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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of: **AMERISTAR CASINOS, INC. & SUBS.**	**HEARING SUMMARY** **CONSOLIDATED CORPORATION FRANCHISE INCOME TAX APPEAL** Case Nos. 605227 (2003-2005), 841016 (2007-2008)

Years	Amounts at Issue[1]
2003	$ 24,825
2004	$ 69,390
2005	$107,962
2007	$ 31,019
2008	$ 57,310

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[1] For the 2004 and 2005 tax years, the Notices of Proposed Assessment (NPAs) and Notices of Action (NOAs) include an adjustment to the California payroll factor. It appears that this adjustment is not in dispute. In addition, on appeal, respondent adjusted the additional tax due to account for a net operating loss deduction for the 2004 tax year. Based on these two factors, respondent states that the amounts in dispute are $24,825, $45,175, and $77,060 for the 2003, 2004, and 2005 tax years.

For the 2007 tax year, appellant also filed an amended tax return claiming a refund for $1,297. Respondent accepted the adjustments made on the amended return. The NOA for 2007 already reflects respondent's acceptance of these adjustments, no change is necessary if the Board determines that respondent's proposed assessment is proper. If the Board determines that respondent's proposed assessment should not be sustained, the refund of $1,297 will be issued to appellant. As such, this amount appears to not be in dispute.

Representing the Parties:

For Appellant: Douglas Bramhall, KPMG LLP

For Franchise Tax Board: Jenna Lewis, Tax Counsel

QUESTION: Whether appellant is entitled to a deduction for various "wagering taxes" paid to other states for the years at issue.

HEARING SUMMARY

Background

Appellant is a developer, owner, and operator of casinos. It offers gaming technology as well as dining, lodging and entertainment in various states outside of California. During the years at issue, appellant operated a form of gaming facility in Colorado, Iowa, Mississippi, Missouri, and Nevada. Appellant also held a gaming license in each of these states. In addition, appellant had administrative offices in California during the years at issue. Appellant claimed a deduction for various taxes paid to other states, including wagering or gaming taxes[2] related to its gaming activity on the basis that those taxes are not income taxes. Respondent determined that the wagering taxes claimed by appellant as a deduction were not deductible for California purposes because those taxes were taxes measured on or measured by income under California law. (Resp. Op. Br., p. 1.)[3]

2003 Tax Year

Appellant filed its California tax return (Form 100) for the 2003 tax year on October 15, 2004. Appellant reported net income before state adjustments of $23,845,884. Appellant also reported a state adjustment (addition) for the amount deducted for foreign or domestic tax paid (i.e., appellant included for California tax purposes the amount of the federal deduction for taxes paid that it determined was not deductible for California purposes). After applying other California adjustments

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[2] Respondent refers to these taxes as gaming taxes in its briefs. Appellant refers to these taxes as wagering taxes in its brief. For ease of reference, these taxes will be referred to as wagering taxes in this hearing summary.

[3] The references to respondent's opening brief for the background facts for the 2003, 2004, and 2005 tax years are to the opening brief for Case No. 605227. The references to respondent's opening brief for the background facts for the 2007 and 2008 tax years are to the opening brief for Case No. 841016.

for depreciation and contributions, appellant reported net income after state adjustments of $34,187,066. Based on its California Schedule R, appellant reported a California apportionment factor of 0.2017 percent. Applying this apportionment factor resulted in net income for tax purposes of $68,955 and tax of $6,096. After applying estimated payments of $13,500, appellant reported an overpayment of $7,404. On its California Schedule F, appellant reported gross receipts of $772,335,715, total cost of goods sold (COGS) of $46,990,914, and gross profit of $725,344,801. The COGS calculation included purchases, but did not include any cost of labor, IRC section 263A costs, or other costs. (Resp. Op. Br., pp. 1-2, Exh. A.)

2004 Tax Year

Appellant filed its California tax return (Form 100) for the 2004 tax year on October 15, 2005. Appellant reported net income before state adjustments of $51,947,779 and a state adjustment for taxes paid of $2,638,222. After applying other unrelated California adjustments, appellant reported net income after state adjustments of $56,600,469. Based on its California Schedule R, appellant reported a California apportionment factor of 0.1727 percent. Applying this apportionment factor and a net operating loss carryover deduction of $52,283 resulted in net income for tax purposes of $45,396 and tax of $4,013. After applying estimate payments of $19,000 and a payment with its extension request of $4,000, appellant reported an overpayment of $18,987. On its California Schedule F, appellant reported gross receipts of $844,673,920, COGS of $52,559,820, and gross profit of $792,114,100. The COGS calculation included purchases of $53,391,587, but did not include any cost of labor, IRC section 263A costs, or other costs. (Resp. Op. Br., pp. 2-3, Exh. B.)

2005 Tax Year

Appellant filed its California tax return (Form 100) for the 2005 tax year on October 15, 2006. Appellant reported net income before state adjustments of $88,119,216 and a state adjustment for taxes paid of $2,410,560. After applying other unrelated California adjustments, appellant reported net income after state adjustments of $70,949,751. Based on its California Schedule R, appellant reported a California apportionment factor of 0.1940 percent. Applying this apportionment factor resulted in net income for tax purposes of $137,642 and tax of $12,168. After applying the overpayment of $18,987 from the 2004 tax year and estimate payments of $3,000, appellant reported an overpayment of $9,819. On its California Schedule F, appellant reported gross receipts of $951,354,207, COGS of $60,689,313, and gross profit of $890,664,894. The COGS calculation included purchases of $60,681,493, but did not include any cost of labor, IRC section 263A costs, or other costs. (Resp. Op. Br., pp. 3-4, Exh. C.)

2007 Tax Year

Appellant filed its California tax return (Form 100) for the 2007 tax year on October 9, 2008. Appellant reported net income before state adjustments of $96,249,133 and a state adjustment (addition) for the amount deducted for foreign or domestic tax paid of $5,582,730. After applying other unrelated California adjustments, appellant reported net income after state adjustments of $91,988,245. Based on its California Schedule R, appellant reported a California apportionment factor of 0.1770 percent. Applying this apportionment factor resulted in net income for tax purposes of $162,819 and tax of $14,393. After applying the overpayment of $12,461 from a prior tax year and estimate payments of $16,000, appellant reported an overpayment of $14,068. On its California Schedule F, appellant reported gross receipts of $1,066,902,084, COGS of $63,447,713, and gross profit of $1,003,454,371. The COGS calculation included purchases, but did not include any cost of labor, IRC section 263A costs, or other costs. (Resp. Op. Br., pp. 1-2, Exh. A.)

On June 26, 2013, appellant filed an amended tax return for 2007 to report a decrease in federal net income. For California purposes, the adjustments resulted in a decrease in net income for state purposes of $23,720, and a decrease in tax of $1,297. The return claimed a refund of $1,297. (Resp. Op. Br., p. 2, Exh. B.)

2008 Tax Year

Appellant filed its California tax return (Form 100) for the 2008 tax year on October 14, 2009. Appellant reported net income before state adjustments of $40,100,112 and a state adjustment (addition) for the amount deducted for foreign or domestic tax paid of $9,897,948. After applying other unrelated California adjustments, appellant reported net income after state adjustments of $49,387,383. Based on its California Schedule R, appellant reported a California apportionment factor of 0.2054 percent. Applying this apportionment factor resulted in net income for tax purposes of $101,442 and tax of $9,767. After applying the overpayment of $14,068 from a prior tax year and estimate payments of $11,600, appellant reported an overpayment of $15,901. On its California Schedule F, appellant reported gross receipts of $1,251,338,288, COGS of $70,107,644, and gross profit of $1,181,230,644. The COGS calculation included purchases, but did not include any cost of labor, IRC section 263A costs, or other costs. (Resp. Op. Br., pp. 2-3, Exh. C.)

Audit and Protest

Respondent audited appellant's 2003 through 2005 tax years beginning on December 14, 2007. Respondent reviewed the claimed deduction for taxes paid, which included wagering taxes paid to Colorado, Iowa, Mississippi, Missouri, and Nevada, and noted that these wagering taxes consist of a tax on the money wagered by gamblers minus payouts made by the casino. Respondent determined that these wagering taxes were taxes measured on or measured by income, and therefore not deductible. The amounts of the wagering taxes paid disallowed were $139,320,842, $158,388,934, and $179,176,832 for the 2003, 2004, and 2005 tax years, respectively. Respondent also determined that appellant erroneously excluded from its California payroll factor certain nonqualified stock options during the 2004 and 2005 tax years. The adjustment was based on the difference between appellant's California DE-7 for payroll taxes and information reported on appellant's Form 10-K filed with the Securities and Exchange Commission as compared to the payroll reported on appellant's Schedule R. Appellant informed the auditor that it would not be responding to the auditor's position on the payroll factor. Respondent then issued NPAs dated May 24, 2010, to appellant reflecting these adjustments. Appellant protested the NPAs on the basis that it should be allowed to deduct taxes paid because the taxes are not income taxes. Appellant did not protest the payroll factor adjustment. After review, respondent issued NOAs dated February 3, 2012, affirming the NPAs. (Resp. Op. Br., p. 4, Exhs. D, E, F, G & H.)

Respondent audited appellant's 2007 and 2008 tax years beginning in December 22, 2011. During the audit, appellant provided a breakdown of the taxes paid, which included wagering taxes paid to Colorado, Iowa, Mississippi, Missouri, Nevada, and Indiana totaling $211,642,071 and $315,629,776 for 2007 and 2008, respectively. These taxes consist of a tax on the money wagered by gamblers minus payouts made by the casino. Respondent determined that these wagering taxes were taxes measured on or measured by income, and therefore not deductible.

Respondent then issued NPAs dated April 13, 2012, to appellant reflecting this adjustment. Appellant protested the NPAs on the basis that it should be allowed to deduct taxes paid because the taxes are not income taxes. Appellant also provided a schedule of the wagering taxes paid for the 2007 and 2008 tax years which were different from the breakdown provided during audit. This schedule reflected total wagering taxes paid of $211,642,070.89 and $287,148,293.94 for the 2007 and 2008 tax years, respectively. Although appellant was unable to provide support for these figures, appellant indicated during this appeal that it is reviewing its records for additional documentation.[4] During the course of the protest, appellant filed an amended 2007 tax return. Respondent determined that the adjustments made on the amended return should be allowed, but the remainder of the 2007 NPA and 2008 NPA should be sustained. After review, respondent issued NOAs dated July 11, 2014, affirming the NPAs. Appellant then filed these timely appeals and requested consolidation of these appeals. (Resp. Op. Br., pp. 3-5, Exhs. D, E, F.)

Contentions

Appellant's Opening Brief

Appellant contends that, as a developer, owner and operator of casino entertainment facilities, appellant is engaged in operating hotels, selling food and beverages, and other casino-related business, such as retail shopping, amusement and entertainment. Appellant explains that it generates revenue primarily from casino wins, which consist of gross receipts from casino winnings less cash paid out to patrons as casino losses. Appellant explains that it also generates a portion of its revenue from rooms, food and beverage, and other sources. Appellant states that the most distinctive feature of the casino industry is that the ownership and operation of casino gaming facilities are subject to extensive state and local regulations. Appellant explains that, in general, state and local governments

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[4] Appellant has not yet provided any additional documents as of the close of the briefing period in this appeal.

impose the following casino taxes or fees on casino operators: (1) wagering tax[5]; (2) slot tax[6]; (3) table games tax[7]; and (4) admissions tax.[8] Appellant explains that it reported these casino taxes as part of its miscellaneous taxes, which were deducted in computing its California taxable income for the years at issue, but respondent disallowed the portion of these casino taxes related to the wagering tax.[9] Appellant notes that, of the total casino taxes it deducted, the following amounts represent the wagering taxes: $139,320,842 was for 2003, $158,388,934 was for 2004, and $179,176,832 was for 2005. Appellant did not break down the wagering taxes out of the total casino taxes for 2007 and 2008.[10] (App. Op. Br., pp. 1-3.)[11]

Appellant contends that these wagering taxes are deductible privilege taxes under R&TC section 24345, subdivision (b). Appellant contends that these taxes are imposed in addition to normal corporate business income taxes imposed by most of the states in which appellant conducts its gaming operations. Appellant contends that the privilege taxes are not measured by gross income or net income, and are required to be paid whether or not appellant makes a profit or loss in each year. Appellant cites Regulation section 24345-1(a) which lists examples of the taxes or licenses that may be deducted, which include city license fees, liquor or alcoholic beverage license fees and other

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[5] Appellant explains that all states that permit operation of casinos impose some form of this tax. The precise definition of the tax base varies from state to state, but the essential tax base is in all cases “gross gaming receipts” generally defined as gross gambling receipts less payouts to patrons as winnings. No other deductions are permitted in calculating gross gaming receipts. These are the taxes at issue.

[6] Appellant explains that this tax is generally based on the number of slot machines and other gaming devices operated by the casino. These taxes appear to not be at issue.

[7] Appellant explains that this tax is based on the number of table games operated by the casinos. These taxes appear to not be at issue.

[8] Appellant explains that this tax is based on the number of patrons admitted in the facility. These taxes appear not to be at issue.

[9] The parties refer to these taxes interchangeably as wagering taxes or gaming taxes. For ease of reference, these taxes will be referred to as wagering taxes in this document.

[10] According to appellant’s opening brief for Case No. 841016, the total casino taxes reported for 2007 and 2008 were $211,642,071 and $315,629,776. Appellant also indicated that it is reviewing additional documentation for 2008 to determine whether some amount of the disallowed tax is attributable to a tax other than the wagering tax. At the hearing, appellant may want to provide the Board with the amount of wagering taxes at issue for 2007 and 2008.

[11] The parties filed briefs for each of the two appeals prior to consolidation. The contentions in these briefs are substantially similar. Unless otherwise indicated, all references to the parties’ briefs refer to the briefs in Case No. 605227.

business, privilege or excise taxes paid to the United States or to a state. Appellant contends that it is paying gaming taxes on its gross gaming revenue or on the number and types of games in the casino. Appellant contends that these paid taxes fall within the category of "other business, privilege or excise tax" listed in the regulation and are deductible. (App. Op. Br., p. 4.)

Appellant contends that the California Supreme Court in *Beamer v. Franchise Tax Board* (1977) 19 Cal.3d 467, 475 (*Beamer*), provided the key objective in determining whether a tax is based on or measured by income, which is to consider the true nature of the tax and to not be guided by labels. Appellant contends that the tax must be analyzed within the context of general tax laws, federal and California statutes and regulations. Appellant further contends that the analysis must measure the tax by reference to the specific activity taxes and should be done on a case by case basis, citing *Robinson v. Franchise Tax Board* (1981) 120 Cal.App.3d 72, 80 (*Robinson*), *MCA, Inc. v. Franchise Tax Board* (1981) 115 Cal.App.3d 185 (*MCA*), and other authorities. Appellant further contends that the Court in *Beamer* considered the deductibility of the Texas occupation tax imposed on the business of producing natural gas and crude petroleum. Appellant contends that the Court concluded that the Texas taxes were not measured by gross income and rather, the measure was the total gross receipts from the sales of the minerals produced. Appellant notes that the Court considered the fact that "lifting costs" incurred in the production could not be deducted from the tax base. (App. Op. Br., p. 5.)

Appellant acknowledges that "gross income" is broadly defined by R&TC section 24271 and IRC section 61 to include all income from whatever sources derived unless specifically excluded. However, appellant contends that "gross income" is not "gross receipts." Appellant contends that "gross receipts" is broader than gross income and contains capital (such as COGS) as well as income and contends that returns of capital cannot be taxed, citing *Beamer*, *supra* at 477, Treasury Regulation section 1.61-3(a), and other authorities. Accordingly, appellant contends that if a tax is based on or measured by gross receipts, imposed on gross income and return of capital, the tax is deductible pursuant to *Beamer* and R&TC section 24345, subdivision (b). Appellant contends, however, that if a tax is based on or measured by gross income imposed only on income without any COGS or return of capital, the tax is not deductible. Appellant further contends that, as a first step, "gross income" must be defined and argues that, if the base is not "gross income", or net income as defined by California law, then it is some other base and the measured tax is deductible. (App. Op. Br., pp. 5-6.)

Appellant contends that gaming taxes are generally described as in the nature of entertainment or regulatory taxes. Appellant states that the base is generally measured on gross gaming receipts (i.e., house receipts less payouts to patrons representing house losses). Appellant contends that no deductions are permitted for prizes, premiums, or other promotional allowances against the house receipts. Appellant further contends that no deductions are permitted for payroll, depreciation on buildings and gaming equipment, which are necessary costs to generate gaming revenue. As such, appellant contends that "the gaming taxes being measured by 'casino win' and not gross income" are deductible under California law. Appellant contends that, as it paid wagering taxes by its gross gaming receipts without any deduction of promotional allowances or other expenditures representing return of capital not subject to income tax, the wagering tax is imposed on an amount that includes both income and return of capital and, therefore, is deductible. Appellant further contends that, as it earned revenue from other activities, such as lodging, the sale of food and beverages, and entertainment which is not included in the wagering tax base, this fact supports finding that the wagering taxes are not being applied against appellant's gross income. (App. Op. Br., pp. 6-7.)

Appellant further contends that the significant promotional allowances they incurred represent an underlying capital investment of appellant for its gross gaming revenue.[12] Appellant contends that the promotional allowances represent an element of appellant's investment of capital necessary to produce its gross gaming revenue and therefore the return of that capital investment (promotional allowances) is not subject to income taxation, just like any other return of capital. Appellant states, to be granted a license to operate a casino in a particular jurisdiction, the company must either purchase an existing property or invest in the construction of a new property. Appellant notes that its most recent acquisition of its East Chicago, Indiana property in 2007 cost approximately $675 million. Appellant notes that other expenditures necessary to operate the casino include the

[12] According to its Form 10-K, appellant incurred 17 percent, 19 percent, and 20 percent of its gross gaming revenue in 2003, 2004, and 2005, respectively.

purchase of equipment, payroll, and utilities, all of which are costs. Appellant contends that these costs are effectively capital investment necessary to the production of gaming revenues. Citing respondent's definition of gross receipts tax, gross income tax, and net income tax in the FTB Notice 2010-02 (December 3, 2010), appellant contends that the gaming tax base is not on gross receipts, gross income or net income.[13] Appellant contends that the wagering tax may be due and payable, even if no profit is generated from the gaming activity. As an example, appellant notes that if it had net gaming revenue of $1 million, after consideration of wages, depreciations, and other ordinary business expenses, it may incur a loss for the year, but still be liable for the wagering taxes. Appellant contends that this example shows that the wagering taxes are not measured on or by gross income and should be deductible under California law. (App. Op. Br., pp. 7-8.)

Appellant further contends that the Board's decisions in the *Appeal of Dayton Hudson Corporation*, 94-SBE-003, decided on February 3, 1994 (*Dayton Hudson*), and the *Appeal of Kelly Service Inc.*, 97-SBE-010, decided on May 8, 1997 (*Kelly Service*), support its position that the wagering taxes are deductible. Appellant contends that in *Dayton Hudson*, the Board concluded that the Michigan Single Business Tax (MSBT) is deductible under R&TC section 24345, subdivision (b), on the basis that the Michigan tax base includes an element of return of capital which results in the MBST being measured by something other than gross income. Appellant contends that in this appeal the element of return of capital is the labor COGS. Appellant contends that in *Kelly Service*, the Board expanded its decision in *Dayton Hudson* to include situations where there is no labor COGS in the MBST base for service businesses. Appellant contends that the Board reasoned that the MBST makes no distinction between activities of the taxpayer when calculating the measure of tax and recognized the "true nature of the MBST" to broaden the tax base beyond profits (the usual tax base upon which an income tax is imposed). Appellant contends that it is clear from these Board decisions that a tax, computed on a tax base which includes an element of return of capital, is deductible if the true nature of the tax is a tax based on a measure beyond profit. (App. Op. Br., pp. 9-10.)

Appellant contends that the wagering tax, like the MSBT, is different from the normal

[13] This FTB Notice addresses the deductibility of the Texas Franchise Tax and may be found at: https://www.ftb.ca.gov/law/notices/2010/2010_02.pdf. This Notice was withdrawn by FTB Notice 2014-01.

corporate income tax in both its conception and computation. Appellant notes that the starting point of the wagering tax is the gross gaming receipts without any deduction for return of capital, COGS, or other expenses incurred for the production of gross income. Appellant contends that the wagering tax base has no connection to the federal taxable income. Appellant contends that the wagering tax is owed regardless of the taxpayer's profitability and the tax is computed on a measure beyond profits. As to respondent's position that the wagering tax cannot be likened to the MSBT because the MSBT formula is defined to measure the value added through the production process and the MSBT is a value added tax imposed on the privilege of doing business, appellant argues that the true nature of the wagering tax is a privilege tax as well. Appellant contends that the tax is imposed on appellant's gross gaming receipts for the privilege of operating a casino in a particular state. Appellant further contends that its position is supported by the fact that appellant is subject to additional traditional income taxes imposed by the states, other than Nevada, that impose the wagering taxes. Appellant also contends that, since the wagering tax base includes the cost of labor without exclusion for labor COGS, the wagering tax is measured by something other than gross income and is deductible. (App. Op. Br., pp. 10-11.)

Appellant contends that, if the Board sustains respondent's action, appellant would be subject to double taxation, once as a privilege tax and then as a tax on gross income. Appellant contends that the gaming industry is highly regulated and subject to state statutes separate and distinct from state income tax statutes through the states' gaming commission, in addition to state income tax statutes through the states' revenue departments. Appellant contends that, if sustained, appellant is subject to tax on its gaming revenue as administered by the state gaming commission for the privilege of operating a casino business and an income tax administered by the state department of revenue on appellant's income or total revenue (including gaming revenue) after various deductions. (App. Op. Br., pp. 11-12.)[14]

<u>Respondent's Opening Brief</u>

Respondent notes that R&TC section 24345 provides a deduction for taxes paid except

[14] Appellant also addressed the NOL carryforward deduction for the 2004 tax year. As noted previously, respondent has adjusted the 2004 assessment for this adjustment.

for "taxes on or measured by income or profits." Respondent contends that, to determine whether a taxpayer is entitled to a deduction for taxes paid, a determination must be made as to whether another state's tax is a tax on or measured by income or profits as opposed to a tax that is not on or measured by income, such as a gross receipts tax or a value added tax. Respondent asserts that the analysis to determine whether a tax is a tax on or measured by income or profits for purposes of the deduction depends on the activity or activities on which the tax applies. Respondent asserts that, when a tax applies to proceeds from manufacturing, merchandising, or mining, the analysis is different from when the tax is applied to an activity without associated COGS, such as rent or interest. Respondent contends that the wagering taxes fall into the latter category and asserts that these taxes are nondeductible income taxes regardless of any deductions from total receipts the other state may or may not allow to arrive at the applicable tax base. (Resp. Op. Br., pp. 5.)

Respondent contends that the California Supreme Court in *Beamer*, *supra* at 479-480, interpreted the issue of whether a tax is on or measured by income in the context of the California deduction for taxes paid turns on how the word "income" is defined. Respondent contends that *Beamer* supports the position that whether a tax is deductible under R&TC section 24345 turns on whether the tax base is comprised of gross income as defined under IRC section 61. Respondent argues that the definition of gross income pursuant to IRC section 61 is expansive and, for most types of income, such as rents, interest, dividends, and compensation for services, is generally comprised of total receipts. Respondent notes that Treasury Regulation section 1.61-3 provides that income from certain specified business activities (manufacturing, merchandising, and mining) as excluding COGS from total receipts when calculating gross income. Respondent notes that the Court in *Beamer* considered whether a group of taxpayers were entitled to a deduction under former R&TC section 17204, subdivision (c)(4), for a Texas tax on oil and gas producers. Respondent notes that the Court explained that if the Texas tax was a tax on or measured on or measured by income, a deduction was not allowed. Respondent notes that the Texas tax only applied to the business activity of mining and was calculated as a percentage of the market value of the oil when produced. Respondent contends that the Court determined that that the taxpayers were entitled to a deduction for Texas taxes paid because the Texas tax was not a tax measured on or by income. Respondent notes that the Court reasoned that, in the context of mining, lifting costs are COGS and the Texas tax did not permit a deduction for lifting costs. (Resp. Op. Br., pp. 6-7.)

Respondent further contends that in *MCA*, the Second District Court of Appeals analyzed various taxes on the gross amount of film rents and royalties where no deduction was provided for expenses in producing the rents and royalties. Respondent contends the court determined that, since the definition of gross income in IRC section 61 explicitly includes rents and royalties, the tax must be a gross income tax regardless of the fact that it was also a tax on the gross receipts received by MCA and therefore not deductible. Respondent notes that the court indicated that the rule in *Beamer* required the gross receipts to include an element of direct return of capital invested as COGS in order for the amount to be deductible. (Resp. Op. Br., pp. 7-8.)

Respondent contends that, similarly, in *Robinson*, the Third District Court of Appeals analyzed whether the Hawaii general excise tax was deductible. Respondent contends that, as the Hawaii general excise tax varied with the business activity being taxes, the court focused on the deductibility of the tax on the type of the taxpayers' income, which consisted of rent and interest. Respondent notes that the court determined that, since rent and interest were specifically listed as gross income in California and federal statutes and under the Hawaii tax all proceeds from rent were included in the tax base without any reduction for costs, the Hawaii tax was a nondeductible gross income tax. (Resp. Op. Br., p. 8.)

Respondent contends that, in *Dayton Hudson*, the Board applied *Beamer* and *Robinson* to the Michigan Single Business Tax (MSBT) paid by a manufacturer taxpayer and found that there was an element of return of capital in the tax base in the form of labor COGS sufficient to find that the tax was not on or measured by income, and therefore, deductible. Respondent contends that, in *Kelly Service*, the Board considered the fact that the taxpayer was primarily a service provider which did not have a return of capital in its line of business. Respondent contends that the Board considered that the MSBT did not allow a deduction for many items routinely deducted for income tax purposes, but due to the inclusion of the labor COGS in the tax base, the Board concluded that the MSBT was taxing something other than gross income and held that the taxpayer was entitled to the deduction for taxes paid. Respondent contends that these cases illustrate that when a tax base includes income from manufacturing, mining or merchandising, the characterization of the tax as a gross income tax depends on whether there are COGS in the tax bases. Respondent argues that, in contrast, when the tax base does not include income from manufacturing, mining or merchandising, and only consists of income such as rent, interest, dividends, or income from gambling, the characterization of the tax must, by definition, be an income tax. Respondent contends that this is true even if the gross income of a particular taxpayer is equal to that taxpayer's gross receipts, citing *MCA*. Respondent contends that the tax bases at issue here only measure income from gaming activity as they are based solely on the difference between amounts wagered and payouts and the tax bases do not include income from manufacturing or merchandising. Respondent contends that even if the taxpayer engages in some form of merchandising activity, the receipts from that merchandising activity would not be included in the tax base. As such, respondent contends that, like in *Robinson* and *MCA*, the COGS can never be in the tax base and the tax must be characterized as a nondeductible gross income tax. (Resp. Op. Br., pp. 8-10.)

With regard to appellant's attempt to analogize to *Kelly Service* by arguing that wagering taxes include "labor costs of goods sold", respondent contends that, unlike the MSBT which applied to various types of business activity, the wagering taxes at issue only apply to the activity of gaming and asserts that there are no COGS associated with gaming. Respondent contends that the concept of COGS is rooted in accounting as the cost of inventory items sold, citing FASB Accounting Standards Codification Subsection 330-10-05-3. Respondent contends that, since gaming does not involve the production, purchase, or sale of goods as an income producing factor, there is no inventory and no COGS associated with gaming. Respondent argues that to allow a deduction for COGS in this context would be allowing a deduction for something that does not exist. Respondent contends that appellant's federal tax returns support respondent's position. Respondent contends that the federal income tax generally applies to all business activity, including manufacturing, merchandising, and mining and, accordingly, the federal tax return begins with gross receipts and provides a line to remove COGS in arriving at gross profit. Respondent contends that, in calculating its COGS, appellant reported purchases, but did not report any other items generally included in COGS, such as the cost of labor. Respondent argues that this omission of items other than purchases shows that appellant only has COGS associated with its merchandising activity, such as gift shops, which is separate from its gaming activity. Respondent points out that the wagering taxes do not apply to merchandising activity or any other type of business activity other than gaming activity. Respondent therefore contends that there are no COGS associated with gaming activity. (Resp. Op. Br., pp. 10-11.)

With regard to appellant's argument that the wagering taxes are privilege taxes and automatically deductible, respondent contends that appellant's reliance on Regulation section 24345-1(a) is misplaced. Respondent contends that appellant misinterprets the regulation in a way that violates the clear statutory language in R&TC section 24345. Respondent contends that Regulation section 24345-1(a) "merely provides clarification on taxes that may qualify under the general rule <u>unless</u> those taxes are on or measured by income." (Respondent's emphasis.) Respondent contends that the Board's discussion in *Kelly Services* highlights the incorrect nature of appellant's argument. Respondent contends that the Board concluded that the Hawaii tax was a "privilege tax" that was not deductible with respect to rent because the tax base consisted of "gross income." Respondent argues that the use of the term "privilege tax" in the regulation did not impact the Board's conclusion that the tax was not deductible. Noting that the term "business taxes" is used in the same context as "privilege taxes", respondent further contends that appellant's interpretation would mean that any tax that falls under the category of "business taxes" would be deductible even if it were clearly a gross or net income tax which would render the language in R&TC section 24345 meaningless. (Resp. Op. Br., pp. 11-13.)

<u>Appellant's Reply Brief</u>

Appellant contends that respondent's reliance on IRC section 61's definition of "gross income" as being synonymous with the definition of gross gambling receipts oversimplifies the analysis. Appellant notes that both respondent and appellant cite to the same basic legal authority in *Beamer* upon which this case turns and the Board's evaluation of the issue in *Dayton Hudson* and *Kelly Services*. Appellant contends that it has shown that the nature of the wagering tax is more appropriately classified as license or regulatory fees and the wager tax is most appropriately evaluated as a tax imposed on gross receipts, not gross income. Appellant argues that the notion that the base coincidently includes an element of income alone dictates non-deductibility is not supported by law. Appellant further contends that, under respondent's position, one would conclude that the same receipts that serve as the base for wagering taxes are also included as gross income for purposes of measuring income taxes imposed on appellant by each state (other than Nevada). Appellant asserts that it is unthinkable that the law would support a conclusion that a state would impose two "income taxes" on the same income. (App. Reply Br., pp. 1-3.)

Appellant contends that Regulation section 24345-1 clarifies the types of taxes that may qualify for the deduction, which includes business, privilege or excise taxes paid to the United States or to a state. Appellant contends that these taxes are included in the regulation because most, if not all business, privilege, or excise taxes are based on gross receipts or some other measure of value. Appellant contends that the tax or "license fee" is often measured by gross receipts, citing *Franklin v. Peterson*, 87 Cal.App.2d 727, and Nevada Revised Statute section 463.370. Appellant contends that the gaming taxes in Missouri, Iowa, Mississippi, and Colorado are imposed under statutes regulating gaming and administered by the state's Gaming Commissions, not departments of revenue, and not under those states' income tax laws. Appellant contends that the label given to an imposed tax is not controlling under California law as to its deductibility. Appellant contends that respondent erroneously contends that, since the gaming tax base, gross revenues or gross gaming receipts, are the equivalent of gross income, the taxes are per se non-deductible. Appellant argues that the Board should find that the wagering taxes are business privilege or license taxes and, thus, deductible under California law. Appellant points out the degree of regulation imposed on gaming activity as discussed in appellant's annual report to shareholders. Appellant contends that, along with the regulations and oversight, the respective states impose taxes for the privilege of operating a casino to derive revenue for the state and to pay for the various state commissions and the oversight of the gaming activities. Appellant further reiterates that it pays an income tax in all of these states, other than Nevada, in addition to the wagering tax on the same revenue that constitutes the tax base for the wagering taxes. Appellant contends that the income tax laws in these other states are separate and distinct from the

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statutes governing the wagering taxes.[15] Appellant contends that, contrary to respondent's assertion that appellant's position requires a circuitous analysis, the proper analysis requires looking at two separate and entirely distinct taxing methods. Appellant contends that the wagering tax is for the privilege of operating a gaming business. Appellant further contends that the income tax is imposed under a state's general income tax laws. Appellant contends that the casino tax base is defined by the state gaming statutes while the income tax base is defined by the state's income tax laws. Appellant argues that, to conclude as the FTB does, that the wagering taxes are on or measured by income would also conclude that Nevada imposes a corporate income tax despite the fact that Nevada does not impose income taxes of any kind. (App. Reply Br., pp. 3-5; Resp. Op. Br., Exh. D.)

Appellant contends that the California Supreme Court in *Beamer* made this distinction clear when it considered the Texas occupation tax on the business of producing natural gas and crude petroleum and the Texas income tax on royalty income received from the oil and gas produced. Appellant argues that the outcome in *Beamer* would have been different had the Court been presented with the sole question of gross income under general tax law instead of two entirely separate and distinct taxes. Appellant further contends that in *MCA* and *Robinson*, the California Court of Appeals reasoning supports the conclusion that, if there is just an issue of one tax that is being assessed under the general income tax laws, then that tax will be considered a gross income tax and will not be deductible. Appellant contends that *MCA* and *Robinson* are dispositive only to the issues addressed, rental and royalty income taxed under income tax laws, and do not support respondent's position in this appeal. Appellant argues that both of these cases were interpretations of gross income under general tax laws currently operating. Appellant contends that this current appeal is distinguishable from *MCA* and *Robinson* because appellant is paying two separate and distinct taxes. Appellant argues that the court in *Robinson* provided that if income excluded COGS from the tax base, the tax would be deductible under California law. (App. Reply Br., p. 6.)

Appellant further argues that the court in *MCA* also stated that the rule in *Beamer* required gross receipts to include an element of direct return of capital invested or COGS in order for

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[15] Appellant lists the following income tax statutes: Colorado Rev. Stat. §39-22-103; Iowa Code §422.7; Missouri Rev. Stat. §143.091; and Mississippi Code Ann. §27-7-15. Nevada does not impose an income tax.

the amount to be deductible. Appellant contends that the return of capital in *Beamer* was the cost of infrastructure required to extract oil from the ground (i.e., lifting costs) and argues that the return of capital in this case is the cost of infrastructure, such as property, equipment, and labor, needed to conduct gaming operations. Appellant argues that an income tax is ordinarily a tax upon net income, gross income reduced by other taxes, expenses, costs incurred in the production of income. In contrast, appellant contends that the wagering taxes here expressly forbid the deduction of business-related expenses and results in a tax measured by gross receipts. Appellant thus contends the characterization of the tax base controls whether a tax is measured by gross receipts or gross income and, here, the tax base includes a return of capital elements and should be characterized as a gross receipts tax, and not an income tax. (App. Reply Br., p. 7.)

Appellant contends that the Board's decisions in *Dayton Hudson* and *Kelly Services* are controlling and support the deduction for wagering taxes. Appellant contends that in *Dayton Hudson*, the issue was whether the MSBT is a tax measured by gross income. Appellant contends that the taxpayer in *Dayton Hudson* deducted the COGS from its gross receipts, but included the cost of labor to derive the MSBT base. Appellant contends that the FTB in *Dayton Hudson* argued that, since gross income for federal tax purposes in a manufacturing, merchandising or mining business is defined as gross receipts less COGS pursuant to Treasury Regulation section 1.61-3(a), the MSBT is measured by gross income. Appellant contends that the Board disagreed with the FTB's approach and determined that the MSBT paid was deductible because the tax base included an item which must be deducted to arrive at gross income (i.e., labor COGS) resulting in the tax being measured by something other than gross income. Appellant contends that in this case, its casino business incurred significant labor costs, as evidenced in its federal returns. Appellant argues that, since the gaming tax base does not include any deductions from the base for the cost of labor, depreciation, or taxes, it supports finding that an element of return of capital is included in the tax base (although not designated as a COGS) and making the tax base something other than on gross income. Appellant, citing *Beamer*, reiterates that gross income is not synonymous with gross receipts and contends that this observation is relevant in the application to gross gaming revenue of a service business, such as appellant. (App. Reply Br., pp. 7-8.)

Appellant contends that in *Kelly Services*, the Board reasoned that the purpose of the various additions and subtractions from taxable income is to broaden the tax base beyond profits (the usual tax base upon which an income tax is imposed). Appellant contends the Board noted that these modifications are designed to draw in other components of the taxpayer's economic activity, which could result in a sizable tax base and tax imposed regardless of profits. Appellant contends that the Board in *Kelly Services* concluded that the MSBT measures economic activity and is not an income tax, and therefore deductible. Appellant reiterates that it is subject to wagering taxes, regardless of its profitability and the wagering taxes are consistent with the MSBT as wagering taxes also include the return of capital cost in the base. Appellant argues that respondent's position is in direct contradiction with the Board's holding in *Kelly Services* which held that a tax base which includes the cost of labor, without exclusion of the labor COGS, results in a tax which is measured by something other than gross income. Appellant maintains that the wagering tax base at issue is basically defined as wagering receipts less wagering payouts and the tax base does not include any deductions for any capital elements such as labor costs, interest, depreciation, which are allowed as deductions from gross income for income tax purposes. (App. Reply Br., pp. 9-10.)

Appellant maintains that the wagering tax is based on gaming gross receipts, contrary to respondent's position that it should be classified as measured on gross income from an income tax point of view. Appellant notes that the AICPA Audits and Accounting Guide (Gaming (updates as of September 1, 2012) defines gross gaming revenue as "the win from gaming activities, which is the difference between gaming wins and losses <u>before deducting costs and expenses</u>. . . . [The] Tax base may also be referred to [as] 'the win'. The win is defined as the net win from gaming activities, which is the difference between gaming wins and losses before <u>deducting costs and expenses</u> and also called gross gaming revenue." (Appellant's emphasis.) Appellant argues that the definition of gross gaming revenue used for financial statement purposes also defines the wagering tax base in all of the states appellant conducted business. Appellant argues that respondent mistakenly concludes that the netting of losses must be considered deductions from income and therefore must result in a measure of gross income. Appellant contends that the AICPA definition of gross gaming revenue supports finding that the netting of losses are not deductions, but part of the definition of total gross gaming receipts (the staring measurement of a business' total gross receipts for federal income taxpayers). Appellant contends that a return and allowance cannot be considered to be a part of gross receipts just like a payout for a patron's win cannot be considered a part of gaming gross receipts. As such, appellant argues that the tax base is not truly gross receipts in the sense of income tax law gross income because a gross receipt in an income tax sense would allow for no offset for patron winnings – each dollar that comes to the table, or goes into the slot is a house receipt. Appellant notes that gaming laws allow the payout, and in some cases, bad debt deductions. (App. Reply Br., pp. 11-12.)

Appellant contends that, contrary to respondent's interpretation, the definition of "gross income" pursuant to IRC section 61 supports the finding that wagering taxes are not based on gross income. Appellant contends that this all-encompassing statute is designed to include all revenue into gross income. Appellant contends that the wagering tax is not a tax on gross income because the wagering tax base does not include rent, which is included in the definition of gross income pursuant to IRC section 61. Appellant similar notes that the states do not include revenue from its entertainment, food, beverage, and other revenue activities into the wagering tax base. (App. Reply Br., pp. 12-13.)

Appellant further contends that the FTB Audit Technique Manual provides, for purposes of R&TC section 24345, the term "income" refers to gross income. Appellant notes that, in order to arrive at gross income, gross receipts are reduced by COGS. Appellant acknowledges that certain types of receipts, such as rents or income from services, do not contain a return of capital element. Appellant notes that, in that case, gross receipts are the same as gross income, and the tax on that income will be considered non-deductible income tax. Appellant contends that the critical inquiry is whether the tax base includes COGS or a return of capital. Appellant contends that, in *Beamer*, the regulations, on which the California Supreme Court relied, recognized the fact that gross receipts of businesses in mining, merchandising, or manufacturing included receipts which may constitute capital as well as income and returns of capital may not be taxed. Appellant argues that, the Court found that, as applied to a mining business, these regulations meant that "lifting costs" were required to be subtracted from gross receipts to determine gross income. Appellant notes that the taxpayer in *Beamer* incurred significant infrastructure costs to extract oil from the ground. Appellant argues that it similarly incurred significant costs (building, equipment, and labor) necessary to operate its casino business. Appellant argues that, under the reasoning of *Beamer*, gaming gross receipts constitute return of capital because none of these infrastructure costs are excluded from the gaming gross receipts tax base. (App. Reply Br., pp. 13-16.)

Respondent's Reply Brief

Respondent contends that, appellant incorrectly asserts that the Board held in *Dayton Hudson* and *Kelly Services* that the general rule applicable to all taxes is if a tax does not allow a deduction for labor costs, it must be deductible. Respondent contends that this is not what the Board held, and this is not what other California court cases have held. Respondent contends that, while *Dayton Hudson* and *Kelly Services* provides helpful guidance as to the analysis of determining the character of a tax for deductibility purposes, the Board specifically limited the holdings in both appeals to the MSBT. Respondent contends that the wagering taxes at issue are distinguishable from the MSBT in those appeals. Respondent contends that the MSBT, prior to its repeal, generally applied to all business activity, including manufacturing, merchandising, rental activity, and services. As such, respondent contends that COGS was relevant to the tax base as there was potential for COGS to be included in the tax base even if the business activities of a particular taxpayer might not involve COGS. Respondent contends that, since the MSBT did not allow a deduction for all COGS, an element of COGS remained in the tax base, which formed the basis for the Board's conclusion in *Dayton Hudson and Kelly Services* that the MSBT was deductible. Respondent argues that in contrast to the MSBT, the wagering taxes here apply only to gaming activity. Respondent argues that the wagering taxes are not imposed on receipts from other activities, such as manufacturing or merchandising. Respondent contends that appellant does not dispute that there are no COGS associated with gaming activity. Respondent argues that the wagering taxes are, therefore, more like the taxes on rents and royalties in *MCA* and *Robinson*, and the wagering taxes are necessarily on or measured by income even where gross income is equal to gross receipts. (Resp. Reply Br., pp. 1-2.)

Respondent contends that, with regard to appellant's position that the wagering tax is a gross receipts tax, the courts have focused on whether there is a return of capital in the form of COGS in the tax base. Respondent notes, for example, in *MCA*, the court stated that where gross receipts are equal to gross income, the tax will be characterized as a gross income tax unless the gross receipts include an element of direct return of capital invested as COGS. Respondent further notes that appellant explicitly states that there is no return of capital associated with rents and royalties and argues that appellant fails to provide any valid support for distinguishing the wagering tax base from rents and royalties. Respondent contends that appellant attempts to distinguish the wagering receipts from rent and royalties by implying that its infrastructure costs constitute return of capital with respect to its gaming activity. Respondent contends that appellant has not explained why the property and equipment associated with rents would not constitute return of capital, and yet with respect to appellant's gaming activity, appellant asserts that its property and equipment does constitute return of capital. Respondent argues that, just as someone who rents a house is not generating receipts from selling that house, appellant's wagering receipts are not from the sale of property, such as slot machines. Respondent contends that, while expenses for items such as property and equipment might constitute ordinary and necessary business expenses potentially allowable as a deduction to determine net income under the federal and California income tax laws, such expenses are not relevant to whether another state's tax is based on gross income or gross receipts. (Resp. Reply Br., p. 3.)

Respondent further contends that, contrary to appellant's assertions, the number of taxes that another state imposes is not relevant to the characterization of a tax for purposes of the deduction. Respondent contends that its reading of *Beamer* does not support appellant's assertion that the Texas occupation tax at issue was deductible because Texas imposed both an occupation tax on the business of producing natural gas and crude petroleum and an income tax on the royalty income received from the oil and gas produced. Respondent contends there is no support in *Beamer* for appellant's contention that the outcome in *Beamer* would have been difference had the court been presented with the sole question of gross income under general tax law instead of two entirely separate and distinct taxes. Respondent argues that *Beamer* analyzed the Texas occupation tax and determined that it was deductible because it was a tax on mining activity and did not provide for a deduction for COGS. (Resp. Reply Br., p. 4.)

Respondent contends that *MCA* and *Robinson* further demonstrate the flaws in appellant's contention regarding the relevancy of the number of taxes imposed by the other state.

Respondent notes that appellant asserts that those two cases are distinguishable from the current appeal because those cases stand for the proposition that if there is only one tax imposed by another state under "general income tax laws currently operating," the tax will always be a non-deductible gross income tax under California law. Respondent contends that appellant has not explained what it means by "general income tax laws currently operating," or how the taxes in *MCA* or *Robinson* fall under this terminology. Respondent contends that court's analysis in *MCA*, which involved foreign taxes on rents and royalties determined to be non-deductible, is relevant. Respondent contends that the fact that the court in *MCA* did not mention any other taxes imposed on the taxpayer simply shows that the imposition of other taxes, or lack thereof, was not relevant to the court's determination. Respondent argues that the failure to mention any other taxes imposed does not mean that there were no other taxes imposed or that there exists a rule that if only one tax is imposed by another state under "general income tax laws currently operating," the tax will always be a non-deductible gross income tax under California law. Respondent further contends that there is no indication that the court in *MCA* considered whether the taxes on rents and royalties were imposed under a particular section of another jurisdiction's code in its analysis. Respondent contends that, similarly, the court's analysis in *Robinson* does not support appellant's position. Respondent notes that, in *Robinson*, the court made it clear that its analysis of different taxes under the same Hawaii statute and the same taxing regime are considered independently. Respondent argues that one tax might be considered a gross receipts tax that would be deductible for California purposes, while another tax under the same statute might not be considered a gross receipts tax that would be non-deductible for California purposes. As such, respondent questions the faulty logic of appellant's analysis. (Resp. Reply Br., pp. 5-6.)

As to appellant's contention that respondent is misinterpreting the laws of other states (such as Nevada), respondent contends that appellant is incorrect. Respondent contends that it is in charge of administering California's franchise and income tax laws. Respondent argues that, while a determination of the California deduction for taxes paid does require it to analyze the characteristics of another state's tax, respondent applies only California law in determining whether such tax qualifies for a deduction under California law. Respondent contends that its position is that, under California law, for purposes of the deduction provided under R&TC section 24345, the wagering taxes paid by appellant are income taxes. Respondent contends that the applicable case law shows that, with respect to a tax on an activity that does not have COGS associated with it, the tax base constitutes gross income, even if it consists of total receipts. Respondent maintains that, similar to rent, gaming has no COGS or any other element of return of capital. As such, respondent contends that it properly disallowed the deduction for wagering taxes paid. (Resp. Reply Br., pp. 6-7.)

Appellant's Supplemental Brief

Appellant contends that respondent incorrectly attributes to appellant the view that appellant fails to recognize the differences between the wagering taxes and the MSBT. Appellant contends that the recognized differences between these wagering taxes and the MSBT supports finding that the wagering taxes are deductible, contrary to respondent's view. Appellant notes that respondent wants the Board to view wagering taxes like income taxes on rents and royalties. Appellant contends that there are two critical differences relevant in this appeal. Appellant first contends that IRC section 61 does not contain the tern "gaming revenue" in the specific definition of gross income. Appellant secondly contends that, in each state in which appellant pays the wagering taxes other than Nevada, appellant is subject to an income tax on the same receipts, measured by an element of gross income under those states' income tax laws. Based on these differences, appellant contends that it is clear that "the tax base upon which the wagering tax is measured is a gross receipts base for gaming licensing and regulatory purposes, while it is also a base for income taxes imposed by the same states." (Appellant's emphasis.) As such, appellant contends that the wagering taxes are deductible taxes, and any income taxes imposed by a state on those same receipts are non-deductible income taxes. Appellant again cites to now-withdrawn FTB Notice 2010-02 which provided guidance regarding the deductibility of the Texas Margin Tax. Although appellant acknowledges that the notice is withdrawn, appellant contends that the summary of the definitions of gross receipts tax, gross income tax, and net income tax are accurate. Appellant contends that a gross income tax subtracts returns of capital from the tax base, and, for a manufacturer or merchandise, gross income may be characterized as gross receipts less COGS. Appellant contends that a gross receipts tax has a broader base and is imposed on gross income, plus a return of capital, such as COGS. Appellant contends that a gross receipts tax for a manufacturer or merchandiser, a gross receipts tax is imposed on revenue without benefit of a deduction for COGS or any other expense. (App. Supp. Br., p. 1-3.)

Appellant contends that, in evaluating the nature of taxes that are deductible, the Board has not limited its conclusion to taxes that include the technically defined COGS. Appellant contends that the Board, in applying *Beamer*, held that when a tax base does not allow a deduction for items normally considered to by COGS or returns of capital, the tax is not measured by gross income, and therefore, deductible, citing *Dayton Hudson* and *Robinson*. Appellant contends that the Board in *Dayton Hudson* found it immaterial that Michigan only disallowed a portion of the expenses normally deductible as COGS or return of capital. As such, appellant contends that *Dayton Hudson* demonstrates that the Board has historically considered the disallowance of any deduction normally includible in a category of expenses associated with COGS to render the tax being imposed as on other than gross income, and thus deductible. Appellant further contends that, in *Robinson*, the court concluded that the excise tax imposed by Hawaii was a tax on or measured by gross income or profits as to some of its application, but not to other applications. Appellant contends that the court in *Robinson* determined that the Hawaii excise tax as applied to rent was an income tax. Appellant contends that the *Robinson* court however determined that the Hawaii excise tax as applied retail sales or mining activities and was a gross receipts tax due to the lack of a COGS deduction. Appellant contends that rents and royalties are specifically listed as gross income and is taxable regardless of whether COGS or returns of capital are excluded from the tax base. Appellant contends that the *Robinson* court analyzed the tax on rents and royalties separate from the other taxes on other business activities and determined that it was a nondeductible income tax. Appellant contends that, even respondent points out, had the taxpayer also argued that the Hawaii excise tax on rock sales was a separate gross receipts tax, the outcome as to the tax on the rock sales may have been different. Appellant further contends that the Board in *Kelly Services* held that the MSBT was deductible for a service provider that had no COGS but was denied payroll deductions in the tax base, regardless of the specific components of the tax base of the taxpayer claiming the deduction. Appellant contends that the decision supports a deduction when the tax base does not allow deductions, such as appellant's payroll expense here, and when the tax base is not specifically defined as gross income. As such, appellant maintains that the application of *Beamer*, *Dayton Hudson*, and *Kelly Services* results in finding that the wagering taxes are deductible. (App. Supp. Br., pp. 3-5.)

Appellant contends that, should the Board conclude that the tax base at issue is on both gross receipts and gross income, the inquiry should be how one determines the true nature of the tax on that dual tax base. Appellant argues that the answer should be based on whether the tax base is exclusive to a state's income tax system or subjected to both income tax and a totally independent tax regime co-existing in that state. Appellant contends that in this case, the wagering tax imposed by the regulatory authorities should be considered the gross receipts tax and the tax imposed by the states on the income derived from those receipts by the states' departments of revenue are taxes measured by income. (App. Supp. Br., pp. 5-6.)

Applicable Law

Income tax deductions are a matter of legislative grace and a taxpayer who claims a deduction has the burden of proving by competent evidence that the he or she is entitled to that deduction. (See, e.g., *INDOPCO, Inc. v. Commissioner* (1992) 503 U.S. 79, 84.) Unsupported assertions are not sufficient to satisfy an appellant's burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

R&TC section 24345, subdivision (b), allows a deduction for taxes or licenses paid or accrued during the taxable year, except taxes on or according to or measured by income or profits paid or accrued within the taxable year imposed by the federal government, any foreign country, or any state or local government. Regulation section 24345-1(a) provides that "[t]axes or licenses which may be deducted include ad valorem property taxes (but see Regulation 24345-2, respecting special assessments), automobile registration fees, city license fees, import or customs duties paid to federal customs officers, liquor or alcoholic beverage license fees, and other business, privilege or excise taxes paid to the United States or to a state."

IRC section 61 provides that, except as specifically excluded, "gross income" means all income from whatever source derived, including, but not limited to, the following items: compensation for services, gross income derived from business, gains from dealings in property, interest, rents, royalties, dividends, and other items not applicable to this appeal. Treasury Regulation section 1.61-3 provides that, with respect to gross income derived from business, for "manufacturing, merchandising, or mining business, ‘gross income’ means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources.”

In *Beamer*, the California Supreme Court considered the issue of whether a Texas occupation tax levied by Texas on producers and purchasers of oil and gas computed on the market value of the oil and gas as produced was a tax deductible under former R&TC section 17204. The Court held the term “income” in the statute is “gross income” as defined under current general tax laws currently operating. (*Beamer*, *supra* at 479.) The Court noted that, in the context of mining, lifting costs are COGS and the Texas tax did not permit a deduction for lifting costs. (*Beamer, supra* at 480.) The Court determined that, although a portion of the gross sales receipts used to compute the Texas taxes was the same dollar amount as the royalty income of the taxpayers, the Texas taxes were measured by gross receipts from the sale of all mineral produced on the taxpayer’s land. Therefore, the Court held that the Texas taxes were not measured by gross income and, thus, deductible. (*Id*.)

In *MCA*, the Court of Appeals for the Second District considered whether various taxes on the gross amount of film rents and royalties where no deduction was provided for expenses in producing the rents and royalties were deductible under R&TC section 24345. The court noted that *Beamer*’s holding that “income” means “gross income under general tax laws currently operating” is controlling. (*MCA*, *supra* at 191.) The court held that, under general tax law, film rentals and record royalties received by MCA were gross income and, therefore, a tax based on the receipt of these items was a tax measured by income and non-deductible. (*Id*.) The court stated that the fact that such rents and royalties also constituted MCA’s gross receipts does not make the taxes any less taxes measured by gross income. (*Id*.) The court stated that, to be deductible under R&TC section 24345, the gross receipts must include, like the Texas tax in *Beamer*, “an element of direct return of capital invested as cost of goods sold.” (*Id* at 198.)

In *Robinson*, the Third District Court of Appeals analyzed whether the Hawaii general excise tax was deductible. The court, citing *Beamer*, noted that the terms “gross income” and “gross receipts” are not synonymous. (*Robinson*, *supra* at 78.) The court further noted that “gross receipts” is a broader term, including within in receipts which may constitute capital as well as income, and returns of capital may not be taxed. (*Id*.) The court noted that the Hawaii general excise tax varied with the business activity being taxed. (*Robinson*, *supra* at 80-81.) The court reasoned that, since the general tax law defines gross income by the nature of the income, the tax should be evaluated by reference to the specific income activity taxed. (*Id*.) The court determined that, since the income at issue was rent and interest, which were specifically listed as gross income in California and federal statutes and, under the Hawaii excise tax, all proceeds from rent were included in the tax base without any reduction for costs, the Hawaii tax was a nondeductible gross income tax. (*Id.* at 82.) The court however noted that the taxpayer's royalties were listed as amounts paid for "rock sales" and stated that, "[i]f the sales were a part of a manufacturing, merchandising, or mineral business activity, the Hawaii tax is measured by gross proceeds . . . and such a Hawaii tax is deductible under California law." (Emphasis in the original.) (*Id*.)

In *Dayton Hudson*, *supra*, the Board considered whether the MSBT was a deductible tax. The Board stated that, in determining whether the MSBT was a deductible tax, the question is not whether the tax is a gross receipts tax or an income tax, but whether the tax is or is not on or measured by gross income. The Board further stated that if it is not a tax or on measured by gross income, then the inquiry ends and the taxpayer need not show whether it is a tax on or measured by gross receipts. The Board applied *Beamer* and *Robinson* to the MSBT paid by a manufacturer taxpayer and found that there was an element of return of capital in the tax base in the form of labor COGS sufficient to find that the tax was not on or measured by income.

In *Kelly Service,* the Board considered whether the MSBT as applied to a service provider taxpayer who did not have a return of capital in its line of business was deductible. The Board affirmed its decision in *Dayton Hudson* and clarified that its decision applies equally to service businesses. The Board concluded that the MSBT measures economic activity and is not an income tax. The Board noted that the MSBT did not allow a deduction for many items routinely deducted for income tax purposes, but due to the inclusion of the labor COGS in the tax base, the MSBT was taxing something other than gross income and held that the taxpayer was entitled to the deduction for taxes paid. The Board also distinguished the holding in *Robinson* based on the fact that *Robinson* involved a privilege tax imposed on business or other activities and that privilege tax was measured by different standards, depending on the activity undertaken by the taxpayer. The Board noted that manufacturers and retailers were taxed measured by gross proceeds of sales while service businesses were taxed measured by gross income. The Board acknowledged that *Robinson* concluded that tax paid by a taxpayer involved in a service business or activity was a nondeductible income tax. The Board noted, in contrast, the MSBT made no distinction between the activities of the taxpayer when calculating the measure of tax. The Board further stated that, "[w]e emphasize that this decision is not intended to enunciate a general rule on all "value-added" type taxes, which must be examined on a case-by-case basis, but applies only to the [MSBT], as written during the periods involved in this appeal."

STAFF COMMENTS

Deductions are a matter of legislative grace, and the burden is on the taxpayer to show by competent evidence that it is entitled to the deductions claimed. (See, e.g., *INDOPCO, Inc. v. Commissioner*, *supra*, 503 U.S. 79, 84.) The deduction at issue is provided by R&TC section 24345, which generally allows a deduction for taxes paid to federal, foreign country, other state, or local government, unless the tax is on or measured by income. "Income" is defined as gross income under general tax laws currently operating. (*Beamer, supra* at 479.) In evaluating whether a tax is deductible, the tax at issue should be evaluated by reference to the specific income activity taxed. (*Robinson*, *supra* at 80-81.)

IRC section 61 provides the general definition of "gross income" and a non-exclusive list of various types of gross income, such as interest. IRC section 61 does not specifically list gaming revenue. However, IRC section 61 does specifically list "gross income derived from business." For businesses in manufacturing, merchandising, or mining, gross income is calculated by excluding COGS. (Treas. Reg., § 1.61-3.) The parties should be prepared to discuss whether appellant's gaming revenue falls within "gross income derived from business." As noted above, if the tax at issue is based on gross income, the taxes paid would not be deductible.

The wagering tax is determined based on the money wagered by gamblers minus payouts made by the casino. Appellant contends that it is a privilege tax measured on gross receipts, and not measured on or by income, and, therefore, deductible. Appellant contends that the tax base for the wagering tax is gross gambling winnings and that tax was calculated on more than just profit or income because the base includes COGS or an element of investment capital. Respondent contends that the wagering taxes at issue are a tax measured on or by income, and, therefore, not deductible. Respondent contends that this analysis depends on whether a tax applies to proceeds from manufacturing, merchandising, or mining or when the tax is applied to an activity without associated COGS, such as rent or interest. Respondent contends that the wagering taxes fall into the latter category and, as a result, these taxes are nondeductible income taxes regardless of any deductions from total receipts the other state may or may not allow to arrive at the applicable tax base. Respondent contends that, with respect to a tax on an activity that does not have COGS associated with it, the tax base constitutes gross income, even if it consists of total receipts.

The parties should be prepared to address whether the gaming business is similar to a manufacturing, merchandising or mining business or might more appropriately be considered a service business. In manufacturing, merchandising, and mining businesses, COGS are deducted in determining gross income. (Treas. Reg., § 1.61-3.) However, in a service business (i.e., a business that does not primarily involve the sale or production of goods or assets), COGS generally would not be deducted in determining gross income. In this connection, staff notes that appellant did not report any COGS related to gaming on their federal tax returns.

To the extent appellant argues that *Kelly Services* supports its contention that the tax is deductible, it should be prepared to address whether the tax imposed by the MBST, which applies to a wide range of businesses, should be distinguished from the tax at issue here, which only applies to wagering. Staff notes that in *Kelly Services*, the Board emphasized that its decision was limited to the MSBT during the periods at issue in that case. The MSBT applied to various business activities including manufacturing, merchandising, rental activity, and services. Due to the MSBT's application to all business activities, the Board had to determine whether the MSBT included COGS in the tax base as applied to the specific taxpayers as there was potential for COGS to be included in the tax base, even if the business activities of a particular taxpayer might not involve COGS. In contrast, the wagering taxes are based solely on gaming activity.

The parties should also be prepared to discuss the application of *Beamer*, *Robinson* and *MCA*, on the present appeal. It appears to staff that, when gross receipts are equal to gross income, the tax will be characterized as a gross income tax unless the gross receipts include an element of direct return of capital invested as COGS. It appears to staff that investment in tangible or intangible property is typically necessary to produce rental or royalty income, however gross income from such investments is calculated without a reduction for COGS because these investments are indirect costs of producing the income. Appellant should be prepared to address whether its costs and investments are also indirect costs or whether they are equivalent to COGS which would be deducted in order to calculate gross income.

If either party has any additional evidence to present, it should provide the evidence to the Board Proceedings Division at least 14 days prior to the oral hearing pursuant to California Code of Regulations, title 18, section 5523.6.[16]

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[16] Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC: 80, Sacramento, California, 94279-0080.