BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
) No. 94A-0284
Rapid-American Corporation)

Representing the Parties:

For Appellant: Ronald M. Loeb, Attorney

For Respondent: Alison M. Clark, Counsel
Craig Swieso, Counsel

Counsel for Board
of Equalization: John S. Butterfield,
Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19045[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Rapid-American Corporation against proposed assessments of additional franchise tax in the amounts of $41,852, $44,831, $98,925, $553,077, and $158,539 for the income years ended January 31, 1979, January 31, 1980, January 31, 1981, January 31, 1982, and January 31, 1983, respectively.

Several of the disputes between appellant and respondent were resolved prior to the hearing on this appeal. The sole question remaining for resolution by this board is whether appellant may adjust its basis in the stock of its subsidiary corporation, when the stock is sold, to add to its basis the amount of retained earnings held in the sold subsidiary. This is a case of first impression for the board.

Rapid-American Corporation and its subsidiaries filed combined California tax returns on a worldwide unitary basis. Schenley Industries, Inc. is a subsidiary of Rapid-American Corporation. DWS Corporation, a Canadian corporation, was a subsidiary of Schenley Industries, Inc. During Fiscal Year Ending ("FYE") January 31, 1982, Schenley Industries, Inc. sold all of its stock in DWS

[1] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the years in issue.

Corporation and realized a substantial capital gain. During FYE January 31, 1982, appellant also sold several other wholly owned subsidiaries, also realizing capital gains on those sales. When appellant filed its combined unitary tax return for the applicable years, it increased its basis in the stock of the sold subsidiaries, adding to its acquisition cost the amount of retained earnings and profits which had previously been reported on combined unitary tax returns filed by appellant and which had not been distributed up as dividends prior to the sales. Respondent disallowed the claimed adjustments to basis and recalculated the capital gains reportable on appellant's combined return. As a result, respondent assessed additional tax due for the years in question.

Appellant submits that the proposed adjustment to basis is appropriate under sections 24912 and 24916, and in particular section 24916, subdivision (a), which provides that basis adjustments shall be made for "expenditures, receipts, losses, or *other items properly chargeable to capital account*". (emphasis added) Appellant avers that because the retained earnings and profits from prior years were included in combined returns filed in those prior years, to include them in the gain recognized on the sale of the stock would result in impermissible double taxation of those earnings.

Respondent submits that California has never recognized retained earnings as an appropriate adjustment to basis. Respondent points out that the adjustment contemplated by appellant is allowed under Treasury Regulation section 1.1502-32, which permits the adjustment in the case of a consolidated federal return, but that California has not adopted a similar statute or regulation.[2]

We are persuaded that California did not intend to allow adjustments to basis of stock in a subsidiary due to the presence of retained earnings on the balance sheet of the subsidiary corporation when the stock is sold. While the operating earnings may have been included in the measure of tax at the entity level (i.e. at the level of the corporate subsidiary), it has not previously been subjected to tax at the shareholder level. We believe there is no dispute that the capital gains income tax paid by a shareholder of a corporation does not constitute impermissible double taxation when the corporation has previously paid tax on its operating earnings.

At the hearing in this case, appellant hypothesized that our affirmation of respondent's position in this case could lead to California being "whipsawed" by companies with careful tax planning. A company planning a divestiture could distribute out the retained earnings as a dividend to the parent company, which dividend, as an inter-company transfer, would allegedly be free of tax. The selling price of the stock would be reduced by an amount equal to the dividend paid, reducing or eliminating any potential capital gain.

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[2]We note that Revenue and Taxation Code section 24916 was derived from Internal Revenue Code (IRC) section 1016. However, when adopted by California, many sections of IRC section 1016 were not adopted, including the adjustment to basis on account of "consent dividends" which are similar to the adjustment proposed by appellant. We further note that if the adjustment proposed by appellant were permitted under IRC section 1016, there would be no reason for the Congress to have authorized the Internal Revenue Service under IRC section 1502 to adopt Treasury Regulation section 1.1502-32 to deal with the retained earnings question.

Respondent's counsel stated at the hearing that the scenario suggested by appellant may well be correct. If so, it is up to the Legislature to address the potential problem, if it perceives one to exist. We suspect that given the tax imposed on excess retained earnings under Internal Revenue Code section 531, the amount of retained earnings which might potentially be distributed free of tax while reducing the value of the stock will usually be insignificant. Similarly, the removal of the retained earnings in total may make the company unsellable, as the buyer might be required to inject significant capital immediately after purchase in order to keep the enterprise viable.

Based on the foregoing, we conclude that there is no statutory, regulatory or case law basis to support an adjustment upward in basis of stock where retained earnings previously reported on a combined return are held in the company whose stock is sold. There may be many legitimate business reasons for a company to sell its subsidiary with the retained earning undistributed. An adjustment to basis for purposes of California tax is not one of them. The decision of the Franchise Tax Board disallowing the proposed adjustment is affirmed.

ORDER

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Rapid-American Corporation against proposed assessments of additional franchise tax in the amounts of $41,852, $44,831, $98,925, $553,077, and $158,539 for the income years ended January 31, 1979, January 31, 1980, January 31, 1981, January 31, 1982, and January 31, 1983, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of October, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, Mr. Dronenburg, Mr. Sherman and Mr. Halverson present.

JOHAN KLEHS, Chairman

DEAN F. ANDAL, Member

ERNEST J. DRONENBURG, JR., Member

REX HALVERSON*, Member

____________________, Member

*For Kathleen Connell, per Government Code section 7.9.