BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
MIRABEL COMPANY)

Appearances:

For Appellant: H. V. Colby, Attorney

For Respondent: Frank M. Keesling, Franchise Tax *Counsel*

O P I N I O N

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 the Mirabel Company, to his proposed assessment of an additional tax in the amount of $1,439.67 for the taxable year ended December 31, 3.937, based upon the income of the company for the year ended December 31, 1936.

The additional assessment was levied by the Commissioner because the Appellant failed to report as net income for 1936 and to pay tax with respect to the sum of $36,874.94, representing accrued interest due the American Trust Company which the latter cancelled and forgave as of December 31, 1935. Appellant contends that both before and after this cancellation took place it was in an insolvent condition, and that therefore it realized no income by the cancellation of the interest. In support of its contentions it cites the following decisions of the Federal Courts and the United States Board of Tax Appeals all of which hold that the cancellation of a debt does not result in the realization of income to the debtor if after the cancellation the debtor is insolvent.

Dallas T. & T. Warehouse Co. v. Commissioner, (C.C.A. 5, 1934) 70 F. (2d) 95;
Burnet v. John F. Campbell Co. (1931), 50 F. (2d) 487;
Commissioner v. Simmons Gin Co. (C.C.A. 10, 1930), 43 F. (2d) 327;
Madison Railways Co. (1937), 36 B.T.A. 1106 (No. 160).

The Commissioner denies that the Appellant was insolvent and states further, as an additional and independent reason for the inclusion in Appellant's income of the amount of the cancelled interest, that the Appellant, whose books are kept on the accrual basis, recorded interest in its accounts as an expense in the years in which the interest accrued and that in making its franchise tax returns for such years it entered the amount of such accrued interest as a deductible item. The Appellant points out in this connection that for the years in

which the interest accrued it sustained net losses in excess of the amount of the accrued interest, so that the latter did not have any effect upon the amount of its tax liability.

In support of its allegation of insolvency, Appellant has shown that in November, 1935, it was indebted to the American Trust Co. in the sum of $287,347.55, and represents that the actual or estimated market value of the company's assets at that time was $194,032.77, as compared to a book value of $346,517.39 as of December 31, 1935. This difference between book values and actual values arises mainly from the following items:

	Book Value	November 1935 Actual or Estimated Value	Difference
2000 shares Coast Realty Co.	$250,000.00	$135,000.00	$115,000.00
Hillsborough Real Estate	73,820.42	30,000.00	43,820.42
	$323,820.42	$165,000.00	$158,820.42

The basis upon which either the book value or the estimated value in November, 1935, of the Hillsborough Real Estate was determined does not appear from the record, although Appellant has submitted a letter from the American Trust Co; dated November 20, 1937, stating that in November, 1935, the Hillsborough Real Estate was valued by them at $30,000.00.

With reference to the shares in the boast Realty Co., it appears that the above valuations were made by the American Trust Co. upon the basis of the prospective earning power of the company, the original book value being fixed in 1931 by averaging the net earnings for 1926-1930 and capitalizing the same at a rate of approximately 7.8 percent, and the valuation in November, 1935, being based upon a decline in earnings of 41 percent for the period 1931 to 1934 and upon an anticipated additional decline of 5 per cent for future years due to local conditions. According to the testimony presented, the earnings for 1935-1937 actually showed a decline of 46 percent from the average earnings for 1926-1930.

We believe that this method of valuation was reasonable and that the figures arrived at should be accepted. The value of stock in a going concern is obviously dependent largely on the corporation's prospective earnings, the most accurate guide to which is ordinarily the record of earnings for several years preceding the valuation date. The use of average earnings as a means of valuing corporate stock for which there is no market has been sanctioned by the Federal courts and the United States Board of Tax Appeals at substantially higher rates of capitalization than the 7.8 percent used by Appellant herein; (Newell v. Comm., 66 F. (2d), 103; Jamieson v. United States, 10 F. Supp. 321; Rheinstrom v. Willcuts, 26 F. Supp. 306; James Couzens, 11 B.T.A. 1040).

We believe that the foregoing sufficiently establishes that the Appellant was insolvent in January, 1936, immediately after the cancellation of the interest, and in view of this circumstanc it is our opinion that the cases cited by Appellant and above referred to are controlling. We believe that the fact that the Appellant in prior years treated the accruing interest as an expense deductible from its gross income does not require that the same be treated as income for the year of cancellation. Although the theory advanced by the Commissioner finds some support in recent opinions of the Board of Tax Appeals, an examination of those opinions discloses that the theory has been applied only in those cases in which the deduction in the prior year has been used to offset income. Where, as in this case, the taxpayer received no benefit from the deduction, since it served *only* to increase its net loss, the principle contended fo by the Commissioner has not been applied. A situation similar to that presented here was before the Board of Tax Appeals in Central Loan & Investment Company, 39 B.T.A. 981. The Board stated:

> "We think that it very material that no actual benefit was derived by the taxpayer through a deduction from its gross income in the year 1923.....If such amount was not deducted to offset income, as the facts indicate and as we have found, then the amount received in the taxable year should not be included in the gross income for that year."

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 Chas. J. McColgan, Franchise Tax Commissioner, in overruling the protest of the Mirabel Company, a corporation, to a proposed assessment of additional tax in the amount of $1,439.67 for the taxable year ended December 31, 1937, based upon the income of said company for the year ended December 31, 1936, be and the same is hereby reversed. Said ruling is hereby set aside and the Commissioner is hereby directed to proceed in conformity wit this order.

Done at Sacramento, California, this 15th day of November, 1939, by the State Board of Equalization.

Fred E. Stewart, Member
George R. Reilly, Member
Harry B. Riley, Member

ATTEST: Dixwell L. Pierce, Secretary