



**BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA**

In the Matter of the Appeal of)
FOSTER CALIFORNIA CORPORATION)

Appearances :

**For Appellant: Valentine Brookes
Lawrence V. Brookes
Attorneys at Law**

**For Respondent: Jon Jensen
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 Foster California Corporation against a proposed assessment of additional franchise tax in the amount of \$24,026.49 for the income year ended February 28, 1976.

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As of January 1976, appellant, a California corporation engaged in the business of real estate development, had two principal assets: appreciated real property in Foster City, California, with book and fair market values of \$892,836.26 and \$3,487,133, respectively, and land in Marina, California with corresponding values of \$44,032.13 and \$77,850. Appellant's total assets were valued on its books at \$964,402.35; their fair market value was \$3,590,831.34. Appellant's stock was held in its entirety by T. Jack Foster and Sons ("Foster"), a California partnership to which appellant was indebted in the amount of \$365,000.

Appellant liquidated under the provisions of Revenue and Taxation Code section 24503 ^{1/} in January 1976. All of appellant's assets were distributed to Foster, which also assumed all of appellant's liabilities. Appellant has explained that the aforementioned debt of \$365,000 was extinguished by virtue of the doctrine of merger of interest. No gains from the distribution were reported on appellant's return for the income year in issue.

Upon audit; 'respondent determined' that appellant's distribution of assets to Foster constituted two transactions: (i) first, a transfer of appreciated property in satisfaction of the indebtedness, and (ii) second, the distribution of the excess of appellant's assets above its liabilities in a corporate liquidation. Accordingly, respondent concluded that there was a recognizable gain on the property transferred in satisfaction of the debt to Foster. Based upon appellant's records, respondent computed that 73.14 percent of the fair market value of appellant's assets was attributable to appreciation. Respondent determined that the same percentage of the \$365,000 indebtedness had been satisfied by appreciated assets, thereby resulting in a taxable gain of \$266,961. The subject notice of proposed assessment was subsequently issued. Appellant has not challenged respondent's manner of computation, but rather argues that no gain has been realized because the liquidation agreements did not provide that any of appellant's property was 'to be transferred to Foster in satisfaction of the subject debt. The resolution of appellant's argument is the sole issue presented by this appeal.

^{1/} Section 24503 of the Revenue and Taxation Code is substantively identical to section 333 of, the Internal Revenue Code of 1954. Accordingly, federal case law is highly persuasive in interpreting the California statute. (Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [280 P.2d 893] (1955).)

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When a corporation transfers property to its creditors in satisfaction of a debt, the transfer is treated as a sale or exchange of property, and gain or loss is realized by the corporation measured by the difference between the corporation's basis in the property transferred and the amount of the indebtedness satisfied. (Houston Natural Gas Corporation, 9 T.C. 570 (1947); Peninsula Properties Co., Ltd., 47 B.T.A. 84 (1942); Carlisle Packing Co., 29 B.T.A. 514 (1933).) Therefore, the tax effects of the liquidation and the satisfaction of the indebtedness must be considered separately. Amounts received by a shareholder-creditor upon the liquidation of a corporation are applied first to satisfy the indebtedness, and any remaining amount constitutes a distribution in liquidation in exchange for the stock. (Braddock Land Co., 75 T.C. 324 (1980); O.D. Bratton, 31 T.C. 891 (1959), *affd.*, 283 F.2d 257 (6th Cir. 1960), *cert. den.*, 366 U.S. 911 [6 L.Ed.2d 235] (1961); Houston Natural Gas Corporation, *supra*.) Adhering to the established authority cited above, we must conclude that respondent's action in this matter was proper.

Appellant has advanced the argument that there is no requirement that assets received by a creditor-shareholder upon liquidation of a corporation must first be applied to extinguish the indebtedness. Consequently, appellant concludes, the liquidation agreements, which did not expressly provide that any of appellant's assets would be used to satisfy the subject \$365,000 indebtedness to Foster, are controlling as to the tax effects of the liquidation, and no taxable gain resulted. Appellant's argument is without merit. Not only is this argument unsupported by any relevant authority, it is in direct contradiction to the well established authority cited above. Furthermore, while it may be true that the liquidation agreements made no provision for extinguishing the subject indebtedness, the mere neglect to make such provision does not negate the reality of the transaction. Regardless of how the liquidation was structured, Foster could not acquire appellant's assets in derogation of the latter's creditors. As noted above, the distributed assets of appellant must first have been used to satisfy its debts and liabilities before any distribution could be made to its shareholder. (Braddock Land Co., *supra*; O.D. Bratton, *supra*; Houston Natural Gas Corporation, *supra*.)

For the reasons set forth above, respondent's action in this matter will be sustained.

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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, a'nd 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 Foster California Corporation against a proposed assessment of additional franchise tax in the amount of \$24,026.49 for the income year ended February 28, 1976, be and the same is hereby sustained.

Done -at Sacramento, California this 7th day of December, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg and Mr. Nevins present.

William M. Bennett . Chairman
Ernest J. Dronenburg, Jr. . Member
Richard Nevins , Member
_____. Member
_____. Member