HEARING

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Franchise
and Income Tax Appeals Hearing of:

2009 METROPOULOS FAMILY TRUST	Nos. 18010012
EVAN D. METROPOULOS 2009 TRUST	18010013

Appellants.

REPORTER'S TRANSCRIPT OF PROCEEDINGS

TUESDAY, JULY 30, 2019; 10:38 A.M.

OFFICE OF TAX APPEALS
400 R STREET
SACRAMENTO, CALIFORNIA

REPORTED BY:

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EXHIBITS

TUESDAY, JULY 30, 2019; 10:38 A.M.

ALJ JOHNSON: We will go on the record now.

This is the consolidated matter of the 2009 Metropoulos Family Trust and the Evan D. Metropoulos 2009 Trust, Case Numbers 18010012 and 18010013, respectively. It is 10:40 a.m. on July 29, 2019, here in sunny Sacramento, California. I'm the lead ALJ for this hearing, John Johnson.

Let me say good morning to my fellow co-panelists.

Good morning, Judge Gast.

ALJ GAST: Good morning.

ALJ JOHNSON: Good morning, Judge Angeja.

ALJ ANGEJA: Good morning.

ALJ JOHNSON: Oh, and correction. It is July 30th.

While I'm in the lead for the purpose of conducting this hearing today, the panel will decide, all three of us. We have read the briefs, examined the exhibits that have been submitted. We will make our decision based on the arguments and evidence provided by the parties on appeal.

We fully respect the importance of the decision to be made on this appeal. We know it's been many steps to get to this point. We appreciate the parties' efforts thus far.

Let me have the parties introduce themselves for the record and who they represent. We'll start with the taxpayer appellants.

MR. MUILENBURG: Thank you. And good morning. I'm Ben Muilenburg. I'm with PriceWaterhouseCoopers, and I represent the appellants. We have the Evan D. Metropoulos 2009 Trust and the 2009 Metropoulos Family Trust.

MR. SPERRING: I'm Jon Sperring, also with PriceWaterhouseCoopers, also representing appellants.

MR. WEINTRAUB: Good morning. William Weintraub, representing appellants, with the law firm of Elkins Kalt Weintraub Reuben and Gartside.

ALJ JOHNSON: Thank you.

And Respondent Franchise Tax Board.

MS. WOODRUFF: Good morning. I'm Sonia Woodruff, and I am counsel for the Respondent Franchise Tax Board.

MS. PAGE: And I'm Natasha Page, also counsel for Franchise Tax Board.

ALJ JOHNSON: Thank you.

And, Franchise Tax Board, would you have -- is anybody else anticipated to be speaking today, or will it be the two of you?

MS. PAGE: Just the two of us.

ALJ JOHNSON: Thank you.

I'll generally direct questions towards Appellant Taxpayer or Respondent FTB, but any representatives feel free to chime in with the answers.

The issue we have before us is whether Appellants are entitled to claims for refund for the 2014 tax year. More specifically, the factual and legal arguments primarily co-vest into two questions -- I will read those -- whether Appellants' flow-through gain from an S corporation's sale of goodwill should be sourced under California Code of Regulations, Section 17951-4, or Revenue and Taxation Code Section 17952; and if sourced under R&TC Section 17952, whether the goodwill has acquired a business situs in California. A second question being whether the Evan D. Metropoulos 2009 Trust is a California resident trust.

Appellant, does that accurately reflect your understanding of the issues before us today?

MR. SPERRING: Yes.

ALJ JOHNSON: Were there any other major issues you're intending on presenting?

MR. SPERRING: No.

ALJ JOHNSON: Thank you.

Same questions for Respondent. Is that

accurate?

MS. PAGE: (Nods head.)

ALJ JOHNSON: Any other issues that you think I've left out?

MS. WOODRUFF: No.

ALJ JOHNSON: Thank you.

The exhibits have been provided by the parties prior to the hearing today. The parties stated off record they have no objections and no new evidence. Therefore, we will introduce into the record Appellants' Exhibits 1-10 and Respondent's Exhibits A-L and O and P.

(Exhibits 1 - 10 and A - L, O and P were admitted into evidence.)

ALJ JOHNSON: Any questions from Appellants before we move on to your arguments?

MR. WEINTRAUB: No.

ALJ JOHNSON: And any question from Respondent before we go?

MS. WOODRUFF: No.

ALJ JOHNSON: All right. With that, Appellants, you have 30 minutes. We are ready to start whenever you're able.

MR. MUILENBURG: Thank you. Good morning.

So just a roadmap. All three of us will be presenting on behalf of the Appellants today. I'm going to be addressing or introducing the taxpayers' sole position, the position they've had from the beginning of the claim through the entire process; namely, that the intangible gain in question should be sourced to the nonresidence state of residence under California law, and that the decision -- or the position reached on the amended returns for both taxpayers is the only possible result under California statutory law and case law precedent.

I'll also be responding to -- introducing and responding to the Franchise Tax Board's -- what I'll call their primary argument, or the first argument, explaining how the capital gain should not be subject to formulary apportionment, as they assert, and instead be allocated under our theory.

Next Mr. Sperring, to my immediate right, is going to be addressing what I guess we'll call the alternative argument; namely, that if 17952 of the allocation statute were to apply, that the business situs exception is met and, therefore, somehow formulary apportionment is resurrected and then applied. Mr. Sperring will be discussing the business situs concepts of that.

And finally, Mr. Weintraub to my far right will be addressing the issue regarding one of the two appellants, the Evan D. Metropoulos Trust, and whether or not his -- the document confers a noncontingent status and, therefore, a resident trust.

ALJ JOHNSON: Let's make sure, just before we go forward, Stenographer, are you able to hear everything he's saying?

(Reporter clarification.)

MR. MUILENBURG: Too close?

ALJ JOHNSON: Okay. Let's go a little bit slower if you can. Maybe that will help.

MR. MUILENBURG: Sure.

So before we get into the actual transaction and the issues before, I wanted to step back and just remind the panel kind of what the issue is here today. There were seven briefs, as you're aware.

Is this better?

There were seven briefs and multiple theories. In some instances, they were complimentary, some contradictory. It got a bit confusing over the many years, so I just want to step back and remind everyone what we're talking about here.

Really the question presented is as follows: How does California tax an intangible gain recognized by a nonresident personal income taxpayer?

I mean, the Appellants will show that the statute and laws are very clear, that an intangible gain must be allocated to the taxpayer's home state. And really, while there are a number of facts that we may need to articulate and distinguish, the base issue, once again, is how does California taxable intangible gain recognized by a nonresident personal income taxpayer?

The two main facts at the top that I think, just in full disclosure, we need to talk about, is, first of all, these are not individuals, right? They're not individual taxpayers. They are two nonresident trusts. Nonetheless, under California law, trusts are treated and taxed the same way as individuals. They're subject to the same sourcing provisions, et cetera, so we knew that as a distinction without a difference, if you will.

I apologize if I refer to them as individual taxpayers or trust taxpayers. I'm meaning that to be synonymous, in the sense that they're subject to the same rules.

The other fact that is more important, that we're going to spend more time talking about today is, what happens if the nonresident trust or individual recognized the intangible gain not directly from their own sale, but recognizes it as distributable share of an S corporation that they're a shareholder in that actually recognized the gain?

The FTB is going to assert that a different result should occur from sort of the clear rule of law when sold directly and that because of the pass-through status and the distributable share from the S corporation, all of that income is subject to formulary apportionment.

However, we're going to show that California law, both statute and regulation, in addition to federal law concepts that we conform to wholly, and then finally precedent from the California Court of Appeal, all directs the determination in this case to be identical to a direct sale of an intangible, that essentially the nonresident individuals are treated as if they sold the intangible directly, and the law is clear on what to do there.

So as we go through this presentation, I just encourage everyone to keep going back to the stated issue being, what is the sourcing rule for an intangible gain recognized by nonresident personal income taxpayer?

So on to the transaction itself. As I mentioned, it's not an intangible from the sale by nonresident. Instead, it was the sale by a Delaware S corporation of its qualified Subchapter S subsidiary. You've got an S corp selling a Q sub, and the sale for legal purposes is the sale of stock, but it's conducted under what's known as a 338 transaction. Right? So for tax purposes, it's a deemed sale of assets.

There are a lot of reasons why a buyer and a seller would enter into an agreement to elect IRC 338, but at the end of the day, you know, the buyer is getting stepped-up basis in the assets. And for legal purposes, the seller is selling the stock. That wouldn't normally be an issue and something we need to deal with. However, we've provided in Appellants' Exhibit 3 basically the purchase price accounting and an allocation of where basis lies and where the gain is associated. And I know it was a contention early on. But if you look at that exhibit, you'll see that, you know, 99.6 percent of the gain is basically allocated and recognized by intangible assets, brand, intangibles, what we're calling goodwill as a whole.

So the income in question is gain from an intangible. And taxpayer is only filing a refund claim on the 99.6. The 4 percent related to other assets are not at issue in today's appeal.

So, secondly, who has recognized the gain? As we mentioned, it's the S corp. The S corp is selling the Q sub. It is recognizing the gain. S corps in California, it's a bit unique. There's a entity-level tax. There's a 100-S filed. They're generally subject to the corporate provisions. And it's important to note that that tax return and the results of that tax return and the 1.5 percent tax on the entity level is not in dispute today. Presumably, the Franchise Tax Board has no issue with the way in which the S corp PCHI reported that income on its 100-S.

However, an S corp, like the partnership, is a flow-through entity and is required by law to flow-through all tax income to its shareholders. The question becomes what about S corp or its shareholders? How are they taxed under California law? What becomes of this intangible gain when it's passed through to them?

So, you know, again, just to reiterate, it's not the taxing S corp that we're talking about. It's the pass-through tax on the two nonresident trusts receiving separately stated capital gain income from the S corp as a result of sale of intangibles.

There's a federal rule on point here, and it's commonly referred to as the conduit theory. And conduit theory is meant to mirror a similar rule in the partnership law, and that rule is IRC 1366(b). I'll read from it, short pertinent language.

It basically says, "The character of any item included in a shareholder’s pro rata share shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation."

I suspect we're going to have disagreement over what this language -- just looking at the FTB's exhibits provided today. I believe they're citing the same language. I'm suspecting there's disagreement in what that means. But case law and others will give us some guidance here.

But essentially this conduit theory means that when you're a shareholder in an S corporation or if you're a partner in a partnership, you step into the shoes of the pass-through entity and whatever income they received, it's as if you realized it directly. That's the conduit theory. That's federal law.

It's important to note that California conforms fully to IRC 1366(b) at 23800 and sequence. California basically adopts all the subchapter S of the federal IRC, with some modifications. There are no modifications to these areas here.

And so by application of the conduit theory and California's conformity to the conduit theory, you have the nonresident individual stepping into the shoes of the S corporation and thereby recognizing a gain from a sale of an intangible directly. That is what the law directs you to find.

So the question is, what is the California statute? What's the treatment when a nonresident personal income taxpayer recognized gain from the sale of an intangible?

And that rule is contained in CRTC, Section 17952, which is income from intangibles is applicable to nonresident taxpayers and, in pertinent part, says income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within the state.

And Mr. Sperring is going talk about the exceptions to that business situs, et cetera. But essentially what that statement is, is what we call the mobilia rule. I'll spare you my attempt at Latin, but essentially the rule is as follows: The person where the gain is related to intangible income, it's gonna be sourced to your state of residence unless a number of other requirements apply.

So if we just stop there, the statutory law in

Appelants' opinion is quite clear. By virtue of the conduit theory and California's conformity to the conduit theory and the statute directly on point, basically source of intangibles, we believe it's very clear that 17952 requires the intangible to be sourced to the state or residence. However, we have additional guidance, and really the only case law precedent that's been cited for this area is Valentino. Right?

Valentino was a California Court of Appeal case in 2001. And, you know, the facts, just really briefly, there's a Florida couple that invested in an S corp doing business in California, and presumably to test the boundaries of 17952, the position taken by taxpayers was, the only thing we own is an intangible. Right? Stock in an S corporation. Therefore, any income we get as flow-through income from the S corporation is necessarily generated by our holding of an intangible; therefore, it should all be allocated to Florida.

Well, the Court didn't agree with that, right, and found instead for the State. But they spent multiple pages describing exactly why they didn't agree. Right? They said 1366(b), the conduit theory exists, and we need to employ that theory when we're talking about income that's a distributive share pass-through to the shareholders.

And instead of just saying, no, this isn't apportionable -- or this is apportionable, excuse me, they said it's apportionable because it's trade or business income, because this is the ongoing profits of the S corporation passed through to you, you step into the shoes. It's as if you're conducting the trade or business directly yourself; therefore, you're apportioning that income.

On the contrary -- they make three quotes. Basically, it's a two-step process: One, identify the income in question, and that was the income from a trade or business, and then apply the rule of law as if the shareholder derived it directly. In this case, it would be 17951-4, trade or business income needs to be apportioned even when it's passed through.

But they made three quotes that are very important, and I know that the State likes to refer to them as dicta, but they're very important because they identify the boundaries of the ruling in Valentino. And those quotes, I'll just read them. "Consequently, Section 17952 never applies to a shareholder's share of S corporation income unless the corporate income itself is derived from intangibles."

Why do they state that? Because they want to indicate that they're applying conduit theory and they're looking at the nature of the income itself under the rules applicable to nonresident individuals. So if it's an intangible and you use the conduit theory, you have to allocate that income.

Continuing on, "Moreover our interpretation harmonizes Internal Revenue Code Section 1366(b) with Section 17952 by applying the latter to income characterized at the corporate level as income from intangibles." So, once again, identifying the difference.

And then, finally, Section 17952 continues to apply in those situations it did before the enactment of the S corporation provisions, that is, to determine the course of stock dividends and income from the sale of stock.

So the taxpayer's position is the statutory law is clear, the regulatory law is clear. The only case on point in California, Court of Appeal decision in Valentino, clearly identifies the two-step process in applying the conduit theory; and, you know, your panel should take into account, you know, that that is the position and the only way to apply the law.

The FTB's position on -- and I'll be brief because we're a little late on time. Essentially, they're stating that all income that's distributive share from an S corporation is necessarily trade or business income and, therefore, it's subject to 17951-4; and basically I believe that comes from a misreading of the conduit theory and this idea that because it's distributive share it's income from an S corporation. And if an S corporation happens to be conducting business, therefore, it's all income from conducting a business.

And quite frankly, no. I mean there are a number of items reported on the K-1 that are not trade or business income, and the case law really, you know, makes a point in pointing this out. Jon is going to go more into depth on the appeal of Ames, a case both sides are very familiar with.

In that case there was nonresident husband and wife who invested in a -- basically a partnership that redeveloped parts of Los Angeles. Obviously, it's California-based property. There are California sourcing and taxation requirements as they hold that partnership interest. But when they got out of the partnership interest and they sold it, the Board was clear to say the gain was not a result of the partnership operations but as a result of the sale of an intangible.

Again, there's a difference between ongoing operations -- in our case it's the sale of beer -- and selling a subsidiary. Clearly PCHI, the S corp at the top, was not in the business of selling subsidiaries. That wasn't its ordinary course of business. This is a onetime event.

Similarly, PHI, the qualified subchapter subsidiary being sold, they weren't in the business of being sold by their parent. That wasn't their day-to-day business. The day-to-day business was Pabst Blue Ribbon Beer, which a lot of us are familiar with.

So there's a difference. And case law, Board of Appeals' position, California Court of Appeals, et cetera, continue to remind us that you need to look at what's trade or business income and what is something else, what is a onetime corporate event like the sale of an intangible?

So the FTB attempts to disregard Valentino by saying two things. One, that the language I quoted was dicta, right? That it's not important to the case. Hey, the State won in that case. Why are you citing Valentino?

Because Valentino wasn't a two-page brief or opinion. It was quite lengthy, because they felt the need to identify. The State won in this case because we're dealing with trade or business income. If we have an item of intangible income, we'd reach a different result; namely, 17952 would apply.

Then, finally, there's been a statement that 17952 only applies to nonbusiness income, and Appellants are just at a loss as to where that comes from. There's no mention in any of the case laws we've cited of nonbusiness. A quick "control F" will tell you that. There is a mention of nonbusiness in the sole proprietorship rules in 17951-4, but it's not the section dealing with flow-throughs so we're not even sure where that argument comes from.

I'll save the rest for rebuttal, but what I'd like to talk about is this case. It's not the first time this has come in California; it's not the first time Franchise Tax Board has made all these arguments. There is a case at the Board of Equalization. I understand it's not a citable, it's not a published case, et cetera. But all these arguments were made, that all distributive shares of income is apportionable. It was rejected. That the language in Valentino is dicta, excuse me, that was rejected. And that, finally, the second sourcing step does not require 17952 because federal law doesn't have sourcing concepts. Again, rejected.

And the attorney that wrote the opinion for the BOE put a lot of thought into this and articulated from appeal of Ames, Valentino, all the precedent out there, the distinction between ongoing trade or business income and income from the sale of intangibles.

Really quickly -- or should we save it for the end?

Really quickly, it's important to understand or be reminded of the actions after all this case law took place, so after Valentino, after Venture. The State actually undertook a process to amend the regulation. Right? They stated publicly in publicly held records -- and we've submitted those as Exhibits 7, 8, 9 -- essentially that they don't like the rule of law articulated in Venture. They believe it should be apportionable just like it is for corporate partners and, therefore, try to amend the regulation to say 17952 never applies when a partnership is involved.

That attempt failed, basically, because the taxpayer community reminded the State that you can't change -- you can't supersede a statute by regulation. But it's important to realize the statements they made during that process. So they said, "Staff believes the rules in 17951-4" -- the apportionment statute -- "should be amended consistent with the rules in 25137" -- the apportionment statute for corporate partners -- "where the unique language required to address the difference in treatment for nonresident individuals instead of corporations. This amendment is provided to remedy that inconsistency." The FTB knew the rule of law is different, the rule of law is different, the statues are different.

And then, finally, the regulation is being revised to explicitly provide that 17952 does not apply with respect to an interest in a partnership that conducts business within and without California. The revisions are effective only as the effective date of this -- of these changes; in other words, the revisions are to be applied prospectively. We need to remedy an inconsistency, we need to change the law, and we're going to do it prospectively.

All of that goes to state of mind and knowledge that the Franchise Tax Board knew that the intangible rule was different for non-residents as opposed to corporate residents. And these are personal taxpayers, not corporations.

So I'll pass on to Jon.

MR. SPERRING: Good morning, Judges. Again, for the record, my name is Jon Sperring, and I'm going to address the FTB's alternative argument that the business situs exception contained in CRT Section 71952 applies to this case.

The California Court of Appeals addressed the very issue of determining business situs of goodwill in Rainier Brew & Co. v. McColgan. Like Pabst Brewing, Rainier is a story brand with a long history.

Interestingly enough, the Rainier trademark became part of the very intangibles sold in the Pabst transaction now in dispute. In the Rainier Brewing Company, the taxpayer licensed the Rainier name and trademark for exclusive use in Alaska and Washington. Importantly, the Court held the revenue from an intangible, license of a trademark, did not have business situs in those states. Rather, the Court held the longstanding document mobilia applied to the goodwill of Rainier Beer's business and determined that 100 percent of the income would be allocated to the owner's domicile in California.

Since we have the very same business intangibles in our case, the mobilia doctrine must also apply and the income must also be allocated to the taxpayer's domicile. In this case, of course, the taxpayer's domicile is outside the state.

The mobilia rule for the taxation of income from the sale of intangibles was also upheld in the appeal of Ames. In Ames, the FTB argued unsuccessfully that the nonresident taxpayer's limited partnership interest fell within the business situs exception contained in Section 7592.

In Ames, the taxpayer purchased interest in the Bunker Hill Redevelopment Company, which was a limited partnership. The partnership's principal business activity concerned real property located in downtown Los Angeles. And the general partners were also in California. The limited partner in Ames were mere passive investors, like the taxpayer trust in this case.

In arguing that the business situs exception had been met, the FTB's position was as follows: A partner is considered engaged in the business of the partnership; second, that the activities engaged in by the taxpayer through its partnership constituted conducting business in California; third, that the distributive share of the partnership are allocated to the partners pursuant to their partnership interest; and, fourth, that the partnership interest being so integrally involved with the business being conducted acquire a business situs where the partnership activity occurs.

The BOE rejected this line of reasoning and instead followed the rules set out by the California Supreme Court in Holly Sugar. In Holly Sugar, the Court stated business situs arrives from the act that the owner of intangibles employing the wealth represented thereby as an integral portion of the business activity of the particular place so that it becomes identified with economic structure of the place. I emphasize "place."

In Holly Sugar, the Court held the stock of Santa Ana Sugar Company had business situs in California because of the economic integration between Santa Ana Sugar and Holly Sugar's unitary business in California; in other words, through its 70 percent stock ownership of Santa Ana Sugar, Holly was able to integrate its sugar business into one operating wholly within California.

In contrast to Santa Ana Sugar, which was growing and refining sugar on 9,000 acres in Orange County, PHI's business activities were in many states and foreign countries and, therefore, not localized to California. In fact, PHI's California sales factor during the year of the sale was 6 percent. PHI's facts are a far cry from Santa Ana Sugar; and equally important, Evan and the Family Trust were not conducting a unitary business with PHI, as was the case between Santa Ana Sugar and Holly Sugar. The taxpayer trusts were merely passive investors like the limited partners in Ames.

If there's any doubt as to the meaning of the Holly Sugar decision, we need look no further than FTB's own regulation under 17952, which specifically states that the intangible property has to be localized in the state to have business situs.

At this point I would be remiss not to call out the FTB -- to call out the fact that FTB's three-page reply brief fails to cite a single case for the proposition that goodwill of a multistate business has business situs in every state that it sells beer. Instead we are left with the following empty statement, "There could not be a better example of intangible property having business situs than goodwill," page 2, line 11 and 12 of Respondent's reply belief.

There's no citation to support this bold statement, and there's good reason for the lack of citation. As discussed, the case law states the exact opposite. The goodwill of the beer business does not have business situs in the states where beer is sold. Moreover, nowhere in FTB's three-page brief does the department explain how the goodwill of a worldwide beer business was localized, as required under its own regulation 17952.

The facts in this case are straightforward. The taxpayers are two Delaware trusts which received gain from the sale of their respective passive ownership interest in PHI's intangibles. These intangibles, which consisted of goodwill from the beer business, had not been pledged as a security for payment of indebtedness or in any other way localized to California by the taxpayer trust. As a result, the intangibles did not have business situs in California and, therefore, the mobilia rule under 17952 applies.

I urge this panel not to be fooled by FTB's old and rejected arguments to the contrary.

I now yield the remainder of my time to Mr. Weintraub, who will address the arguments raised in FTB's sur-reply brief. Thank you.

MR. WEINTRAUB: Good morning. The issue that I will address is whether this trust is a resident trust. And that simply depends on whether we have a California beneficiary whose interest is not contingent. If the interest of the beneficiary is contingent, then we do not have a California resident trust.

Our facts are -- and we think that it's pretty straightforward -- that the interest of Evan is as a contingent beneficiary. His right to receive a distribution is subject to a condition precedent. That condition precedent is the exercise of discretion by a distribution advisor. And during the year in issue, Evan did not receive a distribution. It's pretty straightforward. It's clear. It's simple. These are objective tests. These are the pragmatic tests that the Supreme Court referred to in its recent decision in Kaestner.

The FTB, in contrast, wants to inject subjective considerations. They focus on the fact that, well, Evan could have designated himself the investment advisor and that he could have replaced and appointed a different distribution advisor.

These are subjective concerns. They did not happen. There was no distribution advisor who exercised their discretion to make a distribution to Evan. That is the test for a condition precedent.

The fact that Evan could have appointed a series of distribution advisors until he found one that he liked is no different than any beneficiary in any trust who may have the right to replace a trustee or a trust that is established with a friendly trustee.

If I established a trust for my daughter and designate my brother as the trustee, is the FTB going to look at that and say, well, maybe given the relationship between my brother, my daughter, that she's likely to get a distribution whenever she wants? Or is the test that he's got the discretion to make a distribution and until he exercises it she did not get a distribution and, therefore, her interest is still contingent? That has been the rule for many years in California.

And to understand sort of the overview, let's just -- let's go through a review of what this type of trust is versus a traditional trust. A traditional trust has just one fiduciary, the trustee, who has custody of the assets and who exercises discretion on making investments of the trust based upon the powers given under the trust instrument and who exercises discretion granted under the terms of the trust to make distributions to beneficiaries. That's fairly simple and straightforward.

Here, with a directed trust, we've unbundled the powers and duties of the fiduciary, what would be a trustee. Those powers are now divided among a group of other fiduciaries. So in this case, we have a trustee who is really not much more than a custodian of assets, who holds title to the assets. And for good reason.

In this case, we have a institutional trustee. We know the assets are not going to disappear. But there are various good reasons why we don't want to rely upon an institutional trustee to make all of the investment decisions and to make all of the distribution decisions. There are many things that an institutional trustee or another trustee cannot do without potentially breaching their fiduciary duty.

So in a directed trust, the trustee is permitted to take direction from an investment advisor, who may recommend to the trustee you can hold a concentrated position in stock; you can invest in private equity; you can invest in real estate. You don't have to just invest in a diversified portfolio or stocks and bonds.

Similarly, you may want to have a distribution advisor so that you don't have an institution who is removed from the interest of the beneficiaries exercising discretion when they don't really know what's going on. So it's fairly common in circumstances like this to have a distribution advisor who is granted the discretion to make a distribution or not.

In this case, we had a distribution advisor who had full discretion, sole and absolute discretion, to make a distribution. And that discretion was never exercised in favor of the beneficiary. And because of that, the beneficiary's interest remained contingent unless and until the distribution advisor exercised that discretion and made the distribution.

What would be the consequences if the FTB's approach were adopted as the law? And we'll go through the reasons why that should not be the law.

First of all, this would be a game changer in trust drafting and administration. Every trust that a lawyer drafted, whether in California or not, that provided for discretion in favor of a California beneficiary would have to be concerned about the subjective concerns as to whether there's now a condition precedent or any friendly trustee would be subject to the same analysis.

But there's very good reasons why beneficiaries are given the power to remove and replace trustees. And if we adopt the FTB's view, it's going to be impossible to draft a trust with a California beneficiary and at the same time give the beneficiary the needed power in many circumstances to remove and replace the fiduciary who makes the distribution decisions.

And even if we had a friendly trustee -- so it's not even a matter of removing or replacing the trustee -- the FTB would look at the relationship and see, well, in fact, based upon these circumstances, do we think that there really is no discretion and do we think that there really -- in our judgment, that the interests of the beneficiary is not contingent?

That's wholly subjective. That's not pragmatic, and that's not the test in the Supreme Court case in Kaestner.

Fortunately, we do have history to support the very clear rules that have been applied in California for many years. If you look at the legislative history, which is on page 6 of the reply brief addressing that -- I'll read a few of these.

Talking about the change in Section 17742 that apply the rules to say that the interest of a beneficiary that is contingent prevents the trust from being a California resident trust. It says -- some legislative history, "The purpose of the bill is to exclude from taxation the income of an out-of-state trust with a California beneficiary if the interest of the beneficiary is contingent. The tax would become payable at the time the income of the trust was distributed or becomes distributable." That's very clear.

In another place it says, "The narrow subject of this bill is taxation of an out-of-state trust where the only connection with California is the residence of a contingent beneficiary"; that is, someone who may or may not in the future receive anything from the trust, and the bill provides that he will be taxed if and when he actually receives a distribution.

And, finally, "Exclusion from taxation the income of a trust in which the income of the beneficiary is contingent until the income is distributed or becomes distributable to the beneficiary."

And this approach was also followed in a 2016 TAM issued by the Franchise Tax Board which says, "A resident beneficiary whose interest in a trust is subject to the sole and absolute discretion of the trustee holds a contingent interest in the trust. The exercise of the trustee's discretionary power is a condition precedent that must occur before the beneficiary obtains a vested interest in the trust."

Those are our facts. We have a third party who's granted the discretion who must exercise that before the beneficiary receives anything. And, in fact, the beneficiary never received any distribution in 2014.

In its brief -- and I anticipate the FTB will raise the other arguments. They raised five other arguments, all of which, in our judgment, are irrelevant and were presented in a misleading manner that would confuse a determination of this issue.

ALJ JOHNSON: You have run to the end of your time. Would you want to save those discussions for your rebuttal, or can you finish your thoughts in a minute or two?

MR. WEINTRAUB: I can do that. Let me finish, our facts are virtually the same as the facts in the recent Supreme Court decision in Kaestner. We have a beneficiary who did not receive a distribution; we have someone who had control of that distribution, the sole and absolute discretion to make the distribution or not; and there was nothing in the trust that provided that there's any certainty that the beneficiary would ever receive a distribution. On that basis, the interest of the beneficiary has to be viewed as contingent and, therefore, the trust cannot be viewed as a resident trust in California.

ALJ JOHNSON: Thank you.

MR. WEINTRAUB: Thank you.

ALJ JOHNSON: Respondent, you also have 30 minutes, and you may begin if you're ready.

MS. WOODRUFF: Okay. Thank you. Good morning.

The Evan D. Metropoulos Trust, which I will call the Evan Trust today, is taxable in this state because the beneficiary of this trust is a California resident. The trust instrument grants him -- guarantees him so much power over the assets of the trust that his interest in the trust may not be considered contingent. Even if you find the trust is not taxable on a residency basis, the income is still taxable because it derives from a California source.

I will address the issue of trust residency today, and Ms. Page will address the sourcing question.

Revenue Tax Code Section 17742(a) imposes tax on a trust when the trust's fiduciary or noncontingent beneficiary resides in this state. In this case, the sole beneficiary of the trust, Evan D. Metropoulos, resides in California.

There are three main reasons why Evan's interest may not be considered contingent. First, Evan enjoys significant control and dominion over the trust assets. He holds the right to remove, replace, and act as the investment management -- or investment direction advisor of the trust at any time.

He also has the right to remove and replace the distribution advisor and the right to remove and replace the trust protector. If he wished to change his distributions or to cease control of the management and investment of the trust assets, he could do so at any time simply by exercising the rights guaranteed to him by the trust instrument.

Simply put, a beneficiary's interest is not contingent when the power to overcome the so-called contingency rests in the beneficiary's own hands.

Second, Evan received a distribution from the trust during the tax year, demonstrating actual receipt and enjoyment of trust income. Now, Appellants allege that this distribution came from the non-ESBT portion. I believe that's why they are arguing that there is no distribution. There was, in fact, a distribution from the trust which may have been from a non-ESBT portion.

Finally, he had significant involvement with the underlying business of the trust. He served as the initial investment direction advisor for the first three years of the trust, with full latitude to direct and manage the assets and the investments of the trust. He also worked on behalf of the underlying business of the trust.

These facts show that Evan had substantial control over and involvement with the trust assets. Under these facts, he may not be considered merely a contingent beneficiary. The income accumulated for his benefit may be taxed by the State because of his close relationship with the business of the trust.

Section 17742(a) imposes tax on the entire taxable income of the trust if the fiduciary or noncontingent beneficiary resides here. An exception to this rule exists for merely contingent interests in the trust. A noncontingent beneficiary is defined under the regulations as one whose interest is not subject to a condition precedent.

Now, Appellant argues that Evan's interest in this case is contingent because all distributions are subject to the discretion of the trustee. They reference Technical Advice Memorandum 2006-2, which contains an informal statement of FTB's position with regard to discretionary trusts. The TAM addresses the question of whether a resident beneficiary has a contingent interest when their only interest in the trust is subject to the discretion of the trustee.

And the TAM concludes that in such a case, the resident beneficiary holds a contingent interest. The exercise of the trustee's discretionary power is a condition precedent that must occur before the beneficiary obtains a vested interest in the trust. Of course once a distribution is made, the interest is no longer contingent, at least to the extent of the distribution amount.

The TAM's conclusion, however, is premised on a trustee with complete unfettered discretion over distributions. And the reasoning is that in a purely discretionary trust, the beneficiary has no real vested interests or rights until the trustee decides to make a distribution. And the TAM cautions that the trust instrument must be reviewed in each case to determine any limitations on the trustee's discretion to accumulate income.

So it's not enough to only look at the language regarding discretion, but you must also examine the entire instrument to see if that discretion is truly unfettered. Appellant argues that this analysis imposes too much complexity on tax administration. But the fact of the matter is, that trusts are often complex instruments requiring a higher level of scrutiny to determine the tax effects.

The facts in the TAM are entirely different than those of the Evan Trust. First, the Evan Trust states that the trustee is authorized to make distributions in his sole and absolute discretion. But this discretion is subject to provisions of Article 8 of the declaration. Article 8 then strips away the distribution function from the trustee and grants all distribution powers to the distribution advisor. The trustee is to follow the directions of the distribution advisor with respect to all matters concerning the distribution of income or principal.

Although Michael Kramer is a nonresident and he appears to serve as both the trustee and the distribution advisor, it's critical to note that Evan has the ability under Article 8 of the trust to remove and replace the distribution advisor at any time. Now, Evan cannot name himself or certain family members to serve in that capacity, but he could name virtually anyone else, such as a close friend or a trusted employee, to make all decisions regarding distributions of the trust.

The fiduciary responsibilities for the trust are further divided. The investment direction advisor is a role created by Article 7 of the trust, has the full power to manage the investments of the trust. The trustee is directed to follow the direction of the investment direction advisor with respect to all matters relating to the management and investment of trust assets. The investment direction advisor holds sole responsibility for the investment, voting, and management of the trust assets. The trust relieves the investment advisor of all liability for loss. It also waives the prudent investor rule, the rule against self-dealing, and the duty of loyalty for the investment direction advisor. These provisions demonstrate the extent of the authority and freedom enjoyed by the investment direction advisor.

Also notable is the investment direction advisor's specific authority to direct the trustee to borrow and lend money and to guarantee the repayment of any indebtedness of the trust. This advisor can borrow money from the trust at any time, pledge or encumber any portion of the trust property, and direct the trustee to make -- to guarantee loans.

So this role holds a great deal of authority to control the assets, direct the investments, and hold investments that would otherwise be unlawful or imprudent. It can also cause the trustee to acquire property and business ventures and enter into any contracts as desired. He has no responsibility to conform to a traditional fiduciary duty and is not to be held liable for any loss unless he acts in bad faith or willful misconduct.

Evan was the initial investment management -- investment direction advisor from the inception of the trust, making all investment and management decisions, and enjoying unfettered control before stepping down from that role in 2012.

Under Article 7 of the trust, however, Evan has the unlimited right to remove and replace any acting investment direction advisor, and there's no limitation on who may serve, which means he can resume that role again whenever he likes. The Evan Trust also permits Evan to remove and replace the trust protector, although he may not serve in that role. This trust grants significant functions to the trust protector. He can amend the trust, designate the governing law for jurisdictional purposes and appoint additional advisors.

The powers granted to the beneficiary in this case show that his interest in the trust is not a mere contingency. Appellant would like you to believe that the only fact that matters is the language of the trust purporting to grant the trustee with discretion to make distributions. However, another provision of the trust strips that discretion away and conveys that power to a distribution advisor.

And if you probe even slightly beyond that discretionary language, you see Evan's ultimate control looming over that trust. Evan can remove and replace the distribution advisor or trust protector, and he can at any time step in and manage and control the assets of this trust. If he wanted to sell all of the assets, invest in his own businesses, make loans to anyone, including himself, or purchase real estate, he could do so without any real limitation. And it's that great degree of ultimate control that causes Evan to be more than just a contingent beneficiary with no rights or certainty with regard to his trust. The settlement in this case clearly intended to grant Evan rights over the investment of the assets and the ability to step in should he be unhappy with distributions or with the management of the trust.

Now, Appellant argues that until the beneficiary actually exercises these rights his interest in the trust is still contingent.

But this position is simply not logical. When the beneficiary holds the power to terminate the contingencies that would prevent him from accessing his trust, his interests cannot be considered merely contingent.

Now I'd like to briefly address the recent U.S. Supreme Court decision in North Carolina Department of Revenue versus the Kimberly Rice Kaestner Family Trust.

In that case the U.S. Supreme Court found that a North Carolina statute imposing tax on trust income that's for the benefit of a North Carolina resident was unconstitutional. That decision, however, was narrowly drawn to the particular facts of that case, and the Court expressly declined to address laws such as California's, which, unlike North Carolina, only taxes trusts with noncontingent beneficiaries.

The beneficiary of the Kaestner Trust resided in North Carolina, but the grantor and the trustee resided outside of the state. The beneficiary was entitled only to receive discretionary distributions until the age of 40, at which point she was entitled to receive the assets of the trust.

Now, during the tax years at issue, the Kaestner Trust beneficiary had not yet reached the age of 40, nor had she received any distributions from the trust. So it's important to note that under California law, the Kaestner Trust would not have been taxable had the beneficiary resided in this state during the same tax years.

The facts of Kaestner closely resembles the scenario contemplated by the TAM 2006-2. So long before Kaestner, FTB interpreted fully discretionary trusts as creating contingent interests when there are no other powers or rights involved. So California's law, as written and as applied, already complies with the holding of Kaestner, and so that case should not change the result for the Evan Trust.

There were several important points made in the Kaestner decision. The Court noted that the important factors in whether a state may tax a trust when the beneficiary is a resident are the extent of the beneficiary's control, possession, enjoyment, or receipt of trust income. The Court found that the due process clause demands attention to the particular relationship between the resident and the trust assets that the State seeks to tax.

So under a Kaestner analysis, the Evan Trust is properly taxed by California because of the extent of the beneficiary's rights and control over the assets of the trust. He can exercise his removal and replacement powers at any time. He, in fact, did act in a fiduciary capacity at one time, but chose to step down.

This point is particularly salient because the Court in Kaestner pointed out that the Kaestner Trust beneficiaries -- or the Kaestner Trust trustee authorized the trustee and not the beneficiaries to make investment decisions. The Court reasoned that this fact made the beneficiary's interest less like a potential source of wealth that was property in the beneficiary's hands.

The Evan Trust creates exactly this potential source of wealth that is property in Evan's hands.

As further evidence of the relationship between the resident and the trust assets, Evan was also substantially involved with the underlying business of the trust. He acted as the co-CEO of Pabst Brewing Company, and his close ties with the underlying interest owned by the trust through its S corporation reflects his close involvement with the trust assets.

In addition, the trustee of the trust, Michael Kramer, also appears to have acted as a board member for Pabst Brewing Company. This fact raises questions about whether Mr. Kramer could actually be an independent trustee when he had such close working ties with the beneficiary.

In light of Evan's significant power to control his trust and his close involvement with the business owned through the trust holding companies, Evan may not be considered a merely contingent beneficiary. In addition to the trust being taxable on a residency basis, the trust income was also derived from a California source.

And Ms. Page will now explain why.

MS. PAGE: If I could call the panel's attention to the FTB-1 visual aid that was presented this morning, just briefly go over the transaction itself.

As you can see, the -- in the very center of the page is "PCHI, a Delaware S corporation." This was the S corporation that was held by the trust -- the two trusts in question. And the actual Pabst Brewing Company was down a couple levels from the PCHI.

Those two subsidiaries, Pabst Brewing Company and PHI, were both sold. And since they were subsidiaries of an S corp, they were sold -- they were Q subs, qualified subsidiaries, and so their sales resulted in a sale of assets. The primary asset, as the parties have agreed, was goodwill of Pabst.

As you can see, in green we have the payment for those subsidiaries or for those assets of $607 million accruing to PCHI. Then the distributive share from that sale passed to the family trust and the Evan Trust as distributive share income.

The trusts themselves did not sell the assets of the Pabst Brewing Company or PHI. That will become more important later.

I think the biggest problem that we're having in this case is the disconnect that Appellants are having, which you can find on the next visual aid, which is actually Exhibit E, page 9, and that is the statement to the 2014 California Fiduciary Income Tax Return. That was filed with the amended -- both trusts, it was filed with the amended 541 returns, where they actually changed their position. So they had filed their 541 returns, following 17951-4(d), and later determined that they shouldn't have filed that way, incorrectly.

And this is the sentence that was explaining that change. I've highlighted it. It says, "They shouldn't have reported the gains from the sale of intangible property because taxpayer, as a shareholder of an S corporation, is taxed as if the business of the S corporation were conducted directly by the shareholder."

Yet if you look at the following sheet, FTB-2, you'll see that Valentino says that, on page 1290, which is exactly the place that the shareholder -- the Appellants were citing in the appendix to their tax filing -- it says, "as if the income were realized directly from the source from which realized by the corporation." So they've actually put their feet in the wrong direction.

So what's happened is, they believe that when PCHI sold the intangibles, they follow Valentino in their way, they pretend that the trust sold the goodwill. But instead, 1366 requires that the shareholders stand in the shoes of PCHI and look at it and say -- realize that that was business income in the hands of PCHI and in that way they have to characterize the income.

So the two-step process that is indicated by Valentino is -- the first step is to identify the conduit rule, and then the second is to characterize the income. You characterize the income at the entity level, not at the shareholder level. So the entity level, it was already characterized as apportioned business income. So that's the character that carries through under 1366, not tangible property.

So if you realize that this is income from a business because it was reported on a K-1 -- and notice this is income from a trade, business, or profession first. It's not business income yet. We'll come to that next. But it's income from a trade, business, or profession because it was reported on a Schedule K-1. And that's the point that I was making. The shareholders did not sell Pabst Brewery. The entity PCHI sold its two subsidiaries.

So if we look to (f) under 17951-4, it reads, "If a nonresident," which are the trusts, "If a trust is a shareholder of an S corp which carries on a unitary trade business or profession within and without the state" -- now the S corp we're talking about is PCHI -- they have already said that they are a multistate apportioning business carrying on business within and without the state, at 6.6 percent being in California. So if a trust is a shareholder of PCHI, which is carrying business within and without the state, the amount of the nonresident's pro rata share of S corp income derived from sources within the state shall be determined as if the S corp were a partnership, determined under section (d). (d) provides that if a nonresident is the source, it will be determined based on whether the income is business or nonbusiness income. If it's business income, it will be apportioned using the apportionment rules of UDITPA.

The problem -- or the conflict here seems to be so clearly -- the rules are so clear here that you go through 17951-4. And it gives you how to source business income from an apportioned corporation. Because it even goes so far as to say, and if you go through the apportionment rules and it turns out to be nonbusiness income, then you apply the regular PIT rules of 17951, 2, 3, 4, and 5 -- not 4, but 5.

So it's -- I find it clear that -4 is the ruling regulation here. And I find that 1366, which is saying to characterize the income at the entity level, is speaking to the apportionability and business income, character of the income, not whether it's tangible or intangible.

And I think it's important to note that federal law, which this is piggybacking on IRC 1366, does not make a distinction between intangible and tangible property. Because for their purposes, there's no distinction in tax rate or anything else for tangible and intangible property.

Taxpayers here are the -- the Appellant here has made an argument that Valentino is testing the boundaries of the 17952 distinction and the 17951-4. And, really, Valentino was a case that came out shortly after California began recognizing S corporations. So really Valentino is testing whether or not the conduit theories of 17951-4 would apply to S corporations or if S corporations would instead be treated as C corporations.

And the holding of Valentino is that, yes, indeed they would be treated as partnerships, that the income from an S corporation would be from distributive share and would be taxed according to its character from the partnership where the income-producing activity took place.

When it went on to discuss what that character-producing activity was and said that it was from an intangible, that is where the Court did not have to speak to that because that was not the case before them. And that's the part where we argued it's dicta and had no reason to be in there because they could have come up with several different arguments had they been faced with different types of intangibles.

So the two-step -- oh. The other side has also argued that this was not business income because it was a onetime event. Now, this is getting into the business income definitions under UDITPA, rather than whether this is income from a trade, business, or profession. First we have whether or not we're in 17951-4, which is the PIT tax side, but that's because we're a trust.

But now, once we get into -4, we're starting to now get into the rules of a UDITPA because we have an apportioning entity. Now we have to look and see whether or not it's business income under UDITPA. The onetime event test is part of the sales factor analysis. It doesn't speak to whether or not something is business income.

In this case, we have business income under the functional test, the relationship between the income-producing property and the business operations. It's important to note that the extraordinary nature or infrequency of the income-producing transaction itself is irrelevant to the test. And that's from Jim Beam Brands versus FTB. Income from the sale of stocks in a business that substantially contributes to the generation of business income for the taxpayer should be characterized as business under the functional test.

In this case, PCHI and PHI were in the business of holding a company. And releasing that company was part of its business.

Speaking briefly to the amended regulation that we did not end up completing, that the taxpayer is saying speaks to the fact that we thought we needed to fix the regulation and didn't fix the regulation, back in 2001 and '02 we did amend 17951-4, and we amended it to include the subsection (f), which is the S corporation section. And in the notes and comments, the final statement of reasons where you -- or the whole binder where you put the comments to all of the regulation process, we had a question and we answered it, about whether or not our -- including (f) was consistent with Valentino. And we answered that it was consistent with Valentino.

In this regulation project, we again were working with the regulation. And we realized that it was still -- the standing regulation was still consistent with Valentino and that it was not necessary to try to make it consistent with Valentino when we realized that the first regulation project had already made that determination. So there's -- it's not that it was -- although we may have started the right project thinking that it was inconsistent, by the end of the reg project we determined that it was not inconsistent with Valentino.

The alternative argument is whether or not somebody accidentally can start with 17952 thinking it was income from an intangible.

It really is not income from an intangible to the trust. They did not sell an intangible. They received distributive share. But if it was income from an intangible, which also Valentino makes clear if you have a C corp and you sell C corp shares, that would be income from an intangible. But you didn't sell C corp shares. You're getting it through a distributive share. That takes you to income from a trade, business, or profession. But if for some reason you're looking through the book and you accidentally get to

17952 first, then you're looking at, okay, I may have had an intangible that I sold. So it may be a source to my state of residence.

Well, the rule has an exception. And even if you read Valentino and it says 17952 applies if it's an intangible, well, you go to 17952 and you apply it. And you get to the exception of business situs. And the business situs exception -- business situs sounds like a term of art or it sounds like a confusing word that hasn't been really litigated or explained very much.

But it is defined in our regulation, and it states that -- bear with me a moment. It states that "An intangible property has acquired a business situs when it's employed as capital in the state or localized in connection with a business, trade, or profession in this state," or in this case 6.6 percent in this state, "and its value and substantial use attached to it become an asset of the business, trade, or profession in this state. For example" -- and it gives some examples.

In this case, our argument is that this intangible actually belongs to Pabst Corp., or Pabst Brewery Company, because its goodwill is actually way down here -- way up or down here in the Pabst Brewery

Company. And mobilia is a fiction, and it must fall if the facts underlying the transaction don't line up with reality. So it's a convenience, but in this case it's attenuated too far for us to say that the trusts owned the goodwill for Pabst since goodwill is the value of the business beyond the value of other assets, the going-concern value, or the reputation, contact, networks, intellectual property, branding, et cetera.

The trust did not own these assets. They belonged with Pabst all along. They were sold with the other assets and the distributive share came up with that.

I'd be happy to answer any questions.

ALJ JOHNSON: Thank you.

And we're ready to move on to Appellants' rebuttal, which will be 15 minutes. You may begin if you're ready.

MR. MUILENBURG: And I believe we'll start with Mr. Weintraub addressing the trust issues.

MR. WEINTRAUB: Okay. The FTB's presentation comes down to basically three different factors: Number one, that the beneficiary had the power to remove and replace the fiduciaries, all fiduciaries, whether the trustee, distribution advisor, protector; number two, that the beneficiary has the power to designate himself as the investment direction advisor; and number three, the so-called close relationship between the beneficiary and the distribution advisor, as well as the role of the beneficiary in the operation of the corporation whose shares were owned by the trust.

These are completely unworkable standards. First of all, as I mentioned in my presentation, the power to remove and replace a trustee or any fiduciary is common and necessary in all trusts. If including that power is going to open the trust to review as to whether an interest of a discretionary beneficiary is contingent or not, we will have a completely uncertain and chaotic administration of trusts in California for tax purposes. It would change the administration and the application of the law for over 50 years.

Similarly, if the mere power to designate Evan -- if he can designate himself as an investment direction advisor that, too, has no bearing on whether he, as a beneficiary, has a right to get a distribution. That still depends on a condition precedent. That still depends upon the fiduciary exercising discretion, their sole and absolute discretion, to make a distribution. Evan can direct all the investment of the trust that he desires if he were the direction investment advisor, which he is not.

But whether he chose to invest it in all cash, stocks and bonds, real estate, private equity, or a beer company is irrelevant. It doesn't affect whether a distribution advisor will say, okay, I will exercise my discretion and give you a distribution. Until that happens, his interest as a beneficiary is completely contingent.

And last and most distressing were the comments about looking at the strong relationship between Evan and the distribution advisor and looking at Evan's role in the corporation. If we open up every trust relationship to that type of scrutiny, again, we have not only uncertain trust administration, but it's chaotic, completely subjective.

As I mentioned in my presentation, does a friendly trustee who is related or close to the beneficiary render every discretionary trust noncontingent because, well, there's a close relationship between the trustee or the distribution advisor and the beneficiary? Do we look at the role of the beneficiary? Does it matter if the beneficiary is an officer of the entity, what role they play? These would become endless inquiries and make it impossible.

We've had a rule in California for over 50 years. The Supreme Court in Kaestner called for clear, pragmatic rules. The FTB's approach would not be pragmatic, would be impossible to administer, and would make it very difficult for people drafting trusts in California to come up with a workable trust.

MR. MUILENBURG: Thank you.

And so a couple points that we'll address that were relayed by the FTB. The first one, the FTB stated that when you're applying the two-step test articulated in Valentino and suggested in IRC 1366(b), that it's clear to them that the second step means you source the income according to how it was sourced or how it was characterized at the corporate level.

I'll start by just reading the language once again of 1366(b). I don't see how one could come to that conclusion. The language says, "The character of any item included in a stakeholder's pro rata share shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation."

What that language is saying is, for the purpose of this doctrine, you ignore the corporation. Right? You're realizing it as if you did it directly or in the same manner that they did.

So what the Valentino court clearly lays out when applying the 1366 conduit principle is that you first determine the character of income as realized by the corporation, in this case an intangible. Right? I think we're all in agreement that what was sold was an intangible, goodwill. Then, step two, you determine as if such income were realized directly from the source which realized by the corporation. So the taxpayer here, nonresident trust, is recognizing/realizing that intangible directly, setting the corporation aside.

That step is what Valentino states, you know, mandates the use of the specific sourcing rules applicable to different types of income that could be realized, either directly or indirectly, by nonresident taxpayers.

I guess the question for the panel is, if we're to believe the Franchise Tax Board's reading of conduit theory, then how do you square these quotes in Valentino?

And I understand the statement is that they're dicta, but I would suggest what they're suggesting to you is that the court flat out got them wrong, that they're not only dicta, they believe they're incorrect and not a proper cite of the federal rules.

Again, the Court said, "Consequently, Section 17952 never applies to a shareholder's share of

S corporation unless the corporate income itself is derived from intangibles."

Under the Franchise Tax Board's reading, if you characterize the income at the corporate level and it's all trade or business or business income -- we'll get to that in a second -- then you would have no need for that language. Everything comes out, to the extent it's a distributable share, in the FTB's position, that it's all taxed under 17951-4. It's all a share of trade or business income.

Continuing on, "Moreover our interpretation harmonizes IRC 1366(b) with CRTC Section 17952 by applying the latter to income characterized at the corporate level as income from intangibles."

Why would the Court say that if they didn't mean it? If they didn't mean that we're gonna apply 17952, to the extent a corporation -- an S corporation realizes gain on the sale of intangible, instead everything gets passed through as a distributable share, why would they say that?

And, finally, 17952 continues to apply in those situations it did before the enactment of the S corporation provisions. Again, clear direction from the Court.

Again, the Franchise Tax Board doesn't want to talk about Valentino -- sorry, excuse me, Venture Communications, but let me read quickly exactly how this rule of law was interpreted by the attorney writing this brief. And it's just one quick quote.

"The record indicates this appeal" -- and really quickly, in Venture Communications you've got nonresident individual, S corp in the middle, limited partnership at the bottom that is being sold, intangible being sold by an S corp. They have to pass it through to an individual.

"The record indicates," quote, "this appeal involves income received from the sale of Venture," the S corporation, "Venture's limited partnership interest," the intangible, "not income received from ongoing business activities conducted in California. The results obtained in this appeal is thus consistent with results obtained in earlier appeals involving nonresident limited partners. Our prior decisions regarding nonresident partners highlight a distinction between the income received by a partnership from ongoing business activities" -- trade, business, or profession income, right? -- "in California and pass-through to a nonresident limited partner, which may be taxable to nonresident limited partner. And income received on the sale of a nonresident's partnership interest, an intangible, not trade, business, or profession income, which is not taxable to the nonresident limited partner as long as the partnership interest is not to sell a business situs."

So, again, these distinctions have been indicated in numerous case law. We've cited four, five, six cases, you know, all indicating there's a difference between ongoing business activities and the sale of an intangible.

And I think this all stems from the second point. The FTB talks about business income and the functional test. These are corporate concepts. Business, nonbusiness, that's part of UDITPA. That's a corporate context. We do not have a corporate taxpayer today in this appeal. There is a distinction between trade, business, or profession income and business income. The FTB wants to use them interchangeably to say if it's business income to the S corp, then it's trade, business, or profession income to the nonresident individual.

That is not how the law works whatsoever.

Business/nonbusiness distinctions are irrelevant for the taxation here. The question is, is it ongoing business activity, which would be called trade, business, or profession income; or is it a sale from a onetime event, an intangible?

Again, to quote the 17951-4, the regulation about apportionment, and say that it mandates that the allocation rule only implies to nonbusiness income is, again, conflating different provisions of that statute. The reason they have to talk about nonbusiness and business income in the sole proprietorship is because there is no flow-through entity in between. The individual is conducting this business directly on their own and because the regulation requires them to apply the UDITPA principles, they have to use business/nonbusiness.

That concept is not in the partnership rules. Because the -- you know, the regulation written as such that while business and nonbusiness might be applicable to the entity, it's not applicable to the individual. So if we're flowing through income, the only thing we care about, as required by 1366(b) and as mandated in Valentino, is what was the type of income, intangible, and what is the sourcing rule when that type of income is in the hands of a nonresident individual?

And so that -- with that, I'll pass to Mr. Sperring to conclude.

MR. SPERRING: Sure, yeah.

With regard to business situs, there's four statements made by Respondent that I feel need to be addressed. The first one was that business situs is a term of art, it hasn't been litigated much.

Well, there's two California Supreme Court cases on it that we've cited, two California Court of Appeals and a BOE decision. All four -- four out of five of them said there is no business situs. Right? So -- and then the fifth is Holly Sugar, which is what the regulation codified, the localized requirement.

And if we go to the regulation, you know, FTB wants to say that 17951-4 trumps, okay, 17952, which is a statute. So they're saying their own regulation trumps. The way they use it is, they use the term "harmonize." We need to read it together, okay, these separate statutes.

Well, their problem with that, okay, with this harmony, is that the regulation that they wrote under 17952(c) specifically states for -- that there will be single sourcing. Okay? That if an intangible has business situs, then all the income from that sale, okay, is sourced to the state where the situs is. Okay?

So that directly conflicts with the idea of apportionment. You either allocate or you apportion. Okay? There's -- I don't know the harmony there. You know, I'm not seeing it.

And then the third point is this whole mobilia is a fiction, it must fall. And they cite a 1919 case. Okay? The fiction's been around a while, by the way. Again, this fiction, quote-unquote, is the statute. It's 17952. Okay? And what's the heading of the statute? It's "Intangibles." Okay? So -- and this, quote-unquote, fiction is the doctrine allowing that -- the State of California to tax residents on their worldwide income. I mean, FTB wants to have their cake and eat it too. If you're an in-stater, okay, we're going to tax you 100 percent on the gain. Okay? Even if it's -- the business was only 6 percent operating in California.

But if you're an out-of-stater, we're not going to follow the mobilia rule. It's a fiction. Okay? We're going to apportion. Okay?

So you can't have it both ways. And the courts have slapped whoever tried to have it both ways down. But that's exactly what FTB is trying to do here.

And then my last point is that this -- you heard this is not income from an intangible. This is a distributable share. Okay?

Again, the very language I read in Ames -- and

I'll go through again and conclude there, because Ames dealt with that. Ames said that FTB's position that distributable shares of the partnership are allocated to the partners and, fourth, with the partner's interest being so integrally involved with the business being conducted acquire business situs where the partnership activity occurs. So, again, they were saying it's a distributable share of the partnership, which the partnership was Bunker Hill, Downtown L.A. Okay? And they're saying -- FTB took the position, the distributable share of the income from that real property in Downtown L.A., okay, is business situs in California. Okay?

And the appeal of Ames said, no, it's an intangible. Okay? And that the rule for intangibles is mobilia.

So with there, I'll rest.

ALJ JOHNSON: Thank you. We may have some questions from the panels, and then after that we will have five minutes each for closing.

Let me ask, would anybody like to take a 10- or 15-minute break at this point? Ready to move forward? Okay.

Let me start and ask, Judge Gast, do you have questions?

ALJ GAST: Yeah, thank you.

I'm going to focus most of my questions on the -4 reg, on 17952, because it seems like we do have a trust here that is a nonresident, so we've got to reach that issue anyways.

So let me ask the taxpayers first: When I read Valentino, that case applies to a wholly interstate S corporation. But then FTB amended their reg a year later -- a year or two later to have a -- multistate S corporation rules. So isn't Valentino distinguishable on that basis alone?

MR. MUILENBURG: No. I mean, the rule of law we're citing in Valentino is not anything to do with the entity-level tax or whether it's wholly in state or multistate. You know, Valentino, the way the Appellants are citing it and the way it's interpreted here, is standing for, as I mentioned many times before, how is the conduit theory to be applied on pass-through income. Right? So whether an S corp is 100 percent in California or 6 percent in California, the item of income in question, the intangible income, under conduit theory, will pass-through with certain requirements and certain sourcing requirements to the individual. So the level of apportionment or wholly in state of the S corp should not make a difference. And as you correctly point out, the State's regulations cover multistate businesses as well.

ALJ GAST: Okay. So it doesn't matter that the -- that FTB amended the regulation after Valentino came out. Because there was language in Valentino that talks about there were no S corporation rules around and that's kind of why the Court had to go through all this analysis.

MR. MUILENBURG: Yeah. No. That's a very good point. And FTB is correct, that the timing is such that, you know, the core purpose of the decision is to -- is to provide guidance as to how the S corp provisions are to be interpreted in light of the already existing sourcing regime for nonresident individuals. And so, you know, whether the S corp is wholly in state or multistate, the goal of the guidance is to let you know that you apply this two-step process and you still apply the sourcing rules specific to types of income where applicable.

ALJ GAST: Okay. And then if I can get clarification, so your position is if the flow-through income is intangible income, you always look to 17952?

MR. MUILENBURG: Yeah. So all three of these statutes -- and the one we didn't mention is 1795 -- I know the Franchise Tax Board raised it at certain points.

Essentially the way it works is, intangible income recognized by a flow-through and pass on to a nonresident individual is, first and foremost, governed under 17952. That is the statute directly on point, and it says that, you know, it should be sourced based on mobilia to a state of residence.

Then there's an exception, business situs exception -- there's an exception for the statute -- the statute essentially doesn't apply in the event that the trades in -- or the intangible sales are so regular and systematic as to constitute a trading business, et cetera.

Now, an example of that is asset management. Right? You're conducting stock trades on a daily basis and you're selling intangibles over and over again, say the S corp is doing that. That would then qualify as a trade, business, or profession income.

Remember, we're in the business of selling beer. If they were in the business of buying and selling stocks so regularly and systematically, then that would fall under 17951-4. And when that income was passed on, just like beer profits are passed on to the Appellants in this case, when that income is passed on to the nonresident individuals, that could be apportioned. Unless and -- this is where the third, you know, basically rule comes in -- if the nonresident's only contact with the State is the interest, dividends, and gains it gets from that regular and systematic intangible trading, then our corporate rules and qualified investment partnership rules in 17955 would say you can ignore it and non-source it.

So all three of those statutes apply under the right facts. But it starts with 17952, because it's not your regular course or trade or business, then that intangible is a onetime event and shouldn't be allocated to your state of residence.

ALJ GAST: Let's say you have an S corporation that is in the business of licensing patents and they were generating royalty income. Would that be sourced in the individual's or trust's hands under 17952, in your view?

MR. MUILENBURG: No. I think if their regular course of business was to achieve intangible income from royalties, licensing, et cetera, then that would be trade or business or profession income --

ALJ GAST: So that's -4.

MR. MUILENBURG: -- that would be apportioned.

That would be -4. That's not the facts of the situation we have here.

ALJ GAST: Okay, okay. So Valentino, it's kind of confusing to me, but at the end talks about if it's intangible income, then, you know, you look to 17952.

MR. MUILENBURG: Right.

ALJ GAST: And that seems clear enough. But at the end of the opinion it says, in other words, you know, it really only applies to determine the source of stock, dividends, and income from the sale of stock.

MR. MUILENBURG: Yeah.

ALJ GAST: What do they mean by that?

MR. MUILENBURG: I think the only thing I can guesstimate there is, it's a limited list of the idea of what's intangible. I agree with you that that language, the fact that they stop after corporate stock, et cetera, the intent, like the other two sections we cite, are any intangible. For whatever reason, they just talk about source of stock, dividends, and income from sale of stock as the two examples of intangible income that come to mind.

ALJ GAST: Okay. So then, you know, if we go down and say 17952 applies, what's the test? Because I don't really see it in Valentino because of these almost conflicting statements as to when 17952 applies. It seems like you're saying it would apply if it's not trade or business income --

MR. MUILENBURG: Right.

ALJ GAST: -- but a sale of onetime assets type of thing, right? Which couldn't be business income under the functional test, but still you're saying --

MR. MUILENBURG: Which -- as I mentioned earlier, which is irrelevant for the individual source. I mean 17952 says it's not sourced from the State "except that if a nonresident buys or sells such property in the state or places orders with brokers in this state to buy or sell such property so regularly, systematically, and continuously as to constitute doing business in this state."

So 17952 has its own mechanism to basically say -- so under Valentino you go to 17952 first. If you're doing it so regularly as to constitute a business, then 17951-4 would kick in again.

ALJ GAST: And that's looked at from the S corp's view or the trust's view?

MR. MUILENBURG: The S corp's. Yeah, because if you go back to -- I'll use the Franchise Tax Board's exhibit. I rather like it. But regardless, if you see the payment, they're coming in in green, 607, and then from PCHI, the S corp, it then has lines down to the Appellants and the taxpayers, the black line is the ordinary trade or business profits. That's the beer sales. And, you know, the Appellants sold PBC through PHI, et cetera, towards the end of 2014. I believe it was in November. There were also beer sales reported. And to be honest, beer is -- for four years, you know, while the Appellants owned the Pabst Blue Ribbon Company, they paid millions of dollars in California tax on beer sales. There's no debating that.

The black line is ongoing trade or business profits that are taxed under 17951-4. What 1366 requires you to do and what Valentino requires you to do is, when dealing with the green line, right, your distributive share of the onetime gain, you jump up into that circle and you recognize the intangible directly. And then you either go back or do it there and say what is my rule, a nonresident individual, for sourcing an intangible? That doesn't rise to the level of trade, business, or profession because it's so regular and systematic. My rule is 17952. I have to allocate it to my home state.

ALJ GAST: Okay. Thank you.

Let me go to FTB. Can you clarify your position as to the dicta in Valentino, when Valentino is referring to 17952?

MS. PAGE: Yes. I think that Valentino first addressed the 1366 conduit rule and how the IRC works to distinguish S corporation income and how it's treated in the taxpayer's hands and C corporation income and distinguished that C corporation income is income and dividends that arise from the stock itself that you receive just as a stockholder. And then it did confirm that an S corporation is a business and you're receiving income due to the activities of that business. And since there's no entity-level tax, at least at the federal level, the income from that business is being passed to you and at that level you pay the tax on the -- of the corporation.

ALJ GAST: Okay.

MS. PAGE: So I think they were distinguishing that for the Valentinos.

And I think the reason the rest is dicta after they've made that call is because they say on page -- I don't see the page. It's too hard to get to a page number here, but they say, "Consequently Section 17952 never applies to a shareholder's share of S corporation income unless the corporate income itself is derived from intangibles."

I think that -- I think that is dicta because in this case the income was not arising from intangibles. So the Court never needed to reach that result. Because if you're applying 17951-4, the analysis requires you to go down the list of steps. And one of the steps requires you -- if you're in or out of the state, it requires you to determine whether or not you have business or nonbusiness income.

So it didn't do that test. So it wasn't called upon to do that test because those weren't the facts. And it wasn't called upon to do a 17955 test, which would be the investment partnership test. So it only spoke to it, but didn't actually apply any rules because there were no facts before it to actually determine, if you did a 17955 analysis, it might turn out this way or this way or this way.

So that's why I believe it is dicta, because the Court had no reason to talk about whether the corp had intangibles because that wasn't at issue in the case.

So speaking to the 17955 issue, that -- if you don't mind me answering --

ALJ GAST: Sure.

MS. PAGE: -- ahead of time.

17955 is a provision that provides basically exculpation of taxes for non-residents. If they're dealing -- if they purchase certain securities in California and are trading in them or working with them -- and it especially says if you do this with a company that is selling these -- they're actually buying partnership interests. And it says if you have interests in certain kind of partnerships, it's not going to be taxed here.

Well, if you could always have a partnership that handled -- and you were buying or selling tangible or intangibles and the rule was always 17952, then there would be no reason, if Valentino's dicta were correct, to have to have a separate statute that says, Oh, here's a special rule. If you're doing this only with a qualified investment partnership which meets these rules, then there would be no need to have that special rule with special qualifications. If every partnership could just -- if they had tangible -- if they've sold intangible property at some level in their business, that was something not really business-related, they were gonna be exculpated from California tax anyway, then there would be no need for 17955.

ALJ GAST: Okay.

MR. MUILENBURG: Can I reply to that or is that --

ALJ GAST: I'd like to move on. I don't know how many --

MR. MUILENBURG: Very well.

ALJ GAST: -- on your rebuttal, I guess, at the end.

ALJ JOHNSON: Five-minute closing.

ALJ GAST: Five-minute closing. I'm sorry.

MR. MUILENBURG: Okay.

ALJ GAST: I just have a couple more questions.

So let me ask this: If Pabst Brewing Company, the top S corp, was solely in California, no apportionment, you don't get to (f), would you apply 17952 in that situation for this sale, under Valentino?

MS. PAGE: Well, you first -- you're looking at the taxpayer, and the taxpayer is the trust. So you would look to see if they were receiving -- so you still look at 17951 to see if it's income from a business, trade, or profession. So then you would look to see if it's within California entirely or without California entirely.

So assuming that PHI and PCHI are entirely within California as well --

ALJ GAST: Yeah.

MS. PAGE: -- then the entire amount would be taxed to California because of 17951-4(a).

ALJ GAST: Okay. All right.

Let me go back to the taxpayer on the business situs exception. When I think of goodwill and I -- I think it's appeal of Borden that talks about goodwill, but in the context of business/nonbusiness, that case seems to suggest goodwill is created wherever the business is done. So how come the goodwill here doesn't have a business situs in California, at least partially?

MR. SPERRING: Right. Well, two things. One, FTB responded in their regulation to the Holly Sugar case. Right? And so they put in their regulation that the -- the business has to be localized, and they created the single sourcing rule in the regulation. Right? So you can't have apportionment, right, and single sourcing. So that doesn't, you know -- that doesn't -- you know, they're just opposite concepts. Right? And so they're incongruent.

And keep in mind, right, Holly Sugar came down pre-UDITPA. Right? So this was a way -- in the case of Holly Sugar, by saying that the stock of Santa Ana Sugar had business situs in California, that allowed them to offset their unitary income from Holly against the loss with the liquidation of Holly Sugar. And so it's that concept, right, or it's that construct, if you will, that the statute and the regulation, okay, is reflecting.

ALJ GAST: Okay. So let's say you --

hypothetically, you do have goodwill that does have a business situs in California, but you're a multinational business and that goodwill was built up everywhere. Could you apply 17952 in that situation?

MR. SPERRING: Well, I mean, keep in mind, in a true multistate business, right, you would have -- UDITPA would apply, and so there would be no need for business situs.

ALJ GAST: Well, I'm talking about if it's a flow-through goodwill, just like in this situation.

MR. SPERRING: Right, right.

ALJ GAST: How would you apply 17952 if you do have a business situs? Or would it not ever apply?

MR. SPERRING: Right. Again, I go to Rainier. Okay? Where in that case, okay, they said that even though there was exclusive right to sell Rainier Beer in Washington and Alaska, okay, the mobilia doctrine. So, I mean, I think, you know, everyone generally views the business situs exception as very narrow. Okay? And it really requires -- what they put in their reg, that the intangible be pledged, okay, for a loan. They give examples. Okay?

So I just -- you know, I don't think goodwill, okay, of a multistate business can have business situs. I think that's what Rainier tells us.

ALJ GAST: It can't or can?

MR. SPERRING: Cannot.

ALJ GAST: Okay. So Rainier, though -- let me ask you this. The facts of that case, didn't it deal with an entity that wasn't even in Washington? It had gotten rid of its -- it had licensed its trademarks, it was never taxed in Washington.

MR. SPERRING: Correct.

ALJ GAST: So it seemed like that was why the Court held that the goodwill was built up in California -- or had situs in California, I should say. Here you don't really have that situation, or am I wrong?

MR. SPERRING: So, no, I think that's a correct rendition of the facts. Okay? But, again, that doesn't mean that they couldn't -- the fact that they didn't have a business, okay, in Washington and Alaska didn't mean they didn't have nexus for taxability. Right? They could have sent employees up there. That's not in the record. But it's not clear that those states didn't have jurisdiction to tax Rainier.

ALJ GAST: Okay. I think -- let's see. I think those are all my questions for now. Thanks.

ALJ JOHNSON: Let me turn it to Judge Angeja. Do you have any questions?

ALJ ANGEJA: It may have been answered, but just for my clarification, Franchise Tax Board is treating the goodwill as if it's a trade or business asset for purposes of applying the rules? They're treating it as an intangible for purposes of applying the rules?

MS. PAGE: Yeah. It's income -- income from a trade, business, or profession. So we're not looking at as really an asset, per se, but income from a business, trade, or profession.

ALJ ANGEJA: And I get the trust part, but that's where the difference begins --

MS. PAGE: Right.

ALJ ANGEJA: -- in the two positions.

MS. PAGE: Yes.

ALJ ANGEJA: Because they're agreeing with your rules if it was a trade or business.

MS. PAGE: Right.

ALJ ANGEJA: I don't have any other questions.

ALJ JOHNSON: Okay. Questions, just couple of clarifications.

During Appellants' statements, they said that there were no distributions in 2014 for the -- I believe the Evan Trust.

Was that only as to ESBT income, or was that in total for the trust?

MR. MUILENBURG: I'm sorry. I'll just jump in.

There was a distribution, as FTB correctly points out, but that distribution, as we indicated and offered -- I know you guys issued an order at our hearing to provide any evidence, and we were ready to respond with that, had the request come from the Franchise Tax Board. That distribution was made from non-ESBT income.

So the trust is an electing small business trust. It needs to be in order to hold an S corporation, but it also has other assets, investments, stocks, bonds, et cetera. There's clear delineation -- and that distribution was made from non-ESBT activity. Therefore, a distribution deduction was appropriate, and that income was fully reported by Mr. Metropoulos on his California return. All tax was paid on that income.

ALJ JOHNSON: And was tax paid at the trust level to California on that income?

MR. MUILENBURG: No. Because that income is afforded a DNI deduction because it's non-ESBT income and, therefore, it's picked up at the trust level. If it were ESBT income, it would have been paid -- and it was sourced, it would have been paid at the trust level and distributed without taxation to the beneficiary. But because it was non-ESBT, the reverse occurs. But the important thing, obviously, is that taxes were paid.

ALJ JOHNSON: And it was paid at the individual level because he's a California resident --

MR. MUILENBURG: California resident, correct.

ALJ JOHNSON: Since distributions were made by the trust, does that mean that the trust, at least to that amount, is a non-contingent trust?

MR. MUILENBURG: Correct.

ALJ JOHNSON: So you're saying as to the ESBT income, it's still a contingent trust?

MR. MUILENBURG: That's the way the law works -- and Mr. Weintraub will jump in. That's precisely why you have contingencies and why you have contingent beneficiaries. Up and to and to the extent of a distribution, the trust becomes non-contingent -- or the beneficiary becomes noncontingent and the trust becomes a resident trust with respect to that amount. But then under trust accounting rules, they get a DNI deduction, and that amount is picked up and paid by the resident.

ALJ JOHNSON: Okay.

MR. MUILENBURG: Just with respect to that amount.

ALJ JOHNSON: So you do trace the actual source of the income distribution?

MR. MUILENBURG: That's correct. Painstakingly, I would add, yeah.

ALJ JOHNSON: If I can refer to -- let me ask FTB, does that all sound accurate to you, just because there's confusion there?

MS. WOODRUFF: Right. I am not entirely sure that the income came from the non-ESBT portion, but I don't believe -- that appears to be the way that they reported it on the trust return. So we're not objecting to that.

ALJ JOHNSON: Okay, great. Thank you.

If I could turn to Kaestner for a moment. I note the decision, it specifically mentioned the right to receive income therefrom, talking about distribution as a discretion. But it also mentioned the right to control or possess the control assets.

To Appellants, do you believe that the beneficiary had the right to control the assets in his role as the investment advisor?

MR. WEINTRAUB: The beneficiary did not have the right to control the assets on his own behalf. The -- and during 2014 he was not the advisor, direction investment advisor. But even if he were in that role, to direct the trustee to invest in stocks or bonds or closely held business, that would not have given him a distribution as a beneficiary.

So they're two completely separate areas. That doesn't give him control of the assets for his own personal use, and he could not have caused -- with whatever powers he had over the investment, he could not have caused a distribution to be made to him without the exercise of discretion by the distribution advisor.

ALJ JOHNSON: Okay. So in your interpretation, sort of the right to control or possess would be if, for example, there's real property and the beneficiary is allowed to live in that property rent-free, would that be meeting those standards?

MR. WEINTRAUB: It depends upon what powers -- that could be a distribution decision, where the trustee or distribution advisor and how the trust is written, as to whether to provide that for the use -- a trustee could not just use a trust asset for their own benefit. They have to use it for the benefit of the trust. So he could not, as investment advisor, say, "The trust owns a property; I'm going to live in it rent-free." He would not be able to do that.

ALJ JOHNSON: Franchise Tax Board, I think you covered this largely in your discussion, but if you just want to add something quickly, too; your impression is that there was significant control over the assets and that led towards this being a noncontingent trust. Is that accurate?

MS. WOODRUFF: That's right. I think the fact that he could name himself as direction investment advisor at any point in time is really quite notable in this case. The fact that he can insert himself in there whenever he wants and use the assets of the trust to invest in anything he wants and not be subjected to a duty of loyalty or a rule against, you know, self-dealing or anything like that is pretty -- a pretty extraordinary power, and I think that in itself causes him to be noncontingent.

ALJ JOHNSON: Thank you.

MR. WEINTRAUB: May I address that?

ALJ JOHNSON: Yes. Please do.

MR. WEINTRAUB: The powers that the FTB's refer to are commonly in trusts, particularly if you don't have an institute -- if you have an institutional trustee, they're going to be limited by the prudent investor rule. But almost every trust provides the trustee with the discretion to make loans for the benefit of the beneficiary, to guarantee loans for the benefit. That doesn't give the beneficiary a distribution. That does not give the beneficiary income. But what the FTB is citing is commonly in almost every trust. If you look at the trustee powers, they're virtually almost always authorized to do this. You have to do it as a fiduciary. They have to get appropriate collateral. It has got to be done correctly. But the mere existence of those is nothing unusual in this trust.

ALJ JOHNSON: Let me turn to the Franchise Tax Board. As to the business situs, is the argument here that the -- there was business situs as to the 6.6 percent that was apportioned at the S corp level?

MS. PAGE: Yes.

ALJ JOHNSON: Okay. That's all the questions I have.

Any further questions from the panel?

ALJ GAST: Yeah, I had one more question you -- hopefully one more.

Is the taxpayer challenging FTB's authority to amend -- or to add subsection (f) to the reg?

MR. MUILENBURG: Let me make sure and get the right language here.

ALJ GAST: Or to add the S corp multistate provisions?

MR. MUILENBURG: Sorry. The provisions of (f) that are presently in the regulations?

ALJ GAST: Yeah.

MR. MUILENBURG: No.

ALJ GAST: Okay.

MR. MUILENBURG: No, not at all.

There was an attempt to add language to the regulation and -- let's see. It's page 18. And that language said -- or would have said, "Revenue and taxation code Section 17952 is not applicable in determining the source of income allocated to the nonresident taxpayer of the partnership."

That's the language that was eventually stricken, that, you know, the Appellants and the taxpayer community said was -- they do not have the authority to supersede the statute.

ALJ GAST: Okay. So when (f) was added, was (d)(4) in existence for partnerships dealing with nonbusiness income?

MS. PAGE: Yes.

ALJ GAST: Okay.

MS. PAGE: Because (f) has a carve-out for the special (d)(4) and (d)(5).

ALJ GAST: Okay.

MR. MUILENBURG: Yeah.

But, again, okay, so, "The source of a partner's distributive share which do not constitute business income shall be determined in accordance with the rules of 17951 through 17955."

That's obvious. Right? If it's nonbusiness to the entity, then it's not trade or business income to the individual.

What this doesn't address is, if it is business income to the entity, is it necessarily trade or business or profession income to the individual?

And Valentino says no.

ALJ GAST: All right.

MR. MUILENBURG: Very clearly no.

ALJ GAST: So if we have nonbusiness income to the S corp and I guess even at the -- I don't know if Valentino extends to partnerships as well, then your position is that nonbusiness income is kind of like a bright-line test? That's gonna always be 17952?

MR. MUILENBURG: Right, right, exactly.

ALJ GAST: Okay.

MR. MUILENBURG: But as I stated earlier, the concept is not utilized in the PIT.

ALJ GAST: Right, right.

MR. MUILENBURG: I would argue that that section is not needed because it -- all that matters for the individual taxpayer is, is it trade or business or profession income, or is it intangible or real estate, or some other nature.

ALJ GAST: Okay.

MS. PAGE: Can I respond to that?

ALJ GAST: Yes, please.

MS. PAGE: I would argue that that language is in there for a very important purpose, and that is to make the distinction between nonbusiness and business income; that if you are getting income from a trade, business, or profession, but it's found that it's nonbusiness income, that now you're going to be treated as if it's not income from a trade, business, or profession at all, and then that's why you fall out to 17952 or the income from a real estate or that -- the other kinds of income and how they're traditionally sourced for a PIT purpose.

ALJ GAST: That's how you harmonize 17952-4?

MS. PAGE: Yes.

ALJ GAST: Okay.

MR. MUILENBURG: But then one wonders why Valentino court did not say anything about that? Valentino court said if it's gained from an intangible, 17952 applies. No mention of business or nonbusiness.

MS. PAGE: And that's --

ALJ JOHNSON: Sorry. You can respond.

MS. PAGE: And that's why I think that the 17952 language -- that Valentino was dicta, because they didn't go forward and actually talk about how 17952 would apply because they had no facts before them to apply it.

ALJ GAST: Okay. Were you gonna respond?

MR. MUILENBURG: Again, I go back to the federal law, 1366(b), and our conformity to that. 1366(b) says you step into the shoes of and you recognize the income as if you recognize it directly. By the fact of stepping into the corporation's shoes, it's irrelevant whether that's business or nonbusiness to the S corp, to the flow-through. Because for me, the nonresident individual, it's intangible income.

ALJ GAST: Okay. Thank you.

MR. MUILENBURG: Yeah.

ALJ GAST: No further questions.

ALJ JOHNSON: Just one final question.

So for the S corp, that income was business income. Correct?

MR. MUILENBURG: It was, yeah.

ALJ JOHNSON: With that, we're going to move on to closing statements, which will be essentially the end of the hearing.

Before we do that, are there any questions from the Appellants?

And from Franchise Tax Board, any questions?

Okay. Franchise Tax Board, you will have five minutes for your closing.

Are you prepared to start?

MS. WOODRUFF: Yes, we are.

ALJ JOHNSON: Okay.

MS. WOODRUFF: All right. So back in 1963, the California legislature foresaw the potential for constitutional challenges to Section 17742. They changed the language of that section so that trusts would only allow a beneficiary residing in California -- will only be taxable on that basis if the beneficiary has more than just a contingent interest. The intent of that change, however, was not to exempt trust from taxation unless the beneficiary receives a distribution, as Appellant argues. The point of the change was to clarify that the beneficiary must have some vested current interest in the trust in order to subject that trust to tax in the state.

At the same time, with Section 17745, the legislature highlighted the fact that while a beneficiary was contingent, the income would still be taxable when it was distributed to him or her.

Here Evan had a clear vested interest in the trust. He had the ability to insert himself into the most important affairs of the trust at any time. As investment direction advisor, he could buy and sell assets, vote stock, make loans, encumber trust property, and much more. The trust was a potential source of wealth that amounted to property in his hands.

His removal and replacement powers gave him the ability to effect distributions and the very provisions of the trust. His professional relationship to both Pabst Brewing Company and the trustee of the trust reflect his deep connections to the trust assets. He simply may not be considered contingent when he wields so much control over the trust.

The most notable fact about Evan's trust that distinguishes it from Kaestner and the fact pattern of the TAM is Evan's own hand in terminating the contingencies in the trust. In the TAM and Kaestner, it's up to the trustee to decide to terminate the contingency; i.e., to make a distribution. In this case, it's really only up to Evan. He can decide to assert control over investments; he can remove and replace the advisors.

I'd like to note one final point about Appelants' argument, and that is, if it's correct that Section 17742(a) only taxes trusts after a beneficiary gets a distribution, then the accumulated income of a trust would never be taxable by California based on beneficiary residence. Distributing trusts take distribution deductions and the beneficiary reports the income. So Appelants' position essentially invalidates a portion of 17742(a), and that's the clear statement that trusts with resident beneficiaries are taxable by the State.

MS. PAGE: The income received by the trust was their share of an asset sale by their jointly owned subsidiary as reported to them on a Schedule K-1, which is the shareholder's share of income deductions and credits. California Revenue and Taxation Code provides specific sourcing rules for income from a trade, business, or profession under Section 17951, which in turn provides a particular rule for the narrow application of 17952 in certain circumstances.

The sourcing rules under 177 -- -951 through 17955 are legislative regs pursuant to 17954, which are delegated regs to -- given by the legislature to the Franchise Tax Board, and they carry the weight of statute because they were delegated so that the legislature didn't have to pass sourcing rules. They yielded that power to the Franchise Tax Board.

Appellants were correct in their initial filing of their California tax returns when they sourced their income from the sale of assets by their S corporation pursuant to the rules of 17951. Valentino is satisfied by this treatment because 17952 is applied in the case of nonbusiness income.

UDITPA is part of the personal income tax code. It is incorporated by reference into the 17951-4 reg. It is not correct to say that trusts or S corporations are not subject to the provisions of UDITPA.

Further, goodwill is an intangible where it concerns the reputation, contact, networks, intellectual properties and branding and is an example of an intangible that is owned by the underlying company.

Finally, to cite Valentino one last time, discussing 1366, 1366, which also states that the character of the shareholder's pro rata share of S corporation income is determined as if the income were realized directly from the source from which realized by the corporation, any other interpretation renders the phrase "realized directly from the source from which realized by the corporation" -- or I'm sorry, any other interpretation renders the phrase "realized directly from the source from which realized by the corporation" meaningless.

Here the other side is citing to Ames, which has no intervening entity. They're citing to arguments that they're saying that the business of the corporation is conducted by the -- directly by the shareholder in a case like this. And they're rendering meaningless the statement under 1366 that says that the income is realized as if it's by the corporation.

ALJ JOHNSON: Thank you.

And, Appellants, you'll have five minutes for your closing statements.

MR. WEINTRAUB: Just addressing the issue of whether it's a resident trust. There's nothing in the trusts that are under consideration that are in any way extraordinary, not withstanding what the FTB has said about them. The administrative powers, the investment powers, the power to remove and replace the fiduciary is common in almost every trust in California and everywhere. They're trying to present this as if somehow this beneficiary has unusual powers that make him -- his interests somehow not contingent. None of those powers have any bearing upon his ability to receive, as a beneficiary of the trust, a distribution. It's subject to the exercise of a condition precedent, which has not been exercised. The trustee -- the distribution advisor has not exercised the discretion which the distribution has sole and absolute.

The legislature history is crystal clear. It talks about the distribution of income, and the FTB's concerned about the accumulated income is taxed when it comes out. That's the whole concept of the discretionary trust. It's taxed in California when the California beneficiary receives the distribution. The FTB's analysis and approach would be entirely subjective, making it -- changing everything for the last 50 years, making it possible to draft trusts that would not be subject to taxation no matter what. It is not a pragmatic approach.

And for all of these reasons it should be very clear this is just like thousands of other trusts, where the rights of the beneficiary to receive a distribution are conditioned upon a condition precedent, and that is the very definition of a contingent beneficiary, and that's why the trust is not a resident trust.

MR. MUILENBURG: And as to the sourcing issue, throughout the refund and appeals process, the taxpayer's position never changed. 17952 requires intangible gains reported by nonresident trusts to be allocated to the trust's state of residence. That is what the law says, and that is how the California courts have consistently applied the law. FTB would have you believe that the existence of an S corporation between the intangible property sold and the nonresident taxpayer somehow changes the analysis and results in apportionable income.

In essence, the FTB is asking for the OTA to execute a heavy lift and decree, with its opinion today, what the FTB failed to accomplish by formal regulation. The FTB does not like the holding on appeal of Venture Communications and has been trying for the better part of five years to change the rule of law articulated in that case. To use the FTB's own words, the Board's determination is not consistent with the sourcing rules set forth in Regulation 25137-1, and this amendment is provided to remedy that inconsistency.

What the FTB is failing to recognize and what we are asking your panel to acknowledge today is that there is an entire body of law applicable to nonresident individuals and trusts that necessarily results in determinations that are different from those reached for corporate partners of corporations.

Corporations, as you're well aware, are subject to the provisions of UDITPA, which allow for the apportionment according to methodologies that have passed constitutional scrutiny under the commerce and equal protections clauses.

Individuals and trusts, on the other hand, may not be taxed on income by a state other than their state of residence unless that income has a source in that other state. California has clearly shown today -- has a statute that mandates the sourcing of intangible income to a nonresident taxpayer's state of residence; therefore, until that law is changed, taxpayers must be allowed to rely upon its application and this balance should be tasked with upholding its provisions.

Thank you.

ALJ JOHNSON: Okay. The evidence has been admitted into the record. We have the arguments and your briefs, as well as your oral arguments today. We have a completed record from which to base our decision.

Any final questions from either party before we close the record?

Okay. I wish to thank both parties for their efforts on appeal. The record is now closed. This will conclude the hearing on this appeal. Parties should expect a written decision no later than 100 days from July 30, 2019.

With that, we are now going off the record, and this concludes today's Office of Tax Appeals hearings. Thank you.

(The proceedings adjourned at 12:42 p.m.)

STATE OF CALIFORNIA)
) ss
COUNTY OF CALAVERAS)

I hereby certify that the foregoing in the within-entitled cause was taken at the time and place herein named; that the transcript is a true record of the proceedings as reported by me, a duly certified shorthand reporter and a disinterested person, and was thereafter transcribed into typewriting by computer.

I further certify that I am not interested in the outcome of the said action, nor connected with, nor related to any of the parties in said action, nor to their respective counsel.

IN WITNESS WHEREOF, I have hereunto set my hand this 16th day of August, 2019.

____

MELINDA M. SELLERS, CSR NO. 10686
STATE OF CALIFORNIA