BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of	)	
	)	Nos. 89R-0191-MC
Kenneth M. and Carol Ann Levin	)	90R-1155-MC

Appearances:

For Appellant: Martin J. Tierney
Attorney at Law

For Respondent: Karen D. Smith
Counsel

O P I N I O N

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 claims of Kenneth M. and Carol Ann Levin for refund of personal income tax in the amounts of $321,407.35, $43,341.56, and $3,636.00 for the years 1985, 1986, and 1987, respectively.[2/]

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

[2/] The amounts indicated are a consolidation of the amounts of two separate refund claims filed for 1985 and 1986. We will elaborate on the nature of each claim later in the opinion.

The issue in this case is whether the "tacking" rule of Internal Revenue Code section 1223 applies to the "small business stock" provisions of section 18162.5 for purposes of determining the holding period of such stock and, thus, the amount of gain to be excluded from taxable income on the disposition of the stock. If we conclude that tacking does apply, then we must determine the nature of the assets transferred and their fair market value, which in turn determines the amount of stock to which tacking applies.

In 1974, appellants started a manufacturing business as a sole proprietorship. The business manufactured a product called a transcutaneous nerve stimulation unit. On June 30, 1985, appellants transferred the assets of the sole proprietorship to NTRON Electronics, Inc., in a tax-free transaction pursuant to Internal Revenue Code section 351, in exchange for NTRON common stock. Appellants transferred furniture, fixtures and equipment, leasehold interests, patents, know-how, inventory, and "goodwill" to the corporation; the entire business of the sole proprietorship was transferred.

On October 10, 1985, appellants sold the NTRON stock for a gain, pursuant to an installment sale. This transaction was not contemplated by appellants at the time of the incorporation. The parties agree that the NTRON stock qualified as small business stock pursuant to the requirements of section 18162.5, subdivision (e).

Appellants initially filed their return by reporting as income 50 percent of the long-term capital gain of $3,127,892 and 100 percent of the short-term capital gain of $170,662 for 1985. Appellants also computed and paid a preference tax on the unrecognized portion of the gain. Appellants reported amounts received in 1986 and 1987 in the same manner. Subsequently, appellants filed refund claims (via amended returns), claiming the stock was small business stock, and thus that (1) the unrecognized gain was not an item of tax preference and (2) the gain was not taxable at all under the small business stock provisions since, under the tacking principle, the stock was held more than three years. Respondent partially allowed the refund claims, agreeing that the stock was small business stock and, therefore, that the unrecognized gain was not an item of tax preference, but it disallowed the refunds claimed on the capital gains issue, on the ground that the holding period of the small business stock could not be tacked and, thus, that 50 percent of the long-term gain was properly included in income. Upon further review, respondent determined that since, without tacking, the small business stock was held less than one year, none of the gain should have been excluded from income. Therefore, it issued notices of proposed assessment for 1985 and 1986 for the tax owed on the 50 percent of the gain previously excluded from income. Appellants paid these assessments and filed refund claims, which were denied.

Former section 18162.5 provided that a portion of the gain or loss recognized on the sale or exchange of a capital asset was includable in income depending on the type of asset sold and the length of time the asset was held. Subdivision (a) provided that in the case of gain or loss from the

> sale or exchange of a capital asset, except gains from small business stock or nonproductive assets, [the following percentage] shall be taken into account in computing taxable income:

* * *

> (3) Fifty percent if the capital asset has been held for more than five years.

Subdivision (b) provided that in the case of gain from the

> sale or exchange of small business stock [the following percentages] shall be taken into account in computing taxable income:
>
> (1) One hundred percent if the small business stock has been held for not more than one year.
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> * * *
>
> (3) Zero percent if the small business stock has been held for more than three years, . . .

Pursuant to section 18151, California law has incorporated the provisions of the Internal Revenue Code (I.R.C.) which govern the determination of gains and losses. Among these provisions are those which determine the length of time an asset has been owned at the time it is disposed of, commonly referred to as the asset's "holding period." I.R.C. section 1223 provides rules for determining the holding period of an asset when such asset was acquired in exchange for another asset. Under the concept of "tacking," the holding period of each asset is cumulated if the requirements of the statute are met. I.R.C. section 1223(1) provides that in determining the time period a taxpayer has held property, the amount of time the property given up was held shall be tacked if the property acquired has the same basis, in whole or in part, as the property given up.[3/] For tacking to apply, the asset given up must be a capital asset or section 1231 property (hereinafter jointly referred to as capital assets). (I.R.C. § 1223(1).) Except for the possibility that section 18162.5, subdivision (b), might require something different in the case of small business stock, the parties agree that the holding period of the NTRON stock received by appellants would include the holding period of capital assets transferred to NTRON by appellants. (See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 3.10 (5th ed. 1987).)

[3/] I.R.C. section 1223(1) reads as follows:

> In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231 . . . .

Appellants argue that under the well-settled rule of I.R.C. section 1223(1), the holding period of their NTRON stock should include the holding period of the assets they contributed to NTRON. If the NTRON stock were not small business stock, they say, their holding period would be tacked under section 18162, subdivision (a), and they would have a holding period of more than five years. Appellants argue that the statutory language "has been held" appearing in subdivision (b) of section 18162.5 is used in an identical and parallel manner to the same phrase appearing in subdivision (a). Thus, they argue that "has been held" should be interpreted in an identical manner, incorporating I.R.C. section 1223(1), and thus tacking would apply. They contend that if the Legislature had intended that tacking should not apply under subdivision (b), it would have used different language.

Respondent argues that under subdivision (a), tacking is permitted only when a capital asset is exchanged for a capital asset, although the types of capital assets exchanged may be different. Conversely, if noncapital assets are exchanged for capital assets, no tacking is permitted. Respondent argues that, consistent with this, tacking under subdivision (b) should be permitted only when small business stock is exchanged for other small business stock. Thus, in the instant case, where capital assets were exchanged for small business stock, no tacking should be permitted.

Furthermore, respondent argues, the intent of the Legislature in enacting the small business stock provisions was to encourage taxpayers to take financial risks and form small corporations to develop jobs for Californians. In exchange, the Legislature provided a "tax break." Respondent argues that this policy is not served if a taxpayer can exclude from income 100 percent of the gain from the sale of an existing sole proprietorship simply by incorporating it and selling it shortly thereafter, as compared to selling the business as a sole proprietorship, in which case only 50 percent of the capital gain would be excluded from income. For this policy reason, respondent argues, the holding period of the contributed assets should not be added to the holding period of the small business stock.

Appellants argue that the above position produces an incongruous result. Under the respondent's approach, appellants must include 100 percent of the gain in income since the stock was small business stock, but if the stock were not small business stock, or if appellants had not incorporated NTRON, then appellants would include only 50 percent of the gain in income.[4/] Thus, as a holder of small business stock, they are put in a worse position by respondent's interpretation than they would be in if they had held nonsmall business stock. Appellants argue that this could not have been the intent of the Legislature. Finally, appellants point out that the Legislature was concerned with the "founding and expansion of new private businesses." (Stats. 1981, ch. 534, § 1. Emphasis added.) They contend that tacking is not inconsistent with the expansion of existing businesses.

[4/] It should be noted that there is no apparent basis for avoiding classification of the NTRON stock as small business stock, even though in appellants' case this causes more gain to be recognized than if the stock were not small business stock but merely a capital asset (other than small business stock or a nonproductive asset) under subdivision (a).

We think the above arguments read more subtlety into the statute than is warranted. Section 18151 provides that "[c]apital gains and losses shall be determined in accordance with Subchapter P of Chapter 1 of Subtitle A of the Internal Revenue Code, except as otherwise provided in this chapter." Section 18162.5, subdivision (a), provides that if the taxpayer sells a capital asset, then only a certain amount of the gain is included in income. If the taxpayer sells small business stock (which appears to be a special type of capital asset), a different percentage of inclusion is specified. (Rev. & Tax. Code, § 18162.5, subd. (b).) And if the taxpayer sells a nonproductive asset (again, a special type of capital asset), a third set of percentages applies. (Rev. & Tax. Code, § 18162.5, subd. (c).) Finally, section 18162.5, subdivisions (e) and (f), define small business stock. Otherwise, nothing in the statute provides any special rules for small business stock. Nothing in section 18162.5, or elsewhere, specifically provides that I.R.C. section 1223 is not fully incorporated into section 18162.5.

Pursuant to I.R.C. section 1223(1), in an exchange the holding period of the asset received will include the holding period of the asset given up if two requirements are satisfied. The first is that the basis of the asset or assets received must be determined in whole or in part by the basis of the asset or assets given up. The second requirement is that the assets given up must be capital assets. The key aspect of this requirement is that it focuses on the nature of or type of asset given up, not on the nature of or type of asset received. Nothing in section 18162.5 requires that I.R.C. section 1223(1) be read differently when applied to subsection (b) as opposed to subsection (a) or subsection (c).

Applied to the instant appeal, I.R.C. section 1223 requires tacking. The first requirement is satisfied because in an I.R.C. section 351 transaction, I.R.C. section 358 provides for a carryover basis. Thus, appellants' basis in the NTRON stock was determined by their basis in the assets transferred to NTRON upon its formation. The second requirement is also satisfied. As we explain more fully below, appellants did transfer some capital assets to NTRON upon its formation. I.R.C. section 1223(1) focuses on the nature of the assets given up. Thus, since appellants gave up capital assets, section 1223(1) applies.

We do not think this interpretation creates an absurd result, as respondent contends. (Valley Circle Estates v. VTN Consolidated, Inc., 33 Cal.3d 604, 609 [189 Cal.Rptr. 871] (1983).) In support of its position, respondent cites three bill analyses of the legislation enacting section 18162.5 which estimated no revenue loss from the statute until three years after the enactment of the statute. If the Legislature intended tacking to apply, respondent argues, the revenue estimates would not have stated that no negative impact on revenue would occur until three years after enactment of the statute. While our interpretation does mean that revenue would be lost before three years from enactment, the fact of a loss of revenue does not show absurdity.

In fact, the interpretation suggested by respondent creates, in our opinion, an absurd result. As explained above, since the NTRON stock is small business stock, and appellants apparently may not avoid this classification,[5/] we must apply the provisions of section 18162.5, subdivision (b). If we accept respondent's position that tacking does not apply, then appellants' holding period for the

[5/] See text of footnote 4.

stock is less than one year and 100 percent of the gain is taxable. Had appellants sold their sole proprietorship, however, only 50 percent of the gain would be taxable. Therefore, under respondent's theory, appellants would be severely penalized for forming a corporation.[6/] While there has been substantial debate as to what the Legislature did "intend" when it enacted the small business stock provisions, we have no doubt that it did not intend to put taxpayers in a worse tax position merely because of having formed a corporation which qualified as a "small business."

Finally, although we think I.R.C. section 1223(1) clearly applies, we nevertheless briefly address respondent's argument that to allow tacking conflicts with the purpose of the statute. We stated the argument above - that the bill analyses stating that the loss of revenue would not occur for three years show that the Legislature could not have intended tacking to apply. At least equally persuasive to us, however, is that in the preamble to the statute enacting the provisions of the predecessor to section 18162.5, the Legislature expressed concern with the "founding and expansion of new private businesses." (Stats. 1981, ch. 534, § 1. Emphasis added.) One of the great economic success stories in California's recent history is the creation and growth of the computer industry. Many, if not most, of these companies were able to grow because of funds from venture capital sources. Venture capitalists invested by buying stock in corporations, not by forming sole proprietorships. Therefore, if a business wanted to attract such capital, it would form a corporation. Certainly, expanding an existing business by forming a corporation and then attracting venture capital funds would create new jobs, a stated goal of this statute. Allowing tacking clearly does not conflict with the goal of expanding new businesses or with the objective of creating more jobs through expansion.

We therefore hold that section 18162.5, subdivision (b), includes the tacking provisions of I.R.C. section 1223. This does not, however, mean that appellants must prevail.

I.R.C. section 1223(1) provides that tacking only applies to the extent that appellants transferred capital assets or I.R.C. section 1231 (section 1231) property (sometimes jointly referred to as capital assets) to NTRON upon its formation. To the extent that inventory or other noncapital assets were transferred, the stock "attributable" to such assets would have a holding period which started upon the receipt of the stock. The determination of how much stock has a tacked holding period and how much has a new holding period is based on the ratio of the fair market value of the capital assets transferred over the fair market value of all the assets transferred. (Rev. Rul. 85-164, 1985-2 C.B. 117; see also Rev. Rul. 68-55, 1968-1 C.B. 140.)

On the day of the hearing before this board, respondent presented for the first time (both orally and in a brief submitted that day) the argument that, if tacking does apply, appellants are entitled to a smaller refund because not all of the property transferred constituted a capital asset or

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[6/] At the oral hearing, the parties agreed that appellants did not form NTRON corporation to take advantage of the small business stock provisions. It was agreed that at the time of the incorporation, appellants were not contemplating a sale of the business. If a sale were contemplated and, shortly beforehand, the taxpayer quickly incorporated, appellants and respondent agree that respondent has other arrows in its quiver to prevent a taxpayer from using the small business stock provisions to receive a better tax result than what could be received if the business were sold as a sole proprietorship.

section 1231 property. Appellants objected strenuously to the late introduction of this argument, and further argued that if respondent is allowed to make the argument, then respondent must have the burden of proof on this issue. We did not attempt to resolve the burden of proof issue at the hearing, but instead asked for additional briefing on that issue and also on the factual issue of what capital assets were transferred on formation. We have determined that we need not resolve the burden of proof issue because we conclude that there is sufficient evidence of the nature and value of the assets transferred to NTRON.

Appellants transferred cash, lease deposits, furniture, fixtures and equipment, inventory (including raw materials and work in progress), patents, leasehold interests, and whatever "goodwill" or "going concern" value existed. The first issue is which of these assets were capital assets or section 1231 property and which were not. The parties agree that the cash, lease deposits, and inventory (including raw materials and work in progress) were clearly not capital assets or section 1231 property. They also agree that the furniture, fixtures and equipment, and the leasehold interests were section 1231 property. As to whether the goodwill, going concern value, or patents were capital assets, respondent does not so much dispute that they were capital assets as it disputes whether they were transferred or existed in the first place.

Respondent disputes that, upon the formation of NTRON, any patents, goodwill, or going concern value were transferred. Its argument is essentially that Treasury Regulation section 1.351-3(b) requires a statement of the property transferred, the fair market value of the stock received, and the adjusted basis. Since this statement did not show that any patent or goodwill had been transferred, respondent argues that they must not have been transferred. However, it is clear from the evidence before this board that a patent or patents were in fact transferred to NTRON.

It is also clear that goodwill did exist and thus was also transferred to NTRON. The buyer of the NTRON stock paid $1.3 million in excess of the value of the tangible assets. There is thus no doubt that goodwill existed. Respondent cites Friedlaender v. Commissioner, 26 T.C. 1005 (1956), for the proposition that only through the passage of time can goodwill be created. Furthermore, respondent argues that there is no evidence that the goodwill was created more than three years prior to the sale of the NTRON stock. But the sole proprietorship was founded in 1974. It seems clear to us that at some time between 1974 and October of 1982 (three years before the sale), some goodwill was created. Certainly the passage of at least eight years' time is long enough to create goodwill. (See Friedlaender v. Commissioner, supra.) Since the goodwill existed for some time, we conclude that the holding period was at least three years. This same conclusion applies to going concern value.

Next, we must determine the fair market value of the assets transferred to NTRON upon its formation so that we can determine the amount of stock entitled to a tacked holding period. The key document impacting this analysis is an appraisal secured by the buyer of the NTRON stock, the purpose of which was to value the assets so that the buyer could properly prepare its tax return. (The buyer made an I.R.C. section 338 election.) The appraisal valued the assets as of October 10, 1985, approximately three months after NTRON's formation, and found the following values:

Current assets (inventory)	$ 466,000
Furniture, Fixtures & Equip.	290,000
Leasehold Interests	503,000
Patents	1,704,000
Going Concern Value	637,000
TOTAL	$3,600,000

Because the appraisal was based on a value only three months after the transfer and because it was secured by the buyer for purposes of allocating value for the I.R.C. section 338 election, we find it highly persuasive of the value of the assets at the time of the incorporation. Also, there is nothing in the record to indicate that NTRON changed dramatically between incorporation and sale to suggest that the values as of October 10, 1985, were not essentially the same as those on the date of incorporation, with the exception of inventory. The appraisal of the inventory was based on the amount of inventory at the time of the appraisal. At the time of the incorporation, however, the inventory balance was lower. Thus, the value of the inventory must be reduced from the appraisal value of $466,000 to the incorporation value of $186,258.

We thus find as a fact that the value of the assets transferred upon the incorporation of NTRON was as follows:

NONCAPITAL ASSETS

Cash	$ 2,769
Lease Deposit	5,000
Inventory	186,258
Total NonCapital Assets	$194,027

CAPITAL ASSETS AND SECTION 1231 PROPERTY

Equipment	$ 290,000
Going Concern Value	637,000
Patent	1,704,000
Leasehold Interest	503,000
Total Capital Assets	$3,134,000
Total Assets Transferred	$3,328,027

As to the equipment, we conclude that the ratio of holding periods as determined by respondent on Exhibit J-1 of its Post Hearing Memorandum is correct. Thus, 6.23 percent of the equipment was held less than one year, 82.38 percent was held between one and three years, and

11.39 percent was held over three years.[7/]

Therefore, upon the sale of the NTRON stock, appellants may treat 86.45 percent of the gain as gain from the sale of small business stock held more than three years,[8/] 7.18 percent as gain from small business stock held for between one and three years, and 6.37 percent as gain from small business stock held less than one year.

[7/] $7,372 + $97,259 + $13,487 = $118,388. $7,372/$118,388 = 6.23 percent.

[8/] The equipment of $290,000 times 11.39 percent held over three years equals $33,031. Adding this to the other capital assets equals $2,877,031. Divide this by the total assets of $3,328,027.

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 claims of Kenneth M. and Carol Ann Levin for refund of personal income tax in the amounts of $321,407.35, $43,341.56, and $3,636.00 for the years 1985, 1986, and 1987, respectively, be and the same is hereby modified in accordance with our opinion herein. In all other respects, the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 24th day of June, 1993, by the State Board of Equalization, with Board Members Matthew K. Fong, Ernest J. Dronenburg, Jr., and Windie Scott present.

_____, Chairman

Matthew K. Fong, Member

Ernest J. Dronenburg, Jr., Member

Windie Scott*, Member

_____, Member

*For Gray Davis, per Government Code section 7.9

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