

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DORSEY H. AND BARBARA D. McLAUGHLIN)

Appearances:

For Appellants: James W. **McGuire**
Certified Public Accountant

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

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 Dorsey H. and Barbara D. McLaughlin against a proposed assessment of additional personal income tax in the amount of **\$4,110.00** for the year 1976.

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Appellants filed a joint California personal income tax return for the year 1976 in which they reported total **nonfarm** income in the amount of \$85,212 and an overall net farm loss of \$183,461. Also reported in appellant's 1976 return was an item of tax preference from net farm loss in the amount of \$70,212. Appellants computed this latter amount by offsetting all but \$15,000 of their **nonfarm** income with their net farm loss; this computation resulted in no preference tax liability. Subsequently, appellants determined their net farm loss tax preference item to be the full amount of their **nonfarm** income, thereby resulting in a preference tax liability of \$52.

Upon review of appellants' return, respondent determined that their computation of their net farm loss tax preference item was in error. Respondent concluded, pursuant to former section 17063, subdivision (i), of the Revenue and Taxation Code,^{1/} that appellants' item of net farm loss tax preference was the amount of their overall net farm loss in excess of \$15,000. Appellants' protest of the proposed assessment subsequently issued by respondent has **resulted** in this appeal.

The issue presented by this appeal is whether respondent properly computed appellants' tax on preference items for the year in issue.

Section 17062 of the Revenue and Taxation Code provides, in pertinent part:

In addition to other taxes imposed by this part, there is hereby imposed . . . taxes . . . on the amount (if any) of the sum of the **items** of tax preference in excess of the amount of net business loss for the taxable year

During the year in issue, section 17063^{2/} provided, in relevant part:

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

2/ AB 93 (Stats. 1979, Ch. 1168), operative for taxable **years** beginning on or after January 1, 1979, rewrote subdivision (i) of section 17063 as subdivision (h) and increased the excluded amounts thereunder.

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For purposes of this chapter, the items of tax preference are:

* * *

(i) The amount of net farm loss in excess of fifteen thousand dollars (\$15,000) which is deducted from nonfarm income. (Emphasis added.)

Appellants contend that the emphasized portion of former section 17063, subdivision (i), should be interpreted as providing that net farm loss, if more than \$15,000 in excess of nonfarm income, shall constitute an item of tax preference only to the extent of nonfarm income. Supporting their interpretation, appellants argue, are the legislative history behind the enactment of former subdivision (i), and the general rules of statutory interpretation.

Section 17062, the section setting forth the minimum tax on tax preference items, was enacted as part of a comprehensive legislative plan designed to conform California income tax law to the federal reforms enacted by the Tax Reform Act of 1969. (See Assemb. Com. on Rev. and Tax. Tax Reform: 1971; Detailed Explanation of AB 1215-1219 and ACA 44, As Amended May 20, 1971, p. 85.) The federal counterpart of section 17062, section 56 of the Internal Revenue Code of 1954, imposes a minimum tax on tax preference items. It was enacted to reduce the advantages derived from otherwise tax-free preference income and to insure that those receiving such preferences pay a share of the tax burden. (1969 U.S. Code Cong. & Ad. News 2143.)

The federal minimum tax on tax preference items is imposed only with respect to those preference items which actually produce a tax benefit. Similarly, as we, observed in Appeal of Richard C. and Emily A. Biagi, decided May 4 1976 the intent of the California Legislature in enacting section 17062 was to apply the minimum tax on items of tax preference only with respect to those preference items which actually produce a tax benefit: when items of tax preference do not produce a tax benefit they are not subject to the minimum tax. (See also Appeal of Harold S. and Winifred L. Voegelin, Cal. St. Bd. of Equal., Feb. 3, 1977.)

In order that only those items of tax preference which actually produce a tax benefit be subject to the minimum tax on tax preference items, section 17062

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was constructed so as to impose the minimum tax only on the sum of the items of tax preference in excess of the amount of "net business loss."^{3/} Accordingly, to the extent of "net business loss," the tax benefit otherwise produced by the sum of the items of tax preference is neutralized. (Appeal of Richard C. and Emily A. Biagi, supra.)

Each of the items of tax preference set forth in section 17063 is used to determine a taxpayer's "net business loss." (See Rev. and Tax. Code, § 17064.6; Appeal of Richard C. and Emily A. Biagi, supra.) By deducting "net business loss" from the sum of the items of tax preference, the taxpayer is assured that only those preference items that have provided a tax benefit will be subject to the minimum tax on items of tax preference. (Appeal of Paul B. and Mary E. Schmid, Cal. St. Bd. of Equal., April 6, 1977; Appeal of Richard C. and Emily A. Biagi, supra.)

Appellants' application of former subdivision (i) of section 17063 thwarts the intent of the tax preference^{4/} scheme by permitting them to deduct their net farm loss^{4/} in excess of nonfarm income twice. By "offsetting" the amount of their nonfarm income with their net farm loss in excess of \$15,000 for the purpose of arriving at the amount of their item of net farm loss tax preference, appellants have, in effect, deducted the amount of netfarm loss in excess of nonfarm income from

3/ The term "net business loss" is defined in section 77064.6 as follows:

. . . the term "net business loss" means adjusted gross income (as defined, in Section 17072) less the deductions allowed by Section 17252 (relating to expenses for production of income), only if such net amount is a loss.

4/ The term "farm net loss" is defined in section 17064.7 as follows:

. . . "farm net loss" means the amount by which the deductions allowed by this part which are directly connected with the carrying on of the trade or business of farming exceed the gross income derived from such trade or business.

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the total amount of their net **farm loss** tax preference item. The same amount (i.e., net farm loss in excess of **nonfarm** income) is then used again by appellants when they deduct "net business loss" from the sum of the items of tax preference to arrive at the amount of such items of tax preference which are **subject** to the preference tax. As noted earlier, net farm loss in excess of **nonfarm** income is included in "net business loss." Consequently, whereas section 17062 provides only for the deduction of "net business loss" from the sum of the items of tax preference in order to arrive at the amount of such items which have resulted in a tax benefit, appellants have also used a component of "net business loss" (i.e., net farm loss in excess of **nonfarm** income) in order to determine the amount of their net farm loss tax preference item.

As **previously** indicated, the Legislature's intent in imposing the minimum tax on items of tax preference was to tax those items of tax preference listed in section 17063 to the extent of tax benefits produced; this is determined by deducting a taxpayer's "net business loss" from the sum of the items of tax preference. (Appeal of Paul B. and Mary E. Schmid, supra; Appeal of Richard C. and Emily A. Biagi, supra.) Appellants' interpretation and application of former section 17063, subdivision (i), would frustrate that legislative intent by allowing a taxpayer to partially or completely escape the minimum tax on items of tax preference that did provide a tax benefit. It is an elementary rule of statutory interpretation that a statute must be construed with reference to the object sought to be accomplished so as to promote its general purpose or policy. (Dept. of Motor Vehicles v. Indus. Acc. Corn., 14 Cal.2d 189 [93 P.2d 131] (1939); Candlestick Properties, Inc. v. San Francisco Bay Conservation Etc. Corn., 11 Cal.App.3d 557 [89 Cal.Rptr. 897] (1970).) We have already observed that the Legislature intended to impose the minimum tax on those **items** of tax preference which produce a tax benefit; by frustrating that policy and shielding such items of tax preference from taxation, appellants' interpretation of former section 17063, subdivision (i), is clearly inconsistent with that policy and cannot be sustained.

One of the principal arguments advanced by appellants is, that respondent's application of sections 17062 and 17063, subdivision (i), causes an undue and confiscatory hardship because, in their view, ever larger farm losses in excess of **nonfarm** income will.

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result in an ever increasing preference tax liability. An examination of this **argument, however**, reveals that it is based on a mistaken understanding of how the pertinent statutes apply. For example, assume that a taxpayer has a net farm loss of \$200,000 and **nonfarm** income of \$85,000. His preference income would be computed as **follows**:

Nonfarm income	\$ 85,800
Net farm loss	<u>(200,000)</u>
Adjusted gross income	<u>\$(115,000)</u>
Preference income (net farm loss in excess of \$15,000)	\$185,000
Less net business loss (adjusted gross income)	<u>(115,000)</u>
Preference income subject to preference tax	\$ 70,000

Now assume that the taxpayer has a \$400,000 net farm loss and \$85,000 of **nonfarm** income. As the **following** computation shows, his preference income would remain unchanged despite a doubling of his net farm loss,

Nonfarm income	\$ 85,000
Net farm loss	<u>(400,000)</u>
Adjusted gross income	<u>\$(315,000)</u>
Preference income (net farm loss in excess of \$15,000)	\$385,000
Less net business loss (adjusted gross income)	<u>(315,000)</u>
Preference income subject to tax	<u>\$ 70,000</u>

It should be clear from the above illustration that appellants' fears are groundless. The deduction provided for the taxpayer's net business loss will prevent a larger net farm loss from resulting in an increased preference tax liability. In both of the examples above, the preference tax will be imposed only on the amount of **nonfarm** income, in excess of \$15,000, which is sheltered from ordinary taxation by a net farm loss. While **we can** appreciate the dilemma confronted by appellant in attempting to apply the pertinent statutes to this matter, we must nevertheless conclude, for the reasons stated above, **that respondent's** action be sustained.

