

Appeal of Robert III and Helen Swanston

During the year in issue, appellant-husband was employed by Fat City Feed Lots, Inc., a corporation engaged in the business of farming; he was also a shareholder of that corporation. In addition to the wages received by appellant-husband, appellants reported gain from the sale of 2,600 shares in the aforementioned enterprise, a loss of \$1,824 from the operation of a farm, and a loss of \$190,821 from the operation of a partnership engaged in the trade or business of farming. Appellants did not report any portion of their net farm loss as an item of tax preference.

Upon examination of their return, respondent determined that appellants had improperly failed to report their net farm loss as an item of tax preference; the subject notice of proposed assessment was subsequently issued. Appellants protested respondent's action, asserting that appellant-husband's wages, as well as the gain from the sale of the stock, constituted gross income from the trade or business of farming, thereby reducing the amount of their net farm loss. Upon consideration of appellants' protest, respondent affirmed its action, thereby resulting in this appeal. The resolution of appellants' argument is the principal issue presented by this appeal.

Revenue and Taxation Code section 17063,^{1/} subdivision (i), as it existed for the year in issue,^{2/} included as an item of tax preference "[t]he amount of net farm loss in excess of fifteen thousand dollars (\$15,000) which is deducted from nonfarm income." The term "farm net loss" is defined by section 17064.7 as:

. . . 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. (Emphasis added.)

Former section 17063, subdivision (i), was intended as a replacement for former section 18220. While it changed the method of deterring tax-motivated farm loss operations, the focus of the new section, i.e., "farm net

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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loss," remained the same as that of the section it replaced. Except for certain provisions not in issue here, section 17064.7 defines "farm net loss" in a manner identical to that of former section 18220, subdivision (e). Pursuant to respondent's regulation 19253, regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section 18220 was patterned) governed the interpretation of the term "farm net loss" under former section 18220, subdivision (e). Given the successor relationship between section 17064.7 and former section 18220, subdivision (e), the Treasury regulations promulgated pursuant to section 1251 of the Internal Revenue Code are applicable for purposes of interpreting the term "farm net loss" as it appears in section 17064.7.

Treasury Regulation §1.1251-3(b) defines "farm net loss" as follows:

. . . The term "farm net loss" means the amount by which--

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed

(ii) The gross income derived from such trade or business. (Emphasis added.)

Treasury Regulation § 1.1251-3(e). (1) defines the term "trade or business of farming" as follows:

. . . For purposes of section 1251, the term "trade or business of farming" includes any trade or business with respect to which the taxpayer may compute gross income under §1.61-4, expenses under § 1-162-12, make an election under section 175, 180, or 182, or use an inventory method

3/ In pertinent part, this regulation provides as follows:

In the absence of regulations of the Franchise Tax Board and unless otherwise specifically provided, in cases where the Personal Income Tax Law conforms to the Internal Revenue Code, regulations under the Internal Revenue Code shall, insofar as possible, govern the interpretation of conforming state statutes

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referred to in § 1.471-6. Such term does not include any activity not engaged in for profit within the meaning of section 183 and § 1.183-2.

According to the above, any taxpayer who may compute gross income under Treasury Regulation § 1.61-4 is engaged in the trade or business of farming. Likewise, a taxpayer who may elect, pursuant to section 182 of the Internal Revenue Code of 1954, to treat expenditures which are paid or incurred by him in the clearing of land for farming purposes as expenses which are not chargeable to capital account is also engaged in the trade or business of farming. Treasury Regulation § 1.61-4 is identical to respondent's former regulation 17071(d). The latter, operative for the year in issue, designated as "farmers" "[a]ll individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants" Similarly, respondent's former regulation 17224(c), in effect for the year in issue, provided that "[a] taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant." Treasury Regulation § 1.182-5(a) (2) provides that "[g]ross income derived from the business of farming . . . does not include gains from sales of assets such as farm machinery or gains from the disposition of land." A taxpayer deriving gross income from the sale of assets used in the trade or business of farming or deriving income as an employee or independent contractor of a corporation engaged in the business of farming is neither defined as a "farmer" nor as a "taxpayer engaged in the business of farming" under any of the cited regulations.

Federal Revenue Rulings interpreting Treasury Regulation § 1.175-3 (the substantive federal equivalent of respondent's former regulation 17224(c)) have determined that wages paid farm employees and fees paid to providers of customary farm services are to be excluded from the definition of gross income from farming. (See Rev. Rul. 65-280, 1965-2 Cum. Bull. 433; Rev. Rul. 77-105, 1977-1 Cum. Bull. 374; see also Appeal of Harry and Hilda-Eisen, Cal. St. Bd. of Equal., Oct. 27, 1981; Donald S. and Maxine Chuck, Cal. St. Bd. of Equal., Oct. 27, 1981.) Additionally, it has been determined that dividend income from a corporation engaged in the business of farming does not constitute income from farming to a shareholder of such a corporation. (Rev. Rul. 76-141, 1976-1 Cum. Bull. 381; see also Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963).) Finally, as previously noted, income derived from the sale of assets used in the trade or business of farming is similarly excluded from the definition of gross income from farming. (Treas. Reg. § 1.182-5(a) (2); Rev.

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Rul. 63-26, 1963-1 Cum. Bull. 295.) In light of the above analysis, appellants' contention that the income in issue constitutes farm income is untenable.

In addition to their principal contention, appellants also argue that respondent has construed the relevant provisions of the Revenue and Taxation Code in a manner inconsistent with their legislative intent and that, in any event, those provisions are unconstitutional. Both of these contentions have previously been addressed by this board. (Appeal of Eugene I. Ingrum, Cal. St. Bd. of Equal., June 29 1982; Appeal of Dorsey H. and Barbara D. McLaughlin, Cal: St. Bd. of Equal., Oct. 27, 1981.) **For the reasons** set forth in the cited appeals, we conclude that these arguments are without merit.

For the reasons set forth above, respondent's action in this matter will be sustained.

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Upon examination of their return, respondent determined that appellants had improperly failed to report their net farm loss as an item of tax preference: the subject notice of proposed assessment was subsequently issued. Appellants protested respondent's action, asserting that appellant-husband's wages, as well as the gain from the sale of the stock, constituted gross income from the trade or business of farming, thereby reducing the amount of their net farm loss: Upon consideration of appellants' protest, respondent affirmed its action, thereby resulting in this appeal. The resolution of appellants' argument is the principal issue presented by this appeal.

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. . . 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. (Emphasis added.)

Former section 17063, subdivision (i), was intended as a replacement for former section 18220. While it changed the method of deterring tax-motivated farm loss operations, the focus of the new section, i.e., "farm net loss," remained the same as that of the section it replaced. Except for certain provisions not in issue here, section 17064.7 defines "farm net loss" in a manner identical to that of former section 18220, subdivision (e). Pursuant to respondent's regulation 19253,^{3/} regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section 18220 was patterned) governed the interpretation of the term "farm net loss" under former section 18220, subdivision (e). Given the successor relationship between section 17064.7 and former section 18220, subdivision (e), the Treasury regulations promulgated pursuant to section 1251 of the Internal Revenue Code are applicable for purposes of interpreting the term "farm net loss" as it appears in section 17064.7.

Treasury regulation § 1.1251-3(b) defines "farm net loss" as follows:

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. . . The term "farm net loss" means the amount by which--

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed

(ii) The gross income derived from such trade or business.
(Emphasis added.)

Treasury regulation § 1.1251-3(e)(1) defines the term "trade or business of farming" as follows:

. . . For purposes of section 1251, the term "trade or business of farming" includes any trade or business with respect to which the taxpayer may compute gross income under § 1.61-4, expenses under § 1.162-12, make an election under section 175, 180, or 182, or use an inventory method referred to in § 1.471-6. Such term does not include any activity not engaged in for profit within the meaning of section 183 and § 1.183-2.

According to the above, any taxpayer who may compute gross income under Treasury regulation § 1.61-4 is engaged in the trade or business of farming. Likewise, a taxpayer who may elect, pursuant to section 182 of the Internal Revenue Code of 1954, to treat expenditures which are paid or incurred by him in the clearing of land for farming purposes as expenses which are not chargeable to capital account is also engaged in the trade or business of farming. Treasury regulation § 1.61-4 is identical to respondent's former regulation 17071(d). The latter, operative for the year in issue, designated as "farmers" "[a]ll individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants" Similarly, respondent's former regulation

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17224(c), in effect for the year in issue, provided that "[a] taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant."

Federal revenue rulings interpreting Treasury Regulation § 1.175-3 (the substantive federal equivalent of respondent's former regulation 17224(c)) have concluded that wages paid farm employees and fees paid to providers of customary farm services are to be excluded from the definition of gross income from farming. (See Rev. Rul. 65-280, 1965-2 Cum. Bull. 433; Rev. Rul. 77-105, 1977-1 Cum. Bull. 374.) Assuming, without deciding, that Fat City Feed Lots, Inc., is engaged in the trade or business of farming, this board has previously held that wages received from a corporation engaged in such trade or business do not constitute farm income. (Appeal of Harry and Hilda Eisen, Cal. St. Bd. of Equal., Oct. 27, 1981; Appeal of Donald S. and Maxine Chuck, Cal. St. Bd. of Equal., Oct. 27, 1981.) There is no reason to reach a different conclusion in this appeal.

We also find as without merit appellants' contention that the gain realized from their sale of Fat City stock constituted farm income. Such income does not acquire the trade or business attributes of the corporation. (Cf. Rev. Rul. 76-141, 1976-1 Cum. Bull. 381, which stands for the proposition that dividend income from a corporation engaged in the business of farming does not constitute income from farming to a shareholder of such a corporation; see also Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963).) Thus, even if Fat City Farm Lots, Inc. is engaged in the business of farming, the gain realized by appellants from the sale of **its stock** is not farm income. In light of the above analysis, appellants' contention that the income in issue constitutes farm income is untenable.

In addition to their principal contention, appellants also argue that respondent has construed the relevant provisions of the Revenue and Taxation Code in a manner inconsistent with their legislative intent and that, in any

