

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)	
)	No. 87A-0169-CB
PACIFIC AMERICAN EQUITIES,)	
INC., 0800902, TAXPAYER, AND)	
PACIFIC CANADIAN EQUITIES,)	
LTD., 1236548, ASSUMER AND/OR)	
TRANSFEE)	

For Appellant: Nicholas S. Freud
Attorney at Law

For Respondent: Cody Cinnamon
Counsel

OPINION

This appeal is made pursuant to section 25666^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Pacific American Equities, Inc., 0800902, Taxpayer, and Pacific Canadian Equities, Ltd., 1236548, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of \$1,662,538 for the income year ended March 31, 1984.

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

The issue presented by this appeal is whether appellant, Pacific American Equities, Inc. (PAE), must recognize the gain on its sale of California real property pursuant to Revenue and Taxation Code section 24514, subdivision (a)(3).

Appellant was a California corporation formed on October 19, 1976, and at formation was wholly owned by Canadian International Properties, Ltd. (CIP), a Canadian corporation. Appellant's business was real estate rentals, and appellant acquired a property located at 433 California Street, San Francisco, California, for rental purposes on or about February 17, 1977.

A decision to sell the San Francisco property was made not later than May 1982 according to the corporate minutes of CIP dated May 3, 1982. In May 1982, CIP's board of directors adopted a comprehensive tax planning program which included changes in the corporate structure to minimize the tax consequence from the sale of the San Francisco property.

As a part of the plan to minimize the tax consequences of the sale of the San Francisco property, appellant's ownership was changed in a series of transfers to newly created corporations. Upon the formation of Floribunda in 1982, a Canadian nonprofit corporation, CIP transferred 25 percent of its stock in appellant to Floribunda. Kewi, Inc., a Nevada corporation, was also formed in 1982. In January 1983, CIP and Floribunda transferred their stock in appellant to Kewi, at least in substantial part to effectuate a tax-free liquidation of appellant for California tax purposes. Thus, beginning in January 1983 and continuing until its dissolution in 1984, appellant was, at least in form, owned 100 percent by Kewi, and it in turn was owned 75 percent by CIP and 25 percent by Floribunda, both Canadian corporations.

Kewi was a holding company whose sole function in actuality was the holding of appellant's stock from January 1983 until appellant's liquidation. In October 1983, the boards of appellant and Kewi adopted plans of complete liquidation and dissolution. The San Francisco property was sold by appellant on or about March 28, 1984, for a gain of \$17,439,532. Subsequently, appellant and Kewi carried out their plans of complete liquidation on March 30, 1984, and April 2, 1984, respectively.

Section 24512 provides for the nonrecognition of gain on sales or exchanges during certain liquidations. Section 24514, subdivision (a)(3), states that section 24512 shall not apply to any sale or exchange

(3) Made by a corporation all of whose shareholders are not United States persons (as defined in section 7701(a)(30) of the Internal Revenue Code of 1954). In the case, however, of a corporation having both United States person and non-United States person shareholders (within the meaning of the preceding sentence) this section and sections 24512 and 24513 shall apply only to the extent the gain or loss from the sale or exchange represents the United States persons' shareholder

interest in the corporation.

Respondent issued a notice of proposed assessment (NPA) on the ground that section 24514, subdivision (a)(3) provides that gain at the corporate level must be recognized to the extent that the shareholder of the liquidating California corporation is a non-United States person. Respondent contends that Kewi's entire existence and liquidation were nothing more than an effort to escape California taxation on the sale of the San Francisco property.

Appellant argues that Kewi, Inc. had economic substance and was actively engaged and functionally involved in legitimate business purposes.

It is well-settled law that, absent business activity, a corporation which is formed solely for tax avoidance purposes will not be recognized for tax purposes. (Moline Properties v. Commissioner, 319 U.S. 436 [87 L.Ed. 1499] (1943); Gregory v. Helvering, 293 U.S. 465 [79 L.Ed. 596] (1935); Jackson v. Commissioner, 233 F.2d 289 (2d Cir. 1956); Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597 (1959); Noonan v. Commissioner, 52 T.C. 907 (1969), affd. 451 F.2d 992 (9th Cir. 1971).

Appellant asserts that the existence of economic substance beyond the mere minimization of taxes on the formation of Kewi was shown by the following:

- (1) Kewi was to serve as a repository holding company of appellant's shares and it was contemplated that Kewi would serve as a central holding company for future subsidiaries which would in turn hold United States real estate.
- (2) The centralization of the ownership of appellant between CIP and Floribunda, promoting greater business efficiencies and facilitating negotiations in the sale of appellant's assets. This unification of the different interests of CIP and Floribunda would allegedly eliminate the divergent goals in negotiating the sale of the assets since the buyer would only have to deal with one seller.
- (3) Allegedly Kewi achieved economies of scale because the parent corporations contemplated further acquisitions and transactions.
- (4) Allegedly there would be a consolidation of profits from one real estate investment with the losses of another.

However, appellant's claim that it was contemplated that Kewi would serve as a central holding company for future subsidiaries lacks credibility because the expressed plan from the outset was to liquidate Kewi (see Resp. Reply Br., ex. 2) in order to achieve a tax-free sale of the San Francisco property (see Memorandum dated March 29, 1982, from Ken Williams and the accompanying letter from Peat, Marwick, Mitchell & Co., Resp. Reply Br., ex. 3). There were no business efficiencies

demonstrated by the creation of Kewi. There has been no showing that CIP and Floribunda had divergent objectives which would have adversely affected the negotiations on the sale of the San Francisco property. Both CIP and Floribunda were motivated to achieve the maximum after-tax proceeds from the sale. Clearly, Kewi failed to engage in any business activity other than the mere holding of appellant's stock. There is no evidence that Kewi had any non-income-tax business purpose. CIP controlled Kewi. Kewi had no assets other than appellant's stock. The only reason we can see for Kewi's existence was income tax avoidance. Therefore, we will not recognize Kewi as the owner of PAE stock for purposes of section 24514, subdivision (a)(3).

Accordingly, the determination of respondent, that the gain on the sale of the San Francisco property must be recognized and reported by appellant's Canadian owners, CIP and Floribunda, must be sustained.

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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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Pacific American Equities, Inc., 0800902, Taxpayer, and Pacific Canadian Equities, Ltd., 1236548, Assumer and/or Transferee, against a proposed assessment of additional franchise tax in the amount of \$1,662,538 for the income year ended March 31, 1984, be and the same is hereby sustained.

Done at Torrance, California, this 15th day of August, 1991, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenberg, and Mr. Davies present.

Brad Sherman _____, Chairman

Ernest J. Dronenberg, Jr. _____, Member

John Davies* _____, Member

_____, Member

_____, Member

*For Gray Davis, pursuant to Government Code section 7.9
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