ADOPTED 6/29/95 95-SBE-003

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 90A-0079
Joe E. and Betty S. Davis	)	

Appearances:

For Appellants:	Anthony M. Vienna Attorney at Law
For Respondent:	John W. Penfield Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19045 (formerly section 18593)[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Joe E. and Betty S. Davis against a proposed assessment of additional personal income tax in the amount of $44,172 for the year 1980.

The main issues involved in this appeal are the applicability of various statute of limitations sections of the Revenue and Taxation Code and the applicability of the doctrine of equitable recoupment to "straddle" transactions.

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

During 1980 and 1981, Joe E. and Betty S. Davis (appellants) were partners in a partnership entitled "Trading Company of the West" (TCW). The appellants state that, as a result of an audit by the Internal Revenue Service (IRS), a settlement was reached between TCW and the IRS on November 20, 1986. The appellants further state that on or about April 20, 1987, the IRS issued a formal notice to the appellants in which their income was adjusted for 1980 and 1981. In that notice, the IRS disallowed their TCW-related deductions for 1980, and eliminated their TCW-related income for 1981. The adjustments were related to straddle transactions entered into by TCW. The appellants failed to report these changes to respondent. However, sometime after October 21, 1986, the IRS notified respondent about the adjustments to the appellants' 1980 and 1981 returns. On April 17, 1989, respondent issued appellants a notice of proposed additional assessment (NPA) for the 1980 taxable year.

On or about May 16, 1989, the appellants protested the NPA, claiming that the respondent should offset their alleged overpayment of 1981 taxes against the increased 1980 liability, because the IRS had audited the two years together. Respondent denied the protest because the statute of limitations for filing a refund claim for 1981 had expired, and because the seven-year barred offset statute had also expired. The appellants now contend that they were not required to notify respondent about the federal adjustments, and therefore respondent's NPA was wrongfully issued beyond the statute of limitations. Alternatively, they contend that the doctrine of equitable recoupment should be applied to allow the overpayment amount from 1981 to offset the increased liability for 1980, in spite of the statute of limitations barring the refund claim for 1981.

The Applicable Statutes of Limitations

Former section 19053 (renumbered as section 19306, operative January 1, 1994) provided that taxpayers must file a claim for refund within four years of the last date prescribed for filing the return for the year the claim relates to, or within one year from the date of overpayment, whichever period expires later. The appellants submitted their claim for refund pertaining to 1981 on or about May 16, 1989, which was well beyond four years from the due date of the return (April 15, 1986) and one year from the date of overpayment (April 15, 1983). Therefore, the appellants failed to file a timely claim for refund for 1981 pursuant to section 19053.

However, when a taxpayer's return has been adjusted or changed for any year by the IRS, former section 19053.6 (amended and renumbered as section 19311, operative January 1, 1994) provided a special exception to the general statute of limitations found in section 19053. Under section 19053.6, if a taxpayer was required to, and did, notify the respondent (pursuant to former section 18451 (amended and renumbered as section 18622, operative January 1, 1994)) about federal changes within 90 days of those changes becoming final, the taxpayer had 6 months from the date of that notice to respondent in which to file a claim for refund based upon the federal changes. (See Appeal of Stanley R. and Cheryl J. Huddleston, Cal. St. Bd. of Equal., Aug. 17, 1982.) Section 18451 required that if there were any changes in gross income by the IRS for any year, such changes needed to be reported to the respondent within 90 days, unless the changes did not affect the amount of tax. Further,

if taxpayers experienced IRS changes to their income or deductions and failed to report those changes pursuant to section 18451, the respondent had up to four years after the IRS changes in which to issue a notice of proposed deficiency assessment resulting from the IRS adjustments. (Rev. & Tax. Code, § 18586.2, amended and renumbered as § 19060, operative Jan. 1, 1994.)

In the present appeal, the appellants did not timely inform the respondent about the IRS changes. However, they do argue that because of the net effect of the IRS action regarding 1980 and 1981, they owed no more taxes for any year, and hence section 18451 was not applicable. As a result, they contend that the respondent's extended statute of limitations for issuing an NPA after receiving notice of a final federal change in a taxpayer's income, pursuant to section 18586.2, was not available to respondent. The appellants conclude that because the NPA was issued on April 17, 1989, it was over three years beyond the normal four-year limitation period for issuing deficiency assessments (Rev. & Tax. Code, § 18586 (amended and renumbered as § 19057, operative January 1, 1994)), and was therefore invalid.

The appellants have failed to provide any legal basis for their interpretation of section 18451. While we could not locate any cases specifically interpreting section 18451's reference to "any year", there is a case which interprets section 18451's virtually identical counterpart in California's Bank and Corporation Tax Law, Revenue and Taxation Code section 25432 (amended and renumbered as section 18622, operative January 1, 1994). In the Appeal of Skaggs Payless Drug Stores, decided by this board on June 9, 1959, the taxpayer argued that section 25432 required the respondent to follow IRS action by offsetting a prior underpayment of tax with another year's overpayment, similar to the argument being made in the present case. In the Skaggs appeal, the IRS had allowed the taxpayer to offset the two years, in accordance with a mitigation provision of the Internal Revenue Code. Since California had not adopted (and still has yet to adopt) said mitigation provisions, we did not allow the taxpayer to offset one year with another under section 25432. We see no reason in the present case why we should not follow the reasoning and holding in the Appeal of Skaggs Payless Drug Stores, supra. Therefore, the appellants may not offset taxes owed in 1980 by an alleged refund owed to them for 1981 in order to determine whether the IRS adjustments resulted in a change of taxes owed for "any year."

Further, the documents submitted by the appellants and the respondent indicate that, when the IRS made the income adjustments, it adjusted each year separately. Also, section 18451 itself does not refer to the "netting" of multiple years adjusted at one time by the IRS, but to "any year." Moreover, if the appellants' position is correct, then the respondent would be forced to allow their offset claim, which is contrary to California law,[2/] without having the opportunity to determine if what the IRS did complies with California law. For instance, under the appellants' theory, the respondent would not be able to look at the IRS adjustments to see if there was actually a transfer between 1980 and 1981 of

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[2/] Appellants' offset claim was barred because it was filed over seven years past the filing date of appellants' 1981 return. (Rev. & Tax. Code, § 19053.9, amended and renumbered as § 19314, operative Jan. 1, 1994.)

items of income or deductions, which is required before the offset provisions of section 19053.9 would apply. Therefore, the appellants' contention that they did not need to comply with section 18451's notice requirement is erroneous, and the NPA issued to them for 1980 was timely under section 18586.2.

Equitable Recoupment

The appellants alternatively argue that, even if the applicable statutes of limitations are a bar to their refund claim, they should be allowed to offset their 1980 increased tax liability (which arose because of the IRS' disallowance of deductions connected with their straddle transactions) with their alleged 1981 overpayment of taxes (based upon the IRS' elimination of income from their straddle transactions), by applying the doctrine of equitable recoupment. The application of the doctrine of equitable recoupment has been limited to situations wherein a fund of money arising from a single transaction or taxable event has been subjected to tax twice on inconsistent legal theories. In such event, what was mistakenly paid may be recouped against what is correctly due. (Bull v. United States, 295 U.S. 247, 261 [79 L.Ed. 1421] (1935); Stone v. White, 301 U.S. 532 [81 L.Ed. 1265] (1937); Rothensies v. Electric Storage Battery Co., 329 U.S. 296, 300 [91 L.Ed. 296] (1946); Appeal of Estate of Zebulon P. Owings, Deceased, and Mabel J. Owings, Cal. St. Bd. of Equal., Jan. 7, 1975.) Further, an underlying inquiry in determining the applicability of the doctrine in favor of the taxpayer is whether the government has received monies which in equity and good conscience belong to the taxpayer. (Bull v. United States, supra, 295 U.S. at 260; Boyle v. United States, 355 F.2d 233 (3d Cir. 1965); United States v. Herring, 240 F.2d 225, 228 (4th Cir. 1957).) However, equitable recoupment is to be applied narrowly so as not to seriously undermine the statute of limitations in tax matters. (Rothensies v. Electric Storage Battery Co., supra, 329 U.S. at 303.) We have previously determined that this board has the authority to apply the doctrine in an appropriate situation. (Appeals of Wilford and Gertrude Winkenbach, et al., Cal. St. Bd. of Equal., Dec. 16, 1975.)

In the present appeal, the appellants argue that the straddle transactions which they invested in through TCW constituted the "single transaction" needed to apply the doctrine of equitable recoupment. They assert that the IRS treated the straddles as one transaction, because even after the disallowance of deductions and income relating to the straddles, the IRS did allow the 1981 overpayment amount to be offset against the 1980 deficiency. Further, the appellants contend that to allow the respondent to keep the untimely refund claim amounts relating to the year where the straddle-based income was eliminated, while collecting the deficiency relating to the year wherein the straddle deductions were disallowed, would be incorrect, inequitable and unfair.

To help us determine whether the present appeal meets the requirements for the application of the doctrine of equitable recoupment, we will first briefly examine what constitutes a "straddle." Generally, the term "straddle" has been defined to mean the taking of "offsetting positions" with respect to personal property. A pertinent provision of the Internal Revenue Code (I.R.C.) states:

A taxpayer holds offsetting positions with respect to personal property

> if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions with respect to personal property (whether or not of the same kind).

(I.R.C. § 1092(c)(2)(A), incorporated by Rev. & Tax. Code, § 18031.)

In situations involving straddles wherein the IRS disallowed related deductions and gains, as in the present case, the courts have described the "offsetting positions" as "legs."[3/] The disallowance by the IRS and the courts of deductions and gains relating to straddle transactions is generally because the transactions involved have been found to be either: (1) a factual sham, which was inspired, designed and executed for the sole purpose of achieving for its investors capital gains and ordinary losses, but in reality no real market trading occurred and no purpose other than the avoidance of taxes existed (Seykota v. Commissioner, ¶91,234 T.C.M. (P-H) (1991)); or (2) shams in substance wherein the transactions may have actually occurred, but they lacked economic substance because there was no reasonable prospect for economic gain, or the transactions were undertaken for no business purpose other than the tax benefits. (Horn v. Commissioner, supra, 968 F.2d at 1237; Seykota v. Commissioner, supra.)

[3/]For example, as discussed in a case involving a government securities straddle, a straddle investor would agree to purchase (a long position) or sell (a short position) an underlying security on a specific date. The straddle investor then would hold an equal number of long and short positions in the same underlying security-the "legs" of the straddle. "In theory, a straddle results in both tax deferral and conversion of ordinary income into capital gain by enabling an investor to close out one leg at a loss and offset this loss against ordinary income, while holding the gain leg open until a later year." (Freytag v. Commissioner, 904 F.2d 1011, 1013 (at fn. 1) (5th Cir. 1990), affd. on other grounds, 501 U.S.__ [115 L.Ed.2d 764] (1991).)

Further, in a commodity straddle case, which appears to be the type of straddle the appellants were involved in, the court noted that:

> A "straddle" is the simultaneous taking of offsetting positions with different delivery dates in a given commodity. [Footnote omitted.] In the first year, the taxpayers engaged [in] an options straddle and a futures straddle, closed out the options straddle and the loss leg of the futures straddle and reestablished the futures straddle by purchasing a futures contract to offset the leg remaining from the original futures straddle. The simultaneous closing of the loss leg and reestablishing the straddle is known as a "switch." In the second year, but not sooner than six months after the switch, the taxpayer closed out the remaining futures straddle.
>
> The strategy yielded an ordinary income loss in the first year and a long-term capital gain in the second year, thereby converting ordinary income to long-term capital gain income and deferring taxation to subsequent years.

(Horn v. Commissioner, 968 F.2d 1229, 1231-1232 (D.C. Cir. 1992).)

Whether the appellants' investments in the straddle transactions may have been tax motivated or not,[4/] it is clear to us that these straddles did not constitute the "single" transaction necessary for application of the doctrine of equitable recoupment. Each of these straddles involved different "legs" wherein the appellants would invest in different positions in the same type of personal property in different years. This was not the same situation as in Bull v. United States, supra, wherein the same fund of money was taxed first pursuant to estate tax laws, and then was taxed again pursuant to income tax laws for the same year. Nor is the present case similar to the situation in Stone v. White, supra, wherein a trust had paid income taxes on trust income, and a later Supreme Court decision held that the same income was taxable to the trust's beneficiary and not to the trust. In Stone, the trust had timely filed a claim for refund, but the Court held that the government was allowed to use equitable recoupment to reduce the refund owed to the trust by the amount of tax owed by the beneficiary on that same income, even though the IRS was barred by limitations from assessing the tax against the beneficiary. Here, the appellants' investments were actually made in different years, and for different personal property interests (albeit in the same type of personal property). Further, "the fact that a single tax determination by the IRS may affect the taxes on two transactions does not convert the two transactions into a single one." (Wilmington Trust Co. v. United States, 610 F.2d 703 (Ct. C1. 1979); see also Mann v. United States, 552 F.Supp. 1132, 1141 (N.D. Texas 1982), affd., 731 F.2d 267 (5th Cir. 1984).)

In Wilmington Trust, the court did not allow the IRS to recoup a time-barred estate tax deficiency which was based upon one transaction, from income tax refunds attributable to another related transaction. A similar situation exists in the present case. Appellants are attempting to offset the increased tax liability caused by their disallowed deductions from separate straddle transactions in one year against their decreased tax liability caused by the elimination of income from different straddle transactions in another year. This is not allowable.[5/] The United States Supreme Court has specifically declined to expand the doctrine of equitable recoupment beyond the facts of Bull v. United States, supra, and Stone v. White, supra. (Rothensies v. Electric Storage Battery Co., supra, 329 U.S. at 300-301.) We believe that granting such relief in the present case would expand said doctrine.

Conclusion

Therefore, based upon the foregoing analysis and discussion, the respondent's action in this matter will be sustained.

[4/] In the present case, we believe that the straddle transactions involved were tax motivated.

[5/] Moreover, the fact that the appellants were apparently involved in tax-motivated transactions surely does not weigh in favor of their present claim that they are entitled to equity. Some courts, in deciding on whether to apply the doctrine of equitable recoupment, have looked to see whether the party asking for such relief was guilty of having "unclean hands." (See Kolom v. United States, 791 F.2d 762, 767 (9th Cir. 1986); United States v. Bowcut, 287 F.2d 654 (9th Cir. 1961).)

ORDER

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Joe E. and Betty S. Davis against a proposed assessment of additional personal income tax in the amount of $44,172 for the year 1980, be and the same is hereby sustained.

Done at Sacramento, California, this 29th day of June, 1995, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson* present.

Johan Klehs, Chairman

Ernest J. Dronenburg, Jr., Member

Dean F. Andal, Member

Brad Sherman, Member

____________________, Member

*For Kathleen Connell, per Government Code section 7.9.