BEFORE TRE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No, 79A-438-MW
SIGNAL COMPANIES, INC.)

For Appellant: B. David Freundlich
Vice President - Taxes

Pierre H. Canu
Tax Counsel

For Respondent: Brian W. Toman
Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Signal Companies, Inc., against proposed assessments of additional franchise tax in the amounts of $189,979, $199,583, $165,663, $494,035, and $569,559 for the income years 1963, 1964, 1965, 1966, and 1968, respectively.

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

Appeal of Signal Companies, Inc.

After filing its protest with the Franchise Tax Board, appellant paid a total of $1,386,000 toward the proposed assessments. Some of this total was for amounts not protested. To the extent the amount already paid applies to the issues on appeal, this matter is to be treated as an appeal from the denial of claims for refund pursuant to section 26078.

The sole question remaining in this appeal is whether appellant's basis in the stock of its foreign subsidiary, Space Petroleum (Space), should be increased by the amount of income which the Franchise Tax Board allocated from Space to appellant for the appeal years in accordance with federal action under Internal Revenue Code (IRC) section 482. The Franchise Tax Board has conceded the issue of whether gain on the sale of stock of IPH, Inc., was apportionable business income, and the other issue raised involve income year 1969, a year which is not included in this appeal.

Appellant, formerly Signal Oil and Gas Co. (SOAG), was engaged in a unitary oil and gas business with a number of subsidiaries. Space was one of its foreign subsidiaries from whom SOAG bought oil. The Internal Revenue Service (IRS) determined that, during the appeal years, SOAG paid Space almost $34 million too much for oil, since the price SOAG paid to Space did not reflect world oil costs at that time. Therefore, pursuant to IRC section 482 (the federal counterpart to California's section 24725), the IX treated the amount that SOAG overpaid Space as if it had not been paid. This reallocation reduced Space's taxable income for the appeal years by almost $34 million and caused a corresponding increase in SOAG's income. However, although the income was treated that way for tax purposes, Space never returned the money to SOAG.

The following facts have been stipulated to by the parties:

> For taxable years 1960-1968, the Internal Revenue Service allocated $33,979,083 of income from a wholly-owned foreign subsidiary of Signal Oil and Gas Co. ("SOAG"), Space Petroleum ("Space"), pursuant to section 482 of the Internal Revenue Code of 1954 as amended (the "Code") to SOAG. Similar Section 482 allocations were made to other SOAG domestic and foreign subsidiaries. Space was part of the European Complex that was sold in 1968,

> The Internal Revenue Service properly adjusted SOAG's basis in Space by this.amount.
>
> The California Franchise Tax Auditor similarly allocated $33,979,083 of income from Space to SOAG for 1963-1968. However, the auditor refused to increase SOAG's basis in Space by such amount, and the Franchise Tax Board ("FTB")concurs in this. Section 482 allocation adjustments to all SOAG's domestic and foreign subsidiaries caused an increase in SOAG's California Franchise Taxes fur 1962-1968 in the approximate amount of $300,000 because of a reduction in the dividend deductible, However, as Space paid no dividends to SOAG for 1962-1968, no part of the reduction in the dividend deductible was attributable to Space in particular.

The IRS, when it increased appellant's basis in Space, followed Revenue Procedure 65-31, 1965-2 C.B. 1024. This revenue procedure, in section 2, provides guidelines for computing the offset provided far in Revenue Procedure 64-54, 1964-2 C.B. 1008, which was designed to provide relief from economic double-taxation. "Economic double taxation" as defined in section 3.04 of Revenue Procedure 64-54, supra, is deemed to exist

> if, as a consequence of a section. 482 allocation, the total income tax payable to the United States and another nation by 'the United States controlling taxpayer and its controlled foreign entity is greater than that which would have resulted if the United States controlling taxpayer and its controlled foreign entity had originally treated the transactions giving rise to the section 482 allocation\ in a manner consistent with the section 482 allocation,

Section 4.04(1) of Revenue Procedure 65-31, supra, states that if the taxpayer does not elect to have the amount of income allocated to it paid back to it by the controlled entity from which the income was allocated, that amount will be considered as a contribution to capital made by the taxpayer to the controlled entity. Since Space did not pay back to SOAG the amount of income which was allocated from Space to SOAG, the IRS treated that amount as an additional capital contribution from SOAG to Space,

The Franchise Tax aoard refused to follow the IRS increase in SOAG's basis in Space, although it did follow the allocation of income from Space to SOAG. It states that the basis adjustment of Revenue Procedure 65-31 seeks to prevent the double taxation which occurs at the federal level when the allocated amount is taxed once as income to the domestic parent and again as gain on *the* sale of the foreign subsidiary's stock, The Franchise Tax Board contends that, under state law, Revenue Procedure 65-31 is not applicable. It argues that, because the section 482 allocation did not increase the combined income of the unitary group and did not alter the California taxpayer's apportionment formula, appellant's measure of tax was not increased and, therefore, there was no double taxation to be cured by a basis adjustment to Space's stock.

We believe that the Franchise Tax Board errs both in its characterization of the revenue procedure and in its refusal to adjust appellant's basis in Space. First, the "economic double taxation" which is the focus of the revenue procedure is clearly not concerned with the type of double taxation to which *the* Franchise Tax Board refers. The revenue procedure is concerned with the taxation of the same income by both the United States and a foreign country, not with taxation by the same taxing authority of both ordinary income and capital gain. Secondly, the revenue peocedure's relief from double taxation comes from the offset which it describes in section 2, not from the basis adjustment of section 4.04 of the revenue procedure. The basis adjustment *has* nothing to do with the mitigation of double taxation; it is simply a recognition of the only logical characterization of money received by a corporation from its shareholder that has been determined not to be income. Therefore, the FTB's objections to this revenue procedure are unfounded, and the basis adjustment provided for there ought to be followed. However, even if the revenue procedure did not exist, common sense, consistency, and basic tax and accounting principles would lead to the same result.

The Franchise Tax Board has made no attempt to charact2riz.e the money received by Space but not included in its income. They have simply treated as a nullity almost $34 million which a subsidiary has received without consideration from its parent.. We find this position both baffling and unsupported. Since the Franchise Tax Board has presented us with no alternative characterization of this money, logic and consistency

require that we find it to be a capital contribution from SOAG to Space. (Cf. Howell v. Commissioner, 162 F.2d 316, 318 (5th Cir. 1947).)

The Franchise Tax Board has attempted to make much of the fact that SOAG and Space were engaged in a single unitary business and filed a combined report. We do not believe that the unitary business concept has any effect on the situation before us. "[I]ts function is merely to ascertain the true income of the business attributable to sources within California," (Appeal of Household Finance Corporation, Cal.. St. Bd. of Equal., Nov. 20, 1968.) It has nothing to do with determining the basis of each of the individual corporate entities involved. The Franchise Tax Board could have chosen not to follow the section 482 allocation since, under combined reporting, there would have been no difference in appellant's measure of tax whether or not the allocation was made. However, the Franchise Tax Board did allocate income from Space to SOAG and, having done so, we do not believe that it should be allowed to ignore the logical consequences of its action. Respondent's action, therefore, must be reversed.

Appeal of Signal Companies, Inc.

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 Signal Companies, Inc., against proposed assessments of additional franchise tax in the amounts of $189,979, $199,583, $16.5,663, $494,035, and $569,559 for the income years 1963, 1964, 1965, 1966, and 1967, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 19th day of November, 7986, 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

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	79A-438-MW
Signal Companies, Inc.	)	85A-203-MW

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed December 12, 1986, by the Franchise Tax Board for rehearing of the appeals of Signal Companies, Inc., from the action of the Franchise Tax Board, we are of the opinion that none of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our orders of November 19, 1986, be and the same are hereby affirmed.

Done at Sacramento, California this 28th day of July, 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis, Chairman

William M. Bennett, Member

Paul Carpenter, Member

Anne Baker*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9