

STATE OF CALIFORNIA
BOARD OF EQUALIZATION

110.0025

In the Matter of the Petition)	
for Redetermination Under the)	DECISION AND RECOMMENDATION
Sales and Use Tax Law)	OF HEARING OFFICER
)	
J. C. M---)	Account No. SR --- XX XXXXXX
Dba The B--- M--- S---)	
)	
<u>Petitioner</u>)	

This matter was heard on Friday, May 3, 1974, at 2:00 p.m. in Sacramento, California.

Appearing for Petitioner were Mr. M--- J. P---, CPA, Mr. J. C. M---, and Mr. J--- C---.

Appearing for the Board were Mr. Robert Vogt and Mr. Charles Brown.

Protested Item

Pursuant to an audit for the period 7/1/69 to 12/31/71 and a determination issued on 1/29/73, Petitioner protests used tax liability measured by \$278,280. The measure of tax on the total audited liability was \$280,780; however, the difference was not protested.

Petitioner protests Item B, identified in the audit report as "Breeding stock purchased ex-tax and not reported."

Contentions of Petitioner

(1) Breeding stock (horses) should not be subject to use tax until the owner subjectively decides not to hold them for resale but to retain them as part of his permanent breeding stock.

(2) Alternatively, the depreciation of breeding stock for income tax purposes should not give rise to a use tax; a two-year waiting or holder period should apply to all horses to allow the owner a reasonable time to determine the suitability of horses as breeding stock.

(3) The purchases made in the first three quarters of 1969 are barred by the statute of limitations.

Summary of Petition

Petitioner is engaged in the business of purchasing, selling, breeding, and racing registered quarter horses. Since a seller's permit was issued in July 1969, acquisition of horses for breeding and for resale has proceeded at a fast rate with approximately 80 horses on hand by late 1972.

Petitioner purchased the horses here in issue on resale certificates or from out-of-state retailers without the payment of sales or use tax. The Board's auditor arrived at the \$278,280 measure of use tax by totaling the cost of those horses which Petitioner had recorded as capital assets rather than inventory items and on which Petitioner had claimed depreciation for federal income tax purposes.

During the audit discussions, Petitioner agreed that \$221,245 of the \$278,280 represented the cost of horses which Petitioner had subjectively decided to retain as permanent breeding stock; therefore, even under the most liberal of Petitioner's contentions, the \$221,245 is subject to use tax. The remainder of the measure of use tax continues to be protested.

Analysis and Conclusions

(1) Petitioner's contention that use tax should not apply until the owner subjectively decides to keep the horses as permanent breeding stock must be rejected. Tax determinations must turn on the law as applied to objective fact, not states of mind. For a taxation agency to attempt to administer a tax program on the basis of the subjective intent of taxpayers would lead to chaos.

(2) Petitioner depreciated all of the horses in question for federal income tax purposes. On acquisition by Petitioner, the horses were recorded as capital assets. This procedure has two economic benefits. The lesser of the two is the depreciation expense charged against income. The more important benefit is that, if the horses are held more than two years, the income from their sale may be treated as long-term capital gain for income tax purposes. To convince IRS of the validity of this procedure, it becomes necessary to capitalize and depreciate a horse upon acquisition.

This issue was before the Board in 1973. In the petition for redetermination of D--- H. P---, SS --- XX XXXXXX, the issue, as stated in the summary prepared by the Board, was whether depreciating property for income tax purposes constitutes a taxable use thereof. The Board's staff analysis was that the depreciation of property is a use inconsistent with demonstration and display while holding it for sale in the regular course of business; the taxpayer obtained an economic benefit of the horses as capital assets rather than inventory items. The staff analysis was upheld by the Board which decided that, unless the taxpayer amended his income tax returns so as to undo the economic benefit he had received, the use tax applied.

This same question is one of the issues presently pending before the Los Angeles Superior Court, No. C64517, in an action brought by B--- K. M--- and M. L--- M--- (SR -- XX XXXXXX) against the Board. The Board's position in the case is that the holding of horses as capital assets is inconsistent with the contention that the horses were purchased solely for the purpose of resale in the regular course of business.

In light of these Board precedents, the decision here must be that Petitioner's capitalization and depreciation of the horses constitutes a use subject to use tax.

(3) We agree that when the determination was issued on 1/29/73 the period 1/1/69 to 9/30/69 was barred by the statute of limitations provided in Section 6487. The first evidence of a taxable use was the setting up of the horses as capital assets on Petitioner's books. This evidence raised a presumption that use tax applied and the statute of limitations began to run as of the quarter in which the horse were set up as a capital asset and used in California. Until the capitalization of the horses, any use may have been ambiguous; that is, it could be either use as permanent breeding stock or use for demonstration and display prior to resale. But once there was physical use combined with book entry as a capital asset, a taxable use had to be presumed.

Therefore, the purchase price of any horses purchased, used in California, and capitalized during the period 1/1/69 to 9/30/69 must be deleted from the measure of tax.

Recommendation

Redetermine after district office adjusts the measure of tax by deleting those transactions barred by statute of limitations.

Donald J. Hennessy, Hearing Officer

7/1/74

Date

REVIEWED FOR AUDIT:

Principal Tax Auditor

7/3/74

Date