BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
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ROBERT V. AND MARALYS K. WILLS)

For Appellants: Robert V. Wills, in pro. per.

For Respondent: Bruce W. Walker
Chief Counsel

James C. Stewart
Counsel

O P I N I O N

This appeal is made pursuant to section 19059 of the Revenue'and Taxation Code from the action of the Franchise Tax Board in denying the claim of Robert V. and Maralys K. Wills for refund of personal income tax and interest in the amount of $1,384.72 for the year 1970.

The issue for determination is whether respondent correctly determined the amount of ordinary income arisinu from appellants' disqualifying disposition of stock acquired pursuant to a qualified stock option plan.

During 1965 appellant Robert V. Wills was employed by Petrolane, Inc. On March 16, 1965, he received a qualified stock option to purchase common stock from his employer at $23.50 a share. On May 27, 1969, appellant exercised the option and purchased 900 shares of Petrolane common stock which had a fair market value of $46.75 per share on that date. Appellant sold the 900 shares in December 1970, realizing a gain of $41,969.72. Althouqh acknowledsinq that federal law required a portion of the gain to be reported as long-term capital gain and the remainder as ordinary income, appellants reported the entire gain as a long-term Capital gain on their 1970 California personal income tax return.

Since the 900 shares were acquired pursuant to a qualified stock option plan and disposed of before the three-year holding period required by section 17532 of the Revenue and Taxation Code was complied with, respondent determined that the difference between the option price ($21,150) and the fair market value of the stock when the option was exercised ($42,075), which was $20,925, constituted ordinary income rather than capital gain. Respondent made no adjustment to the remainder of the gain which, concededly, was entitled to capital gains treatment. Since appellants already had reported one-half of the $20,925 amount as capital gain, respondent increased appellants' income by the other one-half to reflect ordinary income treatment. This adjustment resulted in an increased tax of $1,046.25. Appellants ultimately paid the tax plus interest and filed a claim for refund which was denied. This appeal followed.

The foundation for appellants' argument is their assertion that the provisions of the California Revenue and Taxation Code dealing with employees' stock options (Rev. & Tax. Code, §§ 17531-17536) are not the same as the federal statutes dealing with the same subject (Int. Rev. Code of 1954, §§ 421-425). Appellants then arque that since section 17531 of the Revenue and Taxation Code does not specifically provide that any gain on the exercise of a stock option and ultimate disposition of the stock constitutes ordinary income, such gain must be taxable as a long-term capital gain. Appellants also assert that the real question is whether the word 'income" as used in section 17531, subsection (b), is synonymous with "ordinary income!' or "earned income" as assumed bv respondent. While appellants have presented an interesting argument, we need not consider it directly since the underlying premise is faulty. In fact, the California provisions dealing with employee stock options are substantially identical to their federal counterparts. (Compare Rev. & Tax. Code, §§ 17531-17536 with Int. Rev. Code of 1954, §§ 421-425.) Under such circumstances, the interpretation and effect given the federal provisions are highly persuasive with respect to proper application of the state law. (Holmes v. McColgan, 17 Cal. 2d 426, 430 [110 P.2d 428], cert. den., 314 U.S. 636 [86 L. Ed. 510] (1941); Rihn v. Franchise Tax Board, 131 Cal. App. 2d 356, 360 [280 P.2d 893] (1955).)

In general, prior to 1950 the exercise of an employee stock option gave rise to ordinary income equal to the excess of the market value of the stock over the option price at the time of exercise. (Commissioner v. Smith, 324 U.S. 177 [89 L. Ed. 8301 (1945); see also Commissioner v. LoBue, 351 U.S. 243 [100 L. Ed. 1142] (1956).) In 1950, Congress established a class of employee stock options known as "restricted stock options" which was intended to provide rules for granting options under which an employee could be assured of the opportunity to obtain favorable capital gains. (See generally Lefevre, Nonrestricted Stock Options, 20 N.Y.U. Inst. on Fed. Tax. 353 (1962).) In order to receive favorable capital gains treatment, one of the requirements was that the employee not dispose of the stock within two years from the granting of the option or six months from the acquisition of the stock. (See Lefevre. Nonrestricted Stock Options, supra at 361; Rank v. United States, 345 F.2d 337, 340 (5th Cir. 1965) .) California followed the federal lead and provided similar treatment for restricted stock options in 1951. (See Stats. 1951, ch. 361, p. 815; see also Stats. 1955, ch. 939, p. 1725.)

In 1964 Congress substantially expanded the provisions dealing with employee stock options. Although existing restricted stock options continued to be treated in the same manner, two new categories were added: "qualified stock options", those which provide incentives for key business executives; and "employee stock purchase plans", those primarily used to raise capital by issuing stock to employees at a discount. (See generally Baker, Employee Stock Option Plans Under the Revenue Act of 1964, 20 Tax. L. Rev. 77 (1964).) The applicable California statutes were also revised to reflect their federal counterparts in 1964. (See Stats. 1964 (1st Ex. Sess.), ch. 140, p. 471.)

In order to receive favorable capital gains treatment on the disposition of stock acquired pursuant to a qualified stock option, one of the requirements at both the state and federal levels is that the stock must be held for at least three years. (Compare Rev. & Tax. Code, § 17532(a)(1) with Int. Rev. Code of 1954, § 422 (a) (1).) The legislative history of the federal statutes discusses the purpose and effect of this restriction as follows:

> The bill provides that in those cases where [the stock] is not held for this 3-year period, the option will still be a qualified option, but the spread between the option price and the value of the stock at the time the option is exercised will be treated as ordinarv income at the time the stock is sold. However, in such cases the employee will never be taxed on more than his gain .... On the other hand, if the stock is sold at a price which is higher than the price on the date the option was exercised, then in addition to the amount treated as ordinary income (the difference between the option price and value on the date of exercise), there will be an amount treated as a capital gain.
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> For an individual to receive full qualified stock option treatment, he must not sell (Or otherwise dispose of) his stock within 3 years of the date of exercise of the stock option. As indicated previously, where all conditions but this one are met, tax is not imposed until the sale of the stock, but much or all of the tax imposed at that time, if this condition is not met, will be on the basis of ordinary income rather than capital gain. This condition is designed to give assurance that the key executive involved actually maintains a "stake in the business" and is not merely selling the stock shortly after he receives it, thus vitiating the principal purpose of stock options, and converting ordinary compensation into capital gain. This requirement, of course, is not

> a new idea since present law already requires the individual to hold the option, or stock, for at least 2 years and the stock alone for 6 months in order to receive restricted stock option treatment. (1964 U.S. Code Cong. & Ad. News 1374-75.)

As we have indicated above, in the absence of the provisions dealing with employee stock options, ordinary income would generally result where benefit is derived from a stock option. However, compliance with the statutory requirements dealing with restricted stock options, qualified stock options, or employee stock purchase plans enables a taxpayer to have income otherwise taxable as ordinary income taxed at favorable capital gains rates. One of the requirements for such favorable treatment under a qualified stock option is that the taxpayer not dispose of the stock within three years after acquisition. In the instant appeal, appellants did not hold the stock for the required three-year period. The resulting disposition constituted a disqualifying disposition which gave rise to both ordinary income and capital gain. Respondent's adjustment was in compliance with the legislative history discussed above and the applicable regulations. (See Treas. Reg. § 1.422(b) (3) example (2).) Accordingly, we conclude that respondent's action in this matter must be sustained.

Appeal of Robert V. and Maralys K. Wills

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 19060 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claim of Robert V. and Maralys K. Wills for refund of personal income tax and'interest in the amount of $1,384.72 for the year 1970, be and the same is hereby sustained.

Done at Sacramento, California, this 26th day of July, 1978, by the State Board of Equalization.

_______________, Chairman

_______________, Member

_______________, Member

_______________, Member

_______________, Member