69-SBE-013

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
PARK-CITRON AGENCY, TAXPAYER,)
ARTHUR L. PARK, JR. AND HERMAN CITRON,)
ASSUMERS AND/OR TRANSFEREES)

Appearances:

For Appellants: Helen A. Buckley and
Michael C. Agran
Attorneys at Law

For Respondent: Gary Paul Kane
Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Park-Citron Agency, Taxpayer, Arthur L. Park, Jr. and Herman Citron, Assumers and/or Transferees against proposed assessments of additional franchise tax in the amounts of $4,732.54, $655.93, $4,732.54 and $655.93 for the taxable years ended July 31, 1963, 1963, 1964 and 1964, respectively.

Park-Citron Agency (for convenience hereafter referred to as appellant) was created on July 20, 1962, in order to acquire some of the performer-clients of Music Corporation of America's theatrical talent agency business. Music Corporation of America (hereafter referred to as M.C.A.) had been forced out of this type of business by federal anti-trust action. Appellant's principal shareholders, Arthur L. Park, Jr. and Herman Citron, were former employees of M.C.A. and while employed by that corporation had represented the performers who subsequently became clients of appellant.

A disagreement arose between M.C.A. and appellant concerning which of these agencies was entitled to commissions from contracts for clients' services which had been negotiated by M.C.A. prior to the acquisition of the clients by appellant. Both agencies claimed the entire amount of these commissions. Appellant states that a temporary agreement was entered into by M.C.A., the performers, and appellant, which allowed the latter to collect and hold the commissions pending the outcome of further negotiations. The commissions, totaling $51,843.05, were recorded as liabilities on appellant's books, and were put into its clients' trust bank account. This account was used for the temporary deposit of performers* earnings which, according to industry practice, were usually paid to the performers' agents. Appellant would transfer the earnings to the performers after it had deducted its 10 percent commissions, which were left in the clients' trust bank account until needed to pay current operating expenses.

On July 8, 1963, appellant entered into an agreement with Sinton & Brown Co. (hereafter referred to as Sinton) for the acquisition and feeding of cattle. Sinton agreed to finance 100 percent of the purchase price of the cattle in return for appellant's note, a chattel mortgage, and 6 percent annual prepaid interest. Also, Sinton agreed to feed and care for the cattle until they were marketed. Appellant agreed to prepay the feed and care cost, which was subsequently estimated by a cattle raising expert.

Pursuant to the above agreement, during July of 1963 appellant purchased 844 head of cattle from Sinton for $97,255.45. Commissions and fees totaling $940.08 were paid and interest of $3,469.30 was prepaid. In order to make the feed and care prepayment of $108,626.89 appellant found it necessary to transfer to its general expense bank account all of the commissions in its clients' trust bank account, including those it was holding under the agreement with M.C.A. and the performers. Some or all of the commissions appellant was holding under this agreement were paid to Sinton. The cattle were marketed approximately 6 months after their purchase, and on July 29, 1964, appellant was dissolved.

Appellant used the case basis method of accounting. Under the commencing corporation provisions of the Bank and Corporation Tax Law, appellant's franchise tax liabilities for the two full taxable years it operated, i.e., taxable years ended July 31, 1963, and 1964, were measured by the net income earned in the income year dating from August 1, 1962, through July 31, 1963. In computing-this net income appellant did not include as income the $51,843.05 of commissions which it held under the agreement with M.C.A. and the performers. Appellant based this exclusion on the fact that a final agreement concerning these commissions, was not reached until March of 1964, approximately 8 months after the end of the income year. At that-time the commissions were divided between M.C.A. and appellant in the amounts of $29,000 and $22,843.05, respectively. Also, appellant deducted as business expenses the cost of the cattle, the commissions and fees related to the purchase, the prepaid interest, and the total amount for feed and care.

Respondent determined that appellant had held the commissions under a claim of right and therefore the entire amount should have been reported as income in the above net income computation. After subsequent negotiations respondent reduced the inclusion to $22,843.05, the amount which appellant retained after its final agreement with M.C.A. Whether this application of the claim of right doctrine was correct is the first issue of this case. Initially respondent also disallowed the deduction of $101,110.19 of the $108,626.89 feed and care payment on the ground that it was not an ordinary and necessary business expense under section 24343 of the Revenue and Taxation Code. The $7,516.70 difference between these two amounts which was allowed as a deduction was the cost of feed and care provided before July 31, 1963. Subsequently, respondent determined that all of the expense deductions incurred in purchasing and raising the cattle should be disallowed under sections 24421 and 24425 of the Revenue and Taxation Code because they were allocable to income which had not been included in the measure of the bank and corporation tax, However, the $97,255.45 cost of the cattle was inadvertently omitted from the deficiency assessments, and the subsequent running of the statute of limitations prevented disallowance of the deduction of this item. Whether respondent's actions with respect to the cattle raising expenses were correct is the second issue of this case.

'With respect to the first issue, it is well established that if a taxpayer receives funds under a claim of right, without restriction as to their disposition, such funds are reportable as income in the year of receipt, even though at the time of receipt the taxpayer's right to retain the funds is subject to dispute and even though in a later year he may be found obligated to repay all or a portion of the amount received. (North American Oil Consolidated v. Burnet, 286 U.S. 417 [76 L. Ed. 1197]; United States v. Lewis, 340 U.S. 590 [95 L. Ed. 560].)

In the instant situation appellant contends that it was not holding the commissions under a claim of right but rather was holding them in a capacity similar to that of a trustee, under an agreement with M.C.A. and the performers. However, we do not think that this contention can be sustained in view of the fact that during the income year in question appellant did not have on hand sufficient assets to finance its cattle raising venture and consequently used some or all of the $51,843.05 in commissions for this purpose. Appellant's use of these funds for its own purposes is inconsistent with the action of a trustee or fiduciary. (See Angelus Funeral Home, 47 T.C. 391, 396; P. F. Scheidelman & Sons, Inc., T.C. Memo., Feb. 17, 1965; Sara R. Preston, 35 B.T.A. 312, 321; Clay Sewer Pipe Ass'n v. Commissioner, 139 F.2d 130, 133.)

In Estate of Jacob M. Eisenberg, T.C. Memo., June 27, 1947, the primary case relied upon by appellant, the Tax Court pointed out that the adverse claimant was one of the estate's executors and therefore could prevent it from using the disputed funds for its own purposes. The court also analogized the agreement in that situation to the establishment of an escrow, which implies that the estate did not have use of the funds. In Seven-Up Co., 14 T.C. 965, also relied upon by appellant, the taxpayer "had on hand at all times cash and securities in excess of the amount of unexpended funds." (See P. F. Scheidelman & Sons, Inc., supra.) The fact situation in Max E. Cohen, T.C. Memo., May 21, 1965, the last case cited by appellant, is not analogous to the instant situation. There, the taxpayer had not performed the services necessary to entitle him to the advanced funds.

We must conclude that appellant held the $22,843.05 of commissions under a claim of right, without restriction as to their disposition, and consequently these funds should have been reported as income in the income year ended July 13, 1963.

The second issue of this case is concerned with respondent's disallowance of the deduction of appellant's cattle business expenses. Section 24421 provides "no deduction shall be allowed for the items specified in this article," One of these items is specified in section 24425 as:

> Any amount otherwise allowable as a deduction which is allocable to one or more classes of income not included in the measure of the tax imposed by this part, regardless of whether such income was received or accrued during the income year.

Regulation 24201d, title 18, California Administrative Code, applicable to section 24425, provides in part:

> As used in this regulation, the term "class of excludable income" means any class of income Including Interest (whether or not any amount of income of that class or classes is received or accrued), not included in the measure of the tax, such as any item or class of income constitutionally exempt from the taxes imposed by the law; any item or class excluded from gross income under any provision of Chapter 5; and any item or class of income not included in the measure of taxes imposed by law.
>
> The object of Section 24201d is to segregate the excludable income from the includible income, in order that a double exemption may not be obtained through the reduction of includible income by expense3 and other item3 incurred in the production of items of income wholly excludable.

The bank and corporation franchise tax is measured by a corporation's net income for the next preceding income year, and consequently none of the income earned by a corporation during its last taxable year of operation is included in the measure of the tax. In the instant situation appellant's Cattle raising expenses were allocable to the income which was realized upon the sale of the cattle during appellant's last taxable year of operation. Therefore this income was never Included in the measure of franchise tax and under the plain meaning of sections 24421 and 24425 the expenses cannot be, deducted.

Appellant contends that section 24425 was intended to apply only to deductions allocable to classes of income which are specifically exempted from the franchise tax, and not to classes of income which are not included in the measure of the tax because they are outside of its scope. In addition, appellant argues that the income of a corporation's first full year of operation is used twice as the measure of franchise tax and in order to adequately compensate for this it is necessary to exclude the corporation's last year's income and allow the deduction3 allocable to that income. Appellant also states that disallowance of these deductions conflict3 with section 24681 of the Revenue and Taxation Code which provides that a deduction shall be taken for the income year which is the proper income year under the method of accounting used in computing income.

We cannot agree with the above contentions. Section 24425 has been applied to situations where the income was not included in the measure of the tax because it had its source outside of California. (See Appeal of Signal International, Cal. St. Bd. of Equal., Jan. 4, 1966; Appeal of Great Northern Railway Co., Cal. St. Bd. of Equal., June 14, 1943.) Such income was outside the scope of the tax, rather than being specifically exempted from it. Although the income of a corporation's first full year is used twice as the measure of franchise tax, in order to put the taxpayer on a prepaid basis, the deductions allocable to this income are also allowed twice. This double allowance, combined with the exclusion of the last year's income from the measure of the tax, provides the best approximate compensation for the double inclusion of the first full year's income. An additional allowance of the deductions allocable to the last year's income would only give the franchise taxpayer an arbitrary benefit, rather than aid in the above type of compensation. Section 24681's provision for the proper year for the taking of deductions is limited'in the specific situation defined by section 24425. This limitation is the same in the instant situation as it is in the case where the income is specifically exempted, the latter situation being one conceded by appellant to be appropriate for the disallowance of deductions.

We must conclude that respondent's determination that appellant's cattle raising expenses were not deductible was correct under sections 24421 and 24425 of the Revenue and Taxation Code. In view of this holding it is not necessary to consider respondent's alternative contention that $101,110.19 of appellant's feed and care prepayment was not an ordinary and necessary business expense.

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, Appeals of Park-Citron Agency, Taxpayer, etc.

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Park-Citron Agency, Taxpayer, Arthur L. Park, Jr. and Herman Citron, Assumers and/or Transferees, against proposed assessments of additional franchise tax in the amounts of $4,732.54, $655.93, $4,732.54 and $655.93 for the taxable years ended July 31, 1963, 1963, 1964 and 1964, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of February, 1969, by the State Board of Equalization.

John W. Lynch, Chairman

Paul R. Leake, Member

Richard Nevins, Member

____________________, Member

____________________, Member

Attest: W. W. Dunn, Secretary