

Appeal of Roy L. and Ilse M. Byrnes

On December 15, 1972, appellants entered into a written agreement with Frey Nursery, Inc. (Frey), which provided **that** Frey sell to appellants avocado seeds and pots, plant **and** raise **the** seedlings to the transplantable stage and deliver them to appellants' farm for permanent planting. The cost of the avocado seeds and pots totaled \$4,000; Frey **acknowledged in** the agreement that 'that amount had been received.- The charge for planting, grafting, maintenance and delivery was \$3.45 per tree for ten **thousand trees**, a total of \$34,500. Appellants paid \$23,000 of this amount upon execution of the agreement, for services through December 31, 1973. The balance Of **\$11,500** was payable **on or before December 31, 1973** for services and delivery on or about June 15, 1974. The appellants bore the risk of loss other than that avoidable through reasonable care by, Frey.

In 1972 and 1973, appellants deducted, as ordinary business expenses, \$27,200 and \$69,200, respectively, as "farm **losses**". All of the 1972 farm **loss**, represented expenditures under the Frey contract, **and** \$11,500 of the 1973 loss was attributable to that contract. Appellants' deduction of these amounts as ordinary business expenses **was disallowed** by respondent on the grounds that the **expenditures were capital** in nature. Appellants' protest **against this** action was denied and this timely appeal followed.

On appeal, the appellants also maintain that because respondent and the Internal Revenue Service conducted a **joint** audit for 1972, the issuance of a federal closing letter accepting appellants' 1972 **return as** filed precludes respondent from assessing a deficiency for that year.

Thus; two issues are presented for decision: (1) **whether** appellants properly deducted, as ordinary business expenses the cost of nursery services performed under the Frey contract and (2) whether respondent is precluded by federal **law** from assessing a deficiency for 1972. At the oral hearing in this matter, appellants conceded that the expenditures for the seeds, pots; and initial planting of the seeds were capital in nature; therefore, **those items are** no longer in issue here.

It is well established that the disallowance of a deduction by respondent is presumed correct, and the burden is on the taxpayers to show their entitlement to the deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 13481 (1934)]; Appeal of Robert V. Erilane, Cal. St. Bd. of Equal., Nov. 12, 1974.) **For the reasons** which follow, we believe appellants have failed to sustain that burden.

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Appellants have based their argument on a provision in the federal income tax law which allows farmers an election either to capitalize or to deduct certain expenses incurred for development of orchards prior to the time the productive stage is reached. (Int. Rev. Code of 1954, § 162(a); Treas. Reg. 1.162-12.)

Appellants principally rely on a federal court decision applying the above cited regulation in a case similar to that of appellants, Maple v. Commissioner, 55 T.C. 260, affd., 440 F.2d 1055 (9th Cir. 1971); In Maple, the Ninth Circuit upheld the Tax Court's ruling that maintenance costs for citrus seedlings prior to permanent planting were deductible under Internal Revenue Code section 162(a). Because section 162 and Revenue and Taxation Code section 17202 are similar, appellants urge that the Maple decision should control the result in the instant case. We acknowledge that federal court rulings are highly persuasive on state income tax matters where the state statute is patterned after federal law. (Meanley v. McColgan, 49 Cal. App. 2d 203 [121 P.2d 45] (1942)..) However, federal decisions are not conclusive and we must decline to follow Maple here for two reasons. First, our examination of the law on the subject of farming expenses indicates that the Maple decision does not present persuasive reasoning and is contrary to the weight of authority on this issue. Second, there is no authority in California revenue laws for the deduction in question.

We believe the Maple court misapplied the authorities cited therein in rendering its decision. For example, Maple cited the Estate of Richard R. Wilbur, 43 T.C. 322 (1964), for the proposition that **preproductive** maintenance costs, i.e., "cultural practices" expenses for agricultural items, are deductible if they are sufficiently similar to productive stage maintenance expenses. Unfortunately, the Maple court overlooked the definition in Wilbur of deductible "cultural practices," which are **expenditures necessary** for irrigation, cultivation, fertilization and other care which take place "**[a]fter the initial capital expenses are incurred in planting the orchards . . .**" (Emphasis added.) (Estate of Richard R. Wilbur, supra, 43 T.C. at 323.) As a factual matter, appellants' expenditures preceded the establishment of orchards, which are plantings of trees. Thus, those expenditures are not deductible but rather, in the words of the Wilbur court, "may be considered in every real sense as part of directly related to the cost of acquiring a producing orchard, and as such have the characteristics of capital outlays." (Estate of Richard R. Wilbur, supra, 43 T.C. at 327.)

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We also have concluded that the Maple court misapplied Internal Revenue Mimeograph 6030, 1946-2 Cum. Bull. 45, which **interpreted** the predecessor of section 162. Although the court correctly cited Mim. 6030 to support the deductibility of maintenance expenses in the developmental stage of an orchard, it erred in applying Mim. 6030 to the Maple taxpayers, who like the appellants here, 'did not yet have an orchard to develop. Furthermore, Mim. 6030 specifically states that the cost of trees and the **planting** of trees must be capitalized. Clearly, the purpose of the contract with Frey was the acquisition of avocado trees and although the maintenance expenses at issue do continue the growth of seeds, the critical fact is that those expenses are simply part of the cost of acquiring a complete capital asset, i.e., a transplantable tree. (See Estate of Richard R. Wilbur, supra, fn. 6 at 327.) **1/** This distinction was also noted in Ashworth v. United St&es, 28 Am. Fed. Tax. R. 2d 71-5976 (1971), where the court criticized Maple's failure to distinguish between the expenses of growing orange trees and expenses of growing oranges. The former includes the cost of raising a seedling to the transplantable stage and must be capitalized; this result is consistent with other farming and timber cases. (See Ashworth v. United States, supra, 28 Am. Fed. Tax. R. 2d at 71-5985.) This position was adopted by the Internal Revenue Service in Revenue Ruling 75-405, 1975-2 Cum. Bull. 64, after the decisions in Maple and Wagner Mills, both of which the Internal Revenue Service has declined to follow.

It should be noted here that the enactment by Congress and the California Legislature of statutes requiring the capitalization of orchard development expenses (Int. Rev. Code of 1954, § 278 and Rev. & Tax. Code, § 17235, respectively) does not, as appellant suggests, indicate that the type of expenses at issue here were previously deductible under section 162. The statutes were enacted to eliminate the use of farm development period expenses to offset the **nonfarm** income of high income taxpayers. (See S. Rep. No. 91-552, 1969-2 U.S. Code Cong. & Ad. News 2376; see also, S. Rep. No. 91-1529, 1970-3 U.S. Code Cong. & Ad. News 6094.) It is clear that these sections apply only **after** a tree is planted in the permanent place from which **production is** expected, and not before. (See [1979] 3 Fed. Taxes (P-H) ¶ 16,977.)

1/ In light of the foregoing discussion, the case of Wagner Mills, Inc., ¶ 74,274 P-H Memo. T.C. (1974), affd. mem., 530 F.2d 827 (8th Cir. 1976), cited by appellants at oral hearing, is unpersuasive because of its reliance on Maple.

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Finally, it is clear that Revenue and Taxation Code section 17283 prohibits the deduction of appellants' nursery care expenses because those expenses represent the cost of acquiring property having a useful life beyond the taxable year, and as such, must be capitalized. (Cal. Admin. Code, tit. 18, reg. 17283(b), subd. (1).)

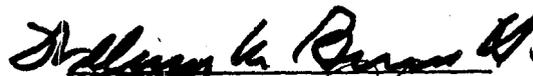
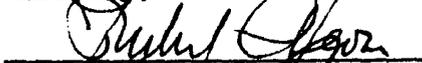
For the above stated reasons, we must **sustain respondent's** assessment of deficiencies against appellant. **There is** no merit in appellants' argument that the issuance of a federal closing letter for 1972 precludes this assessment. We are not bound to follow a federal audit determination where the weight of authority does not support such a result.

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 Roy L. and Ilse M. Byrnes against proposed assessments of additional personal income **tax** in the amounts of **\$4,007.90** and **\$1,670.67** for the years 1972 and 1973, respectively, be and the same is hereby sustained.

Done at **Sacramento, California**, this 28th day
of June , 1979, by the **State Board of Equalization**.

 Chairman
 Member
 Member
 Member
 Member.