BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 85A-511-MA
JEROME W. AND RITA ANN WAYNO)

Appearances:

For Appellants: Jerome W. and Rita Ann Wayno, in pro. per.

For Respondent: Lazaro L. Bobiles
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 Jerome W. and Rita Ann Wayno against proposed assessments of additional personal income tax in the amounts of $499 and $710 for the years 1980 and 1981, 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 sole issue for consideration in this appeal is whether respondent erred in denying appellants' claimed business expense deductions.

During the years at issue Mr. Wayno was an employee of Hughes Helicopter Corporation and Mrs. Wayno was employed by the Aerospace Corporation. Both were employed in California. Neither reported receiving salary from any other employers. During the years at issue appellants were also the officers and sole shareholders of a now defunct Subchapter S Corporation, Florida I.Q. Computer Corporation (Florida I.Q.), which was incorporated under the laws of the State of Florida and provided music and amusement machines at various U.S. military installations. 2/

Appellants filed a joint personal income tax non-resident return for the year 1980 and a resident return for 1981 claiming numerous business expense deductions arising from their operation of Florida I.Q. as follows:

	Item	1980	1981
1.			
2.	Law Legal School Costs Expenses Of Appeal	$ 9,686 828	$ 2,732 6,629
3.	Cost of Submitting and Pratestinq Bids	4,526	14,002
	Total Expenses	$15,040	$23,363
	Income Reported on Schedule C	- o -	- O -
	Net Profit/(loss) Reported on Schedule C	($15,040)	($23,363)

According to appellants the claimed expenses were a result of a contractual dispute between Florida I.Q. and its contractee, the Army and Air Force Exchange Service (Exchange). During 1975, Florida I.Q.'s concession contract with Exchange was terminated because of its alleged failure to remit fees to Exchange. The matter of termination and damages to Florida I.Q. was appealed to the Armed Service Board of Contract Appeals (Board) which held in favor of Exchange. Appellants appealed to the U.S. Court of Claims, which affirmed the Board's holding in Florida I.Q. Computer Corporation v. United States,

2/ The amount of appellants' investment in Florida I.Q. is not contained in the record.

'228 Ct. Cl. 748 (1981).[3/] No further appeal was taken. In addition to the expenses claimed on their Schedule C's which arose from pursuing Florida I.Q,'s appeal against the termination of its concession contract, the remainder of the expenses stemmed from appellants' continuation. of the corporate business by submitting bids of the corporation and protesting the award of those bids to other companies.

After an audit of appellants' returns for the years at issue, respondent disallowed the claimed deductions. Appellants protested, a hearing was held and after due consideration respondent's action was affirmed. This timely appeal followed.

Appellants contend that the claimed law school expenses were properly deductible because appellants believed it was necessary for them to become lawyers in order to pursue Florida I.Q.'s appeal. They also argue that the remaining expenses were necessary in order to preserve their jobs and their source of income with Florida I.Q. Finally, appellants claim that all the deductions were allowed by the Internal Revenue Service and therefore should be accepted by respondent.

During both of the years at issue, Mr. and Mrs. Wayno attended law school. Although Mr. Wayno did not finish'the required curriculum due to ill health, Mrs. Wayno did complete the curriculum. Appellants submit that their law school attendance was necessary because it was the only way they could pursue their company's claim to the United States Court of Appeal and revive their company. In support of their position appellants cite United States v. Michaelsen, 313 F.2d 668 (9th Cir. 1963) which held that law school expenses could be considered deductible business expenses 'under certain circumstances. Appellants argue that their legal expenses did not in reality lead towards qualifying them for a new trade or business because they never actually practiced law and may never practice law.

We do not find appellants' argument concerning the necessity of a law degree to be tenable. 'The taxpayer's subjective intent in pursuing (a) selected

3/ The litigation arose out of a dispute regarding the operation of music and amusement machines at Fort Jackson, Columbia, South Carolina.

program is not dispositive of the issue. It is not necessary nor even relevant that the taxpayer actually embark upon the new trade or business for which the education qualifies him." (Wilmshurst v. Commissioner, ¶ 82,247 T.C.M. (P-H) (1982) citing Roussel v. Co-missioner, ¶ 79,125 T.C.M. (P-H) (1979).) The practice of law is a separate trade or business. Appellants have failed to demonstrate how their situation differs from the general rule that expenses incurred in connection with qualifying for a new' trade or business are not deductible even though their study of law may also have aided them in maintaining and improving skills required in a current trade or business. The fact that their company was involved in protracted Litigation does not demonstrate ipso facto the necessity of their attendance at law school. We note also that appellants' subjective idea that they would be able to pursue their lawsuit after graduation from law school suggests that they intended to practice law, albeit for their company, thereby negating the idea that they weren't attempting to qualify for a new trade or business. Appellants' reliance on United States v. Michaelsen, supra, is also misplaced because it involved the now repudiated "primary purpose" test. The fact that appellants have never utilized their legal education and have not established a new trade or business is likewise irrelevant, (Rehe v. Commissioner, ¶ 80,316 T.C.M. (P-H) (1980).)

The remaining deductions claimed by appellants involve various legal expenses and costs. incurred in submitting contract bids and protesting contracts which were awarded to other vendors. Appellants argue that these expenses were necessary in order to *preserve* their salary and status as employees at Florida I.Q.

It is well established that an expense to preserve one's salary can be an ordinary and necessary expense of an employee (Noland v. Commissioner, 269 F.2d. 108, 111 (4th Cir. 1959).) However, in the instant case appellants have claimed no salary from Florida I.Q. thus making it difficult to preserve something which they never had. Additionally, during this period appellants were both salaried employees at Hughes. Helicopter Corporation and the Aerospace Corporation.

The legal costs incurred by appellants are not deductible. They are clearly expenses which arose from the trade or business of Florida. I.Q. and thus are deductible expenses to the company and not deductible by appellants personally. (Appeal of Walter J. and

Sheila D. Coyne, Cal. St. Ed. of Equal:, April 24, 1967.) Such expenses would be properly deductible by Florida I.Q. since they arise directly from its business. They are not ordinary and necessary 'employee business expenses and may not be taken by appellants. Additionally, we note that the mere payment of a corporation's expenses by a shareholder does not render such payment a deductible cost incurred in the production of income. (Appeal of Walter J. and Sheila D. Coyne, supra,)

Appellants contend that the expenditures are deductible under the legal theory that the corporate entity may be disregarded if a corporation is hot only influenced and governed by a particular person but there is also such a unity of interest and ownership that the corporation has never existed, or has substantially ceased to exist, and the facts *are* such that adherence to the fiction of separate existence would promote unfairness or injustice.

While it is true that where corporate form is a sham, it will be disregarded, such extraordinary circumstances do not exist here. Appellants chose the advantages of incorporation to do business which also requires the acceptance of certain tax disadvantages. (Moline Properties v. Commissioner, 319 U.S. 436 (87 L.Ed 1499) (1943).) The argument that the corporate form should be disregarded under the circumstances before us is without merit.

We further note that for federal purposes appellants elected to take advantage of Subchapter S of the Internal Revenue Code. In general its sections permit the stockholders of a closely held corporation to elect to pay personal income tax on the corporation's earnings, whether or not they are distributed, thereby exempting the corporation itself from corporate income tax. Thus, the income is taxed essentially as if the business were operated as a partnership. However, there is no comparable California provision and an election under Subchapter S does not alter the status of the corporation or its shareholders or effect the tax consequences of transactions between them. (Appeal of Walter J. and Sheila D. Coyne, supra; Appeals of David W. and Marion Burke, et al., Cal. St. Bd. of Equal., October 27, 1964.)

Finally, appellants contend that all claimed expenses were allowed by the Internal Revenue Service

(IRS) and therefore should be accepted by respondent. Respondent has been unable to verify that the IRS did conduct an audit of appellants' 1980 federai income tax return and to date no further evidence other than a photocopy of "no change" letter, which does not go into any detail, has been submitted by appellants. In any event the fact that appellants' 1980 tax return was accepted by the IRS does not relieve them of their burden to establish the propriety of their state return.

For the foregoing'reasons respondents' action in this matter is sustained in all respects.

Appeal of Jerome W. and Rita Ann Wayno

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 Jerome W. and Rita Ann Wayno against proposed assessments of additional personal. income tax in the amounts of $499 and $710 for the years 1980 and 1981, respectively, be and the same is hereby sustained.

Done at Sacramento, Caiifornia, this 3rd day of December , 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