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

10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **LEO R. BOESE**¹) Case No. 547667

	<u>Year</u>	<u>Claim For Refund</u>
	2007	\$250,206 ²

17 Representing the Parties:

18 For Appellant: Jay L. Larsen, CPA, JD
19 Kruse Mennillo, LLP

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

22 QUESTION: Whether appellant has shown respondent erred in denying his claim for refund
23 based upon an asserted qualified small business stock (QSBS) transaction.

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27 ¹ Appellant resides in Long Beach, California.

28 ² This is the amount of tax paid for which appellant is requesting a refund. The amount listed on appellant's appeal letter is \$2,658,342, which represents the disallowed exclusion of gain from the sale of stock claimed on appellant's amended return.

1 HEARING SUMMARY

2 Background

3 On April 14, 2000, appellant entered into an amended and restated stock purchase
4 agreement with AutoNation, Inc., to purchase the Manhattan Beach Toyota Dealership³ (aka Manhattan
5 Beach Motors).⁴ (Appeal Letter, exhibit B.) On June 20, 2000, appellant formed Lebo Automotive, Inc.
6 (Lebo Automotive), doing business as Manhattan Beach Toyota, Inc.⁵ The company was incorporated
7 in Delaware. (*Id.* at exhibit D.) Lebo Automotive qualified to do business in California on July 13,
8 2000. (Resp. Op. Br., exhibit E.)

9 The parties disagree as to the form of the subsequent acquisition of stock in Lebo
10 Automotive. Respondent contends that appellant exchanged his stock in Manhattan Beach Toyota for
11 stock in Lebo Automotive. (Resp. Op. Br., p. 4.) Respondent cites to the statements of appellant's
12 representative at the audit, asserting that Manhattan Beach Toyota was merged into Lebo Automotive
13 under a Delaware merger statute and Internal Revenue Code (IRC) section 368(a), with appellant
14 receiving 17,000 shares, with a par value (stated as \$1,700,000) equal to the fair market value of the
15 assets and cash attributed to the merger. The statements note that the Lebo Automotive stock did not
16 exist until appellant exchanged the Manhattan Beach Toyota shares for it. (*Id.* at p. 4 & exhibit F.)
17 Appellant contends that the acquisition of the Lebo Automotive stock was not transacted through a
18 merger under IRC section 368(a), but rather was an asset purchase under IRC section 338(h)(10).⁶
19 (App. Reply Br., p. 3.)

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22 ³ The dealership also included a Ford division (Manhattan Ford), but that section of the dealership was dissolved prior to
23 appellant taking over the business because Ford Motor Company did not approve of the transfer of ownership. (Appeal
24 Letter, exhibit B, p. 1.)

25 ⁴ The actual closing date of the purchase is not clear, but respondent contends it appears to be sometime prior to July 13,
26 2000, when certain conditions to the agreement were either met or waived or the parties mutually agreed. (Resp. Op. Br.,
27 p. 4; Appeal Letter, exhibit B, p. 2.)

28 ⁵ Lebo Automotive is also referred to by the parties as the "New Manhattan Beach Toyota," while the original Manhattan
Beach Toyota apparently purchased by appellant on April 14, 2000, from AutoNation is referred to as the "Old Manhattan
Beach Toyota."

⁶ Appellant acknowledges its prior representative asserted the acquisition was a merger under IRC section 368(a), but asserts
now that that position is factually incorrect. (App. Reply Br., p. 3; see Appeal Letter, pp. 3 & 4.)

1 Appellant sold his Lebo Automotive stock on March 16, 2007, reporting a gain of
2 \$5,316,683. (Appeal Letter, exhibit E: 2007 Forms 1040X and 540X.) On his amended return,
3 appellant claimed a 50 percent exclusion of that gain, in the amount of \$2,658,342, which reduced his
4 tax liability by \$250,206. (*Ibid.*) Respondent treated this adjustment as a claim for refund in the amount
5 of \$250,206, and denied the claim. (Appeal Letter, exhibit A.) This timely appeal followed.

6 Contentions

7 Appellant's Contentions

8 Appellant argues the \$2,658,342 gain from the sale of his Lebo Automotive stock should
9 be excluded from capital gains because the stock was original issue stock issued in exchange for the
10 assets of Manhattan Beach Toyota; Lebo Automotive was actively engaged in a trade or business for
11 "substantially all" of the taxpayer's holding period; and Lebo Automotive "was not engaged in the
12 activity of investing but rather acquired Manhattan Beach Toyota as an asset purchase for income tax
13 purposes pursuant to its IRC section 338(h)(10) election." (App. Reply Br., p. 2.) Appellant refers to
14 the stock purchase agreement which provides for an IRC section 338(h)(10) election to treat the
15 transaction as an asset purchase (Appeal Letter, exhibit B, pp. 18-19); Lebo Automotive's 2000 tax
16 return shows an IRC section 338(h)(10) election was recorded on the return (*Id.* at exhibit C, p. 6); the
17 lack of any merger documents between Manhattan Beach Toyota and Lebo Automotive (*Ibid.*); and
18 asserts Lebo Automotive's tax year beginning on July 17, 2000, is consistent with a split tax year
19 between Manhattan Beach Toyota and Lebo Automotive (*Id.* at exhibit C). (App. Reply Br., p. 3.)

20 Appellant asserts 17,000 shares of Lebo Automotive original issue stock were exchanged
21 for \$1,700,000 in assets from appellant on or about June 20, 2000, and constituted the initial
22 capitalization of Lebo Automotive. Appellant argues that this transaction was not a merger or an
23 exchange of stock for stock.⁷ (*Ibid.*; Appeal Letter, exhibit G.)

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26 ⁷ As noted in footnote 6 above, appellant originally asserted Lebo Automotive purchased all the outstanding shares and assets
27 of Manhattan Beach Toyota, and thereby effectuated a merger. (Appeal Letter, p. 7.) However, it appears from appellant's
28 reply brief that he no longer asserts there was an exchange of stock for stock or a merger. Appellant also asserted in the
appeal letter that the transaction resulted in the cancellation of Manhattan Beach Toyota stock, as happens when a parent
corporation purchases all the stock and assets of a subsidiary (in a merger fashion). (*Ibid.*) Appellant should clarify at the
hearing its interpretation of the effect Lebo Automotive's exchange of stock for appellant's interest in Manhattan Beach
Toyota had on the Manhattan Beach Toyota stock.

1 Respondent's Contentions

2 Respondent contends appellant is attempting to take advantage of the QSBS gain
3 exclusion indirectly by using the Lebo Automotive stock, since he cannot directly claim the gain
4 exclusion for his purchase of Manhattan Beach Toyota stock because he bought stock from another
5 shareholder rather than original issue stock from a qualified small business. (Resp. Reply Br., pp. 1-2.)
6 Respondent contends appellant asserts in his reply brief that the purchase of the Manhattan Beach
7 Toyota dealership assets was performed by Lebo Automotive, the newly formed corporation, and not
8 appellant as an individual. Respondent asserts this is incorrect, since no documents, including the
9 purchase agreement, show Lebo Automotive as the purchaser, and the company was not incorporated
10 until approximately two months after appellant entered into the stock purchase agreement with
11 AutoNation. (*Id.* at pp. 4-5.) Furthermore, regardless of the technical aspects of the transactions at
12 issue, respondent asserts the end result test shows that appellant as the individual was the purchaser of
13 the Manhattan Beach Toyota stock, which had been in business for approximately 11 years and does not
14 qualify for the QSBS 50 percent gain exclusion. (*Id.* at p. 9, quoting *Commissioner v. Court Holding*
15 *Co.* (1945) 324 U.S. 331, 334.)

16 Respondent concedes that an IRC section 338(h)(10) election allows for a stock purchase
17 agreement to be treated as an asset sale, but asserts there was no IRC section 338(h)(10) election here.
18 (Resp. Reply Br., p. 5.) Even though there is a clause in the purchase agreement discussing an option
19 for an IRC section 338(h)(10) election, respondent contends the election can only apply when the
20 purchaser is a corporation, not an individual like appellant, and there is a lack of documentation showing
21 that a timely election was made. (See, e.g., *Id.* at pp 5-7 & exhibit H.) Respondent states that the only
22 written record of the claimed election is a statement in Lebo Automotive's 2000 return, unsigned and
23 filed September of 2001, after the nine-month election period which ended in April of 2001. (*Id.* at
24 pp. 5-8; Int.Rev. Code § 338(g)(1); Treas. Reg., § 1.338(h)(10)-1T(c)(2).)⁸ Respondent further states
25 that Treasury Regulation 1.338-3(b)(1) provides that an individual (appellant) can form a new
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28 ⁸ This Treasury Regulation section was applicable for stock acquisitions occurring prior to March 15, 2001. For reference, the current Treasury Regulation section 1.338(h)(10)-1(c)(3), as of the time of this writing, lists the deadline for making the election as being the 15th day of the 9th month after the month in which the acquisition occurred.

1 corporation (Lebo Automotive) to purchase the stock of the target (Manhattan Beach Toyota) to take
2 advantage of the IRC section 338(h)(10) election, but only if the new corporation does not quickly
3 liquidate or otherwise dispose of the target. (Resp. Reply Br., p. 8.) Respondent states that since Lebo
4 Automotive requested a tax clearance certificate for Manhattan Beach Toyota, thus ceasing its business
5 operations and, according to the Secretary of State's records, Manhattan Beach Toyota was merged into
6 Lebo Automotive as of October of 2000, it is evident that Lebo Automotive should not be treated as the
7 purchaser of the Manhattan Beach Toyota stock. (*Id.* at pp. 8-9 & exhibits I and G.)

8 Respondent asserts appellant's acquisition of the stock at issue does not meet the
9 requirements for a 50 percent gain exclusion on the sale of QSBS. Respondent asserts the intent of the
10 bill introducing the QSBS exception was intended to encourage investments in new businesses. (Resp.
11 Op. Br., pp. 1-2.) Respondent asserts appellant acquired his stock in Lebo Automotive pursuant to an
12 IRC section 368(a) merger, as reported at audit and in appellant's appeal letter, which takes the form of
13 an exchange of stock for stock, and therefore does not qualify for QSBS gain exclusion as claimed by
14 appellant. (*Id.* at pp. 5-6.)

15 Applicable Law

16 It is well settled that a presumption of correctness attends respondent's determinations as
17 to issues of fact and that an appellant has the burden of proving such determinations erroneous. (*Appeal*
18 *of 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 a taxpayer fails to present uncontradicted, credible, competent, and relevant
22 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 Monablance A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

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1 R&TC section 18152.5, subdivision (a), provides that, under certain circumstances, a
2 taxpayer may exclude 50 percent of the gain from the sale of QSBS. Although IRC section 1202 also
3 provides for a 50 percent exclusion of the gain from the sale of QSBS, the California Legislature
4 specifically provided that this statute is not applicable to determining California income.⁹ (Rev. & Tax.
5 Code, § 18152, subd. (a).)

6 Qualification for the exclusion from gain under R&TC section 18152.5 includes meeting
7 a variety of requirements. To be entitled to exclude gain from the sale of stock under R&TC section
8 18152.5, the stock must be considered QSBS. Pertinent here are various requirements under
9 subdivisions (a), (c), (d), and (e) of the statute. The term QSBS is considered any stock in a C
10 corporation which is originally issued after August 10, 1993, if (1) as of the date of issuance, the
11 corporation is a qualified small business, and (2) the stock is acquired by the taxpayer at the time of its
12 original issuance in exchange for money, property (not including stock), or as compensation for
13 services. (Rev. & Tax. Code, § 18152.5, subd. (c)(1).)

14 In addition to these criteria, subdivision (c) further defines the term QSBS by providing
15 that stock in a corporation will not be treated as QSBS unless, during substantially all of a taxpayer's
16 holding period of the stock, the corporation meets the active business requirements delineated in
17 subdivision (e) of the statute.¹⁰ (Rev. & Tax. Code, § 18152.5, subd. (c)(2)(A).) Under subdivision (e),
18 at least 80 percent (by value) of a corporation's assets must be used in the active conduct of qualified
19 businesses in California (Rev. & Tax. Code, § 18152.5, subd. (e)(1)(A).) In addition, no more than 20
20 percent of a corporation's total payroll expense can be attributable to employment located outside of
21 California. (Rev. & Tax. Code, § 18152.5, subd. (e)(9).) Or, in other words, 80 percent or more of a
22 corporation's total payroll expense must be attributable to employment in California. As such, a
23 corporation meets the active business requirements of subdivision (e) of R&TC section 18152.5 if,
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26 ⁹ Subdivision (l) of R&TC section 18152.5 also provides that: "It is the intent of the Legislature that, in construing this
27 section, any regulations that may be promulgated by the Secretary of Treasury under Section 1202(k) of the Internal Revenue
Code shall apply to the extent that those regulations do not conflict with this section or with any regulations that may be
promulgated by the Franchise Tax Board."

28 ¹⁰ Neither R&TC section 18152.5 nor IRC section 1202 contain a definition of the term "substantially all," and no other
known authority under either California or federal law defines this term for purposes of the small business stock statutes.

1 during substantially all of a taxpayer's holding period of the stock, the corporation meets the 80 percent
2 asset test (Rev. & Tax. Code, § 18152.5, subd. (e)(1)(A)) and the 80 percent payroll test (Rev. & Tax.
3 Code, § 18152.5, subd. (e)(9)).

4 IRC section 338, incorporated by reference into California law by R&TC section 24451,
5 provides generally that in the case of any qualified stock transfer in which one corporation purchases
6 another corporation, the purchasing corporation may make an election to have the target corporation
7 treated as though it sold all of its assets to the purchasing corporation. (Int. Rev. Code, § 338(a).) IRC
8 section 338(h)(10) is implemented by Treasury Regulations section 1.338(h)(10)-1, and subdivision (a)
9 provides generally that the regulation "prescribes rules for qualification for a section 338(h)(10) election
10 and for making a section 338(h)(10) election" and "prescribes the consequences of such election."
11 Subdivision (d) sets forth the consequences to the parties of making an IRC section 338(h)(10) election.

12 STAFF COMMENTS

13 The parties should be prepared to detail their interpretation of the transactions in which
14 AutoNation sold its interest in Manhattan Beach Toyota and appellant acquired its shares of stock from
15 Lebo Automotive. In particular, appellant should clarify at the hearing whether he is making the claim
16 that Lebo Automotive purchased the Manhattan Beach Toyota stock via the purchase agreement that
17 was entered into on April 14, 2000. If so, appellant should address respondent's assertions opposing this
18 contention, including the absence of Lebo Automotive as a listed party in the purchase agreement and
19 the fact that it was not formed until two months after the purchase agreement was entered into.
20 Appellant should also explain how he received the shares of Lebo Automotive in exchange for the assets
21 of Manhattan Beach Toyota if Lebo Automotive directly purchased the assets from AutoNation.

22 Appellant should clarify his assertions regarding the contended IRC section 338(h)(10)
23 election, including a discussion of respondent's contentions that the election is not available for
24 purchases by individuals and the lack of any documentation substantiating an IRC section 338(h)(10)
25 election beyond Lebo Automotive's 2000 tax return statement. Appellant should also address the
26 Secretary of State information showing that Manhattan Beach Toyota was merged into Lebo
27 Automotive (possibly as an IRC section 368(a) merger), and what effect this has on the claimed IRC
28 section 338(h)(10) election as well as the QSBS exception which is not allowed when stock is purchased

1 through the exchange of other stock. (See Resp. Reply Br., exhibit G.)

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