97-SBE-005

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of) No. 93R-1216
Mary G. Brown)

Representing the Parties:

For Appellant: Michael H. Starler, Attorney

For Respondent: Jean Cramer, Counsel
Karen D. Smith, Counsel

Counsel for Board of Equalization: Derick J. Brannan, Tax Counsel

O P I N I O N

This appeal is made pursuant to section 19324, subdivision (a),[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Ms. Mary G. Brown for a refund of personal income tax in the amount of $132,854.29[2] for the 1986 taxable year.

On February 1, 1986, appellant redeemed 200 shares of stock in the Ramak Corporation (Ramak) for $3,000,000. Respondent assessed tax on 50 percent of the gain on the redemption as preference income, resulting in an additional tax liability for the appellant of $80,764.50. Appellant claims that the stock is qualified small business stock and therefore should not be taxed as a preference item pursuant to former sections 17063.11 and 18162.5. In the alternative, appellant claims that the money and stock were exchanged as part of a transfer incident to divorce, and therefore, she should not recognize any gain on the redemption. Respondent disputes each of appellant's substantive

[1]Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the year in issue.
[2]This amount consists of $80,764.50 in taxes and $52,089.79 in interest.

arguments and also contends that this Board should not consider the latter issue because appellant did not raise it in a timely fashion.

I. Small Business Stock:

Qualified small business stock was not subject to a preference tax for the year in question pursuant to Former sections 17063.11 and 18162.5. In order to avoid the preference tax, appellant first contends that the Ramak stock qualified as small business stock when she redeemed it for a substantial gain in 1986.

By way of background, appellant and her ex-husband jointly owned 70 percent of Ramak. Appellant received 200 shares of the Ramak stock as part of a divorce settlement. Shortly after appellant received that stock, Ramak exercised its right to redeem the stock for $3,000,000.

Ramak operated a unitary business with its subsidiaries (the Ramak Group), which in turn sold and manufactured cryogenics equipment. Ramak's only "business" was the rental of equipment to the subsidiaries in the Ramak Group; at the hearing, appellant's counsel acknowledged that Ramak was, "essentially a holding company" for the subsidiaries. According to appellant, Ramak had gross receipts of $92,148 during the income year preceding the stock redemption. Of those receipts, $77,350 represented rental income; of that rental income, $74,008 came from Ramak subsidiaries.[3]

Former section 18162.5, subdivision (f), set forth the requirements for stock to qualify for treatment as small business stock at the time of disposition. The only requirement in dispute was contained in subdivision (f)(1), which indicated that stock will not qualify as small business stock if, during the income year immediately prior to the sale or exchange of the stock, "more than 25 percent of its gross receipts were obtained from rents, interest, dividends, or sales of assets." (Former Rev. & Tax. Code, § 18162.5., subd. (e)(4), emphasis added.) Because more than 25 percent of Ramak's gross receipts came from rents during the prior income year, respondent determined that the Ramak stock did not qualify as small business stock. On appeal appellant makes two distinct arguments: first, that the gross receipts determination should include the total receipts of the Ramak Group; and second, that the rental receipts represent "active" rather than "passive" income and should not be included in the gross receipts calculation.

A. Combined Gross Receipts of the Ramak Group:

Appellant relies on two portions of the Franchise Tax Board's (FTB) Legal Ruling (LR) Number 428 in support of its argument that the gross receipts test should include the gross receipts of the whole Ramak Group. (FTB LR 428, Aug. 19, 1987.) If gross receipts are determined in this fashion, appellant contends that less than 25 percent of Ramak's receipts stem from rental income. Question 3 of LR 428 discusses the gross receipts test as applied to an entity which splits into a holding

[3]Respondent contends that Ramak's correct gross receipts were $89,885, which included interest of $5,658 and rents of $77,350. The precise figures are not critical to our resolution of the appeal because they do not substantially alter the relative percentage of Ramak's rental income.

company and an operating company in order to change its place of incorporation (a forward triangular "A" reorganization). The legal ruling concludes that the two resulting entities should be considered as one for purposes of the gross receipts test because the business continued essentially unchanged after the reorganization. (FTB LR 428, supra, Question 3.)

Subsequent to the time that appellant filed her appeal, this Board issued its decision in the Appeals of George and Leanne Roberts, et al. (96-SBE-020), decided on October 10, 1996. (See also Appeal of Thomas P. and Ancella P. Toldrian, 96-SBE-013, May 15, 1996.) In the Roberts case, we held that no part of Question 3 provides support for the combination of a holding company and its operating subsidiaries for purposes of the gross receipts test under former section 18162.5, subdivision (f)(1). (Roberts, supra; FTB LR 428, supra.) We adhere to our decision and rationale in Roberts, and will not allow appellant to combine the receipts of the Ramak Group for purposes of the gross receipts test.

B. Rents as Active or Passive Income:

Appellant also argues that Ramak's rental income is "active" income such that it would be contrary to the legislative intent to include those rents in the gross receipts calculation. LR 428, Question 22, by reference to Question 12, suggests that there may be a "difference in treatment of rents received in the normal course of a trade or business versus rental income derived from investment activity." (FTB LR 428, supra, Question 22.) The analysis for Question 12 indicates that the intent of the small business stock provisions "was to prevent the small business stock benefits flowing from investments in corporations which engage in passive investment activities." (FTB LR 428, supra, Question 12.)

Appellant relies primarily on this Board's decisions in the Appeal of Russell B., Jr., and Margaret A. Pace (92-SBE-013), decided on May 7, 1992, and the Appeals of Thomas J. and Gerd Perkins, et al. (96-SBE-010), decided on April 11, 1996. In Pace, the subject business received a property dividend as part of a corporate reorganization. This Board held that the distribution did not preclude small business stock treatment because the distribution was not the result of passive investment activity. (Appeal of Pace, supra.) In Perkins, the subject business earned interest on money held temporarily pending its use in the business operations. This Board held that such minimal interest income was not passive investment income of the type envisioned by the statute. Appellant argues that Ramak's rental receipts are the same type of active income excluded from the gross receipts determination in both Pace and Perkins.

Respondent relies on the express statutory language of former section 18162.5, subdivision (f)(1), which included all income from "rents" in the gross receipts determination. The statute itself did not recognize a distinction between active and passive receipts, as suggested by LR 428. Further, respondent argues that rental receipts necessarily represent passive activity of the type sought to be included in the gross receipts test, particularly in a case such as this, where Ramak is essentially a holding company. According to respondent, to exclude receipts from a passive activity such as equipment rental is inconsistent with the stated purpose of the small business stock provisions, that being to encourage the development of small businesses in California. For these reasons, respondent also argues that neither Pace nor Perkins should control the instant decision.

We agree with respondent's position in this matter. While the Pace decision does state that "all the income items listed in section 18162.5, subdivision (f)(1), should be construed to include only items that are 'passive' as that term is used in LR 428," neither Pace nor Perkins necessarily support appellant's position. Both Pace and Perkins concern an entity directly involved in an active business concern. The dividends and interest were received as an intermediate step in the active operations of that business concern. Further, neither entity was a holding company, and neither entity treated the interest or dividends as its primary source of receipts. The same cannot be said about Ramak.

Ramak's only significant activity was the rental of equipment to its own subsidiaries. There is no evidence that Ramak routinely offered its assets for rent to the public at large, or that Ramak was otherwise actively involved in the marketplace. Ramak merely held title to various assets rented to its subsidiaries; any receipts derived from those rentals were akin to passive investment income and were not "active" receipts of the type envisioned by the Pace and Perkins decisions.

Additionally, although this Board continues to recognize a meaningful distinction between active and passive receipts for purposes of the determination under former section 18162.5, subdivision (f)(1), we will require a substantial evidentiary showing as to the active nature of receipts stemming from the items specifically set forth in that statute. Such a conclusion is necessary in order to give due deference to the statutory language and remain consistent with the undisputed purpose of the small business stock legislation. Appellant makes no such showing in this case.

For these reasons, we find that Ramak's rental receipts were passive receipts and therefore should be included in the gross receipts test for purposes of determining whether the Ramak stock constituted qualified small business stock in the year of the redemption.

II. Issue Bar:

When appellant filed her original 1986 tax return, she sought to exclude the gain on her sale of the Ramak stock solely on the basis that it qualified as small business stock.[4] Respondent issued a Notice of Proposed Assessment on January 9, 1992, which denied appellant's requested treatment of the Ramak stock. Appellant protested the assessment on the same basis and respondent denied appellant's protest. On January 21, 1993, appellant filed a timely appeal with this Board in which she argued only that the Ramak stock qualified as small business stock. On November 1, 1995, respondent filed an opening brief in which it only addressed the small business stock issue. On February 20, 1996, nearly nine years after filing her original return, appellant filed her first reply brief; in that brief, appellant argued for the first time that she should not recognize the gain from the sale of Ramak stock because she exchanged the stock in a transfer incident to divorce.

Every refund claim shall be in writing and shall state the specific grounds upon which it is founded. (Rev. & Tax. Code, § 19055.) "The claim must set forth in detail each ground upon which a

[4]While undergoing an audit, appellant agreed to an extension of the statute of limitations for proposing an assessment; that agreement allowed an extension until the issuance of an assessment.

refund or credit is claimed and facts sufficient to apprise the Franchise Tax Board of the exact basis thereof." (Cal. Code. Regs., tit. 18, § 19055, subd. (a).) Further,

> "[n]o refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefore except upon one or more of the grounds set forth in a claim filed before the expiration of such period."

(Cal. Code Regs., tit. 18, § 19055, subd. (a).)

Based on the facts presented, appellant failed to set forth the divorce issue when she filed her claim for refund as required by the regulations in support of section 19055. However, before we invoke the procedural bar implicit in the regulations, we must consider the facts and circumstances surrounding this particular appeal and find substantial delay and prejudice to the respondent.

This Board previously considered the circumstances under which it would be appropriate to preclude a party from raising a particular issue at a Board hearing when we decided the Appeal of Beneficial California, Inc. (96-SBE-001), decided on February 22, 1996. In that case, the taxpayer agreed to defer its Board hearing pending a decision by the United States Supreme Court on a similar issue. After the Supreme Court rendered its decision, and only one month before the Board hearing, the taxpayer attempted to raise new issues for consideration by the Board. The Board found that the taxpayer did not properly identify the new issues in its original claim for refund and that there had been no opportunity for respondent to develop the facts necessary to properly evaluate the case for the hearing. For those reasons, the Board refused to consider the new issues.

Respondent argues that the Beneficial decision should operate to bar appellant from raising her alternative argument regarding the treatment of property transferred incident to divorce. While it is our strong preference to consider the merits of every pertinent issue attendant to an appeal, certain procedures must be followed in order to assure that both parties are able to present their case in the best light and that California may ultimately collect the proper tax. This case highlights the relative importance of those goals.

Appellant argues that the Beneficial decision focused on prejudice to the respondent and that respondent has now had an adequate opportunity to evaluate the evidence and legal arguments so as to avoid any element of surprise at the hearing. We concur that respondent did have an adequate opportunity to present its case; however, the prejudice identified in Beneficial may be of two types. The first is illustrated in Beneficial and appears when one party takes undue advantage of another for purposes of a particular hearing. The second is illustrated by the facts of the present case and arises when the taxing agency is prejudiced, through no fault of its own, such that it is prevented from accomplishing its goal of properly administering the tax system.

Respondent did not address the divorce issue until it filed its first reply brief on April 3, 1996. At that time, the statute of limitations for purposes of issuing an assessment against appellant's

ex-husband had already expired.[5] As evidenced by this case, when the legal issue pertains to the proper taxpayer rather than the efficacy of the underlying tax, timing is critical. These circumstances present a situation in which the respondent may be whipsawed by appellant's delay in raising the divorce issue; in short, the longer appellant waits to raise the issue, the less time respondent has to investigate the ex-husband's tax return, and the greater the potential that the transaction may escape taxation altogether. This particular issue did not appear until February 20, 1996, well after the expiration of the statute of limitations for assessing additional taxes against the ex-husband. Assuming that appellant's claimed treatment is sustained, such a result leaves the respondent powerless to properly administer the tax system. We cannot accept such a result when the factual circumstances demonstrate such a lack of diligence on the part of the appellant. In rendering this decision, we recognize that the holding of this case will not absolutely eliminate the potential for a whipsaw of the respondent in all cases, it will certainly minimize the possibility of abuse resulting from taxpayer collusion and/or delay.

Based on our conclusion that appellant did not timely raise the divorce issue, we need not consider that issue for purposes of resolving this appeal.

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[5]Under normal circumstances, the applicable statutory period runs either four years from the date the original return is due or one year from the date of the alleged overpayment. (Rev. & Tax. Code, § 19053.) However, if the taxpayer agrees in writing to extend that time, the taxpayer may file a claim for refund so long as the respondent may propose an additional assessment. (Rev. & Tax. Code, § 19053.3.)

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Ms. Mary G. Brown for a refund of personal income tax in the amount of $132,854.29 for the year 1986 be and the same is hereby sustained.

Done at Sacramento, California, this 10th day of April, 1997, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Andal, Mr. Klehs, Mr. Halverson* and Mr. Chiang** present.

Ernest J. Dronenburg, Jr., Chairman

Dean F. Andal, Member

Johan Klehs, Member

Rex Halverson*, Member

John Chiang**, Member

*For Kathleen Connell, per Government Code section 7.9.
**Acting Member, 4th District.

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