BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
BAINGO BROTHERS, INC.)

For Appellant: Israel Levy
Attorney at Law

For Respondent: Bruce W. Walker
Chief Counsel

Jean Harrison Ogrod
Counsel

O P I N I O N

This appeal is made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Baingo Brothers, Inc. against a proposed assessment of additional franchise tax in the amount of **$1,463.00** for the income year ended October 31, 1972.

Appeal of Baingo Brothers, Inc.

The issue presented by this appeal is whether appellant has established that certain stock which it owned became worthless during appellant's income year ended October 31, 1972, so as to be deductible as a loss in that year.

Appellant is a California corporation owned by two brothers, Leroy and Russell Baingo. Its fiscal year ends October 31. In late 1969 and early 1970, appellant paid for certain stock of United International Corporation (United); an Arizona-corporation engaged in the business of acquiring small businesses. The stock was issued in the names of the two brothers, who allegedly gave appellant a $19,500 "receivable" in return for its payment for the stock. In October 1971, the receivable was apparently returned to the Baingo brothers and the United stock was reissued in appellant's name,

Appellant states that United had a deficit of $135,454 at the time the stock was issued to the brothers. An unaudited financial statement showed a deficit of $148,618 as of December 31, 1970. On December 28, 1970, United's board of directors declared a stock dividend of one share of Mt. Union Industries, Inc. (Mt. Union) for each two shares of United owned as of that date. The Mt. Union stock distributed apparently constituted the major asset of United, There is evidence in the record indicating that, due to restrictions on the Mt. Union stock, it had no value at the time of its distribution. It appears that no business was conducted by United after the declaration of the stock dividend except for the distribution of its assets, which was not completed until approximately June, 1972. No franchise fees were paid by United to the State of Arizona in either 1971 or 1972. United's right to do business was terminated and its articles of incorporation were revoked by that state on December 26, 1972.

Appellant claimed a $19,500 worthless stock deduction on its California franchise tax return for the income year ended October 31, 1972. After an audit, respondent concluded that there was insufficient evidence to establish that the. stock became worthless in the year claimed. A notice of proposed assessment was issued, disallowing the deduction. Appellant protested, a hearing was held, and respondent then affirmed its action. This timely appeal followed.

A loss from a security which becomes worthless during the income year is deductible, if not compensated for by insurance or. otherwise, under Revenue and Taxation Code section 24347, subdivision (d). A deduction is allowed only for the income year in which the loss is sustained, as evidenced by closed and completed transactions and fixed by identifiable events occurring in that income year. (Cal. Admin. Code, tit. 18, reg. 24347, subd. (a)(2).) The worthless stock provisions of section 24347 are essentially the same as those of Internal Revenue Code section 165, so federal case law on this subject is highly persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

The-parties seem to agree that appellant's United stock became worthless, but they disagree as to the year in which this occurred. It is well settled that the taxpayer bears the burden of showing that the stock became worthless in'the year for which the deduction is claimed. (Boehm v. Commissioner, 326 U.S. 287, 294 [90 L.Ed. 78] (1945); Appeal of Medical Arts Prescription Pharmacy, Inc., Cal. St. Bd. of Equal., June 13, 1974.) To meet this burden, appellant herein must show both that the stock had value at the beginning of its income year ended October 31, 1972, and that some identifiable event occurred in that year which rendered it worthless by the end of that year. (Appeal of Medical Arts Prescription Pharmacy, Inc., supra.) Respondent contends appellant has failed to show either.

In an effort to establish that United's stock had value at the beginning of and during the year in question, appellant contends that United's accumulated deficit was a valuable asset from the time the stock was acquired by the two brothers until all hope was abandoned of selling the corporation to a company which could take advantage of the losses. Appellant urges that such hope existed on November 1, 1971, and was abandoned during its fiscal year ended October 31, 1972, as evidenced by a letter from United's vice president, dated November 28, 1972, indicating that United would not contest the involuntary termination of -United's right to do business in Arizona.

We believe appellant's argument that the stock had value at the beginning of its 1972 'fiscal year because of United's salable accumulated deficit must fall on two counts. First, appellant has presented no

evidence to show that United in fact made any attempt to market its alleged salable deficit. Secondly, as was, pointed out in Textron, Inc. v. United States, 418 F.Supp. 39, 45 (D.R.I. 1976), affd., 561 F.2d 1023 (1st Cir. 1977), loss carryovers do not "provide 'value' where none otherwise exists." In that case, the government argued that the possibility of loss carryover gave value to the otherwise worthless stock of Hawaiian Textron, Inc. The court concluded that existence of the loss carryovers did not give the stock any market value, where the corporation had essentially no assets and no longer did business. Any advantageous use of such a corporation's net operating loss carryovers by a new owner is precluded by sections 269 and 382(a) of the Internal Revenue Code. Therefore, both the District Court and the Court of Appeals in the Textron case found that the existence of such operating loss carryovers could not create any value in the stock of such 'a corporation.

We believe that value did not otherwise exist in appellant's United stock on November 1, 1971, and therefore appellant cannot rely on the existence of a large deficit to give it value. The only evidence presented regarding the value of United's stock at approximately the beginning of appellant's 1972 fiscal year is the October 1971 reissuance of United's stock in appellant's name in exchange for the return to appellant's stockholders of a receivable purportedly worth $19,500. It is true that a contemporaneous sale may be evidence of value. (See, e.g., C. A. Goding, 34 B.T.A. 201 (1936).) However, "[t]ransactions between a closely held corporation and its stockholders are subject to careful scrutiny because of the absence of the adversary element usually present in financial transactions." (Appeal of Bright View Realty Corporation, Cal. St. Bd. of Equal., Feb. 18, 1954.) Here, the corporation originally paid for the United shares, but they were issued in the names of the corporation's shareholders. In return, the shareholders apparently gave the corporation an instrument described simply as a "receivable." There is no evidence of the nature of this instrument or its actual value. It appears that the corporation never collected any part of the receivable's alleged value during the time it was held. In October 1971 the corporation received the shares for which it had previously paid. On these facts, we cannot say that this transaction is the type of "sale" which would be persuasive in determining that the stock had value on November 1, 1971.

Furthermore, we believe that the evidence supports respondent's contention that United's stock was worthless before the commencement of appellant's 1972 fiscal year. United had a large accumulated deficit at the time the brothers purchased the stock in late 1969 and early 1970. This deficit apparently continued to grow, as indicated by the December 31, 1970, financial, statement. The Mt. Union stock is described as United's only or major asset as of December 28, 1970, when the board of directors voted to distribute it as a stock dividend, and it was apparently worthless at that time. This asset was in the process of being distributed even before November 1, 1971. No business was done nor franchise fees paid after December, 1970. No one of these factors alone is conclusive, but together they are a strong indication that United's stock was, for all practical purposes, worthless as early as December 1970, at least ten months before the beginning of the income year in issue.

Assuming, arguendo, that appellant had established that its United stock had value as of November 1, 1971, it would still have to show that some identifiable event occurred between that date and October 31, 1972, which rendered the stock worthless., In this regard, appellant relies on the facts that in June of 1972, the last of United's assets were finally distributed, and in December 1972, the corporation was dissolved by action of the State of Arizona. The dissolution, however, occurred after the end of appellant's 1972 income year. The final distribution of assets is not a sufficient event in itself to delay fixing the worthlessness of the stock until a later year, where events have occurred in a prior year which indicate that the stock was worthless then. (See Industrial Rayon Corporation v. Commissioner, 94 F.2d 383 (6th Cir. 1938).)

We find that appellant has not borne its burden of showing that the United stock had value at the beginning of the 1972' income year or that an identifiable event occurred during that year which resulted in the stock's worthlessness. We therefore sustain respondent's action.

Appeal of Baingo Brothers, Inc.

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 Baingo Brothers, Inc. against a proposed assessment of additional franchise tax in the amount of $1,463.00 for the income year ended October 31, 1972, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day of October 1980, by the State Board of Equalization, with Members 'Nevins, Reilly, Dronenburg and Bennett present..

Richard Nevins, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

William M. Bennett, Member

_______________, Member