



BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
L. R. SMITH

Appearances:

For Appellant: John Leekley, Attorney at Law

For Respondent: W.M. Walsh, Assistant Franchise
Tax Commissioner; Hebard P. Smith,
Associate Tax Counsel

OPINION

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code (formerly Section 19 of the Personal Income Tax Act) from the action of the Franchise Tax Commissioner on the protest of L. R. Smith to a proposed assessment of additional personal income tax in the amount of \$564.69 for the year 1937 and pursuant to Section 19055 of the Code (formerly Section 20 of the Act) from his action on the claim of L. R. Smith for a refund of personal income tax in the amount of \$24.00 for that year.

The principal question at issue herein relates to the amount of gain, if any, derived by the Appellant from the sale in 1937 of certain shares of common stock of A. O. Smith Corporation. These shares were received by the Appellant in 1936 as a part of a distribution by the Smith Investment Company, a personal holding company within the meaning of Section 34 of the Personal Income Tax Act as enacted in 1935. The distribution also involved the payment of cash by the Company to the Appellant as a shareholder and the turning in by him to the Company of 31 shares of its stock. It is the position of the Commissioner that the distribution of the shares is properly to be regarded as one made in kind by a partnership to a partner with the result that no gain was realized by Appellant from the distribution to him in 1936 and that gain was realized by him in 1937 to the extent of the excess of the sales price of the shares over their basis in his hands. The Appellant contends, on the other hand, that the distribution was taxable in 1936 as a dividend out of the most recently accumulated earnings or profits, but exempt from tax, under Article 34-1(c) of the Regulations relating to the Personal Income Tax Act of 1935, because it was out of income accrued prior to January 1, 1935.

The Appellant's contention cannot, in our opinion, be sustained. He concedes that the Smith Investment Company was a personal holding company. Under Section 34 of the Act it must be

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regarded as a partnership (*McCreery v. McColgan*, 17 Cal. 2d 555) and it follows that the distribution by it must be regarded as a distribution by a partnership to a partner rather than as a dividend paid by a corporation to a shareholder. Section 113(a)(13) of the Federal Revenue Act of 1934, incorporated by reference in the State Act by Section 7(d) thereof, provides that upon the distribution in kind of partnership property to a partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property. Article 7(d)-30 of the Regulations under the State Act, based on Article 113(a)(13)-2 of Income Tax Regulations 86 of the United States Treasury Department, further provides that if a partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property. The real point at issue then, relates to the determination of the basis of the A. O. Smith Corporation shares received by Appellant in 1936.

In view of the incomplete state of the record before us, it will serve no useful purpose to review the Commissioner's computations in this connection. It will suffice to say that he has attempted to assign to those shares a portion of the Appellant's basis for his shares in the Smith Investment Company. He has determined the basis of Appellant's shares in the Smith Investment Company by taking the original cost to Appellant of those shares and making appropriate adjustments for losses sustained by the Company in 1935 and 1936 and cash distributions to the partners in those years. It may be that his action has been erroneous in that he has not increased the basis of those shares by adding to their original cost the amount of Appellant's share of the undistributed profits of the Company from its creation in 1923 to 1935, that is to say, by failing to regard it as a partnership from the time of its creation rather than from 1935 at which time the Personal Income Tax Act became effective. The Appellant, however, has not submitted any evidence tending to establish a basis for the Smith Investment Company shares differing from that determined by the Commissioner. In view of this fact and inasmuch as his argument fails to take into account the partnership status conferred on that Company by Section 34 of the Act, we have no alternative other than to overrule his position and sustain the action of the Commissioner in this connection.

As respects the refund claim, the Appellant objects to the action of the Commissioner in disallowing the deduction from gross income as an expense of certain investment counsel fees. For the reasons set forth in our opinion in the Appeal of L. R. Smith and Agnes G. Smith relating to the year 1936, this day decided, the position of the Commissioner must also be sustained on that issued

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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, pursuant to Sections 18595 and 19060 of the Revenue and Taxation Code, that the action of Chas. J. McColgan, Franchise Tax Commissioner, on the protest of L. R. Smith to a proposed assessment of additional personal income tax in the amount of \$964.69 for the year 1937 and that the action of said Commissioner on the claim of said L. R. Smith for a refund of personal income tax in the amount of \$24.00 for that year be and the same are hereby sustained.

Done at Sacramento, California, this 1st day of April, 1948, by the State Board of Equalization.

Wm. G. Bocelli, Chairman
George R. Reilly, Member
J. H. Quinn, Member
Jerrold L. Seawell, Member

ATTEST: Dixwell L. Pierce, Secretary