

BEFORE THE STATE BOARD OF EQUALIZATION.
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
CRAFTON WATER COMPANY, et al.)

Appearances:

For Appellants: Thomas **McPeters**
Attorney at Law

For Respondent: Carl G. Knopke
Counsel

O P I N I O N

These appeals are made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board, on the protests of **Crafton** Water Company, et al., against proposed assessments of additional franchise tax in the following amounts and for the following years:

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<u>Appellant</u>	<u>Amount</u>	<u>Penalty</u>	<u>Income Year Ended</u>
Crafton Water Co.	\$56,713.48	\$2,835.67	2/28/77
Redlands Water Co.	39,362.83	--	11/30/77
West Redlands Water Co.	30,838.39	--	12/31/76
East Redlands Water Co:	8,739.70	--	12/31/76
East Lugonia Mutual Water Co.	1,781.89	--	12/31/76

The central issue is whether property distributed to appellants by Bear Valley Mutual Water Company in accordance with a plan of partial liquidation is subject to taxation at the time of distribution, and, if so, to what extent. In addition, appellant Crafton Water Company's proposed tax assessment includes a late filing penalty, which is not being contested, but will require adjustment to reflect any change in the underlying tax assessment. Because of the identity of facts, issues and legal principles involved in each case, the appeals are consolidated for purposes of this opinion.

Appellants are each nonprofit mutual water companies which, in turn, are each shareholders of Bear Valley Mutual Water Company (hereinafter "Bear Valley"), another nonprofit mutual water company. On December 23, 1976, pursuant to a plan of partial liquidation adopted on November 5, 1976, Bear Valley distributed certain assets to appellants in exchange for 25 percent of its stock held by them. This plan was adopted in order to distribute to its shareholders certain assets held by Bear Valley which had been condemned by a municipal water district through the power of eminent domain. Apparently, appellants did not treat such distributions as taxable events. However, on audit, respondent determined that such distributions were taxable as "amounts distributed in partial liquidation of a corporation" pursuant to Revenue and Taxation Code section 24501, subdivision (b).

Revenue and Taxation Code section 24501, subdivision (b), provides that "[a]mounts distributed in partial liquidation of a corporation (as defined in Section 24516) shall be treated as in part or full payment in exchange for the stock." As such, the transfer of stock in exchange for money or other property is treated as an ordinary sale, the gain from which is deemed to be the excess of the amount realized therefrom over the adjusted basis of the stock surrendered. (See Rev. &

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Tax. Code, § 24901.) For transfers of stock for property that qualify for such liquidation treatment, gain to the shareholder is computed by subtracting the adjusted basis of the stock surrendered by him from the fair market value of the property received by him. Accordingly, respondent determined that gain was to be computed on the subject distributions as though the stock exchanged had been sold for the above-noted **property**.

Apparently, appellants' primary contention in opposition to respondent's determination is not that Revenue and Taxation Code section 24501, subdivision (b), does not apply to the subject distributions as such, but that the amounts distributed to them on December 23, 1976, represent either a return of excess assessments or a return of bases and, on either count, are nontaxable. To this end, appellants first rely on Revenue Ruling 60-49, 1960-1 Cum. Bull. 148, for the argument with respect to excess assessments, and, second, contend that the fair market value of the distributions did not exceed appellants' adjusted bases in their Bear Valley stock. As an alternative contention, appellants argue that the distributions represent "income from or arising out of business activities for or with members," which should be deductible within the meaning of Revenue and Taxation Code section 24405. Another argument of appellants' to the effect that Revenue and Taxation Code section 24452, subdivision (a)(2), requires taxation of the distribution as a dividend has been abandoned and, accordingly, will not be discussed further.

Appellants' primary argument is that Revenue Ruling 60-49 requires that the subject distribution be treated as a nontaxable return of excess assessments by Bear Valley. We find that appellants have misread **Revenue Ruling 60-49**; that ruling has no application to the instant situation. In that ruling, a mutual irrigation company was completely liquidated pursuant to Internal Revenue Code section 333, which provides that a shareholder's gain on the complete liquidation of a corporation may go entirely unrecognized under certain circumstances. (See Rev. & Tax. Code, § 24503.) Section 333 is a special provision of the Internal Revenue Code applicable only to complete liquidations of corporations that occur within one month and does not apply to partial liquidations as found in the instant cases. (Bittker and **Eustice, Federal Income Taxation of Corporations and Shareholders** (4th ed. 1979), ¶ 11.22.) **Accordingly, in Revenue Ruling 60-49, it was clear that, pursuant to section 333, the amounts distributed in complete liquidation of the corporation**

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were eligible -for nontaxable treatment. Notwithstanding the otherwise tax-free complete liquidation, the ruling provided that, pursuant to the tax benefit rule, to the extent that the amount distributed reflected previously deducted excessive noncapital assessments for which the shareholder had received a tax benefit, the amount distributed should be restored to income and taxed as ordinary income. Thus, Revenue Ruling 60-49 actually provides for the taxation of returns of excess assessments as ordinary income in an otherwise nontaxable distribution. Revenue Ruling 60-49 does not provide that restorations of such assessments are nontaxable, as appellants apparently contend. Moreover, contrary to appellants' contention, different tax treatment does result from a partial liquidation than from a complete liquidation. (Compare Rev. & Tax. Code, § 24501 with Rev. & Tax. Code, § 24503.) Again, contrary to appellants' contention, Revenue Ruling 60-49 has no application to the instant cases.

As indicated above, appellants' next argument -contesting the validity of the instant determinations also appears, at least tacitly, to agree with respondent that the amounts distributed are taxable pursuant to Revenue and Taxation Code section 24501, subdivision (b). However, in essence, appellants argue that the fair market value of the property received did not exceed the adjusted bases of the stock transferred so that gain was not realized on the liquidation. Thus, appellants conclude that no tax would be due on such distributions.

We note initially that it is well settled that a presumption of correctness attaches to the action of respondent, and it is incumbent upon the taxpayer to prove otherwise.. (Appeal of Thomas A. Beckett Investment co., Cal. St. Bd. of Equal., July 22, 1952.) Appellants have offered no evidence with respect to the fair market value of the property transferred to them in exchange for the stock, and, accordingly, we must find that the values as determined by respondent are correct. Instead, appellants initially focused their attention upon the adjusted bases of the stock surrendered. Citing Bear Valley Mutual Water Co. v. Riddell, 283 F.Supp. 949 (C.D. Cal; 1968), affd, per curiam, 427 F.2d 713 (9th Cir. 1970), appellants correctly observe that part of the regular assessments made by Bear Valley on them is a contribution to capital. The bases of appellants' stock in Bear Valley would, of course, be increased by the amount of such capital contribution. (See, e.g., Weeks v. White, 77 F.2d 817 (1st Cir. 1935).)

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We note that the parties to these actions have now entered into a stipulation reflecting the adjustments to bases required by such contributions. We find, accordingly, that respondent's determination should **reflect** these adjustments to bases, but we hold that in all other respects, 'respondent's, reliance on Revenue and Taxation Code section 24501, subdivision (b), is proper.

Lastly, appellants contend that the subject distributions should be deductible within the meaning of Revenue and Taxation Code section 24405 as representing income arising out of business activities for or with members. Again, we find that section 24405 has *no* application to the instant situation. As indicated above, the issue, as framed, is the tax effect to shareholders of a partial liquidation by Bear Valley, not the tax effect, if any, to **Bear Valley**. Section **24405** provides for a deduction to mutual associations for "**all** income resulting from or arising out of business activities for or with their members, ..." As noted above, appellants are all shareholders of Bear Valley. Accordingly, appellants are the members of the mutual association known as Bear Valley. Thus, the deduction to income that is contemplated by Revenue and Taxation Code section 24405 would apply, if allowable, to the mutual association (i.e., Bear Valley) and not to the members of that association (i.e., appellants). Moreover, **we have** held that the purpose of section 24405 is "**to exclude from tax the savings or price adjustments produced by a cooperative in carrying out the purpose for its existence**" (Appeal of Los Angeles Firemen's Credit Union, Inc., Cal. St. Bd. of Equal., June 28, 1966.) Clearly, the distributions of the condemned assets to Bear Valley's members are not such price adjustments, and they would not be deductible by appellants within the meaning of section 24405.

Based on the above, we must sustain respondent's action except to the extent that it is inconsistent with the stipulation executed involving the adjustment to appellants' bases in the stock transferred.

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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 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of **Crafton Water Company, et al.**, against proposed assessments of additional franchise tax in the following amounts and for the following years:

<u>Appellant</u>	<u>Amount</u>	<u>Penalty</u>	<u>Income Year Ended</u>
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be and the same is hereby modified in accordance with the views expressed in this opinion. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 26th day Of October , 1983, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Collis, Mr. Dronenburg, Mr. Nevins and Mr. Harvey present.

William M. Bennett , Chairman
Conway H. Collis , Member
Ernest J. Dronenburg, Jr. , Member
Richard Nevins , Member
Walter Harvey* , Member

*For Kenneth Cory, per Government Code section 7.9