BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
JENKEL-DAVIDSON OPTICAL COMPANY)

Appearances:

For Appellants: Richard Harrington
Attorney at Law

For Respondent: Brian W. Toman
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Jenkel-Davidson Optical Company against proposed assessments of additional franchise tax in the amounts of $6,945.05, $22,726.13 and $23,684.05 for the income years 1970, 1971 and 1972, respectively.

Appeal of Jenkel-Davidson Optical Company

This appeal presents two issues: first, whether a claimed deduction for ordinary and necessary business expenses consisting of an allocated share of a parent corporation's overhead must be justified by proof that specific services were actually rendered; and second, whether respondent's assessments against appellant, to the extent the assessments included the proposed liability of two other corporations, each of whom are subsidiaries in the same corporate group as appellant, were barred by the statute of limitations.

Appellant is a California corporation whose principal business activity is dispensing glasses and contact lenses solely within California. In 1970, the House of Vision, Inc. of Chicago, Illinois (House) acquired all of appellant's stock. During the appeal years, House had two other subsidiaries operating within California, H.O.V. Optical Co., Inc. (HOV) and Robinson-Houchin, Inc. (RH). Through these and other subsidiaries House did business in more than ten states.

For the appeal years, appellant and HOV filed franchise tax returns computing their California income by the separate accounting method. RH did not file California franchise tax returns for the years in issue. Respondent determined that the entire corporate group was conducting a unitary business and recomputed the 'California source income of appellant, HOV and RH using the standard three-factor apportionment formula. Respondent also questioned the propriety of the deduction by the subsidiaries of a pro rata share of the parent's overhead expenses as fees for management services. However, no adjustment was proposed at this time because the payments were treated as intercompany eliminations on the combined report and had no tax effect. Based upon its determination, on May 17, 1974, respondent issued notices of proposed assessment for each of the appeal years. Although separate assessments for each appeal year were proposed against appellant, HOV and RH, only a single notice for each year including the total assessments against the three corporations was issued to appellant pursuant to a written consent signed by appellant.

Appellant protested on the grounds that it was not part of the unitary group. The inclusion of HOV and RH was not challenged. As a result of the protest, respondent determined that appellant was not part of the unitary group consisting of House, HOV, RH and certain other subsidiaries. The reason for appellant's exclusion from the combined group was respondent's determination that for the appeal years appellant's operations were autonomous in that its president exercised total control over major policy decisions as well as the day-to-day operations, and that appellant's staff functions were independent of its parent.

Consequently, respondent recomputed the California source income of HOV and RH by formula apportionment excluding appellant's income and factors. Respondent also recomputed appellant's California income by the separate accounting method. However, since appellant's operational independence was now established and the fees for management services were no longer eliminated in the combined report computation, respondent called upon appellant to substantiate the deductibility of those expenses. Respondent did not dispute the fact that $279,600 and $276,000 had been paid in 1971 and 1972, respectively. Respondent, however, did question whether the amounts bore any reasonable relation to services rendered by House on behalf of appellant, or whether the payments were merely nondeductible disguised dividends. The only substantiation submitted for these deductions concerned auditing services rendered on behalf of appellant which were paid for by House in the amounts of $33,850 and $21,000 in 1971 and 1972, respectively. Accordingly, after taking these amounts into account, respondent disallowed the deduction for management services in the amount of $245,750 for 1971 and $255,000 for 1972.

On March 14, 1978, a single notice of action for each of the appeal years was issued to appellant reflecting the recomputation of its income by the separate accounting method and the denial of the deduction for management services claimed for 1971 and 1972. The notice of action also reflected the recomputed tax liability for HOV and RH for all of the appeal years. The net effect of the notices of action was to reduce the total assessments as reflected in the notices of proposed assessment for each appeal year.

Appellant challenges respondent's action on two grounds. First, appellant contends that the deduction for management services is proper because it is acceptable accounting practice for a corporate parent to allocate its corporate overhead expense to its subsidiaries on the basis of the subsidiaries pro rata share of the total sales of the corporate group.

Respondent, on the other hand, argues that the fees are not deductible unless appellant can establish that they are reasonable in-relation to services which were actually rendered. Appellant's second argument is that the assessments involving HOV and RH are barred by the statute of limitations. Respondent contends that the statute of limitations is no bar to the assessments.

We first consider the deductibility of the fees for management services.

Section 24343 of the Revenue and Taxation Code, which is substantially the same as its federal counterpart section 162 of the Internal Revenue Code, permits the deduction of all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. It is well settled, however, that all deductions are a matter of legislative grace and the burden of proving the right to any deduction is on the taxpayer. (See, e.g., New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934).)

In attempting to carry its burden of proof appellant maintains that the amounts deducted as fees for management services were computed by its parent and were equal to the total corporate overhead expense of the parent times the ratio of appellant's total sales to the total sales of the entire corporate group. Appellant contends that this method of allocation is an acceptable accounting practice; therefore, the mere payment is sufficient to entitle appellant to the claimed deduction without showing that an actual benefit was received. We disagree.

Although there is no question that under certain circumstances acceptable accounting practice requires the use of allocation methods, this fact alone does not entitle appellant to deduct as ordinary and necessary business expenses the amounts it paid. An expenditure is not deductible under section 24343 of the Revenue and Taxation Code where there is no corresponding benefit received by the taxpayer as the result of the expenditure. (See Interstate Transit Lines v. Commissioner, 319 U.S. 590, 594 [87 L.Ed. 1607] (1943); East St. Louis Finance Co., Inc., 34 B.T.A. 1085 (1936).) A subsidiary corporation may not deduct as ordinary and necessary business expenses amounts paid to cover the operating costs of its parent unless the payment is directly attributable to a corresponding benefit or service rendered to the subsidiary by the parent in connection with the subsidiary's business. (Cf. Appeal of Cioco Union Store's, Inc., Cal. St. Bd. of Equal., Oct. 6, 1976.) An expenditure made for personal services which have been authorized but not performed is not an ordinary and necessary expense of doing business. (Appeal of West Mayfair Company, Cal. St. Bd. of Equal., Nov. 27, 1956.)

Other than the audit fees which were allowed as a deduction, appellant has been unable to point to any services or other benefit rendered to it by its parent during the appeal years. Since appellant has failed to establish that the payment of the fees for management services was dependent upon the receipt of a corresponding benefit from its parent, the expenses are not deductible under section 24343 of the Revenue and Taxation Code.

The final issue concerns the statute of limitations.

As we have indicated, respondent originally determined that appellant was part of a unitary group with its parent, HOV, RH and certain other subsidiary corporations. As a result of this determination, on May 17, 1974, respondent issued timely notices of proposed assessment for each of the appeal years. Although separate assessments were proposed against appellant, HOV and RH for each year, only a single notice for each year reflecting the total assessments against the three corporations was issued to appellant pursuant to a written consent signed by appellant prior to the issuance of the notices. The propriety of issuing a single notice of proposed assessment for each year has been approved by the courts. (See John Deere Co. v. Franchise Tax Board, 237 Cal.App.2d 663 [47 Cal.Rptr. 2891 (1965).) In John Deere the procedure was approved even in the absence of the taxpayer's written consent, the court holding that consent was to be inferred by the taxpayer's lack of objection to the procedure for more than 27 months. (John Deere Co. v. Franchise Tax Board, supra, at 665.)

Respondent's original determination that appellant was part of the unitary group was successfully protested by appellant. As a result of appellant's successful protest, it was necessary for respondent to modify its original determination. This modification was reflected in the notices of action dated March 14, 1978. It is these notices of action which appellant challenges as untimely "new" assessments issued after the running of the statute of limitations.

The problem with appellant's argument is that the so-called new assessments which appellant complains of as being untimely were not new assessments at all. Rather, they were merely respondent's notices of action in which the original timely assessments were revised. Where notices of proposed assessment were issued within the statutory period, the fact that notices of action were not issued within the four-year period is irrelevant. (Cf. Appeal of King and Dorothy Crosno, Cal. St. Bd. of Equal., Jan. 9, 1979.)

As a result of appellant's successful protest in which it was concluded that appellant was not part of the unitary business, it was necessary to revise the original assessments to reflect this determination as well as the disallowance of the deduction claimed for management services fees. The resulting revised determination was reflected in the notices of action issued March 14, 1978, which resulted in reducing the original proposed assessments. Respondent's subsequent determination to remove appellant from the original combined group does not render appellant's original voluntary consent agreement ineffective in light of appellant's lack of objection to the single issuance procedure for more than three years. (Cf. John Deere co. v. Franchise Tax Board, supra.) Accordingly, we must conclude that respondent's assessments for the appeal years were timely and are not barred by the statute of limitations.

For the reasons discussed above, it is our determination that respondent's action must be sustained.

Appeal of Jenkel-Davidson
Optical Company

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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Jenkel-Davidson Optical Company against proposed assessments of additional franchise tax in the amounts of $6,945.05, $22,726.13 and $23,684.05 for the income years 1970, 1971 and 1972, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of May, 1981, by the State Board of Equalization, with all Board members present.

Ernest J. Dronenburg, Jr., Chairman

George R. Reilly, Member

William M. Bennett, Member

Richard Nevins, Member

Kenneth Cory, Member