BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HUNTINGTON LAND AND IMPROVEMENT CO.)

Appearances:

For Appellant: C. E. Culver, Treasurer of Appellant Corporation
For Respondent: Chas. J. McColgan, Franchise Tax Commissioner

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Statutes of 1929, Chapter 13, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Huntington Land and Improvement Co., a corporation to a proposed assessment of an additional tax in the sum of $70.79 for the year 1932, based upon its return for the year ended December 31, 1931.

For the taxable year ended December 31, 1931, Appellant filed a consolidated return, covering its own operations for said year and also covering the operations of its wholly owned subsidiaries, Standard Felt Corporation, and the Los Angeles Railway Land Company.. After examining the return, the Commissioner added to the income, upon the basis of which the tax should be computed an item representing Federal income tax in the amount of $2,538.24 and an item of $11,327.66 representing dividends received by the Appellant from its subsidiary, the Standard Felt Corporation, As a result of these additions, the Commissioner proposed the additional assessment in question.

The Appellant concedes that the addition of the item representing Federal income taxes was correct but contends that when a consolidated return is filed, dividends received by one member of the affiliated group from another member of the group should be eliminated in computing the tax liability of the group.

It appears that during the year 1931, the Standard Felt Corporation declared dividends in the amount of $25,530.00, all of which were paid to Appellant. It further appears that 55.63% of the Standard Felt Corporation's income was derived from business done within the State and 44.37% of its income was derived from business done without the state.

If separate returns had been filed by the Appellant and its subsidiaries, the full amount of the dividends received by Appellant would have been included in Appellant's gross income. Under Section 8(h) of the Act, which provides that from gross income there may be deducted dividends received during the taxable year from income arising out of business done within the state,

Appellant would have been permitted to deduct 55.63% of the dividends but could not have deducted the remaining 44.37% of such dividends which represent dividends declared out of income from business done outside the state. Thus, if separate returns had been filed, 44.37% of the dividends or $11,327.66, the amount added by the Commissioner, would have been included in the measure of the tax imposed by the Act. Hence, the question at issue is whether a different result should have been obtained because a consolidated return was filed,

Although Section 14 of the Act contemplates that consolidated returns may be filed by affiliated corporations, it does not specifically provide for the method of computing the tax when such returns are filed. In refusing to eliminate the dividends declared out of income from business done outside the state, the Commissioner apparently proceeded upon the theory that in the case of a consolidated return, the net income or losses of each of the members of the affiliated group should first be computed separately, just as if separate returns had been filed, and that the effect of filing a consolidated return is simply to allow the losses of the members having losses to offset the net income of the members having net income.

Appellant contends, however, that for the purpose of computing the tax when a consolidated return is filed, an affiliated group should be regarded as a single economic unit and that the members should be regarded as being in the nature of branches or departments of a corporation rather than as separate corporate entities, Under this theory, dividends received by one member of the corporation from another member of the corporation would, of course, be eliminated inasmuch as the group as a whole would not in any way be enriched by such a transfer.

It is to be observed that the provision of the Act relating to consolidated returns are, with certain differences not material in the instant case, similar to the provisions of the Federal Income Tax Act. Although the problem presented in this appeal does not arise under the Federal Act, for the reason that under that Act corporations are not taxable on dividends received by them, we understand that for Federal income tax purposes, intercompany gains and losses are eliminated when a consolidated return is filed. (See Klein, Federal Income Taxation, par. 31: 3(b),). We also understand that this practice has been followed by the Commissioner. Thus, if the Appellant had, during the year 1931, sold property to its subsidiary, Standard Felt Corporation, at a profit of $11,327.66, the profit would have been eliminated, although, if separate returns had been filed, the profit would have been included in the measure of the tax on the Appellant. It is difficult to see why a different treatment should be accord to the amount received by Appellant from its subsidiary simply because it represents dividends rather than profits.

Furthermore, it is to be observed that even under the Commissioner's theory, when a consolidated return is filed, the total tax liability of the affiliated group is reduced to the extent that the losses of the members having losses offset the net incom

of the members having net income, below what the total tax liability would have been'if separate returns were filed. It would seem that the only justification for such a reduction is on the theory that an affiliated group is to be regarded as a single economic unit rather than as a number of separate and distinct corporate entitites.

For the above reasons, we are of the opinion that dividends received by one member of an affiliated group from another member of the group should be eliminated in computing the tax liability of the group when a consolidated return is filed.

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, that the action of the Franchise Tax Commissioner in overruling the protest of Huntington Land and Improvement Co. against a proposed assessment of an additional tax in the amount of $70.79 based upon the retur of said corporation for the period ended December 31, 1931, be and the same is hereby modified. Said action is reversed insofar as the Commissioner included in the income of said corporation an item of $11,327.66 representing dividends received by said corporation from its wholly owned subsidiary, Standard Felt Corpo ration, during the year 1931. In all other respects said action is sustained. The correct amount of the tax to be assessed to the Huntington Land and Improvement Co. is hereby determined as the amount produced by means of a computation which will exclude from the income of said corporation, the above item of $11,327.66 in the calculation thereof, The Commissioner is hereby directed to proceed in conformity with this order and to send Huntington. Land and Improvement Co. a notice of the assessment revised in accordance therewith.

Done at Sacramento, California, this 16th day of February, 1934, by the State Board of Equalization.

R. E. Collins, Chairman
Fred E. Stewart; Member
Jno. C. Corbett, Member
H. G. Cattell, Member

ATTEST: Dixwell L. Pierce, Secretary