

BEFORE THE STATE BOARD OF **EQUALIZATION**
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
CALIFORNIA LETTUCE **GROWERS**, INC. }

Appearances:

For Appellant: George D, **McKaig**, Attorney at Law

For Respondent; Burl D. **Lack**, Chief Counsel

O P I N I O N

This appeal is made pursuant to section **25667** of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of California Lettuce Growers, Inc., to a proposed assessment of additional franchise tax in the amount of **\$1,621.59** for the income year **1956**.

Appellant is a California corporation whose principal business is growing and processing vegetables.

In **1942** Appellant acquired title to certain agricultural **land**. In exchange for the land Appellant gave a promissory note for \$200,000 and a purchase money mortgage to Vegetable Farms, Inc. By **1948** Appellant had reduced the face value of the note to \$113,000. In **1948** California Vegetable Growers, an agricultural cooperative association of which Appellant was a member, acquired the note for \$93,500.

California Vegetable Growers Association, hereafter referred to as the Association, was a nonprofit agricultural cooperative. It was organized and operated for the purpose of marketing the agricultural products of its members, The members received the proceeds less expenses incurred in connection **with** its marketing activities. The Association was authorized to create reserves for any necessary purpose and to buy and **own** real or personal property for use in its business. The Association created a reserve called a revolving fund, A deduction of **25** cents for each crate of farm products handled by the Association was retained from the proceeds of the sales of products and placed in the revolving fund, The board of directors was authorized to increase or decrease the amount of the revolving fund deduction and to establish, fix, increase or decrease further revolving fund deductions as in its sole discretion it felt would be necessary to establish and maintain reasonable reserves for the Association. The funds accumulated were for the purchase

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of buildings, machinery and equipment, retirement of indebtedness and investment in authorized securities, All property, real or personal, purchased by the Association with amounts from the revolving fund was owned by the Association, Its bylaws provided that:

In the event of dissolution of the Association, the right of the **members** to participate in the distribution of the assets of the Association after **the** payment of all obligations and the Revolving Fund deduction, shall be in proportion to their property rights in the Association.

On December 31, 1956, Appellant was the sole remaining member of the Association. On that date the Association was liquidated and Appellant received its note, all other assets of the Association, and the unexpended balance of the revolving fund in the amount of \$70,261.29.

Respondent's position is that even though the Association was liquidated pursuant to a tax free liquidation statute, Appellant had taxable gain when its note was cancelled, Respondent also asserts that the revolving fund proceeds were not property within the provisions of the tax free liquidation statute and were, therefore, taxable when received by Appellant.

Appellant contends that the express terms of the statute provided for tax free treatment of all property received in liquidation of the Association and, therefore, no gain should have been recognized on either the cancellation of its note or the receipt of the revolving fund proceeds.

The first issue to be decided is whether a parent corporation realizes taxable gain when its note, purchased by its subsidiary at a discount, is cancelled at the time the subsidiary is liquidated.

Revenue and Taxation Code, section 24502, provides, in part, as follows:

No gain or loss shall be recognized on the receipt by a (parent) corporation of property distributed in complete liquidation of (its subsidiary).

In addition, subsection (c) of that statute provides that if a subsidiary is indebted to a parent corporation, no gain or loss shall be recognized to the subsidiary because of the transfer of property in satisfaction of such indebtedness.

The legislative history behind the federal counterpart of this statute shows that subsection (c) was not to apply to the parent upon cancellation of indebtedness due from it to its subsidiary. As to that situation the existing law was to govern. (S. Rep. No. 1662, 83rd Cong., 2d Sess. (1954).)

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The theory behind the tax free liquidation statute is that taxation is not eliminated but merely postponed. This is evident in the requirement that the transferee take the assets of the transferor with the transferor's basis. (Rev. & Tax, Code, Sec. 24504. See H. R. Rep. No. 1885, 74th Cong., 1st Sess.: (1935).)

It has long been held that gain to a corporation by purchasing and redeeming its bonds at a price less than that for which it had sold them is taxable income. (United States v. v. Kirby Lumber Co., 284 U.S. 1; American Packing and Provision Co., 36 B.T.A. 340.) Appellant concedes that this is the general rule and that the rule would have been applicable had it purchased its note from the association at less than face value, but asserts that the rule has no application since the note was received in complete liquidation of the Association.

In accordance with section 24504 of the Revenue and Taxation Code, Appellant received its note from its subsidiary at the subsidiary's basis of \$93,500. Upon receipt of the note, Appellant's obligation to pay the face value of \$113,000 was extinguished and the note was cancelled. (Civ. Code, Sec. 3200.) If the resulting gain was not taxable at that time, it would never be taxed, contrary to the underlying purpose of section 24502 to postpone and not to eliminate gain,

The purpose of the statute is preserved in this case by the provision that makes the statute applicable only to gain or loss "on the receipt ... of property" by a parent corporation. The maker of a note does not receive property when the note is surrendered to him (Bingham v. Commissioner, 105 F.2d 971; David Wise, T.C. Memo., Dkt. No. 77180, June 15, 1961). As stated in the Bingham decision:

What may have been property in the hands of the holder of the notes simply vanished when the surrender took place and the maker received them. He then had, at most, only his own obligations to pay himself. Any theoretical concept of a sale of the notes to the maker in return for what he gave up to get them back must yield before the hard fact that he received nothing which was property in his hands but had merely succeeded in extinguishing his liabilities by the amounts which were due on the notes.

Even if the note were regarded as property in Appellant's hands, the statute would not apply because the gain arose not from the receipt of the note but from the cancellation of the obligation. Considering the note as property, Appellant received it at the subsidiary's basis and realized taxable gain in the amount of \$19,500, the difference between the basis and the amount of the obligation which was canceled.

We note that other statutes provide for an election to postpone the recognition of gain from the cancellation of indebtedness. (Rev. & Tax. Code, Secs. 24307, 24918.) In order to avail itself of the benefit

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of these provisions, a taxpayer must file a consent to adjust the basis of its property, (Cal. Admin. Code, tit. 18, Sec. 24307(b).) Appellant has failed to make such an election to exclude the gain from its gross income. In construing a comparable federal statute and regulation, it has been held that a failure to comply with the regulation forfeits the right to the benefit of the statute, (Denman Tire & Rubber Co. v. Commissioner, 192 F.2d 261.)

We hold, therefore, that the gain which arose from the cancellation of Appellant's note is taxable for the year in question.

The second issue to be determined is whether taxation of the revolving fund received by Appellant is prevented by section 24502.

The revolving fund constituted part of Appellant's share of the net proceeds from the marketing by the Association of its members' farm products. Unexpended sums in revolving funds of this type never become the property of a cooperative such as the Association, but are merely held by it as agent or fiduciary for its members. (Bogardus v. Santa Ana Walnut Growers Ass'n, 41 Cal. App, 2d 939; San Joaquin Valley Poultry Producers' Ass'n v. Commissioner, 136 F.2d 382.)

Section 24502 has reference to property owned by a subsidiary and which is exchanged for stock held by the parent. This is clear from a provision in the section that the distribution by the subsidiary must be "in complete cancellation or redemption of all its stock." The distinction between the revolving fund and the other assets held by the Association is emphasized by the previously quoted language of its bylaws indicating that the revolving fund was to be paid out before the assets were distributed.

It is our conclusion that the amount received by Appellant from the revolving fund was taxable to it.

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 section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of California Lettuce Growers, Inc., to a proposed assessment of additional franchise tax in the amount of \$1,621.59 for the income year 1956, be and the same is hereby sustained.

