BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
PACIFIC ASSOCIATES, INC.)

Appearances:

For Appellant: N. C. W. Izett
Treasurer

For Respondent: Kendall Kinyon
Counsel

OPINION

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 Pacific Associates, Inc. , against proposed assessments of additional franchise tax in the amounts of $1,222.93 and $371.33 for the income years ended September 30, 1968, and September 30, 1970, respectively.

Appellant was incorporated in 1945 to acquire and hold stock in various corporations. In 1946 appellant acquired 80,000 of the 300,000 outstanding shares of common stock of Portland

Transit Company. Appellant still retains 66,000 shares originally purchased by it. From its inception through the appeal years, appellant acquired and disposed of holdings in various subsidiary companies. Presently appellant's only investment, other than its investment in Portland Transit Company, is a 91 percent holding in a small finance company. For the appeal years appellant derived its income from three sources: (1) dividends; (2) interest; and (3) sales of stock.

During the years in issue, appellant properly deducted the dividends received from its subsidiaries, which had been included in the subsidiaries' measure of tax, in computing its taxable income. (Rev. & Tax. Code, § 24402.) However, appellant also sought to deduct the entire amount of its expenses from gross income. These expenses included taxes, interest, legal, accounting, general office, and other miscellaneous expenses. Respondent determined that a portion of the expenses should be allocated to the tax deductible dividend income and that this portion was not allowable as a deduction. The allocation of expenses was made in accordance with the following formula:

$$\text{Total Indirect Expenses}\,1/ \times \frac{\text{Deductible Dividend Income}}{\text{Total Gross Income}} = \text{Nondeductible Expenses}$$

The sole issue for determination is whether respondent properly allocated appellant's indirect expenses between taxable and nontaxable income in proportion to the amount of each,

The Revenue and Taxation Code provides that in computing net income no deduction shall be allowed for any amount otherwise allowable as a deduction which is allocable to income not included in the measure of the tax. (Rev. & Tax. Code, §§ 24421, 24425.) During the years in issue respondent's regulations/ provided for the allocation of such expenses in the following manner:

1/ As a result of respondent's audit it was determined that no expenses were directly related to taxable income and properly deductible in total; all expenses were indirect expenses. Therefore, total indirect expenses were the same as total expenses.

2/ The current regulations are similar and contemplate the same allocation. (See Cal. Admin. Code, tit. 18, reg. 24425, subd. (c).)

> No deduction may be allowed for the amount of any item or part thereof allocable to a class or classes of excludable income. Items, or parts of such items, directly attributable to any class or classes of excludable income, shall be allocated thereto; and items, or parts of such items directly 'attributable to any class or classes of includible income, shall be allocated thereto.
>
> If an item is indirectly attributable both to includible and excludable income, a reasonable proportion thereof, determined in the light of all the facts and circumstances in each case, shall be allocated to each. Apportionments must in all cases be reasonable. (Cal. Admin. Code, tit. 18, reg. 24201(d), subd. (2).)

The purpose of the allocation requirement is to segregate excludable income from includible income, in order that a double exemption may not be obtained through the reduction of includible income by expenses incurred in the production of wholly excludable income. (Great Western Financial Corp. v. Franchise Tax Board, 4 Cal. 3d 1 [92 Cal. Rptr. 489, 479 P. 2d 993]; Cal. Admin. Code, tit. 18, 24201(d), subd. (1), 24425, subd. (b)(3).)

Appellant contends that none of the disallowed expenses were directly or indirectly related to the investments from which exempt dividend income was derived. It is appellant's position that the expenses in question are "corporate" in nature and should not be allocated between exempt and nonexempt income.

Appellant's corporate function is to hold stock in subsidiary corporations and to pass through the profits from those holdings to its shareholders. The execution of appellant's function requires it to maintain corporate offices and books of account, to provide services to shareholders, and to perform similar functions. The expenses incurred in performing these activities are the natural and expected consequence of maintaining the corporate organization. In this sense the expenses are, unquestionably, corporate in nature. Nevertheless, no particular expenditure is directly related to producing any of the difference classes of appellant's income. In

a situation where expenses cannot be directly attributed to any class or classes of includible or excludable income, the regulations require that a reasonable apportionment be made. While the specific formula used by respondent to allocate expenses between exempt and nonexempt income is not mandated by either statute or regulation, its use has been approved both by the California Supreme Court in Great Western Financial Corp. v. Franchise Tax Board, supra, and by this board in Appeal of Mission Equities Corp., Cal. St. Bd. of Equal, Jan. 7, 1975. A similar formula has been approved, in analogous situations, by the United States Tax Court in Edward Mallinckrodt, Jr., 2 T. C. 1128, 1148, aff'd on other grounds, 146 F. 2d 1, cert. denied, 324 U. S. 871 [89 L. Ed. 1426].

After thoroughly considering the arguments advanced by appellant we conclude that it has failed to show that the action of respondent was unreasonable. Accordingly, it is our determination that respondent properly allocated appellant's indirect expenses between taxable and nontaxable income in proportion to the amount of each.

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,

Appeal of Pacific Associates, Inc.

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 Pacific Associates, Inc. , against proposed assessments of additional franchise tax in the amounts of $1,222.93 and $371.33 for the income years ended September 30, 1968, and September 30, 1970, respectively, be and the same is hereby sustained.

Done at Sacramento,' California, this 2nd day of February, 1976, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____. Member

_____. Member

ATTEST: _____, Executive Secretary