BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
ADMIRAL BUILDING COMPANY)

Appearances:

For Appellant: Douglas W. Argue
Attorney at Law

For Respondent: John D. Schell
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 Admiral Building Company against a proposed assessment of additional franchise tax in the amount of $38,410.50 for the taxable year ended June 30, 1967.

Appellant Admiral Building Company was a California corporation engaged in the real estate business. During the year in question, appellant's primary activity consisted of making collections on installment obligations arising from prior sales of real property in the area of La Canada, California. Frior to the stock purchase transaction to be described hereinafter, the estate of M. P. Flynn owned 40 percent of appellant's common stock and M. P. Flynn's three sons owned the remaining 60 percent.

Club Operating Company (Club), also a California corporation, was engaged in the business of country club management. On June 30, 1966, Club purchased all of appellant's common and preferred stock from the Flynn estate and Flynn's sons, the consideration consisting solely of cash. The purchases were made pursuant to

agreements for sale which contemplated that appellant would be liquidated. Accordingly, Club's board of directors met on June 30, 1966, and formally adopted a "plan of liquidation" which called for the complete redemption and cancellation of all of appellant's stock in exchange for the transfer to Club of all of appellant's assets. The plan further provided that this transaction was to be accomplished by means of a merger under Corporations Code section 4124.

On March 31, 1967, appellant was liquidated according to the liquidation plan and all of its assets were transferred to Club. Included among these assets were installment obligations having an unpaid principal balance of $1,101,702.63 and containing $700,986.07 in unreported income. Respondent determined that the unreported installment income was includible in the measure of the tax for the taxable year ended June 30, 1967, the last year in which appellant was subject to the franchise tax. Whether the reporting of any of this installment income should have been accelerated and, if so, in what year it should have been reported are the issues presented by this appeal.

The basic section involved in this case is Revenue and Taxation Code section 24672, which provides in pertinent part as follows:

> 24672. (a) Where a taxpayer elects to report income arising from the sale or other disposition of property ... [on the installment basis], and the entire income therefrom has not been reported prior to the year that the taxpayer ceases to be subject to the tax measured by net income imposed under Chapter 2 or Chapter 3 of this part, the unreported income shall be included in the measure of the tax for the last year in which the taxpayer is subject to the tax measured by net income imposed under Chapter 2 or Chapter 3 of this part.... This section shall not be applicable where the installment obligation is transferred pursuant to a reorganization as defined in Sections 24562 and 24563 to another taxpayer a party to the reorganization subject to tax under the same chapter as the transferor,...

A companion section also involved is section 24670, which provides:

> 24670. (a) If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and --
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> * * *
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> (2) The fair market value of the obligation at the time of the distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.
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> (b) The basis of an installment obligation shall be the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

Appellant 's first contention is that, since the installment obligations were transferred to Club in a merger under Corporations Code section 4124, they were transferred pursuant to a "statutory merger" within the meaning of Revenue and Taxation Code section 24562, subdivision (a) (1) and, hence, section 24672 by its own terms does not apply. From the proposition that section 24672 is inapplicable, appellant jumps to the unwarranted conclusion that no gain is recognizable to it on the transfer of the obligations to Club and that Club's basis in the obligations is the same as appellant's. Nothing in section 24672 permits such a conclusion, nor does anything contained in section 24562. This latter section defines the term "reorganization" for purposes of nonrecognition of gain or loss but does not itself provide for such nonrecognition or for the transferee's basis in the transferred assets. We need not pursue this matter, however, because we agree with respondent that there was no reorganization in this case and that section 24672 thus does apply.

Respondent contends, and we agree, that this transaction was not a section 24562 reorganization

because it lacked the requisite continuity of interest on the part of the transferor or its shareholders in the properties transferred. (Cal. Admin. Code, tit. 18, reg. 24562-24564(b), subd. (1); Cortland Specialty Co. v. Commissioner, 60 F.2d 937, cert. denied, 288 U.S. 599 [77 L. Ed. 975]; Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 [77 L. Ed. 428].) Continuity was lacking because the Flynns sold out entirely for cash and thus retained no continuing proprietary interest in appellant's business or assets. Appellant argues that continuity was present because Club owned all of appellant's stock immediately prior to the merger transaction and thereafter owned all of appellant's assets directly. It is clear, however, that this is not enough to satisfy the continuity of interest requirement or to establish the existence of a reorganization. (Warner Co., 26 B.T.A. 1225, 1227; Prairie Oil & Gas Co. v. Motter, 66 F.2d 309.)

Given our conclusion that section 24672 is applicable, the next question is the amount of "unreported income" which that section requires to be included in the measure of the tax for appellant's last taxable year. Respondent's proposed assessment was based on the theory that appellant is required to include in its last return all of the income which would ultimately be returnable were the installment obligations to be satisfied in full. However, in prior appeals we have held that where, as here, a dissolving corporation distributes installment obligations in the taxable year to which section 24672 is being applied, Revenue and Taxation Code section 24670 must be applied to limit section 24672 "unreported income" to the difference between the fair market value of the obligations at the time of distribution and the taxpayer's basis in those obligations. (Appeal of Contractors Investment Co., Inc., Cal. St. Bd. of Equal., Jan. 5, 1961; Appeal of Pioneer Development Co., Inc., Cal. St. Bd. of Equal., Jan. 5, 1961.) In light of these decisions, respondent conceded at the hearing that the assessment should be adjusted to reflect the fair market value of the distributed obligations, which the parties agree is $605,936.45.

Finally, appellant argues that even if there is income arising from the application of section 24672, that income is taxable on Club's return for the taxable year succeeding the merger transaction. This result follows, says appellant, because the merger was a "reorganization" under section 23251, subdivision (c)

of the Revenue and Taxation Code, thus bringing section 23253, subdivision (a) into operation. While there will be cases in which sections 24672 and 23253 will have to be reconciled, this is not such a case because there was no reorganization within the meaning of section 23251. We agree with respondent that the "merger" of appellant and Club was, in reality, a complete liquidation of a controlled subsidiary to which Revenue and Taxation Code sections 24502 and 24504, subdivision (b)(2) apply, better known as a Kimbell-Diamond liquidation. Section 23251, subdivision (d) specifically excludes section 24504, subdivision (b)(2) distributions from the definition of "reorganization" contained in section 23251. Appellant seeks to evade this result by arguing that there was a "merger" within the meaning of section 23251, subdivision (c), and that the transaction's failure also to qualify as a 23251, subdivision (d) reorganization is of no consequence. However, since nothing in 23251's companion sections turns on whether the transaction is a section 23251, subdivision (a), (b), (c), or (d) type reorganization, we are convinced that the Legislature intended to exclude Kimbell-Diamond liquidation distributions from the whole of section 23251 and not just from subsection (d) of that section.

Appellant misplaces its great reliance on Corporations Code section 4124 to establish that this transaction was a merger, not a liquidation. Revenue and Taxation Code section 24502, subdivision (b) provides that a distribution in complete liquidation within the meaning of that section shall not be considered not to constitute such a distribution merely because it does not constitute a distribution or liquidation within the meaning of the corporate law under which the distribution is made. There is no doubt whatever that the distribution of appellant's assets to Club was a distribution in complete liquidation within the meaning of section 24502, subdivision (b).

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 Admiral Building Company against a proposed assessment of additional franchise tax in the amount of $38,410.50 for the taxable year ended June 30, 1967, be and the same is hereby modified in accordance with respondent's concession. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 22nd day of March, 1971, by the State Board of Equalization.

_______________, Chairman

_______________, Member

_______________, Member

_______________, Member

_______________, Member

ATTEST: _______________, Secretary