75-SBE-002

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MISSION EQUITIES CORPORATION)

Appearances:

For Appellant: David A. Norwitt
Attorney at Law

For Respondent: David M. Hinman
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Mission Equities Corporation against proposed assessments of additional franchise tax in the amounts of $17,325.92, $15,934.32, and $23,624.76 for the income years 1968, 1969, and 1970, respectively.

Appellant is a corporation with its principal place of business in Los Angeles. It has four subsidiaries; two insurance companies, an insurance brokerage company, and a data processing company. On its returns for the years in issue, appellant

reported that it derived its income from four principal sources: (1) dividends from its subsidiaries, (2) management fees from its subsidiaries, (3) interest, and (4) rental fees. It has been appellant's policy to use the entire amount of the dividends received from its subsidiaries to pay dividends to its own shareholders.

During the appeal years, appellant properly deducted the dividends received from its subsidiaries, which had been included in the subsidiaries' measure of tax, in computing its taxable net income. (Rev. & Tax. Code, § 24402.) However, appellant also sought to deduct the entire amount of its expenses from gross income. Respondent determined that a portion of the expenses should be allocated to the tax deductible dividend income and that this portion was not allowable as a deduction. The allocation of expenses was made by respondent in accordance with the following formula:

$$\text{Total Expenses} \times \frac{\text{Deductible Dividend Income}}{\text{Total Gross Income}} = \text{Nondeductible Expenses}$$

Respondent issued proposed assessments for the years in issue reflecting this treatment and appellant protested the assessments. Thereafter, respondent determined that certain expenses incurred in each year, such as real property taxes, the amortization of real estate improvements, and other real property expenses, were directly related to the production of rental income and were properly deductible in total. However, the remaining indirect expenses which were not directly related to the production of taxable income were allocated between taxable and nontaxable income in proportion to the amount of each. 1/ That portion of the indirect

1/ The following allocation formula was used by respondent:

$$\text{Total Indirect Expenses} \times \frac{\text{Deductible Dividend Income}}{\text{Total Gross Income}} = \text{Nondeductible Expenses}$$

expenses allocated to nontaxable income was again disallowed as a deduction and respondent revised its original assessments accordingly. It is from this action that appellant appeals.

The sole issue for determination is whether respondent properly allocated appellant's indirect expenses between taxable and nontaxable income in proportion to the amount of each.

The Revenue and Taxation Code provides that in computing net income no deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to income not included in the measure of the tax. (Rev. & Tax. Code, §§ 24421, 24425.) The applicable regulation provides for the allocation of such expenses in the following manner:

> No deduction may be allowed for the amount of any item or part thereof allocable to a class or classes of excludable income. Items, or parts of such items, directly attributable to any class or classes of excludable income, shall be allocated thereto; and items, or parts of such items directly attributable to any class or classes of includible income; shall be allocated thereto.
>
> If an item is indirectly attributable both to includible and excludable income,, a reasonable proportion thereof, determined in the light of all the facts and circumstances in each case, shall be allocated to each. Apportionments must in all cases be reasonable, (Cal. Admin. Code, tit. 18, reg. 24201(d), subd. (2).)

Apparently, appellant does not contest the law and regulations set out above, or even the basic allocation formula utilized by respondent. However, appellant does maintain that, as applied in this situation, respondent's formula allocation does not result in a reasonable apportionment of indirect expenses as required by the controlling regulation.

In support of appellant's position that the allocation is not reasonable, it asserts that all the nontaxable income, which

was in the form of intercompany dividends, were merely paid to appellant by its subsidiaries, and were, in turn, immediately utilized to pay dividends to appellant's shareholders. Appellant maintains that if economic necessity did not require it to pay dividends to its shareholders, no money would be taken in from its subsidiaries as dividend income. Thus, appellant concludes that -since this was merely a flowthrough transaction, it should not be forced to allocate expenses. While we do not doubt the accuracy of appellant's assertions, we fail to see what bearing they have on the resolution of the question in this appeal.

The purpose of the allocation requirement is to segregate excludable income from includible income, in order that a double exemption may not be obtained through the reduction of includible income by expenses incurred in the production of wholly excludable income. (Cal. Admin. Code, tit. 18, reg. 24201(d) subd. (1); see also Great Western Financial Corp. v. Franchise Tax Board, 4 Cal. 3d 1 [92 Cal. Rptr. 489, 479 P. 2d 993].) Thus, the question is what income did the expenses in controversy help to produce, not what use was the income put to. The fact that the dividends received by appellant were included in the subsidiaries measure of tax is the reason why they are excludable from appellant's income. (Rev. & Tax. Code, § 24402.) However, this is no reason to allow a double exclusion, by allowing the deduction of that portion of the expenses which relate to the production of exempt dividend income. On the contrary, it is a compelling reason to make an allocation of expenses and to disallow those expenses which relate to the tax exempt income, which is what respondent has done.

In arguing that the allocation was unreasonable, appellant also asserts that it cannot merge all its companies since the California Insurance Law prohibits an insurance company from also acting as a broker, and one of its subsidiaries is an insurance broker while others are insurance companies. Again, appellant's assertions are undisputed. However, we fail to see what relevance they have to the question in issue.

Next, appellant argues that the disallowance of the expense deduction results in double taxation. This argument has been considered and rejected by the California Supreme Court in Great Western Financial Corp. v. Franchise Tax Board, supra,

where the court stated:

> The plaintiff corporation maintains that to prohibit deducting the expenses results in double taxation. We have concluded that the Franchise Tax Board properly refused to permit credit for such expenses;' this results not in double taxation, but prevents a double deduction. (4 Cal. 3d at 4.)

Finally, appellant proposes to eliminate all passed-through dividends which were tax exempt from the formula. How-' ever, the applicable statutes and regulation clearly state that indirect expenses must be allocated between exempt and nonexempt income. In this matter, after first allowing the deduction of all direct expenses in total, respondent allocated appellant's indirect expenses between taxable and nontaxable income in proportion to the amount of each. This formula allocation was intended to establish the ratio of exempt income to total income and to apply that ratio to indirect expenses in order to arrive at the portion of indirect expenses reasonably allocable to exempt income. If dividends received from appellant's subsidiaries which were passed through to appellant's own shareholders were eliminated from the formula,+ most of the tax exempt income would be eliminated, thereby frustrating the purpose of the formula allocation.

We note that although the specific formula utilized by respondent is not mandated by statute or regulation its use has been approved by the California Supreme Court in Great Western Financial Corp. v. Franchise Tax Board, supra. A similar formula has also been approved, in analogous situations, by the United States Tax Court and the Internal Revenue Service. (See Edward Mallinckrodt, Jr., 2 T. C. 1128, 1148, aff'd on other grounds, 146 F. 2d 1, cert. denied, 324 U. S. 871 [89 L. Ed. 1426], reh. denied, 325 U. S. 892 [89 L. Ed. 2004]; Rev. Rul. 63-27, 1963-1 Cum. Bull. 57.)

After thoroughly considering all the arguments advanced by appellant we conclude that it has failed to show that the formula utilized by respondent resulted in an unreasonable allocation. Accordingly, it is our determination that respondent properly allocated appellant's indirect expenses between taxable and nontaxable income in proportion to the amount of each.

ORDER

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 Mission Equities Corporation against proposed assessments of additional franchise tax in the amounts of $17,325.92, $15,934.32, and $23,624.76 for the income years 1968, 1969, and 1970, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 7th day of January, 1975 by the State Board of Equalization.

John W. Lynch, Chairman

_____, Member

William M. Bennett, Member

George R. Reilly, Member

_____, Member

ATTEST: W. W. Dunlop, Secretary