



89-SBE-031

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CARMEL MORTGAGE CORPORATION) No. 88R-0276-RO

Appearances:

For Appellant: S. Richard Whitworth
President

For Respondent: Michael R. Kelley
Counsel

O P I N I O N

This appeal is made pursuant to section 26075, subdivision (a), 1 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Carmel Mortgage Corporation for refund of franchise tax in the amount of \$1,933 for the income year ended March 31, 1986.

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

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The issue presented for our decision is whether appellant, Carmel Mortgage Corporation, was a "new" small business for purposes of being entitled to take a net operating loss deduction for the appeal year.

S. Richard Whitworth (Whitworth) is the sole shareholder and president of appellant, a California corporation. In 1980, Whitworth and a partner began a mortgage brokerage business. In 1982, he bought out his partner and conducted the business as a sole proprietorship. However, he subsequently decided to conduct the business as a corporation. Consequently, in March 1983, appellant was incorporated, and Whitworth contributed, in a tax-free exchange, all of the assets from his brokerage business to it.

For appellant's second income year ended March 31, 1985, it reported a net loss of \$20,136. But in the following income year, it reported a net income of \$70,078. Pursuant to section 24416, it later sought to carry forward the reported loss for its income year ended in 1985 to 1986, by filing an amended tax return and requesting a tax refund. Respondent Franchise Tax Board denied appellant's refund claim, because the loss was not incurred within the first 24 months of appellant's active operation. Appellant then filed this timely appeal.

Deductions are narrowly construed and the taxpayer bears the burden of proving entitlement. (Lettie Pate Whitehead Foundation, Inc. v. United States, 606 F.2d 534, 539 (5th Cir. 1979).) Furthermore, the taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms. (New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 [78 L.Ed. 13481 (1934).]) When applying these rules to this case, we find that appellant has not proved its entitlement to the loss deduction it claimed.

Section 24416 provides for a net operating loss deduction to a "qualified taxpayer" as defined in section 24417. According to section 24417, subdivision (a), a "qualified taxpayer" includes a taxpayer engaged in a new small business. The statute provides that a qualified taxpayer can then deduct net operating losses occurring within the first 24 months of active operation of the small business. (Rev. & Tax. Code, § 24417, subd. (a)(1)(B).) Appellant contends that it fits under this provision because the net operating losses it deducted occurred within the first 24 months of its active operation as a corporation.

Respondent contends that appellant is not a "new" small business, because it was conducting a mortgage brokerage

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operation since 1980, and appellant merely changed its form of doing business. For the reasons set forth below, we agree with respondent.

Section 24417 uses the phrase "a taxpayer engaged in a new small business." The question raised here is whether the term 'taxpayer', as used in the provision, also refers to an entity that was previously engaged in the same small business activity in a different form. Under appellant's statutory interpretation, it never engaged in any business activity as a corporation until it came into existence. Under respondent's interpretation of the statute, appellant was engaged in the same business activity as far back as 1980, when it was operating as a partnership.

It is a well established rule that "where the language of a statute is reasonably susceptible of two constructions, one of which in application will render it reasonable, fair and harmonious with its manifest purpose, and another which would be productive of absurd consequences, the former construction will be adopted." (City of L.A. v. Pacific Tel. & Tel. Co., 164 Cal.App.2d 253, 256-257 [330 P.2d 8881 (1958).]) The predecessor statute to section 24417 was section 24343.9, which was intended "[t]o create a more favorable environment for small business in California and, in particular, to encourage the development of new small business ... [by allowing] the carryover of net operating losses incurred by a new small business in the first two years of operation." (Stats. 1983, ch. 959, §1.) In this instance, accepting appellant's interpretation of section 24417 would lead to a construction which would defeat the general purpose and policy behind it. It would allow already existing businesses to unfairly take advantage of the provisions providing for net operating loss deductions by merely changing their business form. Such a construction would not effectuate the purpose of the law. (See California Toll Bridge Authority v. Kuchel, 40 Cal.2d 43, 53 [251 P.2d 4](1952).) Therefore, in this instance, appellant is not a 'qualified taxpayer' for purposes of sections 24416 and 24417.

Accordingly, in view of the foregoing, the action of respondent on the claim for refund of Carmel Mortgage Corporation is sustained.

