

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
LENORE M. STEIN) No. 87R-1627-MW

Appearances:

For Appellant: Jeffrey B. Harris
Attorney at Law

For Respondent: Larry Bobiles
Karen D. Smith
Counsels

OPINION

This appeal is made pursuant to section 19057, subdivision (a),^{1/} of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claim of Lenore M. Stein for refund of personal income tax in the amounts of \$183,812 and \$63,794 for the years 1983 and 1984, respectively.

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

The issue originally raised in this appeal is whether appellant was entitled to exclude from tax preference income, pursuant to section 17063.11, the unrecognized portion of capital gain from the sale of her shares of Community Psychiatric Center stock. The Franchise Tax Board (FTB) has also asked this board to reconsider its holding in the Appeal of Magnus F. and Denise Hagen, decided by this board on April 9, 1986.

In 1982, appellant sold 600 shares of Inter-City Homemakers, Inc. (ICH). Payments were made on the purchase price in 1982 and 1983. In 1983, appellant exchanged shares in Personal Health Care Services Corporation (which had been formed by mergers of several predecessor corporations) for shares in Community Psychiatric Centers (CPC) in a tax-free reorganization. In 1983 and 1984, appellant sold shares of CPC.

On her tax returns, appellant reported as preference income the unrecognized portion of capital gain from the sales of the ICH and CPC stock. Appellant subsequently filed amended returns that excluded these unrecognized capital gains from preference income pursuant to section 17063.11 on the basis that the stock of both companies qualified as "small business stock" under 18162.5, subdivision (e). The FTB determined that the CPC stock was not "small business stock" because it was listed on the New York stock exchange when appellant received it in the tax-free reorganization. Respondent now concedes that appellant is entitled to a refund of preference tax paid with respect to the payments received in 1982 and 1983 from the sale of the ICH stock.

Former section 17063.11^{2/} excluded from tax preference income that portion of capital gain attributable to the sale of "small business stock." Former section 18162.5,^{3/} subdivision (e), defined "small business stock" as stock meeting a number of specified requirements at the time the stock was acquired by the taxpayer. One of the requirements for small business stock treatment was that the stock was not listed on the New York Stock Exchange on the date acquired by the taxpayer. (Rev. & Tax. Code, § 18162.5, subd. (e)(3).)

Appellant apparently concedes that the CPC stock was listed on the New York Stock Exchange when she received it. However, she argues that the stock which she exchanged for the CPC stock qualified as small business stock, and she contends that the purported small business stock character of this stock carried over to her CPC shares. In essence, appellant argues that tax-free reorganizations are merely changes in form and, as a result, there is no new "acquisition" of stock and all tax attributes of the stock exchanged necessarily carry over to the stock which a taxpayer receives in such a reorganization. She contends that, in any case, her stock should not be considered to have a new acquisition date, alleging that it was the same type of reorganization that the Internal Revenue Service held did not create a new acquisition date in Revenue Ruling 56-171, 1956-1 C.B. 179. She

^{2/} This section was repealed by AB 53 (Stats, 1987, ch. 1138), operative for taxable years beginning on or after January 1, 1987.

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argues that this revenue ruling was cited by the court in Knowlton v. Commissioner, 84 T.C. 160 (1985), affd., 791 F.2d 1506 (11th Cir. 1986), the case upon which the FTB principally relies in Legal Ruling 428 (Aug. 19, 1987) for its analysis of the term "acquired" as used in section 18162.5.

The FTB argues that the CPC stock did not qualify on the date appellant acquired it during the reorganization and that there is no carryover of the small business stock character of the stock exchanged. It contends that, while some reorganizations are merely changes in form and may allow carryover of small business stock character, the particular transaction involved here did not involve a mere change in form.

Our board, in the Appeals of Diane L. Morris Trust, et al., (89-SBE-019) decided August 2, 1989, determined that, in tax-free reorganizations which were not simply changes in form, small business stock character did not carryover from the stock exchanged to the stock received and that, for purposes of determining small business stock character, the acquisition date was the date the stock was actually received in the reorganization. Appellant here makes essentially the same arguments made by the appellants in the Morris Trust appeal, supra, and asks that we overrule that decision. Having reexamined the arguments made both in that appeal and the present one, we abide by our reasoning in that opinion and decline the invitation to overrule our decision in Morris Trust.

With regard to appellant's contention that her case should be an exception to the rule of Morris Trust because of Revenue Ruling 56-171, we again must disagree with appellant. In our decision in Morris Trust, we did rely on the court's analysis in Knowlton, supra; Knowlton did cite to Revenue Ruling 56-171; and Revenue Ruling did conclude that stock was "acquired," for purposes of Internal Revenue Code section 333(e)(2), on the date a corporate shareholder acquired the stock that it exchanged for the stock being distributed pursuant to section 333. (Knowlton v. Commissioner, supra, 84 T.C. at 165.) However, the court, while noting that the Commissioner had interpreted "acquired" in this way for one particular purpose, also noted that no explanation was given for this particular interpretation, and went on to discuss a number of other rulings in which "acquired" was interpreted differently by the Commissioner. Ultimately, the court held that the "common and ordinary meaning" of acquired, which the court found to mean that one had obtained ownership, possession, or control, was appropriate as long as it did not lead to absurd results or thwart the obvious purpose of the statute. The FTB, in its Legal Ruling 428, addressed the particular type of reorganization at issue here in Question 1, using the same standard adopted by the Knowlton court. It concluded that this type of reorganization caused a fundamental rearrangement in the nature of the investment and, therefore, a new acquisition date, as of the date of the exchange, was appropriate. We agree with the analysis of the FTB in its Legal Ruling 428 on this issue. Therefore, we find that this particular type of reorganization does not take the appellant's transaction outside the rule set in Morris Trust.

In its Supplemental Brief, the FTB raised, apparently for the first time, the issue of our board's reconsideration of its decision in the Appeal of Magnus F. and Denise Hagen, decided April 9, 1986, rehearing (requested by the FTB) denied July 29, 1986. Having decided that appellant is not entitled to the benefits of section 17063.11 because the stock sold did not qualify as small business stock on the date acquired by the taxpayer, we need not reach the alternative issue raised by the FTB.

However, this issue is discussed, and resolved against the FTB, in the Appeal of Brian L. and Phyllis Harvey, decided this day.

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 Lenore M. Stein for refund of personal income tax in the amounts of \$183,812 and \$63,794 for the years 1983 and 1984, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 23rd day of April, 1992, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Dronenburg, Mr. Fong, and Ms. Scott present.

_____, Chairman

Ernest J. Dronenburg, Jr., Member

Winnie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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