96-SBE-010

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	Nos. 90A-0714
THOMAS J. AND GERD PERKINS,	)	90A-1172
GORDON E. AND BETTY I. MOORE,	)	89R-0138
E. FLOYD AND M. JEAN KVAMME.	)	91R-0540

Representing the Parties:

For Appellants: Donald E. Bradley, Attorney

For Respondent: Janet Ballou, Counsel

Counsel for Board of Equalization: Jefferson D. Vest, Staff Counsel

O P I N I O N

These appeals were made pursuant to section 18593, renumbered as section 19045, operative January 1, 1994, of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protests of Thomas J. and Gerd Perkins against proposed assessments of additional personal income tax and, pursuant to section 19057, renumbered as section 19324, operative January 1, 1994, subdivision (a),[1] from the action of the Franchise Tax Board in denying claims for refund of Gordon E. and Betty I. Moore and E. Floyd and M. Jean Kvamme for personal income tax in the amounts and for the years as follows:

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

Appellants	Years	Proposed Assessments	Proposed For Refund	Claims
Thomas J. and Gerd Perkins 90A-0714 and 90A-1172	1983	$109,746.00		
	1984	38,344.00		
	1985	9,962.00		
	1986	285,036.63		
Gordon E. and Betty I. Moore 89R-0138	1986			$67,186.76
E. Floyd and M. Jean Kvamme 91R-0540	1986			71,912.55

The issues presented in these appeals are whether the stock which is the subject of these appeals qualified as "small business stock" under former Revenue and Taxation Code section 18162.5, subdivision (e); whether the exclusion from preference tax provided by former section 17063.11 applies to stock acquired on or before the effective date of that section, September 16, 1981; and, whether appellants "acquired" the stock which is the subject of these appeals when that stock was distributed to them in a partnership distribution.

With regard to the first issue, except for the "gross receipts test" issue discussed below, the parties have resolved this issue by a Stipulation of Facts. With regard to the second issue, the California Supreme Court, reaching substantially the same conclusion which this board reached in the Appeal of Magnus F. and Denise Hagen, decided on April 9, 1986, held that small business stock was exempt from preference tax under former section 17063.11, even if the stock was acquired before September 17, 1981. (Lennane et al. v. Franchise Tax Board, 9 Cal.4th 263 (Dec. 28, 1994).) The third issue, whether appellants acquired the stock when it was distributed to them in a partnership distribution, is the primary issue left for our consideration.

If we determine that the date of acquisition of the stock sold was the date the stock was distributed by the partnerships then (with one exception discussed below) there is no need for us to determine the issue relating to the "gross receipts test," since the stock was publicly traded when distributed to the taxpayers as partners, thus clearly disqualifying it under former section 18162.5, subdivision (e)(3). If, however, it is determined that the date of acquisition of the stock sold was the date the stock was acquired by the partnerships, a question arises regarding the qualification as small business stock of the stock of five of the corporations involved here: Applied Biosystems, Home Health Care, Quantum, VLSI, and Genentech. The respondent contends that the stock of these corporations did not qualify as small business stock because the corporations did not meet the "gross receipts test" of former section 18162.5, subdivision (e)(4).

This is a case of first impression since there is no authority directly on point that answers the acquisition issue. After reviewing the parties' arguments, we agree with respondent that the acquisition date of the stock sold by the partners was the date the stock was distributed to the partners by the partnerships.

Appellants Thomas Perkins and Floyd Kvamme were general partners in several venture capital partnerships (hereinafter collectively called the "partnerships"). Mr. Perkins was also a limited partner in three of the partnerships. The Moores were limited partners in two of the partnerships. The partnerships were formed to make equity investments in new companies.

Between 1976 and the end of 1982, the partnerships acquired stock in a number of "early-stage" high-technology and biotechnology companies. The corporations purchased which are involved here were: Home Health Care, Inc. (later Caremark); Hybritech, Inc.; Quantum Corporation; Genentech, Inc.; Ungermann-Bass, Inc.; VLSI Technology, Inc.; Applied Biosystems, Inc.; Collagen Corporation; Priam Corporation; Seeq, Inc.; Archive Corporation; Wyse Technology; and Sun Microsystems, Inc. (hereinafter referred to collectively or variously as "the corporations").

In 1983, some of the partnerships sold stock of some of the corporations and distributed the proceeds to the Perkins appellants. Between the end of 1980 and some time in 1986, the partnerships distributed stock of the corporations to the appellants as nonliquidating partnership distributions. At the time of each distribution, the stock distributed was publicly traded.

In 1981, the California legislature enacted the "small business stock" provisions, i.e., former sections 17063.11[2]and 18162.5.[3] The purpose of the enactment of the small business stock provisions was to promote the expansion of new private business in California,[4] and under these

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[2] Former section 17063.11 provided that "[f]or 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] Former section 18162.5 was originally enacted as section 18161.5; however, 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 1983 through 1986, we will refer to the statutes as amended by AB 36.

[4] The preamble to the 1981 enactment of the small business stock provisions stated the purpose as follows:

The Legislature finds that a key element of California's economic growth and prosperity over the past several decades has been the founding and expansion of new private business. A majority of the increase in private employment in California has come as a result of the willingness of private entrepreneurs to take risks in starting and expanding small companies. Similarly, the willingness of private investors to provide start-up equity capital for entrepreneurs has been a critical element in the ability of new and small companies to transform ideas into jobs and income from California.

The Legislature finds, however, that state and national tax laws, in an inflationary era, provide insufficient incentive for many investors to risk their savings in new businesses, and excessive incentive to place their savings into nonproductive assets which add nothing to the strength of the economy. The purely speculative returns on

provisions a taxpayer who sold small business stock received favorable capital gains treatment with respect to gains on the sale of the stock, and was allowed to exclude the portion of any capital gain attributable to the sale from the tax on preference income.[5] Former 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 . . . 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, interest, dividends, or sales of assets.
>
> (5) The corporation is not engaged primarily in the business of holding land.[6]

Therefore, former section 18162.5, subdivision (e), provides the requirements that must be met on the date of acquisition by the taxpayer for corporate stock to qualify as small business stock. However, there is no specific provision in either former section 17063.11 or former section 18162.5 that covers the situation involved in this appeal: whether a partner "acquires" the stock upon a nonliquidating distribution from the partnership or upon the initial acquisition of the stock by the partnership.

In this board's decision in the Appeals of Diane L. Morris Trust, et al., decided on August 2, 1989,[7] we had to decide the meaning of "acquisition" in former section 18162.5, subdivision

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such investments as gold, silver, gems, paintings, stamps, and antiques represent the diversion of scarce capital from productive investment. (S.B. 690 (Stats. 1981, Ch. 534), §1.)

[5] The California legislature repealed the small business stock provisions effective with respect to taxable years ending after September 30, 1987.

[6] 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, which added subsection (6) to former section 18162.5, subdivision (e), and provided that the gross receipts test under subsection (4) would not apply to interest income as to start-up companies for their first four years following incorporation.

[7] On March 30, 1995, the California Supreme Court dismissed review in Morris et al. v. Franchise Tax Board, 32 Cal.App.4th 1368, as improvidently granted and remanded the case to the Court of Appeal for entry of judgment pursuant to rule 29.4(c) of the California Rules of Court. The Supreme Court's order also denied the request for an

(e), as it relates to a tax-free reorganization. In that decision we adopted respondent's position of the meaning of acquisition as provided in respondent's Legal Ruling (LR) 428.[8] However, the parties have agreed that the factual setting of the Morris Trust case is distinguishable from the present appeal since that case involved a corporate merger that fundamentally changed the subject stock itself, whereas in the present appeal the partnership distributions affected no such change in the stock. Rather, our question is whether the partnership distributions effected a fundamental change in appellants' ownership, possession, and control of the stock in such a way that the distributions would constitute an acquisition under former section 18162.5.

The appellants take the position that the gain on the sale of the stock is entitled to the favorable capital gains and tax preference provisions accorded "small business stock" pursuant to former sections 18162.5 and 17063.11. They contend that the stock should be considered acquired at the time it was acquired by the partnerships, and at that time it qualified for small business stock treatment. Appellants argue that there was no fundamental change resulting in a new investment upon the distributions of stock to them and, therefore, no new acquisition of the stock upon distribution. Appellants maintain that federal income tax law and California partnership law support this position. They also contend that the California legislature clearly intended partners in venture capital partnerships to benefit from the small business stock provisions.

Respondent argues that the stock that was sold did not qualify for small business stock treatment since, at the time it was acquired, which the respondent contends is when it was received by the taxpayers as a partnership distribution, it was publicly traded, thus disqualifying it under former section 18162.5, subdivision (e)(3). Respondent contends that under California tax and partnership law, there was a fundamental change in appellants' investment when the stock was distributed, and the stock was not acquired, for small business stock purposes, until the date it was distributed by the partnerships to appellants.

From the record it is clear that federal and California law represent a dichotomy between an "aggregate" approach and an "entity" approach with relation to partnerships. The aggregate theory is based upon the premise that a partnership is no more than the aggregate of its partners, so that each of the partners should be viewed as owning whatever property the partnership owns. (Reed v. Industrial Accident Commission, 10 C.2d 191 (1937); Park v. Union Manufacturing Company, 45

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order directing publication of the appellate court opinion. (892 P.2d 148; 1995 Cal. Lexis 2325; 40 Cal. Rptr.2d 114; 95 Daily Journal DAR 4072.) Therefore, the case is now final but depublished and thus, not citable as precedent.

[8] Respondent issued LR 428 on August 19, 1987. In that ruling respondent adopted the basic position 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. Some of the factual situations discussed in LR 428 put forth the same premise argued by respondent in this appeal; i.e., that a distribution of stock from a partnership to its partners constitutes a new acquisition under former section 18162.5 since the partners did not have ownership, possession, or control until the distribution occurred. We also held in Morris Trust, supra, that our decision in that appeal was in accord with respondent's interpretation as expressed in LR 428, and that ruling appeared, in general, to be reasonable and within the scope of respondent's responsibility and authority as the administering agency.

Cal.App.2d 401 (1941).) However, to rely only on the aggregate theory would ignore the entity theory which provides that a separate legal entity exists, i.e., a partnership, which is separate and distinct from its partners for purposes of determining the ownership of partnership property. California Corporations Code section 15025 provides:

> (1) A partner is coowner with the other partners of specific partnership property holding as a tenant in partnership.
>
> (2) The incidents of this tenancy are such that:
>
> (a) A partner, subject to the provisions of this chapter and to any agreement between the partners, has an equal right with the other partners to possess specific partnership property for partnership purposes; but a partner has no right to possess such property for any other purpose without the consent of the other partners.
>
> (b) A partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property.
>
> (c) A partner's right in specific partnership property is not subject to enforcement of a money judgment, except on a claim against the partnership. When partnership property is levied upon for a partnership debt, the partners, or any of them, or the representatives of a deceased partner, cannot claim any right under the exemption laws.
>
> (d) On the death of a partner, the partner's right in specific partnership property vests in the surviving partner or partners, except where the deceased was the last surviving partner, when the deceased partner's right in such property vests in his or her legal representative. Such surviving partner or partners, or the legal representative of the last surviving partner, has no right to possess the partnership property for any but a partnership purpose.
>
> (e) A partner's right in specific partnership property is not subject to dower, curtesy, or allowances to widows, heirs, or next of kin, and is not community property.

In other words, as to ownership of assets, California law provides generally that a partnership is treated as a separate legal entity. In further support that California law emphasizes the entity theory of partnership law when dealing with the ownership of partnership property, in Bartlome v. State Farm Fire & Casualty Co., 208 Ca.3d 1235 [256 Cal.Rptr. 719] (1989), the Court of Appeals held that "one of the primary areas in which a partnership is viewed as an entity is with respect to ownership of property." (Bartlome v. State Farm Fire & Casualty Co., supra, at 1240.)

Additionally, even federal law seems to emphasize the entity theory as to ownership of partnership property. In Prizant v. Commissioner, T.C.Memo 1971-196, the United States Tax Court used the entity theory to determine when a partnership acquired property as opposed to when a partner acquired property. In that decision, which involved Internal Revenue Code (IRC) Section 1244 (a federal small business stock provision) the Tax Court held that a distributee-partner acquired stock on

the date of the distribution from the partnership, not on the partnership's acquisition date. The Tax Court concluded that the IRC section 1244 "small business stock" attribute (which is similar in some, but not all, respects to California's small business stock provisions) did not pass through to the partners, but instead the distributee-partners were treated as having acquired the stock on the date of the distribution. This holding is consistent with another Tax Court holding that stated that one could not "be said to 'acquire' property before one obtains ownership, possession, or control over it." (Knowlton v. Commissioner, 84 T.C. 160, 163 (1985) aff'd., 791 F.2d 1506 (11th Cir. 1986); See also, United States v. Basye, 410 U.S. 441 (1973); Chase v. Commissioner, 92 T.C. 874 (1989).)

Based upon the above discussion, we find that as to ownership of property, the general partner, absent a specific contract among the partners, exercises dominion and control over the assets only for partnership purposes and cannot be said to have ownership, possession, or control over the partnership property until the property is distributed to the general partners. (Cal. Corp. Code § 15925, subd. (a).) Additionally, the lack of ownership, possession, and control over property owned by the partnership is even more extreme as to limited partners who are not entitled to manage and control the affairs of the partnership. (Cal. Corp. Code §§ 15501, 15507 and 15510.)

The differences in rights and obligations as to ownership before and after the distribution result in a fundamental change of the nature of the partners' investment. Therefore, both the general and limited partners "acquired" the stock at the time of the distribution, when it could be said that they had obtained "ownership, possession, or control over it." The differences in the partners' rights and obligations as to the stock before and after the distribution are what distinguish the partnership distributions from other transactions which appellants argue do not give rise to new acquisition dates for stock.[9] Therefore, we find the transactions referred to by appellants in support of their position not analogous and not persuasive.

Appellants also argue that the California legislature clearly intended partners in venture capital partnerships to benefit from the small business stock provisions. However, this is a broad reading of legislative intent as expressly provided in the preamble of SB 690. Respondent, on the other hand, gives a more narrow interpretation of acquisition under former sections 18162.5 and 17063.11, and we held in the Appeal of Diane L. Morris Trust, et al., supra, that it is the respondent "which is the administering agency of the Personal Income Tax Law, and, in that capacity, it is the [respondent] which is not only equipped to develop, but charged with developing cohesive rules to carry out the legislative intent." (See also Appeal of Russell B., Jr., and Margaret A. Pace, 92-SBE-013, May 7, 1992.) We believe that respondent's position as to the meaning of "acquisition" in former section 18162.5 is correct in light of the authority presented in the record; that the differences in the partners' rights and obligations as to the ownership of the stock before and after the distributions were substantial; and therefore, the partners did not acquire the stock until the distributions from the partnerships, e.g., when they obtained ownership, possession, or control over it. Additionally, we do not believe that absurd results occur with respondent's interpretation simply because they are results unfavorable to appellants' position.

[9] Appellants contend that the partnership distributions in these appeals are similar to a number of other transactions that are tax-free, i.e., a reincorporation under IRC section 368(a)(1)(F); a stock split; and a transaction governed by Revenue Ruling 56-437, 56-2 C.B. 507, and 90-7, 1990-5 I.R.B. 10. However, none of these transactions seem to affect the rights and obligations of the stock before and after the transaction.

Additionally, we believe that had the legislature intended a different result, it could have incorporated language in either former sections 18162.5 or 17063.11 defining "acquisition" to include a partner's purchase of stock through a venture capital partnership. (Cf. Lennane et al. v. Franchise Tax Board, 9 Cal.4th 263, supra, at 273 (regarding acquisition date limitation language).) Taxpayers are free to structure a transaction in whatever lawful manner they choose; however, once having done so, they must accept the tax consequences of their choice and may not enjoy the benefit of some other route they might have chosen to follow but did not. (Commissioner v. Nat'l Alfalfa Dehydrating, 417 U.S. 134 (1974).) If the partnerships chose to distribute the stock to their partners rather than to sell it, the partners must accept the tax aspects of such distributions. Perhaps most importantly, former sections 18162.5 and 17063.11 simply provide no language that would support carryover of small business stock attributes in the distribution of stock from the partnership to its partners.

Therefore, we conclude that the partners did not acquire the stock until it was distributed to them, at which time the subject stock did not qualify as small business stock under former sections 18162.5 and 17063.11; thus, the stock that was distributed to the partners and then sold is subject to tax on preference income.

Having reached this conclusion, as to the stock distributed by the partnerships to the partners prior to its sale, it is not necessary for us to determine the remaining issue relating to the "gross receipts test." However, the record does indicate that respondent is questioning the qualification as small business stock of at least one stock that was acquired by the partnerships and sold by the partnerships rather than being distributed to the partners. Therefore, we must examine the stock sold to see if the proceeds that were distributed to the partners qualified for the special treatment afforded small business stock.

The Applied Biosystems stock was acquired by one of the partnerships prior to 1981. The acquiring partnership sold it during 1983, distributing the proceeds of the sale to appellants Thomas J. and Gerd Perkins. Respondent contends that the Applied Biosystems stock did not qualify as small business stock at the time of its acquisition by the partnership because Applied Biosystems did not meet the "gross receipts test" of former section 18162.5, subdivision (e)(4). This subdivision provides that in order for stock to qualify as small business stock, the corporation must have obtained no more than 25 percent of its gross receipts in the income year immediately prior to the year of acquisition "from rents, interest, dividends, or sales of assets." (Rev. & Tax. Code, former § 18162.5, subd. (e)(4).) In the income year prior to acquisition of the stock, Applied Biosystems had total gross receipts of $192 and 100 percent of that amount was from interest derived from temporary investment of capital of the corporation received from the sale of stock pending expenditure of such capital in the corporation's business. Applied Biosystems was actively engaged in the development of commercial products for manufacture and sale and the corporation had an operating loss for federal tax purposes for its fiscal year ended June 30, 1981.

Appellants argue that the corporation was newly organized and had not yet derived revenue from product sales or other related commercial activities, even though it was conducting research and development activities consistent with its corporate purpose. Appellants contend that

respondent's approach to the "gross receipts" test yields results which are totally inconsistent with the intent of the legislature.[10]

Appellants ask this board to hold that, in a situation such as this, the fact that the new corporation "realizes a de minimus amount of interest income from temporary investment of working capital as part of an overall operating loss should be disregarded." (App. Reply Br. at 37.) Further, appellants maintain that interest earned from short-term investments of working capital pending expenditures in the company business is business income rather than nonbusiness income derived from passive investments. Appellants argue that the legislative intent of former section 18162.5, subdivision (e)(4), was to only include "passive" income in applying the gross receipts test. Therefore, appellants contend that nonpassive income should not be included in determining the gross receipts test under subdivision (e)(4), resulting in the Applied Biosystems meeting the requirements of former section 18162.5 when acquired by the partnership.

Respondent argues that the statute is clear on its face. Nowhere in former section 18162.5 does it say "passive" interest only. It further argues that when a statute is clear on its face, no interpretation is necessary, and the statute must be followed as written. However, this board has previously determined that all the income items listed in former section 18162.5, subdivision (f)(1), should be construed to include only items that are "passive".[11] (Appeal of Russell B., Jr., and Margaret A. Pace, supra.) Our determination was based on legislative intent and respondent's own treatment of such items in LR 428. Respondent has failed to distinguish our determination in the Appeal of Russell B., Jr., and Margaret A. Pace, supra, from the present appeal, nor has respondent been able to show that the same rationale adopted in Pace should not apply to the items of income included under former section 18162.5, subdivision (e)(4). Therefore, we find that the items of income listed in former section 18162.5, subdivision (e)(4), should be construed to include only items that are "passive".

The next issue is whether the gross receipts of interest from temporary investments of capital were passive. We have recently held in the Appeal of Cullinet Software, Inc., et al., (95-SBE-002), May 4, 1995, in the unitary business context, that idle funds invested in liquid financial instruments on a short-term basis are part of the business's working capital pool, and thus generate business income, unless management segregates or earmarks the funds in such a way as to clearly establish that they were not being held readily available for use in the taxpayer's regular trade or business operations. In the present appeal the parties have stipulated to the fact that the interest was derived from a temporary investment of capital pending use in the corporation's business. Additionally, no evidence exists that management segregated or earmarked the funds in such a way as to clearly establish that they were not being held readily available for use in the corporation's regular business operations. Based on

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[10] Appellants also argue that in "clean-up" legislation, effective January 1, 1984, the Legislature added a new subdivision (e)(6) to former section 18162.5, which eliminated interest from the gross receipts test of subdivision (e)(4) during the first four income years following the date of incorporation, and that, if this legislation had been effective for the years involved here, the corporation would not have been disqualified as small business stock.

[11] Former section 18162.5, subdivision (f)(1), provided that "small business stock" does not include an equity security issued by a corporation if more than 25 percent of the corporation's gross receipts were obtained from rents, interest, dividends, or sales of assets.

the foregoing, we conclude that the interest income was not simply "passive" investment income. Therefore, we agree with appellants that the interest of Applied Biosystems in the corporation's income year ending June 30, 1981, should not be included in the gross receipts test, resulting in the stock meeting all the requirements of former section 18162.5, subdivision (e), in the year of acquisition.

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, renumbered as section 19047, operative January 1, 1994, of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protests of Thomas J. and Gerd Perkins against proposed assessments of additional personal income tax and, pursuant to section 19060, renumbered as section 19333, operative January 1, 1994, of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of Gordon E. and Betty I. Moore and E. Floyd and M. Jean Kvamme for refund of personal income tax in the amounts and for the years shown below be and the same is hereby modified to reflect our determination that the Applied Biosystems stock, as discussed in the above opinion, qualified as small business stock. In all other respects, the actions of the Franchise Tax Board are sustained as follows:

Appellants	Years	Proposed Assessments	Claims For Refund
Thomas J. and Gerd Perkins	1983	$109,746.00	
90A-0714 and 90A-1172	1984	38,344.00	
	1985	9,962.00	
	1986	285,036.63	
Gordon E. and Betty I. Moore	1986		$67,186.76
89R-0138			
E. Floyd and M. Jean Kvamme	1986		71,912.55
91R-0540			

Done at Sacramento, California, this 11th day of April, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs, Chairman

Dean F. Andal, Member

Brad J. Sherman, Member

Rex Halverson*, Member

_____, Member

*For Kathleen Connell, per Government Code section 7.9.