BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
MERWYN P. MERRICK, SR., AND)
MARGARET F. MERRICK, et al.)

Appearances:

For Appellants: Merwyn P. Merrick, Sr. , in pro. per.

For Respondent: Richard A. Watson
Counsel

OPINION

These appeals are made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Merwyn P. Merrick, Sr., and Margaret F. Merrick against proposed assessments of additional personal income tax in the amounts of $34.00, $67.09, and $88. 45 for the years 1970, 1971, and 1972, respectively; and on the protest of Merwyn P. Merrick, Jr. , and Elizabeth A. Merrick in the amounts of $167.79, $323.91, and $317.52 for the years 1970, 1971, and 1972, respectively.

The sole issue for determination is whether certain distributions made by Bishop Laundry, Inc., in which appellants are major shareholders, were taxable in full as dividends or whether they were partially nontaxable returns of capital.

During the years in issue, appellants were the major stockholders in Bishop Laundry, Inc. , a California corporation. The corporation's principal business activities were laundry and dry cleaning. For federal purposes the corporation elected to be taxed pursuant to subchapter S of the Internal Revenue Code of 1954 (§§ 1371-1379). California law does not provide for a similar election.

The corporation's principal assets were its plant and two coin-operated laundries, all located in Bishop, California. During 1968, the corporation sold a substantial portion of its plant and elected to report its gain by the installment method. All of the installment payments were distributed to the shareholders when received by the corporation in proportion to the shareholders' interest in the corporation. In their personal income tax returns for the years in issue, appellants excluded that portion of each of the installment payments received which was attributable to the corporation's adjusted basis in the property sold. Appellants' theory for this exclusion was that such amounts were nontaxable returns of capital. The total amounts of the distributions, which were also the amount of the installment payments received by the corporation, were $9,912. 38, $20, 301. 30, and $14, 382. 88 for the years 1970, 1971, and 1972, respectively.

Respondent determined that the distributions were made out of the corporation's earnings and profits and were dividends fully taxable to appellants as ordinary income, notwithstanding the fact that part of the proceeds was a return of capital to the corporation. Appellants have appealed that determination.

It is noted that, previously, respondent had issued assessments against appellants for 1968 and 1969. These assessments included adjustments similar to the ones involved in this appeal. For reasons which do not appear in the record, these adjustments were withdrawn.

A distribution of property, including money, by a corporation to a shareholder with respect to its stock shall be included in gross income to the extent the amount distributed is considered a dividend. (Rev. & Tax. Code, §§ 17321, 17323, subd. (a), 17383.) The term "dividend" means any distribution of property, including money, made by a corporation to its shareholders out of its earnings and profits of the current year or out of its earnings and profits accumulated after February 28, 1913. (See Rev. & Tax. Code, §§ 17381, 17383.)

In the instant matter the distribution of the installment sale proceeds by the corporation to its shareholders was a distribution of property made by a corporation to its shareholders with respect to its stock. All distributions are presumed to be made out of earnings and profits and from the most recently accumulated earnings and profits. (Joseph H. Miller, 26 T. C. 115.) Since appellants have offered no evidence to show that the corporation did not have sufficient earnings and profits, we conclude that the distribution was made out of earnings and profits.

From the foregoing, it would appear that respondent properly characterized the corporate distribution as a dividend taxable to appellants in its entirety as ordinary income. However, appellants, in reliance on subdivision (b) of section 17323 of the Revenue and Taxation Code, 1/ maintain that part of the distribution should be considered a nontaxable return of capital and not includible in the shareholders' income. The error in appellants' argument is that it ignores one of the basic principles of taxation; that a corporation is a separate taxable entity wholly independent of its shareholders. Accordingly, corporate income is taxed to the corporation while dividends paid by a corporation out of its earnings and profits are taxable to the shareholders. In the instant matter it was the corporation, not the shareholders, that sold the capital assets.

1/ Subdivision (b) of section 17323 of the Revenue and Taxation Code provides:

> That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

Therefore, the division of the installment sale proceeds into taxable gain and return of capital occurred at the corporate level, not at the shareholder level. 2/ The cash proceeds, when distributed to the shareholders, did not retain the characteristics of part return of capital and part gain which they possessed at the corporate level. Rather, the distribution of the proceeds by the corporation was merely a distribution of cash to the shareholders.

Appellants also argue that it is their right to recover their capital investment in the corporation, tax free. It is true that, under appropriate circumstances, appellants would be able to "recover" their capital investment. For example, when the stock, a capital asset, is sold or exchanged, its adjusted basis will be available to offset the amount realized on the sale. (See generally, Rev. &Tax. Code, §§ 18041, 18042, 18151-18172.) Furthermore, had the transaction in question been structured as a distribution in partial or complete liquidation, the distribution might have been treated as payment in exchange for stock, thereby allowing the shareholders to offset their gain, if any, by the adjusted basis of the shares redeemed. 3/ (See generally, Rev. & Tax. Code, §§ 17041-17421.) Under the facts of this matter, however, we are

2/ As we have indicated above, for federal purposes the corporation elected to be taxed pursuant to subchapter S of the Internal Revenue Code thereby avoiding any corporate income tax at the federal level. Instead, the shareholders were taxed, basically, as if the corporate income had been received by them instead of the corporation. Although appellants' method of reporting the distributions was correct for federal purposes, it was incorrect for state purposes since California has no provision similar to subchapter S. (See Appeals of David W. and Marion Burke, Cal. St. Bd. of Equal., Oct. 27, 1964.)

3/ A prevelant device prior to the federal Tax Reform Act of 1969 was the use of accelerated depreciation to reduce thk earnings and profits of a corporation. The resulting reduction or elimination of earnings and profits made possible the distribution of property to stockholders free of dividend or ordinary income treatment. The use of accelerated depreciation thus became a shelter for a nontaxable, or partially taxable, dividend, a practice which became frequent in the utility and real estate industries.

aware of no authority, and appellants have offered none, that would allow a distribution of cash out of a corporation's earnings and profits made by the corporation to its shareholders with respect to its stock to be treated as a nontaxable return of capital.

Appellants also maintain that, since similar adjustments for 1968 and 1969 were withdrawn, respondent is now estopped from asserting the adjustments at issue in the present matter. Estoppel will be invoked against a government agency only in rare and unusual circumstances. (California Cigarette Concessions, Inc. v. City of Los Angeles, 53 Cal. 2d 865 [3 Cal. Rptr. 675, 350 P.2d 715].) Detrimental reliance must be shown. (Appeal of Lee J. and Charlotte Wojack, Cal. St. Bd. of Equal., March 22, 1971.) From all that appears in the record, the assessments for 1968 and 1969 were erroneously withdrawn. However, respondent's action gave rise to no detrimental reliance. In fact, respondent's error inured to appellants' benefit since appellants paid less tax in 1968 and 1969 than was actually due.

In accordance with the views expressed above it is concluded **that respondent's action in this matter was correct** and must be sustained.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

Appeals of Merwyn P. Merrick, Sr., and Margaret F. Merrick, et al.

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 Merwyn P. Merrick, Sr., and Margaret F. Merrick against proposed assessments of additional personal income tax in the amounts of $34.00, $67.09, and $88.45 for the years 1970, 1971, and 1972, respectively; and on the protest of Merwyn P. Merrick, Jr., and Elizabeth A. Merrick in the amounts of $167.79, $323.91, and $317.52 for the years 1970, 1971, and 1972, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 19 day of August 1975, by the State Board of Equalization.

John W. Lynch, Chairman

Member

, Member

, Member

, Member

ATTEST: W. W. Dunlop, Executive Secretary