86-SBE-046

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 81A-1045-GO
ARNOLD R. AND BESSIE BUCKLES)

Appearances:

For Appellants: Robert C. Boffa
Attorney at Law

For Respondent: Terry L. Collins
Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Arnold R. and Bessie Buckles against a proposed assessment of additional personal income tax in the amount of $109,464.32 for the year 1977.

1/ Unless otherwise specified, all section references are to sections of the-Revenue and Taxation Code as in effect for the year in issue.

The issues presented in this appeal are the following:

(1) Whether the transaction in which Arbco Electronics, Inc., was liquidated and part of its assets later transferred to a newly formed corporation, Arbco Industries, Inc., can properly be characterized as a liquidation-reincorporation so as to override the provisions of section 17402 which appellants allege they have satisfied.

(2) If not, whether the appellants have, in fact, satisfied all the provisions of section 17402; specifically, whether appellants filed a timely election pursuant to the requirement of subdivision (d) of section 17402, thereby qualifying for certain deferrals of gain realized upon the liquidation of Arbco Electronics, Inc.

Appellants were the sole shareholders of Arbco Electronics, Inc. (hereinafter "Old Arbco"), a corporation incorporated under California law on September 10, 1959. In 1977, a serious fire occurred, resulting in a cash recovery of $392,326 from the corporation's insurance company.- Later in 1977, the decision was made to' liquidate the corporation. To assist in the liquidation, the corporation hired an attorney (hereinafter "the attorney" or "appellants' attorney").

On September 30, 1977, Old Arbco adopted a plan of liquidation pursuant to sections 17402 and 24503. Section 17402 provides that under certain circumstances, a shareholder's gain on the complete liquidation of a corporation may go unrecognized if he and enough other. shareholders so elect by filing the proper forms electing such treatment within 30 days after the date of the adoption of the plan of liquidation. Appellants' attorney was given the responsibility for preparing and filing the necessary elections with the Internal Revenue Service and respondent, Franchise Tax Board, within the 30-day period. The attorney claims copies of IRS form 964 (accepted by respondent in lieu of its own form FTB 3512) were sent to respondent and the IRS on the same day within the required time period. During the course of an audit, it was discovered, however, that respondent had no record of receiving a valid election. Moreover, upon further inquiry, respondent determined that appellants had formed a *new* corporation, Arbco Industries, Inc., later Arbco Electronics, Inc. (hereinafter "New Arbco"), on October 26, 1977. Respondent ascertained that appellants owned 95 percent of the shares of New Arbco and that the business

addresses for Old and New Arbco were identical. In addition, respondent's field auditor determined that the business of New Arbco was a continuation of the business of Old Arbco. (Resp. Br. at 7.) However, three substantial rental properties which had been held by Old Arbco were not transferred to New Arbco but were retained by appellants.

Based upon the above determinations, respondent concluded that a timely election had not been made as required by section 17402, subdivision (d), and, as a consequence, section 17402 should not apply to the distributions (i.e., rental properties) to appellants. In addition, due to the formation of New Arbco, respondent concluded that Old Arbco had, in reality, undergone a liquidation-reincorporation, the effect of which was also to preclude appellants from obtaining such section 17402 treatment. Accordingly, respondent determined that even if a timely election had been made, appellants* gain on the distribution was taxable as ordinary income to "the extent of retained earnings of Old Arbco" and as capital gains from the sale or exchange of assets held over five years with respect to the balance'of gain. (Resp. Br. at 4 and 5.) Respondent issued an assessment reflecting this determination and appellants protested. Respondent subsequently affirmed its assessment and appellants then filed this appeal.

On appeal, appellants argue that a timely election pursuant to section 17402, subdivision (d), was, in fact, filed by their attorney. Moreover, appellants contend that respondent's reliance upon the liquidation-reincorporation theory is misplaced. In addition, appellants contend that if the subject transaction is held to be a liquidation-reincorporation, the assessment was erroneous since under that theory only the "amounts not continued to be held in corporate solution are treated as distributed to shareholders." (App. Reply to Resp. Br. at 13 and 14.) Respondent, however, now agrees with appellants' assertion that should a liquidation-reincorporation be held to exist, its computation of additional tax due is incorrect. Accordingly, respondent now concludes that appellants' additional tax liability resulting from a liquidation-reincorporation is $90,315. (Resp. Reply Br. at 17.)

As indicated above, respondent first seeks to cast the subject transaction as a liquidation-reincorporation thereby obviating the necessity for determining whether appellants filed a timely election pursuant to

section 17402, subdivision (d) (i.e., issue two). Briefly, for the sake of this one issue, respondent would concede that a valid section 17402 liquidation did, in fact, occur, but argues that the subsequent incorporation of New Arbco would constitute a rein-corporation of Old Arbco so that the transaction should be treated as a reorganization rather than as a liquidation. Such treatment, respondent argues, requires that the gain resulting from the property transferred from Old Arbco to appellants "be considered dividend income under sections 17321 and 17323(a) ... to the extent of Old Arbco's retained earnings ... [and] gain resulting from the sale- or exchange of a capital asset" to the extent of the balance of gain realized.2/ (Resp. Br. at 8.)

The term "liquidation-reincorporation" refers to a transaction in which an existing corporation is liquidated with its business thereafter being conducted by another corporation owned solely or substantially by shareholders of the liquidated corporation. Generally, the latter corporation will be newly organized in conjunction with the liquidation of the former.

> [Liquidation-reincorporation transactions can] serve a variety of tax-avoidance purposes. Most notable in this respect is the bail-out of accumulated earnings and other unneeded liquid assets of the 'liquidating' corporation at capital gains rates, while, at the same time, operation of the business is continuing in corporate form.

(Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 14.54 at 14-155 (4th Ed. 1979).)

2/ A more precise and technically correct explanation is that section 17381 would require dividend treatment to the extent of the corporation's "earnings and profits." Moreover, as indicated above, contrary to respondent's statement, in a section 17402 liquidation, all of the corporation's earnings and profits are fully taxed to the individual shareholders as dividends. Appellants did, in fact, treat the distribution from Old Arbco as a dividend to the extent of Old Arbco's earnings and profits. (App. Reply to Resp. Br. at 10.) Accordingly, to the extent that respondent's assessment reflects a duplication of those earnings and profits, it must be modified.

When the resemblance between a liquidation-reincorporation and a tax-free reorganization becomes "overpowering" the taxing agency may seek to classify the transaction "as a reorganization, and the liquidation rules of §§336, 337, 331, and 334 [of the Internal Revenue Code] are supplanted by the provisions applicable to reorganizations." (Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, supra at 14-156; 14-157).) The reincorporation doctrine may be viewed either as an extension of Commissioner v. Court Holding Co., 324 U.S. 331 [89 L.Ed. 981] (1945), with the shareholder being treated merely as a conduit to convey: the property to its ultimate destination in the successor corporation or as an example of the sham transactron theory. (Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935).)

Appellants argue that the liquidation-reincorporation doctrine is not applicable here because tax avoidance, a required element, was not present in the instant situation since under section 17402, they recognized ordinary income to the extent of Old Arbco's earnings and profits. However, a short comparison of the t-ax treatment of distributions 'under section'17.402 and taxable dividends under section 17323 indicates that there were, in fact, significant tax advantages to appellants in characterizing the subject transaction as a liquidation (Rev. & Tax. Code § 17402) rather than as a taxable dividend (Rev. & Tax. Code § 17323). While both sections 17402 and 17323 treat a distribution as ordinary income to the extent of earnings and profits, section 17402, subdivision (e)(2), treats the excess as taxable as capital gain only to the extent that the distribution "consists of money, or of stock or securities acquired by the corporation after August 15, 1950. ..." Any other property taken by qualified electing shareholders that has appreciated in value is received without the recognition of gain on such appreciation. Section 17323, on the other hand, provides, in general, that the portion of the distribution which exceeds earnings and profits is first applied against and reduces the shareholder's basis and to the extent that such distribution exceeds that adjusted basis is "treated as gain from the sale or exchange of property" no matter what kind of property is distributed. (Rev. & Tax. Code § 17323, subd. (c)(1).) Accordingly, since the subject distribution involved substantial real properties, which would be received without recognition of gain on appreciation under section 17402, respondent is correct that such properties would be transferred to appellants at minimum tax cost under section 17402 as

opposed to section 17323. (Resp. Reply Br. at 10). In addition, this comparison between section 17402 and 17323 shows that tax avoidance possibilities are not limited only to distributions of liquid assets (i.e., "money ... stock or securities").

Respondent has relied upon two different reorganization sections to develop its liquidation-reincorporation argument. Initially, respondent relied entirely upon sections 24562, subdivision (a)(6), and 17461, subdivision (a)(6), to base its liquidation-reincorporation theory. (Resp. Br. at 6 and 8.) These sections provide that a "reorganization" includes a "mere change in identity, form or place of organization ...." These sections are substantially identical to Internal Revenue Code section 368, subdivision (a)(1)(F). For the sake of convenience, this type of reorganization will be referred to as an "F reorganization." Later, respondent also relied upon sections 24562, subdivision (a)(4), and 17461, subdivision (a)(4). (Resp. Reply Br. at 14 to 17.) These sections provide, in relevant part, that a "reorganization" includes a "transfer by a corporation of all or part of its assets to another corporation ...." These sections are substantially identical to Internal Revenue Code section 368, subdivision (a)(1)(D), and, accordingly, decisions interpreting the federal law may furnish a guide in construction of the state act. (Douglas v. State of California, 48 Cal.App.2d 835, 838 [120 P.2d 927] (1942).) For the sake of convenience, this type of reorganization will be referred to as a "D reorganization."

Upon reflection, it appears that respondent's characterization of the subject transaction as properly an "F" reorganization is misplaced. In brief, there is no indication from the record that New Arbco was a "mere change in identity [or] form" from Old Arbco. However, respondent's contention that the subject transaction can be properly characterized as a "D" reorganization has merit.

At page 898, the court in Smothers v. United States, 642 F.2d 894 (5th Cir. 1981), outlined the following requirements for a "D" reorganization:

> (1) There must be a transfer by a corporation . . . ; (2) of substantially all of its assets . . . ; (3) to a corporation controlled by the shareholders of the transferor corporation, or by the transferor corporation itself . . . ;

> (4) in exchange for stock or securities of the transferee corporation ...;(5) followed by a distribution of the stock or securities of the transferee corporation to the transferor's shareholders ...; (6) pursuant to a plan of reorganization . ...

Since there is no dispute over the other requirements, the pivotal factual controversy here centers on whether "substantially all" of Old Arbco's assets have been transferred to New Arbco. In Smothers v. United States, supra, the court found a "D" reorganization where the transferee corporation represented only 15 percent of the net worth of the transferor corporation. The court' found that the phrase "substantially all assets" required for a "D" reorganization must be interpreted as an "inartistic way of expressing the concept of 'transfer of a continuing business."' (Smothers v. United States, supra, 642 F.2d at 899.) The record before us indicates that Old Arbco's manufacturing business 'did continue to operate in New Arbco. While, the purported liquidation in Smothers was done pursuant to the statute providing for liquidation in one year, the same logic indicating a "D" reorganization is present in the instant appeal.

In addition, there is one further theory that the Internal Revenue Service has used to cope with reincorporations that may fail to qualify as reorganizations. This position has been described as the "no complete liquidation theory." (Nicholson, 335-2d Tax Mgmt. (BNA), Liquidation-Reincorporation, (1985) at A-26, A-27.) Under this theory, the service treats the transferor corporation and transferee corporation as a single entity and attacks the transaction on the basis that there has not been a complete liquidation of the transferor corporation within the meaning of the statute. (See Telephone Answering Service Co. Inc. v. Commissioner, 63 T.C. 423, affd. (4th Cir. 1974) in an unpublished opinion.) In Telephone Answering Service Co. Inc., the tax court held that, in interpreting similar language in Internal Revenue Code section 337, the phrase that all property "be distributed in complete liquidation":

> . . . evidences an intent to require a bona fide elimination of the corporate entity and does not include a transaction in which substantially the same shareholders continue to utilize a substantial part of the directly owned

> assets of the same enterprise in uninterrupted corporate form.

(Telephone Answering Service Co., Inc. v. Commissioner, supra, 63 T.C. at 433.)

In holding that, based upon the above theory, the conditions for a bona fide liquidation did not occur, the tax court appears to have accepted the assertion that the value of the assets transferred from the old corporation to the new corporation was approximately 12 percent of the total assets.

The instant appeal fits squarely into'the factual pattern outlined in Telephone Answering Service Co. Inc. v. Commissioner, supra. The transfer of the manufacturing business from Old Arbco to New Arbco evidences a situation in which "substantially the same shareholders continue to utilize a substantial part of the directly owned assets of the same enterprise in uninterrupted corporate form" so that there was not a complete liquidation of Old Arbco as required.

Accordingly, we hold that, under either theory appellants would not be entitled to section 17402 treatment. Because of this conclusion, no discussion of issue two is required.

Accordingly, pursuant to the modifications noted above, respondent's action must be sustained.

Appeal of Arnold R. and Bessie Buckles

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 Arnold R. and Bessie Buckles against a proposed assessment of additional personal income tax in the amount of $109,464.32 for the year 1977, be modified in accordance with this opinion. In all other respects it is sustained.

Done at Sacramento, California, this 4th day of March, 1986, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Collis, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

Conway H. Collis, Member

Ernest J. Dronenburg, Jr., Member

Walter Harvey*, Member

________________, Member

*For Kenneth Cory, per Government Code section 7.9

BBFORE THE STATE BOARD OF EQUALIZATION

OF **THE** STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. **81A-1045-GO**
ARNOLD R. AND BESSIE BUCKLES)

ORDER DENTING PETITION FOR REHEARING

Upon consideration of the petition filed April **3, 1986,** by Arnold R. and Besie Buckles for rehearing of their appeal from the action of the Franchise Tax Board, we are of the opinion that none- of the grounds set forth in the petition constitute cause for the granting thereof and, accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of March 4, 1986, be and the same is hereby affirmed.

Good cause appearing therefor, it is also hereby ordered **that** the following sentence be added to the end of the second full paragraph on page 8 of the original opinion: "However, we note that this conclusion requires an adjustment reflecting additional depreciation due to the new basis and new holding period for the subject rental properties. and, to this extent, respondent's assessment must be modified."

Done at Sacramento, California, this 29thday of July **, 1986,** by the State Board of **Equalization,** with Board Members **Mr.** Nevins, Mr. Bennett, Mr. Dronenburg and Mr. Harvey present.

Richard Nevins, Chairman

William M. Bennett, Member

'Ernest J. Dronenburg, Jr., Member

Walter **Harvey***, Member

__________ Member,

*For Kenneth.Cory, per Government Code section 7.9