32-SBE-022

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
R. C. MASON & CO., LTD.)

Appearances:

For Appellant: Raymond R. Hails, its Attorney; C. L. Richardson, Certified Public Accountant, associated with Touche Niven & Co.

For Respondent: Chas, J. McColgan, Franchise Tax Commissions

OPINION

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Chapter 13, Statutes of 1929, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of R. C. Mason & Co., Ltd., against a proposed assessment of additional tax in the amount of $457.33, with interest.

The Appellant was organized in April, 1928 under the name of Mason, Cole & Company, which was subsequently changed to R. C. Mason & Co., Ltd. At the time of incorporation, Appellant acquired all the assets of Mason, Cole & Company, a co-partnership, giving in exchange therefor 1,000 shares of its stock of the par value of $100 and $300 in cash. Among the assets of the co-partnership acquired by Appellant were interests in certain trusts. These trust interests were finally disposed of by Appellant during the taxable year ended April 30, 1931.

In its return for the taxable year ended April 30, 1931, Appellant deducted from its gross income for, said year the sum of $14,210.33, representing an alleged loss sustained during said year from the above trust interests. This loss was computed by taking the difference between the total amount received from the trust interests and the cost of such interests at the time of acquiring the same from the co-partnership. The cost of the trust interests was determined by taking a proportionate part of the total par value ($100,000) of the 1,000 shares of stock issued by the corporation in exchange for the assets of the co-partnership including the trust interests. The Appellant also deducted from its gross income for the taxable year ended April 30, 1931, the sum of 3347.88 representing additional federal income taxes for the taxable year ended April 30, 1929 which Appellant paid during the taxable year ended April 30, 1931.

The Commissioner disallowed as deductions both of the above items. Further, the Commissioner added to Appellant's gross income the sum of $1,035.74 representing "Additional Income

Trust, #3736". This action of the Commissioner resulted in the proposed assessment of additional tax in the amount of $457.33.

We are of the opinion that the Commissioner acted properly in disallowing as a deduction the item of 5347.88 representing additional federal income taxes for the taxable year ended April 30, 1929. Under Section 8(c) of the Act, federal income taxes can be deducted only if they have accrued during the taxable year. In the Appeal of May Department Stores Company, decided b: us on May 11, 1932, we held that additional federal income taxes for the years 1917 to 1928 could not be considered as having accrued in the year 1929 when the amount thereof, and liability therefor, was finally determined and the same were paid. In vier of this, we are unable to see how we could consistently hold that the taxes herein in question accrued during the taxable yeaı ended April 30, 1931.

However, we are of the opinion that the Commissioner erred in disallowing as a deduction the item of $14,210.33 representin losses sustained by the Appellant from the disposition of certain trust interests during the taxable year ended April 30, 1931.

Section 8(d) provides that from gross income there should be 'deducted the "losses sustained during the taxable year". Section 19 of the Act provides that:

> "For the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal or mixed, acquired on or after January 1, 1928, the basis shall be the cost thereof, or the inventoried value if the inventory is made in accordance with this act."

As noted above, Appellant acquired the trust interests herein involved as the result of an exchange of its stock for the assets of Mason, Cole & Company, a co-partnership.. This exchange was effected subsequent to January 1, 1928. Although,- as a result of the above exchange, the co-partnership acquired complete control of the Appellant corporation, there is not the slightest reason for inferring that the exchange was not in all respects honest and legitimate. Apparently, there was not an excessive issue of stock for the assets of the co-partnership. In other words, apparently, the assets of the co-partnership were of a value equal to the total par value of the stock received in exchange for such assets.

From this it follows that the cost to the Appellant of the trust interests acquired by Appellant was the par value of the stock issued in exchange therefor. Under Section 19 of the Act, it is this cost that is to be used as a basis for determining gain or loss to the Appellant from the sale or other disposition of said interests.

The Commissioner seeks to avoid the above conclusion by contending that as a result of the exchange of the assets of the

co-partnership for the stock of the Appellant, there was no change in ownership of such assets. Obviously, this contention is based on the theory that no distinction should be recognized between a corporation and its stockholders. This theory has been repudiated so often and so thoroughly as to require no consideration on our part,

The Commissioner also contends, apparently, that the exchang in question was one with respect to which no gain or loss, if any, wouuld be recognized inasmuch as he cites a Federal Court decision wherein gain was not recognized and one Board of Tax Appeals decision wherein loss was not recognized for Federal Income Tax purposes as the result of exchanges similar to the one involved herein.

In this connection it is to be noted that subdivision 5 of Section 112(b) of the Federal Revenue Act of 1928 provides:

> "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."

In view of this provision, it would seem that if a person transferred property to a corporation in exchange for the stock of that corporation, and immediately thereafter came into control of the corporation, any gain or loss resulting to the transferor as a result of the exchange would not be recognized for federal income tax purposes.

Inasmuch as subdivision 1 of Section 701(a) of the Federal Revenue Act provides that the term "person" means "an individual, a trust or estate, a partnership or a corporation", the above would be true of the exchange under consideration were it not for the fact that the transferor (i.e. the co-partnership) received in exchange for its assets, some money ($300) in addition to the stocks of Appellant corporation. However, it is to be noted that other provisions of Section 112 cover just such a situation.

Subdivision 1 of Section 112(c) provides:

> "If an exchange would be within the provisions of subsection (b) (1), (2), (3) or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

And Section 112(e) provides:

> If an exchange would be within the

> provisions of subsection (b) (1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition, of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

Hence, in view of the above provisions, it seems clear that if loss had resulted to the transferor from the exchange under consideration it would not have been recognized for federal income tax purposes, and if gain had resulted, it would have been recognized only in an amount not in excess of the money received ($300).

The above quoted provisions of the Federal Revenue Act of 1928 are incorporated by reference into the State Act by Section 20 of said Act which provides:

> "Upon the sale or exchange of property the entire amount of the gain or loss, determined under the preceding section shall be recognized, with the exceptions provided for in section 112 of said "Revenue Act of 1928," which are hereby referred to and incorporated with the same force and effect as though fully set forth herein,"

Under this section it would seem that, although gain or loss resulting from an exchange is generally to be recognized, it is not to be recognized if it would not be recognized under the provisions of Section 112 of the Federal Revenue Act of 1928, including, of course, the provisions above quoted.

It is to be noticed, however, that the transferor in the exchange under consideration, being a co-partnership, was not a corporation taxable under the Act. Consequently, it would seem that any gain or loss resulting to it from the exchange was entirely without the purview of the Act. But assuming that the transferor was a corporation taxable under the-Act, and consequently, by virtue of Section 20, above quoted, any loss resulting to it from the exchange would not have been recognized and any gain resulting would have been recognized only to a very limited extent, we are unable to perceive how this fact has any bearing whatsoever on the point involved in the instant appeal --i.e. what should be the basis for ascertaining gain or loss to the transferee, the Appellant corporation, as the result of the subsequent disposition of the property received by it pursuant to the exchange in question. It is one thing to say that gain or loss resulting from the exchange of property shall not be recognized; it is quite a different matter to determine what shall be the basis for ascertaining the gain or loss resulting from the subsequent disposition of such property.

Congress was apparently well aware of this in enacting the Federal Revenue Act of 1928, for, although Congress provided in Section 112 that gain or loss resulting from certain exchanges and transfers should not be recognized, Congress did not rest

there. Rather, Congress proceeded to prescribe in considerable detail, in Section 113 of said Act, what should be the basis for ascertaining the gain or loss in the event of the subsequent disposition of the property received pursuant to such an exchange or transfer.

In fact, one of the provisions in Section 113, namely subdivision 8 of Section 113(a) exactly covers the situations presented by the instant appeal. This provision reads as follows:

> "If the property was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in section 112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

In view of the above provision, it is quite clear that for federal income tax purposes the cost to Appellant of the trust interests acquired by it in exchange for its stock could not serve as a basis for determining either gain or loss resulting. from the subsequent disposition thereof. Rather, the basis would be the same as the basis for the transferor, i.e. the cost to the transferor of the property, if it was acquired subsequent to March 1, 1913, increased in the amount of the gain recognized to the transferor as the result of the exchange,

But it is to be noted that the State Act does not contain any such provision as the above. Further, we are of the opinion that the above provision cannot be considered as being incorporated into the State Act so as to be controlling in the instant appeal.

It is true that Section 8(f) provides that from gross income there shall be allowed as a deduction:

> "Exhaustion, wear and tear and obsolescence of property to be allowed upon the basis provided in sections 113 and 114 of that certain act of the Congress of the United States known as the "Revenue Act of 1928," which is hereby referred to and incorporated with the same force and effect as though fully set forth herein, or upon the basis provided in section 19 hereof,"

It is arguable that by virtue of the above provision, Section 113 of the Federal Revenue Act, including subdivision 8

of subsection (a) above quoted, is incorporated into the State Act for all purposes. But we are of the opinion that by Section 8(f), reasonably construed, it was intended to incorporate Section 113 of the Federal Revenue Act only for the purpose of computing depreciation allowance (exhaustion, wear and tear, etc.) and not for the purpose of determining gain or loss resulting from the sale or other disposition of property.

The only provision of the Act we have been able to find which relates to the method of determining gain or loss from the disposition of property which has been received as the result of an exchange with respect to which gain or loss was not recognized is Section 21 which provides:

> When property is exchanged for other property and no gain or loss is recognized under the provisions of the preceding section, the property received shall be treated as taking the place of the property exchanged therefor."

In view of the above provision, it would seem that property received as the result of an exchange of the kind mentioned in the above Section (i.e. one with respect to which no gain or loss is recognized under Section 20) is to be regarded as steppin into the tax shoes of the property surrendered. In other words, the property received will acquire the same basis as the property surrendered for the purpose of determining gain or loss from the subsequent disposition of the property, regardless of what might be the value of the property received or of the property surrendered at the time of the exchange, 'Thus, if "A", a corporation of the classes taxable under the Act purchases property on January 1, 1929 at a cost of $5,000, holds it until it increases in value to $10,000, and then exchanges it for property of equal value, and the gain is not recognized under Section 20 of the Act, the cost to "A" of the property surrendered, i.e. $5,000 will serve as a basis for determining gain or loss from'the subsequent disposition of the property received,

Although the exchange under consideration was not *one* with respect to which gain or loss was recognized under Section 20, the preceding Section mentioned in Section 21, nevertheless we do not believe that Section 21 can be regarded as specifying the basis for determining gain or loss to the Appellant from the disposition of the property acquired by it as the result of the exchange. If the contrary were held, then the property acquired', by the Appellant would have to be considered as having obtained the same basis for determining gain or loss as the stock surrendered by the Appellant. But stock prior to its being issued for the first time can scarcely be considered as having a basis. Such stock does not cost anything. Further, when stock is issued for the first time, neither gain nor loss results to the corporation issuing it although money and property of value may be obtained in exchange therefor. Consequently, to hold that the property acquired by the Appellant obtained the same basis as the stock of Appellant issued for such property would result in holding that it obtained no basis at all.

There may be good reasons for providing, as is provided in subdivision 8 of Section 113(a) of the Federal Revenue Act of 1928, that, when property is transferred to a corporation in exchange for the corporation's stock and immediately thereafter the transferor obtains control of the corporation, the basis of the property in the hands of the corporation shall not be the cost thereof to the corporation but shall be the same as it was in the hands of the transferor. But clearly, there does not seem to be any good reason for providing that the property should be regarded as having no value at all for the purpose of determining gain or loss to the corporation in the event of the subsequent disposition thereof. We do not believe the Legislature intended that any such result should follow from the provisions of Section 21, above quoted,

Consequently, in the absence of any such provisions in the Act as is contained in subdivision 8 of Section 113(a) of the Federal Revenue Act of 1928, we are inclined to hold that the basis for determining gain or loss resulting to the Appellant from the disposition of the trust interests acquired by it in exchange for its stock, should be the basis provided in Section 19 of the Act. As above noted, Section 19 provides that the basis for ascertaining the gain derived or loss sustained from the disposition of property on or after January 1, 1928 shall be the cost thereof. Hence, we must hold that the Commissioner erred in disallowing as a deduction from Appellant's gross income for the taxable year ended April 30, 1931, the sum of $14,210.33 representing a loss sustained by Appellant during said year computed on the basis of the cost to Appellant of the trust interest

Thus, there remains for our consideration, only the problem as to whether the Commissioner erred in including in Appellant's income for the taxable year ended April 30, 1931, the sum of $1,035.74 representing "Additional Income Trust, #3736".

Apparently, the above sum was received during the above year by the Appellant as the result of the final disposition of one of the trust interests acquired by Appellant pursuant to the exchange hereinbefore considered. Using as a basis the cost to Appellant of said trust interest for the purpose of ascertaining gain derived or loss sustained to Appellant from the disposition of said interest, apparently, insofar as we are able to ascertain, Appellant did not realize any gain from the disposition thereof. Hence, it would seem that the Commissioner erred in considering the sum of $1,035.74, or any part thereof, receive by Appellant during the taxable year ended April 30, 1931, as income of Appellant for said year. If a corporation acquired property at a certain cost and later disposes of it for cost, or for less than cost, the amount received on the disposition thereo clearly cannot be considered as income. Rather, it should be regarded simply as a return of capital.

ORDER

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, that the action of the Franchise Tax Commissioner, in overruling the protest of R. C. Mason & Co., Ltd., a corporation, against a proposed assessment of an additional tax in the amount of $457.33, based upon the net income of said corporation for the period ended April 30, 1931, be and the same is hereby sustained in part and reversed in part. Said action is sustained insofar as the Commissioner disallowed as a deduction the sum of $347.88 representing additional federal income taxes for the period ended April 30, 1929. Said action is reversed insofar as the Commissioner disallowed as a deduction the sum of $14,210.33 representing capital losses sustained during the period ended April 30, 1931, and insofar as the Commissioner included as income for said year the sum of $1,035.74 representing the amount.received during said year from the disposition of a certain trust interest. The correct amount of the tax to be assessed to the R. C. Mason & Co., Ltd., is hereby determined as the amount produced by means of a computation which will include the allowance as a deduction of the above sum of $14,210.33, and which will exclude as income the sum of $1,035.74 in the calculation thereof. The Commissioner is hereby directed to proceed in conformity with this order and to send the said R. C, Mason & Co., Ltd. a notice of assessment revised in accordance therewith.

Done at Sacramento, California, this 6th day of June, 1932, by the State Board of Equalization.

R. E. Collins, Chairman
Jno. C. Corbett, Member
H. G. Cattell, Member
Fred E. Stewart, Member

ATTEST: Dixwell L. Pierce, Secretary