BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
T.E. CONNOLLY, INCORPORATED)

Appearances:

For Appellant: George A. Andrews, Jr., Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
John S. Warren, Associate Tax Counsel;
A. Ben Jacobson, Associate Tax Counsel

O P I N I O N

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 T. E. Connolly, Incorporated, to a proposed assessment of additional franchise tax in the amount of $2,337.02 for the income year 1947.

Appellant, who is engaged in the heavy construction business, filed on June 15, 1948, its Bank and Corporation Franchise Tax Return for the income year of 1947, which shows as its "total income" on line 15 thereof under the section entitled "Gross Income" the sum of $167,831.75. The total receipts appearing on schedules attached to the return are in the sum of $2,454,225.45.

On March 7, 1950, Appellant filed an amended return showing a "total income" of $232,364.62, an increase of $64,532.87. Of this amount, $44,899.20 represents amounts collected by Appellant from employees through payroll deductions for board and room provided the employees who were working on one of Appellant's construction projects; $10,221.54 represents payments made by employees to Appellant for safety helmets and similar equipment, which were also collected through payroll deductions; and the remainder is due to a change in certain joint venture income reported by Appellant.

In a schedule attached to its original return, Appellant deducted from its reported receipts the cost of the services and equipment supplied to its employees. That deduction was included as part of a total-cost figure without being separately identified. The receipts from the employees were not reported.

On February 26, 1954, Respondent issued to Appellant a notice of additional tax assessment in the amount of $2,337.02 for the income year of 1947. This notice was issued more than four years but less than six years after Appellant's original return had been filed.

At the time the original return was filed a notice of deficiency assessment was required to be mailed to the taxpayer within four years after the date the return was filed (Section 25(f) of the Bank and Corporation Franchise Tax Act). In 1949 the following language was added to Section 25(f):

> "If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within six years after the return was filed."

Except for the time limitation, this wording is identical to that of former Section 275(c) of the Internal Revenue Code of 1939.

The question presented by the parties on this appeal is whether Respondent may make this assessment pursuant to the above-quoted language. The only sum alleged by Respondent to constitute an omission is that of $55,120.74, the amount paid to Appellant by its employees.

Appellant argues that the phrase "gross income" in the California statute means "gross receipts." It then points out that the difference between the total income figures on the original and amended return is far less than 25 percent of the gross receipts stated in the original return,

Appellant refers to Section 6501(e) of the Internal Revenue Code of 1954. This section incorporates the language Section 275(c) of the 1939 Code and adds the following:

> "(i) In the case of a trade or business, the term 'gross income? means the total of the amounts received or accrued from the sale of goods or service (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and
>
> (ii) In determining the amount omitted from gross income there shall not be

> taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item."

It is then contended that this section merely clarifies the prior law, on which the California statute is based. Appellant cites Davis v. Hightower, 230 Fed. 2d 549, in support of this proposition. That case indicated that the new Federal section,. clarified existing law by providing that there is no omission if the amount is disclosed in the return or in a statement attached to it. The court made no reference, however, to that part of the section defining gross income as the total bf the amounts received from the sale of goods or services prior to-d-iminution by the cost of the sales or services.

The definition of gross income in Section 6501(e) is a distinct innovation, directly contrary to the previously established meaning of gross income as that portion of gross receipts exclusive of amounts representing a return of capital; the meaning that still applies for Federal tax purposes other than the limited purpose of the new section. (Doyle v. Mitchell Bros. Co., 247 U. S. 179; Southern Pacific Co. v. Lowe, 247 U. S. 330; Lela Sullenger, II T. C. 1076; Rev. Rul. 54-88, C. B. 1954-1, p. 177; Mertens, Law of Federal Income Taxation, Vol. 1, $5.10.)

Under former Section 275(c), the Tax Court and a Circuit Court of Appeal have held that the ordinary meaning of gross income applied in determining whether an omission exceeds 25 percent of "the amount of gross income stated in the return." (Ray Edenfield, 19 T. C. 13; Carew v. Commissioner, 215 Fed. 2d 58.) In that respect, those cases have never been overruled. To the contrary, after the enactment of Section 6501(e) the Tax Court, in applying former Section 275(c) to earlier years, adhered without discussion to its original view of the meaning of the above-quoted.phrase. (Estate of Webb, 30 T. C. 1202; Fred Draper, 32 T. C. 545. Cf. Bond-Gleason, Inc., T. C. Memo. Op., Dkt. No. 57019, Jan. 13, 1959.)

In our opinion, it would require an amendment of the California law similar to the language added by Section 6501(e) to construe "gross income" as meaning "gross receipts." We conclude that the words "the amount of

gross income stated in the return" as used in the California law mean in this case the sum of $167,831.75, arrived at by Appellant after the deduction from gross receipts of those amounts representing returns of Capital.

Appellant argues, nevertheless, that the California statute does not apply because there was no omission from gross income but rather an overstatement of costs. In support of this position, Appellant cites the cases of Uptegrove Lumber Co. v. Commissioner, 204 Fed. 2d 570, and Deakman-Wells Co., Inc. v. Commissioner, 213 Fed. 2d 894.

The cases cited by Appellant stand for the proposition that there is no omission from gross income within the meaning of Section 275(c) if all receipts are reported and appear in the computation of gross income, even though there is an overstatement of costs deducted from gross receipts in arriving at the final gross income figure. Those cases are supported by the decision of the United States Supreme Court in Colony, Inc. v. Commissioner, 357 U. S. 28. The rationale of the Supreme Court is that some clue to the error is provided the Commissioner where all of the receipts are reported, as contrasted with a case where an item of receipts is missing entirely from the return.

As distinguished from those cases, the Appellant here completely failed to disclose in its original return the receipts from the employees. These receipts were compensation for goods and services and were includible in arriving at Appellant's gross income. No doubt the final gross income figure reported by Appellant would have been correct if it had not deducted the costs of the goods and services, but there was no error in deducting those as costs of operation. The error was in failing to account for the receipts from the employees.

Appellant states that the item omitted was an item of gross receipts rather than of gross income. Some portion of those receipts, but not all, was undoubtedly a return of capital. We cannot determine the amount from the information before us. In any event, the failure to report the receipts constituted an omission of the entire amount from the computation of gross income within the purview of the Uptegrove, Deakman-Wells and Colony cases, and resulted in a corresponding amount omitted from the final result of the computation. By failing to make this disclosure in its return, the crucial consideration, that Respondent be provided a clue to the error, was not met.

It is our conclusion that Appellant did, within the meaning of the California statute, omit from gross income

an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return.

Appellant advances as "equitable considerations" a number of points which it does not contend, and which do not in fact, have any legal basis. Although we have considered these points, we will not extend this opinion by discussing them since they cannot control the result.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code, that the Action of the Franchise Tax Board on the protest of T. E. Connolly, Incorporated, to a proposed assessment of additional franchise tax in the amount of $2,337.02 for the income year 1947 be and the same is hereby sustained.

Done at Sacramento, California, this 13th day of September, 1960, by the State Board of Equalization.

_____, Chairman

Richard Nevins, Member

Geo. R. Reilly, Member

Paul R. Leake, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary