57-SBE-013

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal)
of)
SCREEN PLAYS II CORPORATION)

Appearance for Appellant: Samuel Pop and Eli Boyer, Certified Public Accountants

Appearance for Respondents Burl D. Lack, Chief Counsel
John S. Warren, Associate Tax Counsel

O P I NI ON

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Screen Plays II Corporation to a proposed assessment of additional franchise tax in the amount of $7,903.86 for the income and taxable year ended October 31, 1949,

The first issue involved in this appeal is whether advertising and promotional expenditures incurred prior to the release of motion pictures produced by Appellant may be deducted as current business expenses or must be capitalized and amortized over the life of the pictures.

Appellant was incorporated in California on April 5, 1948. During the income and taxable year ended October 31, 1949, it produced two motion pictures entitled "Champion" and "Home of the Brave." "Champion" was released on or about April 2, 1949, and "Home of the Brave" was released on or about May 5, 1949, The premiere showings of both pictures were in theaters in New York City. On August 12, 1949, Appellant distributed all. assets, subject to liabilities, to its stockholders, Among the assets assigned to the stockholders was the right to the receipts from the pictures. Appellant was formally. dissolved on January 20, 1950,

During the income year and prior to the distribution of its assets Appellant expended a total of $586,461.54 for advertising and promotion. It deducted this amount as current expenses on its franchise tax return for that year. The Franchise Tax Board made a redetermination of Appellant's net income by capitalizing the portion of the advertising and promotional expenditures incurred prior to the release date

of each motion picture or during the New York showings and allowing a deduction for the amortization of these expenditures ratably over the life of the pictures upon the basis of the ratio of gross receipts received during each year to estimated total gross receipts. The pre-release advertising and promotional expenditures which were capitalized amounted to $458,437.98 and the deduction allowed by the Franchise Tax Board for amortization during the income year was $114,959.42. The pre-release advertising and promotional expenditures were primarily for advertising in trade papers and in popular magazines of national distribution and for arranging and promoting the premiere showings in theaters in New York City. Included in these expenditures were the following: Newspaper advertising, radio advertising, photos and photostats, press books, printing and stationery, preparing ads for newspapers and for magazines, screenings for critics and reviewers, exploitation men's salaries and expenses, telephone and telegraph, railway express, travel, entertainment, trailer, subway posters, radio, signs and displays, The magazine advertising included ads in weekly, bi-weekly, and monthly national magazines.

The Franchise Tax Board contends that the pre-release advertising and promotional expenditures gave rise to a benefit which extended over the life of each motion picture and that they are, therefore, properly to be regarded as part of the cost of a capital asset, viz., the motion picture. As such, they are not to be deducted in the year paid or accrued, but must be capitalized and recovered through depreciation or amortization deductions spread over the life of the picture. It argues in this regard that the pre-release advertising and promotion were distinguishable from that which would be carried on after release at the local level aimed at building audiences for current shows at particular theaters; that the pre-release expenditures which were localized in New York City were aimed at building a national reputation for the pictures, thereby increasing their value; that it was to be expected that the premiere showings would be attended by critics and exhibitors, whose reaction meant much to the future success of the pictures; that the trade paper advertising was aimed at exhibitors to persuade them to contract for showings of the pictures; and that the national magazine advertising was directed at the general public to persuade it to see the pictures wherever and whenever they played,

We do not agree with the Franchise Tax Board' conclusion on this issue. Advertising expenditures are generally allowable as expenses of carrying on a business and are deductible in the year in which paid or incurred under Bank and Corporation Franchise Tax Act, Section 8(a) (now Revenue and

Taxation Code, Section 24343). See Section 24121a(1), Title 18, California Administrative. Code. The Franchise Tax Board bases its contention that the pre-release advertising and promotional expenditures should be included in the cost of the motion pictures upon an argument that these expenditures would give benefit over the entire life of each picture. However, the time of receipt of the benefits from advertising is virtually impossible to determine and whether the numerous and highly variable items of advertising incurred prior to the release of each picture would give benefit during the entire life of the picture is, in our opinion, purely a matter of conjecture. "The effect of advertising, by its nature, is usually not limited to the year in which it is done ..." (E. H. Sheldon & Co. v. Commissioner of Internal Revenue, 214 Fed. 2d 655, 659) and this is true of the expenditures totaling $128,023.56 which were incurred after the release dates of the pictures and which the Franchise Tax Board agrees should be deducted as current expenses.

The courts have held that advertising expense, even though incurred heavily in a certain year with resulting benefits over future years, is normally deductible expense for the year in which expended. E. H. Sheldon & Co. v. Commissioner of Internal Revenue, supra; Sanitary Farms Dairy, Inc., 25 T.C. No. 58; A. Finkenberg's Sons Inc., 17 T.C. 973, 982, 983; F. E. Booth Co., 21 B.T.A. 148. These cases were decided on the ground that there cannot be an allocation of the advertising expenditures between capital and current expense in the absence of evidence showing with reasonable certainty the benefits resulting in later years from the expenditures, In Consolidated Apparel Co., 17 T.C. 1570, (reversed in part on other grounds, 207 Fed, 2d 580) the court held (contrary to the Commissioner's contention) that an amount paid by a corporation during 1946 to a development and advertising association of merchants to be spent for advertising and promotional work over a 5-year period was deductible in full as a business expense of 1946 and not allocable over the 5-year period.

In X-Pando Corporation, 7 T.C. 48, a corporation made heavy expenditures in 1937, 1938, and 1939 for salaries, traveling expenses, rent, and advertising expenses to develop a method or system of doing business through established distributors. Duringthese years the corporation deducted as current business expenses the percentage of the various expenditures which it felt was properly attributable to the current year's business and charged the remainder of each item to a business development account. It claimed a deduction in 1941 for amortization of this account which was disallowed by the Commissioner on the ground that the items charged to the

account were business expenses, deductible only in the year paid or accrued. The Tax Court sustained the action of the Commissioner. It did not decide whether the expenditures charged to the business development account were a capital investment or whether the corporation had charged the proper portion of the total expenditures to the account, but held that assuming these things had been established, the account could not be amortized in later years because the only asset which might have resulted from the expenditures was something in the nature of goodwill and goodwill is not subject to depreciation allowances for the reason that it does not exhaust itself or become less valuable with use.

Where an advertising expenditure is for acquiring a tangible physical asset whose usefulness as an advertisement will not cease with the taxable year, deduction of the entire amount during the taxable year has been disallowed on the ground that it is a capital expenditure which should be deducted ratably over the years of useful life of the asset. Liberty Insurance Bank, 14 B.T.A. 1428, reversed on another issue, 59 Fed. 2d 320 (coin savings banks used as advertising novelties held a capital expenditure deductible 25 percent each year for four years); Alling & Cory Co., 7 B.T.A. 574 (sample cabinets and samples found to have a useful life beyond the year of purchase), These cases are obviously distinguishable on their facts from the instant appeal.

Also distinguishable are the cases requiring the capitalization of expenditures to establish or to increase the circulation structure of a newspaper or magazine prior to the enactment of Section 23(bb) of the 1939 Internal Revenue Code (now Section 173 of the 1954 Code),--Public Opinion Pub. Co. v. Jensen, 76 Fed. 2d 494; Meredith Publishing Co. v. Commissioner, 64 Fed, 2d 890 cert. den. 290 U.S. 646. These cases held that the circulation of a magazine or newspaper is an intangible capital asset and that money expended in building up this circulation structure is a capital expenditure. Likewise distinguishable is Houston Natural Gas Corporation, 34 B.T.A. 228 (affirmed 90 Fed, 2d 814. cert. den. 302 U.S. 722), cited by-the Franchise Tax Board; involving expenditures by a gas company for salaries and expenses of solicitors and costs of installing service lines without charge to customers in a campaign conducted to retain old customers and obtain new business, which was decided on the basis of and fits more appropriately in the category of the newspaper and magazine circulation structure cases.

In the light of the above considerations, we conclude that the action of the Franchise Tax Board in disallowing deduction of the pre-release advertising and promotional

expenditures as business expense during the income year must be reversed.

The second issue involved herein is whether receipts from the renting of Appellant's pictures to exhibitors were attributable to sources within or outside of California for purposes of the sales factor of the allocation formula.

Appellant's pictures were distributed by United Artists Corporation, a corporation whose normal business is the distribution of motion pictures produced by independent production companies which have no distribution facilities of their own. Appellant retained title to the prints of its pictures which were rented to exhibitors, The master print of each picture from which show prints were made was kept in New York City,

During the year 1949 Appellant retained the services of George Schaefer, for the purpose of accelerating and promoting sales of its pictures, Appellant concedes that he was an independent contractor, not an employee. Appellant alleges that it also employed "exploitation men" in the exploitation of its pictures at specific theater showings throughout the country. The salaries paid to these men were advanced by United Artists Corporation, who in turn billed Appellant for the weekly salary for each man plus payroll taxes thereon. At the hearing in this matter the Franchise Tax Board alleged that the reimbursement by Appellant of the salaries paid the "exploitation men" by United Artists Corporation was paid under the contract between the two companies and that theae men were controlled by United Artists Corporation. The Appellant has presented no evidence to indicate what activities, if any, were performed by the exploitation men under the control of Appellant, Officers of Appellant and some of the key employees who acted in the pictures also rendered services on behalf of Appellant at premieres and other special appearances outside of California.

In its franchise tax return for the year involved, Appellant treated its income as being entirely from California sources, The Franchise Tax Board determined that Appellant had income from sources outside California, within Section 10 of the Bank and Corporation Franchise Tax Act (now Section 25101 of the Revenue and Taxation Code) , in that prints of its pictures being shown in various states and countries were Appellant's property and were a source of income. Consequently, the Franchise Tax Board in the notice of proposed assessment, along with making the adjustment for pre-release advertising expenses, allowed an allocation of income to sources without California by giving weight in the property factor of the

three-factor formula (property, payroll, and sales) to the prints outside the State. It determinedthe percentages of the three factors within California to be as follows: Property - 10 percent, payroll - 100 Percent, and sales - 100 percent. Appellant agrees with the percentages determined by the Franchise Tax Board regarding the property and payroll factors, but contends that only 10 percent of its sales should be considered California sales. Based on this premise, concurrently with filing its appeal from the Franchise Tax Board's action in denying its protest on the pre-release advertising issue, Appellant filed a claim for refund in the amount of $541.87.

Appellant contends that rentals of its pictures outside of California should be considered as sales from sources outside of California for purposes of the sales factor. The Supreme Court of the State of California has held that the focal point for consideration in determining the sales situs for the purpose of computing the sales factor of the allocation formula is the place where the activities of the corporation occurred which resulted in the sales and that where all of a corporation's sales activity outside of California is carried on for it by independent contractors, all of the sales are properly allocable to California, El Dorado Oil Works v. McColgan, 34 Cal, 2d 731, appeal dismissed, 340 U.S. 801; Irvine Company v. McColgan 26 Cal, 2d 160. See also, the decisions of this Board in Appeal of The Times-Mirror Company, October 27, 1953; Appeal of Farmers Underwriters Association, February 18, 1953; Appeal of Great Western Cordage, Inc., April 22, 1948, Appellant does not dispute the soundness of these decisions, but argues that income from the rental of tangible personal property is distinguishable from sales and for purposes of the sales factor should be located at the situs of the property which it further argues was, in this instance, in New York City, the place where the master prints were located.

In making this argument Appellant confuses allocation of income with the composition of the individual factors of the allocation formula, Appellant also confuses the sales factor of the formula with the property factor. Whether income from specific property is to be allocated at all is one question. It is quite another to apportion the same property as in-State or out-of-State for purposes of the property factor, As noted above, Appellant is satisfied with the percentages established in the property factor. Under regulations of the Franchise Tax Board (Section 24301(c), Title 18, California Administrative Code) "Income from property which is not a part of or connected with the unitary business, is excluded from the income of the unitary business which is allocated by formula." Here

the films, master print as well as show prints, were all used in the unitary business. Hence, all income from their rentals is subject to formula allocation. It is the purpose of the formula to allocate net income. But gross sales or receipts are apportioned in the sales factor. Section 24301(a), Title 18, California Administrative Code, The determination of what portion of the rentals is ascribable to California in the sales factor of that formula is governed by the El Dorado Oil Works and Irvine Company decisions. Applying the rule of those cases, it is clear that the place where the activities of Appellant occurred which resulted in the rental receipts was in this State and not at the locations of the films in the hands of United Artists Corporation or of exhibitors of the pictures.

Appellant also contends that it had out-of-State selling activity. The "exploitation men" were on the payroll of United Artists Corporation and there is nothing in the record before us to show that their employment was other than under the control of United Artists. Accordingly, we must conclude that they were employees of that company. Villanazul v. City of Los Angeles, 37 Cal. 2d 718; Gavel v. Jamison, 116 Cal, App. 2d 635. Appellant has given no specific information regarding the extent of the services rendered by various officers and key employees at premieres and other special appearances outside of California or the amount of payroll paid these officers and employees for services outside the State, Appellant does not contend that any allowance should be made in the payroll factor. It does rot appear that any demonstrable portion of the rental receipts resulted directly from such activities, and under such circumstances any adjustment in the sales factor to give consideration to such activities is beyond the practical limitations of an apportionment formula, See Appeal of The Times-Mirror Company, State Board of Equalization, October 27, 1953.

We conclude that the Franchise Tax Board properly determined the sales factor percentage within California to be 100 percent.

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

Appeal of Screen Plays II Corporation

action of the Franchise Tax Board on the protest of Screen Plays II Corporation to a proposed assessment of additional franchise tax in the amount of $7,903.86 for the income and taxable year ended October 31, 1949, be and the same is hereby modified as follows: the action of the Franchise Tax Board in disallowing the deduction of advertising and promotional expenditures as current expenses is reversed*, in other respects the action of the Franchise Tax Board is sustained.

Done at Los Angeles, California, this 25th day of June, 1957, by the State Board of Equalization.

Robert E. McDavid, Chairman

Paul R. Leake, Member

J. H. Quinn, Member

George R. Reilly, Member

________________, Member

ATTEST: Dixwell L. Pierce, Secretary