



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ALFRED M. LEWIS, INC.)

For Appellant: Ross, Landis and Pauw
Certified Public Accountants

For Respondent: Burl D. Lack, Chief Counsel;
Wilbur F. Lavelle, Associate
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Alfred M. Lewis, Inc., against proposed assessments of additional franchise tax in the amounts of \$67,296.74 and \$80,728.12 for the income years ended July 30, 1955, and July 28, 1956, respectively,

Appellant, a California corporation, was originally organized in 1933 for the purpose of operating a wholesale and retail grocery business. It was reorganized in 1944, thereafter limiting its activity to the wholesale grocery business. Pursuant to the reorganization its capital stock was divided into three classes: (1) preferred stock, (2) class "A" common stock, and (3) class "B" common stock.

Each share of preferred stock is entitled to a cumulative, non-participating, 6 percent annual dividend but holders thereof have no voting power unless such dividends are in default for a period of two years. The holders of class "A" common stock are given exclusive voting power and are entitled to dividends declared out of any surplus profits remaining after preferred dividends are paid. Except for certain patronage dividends, class "B" common stockholders are not entitled to participate in any of appellant's net profits and have no voting rights or control over its activities.

Appellant's business is divided into the membership division and the cash and carry division. The membership division, known as the Orange Empire Co-op, is operated as a nonprofit cooperative buying group, doing business with more than 1200 retail grocer-members. The cash and carry division deals with nonmember retailers. Each division's sales, costs and profits are separately accounted for.

Membership in the co-op is conditioned upon the purchase of two shares of appellant's class "B" common stock for \$100 each and the payment of certain

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nominal fees and dues. The "B" stock is held only by members and no other class of stock is held by them.

Under the agreement entered into with the co-op, each member agrees to "maintain a buying deposit equal to two weeks' average purchases through the co-op." These deposits supply much of the capital necessary for acquisition of a large merchandise inventory and also provide security for the member's purchases. Appellant does not, however, rigidly adhere to the two-week purchases requirement in all cases. Figures showing the deposits of members of appellant's Riverside branch in August and October of 1955 indicate that a significant number fell short of the required deposit by amounts ranging from a few cents to \$47,825.04. At the same time an overwhelming majority of the accounts reflected an excess deposit. Whatever the amount, members received 5 percent interest thereon pursuant to agreement with the co-op. Total members' buying deposits averaged more than \$6,900,000 during the years under review while capital and surplus accounts averaged a little over \$4,800,000 (the latter figure includes \$1,411,341 resulting from revaluation of fixed assets).

Appellant buys products in large quantities, storing them in its own warehouses until they are sold to the co-op members. The goods are sold at prevailing market prices and twice each year the co-op's profit is computed and distributed to its members according to the terms of the membership agreement, which states:

7. Members will share in the profits made on their purchases in this manner: (a) Patronage Dividend will be paid on warehouse purchases and drop shipments based on that portion of profit made which the member's purchases bear on the total purchases of all members and (b) rebates and promotional allowances will be paid on each member's purchases of such items. Patronage Dividends will be made semi-annually and will be credited to each member's buying deposit, evidence of which will be furnished each member.

The profits allocable to purchases by the holders of class "B" common stock are specifically protected from being utilized for dividends on preferred or class "A" stock.

Membership in the co-op may be terminated at any time by appellant's board of directors or upon 30 days' notice by a member. At the expiration of 30 days, the member is entitled to receive in cash or merchandise the total of the following amounts: (a) the value of the stock certificate turned in; (b) the amount of the member's credit in the revolving fund; (c) the amount accumulated in the member's buying deposit; and, (d) accumulated trade rebates.

Co-op members receive no distributions based on their investment in class "B" common stock. Appellant contends that the amounts it paid to co-op members as patronage dividends are excludable from gross income on the ground that such distributions are merely price adjustments. It also urges that the amounts paid to members on their buying deposits are deductible as interest expense.

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The Franchise Tax Board determined that appellant may not exclude patronage dividends from its income or deduct the interest expense connected with buying deposits.

While recognizing that under a well established federal practice, patronage dividends are excludable from gross income, respondent contends that this is not the rule in California. The same issue was recently decided by us in the Appeal of Certified Grocers of California, Ltd., Cal. St. Bd. of Equal., Sept. 20, 1962, CCH Cal. Tax Rep. Par. 201-976, 2 P-H State & Local Tax Serv. Cal. Par. 13285, wherein we found that the Legislature, by defining gross income in substantially the same terms as found in federal law, adopted the federal practice with regard to patronage dividends.

It is not disputed that the distributions here in question meet the conditions required to qualify as true patronage dividends under the federal rule. (See Pomeroy Cooperative Grain Co. v. Commissioner, 288 F.2d 326,) This case is distinguishable from the situation posed in the Appeal of Certified Grocers of California, Ltd., supra, in that there business was conducted wholly with Certified's members, who were its only stockholders and who controlled the conduct of its operations. Respondent does not assert, however, that the fact that a portion of appellant's business was conducted with nonmembers or that the persons receiving distributions had no control over the business prevents the application of the patronage dividend rule. And, indeed, it seems clear that these circumstances cannot affect the result here. (Valparaiso Grain & Lumber Co., 44 B.T.A. 125; Clover Farm Stores Corp., 17 T.C. 1255; Uniform Printing & Supply Co. v. Commissioner, 88 F.2d 75; Smith & Wiggins Gin, Inc., 37 T.C. 861, appealed on other grounds, July 11, 1962.) Accordingly, we conclude that appellant is entitled to exclude patronage dividends from gross income,

The Franchise Tax Board's disallowance of appellant's interest expense deductions is bottomed on its conclusion that the amounts paid on co-op members' buying deposits were dividends and not interest. Essentially the same issue was considered by us in the Appeal of Certified Grocers of California, Ltd., Cal. St. Bd. of Equal., Sept. 20, 1962, CCH Cal. Tax Rep. Par. 201-976, 2 P-H State & Local Tax Serv. Cal. Par. 13285, supra, wherein we found that members' deposits created bona fide indebtedness and were not capital contributions, as urged by the Franchise Tax Board. Although, as we stated in Certified, the question involved is one of fact and each case must stand on its own peculiar circumstances, the close similarity of the two cases compels us to conclude that our holding in Certified is dispositive of the issue here.

Most of what we said in Certified applies with equal force here, Furthermore, there are additional factors that support our conclusion. Not only are we not dealing with a closely held corporation, but the opposing interests represented by the class "B" stockholders, as against preferred and class "A" stockholders, insure that all their business was conducted with the co-op on a bona fide, arm's length basis. The fact that some co-op members were considered sufficiently reliable credit risks to exempt them from the general two-week purchases requirement, emphasizes the genuine business purpose

