

Appeal of Ernest Rand Dorothy A. Larsen

Appellants reported negative taxable income of \$56,297, and tax on items of tax preference in the amount of \$1,133, on their joint California personal income tax return for the year 1976. Upon audit, respondent determined that appellants had incorrectly computed their items of tax preference. After consideration of their protest, however, respondent reduced its earlier computation of appellants' item of net farm loss tax preference by \$7,988 to reflect the amount of gross income resulting from the gain on shares of stock in Bear Valley Mutual Water Company (hereinafter referred to as "Bear Valley"). An adjustment was also made to appellants' item of capital gains tax preference: that adjustment is not in issue here,

Appellants contend that respondent has incorrectly computed their item of net farm loss tax preference. Specifically, they assert that certain farm income has been excluded from that computation while various nonfarm losses have been included therein. Appellants also maintain that, since they received only a \$73 tax benefit from the special treatment accorded capital gains, their item of capital gains tax preference should be reduced to reflect this minimal benefit. In the alternative, if a tax benefit theory is inapplicable, appellants seek to revoke their "election" to take a capital gains "deduction." Each of appellants' arguments shall be addressed in the order set forth above.

Exclusion of Income in Net Farm Loss Computation

Appellants contend that since Mr. Larsen has been engaged in farming for more than 50 years, "[a]ll of his income originates from his farming and agricultural pursuits." Accordingly, they maintain that agricultural consulting fees, the gain from the sale of stock of certain corporations engaged in the business of farming, and interest income from a note received from the sale of farm property, constitute gross income from the trade or business of farming for purposes of computing their item of net farm loss tax preference. Upon careful review of the record on appeal, and for the reasons set forth below, we conclude that respondent properly excluded these items of income from the computation of appellants' item of net farm loss tax preference.

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Revenue and Taxation Code section 17063,^{1/} subdivision (i), as it existed for the year in issue,^{2/} included as an item of tax preference "[t]he amount of net farm loss in excess of fifteen thousand dollars (\$15,000) which is deducted from nonfarm income." The term "farm net loss" is defined by section 17064.7 as:

. . . the amount by which the deductions **allowed by** this part which are directly connected with the carrying on of the trade or business of farming exceed the gross income derived from such trade or business. (Emphasis added.)

Former section 17063, subdivision (i), was intended as a replacement for former section 18220. While it changed the method of deterring tax motivated farm loss operations, the focus of the new section, i.e., "farm net loss," remained the same as that of the section it replaced. Except for certain provisions not in issue here, section 17064.7 defines "farm net loss" in a manner identical to that of former section 18220, subdivision (e). Pursuant to respondent's regulation 19253,^{3/} regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section 18220 was patterned) governed the interpretation of the term "farm net loss" under former section 18220, subdivision, (e). Given the successor relationship between section 17064.7 and former section 18220, subdivision (e), the Treasury regulations promulgated pursuant to section 1251 of the Internal Revenue Code are applicable for purposes of interpreting the term "farm net loss" as it appears in section 17064.7.

1/ Hereinafter, all references are to the Revenue and Taxation Code, unless otherwise indicated.

2/ AB 93 (Stats. 1979, Ch. 1168), operative for taxable years beginning on or after January 1, 1979, rewrote subdivision (i) of Section 17063 as subdivision (h) and increased the excluded amounts thereunder.

3/ In pertinent part, this regulation provides as follows:

In the absence of regulations of the Franchise Tax Board and unless otherwise specifically provided, in cases where the Personal Income Tax Law conforms to the Internal Revenue Code, regulations under the Internal Revenue Code shall, insofar as possible, govern the interpretation of conforming state statutes . . .

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Treasury Regulation § 1.1251-3(b) defines "farm net loss" as follows:

. . . The term "farm net loss" means the amount by which I-

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed

(ii) The gross income derived from such trade or business. (Emphasis added,)

Treasury Regulation § 1.1251-3(e)(l) defines the term "trade or business of farming" as follows:

. For purposes of section 1251, the term "trade or business of farming" includes any trade or business with respect to which the taxpayer may compute gross income under § 1.61-4, expenses under § 1.162-12, make an election under section 175, 180, or 182, or use an inventory method referred to in § 1.471-6. Such term does not include any activity not engaged in for profit within the meaning of section 133 and § 1.183-2.

According to the above, any taxpayer who may compute gross income under Treasury Regulation § 1.61-4 is engaged in the trade or business of farming. Likewise, a taxpayer who may elect, pursuant to section 182 of the Internal Revenue Code of 1954, to treat expenditures which are paid or incurred by him in the clearing of land for farming purposes as expenses which are not chargeable to capital account is also engaged in the trade or business of farming, Treasury Regulation § 1.61-4 is identical to respondent's former regulation 17071(d). The latter, operative for the year in issue, designated as "farmers" "[a]ll individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants" Similarly, respondent's former regulation 17224(c), in effect for the year in issue, provided that "[a] taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant." Treasury Regulation § 1.182-5(a)(2) provides that "[g]ross income derived from the business of farming . . . does not include gains from sales of assets such as farm machinery or gains from the disposition of land." A

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taxpayer deriving gross income from the sale of assets used in the trade or business of farming or deriving income as an employee or independent contractor of a corporation engaged in the business of farming is neither defined as a "farmer" nor as a "taxpayer engaged in the business of farming" under **any of the** cited regulations.

Federal Revenue Rulings interpreting Treasury Regulation § 1.175-3 (the substantive federal equivalent of respondent's former regulation 17224(c)) have concluded **that wages paid farm employees and fees paid to providers of customary farm services are to be excluded from the definition of gross income from farming.** (See Rev. Rul. 65-280, 1965-2 Cum. Bull. 433; Rev. Rul. 77-105, 1977-1 Cum. Bull. 374.) Additionally, it has been determined that dividend income from a corporation engaged in the business of farming does not constitute income from farming to a shareholder of such a corporation. (Rev. Rul. 76-141, 1976-1 Cum. Bull. 381; see also Whipple v. Commissioner, 373 U.S. 193 [10 L.Ed.2d 288] (1963).) Finally, as previously noted, income derived from the sale of assets used in the trade or business of farming is similarly excluded from the definition of gross income from farming. (Treas. Reg. § 1.182-5(a)(2); Rev. Rul. 63-26, 1963-1 Cum. Bull. 295.) In light of the above, appellants contention that the income in issue constitutes farm income is untenable.

In addition to the arguments noted above, appellants also maintain that respondent has dealt in an inconsistent manner with a portion of the income under discussion. Specifically, they assert that respondent's treatment of the gain from the sale of the Bear Valley stock as gross income from the **trade** or business of farming dictates that the other capital gain and interest income in issue should be similarly treated because "this income also has its origin in a farming related activity. ..." The propriety of respondent's determination as to the character of the gain **from the** sale of the Bear Valley stock is not an issue presented by this appeal. Consequently, the record of this appeal does not adequately disclose what **provided** the basis for that determination. Notwithstanding respondent's treatment of that income, however, the authority cited above reveals that respondent properly determined that the income in issue did not constitute gross income from the trade or business of farming for purposes of computing appellants' item of net farm loss tax preference.

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Inclusion of Partnership Losses in Net Farm Loss Computation

The second issue presented by this appeal concerns the correctness of respondent's determination that appellants' distributive share of certain partnership losses was to be included in the computation of **their** item of net farm loss tax preference.

Appellants contend that the subject partnership are not **engaged** in the trade or business of farming and that, accordingly, the losses resulting therefrom do not constitute farm losses. Upon examination of the returns filed by these partnerships, however,, respondent discovered that each of the partnerships; reported that "farming" was its principal business activity.

Respondent's former regulation 17224(c) provided that "[a] taxpayer is engaged in the 'business of farming' if he is a member of a partnership engaged in the business of farming." Based upon the express provisions of the quoted regulation, and in view of the evidence in the record of this appeal revealing that the partnerships in issue were engaged in the trade or business of farming, we can only conclude that respondent properly included appellants' distributive share of these partnership losses in the computation of their item of net farm loss tax preference.

Item of Capital Gains Tax Preference

The final issue presented by this appeal pertains to appellants' contention that, because of the presence of itemized deductions in the amount of **\$53,797**, had their capital gain income been treated as ordinary income, they would have had taxable income of \$12,808, with a resultant tax liability of only \$73. Since their capital gains "deduction" provided only a net tax savings of \$73, appellants argue, the tax on items of tax preference should be only \$2 (reflecting the effect of exemption credits) under a "**tax** benefit" theory. In addition to their reliance upon a tax benefit theory, appellants have cited

4/ The partnerships in issue are: (i) Baker; Larsen, and Scholton; (ii) Orange Trust; (iii) Tall Palms; and (iv) Fair Acres.

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Section 17064.5, subdivision (f),^{5/} in support of this proposition. In the alternative, appellants contend that "[i]f . . . a tax benefit theory does not apply, [an election is made] not to take the capital gain deduction and pay a . . . tax of \$73."

The initial contention raised by appellants has previously been addressed by this board. (Appeal of Harold A. and Doris C. Rockwell, Cal. St. Bd. of Equal., March 30, 1981; Appeal of James R. and Jane M. Bancroft, Cal. St. Bd. of Equal., Jan. 11, 1978.) For the reasons set forth in the cited appeals, we conclude that this argument is without merit. Moreover, appellants' reliance upon section 17064.5, subdivision (f), in support of this assertion is misplaced. That subdivision is operative for taxable years beginning in 1977 and therefore is irrelevant to the instant appeal. Appellants' alternative position **that they** be permitted "not to take the capital gain deduction" is equally without merit. No such "deduction" exists. The proper treatment of capital gains is mandated by statute (Rev. & Tax. Code, § 18162.5); there is no provision in the law for elective or alternative treatment of such gains.

For the reasons set forth above, respondent's action in this matter will be sustained.

5/ Section 17064.5, subdivision (f), operative for taxable years beginning in 1977, provides as follows:

(f) The Franchise Tax Board shall prescribe regulations under which items of tax preference shall be properly adjusted where the tax treatment giving rise to such items will not result in the reduction of the taxpayer's tax under this chapter for any taxable years.

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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 Ernest R. and Dorothy A. Larsen against a proposed assessment of additional personal income tax in the amount of \$7,032.00 for the year 1976, be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of November, 1982, by the State Hoard of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett , Chairman
Conway H. Collis , Member
Richard Nevins , Member
_____, Member
_____, Member

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Appellants contend that respondent has incorrectly computed their item of net farm loss tax preference. Specifically, they assert that certain farm income has been excluded from that computation while various nonfarm losses have been included therein. Appellants also maintain that, since they received only a \$73 tax benefit from the special treatment accorded capital gains, their item of capital gains tax preference should be reduced to reflect this minimal benefit. In the alternative, if a tax benefit theory is inapplicable, appellants seek to revoke their "election" to take a capital gains "deduction." Each of appellants' arguments shall be addressed in the order set forth above.

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Appellants contend that since Mr. Larsen has been engaged in farming for more than 50 years, "[a]ll of his income originates from his farming and agricultural pursuits." Accordingly, they maintain that agricultural consulting fees, the gain from the sale of stock of certain corporations engaged in the business of farming, and interest income from a note received from the sale of farm property, constitute gross income from the trade or business of farming for purposes of computing their item of net farm loss tax preference.

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Upon careful review of the record on appeal, and for the reasons set forth below, we conclude that respondent properly excluded these items of income from the computation of appellants' item of net farm loss tax preference.

Revenue and Taxation Code section 17063,^{1/} subdivision (i), as it existed for the year in issue,^{2/} included as an item of tax preference "[t]he amount of net farm loss in excess of fifteen thousand dollars (\$15,000) which is deducted from nonfarm income." The term "farm net loss" is defined by section 17064.7 as:

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Pursuant to respondent's regulation 19253,^{3/} regulations adopted pursuant to Internal Revenue Code section 1251 (after which former section 18220 was patterned) governed the interpretation of the term "farm net loss" under former section 18220, subdivision (e). Given the successor relationship between section 17064.7 and former section 18220, subdivision (e), the Treasury regulations promulgated pursuant to section 1251 of the Internal Revenue Code are applicable for purposes of interpreting the term "farm net loss" as it appears in section 17064.7.

Treasury regulation § 1.1251-3(b) defines "farm net loss" as follows:

. . . The term "farm net loss" means the amount by which--

(i) The deductions allowed or allowable for the taxable year by chapter 1 of subtitle A of the Code which are directly connected with the carrying on of the trade or business of farming, exceed

(ii) The gross income derived from such trade or business. (Emphasis added.)

Treasury regulation § 1.1251-3(e)(1) defines the term "trade or business of farming" as follows:

3/ In pertinent part, this regulation provides as follows:

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. . . For purposes of section 1251, the term "trade or business of farming" includes any trade or business with respect to which the taxpayer may compute gross income under § 1.61-4, expenses under § 1.162-12, make an election under section 175, 180, or 182, or use an inventory method referred to in § 1.471-6. Such term does not include any activity not engaged in for profit within the meaning of section 183 and § 1.183-2.

According to the above, any taxpayer who may compute gross income under Treasury regulation § 1.61-4 is engaged in the trade or business of farming. Likewise, a taxpayer who may elect, pursuant to section 182 of the Internal Revenue Code of 1954, to treat expenditures which are paid or incurred by him in the clearing of land for farming purposes as expenses which are not chargeable to capital account is also engaged in the trade or business of farming. Treasury regulation § 1.61-4 is identical to respondent's former regulation 17071(d). The latter, operative for the year in issue, designated as "farmers" "[a]ll individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants" Similarly, respondent's former regulation 17224(c), in effect for the year in issue, provided that "[a] taxpayer is engaged in the business of farming if he cultivates, operates, or manages a farm for gain or profit, either as owner or tenant."

Federal revenue rulings interpreting Treasury regulation § 1.175-3 (the substantive federal equivalent of respondent's former regulation 17224(c)) have concluded that wages paid farm employees and fees paid to providers of customary farm services are to be excluded from the definition of gross income from farming. (See Rev. Rul. 65-280, 1965-2 Cum. Bull. 433; Rev. Rul. 77-105, 1977-1 Cum. Bull. 374.) We can perceive no substantive difference between fees paid for customary farm services and fees paid to an agricultural consultant. Neither recipient of such fees must necessarily "cultivate, operate or manage a farm for gain

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or profit, either as owner or tenant" to render such services. The fact that the person who renders such services may concurrently own a farm does not make such fee income farm income. (See Appeal of Donald S. and Maxine Chuck, Cal. St. Bd. of Equal., Oct. 27, 1981.)

Appellants' contention that the interest income derived from a note received from the sale of farm property constitutes gross income from the trade or business of farming for purposes of computing their item of net farm loss tax preference is without merit. Whether or not the gain from this sale constitutes farm income for purposes of section 17064.7, an issue we need not address in the instant appeal, the interest income received from the note related to the sale is not income from the trade or business of farming. Interest is payment for the use of money. The fact that the **subject** note had its source in the sale of farm property is irrelevant.

Appellants' argument that the gain realized from their sale of stock of certain corporations engaged in the business of farming constitutes farm income is **equally** unfounded. Such income does not acquire the trade or business attributes of the corporation. (Cf. Rev. Rul. 76-141, 1976-1 Cum. Bull. 381, which stands for the proposition that dividend income from a corporation engaged in the business of farming does not constitute income from farming to a **shareholder** of such a corporation; see also Whipple v. Commissions, 373 U.S. ,193 [10 L.Ed.2d 288] (1963).)

In addition to the arguments noted above, appellants also maintain that respondent has dealt in an inconsistent manner with a portion of the income under discussion. Specifically, they assert that respondent's treatment of the gain from the sale of the Bear Valley stock as gross income from the trade or business of farming dictates that the other capital gain and interest income in issue should be similarly treated **because** "this income also has its origin in a farming related activity. ..."
The propriety of respondent's determination as to the character of the gain from the sale of

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the Bear Valley stock is not an issue presented by this appeal. Consequently, the record of this appeal does not adequately disclose what provided the basis for that determination. Notwithstanding respondent's treatment of that income, however, the authority cited above reveals that respondent properly determined that the income in issue did not constitute gross income from the trade or business of farming for purposes of computing appellants' item of net farm loss tax preference.

Inclusion of Partnership Losses in Net Farm Loss Computation

The second issue presented by this appeal concerns the correctness of respondent's determination that appellants' distributive share of certain partnership losses was to be included in the computation of their item of net farm loss tax preference.

Appellants contend that the subject partnerships^{4/} are not engaged 'in 'the trade or business of farming and that, accordingly, the losses resulting therefrom do not constitute farm losses. Upon examination of the returns filed by these partnerships, however, respondent discovered that each of the partnerships reported that "farming" was its principal business activity.

Respondent's former regulation 17224(c) provided that "[a] taxpayer is engaged in the 'business of farming' if he is a member of a partnership engaged in the business of farming." Based upon the express provisions of the quoted regulation, and in view of the evidence in the record of this appeal revealing that the partnerships in issue were engaged in the trade or business of farming, we can only conclude that respondent properly included appellants' distributive share of these partnership losses in the computation of their item of net farm loss tax preference.

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The initial contention raised by appellants has previously been addressed by this board. (Appeal of Harold A. and Doris C. Rockwell, Cal. St. Bd. of Equal., March 30, 1981; Appeal of James R. and Jane M. Bancroft, Jan. II, 1978.) For the reasons set forth in the cited appeals, we conclude that this argument is without merit. Moreover, appellants' reliance upon section 17064.5, subdivision (f), in support of this assertion is misplaced. That subdivision is operative for taxable years

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