96-SBE-014

BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	No. 91A-1374
Gene and Paula Ray	)	
	)	

Representing the Parties:

For Appellants: Paul J. Dostart, Attorney

For Respondent: David T. Gemmingen, Counsel

Counsel for Board of Equalization: Charles D. Daly, Staff Counsel

O P I N I O N

This appeal is made pursuant to section 18593[1] (renumbered as section 19045, operative January 1, 1994) of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Gene and Paula Ray against proposed assessments of additional personal income tax in the amounts of $1,841 and $37,236 for the years 1983 and 1984.

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

The principal issue to be resolved in this matter is whether stock in Science Applications, Inc. (SAI), should be tested for small business stock status when appellants obtained the actual stock of SAI through the exercise of options or when they obtained the options to purchase the stock.[2]

SAI, a California corporation, was incorporated in 1969. Appellants obtained options to purchase SAI stock on March 26, 1971, and on December 12, 1972, and exercised those options in 1976. In 1981, appellants exchanged their SAI stock for stock in Science Applications International Corporation (SAIC), a newly formed Delaware holding company, as part of what appellants seemingly allege was a tax-free forward triangular reorganization under Internal Revenue Code (IRC) section 368(a)(2)(D). Appellants sold their SAIC stock in 1983 and 1984.

On their 1983 and 1984 tax returns, appellants reported as regular capital gain the gain from the sales of what they characterized as SAI stock. They reported the unrecognized portion of that capital gain as preference income. Respondent states that appellants subsequently filed amended tax returns on which they took the position that the unrecognized gain on the sales of their stock was not subject to preference tax under Revenue and Taxation Code section 17063.11 because that stock was small business stock, as defined in former section 18162.5. After examining appellants' tax returns, respondent concluded that appellants' SAI stock was disqualified as small business stock because appellants had acquired the stock in 1976 when they had exercised their options and SAI had more than 500 employees in the preceding year. As a result, respondent issued Notices of Proposed Additional Tax for the preference tax that it had concluded was generated by the unrecognized gain from appellants' sales of their SAI stock. After respondent denied appellants' protest, this timely appeal followed.

Section 17063.11 stated that the portion of capital gains attributable to the sale of small business stock, as defined in section 18162.5, was not subject to preference tax. Section 18162.5, subdivision (e), defined small business stock as an equity security issued by a corporation which had all of six enumerated characteristics at the time of acquisition by the taxpayer. The characteristic upon which respondent has focused was stated at subdivision (e)(2) of section 18162.5, which required that the corporation have 500 or fewer employees in the year before the taxpayer acquired its stock.

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[2] Respondent also raises the issue of whether small business stock acquired before September 17, 1981, qualified for the tax preference exclusion of former section 17063.11. This board in the Appeal of Magnus F. and Denise Hagen, decided on April 9, 1986, held that the benefits of that statute were available for small business stock purchased before that time if all other requirements were met. The California Supreme Court reached essentially the same conclusion in Lennane v. Franchise Tax Board, (1994) 9 Cal.4th 263 [36 Cal.Rptr.2d 563].

Although appellants described on their tax returns the sales at issue here as sales of SAI stock, the parties now appear to agree that the sales were actually sales of the SAIC stock that appellants received in the 1981 reorganization. In its final brief, respondent takes the position that the SAIC stock should be retested for small business stock status at the time of that reorganization and argues that the SAIC stock should be disqualified because the "surviving entity had more than 500 employees." (Resp. Reply Br. at 2.) We note that, despite taking this position, respondent does not appear to dispute directly appellants' earlier allegation that the 1981 reorganization was a tax-free forward triangular reorganization. Respondent also does not appear to dispute appellants' point that Question 3 of its own Legal Ruling (LR) 428 held that the small business stock status of stock of a California operating corporation carried over to the stock of a newly formed Delaware holding company after a tax-free forward triangular reorganization. However, we need not decide the issue of whether appellants' SAIC stock should be retested at the time of the 1981 reorganization because, even if the small business stock status of appellants' SAI stock carried over to their SAIC stock after the 1981 reorganization, our conclusion regarding the small business stock status of appellants' SAI stock in 1976 disposes of this appeal in a manner adverse to them.

Appellants' primary contention in this appeal is that their SAI stock should be tested for small business stock status when they obtained the options to purchase the stock and should not be retested for small business stock status when the options were exercised. They cite Question 21 of LR 428 to support the proposition that their options to purchase SAI stock were themselves small business stock whose small business stock status carried over to the underlying SAI stock when the options were exercised. They also cite this board's opinion in the Appeals of Diane L. Morris Trust, et al. (89-SBE-019), decided on August 2, 1989, for the basically identical proposition that the exercise of their options was not a "new acquisition" for purposes of testing the small business stock status of their SAI stock. Respondent contends that appellants acquired their SAI stock, for purposes of testing the small business stock status of that stock, when the options were exercised and not at any earlier time. It argues that Helvering v. San Joaquin Fruit and Investment Company (1936) 297 U.S. 496 [80 L.Ed. 824], is controlling with respect to this issue. Respondent also argues that Question 21 of LR 428 is not on point and that Morris Trust actually supports its position here. We agree with respondent's contention and disagree with that of appellants.

The United States Supreme Court concluded in San Joaquin Fruit that, for federal income tax purposes, a taxpayer acquires property underlying an option when the property is conveyed to him rather than on the date that the option was obtained. (Helvering v. San Joaquin Fruit and Investment Company, supra, at 498-499.) The rationale of the Supreme Court for its conclusion was that language used in a tax statute should be read in its ordinary and natural sense and that the common and usual meaning of "acquired" is "obtained as one's own." (Helvering v. San Joaquin Fruit and

Investment Company, supra, at 499.) In Morris Trust, we adopted what is essentially the same rationale used by the Supreme Court in San Joaquin Fruit when we concluded that, for small business stock purposes, a taxpayer generally could not be said to have acquired property before he obtained "ownership, possession, or control" over it. Because we think that the Supreme Court in San Joaquin Fruit applied to the specific factual situation of an option to purchase property the same principles that we applied more generally in Morris Trust, we must agree with respondent that San Joaquin Fruit is controlling for California small business stock purposes as well as for federal income tax purposes. Therefore, we conclude that appellants acquired their SAI stock for purposes of testing the small business stock status of that stock in 1976, when they exercised their options, and not at any earlier time.

We do not agree with appellants' position that Question 21 of LR 428 supports a conclusion contrary to the one that we have just reached, because we think that respondent's view that the ruling is not on point is correct. In Question 21, respondent stated that convertible preferred stock, as well as common stock, represents an equity interest in a corporation that could qualify as small business stock if the requirements of section 18162.5, subdivision (e), were otherwise met. Respondent further stated there that the conversion of the preferred stock to common stock should not be viewed as a "new acquisition" for purposes of that section because the conversion privilege was present when the preferred stock was purchased. Respondent finally concluded that the acquisition date of the converted common stock remained the same as that of the original convertible preferred stock. Appellants argue that an option, like common and preferred stock, is an "equity interest" or an "equity security" in a corporation for small business stock purposes, but they acknowledge that there is no direct support for that proposition. Even though appellants correctly state that an option may be considered a "security" for some purposes of California corporate and federal securities law, respondent's ruling does not explicitly incorporate by reference any portion of those laws, and the discussion in the ruling appears to be limited to financial instruments that conform to the commonly held conception of stock, a conception that clearly does not include a mere option to purchase stock. Therefore, in the absence of statutory, regulatory, or other compelling authority directing the contrary, we must agree with respondent that the conclusion reached in Question 21 of respondent's legal ruling may not be expanded to benefit taxpayers, such as appellants, who exercise options to purchase stock.

Because it appears undisputed that SAI had more than 500 employees in the year preceding appellants' acquisition of their SAI stock through exercise of their options, we must conclude that the SAIC stock sold by appellants during the appeals years was properly disqualified as small business stock.

Accordingly, respondent's action in this matter must be sustained.

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 19047 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Gene and Paula Ray against proposed assessments of additional personal income tax in the amounts of $1,841 and $37,236 for the years 1983 and 1984, be and the same is hereby sustained.

Done at Sacramento, California, this 25th day of July, 1996, by the State Board of Equalization, with Board Members Mr. Klehs, Mr. Dronenburg, Mr. Andal, Mr. Sherman and Mr. Halverson present.

Johan Klehs, Chairman

Ernest J. Dronenburg, Jr., Member

Dean F. Andal, Member

Brad J. Sherman, Member

Rex Halverson*, Member

*For Kathleen Connell, per Government Code section 7.9.