86-SBE-107

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. **83A-1167-PD**
KONSTANTYN AND ROSE BARUCH)

For Appellants: Glenda **M. Bayless**
Certified Public Accountant

For Respondent: David Lew
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 Konstantyn and Rose Baruch against proposed assessments of additional personal income tax in the amounts'of $659.95, $824.81, and **$3,762.00** for the years 1978, 1979, and 1980, respectively.

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

The issues presented by this appeal are: (1) whether appellants may deduct as business expenses payments made to their son; and (2) whether respondent's determination of the useful life of certain rental property has been demonstrated to have been incorrect.

Appellants owned the Laurel Avenue Convalescent Hospital in Fontana, California. They also were the sole owners of Koro Corporation, which leased the Laurel Avenue Convalescent Hospital from the appellants and operated it. Upon their personal income tax returns for 1978, 1979, and 1980, appellants took several business deductions for payments to their son, Terrance Baruch, for services he allegedly performed at the hospital. Appellants' deductions were $6,000 for "miscellaneous repairs" in 1978, and $17,500 for "professional fees" in 1979 and 1980. In addition, appellants claimed a $35,649 deduction for depreciation in 1980 on a rental house they owned in the Los Angeles area. Appellants had elected the component method of depreciation and estimated the useful life of the different component parts of the house at between 2 and 18 years.

Respondent questioned the deductions for the payments to appellants' son because any hospital work performed by the son properly appeared to be an expense of the corporation which operated the hospital and not an expense of the appellants, individually, and because there appeared to be no records of the son's hours of work or the services he performed. Respondent also questioned the appellants' estimate of the useful life of the house components and readjusted the depreciation schedules to reflect a 10-year useful life for the costs connected with the rehabilitation of the building and from a 10 to 20-year life for the costs for additional improvements. Respondent issued notices of proposed assessment for each of the appeal years, which reflected its disallowance of the deductions for payments to the son and a readjustment of the deduction for yearly depreciation on the house. Appellants protested. After a hearing, respondent affirmed its proposed assessment. This appeal followed.

It is well settled that income tax deductions are a matter of legislative grace, and taxpayers who claim a deduction have the burden of proving by competent evidence that they are entitled to that deduction. (New Colonial Ice Company v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).) A determination by respondent that a deduction should be disallowed is supported by a

presumption that it is correct. (Appeal of Nake M. Kamrany, Cal. St. Bd. of Equal., Feb. 15, 1972.)

In support of their deductions for payments to their son, appellants explained that Terrance's duties were to run hospital errands such as buying groceries and other needed items. Appellants produced an informal typewritten document stating that Terrance Baruch agreed to "work in repair and maintenance for all K $ R (sic) Baruchs propertys (sic)" for $857 a month. (Resp. Ex. A.) Appellants stated that during 1979 and 1980, their son, who was attending medical school at the University of Southern California during the appeal years, provided medical services to the patients of the hospital. Appellants produced an informal document calling for Terrance "to review patients (sic) charts, to eveluate (sic) the accuracy charting of the professional staff of Laurel CONV. Hospital." (Resp. Ex. B.) The agreement called for Terrance to receive a fixed amount for these services. Appellants stated that they did not document their son's work as long as his tasks were performed satisfactorily.

Respondent stated that appellants' payments to their son often exceeded the documented amounts due him, that appellants had, in the past, paid for their son's medical school tuition, and that the salary checks approximated the tuition amounts. Respondent also pointed out that the inherent burden of medical school studies and the approximately 75-mile distance between the University and the hospital raised doubts about the substance of Terrance's employment performances.

The general rule is that for a business expense to be deductible by a taxpayer, the expense must be incurred in connection with the taxpayer's own trade or business. Thus, if a taxpayer's expense was incurred in connection with another's trade or business, the expense is not deductible by the taxpayer notwithstanding that the taxpayer may have received some indirect benefit. (Deputy v. DuPont, 308 U.S. 488 (84 L.Ed. 416] (1940).) Here, it appears that appellants were not in the trade or' business of operating a convalescent hospital. Only their wholly owned corporation was in that business. Accordingly, payment of a hospital helper did not benefit appellants' own trade or business although they might, as shareholders, have received some indirect benefit. The fact that the corporation operating the hospital was wholly owned by appellants does not merge their separate businesses for income tax purposes.

Even if we were to assume, arguendo, that the appellants were in the hospital business, the documentation appellants offer to support the payments as business expenses rather than as educational gifts to their son was insufficient to carry appellants' burden of proof. Such an intra-family transaction must be subjected to extra scrutiny. (Appeal of Jesse A. Jones, Cal. St. Bd. of Equal., June 29, 1982.) The written agreements under which appellants' son was to work are not supported by any convincing evidence that his services, if performed, were worth the payments. In this case, the son was attending medical school at a distance from the hospital, the payments were sometimes in excess of the contracted amounts, the payments were equivalent to his medical school tuition, and there is no record of the hours worked or services provided. These circumstances prohibit a conclusion that the appellants' payments to Terrance were for ordinary and necessary hospital business expenses. Therefore, respondent's action on this issue must be upheld.

With regard to the depreciation deduction, appellants stated that the SO-year old house was in a dilapidated condition when appellants purchased it and that they had performed extensive repairs and remodeling on it. Appellants have tried to meet their burden of proof by asserting that, based upon Mr. Baruch's experience as a buyer and restorer of old homes, shorter depreciation periods more accurately reflected the assets'. actual economic lives.

Respondent determined that the appellants' estimated lives of the house components were too low since the extensive repairs to the house mitigated the effects of its age. For that reason, respondent readjusted the depreciation schedules.

Essentially, the case has been presented to us as a clash of opinions. Respondent considers that its estimated depreciation is correct; appellants believe that respondent's estimate is in-correct. But there has been no evidence presented which objectively demonstrates that respondent's estimates were incorrect. Appellants' mere asserted belief is insufficient to constitute that demonstration. (Appeal of John W. and Jean R. Patierno, Cal. St. Bd. of Equal., June 30, 1980.) Accordingly, since respondent's action is presumed correct, and in the absence of proof to the contrary, we have no alternative but to sustain respondent's actions.

Appeal of Konstantyn and Rose Baruch

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 Konstantyn and Rose Baruch against proposed assessments of additional personal income tax in the amounts of $659.95, $824.81, and $3,762.00 for the years 1978, 1979, and 1980, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of June , 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