*86-SBE-150

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
RUDY L. AND GEORGIA TULIPANI) No. 84A-467-GO

Appearances:

For Appellants: Steven Kroff
Certified Public Accountant

For Respondent: B. S. (Bill) Heir
Counsel

OPINION

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 Rudy L. and Georgia Tulipani against proposed assessments of additional personal income tax in the amounts of $33,923.39 and $8,040.35 for the years 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 are whether appellants were entitled to certain deductions claimed in 1979 and 1980. Prior to the oral hearing in this matter, the parties agreed that a charitable deduction involving stoves and refrigerators transferred to the Delancey Street Foundation, which appellants claimed in 1979, was properly deductible in 1980. The other issues involve unrelated expenditures concerning various business enterprises-in which appellants were involved and will be discussed separately below.

I. STREET DEDICATION

During 1979, appellants were involved in the development of a residential housing tract in San Anselmo, California. The record indicates that on February 13, 1940, the town of San Anselmo had authorized the acceptance from a previous owner of certain streets in the subject parcel, but that such authorization and required documentation had not been properly recorded. (Resp. Br., Ex. C.) Nevertheless, it appears that in the intervening years, the contemplated streets had been used by the public as thoroughfares. In August 1979, appellants offered to dedicate such streets to the town of San Anselmo, which by resolution number 1803, was formally and properly accepted. Thereafter, a grant deed from appellants for such streets was accepted and recorded.

Appellants claimed a total charitable deduction of $123,525 for such dedication, to the extent allowable in 1979, with the balance carried over to 1980. Respondent disallowed such deductions, concluding that appellants had no interest in the property dedicated since ownership of the streets had long since been severed from the parcel either by easement or by dedication in 1940. In addition, respondent concluded that even if appellants had had an interest in the property so dedicated, a charitable deduction should be denied since they lacked the requisite donative intent.

We think that respondent's second argument is determinative with respect to this issue. The phrase "charitable contribution," as used in Internal Revenue Code section 170,[2] has been held to be synonymous with the word "gift." (DeJong v. Commissioner, 36 T.C. 896, 899 (1961).) "If a payment proceeds primarily from

2/ Section 17214 is substantially similar to section 170 of the Internal Revenue Code of 1954.

the incentive of anticipated benefit to the payor beyond the satisfaction which flows from the performance of a generous act, it is not a gift." (DeJong v. Commissioner, supra, at 899.) Determining a taxpayer's Incentive, motive, or purpose in making a transfer is a factual problem. The inquiry seeks to expose the true nature of the transaction. (Sutton v. Commissioner, 57 T.C. 239, 243 (1971).) For example, in United States v. Trans-america Corporation, 392 F.2d 522 (9th Cir. 1968), the taxpayer conveyed land, which had been used as a thoroughfare near its manufacturing plant, to a city with the understanding that the city would improve and maintain it as a public street. The court found that the primary incentive, motive, or purpose which prompted the transfer of property was to obtain a direct benefit in the form of enhancement in the value or utility of the taxpayer's remaining land,

The resolution accepting the dedication indicates that, thereafter, San Anselmo agreed to maintain such streets as public streets. (Resp. Br., Ex. C, par. 2.) Clearly, such maintenance enhances the remaining property. Under these circumstances, we find that appellants' primary purpose in making the transfer of property was to obtain a direct benefit and, as a consequence, such conveyance to San Anselmo was not a charitable contribution within the meaning of section 17214 which governs charitable contributions.

II. ARREARAGE PAYMENTS

In 1962, Rancho Del Pantano, Inc., (hereinafter "lessor") leased a large parcel of real property to Mr. and Mrs. Peter Lind (hereinafter "lessees") for 99 years. By the late 1970's, the lessees had fallen behind in the lease payments and the lessor brought an action for unlawful detainer against the lessees. In April 1979, the lessees, as limited partners, entered into a limited partnership agreement with appellants and another individual as general partners, in which the general partners agreed to contribute $25,550 each, and the lessees contributed the subject lease. (Resp. Br., Ex. E.) In August 1979, the partnership paid all the lease arrearages to a court trustee (Resp. Br., Ex. G) and entered into an amendment of the lease agreement approving the assignment of such lease. (Resp. Br., Ex. H.)

On their 1979 return, appellants deducted their ratable share of the payment of the rental arrearages as rental expense. Upon audit, respondent disallowed such

deduction concluding that the payment of arrearages was "a one-time capital expenditure by which the partnership acquired the valuable leasehold interest and thus should be amortized over the life of the lease." (Resp. Br. at 7, 8.)

While respondent concedes that a lease payment is not ordinarily a capital expenditure, it, nevertheless, argues all payments to lessors are not current rental- expenses. Respondent notes that bonuses and advance rentals are not deductible as expenses by the lessee but are considered to be capital expenditures amortized over the life of the lease. (Resp. Br. at 8; see also, 2 Mertens, Law of Federal Income Taxation, § 12.36 (1985 Rev.).) Respondent concludes that the payment of the rental "arrearages was in the nature of a bonus paid to acquire the valuable leasehold interest" and that the rule requiring amortization rather than current deduction should be imposed. (Resp. Br. at 8.) In contrast, appellants argue that "[t]he rule requiring the lessee to deduct the bonus payments over the term of the lease does not apply to payments of accrued but unpaid back rents . .. which are deductible in accordance with the taxpayer's accounting method," (2 Mertens, Law of Federal Income Taxation, § 12.36, p. 164 (1985 Rev.); see also Western Maryland Railway Co. v. United States, 291 F.Supp. 935 (D.Md. 1968); Pritzker Foundation, Inc. v. United States, 1 A.F.T.R.2d 1193 (S.D. Ohio 1958).)

However, in each of the cases cited by appellants, the accrued but unpaid back rent was incurred by the taxpayer at issue. In the instant appeal, the partnership through which the back lease payments were paid did not itself incur the back payments. Accordingly, the cases cited by appellants do not appear to be controlling here. Instead, the partnership's payment of the accrued lease payments seem to be most analagous to costs of acquisition.

It is well settled, for example, that the cost basis of property includes such acquisition costs as accrued taxes paid by the buyer. (See Bittker, Federal Taxation of Income, Estates and Gifts, ¶ 41.2.3 at 41-12 (1981).) Thus, the partnership's payment of the accrued lease payments is most analogous to the payment of accrued taxes and, accordingly, such payment should be treated as a cost of acquisition so that respondent's capitalization and amortization of such payment over the

remaining life of the lease must be upheld. (See also Treas. Reg. § 1.162-11(a).)

III. DREDGING EXPENDITURE

The property acquired by the partnership through the Linds included approximately one mile of waterways. The partnership determined that dredging the existing waterways was needed in order to make its proposed development-accessible to boat owners. To this end, in April of 1979, the partnership began to dredge-the waterways. However, in July 1979, the dredging equipment sank and the dredging permit obtained from the Department of the Army expired on December 31, 1979. Appellants deducted their ratable share of such dredging expenses in 1979 claiming that the project-had been abandoned in 1979. (App. Br. at 7.) Respondent denied the deduction concluding that no evidence existed which established that the dredging project was, in fact, abandoned in 1979. Instead, respondent concluded that the dredging expenditure should properly be amortized over the life of the lease, or, if the project is actually abandoned later, deducted in the year. of abandonment. Appellants answer that should it be found that the dredging project was not, in fact, abandoned in 1979, it should not be capitalized and amortized since it resulted in no permanent improvement to the property.

Section 17206 provides that where a taxpayer owns the fee to land and erects improvements thereon, he may, if the improvements lose their useful value and are actually abandoned and written off as a loss, be entitled to a deduction for an abandonment loss for such improvements. However, there must be something more than merely diminution in value, nonuse of the property, or contemplation of writing off the property as a complete loss. Instead, "the taxpayer must establish that the property actually did lose its useful value, and that he, by reason thereof, actually did write off and abandon the property as an asset in the particular year for which deduction of the loss is claimed." (Burke v. Commissioner, 32 T.C. 775, 780 (1959).) The general rule was stated in Commissioner v. McCarthy, 129 F.2d 84, 87 (7th Cir. 1942), as follows:

> The rule to be deduced from the 'abandonment" cases, we think, is that a deduction should be permitted where there is not merely a shrinkage of value, but instead, a complete elimination of all value, and the recognition by the owner

> that his property no longer has any utility or worth to him, by means of a specific act proving his abandonment of all interest in it, which act of abandonment must take place in the year in which the value has actually been extinguished.

In examining the instant case, no evidence exists which would establish that in 1979 either appellants recognized that the dredging project had no utility or worth to them or that a specific act existed proving abandonment. Indeed, the record indicates that in 1981 appellants and/or their associates continued to apply for a dredging permit for the subject waterway from the Department of the Army. (Resp. Br., Ex. K.) Clearly, this record indicates that in 1979, the dredging project may have encountered some impediments (see Burke v. Commissioner, supra, 32 T.C. at 780, 781), but that appellants did *not*, at that time, abandon the project. Instead, they continued with their efforts to develop the waterways. Moreover, there is no evidence in the record which would establish that the dredging expenditures incurred in 1979 had no value since the 1981 application memorandum indicates that the 1981 project was following the previously dredged channel extension. Accordingly, based on the record presen'ted, we find that respondent's disallowance of this deduction in 1979 must be sustained.

IV. CONSTRUCTION EXPENDITURES

Appellants had an interest in Shelter Ridge Associates (hereinafter "Shelter Ridge"), a partnership engaged in the construction of apartment units in Mill Valley. On April 1, 1978, Shelter Ridge entered into an agreement with the Haywood Company (hereinafter "Haywood") in which Haywood agreed to supervise the construction of their apartment project. (Resp. Br., Ex. N.) In return, Haywood *was* to receive $2,000 per month plus 10 percent of net profits upon completion. The agreement defined "net profits" to mean "the operating net profits ... arising from the sale of the condominium units. . . ." (Resp. Br., Ex. N at 2.) The agreement also provided that in the event units were withdrawn from the market; suitable adjustment would be made in determining Haywood's compensation. Appellants, through the partnership, deducted their ratable share of fees paid to Haywood, which *were* $200,000 in 1979 and $32,554 in 1980. Respondent disallowed these deductions contending that the payments to Haywood were part of the cost of constructing a capital asset, and allocated them to the

units sold over a three-year period. (Resp. Br. at 14.) Appellant appears to concede that the $2,000 per month payments should be capitalized and allocated to the cost of sales of each unit over the years 1978, 1979, and 1980. However, appellant maintains that the payments based upon the percentage of net profits "were a management expense, akin to a sales commission, and deductible in the year paid; $184,000 in 1979 and $32,554 in 1980." (App. Reply Br. at 9.)

It is well settled that compensation paid individuals for services incidental to the construction or improvement of buildings is a capital expenditure which should be added to the cost of the buildings and not deducted currently. (Appeal of Hub City Construction Company, Cal. St. Bd. of Equal., Oct. 16, 1961.) In that appeal, salaries allocated to the construction of projects were capitalized and deferred to the year of sale as part of the cost of construction. We think that the same rule should apply to the instant matter.

Appellants appear to allege that the subject management fees were based upon actual sales in conformity with the aforementioned rule, but they have offered no evidence of such allegation. (App. Reply Br. at 8.) In such circumstance, we must find that respondent's application of the rule is proper and that its determination with respect to this issue must be sustained.

Accordingly, respondent's determination must be sustained subject to the concession with respect to the charitable contributions to the Delancey Street Foundation.

Appeal of Rudy L. and Georgia Tulipani

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 Rudy L. and Georgia Tulipani against proposed assessments of additional personal income tax in the amounts of $33,923.39 and $8,040.35 for the years 1979 and 1980, respectively, 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 20th day of August , 7986, 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

Walter Harvey* , Member

________________ , Member

*For Kenneth Cory, per Government Code section 7.9