96-SBE-003

ADOPTED 2/22/96

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 94A-0303
CTI Holdings, Inc.	)	
	)	

Representing the Parties:

For Appellant:	Joann M. Garvey, Attorney
For Respondent:	Cody Cinnamon, Counsel Lorrie Inagaki, Counsel
Counsel for Board of Equalization:	Tommy Leung, Staff Counsel

O P I N I O N

This appeal is made pursuant to section 19045 (formerly section 25666)[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of CTI Holdings, Inc., against proposed assessments of additional franchise tax in the amounts of $75,641 and $1,199,067 for the income years ended December 31, 1985, and December 31, 1986, respectively.

[1] Unless otherwise specified, all section references hereinafter in the text of this opinion are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The issues presented in this appeal are (1) whether intercompany dividends and royalties are "income or profits" for purposes of determining the deductibility of foreign taxes withheld thereon pursuant to section 24345, and (2) whether respondent properly offset appellant's interest expense deductions with appellant's nonbusiness interest and dividend income.

Appellant is the direct and indirect parent of several subsidiaries which are members of a worldwide unitary group (CTI Group). During the appeal years, appellant received intercompany dividends and royalties from its foreign affiliates, as well as royalties from unrelated third parties, and paid foreign withholding taxes thereon. In addition, branch and partnership taxes were paid to foreign countries. Appellant deducted these foreign taxes on its California combined report. Upon audit, respondent disallowed these deductions and offset interest expense deductions with nonbusiness dividend (other than intercompany dividend) income. These adjustments were reflected in notices of proposed assessment (NPAs). Appellant protested, but the NPAs were subsequently affirmed. This appeal followed.

I. DEDUCTION OF FOREIGN TAXES

"Taxes on or according to or measured by income or profits paid or accrued within the income year" which are "imposed by the authority of . . . the United States or any foreign country" are not deductible. (Emphasis added.) (Rev. & Tax. Code, § 24345.) When affiliated companies file a combined report, intercompany transactions are omitted from the computation of apportionable business income. (See generally Chase Brass & Copper Co., Inc., v. Franchise Tax Board, 70 Cal.App.3d 457 [138 Cal. Rptr. 901](1977); Appeals of Pacific Telephone and Telegraph Co., Cal. St. Bd. of Equal., May 4, 1978; FTB's Guide for Corporations Filing a Combined Report.) Section 24402 generally provides that dividends declared from earnings previously "included in the measure of the [California corporation income or franchise tax]" are deductible, and section 25106[2] provides that dividends paid out of income from a unitary business to which the dividend declarant and recipient belong are eliminated.[3]

In the instant appeal, appellant does not dispute that the foreign taxes deducted on its combined report are taxes on, according to, or measured by income or profits. Thus, this board need

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[2] It is noted that section 25106 has been amended, operative for income years beginning on or after January 1, 1992, making it inapplicable to the section 24345 calculation.

[3] Simply stated, section 24402 applies when the dividend declarant is not engaged in or a member of a unitary business or group with the recipient but the dividend declarant's income is nevertheless subject to tax in California. On the other hand, section 25106 is only applicable to situations where the dividend declarant and recipient are members of a unitary group and the dividends are declared from income of a unitary business. (See Willamette Industries, Inc. v. Franchise Tax Board, 33 Cal.App.4th 1242 (1995); see also FTB LR 376, Aug. 5, 1974, for a more detailed comparison of sections 24402 and 25106.)

only decide whether dividends and royalties are income and, if so, whether the elimination of intercompany transactions under the combined reporting rules strips dividends and royalties of their income characteristics. In support of their respective positions, the parties rely on virtually identical authorities: Safeway Stores, Inc. v. Franchise Tax Board, 3 Cal.3d 745 [478 P.2d 48] (1970), Pacific Telephone and Telegraph Co. v. Franchise Tax Board, 7 Cal.3d 544 [498 P.2d 1030] (1972), Beamer v. Franchise Tax Board, 19 Cal.3d 467 [138 Cal.Rptr. 199] (1977), Max Factor & Co. v. Franchise Tax Board, 35 Cal.App.3d 7 [110 Cal.Rptr. 536] (1973), Robinson v. Franchise Tax Board, 120 Cal.App.3d 72 [174 Cal.Rptr. 437] (1981), MCA, Inc. v. Franchise Tax Board, 115 Cal.App.3d 185 [171 Cal.Rptr. 242] (1981), Appeal of Occidental Petroleum, Cal. St. Bd. of Equal., June 21, 1983, Tektronix, Inc. v. Dep't of Revenue, 11 Or. Tax 125, 1988 Ore. Tax LEXIS 28, Dec. 16, 1988, and respondent's Legal Ruling 376 (FTB LR 376, Aug. 5, 1974). Our analysis begins with a review of these authorities.

In many of the above-cited cases, the main point of contention was over whether foreign taxes paid and deducted were taxes on, according to, or measured by income,[4] an issue which is not in dispute in this appeal. Only Legal Ruling 376 deals with section 25106, the statute which is applicable to appellant. Nevertheless, these cases advance several propositions which are important to the disposition of the instant appeal, regardless of whether intercompany items of income are eliminated or deducted.

"Income" is defined as gross income under general tax law as currently in operation. (Beamer v. Franchise Tax Board, supra; Robinson v. Franchise Tax Board, supra; MCA, Inc. v. Franchise Tax Board, supra.) Under general federal and California tax laws, it is well settled that dividends and royalties are income. (See I.R.C. § 61; Rev. & Tax. Code, § 24271; Willamette Industries, Inc. v. Franchise Tax Board, supra, at 1244; MCA, Inc. v. Franchise Tax Board, supra, Max Factor & Co. v. Franchise Tax Board, supra; Appeal of William E. and Esperanza B. Mabee, supra; see also Appeal of Charles T. and Mary R. Haubiel, Cal. St. Bd. of Equal., Jan. 16, 1973, citing Eisner v. Macomber, 252 U.S. 189, 209 [64 L.Ed. 521] (1920) ("That cash dividends paid out of corporate earnings are income within the ambit of our revenue laws is, of course, elementary.").)

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[4] Beamer is a royalty income case involving a Texas occupation tax levied on producers and purchasers of oil and gas; MCA involves the deductibility of foreign taxes paid on record royalties and film rentals received from foreign licensees; Robinson concerns a Hawaiian excise tax on trust income; and Occidental Petroleum concerns a Libyan tax on crude oil. Most, if not all, of this board's prior opinions interpreting section 24345 also deal with this same issue. (See e.g., Appeal of Lloyd Bochner, Cal. St. Bd. of Equal., May 15, 1974 (Canadian tax on dividends); Appeal of Charles T. and Mary R. Haubiel, Cal. St. Bd. of Equal., Jan. 16, 1973 (South West African tax on dividends); Appeal of William E. and Esperanza B. Mabee, Cal. St. Bd. of Equal., Jan. 1, 1966 (Mexican tax on dividends).) In each of these cases, the modus operandi of the judicial body involved was to analyze the components of the foreign tax imposed, a process which is, fortunately, not required in this appeal.

Appellant argues that since under California unitary theory there is no economic gain or realization on intercompany dividends or royalties, such dividends and royalties cannot be considered income. (See Cal. Code Regs., tit. 18, § 24345-7, subd. (b)(2).) Before income can be recognized, the taxpayer is required to realize an accession to wealth and have control thereof. (Commissioner v. Glenshaw Glass Co., 348 U.S. 426 [99 L.Ed. 483] (1955); Helvering v. Horst, 311 U.S. 112 [85 L.Ed. 75] (1940); Appeal of Occidental Petroleum, supra.) There is no dispute here that appellant received payments of dividends and royalties from its affiliates and third parties over which it had complete control. Thus, it is obvious that appellant realized economic gain and had recognizable income; to find otherwise merely because appellant and its affiliates are engaged in a unitary business would force us to defy economic reality. (See generally Safeway Stores, Inc. v. Franchise Tax Board, supra.) The members of the CTI Group are separate entities, a structural organization which they have selected, and now they are bound by its tax consequences. (See Don E. Williams Co. v. Commissioner, 429 U.S. 569 [51 L.Ed.2d 48] (1977); Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935).) Moreover, the adoption of appellant's position would mean that certain statutory provisions, such as section 25106, which either eliminate income or provide for a deduction thereof would be pointless. This we decline to do. Therefore, we conclude that dividends and royalties are income under the general tax laws.

Tektronix and Pacific Telephone appear to present the strongest support for appellant's position that the elimination language in section 25106 divests dividends and royalties of their income characteristics. In Tektronix, the Oregon Tax Court allowed a deduction for foreign taxes withheld on dividends and royalties paid to a parent by subsidiaries which were included in a combined report. Like California, Oregon has a statutory provision denying a deduction for foreign taxes on or measured by net income or profits. However, unlike California, Oregon also has specific statutory language permitting a deduction for foreign taxes on dividends, interest, and royalties. Moreover, our reading of Tektronix leads us to the conclusion that Oregon law treats entities which file a combined report differently from California law. (See Tektronix, Inc. v. Dep't of Revenue, supra.)

In Pacific Telephone,[5] the California Supreme Court presents us with a more vexing problem. In footnote 11 of its opinion, the court indicates that in enacting section 25106, the Legislature decided that intercompany dividends are not income.[6] On its face, this phrase apparently provides strong support for appellant's cause. However, the court went on to modify its words by stating that intercompany dividends are not income and, thus, should be excluded from the interest offset

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[5] The issue in this case, which involved the telephone utility and its affiliates, was whether intercompany dividends fell within the section 24344 (interest offset calculation) exception relating to interest and dividends not subject to apportionment by formula.

[6] Indeed, at the hearing, appellant submitted a copy of the California State Assembly's version of section 25106, AB 484, ostensibly to buttress its position and footnote 11. But, as appellant's counsel also noted, AB 484 was not adopted. Hence, we do not feel that AB 484 has much of an impact on the outcome of this appeal.

computation of section 24344. The Pacific Telephone case does not involve the deduction or elimination of intercompany dividends within the context of a unitary business or filing a combined report. Moreover, the court's statement in footnote 11 goes against the weight of authority cited above, which includes dividends within the definition of gross income.

It is clear from our reading of these two cases that one involves a set of laws from another state which is different from ours, and the other deals with a statement in a footnote involving another Revenue and Taxation Code section which is taken out of context. Therefore, we do not find persuasive the decisions in either Tektronix or Pacific Telephone.

Appellant also cites respondent's Legal Ruling 376 as justification for its position. This legal ruling deals with whether dividends deducted under section 24402 are "included in the measure of the taxes" in situations where the dividend stream passes through several layers of corporate shareholders for purposes of determining the proper amount of the deduction for the ultimate corporate shareholder. The ruling further provides that when both sections 24402 and 25106 are applicable, section 24402 controls. In its legal ruling, respondent further indicates that the word "eliminated" in section 25106 is probably used in the same context as the federal consolidated return rules use that term, and under the federal consolidated return rules, the word "eliminated" is used in the sense of "nonrecognition" (citing Oscar E. Baan v. Commissioner, 45 T.C. 71 (1965), a case involving a tax-free spinoff under Internal Revenue Code section 355). The ruling also acknowledges footnote 11 in Pacific Telephone but, contrary to appellant's contention, it does not advance the position that by enacting section 25106, the California Legislature has specifically excluded intercompany dividends from the income of an unitary business. Instead, the ruling states that dividends eliminated from the income of the recipient under section 25106 are not required to be reported in California gross income - thus, section 25106 dividends are not included in the measure of the taxes within the meaning of section 24402. Nothing in this legal ruling indicates that intercompany dividends eliminated under section 25106 are not income.

In 1971, this state's highest court considered a case analogous to the instant appeal, except for the fact that it concerned the interpretation of section 24402. In Great Western Financial Corp., the taxpayer received dividends from several California subsidiaries and deducted them under section 24402, which respondent permitted, and attempted to deduct expenses attributable to the receipt thereof, which the respondent disallowed under section 24425.[7] The court held that California corporations which receive dividends from other corporations are separate entities, and section 24402 has no effect on the deductibility of expenses. Moreover, section 24425 is operative whenever income is eliminated from the measure of tax under any authority or for any purpose. Thus, the disallowance of the expenses under section 24425 did not result in impermissible double taxation at the corporate level,

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[7] Generally, section 24425 proscribes the deduction of expenses allocable to income "not included in the measure of the tax." (See Rev. & Tax. Code, § 24425.)

but properly prevented a double deduction. (Great Western Financial Corp. v. Franchise Tax Board, 4 Cal.3d 1 [479 P.2d 993] (1971).)

We believe the reasoning of the Great Western Financial Corp. court is applicable to this appeal and, therefore, we reject appellant's contention that, because of the elimination language in section 25106 and the practice of eliminating intercompany transactions inherent in making a combined report, intercompany dividends and royalties are stripped of their income attributes. In embracing the California Supreme Court's decision in Great Western Financial Corp., we also dispose of appellant's assertions of double taxation and give some passing credence to respondent's apprehension of a double deduction.

Furthermore, in Safeway,[8] this state's Supreme Court found that while the purpose of section 8(h) (the predecessor of section 24402) is to prevent double taxation, at the corporate level, of dividends previously subject to California tax in the hands of the dividend declarant, the mere filing of a combined report by the unitary group and the application of an apportionment formula to the total net operating income of the entire group to determine California-source income does not necessarily mean that all the operating income of the unitary group is included in the measure of tax. Thus, reading Safeway Stores in conjunction with Great Western Financial Corp. We believe appellant's fears of double taxation are without merit.[9]

Appellant further contends that respondent's action is arbitrary, unreasonable, and distortive and thereby fails to fairly reflect the extent of appellant's business in this state, entitling it to utilize an alternate method to determine its California taxable income pursuant to section 25137.[10] Section 25137 is part of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is codified in Revenue and Taxation Code sections 25120 through 25139. However, UDITPA only deals with the allocation and apportionment of income, not with the determination of what constitutes income.

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[8] This case involved the determination under former section 8(h) of the deductible amount of dividends received by the taxpayer, which was domiciled in California and was the parent of a unitary group, from its subsidiaries. Likewise, Max Factor concerned the proper computation of the amount of the dividend deduction under former section 8(h).

[9] As one commentator has noted, unlike the federal system of taxation, which is generally based on residency, California's system is based on the source of income. With the use of the apportionment formula, the likelihood of double taxation is much less under California's unitary method of taxation than under the federal system. "Accordingly, neither a deduction or a credit need be provided by California where a corporate taxpayer has paid foreign income taxes." (Eric J. Coffill, The Treatment of Foreign Income Taxes Under the California Bank and Corporation Tax Law, 17 Pac. L.J. 77, 104 (1985).)

[10] Appellant also claims respondent's action is violative of various provisions of the constitutions of the United States and California, including the commerce, due process, and equal protection clauses. However, appellant acknowledges that article III, section 3.5, of the California Constitution precludes this board from deciding constitutional issues, but nevertheless presents these arguments for purposes of making a thorough presentation.

Moreover, section 25137 cannot be invoked unless appellant proves that application of the general provisions of UDITPA would lead to an unfair representation of the extent of its activities in this state. (See Appeal of Fluor Corp., 95-SBE-016, Dec. 12, 1995; Appeal of Dart Container Corp. of California, 92-SBE-021, July 30, 1992; Appeal of Merrill, Lynch, Pierce, Fenner and Smith, Inc., 89-SBE-017, June 2, 1989; Appeal of Kikkoman International, Inc., Cal. St. Bd. of Equal., June 29, 1982.) A rough approximation under the general UDITPA standards is all that is required. (See Appeal of Merrill, Lynch, Pierce, Fenner and Smith, Inc., supra.) Since appellant has failed to provide any substantive evidence to validate its bald contention that the standard UDITPA formula distorts its income to such an extent that an alternate method must be used, this part of its argument must also fall.

II. INTEREST OFFSET

Finally, we reach the interest offset issue. Appellant contends that respondent's reduction of deductible interest expense by the amount of nonbusiness interest and dividends in accordance with section 24344 represents an improper and unconstitutional attempt by this state to tax otherwise nonapportionable nonbusiness income. Appellant submits that such a result discriminates against entities engaged in interstate and/or international business in favor of those engaged solely in intrastate business; thus, California's interest offset provisions are unconstitutional.

Initially, we note that section 24344 has been upheld by the California Supreme Court in Pacific Telephone. Moreover, as noted above (see footnote 10, supra), article III, section 3.5, of the California Constitution precludes this board from deciding constitutional issues.

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

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of CTI Holdings, Inc., against proposed assessments of additional franchise tax in the amounts of $75,641 and $1,199,067 for the income years ended December 31, 1985, and December 31, 1986, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 22nd day of February, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, Mr. Dronenburg, Mr. Sherman and Mr. Halverson present.

Johan Klehs , Chairman

Dean F. Andal , Member

Ernest J. Dronenburg, Jr. , Member

Brad Sherman , Member

Rex Halverson* , Member

*For Kathleen Connell, per Government Code section 7.9.