

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
JAMES F. AND DEBORAH J. CAHILL) NO. 86R-1273-KP
)

For Appellants: Daniel J. Gatto
Certified Public Accountant

For Respondent: B. (Bill) S. Heir
Counsel

O P I N I O N

This appeal is made pursuant to section 19057, subdivision (a), 1 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying to the extent of \$43,545 the claim of James F. and Deborah J. Cahill for refund of personal income tax in the amount of \$81,445 for the year 1984.

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

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The issue presented by this appeal is whether appellants should be able to exclude from their 1984 income, the bargain element of stock options which the Franchise Tax Board determined were exercised during 1983.

For 1983 and 1984, Mr. Cahill was an employee and an officer of the Price Company. Due to his position with the corporation, Mr. Cahill received options to acquire, his company's stock pursuant to two plans drafted under sections 421 and 422A of the Internal Revenue Code. Appellants exercised those options on July 28, 1983, and March 6, 1984.

Appellants filed a joint tax return for 1984 which reported the bargain element of the options as ordinary income. During July 1985, appellants became aware of a change in the federal tax laws which exempted certain stock option transactions from gross income. AS appellants' stock option transactions met the requirements of the federal law, and, due to California tax law's general conformity with the Internal Revenue code (IRC), Mr. and Mrs. Cahill filed an amended return for 1984 excluding the bargain element of the options from income. Accordingly, the Franchise Tax Board (FTB) treated the amended return as a claim for refund in the amount of \$81,445.

The FTB reviewed appellants' claim and determined that, in this particular instance, California's law did not fully conform to federal law. According to the FTB's interpretation of the Revenue and Taxation code, only those stock options exercised after January 1, 1984, were available for income exclusion. Consequently, the FTB allowed an exclusion for those options exercised on March 6, 1984, but disallowed the claim with regard to those options determined were exercised during July 1983. Appellants appeal from this partial denial.

Section 17514, subdivision (b), states, in relevant part, that:

For taxable years beginning on or after January 1, 1984, the provisions of Section 422A of the Internal Revenue code shall apply with respect to [stock] options granted on or after January 1, 1976, and exercised on or after January 1, 1984.

As stated above, there is no dispute that all of the options in question qualified for income exclusion under sections 421 and 422A of the IRC. The conflict

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between the parties revolves **around the** interpretation of section 17514, subdivision **(b)'s**, wording "exercised on or after January 1, **1984.**" The FTB takes the position that the statute means what it states, that in order for a taxpayer to take advantage of section 422A with regard to the taxpayer's California tax liability, that taxpayer must have exercised his options after January 1, 1984. Since the first options **were** exercised in 1983, the FTB argues that they fail to qualify under section 17514 for the treatment accorded the second set of options which were exercised in 1984.

Appellants take the position that the options initially exercised on July 29, 1983, did not become fully exercised until after January 1, 1984. This argument is based upon California's incorporation of section 83 of the IRC into its tax laws. (See Rev. and Tax. code, section 17081.) As **applicable** to this appeal, section 83 of the IRC defers recognition of the bargain element of a stock option where the stock is considered to be subject to a substantial risk of forfeiture and non-transferable, such as property subject to section 16(b) of the Securities and Exchange Act of 1934, until the stock is no longer so encumbered. (I.R.C. **§ 83(c).**) **Section 16(b) of the Securities and Exchange Act of 1934**, the so-called "insider trading rules," does **not** allow any officer deemed to be an "insider," as Mr. Cahill was in this instance, to buy or sell **shares** of stock of his employer within the same six-month interval. In other words, if Mr. Cahill purchased the stock in question on July 29, 1983, he was unable to sell the stock until the end of January 1984, six months later. Appellants argue that since Mr. Cahill could not sell the stock until January 1984, the first stock option was not fully exercised until that date. Therefore, appellants conclude, since the first option was not fully exercised until after January 1, 1984; section 17514 was complied with and appellants' income from the exercise of the first stock option should also be excluded for that year.

While initially appealing, appellants' argument fails under scrutiny. Section 83, subsection (c), provides that when property is transferred in exchange for services **the income** represented by the property is included in the income of the person who performed the services in the first taxable year in which the rights in that property either are transferable or are not subject to a substantial risk of forfeiture. Section 83 simply defers recognition of income until such time as a taxpayer realizes unrestricted use of the property. Hence, the

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reason why appellants did not recognize the income from the exercise of the 1983 options until 1984. Section 83 does not, however, change the date the stock options were actually exercised. When a taxable event occurs it is a distinct question separate from the issue of when proceeds from that event will be recognized as income to a taxpayer.

When California conformed its tax laws with regard to deferred compensation, IRC sections 401 through 425, it did not do so without reservation. Section 17501 specifically states that California's conformity **is complete** "except as otherwise provided in this chapter." Section 17514 is such an exception. The California Legislature specifically decided that section **422A** of the **IRC**, which **exempts certain stock options from tax** would only apply, with regard to determining a taxpayer's California tax liability, to those stock options that were exercised after January 1, 1984. AS appellants' **first** options were exercised in July 1983, they fail to qualify under the clear language of section 17514.

Accordingly the action of the Franchise Tax Board in this matter will be sustained.

