75-SBE-034

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
DIETER 'AND POLDI SCHMITT)

'For Appellants: Robert S. Wrinkle
Attorney at Law

For Respondent: Crawford H. Thomas
Chief Counsel

Paul J. Petrozzi
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 Dieter and Poldi Schmitt against a proposed assessment of additional personal income tax in the amount of $1,364.51 for the year 1966.

In 1964 appellants formed German Motors Corporation (Motors), a wholly owned corporation engaged in the sales and servicing of automobiles. In order to separate the sales function from the service operations of the business, a new corporation, German Motors Sales Corporation (Sales), was formed by appellants late in 1965.

On or about January 1, 1966, assets of Motors valued at $25,000.00 were transferred to Sales. The transfer was duly recorded on Sales' books. The explanation for the $25,000.00 entry in the journal of Sales was:

> To give recognition to transfer of assets and liabilities from German Motors and capital given by Dieter and Poldi Schmitt to form the Sales Corporation.

The books also indicated that $25,000.00 of Sales' capital stock had been issued to appellants. The issuance of stock had previously been authorized by a resolution of Sales' board of directors on November 16, 1965. However, no stock certificates were ever issued to appellants. Nevertheless, on the 1966 California franchise tax return filed on behalf of Sales, appellants were listed as the sole shareholders of that corporation. In addition, appellants, as sole shareholders, elected to have both Sales and Motors taxed pursuant to subchapter S of the Internal Revenue Code of 1954 (§§1371-1379), whereby the appellants reported the income of both corporations on their joint personal federal income tax returns. During the period in issue, certain entries entitled "Loans from Stockholders Dieter and Poldi Schmitt" appeared in Sales' ledgers.

In the course of an audit, respondent determined that the transfer of Motors' assets to Sales was made for the purpose of acquiring Sales' stock for appellants. This transfer was deemed to be a distribution of Motors' retained earnings to appellants, which was taxable to them as ordinary income. A proposed assessment of additional personal income tax reflecting this determination was then issued;

On December 30, 1970, after learning of respondent's determination, but prior to the issuance of the proposed assessment, Sales' board of directors met and rescinded the aforementioned board resolution of November 16, 1965. The board also passed a new resolution authorizing the issuance of $25,000.00 of Sales' capital stock to Motors. Stock certificates were then issued to Motors pursuant to a permit from the California Department of Investment, Division of Corporations.

The issues for determination are: (1) whether, as a result of the transfer of Motors' assets to Sales, appellants became' stockholders of Sales, and (2) if they did, whether the value of the shares so acquired constituted a distribution of Motors' retained earnings which was taxable to appellants as ordinary income for 1966.

With respect to the first issue, appellants contend that Motors has been the sole stockholder of Sales since Sales' inception as a corporation. This contention is based upon appellants' belief that a prerequisite to the issuance of valid stock is a permit from the Division of Corporations (now Department of Corporations). Appellants reason that since Motors was the only entity issued Sales' stock pursuant to permit, although belatedly, Motors alone can be deemed a Sales stockholder,

We cannot agree. The Corporate Securities Act on which appellants apparently relied in concluding that only Motors could be a Sales stockholder was enacted to benefit the public and to safeguard purchasers. against fraud. (See, e. g., Hargiss v. Royal Air Properties, Inc., 206 Cal:. App. 2d 406 [23 Cal. Rptr. 678]; Farnsworth v. Nevada-Cal Management, 188 Cal. App. 2d 382 [10 Cal. Rptr. 531].) The act may not be used as a sword to avoid an otherwise valid liability. The execution and delivery of share certificates are not conditions precedent to the issuance of shares. Shares are created by the mutual assent of the corporation and the shareholder. (See, e. g., Hughes Manufacturing & Lumber Co. v. Wilcox, 13 Cal. App. 22 [108 P. 871]; Ballantine and Sterling, California Corporation Laws, [4th ed. 1974] § 109.) Similarly, for income tax purposes it has been held that the determination of a

taxpayer's status as a shareholder is not solely dependent on whether or not he has been issued a stock certificate, Rather, this determination can be made only upon consideration of all the facts. (See Wesley H. Morgan, 46 T. C. 878; C. Carroll Collmus, Jr., 21 B.T. A. 210.)

The facts of this case unquestionably indicate that appellants were Sales' shareholders during the period in issue. Their intention to be Sales' shareholders was evidenced by the November 16, 1965, resolution passed by Sales' board of directors, two-thirds of whose membership was comprised of appellants. Furthermore, the various accounting entries previously alluded to and the fact that various corporate tax returns showed appellants as the shareholders, indicate clearly that appellants were treated as; and considered themselves to be, Sales' shareholders. Finally, appellants, by claiming to be Sales' shareholders, derived substantial federal tax benefits from utilization of the subchapter S election. Under these circumstances, appellants' attempt to alter their status as Sales' shareholders by passing a board resolution and issuing stock to Motors nearly five years after the year in question, and only after learning of respondent's adverse determination, is not persuasive of their position.

Having concluded that appellants were shareholders of Sales as a result of the transfer of Motors' assets to Sales, the only question remaining is whether the shares so acquired represented a distribution of Motors' retained earnings which was taxable to appellants as ordinary income for 1966. Appellants' response to this issue is that the transfer of Motors' assets to Sales and the subsequent issuance of Sales' stock to Motors in 1970 should be considered a nontaxable corporate spin-off between a parent corporation and its subsidiary.

Sections 17431 through 17445 of the Revenue and Taxation Code pertain to corporate organizations and reorganizations. These sections contain numerous requirements which must be complied with before a corporate organization or reorganization can be deemed a nontaxable event. One such requirement is that the trade or business carried on by the distributing corporation (Motors) must have been actively conducted for five years prior to the date the stock of the

controlled corporation (Sales) is distributed. (See Rev. & Tax. Code, §§ 17433 and 17434.) The facts herein indicate that appellants began actively conducting their automobile business in 1964 at the time of Motors' incorporation. Accordingly, when appellants became Sales' shareholders in 1966 their automobile business had not been conducted for the necessary five-year period. Under these circumstances there is no merit in appellants' contention that the' transactions between Motors and Sales constituted a nontaxable corporate spin-off.

Respondent's assessment of additional tax against appellants for 1966 was based upon its conclusion that the Sales shares which appellants acquired following the transfer of Motors' assets to Sales were in effect a distribution of Motors' retained earnings to appellants. Since appellants have failed to show wherein respondent's determination was erroneous, we have no alternative but to sustain it.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeal of Dieter and Poldi Schmitt

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 Dieter and Poldi Schmitt against a proposed assessment of additional personal income tax in the amount of $1,364.51 for the year 1966, be and the same is hereby sustained.

Done at Sacramento, California, this 22nd day of April, 1975, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Executive Secretary