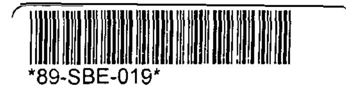

89-SBE-019

BEFORE THE.STATE 'BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
) No. 88R-0247-MW
DIANE L. MORRIS TRUST, ET AL.)

Appearances:

For Appellant: Joel Rabinovitz
Attorney at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

These appeals are made pursuant to section 19057, subdivision (a),[1] of the Revenue and Taxation Code from the actions of the Franchise Tax Board in denying the claims of Diane L. Morris Trust, et al., for refund of personal income tax in the amounts and for the taxable years as follows:

1/ Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the taxable years in issue.

Appeals of Diane L. Morris Trust, et al.

Appellants	Taxable Years	Claims for Refund
Diane L. Morris Trust	1985	$ 32,047
Diane L. Morris Trust	1985	8,904
Diane L. Morris	1982	121,721
	1983	9,722
Mervin G. and Roslyn G. Morris	1982	924,607
John G. Morris	1982	145,378
John G. Morris Trust	1985	65,822
James B. Morris	1982	126,609
	1983	9,200
	1984	9,809
James B. Morris Trust	1985	63,812
Jeffrey A. and Debra 2. Morris.	1982	115,827
	1984	9,250
Jeffrey A. Morris Trust	1985	63,636

The .question in these appeals is whether appellants were entitled to-the. section 17063.11 tax preference exclusion accorded the unrecognized portion of capital gain on the sale of small business stock when they sold stock in Dayton-Eudson Corporation (Dayton-Hudson).

In 1954, appellant Mervin G. Morris incorporated Mervyn's Corporation (Mervyn's) as a California corporation. Mervyn's was a retail operation with its principal office in California. Subsequently, Mervin Morris made gifts of Mervyn's stock to the other appellants in thrs appeal.[2] In 1971, the corporation made its initial public offering of stock. On May 28, 1978, Dayton-Hudson acquired 100 percent of Mervyn's in a tax-free reorganization. In this transaction, Mervyn's shareholders received Dayton-Hudson stock, and all Mervyn's shares were cancelled and retired. Dayton-Hudson was, at the time of acquisition and throughout the appeal period, a Minnesota corporation listed on the New York Stock Exchange.

On their California income tax returns for the appeal years, appellants each reported capital gain income from sales of their Dayton-Hudson stock. The unrecognized portion of that gain was reported as an item of tax preference income pursuant to section 17063, subdivision (e). Appellants subsequently filed amended returns excluding that unrecognized capital gain from preference income on the theory that their Dayton-Hudson stock qualified as "small business stock" under section 18162.5, subdivision (e), and, therefore, under section 17063.11, no preference income resulted on the sale of the stock. These amended returns were considered claims for refund.

2/ Neither party has raised any issue concerning any effect arising out of the gifts of stock before 1971. We do not, therefore, consider any question regarding any such effect. In footnote 2 on page 4 of Appellants" Brief, appellants state that a de minimus percentage of the total amount at issue relates to stock gifts received from Mervin Morris during or after 1971. Appellants state their belief that this stock remained small business stock and offered to 'provide more detailed information with respect to these gifts upon the board's request.. However, we decline to make any specific findings or conclusions with respect to the stock described in footnote 2, but shall treat it, for purposes of this appeal, in the same manner as the remainder of the stock in question. We believe that this is most appropriate since neither party has seen fit to come forward voluntarily with facts or legal arguaents regarding this issue.

Upon review of the claims for refund, the Franchise Tax Board (FTB) determined that the gain on the sales of Dayton-Hudson stock did not qualify for exclusion from tax preference income under section 17063.11 and denied the claims for refund.

Section 17063.11 provided, in its entirety, as follows: "For the purpose of section 17063, that portion of capital gains attributable to the sale of small business stock, as defined in section 18162.5, is not an item of tax preference."3/ Section 18162.5, subdivision (e), provided, in pertinent part, as follows:

> (e) For purposes of this section, "small business stock" is an equity security issued by a corporation which has the following characteristics at the time of acquisition by the taxpayer:
>
> (1) The commercial domicile or primary place of business is located within California.
>
> (2) The total employment of the corporation is no more than 500 employees ....
>
> (3) The outstanding issues of the corporations, including those held by the taxpayer, are not listed on the New York Stock Exchange, the American Stock Exchange, or the National Association of Securities Dealers Automated Quotation System.
>
> (4) No more than 25 percent of gross receipts in the immediate prior income year were obtained from rents, interests, dividends, or. sales of assets.

3/ As originally enacted, the reference in this section was to section 18161.5. Section 18161.5 was repealed and reenacted by AB 36 (Stats. 1983, ch. 488) as section 18162.5, subdivisions (e) and (f), operative for taxable years beginning on or after January 1, 1983. Because these appeals involve years from 1982 through 1985 and the change in the statutes is not substantive, we have chosen to refer to the statutes as amended by AB 36.

(5) The corporation is not engaged primarily in the business of holding land.[4/]

Section 17063.11 requires that, to qualify for the exclusion from preference tax, capital gain must have resulted from a sale of small business stock. One of the few things upon which the parties agree is that there is no specific provision in either section 17063.11 or in section 18162.5 that covers the situation involved in this appeal: the effect of an exchange of small business stock for publicly traded stock in a tax-free reorganization. From this legislative silence, each party draws its own conclusion, each diametrically opposed, of course, to the conclusion drawn by the other party..

The appellants contend that the small business stock character of the Mervyn's stock carries over to the Dayton-Hudson stock which was acquired in the reorganization. They maintain that the Legislature's silence regarding the effect of a tax-free reorganization should be interpreted as sanctioning the carryover because all tax-free reorganizations are regarded as mere changes in form and all "are treated similarly, providing for nonrecognition and its inevitable corollary--attribute carry-over." (App. Reply Br. at 12.) Appellants assert that, for tax purposes, their investment in Dayton-Hudson was a continuation of their investment in Mervyn's. Because of this continuity of investment, appellants argue, the objective of the reorganization provisions is to defer tax consequences until the ultimate disposition of the investment. This objective of deferring tax consequences without alteration, appellant continues, is achieved by numerous ca-rryover provisions which ensure continuity of tax attributes in a reorganization. This general pattern of deferral and attribute carryover requires that the small business stock character be carried over to the Dayton-Hudson stock "to preserve for subsequent recognition the tax consequences of appellants' continuing investment." (App. Br. at 12.) Since 'attribute carry-over" is an essential aspect of any reorganization, and the Legislature did not specifically prohibit the carryover of small business stock character in a 'reorganization, appellant reasons that small business stock character must carry over from the Mervyn's stock to the Dayton-Hudson stock. Appellants

4/ See footnote 3, supra, regarding reenactment as section i8162.5. The characteristics of small business stock were further defined by amendments in AB 2476 (Stats. 1984, ch. 1575), operative for taxable years beginning on or after January 1, 1984, but these amendments do not affect this appeal.

take the position that this is the appropriate way to satisfy the legislative-intent to encourage investment in small California businesses.

The PTB asserts that the Dayton-Hudson stock that was sold was acquired by appellants in 1978, did not qualify as small business stock when it was acquired, and, therefore, the gain on its sale did not qualify for exclusion from preference income under section 17063 .11. The FTB contends that the Legislature's silence regarding reorganizations means that the small business stock character of the Mervyn's stock could not carry over to the Dayton-Hudson stock. It argues that, since exemptions from general taxation statutes are to be strictly construed (e.g., Bingler v. Johnson, 394 U.S. 741, 752 [22 L.Ed.2d 695] (1969); Helvering v. Northwest Steel Rolling Mills, Inc., 311 U.S. 46, 49 [85 L.Ed.2d 291] (1940); Curtis v. United States, 336 F.2d 714, 721 (6th Cir. 1964)), the Legislature's silence regarding reorganizations cannot be interpreted to provide a law where there is none. It argues that, contrary to-appellants' assertions, any carryover of attributes in a reorganization must be specifically provided for by statute. It points out that the carryover provisions referred to by appellants are all statutory exceptions to the usual rules. We find we must agree with the FTB's position.

All the 'tax attributes" noted by appellants which carry over for shareholders in a reorganization are specific statutory provisions (I.R.C. of 1954, §§ 83(g), 306(c), 358, 1223, and 1246(c)), without which, presumably, there would be no carryover of that 'attribute,' despite appellants' description of attribute carryover as an "inevitable corollary" of non- recognition in a reorganization. There is no such carryover provided in section 18162.5 or section 17063.11 and we simply. find no basis to believe that carryover of small business character is so inevitable in the reorganization setting as to exist without benefit of a specific statutory provision.

Appellants' own proffered definition of a reorganization as a mere change in form does not support their position. They quote, and, indeed, underscore, the following language from Bazley v. Commissioner, 331 U.S. 737, 740 (91 L.Ed. 17821 (1947), contending that a tax-free reorganization 'represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets.' While some reorganizations may meet this definition, the reorganization at issue did involve a "change of substance in the rights and relations of the interested parties one to another or to the corporate assets." As the FTB

points out, after the reorganization, the appellants' stock interests were vastly different from their stock interests in Mervyn's. Their proportionate interests had changed from 100 percent of Mervyn's to 32 percent of Dayton-Hudson, their rights were diluted, and their risks diversified. This was no mere change in form, but a funda- mental change resulting in what was essentially a new invest- ment for appellants. While for some purposes, certain reorganizations may be considered mere changes in form, that is clearly not true for all reorganizations for all purposes. (See, e.g., Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 14.01, pp. 14-4--14-5 (5th ed. 1987).) In the present merger structured as a reorganization, there was not the continuity of investment upon which appel- lants base their attribute carryover argument.

As an "inevitable corollary" of our conclusion that the tax-free reorganization resulted in not just a change in form, but essentially a new investment by appellants, we also adopt the FTB's position on the meaning of 'acquisition" in section 18162.5.[5/] It appears well settled that the common and ordinary meaning of a word should be used in statutory construction unless such a use would lead to absurd results or thwart the obvious purpose of the statute. (Knowlton v. Commissioner, 84 T.C. 160, 163 (1985), aff'd.., 791 F.2d 1506 (11th Cir. 1986); accord, Commissioner v. Brown, 380 U.S. 563, 571 (14 L.Ed.2d 75)(1965); Helvering v. Hammel, 311 U.S. 504, 510-511 (85 L.Ed. 303)(1941).) In Knowlton, supra, the court said that one could not "be said to 'acquire' property before one obtains ownership, possession, or control over it." (Knowlton v. Commissioner, supra, 84 T.C. at 163.) Under this

5/ The FTB issued Legal Ruling (LR) 428 on August 19, 1987. That ruling provides a discussion, primarily in question-and-answer format, of the FTB's position on a number of issues involving the small business stock provisions of section 18162.5. The FTB adopts the basic position in LR 428 that it propounds here--that a taxpayer ordinarily "acquires" small business stock when he or she obtains ownership, possession, or control, unless this ordinary meaning would lead to absurd results or thwart the obvious purpose of the statute. In the questions and answers, the FTB applies that standard to a variety of factual situations. While the validity of that legal ruling and the numerous factual situations it discusses are not issues now before us, we observe that our decision in this appeal is in accord with the FTB's interpretation as expressed in LR 428, and that ruling appears, in general, to be reasonable and within the scope of the FTB's responsibility and authority as the administering agency.

definition, respondent argues, appellants did not acquire the Dayton-Hudson stock until the tax-free merger in 1978. At that time, the Dayton-Hudson stock did not qualify as small business stock as defined in section 18162.5 and, therefore, the unrecognized portion of the gain on subsequent sale of the Dayton-Hudson stock did not qualify for the section 17063.11 exclusion from items of tax preference. We agree with the FTB that the plain meaning of "acquire," as defined by the court in Knowlton, supra, does not lead to absurd results or thwart the obvious purpose of the statute.

The parties have argued at great length over the legislative intent behind SB 690 (the bill that added sections 17063.11 and 18161.5, which later became 18162.5, subdivision (e)), each presenting recently solicited letters from legislators and others purporting to show what the Legislature intended in 1981 when the bill was enacted. The appellants, at one point, argued that the California Supreme Court has held that such letters are irrelevant and inadmissable in determining the meaning of a statute. (Citing California Teachers Association v. San Diego Community College Dist., 28 Cal.3d 692 (1981).) Under our liberal hearing rules on admissability,[6] we accepted the letters proffered by both parties, stating that we would accord them appropriate weight. We believe that these letters should not be accorded any particular weight. They are merely the expressions of individual legislators, written more than seven years after the bill in question was enacted, and neither party has had an opportunity to question these letter writers regarding the content and scope of their letters or the inquiries by which they were solicited. The one thing which does appear reasonably certain from these letters, as well as

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[6] Regulation 5035, subdivision (c), of this board's Hearing Procedure Regulations provides, in pertinent part:

> Any relevant evidence, including affidavits and other forms of heresay evidence, will be admitted if it is the sort of evidence on which responsible persons are accustomed to rely in the conduct of serious affairs. The board will be liberal in admitting evidence, but objections to the admission of and comments on the weaknesses of evidence will be considered in assigning weight to the evidence. The board may deny admission of evidence which it considers irrelevant, untrustworthy or unduly repetitious.

(Cal. Code Regs., tit. 18, reg. 5035, subd. (c).)

the committee reports which have been presented, is that the Legislature never considered the situation which is before us now. We are left then with the general intent expressed in the preamble to SB 690, which appears to be to provide incentive for investors 'to risk their savings in new businesses ...." (Stats. 1981, ch. 534, §1.)

The appellants appear to argue that this general intent should be interpreted broadly, to allow the benefits of the provisions to as many as possible. They contend that to do otherwise would lead to absurd results, with similarly situated taxpayers being treated differently. We disagree with these arguments. In the first place, while a general purpose for enactment of a statute may help in interpreting the statute, the appellants here are really asking us to go beyond interpretation of the statutes involved to the point of adding new provisions to cover a situation which the Legislature did not consider. Secondly, we do not believe that absurd results occur with a narrow interpretation, since we do not agree that the taxpayers who would be treated differently are similarly situated, in a tax sense, as appellants allege. Different choices about how an entity or a transaction is structured or consummated frequently lead to radically different tax results. One who exchanges stock for stock is not, for tax purposes, necessarily similarly situated to one who sells stock. We see no absurdity in this, only the inevitable differences which arise when the tax laws are applied to varying factual situations.

We believe that the restrictive reading which the FTB gives to sections 18162.5 and 17063.11 is reasonable and more appropriate than the broad interpretation given those sections by the appellants. We are unwilling to expand the general applicability of this tax exclusion statute where its stated terms are reasonably clear and have been reasonably interpreted by the FTB, which is the agency charged with administering the personal income tax law. The amicus curiae suggests that this board is amply equipped to fashion a set of cohesive rules to carry out the legislative intent in enacting the small business stock statutes. (Brief of West. Assoc. of Vent. Cap. as Am. Cur. at 7.) However, it is the FTB which is the administering agency of the Personal Income Tax Law, and, in that capacity, it is the FTB which is not only equipped to develop, but charged with developing cohesive rules to carry out the legislative intent. We believe it has done so. (See footnote 5, supra.) To adapt language of the United States Supreme Court to our state context:

> [W]e do not sit as a committee of revision to perfect the administration of the tax

> laws. [The Legislature.1 has delegated to the [FTB], not to the courts or [this board], the task of prescribing 'all [...] rules and regulations [necessary] for the enforcement. of the [Personal Income Tax Law]. [Rev.& Tax. Code, S 19253.] In this area of limitless factual variations, "it is the province of [the Legislature] and the [FTB], not [this board] to make the appropriate adjustments." [Citation.] The rule of [this board] in cases of this sort begins and ends with assuring that the [FTB's interpretations] fall within [its] authority to implement the [legislative] mandate in some reasonable manner.

(United States v. Correll, 389 U.S. 299, 306-307 [19 L.Ed.2d 537] (1968).)

We conclude that appellants are not entitled to the tax preference exclusion benefits of section 17063.11 for the unrecognized portion of the capital gains resulting from the sales of their Dayton-Hudson stock. Appellants argue in the alternative, however, that they are nonetheless entitled to exclude from preference income that portion of the gain which was inherent in the Mervyn's stock at the time of the merger but not recognized until the later sale of the Dayton-Hudson. stock.

Appellants argue that '"sale" in section 17063.11 encompasses "exchange." We have already stated that the plain meaning of a term should be used unless it would lead to absurd results or thwart the obvious purpose of the statute. Once again, we do not believe that either of these restrictions on the use of the plain meaning of "sale" applies. The simple fact that entreprenuers who exchange their stock rather than sell it cannot take advantage of section 17063.11 is not an absurd result, but simply the application of the tax laws to different factual situations.

The argument made by appellants that at least some portion of gain must be excluded from preference tax in order to comport with the legislative intent is once again an attempt to create a new provision in the law where none presently exists. Under the plain language of section 17063.11, appellants had no gain which was "attributable to the sale of small business stock,. the only stock sold being that of Dayton-Hudson, which did not qualify as small business stock when acquired by the appellants.

Appellants also argue that their alternative position is supported by this board's decision in the Appeal of Magnus F. and Denise Hagen, decided April 9, 1986. They describe our decision in Hagen as holding. 'that the small business stock exclusion from preference tax applies when gain which is realized on a sale occurring in one year, but deferred pursuant to a nonrecognition provision, is subsequently taken into account for tax purposes in a later year.' (App. Reply Br. at 24.) Appellants' characterization of our holding is erroneous and does not support their position. It is true that in Hagen there was a sale of small business stock in 1979, the gain from which was reported on the installment method. However, the only question before this board in that appeal was whether section 17063.11 could be applied to small business stock acquired before September 17, 1981. No question was raised, argued, or decided regarding any possible implications arising from the use of the deferred reporting provisions of the installment method. Therefore, we find no more basis for finding in favor of appellants on their alternative argument than we did on their primary one,

In accordance with the foregoing, we must sustain the action of the Franchise Tax Board.

Appeals of Diane L. Morris Trust, et al.

ORDER

Pursuant to the views expressed in the opinion of the board on file in these proceedings, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue and Taxation Code, that the actions of the Franchise Tax Board in denying the claims of Diane L. Morris Trust, et al., for refund of personal income tax in the amounts and for the years as shown below, be and the same are hereby sustained.

Appellants	Taxable Years	Claims for Refund
Diane L. Morris Trust	1985	$ 32,047
Diane L. Morris Trust	1985	8,904
Diane L. Morris	1982	121,721
	1983	9,722
Mervin G. and Roslyn G. Morris	1982	924,607
John G. Morris	1982	145,378
John G. Morris Trust	1985	65,822
James B. Morris	1982	126,609
	1983	9,200
	1984	9,809
James B. Morris Trust	1985	63,812
Jeffrey A. and Debra 2. Morris	1982	115,827
	1984	9,250
Jeffrey A. Morris Trust	1985	63,636

Done at Sacramento, California, this 2nd day of August, 1989, by the State Board of Equalization, with Board Members Mr. Carpenter, Mr. Collis, Mr. Bennett, Mr. Dronenburg, and Mr. Davies present.

Paul Carpenter, Chairman

Conway H. Collis*, Member

William M. Bennett, Member

Ernest J. Dronenburg, Jr., Member

John Davies**, Member

*Abstained

**For Gray Davis, per Government Code section 7.9