BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
) No. 80A-701-VN
ROBERT AND M. J.)
MUELLER, ET AL.)

For Appellants: McGee Grigsby
Attorney at Law

For Respondent: Grace Lawson
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Robert and M.J. Mueller, et al., against proposed assessments of additional personal income tax in the amounts and for the years as follows:

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

Appeals of Robert and M. J. Mueller, et al.

Appellants	Years	Proposed Assessments
Robert and M. J. Mueller	1973	$ 212.00
	1974	139.74
	1975	694.00
	1976	1,425.52
	1977	544.00
	1978	3,158.00
Henry A. and Frances M. Wolfsen	1973	$1,665.79
	1974	182.65
	1975	578.46
	1976	455.35
	1977	468.64
	1978	584.60
Henry B. and Helen E. Wolfsen	1973	$1,530.17
	1974	922.39
	1975	644.47
	1976	682.52
	1977	548.20
	1978	696.88
Myrna Wolfsen	1973	$1,274.41
	1974	768.39
	1977	59.00
	1978	367.30
Lawrence J. and Diane M. Wolfsen	1973	$1,275.73
	1974	704.14
	1975	568.71
	1976	1,659.86
	1977	568.71
	1978	3,846.00
Donald and Lynn Skinner	1973	$1,020.04
	1975	45'4.77
	1976	2,947.00
	1977	454.71
	1978	654.12
Warren L. and Carole S. Wolfsen	1973	$1,019.79
	1975	454.83
	1976	432.00
	1977	827.00
	1978	710.60

The common issue presented by these consolidated appeals is whether respondent properly determined appellants' preference item for farm net loss. 2/

Appellants are engaged in the farming business in the Los Banos area. During the appeal years, almost all of the appellants, except for Myrna Wolfsen and Henry B. and Helen E. Wolfsen, owned interests in two partnership enterprises. First, said appellants were among the 41 proprietors who held interests in Murrieta Landowners (Murrieta), a partnership whose principal business activity was the ownership and leasing of ranch and farmland. As co-owners of this organization, appellants received proportionate shares of its net rental income based on their pe-rcentage of ownership. Second, said appellants were also partners in Timco which leased the ranch and farmland from Murrieta for a fixed fee and apparently conducted farming activities on the land. One of Timco's business activities was the ginning of cotton grown by its partners. It also provided ginning services to growers who were not participants in the partnership. In addition, Timco derived interest income from a promissory note received in the prior installment sale of farmland. Appellants each reported their proportionate shares of the rental income from Murrieta and the ginning and interest income from Timco as farm income in the appropriate taxable years.

Subsequently, respondent audited the personal income tax returns of all of the appellants for the taxable years 1973 through 1978, inclusive. Based on the results of this audit and information from federal audit reports, respondent determined that adjustments were in order and then issued the subject proposed assessments of additional tax. Appellants filed protests against the deficiency assessments, but the protests were denied and the assessments affirmed. These timely appeals followed.

2/ Appellants Robert and M. J. Mueller, Myrna Wolfsen, and Henry A. and Francis M. Wolfsen have also contended that the Franchise Tax Board improperly denied deductions that they claimed for charitable contributions. (Rev. & Tax. Code, § 17214.) However, since these appellants have made no attempt to substantiate the claimed contributions (Appeal of Otto L. Schirmer, et al., Cal. St. Bd. of Esual., Nov. 19, 1975) or prove their entitlement to the charitable contribution deductions (Appeal of George B. and Angela R. Sturr, Cal. St. Bd. of Equal., Feb. 1, 1983), we must conclude that respondent properly disallowed the claimed deductions for the years in question.

Among the changes reflected in the deficiency assessments, respondent determined that the rental income from Murrieta and the cotton ginning and interest income from Timco should not have been reported by appellants as income from farming. It was respondent's determination that these three items of income were properly categorized as nonfarm income. As a consequence of this change. in the characterization of these items of income from the partnerships, respondent determined that this nonfarm income must be excluded from the computation of- appellants' preference tax liability for farm net loss.

In addition to other taxes imposed by the Personal Income Tax Law (Rev. & Tax. Code, §§ 17001-19452), section 17062 imposes'a tax on the amount by which a taxpayer's items of tax preference exceed his net business loss. Section 17063, subdivision (i), as it existed for the years in question, 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."[3/] 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."

In these appeals, appellants argue that respondent erroneously excluded their income from the Murrieta and Timco partnerships in the coroputations of their item

3/ AB 93 (Stats. 1979, ch. 1168, § 7.6, p. 4415), 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 to $50,000. SB 813 (Stats. 1983, ch. 498, § 138, p. 690), operative for taxable years beginning on or after January 1, 1983, renumbered subdivision (h) as subdivision (g). AB 2215 (Stats. 1984, ch. 1458, § 3.1, p. 684), operative for taxable years beginning on or after January 1, 1984, renumbered subdivision (g) as subdivision (f).

of tax preference for farm net loss.[4/] It is appellants' position that each of the three items of partnership income constitutes farm income that should have been included in the computations. Thus, the question called for by section 17064.7 is whether or not the income from the partnerships was directly connected with the carrying on of the trade or business of farming.

The Revenue and Taxation Code does not contain a definition of the term "farming," as used in section 17063, subdivision (i), and respondent has not issued

4/ Respondent informs us that, while all of the appellants have contested respondent's treatment of the income from the Murrieta and Timco partnerships as that action relates to the computation of the tax preference item for farm net loss, not all of the appellants were affected by this determination. Appellants Myrna Wolfsen and Henry B. and Helen E. Wolfsen did not participate nor receive any income from the two partnerships. Thus, any changes in these three appellants' tax liabilities were not the result of respondent's recharacterization of the partnership proceeds as nonfarm income and the concomitant adjustment to the preference item for farm net loss. In addition, appellants Henry A. and Frances M. Wolfsen were members of the two partnerships but respondent did not make any changes to their tax preference liability for any year. With regard to the remaining appellants, respondent did determine to increase their preference income for farm net loss based on the recharacterization of the partnership income but this particular change in those appellants' preference liability was made only in the following years:

Robert and M. J. Mueller	1976, 1977, 1978
Warren L. and Carole S. Wolfsen	1976
Lawrence J. and Diane M. Wolfsen	1976, 1978
Donald and Lynn Skinner	1976

In other words, these are the only parties and taxable years under appeal affected by respondent's determination of the preference item for farm net loss. Notwithstanding the claim of these appellants' contesting the disallowance of their charitable contributions deductions were improperly disallowed, the proposed assessments have not been challenged on any other grounds.

regulations interpreting the term. However, this board has announced a general policy of using the definition of that phrase found in federal regulations issued under section 1251 of the Internal Revenue Code. (Appeals of Donald S. and Maxine Chuck; Cal. St. Bd. of Equal., Oct. 27, 1981.) This policy is based on the fact that although section 17063, subdivision (i), and Internal Revenue Code section 1251 employ different methods, they have the identical focus, "net farm loss," and the identical purpose to deter the use of farm loss to shelter large amounts of nonfarm income. Under these circumstances, except where the California Legislature has indicated a contrary intent (see Appeal of Edward P. and Jeannette F. Freidberg, Cal. St. Bd. of Equal., Jan. 17, 1984), we believe that the Legislature intended that the definition of "trade or business of farming" used in section 17063, subdivision (i), be the same as the definition used in Internal Revenue Code section 1251.

Treasury Regulation section 1.1251-3(e)(1) defines the "trade or business of farming" as including "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." In general, the sections referred to in Treasury Regulation section 1.1251-3(e)(1) define the business of farming as including the cultivation, operation, or management of a farm for gain or profit, either as an owner or a tenant. (Treas. Reg. § 1.61-4(d); Treas. Reg. § 1.175-3.) A taxpayer is engaged in the business of farming if he is a member of a partnership engaged in the business of farming. (Treas. Reg. § 1.175-3.)

First, with regard to the income earned by the Murrieta partnership from the leasing of farmland, Treasury Regulation 1.175-3 further provides that "a taxpayer who receives a fixed rental (without reference to production) is engaged in the business of farming only if he participates to a material extent in the operation or management of the farm." Based on this regulation, we have previously found that fixed rental income derived from the sublease of farmland by a taxpayer who did not participate in the operation or management of the subleased farmland is not farm income. (Appeal of Joe J. and Elvira Correia, Cal. St. Bd. of Equal., Oct. 10, 1984.) We see no reason not to apply the same holding to the rental income in the present case where the record indicates that the Murrieta partnership charged a fixed

rental price for its farmland and there is no evidence that the partnership or any of the appellants as partners participated in the operation or management of the leased farmland. Accordingly, we must conclude that respondent correctly determined that this rental income was nonfarm income and properly excluded the income from its calculation of the farm net loss preference.

Second, appellants argue that the income from Timco's cotton ginning enterprise is farm income because the operation of a cotton gin constitutes farming. After the filing of these appeals, appellants submitted additional information which demonstrated that 37 percent of Timco's income from its ginning operation in 1978 was attributable to business derived from its partners whereas 3 percent was derived from ginning services provided to growers who were not partners in the organization. Based on this additional information, respondent agrees that all but 3 percent of Timco's cotton ginning income for 1978 should have been characterized as farm income. Respondent concedes that it did not include this income in the computation of the farm net loss preference for those appellants who were partners in Timco and that the preference item should be modified accordingly for those appellants for the 1978 taxable year. Since we have previously held that income derived from providing services to farmers is not farm income (Appeal of Don P. and Evelyn L. Currier, Cal. St. Bd. of Equal., May 8, 1984; see also Rev. Rul. 77-105, 1977-1 C.B. 374, interpreting Treas. Reg. § 1.175-3), we find no fault with respondent's decision that income earned by Timco in 1978 from providing ginning services to third parties was nonfarm income for purposes of the farm net loss preference. Appellants, however, have not provided any evidence or authority themselves to attempt to convince us that respondent's determination with regard to the Timco ginning income was improper in any other respect or for any other taxable years.

Third, and finally, we address the issue whether appellants' distributive share of the interest income from the promissory note received by Timco from the sale of farmland is derived from the business of farming. Appellants have argued that it is erroneous to treat interest received from the sale of farm assets as nonfarm income when the gain or loss realized from the sale of farm assets is treated as farm gain or loss. In Appeal of Ernest R. and Dorothy A. Larsen, opinion on petition for rehearing, decided June 21, 1983, this board rejected substantially the same argument. We held there

that, regardless whether or not gain from the sale of farm property constitutes farm income for purposes of section 17064.7, interest income received from a note related to the sale is not income from the trade or business of farming. The rationale is that interest is compensation for the use or forbearance of money. (Rosen v. United States, 288 F.2d 658, 660 (3d Cir. 1961).) The fact that the subject note had its source in the sale of farm property is irrelevant. (Appeal of Ernest R. and Dorothy A. Larsen, supra; see also Appeal of Donald and Nada Schramm, Cal. St. Bd. of Equal., Dec. 13, 1983; Appeal of John A. and Betty M. Bidart, Cal. St. Bd. of Equal., Oct. 1, 1984.) We therefore conclude that the Timco interest income was properly characterized by respondent as nonfarm income for purposes of computing the preference item for farm net loss.

Except for the modification required by respondent's concession that the Timco cotton ginning income for 1978 was largely farm income, we find that respondent properly calculated appellants' preference item for farm net loss. Accordingly, respondent's action in these matters will be sustained in every other respect.

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 protests of Robert and M. J. Mueller, et al., against proposed assessments of additional personal income tax in the amounts and for the years as follows:

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	1976.	432.00
	1977	827.00
	'1978	710.60

be and the same is hereby modified in accordance with respondent's concession. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 29th day of July, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.'

Richard Nevins, Chairman

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey* Member

Member

*For Kenenth Cory, per Government Code section 7.9