

CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 428

August 19, 1987

SECTION 18162.5 - SMALL BUSINESS STOCK

Syllabus:

The purpose of this ruling is to announce the position of the Franchise Tax Board regarding a variety of issues arising from the small business stock provisions contained in §18162.5.

Under §18162.5(b), favorable capital gain treatment is afforded taxpayers who sell or exchange small business stock as defined in §18162.5(e). For such sales or exchanges, 65 percent of the realized gain is recognized if the stock is held over one year but not more than three years; if the stock is held over three years, none of the realized gain is to be recognized.

Several questions to be resolved involve the determination of when a taxpayer "acquires" small business stock under §18162.5(e).

Under a common definition of "acquire," one would not acquire stock before one obtains ownership, possession, or control. See John F. Knowlton (1985), 84 T.C. 2681, 2683.

However, there are circumstances in which deviation from the common meaning of a term will be permitted.

In Commissioner v. Brown (1965), 380 U.S. 563, 571, the United States Supreme Court stated that, for purposes of the Internal Revenue Code, the common ordinary meaning of a word should be persuasive of its meaning except when such a reading would lead to absurd results or would thwart the obvious purpose of the statute.

The Brown standard is equally applicable for purposes of interpreting the provisions of the Revenue and Taxation Code. Thus, the common meaning of the term "acquired," as stated above, will be applied unless the application thereof would lead to absurd results or would thwart the obvious purpose of §18162.5.

The purpose of the small business stock provisions is contained in the preamble of the enacting legislation, S.B. 690 (Stats. 1981, Ch. 534), which is provided in §1:

The Legislature finds that a key element of California's economic growth and prosperity over the past several decades has been the founding and expansion of new private business. A majority of the increase in private employment in California has come as a result of the willingness of private entrepreneurs to take risks in starting and expanding small

companies. Similarly, the willingness of private investors to provide the start-up equity capital for entrepreneurs has been a critical element in the ability of new and small companies to transform ideas into jobs and income from California.

The Legislature finds, however, that state and national tax laws, in an inflationary era, provide insufficient incentive for many investors to risk their savings in new businesses, and excessive incentive to place their savings into nonproductive assets which add nothing to the strength of the economy. The purely speculative returns on such investments as gold, silver, gems, paintings, stamps, and antiques represent the diversion of scarce capital from productive investment.

Because the Legislature specifically declared that the purpose of the small business stock provisions was to create jobs by encouraging investors to take risks in starting and expanding small companies, deviation from the common definition of "acquired" as contained in §18162.5(e) will be permitted only under those circumstances in which the above-cited purposes will be advanced, taking into account well-established general principles of tax law.

Questions relating to the meaning of the word "acquired" have arisen in the context of reorganizations and other tax-free transfers.

It is our position that, as a general rule, a reorganization involves a fundamental rearrangement of a shareholder's investment. Therefore, stock acquired pursuant to a reorganization generally will be retaxed as a new acquisition under §18162.5(e) as of the effective date of the reorganization.

An exception to this rule will be applied if, under the factual context of the reorganization under review, the exchange is one of form only and does not result in a fundamental rearrangement in the nature of the investment.

When appropriate, analysis will include the application of such well-established principles as the step-transaction and business purpose doctrines.

Factual application of this principle, as well as the resolution of other issues, is expanded by illustration in the following questions and answers.

QUESTION 1

Corporation A was incorporated under California law on January 1, 1983. All of A's shares were acquired by B, C, and D on that date. On August 14, 1986, A merged into X in a statutory merger pursuant to §24562(a)(1) (see also Internal Revenue Code §368(a)(1)(A)) with X being the surviving corporation. Under the terms of the reorganization, B, C, and D received two shares of X for each share of A surrendered. For purposes of §18162.5(e), what is the date of acquisition of the shares held by B, C, and D?

ANSWER

August 14, 1986.

ANALYSIS

As a result of the "A" reorganization, the nature of the shares of B, C, and D has changed in a fundamental manner, as the corporate restructuring has resulted in a rearrangement of risk at the shareholder level. As an example, it is possible for a small corporation to merge into a large publicly traded corporation in an "A" reorganization, with the result that the shareholders of the small corporation exchange their shares in the small corporation for stock in the large public corporation. Because the nature of the rearrangement is fundamental, the acquisition date of the shares of X by B, C, and D, for purposes of §18162.5(e), is the effective date of the reorganization, August 14, 1986.

This result is buttressed by the fact that, if the acquisition date of the shares were to remain January 1, 1983, B, C, and D would be permitted to transfer their investment in small business stock, tax-free, to a large publicly held corporation and exclude gain attributable primarily to activity of the large corporation when their stock was sold at a later date. Such a result is inconsistent with both the statutory language and legislative intent of §18162.5.

QUESTION 2

Corporation A was incorporated under California law on January 1, 1983. All of A's shares were acquired by B, C, and D on that date. On August 14, 1986, A reincorporated in Delaware. The reincorporation was properly characterized as an "F" reorganization under §24562(a)(6). See also Internal Revenue Code §368(a)(1)(F). (The reincorporation is a "straight F" reorganization and does not involve other entities, including a holding company.) For purposes of §18162.5(e), what is the date of acquisition of the shares held by A, B, and C?

/1 Unless otherwise specified, all Internal Revenue Code citations are to sections of the Internal Revenue Code of 1954 as codified on January 1, 1986.

ANSWER

January 1, 1983.

ANALYSIS

A corporation which undergoes an "F" reorganization as described above has not changed its structure or operation in a fundamental manner, but has merely changed its form. Because the interests of the shareholders are substantially similar before and after the reorganization, it is our opinion that no "reacquisition" would occur on the effective date of the "F" reorganization, as a contrary position would ignore the economic realities of the transaction.

QUESTION 3

Corporation A was incorporated under California law on January 1, 1983. All of the stock of A was acquired by B, C, and D on that date. On August 14, 1986, a plan of reorganization is adopted which will, in effect, permit the "reincorporation" of A in Delaware. For valid business reasons, the reorganization is structured as a forward triangular "A" reorganization (see §24562(b)(4); see also Internal Revenue Code §368(a)(2)(D)). ^{1/2} Pursuant to the plan of reorganization, a Delaware holding company (DHC) is formed along with a 100 percent owned Delaware operating subsidiary (DOS). The assets of A are transferred to DOS. The shareholders of A surrender their stock in A and receive shares of DHC in exchange. The business of A is continued essentially unchanged by DOS. For purposes of this question, it is presumed that the commercial domicile of DOS is California.

1. Under §18162.5(e), what is the date of acquisition of the shares of DHC by the former shareholders of A?
2. How are the gross receipts tests contained in §§18162.5(e) and 18162.5(f)(1) to be applied to holding company DHC?

ANSWERS

1. January 1, 1983.
2. These tests are to be applied as if DHC and DOS were a single corporation.

^{1/2} The conclusions reached in this question are equally applicable to a reverse triangular "A" reorganization under § 24562(b)(5). See also Internal Revenue Code §368(a)(2)(E).

ANALYSIS

1. It is our position that, as a general rule, stock exchanged pursuant to a reorganization results in a fundamental change in the nature of the stock in the hands of the shareholders and is thus to be considered a new acquisition as of the effective date of the reorganization (see Question 1, *supra*).

An exception to this general rule is to be made in the case of a "straight F" reorganization as, under such circumstances, the corporation has not changed in a fundamental manner but has merely changed its state of incorporation (see Question 2, *supra*).

Under the facts as described above, the operation of A is effectively continued, unchanged, by DOS. Irrespective of the fact that a holding company has been interposed between the operating company and the shareholders, the change should be viewed, for purposes of §18162.5, as a change in form and not a fundamental change in the nature of the operation of the corporation. Accordingly, it is our opinion that, under the facts, no new acquisition will be deemed to have occurred, and acquisition date of the DHC stock in the hands of the former shareholders of A is the original date of acquisition of the A stock, January 1, 1983.

It is noted that the conclusions reached in this question are limited to the facts as described and will not be applied in other contexts, including triangular "A" reorganizations which involve structures other than that of a parent holding company and single operating company subsidiary as described above.

2. The conclusion reached above is predicated upon the fact that DHC is a true holding company whose only asset is the stock of DOS. As the only source of (nonliquidating) income from DOS to DHC would be periodic dividends paid with respect to the DOS stock owned by DHC, the application of the gross receipts tests contained in §§18162.5(e) and 18162.5(f)(1) would be jaundiced as applied with respect to the shareholders of DHC if the business activities of DOS were not taken into account. On the one hand, the small business stock gain exclusions could be lost to the DHC shareholders because of the unfortuitous timing of dividend distributions by DOS. On the other hand, these benefits could be secured by careful planning of the timing of dividend distributions outside the context of normal business purpose or activity.

Finally, application to DHC only would ignore the operating company, DOS, which was the intended focus of the gross receipts tests under discussion. Therefore, these tests are to be applied as if the holding company (DHC) and the operating subsidiary (DOS) were a single operating company, as the application of these tests to only the receipts of the holding company would lead to arbitrary results which were unintended by the small business stock provisions.

QUESTION 4

A forms a business on January 1, 1982, and operates the business as a sole proprietorship. On June 30, 1984, A transfers all assets of the proprietorship to a corporation incorporated on that date in exchange for 100 percent of the corporation's

stock. The transfer qualifies under Internal Revenue Code §351, as incorporation by reference - see §17321. A sells the stock on August 14, 1986, at a gain. What is the date of acquisition of the stock by A for purposes of §18162.5(e)?

ANSWER

June 30, 1984.

ANALYSIS

Although the proprietorship, from one point of view, continues in modified form, i.e., a corporation, the holding of the individual owner has changed in a fundamental manner because of the interposition of the corporation. Because of the change in the nature of this holding, and because of the fact that no stock existed prior to June 30, 1984, the acquisition date, for purposes of §18162.5(e), would be June 30, 1984, the date on which the stock was issued by the corporation and received by A.

QUESTION 5

Corporation A, a calendar year corporation, holds stock in corporation B as an investment. On August 1, 1986, A adopts a plan of liquidation. As part of the liquidation, A distributes the shares of B to its shareholders on October 15, 1986. The liquidation is completed on October 30, 1986, and A dissolves on that day. The distribution of B stock by A to its shareholders is governed by Internal Revenue Code §331, as incorporated by reference - see §17321. For purposes of §18162.5(e), what is the date of acquisition of the stock of B by the shareholders of A?

ANSWER

October 15, 1986.

ANALYSIS

Under Section 24511 (see also Internal Revenue Code §336), no gain or loss is recognized to a corporation which distributes its assets pursuant to a plan of liquidation if all of the assets are distributed within 12 months of the date of adoption of the plan of liquidation. Under such circumstances, the shareholders are treated as exchanging their shares in the corporation for the distributed property. Treas. Reg. 1.331-1(a).

Under the facts, the shareholders of A have received stock in B as part of a taxable exchange in which the fundamental nature of their investment has changed. Thus, for purposes of §18162.5(e), the shares of B, held by the former shareholders of A, are to be treated as acquired on October 15, 1986, the date of the taxable exchange.

QUESTION 6

A, B, and C own stock in corporation M. The stock qualifies as small business stock in the

hands of A, B, and C. On August 1, 1985, M adopts a plan of complete liquidation. On August 15, 1985, 50 percent of the corporate assets of M are distributed to A, B, and C on a pro rata basis. The remaining assets are distributed in a similar manner on October 1, 1985. M dissolved on October 30, 1985. The distributions are within the meaning of Section 24511. See also Internal Revenue Code §336. What is the effect upon A, B, and C?

ANSWER

A, B, and C are treated as having sold their stock in M.

ANALYSIS

Under Section 24501 (see also Internal Revenue Code §331), A, B, and C are treated as having sold their shares for the amounts of the distributions received. Thus, the stock of M has been "sold or exchanged" within the meaning of §18162.5(b), and the income exclusions contained therein are applicable so long as the stock otherwise qualifies as small business stock under §§18162.5(e) and 18162.5(f).

QUESTION 7

A acquires small business stock on August 1, 1984. On June 1, 1986, A decides to give the stock to his only son, S. The gift is completed on December 15, 1986. Under §18162.5(e), what is the date of "acquisition" of the stock by S?

ANSWER

December 15, 1986.

ANALYSIS

In the case of a gift of stock, one obtains possession and control over the stock on the date the gift is completed. This date will control for purposes of §18162.5(e).

QUESTION 8

A acquires small business stock on January 1, 1983. A dies on September 15, 1985. Under A's will, all property is to pass to A's sole surviving relative, R. The stock is distributed by A's estate to R on March 10, 1986. Under §18162.5(e), what is the date of acquisition of the stock by R?

ANSWER

September 15, 1985.

ANALYSIS

Upon death, title to the decedent's property, both real and personal, passes to the person

to whom it is devised or bequeathed, subject to administration of the estate. Probate Code §300. During administration, the estate retains control over the property, including the power of sale. Probate Code §750; Estate of Benvenuto (1920), 183 Cal. 382, 386. Further, the powers of administration cannot be affected by agreements or other actions of the beneficiaries during administration. See Carson v. Lindauer (1953), 119 C.A.2d 292, 303. Even though R has no legal right or control over the stock during the period of administration, the passage of title to R, under Probate Code §750, subject only to defeasance by condition subsequent during administration, is a sufficient right so as to conclude that R has acquired the stock within the meaning of §18162.5(e) on September 15, 1985.

QUESTION 9

Partnership P was formed on January 1, 1983, by A, B, and C, who are equal partners. On June 30, 1983, partnership P purchased stock which qualified as small business stock. On July 1, 1985, B sells his partnership interest to N. On December 15, 1985, partnership P sells its small business stock at a gain. What is the effect of the December 15, 1985 sale?

ANSWER

See analysis.

ANALYSIS

In general, the entity approach is adopted for purposes of taxing the sale of partnership interests.

Under Internal Revenue Code §741 (as incorporated by reference - see §17851), gain or loss from the sale or exchange of a partnership interest (with certain exceptions not relevant to this analysis) is treated as capital gain or loss from intangible personal property (which is separate and distinct from the partnership assets). See Corporations Code §15026. Thus, the fact that P owns small business stock has no effect upon the sale of B's partnership interest. The continuing partners are not affected by the sale of B's partnership interest, and the nature of the small business stock, in the hands of the partnership, is unaffected by the sale.

For the purpose of the sale of the stock on December 15, 1985, by the partnership, the date of acquisition remains June 30, 1983. Accordingly, if the stock otherwise qualifies, the exclusion of 65 percent of the realized gain upon sale of the stock by the partnership would be passed through to the individual partners A, C, and N under Internal Revenue Code §702 (as incorporated by reference - see §17851).

QUESTION 10

Partnership P acquires small business stock on January 1, 1983. On August 14, 1986, the partnership distributes the stock in a nonliquidating distribution to A, a 1 percent limited partner. For purposes of §18162.5(e), what is the date of acquisition of the stock in the

hands of A?

ANSWER

August 14, 1986.

ANALYSIS

In general, no gain or loss is recognized to a partner upon the receipt of property distributed from a partnership. Internal Revenue Code §731(a), as incorporated by reference - see §17851. However, a partnership interest is separate and distinct from the assets of a partnership. A partnership interest is personal property (Corporations Code §15026), intangible in character. Prior to the distribution, A's only interest in the stock was through the partnership (see Corporations Code §15510), where the stock was subject to partnership liabilities, creditors, etc., as well as the action of the general partners. After the distribution, the stock is under the dominion and control of A alone. Because A's holding with respect to the stock has changed in a fundamental manner on August 14, 1986, for purposes of §18162.5(e), A will be deemed to have acquired the stock on that date.

QUESTION 11

Partnership P is formed by A, B, and C on January 1, 1986. A and B each contribute \$100,000 in cash, and C contributes stock which he acquired on August 15, 1983, and which qualifies as small business stock on that date, in exchange for equal one-third general partnership interests. C's basis in the contributed stock was \$50,000; the fair market value was \$100,000 on January 1, 1986. For purposes of §18162.5(e), what date will the partnership be deemed to have acquired the stock?

ANSWER

January 1, 1986.

ANALYSIS

In general, no gain or loss is recognized to a partnership or any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership. Internal Revenue Code §721, as incorporated by reference - see §17851. Although the basis of property contributed to a partnership is the adjusted basis of the property to the contributing partner at the time of the contribution (Internal Revenue Code §723, as incorporated by reference - see §17851), the partnership interests of A, B, and C are separate and distinct from the assets of the partnership. Prior to the contribution, the stock was under the dominion and control of C alone. After the contribution, the stock has become a partnership asset, subject to partnership liabilities, creditors, etc., and subject to the dominion and control, as well as the acts, of the other

general partners. Because both the holdings of C and P have changed in a fundamental manner with respect to the stock, the stock, for purposes of §18162.5(e), was acquired by the partnership on the date of contribution, January 1, 1986. ¹³

QUESTION 12

What is an "asset" for purposes of the sale of assets test contained in §§18162.5(e) and 18162.5(f)(1)?

ANSWER

Assets other than those used in the normal course of carrying on a trade or business.

ANALYSIS

There is no evidence in the legislative history of the small business stock provisions to indicate an intent to disqualify small business treatment based upon the sale of assets used in the normal course of a trade or business. Rather, the history shows that the intent was to prevent the small business stock benefits flowing from investments in corporations which engage in passive investment activity.

§18162.5(e)(4) test. Accordingly, it is our opinion that the test should exclude receipts from the sale of assets which are used in the normal course of a trade or business. As a general rule, trade or business assets would include those which could be characterized under Internal Revenue Code §1231(a)(3)(A)(i).

When SB 690 was introduced on March 17, 1981, §18162.5(a)(4), which was the counterpart of currently enacted §18162.5(e)(4), read as follows:

No more than 25 percent of gross revenues in the most recent tax year were obtained from rents, interest payments, royalties, capital gains, or similar financial payments. (Emphasis added.)

Even though the Bank and Corporation Tax Law contains no provisions similar to those contained in the Internal Revenue Code which provide special benefits to certain sales of capital assets, the reference to "capital gains" in SB 690 indicates an intent that amounts realized from trade or business assets be excluded from the

¹³ For purpose of later sale by the partnership or distribution to and later sale by a partner, the holding periods prescribed in §18162.5(b) shall include the period in which the stock was held by individual C. See Treas. Reg. §§1.735-1(b), 1.723-1.

The test will include the gross receipts from the sale of assets held for investment purposes.

QUESTION 13

Are receipts from the sale of "inventory" to be considered gross receipts from the sale of assets for purposes of the tests contained in §§18162.5(e) and 18162.5(f)(1)?

ANSWER

No.

ANALYSIS

The sale of inventory is the result of a sale in the ordinary course of a trade or business. To include inventory receipts as gross receipts under §§18162.5(e) and 18162.5(f)(1) would render the small business stock provisions unavailable to corporations whose primary activity is the sale of goods as opposed to the performance of services. Such a result would contravene the purpose of the small business provisions and ignore §24271(a)(2) which classifies sales of inventory as trade or business income as opposed to income from the sale of property under §24271(a)(3). See also Internal Revenue Code §61(a)(2); Treas. Reg. §1.61-3(a).

QUESTION 14

Are gross receipts from the sale of assets sold under a plan of liquidation pursuant to §24512 included in the gross receipts tests for purposes of §§18162.5(e) and 18162.5(f)(1)?

ANSWER

No, unless the assets were not assets which, if otherwise sold, would be sold in the normal course of the trade or business.

ANALYSIS

The sale of trade or business assets which would normally be excluded from the gross receipts test contained in §§18162.5(e) and 18162.5(f)(1) should not be treated differently because the assets are sold pursuant to a plan of liquidation.

QUESTION 15

A, a calendar year corporation, sells an investment asset within the meaning of §§18162.5(e)(4) and 18162.5(f)(1) on September 30, 1985. The amount realized upon sale is \$10,000. The adjusted basis of the asset is \$3,000. The \$7,000 realized gain is recognized in full on the corporate return for the income year ended December 31, 1985. The \$10,000 cash proceeds are received on October 1, 1985. For purposes of the gross receipts tests contained in §§18162.5(e)(4) and 18162.5(f)(1), what is the amount to be

taken into consideration?

ANSWER

\$10,000.

ANALYSIS

It is widely accepted that "gross receipts" is a broader term than "gross income" and may include within it receipts which may constitute capital as well as income. 1 Mertens Law of Federal Income Taxation P5.10; Beamer v. Franchise Tax Board (1977), 19 Cal.3d 467, 479-80; see also Coffill, The Treatment of Foreign Income Taxes Under the California Bank and Corporation Tax Law (1985), 17 Pac.L.J. 77, 81-94. Therefore, gross receipts from the sale of assets includes the gross amount received unreduced by amounts which represent return of capital.

QUESTION 16

Corporation A, a calendar year corporation, sells an investment asset within the meaning of §§18162.5(e)(4) and 18162.5(f)(1) on the installment method on September 30, 1984. The gross sales price is \$1,000,000. Under §24667(c) (see also Internal Revenue Code §453(c)), 40 percent of each payment constitutes income to be recognized. No payments were received in 1984. In 1985, \$100,000 was received. For purposes of the gross receipts tests contained in §§18162.5(e)(4) and 18162.5(f)(1), what are the amounts to be taken into consideration?

ANSWER

1984: 0

1985: \$100,000

ANALYSIS

Even though "gross receipts" is a more inclusive term than "gross income," yearly gross receipts should be determined under a corporation's normal accounting method. In the above example, irrespective of whether A is a cash or accrual method corporation, it has no "receipts" from the installment sale in 1984, as no payments were received and no gain would be recognized. For 1985, under both cash and accrual methods of accounting, the amount of income recognized would be \$40,000, based upon receipts of \$100,000. Accordingly, \$100,000 constitutes "gross receipts" for the 1985 income year.

QUESTION 17

For purposes of §§18162.5(e)(4) and 18162.5(f)(1), when measuring gross receipts of a corporation, do total gross receipts include the corporation's share of receipts from partnership distributions by partnerships owned by the corporation?

ANSWER

Yes.

ANALYSIS

Because of the adoption of the aggregate approach with respect to the taxation of partnership distributions, partners must account for distributive shares of partnership operations. Section 24271(a)(11). See also Internal Revenue Code §701. Receipts derived by a partnership and, in turn, passed through to a corporate partner will constitute receipts at the corporation level for purposes of the tests under consideration.

QUESTION 18

Under §18162.5(e)(4), stock may not be characterized as small business stock if more than 25 percent of the gross receipts in the income year prior to acquisition were obtained from rents, interest, dividends, or sales of assets.

How is this test to be applied if the stock is purchased during the corporation's first income year?

ANSWER

The test is not applicable under these circumstances.

ANALYSIS

Under the facts, at the time of acquisition, it would be impossible to satisfy the requirements as there is no "immediate prior income year." In our view, impossibility excuses this requirement as there is no reason to distinguish between stock which was originally issued and stock later acquired by sale or exchange.

QUESTION 19

Corporation A was incorporated under California law on January 10, 1982. All of A's shares were purchased on that date by B, C, and D. The corporation was inactive until August 1, 1984, when it began to do business. What is the date of the acquisition of the shares held by B, C, and D?

ANSWER

January 10, 1982.

ANALYSIS

Even though the corporation was inactive until August 1, 1986, §18162.5 makes no provision for redetermination of the requirements contained in §18162.5(e) as of the date

an inactive corporation begins to do business. Thus, under the facts, the acquisition date of the shares is January 1, 1982.

QUESTION 20

Does the "500 or less employees" test contained in §18162.5(e)(2) mean that the corporation must have at least one employee in the year the stock is acquired?

ANSWER

No.

ANALYSIS

Based upon both a reading of the statute and common sense, the corporation is not required to have at least one employee in the year the stock is acquired in order to meet the requirements of §18162.5(e)(2).

QUESTION 21

Corporation A was incorporated under the laws of California on January 1, 1984. On that date, 500 shares of A's common stock was purchased by B, and 500 shares of A's convertible preferred stock was purchased by C.

1. May the convertible preferred stock qualify as small business stock?
2. If the preferred stock is later converted into common stock, will the conversion affect the acquisition date in the hands of C?
3. Will the results differ if the conversion is accomplished as part of a reorganization under §24562(a)(5)?

ANSWERS

1. Yes.
2. No, but see analysis.
3. No.

ANALYSIS

1. Preferred, as well as common stock, represents an equity interest in a corporation. So long as the stock otherwise meets the requirements of §18162.5(e), the fact that the stock is preferred rather than common stock is irrelevant.
2. The conversion of preferred to common stock represents a restructuring of the

shareholder's rights in the corporation (for instance, voting rights, dividend preferences, etc., are altered). Under such circumstances, the shareholder's equity interest in the corporation has changed in a fundamental manner. Therefore, in general, the conversion of preferred into common stock will be considered a new acquisition as of the effective date of the conversion.

However, under the facts, the conversion privilege was one of the rights attached to the convertible preferred stock purchased by C on January 1, 1984. Under these circumstances, it is proper to view the conversion as the exercise of one of the features of the bundle of rights purchased by C, so that the rearrangement of the nature of C's equity securities should not be viewed as fundamental when taken in the overall context of C's purchase. Accordingly, because the conversion privilege was present when C purchased the stock, the conversion will not be considered to result in a new acquisition for purposes of §18162.5(e). C's acquisition date remains January 1, 1984.

3. A recapitalization under §24562(a)(5) (an "E" reorganization - see also Internal Revenue Code §368(a)(1)(E)) usually results in the readjustment of the financial structure of an existing corporation.

At the shareholder level, the analysis is similar to Answers 1 and 2 above.

Therefore, the conclusions in this question will be equally applicable to the situation in which the conversion is accomplished as part of an E reorganization.

QUESTION 22

Are lease payments received by the lessor of tangible personal property considered rents for purposes of the gross receipts test contained in §§18162.5(e) and 18162.5(f)(1)?

ANSWER

Yes.

ANALYSIS

Under Internal Revenue Code § 61(a)(5) (as incorporated by reference - see §17071), gross income includes rental income. Gross rental income includes both rentals received or accrued for the occupancy of real property and for the use of personal property. Treas. Reg. §1.61-8(a). Internal Revenue Code §162(a)(3) (as incorporated by reference - see §17201) allows as a deduction rental payments required to be made as a condition to the continued use or possession of property to which the taxpayer has not taken title or in which the taxpayer has no equity. This deduction applies to rental payments for both real and personal property. Rev. Rul. 69-21, 1969-2 C.B. 303.

Because of this parallel treatment, and because the legislative history of the small business stock provisions does not indicate an intent to treat real and personal property in a different manner for purposes of the gross receipts test contained in §§18162.5(e) and

18162.5(f)(1), it is our opinion that the term "rent" contained therein refers to payments for the use of both real and tangible personal property. (However, see Question 12 for the difference in treatment of rents received in the normal course of a trade or business versus rental income derived from investment activity.)

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