BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
CHARLES W. AND MARY D. PERELLE)

Appearances:

For Appellants: Harold R. Burnstein, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel; Crawford H, Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Charles and Mary Perelle to proposed assessments of additional personal income tax in the amount of $6,874.70 against Charles Perelle and $6,894.70 against Mary Perelle for the year 1946.

and

Charles and Mary Perelle are husband/wife. In July, 1944, while they were residents of California, Mr. Perelle entered into an empioyment contract with the Hughes Tool Company. The contract was made in San Diego, California. Mr. Perelle agreed to work exclusively for the Hughes Tool Company for five years as a director, vice-president in charge of manufacturing and, particularly, as general manager of aircraft activities, He was also to be a director of Transcontinental Western Air, Inc, (TWA), which was controlled by the Hughes Tool Company, He was to receive an annual salary of $$75,000. He commenced his employment in September, 1944, and within that month he received from the company a five-year option to purchase 10,000 shares of stock in TWA at any market price designated by him within one year from and including October 1, 1944. He immediately selected the price existing on October 1, 1944, which was $23.50 per share,,

Although the headquarters of Hughes Tool Company was in Texas, Mr. Perelle performed his services in California at an aircraft manufacturing plant of the company in Culver City. Appellants moved into a house in Bel Air, California, and the company paid for the rent, food, servants and utilities. They maintained no other abode while they stayed in that house.

Appeal of Charles W. and Mary D. Perelle

On December 26, 1945, Mr. Perelle "left the employ" of the Hughes Tool Company. In March or April, 1946, he was hired by a Michigan concern. In July, 1946, he purchased a house in Michigan and moved there with his family.

The following September he entered into a formal agreement with the Hughes Tool Company, terminating his employment contract. Appellant was paid $1,699.22 and each party released the other from any claims or causes of action arising out of the employment contract. At the same time he sold his stock option to the company for $250,000. On its books the company treated this sum as compensation,

The principal question presented is whether the amount realized on the sale of the option is includible in California income for the year 1946, The position of the Franchise Tax Board is that this amount represents compensation for services rendered in California. The Appellants argue that the option was not intended as compensation, but merely to give Mr. Perelle a proprietary interest to insure his loyalty to the business.

During the year in question, former Section 17101 (now 17071) of the Revenue and Taxation Code provided that "Gross income includes gains, profits, and income derived from salaries, wages, or compensation for personal services, of whatever kind and in whatever form paid.... " This section is substantially the same as former Section 22(a) of the United States Internal Revenue Code of 1939.

There are copies of various letters from company officials indicating that the option was intended as compensation, and the company in fact treated the payment for the option on its books as compensation, It is unnecessary to elaborate on this point, however, since the Federal cases on which the Appellants relied have been overruled by the United States Supreme Court in Commissioner v. LoBue, 351 U. S. 243.

The prevailing theory prior to this decision was that gain received by an employee on the receipt, exercise or sale of a stock option acquired from his employer was taxable if it was intended as compensation but not if it was intended to confer a proprietary interest in the business. The Supreme Court abolished the "proprietary interest" test. It held that, since it could not be characterized as a gift, the gain on a stock option transferred by an employer to his employee to secure better services was necessarily compensation for services regardless of any intent to confer a proprietary interest, The court concluded that the employee realized taxable gain measured by the difference between the option price and the market value of the shares at the time the option was exercised.

There is no indication here that the option or the gain on its sale was intended as a gift and no such claim is made by the Appellants, Accepting their statement that the company's purpose in giving the option was to insure loyalty, that is tantamount to a purpose of securing better services as in the LoBue decision. It must be concluded that the option itself or the gain on its sale was compensation for services.

Appellants contend that if the option was compensation, its value in 1944 when it was given was taxable rather than the gain on its sale in 1946. With only one exception of which we are aware, McNamara v. Commissioner, 210 Fed. 2d 505, the courts have held that where compensation was intended the gain was taxable when the option was exercised, or, as in this case, when it was sold (Charles E. Sorensen, 22 T. C. 321). The courts have indicated, however, than an assignable option with a readily ascertainable market value may constitute extra compensation and, therefore, taxable income in the year in which the option is granted (Commissioner v. LoBue, supra; Commissioner v. Smith, 324 U. S. 177). An option will not be considered compensation at the time it is given unless there is a spread between the option and market prices at that time (Commissioner v. Smith, supra, p. 181; Dean Babbitt, 23 T. C. 850, 863).

Appellants rely on McNamara v. Commissioner, supra, and Commissioner v. Stoners Estate, 210 Fed. 2d 33. In McNamara, however, contrary to the instant case, there was a spread between the option and market prices when the option was given. Also, both the employer and the employee in that case treated the option itself in their tax returns as compensation for the year in which it was given, Here, it was the subsequent purchase price paid for the option that the company treated as compensation on its books, Appellants, of course, have never treated the option or the gain on its sale as compensation. The case of Stone's Estate involved stock purchase warrants which were bought by the employee. As pointed out in the opinion of the Tax Court, which was affirmed by the Circuit Court, stock purchase warrants differ widelv from the usual stock-purchase options given to employees (estate of Lauson Stone, 19 T. C. 872, 877).

We do not know whether this option was assignable to anyone but the employer and it has not been established in any event that it had a readily ascertainable market value. We therefore conclude that the gain on the sale was compensation taxable in the year 1946, when it was received. Since the amount received was compensation for services, and the services were performed in California, the amount is taxable here regardless of Appellants' status as residents of another state when it was received (Sections 17052 (now 17041) and 17566 (now Section 17.596) of the Revenue and Taxation Code;

Regs. 17211=17214(b), 17211-17214(e) and 17566 of Title 18 of the Calif. Admin. Code).

Appellants have alleged that expenses denominated as "attorneys fees," "office and clerical," "dues," and "travel expense," totaling $41,000, were incurred in connection with the sale of the option,, These claims were not presented to the Franchise Tax Board prior to this appeal. There has been no verification or explanation of the expenditures presented to this Board as justification for their allowance as deductions.

The final issue is whether the sum of $5,826.76 paid by Hughes Tool Company in 1946 for rent, food, servants and utilities in connection with Appellants? occupation of the house in Bel Air, California, is income taxable to them. Appellants contend that this sum represented either traveling expenses incurred in the pursuit of business or quarters and meals furnished for the convenience of the employer,

Although the employment contract was not formally terminated until September, 1946, both parties state that Mr. Perelle "left the employ" of Hughes Tool Company in December, 1945. It appears, however, that Appellants had the use of the house furnished by the company until they purchased a home in Michigan in July, 1946. Whatever may be the exact situation, both the Franchise Tax Board and Appellants have assumed in their arguments that the expenses paid by the company in 1946 were in the same category as similar expenses paid by it in prior years. In the absence of specific information, we shall do the same.

Section 17301 of the Revenue and Taxation Code (now Section 17202) allowed a deduction for "traveling expenses (including the entire amount expended for food and lodging) while away from home in the pursuit of a trade of business..." Appellants allege that the business headquarters of Mr. Perelle was in Texas and that his expenses while away from there qualify as traveling expenses. They are not, however, aided by the decision upon which they place reliance. In Commissioner v. Flowers, 326 U.S. 465, which involved a statute similar to ours, the court pointed out that the taxpayer could have moved to his post of business and denied a deduction for expenses incurred in traveling between a post of business in one city and living quarters in ancther. It referred to the confusion in the cases as to whether business headquarters should be considered "home" but considered it unnecessary to decide that question.

It appears that the business headquarters of Mr. Perelle was designated by the company as Houston, Texas, so that his expenses while away from there would be paid for as traveling

expenses. Whether or not his headquarters or his living quarters should be regarded as "home" under the statute, and wherever his business headquarters may have been nominally, his business headquarters in fact, as well as his living headquarters, was in the same vicinity in California, He lived with his wife and child and worked only in that vicinity during the entire period of his active employment by the Hughes Tool Company, from 1944 to 1946. We perceive no basis for the claim that the amounts in question *were* traveling expenses incurred away from home,

We now consider the contention that these expenses were incurred for the convenience of the employer and that therefore their payment was not income taxable to the Appellants. The regulations provide:

> "...If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax, If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed or added to the compensation otherwise received by the employees... ." (Title 18, Calif. Admin. Code, Reg. 17101(e)),

This is substantially the same as former Federal Reg. 111, Sec. 29.22(a)-3. (Section 119 of the Internal Revenue Code of 1954 and Section 17151 of the Revenue and Taxation Code now cover the subject matter of these Federal and State regulations.)

Decisions which have sustained the exclusion from income of the value of quarters and meals under the Federal regulation involved situations where the duties of the employees were such that the employers required them to live on the working premises. Typical cases are Arthur Benaglia, 36 B.T.A. 838 (hotel manager); R. Shad Bennett, T.C. Memo., Dkt. No. 104524, Oct. 28, 1942, aff'd. 139 Fed. 2d 961 (sanitarium employee); Lloyd N. Farnham, T.C. Memo., Dkt. No. 11229, Sept. 30, 1947 *(janitor)*, Appellants did not live on the working premises and there is no showing that they were required to live in the Bel Air house for the convenience of Hughes Tool Company. For all that appears, the quarters and meals were furnished to Appellants for their own benefit.

Appellants have cited Olin O. Ellis, 6 T. C. 138, for the proposition that part of the value of the living quarters may be excluded from income where they are furnished in part

for the convenience of the employer, They then allege on brief that other employees used the Bel Air house and that the expenses here involved included many business calls and entertainment on behalf of the company. We have not been informed, however, of the extent to which other employees used the premises or the portion of the expenses which are attributable to the business activities. Accordingly, there is no basis for the exclusion of any part of the expenses in question from the income of the Appellants.

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 protests of Charles W. and Mary D. Perelle to proposed assessments of additional personal income tax in the amount of $6,874.70 against Charles Perelle and $6,894.70 against Mary Perelle for the year 1946 be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of December, 1958, by the State Board of Equalization.

George R. Reilly , Chairman

Paul R. Leake , Member

Robert C. Kirkwood, Member

_____ Member

_____ Member

ATTEST: Dixwell L. Pierce , Secretary