

Appeal of David and Judith G. Kleitman

David Kleitman, hereinafter referred to as 'appellant,' was an officer of Signetics Corporation. In 1971 he entered into a nonqualified stock option agreement with Signetics which permitted him to purchase, within six years, 1,120 shares of Signetics stock for \$4.125 a share. In 1973 Signetics decided to sell its stock publicly and developed a prospectus which listed the sale price of the stock at \$18.00 a share. Appellant was informed of the proposed public sale.

On October 23, 1973, appellant exercised his option and he received his Signetics stock three days later. Signetics prepared a second prospectus November 1, 1973, listing the stock at \$17.00, the price determined by the board of directors based upon an independent appraisal. Some stock was subscribed on November 2, 1973, for \$17.125 a share and the issue was over-subscribed within a week, when the price was reduced to \$16.75 a share.

In valuing the shares sold to appellant Signetics used the \$18.00 price and included \$15,540.00 (\$18.00 less option price of \$4.125 x 1,120 shares) as income on appellant's W-2 form for 1973. On his 1973 return appellant adjusted the value of the stock downward to \$12.00 a share and deducted \$6,720 from the amount shown on the W-2 form. Appellant contends that he was entitled to compute the value of the stock on that basis because \$12.00 was the first reasonably stable market price ^{1/} and was the value at the time when restrictions against transfer of the stock by appellant lapsed. According to appellant, those restrictions were (1) section 16(b) of the Securities Exchange Act of 1934 which provides that an insider may be required to pay any gain to his employer if stock purchased pursuant to a stock option plan is sold within six months, (2) directions from appellant's employer not to sell the stock,, and (3) the duty of officers not to trade on inside information for short-term gain. Appellant relied on California Administrative Code, title 18, regulation 17531-17540(f), which covered non-statutory stock options until it was superseded by the enactment of Revenue and Taxation Code section 17122.7.

^{1/} Appellant furnished evidence upon audit that the stock was selling for about \$12.00 a share within three weeks of the first public sale; it remained at this level for over six months before declining further.

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Respondent advised appellant that pursuant to Revenue and Taxation Code section 17122.7, subdivision (a) the correct amount of appellant's compensation was the difference between the stock option price and the fair market value of the shares on the date of purchase. Respondent determined that the fair market value when appellant exercised his option was \$17.00, the price set by the board of directors and the public sale price within ten days of appellant's exercise of his option. This valuation increased appellant's income by **\$5,600.00** (\$5.00 a share) over the amount he had reported. Accordingly, a proposed assessment of \$492.78 was issued. Appellant's protest against this assessment was denied and this timely appeal followed.

The issues to be **decided are** (1) whether appellant realized income upon receipt of the stock or at some later date, and (2) whether respondent properly determined the fair market value of appellant's stock.

The stock option plan in question here is of the type now covered by Revenue and Taxation Code section 17122.7, enacted in 1971. That section is substantially identical to Internal Revenue Code section 83, which was enacted in 1969 with the intent to eliminate the unfair tax advantages resulting from the treatment of stock purchased under nonstatutory stock option plans. The principal advantages were that the imposition of tax on the value of the shares was deferred until any restrictions affecting the value lapsed, and any appreciation between the time of acquisition and the lapse of the restriction was taxed, if at all, as a capital gain. Thus, taxpayers participating in such restricted stock plans received the benefits of deferring the realization of income and acquiring an interest in their employer's business, without meeting any of the specific requirements which Congress established for the favorable treatment of stock options. (S. Rep. No. 91-552, 91st Cong., 1st Sess. (1969) [1969 U. S. Code Cong. & Adm. News 2152].)

To correct this situation, section 83 and section 17122.7 were added to the federal and California income tax law, respectively. Those sections provide that income from restricted stock options transferred to an employee as compensation shall be recognized upon receipt of the shares, unless the stock is subject to a substantial risk of forfeiture or cannot be transferred to a third party free of such risk. (Int. Rev. Code of 1954, §83(a); Rev. & Tax. Code, § 17122.7, subd. (a).) Furthermore, income is to be measured without

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regard to any restriction, except a restriction which by its terms will never lapse. (Id.) The measure of taxable income is the excess of the fair market value of the property 'over 'the amount paid for it.

There are no regulations interpreting section 17122.7; therefore, in applying that section, we may refer to Treasury' regulations and federal court decisions interpreting section 83. (See Cal. Admin. Code, tit. 18, reg. 19253; see also Meanley-v. McColgan, 49 Cal. App. 2d 203 [121 P.2d 45] (1942).)

Regulation §1.83-3 defines "substantial risk of forfeiture" and "transferability'of property," the conditions that, determine **whether** appellant realized income upon receipt of the shares. A substantial risk of forfeiture exists'wherec rights in the stock are conditioned on the performance of additional substantial services by the employee. (Treas. Reg. § 1.83-3(c).) No such requirement **was** imposed on appellant. Further, property is considered transferable for nurposes of **section 83** if the transferee's rights are not subject to a substantial risk of forfeiture; that is, the property may be sold, assigned, or 'pledged to another party other than the transferor and the transferee is not required to give up the shares or their value if the substantial risk of forfeiture materializes. (Treas. Reg. § 1.83-3(d).) In the instant case, nothing prevented appellant from transferring his shares in any of the ways described above. Section 16(b) of the Securities Exchange Act of 1934 does not, as appellant claims, restrict the transferability of shares but simply provides for the return to the corporation of profits from inside trading. (Theodore M. Horwith, 71 T.C. 932 (1979).) We also believe **that** the other restrictions argued herein by appellant had no effect on the transferability of the shares since they would in no 'way subject a transferee's rights in the stock to a risk of forfeiture. Accordingly, we find that appellant recognized income upon receipt of the shares.

The question remaining is **whether** the value of the shares was determined properly by respondent, Appellant argues that the correct value was the market price when restrictions against transfer by him lapsed. For the reasons stated below, we do not agree.

First, we have determined that appellant recognized income upon receipt of the shares. Section 17122.7 provides that the measure of that income is the excess of the fair market value of the shares, determined without regard to **nonlapse** restrictions, over the amount paid. Clearly, by its terms Securities Exchange Act, section 16(b) is not a **nonlapse** restriction. In Theodore il. Horwith, supra, the Tax Court rejected

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the argument that potential application of **section 16(b)** reduced the fair market value of the taxpayer's stock and held that the shares must be valued on the date issued. (See also Treas. Reg.. § 1.83-3(h).) It is equally clear that the other claimed restrictions were not nonlapsing and are therefore to be disregarded.

We are convinced that respondent correctly set the value of appellant's shares at \$17.00 by using the market price of the first public sale of Signetics stock, which occurred about ten days after appellant exercised his option. Not only did the stock actually sell at this price but it was the value accepted by Signetic's board of directors following an independent appraisal. We find that these facts are reliable evidence that \$17.00 was the correct fair market value of appellant's shares when he received them.

For the above reasons, respondent's action in this matter must be sustained.

O R D E R

Pursuant to the views **expressed** in the opinion of the board on file in this proceeding; and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of David and Judith G. Kleitman against a proposed assessment of additional personal income tax in the amount of \$492.78 for the year 1973, be and the same is hereby sustained.

Done at Sacramento, California, this 14th day of November , 1979, by the State Board of Equalization.

William W. Bennett, Chairman
Paul G. ..., Member
Robert ..., Member
..., Member
..., Member