BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Flatter of the Appeal of)
)
PLANNED MUSIC , INC .)

Appearances:

For Appellant: Willard D. Horwich, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel
Crawford H. Thomas, Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Planned Music, Inc., to proposed assessments of additional franchise tax in the amounts of $1,305.26, $1,111.84, $775.65, and $912.88 for the taxable years ending September 30, 1949, 1950, 1951, and 1952, respectively, based on income for the years ending in 1949, 1950 and 1951.

Appellant was incorporated on January 24, 1949. Its business was the installation and servicing of television sets for which it would receive payment in advance. The Appellant provided service for periods of three months in some instances and for one year in others, There was no fixed amount of service. Service was given upon demand by the customer as the need arose. Appellant would receive approximately three to four calls during the life of a three-month contract and approximately six to eight calls during the life of a one-year contract.

Payments on Appellant's service contracts were credited to a deferred income account by Appellant and later transferred to an earned income account. Appellant reported as income only the amounts transferred to the earned income account during each income year. The remainder was deferred to the following income year.

On April 10, 1950, an affiliated corporation, Television Service Club of America Corporation, was organized. Service Club was operated on a low cost, large volume basis as distinguished from the high quality operation of Appellant. It charged a relatively small initial membership fee to its customers and a small fixed fee for each repair service performed thereafter. A

considerable amount of advertising and promotional work was done in connection with Service Club.

Both corporations were on the accrual basis of accounting and did business entirely in California. The two corporations were commonly controlled, had the same officers and worked out of the same facilities. Service Club held itself out as a separate entity and contracted in its own name. The corporations kept separate records of sales and payroll and filed separate sales tax returns. Separate records of actual expenses were not maintained. Appellant and Service Club filed combined reports for the years ending September 30, 1950, and September 30, 1951, without obtaining prior approval from Respondent.

Respondent denied the two corporations the privilege of filing combined reports and allocated the expenses between the two corporations, based on Appellant's operations for the year ending September 30, 1949, prior to the organization of Service Club. Respondent determined the ratio of each type of expense during the year ending in 1949 to the sales for that year and then allocated the expenses for the later years to Appellant in the same ratios to Appellant's sales for those years. The balance of each expense was allocated to Service Club. Respondent also shifted the deferred income to the year in which it was received.

Respondent issued notices of proposed assessments against Appellant. No proposed assessments were issued against Service Club because after adjustments it showed a loss for each year of its operation.

The first issue is whether for tax purposes Appellant is entitled to defer reporting of prepayments under television service contracts or whether the entire amount must be reported in the year of receipt.

Revenue and Taxation Code Section 24651 (formerly Section 12 of the Bank and Corporation Franchise Tax Act and Section 25201 of the Revenue and Taxation Code) gives the Franchise Tax Board the power to change a taxpayer's method of computing income if, in the Franchise Tax Board's opinion, the method used does not clearly reflect income.

Appellant contends that federal cases have construed provisions of the Internal Revenue Code that are comparable to Section 24651 of our law so as to allow deferment of prepaid income. Appellant relies most heavily on the case of Bressner Radio, Inc. v. Commissioner, 267 F.2d 520, in which the Court of Appeals held that a retail television dealer could defer the inclusion of prepayments on a twelve-month television service contract.

The Supreme Court of the United States granted certiorari in the case of American Automobile Ass'n v. United States, ______ uis. ______, 6 L Ed 2d 1109, because of a conflict between the Bressner Radio case and the holding of the Court of Claims in the case below (see 181 F. Supp. 255). Relying upon the Supreme Court's decision in Automobile Club of Michigan v. Commissioner, 353 U.S. 180, the Court of Claims had held that the entire amount of membership dues actually received should be reported in the year of receipt.

The Supreme Court affirmed the Court of Claims. Although the Supreme Court did not expressly overrule the Bressner Radio case, the granting of certiorari in the American Automobile Ass'n case to resolve the conflict between the two and its resolution in favor of the Court of Claims' holding has that effect,

Appellant's case is similar to the American Automobile Ass'n case. Appellant's services are available upon demand by its customers and, although it would be possible to figure an average cost based upon an average number of service calls, there would still be no fixed amount of service to a definite customer at a fixed time in the future,

We hold, therefore, that Respondent's action in shifting the deferred income from the year in which it was reported to the year in which it was received was proper.

Appellant next contends that if it is required to include prepaid income in the year of receipt for tax purposes, then it should be allowed to deduct the expected cost of producing such income in the same year,

The same considerations which require Appellant to include the prepaid income in the year of receipt prevent the deduction of the expenses before they are incurred. (See Commissioner v. Milwaukee & Suburban Transport Corp., ___ U.S. ___, 6 L. Ed. 2d 1249, where the Supreme Court relied on American Automobile Ass'n v. United States, supra, as authority for reversing a lower court decision that allowed the deduction of anticipated expenses. See also, Brown v. ing, 294 U.S. 193 and Security Flour Mills Co. v. Commissi321 U.S. 281.)

The cases of Harrold v. Commissioner, 192 F.2d 1002; Pacific Grape Products Co. v. Commissioner, 219 F.2d 862; and Schuessler v. Commissioner, 230 F. 2d 722, are cited by Appellant in support of the proposition that the expenses may be deducted although the services are not to be performed until a later year. These cases are not inconsistent with our conclusion in this case. In each of the cited cases the obligation to perform a certain act in the future became definitely fixed during the year and its cost was known in advance. In the case of Appellant's service

contracts, its liability was contingent as to each individual. Any given customer might or might not call upon Appellant for its services. The cost attributable to any individual contract was unknown and unknowable except for a statistical estimate based upon the predictability of the needs of the entire group of customers. This does not meet the tests laid down by the cited cases.

In reliance upon Section 25102 of the Revenue and Taxation Code (formerly Section 24303 of the Code and Section 14 of the Bank and Corporation Franchise Tax Act), Appellant objects to the denial by Respondent of the privilege of filing a combined report. It also alleges abuse of discretion on the part of Respondent in its allocation of expenses between Appellant and Service Club.

Under Section 25102 of the Revenue and Taxation Code, where two corporations are commonly controlled, the Respondent may "permit or require the filing of a combined report" or "distribute, apportion or allocate the gross income or deductions" if it determines it is necessary in order properly to reflect income.

In Appeal of C. E. Toberman Co., Cal. St. Bd. of Equal., Feb. 15, 1951, 1 CCH Cal, Tax Cas. Par. 200-121, 2 P-H State & Local Tax Serv. Cal. Par. 13110, we held that former Section 14 of the Bank and Corporation Franchise Tax Act did not authorize a corporation at its own election to file a combined report with its affiliates. Instead of permitting a combined report, Respondent has determined that the deductions should be allocated between the two corporations. Respondent is authorized by Section 25102 to use either approach and we see no abuse of discretion in employing one method instead of the other.

Respondent's auditor allocated the expenses for the years 1950 and 1951 based upon the percentage which Appellant's expenses for 1949 bore to its sales for that year. Appellant asserts that the allocation gives extraordinary results especially when the advertising expense is examined. Its makes this contention because the allocation gives to Service Club an advertising expense equal to 42.5% and 15.18% of its sales for the years 1950 and 1951, respectively, while assigning to Appellant advertising expense equal to only 0.22% of its sales for those years. Appellant contends that a more reasonable allocation could be made by disregarding Appellant's separate operations in 1949 and simply attributing to each corporation a portion of the expenses in relation to the sales of each corporation. However, each corporation was operating in a different manner, Appellant offers no proof of actual advertising expenses incurred with respect to each corporation, but it does appear that considerable promotion work was done in connection with Service Club.

Appellant's theory of allocationentails the assumption that its expenses sharply increased in proportion to its sales after Service Club was formed. In the absence of evidence to support this assumption, we cannot accept it,

In our opinion, Respondent's allocation of expenses and its denial of the privilege of filing a combined report must be sustained.

O R D E R

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

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 25667 of the Revenue and Taxation Code that the action of the Franchise Tax Board on the protests of Planned Music, Inc., to proposed assessments of additional franchise tax in the amounts of $1,305.26, $1,111.84, $775.65 and $912.88 for the taxable years ending September 30, 1949, 1950, 1951, and 1952, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 25th day of April, 1962, by the State Board of Equalization,

Geo. R. Reilly, Chairman

John W. Lynch, Member

Alan Cranston, Member

Paul R. Leake, Member

________________, Member

ATTEST: Dixwell L. Pierce, Secretary