BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	Nos. 88A-0560-CD
JOEL N. AND BARBARA R. HARRISON	)	88A-0050
AND L. CURTIS WIDDOES	)	

Appearances:

For Appellants: Joanne M. Garvey
Teresa A. Maloney
Attorneys at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

These appeals are made pursuant to section 18593[1]/ of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Joel N. and Barbara R. Harrison against proposed assessments of additional personal income tax in the amounts of $166,677 and $69,874 for the years 1984 and 1985, respectively, and on the protest of L. Curtis Widdoes against proposed assessments of additional personal income tax in the amounts of $113,331 and $137,880 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 issue in these appeals is whether shares of stock that the appellants received in stock splits after September 16, 1981, were "acquired" after that date within the meaning of section 18162.5, subdivision (d).[2/]

The Harrison appellants ("the Harrisons") purchased 60,000 shares of Quantum Corporation ("Quantum"), a California corporation, on June 10, 1980. Joel N. Harrison was a founder and principal of Quantum. As a result of a stock split on February 15, 1982, in preparation by Quantum for a "financing round," the Harrisons received an additional 60,000 shares of Quantum stock. In December 1982, the Harrisons received an additional 120,000 shares as the result of a stock split in preparation for an initial public offering that also occurred in December 1982.[3/] In 1984 and 1985, the Harrisons sold portions of the shares that they had received from the stock splits and excluded the capital gains from taxable income under section 18162.5, subdivision (b)(3).[4/] Respondent determined that those shares of stock did not qualify for the special capital gains benefits for sales of small business stock under the provision because they had not been acquired after September 16, 1981, and issued proposed assessments. After respondent rejected the Harrisons' protest against the proposed assessments, their timely appeal followed.

Appellant Widdoes ("Widdoes") was a founder of Valid Logic Systems, Incorporated ("VLS"), a California corporation. He purchased 168,300 shares of VLS on January 9, 1981. On April 17, 1981, Widdoes received an additional 505,110 shares of VLS stock in a stock split. In preparation for a public offering of VLS stock on October 4, 1983, VLS split its stock again on September 28, 1983, and Widdoes received an additional

2/ The Appeal of Joel N. and Barbara R. Harrison and the Appeal of L. Curtis Widdoes have been consolidated through agreement of the parties.

3/ Respondent has stated that with the stock split and the initial public offering occurred in January 1983. Because the difference in the actual dates are irrelevant to the resolution of the material issue here, we shall assume the correctness of Harrisons' version of these facts.

4/ We are assuming for purposes of this opinion, that such shares, and the corresponding shares in the Widdoes appeal, would have met all the qualifications, other than the one in issue, for "small business stock" under section 18162.5 and its predecessor sections.

224,493 shares. In 1984 and 1985, Widdoes sold portions of the shares that he had received in 1983 and, like the Harrisons, excluded the capital gains from taxable income under section 18162.5, subdivision (b)(3). As in the Harrisons' case, respondent determined that those shares did not qualify for the special capital gains benefits for small business stock under this provision because they had not been acquired after September 16, 1981.

Section 18162.5, subdivision (b)(3), generally permitted a taxpayer during the appeal years to exclude from the computation of taxable income all of the gain from the sale of small business stock that had been held for more than three years.5/ However, section 18162.5, subdivision (d), made this exclusion available only with regard to small business stock acquired after September 16, 1981. Because the term "acquired" has not been legislatively defined for purposes of section 18162.5, subdivision (d), we must interpret that term and apply its meaning here.

Appellants contend that "acquired" should be interpreted for purposes of this section as having its common meaning of obtaining ownership, possession, or control. Because it is undisputed that the appellants received the pertinent shares from stock splits that occurred after September 16, 1981, appellants conclude that they are entitled to the special capital gains benefits of section 18162.5, subdivision (b). Appellants also contend that this result is compelled because, when viewed in their economic contexts, the stock splits represented more than mere changes in form of their underlying shares. Finally, appellants contend that, in interpreting the meaning of the term "acquired" here, it is significant that appellants, as founders of rapidly growing electronics companies, were members of a class whose activities the Legislature had intended to encourage through enactment of the small business stock provisions.

Respondent contends that the shares which appellants received in stock splits represented no more than changes in form of their underlying shares and that, as a result, the

5/ It would seem that appellants' allegations regarding the dates on which they acquired their respective shares are sometimes inconsistent with the claim that the shares were held for more than three years. However, the parties have not discussed this issue and we do not believe it is necessary for us to inquire further into such discrepencies.

pertinent shares were acquired when the appellants received the underlying shares. We agree with respondent's contentions and reject those of appellants.

Appellants' first contention is essentially that the common and ordinary meaning of "acquired" should be used in construing the statute here because such a use does not lead to absurd results or thwart the obvious purpose of the statute. The general validity of this principle of statutory construction is well settled. (Appeals of Diane L. Morris Trust, et al., 88-SBE-019. of Equal., Aug. 2, 1989.)

However, respondent correctly points out that exceptions to the use of the ordinary meaning of "acquired" have been consistently recognized in analogous federal contexts. In determining whether shares received by a taxpayer in a stock split were "acquired" for purposes of Internal Revenue Code section 851, subdivision (d), the Internal Revenue Service held that the stock split there did not result in an acquisition of new shares but was a mere change in the number of shares representing the taxpayer's original investment. (Rev. Rul. 74-133, 1.74-1 C.B. 165.) Similarly, in interpreting the meaning of "acquired" under former Internal Revenue Code section 333, subdivision (e)(2), with regard to stock received as a dividend, the Eleventh Circuit Court of Appeals stated:

> [T]he term "acquired" has a meaning different from that used in common parlance when the "acquired" shares represent no more than a change in form. "This occurs when the 'acquired' shares represent no more than a substitution for, or additional shares of the same type as, shares previously acquired." 84 T.C. 160, 163.

(Knowlton v. Commissioner, 791 F.2d 1506, 1508 (11th Cir. 1986), aff'g., 84 T.C. 160 (1985). Accord, Rev. Rul. 58-92, 1958-1 C.B. 174. See also Rev. Rul. 56-171, 1956-1 C.B. 179.)

In like manner, this board has indicated that shares received by a taxpayer in a tax-free reorganization would not be "acquired" for purposes of section 18162.5 if the shares that were received represented just a change in form and were not a fundamentally new investment by the taxpayer. (Appeals of Diane L. Morris Trust, et al., supra.) By implication, we considered that, under those circumstances, a contrary result would be absurd and thwart the obvious purpose of the statute. (Appeal of Diane L. Morris Trust, et al., supra.)

Because we conclude that our reasoning in Morris Trust regarding the meaning of "acquired" in section 18162.5 is not limited to tax-free reorganizations, but is also applicable to stock splits, we disagree with appellants' first contention if we conclude the pertinent stock splits were mere changes in form. Therefore, we must determine whether the stock splits here resulted in changes of form only or in fundamental rearrangements of the appellants' respective investments.

Corporation Code section 188 defines a "stock split" as the pro rata division, other than by a share dividend, of all the outstanding shares of a class of stock into a greater number of shares of the same class by an amendment to the articles stating the effect on outstanding shares. In a commentary on stock splits, a noted authority has stated:

> A stock split is a mere change in the form of the stockholder's interest in the company and not a change in the substance of the property. [Citation.] It is merely a dividing up of the outstanding shares of a corporation into a greater number of units without disturbing the stockholder's original proportional participating interest in the corporation. [Citation.] The shareholder's proportionate share of ownership, the rights on dissolution and the total value of the investment in the corporation are all preserved intact after the split is consummated. [Citation.] The only noteworthy occurrences resulting from a stock split are the receipt of a new certificate evidencing the change in shares and the necessary clerical corrections to be made on the record books. [Citation.]

(11 Fletcher Cyc Corp § 5362.1 (Perm Ed). Accord, Estate of Helfman, 193 Cal.App.2d 652 (1961).)

Appellants point out that this authority also states in the same commentary that a stock split, in reducing the market price and thereby increasing the marketability of each share, often increases the shares' aggregate market price. However, mere changes in the market values of appellants' investments, even if they occurred here as the result of the stock splits, do not demonstrate the required fundamental rearrangements in the nature of their respective investments. Even when viewed in the economic context that appellants present, the stock splits did not represent a "change of substance in the rights and relations of the interested parties

to one another or to the corporate assets." (See Appeals of Diane L. Morris Trust, et al., supra.) Appellants also argue that the stock splits should be evaluated in conjunction with the previously mentioned "financing round" and public offerings because the nature of their investments were substantially changed after these events. However, appellants frame this argument only in very general terms, cite no directly supporting authority, and provide no evidence that the required changes of substance resulted after these subsequent events occurred.

With regard to appellants' final contention, even though the purpose of section 18162.5 was to encourage entrepreneurs to take risks in starting and expanding small California businesses (Stats. 1981, ch. 534. § 1, p. 1903), appellants had already made their investments before September 16, 1981, the operative date of the provision, and there is nothing in the statutory language of that section or its legislature history to suggest that the Legislature intended to protect earlier investors in the manner that appellants advocate.

For the reasons stated above, we find that the pertinent shares were acquired, for purposes of section 18162.5, subdivision (d), before September 17, 1981, and not when the pertinent shares were received pursuant to the stock splits. Therefore, respondent's actions 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 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Joel N. and Barbara R. Harrison against proposed assessments of additional personal income tax in the amounts of $166,677 and $69,874 for the years 1984 and 1985, respectively, and on the protest of L. Curtis Widdoes against proposed assessments of additional personal income tax in the amounts of $113,331 and $137,880 for the years 1984 and 1985, respectively, be and the same is hereby sustained.

Done at Sacramento , California, this 1st day of August 1990, by the State Board of Equalization, with Board Members Mr. Collis, Mr. Dronenburg, Mr. Carpenter, and Mr. Davies present.

Conway H. Collis, Chairman

Ernest J. Dronenburg, Jr., Member

Paul Carpenter, Member

John Davies*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9