

Appeal of Digital Scientific Corporation

The issue presented is whether certain amounts received by appellant are excludable from its taxable income by virtue of the tax benefit rule.

Appellant is a California corporation which develops, manufactures, sells, and leases computer equipment. During 1974 and 1975, appellant and Digital Leasing Company (DLC), a limited partnership in the business of leasing computer hardware, worked on developing a computer system known as META 4/370 ("META-project"). Appellant and DLC did not have the capital needed to complete the project, and decided to sell it to Exsysco, Inc. ("EXS"), a wholly owned subsidiary of National Semiconductor Corporation ("NSC"). The parties executed an Agreement of Sale on December 5, 1975 (the "Agreement"). The Agreement provided that appellant would receive a certain number of shares of NSC common stock as payment for its interest in the META project. The number of shares was to be determined by reference to the pre-tax earnings of EXS attributable to the META project earned from the date of the Agreement to July 31, 1977. As a result of unforeseen delays, EXS had no earnings from the META project until after July 31, 1977; therefore, appellant received no NSC stock.

The Agreement also provided that EXS and appellant would enter into an additional agreement concerning services to be rendered by each company for the other, but no other written agreement was made. Nonetheless, while EXS was completing the META project in 1976 and 1977, EXS used appellant's computer programs, applications and employees. EXS paid appellant for the use of the equipment and personnel monthly in accordance with the amount of use (hereinafter these payments are referred to as "EXS payments").

Appellant's computer programs, applications, and its employees' expertise, which were used by EXS, had been developed as a result of certain research and development expenditures appellant incurred in connection with the META project. Appellant took deductions for these expenditures in 1974 and 1975. In 1974, the deduction yielded no tax benefit since appellant suffered a loss in that year without the deduction; in 1975, the deduction yielded only a minor tax benefit since only a portion of it was needed to reduce appellant's taxable income to zero.

In its 1976 and 1977 returns, appellant excluded a portion of the EXS payments from its taxable

Appeal of Digital Scientific Corporation

income on the ground that these payments constituted a recovery of previously deducted research and development expenses which did not yield a tax benefit. Upon audit, respondent determined that the entire amount received was taxable and issued a proposed assessment reflecting this determination. Respondent denied appellant's protest and this timely appeal followed.

Revenue and Taxation Code section 24310 is a codification of the "tax benefit rule". That section excludes from a corporation's gross income any amount received which is attributable to the recovery of a bad debt, prior tax, or delinquency amount to the extent that the deduction or credit allowed on account of the debt, tax, or delinquency amount did not reduce the corporation's tax. The regulations provide that this rule is not limited to the losses specified in the statute, and that it applies equally to all other losses, expenditures, and accruals which are the basis of deductions except for depreciation, depletion, amortization, and amortizable bond premiums. (Cal. Admin. Code, tit. 18, § 24310, subd. (a).) Section 24310 is substantially similar to Internal Revenue Code section 111; therefore, **cases** interpreting the federal statute are relevant to this appeal. (Andrews v. Franchise Tax Board, 275 Cal.App.2d 653 [80 Cal.Rptr. 403] (1969).)

By allowing a loss in one tax year to offset gain in a different tax year, the tax benefit rule is an exception to the annual accounting period principle and must be strictly construed. (Capitol Coal Corp. v. Commissioner, 250 F.2d 361 (2d Cir. 1957), cert. den., 356 U.S. 936 [2 L.Ed.2d 812] (1958). The rule is properly invoked only where there exists a direct relationship between the event which constitutes the loss and the event which constitutes the recovery. (Waynesboro Knitting Co. v. Commissioner, 225 F.2d 477 (3rd Cir. 1955).) The relationship must be such that these two events constitute a single integrated transaction; if they do not, the tax benefit rule is inapplicable. (Allen v. Trust Co. of Georgia, 180 F.2d 527 (5th Cir.), cert. den., 340 U.S. 814 [95 L.Ed. 5981] (1950); Merton E. Farr, 11 T.C. 552, affd. sub nom., Sloane v. Commissioner, 138 F.2d 254 (6th Cir. 1951).) With few exceptions, a sufficiently direct relationship has been found only when the alleged recovery was specifically intended to be reimbursement for the deducted expense, and the property or amount of money given to the taxpayer was determined by reference to the amount of the deducted expense. (American Financial Corp., 72 T.C. 506 (1979); Sidney W. Rosen, 71 T.C. 226 (1978), affd., 611

Appeal of Digital Scientific Corporation

F.2d 942 (1st Cir. 1980); Birmingham Terminal Co., 17 T.C. 1011 (1951).) Thus, the tax benefit rule has been held to be inapplicable where the alleged recovery was intended as payment for services, or where it was characterized by the court as sales proceeds, (Merton E. Farr, supra; Buffalo Wire Works Co., 74 T.C. 925 (1980); but see Quincy Mining Co. v. United States, 156 F.Supp. 913 (Ct. Cl. 1957).) It has also been held that the tax benefit rule does not apply to exclude business receipts from a company's taxable income despite the earlier deduction of operational expenses without tax benefit. Although there is some relationship between the deducted expenses and the later receipts, they have been held not to constitute a single integrated transaction. (United States v. Rexach, 482 F.2d 10 (1st Cir.) cert. den., 414 U.S. 1039 [38 L.Ed.2d 330] (1973); Union Trust Co. of Indianapolis v. United States, 173 F.2d 54 (7th Cir.) cert. den., 337 U.S. 940 [93 L.Ed. 1745] (1949); Capitol Coal Corp., supra; see also Bittker, The Tax Benefit Rule, 26 UCLA L.Rev. 265, 279 (1978).)

Appellant contends that the EXS payments were actually proceeds from the sale of the META project and, as such, were sufficiently related to the research and development expenditures to warrant application of the tax benefit rule. Appellant interprets the Appeal of Percival M. and Katharine Scales, decided by this board on May 7, 1963, as indicating that, under certain circumstances, sales proceeds are excludable from taxable income pursuant to the tax benefit rule. The Scales opinion does not support appellant's position. As we indicated in the Appeal of Argo Petroleum Corporation, decided November 17, 1982, Scales held only that the payment of carrying charges on real property in prior years by real estate investors and the subsequent sale of that property did not constitute a single integrated transaction: thus, application of the tax benefit rule was precluded. It would be inappropriate to extend Scales beyond its specific holding. In any event, appellant has offered no evidence that the EXS payments were anything other than payments for services rendered unconnected with the consideration given to appellant for the META project.

We conclude that the EXS payments and appellant's research and development expenditures were not sufficiently related to warrant application of the tax benefit rule. The facts presented in this appeal indicate the absence of a direct relationship between the EXS payments and the research and development expenditures. The amount paid to appellant was not determined by reference to the amount appellant spent on research and development. Rather, it was determined monthly by reference to the number of hours

Appeal of Digital Scientific Corporation

EXS employed appellant's services. Nor were the amounts paid by EXS intended to be reimbursement of appellant's research and development expenses. At most, appellant's research and development expenses were indirectly related to EXS' payments in that appellant was able to provide services to EXS only because it had made the research and development expenditures. An indirect relationship, such as that presented by this appeal, is not sufficient to invoke application of the tax benefit rule. (Merton E. Farr, supra.)

For the foregoing reasons, respondent's action must be sustained.

