BEFORE THE STATE BOARD OF EQUALIZATION

OF TEE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82R-1241-VN
ESTATE OF ANNA COGSWELL)

For Appellant: William A. Gisvold
Arthur Andersen & Co.

For Respondent: David Lew
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of the Estate of Anna Cogswell for refund of personal income tax in the amount of $1,378 for the year 1980.

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

The question raised by this appeal is whether respondent properly computed appellant's item of tax preference for excess itemized deductions for the year in issue.

Appellant filed a separate California personal income tax return for 1980 in which there was reported an adjusted gross' income of $275,622 and itemized deductions in the sum of $266,735, resulting in a taxable income of $8,887. Pursuant to section 17062, appellant also reported tax preference income of $54,494 in unrecognized capital gains and $77,266 in excess itemized deductions.

After reviewing the return, respondent determined that appellant had not reported the correct amount of its preference item for excess itemized deductions. Based on its calculations, respondent found appellant had understated its tax preference income in the amount of $23,810. Appellant paid the attendant tax deficiency but filed a claim for refund which was subsequently denied by respondent.

In addition to other taxes imposed under California's Personal Income Tax Law (Rev. & Tax Code, §§ 17001-19452), section 17062 imposes a tax on "items of tax preference in excess of the amount of net business loss for the taxable year." The purpose of this tax is to reduce the advantages derived from otherwise tax-free income and to insure that those taxpayers receiving such preferences pay a share of the tax burden. (Appeal of Richard C. and Emily A. Biagi, Cal. St. Bd. of Equal., May 4, 1976.) Accordingly, a special minimum tax is levied upon certain items of income and deductions that are accorded preferential tax treatment.

An item of income subject to the minimum preference tax is capital gains, which is partially shielded from ordinary taxation by operation of nonrecognition provisions. (Appeal of Eugene I. Ingrum, Cal. St. Bd. of Equal., June 29, 1982.) When computing taxable income, section 18162.5 provides for a specified reduction in the amount of capital gains and losses depending on the holding period. The unrecognized portion of a taxpayer's net capital gains is designated as an item of tax preference. (Rev. & Tax. Code, § 17063, subd. (g); see Appeal of Harold S. and Winifred L. Voegelin, Cal. St. Bd. of Equal., Feb. 3, 1977.)

The item of tax preference which is the subject of the present appeal is "[a]n amount equal to the excess

itemized deductions for the taxable year (as determined under Section 17063.2)." (Rev. & Tax. Code, § 17063, subd. (a).) Subdivision (a) of section 17063.2 defines "excess itemized deductions" as the amount by which the sum of deductions for a taxable year, other than (1) the deduction for state and local taxes, (2) the deduction for medical and dental expenses, (3) the deduction for casualty losses, and (4) the deduction for inheritance tax, exceeds 60 percent of a taxpayer's adjusted gross income reduced by the same four excepted deductions. In other words, a tax preference amount arises to the extent that itemized deductions, less excepted items, exceed 60 percent of the adjusted gross income, less excepted items.

For example, in the present appeal, appellant claimed excepted deductions for state and local taxes of $659 and medical expenses of $55 in itemizing its personal deductions. Pursuant to the formula under section 17063.2, subdivision (a), respondent recomputed appellant's item of preference income for excess itemized deductions as follows:

Itemized deductions	$266,735
Less deductions for state and local taxes ($659) and medical expenses ($55)	(714)
Revised itemized deductions	266,021
Less 60 percent of adjusted gross income reduced by deductions for state and local taxes and medical expenses [60% of ($275,622 - 714)]	(164,945)
Excess Itemized Deductions Preference	$101,076

Adding the uncontroverted amount of preference income for unrecognized net capital gains ($54,464) to the recomputed amount of excess itemized deductions preference, respondent determined that the sum of appellant's tax preference items was $155,570.

It is well settled that respondent's determination of a tax or tax deficiency is presumed to be correct, and the taxpayer bears the burden of proving that respondent's action is erroneous or improper. (Appeal of K.L. Durham, Cal. St. Bd. of Equal., Mar. 4, 1980; Appeal of

Richard and Diane Bradley, Cal. St. Bd. of Equal., Dec. 6, 1977.) In the instant matter, appellant does not argue that respondent's calculation of the disputed preference item is incorrect. Instead, appellant contends that respondent's determination of its items of tax preference for excess itemized deductions is erroneous for failing to consider the tax benefit rule.

Relying on Revenue Ruling 80-226, 1980-2 C.B. 26, appellant submits that its "maximum tax benefit" from preference items is $131,761. Since it had $54,494 of capital gains preference income, appellant argues that only $77,266 ($131,761 - $54,494) remained for allotment to the preference item for excess. itemized deductions. Appellant thus implies that any amount of the excess itemized deduction preference surpassing the $77,266 balance of its maximum tax benefit does not provide a tax benefit and is therefore exempt from the preference tax.

Section 17064.5, subdivision (f), provides for implementation of the tax benefit rule by requiring the Franchise Tax Board to "prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax under this chapter for any taxable years." The sole regulation promulgated pursuant to this mandate provides:

> (a) In determining the extent to which a taxpayer's tax preference items reduce such taxpayer's tax, all nonpreference deductions will be considered to be taken into account first, followed by preference items of deduction.
>
> (b) The items of tax preference computed under Division 2, Part 10, Chapter 2.1, Revenue and Taxation Code, beginning with Section 17062, shall be reduced by an amount equal to the taxpayer's negative taxable income, except to the extent previously reduced by the taxpayer's "net business loss" as defined in Revenue and Taxation Code Section 17064.6.
>
> (c) The phrase "reduction of the taxpayer's tax" as used in Revenue and Taxation Code Section 17064.5(f) means the reduction of tax liability without regard to the effect of. allowable tax credits.

> (d) This regulation shall apply to taxable years beginning on or after January 1, 1979.

(Cal. Admin. Code, tit. 18, reg. 17064.5.)

In the instant matter, respondent has contended that the controlling tax benefit rule is set forth under regulation 17064.5, subdivision (b), which provides for the reduction of items of tax preference by an amount equal to negative taxable income. It is respondent's position that the existence of negative taxable income determines the extent to which a taxpayer derives a tax benefit from tax preference items. The absence of negative taxable income, respondent asserts, means that a taxpayer is not entitled to any tax benefit adjustment. Noting that appellant had, even after claiming $266,735 in itemized deductions, a positive taxable income ($8,887) from which to take further deductions, respondent argues that appellant received the full tax benefit from its preference item for excess itemized deductions at the amount calculated by the Franchise Tax Board.

The difficulty with respondent's position, which focuses totally on subdivision (b) of regulation 17064.5, is that it overlooks subdivision (a) of that regulation, which also provides for a tax benefit adjustment. As noted above, subdivision (a) provides: "In determining the extent to which a taxpayer's tax preference items reduce such taxpayer's tax, all nonpreference deductions will be considered to be taken into account first, followed by preference items of deduction." (Emphasis added.) Exactly how this computation is to be made is not specified in the regulation, but one means of doing it is set forth in Revenue Ruling 80-226, supra. In language remarkably similar to subdivision (a) of respondent's, regulation 17064.5, this revenue ruling states:

> In determining the extent to which a taxpayer's tax preference items of deduction reduce the taxpayer's gross income and thereby provide a tax benefit, a taxpayer will be treated as using all nonpreference deductions first (other than those itemized deductions that exceed 100 percent of adjusted gross income computed without regard to preference deductions), followed by preference items of deduction to the extent necessary to reduce taxable income to zero.

The ruling goes on to specify how the amount of tax benefit is to be computed in the case of a taxpayer who has an itemized deduction preference item:

> The amount of preference items yielding a tax benefit equals gross income minus the taxpayer's "preference exclusion." In the case of a taxpayer with an adjusted itemized deductions preference, the 'preference exclusion" is computed by totalling (1) nonpreference deductions allowable in arriving at adjusted gross income, (2) medical deductions and casualty losses, (3) itemized deductions to the extent of 60 percent of adjusted gross income computed without regard to deductions which are preference items, and (4) the deductions for personal exemptions.

In computing its preference tax liability, appellant followed the approach of *Revenue* Ruling 80-226, except that in figuring 60 percent of its adjusted gross income it properly reduced its adjusted gross income by the sum of its deductions for state and local taxes and medical expenses, as required by subdivision (a) of section 17063.2. This section, which defines the excess itemized deductions preference, and section 17064.5, which instructs respondent to promulgate tax benefit regulations governing preference items, were added to the Revenue and Taxation Code as part of a legislative scheme to conform California income tax law to the federal tax law changes enacted by the Tax Reform Act of 1976. (See Stats. 1977, ch. 1079, §§ 1-2, p. 3291.) The federal counterpart of section 17063.2, subdivison (a), was former section 57(b) of the Internal Revenue Code which was repealed in 1982. On the other hand, the federal parallel to section 17064.5, subdivision (f), is Internal Revenue Code section 58(h), which similarly provides: "The Secretary shall prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax under this subtitle for any taxable years." Because the California tax preference laws were patterned after federal statutes, the interpretation and effect given the federal provisions by the federal *courts* and administrative bodies are relevant in determining the proper construction of the California statutes. (See Appeal of John Z. and Diane W. Mraz, Cal. St. Bd. of Equal., July 26, 1976, and the cases therein cited.)

While Revenue Ruling 80-226 is not binding upon us, it does appear to be a reasonable method of computing the extent to which a taxpayer has received a tax benefit from his tax preference items, in accordance with respondent's regulation 17064.5, subdivision (a), and with the statutory mandate of section 17064.5, subdivision (f), of the Code. Certainly, by ignoring subdivision (a) of its regulation entirely in this case, respondent has not provided us with any reason to conclude that Revenue Ruling 80-226 should not be used to interpret this portion of the regulation. Under these circumstances, we are constrained to hold that appellant properly relied upon the ruling in computing its preference tax liability and that its claim for refund should have been granted. (See also Rev. Rul. 84-124, 1984-2 C.B. 14), which reached the same result as we do herein, in a fact situation involving taxpayers having both a capital gains preference item and an itemized deductions preference item.)

For the above reasons, respondent's action in this matter will be- reversed.

Appeal of Estate of Anna Cogswell

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 therefot,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying- the claim of Estate of Anna Cogswell for refund of personal income tax in the amount of $1,378 for the year 1980, be and the same is hereby reversed.

Done at Sacramento, California, this 9th day of April , 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

Ernest J. Dronenburg, Jr. , Member

, Member

, Member

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) 82R-1241 DB
Estate of Anna Cogswell)

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed May 12, 1985, by the Franchise Tax Board for rehearing of the appeal of Estate of Anna Cogswell from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of April 9, 1986, be and the same is hereby affirmed.

Done at Sacramento, California, this 19th day of November, 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