



Appeal of James B. and Martha W. Mears

The question presented is whether respondent properly computed appellants' basis in certain capital stock that was sold in 1972.

Theodore J. Kiapos, president of Omega Shoe Polish Co., Inc., hereinafter referred to as Omega, developed and designed a **particular** type of shoe polish applicator. He assigned all of the rights thereto to Omega prior to June of 1960. On June 2, 1960, appellant James B. Mears, Kenneth ROSS Smith, and Vernon **P. Dapper**, who were in the process of developing shoeshining kits that were designed to incorporate the applicator, entered into a written contract with Omega.

At that time, appellant **and** his associates were forming Royal Master Corporation (Royal), as a wholly owned corporation, to manufacture and sell shoeshining kits. Under the terms of the contract with Omega, appellant, Smith, and Dapper agreed to purchase, or cause Royal to purchase, a specific initial number of **applicators**. Appellant, his associates, and Royal also acquired the "exclusive" right to sell, distribute, and market the applicators for five years. This right was **to** terminate automatically if they **did not** purchase a designated minimum number each year. They were given an option to renew this "exclusive" right for three additional five-year periods provided they continued to meet purchasing requirements.

Omega **assumed responsibility** for protecting any patent **rights** that it would obtain pertaining to the applicator. Appellant, his associates, and Royal were **given** the right to join in any action for patent infringement. Any recovery for infringement was to be participated in by the parties in accordance with their respective interests. The contractual rights and liabilities of appellant, Smith, and Dapper were to be assigned by them to Royal when it became legally able to do business in California.

In June of 1960, Royal came into legal existence. Appellant then contributed \$20,000 in cash to it and received one-third of Royal's outstanding capital stock. Smith and Dapper also each acquired one-third shareholding interests.

On **September 16**, 1960, Kiapos filed an application for a patent or patents pertaining to the polish **applicator invented** by him and also to the rest of the polishing equipment (i.e., **also** to that portion of the,

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kits designed and developed by appellant and his associates). Kiapos immediately assigned his right, title, and interest in the patent application to Omega.

As part of a subsequent written contract in February of 1961 between Omega and Royal, Omega assigned to Royal its entire interest in the patent application, and any patent rights to be derived,, pertaining to the applicator and the other polishing equipment. Royal's interest therein was to continue only as long as that corporation used Omega products, as required in the subsequent written contract. Upon Royal's failure to comply with this condition, the assignment **was** to be null and void, with such rights to revert to **Omega**.

The kits proved popular in the consumer market. Consequently, Royal required substantial additional investment capital. Early in 1961, therefore, appellant and his associates made arrangements for a corporate reorganization **involving** a tax-free exchange of stock. Pursuant to this arrangement, they then transferred all of their Royal stock to Pacific Hawaiian Corporation (Pacific) in exchange for Pacific's stock. As part of the transaction, Pacific also agreed to lend \$300,000 to Royal. In consideration for the loan, appellant and his associates apparently agreed to subordinate the outstanding loans owed to them by Royal, and to be employed by Royal for two years, each at a \$20,000 annual salary. They also covenanted not to compete with Royal for seven years, and promised -that Royal would be assigned all patent rights. As previously noted, Omega did assign all of its patent application rights to Royal.

In 1963 appellant acquired 3,000 shares of the R. J. Reynolds Tobacco Company (Reynolds) in exchange for his shares of Pacific, pursuant to another tax-free reorganization. In 1972 appellant sold his Reynolds stock for **\$223,693.50**. In computing his gain he used a basis of \$135,357. This amount reflects the value of the stock on the New York Stock Exchange on April 15, 1963, the date of its acquisition by appellant. Accordingly, he reported a **taxable** gain of **\$88,318.50** in 1972.

Respondent concluded that the correct basis of the Reynolds stock when sold by appellant was \$20,000, the amount of cash appellant originally contributed to Royal. That amount, respondent determined, was the substituted basis which was carried forward to the time of the sale of the Reynolds shares in 1972 as a consequence of the two tax-free exchanges. Whether respondent thus properly computed appellant's basis in the Reynolds stock is the issue presented for decision.

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Initially, we must note that the parties to this appeal agree that both the transfer of Royal stock for Pacific shares and of Pacific stock for Reynolds shares constituted tax-free stock exchanges in pursuance of plans of reorganization. (See Rev. & Tax. Code, §§ 17432, subd. (a) (1), 17461, subd. (a) (2); Int. Rev. Code of 1954, §§ 354(a), 368(a) (1) (B).) In such tax-free exchanges, the basis of the property received is the same as that of the property exchanged. (Rev. & Tax. Code, § 17441, subd. (a); Int. Rev. Code of 1954, § 358(a); Sweetland v. Franchise Tax Board, 192 Cal, App. 2d 316 [13 Cal. Rptr. 432] (1961).) The parties also agree that the basis of appellant's Pacific shares and of his Reynolds stock remained unchanged while held by him. We conclude, therefore, that the substituted basis of appellant's Reynolds stock when sold in 1972 was the same as the basis of appellant's Royal stock when exchanged by him in 1961 for the Pacific stock.

Thus, we must determine the basis of appellant's Royal stock when transferred for the Pacific stock. We first note that the original capital contribution of property to Royal, whether it consisted solely of the \$20,000 cash, or of cash and other property, was a tax-free transfer to a controlled corporation. (See Rev. & Tax. Code, § 17431, subd. (a); Int. Rev. Code of 1954, § 351(a); Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935).) Moreover, any subsequent capital contributions by appellant to Royal, a controlled corporation, without the receipt of any additional shares, would also constitute tax-free transfers. (See Rev. Rul. 64-155, 1964-1, Cum. Bull. (Part 1) 138.)

The basis of the stock received in such transfers is the same as that of the property exchanged for it. (Rev. & Tax. Code, § 17441, subd. (a); see Int. Rev. Code of 1954, § 358(a).) The basis of any property so exchanged would be its cost. (See Rev. & Tax. Code, § 18042; Int. Rev. Code of 1954, § 1012.) Consequently, unless appellant initially transferred other property (having more than a zero cost basis) in addition to cash of \$20,000 for the Royal stock, the original basis of those shares was \$20,000. Furthermore, the adjusted basis of the Royal stock when exchanged by appellant for his Pacific shares would be the same as its original basis unless, prior to that exchange, subsequent capital contributions were made by appellant to Royal increasing his basis in those shares, or there was a recovery of capital by him, reducing their basis. (See Rev. & Tax. Code, § 18052, subd. (a); Int. Rev. Code of 1954, § 1016(a).)

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It is contended in behalf of the appellants that, in addition to cash in the amount of \$20,000, appellant also contributed, as a capital investment in Royal, intangible property consisting of his "right, title and interest in certain patent rights and exclusive sales rights which patents and rights were acquired . . . during the development" of their shoe polishing kits. **It is** also urged that Pacific would not have loaned money to Royal and acquired the Royal stock in exchange **for** Pacific shares unless appellant and his associates made the necessary capital contributions of intangible personal property to Royal, including the patent rights. It is emphasized that the value of the patent rights was particularly important to Royal, and it is contended that such rights were acquired largely because of the efforts of appellant and his two associates.

It is then asserted that the use of the list price of the Reynolds stock in 1963 in determining the basis of the Reynolds stock is proper because the actual basis **"is** difficult, and perhaps impossible, to determine except by using an established yardstick."

The basis assigned to property by respondent is presumptively correct and appellant has the burden of establishing that respondent's valuation of basis is erroneous. (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; William E. Pohlen, ¶47,056, P-H Memo. T.C. (1947), *affd.* 165 F.2d 258 (5th Cir. 1948).)

On the state of the record before us, we **con-**  
**clude** that appellant has not established error in respondent's determination of a \$20,000 basis for the Royal stock when it was exchanged for shares of Pacific. No showing has been made that appellant contributed any patent rights to Royal in exchange for his proprietary interest as a stockholder of Royal, either in June of 1960 or thereafter. **Kiapos** applied for the necessary patent or patents, and assigned all legal rights pertaining to the application to Omega. Then Omega, not appellant, assigned those legal rights to Royal.

Kiapos did apply for patent rights pertaining to that part of the polishing equipment developed by appellant and his associates, as well as for the rights pertaining to the applicator which Kiapos developed. Thus, it would have been possible for appellant to have an equitable interest in a portion of Kiapos' patent application. **Moreover**, an equitable **interest** may be

transferred by a taxpayer to a controlled corporation in a tax-free exchange for a shareholding interest.

(F. L. G. Straubel, 29 B.T.A. 516 (1933).) In that **circumstance**, as already explained, the basis of the stock would be the same as the cost basis of the property transferred. (Rev. & Tax. Code, § 17441, subd. (a); see Int. Rev. Code of 1954, § 358(a).) **Thus, in** such an exchange, the taxpayer's cost of **acquiring** that equitable interest would be the basis of the stock received. Consequently, if such an equitable interest and cash is exchanged for a stockholding interest, the cost of acquiring the equitable interest could be properly added to the basis of the stock received. Appellant, however, has simply not proved that he contributed any equitable interest in the patent application to Royal in exchange for his capital interest. (Cf. F. L. G. Straubel, supra.)

The responsibilities of appellant pursuant to the June 1960 contract with Omega would indicate that **appellant** assigned his rights under that agreement to Royal. Consequently, appellant apparently did transfer to Royal his right to sell the applicator (as an ingredient of the kits). This intangible property right, in addition to the cash, was apparently transferred to Royal by appellant in exchange for his one-third shareholding interest in that corporation. The record fails to establish, however, that appellant incurred any costs in acquiring this right. We must conclude, therefore, that this intangible property right had a zero basis (see Rev. & Tax. Code, § 18042; Int. Rev. Code of 1954, § 1012) **and**, thus, its transfer did not increase the substituted basis of the Royal stock. (See William F. Pohlen, supra; D. H. Willey Lumber Co., ¶48,131, P-H Memo T.C. (1948), atfd. 177 F.2d 200 (6th Cir. 1949).) Therefore, the basis of the Royal stock when exchanged for the Pacific shares was \$20,000, and consequently \$20,000 was the substituted basis of the Reynolds stock when sold in 1972.

Finally, the listed price of the Reynold's stock in 1963 obviously could not reflect the correct basis of the Reynolds shares. There is no rule of law which allows the assignment of a basis completely unauthorized by the statutes merely because arriving at a proper basis would be laborious or difficult.

For the reasons stated, we must sustain respondent's action.

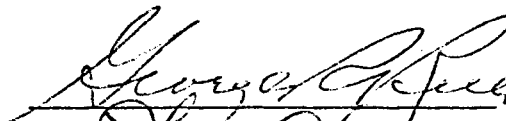
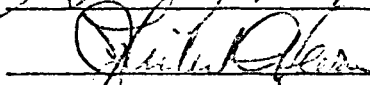
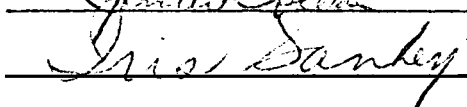
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O R D E R

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 ~~DECEED~~, pursuant to section 18595 of the Revenue and **Taxation** Code, that the action of the Franchise Tax Board on the protest of James B. and Martha W. Mears against a proposed assessment of additional personal income tax in the amount of **\$7,570.89** for the year 1972, be and the same is hereby sustained.

Done at Sacramento, California, this **5th** day of **December**, 1978, by the State Board of Equalization.

  
\_\_\_\_\_, Chairman  
  
\_\_\_\_\_, Member  
  
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