BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
) No. 84R-1138-MA
CALLANDER, HARRINGTON AND )
BOST, A MEDICAL CORPORATION )

For Appellant: Stephen J. Schwartz
Attorney at Law

For Respondent: Lorrie K. Inagaki
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 Callander, Harrington and Bost, A Medical Corporation, for refund of franchise tax in the amount of $1,475 for the income year ended March 31, 1978.

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

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The issue to be decided in this appeal is whether a particular payment made by appellant to an insurance company was properly deductible as an expense or whether that amount represented a nondeductible capital expenditure.

Appellant is a California medical corporation incorporated in 1977. In the income year ended March 31, 1978, appellant made payments to the Doctors' Company (Doctors), an interinsurance exchange, for the purpose of obtaining medical malpractice insurance. In the year at issue, Doctors required appellant to pay $17,220 as a contribution to surplus in addition to an amount designated as a premium payment. The contribution to surplus was designed to provide a safeguard in case of extraordinary claims or unexpectedly high expenses. Doctors, as an interinsurance exchange, is permitted to raise surplus by borrowing from its members in this manner.

The surplus contribution is evidenced by a Certificate of Contribution. In the appeal year, the contributed-surplus required for the'first year of insurance was equal to the insured's annual premium, which was established according to an industry rating formula dependent on the insured's particular medical specialty. Contributed surplus was significantly decreased for the second year of insurance. At that time, no contributed surplus was required after the second year of coverage except in special circumstances. Although there is no obligation to pay interest on the surplus account, interest was being paid annually at the rate of 6 percent in 1978. Further, the surplus amount was invested and dividends were also paid on the surplus. Apart from the annual interest payment and dividends paid, the amount of the contributed surplus which may be returned to the member cannot be increased by the earnings of the insurance company. The Certificate of Contribution is non-negotiable, but may be transferred to another person or holder under certain circumstances. The contributed surplus is considered a loan which is subordinated to other obligations of the insurance company, and repayments may be made out of surplus only after certain levels of surplus have been reached. Although there is no guarantee of repayment, as a result of the financial condition of the insurance company, the Insurance Commissioner authorized the repayment of

contributions under certain circumstances. 2/ The Commissioner also authorized that such repayment of surplus may, at the option of the subscriber, be applied to pay premiums under appropriate circumstances.

Appellant filed a timely return for its income year ended March 31, 1978, and deducted the entire amount of its payments to Doctors as an ordinary and necessary business expense. Respondent issued a notice of proposed assessment against appellant disallowing the entire insurance deduction. After appellant submitted further information, respondent revised its proposed assessment and disallowed only the portion of the insurance payments which was designated as a contribution to surplus. Appellant paid the assessment and filed a claim for refund. Respondent disallowed the claim and this timely appeal followed.

Section 24343 allows a deduction for "ordinary and necessary expenses paid or incurred during the income year in carrying on any trade or business." Section 24422 allows no deduction for capital expenditures. The sections are substantially similar to Internal Revenue Code sections 162, subdivision (a), and 263, subdivision (a). Consequently, the determinations of federal courts construing these statutes are entitled to great weight in interpreting state statutes based on federal statutes. (Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).) In addition, because there are no state regulations interpreting sections 24343 and 24422, we can look to Treasury Regulations to provide interpretation of the state statutes. (Rev. & Tax. Code, § 26422.)

2/ The circumstances are when:

(a) the member has died,

(b) the member is totally and permanently disabled and such disability existed for a period over the last six months following three years of continuous membership,

(c) the member retires from medical practice after attaining the age of 60 after at least 5 years of membership, or

(d) the insurance policy is canceled.

. (Resp. Br., Ex. A.)

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As a general rule, deductible business expenses include insurance premiums against fire, storm, theft, accident or similar losses. (Treas. Reg. 1.162-l(a) (1958).) Payments made as professional liability insurance premiums by a medical service corporation to a physician-owned mutual insurance company are deductible as ordinary and necessary business expenses. (Rev. Rul. 80-120, 1980-l C.B. 41.) There is, however, no authority regarding the treatment of payments required to be made to insurance companies which are designated as contributions to surplus.

Deductible business expenses are primarily those of a recurring nature where the benefit derived from the payment is realized and exhausted within the taxable year. (Stevens v. Commissioner, 388 F.2d 298 (6th Cir. 1968).) If, as a result of the expenditure, the taxpayer acquires an asset which has an economically useful life beyond the taxable year or if it secures a like advantage to the taxpayer which has a life of more than one year, no deduction as a business expense is allowed, and such expenditure is a nondeductible capital outlay. (United States v. Akin, 248 F.2d 742 (10th Cir. 1957).) Whether a particular payment is to be treated as a current business expense or as a capital expenditure turns on whether the payment serves to create or enhance what is essentially a separate and distinct additional asset. If it does, the payment is a capital expenditure and not deductible as a current business expense. (Commissioner v. Lincoln Savings and Loan Asso., 403 U.S. 345 [29 L.Ed.2d 519] (1971); Appeal of Peter L. Crandall, M.D., Inc., Cal. St. Bd. of Equal., Dec. 13, 1983.)

We have previously considered the question-of whether or not payments incurred as contributions to surplus, also termed subordinated loans, are deductible business expenses. The principles set forth in Commissioner v. Lincoln Savings & Loan Asso., supra, and followed by this board in the Appeal of Peter L. Crandall, M.D., Inc., supra, apply equally to the facts presented here. The conclusion reached in both of these decisions is that such expenditures are more readily characterized as an asset rather than an expense and are not deductible. Appellant has presented no compelling reasons for us to deviate from our previous opinion on this issue. As in Crandall, appellant had a distinct and recognized property right in the subordinated loan and as such the expenditures made therefor are not deductible.

Appellant has attempted to distinguish its factual situation from that of the taxpayer in the Appeal of Peter L. Crandall, M.D., Inc., supra, by noting that when appellant terminated the policy in 1980, no refund of the "contribution to surplus" was available and had not been paid as of the date of filing of appellant's brief (Feb. 13, 1985). We recognized that this problem could occur in Crandall and noted at that time that a remedy exists under the provisions of the Revenue and Taxation Code which permit deductions for losses. Moreover, as respondent points out, it has consistently been ruled that an absolute right to the return of surplus is not necessary to the classification of a contribution as such. (See also Commissioner v. Lincoln Savings & Loan Asso., supra.) We see no reason to reach a different conclusion in the instant case,

For the reasons stated above, we conclude that respondent's denial of appellant's claim for refund was proper.

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## 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 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Callander, Harrington and Bost, A Medical Corporation, for refund of franchise tax in the amount of $1,475 for the income year ended March 31, 1978, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of June , 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins , Chairman

Conway H. Collis , Member

William M. Bennett , Member

Ernest J. Dronenburg, Jr. , Member

Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9