76-SBE-081

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
CIOCO UNION STORES, INC.,)
RIVERSIDE UNION STORES, INC.,)
AND UNION DISTRIBUTING CO., INC.)

Appearances:

For Appellants: Jay H. Grant
Attorney at Law

For Respondent: Kendall Kinyon
Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Cioco Union Stores, Inc., Riverside Union Stores, Inc., and Union Distributing Co., Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Taxpayer	Income Year Ended	Proposed Assessment
Cioco Union Stores, Inc.	January 31, 1968	$5,472.66
	January 31, 1969	1,299.12
Riverside Union Stores, Inc.	January 31, 1968	$5,735.77
	January 31, 1969	6,913.04
Union Distributing Co., Inc.	January 31, 1968	$ 30.47

The appellants, Cioco Union Stores, Inc., Riverside Union Stores, Inc., and Union Distributing Co., Inc. (hereinafter referred to as Cioco, Riverside, and Union, respectively), and a fourth corporation, ARC Union Stores, Inc. (hereinafter referred to as ABC), form an affiliated group engaged in the discount department store business in southern California. For the income years ended January 31, 1968, and 1969, the four corporations filed consolidated federal and state tax returns. Upon examination of the state returns, respondent correctly determined that the taxpayers were not entitled to file consolidated state returns for the income years in question. Consequently, after computing the separate tax liabilities of each of the corporate entities on the basis of information contained in schedules attached to the consolidated returns, respondent issued the proposed assessments of additional tax which gave rise to these appeals.

Subsequent to the filing of these appeals, the appellants conceded the propriety and correctness of the assessments in question. However, the appellant Riverside now contends that the particular assessments for which it is liable must be reduced to reflect certain business expense deductions which were not reported on the consolidated returns. Specifically, Riverside contends that during the income years on appeal it incurred previously unreported business expenses in connection with its liability as guarantor of the business property rental obligations of its subsidiary, ABC. Accordingly, as we view the status of these appeals[1/], the sole

1/ In light of appellants' concession regarding the assessments issued against Cioco and Union, we must sustain respondent's action with respect to those appellants.

issue presented for resolution is whether a parent corporation may deduct as business expenses amounts which it paid as guarantor of the business property rental obligations of its subsidiary.

For several years prior to 1967, Riverside, ARC, Cioco, and Union operated as wholly owned subsidiaries of Sage International, Inc. (hereinafter referred to as Sage). Riverside operated a discount department store on leased property located at Arlington, California, and ABC and Cioco operated similar businesses on leased properties located at San Bernardino and Montclair, California, respectively. Union acted as the central purchasing company for the other three subsidiaries. For the years preceding 1967, the respective business property rental obligations of Riverside, ABC, and Cioco were guaranteed by Sage.

During the latter part of 1966, two of the principal shareholders of Sage, Harold and Shirley Staw, initiated negotiations for the divisive reorganization of Sage whereby they would acquire ownership and control of Riverside, Cioco, and Union in exchange for their entire stock interest in Sage. However, Sage would not agree to the transaction unless the Staws accepted ownership of ABC in addition to the other subsidiaries. Apparently, ABC was operating at a loss at the time of the negotiations.

On January 4, 1967, the Staws and Sage entered into an agreement which provided, in part, for: (1) the transfer by the Staws to Sage of all their shares of Sage stock in exchange for the transfer by Sage to the Staws of all the outstanding shares of Riverside; (2) the donative transfer by Sage to Riverside of all the outstanding shares of ABC, Cioco, and Union, thereby making ABC, Cioco, and Union wholly owned subsidiaries of Riverside; (3) the assignment by Riverside, ABC, and Cioco of their existing leases of real property to Sage, and the sublease of such properties back to the respective corporations by Sage; and (4) the joint and several corporate guarantees by Riverside, ABC, and Cioco of their respective lease obligations. In addition, on February 1, 1967, the parties executed a collateral agreement which provided, in part, that "for valuable consideration" Riverside, ABC, Cioco, and Union would jointly and severally guarantee the payment and performance of any of their obligations which had theretofore been guaranteed by Sage. The collateral agreement also' provided, in effect, that the failure of any corporation to perform its obligation as guarantor would result in the cancellation of its own business property lease.

The record on appeal indicates that during each of the income years ended January 31, 1968 and 1969, Riverside, pursuant to its liability as guarantor, expended $90,700 in payment of the business property rental obligations of ABC. Riverside contends that it is entitled to deduct the {payments as business expenses pursuant to section 24343 of-the Revenue and Taxation Code.

Section 24343 permits the deduction of "all the ordinary and necessary expenses paid or incurred ... in carrying on any trade or business." The section is substantially identical to its federal counterpart, section 162 of the Internal Revenue Code of 1954. Under such circumstances the interpretation and effect given the federal statute are highly persuasive with respect to proper application of the state law. (Meanley v. McColgan, 49 Cal. App. id 203, 209 [121 P.2d 45]; Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356, 360 [280 P.2d 893].)

The question whether a parent corporation may deduct as ordinary and necessary business expenses amounts paid to cover the expenses of its subsidiary was squarely presented in Interstate Transit Lines v. Commissioner, 319 U.S.' 590 [87 L. Ed. 16071. Interstate involved a parent corporation which bound itself by contract to be liable for all operating deficits of its wholly owned subsidiary. Basing its decision primarily upon the general principle that the separate corporate entities of parent -and subsidiary may not be disregarded for tax purposes -(see New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L. Ed. 1348]), -the Court ruled that, in ascertaining its taxable income, the parent was not entitled to treat its payment of the subsidiary's operating costs as an ordinary and necessary business expense. The Court expressly noted, however, that the case before it did not involve a parent's payment of its subsidiary's expenses in return for a corresponding benefit or service rendered to the parent by its subsidiary in connection with the parent's business. (Interstate Transit Lines v. Commissioner, supra, 319 U.S. at 594.)

It is apparently Riverside's contention that the instant appeal involves the type of factual situation which the Court in Interstate impliedly excluded from the scope of its decision. In this context, Riverside argues that since its failure to pay the rental obligations of ABC would have resulted in the cancellation of Riverside's business property lease, the payments in question were directly related to the preservation of its own business and therefore constituted deductible business expenses. In support of its position, Riverside relies upon two United States Tax Court decisions, Fishing Tackle Products Co., 27 T.C. 638, and Fall River Gas Appliance Co., 42 T.C. 850, aff'd on another issue, 349 F.2d 515, which, under unusual circumstances, allowed a parent corporation to deduct as business expenses amounts paid to cover certain operating costs of its subsidiary. It is our opinion, however, that Riverside's reliance upon those cases is misplaced.

The Fishing Tackle case involved a subsidiary which provided the sole source of supply of a product indispensable to its parent's business. The entire production and output of the subsidiary were used exclusively for the benefit of the parent. Accordingly, when the subsidiary experienced operating losses in manufacturing its product, the parent reimbursed the subsidiary for those losses. Under such circumstances, the reimbursements represented payment by the parent for a corresponding service or benefit rendered to it by the subsidiary in connection with the parent's business; therefore, the court allowed the parent to deduct the expenditures as ordinary, and necessary business expenses. (Fishing Tackle Products Co., supra, 27 T.C. at 644; see United States v. Berger, 325 F. Supp. 1297, 1301, aff'd, 456 F.2d 1349.)

The Fall River case involved a gas company which paid the selling, installation, and miscellaneous expenses of its subsidiary, a gas appliance company. The court ruled that the direct relationship between an increase in the parent's gas sales and the number of appliances sold and installed by its subsidiary provided a sufficient basis for allowing the parent to deduct the payments as ordinary and necessary business expenses. (Fall River Gas Appliance Co., supra, 42 T.C. at 85.8.) Thus, as was the situation in Fishing Tackle, the payments were directly attributable to a corresponding service or benefit rendered to the parent by the subsidiary in connection with the parent's business. (See Young & Rubicam, Inc. v. United States, 410 F.2d 1233, 1243.)

It is clear that the facts of this appeal do not parallel those.presented in Fishing Tackle or Fall River. The business property rental expenses of ABC were part of its normal operating overhead expense, and Riverside's payment of the expenses was not dependent upon a corresponding service or benefit rendered to it by ABC in connection with Riverside's business. Furthermore, to the extent that an indirect relationship existed between the payments in question and the preservation and promotion of Riverside's business, the relationship was due not to a service or benefit provided by ABC but to the guarantee agreement which Riverside entered into pursuant to the reorganization of Sage. The mere fact that the payments were made pursuant to a contractual obligation does not provide the exceptional circumstances which warranted the decisions in Fishing Tackle and Fall River (See Interstate Transit Lines v. Commissioner, supra, 319 U.S. at 594; Amer.Gen. Ins. Co. v. United States, 32 Am. Fed. Tax R.2d 73-5808, 73-5814.); it is the origin and nature, not the legal form, of the expenses which determines whether they are deductible as ordinary and necessary business expenses. (Deputy v. du Pont, 308 U.S. 488, 494 [84 L. Ed. 416]; cf. Estate of McGlothlin v. Commissioner, 370 F.2d 729, 732.)

Therefore, we must conclude that Riverside's payment of the expenses in question, which expenses clearly represented ordinary and necessary business expenses of ABC, did not entitle Riverside to deduct the payments under section 24343 of the Revenue and Taxation Code.

Appeals of Cioco Union Stores, Inc., et al.

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 protests of Cioco Union Stores, Inc., Riverside Union Stores, Inc., and Union Distributing Co., Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

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be and the same is hereby sustained.

Done at Sacramento, California, this 6th day of October, 1976, by the State Board of Equalization.

_______________, Chairman

_______________, Member

_______________, Member

_______________, Member

_______________, Member

ATTEST: _______________ Executive Secretary