BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

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| In the Matter of the Appeal of SUN & SAND ENTERPRISES, INC., TAXPAYER, AND JAVIER A. TOSTADO, CARL S. MAGGIO, AND MARK NICKERSON, ASSUMERS AND/OR TRANSFEREES | No. 84X-1387-D |

For Appellant: Harry K. Eisenberg
Certified Public Accountant

For Respondent: Alison M. Clark
Counsel

## O P I N I O N

This appeal is made pursuant to section 25666 1/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Sun and Sand Enterprises, Inc., Taxpayer, and Javier A. Tostado, Carl S. Maggio, and Mark Nickerson, Assumers and/or Transferees, against a proposed assessment of additional franchise tax in the amount of $3,884 for the income year ended March 31, 1982.

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income year in issue.

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The issue presented by this appeal is whether a portion or' a distribution made by appellant-corporation to its sharzholdet-creditors during its liquidation was subject to taxation.

Appellant Sun & Sand Enterprises, Inc., a closely held corporation, was incorporated on July 18, 1973, with its principal business activity being the rental of real property. The shareholders at all times consisted of the three individual appellants listed above with each shareholder owning one-third of the outstanding stock of the corporation. Shortly after incorporation, the corporation borrowed $22,360 eath from two of the shareholders. In March 1982, the corporation was dissolved.

As of the date of the dissolution of the corporation, the assets of Sun & Sand Enterprises, Inc., consisted of $169 in cash and real property with a fair market value of $557,200 and an adjusted basis of $69,129. The corporation's liabilities apparently consisted only of the two promissory notes to the two shareholders. In an effort to avoid recognizing the gain from the appreciated property at the corporate level, appellants attempted to conform the corporation's dissolution to the requirements of section 24503. The plan of dissolution not only distributed the property and cash into the hands of the shareholders, it distributed the promissory notes in the same manner. The plan also required an independent accountancy firm to collect the rents from the property and pay off the two notes now allegedly held by the three shareholders in equal amounts, even though the shareholders were the actual owners of the property. It was only after the notes were satisfied that the individual appellants were to directly receive the rent proceeds.

The Franchise Tax Board (FTB) audited the franchise tax return for the income year of liquidation and determined that the alleged distribution of the notes was improper. The FTB determined that the notes were satisfied by the distribution of the appreciated property, and that the resulting relief from the debts constituted income to the corporation in the amount of $39,036, tire balance of the two notes. Respondent issued the appropriate assessment and appellants protested. Appellants argued that the notes had not been assumed by the shareholders or any third party, and the notes were not cancelled by the shareholders at the time of the liquidation. Appellants claimed that the notes were

still in effect at the time of the distribution and were to be satisfied at a later date through the above-described process. Respondent denied the protest and this appeal followed.

Section 24503 provides that a corporation will be considered liquidated if the liquidation is made pursuant to a designated plan, the distribution is in complete cancellation or redemption of all the corporation's stock, and the transfer of all the property under the plan occurs within the same calendar month. Section 24511 states that, with the exception of a disposition of installment obligations, a corporation recognizes no gain or loss on the distribution of property in complete or partial liquidation. However, section 24511 does not apply when a corporation distributes property to any creditor in satisfaction of indebtedness; such transfers are treated as sales or exchanges with gains or losses being recognized by the corporation. (Appeal of Foster California Corporation, Cal. St. Bd. of Equal., Dec. 7, 1982; Appeal of Beverly Design Center Corporation, et al., Cal. St. Bd. of Equal., Nov. 17, 1982.) Upon the liquidation of a corporation, any distribution of cash or property received by a shareholder who is also a creditor is deemed first to be applied to satisfy the corporation's indebtedness. (Bratton v. Commissioner, 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 v. Commissioner, 9 T.C. 570 (1947).) It is only after the debts to the shareholders are satisfied that the remainder of the distribution will be considered an exchange of corporate assets for stock wherein no gain or loss is recognized at the corporate level. (Bratton v. Commissioner, supra; Houston Natural Gas Corporation v. Commissioner, supra.)

> At the outset we believe it pertinent to reiterate the familiar principle that substance rather than form governs the tax effect of transactions such as this. Acknowledging the right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them by whatever means the law allows, the question still remains as to whether the transactions under scrutiny are in reality what they appear to be in form. ... Simply stated, was the characterization given the instant series

of events by petitioners in accord with substantial economic reality? (Citations.)

(Bratton v. Commissioner, supra, 31 T.C. at 899.)

Despite appellants' arguments to the contrary, we find that the economic realities of this case differ from appellants' stated distribution plan. Appellant-corporation distributed appreciated property to its shareholders while two of the three were also creditors. Therefore, the property first applies to satisfy the debts of the two shareholders and, to that extent, the transfer is treated as a sale or exchange of the property, causing the resulting gain to be subject to taxation.

Appellants make two arguments in an attempt to dissuade us from applying the above-stated reasoning. First, appellants argue that all of the federal precedents cited by respondent are inapplicable to this appeal because, in each case cited, all shareholders were also creditors to their corporation. Appellants claim that since only two of the individual appellants were creditors, appellant-corporation must be allowed to distribute the debt or each shareholder would receive an unequal amount of corporate property in exchange for his one-third of the stock.

Appellants' argument does not address the question before us. We are concerned only with the issue of whether the corporation received any taxable gain during the dissolution. Due to this narrow focus, the effect the distribution had on the individual share holders and their respective interests in corporate property is irrelevant.

Appellants' second argument is that sections 24481, 24482, and 24483.5 are applicable to this case and that those statutes preclude our stated result. However, sections 24481, 24482, and 24483.5 deal with carporate distributions other than those in liquidation and are, therefore, of no relevance to this appeal. (Cal.Admin. Code, tit.. 18, reg. 24481, subd. (a).)

For the above-stated reasons, 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, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREER, pursuant to section 25567 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Sun & Sand Enterprises, Inc., Taxpayer, and Javier A. Tostado, Carl S. Maggio, and Mark Nickerson, Assumers and/or Transferees, against a proposed assessment of additional franchise tax in the amount of $3,884 for the income year ended March 31, 1982, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of March , 1987, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Bennett, Mr. Carpenter and Ms. Baker present.

Conway H. Collis , Chairman

William M. Bennett , Member

Paul Carpenter , Member

Anne Baker* , Member

_____ Member

*For Gray Davis, per Government Code section 7.9