96-SBE-013

ADOPTED 5/15/96

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 91A-1176
Thomas P. and Ancella P. Toldrian	)	
	)	

Representing the Parties:

For Appellants: Thomas P. and Ancella P. Toldrian

For Respondent: Janet Ballou, Counsel

Counsel for Board of Equalization: Charles D. Daly, Staff Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1] of the Revenue and Taxation Code (renumbered as section 19045, operative January 1, 1994) from the action of the Franchise Tax Board on the protest of Thomas P. and Ancella P. Toldrian against a proposed assessment of additional personal income tax in the amount of $28,080 for the year 1986.

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

There are two issues presented for our resolution by this appeal.[2] One is whether the stock of Round Table Pizza, Inc. (Round Table), that appellants sold during the appeal year was properly disqualified as "small business stock" under former Revenue and Taxation Code section 18162.5, subdivision (f)(1). The other is whether appellants have substantiated that their Round Table stock qualified as "small business stock" when they acquired it. Because our conclusion regarding the first issue resolves this appeal, we need not consider the second issue.

Appellants and a number of other investors acquired Round Table stock in 1979. Appellants state that, at that time, Round Table was a small chain of pizza restaurants that were owned, for the most part, by franchisees. After the acquisition, appellants and the other investors determined that the business of Round Table should be divided "along functional operating lines," and Round Table accordingly formed a separate subsidiary for each of its operations. One subsidiary was formed to own pizza restaurants. A second subsidiary was formed to conduct franchising operations. A third subsidiary was formed to lend money to new franchisees. The result of this reorganization was that Round Table became a holding company with "no functional purpose except to hold the stock of the operating subsidiaries." (H.T. at 6.) The parties have stipulated that Round Table and its subsidiaries were a single unitary business that properly filed a California combined report.

Appellants sold their Round Table stock in 1986. On their 1986 California tax return, appellants reported regular capital gain from the sale of their Round Table stock under section 18162.5, subdivision (a), and also reported preference income with respect to the excluded portion of the capital gain. Subsequently, appellants filed an amended 1986 tax return on which they claimed a refund of the preference tax that they had paid. The basis for their refund claim was that the gain from the sale of their Round Table stock was excluded from preference tax under former section 17063.11 because that stock was "small business stock," as defined in section 18162.5, subdivision (e). After refunding the claimed amount and accrued interest, respondent examined appellants' amended tax return.

As part of its examination of appellants' tax return, respondent examined a schedule that respondent states was attached to the California combined report that Round Table and its subsidiaries had filed for the income year ending on June 30, 1985, the income year before appellants sold their Round Table stock. As appellants acknowledge, that schedule reveals that Round Table had gross

---

[2] Respondent also raises the issue of whether small business stock acquired before September 17, 1981, qualified for the tax preference exclusion of former section 17063.11. This board in the Appeal of Magnus F. and Denise Hagen, decided on April 9, 1986, held that the benefits of that statute were available for small business stock purchased before that time if all other requirements were met. The California Supreme Court reached essentially the same conclusion in Lennane v. Franchise Tax Board, 9 Cal.4th 263 [36 Cal.Rptr.2d 563] (1994).

receipts in the total amount of $2,612 and gross receipts from interest in the amount of $1,869.[3] Respondent concluded that the amount of interest in relation to the gross receipts that Round Table had received in the income year immediately preceding the year in which appellants sold their Round Table stock disqualified that stock as "small business stock" under section 18162.5, subdivision (f)(1). Therefore, respondent further concluded that appellants were liable for preference tax and issued a notice of proposed assessment. After respondent denied appellants' protest, this timely appeal followed.

Section 18162.5, subdivision (f)(1), provided as follows:

> (f) For purposes of this section, "small business stock" does not include an equity security issued by a corporation which has either of the following characteristics in the income year immediately prior to the taxpayer's sale or exchange of the equity security:
>
> (1) More than 25 percent of its gross receipts were obtained from rents, interest, dividends, or sales of assets.

* * *

Appellants' primary contention in this matter is that Round Table and its subsidiaries should be combined and treated as a single entity for purposes of the test under section 18162.5, subdivision (f)(1). As appellants point out, they would prevail under this approach because both the California combined report and the federal consolidated return show that the combined gross receipts of Round Table and its subsidiaries were in excess of $10 million while the combined amount of interest received by them was only $742,185. In support of their contention, appellants argue that Round Table and its subsidiaries should be treated as a single entity here because they were treated as a single entity for unitary business purposes. Appellants also argue that both the "plain meaning" of section 18162.5, subdivision (f)(1), and the legislative purpose underlying that statute require that Round Table and its subsidiaries be treated as a single entity. Because we disagree with all of appellants' arguments, we must also disagree with their primary contention.

Appellants cite no statutory or other authority in support of their argument that Round Table and its subsidiaries should be treated as a single entity for small business stock purposes because

[3] Respondent has included the schedule as part of an exhibit to its brief. The other part of respondent's exhibit consists of the first page of Round Table's federal consolidated tax return for the income year ending on June 30, 1985.

they were treated as a single entity for unitary business purposes. Section 18162.5 makes no explicit reference to unitary businesses or to the provisions of the Revenue and Taxation Code that govern unitary businesses, and we see no obvious reason why the small business stock provisions of the Revenue and Taxation Code should require treatment of corporate entities in exactly the same manner as they are treated in the unitary business context. Appellants appear to take the position that the status of Round Table and its subsidiaries as separate entities should be disregarded here for the same underlying reasons that their status as separate entities is disregarded for unitary business purposes; however, we think that this position has no merit. The separate entity status of a parent and its subsidiaries is disregarded in the unitary business context for the limited purpose of determining the amount of the business income of the entire unitary group that is attributable to California and then apportioning by formula that amount among the individual corporations in the unitary group. (Appeal of Dasibi Environmental Corporation, Cal. St. Bd. of Equal., Nov. 19, 1986.) This purpose could not be achieved without disregarding their status as separate entities. (See Keesling, A Current Look at the Combined Report and Uniformity in Allocation Practices, 42 Journal of Taxation 106 (1975).) In contrast, the purpose of the small business stock provisions, as appellants acknowledge, is "to encourage the establishment of small businesses in California." (App. Br. at 3.) That purpose is very different from the purpose underlying the unitary business provisions and clearly does not require disregarding the status of a parent and its subsidiaries as separate entities. Therefore, in the absence of any statutory or other compelling support, we must disagree with this argument.

We are unpersuaded as well by appellants' other arguments. Their argument that the "plain meaning" of section 18162.5, subdivision (f)(1), requires treating Round Table and its subsidiaries as a single entity is undercut by the very language of that section, which discusses the treatment of "an equity security issued by a corporation." (Emphasis added.) As respondent points out, the only equity securities at issue here are shares of stock that were issued by the parent corporation, Round Table, and later acquired and sold by appellants. Finally, as we have indicated immediately above, the legislative purpose underlying the statute does not require disregarding the status as separate entities of Round Table and its subsidiaries. Therefore, we conclude that the separateness of the entities here may not be disregarded and that we must focus upon Round Table itself to the exclusion of its subsidiaries in applying the test stated in section 18162.5, subdivision (f)(1).

Appellants' other contention is that they should prevail because "interest income in the amount of $742,185 . . . was not derived from idle funds but was from loans to franchisees from an SBIC that was formed when interest rates were so high in the early 80s." (App. Reply Br. at 2.) Their argument, then, is that the interest in question was not simply "passive" income and, therefore, should not disqualify their Round Table stock as small business stock. Their contention appears to be similar to the position taken by the taxpayers in the Appeal of Russell B., Jr., and Margaret A. Pace, 92-SBE-

013, decided on May 7, 1992, which we agreed with, holding that all the disqualifying income items (including interest) listed in section 18162.5, subdivision (f)(1), should be construed to include only items that are "passive," as that term is used in respondent's Legal Ruling 428, dated August 19, 1987.[4] However, we need not consider the applicability of Pace to the instant matter because appellants have provided no evidence that might cause us to conclude that the interest income actually received by Round Table itself was "non-passive" for purposes of Pace. In the first place, the amount of the interest actually received by Round Table was only $1,869 rather than $742,185, which was the total amount of interest received by Round Table and its subsidiaries. Even if some of the total amount of the interest received by the Round Table group was "non-passive," appellants have provided no evidence that the interest actually received by Round Table alone was "non-passive" interest. In fact, appellants' own statements regarding the formation of its subsidiaries suggest that only the subsidiary established by Round Table to lend money to franchisees received interest that was "non-passive" interest under Pace.

In view of the foregoing, we must conclude that appellants have failed to show that their Round Table stock should not be disqualified as small business stock under section 18162.5, subdivision (f)(1). Accordingly, respondent's action in this matter must be sustained.

[4] Neither party cited Pace in their briefing or referred to it at the hearing.

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Thomas P. and Ancella P. Toldrian against a proposed assessment of additional personal income tax in the amount of $28,080 for the year 1986 be and the same is hereby sustained.

Done at Sacramento, California, this 15th day of May, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs, Chairman

Ernest J. Dronenburg, Jr., Member

Dean F. Andal, Member

Brad J. Sherman, Member

Rex Halverson*, Member

*For Kathleen Connell, per Government Code section 7.9.