

1 William J. Stafford
Tax Counsel III
2 Board of Equalization, Appeals Division
450 N Street, MIC: 85
3 PO Box 942879
Sacramento CA 95814
4 Tel: (916) 206-0166
5 Fax: (916) 324-2618

6 Attorney for the Appeals Division

7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of:) **HEARING SUMMARY¹**
11) **PERSONAL INCOME TAX APPEAL**
12 **HENRY F. LENARTZ AND**) Case No. 524571
13 **NONA M. LENARTZ**)

14 _____
15 Year Proposed
2004 \$60,812
16

17 Representing the Parties:

18 For Appellants: Michael Lenartz
19 For Franchise Tax Board: Ann H. Hodges, Tax Counsel IV
20

21 **QUESTIONS:** (1) Whether appellants’ stock met the “active business requirements” of Revenue and
22 Taxation Code (R&TC) section 18152.5, such that appellants qualify for the
23 50 percent exclusion from gain on the sale of “qualified small business stock”
24 (hereinafter sometimes “QSBS”) under R&TC section 18152.5.
25 (2) Whether appellants’ stock met the “active business requirements” of R&TC
26 section 18152.5, such that appellants qualify for the deferral of gain on the sale of
27

28 ¹ This matter was originally scheduled for oral hearing at the Board’s May 30-31, 2012 meeting. The matter was postponed, at appellants’ request, to the Board’s June 24-26, 2012 meeting to allow them additional time to prepare for the hearing.

1 “qualified small business stock” under R&TC section 18038.5.

2 (3) Whether the Board has jurisdiction to consider the constitutionality of R&TC
3 sections 18152.5 and 18038.5 and, if so, whether the statutes violate the
4 Commerce Clause of the United States Constitution.

5 HEARING SUMMARY

6 Introduction

7 In order to be entitled to exclude gain from the sale of stock under R&TC section
8 18152.5 (the 50 percent exclusion), the stock sold must be considered “qualified small business stock.”
9 (Rev. & Tax. Code, § 18152.5, subd. (a).) Similarly, to be entitled to defer (rollover) gain from the sale
10 of stock under R&TC section 18038.5, the stock sold must also be considered “qualified small business
11 stock”.² (Rev. & Tax. Code, § 18038.5, subd. (a).)

12 In general, pursuant to R&TC section 18152.5, subdivision (c)(2)(A), stock is considered
13 qualified small business stock if, during substantially all of a taxpayer’s holding period, the corporation
14 meets the “active business requirements” of R&TC section 18152.5, subdivision (e). The specific active
15 business requirement at issue in this appeal is whether, during substantially all of appellants’ holding
16 period for their Novacept stock, 80 percent of the corporation’s “total payroll expense is attributable to
17 employment” located in California.³ (Rev. & Tax. Code, 18152.5, subd. (e)(9).)

18 In an analysis completed under both R&TC section 18152.5 and R&TC section 18038.5,
19 two tests are completed which measure time: (1) the individual’s minimum holding period⁴ of the
20 QSBS—a threshold requirement under both statutes, and (2) the test period to determine whether the
21 underlying corporation met the active business requirements of R&TC section 18152.5, subdivision (e).

22 _____
23 ² R&TC section 18038.5 provides that “[t]he term ‘qualified small business stock’ has the meaning given that term by
24 subdivision (c) of Section 18152.5.” (Rev. & Tax. Code, § 18038.5, subd. (b)(1).)

25 ³ R&TC section 18152.5(e) provides that a corporation must meet an 80 percent asset test and an 80 percent payroll test. The
26 80 percent asset test is not at issue in this appeal.

27 ⁴ Under R&TC section 18152.5, subdivision (a), a taxpayer’s minimum holding period of QSBS, to gain the benefit of the
28 statute, is “more than five years”, or five years plus one day. Under R&TC section 18038.5, subdivision (a), a taxpayer’s
minimum holding period, to gain the benefit of that statute, is “more than six months”, or six months plus one day. In other
words, a taxpayer’s minimum holding periods is a threshold requirement under each of these statutes; no further analysis
under either statute is necessary if a taxpayer cannot meet this initial criteria.

1 Only one of these requirements is at issue in this appeal: whether Novacept (i.e., the corporation in
2 which appellants were shareholders) met the “test period” criteria of the active business requirements of
3 R&TC section 18152.5, subdivision (e), either “during substantially all of the taxpayer’s holding period
4 for the stock” (under R&TC section 18152.5, subdivision (c)(2)(A)), or “[o]nly the first six months of
5 the taxpayer’s holding period for the stock” (under R&TC section 18038.5, subdivision (b)(4)(B)).⁵

6 Among the various issues appellants have raised on appeal are: (1) the definition of the
7 term “holding period” as part of the clause “the taxpayer’s holding period of the stock”; (2) the
8 definition of the term “substantially all” as part of the clause “substantially all of the taxpayer’s holding
9 period of the stock”; and (3) the inclusion of stock options as part of the corporation’s “total payroll
10 expense.” As such, when appellants (for example) discuss the holding period for purposes of the active
11 business requirements (in *The Requisite Active Business Requirement Test Period* section of Contentions
12 below), they are referring to the test period of the Novacept stock and whether such stock meets the
13 active business requirements of R&TC section 18152.5, subdivision (e), and can be considered qualified
14 small business stock.

15 Background

16 *Novacept is incorporated in California*

17 Novacept incorporated in California on April 1, 1993. (FTB Br. 9/2011, p. 3.)⁶

18 Novacept designed, developed, and sold medical devices for the treatment of excessive menstrual
19 bleeding. (*Id.*) Novacept conducted a portion of its manufacturing activities in Costa Rica during some
20 of its years of operation. (*Id.*)

21 *Appellants acquire and, later, sell Novacept stock*

22 Appellants acquired Novacept stock on three separate occasions: July 1995, July 1996,
23 and July 1999. (FTB Br. 9/2011, p. 3.) In July 1995, appellants purchased 1,040,000 shares of
24

25 ⁵ Consequently, there is no dispute in this appeal as to whether appellants met the minimum holding period tests under R&TC
26 sections 18152.5 and 18038.5.

27 ⁶ Appellants filed various briefs and exhibits in this appeal, of which the following are cited to in this Hearing Summary:
28 (i) appeal letter (AL); (ii) brief dated May 26, 2010 (App. Br. 5/2010); (iii) brief dated December 30, 2010 (App. Br.
12/2010); (iv) brief dated July 11, 2011 (App. Br. 7/2011); and (v) protest hearing exhibit (App. Protest Hearing Ex.). The
FTB filed various briefs in this appeal, of which the following are cited to in this Hearing Summary: (i) opening brief (FTB
OB); (ii) brief dated May 9, 2011 (FTB Br. 5/2011); and (iii) brief dated September 21, 2011 (FTB Br. 9/2011).

1 Novacept stock. (*Id.* p. 8.) On July 30, 1996, Novacept instituted a reverse stock split on a 1-for-10
 2 basis, which reduced the shares of stock appellants acquired in July of 1995 from 1,040,000 to 104,000.
 3 (*Id.*) In July 1996, appellants purchased an additional 36,000 shares of Novacept stock (which was not
 4 subject to the reverse stock split). (FTB OB, p. 16.) Later, in July 1999, appellants purchased 8,500
 5 shares of Novacept stock. Subsequently, in 2004, appellants sold all of the above-listed shares of
 6 Novacept stock. (*Id.*)

7 *Appellants' return*

8 Appellants filed a joint California resident income tax return for 2004, reporting that they
 9 excluded and deferred gain of \$599,973 and \$199,999, respectively, because their Novacept stock could
 10 be considered qualified small business stock. (FTB OB, p. 16 & Ex. 5.) Appellants reported the
 11 following sales and exclusion/deferral amounts on their federal Form 1040, Schedule D, for the 2004 tax
 12 year:

13 Table 1 (See FTB OB, Ex. H, pp. 5-6)

14 Shares	Date Acquired	Date Sold	Basis	Sales Price	Total Gain	Gain Excluded	Gain Deferred
15 104,000	7/1/95	4/13/04	\$104,000	\$1,105,256	\$1,001,256	\$500,628	\$0
16 20,639	7/1/96	4/13/04	\$20,648	\$219,338	\$198,690	\$99,345	\$0
17 15,361	7/1/96	4/13/04	\$15,352	\$163,251	\$147,899	\$0	\$147,899
8,500	7/1/99	4/13/04	\$38,250	\$90,350	\$52,100	\$0	\$52,100
18 Total						\$599,973	\$199,999

19 *FTB's Audit*

20 During the audit, appellants provided documentation regarding the acquisition and selling
 21 dates which vary slightly from the dates reported above on their federal Form 1040, Schedule D. On
 22 appeal, appellants list the shares, acquisition dates, and selling dates as follows (which for purposes of
 23 this appeal the FTB does not apparently dispute):⁷

24 ///

25 ///

26 _____
 27 ⁷ (App. Br. 12/2010, p. (i); FTB OB, pp. 16-17.) Appellants have not discussed how they arrived at fractional share amounts
 28 for the shares acquired on July 19, 1996. The FTB asserts that the shares reported as being acquired on July 26, 1995, were
 actually acquired on July 27, 1995. (FTB OB, p. 16, fn. 14.) Staff notes that appellants acquired 1,040,000 shares in 1995
 but due to a reverse stock split of 1-to-10, those shares were reduced to 104,000. (*Id.* p. 8.)

Table 2

Shares	Date Acquired	Date Sold	Basis	Sales Price	Total Gain	Gain Excluded	Gain Deferred
54,000	7/20/95	3/24/04	\$54,000	\$573,890	\$519,890	\$259,945	\$0
50,000	7/26/95	3/24/04	\$50,000	\$531,380	\$481,379	\$240,690	\$0
20,636.35	7/19/96	3/24/04	\$20,636	\$219,314	\$198,678	\$99,339	\$0
15,363.65	7/19/96	3/24/04	\$15,364	\$163,278	\$147,915	\$0	\$147,915
8,500	7/15/99	3/24/04	\$38,250	\$90,334	\$52,084	\$0	\$52,084
Total						\$599,973	\$199,999

The FTB audited appellant's 2004 California return and disallowed the exclusion of \$599,973 and the deferral of \$199,999 because, in the auditor's opinion, Novacept's stock was not "qualified small business stock." (FTB OB, p. 16.) Specifically, the auditor determined that Novacept did not meet the payroll test, which requires that, during "substantially all" (which the auditor defined as at least 85 percent) of appellants' holding period, 80 percent or more of Novacept's total payroll expense must be attributable to employment in California. (*Id.* pp. 16-17.) In making this determination, the FTB's auditor conducted two different apportionment tests:

1. *Apportionment based on Form 100's and Schedule Rs*

Based on Novacept's reporting of its payroll expense on Form 100s, the auditor determined that Novacept did not start apportioning its business income until 2001. Thus, the auditor assumed that 100 percent of Novacept's payroll expense was attributable to California for years 1995 through 2000. (FTB OB, p. 16.) Based on this assumption (and Novacept's Schedule R reporting for the tax years 2000 through March 24, 2004), the auditor determined that Novacept's payroll expenses were apportioned between California and other places as set forth in the table below:

Tax Year	Payroll Expense Attributable to California
1995	100%
1996	100%
1997	100%
1998	100%
1999	100%
2000	100%
2001	94.12%
2002	65.85%
2003	50.77%
YE 3/24/04	59.25%

1 In relation to the facts in the above-listed table, the auditor found that, for each block of
2 appellants' stock, Novacept failed the payroll test and, therefore, appellants' stock did not qualify for
3 qualified small business stock treatment. (*Id.*) The auditor took the position that the term "substantially
4 all" has been interpreted to mean at least 85 percent. (*Id.*) Next, as to the stock appellants acquired in
5 1995, the auditor determined that appellants' holding period was 10 years (1995-2004) and, based on the
6 amounts in the table above, the percentage of time that Novacept met the requirement that 80 percent of
7 its payroll expense was attributable to California was only for 7 out of 10 years (i.e., 1995-2001) or 70
8 percent. (*Id.*) Thus, the auditor determined that appellants did not meet the "substantially all"
9 requirement because 70 percent was less than 85 percent. (*Id.*)

10 As to the stock that appellants acquired in 1996, the auditor determined that appellants'
11 holding period was 9 years (1996-2004) and, based on the amounts in the table above, the percentage of
12 time that Novacept met the requirement that 80 percent of its payroll expense was attributable to
13 California was only for 6 out of 9 years (i.e., 1996-2001) or 67 percent. (*Id.*) Thus, the auditor
14 determined that appellants did not meet the "substantially all" requirement because 67 percent was less
15 than 85 percent. (*Id.*)

16 As to the stock that appellants acquired in 1999, the auditor determined that appellants'
17 holding period was 6 years (1999-2004) and, based on the amounts in the table above, the percentage of
18 time that Novacept met the requirement that 80 percent of its payroll expense was attributable to
19 California was only for 3 out of 6 years (i.e., 1999-2001) or 50 percent. (*Id.*) Thus, the auditor
20 determined that appellants did not meet the "substantially all" requirement because 50 percent was less
21 than 85 percent. (*Id.*)

22 2. *Apportionment based on EDD and IRS data*

23 As an alternative method of testing to determine if Novacept met the payroll test, the
24 auditor used quarterly data reported by Novacept to the Employment Development Department (EDD)
25 and the Internal Revenue Service (IRS). (FTB OB, p. 17.) The auditor totaled the amount of payroll
26 reported in each of the four quarters of data to determine an annual percentage for each of the three
27 years (i.e., 2002-2004) for which the prior test (in Table 3 above) showed California percentages of less
28 than 80 percent. However, using this alternative method, the auditor determined that, although its new

1 test increased the amount of payroll expense attributable to California for each of the three periods of
2 2002 through 2004, the percentage of payroll allocated to California during those periods was still less
3 than 80 percent, as set forth in Table 4 immediately below; thus, the auditor determined that, under the
4 alternative test, those years (2002-2004) should still not be counted in determining whether Novacept
5 met the 85 percent “substantially all” requirement. (*Id.* p. 18.)

6 Table 4 (FTB OB, p. 18; App. Br. 12/2010, Ex. 2A, p 34.)

	Payroll California (EDD)	Payroll Total (IRS)	Percentage
7 TYE 12/2002	\$5,675,253	\$8,186,689	69.32%
8 TYE 12/2003	\$8,175,059	\$14,680,797	55.68%
9 TYE 3/2004	\$3,200,728	\$5,117,778	62.54%

10 Based upon these audit results, the FTB issued a Notice of Proposed Assessment (NPA)
11 dated February 3, 2009, which increased appellants’ California taxable income by \$799,972 to account
12 for the disallowed gain exclusion of \$599,973 and the disallowed deferral of \$199,999. (App. Br.
13 5/2010, Ex. N-1.) The NPA listed an additional tax of \$60,812, plus interest. (*Id.*)

14 *Protest*

15 Appellants timely protested the NPA. (FTB OB, pp. 19-20.) In response, the FTB states
16 that, to further assist appellants in determining if Novacept met the payroll requirement, the protest
17 hearing officer conducted a new apportionment test. (*Id.*) Specifically, the protest hearing officer
18 calculated the payroll requirement by treating appellants’ entire holding period as one period. The FTB
19 states, however, that this calculation resulted in a determination that only 74 percent of Novacept’s
20 payroll was attributable to California, as set forth in the following table:

21 Table 5 (FTB OB, p. 20)

	Payroll California	Payroll Total	Percentage
22 TYE 12/1995	\$864,467	\$864,467	100.00%
23 TYE 12/1996	\$473,054	\$473,054	100.00%
24 TYE 12/1997	\$1,026,972	\$1,026,972	100.00%
25 TYE 12/1998	\$1,970,728	\$1,970,728	100.00%
26 TYE 12/1999	\$2,741,543	\$2,741,543	100.00%
27 TYE 12/2000	\$3,988,300	\$3,988,300	100.00%
28 TYE 12/2001	\$3,748,179	\$4,017,371 ⁸	93.29%

⁸ On appeal, appellants assert that appellants and the FTB now agree that this amount (i.e., \$4,017,371) should have been adjusted and listed as \$3,877,044. (App. Br. 12/2010, p. 13 & p. 20, fn. vi.)

Table 5 (FTB OB, p. 20) (continued)

	Payroll California	Payroll Total	Percentage
TYE 12/2002	\$5,675,253	\$8,186,689	69.32%
TYE 12/2003	\$8,175,059	\$14,680,797	55.68%
TYE 3/2004	\$3,200,728	\$5,117,778	62.54%
Total	\$31,864,283	\$43,067,699	73.98%

The FTB subsequently issued a Notice of Action (NOA) on January 22, 2010, affirming the NPA. (App. Ltr., Ex N-0.) This timely appeal followed.

Contentions

Appellants

The Requisite Active Business Requirement Test Period

Appellants argue that R&TC section 18152.5 only requires a holding period of “more than five years” for qualification for the 50 percent exclusion of the gain, such that a corporation must only meet the active business requirements of R&TC section 18152.5, subdivision (e), during substantially all of a taxpayer’s first five years (plus one day) of holding the stock. (Appl. Ltr. pp. 3, 5-6; App. Br. 7/2011, pp. 20-22.) Similarly, appellants argue that R&TC section 18038.5 only requires a holding period of “more than six months” for qualification for the deferral (rollover) of gain, such that a corporation must only meet the active business requirements of R&TC section 18152.5, subdivision (e), during substantially all of the taxpayer’s first six months (plus one day) of holding the stock. (Appl. Ltr. pp. 3, 5-6; App. Br. 7/2011, pp. 22-25.) In fact, for purposes of the deferral provision, appellants assert that R&TC section 18038.5, subdivision (b)(4)(B), expressly states that the applicable testing period is only the first six months of the taxpayer’s holding period:

“Only the first six months of the taxpayer’s holding period for the stock referred to in paragraph (1) of subdivision (a) shall be taken into account for purposes of applying paragraph (2) of subdivision (c) of Section 18152.5.” (Rev. & Tax. Code, § 18038.5, subd. (b)(4)(B); App. Br. 5/2010, p. 6; App. Br. 12/2010, p. 10.)

Appellants assert that the FTB’s interpretation of the testing period as being the entire time the stock is held by a taxpayer is not found under the law as written. (App. Ltr. p. 3.) Furthermore, appellants assert that the FTB’s position (i) is unreasonable and irrational (App. Br. 5/2010, p. 14; App. Br. 7/2011, pp. 1 & 3), (ii) is arbitrary and without foundation (App. Br. 12/2010), and (iii) constitutes a prohibited

1 “underground regulation.” (App. Br. 12/2010, p. 1.) Appellants assert also that the FTB’s position
2 significantly alters the statute’s plain meaning. (App. Ltr. p. 12.) Appellants assert that the proper
3 testing period is the first five years (plus one day) for purposes of the exclusion provision (R&TC
4 section 18152.5) and the first six months (plus one day) for purposes of the deferral provision (R&TC
5 section 18038.5). Furthermore, appellants assert that these calculations must be performed on the basis
6 of the number of days from when appellants first acquired the respective blocks of stock. (App. Ltr.
7 p. 9; App. Br. 5/2010, p. 12.)

8 Also, appellants cite to *Billings v. United States* (1914) 232 U.S. 261 for the proposition
9 that, if a tax statute is found to be ambiguous, a court should interpret the statute in favor of the
10 taxpayer. In addition, appellants argue that when the Legislature enacted the applicable law, it
11 contemplated testing periods of (a) five years (and one day) for purposes of R&TC section 18152.5, and
12 (b) six months (and one day) for purposes of R&TC section 18038.5. (App. Br. 12/2010, p 11.) For
13 example, appellants note that Senate Rules Committee Analysis of SB 519 (February 23, 1998) states in
14 part:

15 This bill will reduce *the length of time that taxpayers must hold qualified small business*
16 *stock before qualifying for a partial capital gains exclusion.* This stock would need to be
17 held for six months (as opposed to five years), but income from the sale would need to be
18 used to purchase other California small business stock in order for the taxpayer to qualify
for the partial capital gains exclusion. (SB 519, Feb. 23, 1998; App. Br. 12/2010, p 11.)
(Emphasis supplied.)

19 Similarly, appellants assert that, for purposes of the exclusion under R&TC section 18152.5, the
20 Legislative intent was to reward a taxpayer who holds the applicable stock over five years. (App. Ltr.
21 pp. 3 & 9.) Also, appellants analogize to the federal long-term capital gain provisions and assert that,
22 for purposes of qualifying for long-term capital gains treatment under federal law, a taxpayer only has to
23 hold stock for over one year and, once the taxpayer fulfills the one-year holding requirement, the
24 taxpayer cannot later lose long-term capital gain treatment based on events occurring subsequent to the
25 one-year (plus one day) holding period. (App. Ltr. p. 3.) In addition, appellants assert that IRS
26 Publication 550 (2004) states that the requirements for a 50 percent exclusion under federal law (and
27 possibly a 60 percent exclusion for federal purposes if in a business empowerment zone) are still met if a
28 corporation ceases to qualify after the five-year period that begins on the date the taxpayer acquired the

1 stock. (App. Protest Hearing Ex. 4-4, fn. 8.) Publication 550 (2004) provides:

2 **Increased section 1202 exclusion for empowerment zone business stock.** Section
3 1202 allows you to exclude up to 50% of your gain on the sale or trade of qualified small
4 business stock. Beginning in 2005, you can exclude up to 60% of your gain if:

- 5 1. You sell or trade stock in a corporation that qualifies as an empowerment zone
6 business during substantially all of the time you held stock,
- 7 2. You acquired the stock after December 21, 2000, and
- 8 3. You held the stock for at least 5 years.

9 ***Condition (1) will still be met if the corporation ceased to qualify after the 5-year
10 period that begins on the date you acquired the stock. . . .*** (IRS Pub. 550, p. 2 (2004).)
11 (Emphasis supplied.)

12 Furthermore, appellants assert that “policy considerations” should be taken into account
13 when interpreting the applicable statutes. (App. Br. 5/2010, p. 7.) For example, appellants assert that
14 the FTB’s position “is clearly at odds with the Legislative intent to reward Californians for investing in
15 small business [and] creates a hostile environment [that] can discourage future investment.” (*Id.*)
16 Appellants assert that “[t]he intent of the law is to reward, not punish patient capital,” and appellants
17 contend that the FTB interpretation of the applicable statutes would punish taxpayers who held stock
18 over the applicable holding periods of five year (plus one day) and six months (plus one day).
19 (*Id.* p. 15.)

20 Appellants conclude by asserting that, if the Board adopts the testing periods of the first
21 five years (plus one day) for purposes of the 50 percent exclusion and the first six months (plus one day)
22 for purposes of the deferral (rollover) of gain, then the Board will not have to determine (as discussed
23 immediately below) whether the term “substantially all” means 75 percent (or 85 percent) because it is
24 undisputed that (i) 100 percent of Novacept’s payroll was within California during the first five years
25 (plus one day) for the blocks of stock for which appellants are seeking the 50 percent exclusion (under
26 R&TC section 18152.5), and (ii) 100 percent of Novacept’s payroll was within California during the
27 first six months (plus one day) for the blocks of stock for which appellants are seeking a deferral of gain
28 (under R&TC section 18038.5). (App. Ltr. pp. 5-6.)

Defining the Term “Substantially All”

Appellants argue that, for purposes of determining whether a corporation has met the

1 active business requirements of R&TC section 18152.5, the term “substantially all” should be
2 interpreted to mean “at least 75 percent.” (App. Protest Hearing Exhibit 4-7.) Alternatively, appellants
3 assert that the term “substantially all” could be interpreted “to mean as low as no more than 77.5% and
4 possibly as low as 75%” (App. Ltr. p 10.)

5 Appellants assert that the FTB’s interpretation of the term “substantially all” to mean “at
6 least 85 percent” is too high. (App. Br. 5/2010, p. 15.) For example, regarding federal law, appellants
7 cite IRC section 302 (regarding distributions in redemption of stock) which describes the term
8 “substantially disproportionate” as less than 80 percent and IRC section 368 (Treas. Reg. Section
9 1.368-2(d)(2)) (regarding corporate distributions) which defines the term “substantially all” as at least 80
10 percent. (App. Protest Hearing Ex. 4-7.) Also, because Novacept was a medical company, appellants
11 analogize to 42 C.F.R. section 411.352(d) (regarding patient care services) which appellants assert
12 imposes a requirement of at least 75 percent. (*Id.*) Regarding California law, appellants cite R&TC
13 sections 6006, 6010.30, and 23251, among other statutes and regulations, for the proposition that
14 “substantially all” is defined as 80 percent or more. (*Id.*) Also, appellants cite to R&TC section 24451
15 for the proposition that “substantially all” is defined as less than 80 percent.⁹ (*Id.*) In addition,
16 appellants note that the Board concluded in the *Appeal of Helen Cantor, et. al.*, 2002-SBE-008, decided
17 by the Board on November 3, 2002,¹⁰ that the term “substantially equivalent,” in the context of a
18 homeowners and renters property tax assistance appeal, could be reasonably defined as at least 80
19 percent. (*Id.*) Based on the Board’s decision in *Cantor*, appellants contend that the FTB’s interpretation
20 of the term “substantially all” to mean at least 85 percent is too high. (App. Br. 5/2010, p. 15.)

21 Finally, appellants assert that the FTB’s interpretation of the term “substantially all” as
22 being at least 85 percent is “clearly at odds with the Legislative intent to reward Californians for
23 investing in small business.” (*Id.*)

24 *Stock Options and Fringe Benefits*

25 Appellants criticize the FTB’s reliance upon the payroll factor provided by Schedule R-1
26

27 ⁹ Appeals Division staff (staff) was unable to find any definition of the term “substantially all” in R&TC sections 6006,
28 6010.30, 23251, or 24451.

¹⁰ Board of Equalization cases are generally available for viewing on the Board’s website (www.boe.ca.gov).

1 as a basis for determining total payroll expense. (App. Br. 7/2011, pp. 4-7.) Appellants assert that it is
 2 appropriate to add stock options and non-reportable fringe benefits into the payroll factor amounts on
 3 Schedule R-1 to convert the compensation-based payroll factor into a payroll expense factor. (*Id.*)
 4 Appellants cite to Novacept's Securities and Exchange Commission (SEC) Form S-1 (as copy of which
 5 is attached as Exhibit G to the FTB's opening brief) as proof that Novacept issued stock options. (*Id.*)

6 *Testing on a Cumulative Daily Basis*

7 Appellants appear to assert that if Novacept's payroll is tested on a cumulative
 8 daily basis, then there are additional days in which Novacept meets the "substantially all"
 9 requirement. (App. Br. 12/2010, p. 15.) In their reply brief dated December 30, 2010, appellants
 10 provide an example of how this calculation would work. Specifically, as for the 54,000 shares
 11 that appellants purchased on July 20, 1995, appellants would calculate the payroll on a
 12 cumulative daily basis for the period of July 20, 1995 (the purchase date) through December 31,
 13 2002 (the end of a random testing period), as follows:

14

15 Table 6 (App. Br 12/2010, p. 15.)

16 Time Period	17 Total Payroll Outside California from 7/20/95 to 12/31/02	18 Total Payroll Everywhere from 7/20/95 To 12/31/02	19 Cumulative Percentage Outside of California	20 Cumulative Percentage within California
21 7/20/95-12/31/02	22 \$2,640,301	23 \$22,482,080	24 11.74%	25 88.26

26 *Base of Operations*

27 Appellants also assert that 100 percent of Novacept's payroll expense was attributable to
 28 employment located within California because Novacept's base of operations, from which all of its
 "employment" decisions were made, was located entirely within California; therefore, appellants argue
 that all of Novacept's payroll expense attributable to employment was located within California. (App.
 Br. 5/2010, p. 16; App. Br. 12/2010, p. 20; App. Br. 7/2011, pp. 3-5.) Additionally, appellants argue
 that 50 percent of the payroll expense attributable to employees geographically located outside of
 California is attributable to California because Novacept's base of operations was located in California.
 (App. Br. 7/2011, p. 6.)

1 R&TC section 18152.5(f)

2 As noted above, the 1,040,000 shares of Novacept stock that appellants acquired in 1995
3 were subject to a reverse stock split—on a 1-for-10 basis—on July 30, 1996, which resulted in
4 appellants holding 104,000 Novacept shares after the split. Appellants assert that, as a result of this
5 reverse stock split, those 104,000 shares of Novacept stock automatically qualify thereafter as QSBS
6 under the provisions of R&TC section 18152.5, subdivision (f), irrespective of whether Novacept
7 continued to meet the requirements of QSBS after the reverse stock split. (App. Br. 7/2011, pp. 8 & 19;
8 App. Br. 12/2010, p. 20.) In making this assertion, appellants rely upon R&TC section 18152.5,
9 subdivision (f), which provides:

10 (f) If any stock in a corporation is acquired solely through the conversion of other stock
11 in the corporation that is qualified small business stock in the hands of the taxpayer, both
12 of the following shall apply:

- 13 (1) The stock so acquired shall be treated as qualified small business stock in the hands
14 of the taxpayer.
- 15 (2) The stock so acquired shall be treated as having been held during the period during
16 which the converted stock was held.

17 Constitutionality of the Statute

18 Appellants assert that the “payroll provision” as set forth in R&TC section 18152.5,
19 subdivision (e)(9), is unconstitutional; however, appellants assert that the California law concerning
20 QSBS “could be fairly construed while avoiding constitutional difficulties in our case.” (App. Ltr. p. 6.)
21 Appellants apparently contend that R&TC section 18152.5, subdivision (e)(9), may discriminate against
22 interstate commerce by providing differential tax treatment which benefits in-state economic interests
23 while burdening out-of-state economic interests. (App. Br. 5/2010, p. 5.) Appellants, however, do not
24 further elaborate on how any alleged constitutional difficulties could be avoided, other than to state that,
25 when interpreting a statute, a court should adopt a construction that avoids constitutional difficulties.
(App. Protest Hearing Exhibit 4-5, citing *United States v. Clark* (1980) 445 U.S. 23, 27.) Appellants
conclude by asserting that “[a] California Appellant Court is scheduled to hear a case on this matter in

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1 March of 2011.”¹¹ (App. Br. 5/2010, p. 5.)

2 The NOA did not set forth the reasons for the assessment

3 Appellants assert that the NOA violates the provisions of R&TC section 19034 because
4 the NOA fails to set forth the reasons for the proposed assessment. (App. Br. 12/2010, p. 10.)

5 Procedural Matters

6 Appellants assert that the auditor and protest hearing officer did not follow proper
7 procedures, such as:

- 8 • The auditor refused to follow the FTB published audit techniques regarding document
9 requests. (App. Br. 12/2010, p. 1.)
- 10 • The auditor was unreasonable in requesting that appellants provide evidence going back to
11 the 1993 tax year. (*Id.*)
- 12 • The auditor completed the audit without warning. (*Id.* p. 4.)
- 13 • The auditor and the protest hearing officer did not consider alternative methods of testing.
14 (*Id.* p. 5.)
- 15 • The protest hearing officer did not consider all of the arguments that appellants previously
16 made to the auditor. (*Id.*)

17 The FTB

18 The Requisite Active Business Requirement Test Period

19 The FTB disagrees with appellants’ assertion that the active business requirements of
20 R&TC section 18152.5 must only be met during the first five years (plus one day) for purposes of the 50
21 percent exclusion provision and for the first six months (plus one day) for purposes of the deferral
22 (rollover) provision. The FTB argues that the five year (plus one day) and six months (plus one day)
23 holding periods are the minimum thresholds which must be met for a taxpayer to be eligible to exclude
24 or defer gain from the sale of qualified small business stock. The FTB asserts that for each block of
25 appellants’ stock (i) the payroll requirement must be tested for appellants’ entire holding period (FTB
26

27 ¹¹ This is possibly a reference to *Cutler v. Franchise Tax Board*, which is currently before the California Court of Appeal
28 (Ct. App. No. B233773). In an August 17, 2011 letter to appellants, the Board Proceedings Division confirmed that
appellants desired to go forward with this appeal, such that appellants did not seek a deferral of this matter pending the
outcome of the *Cutler* litigation.

1 OB, p. 11), and (ii) during substantially all (which the FTB defines as at least 85 percent) of the
2 appellants' holding period, more than 80 percent of Novacept's total payroll expense must have been
3 attributed to California. (*Id.* p. 5.) However, the FTB notes that, throughout appellants' entire holding
4 period for a respective block of stock, the FTB is willing to conduct testing on an annual, quarterly,
5 monthly, etc. basis, provided there is credible evidence of payroll expenses for those testing intervals.
6 (*Id.* p. 9.)

7 The FTB asserts that based upon the test results set forth in Tables 3, 4, and 5 above,
8 appellants have failed to show that, during substantially all of their holding period for each respective
9 block of stock, 80 percent of the corporation's total payroll expense was attributed to employment
10 located in California. (*Id.* pp. 16-18.)

11 Defining the Term "Substantially All"

12 Regarding the term "substantially all," the FTB asserts that this term should be defined as
13 at least 85 percent. (FTB OB, p. 5.) In support, the FTB notes that the federal empowerment zone
14 regulations define the term "substantially all" as 85 percent:

15 For purposes of sections 1397B [nonrecognition of gain on rollover of empowerment
16 zone investments] and 1397C(a) [enterprise zone businesses], the term substantially all
means **85 percent**. (Treas. Reg. § 1.1394-1(l), emphasis supplied; FTB OB, p. 5.)

17 The FTB contends that the federal empowerment zone statutes govern the same subject matter
18 (and were enacted at the same time) as the federal small business stock provisions and, thus,
19 there is a presumption that Congress meant for the provisions to be read consistently. (*Id.*, p. 5;
20 citing *Rucker v. Davis* (9th Cir. 2001) 237 F.3d 1113, 1112.) Moreover, the FTB argues that the
21 interrelationship between the federal empowerment zone provisions and the federal small
22 business stock provisions is evidenced by the fact that the federal qualified small business stock
23 provision (IRC section 1202(a)(2)) allows for a greater exclusion (60 percent) for stock sold by a
24 corporation located in an empowerment zone. (FTB OB, p. 5.) Also, the FTB asserts that the
25 federal empowerment zone provisions and the federal small business stock provisions have
26 similar goals: to stimulate investment and create jobs. (*Id.*)

27 Next, the FTB states that it reviewed various Treasury Regulations and found that the
28 term "substantially all" is defined as "85 percent or more" 13 out of 18 times. (*Id.* p. 4.)

1 The FTB also points out that if “substantially all” is defined as less than 85 percent, a
2 corporation could have no payroll or assets in California for an entire year, out of a 5-year period, and
3 still meet the active business requirements of R&TC section 18152.5. (*Id.* p. 5.)

4 Finally, the FTB asserts that appellants’ reliance on the Board’s decision in the *Appeal of*
5 *Helen Cantor, et. al., supra*, is inappropriate because (1) the term being defined was “substantially
6 equivalent” not “substantially all,” such that the Board’s opinion did not address qualified small
7 business stock; and (2) the term “substantially all” is a technical term which has been used repeatedly in
8 both federal and California tax statutes. (*Id.* pp. 6-7.)

9 *Stock Options and Fringe Benefits*

10 The FTB argues that the compensation associated with nonqualified stock options should
11 have been accounted for in the payroll factor, pursuant to the guidance provided in the FTB’s multistate
12 audit manual. (FTB Br. 9/2011, p. 7; citing FTB Multistate Audit Manual, p. 6.) Also, the FTB argues
13 that appellants have provided no information that income associated with stock options was not included
14 in payroll, other than to reference Novacept’s SEC filings which indicate that Novacept had the
15 authority to issue various types of options. (FTB Br. 9/2011, p. 8.) Finally, the FTB argues that
16 appellants have provided no information regarding the existence of, or the amounts of, other fringe
17 benefits not already included in the payroll factor. (*Id.*)

18 *Testing on a Cumulative Daily Basis*

19 The FTB argues that appellants’ suggestion that testing be conducted on a cumulative
20 basis is not a reasonable method for calculating whether Novacept met the payroll requirement, for the
21 following reasons. (FTB OB, pp. 10-11.) First, the FTB asserts that the effect of using cumulative
22 totals is that amounts for prior periods are included in calculating the current period’s percentage, which
23 the FTB asserts is contrary to the statute’s clear language that testing be done on a discrete basis, i.e., for
24 “any period.” (*Id.*) Second, the FTB states that the protest hearing officer already tested Novacept’s
25 payroll expense by treating the entire holding period as “one period” and found that only 74 percent of
26 Novacept’s payroll expense was attributable to California (which the FTB asserts cannot be considered
27 “substantially all”). (*Id.* p. 11.)

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1 (2) The stock so acquired shall be treated as having been held during the period during
2 which the converted stock was held. (Rev. & Tax. Code, § 18152.5, subd. (f); FTB
Br. 9/2011, p. 8.)

3 The FTB asserts that subdivision (f) only treats the stock acquired in a reverse stock split as qualified
4 small business stock as of the date of the reverse stock split and the active business requirements must
5 still be met for the remainder of the appellants' holding period. (FTB Br. 9/2011, pp. 8-9.)
6 Furthermore, the FTB asserts that appellants have not identified any language which specifically
7 exempts them from meeting the active business requirements for the remainder of their holding period.
8 (*Id.*) Also, the FTB contends that there is no policy reason why shareholders who hold stock as a result
9 of a stock split should receive more favorable treatment than other types of shareholders. (*Id.* pp. 9-10.)

10 *Constitutionality of the Statute*

11 The FTB argues that the Board has a policy of not deciding constitutional issues. (FTB
12 BR. 5/2011, p. 8, citing *Appeal of John H. Grace Co.* 80-SBE-115, Oct. 28, 1980.)

13 *The NOA provided a proper explanation of the assessment*

14 In relation to appellants' argument that the NOA did not provide a proper explanation of
15 the assessment, the FTB argues that the NOA specifically referenced the FTB's position letter dated July
16 23, 2009, which is 18 pages long and gives a detailed explanation of the FTB's position. (FTB Br.
17 5/2011, p. 15.)

18 *Underground Regulation*

19 In relation to appellants' argument that that the FTB is imposing an "underground
20 regulation," the FTB argues that "it is unclear even if an 'underground regulation' exists with respect to
21 the qualified small business stock provisions, how that would assist appellants in showing that they meet
22 the requirements of the statute." (*Id.* p. 7.)

23 *Burden of Proof*

24 The FTB asserts that its determination is presumed to be correct and appellants bear the
25 burden of showing that the determination is erroneous. (FTB Br. 5/2011, pp. 4-5; citing *Todd v.*
26 *McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Ismael R. Manriquez*, 79-SBE-077, Apr. 10,
27 1979.) In addition, the FTB asserts that income tax deductions (or exclusions and deferrals) are a matter
28 of legislative grace, and the burden is on appellants to show by competent evidence that they are entitled

1 to any exclusions or deferrals claimed. (FTB Br. 5/2011, p. 7; citing *New Colonial Ice Co. v. Helvering*
2 (1934) 292 U.S. 435; *Appeal of James C. and Monablanché A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

3 Procedural Matters

4 The FTB asserts that its employees followed proper procedures and/or appellants had
5 more than adequate time to respond and have their issues addressed, such as:

- 6 • The auditor set forth the FTB's positions in writing. (FTB Br. 5/2011, p. 10.)
- 7 • Appellants were allowed more than 120 days to respond to the FTB's position letter prior to
8 the audit becoming final. (*Id.*)
- 9 • Subsequent to the issuance of the position letter, there were extensive written and oral
10 communications between appellants and the FTB. (*Id.*)
- 11 • Subsequent to the issuance of the closing letter, and prior to the issuance of the NPA,
12 appellants were given the opportunity to speak with the auditor and the auditor's supervisor.
13 (*Id.* at 11.)

14 Applicable Law

15 Burden of Proof

16 Income tax deductions and exclusions are a matter of legislative grace, and a taxpayer
17 who claims a deduction or exclusion has the burden of proving by competent evidence that he or she is
18 entitled to that deduction or exclusion. (See *New Colonial Ice Co. v. Helvering* (1934) 292 U.S. 435;
19 *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.) Unsupported assertions cannot satisfy the
20 taxpayer's burden of proof. (*Appeal of James C. and Monablanché A. Walshe*, 75-SBE-073, Oct. 20,
21 1975.)

22 Qualified Small Business Stock

23 To stimulate investments in small businesses, the federal government enacted IRC
24 sections 1202 (50 percent exclusion) and 1045 (rollover of gain), which provide tax relief to investors
25 who are willing to invest funds in certain small businesses. California enacted similar—but not identical—
26 statutes, which provide tax relief to investors who are willing to invest funds in certain small businesses,
27 provided the small businesses conduct a substantial portion of business in California.

28 R&TC section 18152.5 allows certain taxpayers to exclude 50 percent of the gain on the

1 sale of QSBS held for “more than five years” from the date of acquisition.¹²

2 R&TC section 18038.5¹³ allows for a deferral (rollover) of gain on any QSBS that is held
3 for “more than six months,” provided new QSBS (i.e., replacement stock) is acquired within 60 days
4 after the sale of the original stock. The advantage of this rollover provision is that the applicable stock
5 can be held for as little as “more than six months,” and the proceeds reinvested in new qualifying
6 replacement stock (within 60 days), with no immediate tax paid on the gain from the QSBS sold.

7 In order to be entitled to exclude gain from the sale of stock under R&TC section
8 18152.5, the stock sold must be considered “qualified small business stock.” (Rev. & Tax. Code,
9 § 18152.5, subd. (a).) Similarly, to be entitled to defer (rollover) gain from the sale of stock under
10 R&TC section 18038.5, the stock sold must also be considered “qualified small business stock”.¹⁴
11 (Rev. & Tax. Code, § 18038.5, subd. (a).) In general, stock is considered QSBS if, during substantially

12 _____
13 ¹² Although the federal provision (IRC section 1202) also provides for a 50 percent exclusion of the gain from the sale of
14 qualified small business stock, the California Legislature specifically provided that the federal statute is not applicable to
15 determining the exclusion from California income. (Rev. & Tax. Code, § 18152, subd. (a).)

16 ¹³ R&TC section 18038.5 provides as follows:

17 (a) In the case of any sale of qualified small business stock held by a taxpayer other than a corporation for more than six
18 months and with respect to which that taxpayer elects the application of this section, gain from that sale shall be recognized
19 only to the extent that the amount realized on that sale exceeds:

(1) The cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date
of that sale, reduced by

(2) Any portion of the cost previously taken into account under this section.

This section shall not apply to any gain that is treated as ordinary income for purposes of this part.

(b) For purposes of this section:

(1) The term “qualified small business stock” has the meaning given that term by subdivision (c) of Section 18152.5.

(2) A taxpayer shall be treated as having purchased any property if, but for paragraph (3), the unadjusted basis of that
property in the hands of the taxpayer would be its cost (within the meaning of Section 1012 of the Internal Revenue Code).

(3) If gain from any sale is not recognized by reason of subdivision (a), that gain shall be applied to reduce (in the order
acquired) the basis for determining gain or loss of any qualified small business stock that is purchased by the taxpayer during
the 60-day period described in subdivision (a).

(4) For purposes of determining whether the nonrecognition of gain under subdivision (a) applies to stock that is sold, both
of the following shall apply:

(A) The taxpayer’s holding period for that stock and the stock referred to in paragraph (1) of subdivision (a) shall be
determined without regard to Section 1223 of the Internal Revenue Code.

(B) Only the first six months of the taxpayer’s holding period for the stock referred to in paragraph (1) of subdivision (a)
shall be taken into account for purposes of applying paragraph (2) of subdivision (c) of Section 18152.5.

(5) Rules similar to the rules of subdivisions (f), (g), (h), (i), (j), and (k) of Section 18152.5 shall apply.

(c) This section shall apply to sales made after August 5, 1997.

28 ¹⁴ R&TC section 18038.5 provides that “[t]he term ‘qualified small business stock’ has the meaning given that term by
subdivision (c) of Section 18152.5.” (Rev. & Tax. Code, § 18038.5, subd. (b)(1).)

1 all of the taxpayer's holding period, the corporation meets the "active business requirements" of R&TC
2 section 18152.5, subdivision (e).¹⁵ (Rev. & Tax. Code, § 18152.5, subd. (c)(2)(A).)

3 The specific active business requirement, and the applicable test period, for the stock in
4 which appellants seek to exclude 50 percent of the gain under R&TC section 18152.5, is whether during
5 substantially all of appellants' holding period for their Novacept stock, 80 percent of the corporation's
6 "total payroll expense is attributable to employment" located in California. (Rev. & Tax. Code,
7 § 18152.5, subd. (e)(9).)¹⁶

8 R&TC 18152.5 states in relevant part as follows:

9 Stock in a corporation shall not be treated as qualified small business stock unless, during
10 substantially all of the taxpayer's holding period for the stock, the corporation meets the
11 active business requirements of subdivision (e) and the corporation is a C corporation.
(Rev. & Tax. Code, § 18152.5, subd. (c)(2)(A).)

12 ****

13 A corporation shall not be treated as meeting the requirements of paragraph (1) for any
14 period during which more than 20 percent of the corporation's total payroll expense is
15 attributable to employment located outside of California. (Rev. & Tax. Code, § 18152.5,
16 subd. (e)(9).)

17 As noted in the statute, no more than 20 percent of a corporation's total payroll expense can be
18 attributable to employment located outside of California. (Rev. & Tax. Code, § 18152.5, subd. (e)(9).)
19 In other words, 80 percent or more of a corporation's total payroll expense must be attributable to
20 employment in California.¹⁷

21 As for a specific active business requirement test period in R&TC section 18038.5, that
22 statute provides in part as follows:

23 (a) In the case of any sale of qualified small business stock held by a taxpayer other than
24 a corporation for more than six months and with respect to which that taxpayer elects the
25 application of this section, gain from that sale shall be recognized only to the extent that
26 the amount realized on that sale exceeds:

27 (1) The cost of any qualified small business stock purchased by the taxpayer during the
28 60-day period beginning on the date of that sale . . .

(2) . . .

¹⁵ Staff has set forth only the requirements of R&TC section 18152.5 that are relevant to this appeal.

¹⁶ R&TC section 18152.5, subdivision (e), provides that a corporation must meet an 80 percent asset test and an 80 percent payroll test. The 80 percent asset test is not at issue in this appeal.

¹⁷ R&TC section 18152.5, subdivision (d)(1)(C), similarly provides that "[a]t least 80 percent of the corporation's payroll, as measured by total dollar value, is attributable to employment located within California."

1 (b) For purposes of this section:

2 (1) The term “qualified small business stock” has the meaning given that term by
subdivision (c) of Section 18152.5.

3 (2) . . .

4 (3) . . .

(4) For purposes of determining whether the nonrecognition of gain under subdivision
(a) applies to stock that is sold, both of the following shall apply:

5 (A) The taxpayer’s holding period for that stock and the stock referred to in paragraph
(1) of subdivision (a) shall be determined without regard to Section 1223 of the Internal
Revenue Code.

6 (B) Only the first six months of the taxpayer’s holding period for the stock referred to
in paragraph (1) of subdivision (a) shall be taken into account for purposes of applying
7 paragraph (2) of subdivision (c) of Section 18152.5.

8 (5) . . .

(Underlining added.)

9 Based upon this statutory language, R&TC section 18038.5, subdivision (b)(4)(B),
10 provides for the following active business requirement test period: “Only the first six months of the
11 taxpayer’s holding period for the stock referred to in paragraph (1) of subdivision (a) shall be taken into
12 account for purposes of applying paragraph (2) of subdivision (c) of Section 18152.5.” (Underlining
13 added.) The reference in this subdivision is to a taxpayer’s replacement stock, as subdivision (a)(1) of
14 R&TC section 18038.5 provides for the purchase of replacement stock as the basis for deferring gain.
15 Consequently, the active business requirement of R&TC section 18038.5, subdivision (b)(4)(B),
16 provides that only the first six months for which a taxpayer holds his replacement stock is considered to
17 determine whether such stock (the replacement stock) meets the active business requirements of R&TC
18 section 18152.5.

19 Statutory Construction

20 Regarding the issue of statutory construction, in order to determine the Legislature’s
21 intent so as “to effectuate the purpose of the law,” one must “first look to the words of the statute
22 themselves, giving to the language its usual, ordinary import and according significance, if possible, to
23 every word, phrase and sentence A construction making some words surplusage is to be avoided.”
24 In addition, statutory language “must be construed in context, keeping in mind the statutory purpose, and
25 statutes or statutory sections relating to the same subject must be harmonized, both internally and with
26 each other, to the extent possible. Where uncertainty exists consideration should be given to the
27 consequences that will flow from a particular interpretation.” (*Dyna-Med, Inc. v. Fair Employment &*
28 *Housing Com.* (1987) 43 Cal.3d 1379, 1386-87, citations omitted.)

1 Constitutional Issues

2 The Board is precluded from determining the constitutional validity of California statutes,
3 and has an established policy of declining to consider constitutional issues. (Cal. Const., art III, § 3.5;
4 *Appeal of Aimor Corp.*, 83-SBE-221, Oct. 26, 1983; *Appeals of Walter R. Bailey*, 92-SBE-001, Feb. 20,
5 1992.)

6 Procedural Issues

7 In the *Appeals of Fred R. Dauberger, et al.*, (82-SBE-082), decided on March 31, 1982,
8 the Board stated that “the only power that this Board has is to determine the correct amount of an
9 appellant’s California personal income tax liability for the appeal years.”

10 STAFF COMMENTS

11 *The Requisite Active Business Requirement Test Period*

12 As noted above, appellants assert that, for purposes of the deferral (rollover) provision,
13 R&TC section 18038.5, subdivision (b)(4)(B), expressly states that the applicable active business
14 requirement test period is only the first six months of the taxpayer’s holding period. This subdivision of
15 the statute provides that:

16 “Only the first six months of the taxpayer’s holding period for the stock referred to in
17 paragraph (1) of subdivision (a) shall be taken into account for purposes of applying
18 paragraph (2) of subdivision (c) of Section 18152.5.” (Rev. & Tax. Code, § 18038.5,
subd. (b)(4)(B).)

19 Accordingly, at the oral hearing, the FTB should be prepared to discuss whether R&TC section 18038.5,
20 subdivision (b)(4)(B), expressly limits the applicable active business requirement test period for deferral
21 (rollover) of gain to the first six months (plus one day) as appellants allege. Similarly, appellants should
22 be prepared to discuss its basis for arguing that the applicable active business requirement test period for
23 the 50 percent exclusion, under R&TC section 18152.5, should be limited to five years (plus one day).

24 Staff notes that if the Board finds that the applicable active business requirement test
25 periods are six month (plus one day) for the deferral of gain (under R&TC section 18038.5) and five
26 years (plus one day) for the 50 percent exclusion of gain (under R&TC section 18152.5), then the Board
27 need not address the arguments regarding “substantially all”, “stock options”, and “cumulative testing
28 period” because it is undisputed that for each block of stock at issue in this appeal, 100 percent of

1 Novacept’s total payroll expense was attributable to employment located in California during the first
2 six months (plus one day) as to the stock for which appellants are seeking a deferral (rollover) of gain,
3 and for the first five years (plus one day) as to the stock for which appellants are seeking a 50 exclusion
4 of gain.

5 Defining the Term “Substantially All”

6 As noted above, the FTB asserts that the term “substantially all” should be defined as at
7 least 85 percent. (FTB OB, p. 5.) Furthermore, the FTB notes that the federal empowerment zone
8 regulations define the term “substantially all” as 85 percent:

9 For purposes of sections 1397B [nonrecognition of gain on rollover of empowerment
10 zone investments] and 1397C(a) [enterprise zone businesses], the term substantially all
means **85 percent**. (Treas. Reg. § 1.1394-1(l).) (Emphasis supplied.)

11 The FTB contends that the federal empowerment zone provisions govern the same subject matter (and
12 were enacted at the same time) as the federal small business stock provisions and, thus, there is a
13 presumption that Congress meant for the provisions to be read consistently. (FTB OB, p. 5; citing
14 *Rucker v. Davis, supra.*) In contrast, appellants cite to the Board’s decision in *Appeal of Helen Cantor,*
15 *et. al., supra,* where the Board defined the term “substantially equivalent,” in the context of a
16 homeowners and renters property tax assistance appeal. At the oral hearing, the parties should be
17 prepared to discuss the above-listed authorities and any other authorities that the parties deem applicable
18 for purposes of defining the term “substantially all”.

19 Stock Options and Fringe Benefits

20 At the oral hearing, appellants should be prepared to show the amount of stock options
21 and/or fringe benefits that allegedly should be added to Novacept’s total payroll expense attributable to
22 employment in California for the applicable time period(s) at issue. At the same time, appellants should
23 be prepared to establish that such amounts have not already been included in the payroll totals
24 previously reported by Novacept in its Form 100, Schedule R filings.

25 R&TC section 18152(f)

26 Appellants contend that the proper interpretation of R&TC section 18152.5, subdivision
27 (f), is that after a stock split, the characterization of the stock received as qualified small business stock
28 should apply for the remainder of appellants’ holding period, irrespective of whether the corporation

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actually continues to meet the statute’s active business requirements. R&TC section 18152.5, subdivision (f), provides:

(f) If any stock in a corporation is acquired solely through the conversion of other stock in the corporation *that is qualified small business stock in the hands of the taxpayer*, both of the following shall apply:

- (1) The stock so acquired shall be treated as qualified small business stock in the hands of the taxpayer.
- (2) The stock so acquired shall be treated as having been held during the period during which the converted stock was held. (Emphasis added.)

At the oral hearing, appellants should be prepared to address the italicized language above which appears to state that stock, which has already met the qualifications to be considered QSBS stock in the hands of the taxpayer (such as the minimum holding period and the active business requirement test periods), will continue to have that same character after a stock conversion. Also, appellants may want to discuss whether there are any policy reasons why shareholders who hold stock as a result of a stock split or a stock conversion should receive more favorable treatment than other types of shareholders.

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