STATE OF NEW YORK

DIVISION OF TAX APPEALS

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

Petitioners, Salvatore and Janice Tramaglini, 420 Colony Court, Wychoff, New Jersey 07481-2432, filed a petition for redetermination of a deficiency or for refund of personal income tax under Article 22 of the Tax Law for the year 1988.

A hearing was held before Catherine M. Bennett, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on January 19, 1995 at 1:15 P.M., with all briefs to be submitted by June 30, 1995. Petitioners, appearing by Arthur Andersen & Co. (Henry F. Chiwaya, Esq.), submitted their initial brief on May 5, 1995. The Division of Taxation, appearing by Steven U. Teitelbaum, Esq. (Michael J. Glannon, Esq., of counsel), filed its letter brief on June 9, 1995. Petitioners' reply brief was thereafter submitted on June 30, 1995, which date began the six-month period for the issuance of this determination.

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

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 11-14 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 findings 9 and 10 are included as set forth by petitioner, as supported by the record.

The Division issued to petitioners, Salvatore and Janice Tramaglini, 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. Tramaglini for purchase from his employer. For the purpose of presentation only, all references to "petitioner" herein refer to Mr. Tramaglini.

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. Tramaglini 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. Tramaglini 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.

As evidenced by correspondence dated December 31, 1985, petitioner agreed to purchase the 40 shares and agreed to join in the 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.

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.

"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. Tramaglini, 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.

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

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.

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. 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.

SUMMARY OF THE PARTIES' POSITIONS

Petitioner argues that he made a § 83(b) election which the IRS has not disputed, and thus should bind the Division.

Petitioner alternatively argues that he properly reported zero compensation to New York in 1985 and zero capital gain in 1988, on the basis of the fact that when the shares of Cablec stock were transferred to petitioner, they were not subject to a substantial risk of forfeiture and were transferable. The argument is supported by the theory that although the election was made, it was unnecessary, since there were no substantial restrictions on the transferability of the Cablec stock.

The Division maintains that petitioners did not file a timely Internal Revenue Code § 83(b) election, and thus, an assessment for additional tax issued for the 1988 tax year when the stock was sold by petitioners was proper.

In response to petitioners' alternative argument, the Division points to certain provisions of the Management Shareholders Agreement which the Division argues places restrictions on the transferability of the stock.

CONCLUSIONS OF LAW

A. Addressing petitioner's first argument, whether the Division properly included the gain in New York income turns on whether petitioner filed a valid Internal Revenue Code § 83(b) election. In order to properly place the election in the scheme of taxation, a discussion of the general rules of restricted property governed by Internal Revenue Code § 83 in general would be helpful.

Internal Revenue Code § 83 governs the taxation of stock or other property transferred to a person (e.g., an employee or independent contractor) in connection with services performed by the individual, that when received is in some way restricted, affecting its value. Includible in income is the fair market value of such property over the amount (if any) paid for such property, in the first tax 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 (IRC § 83[a]). The fair market value applied in such computation is determined 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, i.e. the property has become substantially vested, whichever occurs earlier (id.). However, as an alternative, an important election is available to the recipient of the property. The recipient of the property can elect to have the excess of the fair market value over the amount paid for such property as of the date of transfer included in income (as compensation for services) in the tax year of transfer (IRC § 83[b]). The fact that the transferee has paid fair market value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election. If the election is made, any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. The result is that the property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially nonvested at that time, and no compensation will be includible in gross income when such property becomes substantially vested (Treas Reg § 1.83-2) In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b) (id.). Where the employee pays fair market value for restricted stock, i.e., there is no bargain element in the purchase, the income in the year the property is transferred is zero, with capital gain treatment available for any gain recognized on any later transfer of the property (Alves v. Commissioner, 79 TC 864, affd 734 F2d 478, 84-2 US Tax Cas ¶ 9546). The primary significance of the capital gain treatment (at the Federal level) is enjoyment of preferential taxation rates in tax years where lower rates are imposed on transactions qualifying for capital gain treatment, as opposed to rates imposed upon ordinary income, particularly compensation. Specific to the facts of this case, the characterization of income becomes crucial to whether the sale of the stock in 1988 is reported as compensation, taxable by New York, or capital gain from the sale of a capital asset, taxable by his state of residence, New Jersey.

B. In order to make the section 83(b) election, within 30 days after the date the property is transferred, the transferee must make an election and file it with the IRS. In addition, one copy of the statement must be submitted with the taxpayer's tax return for the taxable year in which such property was transferred. A copy must also be provided to the party for whom services are performed.

Turning to petitioner's filing of the section 83(b) election, there is no dispute that the election form was prepared within 30 days of the December 31, 1985 transfer. However, the form was not filed with IRS at that time, and rather than attaching the election to petitioner's 1985 tax return (the year of transfer), petitioner mistakenly attached the same to his 1986 return. The IRS thereafter neither challenged nor rejected petitioner's election.

Petitioners do not contend that each and every aspect of the filing requirement was met. Petitioners do argue, however, that since the IRS allowed the election to stand, that there is a strong inference that the election was acceptable to the IRS, and since it has long been the policy of New York State to adopt the Federal construction of substantially similar tax provisions or those of the IRS that impact State taxable income, that the State should give weight to this (Federal) decision for the purpose of maintaining uniformity. The flaw in petitioners' reasoning is rooted in the fact that the IRS made no decision or determination as to the validity of petitioner's election. A failure to address an aspect of a taxpayer's return does not validate such aspect if in fact it is an error. Even if a determination had been made that validated an otherwise invalid election, the State is a separate sovereign which is under no obligation to follow each and every Federal determination

(Matter of Ross-Viking Merchandise Corporation v. Tax Appeals Tribunal, 188 AD2d 698, 590 NYS2d 576). In Ross-Viking, the petitioner argued that New York should follow a Federal determination that reasonable cause existed for a delay in filing a particular return because the Federal determination was based on the same circumstances currently asserted before the State taxation authorities. The court stated: "While the Federal determination may have persuasive value, [the Tax Appeals Tribunal] as representatives of a separate sovereign, are not bound by that determination" (id., 590 NYS2d at 578).

Being guided only by whether in fact an election was made under Internal Revenue Code § 83, and without reaching a determination as to whether there existed substantial restrictions on the stock in issue, and having concluded that an invalid election was made for New York purposes, the Division properly included the gain on the sale of the stock in petitioners' New York income as compensation for services.

C. As previously discussed, if, in connection with the performance of services, property is transferred to an employee or independent contractor, the excess of the fair market value of such property (determined 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 the amount 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 person's rights are transferable or are not subject to a substantial risk of forfeiture (IRC § 83[a]). Stated more simply, in deciding whether a petitioner must include an amount in income under section 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.

Internal Revenue Code § 83(c), in pertinent part, defines the following key terms:

> "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.
>
> "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."

Treasury Regulation § 1.83-3 provides additional guidance referencing the same terms, as follows:

> "(b) Substantially vested and substantially nonvested property. For purposes of section 83 and the regulations thereunder, property is substantially nonvested when it is subject to a substantial risk of forfeiture, within the meaning of paragraph (c) of this section, and is nontransferable, within the meaning of paragraph (d) of this section. Property is substantially vested for such purposes when it is either transferable or not subject to substantial risk of forfeiture.
>
> "(c) Substantial risk of forfeiture--(1) In general. For purposes of section 83 and the regulations thereunder, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. A substantial risk of forfeiture exists where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied. Property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a

portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture.

* * *

"(d) 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. On the other hand, property is not considered to be transferable merely because the person performing the services or receiving the property may designate a beneficiary to receive the property in the event of his death."

D. Petitioner takes a position which assumes arguendo that even if the section 83(b) election is invalid for New York purposes, it was an unnecessary step since the stock was transferable and not subject to a substantial risk of forfeiture. The stock in issue was transferred pursuant to a Management Shareholders Agreement executed November 11, 1985, which addresses provisions relating to the transfer of the stock. Petitioner agreed to be bound by the agreement, evidenced by his signing of the December 31, 1985 correspondence. The agreement states that the shares may be transferred by petitioner (as a management shareholder) with the prior approval of the board of directors of the company, and such shares would be subject to any additional restrictions imposed by the board not inconsistent with such rights, as a condition of giving its approval (Agreement, Article I, § 1.6). Upon transfer, petitioner must serve notice to the Company and other specified members of the company, bearing the number of shares of the proposed transfer, the name and address of the transferee(s), and all of the terms and conditions imposed upon the shares, including those relating to payment (id., Article II, § 2.1). A transfer may be made if within 10 days following service of notice the board approves the transferee as a prospective holder of the shares. The board may not unreasonably withhold approval of any transferee, and shall not withhold approval if the transferee is then a management shareholder, or another specified company group. The board will be deemed to approve within the 10 days, unless it notifies petitioner of its disapproval (id., Article II, § 2.3). The agreement further provided that if petitioner voluntarily terminated his employment with the company, including by reason of retirement prior to the rendition of not less than three years of continuous service as an employee, or was terminated by the company for "just cause", the other management shareholders, the company and other nonmanagement shareholders had the option to purchase all or any portion of petitioner's shares (id., Article III, § 3.1) Further, if petitioner's employment with the company was terminated without just cause, or terminated by his retirement following the rendition of not less than three years of continuous service as an employee, or he becomes permanently disabled, petitioner "shall have the right, but not the obligation (exercisable by the service of written notice upon the Company within the 30 day period next following the occurrence of any the events described in this Section 3.2), to sell all or any portion of the Shares owned by him to the Company and, upon the exercise of such right by the Terminated Shareholder, the Company shall purchase all such Shares; . . . for the price and on the terms and subject to conditions contained in . . . Article III."

The Division only briefly discussed restrictions on transferability, and pointed to the provisions mentioned above to conclude that such provisions restricted the transferability of the stock.

The provisions of the agreement (30 pages in length) which most significantly related to the transferability, and whether, in fact, there existed a substantial risk of forfeiture, have been enumerated above. There were no provisions in the agreement requiring petitioner to sell his stock to the company upon his termination under various circumstances, with the exception of death. In that case, the agreement provided him a method by which he could sell his stock, if he opted to do so. It was not premised upon his remaining an employee, or "conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services . . . ." I find no provisions restricting petitioner's transfer in a way which creates a substantial risk of forfeiture, as defined by the Internal Revenue Code and

Regulations. Accordingly, the stock was transferable in 1985 when he acquired it. Inasmuch as there was no substantial risk of forfeiture, Internal Revenue Code § 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 he paid fair market value, the excess to be included in income was zero. Thereafter, upon the subsequent sale of the shares in 1988, the appreciation should be treated as gain from the sale of a capital asset, an intangible, reportable to New Jersey, and not as compensation from services, which would have been reportable to New York. Petitioners prevail on their alternative argument.

E. The petition of Salvatore and Janice Tramaglini is granted, and the Notice of Deficiency dated February 18, 1992 is hereby cancelled.

DATED: Troy, New York
December 14, 1995

/s/ Catherine M. Bennett

ADMINISTRATIVE LAW JUDGE