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10 **BOARD OF EQUALIZATION**  
 11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeal of: ) **HEARING SUMMARY<sup>2</sup>**  
 13 ) **PERSONAL INCOME TAX APPEAL**  
 14 **CHARLES P. FRANKLIN<sup>1</sup>** ) Case No. 417829

<u>Year</u>	<u>Proposed Assessment</u>	<u>Post-Amnesty Penalty</u>
2000	\$96,210.00	\$7,579.38

15 Representing the Parties:

16 For Appellant: Eric M. Anderson<sup>3</sup>.  
 17 Amanda Horst

18 For Franchise Tax Board: Daniel V. Biedler, Tax Counsel III

19 QUESTIONS: (1) Whether appellant has shown that the \$1 million note he owed to Prefix Venture  
 20 Partners, LLC (Prefix) is includible in his basis in Prefix for the 2000 tax year.

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 22 \_\_\_\_\_  
 23 <sup>1</sup> Appellant resides in Sunnyvale, California, in Santa Clara County.

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 25 <sup>2</sup> This appeal was originally scheduled for an oral hearing on the October 2009 calendar. In August 2009, the appeal was  
 26 submitted for summary decision and then deferred pending settlement, under Revenue & Taxation Code (R&TC) section  
 27 19442. The matter was then returned to active status in May 2010, and scheduled for oral hearing.

28 <sup>3</sup> Richard E. Nielsen filed appellant's appeal letter and opening brief but no longer represents appellant. At the time of  
 drafting this hearing summary, Mr. Anderson and Ms. Horst are appellant's designated representatives.

1 (2) Whether Endeavor Information Systems, Inc. (Endeavor) satisfied the active  
2 business requirement test for qualified small business stock under Revenue and  
3 Taxation Code (R&TC) section 18152.5.

4 (3) Whether appellant met the five-year holding period for qualified small business  
5 stock (the Endeavor stock) required under R&TC section 18152.5, subdivision  
6 (a), commencing on March 16-17, 1995, or on June 23, 1995.

7 (4) Whether the Board may consider if the active business requirement test for  
8 qualified small business stock under R&TC section 18152.5, subdivision (d), is  
9 unconstitutional under the U.S. Commerce Clause.

10 (5) Whether the Board has jurisdiction to review the post-amnesty penalty in this  
11 appeal.

12 HEARING SUMMARY

13 General Background

14 Appellant filed an amended return for the tax year 2000, claiming a refund of \$54,471 by  
15 restating a capital loss, from \$1,000 to \$1,000,000, concerning the stock that he held in Prefix .  
16 (Appellant's Appeal Letter (AAL) at p. 1.) On May 3, 2003, respondent's auditor contacted appellant  
17 regarding the refund claim and audited appellant's returns for the 1999, 2000, and 2001 tax years. (*Id.*)  
18 For 2000, respondent reviewed: (1) appellant's claimed capital loss from his investment in Prefix; and  
19 (2) appellant's qualified small business (QSB) stock exclusion claimed pursuant to R&TC section  
20 18152.5 on the sale of appellant's stock in Endeavor. (*Id.*) Respondent disallowed the capital loss from  
21 the Prefix investment and the QSB stock exclusion and notified appellant that the refund claim would be  
22 disallowed. (*Id.*, p. 1-2.)<sup>4</sup> Respondent issued its Notice of Proposed Assessment (NPA) for 2000 on  
23 March 23, 2006, which appellant timely protested. (*Id.*) Respondent issued its Notice of Action (NOA)  
24 affirming the NPA on July 10, 2007. (*Id.*) This timely appeal followed.

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28 <sup>4</sup> Appellant states that he did not receive a notice denying his refund claim. (AAL footnote 2.)

1 Issue 1: Appellant's Basis in Prefix for 2000

2 Additional Background

3 Prefix is a limited liability company formed in December 2000, and is treated as a  
4 partnership for tax purposes. (Appellant's Opening Brief (AOB) at p. 1 and exhibits 1 & 2;  
5 Respondent's Opening Brief (ROB) at p. 8.) Appellant received an interest in Prefix in exchange for a  
6 \$1 million promissory note (the Note) executed by appellant, and issued in December 2000, and payable  
7 to Prefix. Appellant included \$1 million in the basis of his membership interest in Prefix. (ROB at p.  
8 9.) In 2000, Prefix incurred a loss from its sale of Resonex stock and appellant's distributive share of  
9 that loss was \$1,000,000. Appellant subsequently recognized a loss of \$1 million from Prefix for the  
10 2000 tax year, as a result of the Resonex stock sale, on his return. (AOB at p. 3.) Appellant states  
11 additional collateral was pledged on the Note on November 21, 2001, and that the Note was satisfied in  
12 January 2004, with accrued interest of \$210,000 paid in April 2005. (AOB at p. 2.)

13 In its NPA for 2000, respondent disallowed the loss from Prefix on the ground that  
14 appellant had no basis in the Note during the 2000 tax year, because he made no payments on the note in  
15 2000. (AOB at p. 2.)

16 Contentions

17 *Appellant's Contentions*

18 Appellant contends Prefix is a successor entity to Technology Funding Secured Investors  
19 (TFSI) and was formed in 2000 to assume investment responsibility for the remaining portfolio assets of  
20 the TFSI funds as those funds reached the end of their partnership lives. (AOB at p. 1.) Appellant states  
21 it received one million preferred shares of Prefix in exchange for the Note. Appellant contends Internal  
22 Revenue Code (IRC) section 704(d), to which R&TC section 17858 conforms, provides that a partner's  
23 distributive share of a partnership loss is allowed to the extent of the partner's adjusted basis in the  
24 partnership interest at the end of the partnership year in which the loss occurred. (AOB at p. 3.)  
25 Appellant states that when Prefix incurred a loss from the sale of Resonex stock in 2000, appellant was  
26 entitled to a loss that equaled the value of his personal secured promissory note (i.e., the \$1 million  
27 Note). (*Id.*) Appellant concedes he did not make any payments on the Note in 2000, as no demand was  
28 made by Prefix. (*Id.*) However, appellant contends the Note remained an asset on the books of Prefix

1 and was relied upon by creditors and others in dealing with Prefix. (*Id.*) Appellant states the note was  
2 fully paid in January 2004 and that accrued interest was paid in April 2005. (*Id.*)

3 Appellant contends that a lack of payment on the Note during 2000 did not transform his  
4 basis in Prefix to zero. (AOB at p. 4.) Appellant contends the rationale that a taxpayer has no basis in  
5 his own note was rejected in *Peracchi v. Comm’r*, (9th Cir. 1998) 143 F. 3d. 487, where the court held  
6 that the contribution of a bona fide promissory note by a corporate shareholder to a corporation for stock  
7 in the corporation increases the shareholder’s basis in the corporation’s stock. (*Id.*) Appellant contends  
8 that in *Peracchi* the court dismissed Internal Revenue Service (IRS) Revenue Ruling 68-629, stating that  
9 the ruling offered no rationale, let alone a reasonable one, for its holding that it costs a taxpayer nothing  
10 to write a promissory note. (*Id.*) Appellant contends the *Peracchi* comment is equally applicable to  
11 respondent’s position. (*Id.*) Appellant contends that he is entitled to a step-up in basis due to the  
12 contribution of the Note, irrespective of whether it was contributed to a corporation or a partnership.  
13 (*Id.*) Appellant contends this appeal presents the Board “the opportunity to establish that the rationale in  
14 *Peracchi* is equally applicable in the partnership context.” (AOB at p. 5.)

15 *Respondent’s Contentions*

16 Respondent, citing *Appeal of Jack and Lian N. Wybenga*, 86-SBE-083, decided April 9,  
17 1986, contends appellant’s contribution of a personal, written obligation (i.e., the Note) does not  
18 increase appellant’s basis in Prefix under IRC section 722, because appellant has a zero basis in the  
19 written obligation. (ROB at p. 16.) Respondent contends the Board in *Appeal of Jack and Lian N.*  
20 *Wybenga, supra*, held that payments on such written obligations are added to the partner’s basis in the  
21 partnership as the payments are made and since no payments were made in 2000 on the Note, no  
22 additional basis can be attributed to appellant’s interest in Prefix for 2000. (*Id.*) Respondent contends  
23 that *Peracchi* is limited to the corporation-shareholder context. (ROB at p. 17.) Thus, respondent  
24 contends that since appellant’s basis was zero in Prefix in 2000, appellant was not entitled to any losses  
25 from Prefix for that year.

26 Respondent questions the bona fide nature of the Note and/or the transactions  
27 surrounding its later payoff. (ROB at pp. 9, 16, &17, and footnote 10.) Respondent states that exhibit 2  
28 to appellant’s opening brief is entitled ““Amendment Number One To Loan And Security Agreement,”

1 and indicates an addition ‘to the Collateral in the Loan Agreement’ (presumably the \$1,000,000 note to  
2 Prefix), ‘additional Collateral securing the indebtedness under the Load [sic] Agreement all securities of  
3 Metara, Inc. a Delaware corporation, which are now owned or hereafter acquired by Debtor...’” (ROB  
4 at p. 9; AOB exhibit 2, sec. 1.1.) Respondent contends AOB exhibits 3 and 4 entitled “Securities  
5 Purchase And Sale Agreement” and “Amendment Number Two To Loan And Security Agreement,”  
6 appear to document the transfer of shares in Metara owned by appellant, and equal to a stated value of  
7 \$1,000,000, as payment of the principal owed under the Note to Prefix and fixing the interest owed at  
8 maturity at \$210,000. Respondent contends that AOB exhibit 5, dated April 5, 2005, entitled “Stock  
9 Purchase And Sale Agreement,” appears to document the transfer of the Metara shares owned by  
10 appellant as consideration for a reduction (satisfaction) of appellant’s \$210,000 stated interest obligation  
11 on the Note and an approximately \$99,000 increase in appellant’s ownership share of Prefix. (*Id.*)

12 In addition, respondent states that the relationship between Mr. Gregory George, a former  
13 director of Endeavor,<sup>5</sup> (ROB at p. 9) and appellant appears significant, as Mr. George signed all the  
14 documents which were attached as exhibits 2 through 5 of appellant’s opening brief and that Mr. George  
15 and appellant became owners of Metara. (*Id.*) Respondent contends that Mr. George and appellant also  
16 engaged in various other activities of Endeavor. (*Id.*) Respondent also stated that, assuming the Metara  
17 stock actually had the value stated therein, which has not been established, and given the close business  
18 relationship between appellant and Mr. George, a question may be raised as to the actual economic value  
19 of these transactions. Respondent asserts that answering this question is not necessary to establish  
20 respondent’s correctness, but this question and similar ones suggest the possibility that a closer  
21 examination of the business interactions between appellant and Mr. George “could prove illuminating.”  
22 (ROB footnote 10.)

### 23 Applicable Law

#### 24 *Partnership Basis Rules*

25 California generally conforms to the federal partnership rules. (Rev. & Tax. Code,  
26 § 17858.) IRC section 722 provides that a partner’s basis in his partnership interest, acquired by a  
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28 <sup>5</sup> See *infra* for a discussion on the qualified small business stock issue related to Endeavor.



1 contribution would not increase the shareholder's basis. The *Peracchi* court disagreed with the IRS and  
2 held that a self-created note that is contributed to a corporation can increase the shareholder's basis as  
3 long as it is a bona fide note and there is a risk that it may be called upon to be repaid in bankruptcy.

4 The *Peracchi* court stated:

5 We confine our holding to a case such as this *where the note is contributed to an*  
6 *operating business which is subject to a non-trivial risk of bankruptcy or receivership.*  
7 *NAC [the corporation] is not, for example, a shell corporation or a passive investment*  
8 *company; Peracchi got into this mess in the first place because NAC was in financial*  
9 *trouble and needed more assets to meet Nevada's minimum premium-to-asset ratio for*  
10 *insurance companies.*<sup>6</sup>

11 \*\*\*

12 The key to solving this puzzle, then, is to ask whether bankruptcy is significant enough a  
13 contingency to confer substantial economic effect on this transaction. If the risk of  
14 bankruptcy is important enough to be recognized, *Peracchi* should get basis in the note:  
15 He will have increased his exposure to the risks of the business--and thus his economic  
16 investment in NAC--by \$1,060,000 [the amount of the note]. *If bankruptcy is so remote*  
17 *that there is no realistic possibility it will ever occur, we can ignore the potential*  
18 *economic effect of the note as speculative and treat it as merely an unenforceable*  
19 *promise to contribute capital in the future.*<sup>7</sup>

20 The *Peracchi* court identified special issues that its holding would have in the partnership  
21 context; namely, that pass-through losses can flow through to the partners (something that does not  
22 happen in the corporation-shareholder context). In making this distinction between C corporations and  
23 partnerships, the *Peracchi* court stated, "We don't have to tread quite so lightly in the C Corp context,  
24 since a C Corp doesn't funnel losses to the shareholder. Our holding therefore does not extend to the  
25 partnership or S Corp context."<sup>8</sup>

#### 26 Staff Comments

##### 27 *Peracchi Basis Rule*

28 Pursuant to the Board's opinion in *Appeal of Jack and Lian N. Wybenga, supra*, since  
appellant did not make payment on the Note in 2000, the Board could move to sustain respondent's  
position with respect to this issue. However, appellant requests the Board to extend the rationale of  
*Peracchi* to partnerships (AOB, p. 5), which would appear to be a change from the Board's opinion in

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<sup>6</sup> *Peracchi* footnote 14 (emphasis added).

<sup>7</sup> *Peracchi* at 493 (emphasis added).

<sup>8</sup> *Peracchi* footnote 16 and accompanying text.

1 *Appeal of Jack and Lian N. Wybenga, supra.* Therefore, at the oral hearing, the parties should be  
2 prepared to discuss the following:

- 3 1. Whether *Peracchi* can/should be extended to partnerships in light of the flow through loss  
4 concerns mentioned by the *Peracchi* Court (or on other grounds) under the facts of this appeal.  
5 If the Board declines to extend the basis rule of *Peracchi* to partnerships, then the remaining  
6 considerations below would become moot.
- 7 2. If the Board finds that the *Peracchi* basis rule can be extended to partnerships, the Board should  
8 consider whether the test/standard in *Peracchi* was satisfied (i.e., whether there was a bona fide  
9 note), whether Prefix was an operating company, and whether Prefix was subject to a non-trivial  
10 risk of bankruptcy.

11 *IRC Section 704(c)*

12 In considering whether the *Peracchi* basis rule should be extended to partnerships in light  
13 of the pass-through loss concerns raised by the *Peracchi* court, IRC section 704(c) also provides detailed  
14 rules, which in some cases, work to ensure that gains or losses resulting from built-in gain/loss property  
15 which has been contributed to a partnership are assigned to the partner that contributed the property.  
16 Thus, in considering whether appellant's basis should be increased by the Note, and whether the loss  
17 related to the Resonex stock was properly allocated to appellant, the Board may wish to inquire:

- 18 1. Whether the \$1 million loss (associated with the Resonex stock) was a built-in loss at the time it  
19 was contributed to Prefix and why the loss was allocated to appellant, as opposed to the  
20 contributing partner;
- 21 2. Appellant should be prepared to explain why he contributed the \$1 million Note in December  
22 2000 to Prefix and whether he anticipated an immediate \$1 million loss deduction at the time of  
23 the contribution for the 2000 tax year.

24 Issue 2: Active Business Requirement for QSB Stock

25 Additional Background

26 Appellant excluded 50 percent of the capital gains on the sale of stock held in Endeavor  
27 that was sold on May 2, 2000, contending he was eligible for the QSB stock exclusion of R&TC section  
28 18152.5. As explained below, in order to claim this exclusion, the active business requirement test of

1 this statute requires that 80 percent (by value) of the assets and 80 percent of the payroll of the  
2 underlying corporation must be attributable to the active conduct of one or more qualified trades or  
3 business in California (the California 80 Percent Test). (Rev. & Tax. Code, § 18152.5, subds. (e)(1)(A)  
4 and (e)(9).)

5 Contentions

6 *Appellant's Contentions*

7 Appellant does not address whether Endeavor satisfied the active business requirement  
8 test for qualified small business stock.

9 *Respondent's Contentions*

10 Respondent contends that, from 1995 to 2000, Endeavor had no California property and  
11 the only year Endeavor's California payroll exceeded 20 percent was in 1995 (26.23 percent), with the  
12 remaining years' payroll percentages generally 5 percent or less. Thus, respondent submits that  
13 Endeavor failed to satisfy the active business requirement test of section 18152.5 and appellant is not  
14 entitled to claim the 50 percent capital gains exclusion under R&TC section 18152.5.

15 Applicable Law

16 R&TC section 18152.5 excludes from an individual's gross income 50 percent of the  
17 gains from the sale of QSB held for more than five years. In order to be treated as QSB stock, the  
18 underlying corporation must satisfy the active business test for substantially all of the shareholder's five-  
19 year holding period. (Rev. & Tax. Code, § 18152.5, subd. (c)(2)(A).) The active business test requires  
20 that 80 percent (by value) of the assets and 80 percent of the payroll of the underlying corporation are  
21 attributable to the active conduct of one or more qualified trades or business in California. (Rev. & Tax.  
22 Code, § 18152.5, subds. (e)(1)(A) and (e)(9).)

23 Staff Comments

24 At the oral hearing, appellant should be prepared to demonstrate that the active business  
25 requirement test was satisfied, and if not, whether this test under R&TC section 18152.5 has been  
26 declared unconstitutional by a California court of appeal or by a federal court. If appellant is unable to  
27 make this showing, the Board could move to sustain respondent on Issue 2 and deny the QSB exclusion  
28 in its entirety. If the Board reaches this conclusion, then Issues 3 and 4 become moot.

1 Issue 3: The Five-Year Holding Period for QSB Stock

2 Additional Background

3 In addition to the requirement that Endeavor satisfy the active business requirement test,  
4 in order to claim the QSB stock exclusion under R&TC section 18152.5, appellant must hold the  
5 Endeavor stock for more than five years. The parties disagree as to whether the five-year holding  
6 requirement was met.

7 Contentions

8 *Appellant's Contentions*

9 Appellant contends he was awarded QSB stock in Endeavor in 1995, which was sold in  
10 2000. (AOB at p. 2.) Appellant contends the Endeavor board of directors held a meeting on  
11 March 16-17, 1995, and established share grants for appellant for past services as of that date. (AOB at  
12 p. 5.) A stock register list dated June 23, 1995, indicated that appellant received a stock distribution on  
13 June 23, 1995. (*Id.*) Appellant contends he was authorized to receive and became entitled to receive  
14 shares at the March 1995 board meeting. (*Id.*) Appellant produced an affidavit from Mr. Gregory  
15 George, former president and chairman of the Endeavor board of directors, dated September 28, 2005,  
16 indicating that “[T]he structure of the Company’s employee stock ownership plan, including specific  
17 initial grants of shares and of options, was determined and agreed upon [at the March 1995 meeting].”  
18 (AOB, exhibit 6 ¶ 4; appellant refers to this exhibit as exhibit F in his opening brief (AOB at p. 5, line  
19 26).) Mr. George also stated that “I left the March 16-17 meeting with the assignment to prepare  
20 instructions for Counsel describing the parameters of the incentive share and option plans voted at that  
21 meeting, which I subsequently did.” (*Id.*, ¶ 8.)

22 Appellant contends it is well established that the date shares are awarded and vested  
23 (March 16-17, 1995) is controlling for purposes of determining the relevant holding period, since that is  
24 when appellant obtained a beneficial interest in the stock.<sup>9</sup> Appellant therefore believes the award and  
25 vesting date controls and not the stock register listing date. Appellant relies on *W. F. Marsh v. Comm’r*,  
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27 \_\_\_\_\_  
28 <sup>9</sup> Appeals Division staff (staff) notes appellant in its initial appeal letter indicated the Endeavor Board meeting occurred on  
March 23, 1995, and that the shares were awarded on March 23, 1995. (AAL at p. 2.)

1 (1949) 12 T.C. 1083<sup>10</sup> and *A. K. Orth v. Comm'r*, (1952) 11 T.C.M. 452<sup>11</sup> to support his contention that  
2 beneficial ownership, regardless of the actual issuance date, controls for purposes of starting the five-  
3 year holding period.<sup>12</sup> Appellant therefore contends that he was entitled to the 50 percent capital gains  
4 exclusion under R&TC section 18152.5 on the sale of his Endeavor stock.

5 *Respondent's Contentions*

6 Respondent states appellant on his original return reported an acquisition date of the  
7 Endeavor stock as January 1990, but that during the audit explained the acquisition took place in 1994.  
8 (ROB at p. 7.) Respondent contends that the subscription date of June 23, 1995, as evidenced by  
9 Endeavor's official corporate stock register, identifies the date which appellant acquired ownership,  
10 possession and control over the stock. (ROB at p. 11.) Respondent contends: (1) appellant did not  
11 obtain constructive ownership in March 1995; (2) that the board meeting in March 1995 simply  
12 determined the number of shares and options to grant to employees; and (3) that ownership of the stock  
13 and thus appellant's holding period did not begin until subscription was established by official recording  
14 of stock ownership in Endeavor's corporate records. (*Id.*) Respondent also relies on *W. F. Marsh v.*  
15 *Comm'r, supra, A. K. Orth v. Comm'r, supra*, and on *Edward R. Bacon Co. v. Comm'r*, (1945) 4 T.C.M.

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19 <sup>10</sup> Staff notes that in *W. F. Marsh v. Comm'r*, (1949) 12 T.C. 1083, on or before October 14, 1943, the taxpayer entered into a  
20 contract with a corporation to loan the corporation \$65,000 for a note and 6,500 new shares in the corporation. The stock  
21 certificates were issued February 26, 1944, and dated October 14, 1943. For capital gains holding period purposes, the IRS's  
22 position was that the holding date began when the stock certificates were issued. The tax court held that immediately upon  
the execution of the contract between the taxpayer and the corporation (on or before October 14, 1943), the taxpayer's  
became the beneficial owners of the stock for capital gains holding period purposes.

23 <sup>11</sup> Staff notes that in *A. K. Orth v. Comm'r*, (1952) 11 T.C.M. (CCH) 452, on April 1, 1940, the taxpayer conveyed all of his  
24 printing business assets to a new corporation. The taxpayer was supposed to receive 246 shares with four others receiving  
25 one share each. These additional four shares were qualified shares and remained in the possession of the taxpayer. Despite  
26 this incorporation plan in 1940, only 50 shares were issued for the benefit of the taxpayer. For reasons that were unclear to  
27 the court, the taxpayer did not receive the remaining shares in the corporation. On December 31, 1942, the taxpayer was  
issued an additional 161 shares of the corporation and then sold all of his outstanding stock to a third party on January 2,  
1943. The IRS attempted to claim that the 161 shares were only held for 3 days (from the date of issuance to the date of  
sale). The tax court held otherwise stating that the taxpayer had been the beneficial owner of all of the corporation's  
outstanding stock since April 1, 1940.

28 <sup>12</sup> Appellant states that "The fact stock is not issued does not preclude a taxpayer from constructively holding said stock from  
the date it was granted and became vested." (AOB at p. 6, lines 22-23.)

1 868,<sup>13</sup> to support its contention that a taxpayer has constructive ownership when stock is subscribed, not  
2 when the stock certificates are physically issued and that constructive ownership occurred with respect  
3 to appellant when the official stock subscription was recorded on June 23, 1995. (*Id.*) Respondent  
4 states that since the stock was sold on May 2, 2000, the minimum five-year holding period for QSB  
5 stock was not satisfied.<sup>14</sup>

#### 6 Applicable Law

7 R&TC section 18152.5 provides for an exclusion of gain from the sale of QSB stock. To  
8 meet this exclusion, the following applies:

9 (a) For purposes of this part, gross income shall not include 50 percent of any gain from  
10 the sale or exchange of qualified small business stock *held for more than five years.*

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11 (b)(2) For purposes of this subdivision, the term “eligible gain” means any gain from the  
12 sale or exchange of qualified small business stock *held for more than five years.*

\*\*\*\*\*

13 (c)(1) Except as otherwise provided in this section, the term “qualified small business  
14 stock” means any stock in a C corporation which is originally issued after August 10,  
15 1993 if both of the following apply:

16 (A) As of the date of issuance, the corporation is a small business.

17 (B) Except as provided in subdivisions (f) and (h), *the stock is acquired by the*  
18 *taxpayer at its original issue* (directly or through an underwriter) in either of the  
19 following manners:

- 20 i. In exchange for money or other property (not including stock)
- 21 ii. As compensation for services provided to the corporation....

22 (Rev. & Tax. Code, § 18152.5, subs. (a), (b)(2), and (c)(1), emphasis added.)

#### 23 Staff Comments

24 As noted above, if the Board determines that the active business requirement test is not  
25 satisfied, then this issue becomes moot. However, if the Board determines that Endeavor satisfied the  
26 active business requirement test, then the parties must demonstrate which date should be the beginning  
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28 <sup>13</sup> In *Edward R. Bacon Co. v. Comm’r*, (1945) 4 T.C.M. 868, the Tax Court held that:

The issuance of a certificate of stock is not necessary to make one a stockholder in a corporation. It is well settled as a general rule of corporation law that in the absence of a statutory or charter provision or agreement to the contrary a subscriber for stock in a corporation becomes a stockholder as soon as his subscription is accepted by the corporation, whether a certificate of stock is issued to him or not, and, although he may have no certificate, he is thereupon entitled to all the rights and is subject to all the liabilities of a stockholder.

<sup>14</sup> By comparison, it appears appellant’s contended starting date (i.e., March 1995), if accepted, through May 2, 2000, would satisfy the five-year holding period.

1 date for the five-year holding period required under R&TC section 18152.5. The cases cited by the  
2 parties (i.e., *W. F. Marsh v. Comm'r*, *A. K. Orth v. Comm'r*, and *Edward R. Bacon Co. v. Comm'r*,  
3 *supra*) do not specifically address what it means to acquire and hold stock for purposes of R&TC section  
4 18152.5. These cases dealt with the holding period for purposes of determining capital gains at the  
5 federal level.<sup>15</sup>

6 It appears to staff that both parties may be asserting that the holding period for QSB stock  
7 exclusion begins when the beneficial ownership of the stock occurs. If this is correct, then the parties  
8 should be prepared to discuss what ownership rights in the Endeavor stock were conferred on appellant  
9 when Endeavor's Board met on March 16-17, 1995, and whether appellant could have enforced those  
10 rights prior to the subscription of the stock on June 23, 1995, such that appellant could be said to "own"  
11 the stock prior to June 23, 1995.

#### 12 Issue 4: Constitutionality of the Active Business Requirement Test

##### 13 Contentions

##### 14 *Appellant's Contentions*

15 Appellant contends the active business requirement test is facially discriminatory of  
16 interstate commerce, because it discourages California corporations from purchasing property and hiring  
17 employees outside of California. Accordingly, appellant contends that the active business requirement  
18 test violates the Commerce Clause of the U.S. Constitution.

##### 19 *Respondent's Contentions*

20 Respondent contends that under Section 3.5 of Article III of the California Constitution,  
21 the Board is precluded from declaring a statute unconstitutional or refusing to enforce a statute on the  
22 basis that it is unconstitutional.

##### 23 Applicable Law

24 The Board has determined that it does not have jurisdiction to consider whether a  
25 California statute is constitutionally invalid, unless a federal or California appellate court has already  
26 made such a determination (Cal. Code Regs., tit. 18, § 5412, subd. (b)(1).) Moreover, section 3.5 to  
27

28 <sup>15</sup> Board staff described these cases in footnotes in the parties' contentions.

1 article III of the California Constitution prevents the Board from determining that statutory provisions  
2 are unconstitutional or unenforceable. (*Appeal of Aimor Corporation*, 83-SBE-221, Oct. 26, 1983.)

3 Staff Comments

4 At the oral hearing, appellant should be prepared to demonstrate that R&TC section  
5 18152.5 has been declared unconstitutional by a California court of appeal or by a federal court.

6 Issue 5: the Post-Amnesty Penalty

7 Additional Background

8 On the NOA, respondent included a post-amnesty penalty amount that respondent  
9 indicated would be recomputed and assessed only if and when the proposed deficiency assessment  
10 becomes a final assessment. (AAL exhibit A at p. 2.)

11 Contentions

12 *Appellant's Contentions*

13 Appellant contends that the post-amnesty penalty cannot be imposed because: (1)  
14 appellant is not liable for any additional tax or interest for 2000; (2) the tax in this case has not yet  
15 become due and payable; and (3) the penalty violates due process. More specifically, appellant contends  
16 that the post-amnesty penalty violates: (a) procedural due process by not providing any pre- or post-  
17 payment opportunity to challenge the imposition of the Amnesty Penalty; and (b) substantive due  
18 process by (i) imposing a penalty that did not exist when appellant originally filed its 2000 California  
19 tax return and (ii) being void for vagueness. (AOB at pp. 8-9.) Additionally, appellant argues that any  
20 penalty should be abated in this case because he reasonably relied upon his accountant to report his  
21 income and prepare his returns. (AOB at p. 10.)

22 *Respondent's Contentions*

23 Respondent contends the post-amnesty penalty shown on the NOA is an estimated  
24 amount, that it is not part of the deficiency amount and will be recomputed and imposed if and when the  
25 proposed deficiency becomes final. (ROB at p. 18.) As a result, respondent states the post-amnesty  
26 penalty is not included in the proposed deficiency amount that is subject to this appeal. (*Id.*)  
27 Respondent contends the Board does not have jurisdiction to consider the post-amnesty penalty in the  
28 context of this appeal.

1                   Applicable Law

2                   In 2004, the Legislature enacted the income tax amnesty program. (Rev. & Tax. Code,  
3 §§ 19730-19738.) Eligible taxpayers could participate by filing an amnesty application and paying their  
4 outstanding liabilities of tax and interest, or entering into an installment plan, during the period of  
5 February 1, 2005, through March 31, 2005, inclusive. (Rev. & Tax. Code, §§ 19730 & 19731.) For  
6 liabilities that remained outstanding after the last day of the amnesty period, a post-amnesty penalty was  
7 imposed equal to 50 percent of the accrued interest payable. (Rev. & Tax. Code, § 19777.5, subd. (a).)  
8 The Board's jurisdiction to review the post-amnesty penalty is limited. For example, a taxpayer has no  
9 right to an administrative protest or appeal of an unpaid post-amnesty penalty. (*Id.*, subd. (d).) A  
10 taxpayer also has no right to file an administrative claim for refund of a paid post-amnesty penalty,  
11 except upon the basis that the penalty was not properly computed. (*Id.*, subd. (e).) Therefore, the  
12 Board's jurisdiction to review the post-amnesty penalty is limited to situations where the penalty is  
13 assessed and paid, the taxpayer files a timely appeal from a denial of a refund claim, and the taxpayer  
14 attempts to show a computational error in the penalty calculation.

15                   Staff Comments

16                   At the oral hearing, appellant should be prepared to provide legal support that the Board  
17 has subject matter jurisdiction over the post-amnesty penalty in the context of this appeal.

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