81-SBE-004

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ANTHONY C. AND CECILIA I. ROSS1)

Appearances:

For Appellants: Richard H. Foster
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

OPINION

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Anthony C. and Cecilia I. Rossi against proposed assessments of additional personal income tax in the amounts of $1,030.58 and $4,270.60 for the years 1967 and 1968, respectively.

Cecilia I. Rossi is a party to this appeal solely because she filed joint income tax returns with Anthony C. Rossi, her husband, for the years in issue. Accordingly, only the latter will hereinafter be referred to as "appellant."

On March 10, 1967, appellant sold his interest in a lease of the Stanford Court Hotel in San Francisco to two corporations for $1,000,000. This appeal concerns the sale of one-half of the lease to T and T Factors, Inc. (later called Nob Hill Hotel Company, and hereinafter referred to as "Nob Hill") for $500,000.

In accordance with the sale contract, the lease was assigned to a partnership known as Stanford Court Investment Company (hereinafter referred to as "Stanford Court"), in which Nob Hill and the other purchasing corporation were equal partners. The contract of sale also provided that Nob Hill would pay appellant $75,000 in cash upon execution of the contract, with the $425,000 balance payable no later than December 25, 1967. Although Nob Hill paid appellant the initial $75,000 upon execution of the contract on March 10, 1967, it failed to make any further payments to him in that year.

On March 5, 1968, Nob Hill pledged its partnership interest in Stanford Court to appellant to secure a promissory note to him for the balance of the lease's purchase price. The note required the balance. to be paid by August 3, 1968, and the pledge agreement gave appellant the right to sell Nob Hill's partnership interest in the event of default. By August 3, Nob Hill had paid only $250,000 of the remaining balance, and appellant thereafter sent it a notice of default declaring his intention to foreclose under the pledge agreement. On October 11, 1968, Nob Hill granted appellant an option to purchase its partnership interest, and on January 1, 1969, Nob Hill assigned its interest to appellant in return for a payment (in March 1969) of $329,107.64 and the cancellation of the remaining balance of the purchase price. Appellant alleges that the $329,107.64 payment was actually a repayment of the $325,000 Nob Hill had already paid appellant, plus $4,107.64 interest, and that it was made pursuant to an oral agreement in 1968 to rescind the original sale of the lease.

For both federal and state income tax purposes, appellant elected to report the gain from the

1967 sale of the lease under the installment method. Appellant reported gain based on the $75,000 received in 1967, but did not report any part of the $250,000 received in 1968 on his federal and state returns. The Internal Revenue Service audited appellant's federal returns for 1967 and 1968, and determined that appellant had underreported his gain from the installment sale of the lease. On August 3, 1973, appellant furnished respondent with a copy of the federal audit report, and on October 9, 1973, respondent issued notices of proposed assessment for 1967 and 1968 based on the federal action. Appellant protested the assessments, and action on the protest was held in abeyance pending final IRS action on his federal returns. The IRS Appellate Division adjusted certain parts of the original audit report, and respondent received from appellant a copy of the final federal determination on May 15, 1975. On June 20, 1977, respondent issued its notices of action on appellant's protest against the proposed assessments issued in 1973.

The issues presented for determination are: (i) whether the proposed assessments are barred by the statute of limitations; (ii) whether that part of the installment payments representing gain was taxable in the years the payments were made: and (iii) whether appellant is entitled to a bad debt deduction because Nob Hill did not pay the remaining balance on the contract price.

Appellant, relying upon Revenue and Taxation Code section 18586,[1] contends that the proposed assessments are barred by the statute of limitations in that they were issued on October 9, 1973, more than four years after the due date of the returns. Additionally, appellant argues that even if the proposed assessments are not barred by section 18586, they are barred by operation of section 18586.3, since respondent did not issue its notices of action within six months of May 15, 1975, the date on which appellant reported to respondent the final federal determination as to his 1967 and 1968 gross income. A review of the relevant statutes and previous opinions of this board reveals that both of appellant's arguments are without merit.

1/ Hereinafter, all references are to the Revenue and Taxation Code.

The basic statute of limitations for deficiency assessments is found in section 18586, which provides:

> Except in case of a fraudulent return and except as otherwise expressly provided in this part, every notice of a proposed deficiency assessment shall be mailed to the taxpayer within four years after the return was filed. No deficiency shall be assessed or collected with respect to the year for which the,return was filed unless the notice is mailed within the four-year period or the period otherwise fixed. (Emphasis added.)

Section 18586.3 provides, in pertinent part:

> If a taxpayer is required to report a change or correction by the Commissioner of Internal Revenue or other officer of the United States or other competent authority or to file an amended return as required by Section 18451 and does report such change or files such return, a notice of proposed deficiency assessment resulting from such adjustments may be mailed to the taxpayer within six months from the date when such notice or amended return is filed with the Franchise Tax Board by the taxpayer .... (Emphasis added.)

Insofar as relevant to the instant appeal, section 18451 requires taxpayers to notify respondent of any federal adjustments to their gross income or deductions within 90 days of the final determination of such adjustments. It also provides that any taxpayer filing an amended federal return shall also file within 90 days thereafter an amended return with respondent.

Section 18586.3 provides an exception to the standard four-year statute of limitations for those instances in which a taxpayer is required to file an amended return pursuant to section 18451. Accordingly, as appellant was required to file an amended return in accordance with section 18451, the proposed assessments in issue were not barred by the fact that respondent did not issue its proposed assessments until October 9, 1973. Furthermore, as indicated above, section 18586.3 provides that respondent issue its notice of proposed assessment resulting from federal adjustments to a taxpayer's gross income or deductions within six months from the date the taxpayer files his notice or amended return resulting from such federal adjustments with respondent. Inasmuch as the assessments in issue here actually antedated the final federal determination, they obviously were issued well within the applicable limitations period. (Appeal of David B.' and Delores Y. Gibson, Cal. St. Bd. of Equal., April 22, 1975.)

In addition to the contentions discussed above, appellant, in reliance upon respondent's Legal Ruling 280 (FTB LR 280, Nov. 2, 1964), argues that section 18451 is inapplicable to 1967 because the IRS granted him a refund for that year on the basis of a net operating loss carryback which reduced his taxable income to zero. Section 18451, as amended effective August 25, 1967, requires taxpayers to report to respondent federal changes or corrections to gross income: prior to that date it required taxpayers to report to respondent federal changes or corrections to taxable income. Respondent's Legal Ruling 280 has no relevance to this appeal since it pertains to statute of limitations questions arising under section 18451 prior to its amendment: the years in issue here are controlled by section 18451 subsequent to its August 25, 1967, amendment.

As noted above, respondent issued appellant its notices of proposed assessment based on the federal audit report. On June 20, 1977, it issued its notices of action on appellant's protest; those notices of action were based entirely upon the final federal determination of appellant's income except with regard to the net operating loss deductions, which are not applicable for California income tax purposes. Respondent's proposed assessments, based on a federal audit report, are presumed correct, and the burden is on appellant to prove them erroneous. (Appeal of James A. McAfee, Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Robert J. and Evelyn A. Johnston, Cal. St. Bd. of Equal., April 22, 1975; Appeal of J. Morris and Leila G. Forbes, Cal. St. Bd. of Equal., Aug. 7, 1967.) After a careful review of the record on appeal and for the specific reasons set forth below, it is our opinion that appellant has failed to carry his burden of showing the federal determination was erroneous.

Appellant argues that gain from the sale of the lease was not reportable in the years the installment payments were received because the January 1, 1969, assignment by Nob Hill to appellant of its partnership interest in Stanford Court, together with appellant's payment of $329,107.64 to Nob Hill in March 1969, effected a rescission of the March 10, 1967 sale agreement upon which, appellant claims, he never recovered his basis. In any event, appellant contends, he had no "claim of right" to the installment payments of $75,000 and $250,000 when made in 1967 and 1968, respectively.

Gross income includes gains derived from dealings in property (Rev. & Tax. Code, § 17071, subd. (a)(3)), unless such gain is excludable by law from gross income. (Cal. Admin. Code, tit. 18, reg. 17071 (e).) Section 17571 provides that the amount of any item of gross income be included in the gross income for the taxable year in which received by the taxpayer.

Gain from the sale or other disposition of real property may be reported on the installment method. (Rev. & Tax. Code, § 17578, subd. (a)(l).) When a taxpayer elects to use the installment method, he must return as income in the taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price. (Rev. & Tax. Code, § 17577, subd. (a).)

Pursuant to section 17578, appellant elected to report the gain from the 1967 sale of the lease under the installment method. Accordingly, he reported the gain from the first installment payment of $75,000 in his original 1967 return. Later, however, contending that the March 10, 1967 sale agreement had been rescinded and that he had no "claim of right" to the installment payments, appellant filed his 1968 return without reporting the gain from the $250,000 installment payment made during that year and filed an amended 1967 return eliminating the gain from the $75,000 installment payment.

Under the installment method of reporting income, the portion of the payment not reportable as gain represents recovery of the taxpayer's basis in the property. Consequently, a taxpayer will not recover his entire basis in the property sold until all the installment payments are received, The fact that a taxpayer may not subsequently recover his entire basis does not directly affect the gain from such payments reportable in prior years: however, it may entitle the taxpayer to a deduction in a later year in which loss is incurred.

(Sid Luckman, 56 T.C. 1216 (1971).) Appellant's decision to report the gain from the sale to Nob Hill on the installment method was binding upon him. (United States v. Kaplan, 304 U.S. 195 [82 L.Ed. 12851 (1938); Ivan D. Pomeroy, 54 T.C. 1716 (1970).) Having made this election, the annual accounting concept required him to report the gain from the installment payments in the years the payments were received, regardless of whether the sale was later rescinded. (Rev. Rul. 80-58, 1980-9 I.R.B. 17; see aiso Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940).) Our determination that appellant was required to report the gain from the installment payments in the years they were received, regardless of whether the March 10, 1967 sale agreement was subsequently rescinded, obviates the necessity of determining whether in fact appellant and Nob Hill actually perfected a rescission of that agreement.

Appellant contends that the $325,000 received in installment payments did not cover his basis in the portion of the lease sold to Nob Hill and that, consequently, he was not required to report the gain realized from the installment payments received. We are aware of no authority, nor has appellant provided us with any, supporting this proposition. Furthermore, as we have already noted, the fact that appellant alleges he did not recover his entire basis in the portion of the lease sold to Nob Hill does not affect his obligation to report gain from the installment payments received in 1967 and 1968.

Appellant has also argued that, because of what he alleges was the "rescission" of the sale of the lease to Nob Hill, he never had a "claim of right" to the 1967 and 1968 installment payments, and therefore is not required to report any income therefrom. A careful review of the record of this appeal and pertinent court decisions reveals that appellant's interpretation of the law is in error.

It is well established that if a taxpayer receives funds under a claim of right, without restriction as to their disposition, such funds are includible in income in the year of receipt, even though it may subsequently turn out that the taxpayer is obliged to repay all or a portion of the amount received. (North American Oil Consolidated v. Burnet, 286 U.S. 417 [76 L.Ed. 11971 (1932); Rev.,y v. Commissioner of Int. 345 U.S. 278 [97 L.Ed. 10071 (1953).) This rule is based on the annual accounting concept which requires determination of income at the close of the taxable year without regard to subsequent events. (United States v. Lewis, 340 U.S. 590 [95 L.Ed. 560] (1951); Burnet v. Sanford & Brooks Co., 282 U.S. 359 [75 L.Ed. 383] (1931).) Therefore, appellant's argument that the subsequent "rescission" of the purchase contract deprived him of a claim of right to the installment payments, when received, is without merit. Even where there is a later rescission of a valid contract for the sale of real property, the gain from the property originally transferred for consideration must be reported in the year it is received. (Rev. Rul. 80-58, supra; see also Penn v. Robertson, supra.)

Appellant's reliance upon United States v. Merrill, 211 F.2d 297 (9th Cir. 1954) in support of his contention that he had no claim of right to the payments when received is misplaced. The taxpayer in that case received money mistakenly paid to him and there was a recognized obligation to repay the money in the year of receipt. Appellant, on the other hand, received the installment payments pursuant to a valid contract of sale and was not obligated, by the terms of that contract, to repay the sums received, or any part thereof, in the years of receipt.

Appellant's final argument appears to be that, if it is determined that he realized taxable gain from the installment payments in the years those payments were made, he is entitled to a bad debt deduction arising out of Nob Hill's failure to pay the remaining balance of the sale price.

In order for a taxpayer to qualify for a bad debt deduction, he has the burden of proving that a bona fide debt existed (Cal. Admin. Code, tit. 18, reg. 17207 (a), subd. (3)), that the debt became worthless in the taxable year for which the deduction is claimed, that it had value at the beginning of the taxable year, and that some identifiable event occurred which formed a reasonable basis for abandoning any hope that the debt would be paid sometime in the future. (Appeal of Fred and Barbara Baumgartner, Cal. St. Bd. of Equal., Oct. 6, 1976.) In the instant appeal, appellant has failed to indicate for which year he feels entitled to a bad debt deduction. In any event, neither the facts present in this appeal nor applicable law supports appellant's contention that he is entitled to a bad debt deduction for either of the years in issue.

Appellant's purchase of Nob Hill's partnership interest in Stanford Court and cancellation of Nob Hill's remaining installment obligation has been characterized by appellant as a "rescission" of the March 10, 1967 sale agreement. In a previous opinion of this board involving a virtually identical factual situation, we determined that the course of action pursued by appellant here, rather than rescinding the original sale contract, actually constituted a disposition of the remaining balance of the installment obligation which resulted in gain to the taxpayer. (Appeal of Haskell C., Jr., and Felicitas Billings, Cal. St. Bd. of Equal., Oct. 26 1965.) However, even if we accept appellant's assertion that the original sale contract was later rescinded, we cannot find that appellant is entitled to a bad debt deduction. In that event, Nob Hill's indebtedness would have been cancelled by returning each party to its status quo, and appellant would fail to meet even the threshold requirement of showing that a bona fide debt existed.

Finally, appellant's reliance on Treasury Regulation § 1.1038-1(f)(2) is of no support to his position. That regulation provides that if for any taxable year ending before the taxable year in which occur certain reacquisitions of real property the seller of such property has treated any indebtedness of the purchaser which is secured by such property as having become worthless or partially worthless by taking a bad debt deduction, he shall be considered as receiving, at the time of such reacquisition, income in an amount equal to the amount of such indebtedness previously treated by him as having become worthless. The amount treated as income received shall be treated as a recovery of a bad debt previously deducted as worthless or partially worthless. Appellant never treated any portion of Nob Hill's installment obligation as worthless by taking a bad debt deduction; accordingly, the above referenced federal regulation has no relevance to the instant appeal.

As earlier noted, proposed assessments based on a federal audit report are presumed correct, and the burden is on appellant to prove them erroneous. (Appeal of James A. McAfee, supra; Appeal of Robert J. and Evelyn A. Johnston, supra; Appeal of J. Morris and Leila G. Forbes, supra.) Given appellant's failure to carry his burden-of proof, we must conclude that respondent's action in this matter was correct.

Appeal of Anthony C. and Cecilia I. Rossi

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 Anthony C. and Cecilia I. Rossi against proposed assessments of additional personal income tax in the amounts of $1,030.58 and $4,270.60 for the years 1967 and 1968, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of January, 1981, by the State Board of Equalization, with Members Dronenburg, Bennett, Nevins and Reilly present.

Ernest J. Dronenburg, Jr., Chairman

William M. Bennett, Member

Richard Nevins, Member

George R. Reilly, Member

____________________, Member