BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of:	)	
	)	
Douglas and Barbara Broyles, and	)	No. 92A-0529
Federico and Elvia Faggin	)	No. 92A-0541
	)	

Representing the Parties:

For Appellants: Alan B. Kalin, Attorney

For Respondent: Ann Hoover, Counsel

Counsel for Board of Equalization: John S. Butterfield, Tax Counsel

O P I N I O N

This appeal is made pursuant to former section 18593[1] of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of Douglas and Barbara Broyles for refund of personal income tax in the amounts of $108,361 and $27,215 for the years 1986 and 1987, respectively, and denying the claims of Federico and Elvia Faggin for refund of personal income tax in the amounts of $76,074 and $17,339 for the years 1986 and 1987 respectively. These appeals have been consolidated for decision due to an identity of issues to be decided.

In these appeals, we again consider whether stock purchased by a partnership and subsequently distributed to the partners in a non-liquidating distribution may qualify for small business stock treatment. We begin with a recitation of the factual background involved in these appeals. In 1979, a limited partnership known as West Coast Venture Capital (WCVC) was formed. Appellants Federico Faggin and Douglas Broyles invested in limited partnership units of WCVC at its inception. The purpose of the WCVC partnership was to identify and invest in promising high technology start-up firms in California.

In 1981, the California Legislature enacted SB 690, which was legislation intended to stimulate investment in emerging California companies. This legislation, effective January 1, 1982,

[1]Unless otherwise specified, all section references in the body of this opinion are to sections of the Revenue and Taxation Code as in effect for the years in issue. Section 18593 was renumbered as section 19045, operative January 1, 1994.

provided for reduction or elimination of capital gains and preference income taxes on gains realized from investments in "small business stock." Small business stock was defined by the Legislature, in Revenue and Taxation Code section 18162.5, subdivision (e),[2] as:

> "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, including those held by the taxpayer, 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."

During 1982, after the effective date of the small business stock legislation, WCVC purchased a significant amount of the stock of Sun Microsystems, Inc. (Sun). These purchases were made as a part of several private placement offerings by Sun during a period when Sun's stock was not publicly traded. In 1986, Sun made its initial public offering. Thereafter, WCVC distributed its Sun stock to its partners, including appellants, in a non-liquidating distribution. When appellants subsequently sold the stock which had been distributed to them, respondent denied appellants "small business stock" treatment of the capital gains reported. Respondent maintained that when appellants "acquired" the stock in the distributions from WCVC, the stock no longer met the qualifications of section 18162.5, subdivision (e), because it was publicly traded.

We last considered this issue in the Appeals of Thomas J. and Gerd Perkins, et al., (96-SBE-010), decided April 11, 1996, Petition for Rehearing denied November 13, 1996. In Perkins, we concluded that because a limited partner does not have ownership, possession or control of stock which is owned by a limited partnership,[3] the partner may not be regarded as having "acquired" the stock until such time as it was distributed. Since section 18162.5, subdivision (e), tests the stock for small business stock qualification at the time of "acquisition by the taxpayer," we held in Perkins that small business stock treatment was not available when the stock was publicly traded prior to distribution.

While appellants, in their submissions to this Board, do not assert that they had any ownership, possession or control of the stock in question prior to the date of distribution to them, they nonetheless argue that the Perkins result was contrary to the Legislature's intent, because this Board's

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[2] As originally enacted, the language in this section was codified as section 18161.5. 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 1982 through 1987 and the change in the statutes is not substantive, we have chosen to refer to the statute as amended.

[3] See former California Corp. Code, §§ 15501 et seq., 15507 and 15671, and Evans v. Galardi (1976) 16 Cal.3d 300.

construction of the statute denies the benefit of the statute to the persons whom the Legislature intended to receive them.

While we affirm and reiterate our holding in Perkins that a limited partner has no ownership, possession or control of assets held by a limited partnership until such time as the assets may be distributed to the partner, we are persuaded that our analysis in that case did not correctly consider the unique status of a partnership for purposes of section 18162.5, subdivision (e). We therefore overrule Perkins.

We begin our analysis by widening our examination of the language of the statute beyond the word "acquisition" to the phrase "acquisition by the taxpayer." During the years involved in these appeals, Revenue and Taxation Code section 17004 provided: "'Taxpayer' includes any individual, fiduciary, estate or trust subject to tax imposed by this part." Partnerships were not included in the definition. Section 17851 specifically provided that a partnership shall not be subject to tax. Therefore, if a partnership purchased stock which at the time of purchase would otherwise meet the requirements to be considered small business stock, and subsequently sold it, a literal application of former section 18162.5 would deny small business stock treatment, since the stock would not have qualified at the time of purchase because it had not been acquired by a "taxpayer."

However, respondent has not so applied the section. Rather, in the case of stock purchased and subsequently sold by a partnership, respondent has treated the stock as having been "acquired" on the date it was acquired by the partnership. (See Question 9, Legal Ruling 428.) It necessarily follows that respondent considers the stock, in that situation, to have been acquired "by the taxpayer" on the date the partnership purchased it. Since the partnership itself is not the taxpayer, respondent appears to consider that the partners, who are taxpayers, acquired the stock on that date for purposes of section 18162.5.[4]

The question is thus squarely put: Should a taxpayer be considered to have "acquired" small business stock at the time it is purchased by a partnership in which he is a partner when the stock is eventually sold by the partnership, but not to have "acquired" the stock at the time the partnership purchased it if, instead, the stock itself, rather than the proceeds from its sale, is distributed to him? We conclude that so long as the partner/taxpayer was a partner at the time the partnership purchases the stock (i.e., he does not purchase a partnership interest after the date the partnership had purchased the stock), the "acquisition" of the stock "by the taxpayer" should be considered as the date purchased by the partnership, regardless of whether the stock is eventually sold by the partnership or by the

[4]The taxation of partners has been described as a mixture of "entity" and "aggregate" approaches, depending upon which aspect of tax law is being applied. A partnership will be treated as an entity for some purposes, such as filing returns and determining and characterizing income, but as a conduit through which partners are taxed directly under the "aggregate" approach. We note that respondent prefaced its analysis in Question 9 of Legal Ruling 428 by stating that "In general, the entity approach is adopted for taxing the sale of partnership interests." However, these appeals do not deal with the sale of "partnership interests," rather with the sale of assets purchased by a partnership and subsequently distributed to the partners. Further along in Legal Ruling 428, in Question 17, respondent's analysis recognizes "the adoption of the aggregate approach with respect to the taxation of partnership distributions." We believe that for purposes of the treatment of distributions from a partnership, the "aggregate" approach is the correct one.

partner/taxpayer after distribution. In reaching this conclusion, we are guided in part by the language of respondent's Legal Ruling 428 which recognizes that:

> "Under a common definition of the term "acquire," one would not acquire stock before one obtains ownership, possession or control. . . However, there are circumstances in which deviation from the common meaning of a term will be permitted. Because the Legislature specifically declared [in §1, S.B. 690(Stats. 1981, Ch. 534)] that the purpose of the small business stock provisions was to create jobs by encouraging investors to take risks in starting and expanding small companies, deviation from the common definition of "acquired" as contained in § 18162.5(e) will be permitted only under those circumstances in which the above-cited purposes will be advanced, taking into account well-established general principles of tax law."

We believe that these appeals present just such circumstances. Much of the growth of small biomedical and high technology enterprises in this state has been initially financed and supported by investors banding together in venture capital partnerships. These partnerships, beyond providing capital, often also provide management direction and other assistance to the companies in which they invest. We are confident that the Legislature's purposes in enacting S.B. 690 included providing incentives for such venture capital activity.

We recognize that we have adhered to the common meaning of the term "acquired" in several prior decisions regarding construction of section 18162.5; however, we believe the prior cases are distinguishable. In Appeals of Diane L. Morris Trust, et al. (89-SBE-019), decided by this Board on August 2, 1989, we found that the exchange of one security for another in a merger transaction resulted in a new "acquisition" date for the newly acquired security. In the appeals before us here, the securities in question were the same in the hands of the partnership and the partner. In the Appeal of Bauer Stock Trust, Edward Landry and James Hassan, Trustees (92-SBE-003), decided on April 23, 1992, we found that stock given to an irrevocable, non-grantor trust was to be retested for small business stock status on the date of the gift even though the stock had been small business stock in the hands of the donor. (See also Appeal of Ury Family 1978 Residual Trust, 96-SBE-005, Mar. 14, 1996.) However, in both Bauer Stock Trust and Ury, the stock in question was transferred from one taxpayer, the donor, to another, the trust, resulting in a new "acquisition" date by the trust. In these appeals, the stock was transferred from a nontaxpayer, the partnership, to the taxpayer/partner.

Finally, we note that unlike the taxpayers in Morris Trust, Bauer Trust and Ury, who voluntarily entered into the transactions which resulted in a new acquisition date, the appellants in these appeals, as limited partners, had no control over the decision as to whether to distribute the stock to partners, or to sell it in the partnership.

We therefore find that in the case of a partner who owns a partnership interest at the time small business stock is purchased by a partnership, and who subsequently receives a distribution of the stock, will be considered to have "acquired" the stock at the time it was purchased by the partnership, and not on the date it was subsequently distributed, for purposes of applying the qualification test of former section 18162.5, subdivision (e).

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 in denying the claims of Douglas and Barbara Broyles for refund of personal income tax in the amounts of $108,361 and $27,215 for the years 1986 and 1987, respectively, and denying the claims of Federico and Elvia Faggin for refund of personal income tax in the amounts of $76,074 and $17,339 for the years 1986 and 1987, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 1st day of May, 1998, by the State Board of Equalization, with Board Members Mr. Andal, Mr. Klehs, Mr. Dronenburg, Mr. Chiang, and Ms. Bornstein present.

Dean F. Andal, Chairman

Johan Klehs, Member

Ernest J. Dronenburg, Jr., Member

Julie Bornstein*, Member

John Chiang**, Member

*For Kathleen Connell, per Government Code section 7.9.
**Acting Board Member, 4th District.

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