

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of:)	
)	
Brooks, Jr. and Danielle Walker;)	No. 93R-1349
John G. and Frances F. Bowes;)	No. 88R-1432
James J. and Eileen Ludwig;)	No. 89R-0004
B.J. and Julius Feigenbaum Trust;)	No. 89R-0609
and Kenneth C. and Joan R. Mirov)	No. 91R-0119
)	

Representing the Parties:

For Appellants:	Richard L. Greene, Attorney Edward I. Kaplan, Attorney
For Respondent:	Ann Hoover, Tax Counsel
Counsel for Board of Equalization:	John S. Butterfield, Tax Counsel

OPINION

These appeals are made pursuant to former section 19057, subdivision (a),¹ of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Brooks, Jr. and Danielle Walker for refund of personal income tax in the amount of \$75,110.80 for the year 1986, of John G. and Frances F. Bowes for refund of personal income tax in the amounts of \$4,177.00 and \$7,544.00 for the years 1983 and 1985, respectively, of James J. and Eileen Ludwig for refund of personal income tax in the amounts of \$2,064.00, \$6,113.00 and \$27,862.00 for the years 1983, 1985 and 1986, respectively, of the B.J. and Julius Feigenbaum Trust for refund of income tax in the amounts of \$3,365.00 and \$38,952.00 for the years 1984 and 1986, respectively, and of Kenneth C. and Joan R. Mirov for refund of personal income tax in the amounts of \$5,331.00 and \$28,524.00 for the years 1985 and 1986, respectively.

The principal issue to be resolved in these consolidated appeals is whether stock in Gap Stores, Inc. should be tested for small business stock status on the dates appellants obtained the actual stock of Gap Stores, Inc. through the exercise of the conversion feature of convertible subordinated

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

debentures (debentures) previously held by appellants, or on the dates appellants acquired the debentures.

In these consolidated appeals, all appellants are similarly situated. Each of appellants acquired convertible debentures issued by Fisher Enterprises (now known as Gap Stores, Inc.) during a period when the issuing corporation qualified as a small business as defined in former section 18162.5. Each appellant subsequently exercised the conversion feature of the debenture to convert his debentures into shares of the common stock of Gap Stores, Inc. during a period when Gap Stores, Inc. did not qualify as a “small business”. When appellants subsequently sold their Gap Stores, Inc. stock, they claimed an exemption from preference tax based on their contention that the stock sold was “small business stock” at the time of acquisition.

Appellants’ contention in these appeals is that the conversion of the debentures into common stock was a “non-realization” event for capital gains tax purposes,² and as such should not be considered as a new acquisition of the common stock on the date of conversion. Appellants point out that respondent has issued Legal Ruling 428, wherein in Question 21 of that Ruling, respondent opines that the conversion of convertible preferred stock to common stock would not result in a new acquisition date for the common stock for small business stock testing purposes. However, while the interpretation accorded a statute by the agency charged with administering the statute is to be given great weight (Mel v. Franchise Tax Board (1981) 119 Cal.App.3d 898, 911, fn.15 [174 Cal.Rptr. 269]; Coca-Cola Co. v. State Board of Equalization (1945) 25 Cal.2d 918, 921 [156 P.2d 1]), and this Board has been reluctant to substitute its own judgment unless it is persuaded that respondent's construction is clearly erroneous (see, e.g., Appeal of Estate of Philip Rosenberg, et al., Cal. St. Bd. of Equal., Aug. 19, 1975, modified Feb. 2, 1976), we have routinely limited the authority of a Franchise Tax Board legal ruling to the specific facts recited therein (cf. Appeal of Russell B., Jr., and Margaret A. Pace, 92-SBE-013, May 7, 1992). Legal Ruling 428 deals with conversion of preferred stock to common stock, and recites that both constitute equity interests in the company. We have held that Question 21 of Legal Ruling 428 is limited to financial instruments that conform to the commonly held conception of stock. (Appeal of Gene and Paula Ray, 96-SBE-014, July 25, 1996.) In these cases, we are dealing with debt converted to equity. We therefore decline to expand the interpretation given in Legal Ruling 428 to encompass these distinguishable facts.

Although we agree with respondent that a convertible debenture (prior to conversion) does not represent an equity interest in a company, we do not agree with respondent’s further argument that a convertible debenture does not constitute small business stock. We agree with appellants that when defining small business stock as an “equity security”, the legislature intended to include all securities included in the definition of that term in the California Corporations Code section 168. A convertible debenture is included in that definition.³ A sale of a convertible debenture would qualify for

²See Revenue Ruling 72-265, 1972-1 C.B. 222.

³Corporations Code § 29004 defines securities as “all shares in any corporation or association or of trustees, bonds, coupons, scrip, rights, choses in action, and other evidences of debt or property and options for the purchase or sale thereof or of any rights entitling the holder thereof to participate in profits or a division of assets.” (Emphasis added.) An “equity security” is defined in Corporations Code section 168 as “any share, any security convertible, with or without consideration, into shares or any warrant or right to subscribe to or purchase any of the foregoing.” (Emphasis added.)

small business stock treatment if all the other qualifications were met. In other words, an instrument may be an "equity security" for purposes of small business stock treatment without representing an actual equity interest. The contingent conversion right qualifies it as an equity security.

Unfortunately, appellants did not sell their debentures. Instead, they converted them to stock and then sold the stock. We find this conversion to be a fundamental change in the nature of appellants' investment. Prior to conversion, they were creditors of the company. After conversion they were owners. We have held that a "change of substance in the rights and relations of the interested parties one to another or to the corporate assets," represents a fundamental change in the nature of the investment, and as an "inevitable corollary" a new acquisition date must be found. (Appeals of Diane L. Morris Trust, et al., 89-SBE-019, Aug. 2, 1989.) We conclude, therefore, that appellants are not entitled to the tax preference exclusion benefits of section 17063.11 for the unrecognized portion of the capital gains resulting from the sales of their Gap Stores, Inc. stock. Their acquisition date occurred when they exercised the conversion privilege and thus obtained ownership, possession or control over the stock. At that time, the Gap Stores, Inc. was not a qualifying small business.

Accordingly, respondent's actions in these matters must be sustained.

ORDER

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 claims of Brooks, Jr. and Danielle Walker, et al., for refund of personal income tax in the amounts and for the years as follows:

<u>Appellants</u>	<u>Years</u>	<u>Claims for Refund</u>
Brooks, Jr. and Danielle Walker	1986	\$75,110.80
John G. and Frances F. Bowes	1983	\$ 4,177.00
	1985	\$ 7,544.00
James J. and Eileen Ludwig	1983	\$ 2,064.00
	1985	\$ 6,113.00
	1986	\$27,862.00
B. J. and Julius Feigenbaum, Trust	1984	\$ 3,365.00
	1986	\$38,952.00
Kenneth C. (deceased) and Joan R. Mirov	1985	\$ 5,331.00
	1986	\$28,524.00

be and the same are hereby sustained.

Done at Sacramento, California, this 22nd day of November, 1996, by the State Board of Equalization, with Board Members Mr. Dronenberg, Mr. Klehs and Mr. Halverson present.

Johan Klehs _____, Chairman

Ernest J. Dronenburg, Jr. _____, Member

Rex Halverson* _____, Member

_____, Member

_____, Member

Opinion adopted at San Diego, California, this 24th day of April, 1997 by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Klehs, Mr. Halverson and Mr. Chiang present.

Ernest J. Dronenburg, Jr. , Chairman

Johan Klehs _____ , Member

_____ , Member

Rex Halverson* _____ , Member

John Chiang** _____ , Member

*For Kathleen Connell, per Government Code section 7.9

**Acting Member, 4th District