

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE, OF CALIFORNIA

In the **Matter** of the Appeal of)
KARSEAL CORPORATION)

Appearances:

For Appellant: **Milo W. Bearden**, Certified Public
Accountant

For Respondent: **Burl D. Lack**, Chief Counsel;
Israel Rogers, Assistant 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 **Karseal Corporation** against a proposed assessment of **additional** franchise tax in the amount of **\$680.75** for its income year ended June **30, 1953**.

Appellant, a California corporation, manufactures a car polish called Wax Seal and sells the product to distributors, who resell it to jobbers and retailers.

Appellant began a promotional program in 1950 which involved the furnishing of premiums to retailers for handling its product. Watches were sold to distributors and when a distributor notified Appellant that a watch had been delivered to a retailer, Appellant credited the distributor with one-half of the purchase price of the watch.

In March 1950, Appellant began making inquiries of its attorney, its accountant and federal tax officials in an effort to determine who, if anyone, would be liable for the Federal retailers' excise tax on the watches. It was **unable** to get a definite answer but the opinion most often expressed was that Appellant would not be liable.

An agent of the United States Internal Revenue Service called upon Appellant in October of 1952 to inquire concerning the excise tax. Appellant's accountant immediately wrote to the office of the Internal Revenue Service in Los Angeles and to the Commissioner of Internal Revenue in Washington, D. C., asking for a ruling on the matter.

A letter, dated October 23, 1952, from the head of the Wage and Excise Tax Division of the Los Angeles office stated

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that Appellant was not liable for the retailers' tax. This however, was expressly stated to be the opinion of that office only. The letter indicated that a definite ruling on the matter could be expected later.

In November 1952, on the assumption that Appellant was not liable for the excise tax, Appellant's Board of Directors determined that some provision should be made to protect the "distributor setup" if the distributors were held liable for the tax.

In December 1952, the agent again called and stated that he had been assigned to assess Appellant with the taxes it owed, if any. He wrote to one of Appellant's officers asking for the complete details of the watch transactions. After this information was furnished, the agent informed Appellant that it was liable for a total of \$29,237.17, of which \$4,994.60 was a penalty. He indicated that Appellant would have no trouble recovering the latter amount, in view of its diligent efforts to discover its responsibility in this connection.

A Federal excise tax return showing the above liability was prepared by the agent and signed by Appellant's Vice President on January 8, 1953.

Due to the excise tax liability and obligations owed to suppliers, Appellant found itself in serious financial condition. It was unsuccessful in its attempt to borrow \$30,000 from a bank to pay the tax. Based upon the excise tax return, a Notice and Demand for Tax requiring immediate payment from Appellant was issued by the Internal Revenue Service on March 9, 1953. However, at its request, Appellant was permitted to satisfy this liability by installments of \$3,000 per month. Appellant paid a total of \$21,000 during the period of April 1 through October 30 pursuant to this arrangement.

Appellant received a letter from the Los Angeles office of the Internal Revenue Service dated March 23, 1953, quoting a letter received from the Commissioner of Internal Revenue concerning Appellant's excise tax liability, which indicated that only persons who sell watches to purchasers for use or consumption and not for resale are liable for the tax on jewelry. The Commissioner's letter said, in part:

Where the Karseal Corporation sells the watches and Wax Seal to distributors for resale by them, such sales are considered to be sales for resale and the corporation incurs no liability for retailers' excise tax.

When contacted about this letter, the Internal Revenue Agent told Appellant that it was, nevertheless, liable for the tax.

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In April 1953, there was considerable confusion among the corporation's officers as to Appellant's excise tax responsibility. It was resolved, however, to pay the tax and immediately to request an abatement of the penalty. A claim for abatement of the penalty in the amount of \$4,994.60 was filed with the Internal Revenue Service on May 29, 1953. Several months later, this claim was allowed in its entirety.

In November 1953, Appellant received a telephone call from the local office of the Internal Revenue Service directing Appellant to cease making further payments and indicating that the distributors were liable for the tax. Appellant filed a claim for refund and abatement the following month.

Appellant paid \$9,000 of the self-assessed excise tax during the income year ended June 30, 1953. Because it was an accrual-basis taxpayer Appellant claimed the entire amount assessed, \$29,264.42 (including interest), as a deduction for that year. When the tax was abated in a later year, this same amount was reported as income, although it was entirely offset by an overall loss for that year.

The Franchise Tax Board disallowed as a deduction all but the \$9,000 actually paid, on the theory that the unpaid portion of the asserted liability was contingent and therefore non-deductible.

The separate treatment of each "taxable year" is a well-settled principle; an item of income or deduction must be reflected in terms of its posture at the close of each year. (Burnet v. Sanford & Brooks Co., 282 U.S. 359 [75 L.Ed. 383]; Heiner v. Mellon, 304 U.S. 271 [82 L. Ed. 1337]; Guaranty Trust Co. v. Commissioner, 303 U.S. 493 [82 L. Ed. 975].) In order to be deductible, all the events must occur in the year the deduction is taken which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid. A taxpayer may not accrue an expense the amount of which is unsettled or the liability for which is contingent, and this fully applies to liability for a tax which is denied and contested by the taxpayer. (Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 [88 L. Ed. 270]; Security Flour Mills Co. v. Commissioner, 321 U.S. 281 [88 L. Ed. 725].) It is clear that the term "contest" is not limited to litigation in the courts but includes contests lodged with the tax authorities as well. (Great Island Holding Corp., 5 T. C. 150; G.C.M. 25298, 1947-2 Cum. Bull. 39.) An obligation will be considered contingent when the existence of any liability at all is uncertain. (Rev. Rul. 57-105, 1957-1 Cum. Bull. 193.)

The deductibility of Appellant's excise tax must, therefore, depend upon the facts as they existed at the close of its fiscal year, June 30, 1953. We find that Appellant had by that

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time filed a claim for abatement of the penalty but had not, as yet, claimed any right to abatement of the remainder of the assessment. We recognize that there is a serious question whether a penalty such as this is ever deductible, but we need not decide that point. It seems clear that Appellant was **contesting** its liability for the penalty and, according to the principles enunciated in Dixie Pine Products Co. v. Commissioner, supra, could not accrue that amount until final determination of the controversy.

As to the non-penalty portion of the excise tax, nothing in the record supports a finding that Appellant either denied or contested its **obligation**. Had it done so, Appellant would have immediately filed a claim for abatement of the entire **self-**assessment. We are of the opinion, however, that the existence of any liability at all was so uncertain that it **must** be considered contingent even though, for reasons known only to Appellant, the asserted obligation was not contested.

The record shows that from the very beginning, the advice **Appellant** most frequently received was that it was not liable for the retailers' excise tax. The most authoritative source, a ruling issued prior to the close of the year in question by the Commissioner of Internal Revenue, confirmed this view and the tax was, in fact, ultimately abated. The conflicting position taken by the Internal Revenue Agent is unexplained. Despite his position, it certainly cannot be said in the face of the advice by the **head** of the Wage and Excise Tax Division of the Los Angeles office of the Internal Revenue Service and the ruling by the Commissioner of Internal Revenue that all events had occurred which definitely fixed Appellant's liability. Having failed to meet this test, Appellant was not entitled to accrue and deduct the unpaid **portion** of the retailers' excise tax. This holding is specifically limited to the question of the deductibility of the unpaid portion of the assessment since there is no dispute as to whether Appellant could deduct the \$9,000 it paid prior to June 30, 1953.

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

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action of the Franchise Tax Board on the protest of Karseal Corporation ~~against~~ a proposed assessment of additional franchise tax in the amount of \$680.75 for its income year ended June 30, 1953, be and the same is hereby sustained.

Done at Sacramento, California, this 19th day of March, 1963, by the State Board of Equalization.

John W. Lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

_____, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary