BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
AFFILIATED GOVERNMENT EMPLOYEES')
DISTRIBUTING COMPANY)

Appearances:

For Appellant: Charles J. Leighton, Jr.
Attorney at Law

For Respondent: A. Ben Jacobson
Counsel

O P I N I O N

These appeals are made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Affiliated Government Employees' Distributing Company against proposed assessments of additional franchise tax in the amounts of $2,930.84, $2,930.84, $2,055.28, $3,552.96, and $2,482.60 for the income years ended June 30, 1954, 1955, 1956, 1957, and 1958, respectively, and against a second proposed assessment of additional franchise tax in the amount of $2,010.64 for the income year ended June 30, 1958. Prior to filing these appeals Affiliated Government Employee's Distributing Company (hereafter referred to as "appellant") paid all of the proposed assessments. Accordingly, pursuant to section 26078 of the Revenue and Taxation Code these appeals will be treated as appeals from the denial of claims for refund.

The primary question for decision is whether membership fees received by appellant constituted taxable income.

Appellant was incorporated on September 22, 1953, under the General Nonprofit Corporation Law of California. (Cal. Corp. Code, § 9000 et seq.) It is engaged in the retail merchandising business and sells a broad line of

consumer goods. Appellant does not sell to the public at large, however, but restricts its sales and the use of its premises to members and their guests.

Prior to July 23, 195'6, appellant had two classes of membership, regular and honorary. Regular memberships, which constituted the great bulk of appellant's memberships, were issuable to any active or retired employee of the federal, state, or local government for a fee of $2.00. Such memberships were for the life of the member and were nontransferable and nonassessable. A maximum of five honorary memberships per year were issuable, without payment of a fee, at the discretion of appellant's board of directors. Both regular and honorary members possessed the right to vote for its board of directors and on other corporate matters. On June 30, 1956, appellant had 77,991 regular members and less than 10 honorary members.

On July 23, 1956, appellant revised its bylaws. Thereafter appellant had three classes of membership: life, associate (Classes 1 and 2), and honorary. Life memberships were the counterpart of the earlier regular memberships, issuable to any active or retired government employee for life for a fee of $2.00. Class 1 associate memberships were issuable to widows of government employees, were for life, and cost $2.00. Associate memberships, Class 2, were issuable to veterans of the United States armed services upon payment of a single, nonrecurring fee of $3.00. A maximum of fifteen honorary memberships per year were issuable without cost at the discretion of the board of directors.

Under the revised bylaws only life members were entitled to vote. In the event of appellant's liquidation or dissolution both life and associate members were entitled to a distribution prorata of any assets remaining after payment of liabilities. All classifications of memberships were nontransferable and nonassessable.

After an audit of appellant's federal income tax returns for the income years ended June 30, 1956 and 1957, the Internal Revenue Service determined that the membership fees received by appellant constituted taxable income. Appellant litigated this issue before the United States Tax Court (37 T.C. 909) and the United States Court of Appeals, Ninth Circuit (322 F.2d 872). Both courts upheld the Commissioner's determination that the membership fees constituted taxable income to appellant. Respondent's proposed additional assessments were based upon that determination by tine Commissioner and the federal courts, and were issued for all years not barred by the statute of limitations.

In appealing to this board appellant contends that the membership fees which it received did not constitute taxable income because under the California Corporations Code memberships in a nonstock corporation are equivalent to stock, and payments made in exchange for stock are not taxable to the issuing corporation under section 24942 of the Revenue and Taxation Code. Subdivision (a) of that section provides:

> No gain or loss shall be recognized to a bank or corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such bank or corporation.

Appellant made a similar argument when it litigated this question in the federal courts. Appellant there relied on section 1032 of the Internal Revenue Code of 1954, which reads substantially the same as section 24942, quoted above, and allows the exclusion of amounts received by a corporation in exchange for its stock. The Tax Court and the United States Court of Appeals agreed that although memberships in appellant technically had some of tine characteristics of stock, the membership fees were paid primarily for the privilege of shopping at appellant's stores and using its facilities and, accordingly, the fees constituted taxable income to appellant. A similar determination was made by the same federal court of appeals in United States v. Federal Employees* Distributing Co., 322 F.2d 891, decided Sept. 16, 1963.

On April 11, 1968, the California District Court of Appeal reached a contrary conclusion in Federal Employees Distributing Co. v. Franchise Tax Board, *260 Cal. App. 2d ___ [___ Cal. Rptr. ____]. That case presented the same question under state law, i.e. whether the taxpayer's membership fees constituted taxable income for California franchise tax purposes. Like the appellant, the Federal Employees* Distributing Co. (hereafter "FEDCO") is a nonprofit corporation which operates retail merchandising stores for members and guests. Its business format and mode of operations are virtually identical to appellant's.

The California court observed that FEDCO is a nonstock corporation formed pursuant to the General Nonprofit Corporation Law (Cal. Corp. Code, § 9000 et seq.), and that under state law memberships in such nonstock corporations are equivalent to stock. (Cal. Corp. Code, §§ 115, 103.) The

* Advance Report Citation: 260 A.C.A. 987.

court also noted that proceeds from the sale of stock are exempt from the franchise tax, under section 24942 of the Revenue and Taxation Code. It concluded:

> The fact that the memberships are not transferable is not of itself or otherwise sufficient to overcome the fundamental basic stock characteristics of the memberships under the code definitions. It is readily apparent that the members for the membership fee received a proprietary interest. In our opinion the transaction is a capital one and it is incorrect to ascertain and declare the fee to be income and taxable as such. (*260 Cal. App. 2d ___ [__ Cal. Rptr. ____].)

In its opinion the California District Court of Appeal acknowledged the existence of the federal decisions reaching the opposite conclusion with respect to both FEDCO and appellant. However, it distinguished those decisions on the ground that they involved interpretations of the federal tax statutes, and did not take into consideration the sections of the California Corporations Code which expressly provide that memberships in nonstock corporations are to be treated as stock. The California Supreme Court has denied a hearing on the Court of Appeal's determination in this matter.

Section 24942 of the Revenue and Taxation Code, which is relied on by appellant herein, was not enacted by the California Legislature until 1961, subsequent to the years involved in these appeals. However, in the FEDCO case the District Court of Appeal stated:

> The receipt of money by a corporation in exchange for its stock has universally been treated as a nontaxable receipt for income tax purposes. That philosophy is codified in Revenue and Taxation Code, section 24942, ... and was practically copied from section 1032 of the Federal Internal Revenue Code. (**260 Cal. App. 2d ___ [__ Cal. Rptr. ____].)

* Advance Report Citation: 260 A.C.A. 987, 991.
** Advance Report Citation: 260 A.C.A. 987, 994-995.

Since the enactment of section 24942 represented a mere codification of prior decisional law, it seems clear that if we conclude that memberships in appellant constituted stock, then they are not taxable, even though section 24942 did not exist during the years in question.

We believe our decision in these appeals must be in accord with that of the California District Court of Appeal in Federated Employees Distributing Co. v. Franchise Tax Board, supra, *260 Cal. App. 2d ___ [___ Cal. Rptr. ___]. That case constitutes the only existing interpretation of the California law on this question.

The second issue raised by these appeals is whether respondent properly disallowed certain deductions claimed by appellant on both its federal and state returns, and disallowed by the Internal Revenue Service,

In early 1961 appellant's federal income tax return for its fiscal year ended June 30, 1958 was audited by the Internal Revenue Service. In his report dated August 14, 1961, the revenue agent partially disallowed certain business expense deductions claimed by appellant. Respondent's second proposed assessment for the income year ended June 30, 1958 reflects the preliminary federal adjustments which were considered applicable for California tax purposes.

Of the business expense deductions disallowed by the Internal Revenue Service for the income year ended June 30, 1958, appellant protested the following: Salary, $36,835.39; Travel and Entertainment, $6,004.20; Automobile, $1,500.00. The amount of the salary expense disallowed as unreasonable compensation was that part of the general manager's salary which exceeded $70,000; The other expenses were disallowed on the ground that they were of a personal nature rather than ordinary and necessary business expenses.

Subsequently, the Internal Revenue Service revised its deficiency assessment against appellant for the fiscal year ended June 30, 1958, by allowing larger portions of several of the deductions originally disallowed. Disallowed salary expense was reduced from $36,835.39 to $2,400.00 and the earlier travel and entertainment disallowance of $6,004.20 was reduced to $4,293.57. No revisions were made in the $1,500.00 automobile expense deduction already disallowed. Appellant agreed to the Internal Revenue Service's offer of settlement on the basis of these revised figures.

* Advance Report Citation: 260 A.C.A. 987.

Since this appeal was filed and heard, respondent has been notified of the final adjustments agreed to by appellant and the Internal Revenue Service. Upon the basis of that settlement respondent has revised its second proposed assessment for the income year ended June 30, 1958. Since appellant has paid the $2,010.64 assessment, respondent now concedes that appellant is entitled to a refund of that payment to the extent of $1,549.15, plus interest, for the income year ended June 30, 1958.

Respondent's proposed assessment based upon the federal determination is presumed to be correct, and the burden is on the taxpayer to show that it is incorrect. (Todd v. McColgan, 89 Cal. App. 2d 509 [201 P.2d 414]; Helvering v. Taylor, 293 U.S. 507 [79 L. Ed. 623]; Appeal of J. Morris and Leila G. Forbes, Cal. St. Bd. of Equal., Aug. 7, 1967.) Appellant agreed to the final adjustments made by the Internal Revenue Service. Respondent's assessment has been revised in accordance with those federal adjustments and appellant has made no showing that the remaining assessments are erroneous. The only rebuttal evidence presented by appellant consists of its own self-serving allegations that the amounts deducted were spent for the purposes claimed. We conclude that appellant has failed to sustain its burden of showing error in the adjusted assessment.

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 26077 of the Revenue and Taxation Code that the action of the Franchise Tax Board in denying the claim of Affiliated Government Employees' Distributing Company for refund of franchise tax in the amounts of $2,930.84, $2,930.84, $2,055.28, $3,552.96, and $2,482.60 for the income years ended June 30, 1954, 1955, 1956, 1957, and 1958, respectively, be and the same is hereby reversed, and that the action of the Franchise Tax Board in denying the claim of Affiliated Government Employees* Distributing Company for refund of franchise tax in the amount of $2,010.64 for the income year ended June 30, 1958, be and the same is hereby modified in accordance with respondent's revised assessment based upon the federal settlement agreement, justifying a refund of franchise tax paid for that year in the amount of $1,549.15.

Done at Sacramento, California, this 12th day of September, 1968, by the State Board of Equalization.

_____, Chairman

_____, Member

_____ Member

_____, Member

_____, Member

ATTEST: _____, Secretary