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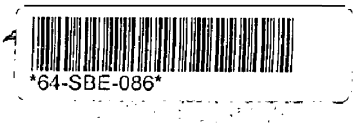

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CONTINENTAL HOLDING CORPORATION)

Appearances:

For Appellant: John Alden Doty,
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 Continental Holding Corporation against a proposed assessment of additional franchise tax in the amount of $14,376.21 for the income year 1960.

The question raised by this appeal is one of statutory interpretation, involving the treatment of certain incomerealized on a cancellation of indebtedness. The facts of the case are not in dispute.:

Appellant is a holding and investment company incorporated in California in 1953. All of its stock is held by a New York corporation, Liebmann Breweries, Inc. Appellant computes its annual income on the basis of the calendar year and uses an accrual method of accounting.

In 1960 appellant owed Liebmann Breweries, Inc., a principal amount of $12,645,312.34 for advances and loans which that company had made to appellant; The entire debt was evidenced by interest-bearing notes . On June 27, 1960,

the board of directors of Liebmann Breweries, Inc., authorized the cancellation of the full amount of the indebtedness, including interest, which was owed to it by appellant. As of that date, accrued interest on the notes totalled $278,446.50.

In its tax returns for income years prior to 1960, appellant had deducted the interest which accrued annually on the notes held by Liebmann Breweries, Inc. The total tax benefit resulting from such deductions was $269,330.04. In its return for the income year 1960 appellant filed the consent to a reduction in the basis of its assets which it deemed required by section 24307, subdivision (a), of the Revenue and Taxation Code and reported a net loss of $6,126.17. Respondent increased appellant's income by $269,330.04 on the ground that the 'cancellation of indebtedness by Liebmann Breweries, Inc., constituted income to appellant to the extent that it received" tax benefit from the cancellation. Appellant protested the proposed additional assessment, and this appeal is taken from respondent's denial of appellant's protest.

The precise issue here is whether or not a corporate taxpayer can elect to reduce the basis of its assets as an alternative to including in its gross income an amount representing past tax benefits resulting from a cancellation of indebtedness by its sole shareholder.

Gross income will ordinarily include income derived from a discharge of indebtedness, (Rev. & Tax. Code, § 24271, subd. (10).) Section 24307, subdivision (a), of the Revenue and Taxation Code, however, permits a corporate taxpayer to elect to exclude income attributable to discharge of its indebtedness 'if it makes and files a consent to a corresponding, reduction in the basis of its assets, Section 24308 of the Revenue and Taxation Code provides:

> If a stockholder or stockholders of a taxpayer cancels any indebtedness owing to the stockholder or stockholders by the taxpayer, such cancellation shall not constitute income to the taxpayer except to the extent that the taxpayer received a tax benefit, under this part, 'from such indebtedness.

Respondent contends that section 24308 was specifically enacted to take care of the situation in which it is a

shareholder of the corporation who cancels an indebtedness owed to it by the corporation. It is argued by respondent that the provisions of section 24307, subdivision (a), being general in nature, are not applicable when this particular set of facts exists, and that the election to reduce the basis of its assets is not available to 'such a corporate taxpayer.

Appellant urges that section 24308 is merely a measuring provision which defines the portion of a cancellation', of indebtedness by a shareholder which constitutes income, as opposed to a contribution to capital, and that after that amount of income is determined the corporate taxpayer may still elect to reduce the basis of its assets under subdivision (a) of section 24307.

Provisions substantially identical with those in section 24308, prescribing the extent to which income results from the cancellation of a corporation's debt by a stockholder, first appeared in 1945 as section 6, subdivision (d)(2) of the Bank and Corporation Franchise Tax Act. (Stats. 1945, p. 1781.) There is no direct counterpart'of these provisions in the federal income tax statutes, Provisions similar to those of section 24307, permitting an election to exclude income from the discharge of a debt, were first enacted in 1943, and were based upon section 22(b)(9) of the United States Internal Revenue Code of 1939. (Bank and Corp. Franchise Tax Act, § 6, subd. (b)(5); 'Stats, 1943, p. 1406,) Section 24307 in its present form was adopted in 1955, based upon section 108 of the Internal Revenue Code of 1954. (Stats. 1955, p. 1579.)

In support of its position,' respondent refers to certain, provision& which appeared in the original House of Representatives bill introduced in connection with the 1954 revision of the Internal Revenue Code (H.R. 8300, 83d Cong., 2d Sess. §§ 76 and 108 (1954)), but which were deleted by the Senate Committee on Finance before the bill was finally approved. (S. Rep. No. 1662, 83d Cong., 2d Sess. (1954) [Vol. 3, 1954 U. S. Code Cong. & Ad. News, pp. 4643, 4821].)

Proposed section 76 of the original bill stated that gross income resulted from'any discharge of indebtedness for which the taxpayer was liable unless such discharge fell within one of.several specified categories, Transactions within the provisions of section 108 were to constitute one of the categories,' (H.R. 8300, 83d Cong., 2d Sess. § 76(a)(6) (1954).) Under section 108, the debtor-t&payer could elect to reduce the basis of its assets as an alternative to' including

in its gross income the amount realized from the cancellation of the debt. (H.R. 8300, supra, § 108(a)(1),), The privilege of this election was specifically denied the otherwise qualified taxpayer who had received a tax benefit from the indebtedness in prior years. (H.R. 8300, supra, §§ 76(b) and 108(a)(2)(B).)

Respondent argues that the retention of present section 24308 was intended to similarly limit the basis reduction provisions of section 24307, and to make them unavailable to the debtor corporation whose shareholder has cancelled a debt owed him by the corporation. Accordingly, under respondent's reasoning, the total tax benefit received in prior years from that indebtedness must be included in the corporation's gross income for the year in which the cancellation occurred, without any option on the part of the corporation. We do not believe that this conclusion is justified,

The federal sections referred to by respondent (H.R. 8300, 83d Cong., 2d Sess. §§ 76 and 108 (1954)), as they appeared in the original draft of the House bill, were quite specific in their limitations on the availability of the basis reduction option in a fact situation like the one before us. No such specificity appears in sections 24307, subdivision (a), and 24308; nor does the language of those sections, or their legislative history, indicate that it was intended that one should constitute an exception to the other. On the contrary, the two sections deal with complementary rather than conflicting concepts,

Though there has been some uncertainty in the federal cases as to when and to what extent income is derived from the cancellation of a debt, it has become a well established rule of law that contributions to capital do not constitute income to a corporation, This rule has been codified in section 118(a) of the Internal Revenue Code of 1954, There is also ample authority in the federal regulations and court decisions for the proposition that where a shareholder gratuitously cancels a debt which the corporation owes to him, the transaction amounts to a contribution to capital, to the extent of the principal of the debt, (Treas. Reg. § 1.61-12(a) (1958); Helvering v. Jane Holding Corp., 109 F.2d 933, cert. denied, 310 U.S. 653 [84 L. Ed, 1418]; Chenango Textile Corp., 1 T.C. 147, aff'd in part, rev'd in part, 148 F.2d 296,) We believe, that section 24308 of the Revenue and Taxation Code, and its predecessors, including section 6, subdivision (d) (2) of the

Bank and Corporation Franchise Tax Act, constitute a codification of and an elaboration on this rule, rather than a limitation on the availability of the basis reduction election provided for in section 24307.

Section 24308 defines the portion of a cancelled indebtedness which will be considered income, i.e., the amount of the tax benefit which the taxpayer has received from such indebtedness. That tax benefit will generally be composed of deductions of interest accruing on the principal in the case of an accrual basis taxpayer. In the absence of a valid election to reduce the basis of corporate assets, as provided for in section 24307, subdivision (a)., section 24308 provides a measure of the amount which must be included in corporate gross income for the year in which the cancellation occurs. On the other hand, if a valid election is made; section 24308 provides a measure of the amount by which the basis of the assets must be reduced,

We therefore conclude that since the explicit requirements of section 24307, subdivision (a), of the Revenue and Taxation Code have been met, i.e., the debt was one incurred by a corporation and appellant filed a consent to a reduction of the basis of its assets in accordance with the regulations under section 24918, the appellant is entitled to the benefits of that section.

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 Continental

Appeal of Continental Holding Corporation

Holding Corporation against a proposed assessment of additional franchise tax in the amount of $14,376.21 for the income year 1960, be and the same is hereby reversed.

Done at Sacramento, California, this 17th day of November, 1964, by the State Board of Equalization.

Paul R. Leake, Chairman

Geo. R. Reilly, Member

Richard Nevins, Member

Lee Kapiloff, Member

_____, Member

ATTEST: _____, Secretary