



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
CONTINENTAL SECURITIES COMPANY }

Appearances:

For Appellant: Scott Carter, Attorney; W. H. Rankin, Vice-President.
For Respondent: W. M. Walsh, Assistant Franchise Tax Commissioner; James J. Arditto, Franchise Tax Counsel.

O P I N I O N

This appeal is made 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 upon the protest of Continental Securities Company to his proposed assessments of additional taxes in the amounts of \$905.73 for the taxable year 1938; \$88.13 for the taxable year 1939; \$127.27 for the taxable year 1940, and \$451.77 for the taxable year 1941.

Three questions were involved originally in this appeal. The first, applicable to all four years for which the assessments were levied, concerns the problem of whether or not Appellant should be taxed as a financial corporation; the second relates to the deductibility of an alleged loss on the sale of stock of the Studebaker Corporation in the year 1937; the third applies to the taxable years 1939, 1940 and 1941, and pertains to the method of determining the basic cost of certain real estate sold in the corresponding income years. At hearing before this Board on November 8, 1943, representatives of Appellant agreed to acquiesce in the action of the Commissioner insofar as the last question was a factor in the assessments, so we are now concerned with only the two remaining questions which are discussed in the order of their enumeration.

Should Appellant be classified as a financial corporation or as a business corporation?

This controversy involves the interpretation of Section 4 of the Bank and Corporation Franchise Tax Act. The Commissioner claims that Appellant was correctly taxed as a "financial corporation" as provided by the first paragraph of Section 4 of the Act, at the rate specified in Section 4(a) thereof. Appellant disputes that claim and asserts that it was liable for taxes as a general business corporation as provided by Section 4(3) of the Act.

A pertinent excerpt from the opinion of this Board in the Appeal of Bankamerica Agricultural Credit Corporation, decided July 7, 1942, follows:

"It seems clear in view of the separate treatment of financial corporations in the Bank and Corporation

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Franchise Tax act, that the term 'financial corporations' is used therein in the same manner as in Section 5219 of the Revised Statutes of the United States, relating to state taxation of national banks and prohibiting the taxation of such banks at a rate higher than that assessed upon other financial corporations. Neither Section 5219 nor the Hank and Corporation Franchise Tax Act defines the term 'financial corporations. The Corporation and the Commissioner, however, agree that the correct definition of the term is to be found in the decisions interpreting the phrase 'other moneyed capital' in Section 5219 and that the Corporation is properly to be regarded as a financial corporation only if its capital was employed during the year ended December 31, 1934, in such a way as to bring it into substantial competition with the business of national banks. Mercantile National Bank v. New York, 121 U.S. 138; First National Bank of Guthrie Center v. Anderson, 269 U.S. 341; First National Bank of Hartford v. Hartford, 273 U.S. 548; Minnesota v. First National Bank of St. Paul, 273 U.S. 561 ..."

Appellant engages in many business activities and has substantial investments of diverse character. It operates the Angels Flight Railway Company. In the years involved it received rentals from real estate owned, ranging from \$12,000.00 to \$35,000.00 annually; dividends on large investments in capital stocks; and commissions for insurance underwritings and services rendered. It is properly to be regarded as a financial corporation only if its capital was employed during the years 1937 to 1940, inclusive, in such a way as to bring it into substantial competition with the business of national banks, in the Los Angeles area.

Taking the year 1937 as an example, we find that Appellant then had outstanding long term loans (in the amount of \$572,164.14) secured by deeds of trust on real estate. Appellant argues that inasmuch as such investments were made "with its own capital only," rather than with deposited or borrowed money, it was not infringing on regular banking functions.

Respondent shows by affidavits of executive officers of national banks operating in the same locality that the banks were making numerous loans of substantially the same type as those made by Appellant. This is not controverted, but Appellant argues that "competition," within the meaning here applicable, involves business rivalry which, it says, did not exist between it and any Los Angeles bank. Appellant further argues that its loan activity was merely incidental; that four-fifths of its manpower was used in conducting non-banking business, such as operating a public utility, managing real estate, collecting rentals and handling insurance.

"Competition" as used herein is aptly defined in the case of People ex rel Pratt v. Goldfogle, 242 N. Y. 277; 151 N.E. 452, 461 from which we quote the following:

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"Competition means a condition of business rivalry which arises when moneyed capital is devoted with reasonable continuity and regularity to operations having for their primary and characteristic purpose, as distinguished from some incidental operations or details, the transaction of some branch of business which may be carried on by national banks and it is not necessary that this employment shall bring capital into competition with all such **branches.**"

Appellant, prior to, during, and subsequent to the year involved in this appeal regularly invested some \$500,000.00 in real estate loans of a type solicited by national banks operating in the same area.

We believe the conclusion inescapable that Appellant was in substantial competition with the loan and investment features of the business of national banks in the years **193'7 to 1940, inclusive.** Any doubt remaining would be resolved by the following language of the Court in an appeal involving the same basic question:

"**Competition** within the meaning of section 5219, Revised Statutes of the United States does not mean there should be a competition as to all of the business of national banks section 5219 is violated whenever capital, substantial in amount when compared with the capitalization of national banks, is employed either in a business or by private investors in the same sort of transactions as those in which national banks engaged and in the same locality in which they do business ... It is enough as stated if both engaged in seeking and securing in the same locality capital investments of the class now under consideration which are substantial in amount . . . even though the competition be with some, **but not all,** phases of the business of national banks, or it may arise from the **employment** of capital invested by institutions or individuals in particular operations or investments like those of national **banks.**"

The Morris Plan Co. v. Johnson, **37 Cal. App. (2d) 621.**

Finally, the Supreme Court of this State in the case of Crown Finance Corp. v. McColgen, 23 A. C. 282, decided since this matter was submitted, has held that "The word 'financial' when used with reference to corporations (within the purview of Section 4 of the Bank and Corporation Franchise Tax Act) indicates dealing in money as distinguished from other **commodities.**" There purchase by a corporation of conditional sales contracts from neighborhood retail stores dealing in furniture and equipment was held to constitute substantial competition with national banks which engaged in the same general investment business, even though other phases or aspects of their respective businesses were not parallel. This authority, together with the others already cited, impels to the conclusion that Appellant must be regarded as a financial corporation for the purposes of the Bank and Corporation Franchise Tax Act.

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Was the loss on "old" Studebaker stock realized for tax purposes in 1935 or in 1937?

Under date of March 30, 1935, the City Bank Farmers Trust Company of New York, Corporate Trust and Reorganization Department, pursuant to the terms of a "Plan of Reorganization" of the Studebaker Corporation, a New Jersey corporation, mailed to Appellant 100 shares of the common stock of Studebaker Corporation, a Delaware corporation, and \$675.00 par value of 6% Income Debenture of the Delaware Corporation. The "Plan of Reorganization" was confirmed January 28, 1935, by the United States District Court on the conclusion of proceedings under Section 77B of the Bankruptcy Act. The stock in the Studebaker Corporation, a New Jersey corporation, was sold by Appellant in the year 1937 at an alleged loss of \$10,681.79. Appellant contends that the stock of the new corporation inherited the value history of the "old" Studebaker Corporation, and if so, the loss is allowable for the year 1937. The Commissioner contends that the stock of the "old" Studebaker Corporation became worthless in 1935, as the corporation did not go through a tax free reorganization within the purview of Section 13(j) of the Bank and Corporation Franchise Tax Act, defining a reorganization. The Treasury Department has ruled that the transaction involving the exchange of securities in 1935 did not constitute a reorganization, and that the common stock of the "old" Studebaker Corporation became worthless on January 28, 1935.

(Prentice-Hall, Inc., Capital Adjustments, Vol. II, page 6446)
We are required to give great weight to this holding under the case of Innes v. McColligan, 47 Cal. App. (2d) 781, yet we are not conclusively bound thereby.

Appellant makes much of the fact that the securities of the "old" Studebaker Corporation emerged from the reorganization proceedings with some value, reflected by quotations of the New York Stock Exchange and actual sales. The Plan of Reorganization became effective January 28, 1935, and the new securities of the New Jersey Corporation, sold in 1937, were mailed to Appellant on March 30, 1935. Large blocks of the "old" stock were sold in January, 1935, at a range of \$1.75 to \$3.75 per share; in February, 1935, at a range of 12½ cents to \$1.62½ cents per share; and in March, 1935, there was a bid price of not less than 12½ cents per share.

We need not rule on the question of whether or not *the* "old" Studebaker stock became entirely worthless in the year 1935, if the transaction effecting the exchange of securities in 1935 failed to satisfy the statutory definition of a reorganization as contemplated by Section 20 of the Bank and Corporation Franchise Tax Act, identical with Section 112 of the "Revenue Act of 1934," and adopted in its entirety by reference.

In this connection, we quote from a letter of September 21 1936, from the Commissioner of Internal Revenue to Studebaker Corporation:

"At the time of the reorganization the Studebaker

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Corporation (New Jersey) owned the entire stock of the Rockne Motors Corporation and approximately 95% of the stock of the White Motors Corporation. It had outstanding 58,082 shares of \$100.00 par value preferred stock and 2,464,287 shares of no par value common stock. Its principal liabilities consisted of \$14,081,050.00 principal amount of 6% gold notes, \$6,101,470.52 unsecured claims and \$2,282,642.90 accrued interest.

"The plan provided for the formation of a new corporation under the laws of the State of Delaware, to be known as the Studebaker Corporation, to which all the assets and properties of the old corporation (except the stock of the White Motors Corporation) and of the Rockne Motors Corporation were transferred. In consideration of such transfer the new corporation issued its securities and made payments to the creditors and stockholders of the old corporation and of the Rockne Motors Corporation, as follows:

<u>Class of Creditor or Stockholder of old Corporation</u>	<u>New Securities Received</u>		Shares of Stock of White Motors Corporation	Shares of Stock of new Corporation
	<u>Cash</u>	<u>Debentures of new Corporation</u>		
Holders of Gold Notes For each \$1,000.00 and accrued interest			\$ 29.75	\$ 45.08
Holders of Unsecured Claims For each \$1,000.00 and accrued interest			29.23	44.29
Holders of Rockne Debt For each \$1,000.00 and accrued interest	\$276.84	\$553.67	7.75	11.07
Holders of Preferred Stock For each 100 shares (Upon payment of \$1,500.00)		1,500.00		125.00 229 2/9
Holders of Common Stock For each 100 shares (Upon payment of \$225.00)		225.00		33 1/3

"Section 112 of the Revenue Act of 1934 provides:

'(a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111 shall be recognized, except as hereinafter provided in this section.

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'(b)(3) No gain or loss shall be recognized if stock or securities in a corporation a party to reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

'(g)(1) The term reorganizations means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange **solely** for all or a part of its voting stock; of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or

'(d) a recapitalization, or (E) a mere change in identity, form or place or organization, however effected.'

"It is apparent that no attempt was made to merge or consolidate in pursuance of the corporation laws of the United States, a state or territory or the District of **Columbia**, so as to constitute a reorganization **within** the meaning of section 112(g) (1)(A) and article 112(g)(2) or Regulations **86** relating to statutory mergers or consolidations. The fact that the transaction was consummated pursuant to the provisions of section 77B of the Federal Bankruptcy Act does not, in the opinion of this office, make it a statutory merger or consolidation within the meaning of the Act. Nor can the transaction qualify as a reorganization under the provisions of (b), since the new corporation did not acquire the properties solely in exchange for all or a part of its voting stock. The transferor of its stockholders or both were not in control of the new corporation immediately after the **transfer**, so that the transaction does not qualify as a reorganization under (C). A recapitalization involves a corporate readjustment **of** existing interests and the rearrangement of the capital structure. It is the view of this office that the transfer of a part of the assets of a corporation to a new corporation organized under the laws of another state cannot be considered a recapitalization under (D). Nor was there a mere change in identity, form, or place of organization, as contemplated by (E).

"It is, therefore, the opinion of this office that the transaction in question fails to satisfy the definition of a reorganization as set forth in section 112(g)(1)

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of the 1934 Act. Since the receipt by the creditors and stockholders of the old corporation of stock and/or securities of the new corporation was not in connection with a reorganization, the transactions are **governed** by the general rule set forth in section 112(a), which recognizes gains or losses therefrom.

"The fair market values of the securities involved, as indicated by sales on the New York Stock Exchange immediately after the plan was consummated were as follows:

Studebaker Corporation

Debentures	\$46.75 per \$100.00
Common stock	2.75 per share

White Motors Corporation

Common stock	\$ 9.50 per share
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"On the basis of the above values the units of debentures and common stock that the preferred stockholders of the old corporation were entitled to subscribe for upon payment of \$15.00 could have been bought for approximately \$13.12. Likewise the units the common stockholders were entitled to upon payment of \$2.25 could have been acquired for approximately \$1.97. It is, therefore, apparent that the rights had no actual value and since there was no distribution to the common stockholders, other than the right to acquire new securities upon payment of the subscription price, the common stock of the old corporation is held to have become worthless, within the meaning of article 23(e)-4 of Regulations 86, on January 28, 1935, when the plan of reorganization was confirmed by the court. The cost, or other basis of such stock is accordingly an allowable deduction from gross income in the 1935 returns of the individual stockholders.

"The holder of each share of preferred stock of the old corporation is entitled to deduct the difference between the cost, or other basis, of his share of preferred stock and \$3,4375, the fair market value of 1 1/4 shares of the no par value common stock of the new corporation received in exchange. Such losses are, however, subject to the limitations prescribed in section 117 of the 1934 Act.

"Any stockholder or creditor of the old corporation who elected to subscribe for units of debentures and common stock of the new corporation should treat the amount paid for such units as a new investment. The subscription price should be apportioned between the debentures and stock received on the basis of the respective fair market values of the new securities, as follows:

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Debentures	53.43%
Stock	46.57%

"Bondholders and other creditors of the old corporation are entitled to deduct the difference between the basis of their claims and the fair market value of the new securities and cash, if any, received, in accordance with the provisions of section 23(k) of the Revenue Act of 1934."

We agree with the holding of the Treasury Department that the transaction of 1935 was not a reorganization within the statutory concept of Section 112(g)(1) of the Revenue Act of 1934 and must decide that a deductible loss on exchange of the "old" Studebaker stock was sustained in 1935, and the new securities did not inherit the value history of the "old" stock.

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 protests of Continental Securities Company under the Bank and Corporation Franchise Tax Act to proposed additional assessments of \$905.73 for the taxable year 1938; \$88.13 for the taxable year 1939; \$127.27 for the taxable year 1940; and \$451.77 for the taxable year 1941, be, and the same is hereby, sustained.

Done at Sacramento, California, this 3rd day of February, 1944, by the State Board of Equalization.

R. E. Collins, Chairman
Wm. G. Bonelli, Member
Geo. R. Reilly, Member
Harry B. Riley, Member
J. H. Quinn, Member

ATTEST; Dixwell L. Pierce, Secretary