74-SBE-040

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
WESTERN OUTDOOR MARKETS)

For Appellant and Petitioner: Anthony J. Quigley
Attorney at Law

For- Respondent: Crawford H. Thomas
Chief Counsel

Gary M. Jerrit
Counsel

OPINION ON REHEARING

The petition giving rise to a rehearing in the above entitled matter was filed by Western Outdoor Markets pursuant to section 25667 of the Revenue and Taxation Code, in response to a decision rendered by this board on January 4, 1972, sustaining the Franchise Tax Board's action on the protest of Western Outdoor Markets against proposed assessments of additional franchise tax in the amounts .of $2,211.04 and $2,168; 12 for the taxable years 1962 and 1963, respectively.

The questions presented on the first hearing of this matter were whether appellant Western Outdoor Markets was doing business during the taxable year 1962 and whether $43,745 received by appellant in 1962 constituted income which should have been reported in that year. In our original opinion, we decided both questions adversely to appellant. Both are again in issue on rehearing.

Appellant was incorporated in California on September 18, 1962, and its board of directors met for the first time on October 1, 1962. At the second meeting of the board on October 16, 1962, corporate officers were elected, bylaws were adopted, and it was resolved that corporate funds would be deposited with a San Francisco branch of the Bank of America. Appellant's president and its secretary-treasurer were authorized to sign checks on appellant's behalf, and the president was authorized to obligate appellant for short-term borrowing not to exceed $30,000. In its brief on rehearing, appellant alleges that the president's authority to borrow on appellant's behalf could be exercised only after January 1, 1963, provided appellant commenced its business operations on or after that date. The corporate minutes, however, do not reflect any such restriction on the authority granted to the president.

Appellant is a trade association which was created by certain independent billboard owners to serve as a central selling agent of billboard space in the western United States. Similar services had previously been provided by Outdoor Advertising Institute (OAI), but that organization planned to terminate its western operations on January 1, 1963. Since most of appellant's prospective members had contracts with OAI until that date, appellant did not intend to begin its selling operations until then. In anticipation of commencing operations in 1963, appellant began in 1962 to sign contracts with the billboard owners participating in, the venture. These contracts were identical in form and provided that appellant would receive for its services an annual fee measured by the annual gross poster and bulletin space sales of the particular billboard owner. The fee for the first six months was. payable i-n advance and thereafter the fee was payable quarter-annually in advance. By January 1, 1963, appellant had received $40, 745, in advance fees. These funds were deposited in appellant's general bank account, along with an additional $3,000 which three billboard owners had contributed on

September 18, 1962, to cover appellant's organizational expenses.

During 1962, appellant also reached agreement with the employees of OAI's western offices to come to work for appellant beginning January 2, 1963.. In cases where OAI possessed long-term leases on its western offices, appellant agreed to assume those leases effective January 2, 1963. Where OAI rented offices on a month-to-month basis, appellant attempted to secure less costly offices. In Seattle appellant agreed to sublet certain office space and made a rent deposit with the sublessor on December 4, 1962, All of these agreements allegedly were conditional on the commencement of appellant's operations on or after January 1, 1963.

Based on all of the above facts, respondent determined that appellant was. "doing business" in 1962 within the meaning of Revenue and Taxation Code section 23101 and that the $43,745, which appellant received and deposited in 1962, was income that should have been reported in its return for that year. Accordingly, respondent issued two notices of proposed assessment: one for the income year '1962, taxable year 1962, including the $43,745. in appellant's income: the other for income year 1962, taxable year 1963, covering appe'llant' s prepayment for the 19 63 taxable year.

Revenue and Taxation Code section 23151 imposes on every corporation "doing business" in this state a franchise tax measured by the corporation's net income. "Doing business" means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. " (Rev.' & Tax. Code, § 23101.) In support of its contention that appellant was "doing business" during 1962, respondent relies on the Appeals of Kleefeld & Son Construction Co., Inc., et al., decided by this board on June 9, 1960.. That case involved two solely-owned corporations that had been organized to take part in a five-corporation joint venture to build a housing project. We held that the following post incorporation activities, carried on by each sole incorporator for and on behalf of his corporation, "clearly constituted 'doing business"' within the meaning of section 23101: "actively conducting negotiations, assernbling plans , data, etc. , preparatory to the execution of formal agreements with the other participating corporations, suppliers, contractors and the bank, "

Appellant's activities during 1962 were, if anything, even more extensive than those in Kleefeld. Not only did appellant actively

negotiate to obtain members, new employees, and office space, but it actually executed formal contracts with 37 billboard owners and received advance fees in cash from 16 of them. Appellant has attempted to distinguish Kleefeld on the ground that the construction planning and financing negotiations were 'initiated by the individual incorporators before the appellant' corporations were formed. The basis of our decision in Kleefeld, however, was the post incorporation activities of the incorporators. Preincorporation activities were discussed in-the opinion, but they were not essential to'the decision. (Appeal of Ebee Corp. , et al. , Cal. St. Bd. of Equal. , Feb. 19, 1974.) We believe Kleefeld is controlling and that it requires the conclusion that appellant was "doing business" during 1962.

Having found that appellant was doing business, we now must determine whether the $43,745 it received from its members in 1962 constituted income that it should have reported in that year. Appellant kept its books and filed its, tax'returns using an accrual method of accounting. Under its accounting system appellant deferred reporting the $43; 745 in prepaid fees until, 1963, the first year for which it would actually provide selling services for its members'. Respondent determined, however, that these fees were properly reportable in 1962 because they had been received in that year under a claim of right and without restriction 'as to their disposition.

As we indicated in out prior' opinion; the specific statutory authority for respondent's determination appears to 'be Revenue and Taxation Code section 24651, subdivision (b)', which permits respondent to prescribe a method of accounting that will clearly reflect income when the method selected by the taxpayer 'does not do so. (See Automobile Club of New York v. Commissioner, 304 F.2d 781, 783-784.) In'three cases concerning the proper federal income tax treatment of prepaid income from services , the United States Supreme, Court held that the federal counterpart of section" 24651 permits the Commissioner of Internal Revenue to reject accrual accounting methods that defer reporting such prepayments to a taxable

year beyond that of actual receipt.[1] (Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1 L. Ed. 2d 746); American Automobile Association v. United States, 367 U.S. 687 [6 L. Ed. 2d 1109]; Schlude v. Commissioner, 372 U.S. 128 [9 L. Ed. 2d 633].)

Both Michigan and AAA involved automobile clubs that received prepaid annual membership dues that were deposited in the clubs' bank accounts without restriction as to their use for any corporate purpose. Each taxpayer used an accrual method of accounting that deferred accrual of a ratable portion of each dues payment corresponding to the number of membership months falling in the next taxable year following receipt of the payment. In upholding the Commissioner's determination that all dues were reportable as income in the year actually received, the Court held that the taxpayers' accounting systems were "purely artificial" for tax purposes since "substantially all services are performed only upon a member's" demand and the taxpayer's performance was not related to fixed dates after the tax year." (American Automobile Association v. United States, supra, 367 U.S., 687, 691, quoting Automobile Club of Michigan v. Commissioner, supra, 353 U.S. 180, 189, note 20.) The same rationale was applied in Schlude to prohibit deferral of advance payments received by a dance studio under contracts that did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student.

We believe that the reasoning of the Court in Michigan, AAA, and Schlude applies to the present appeal and compels us to conclude that respondent did not abuse its discretion in requiring the advance fees to be included in appellant's income in the year received. Appellant's performance under the contracts with its members was totally unrelated to fixed dates after the taxable year

1/ Rev. Proc. 71-21, 1971-2 Cum. Bull. 549, which respondent announced that it would follow beginning September 14, 1972, substantially liberalized the circumstances under which the Internal Revenue Service will permit accrual basis taxpayers to defer recognition of compensation for services until the year the services are actually performed. Even assuming, without deciding, that appellant's deferral of its advance fees would now be permitted under the Procedure, neither the Service nor respondent has made the Procedure retroactive to the taxable year here in issue.

in question and depended on each member providing it from time,, to time with schedules of the member's advertising rates', geographical areas of operatidn, and availability of advertising. space.

Appellant has argued throughout these- proceedings that it should not be taxed on the prepaid fees because it was a "trustee" with respect to them and would have been required under its contracts to return them to its members if it did not become operative on or before January 1, 1963. The record on rehearing', however, contains no more support than the original record for a finding that appellant was a "trustee," and at no time has appellant cited any authority for its bald claim to some nebulous form of nontaxable trusteeship status. Likewise, as we' said in our prior opinion, the existence of an alleged contingency that the fees 'would have to be returned if appellant did not commence operations does 'not alter the. nature of those feks as income. '(Brown v. Helvering, 291 U.S. 193 [78 L. Ed. 7,25]',).: Under its contracts appellant had a specific right to receive the 'fees for the first six months in advance; consequently, appellant's right to those fees was fixed and the possibility of refunds was nothing more than a contingent liability which had no bearing on appellant's right to the fees when received. (See S. Garber, Inc., 51 T. C. 733; Wallace A. Moritz, 21 T.C. 622.)

ORDER ON REHEARING

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

Appeal of Wcstcrn Outdoors Markets

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that our order dated January 4, 1972, sustaining the action of the Franchise Tax Board on the protest of Western Outdoor Markets against proposed assessments of additional franchise tax in the amounts of $2,211.04 and $2,168.12 for the taxable years 1962 and 1963, respectively, be and the same is hereby affirmed on rehearing.

Done at Sacramento, California, this 7th day of October, 1974, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary

I would grant rehearing.