

Rev & T C §25128—requiring double weighting of the sales factor in the income apportionment formula—to two water's-edge provisions that require calculation of a taxpayer's sales.

Under Rev & T C §25110(a)(3), a corporation may be included in a water's-edge electing group if the average of its payroll, property, and sales factors in the United States is 20 percent or more. Under Rev & T C §25115, repealed with respect to taxable years commencing after January 1, 1994, a water's-edge election fee is imposed, based in part on the taxpayer's sales in this state.

The FTB has ruled that the amendments to Rev & T C §25128 have no effect with respect to either of the foregoing provisions. Thus, inclusion of an entity in a water's-edge group is based on the simple average of the payroll, property, and sales factors, without double weighting sales. Similarly, the calculation of the water's-edge fee remains based in part on the numerator of the sales factor, with no further adjustment. ❖

## RELATED CASES

### S corporations

**Franchise tax was properly computed for year in which S corporation election was made.**

*Handlery Hotels, Inc. v Franchise Tax Bd.* (1995) 39 CA4th 1360, 46 CR2d 525

The trial court granted summary judgment in favor of the Franchise Tax Board in plaintiff's refund action. The appellate court affirmed. The only issue was whether plaintiff's 1991 franchise tax should be calculated using the California C corporation franchise tax rate of 9.3 percent or the S corporation tax rate of 2.5 percent (now 1.5 percent).

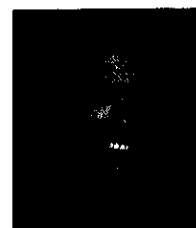
Effective January 1, 1991, plaintiff qualified for and elected to be treated as an S corporation. Plaintiff timely filed its franchise tax return covering the income year January 1, 1990, through December 31, 1990. In its return it calculated its franchise tax liability for the tax year 1991 using the ordinary 9.3-percent rate and paid it in installments in the fourth, sixth, ninth, and 12th months of the income year 1990.

The favorable tax treatment inherent in S corporation status first applied in California for "income years" beginning on or after January 1, 1987. Rev & T C §23800. Other sections of the Revenue and Taxation Code also use the "income year" language in dealing with S corporation elections (see Rev & T C §23801(a)(2), (a)(3), and (a)(4)). The court found these statutes to be unambiguous. "They uniformly point to one conclusion—that once the 'S corporation' election was first made in 1987, the application of the favorable franchise tax rate com-

menced in the 1987 income year, with 1988 being the first taxable year in which the reduced 'S corporation' franchise tax rate would apply." 39 CA4th at 1365.

The legislature also had a sound practical basis for selecting the first income year after the year in which the S corporation election was made for favorable tax treatment. If plaintiff's interpretation were correct, and it were allowed to apply the lower franchise tax rate to its 1990 income year, the resulting computation could well result in a tax windfall for plaintiff and its shareholders. The 1990 corporate income was not passed through to plaintiff's shareholders to be reported on their personal tax returns because plaintiff had not yet invoked its election to become a valid S corporation. Thus, plaintiff was attempting to apply the more favorable S corporation franchise tax rate to 1990 corporate income that was never taxed at the shareholder level.

## Federal Taxation



MARILYN BARRETT  
Los Angeles

### Stock Options

**Ninth Circuit holds that founders of emerging company must pay ordinary income tax on value of stock covered by stock options when options were sold as part of company's acquisition, because options had no ascertainable value when originally issued.**

*Cramer v Commissioner* (9th Cir 1995) 64 F3d 1406

In a decision that has significant implications for employees of privately held corporations who are compensated in part with stock options, the Ninth Circuit Court of Appeals has held that, under IRC §83, such employees may be subject to tax at ordinary income tax rates on the full value of the stock covered by the options when their rights represented by the options are subsequently purchased by a third party at the stock's fair market value.

### **IRC §83: Receipt of Property for Services**

Generally, under IRC §83(a), an employee who is compensated in part by the transfer of property, such as corporate stock, is taxable at ordinary income tax rates on the value of property, net of any payment required to obtain the property. If the stock is not transferable by the employee or is subject to a substantial risk of forfeiture, the employee is not subject to tax until the stock is transferable or until it is not subject to a substantial risk of forfeiture, whichever occurs first. Property is subject to a substantial risk of forfeiture if the employee's right to it is conditioned on the employee's performance of services. IRC §83(c)(1). Under IRC §83(e)(3), IRC §83 does not apply to the transfer of an option that does not have a readily ascertainable fair market value.

Under IRC §83(b), the employee can elect to report the net value of the property received as ordinary income in the year of receipt even though it is subject to a substantial risk of forfeiture or transfer restrictions. By making this election, the compensatory portion that is subject to ordinary income tax treatment is limited to the net value of the property, *i.e.*, the fair market value of the property less amounts paid for the property, if any, on the date of receipt. Future appreciation, if any, is taxable as capital gain on a later disposition of the property if the property otherwise qualifies as a capital asset.

The tax consequences of employee stock options are more fully detailed in Reg §1.83-7, which provides that, if the option has a readily ascertainable value at the time it is granted, the recipient realizes taxable income on the date of grant in the amount determined under IRC §83(a), *i.e.*, the fair market value of the option less any payments made to acquire it. If the option does not have a readily ascertainable value on the date it was granted, its net value is includable in the employee's income when the option is exercised even if the fair market value may have become ascertainable before exercise. In addition, the employee realizes ordinary income equal to the value of the stock received on exercise of the option less the exercise price paid when the stock is transferred to the employee. If the option itself is sold or otherwise disposed of in an arm's-length transaction, the employee is taxable on the transfer of money or other property received in the same manner as if he or she had received the stock covered by the option or, in other words, on the value of the stock when it is transferred less any payments made by the employee.

### **The Ninth Circuit Applies the Rules**

Cramer founded and served as president and CEO of IMED Corporation, a company that designed, manufactured, and sold electronic medical instruments. Boynton served as vice president and Monaghan served as out-

side general counsel. The three also served on the board of directors at various times.

The stock of IMED was not publicly traded or registered with the SEC, but it was held by 150 to 250 shareholders. In 1978, the board granted Cramer a stock option to purchase 50,000 shares of IMED stock at \$50 per share. Cramer could exercise the option for only 20 percent of the total stock covered by the option per year for the next five years. The option lapsed if Cramer ceased employment, he could transfer the option only to persons deemed "qualified offerees" by the board, and any transferee would take the option subject to the vesting requirements.

In 1979, the board granted Cramer an option to purchase 4390 shares at \$8 per share, Boynton an option to purchase 30,000 shares at \$13 per share, and Monaghan an option to purchase 4500 shares at \$13 per share. Each of these options was subject to the five-year vesting and transfer restrictions.

Cramer, Boynton, Monaghan, and the other directors of IMED were beneficiaries of a trust that in 1981 was granted an option to buy 325,000 paired shares of IMED stock at various prices. This option was subject to three-year vesting. Under the terms of the trust agreement, the trustee could transfer the option only to its beneficiaries. A separate agreement among the beneficiaries provided that a beneficiary would be divested of his allocable share of the option if he was not still employed by IMED as of the vesting date.

The employees did not exercise any of these options and did not report any taxable income in the year the options were granted. Elections under IRC §83(b) were filed for Cramer's 1978 option, Boynton's 1979 option, and Monaghan's 1979 option. The options' value were stated at zero in these elections. No elections were filed for Cramer's 1979 option or for the trust's option.

In 1982, Warner-Lambert Corp. purchased all of the stock of IMED for approximately \$163 per share and agreed to purchase all of the outstanding vested and nonvested options at the per-share price, less the exercise price called for in the options. Cramer received \$25,945,506 for his options, Boynton received \$7,714,800, and Monaghan received \$2,273,895.

Cramer, Boynton, and Monaghan had been advised by professionals that the IRS might claim that their IRC §83(b) elections were invalid and that capital gain treatment of proceeds received from the sale of their options was contrary to specific regulations. Nevertheless, they each reported the gain as capital on their returns. Cramer claimed a basis of \$7,535,620 (presumably the cost he would have paid to exercise the options and purchase the covered stock, although this is not clear in the decision) and reported sales proceeds of \$32,181,126. Monaghan claimed a basis of \$2,558,500 and sales proceeds of \$4,832,395. Boynton claimed a zero basis and reported all proceeds received as capital

gain. None of the returns disclosed that the options were subject to transfer and vesting restrictions; that IRC §83(b) elections had been filed for some of the options; or that the options had no ascertainable fair market value. The returns did not otherwise include any authority to support treatment of the proceeds as capital gain. In several of the returns, the property sold was described as stock and not as options, and was reported in a section of the return designated for stock transactions rather than in another portion of the return designated for option transactions.

The IRS audited the 1982 returns and determined that the sales of the options produced ordinary income, not capital gain. The IRS also assessed penalties for intentional disregard of tax rules and regulations and for understatement of tax.

### **Readily Ascertainable Value**

The taxpayers argued that the options had a "readily ascertainable value" on the date they were granted, even though that assertion conflicted with the zero value reported in their IRC §83(b) elections. In the taxpayers' view, the value of the options should have been taxable to them as ordinary income in the year granted, and subsequent appreciation was taxable as capital gain.

The Ninth Circuit held that the options did not have a "readily ascertainable value" under the definition of that term in Reg §1.83-7(b)(2), which provides that an option that is not traded on a established market does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist: (1) the option is transferable; (2) the option is exercisable immediately in full; (3) the option or the property covered by the option is not subject to any restriction or condition that has a significant effect on the fair market value of the option; and (4) the fair market value of the option privilege is readily ascertainable within the meaning of Reg §1.83-7(b)(3) (this includes a determination of not only the difference between the value of the property covered by the option price and the exercise price at a specific time, but also the value of the option privilege for the remainder of the option period, taking into account the possibility of increases and decreases in value of the covered property and the length of the option period).

The Ninth Circuit concluded that the options did not satisfy these conditions. The court further rejected the taxpayers' argument that Reg §1.83-7 was simply invalid. The court based its determination in part on the fact that legislation had been proposed that would have allowed options without a readily ascertainable value to be the subject of an IRC §83(b) election, but the legislation was not enacted.

The taxpayers also argued that the value of 1981 options granted to the trust was includable in their ordinary

income in 1981, the year of grant, rather than 1982, the year of sale, even though no IRC §83(b) election had been filed. The taxpayers asserted that the options were not subject to a substantial risk of forfeiture because a separate agreement, and not the option itself, provided for the forfeiture of their shares if they ceased employment with IMED. The court, however, saw no need to address this issue because the 1981 option was not immediately exercisable in full but vested over a period of years, and, on this basis, did not satisfy the conditions of Reg §1.83-7(b)(2).

### **Penalties**

The Ninth Circuit also upheld assessment of a penalty for intentional disregard of rules and regulations under IRC §6653(a). The taxpayers had been counseled by their advisers that capital gain treatment was contrary to Reg §1.83-7(b)(2), but had concluded that there was a plausible argument that the regulation was invalid. The Ninth Circuit opined that, if the taxpayers wanted to challenge the regulation as invalid and yet avoid penalties if they were not successful, their proper course of action was to pay the tax and contest the validity of the regulation in a claim for refund.

The Ninth Circuit also upheld imposition of the substantial-understatement-of-tax penalty under former IRC §6661(a) (both penalties at issue are now incorporated in the accuracy-related penalty under IRC §6662). The court noted that this penalty will not be assessed if the tax treatment is supported by substantial authority or the relevant facts are adequately disclosed on the return or on a statement attached to the return. The court concluded that substantial authority for the taxpayer's position did not exist and that adequate disclosure had not been made. Indeed, because the taxpayers claimed a basis in the options and/or stock when they were not entitled to and described the options as stock rather than options on their returns, the Ninth Circuit found that, rather than disclosing the relevant facts, the returns actually concealed the true nature of the proceeds received. Based on these acts of concealment and the taxpayers' decision to ignore Reg §1.83-7(b)(2), the Ninth Circuit concluded that the taxpayers had not acted in good faith and the good faith/reasonable cause waiver to the understatement-of-tax penalty did not apply.

►**COMMENT:** The employees in *Cramer* could have minimized the possibility of full ordinary income tax treatment. First, if the employees had in fact exercised their options to the extent possible under the vesting schedules, they could have made an IRC §83(b) election with respect to the stock received. In that case, they would have reported ordinary income to the extent that the value of the stock received exceeded the exercise price paid in the year of the exercise, but subsequent ap-

preciation would have been entitled to capital gain treatment. This strategy, however, requires payment of the exercise price, which employees may not be financially able to do, or, in the case of a newly formed company of uncertain value, involves a greater financial risk than the employees are willing to take. The risk will be reduced if the value of the company is low and the exercise price is set low.

Alternatively, it may in some cases be possible to structure the options so that they have a "readily ascertainable value" and are eligible for an IRC §83(b) election under Reg §1.83-7(b)(2). Options qualify under that regulation, however, only if they do not have vesting or transfer restrictions and the value of the option privilege can be ascertained. Because vesting and forfeiture provisions are frequently included in options to encourage employees to stay with the company, and it may be virtually impossible to value the "option privilege" in a young company, this alternative may not be practicable.

Finally, a company that wishes to grant stock options as an incentive to its key employees, yet protect them from ordinary income tax liability, should consider adoption of an incentive stock option plan that qualifies under IRC §422. The employee will not realize any taxable income on the receipt or exercise of the option and will realize capital gain on the later sale of the stock if the holding periods and other requirements in IRC §422 are met. The company, however, would not be entitled to take any compensation deduction. Alternatively, the company can adopt a nonqualified stock option plan that provides for a bonus cash payment to the employee in the amount necessary to help the employee pay his or her income tax liability on the exercise of the option. Even though the employee will be taxable on both the exercise of the option (to the extent the fair market value of the covered stock exceeds the exercise price) and receipt of the bonus, the company will be able to deduct both the bonus and the amount taxable to the employee on exercise of the option. On a combined basis, this may achieve the best overall tax result. See Sparks, *Equity Compensation Strategies for Emerging Growth Companies*, 10 CEB Cal Bus L Prac 138 (Fall 1995).

Taxpayers and their advisers should also note the Ninth Circuit's holding that a penalty may be imposed when the taxpayer disputes the validity of a regulation and pursues the dispute through Tax Court proceedings. The Ninth Circuit concluded that, to avoid a penalty in such cases, the taxpayer's proper course is to first pay the tax and then challenge the regulation through a claim for refund.

Under Reg §1.6662-3(c), promulgated in 1991, a penalty for disregard of the rules and regulations will not be imposed if (1) the contrary position is adequately disclosed on the return, and (2) when a position contrary to a regulation is involved, the position represents a

good faith challenge to its validity. The taxpayers in *Cramer* would not have been able to avoid the penalties under these regulations because they did not disclose their contrary position on their return. Under Reg §1.6662-4, an understatement-of-tax penalty will not be imposed if (1) there is substantial authority for the taxpayer's position, or (2) the contrary position is adequately disclosed on the return and there is a reasonable basis for the taxpayer's position. In addition, neither penalty will be imposed if the taxpayer can show that he or she acted with reasonable cause and in good faith. The court also concluded that they had not acted in good faith and substantial authority did not support their position. Regulation §1.6662-3(c) was amended in 1995 to provide that this disclosure exception does not apply in the case of a position that does not have a reasonable basis or when the taxpayer fails to keep adequate books and records or to substantiate items properly. ❖

## RELATED DEVELOPMENTS

### Employment Tax

#### **Public policy favors denial of deductions for IRC §6672 penalties.**

*Duncan v Commissioner* (9th Cir 1995) 68 F3d 315

Taxpayers owned all the stock of two corporations. The corporations withheld employees' federal taxes but failed to pay the federal government before going out of business. The IRS assessed a penalty pursuant to IRC §6672. The taxpayers paid the penalty and then deducted the amount of the penalty as nonbusiness, bad debt deductions under IRC §166. The IRS disallowed the deduction. The Tax Court affirmed on policy grounds. The Ninth Circuit affirmed.

In deciding this issue of first impression in the federal appellate courts, the Ninth Circuit relied on *Tank Truck Rentals, Inc. v Commissioner* (1958) 356 US 30, 2 L Ed 2d 562, 78 S Ct 507. *Tank Truck* held that penalty road tolls assessed against a trucking company for operating trucks above a specified weight limit were not deductible because the payments were levied against the truckers as a penal measure and allowing the deductions would frustrate the public policy to deter carriers who overload their trucks. The court rejected the argument that the fines were merely revenue measures.

The taxpayers argued that the payments should be regarded as revenue measures based on the IRS policy that withheld taxes would be collected only once, despite the fact that taxpayers could be found personally liable under IRC §6672 for obligations already satisfied by the corporations they controlled if there had been an origi-