

STATE OF NEW YORK
TAX APPEALS TRIBUNAL

In the Matter of the Petition	:	
of	:	
SALVATORE AND JANICE TRAMAGLINI	:	DECISION
for Redetermination of a Deficiency or for	:	DTA No. 812885
Refund of Personal Income Tax under Article 22	:	
of the Tax Law for the Year 1988.	:	

The Division of Taxation filed an exception to the determination of the Administrative Law Judge issued on December 14, 1995 with respect to the petition of Salvatore Tramaglino, 15310 S.W. Widgeon Court, Beaverton, Oregon 97007 and Janice Tramaglino, 136 Marshall Drive, Pittsburgh, Pennsylvania 15228. Petitioners appeared by Arthur Andersen LLP (Henry F. Chiwaya, Esq., of counsel). The Division of Taxation appeared by Steven U. Teitelbaum, Esq. (Michael J. Glannon, Esq., of counsel).

The Division of Taxation filed a brief in support of its exception. Petitioners filed a brief in opposition and the Division of Taxation filed a letter in reply. Oral argument was heard on February 6, 1997 in Troy, New York.

After reviewing the entire record in this matter, the Tax Appeals Tribunal renders the following decision.

ISSUE

Whether the Division of Taxation properly included in income, subject to New York State taxation, gain from the sale of certain stock in the tax year 1988.

FINDINGS OF FACT

We find the facts as determined by the Administrative Law Judge except for findings of fact "5," "10" and "13" which have been modified. The Administrative Law Judge's findings of fact and the modified findings of fact are set forth below.

Petitioners proposed that the Administrative Law Judge adopt 12 proposed findings of fact. The Division of Taxation ("Division") objected to proposed findings 6, 9, 10, and 11 as incomplete, inaccurate or not supported by the record. Proposed findings 1, 2, 3, 5-8, and 10-14 are incorporated into the facts below, and modified where necessary to more accurately reflect the record. Proposed finding of fact 4 is not supported by the record and is thus omitted. Proposed finding 9 is included as set forth by petitioner, as supported by the record.

The Division issued to petitioners, Salvatore and Janice Tramaglino, a Notice of Deficiency dated February 18, 1992, asserting personal income tax for the tax year 1988 in the amount of \$41,837.95, plus interest and penalty of \$12,354.34 and \$12,452.85, respectively, for a total amount due of \$66,645.14. Although the Notice of Deficiency was issued in both names, the tax liability asserted is attributable to stock offered to Mr. Tramaglino for purchase from his employer. For the purpose of presentation only, all references to "petitioner" herein refer to Mr. Tramaglino.

The Notice of Deficiency followed a Statement of Personal Income Tax Audit Changes issued to petitioners dated October 1, 1991, asserting the same additional tax liability stated above, bearing the following explanation: "Based on an audit, it has been determined that the gain of the Cablec stock in 1988 is taxable to a nonresident, since the stock was compensation for the taxpayer's services to the corporation. There was not a bonafide sale of stock to the taxpayer in 1985."

In August 1985, Mr. Tramaglino accepted employment as the management information systems vice president with Cablec Corporation ("Cablec"), a closely-held Delaware corporation conducting business in New York. The corporation was newly formed by former

business associates. The terms of his employment were set forth in correspondence dated August 8, 1985, which was submitted into evidence. As one of the provisions of his employment he was provided the following:

"Option to purchase 20 shares of Cablec Common Stock at \$473 per share valued at \$9,460 with cash payment of \$6,307 and a three-year note at 9% for the balance of \$3,153."

During December 1985, the Cablec stock split into two classes, Class A and Class B.

This event doubled the number of shares available to petitioner to purchase (from 20 to 40).

While testifying, Mr. Tramaglino explained that as a privately-held company attempting to raise money, the company intended to sell shares of the company to investors, who would only be able to purchase nonvoting shares, designated as the Class B shares.

We modify finding of fact "5" of the Administrative Law Judge's determination to read as follows:

As evidenced by correspondence dated December 31, 1985, petitioner agreed to purchase the 40 shares and agreed to join in the Amended and Restated Management Shareholders Agreement ("Management Shareholders Agreement") dated as of November 11, 1985, and be bound by its provisions and restrictions. The 40 shares were purchased for \$214.25 per share, for a total of \$8,570.00. In payment of this amount, petitioner issued a personal check for \$6,427.50 and signed a note for \$2,142.50, which was later satisfied. Section 5.3 of the Management Shareholders Agreement provided the following:

"Legend on Certificates. All certificates evidencing Shares which are subject to this Agreement shall bear the following legend:

'The sale, transfer and encumbrance of the shares represented by this certificate are subject to a certain Amended and Restated Management Shareholders Agreement dated as of November 11, 1985, among the corporation and certain of its Shareholders. A copy of said Agreement is on file in the office of the Secretary of the corporation. No sale or other transfer of the shares represented by this certificate may be effected except pursuant to the terms of said Agreement. In addition, the shares represented by this certificate have not been registered under the Securities Act of 1933, as amended. The shares have been acquired for investment only and may not be sold or transferred in the absence of an effective Registration Statement for the shares under said Act or an opinion of counsel satisfactory to the Company that registration under said Act is not required.'

"Upon termination of this Agreement, certificates for Shares may be surrendered to the Company in exchange for new certificates without the foregoing legend."¹

On January 23, 1986, petitioner signed a document provided to him by his employer which states his desire to make an election pursuant to Internal Revenue Code § 83(b). The document describes the two classes of stock and states that the shares were transferred on December 31, 1985. It also states that: "The taxable year of the taxpayer for which this election is made is 1985." Other pertinent provisions are reproduced below:

"4. The nature of the restrictions to which the Shares are subject is as follows:

A. The Taxpayer is subject to the following rights and obligations with respect to the Shares:

I. The Employer shall have an option to purchase the Shares on the Taxpayer's voluntary termination of employment or retirement prior to rendering three years of service or upon the Employer's termination of his employment for just cause.

II. The Taxpayer shall have an option to sell the Shares to the Employer upon the Employer's termination of the Taxpayer's employment without just cause, retirement after rendering three or more years of service, or permanent disability.

III. Upon the death of the Taxpayer, the Employer shall be required to purchase, and the Taxpayer shall be required to sell, the Shares.

* * *

"D. Restrictions creating a right of first refusal in the Employer, based upon a proposed transferee's purchase offer, are imposed on the Shares.

"E. By reason of a legend on the share certificate, the Shares are not transferable within the meaning of Reg. §1.83-3(d). Transferees are subject to the restrictions imposed on their transferors, unless waived by the Employer.

* * *

"5. The fair market value at the time of transfer (determined without regard to any lapse restriction, as defined in Reg. 1.83-3(i)) of each property with respect to which the election is being made is \$214.25 per Share (or less), (or \$8,570.00 (or less) in the aggregate.

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We modified this finding of fact to more accurately reflect the record.

"6. The amount paid for Shares is \$214.25 per share, or \$8,570.00 in the aggregate."

Petitioner attached the Internal Revenue Code § 83(b) election to his 1986 tax return that was received by the Internal Revenue Service ("IRS") on February 28, 1987. As submitted into evidence, both the Form 1040 and the election form are stamped with such date and acknowledged as having been received by the IRS on February 28, 1987.

According to the testimony provided by Mr. Tramaglino, the IRS never raised a question or otherwise challenged the appropriateness of petitioners' section 83(b) election as filed.

During the entire time petitioner worked for Cablec and when he sold the shares in 1988, he was a resident of New Jersey.

We modify finding of fact "10" of the Administrative Law Judge's determination to read as follows:

The sale of Cablec stock in 1988 resulted in a gain in the amount of \$606,397.00, which was not included on petitioners' 1988 New York Nonresident Income Tax Return.²

The fair market value for the shares, as set forth in the election form dated January 23, 1986, has not been raised as a matter in dispute.

Petitioner purchased the shares of Cablec under terms contained in the Management Shareholders Agreement. Pursuant to the Management Shareholders Agreement, petitioner had the liberty to transfer his shares to anybody provided he sought prior approval from the board of directors. The agreement set forth the following steps for the transfer of the shares by any management shareholder. In order to transfer shares, a transferor of shares had to first serve notice upon the company. The board had to approve the prospective shareholder within 10 days of receiving notice. The board was specifically precluded from unreasonably withholding approval of any transferee and had to approve the transfer if the prospective transferee was another management or nonmanagement shareholder.

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We modified this finding of fact by deleting the word "capital" in order to accurately reflect the record.

We modify finding of fact "13" of the Administrative Law Judge's determination to read as follows:

In order to protect and maintain the closely-held nature of the corporation and provide a distressed shareholder a market for his shares, the agreement enumerated three options included in the section 83(b) election as follows: If the shareholder voluntarily left the company or was terminated for just cause, the company, management shareholders, and nonmanagement shareholders had an option, but not an obligation, to purchase the shares at a price determined by a formula. If the shareholder retired from the company, was terminated without just cause, or became permanently disabled, the company, management shareholders, and nonmanagement shareholders had an option, but not an obligation, to purchase the shares. Finally, upon the death of a shareholder, the company was required to purchase and the shareholder was required to sell the shares. For purposes of this section, the purchase price was determined by multiplying the book value by a vesting schedule which increases 25% for each year of employment and becomes fully vested on the fourth anniversary of the employment date, except in the instance of the purchase of shares by reason of the

permanent disability or death of a shareholder, where the percentage of vesting is 100%.³

OPINION

In the determination below, the Administrative Law Judge concluded that petitioner's filing of the Internal Revenue Code (hereinafter "IRC" or "Code") § 83(b) was invalid since petitioner failed to file the election form with his 1985 Federal tax return, but rather, filed the form with his 1986 Federal income tax return. The Administrative Law Judge rejected petitioner's argument that because the IRS never challenged or denied petitioner's election form, such election is binding on New York State.

Despite finding that the § 83(b) election is not binding on the Division, the Administrative Law Judge analyzed the Management Shareholders Agreement provisions and concluded that there were no restrictions on transferability which created a substantial risk of forfeiture on petitioner's stock as defined by the Code and regulations. Thus, the Administrative Law Judge reasoned that the stock was transferable in 1985 when petitioner acquired it. As

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We modified this finding of fact to reflect the third option.

such, IRC § 83(a) required petitioner to include in his gross income in 1985 the excess of fair market value over the price paid for the stock. Since petitioner paid fair market value, the excess to be included in income was zero. Therefore, since the appreciation from the gain of a sale of a capital asset is an intangible, and because petitioner is a nonresident of New York State, the Administrative Law Judge found that the gain was not subject to New York State tax.

The Division filed an exception to the Administrative Law Judge's conclusion that petitioner had no restrictions on transferability of the stock when he purchased it in 1985. The Division states that certain provisions of the shareholder agreement (i.e., sections 1.5, 1.6[a], 2.1 and 2.3) imposed restrictions on the transferability of petitioner's shares of stock. Moreover, the Division asserts that sections 3.1, 3.4, 5.3 and 6.1 of the shareholders agreement note that petitioner's rights in the stock were not fully vested. Furthermore, the Division alleges that the Administrative Law Judge inappropriately amended petitioners' 1985 income tax return well beyond the three-year statute of limitations through the reasoning employed in her determination.

In response, petitioner commences by arguing the validity of the section 83(b) election filed with the IRS. Since the Administrative Law Judge determined that the election was not valid, and since petitioner did not file an exception to this conclusion of the determination, this issue was not preserved for our review (see, Matter of Klein's Bailey Foods, Tax Appeals Tribunal, August 4, 1988).

With respect to the issue of whether, in 1985, the stock was transferable and whether it was subject to a substantial risk of forfeiture, petitioner argues that the Management Shareholders Agreement does not prohibit a party to that agreement from transferring their shares. Furthermore, petitioner asserts that at no time was there a substantial risk of forfeiture. Petitioner notes that the vesting schedule set forth in section 3.4 of Article III of the Management Shareholders Agreement was intended to be used to determine the purchase price. However, this vesting schedule was not a restriction or a substantial risk of forfeiture since the shareholder could transfer the stock to a third party at an arm's length price. Petitioner asserts

that the vesting schedule merely established a price that the company would pay, if petitioner was unable to sell the stock to a third party.

In deciding whether petitioner must include the amount of gain as income under IRC § 83(a), a determination must be made as to when petitioner's rights in the stock were transferable or were not subject to a substantial risk of forfeiture. The Division points to the language set forth in exhibit "5," wherein it states:

"[b]y reason of a legend on the share certificate, the Shares are not transferable within the meaning of Reg. §1.83-3(d). Transferees are subject to the restrictions imposed on their transferors, unless waived by the Employer" (Exhibit "5," ¶ 4[E]).

As noted by the Division, the share certificates were not offered into evidence. However, the legend is reprinted in full in the Management Shareholders Agreement in section 5.3, along with the provision mandating that "[a]ll certificates evidencing Shares which are subject to this Agreement shall bear the following legend."

We reverse the determination of the Administrative Law Judge on this issue.

Section 83(a) of the Code provides as follows:

"[i]f, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of --

"(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

"(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture."

Section 83(b)(1) of the Code provides, in pertinent part, as follows:

"[a]ny person who performs services in connection with which property is transferred to any person may elect to include in his gross income, for the taxable year in which such property is transferred, the excess of --

"(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

"(B) the amount (if any) paid for such property."

Section 83(c) of the Code defines the terms "substantial risk of forfeiture" and "transferability of property" as follows:

"(1) SUBSTANTIAL RISK OF FORFEITURE.--The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

"(2) TRANSFERABILITY OF PROPERTY--The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture."

The explicit language contained in the election form utilized by petitioner states that the shares are not transferable within the meaning of regulation § 1.83-3(d) which states as follows:

"Transferability of property. For purposes of section 83 and the regulations thereunder, the rights of a person in property are transferable if such person can transfer any interest in the property to any person other than the transferor of the property, but only if the rights in such property of such transferee are not subject to a substantial risk of forfeiture. Accordingly, property is transferable if the person performing the services or receiving the property can sell, assign, or pledge (as collateral for a loan, or as security for the performance of an obligation, or for any other purpose) his interest in the property to any person other than the transferor of such property and if the transferee is not required to give up the property or its value in the event the substantial risk of forfeiture materializes."

Petitioner was asked to explain the significance of this restriction during oral argument. Petitioner stated that this restriction was merely boilerplate language contained on the share certificates. We do not find this explanation persuasive.

Exhibit "5" clearly states that the share certificates indicate that they are not transferable within the meaning of the above-cited regulation. The burden of proof was properly upon petitioner to show why the certificates were transferable despite the legend contained on them (see, Tax Law § 689[e]; 20 NYCRR 3000.15[d][5]). Petitioner did not address this point in the

brief or in response to questions asked to him at the oral argument in these proceedings. In light of the evidence submitted, we find that the shares were not transferable at the time of purchase and, thus, petitioner was required to include the amount of the gain as income for New York State taxation purposes.

Accordingly, it is ORDERED, ADJUDGED and DECREED that:

1. The exception of the Division of Taxation is granted;
2. The determination of the Administrative Law Judge is reversed;
3. The petition of Salvatore and Janice Tramaglino is denied; and
4. The Notice of Deficiency dated February 18, 1992 is sustained.

DATED: Troy, New York
July 31, 1997

/s/Donald C. DeWitt
Donald C. DeWitt
President

/s/Carroll R. Jenkins
Carroll R. Jenkins
Commissioner

/s/Joseph W. Pinto, Jr.
Joseph W. Pinto, Jr.
Commissioner