93-SBE-008

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of) No. 89A-0814-JG
SARGENT INDUSTRIES, INC.)

For Appellant: Stephen L. Toller
Attorney at Law

For Respondent: Douglas K. Powers
Counsel

O P I N I O N

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 Sargent Industries, Inc., against a proposed assessment of additional franchise tax in the amount of $226,351 for the income year ended April 30, 1979.

[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. In addition, the parties hereto agree, and we concur, that regarding the issue here considered, state law was based upon and, during the income year in question, was substantially similar to federal law. Federal authority, therefore, may properly be used in interpreting the comparable state law. (Meanley v. McColgan, 49 Cal.App.2d 203 (1942).)

Appellant was formerly known as Open Road Industries, Inc. (ORICO). On June 1, 1979, it changed its name to Sargent Industries, Inc. Appellant's wholly owned subsidiary, ORICO Sub, Inc., (OSI) changed its name to Sargent Industries of Delaware.

The issue for determination is whether appellant should recognize taxable income from a cancellation of indebtedness.

Appellant was engaged in the manufacture and sale of recreational vehicles. Beginning with the energy crisis of 1973, it started to experience significant losses, which continued as it began a program to dispose of assets and operations.

On November 12, 1976, appellant filed a debtor-in-possession petition under Chapter XI of the Bankruptcy Act. The consolidated plan of arrangements was confirmed on December 10, 1976. Section VII of that plan stated that "it is anticipated that a substantial portion of the amounts owing the Bank of America would be converted into equity . . . . [T]he debtors anticipate that an agreement for the funding [with the bank] will be substantially completed prior to confirmation [of the plan]." Appellant's status as a debtor-in-possession was terminated on April 11, 1977.

On April 13, 1977, appellant entered into a credit restructuring agreement with its principal lender, the Bank of America (the Bank). Under the terms of this agreement and a related preferred stock purchase agreement, the Bank canceled $22,806,473.87 of appellant's indebtedness in exchange for 900,000 shares of appellant's Series A Convertible Preferred stock. After this exchange there remained approximately $6,800,000 owed by appellant to the Bank. This amount had also not been discharged by the bankruptcy proceedings.

On October 31, 1978, appellant entered into an agreement with Sargent Industries, Inc., under which appellant's newly formed subsidiary, OSI, would acquire all of Sargent's outstanding common and preferred stock for a cash payment of $9.50 and $53.00 per share, respectively. The agreement further provided that after the stock acquisition OSI would be merged into Sargent and would thereafter cease to exist. The agreement was contingent upon the required financing being obtained.

On December 7, 1978, appellant entered into a long-term credit agreement with Banker's Trust under which appellant could borrow up to $7,000,000.

On December 11, 1978, appellant and OSI entered into a purchase agreement with The Prudential Insurance Company of America (Prudential). Under this agreement, appellant was to sell Prudential (1) its 10 percent Senior Promissory Notes in the total amount of $7,000,000, due December 1, 1993, for $7,000,000, (2) 14,150 shares of its Series C Preferred stock for $1,000 per share, and (3) 2,025 shares of its Series D Convertible Preferred stock for $1,000 per share. In addition, under the agreement, OSI was to sell to Prudential (1) its 10 percent Senior Promissory Notes in the principal amount of $2,500,000 due December 1, 1993, for $2,500,000, (2) 25,000 shares of its

Senior Preferred stock for $100 per share, and (3) 9,500 shares of its Class A Common stock for $100 per share.

The closing of the Prudential agreement was contingent upon (1) payment by appellant of $732,000 to the Bank in total satisfaction of its then remaining indebtedness, (2) the exchange by the Bank of 526,105,408 shares of Series A Preferred stock for 19,136.5 shares of appellant's new Series A Convertible Junior Preferred stock, and (3) consummation of the merger of OSI into Sargent.

In connection with the described acquisition program appellant engaged the services of the merchant banking firm of Kohlberg, Kravis, Roberts & Company (KKR) to act as financial advisor in connection with the financing transactions and the merger. KKR was paid $600,000 for its services. In addition, appellant sold KKR 300,000 shares of its Common stock for $450,000 and 500 shares of its Class A Common stock for $50,000.

Appellant's shareholders approved the merger agreement on January 9, 1979, and, on January 10, 1979, the merger, the infusion of the Prudential capital, and the discharge of appellant's indebtedness to the Bank were consummated.

Respondent, after reviewing these transactions, concluded that appellant had received taxable income from the discharge of indebtedness and so informed appellant by appropriate notice. Appellant disagreed and, after its protest was denied, brought this timely appeal.

We note initially that appellant does not dispute that there was a discharge of indebtedness (App. Br. at 6), and appellant also expressly declares that the amount of the debt canceled is not in dispute (App. 2nd Reply Br. at 10). We therefore do not address either question.

For the income year in issue Revenue & Taxation Code section 24271, subdivision (a)(10), provided that gross income includes income from discharge of indebtedness.

The appellant offers three exceptions to the above language of inclusion:

1. The cancellation was gratuitous and was thus a contribution of capital;

2. The appellant was insolvent both before and after the cancellation and therefore no income was realized; and

3. The transactions merely substituted appellant's stock for appellant's debt and were just the continuation of the existing liability in a different form.

We believe only appellant's last argument need be considered in order to decide the question presented.

The starting point of this consideration is the "step- transaction" doctrine. In Commissioner v. Clark, 489 U.S. 726, 738 [103 L.Ed.2d 753] (1989), the Supreme Court explained the concept.

> Our reading of the statute as requiring that the transaction be treated as a unified whole is reinforced by the well established 'step-transaction' doctrine, a doctrine that the Government has applied in related contexts, see, e.g., Rev. Rul. 75-447, 1975-2 Cum. Bull. 113, and that we have expressly sanctioned, see Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 [82 L.Ed. 474] (1938); Commissioner v. Court Holding Co., 325 U.S. 331, 334 [89 L.Ed. 981] (1945). Under this doctrine, interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus 'linking together all interdependent steps with legal or business significance, rather than taking them in isolation,' federal tax liability may be based 'on a realistic view of the entire transaction.' 1 B. Bittker, Federal Taxation of Income, Estates and Gifts, ¶ 4.3.5, p. 4-52 (1981).

From a review of the facts it seems clear that a "realistic view of the entire transaction" would reveal, from the very beginning, a deliberate, concerted plan to restructure appellant's financial affairs. Respondent itself notes in its recitation of the facts that a number of the transactions were contingent upon certain other actions taking place.

The leading case in this area appears to be Commissioner v. Capento Securities Corporation, et al., 47 B.T.A. 691 (1942), affd., 140 F.2d 382 (1st Cir. 1944). In that case the Raytheon Manufacturing Company had a wholly owned subsidiary, Raytheon Production Corporation (Production). In 1929, Production issued secured gold bonds of $500,000 face value. In 1933 Capento Securities Corporation (Capento) was organized with a capital stock of 10 shares of common, par value $100 per share, all owned by Raytheon Manufacturing Company. Capento, thereafter, purchased, for $15,160, all of the $500,000 gold bonds issued by Production. The bonds were Capento's only asset and it was apparently organized for the sole purpose of acquiring them.

In 1934, Production borrowed $200,000 from the First National Bank of Boston. By agreement the bonds held by Capento were subordinated to the loan. In 1935, Production applied to the First National Bank of Boston and to the Federal Reserve Bank of Boston for an additional loan of $100,000. It was apparently understood that the $500,000 of bonds would also be subordinated to this second loan. However, the First National Bank, in order to insure the senior status of its loans, suggested that the bonds be replaced by a stock interest.

In accordance with this suggestion, a plan of reorganization was adopted by the three affiliated corporations under which:

1. The capital stock of Production was increased by 5,000 shares of 6 percent noncumulative preferred stock, par value $100 per share, said shares to have full voting power with the common shares, share for share;

2. Capento transferred the $500,000 of bonds to Production for cancellation and retirement solely in exchange for all of the new issue of 5,000 shares of Production's preferred shares; and

3. Production's existing liability with respect to the bonds was transferred to the capital stock account in payment of the preferred shares.

The Board of Tax Appeals found as a fact that the preferred stock that Capento received was worth $50,000 when acquired. Since the bonds exchanged for the stock had a cost basis of $15,160, the Commissioner calculated a gain for Capento of $34,840 ($50,000 - 15,160) and assessed a tax accordingly.

The courts did not support the Commissioner. The reorganization was said to be an ordinary business transaction, entered into at the suggestion of the banks. This resulted in a permanent revision of the capital structure of Production - a normal business procedure dictated by the necessity of raising new capital. There had been a mere change in the form of ownership and Capento had not really benefitted from a theoretical gain, though a gain may have accrued in a constitutional sense.

As to Production, the Commissioner held that the relief of a liability of $500,000 by issuing stock worth only $50,000 resulted in a gain of $450,000. Again the courts said no. Quoting the Board of Tax Appeals, the Court of Appeals said,

> "[I]t is hard to see that gain was in fact realized. The corporation had a liability of $500,000 on the bonds having presumably borrowed that amount. While it discharged that liability, it created a new stock interest which became a balance sheet liability called capital stock. This is plainly different from the discharge of its indebtedness by the payment of money in a less amount of the indebtedness [citation omitted] . . . . To substitute a capital stock liability for a bonded indebtedness may have its advantages . . . but it cannot be called a present realization of gain."

The comparison to the instant appeal is obvious. Here appellant, in order to revive itself financially and to continue in business, entered upon a plan of reorganization and restructuring. The transactions undertaken were undoubtedly done at the behest of its lenders, present and future, and those transactions were the substitution of stock for debt.

Respondent, in its original brief, argues that the Bank did not actually receive stock in

consideration for the discharge of appellant's indebtedness and that the preferred stock exchange was a separate transaction. Respondent also claims that the debt discharge transaction was effected solely in exchange for $732,000.

There seems to be some conflict in respondent's positions. If the Bank received no stock from appellant, how could there have been a preferred stock exchange? And the idea that the exchange was a separate transaction would appear to do violence to the step-transaction doctrine, which respondent agrees should be applied (Resp. Reply Br. at 10). It also seems unlikely that the Bank would agree to accept $732,000 in payment of debt of approximately $29,600,000 without more.

We also note that paragraph 2E of the Prudential Agreement (quoted in part in Resp. Br. at 5, 6) provides that appellant would use borrowed funds and monies from the sale of stock to pay the Bank the $732,000. Therefore, if this was not one integrated plan, presumably appellant would not even have been able to pay the $732,000.

In its reply brief respondent has apparently abandoned its position that the Bank received no stock from appellant and instead urges that we value the stock received by "computing a residual equity value of appellant's net assets after subtracting any senior secured indebtedness." (Resp. Reply Br. at 12, 13). This, presumably, would lead us to the conclusion that the stock received by the Bank had little or no value when received and thus we should ignore the stock exchanges in analyzing the debt cancellation. We believe it suffices to say that respondent offers no authority for its position, and we are aware of none.

We also believe that application of the step-transaction doctrine and existing case law leads to the conclusion that appellant falls within the "stock for debt" exception to the income from discharge of indebtedness general rule.

For that reason, we hold that respondent's action in this matter must be reversed.

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 Board on the protest of Sargent Industries, Inc., against a proposed assessment of additional franchise tax in the amount of $226,351 for the income year ended April 30, 1979, be and the same is hereby reversed.

Done at Sacramento, California, this 22nd day of April, 1993, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong, Mr. Dronenburg, and Ms. Scott present.

Brad Sherman, Chairman

Matthew K. Fong, Member

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

____________________, Member

*For Gray Davis, per Government Code section 7.9