BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HAROLD E. AND ANGELA E. CASEY)

Appearances:

For Appellants: Paul F. Kelly, Attorney at Law

For Respondent: Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Harold E. and Angela E. Casey against proposed assessments of additional personal income tax in the amounts of $944.42 and $757.20 for the years 1955 and 1956, respectively.

The first question presented is whether certain distributions in redemption of stock constituted payments in exchange for the stock, as Appellants contend, or were equivalent to dividends taxable as ordinary income, as Respondent contends.

For many years, the H. E. Casey Company was a partnership in which Appellants were the sole partners. On December 31, 1952, Appellants incorporated the business in order to facilitate the transfer of their interest to key employees. Appellants transferred to the corporation partnership assets which had a basis to them for tax purposes of approximately $190,000. The business was valued at $350,000, based upon its income for a five year period: The issuance of shares to Appellants was delayed until November 18, 1954, pending the appointment of an escrow holder approved by the Commissioner of Corporations. On that date, Appellants received 35,000 shares of stock with a par value of $10 per share.

On March 1, 1955, the corporation redeemed 2,100 of Appellants' shares for $21,000. An additional 2,000 shares were redeemed for $20,000 on June 21, 1956. Appellants also disposed of other shares, primarily through sales to employees

at prices not exceeding par value and in part through gifts to them. The sequence of the transactions during 1955 and 1956 was as follows:

	Sales and gifts	Redemptions
March 1, 1955	2,300 shares	2,100 shares
June 21, 1955	2,400 "	
June 21, 1956		2,000 "
June 29, 1956	1,550 "	

During 1957, Appellants transferred 20,650 shares, reducing their holdings to 4,000 shares by the end of that year.

The following table shows the earned surplus of the corporation at the end of each of the years 1953 through 1956:

Date	Earned surplus
December 31, 1953	$18,933.06
December 31, 1954	50,799.25
December 31, 1955 (after redemption of 2,100 shares)	50,044.17
December 31, 1956 (after redemption of 2,C00 shares)	50,651.89

No dividends were declared until February 4, 1957, when the corporation declared a dividend of $.30 per share to stockholders of record as of December 31, 1956.

Pursuant to Section 17326, subsection (a), of the Revenue and Taxation Code, a distribution in redemption of stock is to be treated as a payment in exchange for the stock if the redemption is "not essentially equivalent to a dividend."

Characteristically, a dividend is a proportionate distributiontion to stockholders out of earnings and profits leaving the ownership and control of the corporation unchanged, while a normal redemption of stock eliminates the interest represented by that stock with a proportionate increase in the ownership rights represented by the stock which remains outstanding. (In re Lukens' Estate, 246 F. 2d 403.) The federal courts have considered numerous factors in determining whether a redemption is essentially equivalent to a dividend (see Earle v. Woodlaw, 245 F. 2d 119) but, so far as we are aware, none has found a distribution to be equivalent to a dividend where there was a real and substantial change in ownership and control of the corporation after the redemption.

Although Appellants retained a majority interest in the corporation immediately after each of the redemptions in question,

these redemptions were made in the course of a plan to terminate their interest. Together with sales and gifts of their stock to employees, the redemptions reduced their holdings from an original figure of 35,000 shares to 4,000 by the end of 1957. All of these transactions should be considered in determining the net effect of the redemptions. (In re Lukens' Estate, 246 F. 2d 403; Bains v. United States, 289 F. 2d 644; Jackson Howell, 26 T.C. 846, aff'd sub nom. Phelps v. Commissioner, 247 F. 2d 156; Auto Finance Co., 24 T.C. 416 aff'd, 229 F. 2d 318; James F. Boyle, 14 T. C. 1382, aff'd, 187 F. 2d 557.)

The fact that no dividends were declared until 1957, even though the earned surplus was adequate for this purpose, militates against Appellants' position. The surplus, however, did not reach significant proportions until 1954. It should be noted also that the distributions in redemption of Appellants' stock were small in relation to the amounts available for dividends. Moreover, at least in 1956, the distribution was not in proportion to the shares held by Appellants. We do not believe that the failure to declare dividends outweighs the fact that the redemptions were made as part of a series of transactions which greatly reduced Appellants' interest in the corporation.

We do not purport to decide whether the redemptions qualified as payments in exchange for stock under subsection (b) of Section 17326. That subsection refers to a redemption which results in a reduction of stock ownership below 50 percent "immediately after" the redemption. As prescribed in Subsection (e) of the same section, in determining whether a distribution is "essentially equivalent to a dividend" it is immaterial whether the requirements of Subsection (b) are met.

It is our conclusion that the distributions in redemption here involved were not essentially equivalent to dividends, but should be treated as distributions in payment for the stock redeemed.

The second question presented is whether certain shares sold to one employee, J. E. Taylor, were sold to him at the par value of $10 per share, as Respondent contends, or at Appellants' cost basis of approximately $5.45 per share, as Appellants contend.

As evidenced by a letter written by Appellants' accountant on December 18, 1952, two weeks before the incorporation, the original plan was to sell the shares to the employees at par value. It was contemplated that there would be taxable gain on the sales, representing the difference between the price of $10 per share and the allocated cost to Appellants of the partnership assets, approximately $5.45 per share,

On March 1, 1955, Appellants sold 1,000 shares to J. E. Taylor, an employee, and gave him 100 shares. The sale was

recorded in the books of the corporation at a price of $10 per share. On June 21, 1955, Appellants sold an additional 1,200 shares to Taylor at a recorded price of $10 per share, payable in installments. These transactions were not reported in Appellants' return for 1955. An amended return for that year was filed in April 1957, reporting a relatively small gain based upon a price of $10 per share and an unexplained cost figure slightly less than the price.

The position now taken on Appellants* behalf is that at the' time of these sales their intention was to sell to Taylor at $5.45 per share, which was their basis for computing gain on the sales. They state that the error was due to the fact that Appellant Harold E. Casey, who handled the sales for Appellants, has been unable to communicate properly because of a stroke suffered just before the incorporation, and to the fact that the employees who recorded the transactions were not aware of the difference between cost and par value of the stock.

A contract of sale between Taylor and Appellants, dated June 13, 1957, has been submitted. This contract evidences a sale of 6,300 shares to Taylor at a price of $34,353.90 with an initial payment of $11,300 and monthly installments of $300 on the balance. The explanation offered is that this contract was entered into to correct the mistake in price by consolidating the 1955 sales of 2,200 shares, the original gift of 100 shares and a 1957 sale of 4,000 shares and treating the total number of shares as sold to Taylor at $5.453 per share.

There has also been submitted an affidavit by J. E. Taylor which states in part, with reference to the block of 1,000 shares sold to him in 1955, that "Mr. Casey told us that he would sell the shares at the same price that he paid for them and that I would receive $10,000.00 worth of stock based upon his cost whatever the number might be."

Appellants' accountant testified that although there was no definite discussion as to the price of the stock, Casey indicated that he did not want to enter into a taxable transaction.

At the time of the incorporation, the plan was to sell the stock at $10 per share. The facts that the sales were initially recorded at this price and that a return filed as late as April 1957 reported this as the price with an unexplained higher cost basis indicate that the plan was being followed. The evidence which has been submitted to show a contrary intent only reflects the recollection of other parties as to what was said by a man who was hardly able to communicate.

Respondent's position is that the sales in question were made in 1955 at $10 per share, that the gain over Appellants'

basis of $5.45 was taxable in that year and that the adjustments in 1957 were the result of subsequent negotiations. In our opinion, the weight of the evidence supports the correctness of that position.

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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Harold E. and Angela E. Casey against proposed assessments of additional personal income tax in the amounts of $944.42 and $75'7.20 for the years 1955 and 1956, respectively, be modified by treating the distributions in redemption of stock as payments in exchange for the stock. In all other respects the action of the Franchise Tax Board is sustained,

Done at Sacramento, California, this 5th day of November, 1963, by the State Board of Equalization.

John W. lynch, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Richard Nevins, Member

____________, Member

ATTEST : H. F. Freeman, Executive Secretary