



Appeal of Kenneth L. and Lucille G. Young

The issues for determination are:

(1) Whether a trust purportedly created by appellants is entitled to be recognized as an entity separate and distinct from the taxpayers;

(2) Alternatively, whether the appellants are to be treated as owners of the trust under sections 17781 through 17791 of the Revenue and Taxation Code; and

(3) Whether appellants are entitled to claimed farm losses.

The facts with regard to the family trust are as follows. Appellant-husband (hereinafter "appellant") is a medical doctor engaged in the private practice of medicine in Ukiah, California. On August 4, 1976, appellant executed a document captioned "Declaration of Trust." This document begins as follows:

Declaration of Trust

To be administered by natural persons, holding title in joint tenancy acting under their constitutional rights as citizens of the United States of America.

The document then states that the trust will operate under the name of Kenneth L. Young, Family Trust. Further, it is stated that Lucille G. Young (appellant's wife) and Jerald M. Young (appellant's son) are designated as trustees of the trust. The document also states that the trust is irrevocable and recites that the grantor agrees to sell, assign or convey certain property to the trustees. The document does not identify any beneficiaries or describe the **rights of** beneficiaries. The document provides that the trust may engage in any business desired by the trustees.

A second document, executed August 5, 1976, and designated "Bill of Sale," purports to transfer to the trust certain **real** and personal property as described in "attached Schedule 'A'." Appellant has not submitted a copy of "attached Schedule 'A'."

Appellant executed another document on August 5, 1976, wherein he recites that he was the **Grantor-Creator** of the Kenneth L. Young Family Trust and that he conveyed certain parts of his real and personal

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property to the trust. **This** document also specifies that the conveyance includes appellant's "lifetime services and all the currently earned remuneration accruing therefrom." (Emphasis added.)

Respondent determined that appellant's gross receipts from his medical profession from January 1, 1976 to July 31, 1976 were **\$125,348.30**. These gross receipts were reported on appellants' 1976 tax return (Schedule "C"). It was determined, and conceded by appellants, that a \$15,500 deduction error was made in arriving at net profit. Therefore, the correction of the \$15,500 error is not in dispute. Respondent also determined that appellant's gross receipts from his profession from August 1, 1976 to December 31, 1976 were **\$84,565.26**. Further, it was determined that \$60,500 of these gross receipts were paid over to the family trust and not reported by appellant. The balance of appellant's gross receipts for this period were not transferred to the trust or reported by appellants in their individual income tax return. Appellant wife stated that she and her husband retained 20 percent of appellant husband's gross earnings in August, apparently for living expenses. However, they found that this amount was not sufficient so they increased it to 25 percent of the husband's gross receipts thereafter. Respondent determined that appellants retained 28 percent of appellant husband's gross receipts for the period August through December 1976. Consequently, respondent determined that appellant's income should be increased by **\$84,565.26**, which was determined as follows:

|                    |               |
|--------------------|---------------|
| <b>\$60,500.00</b> | Paid to trust |
| <b>24,065.26</b>   | Not reported  |
| <b>\$84,565.26</b> |               |

In addition, it appears that some of appellant's professional expenses for the period August through December 1976 may have been paid by the trust out of the income which appellant transferred to the trust.

The facts with regard to the claimed farm losses are as follows. In 1969 appellants purchased 53 acres of land in Potter Valley. In connection with this land, they deducted farm losses as follows:

| <u>Year</u> | <u>Losses</u> |
|-------------|---------------|
| <b>1974</b> | \$15,284      |
| 1975        | 19,082        |
| 1976        | 17,559        |

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Upon audit, appellant wife **stated** that they purchased the Potter Valley land with plans to build a personal residence on part of the **property** and to convert the balance of the land to farm uses. When purchased, the property did not have any roads, water, electricity or structures of any kind. During 1974, 1975 and 1976, appellants acquired and/or constructed roads, a well, a septic system, a generator **and** a mobile home, the cost of which were all claimed as farm expenses. Appellants also claimed numerous expenses for tools and the repair of tractors, a road grader and other vehicles.

Appellant husband has stated that the Potter Valley property was operated as a farm and that the expenses should be deductible. In support of his statements that the property was operated as a farm, appellant indicates that he purchased three female llamas and one male llama in August 1976 to raise wool and to sell young llamas.

Respondent notes, however, that these llamas remained at appellant's residence in Ukiah, which included one acre of fenced land and a barn, until sometime after the end of August 1977.

Appellants claimed farm expenses and farm income from 1974 through 1978 as follows:

| <u>Year</u> | <u>Total Potter Valley Expenses</u> | <u>Expenses for Llamas</u>   | <u>Income</u> |
|-------------|-------------------------------------|------------------------------|---------------|
| 1974        | \$15,284.00                         |                              | 0.00          |
| 1975        | 19,080.00                           |                              | 0.00          |
| 1976        | 17,559.00                           |                              | 0.00          |
| *6/30/77    | 8,760.00                            | Wet \$ 81)<br>(Feed \$1,287) | 0.00          |
| *6/30/78    | 14,135.00                           | Wet \$ 80)<br>(Feed \$1,531) | 0.00          |

\*Deductions by **trust**

Respondent determined that the claimed farm expenses **were** not incurred in the operation of a farm for profit. Therefore, the expenses for 1974, 1975 and 1976 were disallowed. However, appellants **have** appealed only the disallowance of these farm expenses for taxable year 1976. We note here that with regard to the disallowed farm expenses for 1976, respondent permitted appellants to claim a portion thereof, **\$1,132.00**, since

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this amount represented interest expense which is deductible whether or not a profit motive was involved.

The combined family trust and farm loss determinations resulted in the issuance of a Notice of Additional Tax Proposed to be Assessed which increased appellant's taxable income and taxes for 1976 as follows:

|   |                     |
|---|---------------------|
| Income as reported                                      | \$ 42,199.00        |
| Family trust *  | 84,565.26           |
| Cost per Schedule "C"<br>(not in dispute)               | 15,500.00           |
| Net farm loss   | 17,559.00           |
| Allowable interest deduction<br>(was part of farm loss) | - 1,132.00          |
| Taxable income  | <u>\$158,691.26</u> |

\* Amount paid to trust plus amount not reported.

This notice resulted in an additional tax of **\$12,814.03**. Thereafter, appellant paid the tax and filed a claim for refund in the amount of **\$11,772.00**. The claim for refund was denied and appellants filed this timely appeal.

The first issue is whether **appellants** can transfer the tax burden on income earned by appellant to a family trust because appellant conveyed his lifetime services to the trust. Appellants argue that after the conveyance compensation for services was properly paid to the trust, and thereafter, was not includible in their gross income. Respondent, on the other hand, contends that the amounts of income in dispute are properly includible in appellants' gross income under section 17071, regardless of contractual obligations concerning the disposition of earnings for the reason that the purported conveyance of lifetime services is an anticipatory assignment of income or, in the alternative, is within the definition of gross income as governed by sections 17781 through 17791, inclusive. We agree with respondent.

Section 17071 of the Revenue and Taxation Code provides, in part, that gross income means all income from whatever source derived, unless excluded by law. Section 17071 is substantially the same as section 61 of the Internal Revenue Code. Therefore, the interpretation of section 61 of the Internal Revenue Code is persuasive as to the proper interpretation and application of section 17071. (See Rihn v. Franchise Tax

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Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955); Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).) It is a fundamental principle of income taxation that income must be taxed to the one who earns it. (Commissioner v. Culbertson, 337 U.S. 733, 739-740 [93 L.Ed. 1659] (1949), 1949-2 Cum. Bull. 5.) Further, one who earns income cannot avoid taxation by diverting it to another entity, since anticipatory assignment of income is ineffective as a means of avoiding tax liability. (Lucas v. Earl, 281 U.S. 111 (74 L.Ed. 7311 (1930); Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935); United States v. Basye, 410 U.S. 441, 449-450 [35 L.Ed.2d 412] (1973), 1973-1 Cum. Bull. 3 2 5 . )

Regardless of whether an assignment of income is an irrevocable assignment, and regardless of whether the income is assigned for a substantial period of time, the true earner of the income realizes economic gain from the disposition of such income and is taxable on it. (Galt v. Commissioner, 216 F.2d 4.1 (7th Cir. 1954).) In resolving the question of who earns the income, the court will look to who has actual control over the earning of the income rather than who has apparent control over the income. (American Savings Bank v. Commissioner, 56 T.C. 828 (1971); Richard L. Wesenberg v. Commissioner, 69 T.C. 1005 (1978).)

In Richard L. Wesenberg v. Commissioner, supra, the petitioner, a medical doctor, executed an affidavit purporting to convey to a family trust created by him "the exclusive use of his lifetime services and all my earned and to be earned remuneration and all my right, title and interest in such earnings from my services rendered or to be rendered" to the University of Colorado Medical School . . ." Petitioner notified the school of his conveyance at about the time he commenced work and requested that his payroll (checks be made payable to the trust. The checks were made payable to the trust.

The court, in holding the income taxable to the doctor, stated:

[T]he "first principle of income taxation" is the old saw: that income must be taxed to the one who earns it. [Citation.]

. . .

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Presumably, it is petitioner's contention that Richard was a servant or agent of the Trust, and therefore the income paid for the performance of his services is taxable to the Trust.

After careful examination of all the surrounding facts and circumstances, we believe that the ultimate direction and control over the earning of the compensation rested in Richard and not in the Trust. While Richard may have conveyed, at least in form, his services to the Trust, in substance he was not a bona fide servant or agent of the Trust with respect to the services he rendered to the school.

. . . We seriously question whether the Trust **could** (or that Richard ever intended that **it** be able to do so) obligate Richard to perform these services or interfere with his contractual arrangement with the school. Furthermore, it **was** the school, and not the Trust, which determined Richard's salary and supervised his employment. [Citations.]

Accordingly, we hold that Richard's conveyance of his lifetime services, and the income earned through the performance of those services, was simply an assignment of income and ineffective to shift the tax burden thereon from petitioner to the Trust. Thus, the total amount paid to the Trust by the school for Richard's services was includable in petitioner's gross income.

In the instant case appellant fails to show that his services were effectively assigned to the trust **and that** he worked as an agent or employee of the **trust.**<sup>1/</sup> First, the documents concerning conveyance **give** the **trust** no rights to direct appellant's

<sup>1/</sup> In addition, under section 2008 of the California Business and Professions Code, it does not appear that appellant could assign his **services** to the trust. An attempt by the trust to control appellant's services would constitute an unlawful practice of medicine. (See 55 Ops. Cal. Atty. Gen. 103 (1972).)

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professional services, and the record shows that appellant continued his professional services in the same manner as was done in the past. Furthermore, although appellant purportedly assigned all his lifetime services to the trust, he had complete **control** over how much of his income was to be paid over to the trust. He also determined when he would work and where, without any **supervision** from the trust, and he also determined the fees charged for his services. Moreover, even if the trust had specified duties and remuneration, we agree with the statement in Wesenberg that it is questionable whether the trust could obligate appellant to perform services which were inherently personal to him in nature. Accordingly, we hold that the **income earned** by appellant during the period August 1, 1976, to **December 31, 1976**, was **includible** in income and should have been so reported. (See Ronald E. Morgan, ¶ 78,401 P-H Memo. T.C. (1978); Wallace J. Vnuk, ¶ 79,164 P-H Memo. T.C. (1979); Anthony Mirenda, ¶ 80,252 P-H Memo. T.C. (1980); Gregory R. Dekutowski, ¶ 80,260 P-H Memo. T.C. (1980); George T. Horvat, ¶ 90,266 P-H Memo. T.C. (1980); Markosian v. Commissioner, 73 T.C. 1235 (1980); see also Vercio v. Commissioner, 73 T.C. 1246 (1980).) In light of our finding that the assignment of income doctrine prevails, we find it unnecessary to discuss **respondent's** alternative position on this issue.

The second issue is whether appellants are entitled to their claimed farming losses. Specifically, appellants maintain **that they** incurred deductible losses in connection with their efforts to develop a llama herd. Respondent, on the other hand, argues **that** appellants have not shown that they incurred their expenses in an activity engaged in for profit, nor have they shown that certain expenses were ordinary or necessary rather than capital in nature. We agree with respondent.

Section 17202 provides, in pertinent part, as follows: "(a) There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

Section 17233 reads, in pertinent part, as follows:

(a) In the case of an activity engaged in by an individual, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this part except as provided in this section.

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\* \* \*

(c) For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under Section 17202 or under subdivision (a) or (b) of Section 17252.

The first question that arises is whether appellant purchased and raised the llamas as a business for profit. Such expenses are only deductible when the operations were begun and conducted with the bona fide intent to make a profit. (See Lamont v. Commissioner, 339 F.2d 377 (2d Cir. 1964) and Alden G. Thompson, ¶ 69,019 P-H Memo. T.C. (1969).)

The determination of whether or not an activity is engaged in for profit depends upon the specific facts and circumstances of the case. California Administrative Code, title 18, regulation 17233(b), discusses relevant factors in such a determination, and several of those **factors** apply in this case.

For example, we have been furnished no information to show that appellant entered into and carried out his activities with the llamas in a businesslike manner. In fact, all we know is that appellant bought the llamas and then kept them on his residence property. From the information furnished, it does not appear that appellant treated his ownership of the llamas as a business from which he expected to realize a profit.

Also, appellant has carried out his purported farming operations at Potter Valley for five tax years, if the two trust years are included, and his losses have exceeded \$14,000 each year, with no gross receipts having ever been reported. In Peter Hurd, ¶ 78,113 P-H Memo. T.C. (1978), the court stated that a record of substantial losses **over** a period of years and the fact that the prospects of ever achieving a profitable operation are minimal, are important factors indicative of the taxpayer's intent. (See also Besseney v. Commissioner, 45 T.C. 261 (1965).)

The financial status of the taxpayer is also important. Appellant's gross income from his profession as a doctor averaged approximately \$180,000 per year from 1974 through 1976. By comparison, the purported farming activity is an unimportant sideline, and

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regulation 17233(b) states that this indicates that the subject activity was not entered into for profit.

On the basis of the above factors, we conclude that appellant never entered into or conducted **his** purported llama farm operation with a bona fide intent to make a profit. Consequently, appellant is not entitled to deduct costs for feed, veterinarian fees, or any other expenses in connection therewith.

Furthermore, there is another reason for disallowing the expenses relating to the Potter Valley property. They were not deductible because they were capital in nature rather than ordinary and necessary. Under federal provisions similar to section 17202, case law has determined that expenditures made to develop land for farming were capital expenditures and not ordinary or necessary business expenses. (See Ashworth v. U.S., 28 Am. Fed. Tax R. 71-5976 (1976) and Gleis v. Commissioner, 245 F.2d 237 (6th Cir. 1957), affirming 24 T.C. 941 (1955).)

Except for minor expenses for feed and veterinary fees; all of appellant's expenditures relating to his purported farm were for the acquisition of capital assets and/or the construction of improvements such as roads, housing and water facilities. These expenses are of the sort incurred preparatory to using real property for farming. Therefore, those expenditures were capital expenditures and not ordinary and necessary. Thus they were not deductible in the appeal year.

To summarize, it is our conclusion that appellant has not shown that his farming operations were conducted with an intent to make a **profit** or that the Potter Valley expenses were not capital expenditures. Hence, appellant is not entitled to any of the deductions claimed or to those that may be attributed to him from the trust.

