



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ORANGE ICE AND COLD STORAGE COMPANY)

Appearances:

For Appellant: Leonard Evans, Attorney at Law; D. D. Winans, Auditor of Appellant Corporation
For Respondent: Chas. J. McColgan, Franchise Tax Commissioner

O P I N I O N

This is an appeal pursuant to Section 25 of the Bank and Corporation Franchise Tax Act (Stats. 1929, Chapter 13, as amended) from the action of the Franchise Tax Commissioner in overruling the protest of Orange Ice and Cold Storage Company, a corporation, to a proposed assessment of an additional tax in the amount of \$232.28 based upon the return of Appellant corporation for the period ended December 31, 1929.

The Appellant contends that 'it had no income during the year 1929 and consequently should not be required to pay any tax in excess of the minimum based upon its return covering the year 1929. In support of this contention, the Appellant alleges that pursuant to a contract entered into on September 15, 1926, between the Appellant, the stockholders of Appellant, and one C. E. Short, the Appellant's secretary and owner of 960 shares of Appellant's capital stock, the entire business of Appellant was sold to C. E. Short, hereinafter referred to as the third party; and that thereafter the income from the business should not be considered as the Appellant's income, but should be considered as income of the third party,

Reference to the provisions of the above mentioned contract discloses that under it, the third party was to assume responsibility for the management and control of the Appellant's business; that the stockholders of Appellant agreed to sell to the third party the entire amount of outstanding capital stock of Appellant (5000 shares) at an agreed price of \$10.70 per share, if one-half of the purchase price were paid within ten years, and if the balance of the purchase price were paid within an additional period of two years; and that all the moneys derived from the operation of the business were to be applied to the payment of the operating expenses of the business, to the payment to the third party as manager of said business a salary not to exceed \$225 per month, to the payment to the stockholders of Appellant annually an amount equal to seven per cent of the par value of their stock (\$10.00), to the payment of liabilities of Appellant outstanding at the date of the contract, and to

Appeal of Orange Ice and Cold Storage Company

the payment to the stockholders of Appellant of the purchase price of the stock agreed to be sold by them.

Apparently acting on the theory that the contract did not effect a sale of the business of Appellant, and that consequently all the income of the business for the year 1929 was income of the Appellant, the Commissioner proceeded to compute Appellant's tax liability under the Act accordingly, allowing as a deduction from gross income on account of compensation for personal services rendered by the third party, the sum of \$2,700 only, the maximum amount permitted, under said contract, to be paid to the third party as "salary" during the year.

After careful consideration of the contract and the circumstances surrounding the making of the contract as set forth in the brief of the Appellant filed in this appeal, we have come to the conclusion that the Commissioner proceeded correctly in computing the amount of taxes due from Appellant according to or measured by its net income for the year 1929. We have been unable to find, and there has not been called to our attention, a single provision of the contract from which it could be inferred that the contract effected, or that it was intended to effect, a sale by Appellant of its business to the third party mentioned therein. It is true that the contract contemplates a sale to the third party of all the outstanding stock of Appellant, and if the contract is fulfilled, the third party will become the owner of all of such stock. But, a sale of Appellant's stock cannot, of course, be regarded as a sale of the business of the Appellant without disregarding the separate, corporate existence of Appellant,

It may be argued that making a distinction between a sale of all of the Appellant's capital stock and a sale of the Appellant's business is making a distinction without any substantial difference. But we do not think so. By purchasing all of Appellant's stock, the third party could still operate the business through the corporate structure of Appellant, obtaining thereby certain advantages, such as use of the Appellant's name and immunity from liability to a large extent, which could not have been obtained if the third party had purchased the business directly from the Appellant.

Judging from the brief filed by Appellant with this Board in this appeal, we are of the opinion that the Appellant and the stockholders thereof, realizing that the Appellant was in a precarious financial position, entered into the contract giving the third party complete control of Appellant's business in the hope that he would be able to manage it in such a way so that it would produce income in amounts sufficient to pay the operating expenses of the business, including a salary to the third party of not to exceed \$225 per month, to pay the principal and interest on the debts of Appellant, and to return to the stockholders annually an amount equal to seven per cent on their investment. Furthermore, it appears to us that the Appellant with the consent of its stockholders, agreed that the third party should receive as a reward for managing the business

appeal of Orange Ice and Cold Storage Company

so as to produce the above amounts, the entire amount of outstanding capital stock of Appellant to be paid for at the rate of \$10.70 per share over a period of twelve years out of the income from the business.

Viewed in this light, it is apparent that all the income of the business for the year 1929 was the income of the Appellant. The only question then remaining for consideration is, in arriving at the net income of Appellant for the year 1929, how much of a deduction should be allowed on account of compensation to the third party?

Section 8(a) of the Act provides that from gross income there shall be deducted "a reasonable allowance for salaries or other compensation for personal services actually rendered." The Commissioner allowed as a deduction on account of compensation to the third party only the sum of \$2,700, the maximum amount permitted under the contract to be paid to the third party as "salary", and disregarded any amount to be paid to the third party as a reward for performance of the contract. We think the Commissioner acted properly in so doing.

As above noted, the reward was to consist of a transfer to the third party of all the outstanding capital stock of Appellant. Inasmuch as the purchase price of the stock was to be paid out of the income of the business in excess of the operating expenses of the business, the payments on the debts of the Appellant, and the annual payment to the stockholders of an amount equal to seven per cent on their investment, it is arguable that the entire amount of such excess income should be regarded as compensation to the third party and that deduction of such amount should accordingly be allowed Appellant. But it is to be noted that the third party was to receive a reward only in the event that he fully performed all the conditions of the contract, a contingency which might or might not occur. Furthermore, it must be borne in mind that all of such excess income, even though in form paid to the third party as compensation, was to be passed on to the stockholders of Appellant.

In this connection it becomes significant to note the amount of the purchase price of the stock to be sold to the third party and to be paid for out of such excess income. It seems reasonable to assume that a contract of the nature of the one here under consideration would not have been entered into, unless at the time the Appellant were in an unsound condition. This surmise is amply borne out by the following statement quoted from page five of Appellant's brief:

"As a matter of fact, at the time the contract was executed Appellant was heavily in debt and practically unable to continue in the business."

Under such circumstances, one might expect that the actual value of the stock of the Appellant at the time of making the contract was considerably under the par value thereof. Yet the

Appeal of Orange Ice and Cold Storage Company

purchase price of the stock to be sold to the third party and to be paid for out of the excess income of the Appellant was fixed at seventy cents above par. Thus it seems evident that it was contemplated that in no event should the entire amount of such excess be paid to the third party as compensation for managing the business, but that a substantial part, if not the entire amount of such excess should be paid to the stockholders in order to avoid a loss being sustained by them on their investment.

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, that the action of Hon. Chas. J. **McColgan**, Franchise Tax Commissioner, in overruling the protest of Orange Ice and Cold Storage Company, a corporation, against a proposed assessment of an additional tax of \$232.28, with interest, under Chapter 13, Statutes of 1929, be and the same is hereby sustained,

Done at Sacramento, California, this 11th day of February, 1933, 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