



89-SBE-020

BEFORE THE STATE BOARD OF EQUALIZATION  
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of )  
CHARLES A. DRACE ) N o . 87R-0919-CD  
)

For Appellant: Rudy J. Merrick, Jr.  
Enrolled Agent

For Respondent: Lotrie K. Inagaki  
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a) of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Charles A. Drace for refund of personal income tax in the amounts of \$15,856 and \$3,940 for the years 1984 and 1985, respectively.

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

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The **question** presented by this appeal is whether appellant was **entitled** to exclude from tax preference income the unrecognized portion of capital gains resulting from the sale of stock of Cooper Labs in 1984 and 1985.

In 1973, appellant was a co-founder of Lexel Corporation and was issued 99,940 shares of stock in the company, in proportion to his investment, on February 8, 1973. On August 16, 1979, he received 100 additional shares. The stock of Lexel Corporation split 2-for-1 on April 8, 1981, with the result that appellant then possessed 200,080 shares of Lexel Corporation stock.

Cooper Labs acquired Lexel Corporation on February 2, 1983, and appellant was issued, as a result of a tax-free reorganization, 31,069 shares of stock in Cooper Labs in exchange for his shares of stock in Lexel Corporation. On May 2, 1983, Cooper Labs had a 2.5-for-1 stock split, which resulted in appellant's owning 77,670 shares of stock in Cooper Labs.

Appellant sold 30,000 shares of his stock in Cooper Labs on May 1, 1984, and reported a capital gain of \$591,611. On June 27, 1985, he sold additional shares of Cooper Labs stock. With regard to this transaction, appellant reported a capital gain of \$143,264.

For the respective appeal years, appellant reported the unrecognized portion of the capital gains as an item of tax preference. Subsequently, he filed amended returns which excluded the gain from preference income. Appellant's amended returns were treated as claims for refund. Upon review of the claims for refund, the Franchise Tax Board (FTB) determined that the shares of stock in Cooper Labs that appellant sold did not qualify as 'small business stock,' **excludible** from tax preference treatment 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 .' 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:

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(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.

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

Appellant states, and the FTB does not dispute, that his shares of stock in the Lexel Corporation were small business stock. He maintains that he is, accordingly, entitled to exclude from preference income (under section 17063.11) unrecognized capital gains with regard to his sales of Cooper Labs stock in 1984 and 1985 because the small business stock character of his Lexel Corporation stock carried over to the shares of stock in Cooper Labs that he received in the tax-free reorganization in 1983. Appellant argues that even though no statute expressly permits it, the existence of a large number of other tax attributes that are carried over in a tax-free reorganization indicates that the Legislature contemplated, and approved by its silence, a carryover of small business stock status as well. Appellant also contends that denying him a tax **benefit** that he would have received if he had sold his shares of stock in the Lexel Corporation, rather than exchanged them in a tax-free reorganization, is an unfair result that the Legislature cannot have intended when it enacted the pertinent statutes.

The FTB maintains that appellant is not entitled to favorable treatment under section 17063.11 because his shares of stock in Cooper Labs were publicly traded at the time of their acquisition in 1983 and, therefore, did not satisfy the requirements of section 18162.5, subdivision (e). The FTB also asserts that the explicit language of the small business stock statute ~~does~~ does not support, and its underlying purposes do not permit, the carryover of small business stock status to these shares.

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In the Appeals of Diane L. Morris Trust, et al., decided this **day**, we considered issues identical to those raised here and determined that the appellants in that appeal were not entitled to the tax preference **exclusion** provided by section 17063.11, **because** the **stock** they sold did not qualify as **small business stock**. In Morris Trust, we determined that small business stock character **does not carry over** in a tax-free reorganization. We also agreed with the FTB that, in a tax-free reorganization, the stock received is "acquired," for purposes of section 18162.5, when it is received in the reorganization. The stock received by the appellants in Morris Trust did not qualify as small business stock on the date they acquired it.

Applying our determination in Morris Trust to the matter at hand, we conclude that the small business stock character of appellant's Lexel Corporation stock did not carry over to his shares of stock in Cooper Labs. Appellant acquired his shares of stock in Cooper Labs in 1983, and at that time they did not satisfy all the requirements of section 18162.5. **Since** the stock he sold did not qualify as small business stock when acquired, appellant was not entitled to the preference tax exclusion of **section 17063.11**. Accordingly, the action of the FTB must be sustained.

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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 Charles A. Drace for refund of personal income tax in the amounts of \$15,856 and \$3,940 for the years 19'84 and 1985, respectively, be and the same is hereby sustained.

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

\*For Gray Davis, per government Code section 7.9