

Appeal of Milton K. and Irene T. Harwood

This appeal presents three questions arising out of appellants' sale of all the stock in their wholly-owned corporation. The issues are: (1) whether certain cancelled accounts receivable constituted constructive dividends; (2) whether a loss claimed in 1972 representing the amount of uncollectible accounts receivable assigned back to appellants by the purchaser was properly denied; and (3) whether the basis of appellants' stock was properly computed.

Initially, there were two additional issues involving another constructive dividend and the proper depreciable life of a building owned by appellants. Appellants now concede the propriety of respondent's determination with respect to these issues.

In 1953 Milton K. Harwood (appellant) purchased one-half of the capital stock of Holbrook Refrigeration, Inc. (Holbrook) for \$20,500. In 1959 he acquired the remaining one-half of the stock for \$25,500. Holbrook is a California corporation engaged in the business of selling and installing air conditioning and refrigeration units. On June 9, 1971, appellant entered into an installment sale agreement whereby he agreed to sell his Holbrook stock to American Building Maintenance Industries (ABMI) for a stated purchase price of **\$150,000.00**. In that agreement it was provided that appellant guaranteed payment of all accounts receivable on Holbrook's books at the closing date and, to the extent such receivables were uncollected by a specified date, they would be assigned to appellant and the purchase price of the Holbrook stock reduced accordingly. The agreement also stated that two accounts receivable had been removed from the assets shown on **Holbrook's** balance sheet of February 28, 1971. One account was due from appellant in the amount of **\$4,363.00**, and the other account was due from Compressor Parts and Repair, Inc. (Compressor), a corporation wholly owned by appellant, in the amount of **\$61,775.19**.

In his 1971 personal income tax **return**, appellant reported that he sold the Holbrook stock for a total price of **\$216,138.00**. This amount consisted of the **\$150,000.00** purchase price stated in the agreement plus the two accounts receivable cancelled which **totalled \$66,138.00** when rounded to the nearest dollar. Appellant treated the gain from the sale as a long-term capital gain, contending that the cancelled accounts

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receivable were part of the total consideration paid by **ABMI** for his Holbrook stock. Respondent maintains that the selling price of the stock was **\$150,000.00** as stated in the contract, and that the cancelled accounts receivable constituted constructive dividends taxable to appellant as ordinary income.

On July 12, 1972, Holbrook assigned back to appellant accounts receivable **totalling \$14,153.14**. Based upon information submitted by appellant, **\$3,494.84** of those accounts receivable remained uncollectible. Appellant argues that, in accordance with the sales agreement, the sales price of the Holbrook stock should be reduced and a loss allowed in the amount of the uncollectible accounts. Respondent has offered neither argument nor authority in opposition to appellant's position.

In computing his gain from the sale of the Holbrook stock, appellant used a basis of **\$108,000.00**. This amount was determined by adding to the **\$46,000.00** original purchase price of the stock the sum of **\$62,000.00**, which appellant alleges represented the amount of Holbrook debts he personally paid in 1960 on behalf of the corporation. Respondent reduced the basis of **appellant's Holbrook** stock to **\$46,000.00** on the grounds that he had failed to substantiate his payment of **Holbrook's** debts. This action resulted in an increase in appellant's taxable gain.

The first issue is whether the two cancelled accounts receivable from appellant and his wholly owned corporation constituted constructive dividends. A dividend is any distribution of property, including the cancellation of an indebtedness, made by a corporation to its shareholders out of earnings and profits. (Rev. & Tax. Code, § 17381; Cal. Admin. Code, tit. 18, reg. 17321-17324, subd. (i).) In determining whether a corporate distribution constitutes a constructive dividend, the crucial question is whether the corporation conferred an economic benefit on the shareholder without expectation of repayment. (See, e.g., United States v. Smith, 418 **F.2d** 589, 593 (5th Cir. 1969).) It is well settled that corporate payments in discharge of a **shareholder's** personal debts and liabilities are in the nature of a constructive dividend. (See United States v. Smith, supra; Sam E. Wilson, Jr., 27 T.C. 976 (1957).)

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The sales **agreement**, which states that it contains the entire agreement between the parties, specifically provides for a purchase price of **\$150,000.00** which does not include the accounts receivable. **Addi-** tionally, that portion of the agreement pertaining to how the purchase price was to be paid does not mention the receivables. More importantly, the agreement clearly indicates that the removal of the receivables from Holbrook's balance sheet occurred prior to the sale of the stock to ABMI. Thus, it is apparent from the language of the agreement that the parties did not contemplate that the cancelled receivables would be part of the purchase price. Therefore, in line with the authority cited above, it would appear that the cancellation of indebtedness by Holbrook constituted a constructive dividend taxable as ordinary income to appellant.

In opposition to this conclusion, appellant maintains that the cancellation of indebtedness by **ABMI** as the owner of Holbrook was part of the purchase price. To support this contention appellant submitted a copy of an inter-office memorandum prepared by the selling agent indicating that the agent believed the purchase price included the cancelled indebtedness. According to appellant, the economic substance of the sales transaction, which for tax purposes is controlling, was not consistent with the economic form of the transaction as evidenced by the purchase agreement. (See Casner v. Commissioner, **450 F.2d** 379 (5th Cir. 1971).)

We have no **quarrel** with the principle of Casner relied on by appellant to the effect that tax consequences should be determined by a transaction's economic substance and not by its form. However, we believe that in both form and substance the distributions in question represent dividends. Initially, we note that, contrary to appellant's assertion, the clear language of the sales agreement states that when the accounts receivable were cancelled it was appellant, not ABMI, who owned and controlled the stock of Holbrook. The agreement also states that the cancellation occurred prior to the sale. Thus, appellant's assertion that at the time of the cancellation he was no longer a shareholder of Holbrook and, therefore, not entitled to a dividend from that corporation is without any factual support. Additionally, there was no mention of the receivables in the portion of the agreement dealing

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with how the purchase price was to be paid, Furthermore, we attach little significance to the memorandum between the agents suggesting that the purchase price upon which their commission was based was **\$216,138.00**, when the written agreement stated that the purchase price was **\$150,000.00**. Finally, appellant admitted that his commission was ultimately computed on the **\$150,000.00** figure, not **\$216,138.00**. **It** is our conclusion that appellant is simply unable to establish that the economic substance of the transaction was other than that set forth in the agreement between the parties.

Appellant also argues that the cancellation by Holbrook of the accounts receivable from his wholly owned corporation, Compressor, would not be dividend income to him even if not considered part of the purchase price. As we have indicated, the crucial concept in finding a constructive dividend is whether the corporation, Holbrook, conferred an economic benefit on the stockholder, appellant, without expectation of repayment. In this appeal, Compressor treated the cancellation of its indebtedness by Holbrook as an increase to its **earned** surplus and later applied the same amount to reduce an indebtedness appellant owed to it. This transaction is no different than Holbrook distributing a dividend to appellant out of its earnings and profits followed by appellant paying his indebtedness to Compressor in the same amount, **Holbrook's** cancellation of Compressor's indebtedness followed by Compressor's cancellation of appellant's indebtedness to it in the same amount had the net effect of Holbrook conferring an economic benefit upon appellant in the amount of the debt cancelled.

For the reasons set out **above**, we conclude that respondent properly treated the cancelled accounts receivable as constructive dividends taxable as ordinary income to appellant.

The next issue is whether a loss claimed in 1972 representing the amount of uncollectible accounts receivable assigned back to appellant by the purchaser was properly denied. As previously indicated, pursuant to the sales agreement, during 1972 **ABMI** assigned back to appellant those accounts receivable which remained uncollected 12 months after the closing date. Appellant was able to collect certain of these accounts

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and reported the uncollected portion as a loss on his 1972 return. Although respondent initially disallowed the loss for failure of proof, in view of the documentation submitted by appellant, it now offers no argument against such treatment. Accordingly; we conclude that respondent's action in this respect must be reversed.

The final issue is whether the basis of appellant's stock was properly computed. As indicated, appellant increased the basis of his Holbrook stock by **\$62,000.00**. According to appellant, this figure represents the amount of Holbrook debts he personally paid in 1960. Respondent reduced the basis of the stock by this amount on the grounds that appellant failed to substantiate that he paid the debts. Respondent's determination of basis is presumptively correct and appellant has the burden of proving that he is entitled to a higher basis. (Appeal of Evelyn I. Tingley, Cal. St. Bd. of Equal., April 5, 1976; Appeal of Florence L. Cuddy, Cal. St. Bd. of Equal., May 12, 1965.)

Appellant testified that in 1960 Holbrook was indebted to four suppliers in the total amount of **\$62,000.00**, and that this indebtedness impaired the financial integrity of the corporation. According to appellant, he borrowed this sum from relatives and personally satisfied Holbrook's indebtedness. However, appellant was unable to establish that the loans were made or, if they were, that the sums borrowed were used to extinguish Holbrook's debts. Appellant failed to produce any notes, cancelled checks or other documentation which should have been available, even at this late date, to evidence a transaction of this magnitude. Employees of two of Holbrook's creditors testified that, during 1960, Holbrook was indebted to their companies and that such debts were paid. **However**, these witnesses were unable to specify the amounts of the indebtedness or who paid them.

Since appellant has failed to establish the precise amount of the alleged **debts or** that he paid them, we cannot conclude that he has established his entitlement to a basis higher than that allowed by respondent.

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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 protest of Milton **K.** and Irene' **T.** Harwood against a proposed assessment of additional personal income tax in the amount of **\$6,890.10** for the year 1971, be and the same is hereby sustained; and that the action of the Franchise Tax Board on the protest of Milton **K.** and Irene T. Harwood against a proposed assessment **of** additional personal income tax in the amount of \$777.30 for the year 1972, be and the same is hereby reversed.

Done at Sacramento, California, this 30th day of June , 1980, by the State Board of Equalization.

, Chairman
 , Member
 , Member
 , Member
 , Member

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The first two paragraphs on the second page of the opinion are deleted and replaced with:

This appeal presents two questions arising out of appellants' sale of all the stock in their wholly-owned corporation. The issues are: (1) whether certain cancelled accounts receivable constituted constructive dividends; and (2) whether the basis of appellants' stock was properly computed.

Initially, there **were** two additional issues involving another constructive dividend and the proper depreciable life of a building owned by appellants. Appellants now concede the propriety of respondent's determination with respect to these issues. Since the sole issue for 1972, involving the proper depreciable life of appellants' building, has been conceded, respondent's action for that year must be sustained.

The first full paragraph on page three of the opinion beginning with: "On July 12, 1972, ..." is deleted.

The last paragraph commencing on page five and ending on page six of the opinion beginning with: "The next issue ..." is deleted.

The order of June 30, 1980, **is modified** to read as follows:

