



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
DAVID W. AND MARION BURKE and)
DAVID E. AND GERALDINE BURKE)

Appearances:

For Appellants: John R. Spaulding,
Certified Public Accountant
For Respondent: A. Ben Jacobson,
Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to section 19059 of the Revenue and Taxation Code from the action of the Franchise Tax Board denying the claims of David W. and Marion Burke for refund of personal income tax in the amounts of \$1,851.96 and \$5,597.36 for the years 1960 and 1961, respectively, and the claims of David E. and Geraldine Burke for refund of personal income tax in the amounts of \$1,608.38 and \$4,915.50 for the years 1960 and 1961, respectively,

The sole question raised by these appeals is whether that portion of corporate distributions equal to the federal income tax liability of shareholders of a "subchapter S corporation" constitutes a taxable dividend to those shareholders for California income tax purposes,

Appellant David W. Burke and his son, appellant David E. Burke, were partners in a home construction business. In late 1958 they dissolved the partnership and formed a California corporation, the Burke Construction Company, Inc., which began doing business on January 1, 1959. Each of the two former partners owns 50 percent of the stock of the corporation.

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During its first year in operation the Burke Construction Company, Inc., elected to report corporate income for federal tax purposes under the provisions of subchapter S of the Internal Revenue Code of 1954. That election was effective during the taxable years in question here.

Appellants withdrew cash and received distributions of real property from the corporation during 1960 and 1961 in the following amounts:

	<u>1960</u>	<u>1961</u>
David W. Burke	\$24,654.33	\$76,203.99
David E. Burke	<u>22,383.53</u>	<u>67,900.6</u>
Total	\$47,037.86	\$144,104.75

The net income of the Burke Construction Company, Inc., exceeded the total of these distributions in both 1960 and 1961. Substantial portions of these distributions were used by appellants to pay their federal income tax liability which arose as a result of the corporation's election to be taxed under subchapter S of the Internal Revenue Code of 1954.

Appellants filed joint California income tax returns with their respective wives for the years 1960 and 1961. They did not report the above amounts distributed to them by the corporation as taxable income. Respondent issued notices of proposed additional assessments against appellants on the ground that these corporate distributions constituted dividends, and should therefore have been included in their gross income. Appellants paid the assessments and filed claims for refund. This appeal followed respondent's denial of those claims.

Subchapter S (Int. Rev. Code, §§ 1371-1377) was added to the Internal Revenue Code in 1958. In general, its sections permit the stockholders of a closely held corporation to elect to pay personal income tax on the corporation's earnings, whether or not they are distributed, thereby exempting the corporation itself from corporate income tax. Thus, the income is taxed essentially as if the business were operated as a partnership. (William Pestcoe, 40 T.C. 195.) There is, no comparable California legislation,

In essence, appellants' position is that it is inequitable to tax them upon the distribution of an amount which normally would have been paid by the corporation as a federal tax. It would serve no useful purpose, however, for

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us to enter into an extended analysis of the equities involved, since it is clear that the California statutes do not permit the result sought by appellants.

We agree with respondent that an election under subchapter S of the Internal Revenue Code does not, at the state level, alter the status of the corporation or its shareholders or affect the tax consequences of transactions between them. Viewing the instant case in this light, in 1960 and 1961 the Burke Construction Company, Inc., made distributions of money and real property to its shareholders which did not exceed its earnings and profits for each of those years and which did not constitute salaries. Accordingly, we must conclude that appellants received dividends (Rev. & Tax. Code, § 17381) and that regardless of the purpose of the distributions or the manner in which they were used, such dividends are includible in appellants' gross income. (Rev. & Tax. Code, §§ 17071, subd. (a)(7) and 17323, subd. (a).) To hold otherwise would be to allow a deduction for federal income taxes paid, which is specifically precluded by section 17204, subdivision (b)(2)(A) of the Revenue and Taxation Code.

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board denying the claims of David W. and Marion Burke for refund of personal income tax in the amounts of \$1,851.96 and \$5,597.36 for the years 1960 and 1961, respectively, and the claims of David E. and Geraldine Burke for refund of personal income tax in the amounts of \$1,608.38 and \$4,915.50 for the years 1960 and 1961, respectively, be and the same is, hereby sustained,

Done at Sacramento, California, this 27th day of October, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman
John W. Hirsch, Member
Richard Nelson, Member
_____, Member
_____, Member

Attest

[Signature]

Secretary