BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-45-VN
HARRY AND ELEANOR H. GONICK)
)

For Appellants: Harry Gonick,
In pro. per.

For Respondent: David Lew
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Harry and Eleanor H. Gonick against a proposed assessment of additional personal income tax in the amount of $4,807.73 for the year 1977.

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

The issue presented by this appeal is whether appellants are entitled to deduct that portion of a claimed dredging expense paid by a nonrecourse promissory note.

On their joint return for 1977, appellants claimed a $32,000 loss on a Schedule C (Profit or (Loss) From Business or Profession) on which they indicated they were engaged in the land reclamation business using the cash method of accounting. The loss was attributed wholly to a construction services expense of $32,000 since appellants reported no income from the business.

On review, the Franchise Tax Board learned that appellants in 1977 invested in a construction services tax shelter promoted by the International Monetary Exchange (IME), an investment services corporation organized under the laws of Panama. By the terms of the tax shelter plan, appellants agreed to provide certain dredging services to Diversiones Internationales, S.A. (DISA), a corporation headquartered in Panama City which was developing an oceanfront resort at Punta Chame on the Bay of Panama. The actual dredging work was subcontracted to Dredgeco, another Panamanian corporation that was engaged in dredging and drilling. IME's promotional. materials provided that the desired "tax work-off" would correspond to the cost of the dredging. To obtain their $32,000 write-off, appellants, were required to make a cash payment equal to 25 percent, or $8,000, and to execute a nonrecourse promissory note to IME which thus financed the remaining 75 percent, or $24,000, of this dredging cost. Interest on the note accrued at 10 percent per annum. IME thereupon paid the entire $32,000 to Dredgeco which required payment of the dredging cost in advance of the work. Appellants were advised by IME that the total cost of the dredging, including both their cash outlay and nonrecourse borrowing, was fully deductible by them as cash-basis taxpayers on Schedule C and would result in a 400 percent tax write-off.

When Dredgeco completed the dredging, IME as appellants' agent was to transmit to DISA an invoice or bill for the cost of the dredging services ($32,000) plus an amount equal to appellants' cash payment ($8,000). In other words, IME also promised to obtain for appellants a 100 percent return on their cash investment. DISA, in turn, was to pay appellants this $40,000 dredging services invoice from one-half of the proceeds or monies received from its sale of the improved oceanfront lots developed as a result of appellants' dredging services. Interest was assessed on the unpaid balance of the invoice at six percent per annum. Moreover, appellants' payment on. their $24,000 nonrecourse note to IME was linked to their receipts from DISA on the dredging invoice. Under the terms of the note, appellants were only obligated to repay the $24,000 obligation from 75 percent of any payments made to them by DISA on the dredging services invoice as well as from 100 percent of any interest paid by DISA on the unpaid portion of the invoice.

On or about December 7, 1977, appellants followed IME's instructions and submitted to IME an $8,000 check for the dredging and an application to receive IME's nonrecourse financing for $24,000. On December 15, 1977, appellants executed a $24,000 nonrecourse note in favor of IME. Subsequently, appellants received notification from IME that the $32,000 payment had been made to Dredgeco for the dredging services and a $40,000 service invoice had been sent to DISA. Appellants aiso assigned any payments due them from DISA to IME as security for their payment on the nonrecourse note. Appellants then claimed the-suggested $32,000 tax deduction on their 1977 return.

On September 4, 1979, the Franchise Tax Board issued appellants a deficiency assessment, disallowing the entire $32,000 loss deduction. Appellants filed a protest against the assessment. On October 27, 1983, the Franchise Tax Board revised its determination by allowing the deduction of appellants' cash payment of $8,000. The Franchise Tax Board affirmed, however, the disallowance of the balance of appellants' construction services expense paid with the $24,000 nonrecourse note based on the United States Tax Court decision in Graf v. Commissioner, 80 T.C. 944 (1983).

Section 17591 of the Revenue and Taxation Code provides that a taxpayer is allowed a deduction. for the taxable year which is the proper year under the method of accounting used by the taxpayer in computing his taxable income. This section was substantially the same as Internal Revenue Code section 461(a). Federal precedent is therefore persuasive of the proper interpretation of section 17591. (Meanley v. McColgan, 49 Cal. App. 2d 203 [121 P.2d 45] (1942).)

A taxpayer using the cash method of accounting may deduct an expense only in the taxable year in which payment of the expense was made. (Helvering v. Price, 309 U.S. 409, 413-414 [84 L.Ed. 836, 839.1 (1940); Treas. Reg. § 1.461-1(a)(1).) Under tax law, payment occurs only when a taxpayer's money is "irretrievably out of pocket" (Ernst v. Commissioner, 32 T.C. 181, 186 (1959)) or when the taxpayer sustains "an economic detriment, i.e., an actual depletion of his property" (Rife v. Commissioner, 356 F.2d 883, 889 (5th Cir. 1966), revg. 41 T.C. 732 (1964)). Where a taxpayer borrows money from a third'party to pay an expense, the courts have generally held the expense to be deductible when paid and not when the loan is repaid. (See McAdams v. Commissioner, 15 T.C. 231 (1950), affd. 198 F.2d 54 (5th Cir. 1952); Granan v. Commissioner, 55 T.C. 753 (1971).) On the other hand, it has been repeatedly held that, if repayment of the borrowed funds is contingent on some uncertain future event, the payment of the expense will not be recognized for tax purposes and the expense itself is not deductible until the debt is actually paid. (See Saviano v. Commissioner, 80 T.C. 955, 961-962 (1983), and cases cited therein; Chamberlain v. Commissioner, ¶ 87,020 (P-H) T.C.M. (1987).)

Moreover, it is well settled that a cash basis taxpayer may not deduct an expense that he paid with a promissory note until the note is satisfied. (Helvering v. Price, supra; Eckert v. Burnet, 283 U.S. 140 [75 L.Ed. 911] (1931).) The rationale for this rule is that the note may never be paid, and if it is never paid, the taxpayer will have given up nothing except his promise to pay. (Williams v. Commissioner, 429 U.S. 569 [51 L.Ed. 2d 481 (1977).)

In Graf v. Commissioner, supra, the United States Tax Court was faced with a situation similar to the present appeal; that is, a cash basis taxpayer had invested in the same Panamanian dredging tax shelter promoted by IME and attempted to deduct amounts paid to the dredging subcontractor which were allegedly borrowed from IME. Like appellants, the taxpayer in Graf had executed a promissory note to IME that was payable only out of one-half the profits from the sale of oceanfront properties created by the dredging operation. In support of his expense deductions, the taxpayer contended that the amounts advanced by IME for dredging services were "loans" from which they made the requisite cash payment. The court disagreed, finding the obligation to repay IME too contigent to constitute a bona fide loan:

> [T]he loan herein is utterly and inherently so contingent and speculative that its repayment cannot be predicted with any'degree of accuracy. Payable solely out of profits, it is wholly contingent upon the success or failure of the foreign dredging operation. Thus, not only do oceanfront lots first have to be produced, but those lots have to be sold at a profit before any payments on the loan are required. And then, only 50 percent of those profits are subject to payment on the note. Given the terms of this agreement and given the clearly abusive tax shelter out of which this case arises, we find petitioner's obligation is so contingent

that it cannot be treated as a loan for tax purposes

(Graf v. Commissioner, supra, 80 T.C. at 948.)

Since the taxpayer had funded his dredging expenditures with a wholly contingent obligation, the court adjudged that he had not made a recognizable payment for tax purposes. The court indicated that the situation in Graf was distinguishable from those cases that had allowed deductions for expenses paid with borrowed money, noting that the taxpayers in each of those cases were personally liable for the debt, repayment was not contingent, and there was little doubt the debt would be repaid. In Graf, the court observed that the taxpayer's obligation to repay IME was entirely contingent on future profits and he would incur no liability in the absence of any profits. The court thus expressed doubt that the IME debt would ever be paid off. Having found the taxpayers' obligation to IME too contingent to support their contention that they had made a cash payment of the dredging expense, the court held that, "[T]his case is governed by the fundamental principle 'of taxation that payment of an expense by.note does not give rise to a deduction by a cash basis taxpayer." (Graf v. Commissioner, supra, 80 T.C. at 953.) The court concluded that no ded ction would be allowed for the amount of the taxpayer's note.2/

In the present matter, the Franchise Tax Board ultimately determined that the facts and tax shelter program described in Graf were identical to those in appellants' case and disallowede current deduction of appellants' dredging expense to the extent of their $24,000 note based on the holding in Graf that said indebtedness to IME under this particular tax shelter was too contingent to constitute a valid obligation. Respondent's determinations with regard to the disallowance of the deduction and imposition of tax are presumptively correct, and the taxpayer has the burden of showing error in those determipations. (Appeal of K. L. Durham, Cal. St. Bd. of Equal., Mar. 4, 1980.)

In the present matter, appellants have attempted to distinguish the dredging tax shelter in which they invested

2/ The issue of whether or not the taxpayers were entitled to a deduction for the amount of their out-of-pocket expense to the dredging subcontractor was not addressed in the Graf decision since the case was brought before the United States Tax Court on the motion of the Commissioner of Internal Revenue for partial summary judgment and the only issue raised therein concerned the deduction for the amount of the note.

from that in the Graf case, arguing that the taxpayer's note in Graf was payable from the "profits" generated from the sale of theoceanfront lots whereas their note was payable from the "gross proceeds" of such sales. In the alternative, appellants have contended that their obligation to IME was not contingent since there was a high probability that the oceanfront properties would be-sold and payments made toward their note. Appellants take the position that the taxpayer in Graf simply failed to make a sufficient factual showing that payment on the note was. probable. We are not convinced. Our analysis of the record in this appeal, which includes copies of the promotional materials and documents executed by appellants, clearly indicates that appellants entered into the same IME tax shelter described in Graf. As such, we find that appellants have failed not only to show it was erroneous for respondent to have relied on said federal precedent to disallow that portion of their expense deduction funded by a promissory note but also to demonstrate that their note to IME was not in fact a contingent obligation.

Finally, appellants have also made the argument that respondent failed to set forth the reasons for disallowance of their construction services expense in its notice of proposed assessment and therefore violated section 18584. Appellants. contend that the assessment must be barred since respondent did not provide them with the reasons for its disallowance within the four years statute of limitations period prescribed by section 18586 for issuance of a deficiency assessment. Appellants complain that the notice of action in which the Graf decision is cited was not issued until after this four-year period had expired and that they were therefore prejudiced by respondent's delay from adequately presenting their appeal. Appellants' argument is meritless. In Appeal of Avis J. Luer, decided on June 3, 1975, this boa'rd stated that the purpose of section 18584 is to inform the taxpayer of the basis of an assessment so that he can protest intelligently if he desires to do so. In the absence of a showing that a taxpayer was deprived of the opportunity to file an effective protest, we held that an alleged defect in 'a notice of proposed assessment 'would not invalidate the notice. Appellants have not made this showing. In fact, the number of briefs filed by appellants show that they had ample opportunity in these proceedings to show entitlement to the full amount of their claimed deduction.[3] Respondent's action will be sustained;

[3] Appellants have made other arguments which we have considered and rejected. For example, appellants complain that the imposition of interest is unfair since it took four years for respondent to formally act upon their protest. However, it is well settled that interest, imposition of which is mandatory on an unpaid deficiency under section 18688, is not considered a penalty but compensation for the taxpayer's use of the money during the period of underpayment. (Appeal of Patrick J. and Brenda L. Barrington, Cal. St. Bd. of Equal., Jan. 11, 1978.) Even if respondent had caused a delay which may have been unduly long, it would not be precluded from assessing interest; besides, a taxpayer can stop interest from accruing by paying the tax assessed without jeopardy any right to a refund. (Appeal of Ronald J. and Eileen Bachrach, Cal. St. Bd. of Equal., Feb. 6, 1980.)

Appeal of Harry and Eleanor H. Gonick

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 Harry and Eleanor H. Gonick against a proposed assessment of additional personal income tax in the amount of $4,807.73 for the year 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of May 1988, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Carpenter and Mr. Collis present.

Ernest J. Dronenburg, Jr., Chairman

Paul Carpenter, Member

Conway H. Collis, Member

______, 'Member

______, Member