BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of' the Appeal of)
)
3M BUSINESS PRODUCTS SALES, INCORPORATED,)
FORMERLY THERMO-FAX SALES, INCORPORATED)

Appearances:

For Appellant: W. R. Spangler
Certified Public Accountant

For Respondent: Robert S. Shelburne
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 Franchlae Tax Board on the protest of 3M Business Products Sales, Incorporated, formerly Thermo-Fax Sales, Incorporated, against a proposed assessment of additional franchise tax In the amount of $33,817.05 for the Income year 1961.

Thermo-Fax Sales, Incorporated, (hereafter referred to as appellant) was formed In 1955 under the laws of Delaware, and is a wholly owned subsidiary of Minnesota Mining and Manufacturing Company. In 1961 a plan was formulated to enable appellant to acquire the business of Thermo-Fax Sales of Los Angeles, Incorporated (hereafter referred to as Thermo-Fax), which wae engaged in the distribution of Minnesota Mining and Manufacturing Company products. On December 6, 1961, an officer of appellant and Norman A. Kramer, the president and sole shareholder of Thermo-Fax. entered Into a contract which formalized the acquisition transaction deacrlbed hereinafter.

Appellant obtained from its parent 16,996 shares of that corporation's stock. Appellant states that these shares were worth $1,139,784 and that the Minnesota Mining and Manufacturing Company's total stock numbered approximately 52 million shares. On December 30, 1961, appellant transferred the above 16,996 shares to Thermo-Fax in exchange for all of that corporation's assets. Appellant assumed various liabilities of Thermc-Fax and continued the operation of that company's former business. On March 7,1962, Thermo-Fax was dissolved and the 16,996 shares of stock In Minnesota Mining and Manufacturing Company was distributed to Mr. Kramer. In 1965 appellant's name was changed to 3M Business Products Sales, Incorporated.

The Franchise Tax Board determined that the above transaction was a reorganization in the form of a merger under subdivision (c) of section 23251 of the Revenue and Taxation Code. Therefore that board Included the $535,454.57 net Income realized by Thermo-Fax during 1961 In the measure of appellant'8 tax for'the taxable year 1962. Whether such a reorganization In fact occurred is the sole Issue of this appeal.

Section 23253 of the Revenue and Taxation Code provides In part:

> Where, pursuant to a reorganization, all or a substantial portion of the business or property of a taxpayer, a party to the reorganization, is transferred to another taxpayer, a party to the reorganization:
>
> (a) The net gain of the transferor from the business or property so transferred to any taxpayer for the taxable year In which the transfer occurs, shall be included In the measure of the tax on the transferee for the taxable year succeeding the taxable year In which the transfer occurs....

Section 23251 defines "reorganization" and Includes, In subdivision (c), "a merger or consolidation." The primary requisite of a merger is that the former owners of the merged corporation must have retained a contlnu- ing proprietary Interest *In* the transferee corporation

which was definite and substantial and represented a material part of the value of the thing transferred. (Heating Equipment Mfg. Co. v. Franchise Tax Board, 228 Cal. App. 2d 290 [39 Cal. Eptr. 453].)

Appellant contends that a merger did not occur because the Indirect Interest which Thermo-Fax's former shareholder retained In appellant, by virtue of his ownership of Its parent's stock, does not qualify as a definite, substantial, and material; continuing interest. Appellant states that the Appeal of Meyenberg-Old Fashion Products Co., Cal. St. Bd. of Equal., decided October 1, 1963, supports this contention.

In the recent Appeal of Western Butane Service, Inc., Cal. St. Bd of Equal., decided August 5, 1968 this board considered a transaction very similar to those Involved In the Instant case and the Meyenberg appeal, supra. We stated In part:

> The predecessors of the present reorganization sections were enacted In 1933 to remedy a considerable inequity In the Bank and Corporation Franchise Tax Law. As stated by Roger J. Traynor and Frank M. Keesling In "Recent Changes in the Bank and Corporation Franchise Tax Act," 23 Cal. L. Rev. 51,62:
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> > Until the 1933 amendments, the Act made no provision for reorganizations, consolidations, and mergers. Banks or corporations dissolving or withdrawing from the state In any year, even when pursuant to a reorganization, consolidation or merger, obtained an abatement or refund of the tax for that year measured by the net income for the preceding year. As a result a portion of the income for the preceding year escaped taxation; likewise the net Income for the months of the year in which dissolution or withdrawal occurred did not become the measure of any tax imposed by the Act. A bank or corporation which came Into existence through reorganization or consolidation was considered as a commencing bank or corporation, and Its tax liability for its first and second taxable years was

> computed on that basis. Thus, a change In the corporate structure of a business sufficed to change considerably the amount of taxes due.

Sections 23253 and 23332 of the Revenue and Taxation Code presently remedy this Inequity.... However, this remedy only operates when a transaction can be first classified as a reorganization, With this In mind the court in San Joaquin Ginning Co. v. McColgan, 20 Cal. 2d 254,259, 260, stated:

> The rule to be applied in the interpretatlon of the terms reorganization, merger and consolidation in relation to exemptlona, abatements and refunds In the taxing provisions is the rule of liberal construction. And the language is language of exemption even though a portion thereof partake8 of the form of a taxing provlslon.... Also, in conformity with the legislative purpose, conoolldatlon *or* merger as a form of reorganization is not restricted to statutory consolidation or merger in the absence of appropriate language of limitation.

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Respondent contends that the Appeal of Meyenberg-Old Fashion Products Company, Cal. St. Bd. of Equal., Oct. 1, 1953 is controlling in the instant situation. In Meyenberg, this board held that a merger had not occurred and stated:

> In order to establish that a merger occurred within the meaning which concerns us here It must be shown that Meyenberg, the former owner of a portion of the assets and the former stockholder of Old Fashion which owned the balance of the assets, retained a definite and material continuing interest in the transferred aesets. (Cases cited.) The indirect Interest retained by Meyenberg, as the owner of part of the stock of Starrett, which in turn owned the stock of Appeliant, the ultimate owner of the assets, does *not* qualify (Groman v. Commissioner, 302 U.S. 82 [82 L. Ed. 63];

Bashford v. Commissioner, 302 U.S. 454 [78 L. Ed. 367]....

We do not believe that the distinction drawn in Meyenberg between direct and indirect interests is valid. The Groman and Bashford cases, cited as authority for the Meyenberg decision, have been criticized because of their [illegible] limitation upon the use of subsidiary corporations in reorganizations. (See Traynor, "Tax Decisions of the Supreme Court, 1937 Term," 33 Ill. L. Rev. 371, 389.) Both Groman and Bashford dealt with the recognition of gain or loss under a predecessor of the present section 368 of the Internal Revenue Code. With respect to transactions after December 31, 1963, section 368 was amended to reverse, in effect, the holdings in these cases.

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The Meyenberg declalon has had the unforeseen effect of allowing a taxpayer to choose whether, or not a transaction will be classified as a reorganization. That Is, through the creation of a wholly-owned subsidiary corporation to receive the transferred assets, the taxpayer could avoid reorganization status. In certain situations under section 23251 this option can have considerable tax effect. Such an option is neither warranted under the statute nor desirable.

We conclude that under a liberal construction of the organization [sic] statute a Continuing, Indirect proprietory interest, like that presented In the instant case, is sufficiently definite, substantial and material. Therefore, *we* hold that the subject transaction was a merger under section 23251(c) of the Revenue and Taxation Code. Any language to the contrary in Appeal of Meyenberg-Old Fashion Products Company, supra, Cal. St. Bd. of Equal., Oct. 1, 1963, will *not* be followed.

Appellant contends that the instant transaction and the Meyenberg case, supra, can be distinguished from the Western Butane appeal, supra, on the ground that in the latter case the assets of the merged corporation were

initially transferred to the parent company, and at that point the former shareholders of the merged corporation did have a direct continuing proprietary Interest In the transferee corporation. Appellant argues that such a distinction should be made because the legislative history of section 23251 demonstrates that the Instant transaction was not intended to be a reorganization. According to appellant, section 23251 was patterned after the federal reorganization provision relating to the nonrecognition of gain or loss, and the latter statute had to be amended In 1954 in order for the present type of transaction to be included within the definition of reorganization. However section 23251 was not similarly amended and therefore, appellant argues, It was the implied Intention of the California Legislature to exclude the Instant transaction from the scope of this provision.

Appellant's contention, which distinguishes the Meyenberg and Instant appeals from the Weatern Butane situation, requires that the final step In the latter cane be ignored. However we think that the parent company's immediate distribution of the assets to Its newly formed subsidiary was an Integral part of the reorganization transaction, and therefore this step must be given effect. (Walter S. Heller, 2 T.C. 371, aff'd, 147 F.2d 376, cert. denied 325 U.S. 668 [89 L. Ed. 1987].) Also, as stated in the Appeal of Western Butane Service, Inc., supra, Cal. St. Bd. of Equal., decided August 5 1968, this type of distinction would allow a taxpayer: through an insignificant variation of the form of a transaction, to avoid the tax consequences resulting from reorganization statua.

Appellant's argument concerning the scope of section 23251, as Intended by the Legislature, is very similar to a contention made in Heating Equipment Manufacturing Company v. Franchise Tax Board, supra, 228 Cal. App. 2d 290 [39 Cal. Rptr. 453]. In that case that taxpayer urged a comparison of section 23251 with section 24562 of the Revenue and Taxation Code, which is the California provision defining reorganization for nonrecognition of gain and loss purposes, and which has closely followed the atatutory evolution of Its federal counterpart. The District Court of Appeal rejected this comparison and stated *In* part:

> ... the above sections set forth two separate" definitions of "reorganization" for two

> different tax purposes . . . while both sections may have had their genesis In the same federal legislation, It seems obvious from a comparison of them that California followed a legislative eclecticism In constructing an appropriate yardstick In each case and thus not providing for a uniform statutory result. We do not find the general coincidence between them that plaintiff claims to exist nor such an Identity prevailing In respects other than that singled' out a8 to compel the conclusion that the type of transaction here present was purposely withheld from the operation of section 23251. (Heating Equipment Mfg. Co. v. Franchise=T& Board, supra, 228 Cal. App. 2d 290, 309, 310 [39 Cal. Rptr. 453].)

We think that the District Court of Appeal's reasoning applies to, and Invalidates, the statutory comparison proposed by appellant.

We conclude that the Instant case is controlled by our decision In the Appeal of Western Butane Service, Inc., supra, Cal. St. Bd. of Equal., decided August 5, 1968. Therefore the transaction in question was a reorganization under subdivision (c) of section 23251, and appellant's tax liability must be computed accordingly.

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 3M Business Products Sales, Incorporated, formerly Therxno-Fax Sales, Incorporated, against

a proposed assessment of additional franchise tax In the amount of $33,817.05 for the income year 1961, be and the same is hereby sustained.

Done at Sacramento, California, this 18th day of February, 1970, by the State Board of Equalization.

, Member

, Member

, Member

, Chairman

Attest: , Secretary