86-SBE-033

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFOHNIA

In the Matter of the Appeal of)
) No. 84A-607-GO
PACIFIC BRIDGE COMPANY)

Appearances:

For Appellant: Richard G. Thomas
Attorney at Law

For Respondent: Patricia Hart
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Pacific Bridge Company against a proposed assessment of additional franchise tax in the amount of $9,300 for the income year ended June 30, 1980.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

The sole issue for review is whether appellant is entitled to deduct $100,000, representing the amount of an unsecured promissory note, upon the apparent lapse of an option on March 28, 1980.

Appellant is an accrual-basis taxpayer, with a taxable year ending on June 30. On December 15, 1979, appellant entered into an option with Bardacos/Garro Enterprises ("Bardacos/Garro") to purchase a parcel of land located in Del Mar, California, which Bardacos/Garro controlled.

The purchase price for the option was $300,000 payable as follows:

(1) $200,000 in cash due on or before December 31, 1979, and

(2) an unsecured promissory note in the amount of $100,000 due on or before March 28, 1980.

In addition-to the payment of the $100,000 note on March 28, 1979, pursuant to the terms of the Option Agreement, an additional payment of $10,000 was due on March 28, 1980, in order for the option to continue in effect. (Resp. Br., Ex. A at 1.) On December 28, 1979, appellant delivered to Bardacos/Garro cash in the amount of $200,000 and its promissory note of $100,000 due on March 28, 1980.

By letter to Bardacos/Garro dated March 25, 1980, appellant alleged that Bardacos/Garro was in breach of the Option Agreement and that, if affirmative action was not taken by March 28, 1980, by Bardacos/Garro, it would "rescind the Option Agreement and ... require the return of all the monies ...." (Resp. Br., Ex. A at 2.) By letter to appellant dated March 27, 1980, Bardacos/Garro alleged that no breach had occurred and that it expected payment of the $100,000 from appellant on March 28, 1980, the next day. (Resp. Br., Ex. B.) No payment was made and, apparently, no additional payment of $10,000 was made to extend the period of the option. Accordingly, pursuant to the terms of the Option Agreement, on March 28, 1980, the option apparently lapsed.

On its tax return for the year ended June 30, 1980, appellant claimed $300,000 as a deduction for the forfeited option. (Resp. Br., Ex. E at 3.) With respect to the lapsed option, appellant deducted the sum of the

cash payment of $200,000, plus the promissory note of $100,000 executed on December 28, 1979, and due on March March 28, 1980, but unpaid as of the end of its tax year.[2] Upon audit, respondent allowed appellant to deduct the $200,000 but disallowed appellant's deduction of the $100,000 represented by the promissory note. Appellant protested and upon review, respondent affirmed its disallowance. This appeal followed.

Both parties appear to agree that a deductible loss may result to appellant from an apparent failure to exercise an option to buy property. The disagreement, of course, centers upon the amount of that loss. Appellant argues that, as an accrual-basis taxpayer, the consideration paid for the option in the form of the promissory note was properly accrued and then deducted upon the apparent lapse of that option on March 28, 1980, (App. Reply Br. at 1.)[3]

2/ As indicated, appellant refused to pay the $100,000 to Bardacos/Garro on March 28, 1980, as provided in its note. On April 10, 1980, Bardacos/Garro filed a lawsuit against appellant for payment of that note. (Resp. Br., Ex. C at 2.) On May 13, 1980, appellant answered that lawsuit and alleged as an affirmative defense that the option agreement had been rescinded and that the subject note was of no further force and effect. Appellant stated that its "obligation under said promissory note has been excused and that no sum at all is due under said promissory note." (Resp. Br., Ex. D at 3.) By letter dated October 15, 1981, to appellant's attorney, Bardacos/Garro suggested that the lawsuit be settled by a mutual dismissal of claims. (Resp. Br., Ex. F at 2.) By letter dated October 23, 1981, appellant's attorney suggested that the mutual dismissal be accepted since this settlement would "cut off the exposure for the promissory note claim of $100,000 ...." (Resp. Br., Ex. F. at 1.) Appellant accepted the settlement and was thus released from the obligation (if any) to honor the subject note at that time.

3/ As indicated above, in its taxable year 1982, appellant was ultimately succesful in its attempt to prevent payment to Bardacos/Garro of $100,000 for the promissory note. Appellant states that at that time (taxable year 1982), it included in its income $100,000 as cancellation of a debt. (App. Br. at 1.) We note, in passing, that

(Continued on next page.)

Respondent's initial position apparently is that, in view of the contest, the $100,000 liability was not properly accruable and, therefore, not deductible in the appeal year since all the events had not occurred which determine the fact and amount of the liability. Furthermore, anticipating an argument based on the section 24684, respondent contends that, even if the liability constituted a "contested liability" within that section, deduction during the year in issue is still precluded since no "money or other property' was transferred "to provide for the satisfaction of the asserted liability" which would have permitted the deduction. 4/ (Rev. & Tax. Code, § 24684.) Appellant argues that section 24684 has no application to the instant situation, since it alleges that the liability itself was not contested. Even if section 24684 were applicable, appellant continues, the $100,000 note constituted "other property" within the meaning of that statute so as to be deductible..

Under the "accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy." -(Treas. Reg. § 1.461-1, subd. (a)(2).) Cases have indicated that if a liability is contested by an accrual-basis taxpayer, all events have not occurred to permit deductibility.

> It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the

3/ (Continued)
based upon 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)), inclusion of the income in 1982 is not relevant to our present inquiry.

4/ In order for section 24684 to apply, the taxpayer iiiust contest an "asserted liability." The applicable regulation defines "asserted liability" to be a deduction which would be allowable under an accrual method of accounting but for the contest. (Cal. Admin. Code, tit. 18, reg. 24681-24684(b), subd. (2)(A).) Therefore, before the section 24684 issue can be addressed, the accrual question must be answered.

> amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid: and this cannot be the case where the liability is contingent and is contested by the taxpayer. (Footnotes omitted.)

(Dixie Pine Products Co. v. Commissioner, 320 U.S. 516, 519 [88 L.Ed. 270] (1944); see also Lutz v. Commissioner, 396 F.2d 412, 414 (9th Cir. 1968).)

It is recognized that where the taxpayer is judicially contesting the question of liability or the amount of the liability, the liability is contingent. (See Gillis v. United States, 402 F.2d 501 (5th Cir. 1968).) As of March 28, 1980, appellant had refused to pay the $100,000 as provided by its note. By the end of the taxable year at issue, appellant had judicially contested the liability reflected by the promissory note. Under such circumstances, we cannot find that all events had occurred during the year at issue, which would fix the liability reflected by the subject note.5/ Accordingly, we find that solely because of the judicial contest accrual of the liability reflected by the $100,000 note was prevented. (Cal. Admin. Code, tit., 18, reg. 24681-24684(b), subd. (2)(B).)

Since, except for the contest, the liability would be accruable and deductible, the contested liability constitutes an "asserted liability" within section 24684 and might still be deductible if certain requirements set forth in that section were fulfilled. One of the requirements is that the "taxpayer transfers money or other property to provide for the satisfaction of the asserted liability." (See Rev. & Tax. Code, § 24684(b).) Clearly, no transfer of money took place with respect to the disputed transaction. Appellant then argues that the note itself was such qualifying "other property" so as to

5/ While it is true that appellant did not actually file the lawsuit, it is clear from the record that as of March 25, 1980, (three days before the option was to lapse on March 28, 1980) appellant contested its liability under that agreement and that letter "set up" the lawsuit. Such action constitutes a contest within section 24684. (See Cal. Admin. Code, tit. 18, reg. 24681-24684(b), subd. (2)(B).) In addition, we find appellant's contention that it did not actually contest the obligation but only claimed damages due to injuries it suffered to be unpersuasive.

bring the transaction within the protection of section 24684 and to allow, therefore, the deduction in the year of appeal. However, there is nothing in that statute or the regulations thereunder which would indicate that a note which is itself the subject of the contest could be such other property. To make such a finding would mean that the very thing that is in doubt would permit the deduction. Such a reading not only appears to be a somewhat perverse interpretation of that statute, but also would considerably weaken the impact of the statute. Accordingly, we hold appellant's last argument to be mistaken and we, therefore, find that the subject note was not such qualifying "other property" within the meaning of section 24684.

For the reasons stated above, respondent's action must be sustained.

Appeal of Pacific Bridge Company

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Pacific Bridge Company against a proposed assessment of additional franchise tax in the amount of $9,300 for the income year ended June 30, 1980, be and the same is hereby sustained.

Done at Sacramento, California, this 4th day of February, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

*For Kenneth Cory, per Government Code section 7.9