OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **L. CONACHER AND** **J. DEA**	OTA Case No. 18022358

OPINION

Representing the Parties:

For Appellants: Mardiros H. Dakessian, Dakessian Law, LTD
Steven Rauser, Dakessian Law, LTD

For Respondent: Kamalpreet K. Khaira, Tax Counsel
Louis A. Ambrose, Tax Counsel IV

H. LE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) sections 19045 and 19324, L. Conacher and J. Dea (appellants) appeal actions by Franchise Tax Board (respondent) denying appellants' claim for refund of $423,695 for the 2011 tax year, proposing $20,120 of additional tax, plus applicable interest, for the 2011 tax year, and disallowing $5,553,205 of a capital loss carryover claimed for the 2013 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Jeffrey I. Margolis, Kenneth Gast, and Huy "Mike" Le held an oral hearing for this matter on July 23, 2020.[1] At the conclusion of the hearing, the record was closed and the matter was submitted for decision.

ISSUE

Whether appellants have shown that their adjusted basis in certain stock they sold in 2011 was $13,672,897.[2]

[1] The oral hearing was noticed for Cerritos and conducted electronically due to COVID-19.

[2] All dollar amounts in this opinion are in United States (U.S.) dollars.

FACTUAL FINDINGS

1. In 2002, appellant-husband, while a Canadian citizen and resident, co-founded Westwind Capital Corporation (Westwind), an international investment bank headquartered in Toronto, Canada.[3]
2. Thomas Weisel Partners Group, Inc. (TWPG), a Delaware incorporated investment bank headquartered in San Francisco, California, acquired Westwind stock effective January 2, 2008. To accomplish the acquisition, TWPG formed TWP Acquisition Company (Canada), Inc. (TWPA), an indirect, wholly-owned subsidiary of TWPG, to acquire all of Westwind's outstanding shares.[4]
3. As part of the Westwind acquisition, Westwind's shareholders, including appellants,[5] exchanged their Westwind shares for a total consideration of approximately $156 million, consisting of $45 million in cash, 7,009,112 TWPA shares, and direct acquisition costs of $3.1 million. Appellants' portion of the preceding consideration amounted to approximately $5.8 million in cash and 1,523,723 TWPA shares. At the time of the exchange, appellants acquired TWPA shares with a fair market value of approximately $13.65 per share.
4. On their 2008 Canadian individual income tax return, appellants reported gain on the cash portion of the sale proceeds, after fully deducting their adjusted basis in the Westwind stock, but did not report any gain on the exchange of their Westwind shares for TWPA shares according to a deferral election under Canada Income Tax Act section 85(1) (Section 85 Election).[6]
5. After the Westwind acquisition, appellants reduced their original stock holdings in TWPA from 1,523,723 to 1,030,139 shares through various transfers, donations, and

[3] Nothing in the record indicates that Westwind was subject to U.S. tax law.

[4] TWPG also formed TWP Holdings Company (Canada), ULC, a direct, wholly-owned subsidiary, to hold the shares of TWPA.

[5] For convenience, we are referring only to appellants even though the transactions involving Westwind were undertaken by L. Conacher, appellant-husband.

[6] The Section 85 Election permits a taxpayer to elect to defer all or part of the income that would otherwise arise on the transfer of certain types of property to a taxable Canadian corporation.

sales.

6. On August 16, 2009, appellants emigrated to the U.S. and became California residents. In connection with their emigration, appellants were required to pay a "departure tax"[7] and thus reported gain of $4,112,687 to Canada on the 1,030,139 TWPA shares held as of August 16, 2009, measured by the difference between the then fair market value of their TWPA shares of $4,112,687 and their adjusted cost basis of $0.

7. After emigrating, appellants again reduced their TWPA stock holdings from 1,030,139 to 1,016,224 shares through a donation and a reduction that appears attributable to a currency conversion on the donation.

8. In 2010, TWPG merged with and into Stifel Financial Corporation (Stifel), a Delaware incorporated financial holding company, in a stock-for-stock exchange that was tax-free under the Internal Revenue Code (IRC) at a ratio of 0.1364 Stifel share for each TWPA share. As such, appellants' remaining 1,016,224 TWPA shares were converted into 138,613 Stifel shares.

9. In 2011, appellants sold 136,613 (of their 138,613) Stifel shares for $8,963,696.

10. On their original 2011 joint California resident income tax return, appellants reported a cost basis of $4,152,000 in their Stifel shares[8] and a capital gain of $4,811,696 ($8,963,696 - $4,152,000).

11. Respondent audited appellants' 2011 California tax return.

12. During audit, appellants filed an amended 2011 California tax return on September 2, 2017, revising their basis in Stifel shares from $4,152,000, as initially reported, to $13,672,897.[9] This revised basis amount reflects appellants' position that since the stock portion of the 2008 share exchange would have been a transaction taxable under the IRC had the transaction occurred in the U.S., their basis in the TWPA shares

[7] In general, Canadian Income Tax Act section 128.1(4)(b) & (c) provide that when a Canadian resident ceases to be a resident, there is a deemed disposition and reacquisition of all property owned by the resident at fair market value at the time of departure. The resulting tax on these deemed dispositions is commonly referred to as the "departure tax."

[8] Appellants assert the $4,152,000 in basis was calculated using a share value of $4 per share for TWPA as of August 16, 2009, the date appellants emigrated to the U.S.

[9] Appellants also filed an amended 2011 federal return to revise the stock basis to $13,672,897. The Internal Revenue Service (IRS) accepted the amended federal return and issued a refund. However, the IRS made no examination or inquiries in connection with appellants' amended federal return.

was the fair market value of the TWPA shares at the time of the transaction. Appellants asserted that after adjusting for share decreases through various transfers, donations, and other dispositions, their basis in the TWPA shares would then be carried over to their Stifel shares. Therefore, according to appellants, application of the claimed $13,672,897 basis against the $8,963,696 sale proceeds resulted in a claimed capital loss of $4,709,201.

13. At audit, respondent disagreed with appellants' reporting positions on their original and amended returns. Respondent took the position that the 2008 transaction between Westwind and TWPA qualified as a tax-free transaction under IRC section 351 had it occurred in the U.S. Therefore, respondent recomputed appellants' basis in Westwind to be $718,235, which carried over to their TWPA and, consequently, Stifel shares.

14. At protest, however, respondent changed its position by concluding that the 2008 transaction between Westwind and TWPA did not qualify as a tax-free transaction under IRC section 351.[10] Nevertheless, because appellants made a Section 85 Election under Canadian law to defer gain on that portion of the exchange, respondent rejected appellants' contention that they were entitled to increase their basis in their TWPA shares to the fair market value of those shares in 2008. However, respondent increased appellants' basis to the extent they reported taxable gain to Canada on the deemed disposition and reacquisition of their TWPA shares in connection with their departure tax when they emigrated to the U.S.[11]

15. Respondent issued a denial of appellants' claim for refund of $423,695 for the 2011 tax year. Respondent also issued a Notice of Action proposing $20,120 of additional tax, plus applicable interest, for the 2011 tax year, and disallowing $5,553,205 of a capital loss carryover reported for the 2013 tax year. This timely appeal followed.

[10] Although application of IRC section 351 was previously in dispute during audit, both parties now agree on appeal that the 2008 transaction between Westwind and TWPA did not qualify as a tax-free transaction under IRC section 351 or any other provision of the IRC.

[11] On appeal, respondent now believes that the position it took in the Notice of Action was incorrect because appellants are not entitled to an increased basis in the TWPA shares as a result of the gain recognized in 2009 for the Canadian departure tax: "While the protest hearing officer allowed the additional basis because Appellants paid the Canadian Departure Tax, Respondent notes that Appellants did not make the election specified in [IRS] Revenue Procedure 2010-19 and, therefore, Appellants are not entitled to the basis increase attributable to the payment of the Canadian Departure Tax. However, on appeal, Respondent will not increase the amount of additional tax stated in the [Notice of Action]."

DISCUSSION

Appellants bear the burden of proving entitlement to their refund claim, which means they must not only prove that the tax assessment was incorrect but must also produce evidence to establish the proper amount of the tax due, if any. (*Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, 1235.) A deduction, such as a capital loss, is a matter of legislative grace, and appellants have the burden of proving, by a preponderance of the evidence, they are entitled to it. (*New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435, 440; Cal. Code Regs, tit. 18, § 30219(c).) Appellants also bear the burden of proving basis to calculate gain or loss on the sale of the underlying property. (*Marcus v. Commissioner*, T.C. Memo. 1996-190.)

The sole question in this appeal is the proper amount of appellants' adjusted basis in the TWPA shares they acquired in 2008. The parties agree that the determination of this basis amount would then be carried over to appellants' basis in their Stifel shares acquired during the 2010 TWPG tax-free merger with Stifel and applied in computing appellants' 2011 gain or loss from the sale of their Stifel shares. From the outset, we note that we have not found, and the parties do not cite, controlling precedent directly addressing this issue—i.e., how to compute the adjusted basis in stock owned by a California resident individual when that stock was acquired while a citizen and resident of a foreign country. Therefore, this appears to be a case of first impression.

The basic thrust of the parties' contentions can be described as follows. Appellants argue that Canadian tax law does not affect their basis in the TWPA shares. Since they exchanged their Westwind shares for TWPA shares in what would have been a taxable transaction if the transaction occurred in the U.S.—a point which respondent has conceded[12]—they are allowed a cost basis equal to the fair market value of the TWPA shares at the time of the 2008 transaction.

[12] In its opening brief, respondent made multiple concessions: (1) "Appellants argue and Respondent agrees that the exchange did not result in a merger and that none of the tax-free reorganization provisions of the IRC apply to this transaction. Therefore, if U.S. tax law applied Appellants would have been taxable on the gain resulting from the exchange"; (2) "Thus, the holding in *Biddle* supports Respondent's position that Appellants' basis in the Westwind stock carried over to the TWPA stock in the sale transaction *even though such a transaction would have been taxable under U.S. tax law*" (second italics added); and (3) "As stated above, Respondent agrees that the sale of the Westwind stock did not qualify as a tax-free transaction under the provisions of the Internal Revenue Code to which IRC section 358 applies." At the prehearing conference, OTA asked the parties to be prepared for questions at the hearing on whether the Westwind and TWPA share exchange was taxable under the IRC and, in particular, the application of IRC section 351. At the hearing, respondent agreed that "none of the Internal Revenue Code tax-free reorganization provisions apply to the Westwind acquisition. Therefore, if U.S. tax law applied, Appellants were required to recognize the gain from the sale of Westwind stock."

In contrast, respondent argues that since appellants made a Section 85 Election under Canadian tax law to defer gain on the stock portion of the 2008 exchange, and did not otherwise recognize that gain or pay Canadian tax on it, they cannot obtain a cost basis equal to the 2008 fair market value of the TWPA shares under the IRC.

As a threshold matter, we must address which jurisdiction's tax law to apply to a transaction that occurs outside of the U.S. and that was conducted by a foreign individual before that individual became a U.S. and California resident taxpayer. We find, and the parties agree, that California tax law, and the relevant U.S. tax law provisions to which it conforms, governs the dispute in this matter. (See *U.S. v. Goodyear Tire and Rubber Co.* (1989) 493 U.S. 132, 145 (*Goodyear*), citing *Biddle v. Commissioner* (1938) 302 U.S. 573, 578 (*Biddle*) ["tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control"].) Thus, the starting point of our analysis is the R&TC and IRC.

Under R&TC section 18031, California generally conforms to Subchapter O of the IRC, which includes rules on the determination of gain or loss (e.g., IRC, § 1001) and basis (e.g., IRC, §§ 1011-1016).[13] IRC section 1001(a) provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis as defined in IRC section 1011, and the loss shall be the excess of the adjusted basis over the amount realized. Here, it is undisputed that appellants' amount realized from the 2011 sale of Stifel shares is $8,963,696. As noted above, however, what is in dispute is the amount of appellants' basis in those sold shares.

IRC section 1011(a) provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property shall be the property's basis determined under IRC section 1012 (or other applicable sections not relevant here)[14] with adjustments provided in IRC section 1016. IRC section 1012, in turn, provides that the basis of property shall be "the cost" of such property, except as otherwise provided. Treasury Regulation section 1.1012-1 provides that the cost is the amount paid for the property in cash or other property. As relevant to this appeal,

[13] It is well settled that where federal law and California law are the same, federal rulings and regulations dealing with the IRC are persuasive authority in interpreting the applicable California statute. (See *J. H. McKnight Ranch, Inc. v. Franchise Tax Bd*. (2003) 110 Cal.App.4th 978, fn.1.)

[14] IRC section 1011 references subchapter C, but this subchapter is not relevant in this appeal since the parties agree that neither IRC section 351 nor any tax-free reorganization provisions apply.

there is no dispute that the plain language of IRC section 1012 applies to "property" generally, without distinguishing between the location of the property (domestic or foreign) or the nature of the owner (U.S. or non-U.S. person). Furthermore, the term "cost" must be read to incorporate domestic tax concepts because the relevant IRC provisions contain no clear congressional expression that basis is dependent upon a foreign jurisdiction's tax laws. (See *Biddle*, *supra*, 302 U.S. at p. 578.) Therefore, to determine appellants' cost basis in the Stifel shares, we must apply U.S. tax concepts and examine how appellants acquired these shares.

While California residents, appellants acquired the Stifel shares when Stifel and TWPG merged in 2010. At that point, appellants' TWPA shares were converted to Stifel shares in a nontaxable transaction under the IRC in which appellants' basis in their TWPA shares carried over to their Stifel shares. As such, the issue in this case narrowly focuses on requiring us to determine appellants' basis in their TWPA shares by examining how those shares were acquired.

While Canadian residents, appellants acquired their TWPA shares in 2008 when they exchanged their Westwind shares for TWPA shares as part of TWPG's acquisition of Westwind. As noted above, the parties agree that had this stock-for-stock exchange occurred in the U.S., it would have been fully taxable under the IRC. Under U.S. tax law, as conformed to by California, property acquired in a taxable exchange takes a cost basis equal to the fair market value of the property received at the time of the exchange, even if the gain was not, but should have been, recognized. (*Williams v. Commissioner* (1962) 37 T.C. 1099, 1106 (*Williams*) ["By holding that the fair market value of the property received in a taxable exchange is the cost basis[,] . . . the basis of the property received will equal the adjusted basis of the property given plus any gain recognized, *or that should have been recognized*, or minus any loss recognized, *or that should have been recognized*," italics added].) In fact, the tax court in *Williams* noted that although neither party to the exchange "reported any gain or loss on the exchange in their Federal income tax returns," the taxpayers were still entitled to a cost basis equal to the fair market value of the property received. (*Ibid*.) Consequently, we conclude that appellants took a cost basis in the 1,523,723 TWPA shares equal to the fair market value of approximately $13.65 per share.[15]

[15] For support, appellants submitted Canadian Forms T2057 showing fair market value of consideration received in the exchange, a website screenshot of the historical Canadian to U.S. dollar exchange rate on

This fair market value basis in appellants' TWPA shares, after taking into consideration various sales, transfers, and donations, carried over to the basis in their Stifel shares since the 2010 TWPA and Stifel stock exchange constituted a nontaxable transaction.[16] Accordingly, we agree with appellants that the basis in their Stifel shares sold in 2011 was $13,672,897, the amount claimed on their amended California tax return. Applying the amount realized of $8,963,696 from the 2011 sale of appellants' Stifel shares against their basis in Stifel shares sold of $13,672,897 results in a capital loss of $4,709,201.

In reaching this conclusion, we emphasize that our opinion here is limited to the basis issue raised in this appeal. In other areas of U.S. tax law, Congress may have provided a clear congressional expression that foreign concepts control, but we need not address those issues here. Furthermore, although IRC section 358 allows for an "exchanged basis" (generally, where the transferor's basis in the stock received is equal to the basis of the stock given up), this provision only applies "[i]n the case of an exchange to which section 351, 354, 355, 356, or 361 applies . . . ." Since respondent has conceded that neither IRC section 351 nor any of the IRC's tax-free reorganization provisions apply, IRC section 358 is inapplicable here.

Respondent's core argument is that the TWPA shares were not entitled to a cost basis on the date of the 2008 Westwind and TWPA share exchange because "[a]s a factual matter, under Canadian law Appellants paid no tax at the time of the transaction and, therefore, the stock would not have an increased basis under U.S. tax law." To support its argument on the "factual use of foreign law," respondent claims the U.S. Supreme Court's decision in *Biddle*, *supra*, supports its position, not appellants'. However, we disagree because in *Biddle* the Court confirmed that a statutory term's legal meaning is derived from its plain meaning as used under U.S. tax law and not from its meaning under foreign law.

In *Biddle*, the principal question was whether a U.S. person owning stock in a British corporation could claim a credit for foreign taxes paid directly by that corporation under former IRC section 131, which directed that income tax be credited with "the amount of any income . . . taxes paid or accrued during the taxable year to any foreign [country]." (*Biddle*, *supra*, 302 U.S.

January 2, 2008, and their calculation converting Canadian fair market value of the TWPA shares to U.S. dollars. Respondent does not challenge this calculation.

[16] Since the parties do not dispute this calculation, we need not explain in depth.

at p. 578.) The Court found that interpretation of the phrase "income taxes paid" must be determined under U.S. tax law, unless the statute by "express language or necessary implication" depends upon foreign law:

> At the outset it is to be observed that decision must turn on the precise meaning of the words in the statute which grants to the citizen taxpayer a credit for foreign 'income taxes paid.' The power to tax and to grant the credit resides in Congress, and it is the will of Congress which controls the application of the provisions for credit. The expression of its will in legislation must be taken to conform to its own criteria unless the statute, by express language or necessary implication, makes the meaning of the phrase 'paid or accrued,' and hence the operation of the statute in which it occurs depend upon its characterization by the foreign statutes and by decisions under them.

(*Ibid*.)

In applying that rule to former IRC section 131, the Court found that "Section 131 does not say that the meaning of its words is to be determined by foreign taxing statutes and decisions, and there is nothing in its language to suggest that, in allowing the credit for foreign tax payments, a shifting standard was adopted [by Congress] by reference to foreign characterizations and classifications of tax legislation." (*Biddle*, *supra*, 302 U.S. at pp. 578-579.) Because IRC section 131 did not reveal a clear congressional intent that the tax issues in that case be governed by anything other than U.S. law, the Court concluded the taxpayer was not viewed as having paid a corporate tax for foreign tax credit purposes. (*Id*. at pp. 581-582.)

In *Goodyear*, the Court also confirmed that a statutory term should be interpreted in accordance with domestic tax concepts. (*Goodyear*, *supra*, 493 U.S. at p. 145.) The issue in *Goodyear* was whether the term "accumulated profits," as it appeared in former IRC section 902, governing the indirect foreign tax credit, should be calculated in accordance with foreign or domestic tax concepts. (*Id*. at p. 134.) Although the Court noted that the starting analysis in all cases involving statutory interpretation must be the statutory language itself, it found the text of IRC section 902 ambiguous. (*Id*. at p. 138.) IRC section 902 relates "accumulated profits" both to the foreign tax paid by the subsidiary, calculated in accordance with foreign law, and to the dividend issued by the subsidiary, calculated in accordance with domestic law. (*Id*. at p. 139.) The Court therefore looked beyond the statute's language to its legislative history, purposes, and operation of the indirect foreign tax credit. (*Ibid*.) The legislative history demonstrated that the credit was intended (1) to protect a domestic parent from double taxation, and (2) to equalize treatment between domestic corporations that operate through foreign subsidiaries and those that operate through unincorporated foreign branches. (*Id*. at pp. 139-140.) However, double taxation can result if accumulated profits were computed under U.S. law, and unequal treatment can result if accumulated profits were computed under foreign law. (*Ibid*.) The Court found the risk of double taxation less substantial than the risk of unequal treatment. Therefore, the Court held that the term "accumulated profits" "should be calculated in accordance with domestic tax principles." (*Id*. at p. 145.) The Court also found support for its holding in the statutory canon adopted in *Biddle* that "tax provisions should generally be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control." (*Ibid*.)

Accordingly, we conclude that under the facts of this case, whether the 2008 exchange of the Westwind stock for TWPA stock is taxable—and if so, thus entitling appellants to a cost basis equal to the fair market value of the TWPA stock—is determined under U.S., not Canadian, tax law. We find no clear congressional expression under the relevant IRC provisions involving basis (e.g., IRC sections 1011-1016) to support respondent's position that the gain realized from the 2008 Canadian stock-for-stock transaction must have been recognized and subject to tax under Canadian tax law in order for appellants to obtain a cost basis equal to the fair market value of the TWPA stock. Respondent argues that in *Biddle* the Court looked to United Kingdom law "as a fact" to show who "paid" the tax, as that term is used in the U.S. sense, but respondent fails to acknowledge that this was expressly required by the operative language of former IRC section 131 that directed income tax be credited on "taxes *paid* . . . to any foreign [country]." (Italics added.) However, as relevant to this appeal, nothing in the R&TC or IRC indicates that basis is dependent upon whether gain was reported or tax was paid in a foreign country. Simply put, the relevant IRC provisions involving basis do not direct us to look to foreign tax law "as a fact" to calculate basis.[17]

Respondent further contends that appellants were not entitled to a cost basis equal to the fair market value of TWPA shares because the gain from the Westwind and TWPA share exchange was not recognized and reported on appellants' Canadian tax return, as allegedly required under the recognition provision in IRC section 1001(c) and IRC sections 61(a)(3) and

[17] Given the lack of ambiguity in the statutes' language, we need not consider extrinsic aids. (See *Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 519.) Also, for this same reason, we need not address appellants' argument that ambiguous statutes should be construed in their favor.

63(a). But none of these sections, when read together, supports respondent's position. IRC section 1001(c) simply provides that "gain or loss . . . on the sale or exchange of property shall be recognized," unless a nonrecognition rule otherwise provided in the IRC applies; IRC section 61(a)(3) defines "gross income" as "[g]ains derived from dealings in property"; and IRC section 63(a) defines "taxable income" as "gross income minus the deductions." Thus, the plain and unambiguous language of these IRC sections does not support respondent's argument because they do not expressly state that basis depends on whether gain was recognized in, or taxes were reported to, a foreign jurisdiction and respondent cites no authority supporting that they do. Thus, these IRC provisions must be analyzed under U.S. concepts of taxation, regardless of whether appellants recognized gain or reported tax on their foreign tax return.

We also note that IRS guidance is consistent with our determination that appellants are entitled to a cost basis in their Stifel stock of $13,672,897. That guidance supports that the basis of foreign (non-U.S.) property generally must be determined under U.S. tax principles, regardless of the tax treatment under foreign law or whether gain was recognized in, or tax was paid to, the foreign country. For example, the U.S.-Canada income tax treaty[18] was amended in 2007 to allow taxpayers to elect to obtain a basis step-up (for U.S. income tax law purposes) because of the Canadian departure tax. The IRS issued Revenue Procedure 2010-19, 2010 WL 773913, to guide individuals who emigrated from Canada to the U.S. and wished to make the election. The procedure states that the treaty was amended to avoid double taxation when Canadian residents recognize gain and pay tax on the deemed disposition of their property due to the departure tax but receive no corresponding basis step-up in those assets when they move to the U.S. and actually sell the assets. "If the individual is not subject to U.S. federal income tax at the time of emigration, the effect of the election will be to give the individual an adjusted basis in the relevant property for U.S. federal income tax purposes equal to the fair market value of the property as of the date of the deemed disposition in Canada, with the result that only post-emigration gain will be subject to U.S. federal income tax when there is a disposition of the property." (*Ibid*.)

[18] See https://www.irs.gov/businesses/international-businesses/canada-tax-treaty-documents [accessed Oct. 7, 2020]. Tax treaties between the U.S. and foreign countries generally do not apply to taxes imposed by California. (See *Container Corp. of America v. Franchise Tax Bd.* (1983) 463 U.S. 159, 196-197.) However, we cite to IRS Revenue Procedure 2010-19 for the proposition that the IRC does not allow a stepped-up basis for taxable gains reported to Canada under the departure tax (unless a treaty election is made).

Based on this revenue procedure, it is clear that the Canadian departure tax is irrelevant in computing basis under the IRC without the treaty election (which appellants undisputedly did not make). Therefore, respondent's position that appellants had to recognize gain on their Canadian return in order to obtain a cost basis cannot be correct because, absent a treaty election, the IRC does not allow a cost basis even though taxpayers do in fact recognize gain and pay tax for departure tax purposes. Thus, we believe this further supports that the gain deferral feature under the Canadian Section 85 Election is also irrelevant in computing basis for U.S. tax purposes. Accordingly, what matters here is whether the 2008 transaction would have been taxable had it occurred in the U.S., which the parties agree it would have been.[19]

Lastly, we acknowledge our conclusion will result in a double benefit to appellants who did not recognize or pay tax on a large portion of the deferred gain realized from the Canadian stock exchange in 2008 but will receive a cost basis under the R&TC (by way of conformity to the IRC). However, inconsistent treatment of the same tax item by foreign and U.S. tax law can produce instances of double benefits or double taxation, and, as such, there will be winners or losers depending on the particular facts involved. For instance, double benefits resulted in *Gutwirth v. Commissioner* (1963) 40 T.C. 666, where the U.S. Tax Court, in determining the appropriate amount of a war loss, increased the property basis by the capitalizable items and allowed the taxpayer a war loss for such items under U.S. tax law, even though the taxpayer had expensed the items for foreign tax purposes. Conversely, double taxation results when the basis of foreign property is reduced for depreciation sustained prior to the property owner becoming a U. S. resident, notwithstanding the fact that no U.S. tax deduction was ever received for the

[19] The IRS has issued other nonbinding guidance that takes a position consistent with our conclusion. For example, Technical Advice Memorandum (TAM) 8251014, 1982 WL 206207, addressed a situation where the Canadian tax law permitted, in effect, income to be deferred with respect to the sale of a capital asset if such amounts are invested in an income-averaging annuity contract. The IRS stated that "[w]hether the individual pays a foreign income tax on this income when received, is permitted to defer the income as in the case in question or does not pay any foreign tax because this particular type of income is exempt from the foreign income tax is not relevant since the recognition of income must be analyzed under United States concepts of taxation." In TAM 8708002, 1986 WL 371567, the IRS found that to determine the application of the installment method rules, "it must be determined what the U.S. tax treatment *would have been if taxpayer had been a resident at the time of the sale*. The treatment of this transaction under the tax laws of Country X is not relevant in determining U.S. tax law consequences." (Italics added.) Chief Counsel Memorandum AM-2007-006, 2007 WL 582517, held that a domestic or foreign corporation that acquires a requisite percentage of foreign target stock can make an IRC section 338 election for the foreign target and thereby obtain a step-up in the basis of the foreign target's assets—even if no U.S. or foreign tax is incurred. Lastly, Field Service Advisory (August 14, 1997) 1997 WL 33314847, found that the basis of stock acquired by foreign persons must be determined under U.S. tax principles and, accordingly, the basis write-downs for Japanese book and income tax purposes do not affect this determination.

depreciation. (*Ibid*; see also *Appeal of Kuhn* (91-SBE-006) 1991 WL 280344 [involving domestic property].) Double taxation also results when an alien immigrates to the U.S. and does not receive any step-up in basis as a result of exit taxes paid to a foreign jurisdiction.[20] (See IRS Revenue Procedure 2010-19, *supra*.) To the extent there are concerns taxpayers will "game the system," we note that respondent made no attempt to argue the foreign transactions at issue here lacked a nontax business purpose or economic substance. Our role here is to interpret the laws as they are written; policy arguments are best directed to the Legislature. (See *Appeal of Rowland* (75-SBE-071) 1975 WL 3555.)

[20] In fact, in this appeal, had appellants not engaged in the 2008 transaction, they may have been subject to double taxation by paying the departure tax to Canada but not receiving a corresponding step-up basis for California purposes.

HOLDING

Since the 2008 exchange of appellants' Westwind shares for TWPA shares constituted a taxable transaction under the IRC, appellants are entitled to a cost basis equal to the fair market value of the TWPA shares at the time of the transaction, which carried over to their Stifel shares as part of the nontaxable exchange of their TWPA shares in 2010. Therefore, appellants are entitled to a basis of $13,672,897 in the Stifel shares sold in 2011.

DISPOSITION

Respondent's actions are reversed, and appellants' appeal is granted: (1) appellants are entitled to a refund of $423,695 for the 2011 tax year; (2) respondent's proposal of additional tax of $20,120, plus applicable interest, for the 2011 tax year is reversed; and (3) appellants are entitled to an additional capital loss carryover of $5,553,205, as originally reported for the 2013 tax year.

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Huy "Mike" Le
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Huy "Mike" Le
Administrative Law Judge

I concur:

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

Dissenting opinion of J. MARGOLIS:

I dissent from the majority's opinion because it generates a tax windfall that is fundamentally inconsistent with the provisions of the Internal Revenue Code (IRC) upon which it purports to be based. The majority misapplies the following general statement by the U.S. Supreme Court: "[T]ax provisions should *generally* be read to incorporate domestic tax concepts absent a clear congressional expression that foreign concepts control." (*U.S. v. Goodyear Tire and Rubber Co.* (1989) 493 U.S. 132, 145 (*Goodyear*), citing *Biddle v. Commissioner* (1938) 302 U.S. 573, 578 (*Biddle*), italics added.) It errs by treating what was intended to be a *general* rule of statutory construction as a blanket rule of tax law, and compounds that error by applying this rule to a situation where it generates a tax windfall that violates fundamental principles of taxation, thereby allowing appellants a tax loss in the U.S. from a gain that had accrued overseas and was not subject to tax *anywhere*.

In this appeal, appellants admit that they deferred, and ultimately never recognized, approximately $9 million of gain they realized *in Canada* when they exchanged their Westwind stock for shares of TWPA. On their originally filed U.S. and California income tax returns, appellants claimed that their basis in the shares sold was derived from their remaining carryover basis (of zero) in their Westwind shares, adjusted by the gain they reported to Canada from the deemed disposition and reacquisition of their TWPA shares in connection with their departure from Canada (of approximately $4.5 million). On their Canadian tax returns, appellants did not assert that their basis in TWPA included the additional $9 million of gain they never recognized for tax purposes in either Canada or in the U.S.[21] It was not until appellants' California return came under audit that they filed an amended return raising that argument.

Appellants' amended tax return (and position in this appeal) is based upon a striking inconsistency. In it, appellants ignore the tax effects of the one transaction that was *actually* subject to tax in the country of their residence (the departure tax transaction) while they give tax effect to the transaction that was not subject to tax in that country (the tax-free exchange of appellants' Westwind shares for TWPA shares).

Appellants claim (and the majority agrees) that this result is required because of *Biddle's* statement that *generally* one should ignore the foreign tax consequences of transactions and

[21] In this regard, appellants' repeated assertion in their briefing that their entire gain was "recognized" and "taxable" is clearly incorrect.

instead view those transactions *as if* they had occurred in the United States. However, that statement was not a rule of unwavering application, and it does not justify the result reached in this appeal.

The parties have agreed among themselves that appellants' tax-free exchange of Westwind shares for TWPA shares in Canada, pursuant to a Canadian "plan of arrangement," would *not* have qualified for tax-free exchange treatment if it had occurred when Conacher was a U.S. citizen or resident. However, neither side has explained why this is so. A plan of arrangement is simply a statutory mechanism under Canadian law, which is, in effect, a court-approved merger or reorganization. And in 2006, the IRS issued final regulations clarifying that mergers and consolidations undertaken pursuant to foreign law can qualify as tax-free reorganizations under IRC section 368(a)(1). (Treas. Reg. § 1.368-2(b)(1)(ii) & (iii), & example 13.)

Indeed, it seems rather peculiar to allow appellants to treat what was admittedly a tax-free exchange under the laws of Canada—the only country that had jurisdiction to tax the transaction—as if they had actually recognized that gain because they allegedly failed to satisfy some unidentified requirement for tax-free treatment under U.S. tax law. The U.S. had no jurisdiction, and the IRC had no application, to tax the exchange transaction at the time it occurred; there would have been no reason for the participants to that exchange to meet whatever requirements they allegedly failed to meet in order to qualify for tax-free treatment under U.S. law. Appellants' only "loss" was a loss of expectations; they never recognized the full gain they expected to recognize at the time of their Canadian tax-free exchange in 2008. And as appellants themselves argued in their reply brief: "The source of income here has absolutely nothing to do with California. All the income was earned in Canada at the time of Conacher's exchange of Westwind stock." Yet the majority opinion allows appellants to claim for California tax purposes a paper loss that appellants admit had "nothing to do with California."

Even if the foreign transactions would have generated immediate recognition of appellants' gain if those transactions had occurred in the U.S., the general rule of statutory construction set forth in *Biddle* and *Goodyear* should not be applied here. To treat appellants' tax-free transactions in Canada as if they were taxable would be fundamentally inconsistent with the general concepts underlying U.S. tax law.

Those general concepts are reflected in the rules for adjusting basis under IRC section 1016. That section provides that "proper adjustment" of a taxpayer's basis in property shall be made for various situations that are analogous to the one before us. For example, IRC section 1016(a)(4) provides that proper adjustment shall be made "in the case of stock … for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, . . . were tax-free . . . ." Similarly, IRC section 1016(a)(22) provides that proper adjustment shall be made "in the case of qualified replacement property the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale or exchange of any property . . . ." And IRC section 1016(a)(23) provides that proper adjustment shall be made "in the case of property the acquisition of which resulted under section 1043, 1045, or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, to the extent provided in section 1043(c), 1045(b)(3), or 1397B(b)(4) ...." Similarly, (1) under IRC section 108(c)(1)(A)(i), the basis of property is reduced by the amount of excluded discharge of indebtedness income (unless the excluded income was applied to reduce the taxpayer's net operating losses, general business credits, minimum tax credits, or capital loss carryovers); (2) under IRC 1359(e), when gain is not recognized on the disposition of a qualifying vessel and a replacement vessel is acquired, the basis of any replacement qualifying vessel is reduced by the amount of gain deferred; and (3) under IRC section 130(b)(1), the basis of any qualified funding asset is reduced by the amount excluded from gross income under IRC section 130 as a qualified assignment.

In fact, in situations where the IRC permits a taxpayer to exchange one property for another and defer reporting the gain on the exchange, the IRC generally requires that the taxpayer's basis in the property given up in the exchange be carried over and treated as the taxpayer's new basis in the property received. (See, e.g., IRC, §§ 1031(d), 1033(b), 1036(c)(2), 1040(c), 1042(d), 1043(c), 1045(b)(3).)

These basic concepts also apply to corporate organizations and reorganizations, the taxation of which are governed by Part III or Subchapter C of Chapter 1, Subtitle A of the IRC (beginning with IRC sections 351). There, the general rule is that when property is exchanged under IRC section 351 (concerning tax-free transfers to a corporation in exchange for stock) and IRC sections 354, 355, 356 or 361 (concerning tax-free reorganizations and distributions), the taxpayer's basis in stock received in the exchange generally will be equal to "the taxpayer's basis in the stock exchanged, with adjustments to take into account the amount of gain or loss recognized at the time of the exchange by the taxpayer. In this regard, IRC section 358(a) provides, in pertinent part, as follows:

> (a) General rule.—In the case of an exchange to which [IRC] section 351, 354, 355, 356, or 361 applies—
> (1) Nonrecognition property.—The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—
> (A) decreased by—
> (i) the fair market value of any other property (except money) received by the taxpayer,
> (ii) the amount of any money received by the taxpayer, and
> (iii) the amount of loss to the taxpayer which was recognized on such exchange, and
> (B) increased by—
> (i) the amount which was treated as a dividend, and
> (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).
> . . .

The majority opinion contravenes these fundamental tax principles, with little justification other than the majority's contention that the rule of statutory construction in *Biddle* and *Goodyear* must be applied, and compels one to apply "domestic tax concepts" on a hypothetical basis to treat a foreign *nontaxable* exchange of stock as if it had been a taxable one. But application of that rule makes no sense where, as here, the domestic tax concepts expressed in the IRC are the same as those in Canadian law,[22] and application of the *Biddle/Goodyear* rule will result in a tax windfall that is at odds with the basic structure of the IRC.

The fact that the U.S./Canada tax treaty contains an election mechanism for ensuring that double taxation of income may be avoided does not mean that in the absence of such a treaty provision, a contrary result necessarily would have been obtained.[23] Moreover, as the majority correctly notes, tax treaties between the U.S. and foreign countries are not binding upon California. (*Container Corp. of America v. Franchise Tax Bd.* (1983) 463 U.S. 159, 196-197.)

[22] Critically, both U.S. and Canadian law apply the same underlying concept; namely, that where, as here, one exchanges stock in one corporation tax free for stock in another, one carries over one's basis from the stock exchanged to the stock received.

[23] The parties have not provided any clear precedential authority as to what the result would be in the absence of a treaty.

Thus, whether an election had or had not been made under the treaty would not be binding on respondent or this panel in deciding the tax effect of the transactions involved.

The majority's discussion of various IRS's Technical Advice Memoranda, an IRS Chief Counsel Memorandum, and an IRS Field Service Advisory is unpersuasive; those documents have no precedential value. The documents themselves state that they "may not be used or cited as precedent" and, until now, they have never before been so used.

The majority's reliance on *Williams v. Commissioner* (1962) 37 T.C. 1099 (*Williams*), also is misplaced. In that case the court states that " 'the fair market value of the property received *in a taxable exchange* is the cost basis . . . .' " (*Williams* at p. 1106, quoting *Philadelphia Park Amusement Co. v. United States* (Ct.Cl. 1954) 126 F.Supp.184, 188 (*Philadelphia Park*), italics added.) Of course, in the situation before us, appellants' exchange of Westwind shares for TWPA shares *was not a taxable exchange*. In Canada—the only jurisdiction that had the power to tax that transaction—appellants' exchange of Westwind shares for TWPA shares was tax-free.[24] Moreover, the stated rationale for the rule set forth in *Williams* strongly supports respondent's position. The courts in *Williams* and *Philadelphia Park* stated that the reason why they held that "the fair market value of the property received in a taxable exchange is the cost basis" was because "[t]he failure to do so would result in allowing the taxpayer a stepped-up basis, without paying a tax therefor . . . ." (*Ibid.*) That is, of course, the precise situation we have before us. The majority's opinion allows appellants "a stepped-up basis, without paying a tax therefor."

The majority's opinion allows taxpayers entering the U.S. to game the system, as they are doing here. Although the majority claims that there will be "winners and losers" from its ruling, that is unlikely to be the case, as taxpayers can easily plan around any potentially adverse tax consequences.

To prevent the type of international tax law arbitrage that generates the tax windfall in the situation before us, the position taken by respondent in its Notice of Action should be sustained. That position recognizes the deemed sale and repurchase of appellants' TWPA stock that occurred in connection with appellants' emigration from Canada as a sale and repurchase within the meaning of the U.S. tax laws. Under IRC section 1011(a), one receives an "adjusted basis"

[24] Appellants were required to, and did, pay tax on the cash received in the exchange, and utilized all of their basis in their Westwind shares to reduce the amount of that gain.

in property when there is a "sale or other disposition" of the property. Respondent's Notice of Action gave effect to this provision by treating the deemed disposition of appellants' stock upon their departure from Canada as a "sale or other disposition" and then an acquisition of TWPA stock at its then fair market value, $4,152,000. Respondent's Notice of Action correctly determined that appellants entered the U.S. with this basis in their TWPA stock, not the $13 million amount that appellants never recognized as taxable income in *any* jurisdiction.

Accordingly, I dissent.

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Jeffrey I. Margolis
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Jeffrey I. Margolis
Administrative Law Judge

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