3. Whether the Evan Trust is a California resident trust.[1]

FACTUAL FINDINGS

1. Pabst Corporate Holdings, Inc. (Pabst), a Delaware S corporation, sold all of its shares of its qualified subsidiary, Pabst Holdings, Inc. (PHI), in a transaction treated as an asset sale for tax purposes.[2] Pabst reported as a distributive share the gain to its shareholders, including the Family Trust and the Evan Trust, both of which are electing small business trusts (ESBT[3]).[4] The sale resulted in long-term capital gain, which was reported as apportionable business income of $607,153,219 on Pabst's 2014 S corporation return.[5] Pabst apportioned this gain using a 6.6 percent apportionment formula and paid tax on it for purposes of the 1.5 percent entity-level income tax imposed on S corporations.
2. As shareholders in Pabst, appellants received California Schedules K-1 from Pabst reporting their "Share of Income, Deductions, Credits, Etc." listing their pro rata distributive shares of this income. Appellants then reported the income on their 2014 California fiduciary income tax returns (Forms 541), treating the net income as apportionable to California using the same ratio (i.e., 6.6 percent) as used by Pabst. Appellants paid tax on their respective distributive shares of the gain at the trust level for purposes of the ESBT tax.[6]
3. Subsequently, appellants filed amended 2014 California returns treating all income attributable to the sale of PHI as not being subject to California taxation. Appellants

[1] On appeal, FTB states that it does not contest appellants' position that the beneficiaries of the Family Trust held contingent interests and the trust was a California nonresident trust for 2014. Therefore, this issue only pertains to the Evan Trust.

[2] Pabst owned 100 percent of PHI, a qualified subchapter S subsidiary.

[3] An ESBT is a trust that is permitted to hold S corporation stock, and "is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust . . . The ESBT is treated as a single trust for administrative purposes, such as . . . filing one tax return. (Treas. Reg. § 1.641(c)-1(a).)

[4] During the 2014 tax year, the Evan Trust owned 39.5 percent and the Family Trust owned 20 percent of the outstanding shares in Pabst.

[5] Pabst was a unitary business that treated all of its income as business income and apportioned that income on its CA Schedule R.

[6] As used here, ESBT tax means the portion of the trusts' income that is received from its ownership in an S corporation, i.e., distributive gain from the sale of PHI by Pabst. (See Treas. Reg. § 1.641(c)-1(d).)

asserted that, as the gains arose from the sale of intangible property (i.e., goodwill), the gains lacked a California source and therefore should have been sourced to the state of appellants' domicile (i.e., outside of California). These amended returns constituted timely claims for refund filed by the trusts.

4. After reviewing the claims for refund, FTB issued an "Audit Issue Presentation Sheet (AIPS) – Proposed Claim Denial" to each appellant. Thereafter, appellants filed timely appeals of the deemed denial of their claims for refund.

5. On appeal, appellants verified that the income at issue in their claims for refund was wholly attributable to the gain from the sale of intangibles (i.e., goodwill). The parties agreed that the sale of intangibles was business income of Pabst, which, with its unitary subsidiaries, was a multistate apportioning business carrying on business within and without of California.

DISCUSSION

California has essentially adopted federal tax law regarding the treatment of subchapter S corporations. (R&TC, § 23800; see *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284, 1290 (*Valentino*).) The character of a 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. (*Valentino, supra,* 87 Cal.App.4th at p. 1290, citing Internal Revenue Code (IRC), § 1366(b).)[7] This principle is known as the "conduit rule." (*Valentino, supra,* 87 Cal.App.4th at p. 1290, citing Sen. Rep. No. 97-640, 2d. Sess. (1982).) The court in *Valentino* addressed whether income received by nonresidents through an S corporation wholly conducting business in California should be sourced based on the income-producing activity of the S corporation, or as income from an intangible under R&TC section 17952[8] (i.e., S corporation ownership). The court found that "an S corporation shareholder's income is characterized by reference to the corporate-income-producing activity and, once characterized, the items are then sourced

[7] Specifically, IRC section 1366(b) provides: "The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) 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."

[8] R&TC section 17952 provides that "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state," or the nonresident buys or sells such property in this state regularly enough to constitute doing business in this state.

according to the particular sourcing rule applicable to each type of income." (*Id*. at p. 1291.) The court also reasoned that S corporations are to be taxed in the same manner as partnerships, and "pass-through partnership income received by a non-resident is subject to California tax where the source of the partnership's income is in this state," under California law. (*Id*. at p. 1295.)

The taxpayers in *Valentino* raised the applicability of the doctrine of *mobilia sequuntur personam* (i.e., "movables follow the law of the person") to income from S corporations. (*Valentino, supra*, 87 Cal.App.4th at p. 1287.) Although the court had determined that there was no intangible income from the S corporation, the court specifically addressed R&TC section 17952, stating that, unlike with C corporations, the section never applies to a shareholder's share of S corporation income *unless* the corporate income itself is derived from intangibles. (*Id.* at p. 1292.) The court reasoned that this interpretation harmonized IRC section 1366(b) with R&TC section 17952, by applying the latter to income characterized at the corporate level as income from intangibles, and therefore R&TC section 17952 "continues to apply in situations it did before . . . [i.e.,] stock dividends and income from the sale of stock." (*Id*. at p. 1296.)

In *Valentino*, the taxpayers asserted that the Legislature and administrative agencies know how to expressly make the source of income of a business entity pass through as the source of income to nonresidents when they so intend (see Regulation 17951-1), and therefore contended that the lack of such a statement with regard to S corporations should be read as an intentional omission. The court acknowledged that FTB had not (at the time *Valentino* was decided) amended the relevant regulations to account for S corporations, but the court still held that the principle applied to S corporations based on the reasoning discussed above and the "universal recognition of the similarity in treatment between the taxation of partnerships and S corporations." (*Valentino, supra*, 87 Cal.App.4th at p. 1296.) After the *Valentino* decision was issued, FTB did amend its regulation and specified that the pro rata share of S corporation income derived from sources within California shall be determined as if the S corporation were a partnership when the S corporation is a unitary business operating within and without California (as opposed to an S corporation operating solely within or solely without California, as

contemplated by Regulation 17951-4(a)).[9] (Regulation 17951-4(f) [redirecting to Regulation 17951-4(d)].)

Appellants contend that *Valentino*, among other authorities,[10] requires that the income distributed to a shareholder of an S corporation be characterized as if the shareholder itself had received the income. Under that theory, appellants argue that the income from the sale of intangible assets, such as goodwill, is excluded from appellants' California source income under R&TC section 17952, unless (1) the intangible property itself (e.g., goodwill) acquired a "business situs" in California, which appellants assert did not occur, or (2) appellants were "doing business" in California, which appellants also assert did not occur.

FTB asserts that because the parties agree that the income at issue is apportionable business income of Pabst, it must be apportioned at the S corporation level pursuant to Regulation 17951-4(d) and (f). Therefore, FTB contends, that R&TC section 17952 is not the appropriate method for determining whether business income of an S corporation should be apportioned or sourced to California. As to *Valentino*, FTB contends that the language regarding R&TC section 17952 was dicta because the court was unable to discuss the application of R&TC section 17952 in detail since it did not have applicable facts before it.[11]

The primary dispute stems from differing interpretations of the IRC section 1366(b) and *Valentino* wherein the section and decision state that the character of any item included in a shareholder's pro rata share of income shall be determined as if the item were realized directly from the source from which realized by the corporation. One interpretation would essentially ignore the S corporation. This position is supported by the final sentence of the discussion in *Valentino*, in which the court attempted to protect the utility of R&TC section 17952. The other

[9] The *Valentino* decision was issued on March 23, 2001, and specifically notes that as of the date the decision was issued FTB had not promulgated regulations addressing sourcing rules for S corporation shareholders. (*Valentino, supra*, 87 Cal.App.4th at p. 1296.) FTB subsequently promulgated sourcing rules for S corporation shareholders by adding pertinent language to subsections (d) and (f) to Regulation 17951-4, which FTB filed with the California Secretary of State on December 24, 2001, and which became effective on January 23, 2002.

[10] Appellants also cite *Appeal of Venture Communications, Inc*. (*Venture*), a "Summary Decision" issued by the California State Board of Equalization on February 5, 2003. We note, however, that the Summary Decision specifically states that it is "Not to be Cited as Precedent."

[11] FTB provides arguments in the alternative, contending that if R&TC section 17952 applies, then it would only apply to the extent of the business situs exception and that the intangible property at issue is still subject to the business situs rule and is still subject to apportionment. FTB also provided arguments in the alternative regarding whether the Evan Trust was a resident trust for purposes of the 2014 tax year. Based on our findings herein, we do not need to address these arguments.

interpretation puts the shareholder into the shoes of the S corporation, including its obligation to apportion business income, and finds support in Regulation 17951-4.

The court in *Valentino* faced the difficult task of construing the generalities provided by the statutes, including the lack of direction as to how to treat S corporations, and relied partially on general legal principles to provide guidance on the sourcing of shareholder income received from an S corporation. The main issue in *Valentino* was whether all S corporation income should be treated as an intangible and sourced to the shareholder's domicile, or if the source of that income in the hands of the shareholder looks through the S corporation to the income-producing activity of the S corporation. *Valentino* found the latter, sourcing income based on the "corporate-income-producing activities." (*Valentino, supra*, 87 Cal.App.4th at p. 1296.) The issue of sourcing in this appeal carries the conversation one step forward. Now that we know we must look at the income-producing activity to determine the source of the income, how do we apply the relevant sourcing rules, including new regulations promulgated subsequent to the decision in *Valentino*?

While *Valentino* addressed the applicability of R&TC section 17952, suggesting it would apply in cases of income from intangibles, it then lists the determination of "the source of stock dividends and income from the sale of stock" as the situations in which R&TC section 17952 would apply. As such, and because income from the sale of intangibles was not before the court, *Valentino* offers an incomplete guide on how to treat income like the income at issue in this appeal. *Valentino* is further distinguished from the present appeal in the fact that *Valentino* dealt with an S corporation conducting business entirely within California (see Regulation 17951-4(a)), rather than a multistate apportioning business (see Regulation 17951-4(d)). This factor becomes more significant considering the regulatory amendments that followed *Valentino*.

While *Valentino* provides helpful guidance on the issue of sourcing income received by shareholders in an S corporation, we find an explicit set of instructions in Regulation 17951-4, which was revised after the decision in *Valentino* to provide additional clarity on the treatment of S corporations. Regulation 17951-4(f) provides that subsection (d) applies to determine the amount of the taxpayer's pro rata share of S corporation income that is derived from sources within this state for multistate unitary S corporations, such as Pabst (and unlike the entity in *Valentino*). Regulation 17951-4(d) provides the following (emphasis added):

> (d) If a nonresident is a partner in a partnership which carries on a unitary business, trade or profession within and without this state, the source of the partner's distributive share of partnership income derived from sources within this state shall be determined in the manner described below.
>
> (1) Except as provided, **the total business income of the partnership shall be apportioned at the partnership level** in accordance with the apportionment rules of the Uniform Division of Income for Tax Purposes Act, Sections 25120 to 25139, Revenue and Taxation Code, and the regulations thereunder. Each partner's distributive share of the partnership business income apportioned to this state is income derived from sources within this state.
>
> ***
>
> (3) The source of a partner's distributive share of items which do not constitute business income shall be determined in accordance with the sourcing rules of Sections 17951 through 17955, Revenue and Taxation Code, and the regulations thereunder, as if the income producing activity were undertaken by the partner in its individual capacity.

Regulation 17951-4(d)(1) provides the general rule that business income is apportioned at the S corporation level, not the shareholder level as appellants essentially argue using R&TC section 17952. Regulation 17951-4(d)(3),[12] by contrast, provides further confirmation of this finding, in showing that R&TC section 17952 could be the appropriate tool to use when sourcing *nonbusiness* income received by a shareholder of an S corporation. As such, appellants are required to source the income received from Pabst in the manner in which it was apportioned at the S corporation level, or in other words, as originally reported.

Following Regulation 17951-4 rather than R&TC section 17952 comports with *Valentino*. The court in *Valentino* indicated that pro rata S corporation income is to be characterized first at the S corporation level, and then sourced according to the particular sourcing rules applicable to that type of income. Here, the income at issue is properly characterized as business income, which falls under the sourcing rules of Regulation 17951-4(d) for multistate unitary S corporations. To focus instead on the classification of the income as originally being from the sale of intangibles and to apply the general rules of R&TC section 17952 would be to completely bypass the more explicit rules of Regulation 17951-4 (and thereby bypassing R&TC sections 17951 and 17041), which would be an incorrect application of

[12] A 2018 amendment to Regulation 17951-4 moved this subparagraph from (d)(3) to (d)(4).

the law. The application of R&TC section 17952 as it applies to shareholder income from an S corporation's nonbusiness income on the sale of intangibles is supported by Regulation 17951-4(d)(3). Here, however, the income at issue was business income, and Regulation 17951-4(d)(3) does not apply.

HOLDINGS

The income received by the trusts, as shareholders in the multistate unitary S corporation, from the sale of intangibles characterized as business income at the S corporation level subject to apportionment, is apportionable to California based on the apportionment formula as determined at the S corporation level, in accordance with Regulation 17951-4(f) and (d)(1).[13] That income is not sourced under R&TC section 17952. Accordingly, appellants' claims for refund were properly denied.[14]

DISPOSITION

The FTB's denials of appellants' claims for refund for the 2014 tax year are sustained.

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John O Johnson
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John O. Johnson
Administrative Law Judge

I concur:

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Jeff Angeja
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Jeffrey G. Angeja
Administrative Law Judge

[13] Current court action is pending regarding the application and constitutionality of R&TC section 17951 as it pertains to trusts. (*Paula Trust et al. v. FTB* (Super. Ct. S.F. County, 2018, No. CGC-16-556126), app. pending.) We note that the result of that court action might impact future appeals with facts and legal issues that are similar to those discussed in this Opinion.

[14] This finding in favor of FTB's position is dispositive, and renders unnecessary a discussion of FTB's alternative arguments that the Evan Trust was a California resident trust for the year at issue and regarding application of the business situs rule.

K. GAST, Concurring:

I. Introduction

I concur with the majority's ultimate disposition of this case that neither appellant is entitled to a refund. However, I take a different legal path to reach that determination. First, I conclude the goodwill gain passed through from Pabst, an S corporation, is properly sourced under R&TC section 17952, instead of Regulation 17951-4(f). Second, employing R&TC section 17952, I further conclude the goodwill, an intangible asset, acquired a business situs, in part, in California, and in the absence of contrary evidence, a portion of the gain should be sourced to the state using Pabst's as-filed 2014 apportionment percentage of 6.6 percent.

II. R&TC Section 17952 Applies to Source the Goodwill Gain, Not Regulation 17951-4(f)

FTB initially contends the *Valentino* court's discussion of R&TC section 17952 is dicta. I disagree. There, the crux of the taxpayers' contention was their income must be classified as intangible income because it was derived from the ownership of stock. (*Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284, 1286.) Consequently, the taxpayers argued, R&TC section 17952 sourced the income to their out-of-state residence, rather than to California where the corporation conducted its business. (*Ibid.*) The court disagreed, finding California conformed to the "conduit rule" under Internal Revenue Code (IRC) section 1366(b), and therefore the taxpayers' distributive share should be sourced to the location where the S corporation conducted its business. (*Id.* at pp. 1290-1291.)

Critically, in reaching its holding, the court discussed when R&TC section 17952 applied.[1] It did so to "harmonize" that section with California's concurrent recognition of S corporations as pass-through entities under IRC section 1366(b), giving force and effect to

[1] See, e.g., *Valentino*, *supra*, 87 Cal.App.4th at p. 1292 ["Consequently, [R&TC] section 17952 never applies to a shareholder's share of S corporation income unless the corporate income itself is derived from intangibles"]; *id.* at p. 1296 ["In other words, [R&TC] section 17952 is not displaced by [IRC] section 1366(b), because it continues to apply in those situations it did before the enactment of the S corporation provisions—that is, to determine the source of stock dividends and income from the sale of stock."]

each. (*Valentino, supra,* 87 Cal.App.4th at p. 1296.) Therefore, the court's statements concerning R&TC section 17952 were essential to its holding and cannot be dismissed as dicta.[2]

Valentino, however, was less clear what type of intangible income gives rise to R&TC section 17952 treatment. One plausible reading is that R&TC section 17952 applies to *all* types of intangible income passed through from an S corporation, but this construction is too broad and would encompass intangible income from regular trade or business activities properly covered by R&TC section 17954 and Regulation 17951-4.[3] A better reading is that R&TC section 17952 applies to intangible income not derived from the S corporation's regular trade or business.

Thus, to harmonize R&TC section 17952 with Regulation 17951-4(f)—as *Valentino* did with R&TC section 17952 and IRC section 1366(b)—I believe Regulation 17951-4(f) characterizes intangible income as apportionable business income at the shareholder-level only if it is derived from an S corporation's regular trade or business. When IRC section 1366(b) is read in conjunction with the court's statement that R&TC section 17952 continues to apply to income from dividends and stock sales, I conclude R&TC section 17952 applies to intangible income derived from passive activities, as well as those activities generating intangible income outside of an S corporation's regular trade or business, such as, here, goodwill gain from the one-time, extraordinary sale of a business.[4] This conclusion is consistent with how R&TC section 17952 would have applied if the business had been sold by appellants themselves, rather than by Pabst, because they are not in the trade, business, or profession of selling businesses.

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[2] FTB also argues that if the "dictum" in *Valentino* is correct about how R&TC section 17952 applies under certain circumstances, then that would render R&TC section 17955 moot. However, it appears R&TC section 17955—which essentially provides that a nonresident partner's distributive share of income from qualifying investment securities (i.e., intangible income) is not income from California sources—was enacted to avoid R&TC section 17952's business situs exception where nonresidents were otherwise doing business in California and consequently their investment securities acquired a business situs in the state. Therefore, I believe R&TC sections 17952 and 17955 are in harmony with each other.

[3] *Valentino* dealt with regular trade or business income, which is why Regulation 17951-4(a) applied.

[4] Admittedly, the court seemed to confine R&TC section 17952 treatment to "those situations it did before the enactment of the S corporation provisions—that is, to determine the source of stock dividends and income from the sale of stock." (*Valentino, supra,* 87 Cal.App.4th at p. 1296.) However, I do not believe the court intended to limit R&TC section 17952's application to income derived solely from dividends and stock sales. Rather, before the enactment of the S corporation provisions, R&TC section 17952 applied (and still applies) to many other types of intangible income, including that from goodwill. (See Regulation 17952(a).) Therefore, I find R&TC section 17952 continues to apply to intangible income not derived from an S corporation's regular trade or business, even if such income is classified as business income at the S corporation level under R&TC section 25120(a).

The majority correctly notes that *Valentino* dealt with a wholly intrastate S corporation, whereas Pabst is a multistate S corporation, and that subsection (f) was added to Regulation 17951-4 shortly after that case was decided. However, it would make little sense to apply R&TC section 17952 to only those nonresident shareholders of S corporations conducting business entirely within California, as *Valentino* directs, but not to nonresident shareholders of multistate S corporations conducting business only partially within the state. Otherwise, the former will be allowed to escape California tax on their qualifying pass-through intangible income, while the latter would be subjected to California tax on such income on an apportioned basis. Accordingly, under step one of *Valentino*'s two-step sourcing process, appellants must source the goodwill gain under R&TC section 17952.

III. Application of R&TC section 17952

The issue here is whether the goodwill asset acquired a business situs in California. If it did, the income therefrom is taxed in this state. But if it did not, as appellants argue, California cannot tax the income because under the *mobilia* doctrine, it has a source in appellants' out-of-state residence. R&TC section 17952 pertinently provides that "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state ..... " I believe the goodwill asset here falls within "other intangible personal property."

Regulation 17952(c) provides that "[i]ntangible personal property has a business situs in [California] if it is employed as capital in [California] or the possession and control of the property has been localized in connection with a business, trade or profession in [California] so that its substantial use and value attach to and become an asset of the business, trade or profession in [California]." Since there is a lack of guidance how to apply this rule in the context of goodwill, it is helpful to review a general description of what that term means:

> [T]he advantage or benefit which is acquired by an establishment beyond the mere value of its capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of *its local position,* or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices. [Citations.]
>
> Whether acquired by purchase or built up over a period of time, the advantage or benefit of goodwill makes possible the profitable operation of a business. *Indeed,*

> *goodwill is so essential to the viable conduct of a business that it has been held to be inseparable from the business as a whole*. [Citation.]

(*Appeal of Borden, Inc.* (77-SBE-007) 1977 WL 3818 at p. *4, emphasis added (*Borden*).)

In these appeals, the record is silent as to what the goodwill in question related to, what contributed to its appreciation, and when that occurred. Therefore, consistent with *Borden*'s general description of goodwill, one can only conclude the goodwill here was created, maintained, built-up, and localized wherever Pabst conducted its unitary business and that this remained true in 2014, when the business was sold. Thus, the goodwill acquired a business situs in California.[5]

However, it still must be determined whether the entire goodwill asset or only a portion thereof acquired a business situs in this state. Regulation 17952(c) provides guidance: "If intangible personal property of a nonresident has acquired a business situs [in California], *the entire income from the property* including gains from the sale thereof, regardless of where the sale is consummated, is income from sources within [California], taxable to the nonresident." (Emphasis added.) Appellants argue the entire goodwill asset must have acquired a business situs in California, or it cannot have a situs in the state. However, nothing in this language suggests the goodwill cannot acquire a business situs partially in California. Indeed, the word "entire" modifies "income," not "the property." Thus, a better reading is that an asset can partially acquire a business situs in this state, and if it does, "the entire income" from that portion is sourced to this state.

Here, only a portion of the goodwill asset acquired a business situs in California because Pabst's unitary business was conducted in multiple jurisdictions. In the absence of contrary evidence—such as what the goodwill related to and what year(s) the appreciation built-up

[5] Appellants largely rely on *Rainier v McColgan* (1949) 94 Cal.App.2d 118, for their position that the goodwill here did not acquire a business situs in California, but that case is factually distinguishable. There, the court held that a California corporate taxpayer was properly assessed additional California franchise taxes on royalties received from a Washington corporation. The court found the royalties were attributable to the taxpayer's goodwill, which was attached to its trademark, and in applying the *mobilia* doctrine, the situs of that property was in California, where the taxpayer's principal place of business was located. The court essentially characterized the taxpayer's relationship with its customer as one of creditor-debtor, suggesting the creditor-taxpayer passively collected royalty income on intangibles being controlled and exploited in Washington by the debtor-customer. Here, though, the goodwill was partially localized in California where Pabst conducted its unitary business.

occurred—I conclude the gain should be sourced to California using Pabst's as-filed 2014 apportionment percentage, which approximates the goodwill's geographical location.[6]

For the foregoing reasons, I would have denied appellants' refund claim on this basis.

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Kenneth Gast
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Kenneth Gast
Administrative Law Judge

[6] This conclusion in no way suggests the UDITPA sourcing provisions apply whenever the business situs exception is met. Rather, in this case, there is no other evidence to make a more reasonable sourcing approximation.