BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 84A-432-MCA
YOUNG'S MARKET COMPANY)

Appearances:

For Appellant: Albert R. Rodriguez and
William R. Nicholas
Attorneys at Law

For Respondent: Karl F. Munz
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 Young's Market Company against proposed assessments of additional franchise tax in the amounts of $9,135 and $233,167 for the income years ended February 28, 1979, and February 29, 1980, 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 Young's Market Company

The issues presented in this appeal are: (1) whether appellant's distribution of the Buena Vista (BV) vineyards was a dividend or a return of capital; and (2) whether appellant is entitled to offset its overpayment for income year 1978 against its proposed assessment for income year 1979.

Appellant is a corporation engaged primarily in wholesale liquor distribution in California. Appellant and its wholly owned subsidiary, BV, were members of a single unitary business.

In 1970, appellant purchased BV through a newly formed subsidiary. BV began operating a winery and developing vineyards for the purpose of supplying products to appellant and others. BV's products were sold by a distributor to appellant and to a Hawaiian subsidiary of appellant as well as to unrelated parties. Over the course of several years, BV's financial results proved to be disappointing.

In 1979, because of BV's poor financial showing, appellant decided to find a purchaser to acquire BV's winery and vineyards. Appellant was able to find a buyer who was willing to purchase all of BV's assets except its vineyards. In order to accomplish the transaction, appellant caused BV to declare a dividend in kind of its vineyards which were then distributed to appellant. The BV stock was sold to the purchaser on October 31, 1979.

BV's adjusted basis in the vineyards distributed to appellant was $1,912,989 at the time of the dividend. It is undisputed that the fair market value of the vineyards at the time of the distribution exceeded their basis and that pursuant to section 24452, subdivision (a), BV's adjusted basis in the vineyards properly measures the amount of the distribution. Appellant eliminated the entire amount of this dividend in its combined report for its fiscal year ended February 29, 1980. Appellant also reported a loss on its sale of the BV stock in the amount of $3,736,083. On audit, respondent took the position that the distribution by BV could not be treated as a dividend because BV did not have sufficient earnings and profits, computed on a separate accounting basis, to fund the dividend. Appellant took the position that the earnings and profits of BV would have been determined by reference to the amount of unitary business income attributed to BV by formula

apportionment. Respondent treated BV's distribution as a return of capital and decreased appellant's basis in the BV stock. This adjustment reduced the loss on the subsequent sale of the stock and increased appellant's taxable income by the amount of the dividend.

The answer to whether appellant's distribution of the BV vineyards was a dividend *or* a return of capital turns on the'question of whether members of a unitary group must compute their earnings and profits on the basis of separate accounting or whether the earnings and profits of each member should be computed by reference to the amount of unitary business income attributed to-each member of the group by formula apportionment.

A distribution of property may be a return of capital or a dividend. "That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock." (Rev. & Tax. Code, § 24453, subd. (b).) A dividend is defined as "any distribution of property made by a corporation to its shareholders--(a) Out of its earnings and, profits accumulated after February 28, 1913; or (b) Out of its earnings and profits of the income year." (Rev. & Tax. Code, § 24495.) The amount distributed, whether dividend or return of capital, is defined under section 24452 as "whichever of the following is the lesser: (1) The fair market value of the other property received: or (2) The adjusted basis (in the hands of the ... corporation immediately before distribution) of the other property received." It would thus be seemingly impossible for a corporation, such as BV which has losses, to make a distribution of property which constituted a dividend out of "its" earnings and profits. Appellant, however, argues that income apportioned to a member of unitary group by formula can be utilized to determine the earnings and profits of the declining corporation.

A review of relevant case law does not support appellant's position. The early case of Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472, 481 [183 P.2d 16] (1947), which defined the concept of unitary income, stated: "The ascertainment of income by the apportionment method is not necessarily a disregard of the corporate entity .... Formula allocation [apportionment] is merely a method of ascertaining the true income attributable to the plaintiff's business." In the Appeal of Household Finance Corporation, decided by this Board on November 20, 1968, we further described

the concept of formula allocation of unitary income, concluding:

> The function of this concept is not to disregard the various taxable entities involved and combine them as one unit. (Citations.) Rather its function is merely to ascertain the true income of the buisness attributable to sources within California.

In summary, the unitary concept and formula apportionment ascertains the amount of income subject to taxation within the state and does not act to consolidate the business group. It does not affect the earnings and profits of the separate entities, but simply determines how much of the unitary business income should be taxed to each corporate entity in California:

Both appellant and respondent point to favorable language taken from the decision by the court in Safeway Stores, Inc. v. Franchise Tax Board, 3 Cal.3d 745 [91 Cal.Rptr. 616] (1970) as standing for the proposition that formula apportionment can or cannot be used in the particular circumstances before us. While the Safeway court acknowledged that dividends were properly payable as determined by separate accounting, implicit in the court's analysis was the following: first, a determination as to whether the entity had separate earnings and profits to pay a dividend, and, second, whether any part of the funding source was taxed in California. The first criteria is clearly lacking in the instant case.

Appellant places great reliance on the authorities which cite the benefits of combined reporting and formula apportionment, yet it fails to take into account that the benefits are spoken of within the context of the unitary concept as a whole. Appellant is unable to cite an authority that stands for the proposition that a company utilizing combined reporting methods abandons its separate accounting method. for all other purposes. We must conclude that this is clearly not the case.

In summary, during the years at issue, BV had no earnings and profits from which to declare a dividend. The income, attributed to it because of the utilization of combined reporting cannot form the basis of earnings and profits from which a dividend can be declared.

The second issue is a statute of limitations problem. There was a dispute between appellant and respondent concerning the correct apportionment of income appellant received over a number of years under a distribution agreement with Tequila Cuervo, S.A. The settlement of this dispute led to an overpayment for income year 1978 in the amount of $1,949 and a deficiency for the income year 1979. Appellant contends it is entitled to an offset of the 1978 overpayment against the 1979 deficiency under section 26073d of the Revenue and Taxation Code. Respondent contends that a refund of the overpayment is barred by the statute of limitations contained in section 26073 and that appellant is not entitled to an offset under section 26073d. It cites section 26073 which provides:

> No credit or refund shall be allowed or made after four years from the last day prescribed for filing the return or after one year from the date of the overpayment, whichever period expires the later, unless before the expiration of such period a claim therefor is filed by the taxpayer, or unless before the expiration of such period the Franchise Tax, Board allowed a credit, made a refund, issued a notice of proposed overpayment, or certified such overpayment ....

Appellant failed to timely claim a refund or credit but has asserted in its brief that section 26073d applies. That section states, in pertinent part, as follows:

> (1) Notwithstanding any statute of limitations otherwise provided for in this part, any overpayment due a taxpayer for any year, shall be allowed as an offset in computing any deficiency in tax, for the same or any other year, if such overpayment results from:
>
> (a) A transfer of items of income or deductions or both to or from another year for the same taxpayer; or
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> * * *
>
> (b)(2) The offset provided by subdivision (1) shall not be allowed after the

> expiration of seven years from the due date of the return or returns on which the overpayment is determined.

The $1,949 corporate franchise tax overpayment for income year ended February 28, 1978, resulted from a reduction in the amount of income to be-reported. This was caused by the utilization of different income apportionment percentages and the recharacterization of items of income generated by the agreement between appellant and respondent regarding the Reublein income. Under that agreement, income characterized as capital gains by the Internal Revenue Service (IRS) was apportioned 100 percent to California, and that portion deemed to be ordinary income by IRS was apportioned at 88-89 percent rather than at the original 100 percent.

We agree with respondent that appellant does not come within the terms of section 26073d because there was no transfer of items of income. Appellant has failed to demonstrate how section 26073d applies in the instant case.

Based on the foregoing, we must conclude that respondent's actions in this matter are sustained in all respects.

Appeal of Young's Market 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 Young's Market Company against proposed assessments of additional franchise tax in the amounts of $9,135 and $233,167 for the income years ended February 28, 1979, and February 29, 1980, respectively, be and the same is hereby sustained.

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