

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
Rapid-American Corporation ) No. 94A-0284

ORDER DENYING PETITION FOR REHEARING

Upon consideration of the petition filed November 5, 1996, by Rapid-American Corporation, for rehearing of its 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.

Accordingly, it is hereby ordered that the petition be and the same is hereby denied and that our order of October 10, 1996, be and the same is hereby affirmed.

After further consideration of our original opinion in this matter and appellant's petition, it is further ordered that our opinion in this case dated October 10, 1996 is withdrawn. The following opinion shall be given in its place:

OPINION

This appeal is made pursuant to section 19045<sup>1</sup> of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Rapid-American Corporation against proposed assessments of additional franchise tax in the amounts of \$41,852, \$44,831, \$98,925, \$553,077, and \$158,539 for the income years ended January 31, 1979, January 31, 1980, January 31, 1981, January 31, 1982, and January 31, 1983, respectively.

Several of the disputes between appellant and respondent were resolved prior to the hearing on this appeal. The sole question remaining for resolution by this Board is whether appellant may adjust its basis in the stock of its subsidiary corporation, when the stock is sold, to add to its basis the amount of undistributed earnings and profits held in the sold subsidiary.

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

Rapid-American Corporation and its subsidiaries filed combined California tax returns on a worldwide unitary basis. Schenley Industries, Inc. is a subsidiary of Rapid-American Corporation. DWS Corporation, a Canadian corporation, was a subsidiary of Schenley Industries, Inc. During Fiscal Year Ending (“FYE”) January 31, 1982, Schenley Industries, Inc. sold all of its stock in DWS Corporation and realized a substantial capital gain. During FYE January 31, 1982, appellant also sold several other wholly owned subsidiaries, also realizing capital gains on those sales. When appellant filed its California tax return for the applicable years, it increased its basis in the stock of the sold subsidiaries, adding to its acquisition cost the amount of earnings and profits which had previously been reported on its consolidated federal tax returns, reported to California in a combined unitary report, and which had not been distributed up as dividends prior to the sales. Respondent disallowed the claimed adjustments to basis and recalculated the capital gains reportable on appellant’s combined return. As a result, respondent assessed additional tax due for the years in question.

Appellant submits that the proposed adjustment to basis is appropriate under sections 24912 and 24916, and in particular section 24916, subdivision (a), which provides that basis adjustments shall be made for “expenditures, receipts, losses, or *other items properly chargeable to capital account*”. (Emphasis added.) Appellant avers that because the earnings and profits of its subsidiaries from prior years were included in combined reports filed in those prior years, to include them in the gain recognized on the sale of the stock would result in impermissible double taxation of those earnings.

Respondent submits that California has never recognized earnings and profits as an appropriate adjustment to basis. Respondent points out that the adjustment contemplated by appellant is allowed under Treasury Regulation section 1.1502-32, which permits the adjustment in the case of a consolidated federal return, but that California has not adopted a similar statute or regulation.<sup>2</sup>

We are persuaded that California did not intend to allow adjustments to basis of stock in a subsidiary due to the earnings and profits of the subsidiary having been previously included in a combined report filed by the unitary group, and that these items do not constitute an item properly chargeable to the capital account. Two California companies, organized in a parent and subsidiary fashion and operating as a unitary business, would file a combined report, and would also each file individual California corporate tax returns. If the subsidiary did not distribute its earnings and profits as a dividend to the parent, California would tax the income of the subsidiary, and would also tax a subsequent capital gain realized by the parent on a sale of the subsidiary. (See Appeal of CRG Holdings, Inc., formerly Charles of the Ritz Group, 97-SBE-\_\_\_, decided this date.) We believe there is no dispute that the capital gains tax paid by a parent/shareholder of a corporation does not constitute impermissible double taxation when the subsidiary corporation, whose shares are sold, has previously paid tax on its operating earnings.

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<sup>2</sup>We note that Revenue and Taxation Code section 24916 was derived from Internal Revenue Code (IRC) section 1016. However, Congress apparently did not consider that the proposed adjustments were permitted under section 1016, as it subsequently adopted section 1502 to specifically authorize them on federal returns. The proposed adjustment is analogous to a “consent dividend,” which we have also found not to have been authorized by section 24916. See Appeal of CRG Holdings, Inc., formerly Charles of the Ritz Group, Ltd. (97-SBE- ) decided on this date. We also note appellant’s counsel’s statements, at the hearing, that prior to the adoption of the Treasury Regulations under IRC section 1502, the language in question from IRC section 1016 was not construed to allow the proposed adjustments for federal purposes either. (Transcript of Hearing held April 25, 1996, p. 15, lines 12-18.)

We find no basis to treat the appellant differently simply because the subsidiary company in question was not required to file a California return, did not pay California tax, but may potentially have had a portion its earnings and profits included in the California tax returns filed by the parent (by reason of said earnings and profits being contained in a combined report filed by a unitary group of which the subsidiary and the parent were members). To do so would confer a tax benefit on the appellant which is not available to a unitary group comprised solely of California companies, which we decline to do.

Based on the foregoing, we conclude that there is no statutory, regulatory or case law basis in California to support an adjustment upward in the basis of stock on account of undistributed earnings and profits, even if those earnings and profits have been included in a combined unitary report. The decision of the Franchise Tax Board disallowing the proposed adjustment is affirmed.

Done at Sacramento, California, this 8th day of May, 1997, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Klehs, Mr. Andal, Mr. Halverson and Mr. Chiang present.

Ernest J. Dronenburg, Jr., Chairman

Johan Klehs, Member

Dean F. Andal, Member

Rex Halverson\*, Member

John Chiang\*\*, Member

\*For Kathleen Connell, per Government Code section 7.9.

\*\*Acting Member, 4th District.