BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PETER L. CRANDALL, M.D., INC.)

Appearances:

For Appellant: William J. Mitchell
Certified Public Accountant

For Respondent: James C. Stewart
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Peter L. Crandall, M.D., Inc., against a proposed assessment of additional franchise tax in the amount of $501 for the income year ended March 31, 1977.

The sole question raised by this appeal is whether a particular payment made by appellant to an insurance company was properly deductible as an expense or whether that amount represented a nondeductible capital expenditure..

Appellant is a California professional corporation licensed to practice medicine. In the income year ended March 31, 1977, appellant paid Norcal Mutual Insurance Company ("Norcal") $6,042 for professional liability insurance and $5,568 for a subordinated loan. In its "Offering Brochure," Norcal, a mutual insurance company organized in 1975, discussed the terms of such subordinated loans under the heading entitled "CAPITALIZATION OF THE COMPANY." The discussion noted that in order to do business as an insurance company, the California Insurance Code requires that insurance companies raise a certain amount of money denoted as "surplus." The Insurance Code permits mutual insurance companies to raise "surplus" by borrowing funds from policyholders under certain terms and conditions. Norcal designates these loans as subordinated loans and, in fact, issues certificates evidencing each loan. The certificate issued to appellant indicates the principal sum of that loan and the conditions under which repayment will be made. While the certificate indicates that no interest will be paid on the loan, dividends or savings to policyholders may be issued. The certificate is evidence of the security and is transferrable only on the books of the company. The brochure advised that no public market exists for such subordinated loan certificates. However, the record indicates that beginning in 1981, Norcal did begin to redeem the outstanding certificates for cash.

In its return for the period at issue, appellant included the $5,568 paid to Norcal for the subordinated loan as part of its insurance expenses and deducted that sum as an ordinary and necessary expense incurred in carrying on its trade or business within the provisions of Revenue and Taxation Code section 24343. On audit, respondent determined that this expenditure was a capital contribution by appellant to Norcal and, as a consequence, it was not deductible as an ordinary and necessary business expense. Appellant protested the proposed additional assessment which resulted from respondent's determination and respondent's denial of that protest gave rise to this timely appeal.

A deduction is allowed for "ordinary and necessary expenses paid or incurred during the income year in

carrying on any trade or business ...." (Rev. & Tax. Code, § 24343.) The above statute is similar to its federal counterpart. (Int. Rev. Code of 1954, § 162.) As there are no regulations of the Franchise Tax Board interpreting section 24343, pursuant to the authority of section 26422 of the Revenue and Taxation Code, regulations under the Internal Revenue Code govern the interpretation of the conforming state statute. (Cal. Admin. Code, tit. 18, reg. 26422.) Moreover, cases interpreting section 162 are highly persuasive as to the proper application of section 24343. (Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] (1941); Union Oil Associates v. Johnson, 2 Cal.2d 727 [43 P.2d 291] (1935); Meanley v. McColgan, 49 Cal.App.2d 203 [121 P.2d 45] (1942).) We further note that deductions are a matter of legislative grace, and the burden is upon the taxpayer to show that he is entitled to the deduction. (New Colonial Ice Co. v. Helvering, 292 U.S. 435 [78 L.Ed. 1348] (1934); Joe B. Thornton, 47 T.C. 1 (1966); Appeal of Felix and Annabelle Chappellet, Cal. St. Bd. of Equal., June 2, 1969.)

With these facts in mind, we note that as a general rule, premiums incurred to insure against accidents or similar losses in the case of a business are included in deductible business expenses. (Treas. Reg. § 1.162-1(a).) While it has been determined that payments made by a professional corporation to a mutual insurance company as professional liability insurance premiums are deductible as ordinary and necessary expenses within section 162 of the Internal Revenue Code (see Rev. Rul. 80-120, 1980-1 Cum. Bull. 41; Rev. Rul. 60-365, 1960-2 Cum. Bull. 49), our research has uncovered no authority dealing precisely with the deductibility of payments incurred for subordinated loans.[1/]

1/ We note that San Jose Women's Medical Group, Inc., T.C. Summary Opinion 1980-375 (1980), has been cited by appellant in this matter. However, that case was submitted pursuant to the provisions of section 7463 of the Internal Revenue Code which provide, in part, that a decision entered under that section "shall not be treated as a precedent for any other case." (Int. Rev. Code of 1954, § 7463 (b).) Accordingly, it is questionable what precedential value, if any, that decision has in this appeal. In any event, we decline to follow the San Jose decision because the issue was not considered in any depth and because we believe the present appeal is controlled by Commissioner v. Lincoln Savings & Loan Asso., 403 U.S. 345 [29 L.Ed.2d 51 9] (1971), a decision of the United States Supreme Court not considered by the court in San Jose which we will discuss below.

Section 162 was "primarily intended to cover recurring expenditures where the benefit derived from the payment is realized and exhausted within the taxable year.." (Stevens v. Commissioner., 388 F.2d 298, 300 (6th Cir.. 1968).) On the other hand; an expenditure is treated as. a nondeductible- capital out-lay "if- it brings. about t'he acquisition of. an asset having a period of useful... life in excess of: one. year, or if it secures a like-advantage to the taxpayer-which has a life of. more.than one year.." (United States v. Akin., 24-8. F.2d 742, 744 (10th Cir. 1957).) What is controlling- is whether the. payment serves to create or. enhance what is- essentially a separate a-n-d distinct additional asset.. If it does, the payment is capital in nature and not an expense. (Commissioner v. Lincoln Savings & Loan Asso., 403 U.S. 345, 354 [29 L.Ed.2d 519] (1971).) In the Lincoln Savings & Loan case, the.taxpayer was required by law to pay the Federal Savings and Loan Insurance Corporation an additional premium credited to the insurance corporation's secondary reserve. Under the applicable law, the taxpayer had a property interest in its pro rata share of that-secondary reserve, with limited rights to transfer or to obtain a cash refund for such share. Wotwithstanding the fact that this payment was "necessary" for the development of the taxpayer's business, the Supreme Court found that the taxpayer had a distinct and recognized property interest in the secondary reserve, making it more of the character of an asset than an expense. Accordingly, the Supreme Court held that expenditures made to such secondary reserves.were not deductible under section 162, but were capital outlays..

Under the principles enunciated above,, we must find that appellant had a property right in the subordinated loan and, as a consequence, the expenditures made therefor are not deductible as ordinary and necessary expenses within the meaning of Revenue and Taxation Code section 24343, but are instead capital outlays. As noted above, Norcal's Offering Brochure indicates that the expenditures for the subordinated loans were intended to ra-ise contributions for the capital of the company. The expenditures for the certificate-s are designed to raise "surplus" wh-ich California Insurance Code section 700.02 defines as "the minimum paid-in capital required ..." to transact any insurance business. Like the taxpayer in Commissioner v. Lincoln Savings & Loan Asso., supra, appellant has the limited right to transfer the certificate. Moreover, Norcal has provided for a systematic redemption of outstanding certificates. Thus, appellant also has the right to obtain a cash refund for its loan.

Certainly, the description of the certificate as evidence of the security and the documentation of the certificate itself are indicative of its character as an asset. While the expenditure for the subordinated loan might be necessary for the development of its business, appellant has a distinct and recognized property interest in the loan as evidenced by the certificate. Thus, the expenditure represented by the certificate is more readily characterized as an asset rather than as an expense.

We are not unmindful of certain equities favoring appellant's position and the possibility of treating any repayments of the subordinated loan as income when received. (See. G.C.M. 10798, XI-2 Cum. Bull. 58 (1932).) However, we agree with respondent that the situation must be viewed in light of what actually was done and what rights were created. In addition, we note that Norcal has begun a systematic redemption of such loans and it is, therefore, likely that appellant will have its loan repaid. If it does not, its remedy must be obtained under the provisions of the Revenue and Taxation Code which permit deductions for losses. Moreover, we note that Norcal's billing statement to appellant indicated that the Internal Revenue Service considered expenditures made for subordinated loans were capital in nature; and not deductible.

We conclude, accordingly, that respondent's action must be upheld.

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 Peter L. Crandall, M.D., Inc. , against a proposed assessment of additional franchise tax in the amount of $501 for the income year ended March 31, 1977, be and the same is he-reby sus.ta.ined.

-Done at Sacramento, California, this 13th -day o'f December , 1983, by the State -Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett _ . _ . _ _ _ , Chairman

Conway H. Collis _____ , Member

Ernest J. Drmenburg, Jr. _____ , Member

Richard Nevins _____ , Member

_____ , Member