BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MCA, INC.)

Appearances:

For Appellant: John S. Warren
Attorney at Law

For Respondent: Kendall E. Kinyon
Counsel

O P I N I O N

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 MCA, Inc., against a proposed assessment of additional franchise tax in the amount of **$110,797.00** for the income year ended December 31, 1967. The actual amount in controversy is **$34,264.00.**

The question presented is whether appellant is entitled to a deduction under section 24345 of the Revenue and Taxation Code for the payment of certain taxes to foreign countries.

Appellant and its subsidiaries engage in various aspects of the entertainment business. A principal activity of appellant's business is the production and worldwide distribution of motion picture and television films. Appellant arranges distribution of the films through licensing agreements with foreign exhibitors and, in return for the right to exhibit the films, the foreign licensees pay to appellant sums of money commonly referred to as film rentals.

Appellant also engages in the promotion and distribution of phonograph records. In this connection, appellant licenses reproduction and sale of the records in foreign countries and, in return, receives sums of money commonly referred to as record royalties.

Most of the foreign countries in which appellant conducted business during 1967 imposed a tax upon or measured by the gross amount of film rentals and record royalties paid to appellant by the foreign licensees. Generally, the foreign taxes were computed without adjustment for the deduction of items such as business expenses, depreciation, or amortization.

On its 1967 California franchise tax return, appellant claimed a deduction under section 24345 of the Revenue and Taxation Code for the foreign taxes paid in that year. Section 24345 provides, in pertinent part:

> There shall be allowed as a deduction --
>
> (a) Taxes or licenses paid or accrued during the income year except:
>
> * * *
>
> (2) Taxes on or according to or measured by: income or profits ... imposed by the authority of
>
> (A) The Government of the United States or any foreign country. (Emphasis added.)

Respondent disallowed the deduction claimed by appellant on the basis of its determination that the foreign taxes

in question were "on or according to or measured by income" within the meaning of section 24345.[1/]

The question of whether a foreign tax is "on or according to or measured by income" must be decided on the basis of the concept of income which has evolved under our own revenue laws and court decisions. (See Appeal of Charles T. and Mary R. Haubiel, Cal. St. Bd. of Equal., Jan. 16, 1973.) Although the concept of income is a changing concept for which there has not been formulated a precise definition applicable under all circumstances, a distinction between income and return of capital is generally recognized. (See generally 1 Mertens, Law of Federal Income Taxation § 5.01 et. seq. (1974 Revision)) This principle is the touchstone of the basic approach which has developed under prior decisions of this board for ascertaining whether a particular foreign tax is deductible. For example, in Appeal of Georgica Guettler and Appeals of Edward Meltzer and Frieda Liffman Meltzer, both decided April 1, 1953, this board held section 27 (1) of the Canadian Income War Tax Act to be a gross receipts tax and not an income tax because it allowed taxation, inter alia, of gross receipts from the sale of property without a cost of goods sold deduction to reflect the return of capital. However, although the appellants in both Guettler and Meltzer were taxed under section 27(1), in neither case was a sale of property involved. In Guettler the taxes were paid on royalties, while in Meltzer the income taxed was derived from rents. In effect, these cases classified an entire section of the Canadian law on the basis of the characteristics of a portion of that section which was not in issue. This overly broad approach to classifying foreign law was subsequently overruled by our decisions in Appeal of Charles T. and Mary R. Haubiel, supra, and Appeal of Lloyd W. and Ruth Bochner, decided May 15, 1974. In Haubiel and Bochner, rather than directing our attention to the general operation of the foreign tax law, we focused upon the particular item being taxed. Specifically, in each of those cases it was determined that the foreign tax was a nondeductible tax "on or according to or measured by income" because the particular item being taxed did not contain a return of capital.

1/ The foreign taxes in question clearly were not on or measured by "profits," and respondent does not so contend.

The logical extension of Haubiel and Bochner to the instant appeal would be to inquire whether the gross film rentals and record royalties earned by appellant contain a return of capital. However, the California Supreme Court recently rendered a decision which, at least in the present context, requires us to modify the approach developed in Haubiel and Bochner for determining whether a foreign tax is "on or according to or measured-by income."

In Beamer v. Franchise Tax Board, 19 Cal. 3d 467 [___ Cal. Rptr. ___, ___ P.2d ___] (1977), the court was faced with the question whether a Texas "occupation tax" levied on producers of oil was a tax "on or according to or measured by income" within the meaning of section 17204 of the Revenue and Taxation Code. [2/] In, holding that the tax was not on or measured-by income, the court stated: "[W]e read our statutory language, 'taxes-on or according to or measured by income,' to use the term 'income' in the sense of gross income under general tax law as currently operating." (Emphasis added.) (Beamer v. Franchise Tax Board, supra, 19 Cal. 3d at 479.) Applying this analysis to the Texas tax, the court concluded that the tax was measured not by gross income., but by the, total gross receipts generated from the sale of the oil produced. [3/]

As we interpret the language and. holding, of Beamer, the initial inquiry in ascertaining whether a particular foreign tax is "on or according to or measured by income" must be whether the foreign income received;

2/ Section 17204 is the Personal Income Tax Law counterpart of section 24345. The language of the two statutes concerning the deductibility of foreign taxes on or measured by income is identical.

3/ The terms "gross receipts" and "gross income". are not synonymous. "Gross receipts" is a.broader term generally used to describe the gross proceeds, including return of capital in the form of cost of goods sold or its equivalent, derived, from the sale of certain goods or assets. (See 1 Mertens, Law of Federal Income Taxation § 5.10 (1974 Revision).) In this sense, a tax. on or measured. by gross receipts is distinguishable from a. tax. on or measured by gross income. (Beamer v. Franchise. Tax. Board, 19 Cal. 3d 467 (1977).)

by the taxpayer falls within the definition of gross income under our general revenue law as currently operating. If the income does constitute gross income as defined by our tax law, the inquiry ceases and the foreign tax must be considered a tax "on or according to or measured by income," regardless of the composition of the item taxed. If, on the other hand, the foreign tax is imposed upon gross receipts, including a return of capital, the tax will not be considered a tax "on or according to or measured by income."

In the instant case, appellant contends that the film rentals and record royalties which it received from the foreign licensees represent, in part, a return of its original investment in the assets from which such receipts were derived. Furthermore, appellant argues, the return of capital generated from depreciable or amortizable assets, such as the film negatives and record master prints, is recognized and exempted from taxation under our revenue laws by virtue of the deductions from gross income allowed for depreciation or amortization. As previously indicated, the foreign taxes under consideration were computed without adjustment for depreciation or amortization. Therefore, appellant concludes, the foreign taxes were imposed upon or measured by receipts which represent a return of capital and may not be considered taxes "on or according to or measured by income" within the meaning of section 24345.

We shall assume, without deciding, that the receipts earned by appellant in the foreign countries represent, at least in part, a return of capital. However, according to our analysis and interpretation of Beamer, the primary question which must be answered in ascertaining whether the foreign taxes are deductible is whether the items taxed fall within the definition of gross income under our revenue law.

Section 24271 of the Revenue and Taxation Code provides that gross income under the Bank and Corporation Tax Law means all income from whatever source derived, including rents and royalties. Thus, it is clear that the foreign taxes paid by appellant were imposed upon or measured by what is defined under our revenue law as appellant's gross income from the film rentals and record royalties. Therefore, we must conclude that the foreign taxes were "on or according to or measured by income" within the meaning of section 24345.

Appellant also contends that the term 'income' as used in the phrase "on or according to or measured by income" was intended to mean "net" as opposed to "gross" income'., In light of the clear and inescapab-le language used by the court in Beamer in construing the term "'income," however, appellant's interpretation of that term must be rejected. Moreover, there is no evidence of the legislative intent suggested by -appellant in either the language of section 24345 or its legislative history. Finally, a close reading of the original enactment of the Bank and Corporation Franchise Tax Act, which contained the predecessor of section 24345 (Stats. 1929, ch. 13, § 8.), convinces us that if the Legislature had intended the term "income" to mean 'net" income, it would have so provided. 4/

In summary, it is our opinion that any foreign tax imposed upon or measured by receipts which constitute gross income under our revenue laws is a tax "on or according to or measured by income' within the meaning of section 24345. As we have indicated above, the film rentals and record royalties paid to appellant by the foreign licensees constituted gross income. We must conclude, therefore, that the foreign taxes imposed upon such receipts are not deductible under section 24345.

Accordingly, respondent's action in this matter must be sustained.

4/ There are several instances revealed in the act where the Legislature found it necessary or appropriate to refer specifically to "net" income. (See, e.g., Stats. 1929, ch. 13 §§ 7, 10, 12.)

Appeal of MCA, Inc.

ORDER

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 MCA, Inc., against a proposed assessment of additional franchise tax in the amount of **$110,797.00** for the income year ended December 31, 1967, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of October, 1977, by the State Board of Equalization.

, Chairman

, Member

, Member

, Member

, Member