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2021 – OTA – 014
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **G. KAVIPURAPU**	) OTA Case No. 18011117

OPINION

Representing the Parties:

For Appellant: G. Kavipurapu

For Respondent: Richard I. Tay, Tax Counsel III[1]

For Office of Tax Appeals: William J. Stafford, Tax Counsel III

M. GEARY, Administrative Law Judge: Under California Revenue and Taxation Code section 19324, appellant G. Kavipurapu appeals respondent Franchise Tax Board's denial of his claim for refund of $54,436 for the 2012 tax year.[2]

Because appellant waived his right to an oral hearing, we decide this matter based on the written record.

ISSUE

Is appellant entitled to a refund of any portion of the $733,458 reported as long-term capital gains on his California Resident Income Tax Return filed for the 2012 taxable year?

FACTUAL FINDINGS

1. Narada Systems, LLC (Narada), a Texas LLC, elected to be taxed as a corporation. In 2012, appellant was a member of Narada and served as its president.

[1] The former representative for respondent is now an administrative law judge at the Office of Tax Appeals (OTA). Judge Tay has had no involvement in this appeal since joining OTA.

[2] Appellant and his spouse filed a joint 2012 California return, but they have since divorced. Only appellant signed the appeal letter. For the sake of brevity, although appellant and his ex-spouse filed joint returns while married, this opinion will refer only to appellant.

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2. In January 2012, Narada filed a lawsuit against Violin Memory, Inc. (Violin) alleging infringement on two patents.
3. In September 2012, Three Oaks, LLC (Three Oaks), an Illinois entity, entered into an agreement with appellant and others to purchase all membership interests in Narada (purchase agreement). As part of the same transaction, Three Oaks also purchased four patents (subject patents) which were held by Narada and others.[3] In exchange for the membership interests and patents, Three Oaks agreed to make a series of payments equal to 95 percent of the gross profits derived from commercialization of the patents through licensing, litigation, sale, or product development, said payments being due quarterly based on the cash stock collections (cash or shares of stock) it received. The payments were to be made quarterly, not later than the 20th day of the month immediately following the close of the quarter.
4. After the sale to Three Oaks and for all relevant times in this appeal, appellant remained Narada's president.
5. In October 2012, Violin entered into an agreement to settle the lawsuit between it and Narada and to acquire licenses to exploit the inventions protected by the subject patents (settlement agreement). In return for Narada's dismissal of the lawsuit and the patent owners' or assignees' issuance of the licenses, Violin agreed to pay $700,000 and issue 200,000 shares of restricted Violin stock to the patent holders. Appellant agreed that Violin would deliver all "payments" to Narada. While the Violin stock was restricted and not publicly traded at the time, and although the settlement agreement states that Violin shares then had a par value of $0.0001 per share, the parties to the settlement agreement valued the stock at $7.00 per share.
6. The Violin shares delivered to Narada were restricted because they were unregistered and, therefore, generally could not be sold in the public marketplace absent a recognized exception to Security and Exchange Commission Rule 144. In addition, the parties to the settlement agreement agreed that they would not attempt to dispose of the shares before the shares were registered as part of a public offering without first obtaining and providing to Violin a legal opinion that the disposition did not require registration.

[3] The evidence indicates that Three Oaks' goal was to purchase the patents, some of which were actually held by individual members of Narada or companies set up by those members, including appellant, to hold title to the patents. These ownership details are not material to our analysis.

7. The parties to the settlement agreement understood that the value of the Violin shares was subject to change and that the intended recipients of the shares, including appellant, would reap any gains or suffer any losses that may occur.
8. Narada paid appellant $240,857, his share of Violin's cash payment, in 2012.[4] Appellant's share of the stock consideration was 70,568.07 shares, which Narada did not transfer to appellant at any time.
9. In July 2013, Narada signed a "Waiver of Registration Rights and Notice of Registration Rights" (Waiver and Notice), which added additional restrictions on Narada's ability to register or transfer the Violin shares it held for appellant and others.
10. Violin eventually registered its shares as part of an initial public offering (IPO), which began with its stock publicly trading on the New York Stock Exchange on September 27, 2013.
11. On October 7, 2013, appellant filed an original 2012 California Resident Income Tax Return reporting long-term capital gains of $732,458.
12. On October 8, 2013, Violin advised its stockholders regarding a two-for-one reverse stock split.
13. In April 2014, Narada sold the Violin stock at $4.45 per share and shortly thereafter distributed to appellant his share of the proceeds. Due to the reverse stock split and the substantially lower share price, appellant received far less in sales proceeds than the stock value he reported on his 2012 return.
14. In October 2015, appellant filed an amended 2012 California return to reduce his reported capital gains by $492,601. The amended return was based on appellant's belief that the agreed-upon value of his share of the stock delivered to Three Oak in 2012 did not constitute 2012 income to him because he did not possess or have the right to control and sell the stock in 2012.[5]

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[4] Although the evidence suggests that Narada became an empty shell as a result of the purchase agreement, it apparently continued to function, at least for the purpose of concluding the settlement. In this Opinion, we at times refer to Narada when the evidence indicates that Narada took some action, and at other times we refer to Three Oaks. Such references and the legal status of either entity have no real impact on our analysis.

[5] We do not know whether appellant also reported a capital gain from the sale of the Violin stock in 2014.

15. Respondent treated that amended return as a claim for refund and denied the claim on the grounds that appellant had at least constructive receipt of the stock with the agreed value of $7 per share in 2012. This timely appeal followed.

DISCUSSION

Gross income is all income from whatever source derived, including compensation for services and gains derived from dealings in business and property. (Internal Revenue Code (IRC), § 61(a).) A taxpayer who uses the cash basis accounting method must pay tax on income in the taxable year in which it is "actually or constructively received." (Treas. Reg. § 1.446-1(c)(1)(I).) Income is constructively received by a taxpayer in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. (Treas. Reg. § 1.451-2(a).) The fact that shares of stock paid as consideration are placed in a restricted account with limitations on when, how, and to whom the shares may be sold does not necessarily mean that there is no receipt of the shares when first deposited for the recipient's benefit. (*U.S. v. Fletcher* (7th Cir. 2009) 562 F.3d 839 (*Fletcher*); *U.S. v. Nackel* (C.D. Cal. 2009) 686 F.Supp.2d 1008.)[6] The same is true even when there are forfeiture provisions in addition to other limitations. (*Ibid.*)

Appellant argues that he did not receive the stock in 2012, or at any time, but rather, received only the proceeds of the sale in 2014. Based on those alleged facts, he concludes that he is entitled to a refund of taxes paid on what he only mistakenly thought was income received in 2012.

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[6] Both cases, and several related cases (see, e.g., *United States v. Fort* (11th Cir. 2011) 638 F.3d 1334; *United States v. Berry* (D.N.H. 2008) 2008 WL 4526178; *United States v. Bergbauer* (4th Cir. 2010) 602 F.3d 569, cert. den. (2010) 562 U.S. 893; *U.S. v. Culp* (M.D.Tenn. Dec. 29, 2006) 2006 WL 4061881), involve the same basic issue, the tax treatment of restricted stock that was provided to former Ernst & Young consulting partners as part of the sale of their consulting practice to a large, publicly traded French company. The stock paid to the partners went into restricted accounts. The restrictions included limitations on when, how, and to whom the stock could be sold and a forfeiture provision. The consulting partners filed an original income tax return for the 2000 taxable year, declaring the value of the restricted stock (minus a five percent discount) as present income subject to immediate taxation. Years later, after the value of the stock dropped significantly and most of the partners were no longer employed by the French company, those same partners filed amended tax returns for the 2000 taxable year that sought to modify the tax treatment of the restricted stock so that the value of stock placed in the restricted escrow account was not included as present income for that year, thereby seeking and receiving a tax refund for the 2000 tax year from the government on that basis. The government sued to recover the refund that, it contended, was paid in error and in all cases the courts found in favor of the government, usually based on a finding of constructive receipt.

The parties do not dispute that appellant properly reported the cash portion of the consideration paid by Violin as long-term capital gain received in 2012. There is also no dispute that appellant owed tax on any other consideration received by him in exchange for transfer of Narada and the licenses. The sole issue is whether appellant received the stock as income in 2012.

There is evidence in the record that indicates that appellant's ability to monetize the stock through a sale was limited. The purchase agreement transferred ownership of Narada and the patents to Three Oaks, which had the exclusive right to derive profits from the use of the patented inventions, though the same agreement required Three Oaks to pay 95 percent of the gross proceed from such commercialization to the former owners, including appellant. Violin delivered the stock to Narada, not appellant, and the evidence does not show that appellant ever physically possessed or asserted a right to control the Violin shares. Furthermore, there were restrictions on the transfer of the unregistered shares, which prevented the monetization of the stock for distribution of cash by Three Oaks. However, these facts do not necessarily defeat respondent's contention that appellant constructively received the stock.

First, the evidence indicates appellant chose to have the stock transferred to Narada rather than to himself personally. Violin delivered all the cash and at least most of the stock to Narada,[7] which apparently had no difficulty delivering the cash settlement to appellant in 2012. The evidence does not show why Narada held the stock well beyond the period allowed by the purchase agreement. We are not persuaded that Violin was prohibited from issuing the shares to appellant. Furthermore, the evidence does not show that the restrictions on transfer of the stock agreed to at the time of the settlement prevented Narada from transferring the stock to appellant in 2012.[8] It is unlikely that such a transfer would have been considered a public sale. (See *People v. Humphreys* (1970) 4 Cal.App.3d 693, 697-698.) In addition, the fact that the settlement agreement states that appellant, and only appellant, agreed that payments to Narada constituted full consideration indicates that appellant specifically wanted Narada to hold the shares. As observed by the 7th Circuit in *Fletcher*:

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[7] The evidence (principally the Stock Issuance Agreements) account for only 188,000 of the 200,000 shares.

[8] The Waiver and Notice was not signed by Narada until months after the settlement and the date by which Three Oaks was required to distribute the collected amounts (cash and stock) to appellant.

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> [A] taxpayer's willingness to defer consumption does not defer taxation—for the tax falls on income rather than consumption. See 26 U.S.C. § 451(a) (any item of gross income is taxed in the year received). Income is "received" not only when paid in hand but also when the economic value is within the taxpayer's control; this is known as constructive receipt. 26 C.F.R. § 1.451–2. It is why a person who earns income can't avoid tax by telling his employer to send a paycheck to his college, or his son, rather than to his bank. Authority to direct the disposition of income is constructive receipt.

(*Fletcher*, *supra*, 562 F.3d, at p. 843.)

Second, appellant received unregistered, and therefore restricted, shares because they were part of the bargain he made. He wanted, or at least was willing to accept the stock knowing that the shares had no established market value, that he would be limited in what he could do with the stock, and that he could lose the gamble as easily as he could win it. It is unlikely that he believed the agreed-upon $7 per share was an unreasonably low value, and even less likely that he was expecting the market value of the shares to be less than $7 per share after the IPO. It is more likely than not that appellant expected the stock value would exceed the $7 mark, which would make his decision to agree upon that mark a good one. But the reality is that the decision also carried risks, which appellant assumed when he made the deal. The evidence that appellant chose to accept the unregistered stock and directed that it be held by Narada, and the fact that he was always going to be the sole beneficiary of any gain and the sole victim of loss persuades us that he constructively received the stock in 2012. (See *Fletcher*, *supra*, 562 F.3d, at p. 844.)

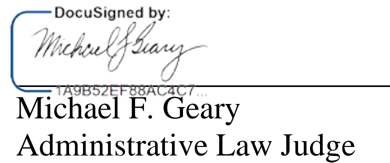
Based on the evidence, we find that appellant had at least constructive receipt of the stock in 2012.

HOLDING

Appellant is not entitled to a refund of any portion of the $733,458 reported as long-term capital gains on his California Resident Income Tax Return filed for the 2012 taxable year.

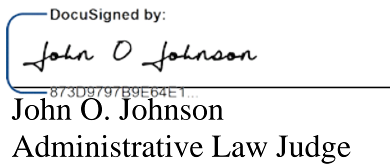
DISPOSITION

We sustain respondent's action denying appellant's claim for refund.



Michael F. Geary
Administrative Law Judge

I concur:



John O. Johnson
Administrative Law Judge

A. ROSAS, Concurring, in part:

The majority and respondent Franchise Tax Board rely on the constructive receipt theory. Under this theory, the majority holds that appellant G. Kavipurapu constructively received the shares in 2012 and must report their fair market value as income on his 2012 return. Although I concur with sustaining respondent's denial of appellant's claim for refund, I do so not under the constructive receipt theory but under the installment sale method.

Under Internal Revenue Code (IRC) section 453(a), a taxpayer generally shall report income from an installment sale under the installment method. An "installment sale" is defined as a disposition of property for which at least one payment is to be received after the close of the taxable year of the disposition. (IRC, § 453(b)(1).) Under Revenue and Taxation Code (R&TC) section 17551(a), California law conforms to federal law concerning installment sales.

In 2012, appellant and the other members of Narada Systems, LLC (Narada) sold all their Narada membership interest to Three Oaks, LLC (Three Oaks). Based on the Purchase Agreement, it is more likely than not that the parties contemplated that some of the payments would be received after 2012—that is, after the close of the taxable year of the disposition.[1] Thus, the sale of the Narada membership interest constituted an installment sale.

The Purchase Agreement was based on contingent payments: "Said payments shall be equal to 95% of the 'Gross Profits' derived from commercialization of the Patents, through licensing, litigation, sale, or product development." The regulations under IRC section 453 apply several conventions to contingent payments, such as earn-outs. The criteria on which earn-outs are determined can be financial in nature, including sales revenues, net profits, income, or measures such as earnings. For example, in sales of patents, because the value of a patent cannot be easily ascertained due to various inherent uncertainties, it is quite reasonable for sellers and buyers to use contingent payments.[2] Temporary Treasury Regulation section 15A.453-1(c) provides the conventions applied under the installment method to sales, which include contingent payments.

A taxpayer may elect to opt-out of the installment method. (IRC, § 453(d)(1); Temp. Treas. Reg. § 15a.453-1(d)(1).) Except as otherwise provided in the regulations, IRC section 453(d)(2)

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[1] The September 2012 Purchase Agreement states the buyer, Three Oaks, shall make payments to the seller "on a quarterly basis . . . based on the cash or in-kind (i.e. stock) collections that it has received during the month then ended." The Purchase Agreement also states that it "shall remain in effect during the life of the Patents........"

[2] See Izzo, *Contingent Payment Transfers of Trademarks: A Sale in License Clothing* (1992) 12 Va. Tax Rev. 263, 265, 276.

requires a taxpayer who desires to opt-out of the installment method to do so on or before the due date (including extensions) of the taxpayer's federal income tax return for the taxable year of the sale. The U.S. Tax Court found that for a taxpayer to elect to opt-out of the installment method, Temporary Treasury Regulation section 15a.453-1(d)(3)(i) requires the taxpayer to report the full selling price and the full amount of income on the taxpayer's income tax return for the taxable year in which the installment sale occurred. (*Estate of Wilkinson v. Commissioner* (1993) 66 T.C.M. 986, 987.) The requirement of reporting the full amount of the sales price in the year of the sale is the "substance or essence of the election-out provision." (*Id*. at p. 988.) Compliance with this Treasury Regulation is mandatory to elect out of the installment sale method. (*Ibid*.)

For federal income tax returns, to opt-out of the installment method, a taxpayer would report the sale on Form 8949, Form 4797 or both; a taxpayer would not report the sale on Form 6252. (IRS Pub. 537 (2012) at p. 5). That is what appellant did here; he reported the sale on Form 8949, not on Form 6252. Appellant indicated on Form 8949 that he sold this property in September 2012, for "Proceeds (sales price)" of $733,458, and that the sale resulted in a gain of $732,458. This constituted an election out of the installment method.

When a deferred payment sale is made and the seller elects out of the installment method, the fair market value of the contingent payments must be included in the seller's amount realized. (Treas. Reg. § 1.1001-1(g)(2)(ii).) In other words, a seller who elects out of the installment method is subject to the general gain-recognition rules of IRC section 1001, and generally reports the entire amount of gain per the seller's method of accounting. (Temp. Treas. Reg. § 15A.453-1(d)(2).) California conforms to IRC section 1001. (R&TC, § 18031.)

Generally, a cash-method seller would report gain in the year of receipt of the closing proceeds. Under IRC section 1001(b), the amount realized from a sale or other disposition of property is "the sum of any money received plus the fair market value of the property (other than money) received." So, if the seller elects out of the installment method, the amount realized includes "the fair market value of the contingent payments." (Treas. Reg. § 1.1001-1(g)(2).) Thus, when property is sold and the consideration has an ascertainable market value (even though it may be restricted in some way), the seller is obligated under IRC section 1001 to report the entire gain in the year of sale, unless the seller uses the installment method.[3] Here, because

[3] (See, e.g., *Bernice Patton Testamentary Trust v. United States* (Fed. Cl. 2001) 726 F.2d 1574; *Lustgarten v. Commissioner* (5th Cir. 1981) 639 F.2d 1208, 1210-11 [proceeds from stock sale had to be reported in year of sale notwithstanding escrow arrangement].)

appellant elected out of the installment method by reporting the sale on Form 8949, appellant was required under IRC section 1001(b) to report his gain in 2012. And appellant did so, reporting the money received, plus the fair market value of the shares that Narada received. In its Supplemental Brief, respondent agrees appellant "elected out of the installment sale method by reporting the full selling price and income from the sale of his Narada interest ...."

It is unnecessary to focus on the settlement agreement and the stock restrictions. The taxable income at issue is based on appellant's capital gain from the sale of his membership interest in Narada. Thus, I believe the focus should be on the Purchase Agreement, under which Three Oaks was contractually required to make payments to the sellers, including appellant, "based on the cash or in-kind (i.e. stock) collections that it has received . . . ." Accordingly, of the $700,000 paid to Narada in 2012 as part of the settlement, that same year Narada paid to appellant the sum of $240,857. Moreover, of the 112,800 shares that Violin Memory, Inc. issued to Narada in 2012, Three Oaks was required to make payments to appellant because of Narada's receipt of 70,568.07 shares.[4]

Appellant made an election under IRC section 453(d)(1) to opt-out of the installment method, and, as such, he reported the amount realized as required under IRC section 1001(b), reporting the money received and the fair market value of the 70,568.07 shares. Generally, an election under IRC section 453(d)(1) is irrevocable. (Temp. Treas. Reg. § 15a.453-1(d)(4).) Such an election may be revoked only with the consent of the Secretary of the Treasury (IRC, § 453(d)(3)); however, there is no evidence that appellant took such efforts to revoke the election. Accordingly, based on the application of the installment sale method, I sustain respondent's denial of appellant's claim for refund.

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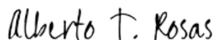
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Alberto T. Rosas
Administrative Law Judge

Date Issued: 11/5/2020

[4] The exact amount of the payments that Three Oaks was required to make to appellant in 2012 is unclear. It is not clear how the "gross profits" were calculated, but the fact remains that appellant elected to report a fair market value of $492,601 based on the 70,568.07 shares. Based on this reporting position, appellant calculated the "gross profits" as follows: money received in 2012 ($240,857) + the fair market value of the 70,568.07 shares ($492,601) = $733,458.