91-SBE-006

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	89R-0267-MC
CHARLES E. KUHN	)	

Appearances:

For Appellant: Eugene D. Silverman,
Attorney at Law

For Respondent: Cody C. Cinnamon, Counsel

O P I N I O N

This appeal is made pursuant to section 19061.1[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Charles E. Kuhn for a refund of personal income tax in the amount of $24,363[2/] for the year 1984.

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

[2/] Respondent and appellant agree that a refund of $6,049 plus interest is proper and that the balance is still in dispute.

The question presented in this appeal is the proper basis of property for California personal income tax purposes when depreciation has been taken prior to the time the appellant became a resident of California.[3/]

Appellant was a resident of Texas prior to becoming a resident of California in 1982. While a resident of Texas, appellant acquired an interest in a Texas partnership which acquired real property in Texas. Apparently the Texas property consisted of apartments rented out to tenants and thus depreciation was taken, including "accelerated" depreciation.[4/] In 1984, the property in Texas was sold, and appellant was allocated a share of the gain based on his partnership interest.[5/]

It is not entirely clear from the record what amount appellant reported on his California return as gain from the sale of the property by the partnership. However, the parties are clear as to the issue raised by the above facts. The question is what is the proper basis of the property for purposes of computing gain for California personal income tax purposes.

The question we face here is whether appellant must reduce the basis of his property for depreciation taken prior to his becoming a resident of California. Appellant argues that it is not "equitable" to require him to reduce his basis since the depreciation did not reduce his taxes in California. He argues the purpose of depreciation is to allow the taxpayer to recover the cost of invested capital over the life of the asset and that the purpose of the reduction in basis is to prevent a double tax benefit. Since no tax benefit was received in California for the depreciation, and therefore no double tax benefit could be received if the property's basis were not reduced for such depreciation, appellant argues that no reduction in basis should be required. Respondent argues that notwithstanding the "inequity" of the situation, a basis reduction is required.

This appears to be a case of first impression in California. We note that the California Legislature has not directly spoken on this question. Neither party has pointed to any directly relevant California code section and in our research we discovered no such code section. Instead, California has incorporated federal law governing adjustments to basis of property and from these rules we are required to discern the applicable state rule.

For years 1982 and later, Revenue and Taxation Code section 18031 fully incorporates the Internal Revenue Code ("I.R.C.") for purposes of determining gain or loss on the disposition of

---

[3/] A secondary question originally raised was whether appellant is required to recapture as ordinary income accelerated depreciation taken prior to becoming a resident. Respondent has now conceded that recapture is not necessary. In light of the language of Internal Revenue Code section 1250(b)(3), we agree with respondent's concession.

[4/] By accelerated, we are referring to depreciation taken in excess of straight line.

[5/] Throughout this opinion, for convenience we will disregard the existence of the partnership for certain issues and analyze the questions presented as if appellant owned the property directly. The existence of the partnership does not affect the analysis of the issues at hand.

property.[6] I.R.C. section 1001 provides that gain from the sale of property shall be the excess of the amount realized over the adjusted basis. Adjusted basis is defined in I.R.C. section 1011(a) as the cost basis of the property (as defined in I.R.C. section 1012) plus or minus any adjustments as provided for in I.R.C. section 1016.

I.R.C. section 1016 generally provides for adjustments to basis for depreciation, capital expenditures, etc. Relevant to the inquiry at hand is I.R.C. section 1016(a)(3). Section 1016(a)(3)(B) provides for an adjustment to basis for any period "during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws ... for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained."

We think the phrase "person ... not subject to taxation under this chapter" is clear on its face. Generally, a person who is not a California resident and who has no California-source income will not be subject to taxation by California. Appellant was not a resident of California and apparently had no California-source income prior to 1982. We conclude that he was therefore not a person "subject to taxation" by California prior to 1982. Consequently, section 1016(a)(3) applies to appellant.

A situation analogous to the present case occurs when a nonresident alien becomes a resident of the United States and then sells foreign property which had been acquired and used in a trade or business or for the production of income in the foreign country prior to the time the person became a U. S. resident. This presents the same question as the instant appeal. Is the basis of the property reduced for depreciation sustained prior to the person becoming a resident of the United States?[7] The well-settled federal rule is that the basis of property must be reduced for depreciation sustained prior to the person becoming a U. S. resident, notwithstanding the fact that no U. S. "tax deduction" was ever received for the depreciation. (Gutwirth v. Commissioner, 40 T.C. 666 (1963); Abraham v. Commissioner, 9 T.C. 222 (1947).[8]) In Gutwirth, the tax court stated that the rationale for this rule was that to not require a basis adjustment for wear and tear would discriminate in favor of nonresident aliens owning property abroad as compared to U. S. residents in similar circumstances and that without a clear statement from Congress, the court would not assume Congress intended such discrimination. (Gutwirth v. Commissioner, supra, 40 T.C. at 679.) We think this rationale is equally applicable under California law and, thus, that the same rule should apply. The basis of property should be reduced for depreciation "sustained" prior to a person becoming a resident of California, notwithstanding that no "tax deduction" was taken in California for the depreciation. (I.R.C. § 1016(a)(3)(B).)

---

[6] Unless otherwise specified, all references to the Internal Revenue Code are to the version of the code in existence for the year in question.

[7] We presume that prior to becoming a U. S. resident, the nonresident alien was not subject to U. S. taxation and that once he became a U. S. resident, he is taxed on his worldwide income.

[8] This rule also applies in the corporate context in several circumstances where entities convert from tax-exempt to taxable status. (See, e.g., I.R.C. § 1016(a)(3)(C) (insurance companies) and Treas. Reg. § 1.1382-7 (exempt cooperatives).)

The next problem is how to determine the amount of depreciation "sustained." There are several choices: (1) federal tax depreciation, (2) state (or foreign country) tax depreciation, (3) book depreciation, or (4) some other method. Treasury Regulation section 1.1016-4(b) provides that the amount "actually sustained is that amount charged off on the books of the taxpayer where such amount is considered by the Commissioner to be reasonable." (Emphasis added.) If the I.R.S. Commissioner determines that the amount charged on the books is not reasonable, then the amount "sustained" is the amount allowable as if the taxpayer were subject to the income tax during the period in question, computed on the straight-line method. (Treas. Reg. §§ 1.1016-4(b)(1) and 1.1016-4(b) Flush language.)

Therefore, to compute gain for California purposes, appellant is required to reduce the basis of the Texas property by the amount of book depreciation taken by the partnership on the property during the years that appellant was not a California resident, so long as such method was reasonable.[9/] On the record before us, we cannot say that appellant's book method was reasonable since neither party has presented any evidence as to the book method used nor have they discussed the question of reasonableness. In fact, we do not know what method of depreciation respondent used to reduce basis and thereby increase the gain appellant was required to report. We think that if the partnership's books were kept in conformity with generally accepted accounting principles, that this method in most cases will be reasonable. Otherwise, a method which is close to California state tax methods should be reasonable, even if the life or method used for books might allow less depreciation than what would be allowed under California tax law.[10/] If the book method is not reasonable, then the method used must be straight-line depreciation over the useful life as defined under the applicable tax rules.

For the above reasons, we conclude that appellant should reduce the basis of the Texas property owned by the Texas partnership for depreciation sustained prior to appellant becoming a California resident. Accordingly, respondent's denial of appellant's refund claim will be modified in accordance with respondent's concessions and with this opinion.

[9/] We do not address the issue of what method of depreciation is to be used to compute depreciation once appellant became a California resident. Other than the general statement that whatever method used must comply with California law, we leave resolution of this issue to the parties.

[10/] We do not intend to foreclose the taxpayer from offering valid persuasive evidence that what is reasonable for books is very different from what is allowed for tax purposes. What is reasonable should be based on the facts known at the time the book method was adopted. However, we are not in any way attempting to set up a bright-line rule as to what is reasonable.

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Charles E. Kuhn for a refund of personal income tax in the amount of $24,363 for the year 1984, be and the same is hereby modified in accordance with the Franchise Tax Board's concessions and with the views set forth herein. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 21st day of November, 1991, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Bennett, Mr. Davies and Mr. Fong present.

________________________, Chairman

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

John Davies*, Member

________________________, Member

*For Gray Davis, per Government Code section 7.9

kuhn.mc