63-SBE-056

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PERCIVAL M. AND KATHARINE SCALES)

For Appellants: Bronson, Bronson & McKinnon, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel; C. M. Gray, Associate Tax Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Percival M. and Katharine Scales to a proposed assessment of personal income tax in the amount of $600.26 for the year 1957.

Appellants are real estate investors. They deducted on their 1956 personal income tax return property taxes and interest of $7,776.69, but received no tax benefit therefrom as they would have realized a loss even if the deductions had not been taken. The property taxes and interest constituted carrying charges with respect to property which was not held for sale at the time the charges were incurred.

The property to which the taxes and interest related was sold at a gain during 1957. The $7,776.69 in taxes and interest already deducted at no tax benefit on the return for 1956 was used to reduce the amount of the 1957 gain on the authority of section 17144 of the Revenue and Taxation Code which reads as follows:

> Gross income does not include income attributable to the recovery during the taxable year cf a bad debt,' prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax, or amount.

The section, by regulation of respondent, applies to interest of the sort at issue. (Cal. Admin. Code, tit. 18, reg. 17144-17145, subd. (a).)

Respondent disallowed the exclusion from income of the item of $7,776.69 on the ground that the amount was not attributable to a "recovery" within the meaning of the code,, In support of the deduction, appellants rely on the case of Smyth v. Sullivan, 227 F.2d 12, There the taxpayer was the executor of a probate estate the liabilities of which exceeded its assets. Rather than immediately disposing of real property of the estate at depressed prices, he held the property for sale from 1938 until 1946, when it was sold at a gain. When reporting the gain for tax purposes, the executor excluded an amount equal to carrying charges on the property which had been paid and taken as tax deductions with no tax benefit during the years prior to 1946. This was done under authority of section 22(b)(12) (now section 111) of the Internal Revenue Code, which for present purposes is identical with section 17144 of the Revenue and Taxation Code.

The court held that the taxpayer had properly netted from the proceeds of the sale a sum equal to the carrying charges deducted at no tax benefit on prior returns because the administration of the property until its sale and the sale itself amounted to a single integrated transaction.

The cases principally relied upon by respondent are Allen v. Trust Co. of Georgia, 180 F.2d 527, cert. denied, 340 U.S. 814 (95 L. Ed. 598), and Merton E. Farr, 11 T.C. 552, aff'd sub nom. Sloane v. Commissioner, 188 F.2d 2[illegible].

In the Allen case, the taxpayer in 1932 accepted pledged stock with a value of $180,000 in satisfaction of a $400,000 debt, and attempted to offset the 1932 loss against a gain due to sale of the stock in 1940. The court held that the making of the loan, the acceptance of the stock in cancellation of the debt and the subsequent sale of the stock were not parts of one integrated transaction, and refused to allow the offset.

The case of Merton E. Farr involved a taxpayer who, to permit the purchase of certain property and, after the purchase, to meet carrying charges, made unsecured advances to a corporation owned by him and his family, The corporation defaulted and others in the family, who had made secured advances for the purchase price, foreclosed, On a subsequent sale of the property, the taxpayer received a portion of the proceeds for his services in managing the property. The court held that the taxpayer's share of the proceeds could not be reduced by his losses on the advances to the corporation, stating that "we are unable to find such an interrelationship between the steps which resulted in losses to petitioner and the events which produced the gain in question that we can consider them one and the same transaction."

Appellant does not disagree with the general principle concerning integrated transactions but contends that the transaction at issue was sufficiently interrelated to support the offset. Thus the issue is narrowed down to the question of whether the circumstances of the case do in fact amount to a single integrated transaction.

The "tax benefit" rule by which expenses incurred in one period may be offset against gain received in a later period is a limited exception to the well established fixed annual accounting-period principle and must be strictly applied. (Capitol Coal Corp. v. Commissioner, 250 F.2d 361, cert. denied, 356 U.S. 936 (2 L. Ed. 2d 812).) A significant difference between appellants' case and the Smyth case on which they rely is that in Smyth the executor at all times held the property primarily for sale and incurred carrying charges as a necessary incident of the plan to sell, There was thus a direct relationship between the carrying charges and the sale which is lacking here. In our opinion, appellants' payment of tax and interest with respect to the property, at a time when they did not plan to sell the property, did not constitute, together with the sale, a single, integrated transaction"

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 Percival M. and Katharine Scales to a proposed assessment of personal income tax in the amount of $600.26 for the year 1957, be and the same is hereby sustained,

Done at Sacramento, California, this 7th day of May, 1963, by the State Board of Equalization.

Paul R. Leake, Chairman
Geo. R. Reilly, Member
Richard Nevins, Member
__________, Member
__________, Member

ATTEST: Dixwell L. Pierce, Secretary