basis in'partnership interest	217,156.00
Gain on sale of partnership interest	$102,844.00

Accordingly, respondent increased appellants' long-term capital gains by $52,844.00, which represented the difference between the amount of capital gain determined by respondent ($102,844.00) and the amount reported by appellants ($50,000.00) on their 1969 return. This action resulted in the proposed deficiency of $2,292.68 for 1969.

On September 30, 19'70, appellants sold their remaining 15 percent interest in Whittier to four of the remaining partners for $75,000.00. Appellants reported the gain from this transaction on their 1970 return as a $69,615.62 long-term capital gain. In computing the amount of gain appellants determined that they had a zero basis and reduced the $75,000.00 selling price by their selling expenses of $5,384.38. Upon examination, respondent once again determined that the amount realized by appellants should have been increased by appellants' share of the partnership liabilities of which they were relieved., Such liabilities amounted to $270,000.00, which represented appellants' 15 percent share of Whittier's total liabilities as of the date of sale. Consequently, respondent recomputed appellants' gain from the 1970 sale of their remaining 15 percent interest in Whittier as follows:

Selling price:	
Cash received	$ 75,000.00
Share of appellants' partnership liabilities relieved	270,000.00
Total selling price	$345,000.00
Less:	
Cost of sale	5,384.38
Adjusted basis in partnership interest	208,599.00
Gain on sale of partnership interest	$131,016.62

Respondent also determined that, as a result of Whittier's use of accelerated depreciation, the portion of the amount realized from the 1970 sale which represented "potential depreciation recapture income" should be attributed to appellants' interest in "unrealized receivables" as defined in section 17913 of the Revenue and Taxation Code. As a result, respondent recharacterized the portion of the $131,016.62 gain realized in the 1970 sale which was attributable to appellants' interest in "unrealized receivables" as ordinary income. The amount so characterized as ordinary income was $36,845.34. The remainder of the $131,016.62 gain, or $94,171.28, was treated as a long-term capital gain. Respondent's action resulted in the proposed deficiency of $4,668.79 for 1970.

Initially, we note that the applicable Revenue and Taxation Code sections 17891, 17901, 17911-17914, 17915, 18211 and 18214 and the regulations issued thereunder were patterned after sections 731, 741, 751, 752, 1245 and 125.0 of the Internal Revenue Code and the corresponding federal regulations. Accordingly, federal statutory and case law is highly persuasive as to the proper interpretation of the California statutory and regulatory scheme. (Holmes v. McColgan, 17 Cal. 2d 426 [110 P.2d 4281 (1941); Meanley v. McColgan, 49 Cal. App. 2d 203 [121 P.2d 45] (1942).)

The first issue.concerns the proper treatment of appellants' share of the partnership liabilities of which they were relieved in computing their gain on the sales of their. partnership interest.

Section'17901 of the Revenue and Taxation Code provides that in a sale or exchange of all or part of an interest in a partnership, gain or loss shall be recognized to the transferor partner. The same section provides that; as a general rule, the gain or loss shall be treated as arising from the sale or exchange of a capital asset. The amount of capital gain or loss is measured by the difference between the amount realized and the adjusted basis of the partnership interest transferred. (Cal. Admin. Code, tit. 18, reg. 17901.)

In computing the adjusted basis of a partner's partnership interest, the starting point is the amount of money contributed and the adjusted basis, at the time of contribution, of any property contributed. (Rev. & Tax. Code, § 17882; Cal. Admin. Code, tit. 18, reg. 17882.) Where partnership liabilities are increased, resulting in an increase, to each partner's share of'partnership liabilities, the amount of the partner's increase is considered to be a contribution of money by that partner to the partnership. (Rev. & Tax. Code, § 17915; Cal. Admin. Code, tit. 18, reg. 17915; see also Crane v. Commissioner, 331 U.S. 1 [91 L. Ed. 1301] (1947).) Thus, .a partner's adjusted basis in his partnership interest includes his share of the partnership's liabilities. 1/ The partner's original basis of his interest is also increased. by

1/ In effect, Rev. & Tax. Code, § 17'915, subd. (c) adopts" the rule of Crane v. Commissioner, supra, as to unassumed liabilities by providing that for the purposes'of'the'section, a liability to which property is subject shall, to the extent of the fair market value of that property, be considered as a liability of the owner of the property. As shall be seen; section 17915, subd. (d) completes the Crane analogy by providing that upon a sale or exchange of the partnership interest, liabilities shall be treated in the same manner as are liabilities in the sale or exchange of other types of property. Thus, on disposition of the partnership interest, the partner's share of the partnership liabilities is included in the amount realized upon the sale of the interest;

the sum of his distributive share of partnership taxable income and reduced by his share of partnership losses. (Rev. & Tax. Code, § 17860, Cal. Admin. Code, tit. 18, reg. 17860.) This is true with respect to partnership losses even if the partner received no tax benefits from his distributive share of partnership losses because he had more deductions than income without regard to his share of the partnership losses. (See 1 Willis, Partnership Taxation, § 21.02 (2d ed. 1976).) Certain other basic adjustments are provided for by statute: however, they are not pertinent to this inquiry. (See Rev. & Tax. Code, § 17860.)

In addition to any cash received, the amount realized on the sale of a partnership interest by the selling partner includes the reduction or elimination of his share of partnership liabilities. (Rev. & Tax. Code, § 17915, subd. (d).) The regulations provide that when a partnership interest is transferred and the transferor's share of partnership liabilities is reduced or eliminated, the transferor is treated as having sold the partnership interest for an amount equal to the share of liabilities reduced or eliminated. (Cal. Admin. Code, tit. 18, reg. 17915; see also Arthur R. Fixel, ¶ 74,197 P-H Memo. T.C. (1974); Rev. Rul. 77-402, 1977-2 Cum. Bull. 222.)

A review of the record reveals that respondent computed the gain from both sales in accordance with the statutory criteria discussed above. Respondent determined the total amount realized on each sale of appellants' partnership interest and reduced that amount by appellants' adjusted basis in their interest as of the date of the sale. Respondent's computation of appellants' adjusted basis in their partnership interest properly included, contrary to appellants' contention, their total capital contribution of $296,953.60, as well as their $365,585.44 share of the partnership losses, and the appropriate amount of appellants' share of the partnership liabilities. Similarly, the computation of the amount realized properly included the net cash proceeds received by appellants and their share of the partnership liabilities of which they were relieved.

The second issue concerns respondent's treatment of appellants' share of the partnership's "unrealized receivables".

As we have indicated above, the general rule is that the gain or loss on the sale of all or a part of a partnership interest is treated as arising from the sale or exchange of a capital asset. However, in order to avoid the conversion of ordinary income to capital gain, an exception is made with respect to gain attributable to partnership assets which, if sold by the partnership, would produce ordinary income. Thus, section 17901 of the Revenue and Taxation Code provides that capital gain or loss treatment shall apply on the sale of all or a part of a partnership interest "except as otherwise provided in Section 17911 to 17914, inclusive (relating to unrealized receivables and inventory items which have appreciated substantially in value)." If the partnership does possess "unrealized receivables" a portion of the sales price is allocated to such receivables and treated as ordinary income. (See Rev. & Tax. Code, §§ 17911-17914.) In effect, the sale of the partnership interest is fragmented into two sales: (1) a sale of "Sections 17911 to 179.14 property"; and (2) a sale of the remainder of the partnership interest. (See Cal. Admin. Code, tit. 18, reg. 17911-17914, subd. (a) (2) & subd. (g), example (1).)

"Sections 17911 to 17914 property" is defined as "unrealized receivables" or substantially appreciated inventory items. (Cal. Admin. Code, tit. 18, reg. 17911-17914, subd. (e).) The definition of "unrealized receivables" includes "potential section 18211 income" and "potential -section 18212 income." (See Rev. & Tax. Code, § 17913; Treas. Reg. § 1.751-l (c) (4).) The depreciation recapture provisions of sections 18211 and 18212 require that when certain depreciable personal and real property is sold or exchanged, a portion of the gain representing a specified amount of depreciation previously deducted shall be reported as ordinary income. Thus, "potential section 18211 income" and "potential section 18212 income," which may be referred to as "potential depreciation recapture income,' are the amounts that the partnership would be required to report as ordinary income if the partnership had sold its depreciable personal and real property immediately before a partner sells or exchanges his partnership interest. (Rev. & Tax. Code, §§ 18211, subd. (a) Cl) & 18212, subd. (a) (2) & (a)(3).) The purpose of these statutes is to prevent the conversion of ordinary income into capital gain by the use of the partnership form of doing business.

It is not disputed that the partnership owned 'section 18211 property" and "section 18212 property" which was depreciated by accelerated methods since 1963. Thus, in accordance with the prior discussion, both the 1969 and 1970 sales of appellants' partnership interest should have been, fragmented and treated as two sales: (1) a sale of appellants' interest in the partnership's "unrealized receivables" to the extent the "unrealized receivables" represented "potential, section 18211 income" or "potential section 18212 income"; and (2) a sale of the remainder of appellants' partnership interest. 2/ Since a partner's basis for potential depreciation recapture income is zero (Treas. Reg. § 1.751-l(c) (5)), the ultimate amount of gain to be characterized as ordinary income would be the selling partner's total interest in the partnership's "potential section 18211 income" or "potential section 18212 income."

Respondent fragmented the 1970 sale of appellants' partnership interest, treating it as two sales, one giving rise to ordinary income, and the other generating capital' gain. In effect, respondent recaptured all of appellants'- share of the partnership's "potential depreciation recapture income" in 1970. Respondent did not fragment the 1969 sale of part of appellants' partnership interest, thus recapturing part of the depreciation for that year as required by section 17911 of the Revenue and Taxation Code. During the course of these proceedings, respondent has conceded that appellants' share of the partnership's "potential depreciationrecapture income" should have been recaptured and characterized as ordinary income for 1969 as well as 1970. The effect of this concession is to reduce the 1970 deficiency. Ordinarily, the effect of this adjustment would be to increase the 1969 deficiency: however, respondent does not seek such increase in

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2/ Here, respondent fragmented, or allocated to "unrealized receivables", a portion of the ultimate gain realized on the sale of appellants' partnership interest. However, in accordance with the statutory formula, it is the selling price of the partnership interest that is fragmented in part to unrealized receivables, not realized gain. (See Cal. Admin. Code, tit. lb, reg. 17911-17914(a) (2); 1 Willis, Partnership Taxation § 27.13 (2d ed. 1976).) If it were otherwise, in certain circumstances such as where a partnership interest is transferred at a loss, there would be no gain to allocate to "unrealized receivables". Nevertheless, under the facts of this appeal, the resulting determination is the same under-either method as the following computation illustrates:

Selling price:	
Cash received	$ 75,000.00
Liabilities relieved	270,000.00
	$345,000.00
Less: Cost of sale	5,384.38
Total amount realized	$339,615.62
Less: ""Unrealized receivables" allocated as ordinary income	36,845.34
Unallocated selling price	$302,770.28
Less: Basis in partnership interest	208,599.00
Gain on sale of partnership interest	$ 94,171.28

this appeal. Respondent's concession fails to consider the 1967 sale, however. Appellants' share of the partnership's "potential depreciation recapture income" must be considered with respect to the 1967 sale in order to properly determine the amount of "potential depreciation recapture income" to be characterized as ordinary income with respect to the 1970 sale. Therefore, respondent's action must be modified in this regard.

Appellants have objected to the recapture of depreciation on the basis of the "tax benefit rule." It is appellants' position that notwithstanding the fact that the partnership claimed accelerated depreciation since 1963, they did not derive full California tax benefits from the depreciation deductions. Therefore, appellants conclude, the "tax benefit'rule" of Revenue and Taxation Code sections 17144 and 17145 applies to the depreciation deductions which did'not result in any tax benefits to them. We believe that appellants' argument,, is without merit.

The regulations explicitly provide for an exception to the "tax benefit rule" with respect to depreciation deductions which states:

> The rule of exclusion so prescribed by statute applies equally with respect to all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years, including war losses referred to in Sections 17330 through 17350, inclusive, of the Personal Income Tax Law of 1954, but not including deductions with respect to depreciation.... (Cal. Admin. Code, tit. 18, reg. 17144-17145.) (Emphasis added.)

In view of the regulatory exclusion, we must conclude that. the depreciation deductions for which appellants did not obtain full tax benefits in prior years are not within the "tax benefit rule." (cf. Douglas v. Commissioner,,322 U.S. 275, 287 [88 L. Ed. 12711 (1944).)

Next, appellants contend that respondent's action with respect to the 1970 sale subjects them to "double taxation" by first taxing their share of the partnership's interest'in potential depreciation recapture income and then taxing their negative partnership capital account balance. Since a negative capital account balance occurs when the partner has taken a tax loss in excess of his investment and since, in this case, the tax losses taken by appellants leading to the negative capital account balance were the result of accelerated depreciation, appellants argue that it is double taxationto tax both. Appellants' argument is without merit since respondent did not subject appellants' negative capital account balance to taxation.

After determining that the amount realized from the 1970 sale included both the cash received ($75,000.00) and the share of partnership liabilities of which appellants were relieved ($270,000.00), respondent characterized $36,845.34 of the total amount realized as potential depreciation recapture income. (See Rev. & Tax. Code, §§ 17911-17914.) Since the basis of potential depreciation recapture income is zero (Treas. Reg. § 1.751-1(c)(5)), respondent further characterized $36,845.34 of the total gain realized ($131,016.62) as ordinary income and the balance ($94,171.28) as a long-term capital gain. Respondent did not include the same income twice. Appellants' negative capital account balance was not subjected to taxation. Respondent.merely characterized part of the income as ordinary income and part as capital gain.

Finally, appellants have submitted a number of computations detailing what, they believe, would be a fair method of computing their state tax liability for the appeal years. In two calculations, appellants reduced the total amount realized from the sales (cash received plus liabilities relieved) by their share of the partnership's fixed assets based on an appraisal. The error in these calculations is that the amount realized from the sale must be reduced by appellants' basis in their partnership interest, not by their share of the fair market value of the partnership's fixed assets. The other calculations have ignored the effect of appellants' share of the partnership liabilities. None of appellants' computations are reconcilable with the statutory requirements for computing gain or loss on the sale of a partnership interest. Accordingly, they must be rejected.

For the reasons set out above, we conclude that respondent's action, as modified in accordance with this opinion, must be sustained.

Appeal of Gerald H. and Dorothy A. Bense

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 Gerald H. and Dorothy A. Bense against proposed assessments of additional personal income tax in the amounts of $2,292.68 and $4,668.79 for the years 1969 and 1970, respectively, be and the same is hereby modified in accordance with the views expressed in this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 7th day of March , 1979, by the State Board of Equalization.

William M. Bennett, Chairman

Richard Nevins, Member

George R. Reilly, Member

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