BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 82A-707-VN
HADDON N. AN-D GRACE SALT)

Appearances:

For Appellants: Twila Dawn Castellucci
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 Haddon N. and Grace Salt against proposed assessments of additional personal income tax in the amounts of $4,058 and $702 for the years 1977 and 1978, 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 issue presented for our decision is whether respondent properly determined appellants' item of tax preference for unrecognized' net capital gains for the years 1977 and 1978.

On their joint California personal income tax returns for 1977 and 1978, appellants., who are husband and wife, listed their occupations as investors and reported taxable income of $44,471 and $10,220, respectively. Appellants also indicated on their returns that they realized total net capital gains of $189,828 in 1977 and $150,465 in 1978. However, because they had an unused capital loss carryover from preceding taxable years that exceeded their recognized capital gains in both years, appellants claimed capital loss deductions of $1,000 when they calculated their taxable incomes for 1977 and 1978.

Upon audit of appellants' returns, the Franchise Tax Board determined that appellants had failed to report tax preference income for unrecognized net capital gains in the amounts of $70,870 for 1977 and $21,017 for 1978. Respondent thereupon issued proposed assessments of additional tax based upon this unreported preference income. Appellants filed protests against the deficiency assessments, but the protests were denied and the assessments affirmed by respondent. This timely appeal followed.

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 the preference tax is to reduce the advantages derived from the preferential tax treatment accorded certain items of income and deduction and to ensure that those taxpayers who are able to take advantage'of 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.)

Section 17063, subdivision (g), provides, in part, for the capital gains preference item:

> For taxable years beginning after December 31, 1971, the amount of the tax preference income with respect to capital gains shall be an amount (but not below zero) equal to the difference between (1) the taxpayer's total net capital gains and losses (determined without regard to any capital loss carryover) for the taxable year, and (2) the taxpayer's net

capital gains and losses recognized by virtue of Section 18162.5 for the same taxable year.

When computing taxable income, section 18162.5 provides for a specified reduction in the amount of capital gains or losses depending on the holding period of the capital asset. It is that portion of a taxpayer's net capital gains which is shielded from ordinary taxation by operation of the nonrecognition provisions of section 18162.5 that is designated as an item of tax preference. (Appeal of Eugene I. Ingrum, Cal. St. Bd. of Equal., June 29, 1982; Appeal of Harold S. and Winifred L. Voegelin, Cal. St. Bd. of Equal., Feb. 3, 1977.)[2/]

It is well settled that respondent's determination of a tax or tax deficiency is presumptively 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 these proceedings, appellants concede that the unrecognized portion of their capital gains constituted an item of tax preference but assert that they did not report the items because they did not receive any tax benefit from them. It is appellants' argument that preferential nonrecognition of their capital gains under section 18162.5 did not reduce their taxes for 1977 and 1978. They initially note that their unused capital loss carryover completely offset the recognized portion of their capital gains, resulting each year in a net capital loss. Appellants contend that even if they did not receive preferential treatment of their capital gains and, consequently, all of their net capital gains for 1977 and 1978 had been recognized, they would still have had net capital losses in both years since their unused capital loss available for carryover was greater than their net capital gains. Appellants state that if these nonrecognized items had been included in income, their tax would have been the same. Because the preferential tax treatment of their net capital gains did not reduce their tax liabilities in the appeal years, appellants argue that they should be entitled, pursuant to the tax benefit rule found in section 17064.5, to defer liability

2/ Gains from the sale or exchange of a taxpayer's principal residence are excluded from the preference item for. unrecognized net captial gains. (Rev. & Tax. Code, § 17063.1.)

for the preference tax until such taxable year that their unused capital loss carryover has been depleted.

'It is true that the preference tax was intended to be imposed only on items of tax preference that actually produce a tax benefit; to the extent preference items do not produce a tax benefit, they are not to be subjected to the minimum.tax. (Appeal of Martin S. Ryan, Cal. St. Bd. of Equal., Nov. 14, 1979; Appeal of Richard C. and Emily A. Biagi, supra.) As part of a legislative scheme to conform California income tax law to the federal tax changes enacted by the Tax Reform Act of 1976, a "tax benefit rule" was formally added to the California tax preference statutes in 1977 by enactment of subdivision (f) of section 17064.5. (Stats. 1977, ch. 1079, § 20, p. 3307.) Subdivision (f) states:

> The Franchise Tax Board 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 chapter for any taxable years.[3]

The federal counterpart had been added earlier to the federal statutes imposing tax on preference income as Internal Revenue Code § 58(h), effective for taxable years beginning after December 31, 1975. (26 U.S.C.A. § 58(h).)[4]

Recently, the United States Tax Court had the occasion to interpret the federal tax benefit rule in

3/ In 1982, the Franchise Tax Board promulgated regulation 17064.5 in response to the legislative mandate contained in subdivision (f) of section 17064.5. (Cal. Admin. Code, tit. 18, reg. 17064.5.) The substantive provisions of this tax benefit regulation are applicable, however, to taxable years beginning on or after January 1, 1979. (Cal. Admin. Code, tit. 18, reg. 17064.5, subd. (d).)

4/ Because the California tax preference laws were patterned after federal statutes, the interpretation and effect given the federal provisions by the federal courts 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.)

Occidental Petroleum Corp. v. Commissioner, 82 T.C. 819 (1984). Based on the plain language of the statute, the court held that section 58(h) required that the preference tax not be imposed even in the absence of regulations by the Secretary of the Treasury where the item of tax preference did not result in a decrease of a taxpayer's final tax liability. Moreover,. the court added that since the section is concerned with the reduction of the taxpayer's tax "for any taxable year," application of the tax benefit rule must consider whether the preference resulted in a decrease of tax not only for the year under consideration but also for any other year. Finally, the court found that Congress in enacting the provision intended that a tax benefit from preference items encompass an indirect benefit such as "the mere deferral of tax for only 1 year." (Occidental Petroleum Corp. v. Commissioner, supra, 82 T.C. at 827; see also Occidental Petroleum Corp. v. United States, 685 F.2d 1346, 1351 (Ct.Cl. 1982).)

Indeed, this board has previously held that a potential benefit from the preference item for unrecognized net capital gains is sufficient for imposition of the preference tax. (Appeal of Harold S. and Winifred L. Voegelin, supra.) In Voegelin, which was decided before promulgation of the California tax benefit statute, the taxpayers had argued that they derived no immediate tax benefit from the preference item for unrecognized net capital gains since their recognized net capital losses for the year exceeded their recognized net capital gains, resulting in a total net capital loss available for carryover. We held that it did not matter whether or not the taxpayers' net capital losses exceeded their net capital gains, for the capital gains preference was defined by statute as the amount of the net capital gains reduction under section 18162.5 less the reduction in net capital losses.[5/] we held there that preferential nonrecognition of the taxpayer's net capital gains produced a potential as opposed to an immediate tax benefit and found them liable for the preference tax.

In the present matter, appellants contend that the section 18162.5 nonrecognition of a portion of their net capital gains did not result in the reduction of

5/ For taxable years beginning January 1, 1979, regulation 17064.5 requires that preference items be reduced by the amount of the taxpayer's negative taxable income. (Cal. Admin. Code, tit. 18, reg. 17064.5, subd. (b).)

their taxes and, therefore, they did not obtain a tax benefit from the preference item. However, as respondent has pointed out, appellants did receive an indirect tax benefit from nonrecognition of their capital gains. Since only recognized capital gains are offset against unused capital loss carryover in computing capital gains income, the exclusion of the unrecognized capital gains preference from this calculation resulted in a smaller reduction of their unused capital loss carryover from prior years. (Rev. & Tax. Code, §§ 18152, 18162.5.) The preferential reduction in their net capital gains thus allowed appellants to preserve a larger balance in their existing unused capital loss carryover. While they may not have had a reduction in their 1977 and 1978 taxes from nonrecognition of their capital gains, appellants were therefore provided a potential tax benefit from the preference in the form of a greater, unused capital loss carryover that could be used to reduce their taxes in subsequent taxable years. (See Occidental Petroleum Corp. v. Commissioner, supra, 82 T.C. at 828-829.) Since appellants received a tax benefit, it follows that they are not entitled to any tax benefit adjustment of their capital gains preference item under section 17064.5.

Finally, in support of their position, appellants have argued that federal law permits the deferral of the tax on preference items until such time as the preference provides a tax benefit. As authority for this proposition, appellants have cited Internal Revenue Code section 56(b) and the regulations promulgated thereunder. However, section 56(b), as it existed for the years in question, provided for the deferral of the federal minimum tax on preference items only where a taxpayer had a net operating loss carryover and tax preference items in excess of $10,000. Upon researching the federal tax laws, we have found no authority for the deferral of the federal minimum tax under the circumstances of the present situation in which a taxpayer has a net capital loss carryover and capital gains preference. Nor does the California tax benefit statute or regulation provide for such a tax benefit adjustment. (See Rev. & Tax. Code, § 17064.5, subd. (f); Cal. Admin. Code, tit. 18, reg. 17064.5.)

Based on the foregoing, we find that respondent correctly determined appellants' item of tax preference for unrecognized net capital gains for 1977 and 1978. Accordingly, respondent's action in this matter must be sustained.

Appeal of Haddon N. and Grace Salt

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 Haddon N. and Grace Salt against proposed assessments of additional personal income tax in the amounts of $4,058 and $702 for the years 1977 and 1978, respectively, be and the same is hereby 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 Kenneth Cory, per Government Code section 7.9