



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
PAN-CHEMICAL COMPANY)

Appearances:

For Appellant: Allan J. Carter, Attorney at Law;
John A. Stephens, Vice-President
of Appellant

For Respondent: Burl D. Lack, Chief Counsel;
Crawford H. Thomas, Associate Tax
Counsel; Paul L. Ross, Associate
Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code (formerly Section 25 of the Bank and Corporation Franchise Tax Act) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protest of Pan-Chemical Company to proposed assessments of additional tax in the amounts of \$215.12 and \$239.17 for the income years ended May 31, 1942, and 1943, respectively.

H. B. Alexander, John A. Stephens and Lewy Carsten held equal interests in a lease of land in which there was a deposit of celestite containing strontium sulphate. The lease was obtained by them in May, 1938, in consideration of the payment of one dollar and their agreement to pay a specified royalty on any ore mined. They also owned a secret chemical process for procuring sulphonated bitumen from a certain type of crude oil produced by a small oil field in California. This crude oil was available by reason of a contract held by Stephens.

Appellant was organized by these three individuals in June, 1938, for the purpose of doing a general chemical and mining business to produce chiefly the aforementioned strontium sulphate and sulphonated bitumen. On July 8, 1938, Appellant obtained a permit from the Commissioner of Corporations to issue, as follows, 3,495 of its 5,000 authorized shares of stock:

1. To Alexander, Stephens and Carsten, "or to any or all of them," an aggregate of not more than 115 shares for certain personal property to be transferred to Appellant. This was property other than the lease, contract and chemical process.

2. For sale to the general public, an aggregate of not more than 1,520 shares at a price of \$10 per share.

3. To Allen J. Carter, not more than 150 shares for legal services performed by him for Appellant.

4. "Whenever and as often" as shares were sold and issued pursuant to paragraphs 1, 2 and 3, a like number to Alexander, Stephens and Carsten, "or to any of them," with a maximum of 1,710, as consideration for the lease, contract and chemical process.

(For reference purposes, the foregoing paragraphs will be referred to as paragraphs 1, 2, 3 or 4.)

The permit further provided that it was to be ineffective until the lease was recorded, together with any additional documents necessary to perfect Appellant's title thereto; that none of the shares authorized by paragraph 4 was to be sold or issued until Appellant selected an escrow holder approved by the Commissioner of Corporations.; that, when issued, such shares were to be placed in escrow and were not to be transferred without the written consent of the Commissioner of Corporations; and that none of such shares was to be issued unless Alexander, Stephens and Carsten agreed in writing with Appellant to waive their rights to participate in any distribution of Appellant's assets, except as dividends, until all other stockholders who had paid cash or its equivalent for their shares received the return of the full amount of the purchase price.

Prior to August 1, 1938, all assignments and conveyances were executed and all necessary documents were recorded or filed as required by the permit. On or before that date Mrs. Alexander, wife of H. B. Alexander, and Mrs. Carter, wife of Allen Carter, each subscribed and paid for 100 shares of paragraph 2 stock at \$10.00 per share.

Between August 1, 1938, and December 28, 1938, the remaining shares of paragraph 2 stock were sold and as of the latter date all the shares authorized by the permit had been issued. In the interval be-

tween August 1, and December 28, 1938, after extensive negotiations, Alexander and Stephens purchased Carsten's interest in the corporation. Carter represented Alexander and Stephens as their attorney in these negotiations and agreed to accept as consideration for his services 110 shares of paragraph 4 stock and 4 shares of the stock falling in the paragraph 1 category. Carter also had purchased directly from Carsten an additional 10 shares of paragraph 1 stock.

In its returns for the years involved, Appellant took deductions for the amortization of the lease, showing it as having a basis of \$17,100 and alleging that was its cost to Appellant on the date of its acquisition from Alexander, Stephens and Carsten. The Franchise Tax Commissioner, however, disallowed the deductions on the ground that the basis of the lease was its cost to Alexander, Stephens and Carsten, which, as previously noted, was approximately zero.

The basis for depletion allowance of a mineral deposit under Section 8(g)(2) of the Bank and Corporation Franchise Tax Act, as it read during the years involved herein, is the basis provided in Section 21(b) of the Act for the purpose of determining gain or loss on the sale or other disposition of the property. The basis for determining gain or loss from the sale or other disposition of property under Section 21 is the cost of the property, except that, as provided in Section 21(a)(6), if the property was acquired after December 31, 1920, by a corporation, by the issuance of stock or securities in a transaction described in Section 9.2(b)(4) of the Personal Income Tax Act-(now Section 17676 of the Revenue and Taxation Code), the basis is the same as it would be in the hands of the transferor. Section 9.2(b)(4) read:

"(4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange ..."

"Control", as used in this Section, is defined in Section 9.2(g) of the Personal Income Tax Act (now Section 17681, Revenue and Taxation Code) as "the ownership of stock possessing at least 80 per centum

of the total combined voting power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

The first major requirement under Section 9.2(b)(4) is that the transferors must have "control" of the corporation immediately after the exchange. Appellant contends that the transferors of cash for stock in Appellant cannot be included with the transferors of other property for this purpose and, hence, that the transaction involved herein is not within that Section inasmuch as the transferors of property other than cash were not in 80 percent control of Appellant after the transfer. Appellant agrees that the courts have held that money is "property" within the meaning of Section 112(b)(5) of the Internal Revenue Code (comparable to Section 9.2(b)(4)). Halliburton v. Commissioner, 78 Fed. 2d 265; Portland Oil Co., 38 B.T.A. 757; Claude Neon Lights, Inc., 35 B.T.A. 424, 430. It argues, however, that the cases so holding require participation by the cash transferors, as well as the transferors of other property, in the prior plan or "pre-arrangement" pursuant to which the transfer was made. This contention is not supported by the decisions. Claude Neon Lights, Inc., supra, pp. 428-430; Columbia Oil and Gas Co., 41 B.T.A. 38. In these cases a part of the prior plan or agreement was that one of the organizers would procure cash subscriptions to a certain number of shares of stock of the new corporation. Although the cash subscribers were not originally parties to the plan, the courts included them with the transferors of other property in determining whether the transferors were in control of the corporation immediately after the exchange.

In our opinion, the exchange of shares of stock in the corporation for the assignment of the mineral lease and the sale of paragraph 2 shares of stock did not constitute separate and disconnected transactions but were, rather, integral steps in a prearranged plan. The permit authorizing the sale of paragraph 4 shares required that prospective subscribers be furnished a copy thereof. Furthermore, when it is considered that the purchase of those shares for cash was the very act which permitted a like number of shares to be issued in exchange for the lease, it appears obvious that the transferors of cash were participants in the overall plan. On December 28, 1938, the plan was fully executed and on that date the transferors of property and cash held 3221 shares of the corporation's stock, more than 80 percent of the 3495 issued shares.

The second major requirement under Section 9.2(b)(4) is that the amount of stock of securities received by each transferor must be substantially in proportion to his interest in the property prior to the exchange. Appellant contends that the transaction in question does not meet this requirement because **Carsten**, who had a one-third interest in the lease, sold his interest in the corporation to Alexander and Stephens prior to December 28, 1938. This transaction, however, occurred several months after the transfer of the lease to the corporation. At that time **Carsten** had a right to receive a proportionate share of the stock to be issued in exchange for the lease. That such shares of stock were permitted, under a separate and independent agreement, to be ~~issued directly~~ to Alexander and Stephens does not, in our opinion, remove the ~~original~~ transaction from the operation of Section 9.2(b)(4). See Robert Campbell; 15 T.C. 312; Columbia Oil and Gas Co., supra, and Royal Marcher, 32 B.T.A. 76.

As we have concluded that the transfer of the mineral lease to the corporation constituted a transaction in which gain or loss was not recognized, the **Commissioner's** action in disallowing the Appellant's deductions for amortization of the lease computed on a stepped up basis must be sustained.

O R D E R

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 Commissioner (now succeeded by the Franchise Tax Board), on the protests of Pan-Chemical Company to proposed assessments of additional tax in the amounts of \$215.12 and \$239.17 for the income years ended May 31, 1942, and 1943, respectively, be and the same is hereby sustained,

Done at Sacramento, California, this 18th day
of December, 1952, by the State Board of Equalization.

Wm. G. Bonelli, Chairman

J. H. Quinn, Member

Geo. R. Reilly, Member

_____, Member

_____, Member

ATTEST: F. S. Wahrhaftig, Acting
Secretary