79-SBE-063

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DER WIENERSCHNITZEL INTERNATIONAL, INC.)

For Appellant: John R. Skoog
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Steven S. Bronson
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 Der Wienerschnitzel International, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

Appeal of Der Wienerschnitzel International, Inc.

	Income Year Ended	Taxable Year Ended	Proposed Assessment
Der Wienerschnitzel International, Inc.		6/30/66	$15,947.24
		6/30/67	15,947.24
		6/30/68	4,115.81
Der Wienerschnitzel International, Inc., successor in interest to Der Wienerschnitzel of San Diego, Inc.	6/30/67		$ 4,236.44
	6/30/68		4,831.18
Der Wienerschnitzel International, Inc., successor in interest to Der Wienerschnitzel		6/30/68	$ 5,248.61

Appellant is a California corporation which files its tax returns o:n an accrual method of accounting. Appellant is in the fast food business, and earns its income from selling franchises, from operating company owned or licensed stands, and from providing services to franchised locations.

During the years on appeal, appellant entered into a number of franchise agreements that required the franchisee, upon execution of the agreement, to deposit with appellant all or a part of the franchise fee. These funds were deposited in appellant's general checking account without any restrictions on their use. Under a typical agreement, appellant had 24 months from the date of execution in which to find a restaurant location acceptable to.the franchisee. If a suitable location was not found within that time, either party could terminate the agreement, and the franchisee was entitled to a refund of his deposit less the expenses appellant had incurred in carrying out its obligations under the agreement. On the other hand, if an acceptable location was found, then the remaining balance, if any, of the franchise fee became due and payable when the franchisee executed a lease agreement covering that location.

In its federal and state tax returns, appellant treated the franchise fees as deferred income properly reportable when the franchisees approved their specific locations. After auditing appellant's federal returns for the years in question, the Internal Revenue Service assessed deficiencies on the grounds that the franchise fees constituted income when received rather than when the locations were approved. On the basis of this federal action, respondent proposed similar assessments of additional franchise tax, which appellant protested. Subsequently, the Internal Re'venue Service

reversed its position, but respondent declined to follow suit. The question presented on appeal, therefore, is whether respondent correctly determined that the franchise fees constituted income when received.

The proper tax treatment to be accorded advance payments received by accrual basis taxpayers has been a frequently litigated area of federal income tax law, and has given rise to a considerable body of decisional law. The United States Tax Court has taken a firm position against the deferral of such receipts. For example, in S. Garber, Inc., 51 T.C. 733 (1969), a case involving advance payments received for custom-made fur coats to be delivered in the future, the taxpayer deferred reporting the advances as income until the garments were ready for delivery. The Tax Court rejected this approach, however, holding that the payments were income when received and stated that:

> [U]nder accrual accounting where there is actual receipt, as in this case, and the funds are at the unrestricted disposal of the taxpayer, as in this case, all the events have occurred, that call for accrual and ... no further inquiry is necessary to determine whether the income has been earned. (51 T.C. 733, 735.)

The Tax Court reached a similar result in New England Tank Industries, Inc., 50 T.C. 771 (1968), affd. per curiam, 413 F.2d 1038 (1st Cir. 1969). In that case, the taxpayer had entered into a long-term contract with the federal government to provide oil storage facilities and related services for an air force base. When the taxpayer was unable to arrange financing of the construction, the original contract was revised to provide an additional payment by the government during the first year of the contract. The taxpayer contended that this payment could be deferred as income until later years, when the services were performed, but the court rejected that contention on the grounds that deferral of income arising from payments actually received could be predicated only on specific statutory authorization, which was lacking. The court noted that it was not enough that the taxpayer's accounting method was accurate and precise.

Other federal courts have also rejected deferral in other contexts. See, for example, United States v. Williams, 395 F.2d 508 (5th Cir. 1968), involving prepaid rent on timberland, and Union Mutual Life Ins. Co. v. United States, 570 F.2d 382 (1st Cir. 1978), which concerned interest on policy loans required to be paid in advance. In light of this array of case law, it seems to us that respondent had ample authority to treat appellant's franchise fees as income when received.

Appellant argues that these fees should be characterized as "refundable good faith deposits" that did not vest as income until a franchise site was agreed upon. It is settled, however, that the possibility of refunds is nothing more than a contingent liability which has no bearing on appellant's right to the "deposits" when received. (S. Garber, Inc., supra; Wallace A. Moritz, 21 T.C. 622 (1954); Appeal of Western Outdoor Markets, Op. on Reh., Cal. St. Bd. of Equal., Oct. 7, 1974.) Appellant also relies on Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955) and Veenstra and DeHaan Coal Co., 11 T.C. 964 (1948) to support its reporting method. Those cases, however, are readily distinguishable from this one. Beacon involved prepaid newspaper subscriptions that were allowed to be deferred in a situation where the taxpayer's performance was related to fixed dates in the future. (Cf. Schlude v. Commissioner, 372 U.S. 128 [9 L. Ed. 2d 633] (1963); American Automobile Association v. United States, 367 U.S. 687 [6 L. Ed. Automobile Club of Michigan v. Commissioner, 353 U.S. 180 [1 L. Ed. 2d 746] (1957); Appeal of Western Outdoor Markets, Op. on Reh., supra.) Appellant's performance in this case was not limited in that fashion. Veenstra and DeHaan concerned advance payments against possible future deliveries of coal. Although the Tax Court allowed deferral of the receipts until the coal was shipped, it later distinguished that case as one involving an executory contract rather than a transaction that was subject only to some future contingent liability. (Wallace A. Moritz, supra.) The present appeal falls into the contingent liability category, in that appellant's duty to refund any franchise fees depended upon the happening of a future event, namely, the franchisee's refusal to accept a location.

Finally, appellant contends that the final Internal Revenue Service determination in its favor is controlling on respondent. That is simply not the case, however. While Revenue and Taxation Code section 25432 creates a rebuttable presumption in respondent's favor when it bases its action on a federal determination, neither that section nor any other binds respondent to follow Internal Revenue Service decisions which it believes to be erroneous. As we indicated above, there is ample case law to support respondent's position in this matter, and we will sustain it on that basis.

Appeal of Der Wienerschnitzel International, Inc.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in thisproceeding, 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 Der Wienerschnitzel International, Inc., against proposed assessments of additional franchise tax in the amounts and for the years as follows:

	Income Year Ended	Taxable Year Ended	Proposed Assessment
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Der Wienerschnitzel International, Inc., successor in interest to Der Wienerschnitzel		6/30/68	$ 5,248.61

be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of April, 1979, by the State Board of Equalization.

Chairman

, Member

, Member

, Member

, Member