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FOR C/G BENEFIT

64-SBE-087

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
CHARLES H. AND VIRGINIA B. RAY)

Appearances:

For Appellants: Michael J. Clemens and John J. Raymond, Attorneys at Law

For Respondent: Burl D. Lack, Chief Counsel

OPINION

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Charles H. and Virginia B. Ray against a proposed assessment of additional personal income tax in the amount of $26,362.76 for the year 1957.

The dispositive question raised by this appeal is whether appellants' failure to file with their 1957 tax return an agreement to notify respondent of stock reacquisition precludes their treating the redemption of all their stock in a corporation as a sale of stock which resulted in capital gain.

Prior to 1957 appellant' Charles H. Ray was president and majority stockholder of Ray Industries, Inc., a Michigan corporation, He and Mrs. Ray owned 72 percent of the stock of the corporation, The remaining shares were held by appellant's son, their daughter, and two unrelated stockholders, After being advised by their attorneys' that the proceeds from a complete redemptfon of their stock would qualify for capital gain treatment under both federal and California income tax law, Mr. Ray resigned as president and appellants arranged to sell their stock on an installment basis to Ray Industries, Inc. On January 2, 1957, they entered into separate redemption agreements, thereby transferring their entire stock interests back to the corporation.

Edward J. Fletcher, an experienced tax attorney with a Michigan law firm, prepared joint federal and California income tax returns for appellants for the taxable year 1957, reporting the redemption as a long term capital gain transaction. Mr. Fletcher had completed his' research of relevant federal and California tax. law prior to January 2, 1957, the date on which the redemption agreements were executed. He prepared the agreement to notify the Internal Revenue Service of stock reacquisition, which is required by the 1955 regulation under section 302(c)(2) of the Internal Revenue Code of 1954, and appellants filed it with their 1957 federal income tax return. The corresponding regulation8 under the California Revenue and Taxation Code were-not adopted until January. 7, 1958. In preparing appellants' California tax return for 1957 Mr. Fletcher relied on his 1956 research, and inadvertently failed to file the similar agreement required under California law.

Following the redemption of their stock on January 2, 1957, appellants have had no interest in the corporation other than as creditors under the installment sale agreements. That redemption caused. appellants' son to become majority stockholder in Ray Industries, Inc.; holding 57 percent of the outstanding' capital stock, and their daughter's interest was increased to 25 percent of the outstanding capital stock,

Respondent audited appellants' 1957 tax return and issued a proposed deficiency assessment on October 11, 1962. Upon learning of the additional assessment, Mr. Fletcher forwarded to appellants the missing agreements to notify respondent of reacquisition of stock and those agreements were filed with respondent on April 5, 1963. This appeal is taken from respondent's action affirming the asserted deficiency.

The deficiency assessment is based on a determination by respondent that the gain realized by appellants on the sale of their stock to the corporation constitutes dividends, and should therefore receive ordinary income treatment. Respondent claims that appellants8 failure to file the agreement to notify. It of stock reacquisition with their 1957 tax return precludes treatment of the proceeds received from the distribution in question as capital gain,

Appellants contend that section 17327, subdivision (b)(l)(C) of the Revenue and Taxation Code, which requires the filing of this agreement, is directory in nature, rather than mandatory, and that their full compliance with other provisions of the law and their filing of an agreement when the omission came to their attention constitute substantial compliance with the terms of the. California statute,. which is sufficient in the case of a directory provision such as this one. It is their position that the omission was due to error, mistake, and inadvertence, and that they should not be prevented thereby from receiving the benefits of the capital gain treatment otherwise available in such a transaction,-

Sections 17325 and 17326, subdivision (c) of the Revenue and Taxation Code allow a shareholder to treat gain realized in a redemption situation as capital gain rather than ordinary income, if the redemption is in complete redemption of all stock of the corporation owned by the taxpayer-shareholder. In determining whether or not a stockholder's complete stock interest has been redeemed, section 17327 of the Revenue and Taxation Code specifically makes the rules of constructive ownership of stock applicable in the stock redemption Situation.' Under those rules, an individual will be considered to own the stock owned by his children, (Rev, & Tax, Code, § 17384, subd. (a)(l)(B).) Since appellants' son and daughter continued to hold stock.in the corporation after January 2, 1957, their stock ownership is thereby attributed to appellants.

Appellants are thus precluded from receiving the benefits of capital gain treatment unless the exception set forth in subsection (b)(l) of section 17327 of the Revenue and Taxation Code is applicable, That exception provides that in the case of a redemption of a shareholder's complete stock interest in a' corporation, the constructive ownership of stock rules will not apply if: (A) immediately after the distribution the distributee has no interest in the corporation, other than as a creditor, (B) the distributee does not acquire such interest within ten years from the date of distribution, and (C) the distributee files an agreement, pursuant to regulations adopted by the Franchise Tax Board, to notify it of any such reacquisition and to keep necessary records.

Respondent 's regulation 17325-17328(d), title 18, of the California Administrative Code, provides that the agreement specified in subdivision (b)(l)(C) of section 17327 shall be in the form of a separate statement attached to the. distributee's return timely filed for the yeas? in which the distribution occurs. It shall recite, according to the regulation, that the distributee has not reacquired any interest in the corporation, and that if he does acquire such an interest within ten years he will notify respondent within thirty days of such reacquisition,

These provisions are almost identical with the federal sections found in the Internal Revenue Code of 1954 (§ 302(c)(2)) and the corresponding regulations, (Treas. Reg. § 1.302-4.) We conclude, on the basis of recent, decisions by federal courts interpreting those counterpart sections, that appellants must be sustained in their resistance to respondent's proposed additional assessment.

In Van Keppel v. United States, 206 F. Supp, 42, aff'd, 321 F.2d 717, the taxpayer's entire stoek interest in a corporation was redeemed in 1956, but the stock which her husband continued to hold in that company was attributed to her under the. constructive ownership provisions . When she filed her 1956 return, the taxpayer reported the transaction, but inadvertent&y failed to attach the agreement to notify the fnternal Revenue Service of reacquisition of stock in the company, She filed that agreement in 1958, after her 1956 return had been audited, but before any additional assessment hgd been proposed, The District Court held that the taxpayer had substantially complied with the section, and that the proceeds from the sales should be treated as capital gains rather than ordinary dividend income, The court reasoned that the statutory provision requiring the agreement to be filed was directory in nature rather than manda-. tory, and that substantial compliance with its terms was therefore sufficient, The United States Circuit Court of Appeals affirmed this decision, viewing the case as a mistake situation which required the exercise of discretion by the commissioner.

Under similar facts the United States Tax Court recently followed the Van Keppel decision and agreed with the taxpayer that where it appeared that her failure to file the agreement was through someone's inadvertence, that. she forthwith filed it upon learning of the defect, that in the interim she acquired no interest in the corporation, and that she had maintained appropriate records relating to the transaction, she had substantially and sufficiently complied with the terms of this directory provision. (Georgie S. Cary, 41 T.C. 214.)

Even more recently, a District Court in New York rendered a summary judgment for the taxpayer, holding that he was entitled to capital gain treatment of the gain realized on the redemption of his entire stock interest in a corporation, even though through mistake or inadvertence he had filed no notification agreement with his tax return for the year In which the redemption took place. (Pearce v. United States, 226 F. Supp. 702.) The court there stated-the Internal Revenue Service's refusal to accept late filing under such circumstances constituted an abuse of discretion.

Respondent relies on the case of Archbold v. United States, 201 F. Supp, 329, aff'd per curiam, 311 F.2d 228, in which the District Court held that the commissioner was justified In refusing to accept the taxpayer's offer to file the agreement after the filing date of the return for the taxable year in which the distribution took place, and in treating the proceeds of the redemption as ordinary income. That case can be distinguished on its facts from the one before us, however, for in Archbold there was no claim of mistake. The taxpayer had made no effort to comply with the terms of the statute; not only had she failed to file the requisite agreement, but she also had not reported any gain on the transaction in her tax, return for the year in which it occurred. In contrast, this appeal falls within the same category of cases as Van Keppel, Cary and Pearce. In each, the taxpayer's faire ~~to file~~ a timely notification agreement was due to inadvertence or mistake for which, it was determined, the taxpayer should not be penalized,

We hold that the facts of this case justify a finding that appellants substantially complied with section 17327, subdivision (b)(l)(C) of the Revenue and Taxation Code and the related regulation (Calif. Admin. Code, tit, 18, reg. 17325-17328(d)), and that such compliance was sufficient .

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Charles H, and Virginia B. Ray against a proposed assessment of additional personal income tax in the amount of $26,362.76 for the year 1957, be. and the same is, hereby reversed.

Done at Sacramento, California, this 17th day of November, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

John W. Lynch, Member

_______________, Member,

_______________, Member

Geo R Reilly, Member

Attest W Freeman, Secretary