



BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
LESTER and MILDRED BICK )

Appearances :

For Appellant: Irving I, Axelrad, Attorney at Law  
For Respondent: A. Ben Jacobson, Associate Tax  
Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Lester and Mildred Bick to a proposed assessment of additional personal income tax in the amount of \$4,573.54 for the year 1953.

Appellants, husband and wife, borrowed money to purchase U. S. Treasury Notes, the interest on which is exempt from the California personal income tax. The notes were purchased on February 17, 1953, and were sold on December 28, 1953, resulting in a gain of \$62,109.38. During the period that Appellants held the notes, they received interest income from them in the amount of \$88,311.46. During the same period they paid interest in the amount of \$164,537.01 on the indebtedness incurred to purchase the notes.

On their joint return for the year 1953 Appellants included as taxable income the gain of \$62,109.38 realized on the sale of the notes and claimed a deduction of \$76,225.55 as an interest expense allocable to the production of that income. This deduction equals the amount by which the interest paid on the loan exceeded the tax-exempt interest income received from the notes,

The first issue presented is whether any part of the expense incurred to purchase the tax-exempt securities is deductible.

Section 17304 (now Section 17203) of the Revenue and Taxation Code in 1953 read as follows:

Appeal of Lester and Mildred Bick

"In computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness of the taxpayer, However, no deduction shall be allowed (a) to the extent that it is connected with income not taxable under this part; or (b) for interest paid or accrued within the taxable year on indebtedness incurred or continued to purchase or carry obligations, the interest upon which is wholly exempt from the tax imposed by this part. The proper apportionment and allocation of the deduction with respect to taxable and nontaxable income shall be determined under rules and regulations prescribed by the Franchise Tax Board."

The Appellants regard this language as express permission to apportion interest expense when, in addition to the receipt of exempt interest from securities, taxable gain is realized on their sale,

The regulation covering this particular section contains nothing concerning apportionment (Title 1.8, California Administrative Code, Regulation 17304.) However, clause (b) of the section, when considered by itself, seems clearly to prohibit the deduction of interest received from securities such as those held by the Appellants, regardless of whether any gain from their sale is taxable. Section 23(b) of the 1939 Internal Revenue Code (now Section 265(2) I.R.C., 1954) uses substantially the same language as clause (b) of the statute here in question. In Clyde C. Pierce Corp. v. Comm'r., 120 Fed. 2d 206, the literal meaning of that language is forcefully expressed:

"...The statute providing that no deduction for interest shall be allowed when the interest was paid on indebtedness incurred or continued to purchase or carry obligations, the interest on which is wholly exempt from income tax, means exactly what it says. It must be applied as written. The securities in which petitioner dealt, securities of political subdivisions of the State of Florida, are certainly obligations, the interest on which is wholly exempt from income tax and the money it borrowed and paid interest on was money borrowed to purchase or carry them, The fact that petitioner must pay an income tax on account of capital gains, realized from its activities as a dealer, in the purchase and sale of such securities,

Appeal of Lester and Mildred Bick

which are in default, and that a part of the purchase price was for the accrued and defaulted interest, does not at all effect the question, of whether the securities it dealt in are tax exempt securities, "

To the same effect is *R.O. Holton & Co.*, 44 B.T.A. 202.

-The apportionment provisions of Section 17304 can be given effect without overriding the plain meaning of clause (b). The clearest application of those provisions is in connection with the language of clause (a) of the section. Apportionment may also be called for where money is borrowed to purchase both exempt and nonexempt securities. (See *Kentucky Joint Stock Land Bank v. Glenn*, 46 Fed. Supp. 400). That, however, is not the case before us. We conclude that none of the interest paid on the money borrowed to purchase the securities may be deducted,

The issue next presented is whether Appellants can capitalize the interest expense, and thereby increase the basis of the exempt securities and decrease the **gain on** their sale.

Section 17782 (now Section 18052) of the Revenue and Taxation Code provided:

"Proper adjustment in respect of the property shall in all cases be made for the expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for taxes or other carrying charges, ... for which deductions have been taken by the taxpayer..."

We do not agree with Appellants' theory that the interest expense may be capitalized simply because it is not deductible. Appellants have cited no legal or accounting authority, nor have we discovered any; which would justify a conclusion that the interest in question is "properly chargeable to capital account." To the contrary, in the Accountants' Handbook, 4th ed., Sec. 13, p.4, it is stated that:

"In connection with the acquisition of securities on the instalment plan, the preferred procedure is to treat all interest and dividend charges and credits associated with the transaction as income items. Nevertheless, interest paid on unpaid balances of securities purchased on the instalment plan may be viewed as a proper carrying charge and included in the cost of security.

Appeal of Lester and Mildred Bick

Where this is done, however, any dividends or interest allowed by the issuing corporation (or other party involved) during the period of purchase must be credited to the investment account. Inclusion in the investment account of interest paid on funds borrowed to buy securities either on margin or outright is objectionable."  
(Emphasis added.)

We conclude that the interest expense may not properly be charged to capital account.

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 Lester and Mildred Bick to a proposed assessment of additional personal income tax in the amount of \$4,573.54 for the year 1953 be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of September, 1958, by the State Board of Equalization.

Geo. R. Reilly, Chairman

Paul R. Leake, Member

Robert E. McDavid, Member

M. H. Quinn, Member

Robert C. Kirkwood, Member

ATTEST: Ronald B. Welch, Acting Secretary