96-SBE-020

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	
George and Leanne Roberts	)	No. 93R-0489
Michael W. and Ellen Michelson	)	No. 93A-0211
George A. and Winifred Vandeman	)	No. 91R-0513

Representing the Parties:

For Appellants: Thomas Bost, Attorney

For Respondent: Jozel L. Brunett, Counsel

Counsel for Board of Equalization: Charles D. Daly, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Michael W. and Ellen Michelson against a proposed assessment of additional personal income tax and pursuant to section 19057 from the actions of the Franchise Tax Board in denying the claims of George and Leanne Roberts and George A. and Winifred M. Vandeman for refund of personal income tax in the amounts and for the year as follows:

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

Appellants	Years	Proposed Assessment	Claims For Refund
George and Leanne Roberts 93R-0489	1985		$246,384.52
Michael W. and Ellen Michelson 93A-0211	1985	$19,705	
George A. and Winifred M. Vandeman 91R-0513	1985		31,996.89

The primary issue to be resolved in this appeal is whether a parent holding company and its subsidiaries may be combined for the purpose of applying the gross receipts test of former Revenue and Taxation Code section 18162.5, subdivision (f)(1). Another issue is whether part of the claim for refund filed by the Roberts appellants is barred as untimely even if appellants prevail with regard to the primary issue. Because of our conclusion regarding the primary issue, we need not resolve the issue regarding the timeliness of the claim for refund of the Roberts appellants.

Appellants in this matter were part of a group of investors who desired to acquire Golden West Television, Inc. (GWT), and its wholly owned operating subsidiary, Golden West Television Productions (Productions). To achieve the maximum amount of flexibility with regard to a possible future sale of GWT and Productions, the investors decided to form a holding company that would own all of the stock of GWT. As a result of this corporate structure, a potential buyer of GWT and/or Productions could negotiate and enter into a contract with the holding company rather than with a large number of individual investors.

Appellants state that the acquisition of GWT was accomplished as follows:

(1) The investors formed Golden West Television Holding Company (Holding), a Delaware corporation, by contributing cash and promissory notes to Holding in exchange for its stock.

(2) Holding then formed a subsidiary, Golden West Acquisition Company (Acquisition), which acquired the stock of GWT with borrowed funds and the equity capital contributed by Holding.

(3) Acquisition was subsequently merged into GWT, with the result that Holding directly owned the stock of GWT.

Appellants state in their briefing that Holding was a "true holding company" whose only assets, after the merger of Acquisition into GWT, were the stock of GWT and the notes of the shareholders of Holding. However, respondent produced at the hearing a consolidated balance sheet

which showed two other assets of Holding. The parties apparently agree that one of those assets represented some form of advance from Holding to GWT and that the other asset represented accrued but unpaid interest on the notes of the shareholders of Holding.[2] A consolidated income statement that was also produced by respondent at the hearing shows that, during the year at issue, Holding's only income was interest from the notes.

All of the appellants sold stock in Holding during the appeal year. On their respective tax returns for that year, appellants did not report the unrecognized gain from the sales of their Holding's stock as preference income on the basis that their Holding's stock qualified as small business stock. On review, respondent concluded that the unrecognized gain from preference income should have been reported as preference income because the amount of interest received by Holding in its income year immediately preceding the sales of its stock by appellants disqualified the stock as small business stock.

Former Revenue and Taxation Code section 17063.11 excluded from preference income the unrecognized portion of gain from the sale of small business stock.[3] Former section 18162.5, subdivision (f)(1), disqualified as small business stock the stock of a corporation whose gross receipts from rents, interest, dividends, or sales of assets in the income year immediately preceding the taxpayer's sale of the stock exceeded 25 percent of its total gross receipts for that year.

Appellants do not dispute that, when viewed alone, Holding received disqualifying amounts of interest for purposes of former section 18162.5, subdivision (f)(1). However, they contend that the gross receipts test under that section should be applied only after combining Holding with its financially successful operating subsidiaries. In support of their contention, appellants make essentially three arguments. Appellants' primary argument is that their transaction is controlled for purposes of that test by the exception stated in Question 3 of respondent's Legal Ruling (LR) 428, dated August 19, 1987, because the facts in their transaction are "substantially identical" to those in the ruling. Appellants also argue that the opinion of this Board in the Appeal of Thomas P. and Ancella P. Toldrian (96-SBE-), decided on May 15, 1996, was wrongly decided and should be reconsidered.[4] Finally, appellants argue that the form of the transaction that appellants undertook should not be elevated, for purposes of the gross receipts test, over the economic substance of that transaction.

Respondent contends that the gross receipts test of former section 18162.5, subdivision (f)(1), may be applied only to Holding and that the gross receipts of its subsidiaries may not be taken into account. It argues that the statute is clear on its face that only the corporation whose stock was sold by a taxpayer may be considered when applying the gross receipts test and cites the Appeal of Murray Schwartz (94-SBE-009), decided by this Board on March 9, 1994, as controlling authority with regard to that proposition. Respondent also argues that appellants have misrelied on Question 3 of

---

[2] Holding was an accrual basis taxpayer. Appellants state that only a portion of interest accrued during the appeal year was actually received by Holding during that year.

[3] Both former section 17063.11 and former section 18162.5 have been repealed for taxable years beginning on or after January 1, 1987.

[4] We note that the appellants in Toldrian have filed a petition for rehearing in that matter. We have denied that petition on the same date as our opinion in the instant matter. The reasons for our denial of the petition for rehearing in Toldrian are, in essence, stated in the text below.

LR 428 because the facts in that ruling are distinguishable from those in this matter. For the reasons stated below, we agree with respondent's contention and disagree with that of appellants.

We begin our discussion by stating our view that, even though our ultimate conclusion here favors respondent, Murray Schwartz is not controlling with regard to the issue that we are considering. In Murray Schwartz, we held that, for purposes of former section 18162.5, subdivision (e)(1), the determination of the commercial domicile of a corporation whose stock was sold by a taxpayer could properly take into account only the corporation that issued the stock and not its affiliates. In support of our holding, we stated that the statute under consideration there was clear on its face and required no further interpretation. However, as appellants point out, subdivision (f)(1) of former section 18162.5 was not at issue in Murray Schwartz, and we have stated in the Appeal of Russell B., Jr. and Margaret A. Pace (92-SBE-013), decided by this Board on May 7, 1992, that the very fact that respondent promulgated LR 428 interpreting aspects of subdivision (f)(1) refutes its argument that the statute that we are considering here is clear on its face when applied to all circumstances. Therefore, it is appropriate for us to consider appellants' argument that they should prevail under Question 3 of LR 428.

The preamble to LR 428 states that its purpose is to announce respondent's position regarding a variety of issues arising from the small business stock provisions contained in former section 18162.5. Respondent's representative at the hearing indicated that the questions in the ruling were primarily based on inquiries that were actually received by respondent from taxpayers or their representatives.

The following facts and questions were presented in Question 3 of LR 428:

The taxpayers in the ruling formed a California operating company on January 1, 1983. On August 14, 1986, the company was effectively "reincorporated" in Delaware under a plan of reorganization. As part of the reorganization, a Delaware holding company and its wholly owned Delaware operating subsidiary were formed, and the assets of the California operating company were transferred to the Delaware operating subsidiary. The taxpayers received shares of the Delaware holding company in exchange for their stock in the California operating company. The business of the California operating company was unchanged in the hands of the Delaware operating subsidiary, the commercial domicile of which was California. The ruling states that the reorganization was structured as a forward triangular "A" reorganization under Internal Revenue Code (IRC) section 368(a)(2)(D) and that the conclusions reached in the ruling were equally applicable to a reverse triangular "A" reorganization under IRC section 368(a)(2)(E). The ruling does not state whether the reorganization would qualify as a reorganization under IRC section 368(a)(1)(F).

The two subquestions in Question 3 of the ruling are (1) what is the date of acquisition of the shares of the Delaware holding company by the former shareholders of the California operating company and (2) what is the appropriate way to apply the gross receipts tests, contained in subdivisions (e) and (f)(1) of former section 18162.5, to the Delaware holding company. In the answer segment of the ruling, it is stated that the answer to subquestion 1 is January 1, 1983, the date on which the California operating company was formed. The answer to subquestion 2 is that the gross receipts tests

are to be applied as if the Delaware holding company and its Delaware operating subsidiary were a "single corporation." Subquestion 2 and its answer state the exception into which appellants have attempted to place themselves.

Question 3 of the ruling contains an analysis segment that provides rationales for the answers to the subquestions. The analysis segment is divided into two parts. Each part corresponds, at least roughly, to the subquestion and answer in the ruling of the same number. In justifying the conclusion that the shares of the Delaware holding company are to be treated as having been acquired on the date that the California operating company was formed, part 1 of the analysis segment places great emphasis on the fact that the operations of the California operating company were continued, unchanged, by the Delaware operating company despite the interposition of a holding company between the ultimate operating company and the shareholders of the original operating company. Part 1 of the analysis segment ends by stating, in pertinent part, that "the conclusions reached in this question are limited to the facts as described and will not be applied in other contexts."

Part 2 of the analysis segment begins by stating that "the conclusion reached above" is predicated upon the fact that the Delaware holding company is a "true holding company" whose only asset is the stock of the Delaware operating subsidiary. In reaching the conclusion that the gross receipts tests should be applied as if the Delaware holding company and its Delaware operating subsidiary were a "single operating company," part 2 first emphasizes the unfairness that might result if the benefit of the small business stock provisions could be gained or lost through the manipulation of the timing of dividends from the Delaware operating subsidiary to the Delaware holding company. Part 2 then states that application of the gross receipts tests to the Delaware holding company alone would ignore the Delaware operating subsidiary, "which was the intended focus of the gross receipts tests under discussion."

In the present case, respondent takes the position that appellants may not benefit from the exception stated in subquestion 2 of Question 3 because the statement at the end of part 1 of the analysis segment that "the conclusions reached in this question are limited to the facts as described and may not be applied in other contexts" is applicable to Question 3 as a whole and not merely to subquestion 1. Appellants, on the other hand, deny that the aforementioned language applies to subquestion 2 and appear to rely upon the lack of any reference to a reorganization in part 2 of the analysis segment to justify their position that the combination of Holding and its operating subsidiaries should be permitted for purposes of the gross receipts test under former section 18162.5, subdivision (f)(1). We think that respondent's position is the better of the two.

In the first place, as respondent indicated at the hearing, the questions and answers contained in LR 428 were primarily responses to inquiries about particular transactions. Respondent stated at the hearing that Question 3 of the ruling was its response to an inquiry regarding the "unique and special situation" of shareholders who had originally received stock in an operating company but then received stock in a holding company as the result of a forward triangular "A" reorganization. Although the language in part 2 of the analysis segment upon which appellants rely makes no reference to a reorganization, we think respondent's statement at the hearing demonstrates a concern to protect the expectations, regarding the small business stock status of their stock, of shareholders who

purchased shares in an operating company even though those shares were subsequently exchanged for shares in a holding company formed as part of a reorganization that had no operational significance. We see no reason why that concern should apply to one part of Question 3 and not to the other. Moreover, we see no reason why that limited concern should be treated as having been expanded by subquestion 2 of Question 3 to permit shareholders who had formed a holding company for the purpose of acquiring a new business to receive a tax benefit to which they would not otherwise be entitled under a literal reading of the small business stock provisions. If respondent had intended to provide such a tax benefit to those shareholders, we think that it would have expressed that significant intention in a question of its legal ruling that was devoted solely to that issue.

In view of the foregoing, we conclude that the statement at the end of part 1 of the analysis segment of the ruling that "the conclusions reached in this question are limited to the facts as described and will not be applied in other contexts" was intended to implement respondent's underlying concern with respect to Question 3 as a whole. The mere inartful placement by respondent of that statement at the end of part 1 of the analysis segment does not detract from our conclusion. Because of the basic dissimilarities between the facts of the ruling and the facts of the instant appeal, we further conclude that no part of Question 3 provides support for the combination of Holding and its operating subsidiaries for purposes of the gross receipts test under former section 18162.5, subdivision (f)(1).

With regard to respondent's next argument, we disagree that our opinion in Toldrian was wrongly decided. The only justification for reconsideration that has been offered by appellants is that the taxpayers in Toldrian did not make an argument based on Question 3 of LR 428. However, as appellants themselves acknowledge, an argument based on Question 3 is an alternative argument to the argument based on unitary business principles actually made by the taxpayers in Toldrian. The taxpayers there were under no obligation to make such an alternative argument and, for whatever reason, chose not to make it. In Toldrian, the taxpayers argued that a parent corporation and its subsidiaries should be treated as a single entity for purposes of former section 18162.5, subdivision (f)(1), if they were treated as a single entity for unitary business purposes. We rejected that argument essentially because the small business stock provisions and the unitary business provisions of the Revenue and Taxation Code made no explicit reference to one another and served completely different purposes. To have concluded otherwise would have resulted in a potential double tax benefit for taxpayers even though there is no evidence that such a double tax benefit was intended by the Legislature. Because we consider our reasoning in Toldrian to be almost self-evidently correct, we take this opportunity to reaffirm our holding in that matter.

Appellants' final argument is that they should prevail here because the form of the transaction that they undertook should not be elevated for purposes of the gross receipts test of former section 18162.5, subdivision (f)(1), over the economic substance of that transaction. However, appellants chose the form of their transaction for sound business reasons, and it is axiomatic that a taxpayer is normally required to accept the tax consequences of the form of the transaction that he chose for business purposes. Former section 18162.5, subdivision (f)(1), stated in pertinent part that small business stock does not include an equity security issued by a corporation more than 25 percent of whose gross receipts in the income year immediately before the sale of the equity security consisted of interest. The equity security sold by appellants was the stock of Holding. Therefore, in the absence

of other persuasive arguments to the contrary, we conclude that appellants must accept the tax consequences that result from applying the gross receipts test of former section 18162.5, subdivision (f)(1), to Holding alone. Because the amount of interest that Holding received in the income year before appellants sold their stock in Holding disqualified that stock as small business stock, we must further conclude that the unrecognized gain from appellants' sale of their stock in Holding was properly reportable as preference income.

Accordingly, respondent's action in this matter must be sustained.

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 DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Michael W. and Ellen Michelson against a proposed assessment of additional personal income tax and, pursuant to section 19060 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board in denying the claims of George and Leanne Roberts and George A. and Winifred M. Vandeman for refund of personal income tax in the amounts and for the year as follows:

Appellants	Years	Proposed Assessment	Claims For Refund
George and Leanne Roberts 93R-0489	1985		$246,384.52
Michael W. and Ellen Michelson 93A-0211	1985	$19,705	
George A. and Winifred M. Vandeman 91R-0513	1985		31,996.89

be and the same are hereby sustained.

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

Johan Klehs, Chairman

Ernest J. Dronenburg, Jr., Member

Dean F. Andal, Member

_____, Member

Rex Halverson*, Member

*For Kathleen Connell, per Government Code section 7.9.