BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81A-1313-VN
ESTATE OF ALBERT KAHN (DEC'D))
AND LILLIAN KAHN)

For Appellants: Robert B. England
Attorney at Law

For Respondent: Elleene K. Tessier
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of the Estate of Albert Kahn (Dec'd) and Lillian Kahn against a proposed assessment of additional personal income tax in the amount of $6,422.24 for the year 1976.

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

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Prior to the year in question, Albert and Lillian Kahn-were long-time residents of the State of New York. They lived in an apartment cooperative in New York City and owned two rental properties located in Rye, New York, and Holyoke, Massachusetts. On May 21, 1976, they relocated to Thousand Oaks, California, and became residents of this state. Albert Kahn died on November 15, 1976.

Before they left New York, the Kahns had entered into agreements to sell all three of their properties. On May 21, 1976, just before they departed for California, they attended the closing of escrow for the sale of their New York City residence. Subsequently, the escrow for the sale of the Holyoke property closed on *June* 1, 1976. Their attorney forwarded to them the net proceeds from this sale on June 24, 1976. Lastly, the escrow for the sale of the property in Rye; New York, closed on July 23, 1976. From these three real estate transactions, the Kahns realized capital gains in the following amounts:

Property	Capital Gains Realized
New York, New York	$ 485
Holyoke, Massachusetts	150,223
Rye, New York	25,579
TOTAL	$176,287

On a joint, part-year resident California tax return (form 540NR) for 1976, appellant Lillian Kahn indicated that she and her late husband established residence in this state on May 21, 1976. Mrs. Kahn disclosed that they derived $176,287 in long-term capital gains from the disposition of the three properties. She declared net capital gains income of $79,642 on the return but did not attribute any of this amount to their California income. In addition, Mrs. Kahn claimed a total net loss of $261,867 in rental income from all three properties and assigned $73,100 of this loss to their California income. Appellants' taxable California income for 1976 was reported to be ($44,713), resulting in no California tax liability.[2/]

2/ Based on their belief that the sales of their properties were attributable to the period of their New York residency, appellants filed a 1976 New York nonresident (Continued on next page.)

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Upon auditing appellants' 1976 return, the Franchise Tax Board determined that the sales of the three properties occurred after appellants had become California residents. Since the parcels had all been held by the Kahns for more than five years, respondent found that one-half of the gains realized from the sales, or $88,143.50, should have been included in their 1976 California taxable income as long-term capital gains. Furthermore, respondent determined that appellants had failed to report the unrecognized portion of these net capital gains as tax preference income under section 17063, subdivision (g). Consequently, respondent issued a proposed assessment of additional tax which reflected the inclusion of appellants' long-term capital gains in their California taxable income for 1976 as well as the tax on the preference item for unrecognized capital gains. Appellants filed this appeal following denial of a protest against the proposed deficiency assessment.

At the outset, we reiterate that determinations of the Franchise Tax Board in regard to the imposition of taxes are presumptively correct, and the taxpayer has the burden of proving error in these determinations. (Todd v. McColgan, 89 Cal.App.2d 509 [201 P.2d 4141 (1949); Appeal of Myron E. and Alice Z. Gire, Cal. St. Bd. of Equal., Sept. 10, 1969.) The first question raised by appellants is whether the capital gains realized from the disposition of the three out-of-state properties were properly includible in their California income for 1976. Appellants contend that they had entered into "binding commitments" to sell the parcels while they were still residents of New York and before they moved to California. Therefore, appellants argue, the gain from the sales was correctly reported only on their 1976 New York income tax return. We cannot agree.

The California personal income tax is to be imposed on the entire taxable income of every resident of this state, regardless of the source of the income, and upon the income of nonresidents which is derived from sources within California. (Rev. & Tax. Code, § 17041.) Where the taxpayer has not been a resident for the full year, he is nevertheless subject to California tax on his

2/ (Continued) return in which they reported all their capital gain and paid a minimum tax for their capital gains preference income. In addition, appellants claimed the remaining $188,767 of the rental loss from their properties on the New York return.

entire taxable income received during the portion of the year in which he was a resident. (Appeal of Jess D. and Marguerite M. Tush, Cal. St. Bd. of Equal., Mar. 19, 1963.) The policy behind California's personal income taxation of residents is to ensure that individuals who are physically present in this state, enjoying the benefits and protections of its laws and government, contribute to its support regardless of the source of their income. (See Cal. Admin. Code, tit. 18, reg. 17014.)

Taxable income is gross income minus allowable deductions. (Rev. & Tax. Code, § 17073.) Gross income is defined as all income from whatever source derived, including, specifically, gains derived from dealings in property. (Rev. & Tax. Code, § 17071; I.R.C. § 61(a).) It is well settled that gain from the sale of property is realized entirely at the time of sale. (Helvering v. San Joaquin Fruit & Invest. Co., 297 U.S. 496 [80 L.Ed. 824] (1936); Appeal of William J. and Esther L. Strobel, Cal. St. Bd. of Equal., Nov. 17, 1982; Appeal of John and Haroula Guido, Cal. St. Bd. of Equal., May 8, 1985.) For tax purposes, the sale of real property takes place either when the seller transfers legal title or when the buyer obtains possession of the property and assumes the benefits and burdens attendant with ownership. (Appeal of Frances L. Baker, Cal. St. Bd. of Equal., Oct. 9, 1985; Appeal of Calavo Growers of California, Cal. St. Bd. of Equal., Feb. 2, 1984; Rev. Rul. 69-93, 1969-1 C.B. 139.) In the present appeal, the record indicates that the Kahns did not transfer title or possession of their properties when they entered into the agreements for their sale. Rather, these events occurred at the time of the close of escrow for the sale of each property. Based on the escrow closing dates; it is apparent that the New York City cooperative apartment was sold before the Kahns became California residents, but the Holyoke and Rye properties were sold after they were residents. Accordingly, only the gains realized by the Kahns from the sales of these latter two properties were includible in their California taxable income for 1976.[3]

3/ During the pendency of this appeal, respondent determined that the sale of the New York City apartment cooperative actually took place just before appellants established residency in this state and has agreed to modify the proposed assessment so as to exclude the gain therefrom.

The second question presented for our decision is whether appellants should be entitled to deduct certain rental expenses incurred in connection with the Holyoke property and paid at the time of the sale. On their return, appellants allocated $73,100 of their total net loss of $261,867 from their rental properties to their 1976 California income apparently based on the "period of [their] California residency." (App. Br. at 3.) Among their rental deductions was $247,418.22 in rental expenses for the Holyoke realty which was paid at the sale of the property from the escrow established for said sale. These rental expenses were largely comprised of property taxes assessed by the City of Holyoke ($212,495.29) and gas and electric costs ($28,356.63). Appellants argue that, if the gains from the sales of the Holyoke and Rye rental properties are to be attributed to their California income for the reason that the sales occurred after they became California residents, then they should be allowed to deduct all the rental expenses for the Holyoke parcel which were paid at the time of sale. Appellants wish to claim then an additional $172,367.42 in rental losses for 1976 which, if allowed, would result in negation of the capital gains income that should have been reported on their California return.

In rebuttal, the Franchise Tax Board has argued that these rental expenses and liabilities, even though paid at the close of escrow for the sale of the Holyoke property, had actually accrued before the Kahns became California residents and, thus, were not deductible under section 17596, which provides:

> When the status of a taxpayer changes from resident to nonresident, or from nonresident to resident, there shall be included in determining income from sources within or without this State, as the case may be, income and deductions accrued prior to the change of status even though not otherwise includible in respect of the period prior to such change, but the taxation or deduction of items accrued prior to the change of status shall not be affected by the change.

In the Appeal of Virgil M. and Jeanne P. Money, decided by this board on December 13, 1983, we concluded that section 17596 was designed merely to prevent California from treating cash-basis and accrual-basis taxpayers differently when they change residency and are subject to California tax by virtue of their residency. Consistent

treatment is accomplished under section 17596 by placing all taxpayers on the accrual method of accounting, even though a taxpayer may be on the cash receipts and disbursements accounting basis. We held that section 17596 should be applied only when two conditions are satisfied: (1) when California's sole basis for taxation is the residency of the taxpayer, and (2) when the taxation would differ depending on whether the taxpayer uses the cash or the accrual method of accounting.

In the present appeal, the first condition is met, for it is clear the only basis for California to tax the Kahns is their residency in this state. The second condition is likewise satisfied because the taxation of appellants' income would differ under the cash and accrual methods of accounting.

In general, a taxpayer is allowed a deduction for the taxable year which is the proper taxable year under the method of accounting used by the taxpayer in computing his income. (Rev. & Tax. Code, § 17591.) Under the cash receipts and disbursements method of accounting, which is presumbably the method by which appellants calculated their income, amounts representing allowable deductions are taken into account for the taxable year in which paid. (Treas. Reg. § 1.461-l(a)(l).) On the other hand, a taxpayer using an accrual method of accounting may deduct an expense for the taxable year in which all the events have occurred that determine the fact of liability and fix the mount of such liability with reasonable accuracy. (Treas. Reg.. § 1.461-1(a)(2); United States v. Anderson, 269 U.S. 422 [70 L.Ed. 3471 (1926).)

Applying these principles to the facts in the instant appeal, under the cash method of accounting, the Holyoke rental expenses and liabilities would be deducted when paid by escrow at the close of the sale. Since the Kahns were California residents by that time, the expenses would be deductible on their California return under this method. Under an accrual method of accounting, however, it appears that liability for and the amount of a major portion of these expenses was established before Albert and Lillian Kahn moved to this state. The closing statement for the Holyoke sale indicates that the city property taxes were assessed for the years 1971-1976 and the utility costs were for the prior year. (App. Br., Ex. C.) Because these expenses accrued before the Kahns were residents of this state, the items would not-be deductible

under an accrual method for calculating their rental loss on their California return. In other words, taxation of these rental expenses would differ under the cash and accrual methods of accounting.

Because both parts of the Money test are satisfied, section 17596 would have to be applied in this appeal and require that appellants be placed on an accrual method for purposes of computing their California income and deductions. In such case, we have seen that the record supports respondent's conclusion that the bulk of the Holyoke rental expenses accrued before the Kahns became California residents and would not be deductible in computing their California taxable income. For their part, appellants have not presented any arguments against respondent's position nor any contrary evidence showing that the claimed Holyoke rental expenses accrued when paid on the date of sale or at least after they became residents of this state. Whereas appellants have the burden of proving that they are entitled to claim the deductions-(New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Appeal of James C. and Monablanche A. Walshe, Cal. St. Bd. of Equal., Oct. 20, 1975), we must sustain respondent's determination not to allow-the deduction of the-Holyoke rental expenses and liabilities. 4/

The third and final issue presented by this appeal is whether appellants are entitled to a credit against California personal income tax for personal income tax paid to the State of New York. Appellants contend that they should be allowed a credit for the minimum tax paid to New York on the same capital gains preference income that the Franchise Tax Board has assessed a preference tax under section 17063, subdivision (g). Appellants' position is not well taken.

4/ Respondent observes that, while section 17596 operates to disallow the deduction of the additional $172,367.42 in rental expenses paid on consummation of the sale, appellants were nevertheless allowed the original $73,000 rental loss claimed on their return. This amount of allowed loss, respondent surmises, probably exceeds that to which appellants should be entitled since the record does not clearly demonstrate that a corresponding amount of rental expenses accrued after appellants became California residents.

Subject to certain conditions, section 18001 of the Revenue and Taxation Code allows a credit to California residents for net income taxes paid to other states on income also taxable in California. One of the several limitations on the availability of the credit is set forth in subdivision (a) of section 18001, which provides in pertinent part:

> The credit shall be allowed only for taxes paid to the other state on income derived from sources within that state which is taxable under its laws irrespective of the residence or domicile of the recipient. (Emphasis added.)

The credit thus does not apply to income which is not derived from sources within the foreign taxing state.

In'order for appellants to succeed on their claim for the credit,' they must submit evidence demonstrating that the preference income in question came from New York sources. (Appeals of Joseph A. and Marion Fields, Cal. St. Bd. of Equal., May 21, 1961,) Moreover, appellants must show the total amount of their foreign source income and foreign tax liability by proffering a copy of the New York return and a receipt showing payment of the New York minimum tax on the capital gains preference item. (Appeal of David L. and Diane J. Goodman, Cal. St. Bd. of Equal., June 28, 1979; see also Cal. Admin. Code, tit.-18, reg. 18001-1, subd. (b).)

It is well settled that income from real property or gain from the sale or transfer of real property has its source or situs where the realty is located. (Appeal of The Inn at La Jolla, Inc., Cal. St. Bd. of Equal., Dec. 18, 1964; Appeal of Aetna Plywood & Veneer Company, Cal. St. Bd. of Equal., Apr. 21, 1959.) Here, the major portion of appellants' net capital gains was derived, not from New York-source property, but from the sale of the property in aolyoke, Massachusetts. A credit cannot be allowed for any income tax paid to New York on this non-New York income. As for the balance of their capital gains income derived from New York sources, appellants have failed to present sufficient documentation that they paid the minimum preference tax to New York on such sums. We, thus, have no choice but to sustain the denial of the claimed credit.

Based on the foregoing, we find that appellants have failed to carry their burden on any of the disputed

issues. Accordingly, except for the modification noted herein, respondent's action in this matter must be sustained.

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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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of the Estate of Albert Kahn (Dec'd) and Lillian Kahn against a proposed assessment of additional personal income tax in the amount of $6,422.24 for the year 1976, be and the same is hereby modified in accordance with this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

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 and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

William M. Bennett, Member

Walter Harvey*, Member

_____, Member

*For Kenneth Cory, per Government Code section 7.9