

1 Charles D. Daly  
Tax Counsel III  
2 Board of Equalization, Appeals Division  
450 N Street, MIC: 85  
3 PO Box 942879  
Sacramento CA 95814  
4 Tel: (916) 322-5891  
Fax: (916) 324-2618  
5

6 Attorney for the Appeals Division

7 **BOARD OF EQUALIZATION**  
8 **STATE OF CALIFORNIA**  
9

10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **PERSONAL INCOME TAX APPEAL**<sup>1</sup>  
12 **FRANK CUTLER** ) Case No. 400347  
13

	<u>Years</u>	<u>Proposed Assessments</u> <sup>2</sup>
	1998	\$200,182
	1999	804,948
	2000	764,141 <sup>3</sup>

17 Representing the Parties:

18 For Appellant: David Keligian, Attorney at Law  
Marty Dakessian, Attorney at Law

20 For Franchise Tax Board: Ann H. Hodges, Tax Counsel III

23 <sup>1</sup> An oral hearing in this case was originally scheduled for October 28, 2008, but was rescheduled to the first available Culver  
24 City meeting in 2009 because the taxpayer had a scheduling conflict. On February 4, 2009, the taxpayer waived appearance  
25 for the oral hearing scheduled for February 25, 2009, and the case was rescheduled for the nonappearance consent calendar of  
26 April 15-16, 2009. Subsequently, the case was rescheduled for the nonappearance adjudicatory calendar of May 27, 2009, as  
the result of Board Member contact. At the request of the taxpayer, the case was then placed back on the oral hearing  
calendar, and scheduled for July 21-22, 2009.

27 <sup>2</sup> Respondent should be prepared to provide, at the hearing, the amount of accrued interest.

28 <sup>3</sup> Respondent states in its final brief that an error by its auditor in calculating the amount of its disallowance of appellant's  
claimed deferral of gain for 2000 resulted in an overstatement of his tax liability by \$89,600. Respondent now concedes that  
the correct amount of appellant's additional tax liability for 2000 is \$674,541 rather than \$764,141.

- 1 QUESTIONS: (1) Whether the Board has jurisdiction to consider the constitutionality of Revenue  
2 and Taxation Code (R&TC) sections 18038.5 and 18152.5.  
3 (2) Whether, if the Board has such jurisdiction, those statutes violate the “dormant  
4 commerce clause” of the United States Constitution.  
5 (3) Whether appellant is entitled to defer or reduce gain from the sale of stock under  
6 those statutes if they are unconstitutional.  
7 (4) Whether R&TC section 18152.5, subdivisions (c)(2)(A) and (e)(9), should be  
8 applied as written.  
9 (5) Whether appellant has shown that he was issued stock in SRS Lab before August  
10 10, 1993, for purposes of R&TC section 18152.5, subdivision (c)(1).  
11 (6) Whether appellant has shown that, during “substantially all” of his holding period  
12 for the SRS Lab stock, SRS Lab was a C corporation.  
13 (7) Whether that stock was C corporation stock on the date of issuance.  
14 (8) Whether appellant has shown that respondent mistakenly determined that US Web  
15 did not satisfy the “substantially all” test of R&TC section 18152.5, subdivision  
16 (c)(2)(A).

### 17 HEARING SUMMARY

#### 18 Background

19 Appellant is a California resident who was an active investor during the appeal years in  
20 numerous California start-up companies, many of which were engaged in the internet or other kinds of  
21 high-tech business. On his California tax returns for the appeal years, appellant reported that the stock  
22 that he sold of the following corporations was “qualified small business stock” under R&TC section  
23 18152.5: (1) US Web, (2) Waste Connections, (3) SRS Lab, (4) Corvis, (5) Am Air Carrier, (6) Serena,  
24 and (7) stock identified as “various.” During each of the appeal years, appellant claimed deferral of gain  
25 of several million dollars on the sale of stock of a number of those corporations. In connection with that  
26 deferral of gain, appellant reported that he purchased 50 different “replacement stocks” in an amount  
27  
28

1 sufficient to defer the total amount of appellant's gain during the appeal years.<sup>4</sup> For 2000, appellant also  
2 claimed an exclusion of gain in the amount of approximately one-half million dollars on the sale of the  
3 stock of SRS Lab.

4 Respondent's auditor disallowed all of the deferrals and exclusions claimed by appellant  
5 primarily on the ground that the stock that he sold was not "qualified small business stock." With regard  
6 to the "qualified small business stock" status of corporations whose stock accounted for a large amount  
7 of sales during the appeal years, respondent states that the auditor made the following determinations:

8 US Web

9 The auditor determined that the stock of US Web was not "qualified small business  
10 stock" because the stock did not meet the requirement of R&TC section 18152.5, subdivision (c)(2)(A),  
11 that, during "substantially all" of the taxpayer's holding period for the stock, the corporation meets the  
12 "active business requirements" of subdivision (e). The auditor determined that the corporation met the  
13 requirements of R&TC section 18152.5, subdivision (e)(9), that 80 percent of a corporation's payroll be  
14 attributable to California between 33 percent and 57 percent of its holding periods. Because the auditor  
15 could not find any authority that 57 percent or less of a taxpayer's holding periods was "substantially  
16 all" of those periods for purposes of the applicable statute, the auditor concluded that the corporation did  
17 not meet the "substantially all" requirement. (Resp. Br., p. 7; Resp. Br., Appendix A, p. 23.)

18 Waste Connections

19 On the basis of information from the corporation's tax returns, the auditor determined  
20 that it did not meet the "active business requirements" of R&TC section 18152.5, subdivisions (e)(1)(A)  
21 and (e)(9), respectively, because of its small payroll and property percentages. (Resp. Br., p. 8; Resp.  
22 Br., Appendix A, p. 24.)

23 SRS Lab

24 The auditor determined that the corporation's stock was not "qualified small business  
25 stock" (and, therefore, the gain on its sale did not qualify for exclusion from tax) as a result of his  
26 conclusion that the corporation did not meet the requirements of R&TC section 18152.5, subdivision  
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28 \_\_\_\_\_  
<sup>4</sup> By the term "replacement stocks," apparently means "qualified small business stock" purchased within the 60-day period mentioned in R&TC section 18038.5, subdivision (a), to allow for the deferral of gain.

1 (c)(1), that its stock must have been acquired after August 10, 1993, and that the stock must have been C  
2 corporation stock when it was acquired. The auditor's determination was based on appellant's statement  
3 on his tax return that he acquired the stock on August 1, 1993, and information that the Internal Revenue  
4 Service (IRS) determined that the corporation became an S corporation on July 1, 1993. (Resp. Br., p. 8;  
5 Resp. Br., Appendix A.)

6 With regard to the remainder of the stocks at issue here, the auditor either determined that  
7 the stocks did not meet the statutory requirements of R&TC section 18152.5 or concluded that he had  
8 insufficient evidence that they did.

9 As an additional ground for disallowance of the deferrals claimed by appellant, the  
10 auditor determined that the "replacement stocks" purchased by appellant were not "qualified small  
11 business stock" because he did not provide substantiation establishing: (1) that he acquired "replacement  
12 stocks" within 60 days after the sales of the original "qualified small business stock;" (2) that the  
13 "replacement stocks" were "qualified small business stock;" (3) what were the purchase prices and  
14 purchases date of the "replacement stocks;" and (4) that the "replacement stocks" were acquired at  
15 original issuance. (Resp. Br., pp. 8-9; Resp. Br., Appendix A.)

16 After respondent denied appellant's protest, this timely appeal followed.

### 17 Contentions

18 Appellant's main contention is that R&TC sections 18038.5 and 18152.5 (which,  
19 collectively, appellant characterizes as the "Rollover Provisions") violate the "dormant commerce  
20 clause" of the United States Constitution by discriminating against investors in corporations that operate  
21 to a significant extent outside of California. With regard to the "dormant commerce clause," the United  
22 States Supreme Court has stated that "[t]hough phrased as a grant of regulatory power to Congress, the  
23 [Commerce] Clause has long been understood to have a 'negative' aspect that denies the States the  
24 power unjustifiably to discriminate against or burden the interstate flow of articles of commerce."  
25 (*Oregon Waste Systems, Inc. v. Department of Environmental Quality of Ore.* (1994) 511 U.S. 93, 98.)  
26 In support of its contention, appellant relies heavily upon *Ceridian Corporation v. Franchise Tax Board*  
27 (2000) 85 Cal.App.4<sup>th</sup> 875 ("*Ceridian*") and *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108  
28 Cal.App.4<sup>th</sup> 976 ("*Farmer Bros.*"). He also relies heavily upon such United States Supreme Court cases

1 as *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325 (“*Fulton*”). Although appellant is aware of the  
2 inability of the Board to consider constitutional arguments unless an appellate court has ruled on them,  
3 he states that he is raising the constitutional issue here as a protective measure in the event that an  
4 Appellate court invalidates the Rollover Provisions on constitutional grounds before this case is  
5 decided.<sup>5</sup>

6 In *Ceridian*, the court held that R&TC section 24410 violated the dormant commerce  
7 clause both by allowing a deduction for insurance subsidiary dividends only to corporations domiciled in  
8 California (former R&TC section 24410, subdivision (a)), and in limiting the amount of the deduction  
9 according to a formula based on the subsidiary’s gross receipts, payroll, and property within California  
10 (former R&TC section 24410, subdivision (b)). (*Ceridian Corporation v. Franchise Tax Board, surpa*,  
11 85 Cal.App.4<sup>th</sup> at p. 890.) In *Farmer Bros.*, the court followed the reasoning of *Ceridian* and held that  
12 R&TC section 24402 violated the dormant commerce clause by discriminating against corporations  
13 engaged in interstate commerce. (*Farmer Bros. Co. v. Franchise Tax Board, supra*, 108 Cal.App.4<sup>th</sup> at  
14 pp. 980-981.) R&TC section 24402 afforded to a corporate taxpayer an income tax deduction for a  
15 portion of the dividends it received from another corporation when the dividends were declared from  
16 income that was included in the payer corporation’s measure of California franchise tax, alternative  
17 minimum tax, or corporate income tax. (*Farmer Bros. Co. v. Franchise Tax Board, supra*, 108  
18 Cal.App.4<sup>th</sup> at p. 980.)

19 In *Fulton*, the United States Supreme Court held invalid under the dormant commerce  
20 clause North Carolina’s “intangibles tax,” which taxed “a fraction of the value of corporate stock owned  
21 by North Carolina residents inversely proportional to the corporation’s exposure to [North Carolina’s]  
22 income tax.” (*Farmer Bros. Co. v. Franchise Tax Board, supra*, 108 Cal.App.4<sup>th</sup> at p. 987 (citing *Fulton*  
23 *Corp. v. Faulkner, supra*, 516 U.S. at p. 327).) It noted that residents of North Carolina were “entitled  
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25 <sup>5</sup> Appellant also seemingly states that he is raising the constitutional issue here because he is required to show that he has  
26 exhausted his administrative remedies before proceeding to court. In support of that position, appellant cites *Shiseido*  
27 *Cosmetics America Ltd. v. Franchise Tax Board* (1991) 235 Cal.App.3d 478, 487-488 (“*Shiseido*”). However, *Shiseido* holds  
28 that the taxpayer there was required to file a refund claim specifying grounds for the claim within one year of payment of the  
tax and that the taxpayer’s prepayment protest and appeal cannot be considered a claim for refund. (*Shiseido Cosmetics*  
*America Ltd. v. Franchise Tax Board, supra*, 235 Cal.App.3d at p. 491) As appellant has apparently not paid the tax at issue  
yet, *Shiseido* does not appear to support his position.

1 to calculate their tax liability by taking a percentage deduction equal to the fraction of the issuing  
2 corporation's income subject to tax in North Carolina." (*Farmer Bros. Co. v. Franchise Tax Board*,  
3 *supra* (citing *Fulton Corp. v. Faulkner, supra*, 516 U.S. at p. 328).) The Court concluded that "[t]here is  
4 no doubt that the intangibles tax facially discriminates against interstate commerce," because such a tax  
5 "favors domestic corporations over their foreign competitors in raising capital," and tends "to discourage  
6 domestic corporations from plying their trades in interstate commerce." (*Farmer Bros. Co. v. Franchise*  
7 *Tax Board, supra* (citing *Fulton Corp. v. Faulkner, supra*, 516 U.S. at p. 333).)

8           The courts in *Ceridian* and *Farmer Bros.* determined that the respective statutes at issue  
9 in those cases were also facially discriminatory against interstate commerce but then noted that a facially  
10 discriminatory tax scheme "may be saved from constitutional infirmity if it is a valid 'compensatory tax'  
11 designed simply to make interstate commerce bear a burden already borne by intrastate commerce."  
12 (*Ceridian Corporation v. Franchise Tax Board, supra*, 85 Cal.App.4<sup>th</sup> at p. 885 (citing *Associated*  
13 *Industries of Mo. v. Lohman* (1994) 511 U.S. 641, 647); *Farmer Bros. Co. v. Franchise Tax Board*,  
14 *supra*, 108 Cal.App.4<sup>th</sup> at p. 989.) The court in *Farmer Bros.* explained that the following three  
15 conditions are necessary for a valid compensatory tax: (1) a statute must, as a threshold matter, identify  
16 the intrastate tax burden for which the state is attempting to compensate; (2) the tax on interstate  
17 commerce must be shown roughly to approximate, but not exceed, the amount of tax on intrastate  
18 commerce; and (3) the events on which the interstate and intrastate tax are imposed must be  
19 substantially equivalent. (*Farmer Bros. Co. v. Franchise Tax Board, supra* (citing *Fulton Corp. v.*  
20 *Faulkner, supra*, 516 U.S. at pp. 332-333).) The court in *Ceridian* states that respondent in that case did  
21 not contend that the statute at issue there was a compensatory tax and that, in any event, it would not  
22 have qualified as one. (*Ceridian Corporation v. Franchise Tax Board, supra*, 85 Cal.App.4<sup>th</sup> at p. 886.)  
23 The court in *Farmer Bros.* concluded that, as in *Fulton*, none of the three conditions for a compensatory  
24 tax were met there. (*Farmer Bros. Co. v. Franchise Tax Board, supra*, 108 Cal.App.4<sup>th</sup> at pp. 989-991.)

25           In support of his contention, appellant argues that factual similarities of the Rollover  
26 Provisions to the tax schemes declared unconstitutional in the cases upon which he relies establish that  
27 the Rollover Provisions are facially discriminatory against investors in corporations that operate to a  
28 significant extent in other states. As a concrete example of the facial discrimination caused by the

1 Rollover Provisions against such investors, appellant alleges that he is paying a higher California tax on  
2 his investments in California corporations which grew to such an extent that they had significant  
3 operations outside of California than he would have paid if he had invested in California corporations  
4 which were not similarly successful or corporations that did not operate in California. He alleges further  
5 that he and other investors are inhibited for that reason from investing their capital in California  
6 corporations that might become successful enough to have operations in other states. Finally, appellant  
7 also supports his contention by stating that respondent does not take the position that the Rollover  
8 Provisions are compensatory statutes.

9 Appellant's next contention is apparently that R&TC section 18152.5, subdivision (c)(1),  
10 provides the sole test for the determining whether stock is "qualified small business stock." That part of  
11 the subdivision states that, "except as otherwise provided," the term "qualified small business stock"  
12 essentially means any stock in a C corporation that is originally issued after August 10, 1993, if (A) at  
13 the date of issuance, the corporation is a qualified small business and (B) with certain exceptions, the  
14 stock is acquired by the taxpayer at its original issue either for money or other property (not including  
15 stock) or for services. In conjunction with that contention, appellant takes the position that neither  
16 subdivision (c)(2)(A) nor subdivision (e)(9) of section 18152.5 should be interpreted literally, as  
17 respondent has acknowledged that it has done, because such an interpretation is unduly restrictive and  
18 inconsistent with the intent of the Legislature. Subdivision (c)(2)(A) provides that stock in a corporation  
19 shall not be treated as qualified small business stock unless, during substantially all of a taxpayer's  
20 holding period for the stock, the corporation meets the active business requirements of subdivision (e)  
21 and the corporation is a C corporation. Subdivision (e)(9) modifies subdivision (e)(1), which provides  
22 that, for purposes of subdivision (c)(2), the requirements of subdivision (e) are met by a corporation for  
23 any period if, during that period, (A) at least 80 percent of the assets of the corporation are used by the  
24 corporation in the active conduct of one or more qualified trades or businesses in California and (B) the  
25 corporation is an "eligible corporation." Subdivision (e)(9) states specifically that a corporation shall  
26 not be treated as meeting the requirements of subdivision (e)(1) for any period during which more than  
27 20 percent of the corporation's total payroll expense is attributable to employment located outside of  
28 California.

1 Appellant supports his position regarding R&TC section 18152.5, subdivisions (c)(2)(A)  
2 and (e)(9), by arguing that the purpose of the Rollover Provisions would be defeated if respondent's  
3 interpretation of those subdivisions was correct because the very success of the businesses with which  
4 the Rollover Provisions were concerned would result in disallowance of their tax benefits. In addition,  
5 appellant points out that there are no corresponding provisions to subdivisions (c)(2)(A) and (e)(9) in the  
6 federal statutes upon which the Rollover Provisions are modeled.<sup>6</sup> With regard to subdivision (e)(9) in  
7 particular, appellant also argues that the subdivision would be redundant if respondent's view of that  
8 provision was correct because it basically restates the provisions of R&TC section 18152.5, subdivision  
9 (d)(1)(C), which applies at the date of issuance. Finally, appellant points out that subdivision (e)(9) is  
10 not addressed in respondent's questionnaire regarding small business stock (Form 3565) that a  
11 corporation completes at the end of an accounting period in which stock was issued to assist the  
12 California legislature in determining the effectiveness of the small business stock incentives.

13 Appellant's final contention is that SRS Lab satisfied the requirement of R&TC section  
14 18152.5, subdivision (c)(1)(A), that its stock was in a C corporation when it was acquired. Appellant  
15 argues that his stock in SRS Lab remained C corporation stock until the election of SRS Lab to become  
16 an S corporation was accepted by the Internal Revenue Service ("IRS") on October 11, 1993. Further,  
17 he argues that it would be unfair to treat that stock as S corporation stock retroactively because he had  
18 no knowledge of or control over the election by SRS Lab to become an S corporation.

19 Respondent contends that the Board has no jurisdiction to consider the constitutionality  
20 of the Rollover Provisions. It notes that, under section 3.5 of Article III of the California Constitution, it  
21 is required to enforce the Rollover Provisions until an appellate court has determined that they are  
22 unconstitutional and that neither the Board nor respondent may invalidate them until an appellate court  
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24 <sup>6</sup> Internal Revenue Code ("IRC") section 1202(a)(1) provides that, in the case of a taxpayer other than a corporation, gross  
25 income shall exclude 50 percent of any gain from the sale or exchange of qualified small business stock held for more than 5  
26 years. IRC section 1202(c) provides the federal definition of "qualified small business stock."

27 IRC section 1045(a) provides that, in the case of any sale of qualified small business stock held by a taxpayer other than a  
28 corporation for more than six months and with respect to which such taxpayer elects the application of that section, gain from  
such sale shall be recognized only to the extent that the amount realized on such 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 such sale, reduced by (2)  
any portion of such cost previously taken into account under that section. IRC section 1045(b)(1) provides that the term  
"qualified small business stock" has the same meaning for that section as the meaning given that term by IRC section  
1202(c).

1 has made that determination. With regard to the actual constitutionality of the Rollover Provisions,  
2 respondent contends that they satisfy the dormant commerce clause because (1) they apply equally to  
3 corporations that were incorporated in California and those that were incorporated outside of California  
4 and (2) both interstate and intrastate commerce are equally impacted by them. Respondent also  
5 distinguishes *Ceridian* on the basis that, unlike that case, investors in either a foreign or domestic  
6 corporation can qualify for an exclusion from gain even if all of its sales are outside of California.

7           Respondent further contends that if the Rollover Provisions are unconstitutional,  
8 appellant would not receive the tax benefits that he seeks because California would no longer have  
9 provisions allowing for the deferral or exclusion from gain. In support of that contention, respondent  
10 relies upon language in *Kopp v. Fair Pol. Practices Com.* (1995) 11 Cal.4<sup>th</sup> 607, 661, that a statute may  
11 be reformed to preserve it against invalidation when “(i) it is possible to reform the statute in a manner  
12 that closely effectuates policy judgments closely articulated by the enacting body, and (ii) the enacting  
13 body would have preferred the reformed construction to the invalidation of the statute.” Respondent  
14 argues that if the Rollover Provisions contain constitutional infirmities, they can be remedied only by  
15 invalidating them in their entirety because the California legislature intended that the incentives  
16 contained in them should be available only for investments in California businesses. In that regard,  
17 respondent points out that the Legislature specifically stated in R&TC sections 18152 and 18038.4,  
18 respectively, that the federal provisions for deferral and exclusion of gain would not apply in California  
19 and then enacted sections 18152.5 and 18038.5, which substantially adopt the federal provisions but  
20 include language limiting the incentives to California businesses. In reply, appellant takes the position  
21 that even if reformation of the Rollover Provisions is not possible, they can be interpreted in such a  
22 manner that they would not apply the offending provisions, with the result that California businesses  
23 would continue to benefit from the desired incentives. Appellant points out, for example, that an  
24 interpretation of that kind would allow the benefits of the Rollover Provisions to be received by  
25 California businesses that grew and expanded outside of California. Appellant also seemingly argues  
26 that any loss of benefits resulting from excising the offending provisions should occur prospectively  
27 through the action of the Legislature.

28           In addition, respondent contends that R&TC section 18152.5, subdivisions (c)(2)(A) and

1 (e)(9), should be applied as written. Respondent argues that the express statutory language of section  
2 18152.5, taken as a whole, clearly indicates that the “payroll test” should be applied not only at the time  
3 of the acquisition of stock under subdivision (d)(1)(C) but also during “substantially all” of a taxpayer’s  
4 holding period for the stock under subdivisions (c)(2)(A) and (e)(9). Respondent also states that the  
5 legislative history, as well as the plain language, of the Rollover Provisions shows that they were drafted  
6 to conform to their federal counterparts but with the exception that they were limited to California  
7 businesses. Finally, respondent addresses appellant’s position that the lack of discussion of R&TC  
8 section 18152.5, subdivision (e)(9), in Form 3565 shows that the provision is essentially nugatory by  
9 pointing out that the form is not intended to be an exhaustive and binding interpretation of California  
10 law relating to qualified small business stock.

11 Respondent acknowledges in its discussion of the “substantially all” requirement of  
12 R&TC section 18152.5, subdivision (c)(2)(A), that there is no definition of “substantially all” in the  
13 Rollover Provisions. After examining numerous provisions of other parts of the R&TC, the IRC, and  
14 regulations under the IRC to ascertain an appropriate definition of “substantially all,” respondent  
15 selected “85 percent” as a benchmark for “substantially all” in the context of the Rollover Provisions.  
16 Respondent also notes that the Board has held that “substantially equivalent,” as used in R&TC section  
17 20509, can be reasonably defined as at least 80 percent.<sup>7</sup> (*Appeals of Helen Cantor, et al.*, 2002-SBE-  
18 008, Nov. 13, 2002.) Appellant rejects the benchmark of 85 percent for “substantially all” in the context  
19 of the Rollover Provisions as arbitrary. He states that “[the] Board’s opinion in *Cantor* confirms that the  
20 ‘substantially all’ definition is ‘inherently imprecise’ ”and that “*Cantor* does not aid Respondent’s  
21 position.” (App. Supp. Br. at p. 6.) With regard to respondent’s benchmark of 85 percent, appellant  
22 disputes the statement in respondent’s reply brief that “appellant held the SRS stock from August 1993  
23 until February or March of 2000. As a result, respondent’s auditor determined that SRS was a C  
24 corporation between 73 and 75 percent of appellant’s holding period.” (Resp. Reply Br., p. 3.)  
25 Appellant takes the position that if respondent’s calculations had taken into account the correct number  
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28 <sup>7</sup> R&TC section 20509 provides, in pertinent part, that a “rented residence,” for purposes of property tax assistance, does not include premises exempt from property taxation, except those premises on which the owner makes payments that are substantially equivalent to property taxes paid on properties of comparable market value.

1 of months, the result would be that SRS was a C corporation for 80 percent of appellant's holding  
2 period. (App. Supp. Br., pp. 3-5.) Appellant argues that 80 percent satisfies the "substantially all"  
3 requirement of R&TC section 18152.5, subd. (c)(2)(A), and implicitly takes the position that *Cantor*  
4 actually supports his argument. In addition, appellant states that respondent mistakenly determined that  
5 US Web did not satisfy the "substantially all" requirement because respondent allegedly did not take  
6 into account increases and decreases in the value of property held by that corporation which were not  
7 reflected on its tax returns and the value of intangible assets that the corporation held.

8 Respondent also contends that the SRS Lab stock was not qualified small business stock  
9 under R&TC section 18152.5, subd. (c)(1), because it was allegedly not C stock on the date of its  
10 acquisition by appellant. Respondent states that appellant's tax return for 2000 indicates that he  
11 acquired the SRS Lab stock on August 1, 1993, and that the IRS determined the election of SRS Lab to  
12 become an S corporation became effective on July 1, 1993. Respondent cites IRC section 1362(c) for  
13 the proposition that a Subchapter S election is effective for a corporation's entire taxable year and states  
14 that the annual report of SRS Lab supports its position that the corporation was an S corporation on July  
15 1, 1993, after having been incorporated in June of that year. Finally, respondent points out that  
16 appellant has cited no authority for his position that his SRS Lab stock did not become qualified small  
17 business stock until the IRS accepted the election for status as an S corporation on October 11, 1993.

18 In addition, respondent originally contended that even if the SRS stock was C corporation  
19 stock on the date of its acquisition by appellant, the stock does not meet the requirement of R&TC  
20 section 18152.5, subd. (c)(1), that the stock was acquired after August 10, 1993. However, even though  
21 appellant stated on his tax return that he acquired the SRS Lab stock on July 1, 1993, he has  
22 subsequently provided documentary evidence that he actually acquired the stock on August 31, 1993.  
23 Appellant notes that his accountant's error in setting forth the incorrect date on his return was not  
24 surprising given other errors he made (including ignoring differences between the federal and California  
25 rollover statutes), as well as the large number of securities transactions reflected on appellants returns.  
26 Appellant further notes that the best evidence of the date of acquisition are the records of SRS, which  
27 reflect the August 31, 1993, acquisition date. Although it is not completely clear, respondent does not  
28 appear to dispute that those documents establish the date of acquisition of the SRS Lab stock.

1           Applicable Law

2           The United States Constitution gives Congress the power to regulate commerce between  
3 the states. (U.S. Const., art. I, § 8, cl. 3.) The California Constitution prohibits, in pertinent part, an  
4 administrative agency from refusing to enforce a statute unless an appellate court has determined that  
5 the statute is unconstitutional. (Cal. Const., art. III, § 3.5.)

6           R&TC section 18038.5, subdivision (a), provides generally that, in the case of any sale of  
7 qualified small business stock held by a taxpayer other than a corporation for more than six months and  
8 with respect to which that taxpayer has made an election under that section, gain from that sale shall be  
9 recognized only to the extent that the amount realized on that sale exceeds: (1) the cost of any qualified  
10 small business stock purchased by the taxpayer during the 60-day period beginning on the date of that  
11 sale, reduced by (2) any portion of the cost previously taken into account under that section. R&TC  
12 section 18038.5, subdivision (b)(1), states that the term “qualified small business stock” has the meaning  
13 given that term by section 18152.5, subdivision (c). R&TC section 18038.4 provides that IRC section  
14 1045 is inapplicable in California.

15           R&TC section 18152.5, subdivision (a), provides that gross income shall not include 50  
16 percent of any gain from the sale or exchange of qualified small business stock held for more than five  
17 years. R&TC section 18152.5, subdivision (c)(1), provides that the term “qualified small business  
18 stock” means any stock in a C corporation that is originally issued after August 10, 1993, if both of the  
19 following requirements are met: (A) as of the date of issuance, the corporation is a qualified small  
20 business and (B) except as otherwise provided in certain subdivisions, the stock is acquired by the  
21 taxpayer at the original issue (directly or through an underwriter) either (i) in exchange for money or  
22 other property (not including stock) or (ii) as compensation for services provided to the corporation  
23 (other than services performed as an underwriter of the stock). R&TC section 18152.5, subdivision  
24 (c)(2)(A), provides that stock in a corporation shall not be treated as qualified small business stock  
25 unless, during substantially all of the taxpayer’s holding period for the stock, the corporation meets the  
26 active business requirements of subdivision (e) and the corporation is a C corporation.

27           R&TC section 18152.5, subdivision (d)(1), provides that the term “qualified small  
28 business” means any domestic corporation (as defined in IRC section 7701(a)(4)) that is a C corporation

1 and meets a number of other requirements, including the requirements stated in subdivision (d)(1)(C).  
2 R&TC section 18152.5, subdivision (d)(1)(C), provides that at least 80 percent of the corporation's  
3 payroll, as measured by total dollar value, must be attributable to employment located within California.

4 R&TC section 18152.5, subdivision (e)(1), provides that, for purposes of subdivision  
5 (c)(2), the requirements of subdivision (e)(1) are met by a corporation for any period if during that  
6 period both of the following requirements are met: (A) at least 80 percent (by value) of the assets of the  
7 corporation are used by the corporation in the active conduct of one or more qualified trades or  
8 businesses in California and (B) the corporation is an eligible corporation. R&TC section 18152.5,  
9 subdivision (e)(9), provides that a corporation shall not be treated as meeting the requirements of  
10 subdivision (e)(1) for any period during which more than 20 percent of the corporation's total payroll  
11 expense is attributable to employment located outside of California. R&TC section 18152.5,  
12 subdivision (e)(3), provides that the term "qualified trade or business" means any trade or business other  
13 than certain enumerated exceptions. R&TC section 18152.5, subdivision (e)(4), provides that the term  
14 "eligible corporation" means any domestic corporation other than certain enumerated exceptions.  
15 R&TC section 18152, subdivision (a), provides that IRC section 1202 is inapplicable in California.

16 It is well settled that a presumption of correctness attends respondent's determinations as  
17 to issues of fact and that appellant has the burden of proving such determinations erroneous. (*Appeal of*  
18 *Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Jun. 29, 1980.) This presumption is, however, a  
19 rebuttable one and will support a finding only in the absence of sufficient evidence to the contrary.  
20 (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) Respondent's determination cannot, however, be  
21 successfully rebutted when the taxpayer fails to present uncontradicted, credible, competent, and  
22 relevant evidence to the contrary. (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) To overcome the  
23 presumed correctness of respondent's findings as to issues of fact, a taxpayer must introduce credible  
24 evidence to support his assertions. When the taxpayer fails to support his assertions with such evidence,  
25 respondent's determinations must be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer, supra.*) A  
26 taxpayer's unsupported assertions are not sufficient to satisfy his burden of proof. (*Appeal of James C.*  
27 *and Monablanche A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

28 The basic rule of statutory construction is that the intention of the Legislature be

1 ascertained and given effect. (*Marrulo v. Hunt* (1977) 71 Cal.App.3d 972, 977.) In ascertaining that  
2 intention, a statute must be read and considered as a whole, and each section must be reconciled with the  
3 other and given effect, if possible. (*Marrulo v. Hunt, supra.*)

4 STAFF COMMENTS

5           The parties should be prepared to discuss whether only subdivision (c)(1) should be  
6 considered in interpreting the requirements of R&TC section 18152.5 when the principles of statutory  
7 construction under *Marrulo* and numerous other cases seem to require that subdivisions (c)(1) and  
8 (c)(2)(A) be considered together in interpreting that statute. Both parties should also be prepared to  
9 provide any authority of which they are aware that directly or indirectly addresses the issue regarding  
10 the date a corporation becomes an S corporation for purposes of R&TC Code section 18152.5,  
11 subdivision (c)(1).

12           Appellant should provide evidence at the hearing that an appellate court is considering or  
13 has considered the constitutionality of the Rollover Provisions. In addition, appellant should provide  
14 evidence that it has not previously provided to respondent that any of the stock with respect to which  
15 respondent’s auditor made disallowances satisfied the requirements of the Rollover Provisions. In  
16 particular, appellant should provide evidence that shows that US Web satisfied the “substantially all”  
17 requirement of R&TC Code section 18152.5, subdivision (c)(2)(A). Respondent should be prepared to  
18 clarify its position regarding whether the documentary evidence provided by appellant establishes the  
19 date on which he acquired the SRS Lab stock.

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