*68-SBE-011*

BEFORE THE STATE BOARD OF 'EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )
)
CHRIS-CRAFT INDUSTRIES, INC. )

Appearances:

For Appellant: Victor D. Rosen and
Adrian A, Kragen
Attorneys at Law

For Respondent: James W. Hamilton and
A. Ben Jacobson
Tax Counsels

## 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 protests of Chris-Craft Industries, Inc., against proposed assessments of additional franchise tax in the amounts of $11,052.03 and $853,118.11 for the income years 1959 and 1961, respectively.

Appellant Chris-Craft Industries, Inc., formerly the NAFI Corporation and hereinafter called "NAFI," is a highly diversified company which manufactures a variety of textile and fiber products used in automobile trimming. It also has interests in gas and oil properties and television stations, During the years in question, NAFI's automotive division had plants in Oakland and Monterey, California; Trenton, New Jersey; and Waterford, New York, Chris-Craft Corporation, hereafter called "Chris-Craft," manufactures motorboats and is a wholly-owned subsidiary of NAFI.

The issues to be decided in this appeal are:

(1) Whether the payment of $15 million by Chris-Craft to NAFI constituted a dividend that was includible in taxable income;

(2) Whether amounts accrued or paid to NAFI by its subsidiaries in excess of their pro rata share of the consolidated income tax liability constituted dividend income to NAFI;

(3) Whether the gain from the 1959 sale of real property in Newark, California, was unitary income;

(4) Whether the gain from the 1959 sale of the Oakland plant was allocable between the automotive and carpet divisions,

A fifth issue originally raised, concerning whether interest received by NAFI with federal and state tax refunds was unitary income subject to allocation, has been conceded by respondent and this concession will be reflected in the order. Hereinafter we will consider the facts, arguments and law connected with each remaining issue.

1.

On April 5, 1960, NAFI purchased all of the stock of Chris-Craft from the family of Chris Smith, founder of Chris-Craft. Approximately $28 million of the total purchase price of $40 million was to be paid by NAFI in installments beginning in 1961 and extending until 1965. Those installment payments were secured by NAFI's pledge in favor of the Smith family of all the stock which it held in Chris-Craft. At the time of its acquisition of Chris-Craft, NAFI anticipated that at some later date it would be necessary to refinance its obligation to the Smith family so as to extend payment over a longer period of time, in order to avoid the large cash drain that otherwise would occur under the terms of the purchase agreement.

In the spring of 1961 a tentative agreement was reached between NAFI and the Smith family that would permit NAFI to refinance its remaining $18 million obligation to the Smith family by paying $15 million in cash and $3 million in NAFI stock. At NAFI's request a New York investment banking firm contacted various banks and institutional lenders and was finally able to negotiate a loan of $15 million from a group of lenders headed by the Ford Foundation, Under the refinancing plan the lender's required that NAFI use the $15 million loan proceeds solely to satisfy NAFI's obligation to the Smith family, and that NAFI pledge its main asset, i.e., all of its stock in Chris-Craft, as security for the loan. In addition NAFI was required to grant the lenders warrants to purchase 75,000 shares of NAFI stock.

As a further condition of the loan the lenders required that Chris-Craft also be made a party to the transaction and that there be an enforceable obligation against both the subsidiary and NAFI. Tentatively the loan proceeds were to be paid directly to NAFI, In early September 1961, however, the lenders imposed the further condition that the loan proceeds be paid to Chris-Craft, and that Chris-Craft simultaneously transmit $15 million to NAFI. Although NAFI sought to have payment made directly to it, arguing that Chris-Craft was realizing no economic benefit from the refinancing, ultimately NAFI had to agree to the lenders* conditions in order to obtain the needed funds,

Consequently, as of early September 1961, it was the intent of all parties that Chris-Craft would receive the $15 million from the lenders and simultaneously would transmit the funds to NAFI in the form of an interest-bearing loan, with the same payment schedule as was provided in the promissory notes in favor of the lenders. On September 13, 1961, however, Michigan counsel for the lenders indicated they could not guarantee the validity of such an "upstream" loan by Chris-Craft, a Michigan corporation, because of certain limitations contained in the Michigan statutes. The lenders therefore required that the loan proceeds be paid to Chris-Craft and that the subsidiary simultaneously transmit the $15 million to NAF'I in the form of a dividend, (At the time Chris-Craft had some $16 million in earned surplus on its books,) The lenders prevailed, and the transaction ultimately was carried out on that basis,

On September 29, 1961, NAFI and the Smith family entered into a written agreement providing for NAFI's payment of $15 million in cash to the family and $3 million in NAFI common stock, in complete satisfaction of NAFI's debt to the Smith family. That agreement was expressly conditioned upon NAF'I being able to borrow $15 million from the lenders with which it was negotiating,

The various transactions were closed on October 10, 1961. Chris-Craft received a check for $15 million from the lenders, simultaneously deposited it in a special commercial account established solely for that purpose, and at the same moment delivered a previously prepared check made payable to NAFI for $15 million, which was drawn on the same special account. On its books Chris-Craft treated the payment to NAFI as a dividend. The lenders did not require NAFI to report receipt of the $15 million as a dividend, and in its financial statements and S.E.C. prospectuses NAFI reported that amount as a credit arising from refinancing.

Since the completion of the above transaction all payments of principal and interest have been made by NAFI directly to the lenders. NAFI has had to obtain funds from Chris-Craft in the form of taxable dividends in order to make the payments when due.

Respondent takes the position that the $15 million payment received by NAFI from Chris-Craft constitutes taxable dividend income. Appellant urges various reasons why that determination by respondent is erroneous.. First and foremost, appellant contends that the $15 million payment is not in substance a taxable dividend because it was merely a step in a single integrated transaction undertaken for the purpose of refinancing the obligations of NAFI to the former owners of Chris-Craft's capital stock.

It is an established principle of income tax law that the incidence of taxation depends upon the substance of a transaction, and courts will look through the form in order to determine what really took place. (Commissioner v. Court Holding Co. 324 U.S. 331 [89 L. Ed. 981]; Gregory v. Helvering, 293 U.S. 465 [79 L. Ed. 596].) The taxpayer as well as the government is entitled to the benefit of the rule that the substance rather than the form of a transaction controls. (Landa v. Commissioner, 206 F.2d 431; Robert N. Peterson, T.C. Memo., Jan. 28 1964.) Where there are a series of steps in the overall transaction, it is important to determine whether each step should be treated separately for tax purposes or whether the completed transaction is to be viewed as a whole, each step merely constituting an element of a unitary plan to achieve an intended result. (Kanawha Gas & Utilities Co. v. Commissioner, 214 F.2d 685.)

For a series of steps to be treated as a single transaction for tax purposes, it must appear that the entire series has been carried out in accordance with a prearranged plan and that they are in fact component steps of a single transaction. (ACF-Brill Motors Co. v. Commissioner, 189 F.2d 704.) Applying this standard to the facts before us, as they are evidenced by documents contained in the record, it is clear that NAFI's sole purpose, from beginning to end, was to borrow $15 million from outside sources in order to satisfy its obligation to the Smith family, thereby avoiding the prohibitive cash drain which otherwise would occur.

The integrated nature of the transaction is shown by the simultaneous transfer of funds from the institutional lenders to Chris-Craft, from Chris-Craft to NAFI, and from NAFI to the Smith family. This coincidence of steps was necessitated by the fact that the Chris-Craft stock pledged by NAFI as security for its indebtedness to the Smith family

had to be deposited with the institutional lenders as security for the $15 million loan, Furthermore Chris-Craft was never intended to bo the end recipient of the loan proceeds,, The entire loan was specifically designated for use in paying off NAFI's obligation to the Smith family.

NAFI's original desire for a direct loan of the amount which it needed for refinancing was frustrated by conditions imposed by the institutional lenders,, The ultimate form of the transaction was the result of those demands made by the lenders and, although NAFI objected, it was in no position to risk being deprived of the badly needed funds. Under comparable facts the United States Tax Court recently concluded that for tax purposes the substance of a transaction was controlling over its form, where the final form of the transaction was dictated by the financing bank. (Frank Ciaio, 47 T.C. 447.) There, as here, the attending facts and circumstances made the purpose of the transaction clear, although its form was misleading.

We conclude that Chris-Craft was acting solely as an agent or conduit for NAFI; that the transaction was intended to be, and in fact was, a loan of $15 million by the institutional lenders to NAFI; and that, accordingly, the distribution by Chris-Craft to NAFI under the guise of a dividend did not constitute a taxable dividend paid out of corporate profits, even though Chris-Craft had sufficient surplus earnings in 1961 to make such a distribution,

Because of these conclusions it will be unnecessary for us to consider the other contentions raised by NAFI relative to the $15 million distribution made by Chris-Craft.

2.

NAFI and its subsidiaries, including Chris-Craft filed consolidated federal income tax returns for 1961 and' subsequent years. They kept their books and reported tax on the accrual basis.

Chris-Craft orally agreed that beginning in 1961 it would accrue an amount equivalent to its federal income tax liability as a separate taxpayer, i.e., 52 percent of its taxable income. For the calendar year 1961 the amount' accrued was $2,239,000. This was shown on Chris-Craft's books as a liability owing to NAFI. Chris-Craft had sufficient surplus funds for a distribution of $2,239,000, and it reduced its surplus account by that amount. NAFI's books for 1961 showed the entire $2,239,000 as income from its subsidiary, Chris-Craft.

The amount accrued exceeded Chris-Craft's pro rata share of the actual consolidated federal income tax by $892,000. Respondent determined that that excess constituted a dividend to NAFI in 1961. NAFI disagrees, contending that the accrual bookkeeping entries were purely tentative and were subject to adjustment after federal auditors had determined NAFI's correct tax liability for 1961.

During 1961 NAFI's subsidiaries paid sums to NAFI which exceeded their actual federal income tax liability for 1960 by $37,431. Respondent determined that the $37,431 constituted dividend income to NAFI in 1961. NAFI argues that those payments by the subsidiaries in excess of their actual tax liability were not taxable as dividends since they merely constituted a "cushion" on NAFI's books to reflect Contingent federal tax liabilities of the subsidiaries,

With respect to the accrual of $892,000, respondent's regulations provide:

> A distribution made by a corporation to its shareholders shall be included in the gross income of the distributees when the cash or other property is unqualifiedly made subject to their demands. (Cal. Admin. Code, tit. 18, reg. 24451-24453(b).)

It has been held under federal law that this rule applies to accrual basis taxpayers as well as cash basis recipients. (American Light and Traction Co., 3 T.C. 1048, aff'd, 156 F.2d 398; Tar Products Corp. v. Commissioner, 130 F.2d 866.)

It is well settled under federal law that a charge to a corporation's surplus and a credit to a shareholder will give rise to a taxable dividend if the income is thereby made unqualifiedly subject to the shareholder's demand and withdrawal. (1 Mertens, Law of Federal Income Taxation, § 9.07.) Under those circumstances no formal declaration of a dividend is necessary. (Hadley v. missioner, 36 F.2d 543.) In the instant case the bookkeeping entries made by NAFI and Chris-Craft suffice to constitute a dividend if the income was thereby made unqualifiedly subject to the demands of NAFI. Therefore, that is the crucial inquiry.

Although it turned out that $892,000 of the total accrual was not needed to pay Chris-Craft's pro rata share of the group's consolidated federal income tax liability for 1961, if such additional amount had been necessary it clearly would have been forthcoming. Chris-Craft had sufficient surplus to make the full distribution. As the sole shareholder of

Chris-Craft, NAFI could have drawn that amount from Chris-Craft without restriction, In view of the bookkeeping entries which were made, the fact that sufficient surplus was available for the distribution, and NAFI's status as sole shareholder of Chris-Craft, we conclude that respondent properly treated the $892,000 as dividend income received by NAFI in 1961.

We also concur with respondent's characterization of the $37,431 received by NAFI from its subsidiaries in 1961 as dividend income. It appears that those amounts were received by NAFI during 1961 under claim of right, without any restriction on their disposition. Under very similar facts the United States Tax Court has held that such payments by subsidiaries in excess of their share of the consolidated federal income tax liability constituted taxable dividends to the parent company. (Beneficial Corp., 18 T.C. 396,. aff'd, 202 F.2d 150.)

3.

In 1953 NAFI purchased a parcel of unimproved real estate in Newark, California, for the specific purpose of erecting a manufacturing plant thereon for use by its automotive division. The property was located about twenty miles from NAFI's plant in Oakland, California, Without ever having made any use of the property, NAFI sold it in 1959 and treated the gain as unitary income subject to allocation. Respondent determined that the property had never become part of the unitary business operation and, accordingly, that the gain was nonunitary income allocable in full to California.

We ruled on a very similar situation in the 'Appeal of American President Lines, Ltd., Cal. St. Bd. of Equal., Jan. 5, 1961, where the appellant purchased land intending to build a terminal. Since no terminal was ever built and no other use made of the land, we ruled that the value of the land was properly excluded from the property factor of the allocation formula. By analogy, we do not believe the Newark property ever became part of NAFI's unitary business operation. It was never used in connection with NAFI's business and it apparently never contributed to the unitary income. Under the circumstances, we must conclude that respondent correctly determined that the gain from the sale of the Newark property was nonunitary income allocable in full to California.

4.

During the late 1930's NAFI acquired a plant in Oakland, -California, for housing the operations of its automotive division. In July 1958 the automotive division

made an intercorporate sale to NAFI's carpeting division of the automotive yarn-spinning operations. At the same time, 17.25 percent of the plant was leased to the carpet division. In January 1959 NAFI sold the Oakland plant and allocated the entire gain from the sale to the automotive division. Respondent determined that 17.25 percent ($4,262.50) of the gain should be allocated to the carpeting division.

NAFI contends that the entire gain is allocable to the automotive division on the ground that it was available for use by that division at all times. In support of that position, NAFI cites opinions of this board to the effect that property which is temporarily withdrawn from unitary use or is temporarily idle is still to be considered as unitary property. We do not believe those decisions are controlling in the instant case. Here, the property previously used by the automotive division was actively put to use by the carpeting division and, therefore, we do not have a temporary nonuse situation comparable to those found in the earlier cases cited by appellant. Upon consideration of the arguments made by the parties and in view of the fact that 17.25 percent of the plant was being used at the time of the sale by the carpeting division, we find no basis for disturbing respondent's determination that that percentage of the gain should be allocated to that division.

## ORDER

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 protests of Chris-Craft Industries, Inc., against proposed assessments of additional franchise tax in the amounts of $11,052.03 and $853,118.11 for the income years 1959 and 1961, respectively, be reversed with respect to the $15 million payment received from its subsidiary, and that it be reversed in accordance with the concession of the Franchise Tax Board by treating interest received with federal and state income tax refunds as nonunitary income. In all other respects, the action of the Franchise Tax Board is hereby sustained.

Done at Sacramento, California, this 26th day of March, 1968, by the State Board of Equalization,

_____, Chairman

_____, Member

_____, Member

_____, Member

_____, Member

ATTEST: _____, Secretary