BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
EDWARD J. AND SARAH RILEY)

For Appellants: Edward J. Riley,
in pro. per.

For Respondent: James C. Stewart
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 protest of Edward J. and Sarah Riley against a proposed assessment of additional personal income tax in the amount of $8,117.45 for the year 1977.

Appeal of Edward J. and Sarah Riley

The issue presented is whether appellants are entitled to use the installment method to report gain realized from the sale of stock they acquired through a qualified employee stock option plan, but disposed of prior to the expiration of the three-year holding period.

Prior to and during 1977, Edward J. Riley (hereinafter referred to as "appellant") was employed by The Pinseckcr Corporation ("Pinseeker"). As an employee, appellant participated in the corporation's employee stock option plan, which was qualified under section 17532 of the Revenue and Taxation Code.

On September 14, 1977, appellant purchased 19,000 shares of Pinseeker stock pursuant to the stock option plan for the price of $1.00 per share. On November 4, 1977, he sold these shares of stock for $6.50 per share. Appellant received cash in the amount of $35,815, which represented 29 percent of the purchase price; the balance was payable over three years. On the 1977 California joint personal income tax return filed by appellant and his wife, they included in their gross income only the amount of cash received in connection with the sale less a pro rata portion of their basis in the stock.

In general, when an employee exercises a stock option received in connection with his employment, he immediately realizes ordinary income equal to the difference between the fair market value of the stock and the option price. (Commissioner v. LoBue, 351 U.S. 243 [100 L.Ed. 11421 (1956).) On the other hand, the exercise of a "qualified stock option" and the ultimate disposition of the stock received pursuant to such an option, are granted favorable tax treatment. The employee who receives a qualified stock option realizes taxable income when he disposes of the stock purchased pursuant to the stock option rather than when he exercises the option, and the gain realized upon the sale of the stock is treated as capital gain. (Rev. & Tax. Code, § 17531, et seq.) In order to receive capital gain treatment, the stock purchased pursuant to a qualified stock option must be retained for a minimum of three years from the date of purchase. (Rev. & Tax. Code, § 17532, subd. (a)(1).) In this appeal, the disposition of appellant's stock would have qualified for such favorable treatment except that the sale of the stock by appellant within the three-year holding period constituted a disqualifying disposition.

In the event of a disqualifying disposition such as the one in this appeal, a portion of the employee's gain equal to the difference between the option price and the stock's fair market value as of the date the option was exercised is taxable as ordinary income. (Rev. & Tax. Code, §§ 17531, subd. (b), 17532, subd. (c)(4); Appeal of Robert V. and Maralys K. Wills, Cal. St. Bd. of Equal., July 26, 1978). Any increase in the stock's value which occurred between the time the option was exercised and the time the stock was sold is treated as capital gain. (Rev. & Tax. Code, §§ 17531, subd. (b), 17532, subd. (c)(4).)

In the instant appeal, appellant sold the Pinseeker stock less than two months after he exercised the option to purchase it. On the basis of this fact,, respondent determined that the price at which appellant sold the stock equaled the stock's fair market value as of the date he purchased it, and that the entire gain realized by appellant was ordinary income. Respondent concluded that the gain realized by appellant represented compensation for services and, as such, could not be reported on the installment method. Thus, it determined that the entire amount of the gain was includable in appellant's 1977 gross income. Respondent issued a notice of proposed assessment of additional personal income tax reflecting this determination. Respondent's denial of appellant's subsequent protest led to this appeal.

Apparently, appellant does not dispute either the amount of the gain or its character as ordinary income. However, he asserts that he should be allowed to use the installment method to report this gain, Appellant argues that the installment method of reporting gain should have been available to him because he had no guarantee of ever receiving the entire amount due him.

The installment method of reporting gain is not available merely because the seller of property receives the right to deferred payment and has no guarantee of ever actually receiving the full payment. On the contrary, the general rule is that when property is exchanged for a promise of future payment, the difference between the fair market value of the obligation and the taxpayer's basis in the property is recognized as gain in the year of sale. (Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 [77 L.Ed. 428] (1933); Cherokee Motor Coach Co., Inc. v.

Commissioner, 135 F.2d 840 (6th Cir. 1943).) An exception to this general rule is made if a sale of property meets the requirements of an installment sale. Gain from an installment sale is reported as income as it is actually received rather than the entire gain being reported in the year of sale. (Rev. & Tax. Code, §§ 17577-17580.5.)

At issue in this appeal is the relationship between the provisions of the Revenue and Taxation Code allowing installment sale reporting of gain and those dealing with qualified stock options. The California provisions, which cover these areas are substantially similar to the federal provisions. (Compare Rev. & Tax. Code, §§ 17577-17580.5 with Int. Rev. Code of 1954, § 453; Rev. & Tax. Code, §§ 17531-17536 with Int. Rev. Code of 1954, §§ 421-425,) Therefore, interpretations of the federal provisions are relevant to the correct interpretations of the state provisions. (Holmes v. McColgan, 17 Cal.2d 426 [110 P.2d 428] cert. den., 314 U.S. 636 [86 L.Ed. 510] (1941); Andrews v. Franchise Tax Board, 275 Cal.App.2d 653 [80 Cal. Rptr. 403] (1969).)

In a case somewhat similar to this appeal, the Tax Court has held that the installment method cannot be used to report gain which represents compensation. (Charles E. Sorensen, 22 T.C. 321 (1954).) In that case, the employer corporation gave the employee options to purchase shares of its stock at below fair market value. The employee sold the options for cash and notes and attempted to report the gain on the installment method. The court held that he could not do this. It reasoned that since the options were granted to the employee in payment for his services, the amount he received when he sold those options was also compensation for services. It then held that the sections of the Internal Revenue Code providing for installment sale reporting "relate only to the reporting of income arising from the sale of property on the installment basis. Those provisions do not in anywise purport to relate to the reporting of income arising by way of compensation for services." (Sorensen, supra, at p. 342.) It is well established that when an employee exercises a stock option received from his employer, he is receiving compensation for services. (Commissioner v. LoBue, supra.) Thus, the gain realized by appellant was compensation for services.

The language of the California regulations under section 17531 supports the tax court's decision

in Charles E. Sorensen, supra. This regulation deals specifically with a restricted stock option, but is applicable to qualified stock options since both types of options are treated identically under section 17531. The regulation states that when income attributable to the transfer of an option from employer to employee is taxable because the taxpayer has made a disqualifying disposition, "no amount shall be treated as income ... for any taxable year other than the taxable year in which occurs the dispositions." (Cal. Admin. Code, tit. 18, reg. 17531-17540, subd. (e)(S).)

We must conclude that since appellant's gain from the sale of the Pinseeker stock constituted compensation for services, the installment method of reporting that gain is not available. (Charles E. Sorensen, supra.) Accordingly, the entire gain from the sale of the 19,030 shares of Pinseeker stock is includable in appellant's 1977 gross income.

For the foregoing reasons, respondent's action must be sustained.

Appeal of Edward J. and Sarah Riley

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 Edward J. and Sarah Riley against a proposed assessment of additional personal income tax in the amount of $8,117.45 for the year 1977, be and the same is hereby sustained.

Done at Sacramento, California, this 3rd day of March, 1982, by the State Board of Equalization, with Board Members Mr. Bennett, Mr. Reilly, Mr. Dronenburg, Mr. Nevins and Mr. Cory present.

William M. Bennett, Chairman

George R. Reilly, Member

Ernest J. Dronenburg, Jr., Member

Richard Nevins, Member

Kenneth Cory, Member