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2020 – OTA – 290P
Pending Precedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

MICELLE LABORATORIES, INC.

) OTA Case No. 18011961
) CDTFA Account No. 24-950336
) CDTFA Case ID 625207

OPINION

For Appellant: Steven A. Silverstein, Attorney
Mark W. Huston, Attorney

For Respondent: Mengjun He, Tax Counsel III

For Office of Tax Appeals: Corin Saxton, Tax Counsel IV

A. KWEE, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 6561, Micelle Laboratories, Inc. (appellant) appeals a decision issued by respondent California Department of Tax and Fee Administration (CDTFA)[1] denying appellant's petition for redetermination of a Notice of Determination (NOD) dated July 16, 2012. The NOD is for $430,748,979 in tax, plus applicable interest, for the period July 1, 2007, through August 21, 2009 (audit period). This matter is being decided based on the written record because appellant waived the right to an oral hearing.

ISSUES

1. Whether appellant established a basis for adjustment to the liability as determined by CDTFA.
2. Whether appellant established a basis for relief of interest.

[1] Sales taxes were formerly administered by the State Board of Equalization (SBE or board). Effective July 1, 2017, functions of SBE relevant to this case were transferred to CDTFA. (Gov. Code, § 15570.22.) When this opinion refers to acts or events that occurred before July 1, 2017, "CDTFA" shall refer to its predecessor, SBE.

FACTUAL FINDINGS

1. Appellant, a California corporation, manufactured nutritional supplements during the audit period.
2. Appellant held a California seller's permit with an effective start date of January 1, 1992.
3. During 2009, appellant and Herbalife International of America, Inc. (Herbalife) began negotiations and arrangements for the sale of appellant's business assets to Herbalife.
4. During April of 2009, Herbalife hired an appraiser, Chris Hillseth Enterprises (appraiser), to appraise the fair market value or new replacement value[2] for the fixed assets (physical assets such as machinery and equipment) of appellant's business. The appraiser prepared an appraisal report dated April 23, 2009, which estimated the value (identified as "Price FMV") of appellant's fixed assets as $3,491,356.10 (appraiser's fair market value).[3]
5. On August 13, 2009, appellant entered into an Asset Purchase Agreement (Purchase Agreement) with Herbalife. Pursuant to the Purchase Agreement, appellant sold all the assets of appellant's business to Herbalife. The assets were identified in Exhibit A to the Purchase Agreement.
6. On August 20, 2009, prior to close of escrow on August 21, 2009, Herbalife inspected appellant's assets.
7. As required by the Purchase Agreement, appellant provided Herbalife a document titled "Pre-Closing Balance Sheet" (pre-closing balance sheet).[4] The pre-closing balance sheet

[2] The original report is not contained in the record. CDTFA contends that appraisal was the fair market value. Appellant contends it was the new cost replacement value. In support, in connection with this appeal, appellant submitted a letter from the appraiser dated January 17, 2012, stating that the 2009 report appraised the cost of new replacement items.

[3] The record contains some inconsistencies regarding what constitutes the fair market value. According to a spreadsheet submitted by appellant, titled "Analysis of Asset Purchase Listing," the "Price FMV" (excluding in-place value) of fixed assets in the appraiser's report was $3,524,946.11. According to a document prepared by Herbalife, titled "Herbalife Asset Purchase Listing," which was based on the appraiser's report, the "Price FMV" was $3,491,356.10. Finally, according to a document titled "Amended 1120-S data," submitted by appellant, the "Equip Value" was $3,340,700." For ease of analysis, we use $3,491,536.10, because that was the amount listed in CDTFA's decision, and that amount was not disputed by appellant (appellant did dispute, however, whether this was an accurate reflection of fair market value). We define this as the "appraiser's fair market value" for consistency because the documents citing the appraisal refer to the amounts as "Price FMV."

[4] Appellant also prepared a "Closing Balance Sheet" (closing balance sheet). The closing balance sheet included line items subtracting the amounts for two items from current assets (bad debt allowance, and inventory reserve), and adding them as a separate line item under "working capital adjustment." This was done for purposes of calculating the working capital adjustment (discussed below). Nevertheless, the Purchase Agreement specifically

identifies a book value[5] for all assets of the business: $6,646,583.40. This balance sheet allocates the book value as follows: $1,426,378.90 for fixed assets, and $5,220,204.50 for current assets (e.g., inventory, cash, accounts receivables).[6]

8. On August 21, 2009, appellant executed a Bill of Sale, which transferred title to the assets of its business to Herbalife pursuant to the Purchase Agreement. Appellant thereafter reported the closeout of its seller's permit to CDTFA with an effective termination date of August 21, 2009.

9. On September 4, 2009, Herbalife discussed the results of its inspection with the appraiser and generated its own list of appellant's fixed assets as of August 20, 2009. Herbalife's asset listing starts with the appraiser's fair market value for fixed assets ($3,491,356.10), adds $33,000 for additional fixed assets discovered during the inspection, and also adds $847,000 for an "in place" value for certain fixed assets, for a total fair market value of $4,351,536.10 (Herbalife's appraised value).[7]

10. The parties did not specify in the Purchase Agreement, or otherwise reach agreement, as to what portion of the purchase price was allocable to fixed assets or to tangible personal property purchased for use by Herbalife (i.e., the measure of tax).

11. According to the Purchase Agreement, the purchase price for the business was $10,000,000, less holdback (as defined), and less (or plus) any estimated working capital surplus or deficiency (as defined), as applicable. In addition, the Purchase Agreement requires Herbalife to assume $4,314,384 in liabilities identified on a schedule titled "Assumption

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identified the bad debt allowance and inventory reserve as "assets," which were included in the sale to Herbalife. The remaining current and fixed asset values on both balance sheets are otherwise identical.

[5] The book value of an asset is the value at which an asset is carried on a balance sheet; and is calculated by subtracting accumulated depreciation from the acquisition cost. (See Black's Law Dict. (8th ed. 2004) p. 195, col. 1.) The fair market value is the price that a seller is willing to accept and a buyer is willing to pay in an open market and arm's length transaction. (See Black's Law Dict. (8th ed. 2004) p. 1587, col. 1.)

[6] Consistent with its pre-closing balance sheet, appellant provided a statement of depreciation showing total book value of $7,189,281.29 as of July 31, 2009, for all assets (fixed assets and current assets). Of this amount, the book value for current assets was $5,763,602.39. For fixed assets, the acquisition cost was $7,598,258.04, less accumulated depreciation of $6,172,579.14, for a book value of $1,425,678.90.

[7] As noted in footnote 2, there are some inconsistencies in the available documentation summarizing the appraiser's report, and the appraiser's report is not in the record to resolve these inconsistencies.

of Liabilities." The Purchase Agreement specified how to calculate the adjustments to the purchase price, as follows:[8]

- Holdback adjustment: First, regarding the holdback, Herbalife was required to pay $1,000,000 into escrow, to be held as a deposit pending determination of the amount of any working capital adjustment.[9] Appellant was entitled to receive the deposit, less any amount that Herbalife was permitted to retain due to the adjustment. The Purchase Agreement specifies how to calculate the working capital adjustment. The Purchase Agreement provides that the purchase price shall be reduced to the extent Herbalife is entitled to retain the $1,000,000 deposit.
- The working capital surplus or deficiency adjustment: To the extent the estimated working capital exceeded $1,400,000 by a certain amount, there was an estimated working capital surplus. To the extent the estimated working capital was less than the Target Working Capital (as separately defined) by a certain amount, there was an estimated working capital deficiency. Appellant was required to provide this information on an estimated closing balance sheet at least two days prior to the closing date (August 21, 2009). In addition, appellant was required to provide a final closing balance sheet, identifying the closing working capital amount.
- The Purchase Agreement specified there would be a dollar-for-dollar increase (or decrease) to the purchase price to the extent that the working capital exceeds (or falls short of) the target working capital by a certain amount.[10]
- Disputes: Appellant was required to provide Herbalife with the final closing balance sheet within 120 days of the closing date, and then Herbalife had 30 days to make any adjustments. Herbalife's adjustments would be final and binding, unless appellant objected within 10 days. If the parties were unable to reach an agreement as to the working capital adjustment, the matter would be submitted to a neutral

[8] This is a high-level summary of the adjustments. Greater specificity on the calculations is not relevant for purposes of this appeal.

[9] Although the holdback was also tied to seller's indemnification obligations, we have no evidence that these came into play.

[10] These calculations also included any previously calculated estimated working capital adjustments.

third party for decision, and the third party's decision was binding. The parties had until June 30, 2010, to resolve any disputes regarding the working capital adjustment, and to instruct the escrow holder how to disburse the $1,000,000 deposit to the parties.

12. Appellant and Herbalife had a dispute regarding the working capital adjustment. Herbalife and appellant's former landlord, Biocol Investments, LLC (landlord), had a dispute regarding the landlord's alleged failure to timely consent to tenant improvements. Ultimately, the parties to those disputes entered into a Settlement Agreement dated March 5, 2010, resolving their disputes (settlement agreement). As relevant here, Herbalife and appellant agreed to a $1,000,000 working capital adjustment in favor of Herbalife, and appellant allowed the escrow holder to return the entire $1,000,000 escrow deposit to Herbalife; and Herbalife and the landlord agreed that the landlord would, on behalf of appellant, provide Herbalife with a $200,000 credit for rent otherwise payable by Herbalife to the landlord.
13. For the 2009 tax year, Herbalife filed an Asset Acquisition Statement with the Internal Revenue Service (IRS) (Form 8594), reporting a total purchase price of $12,500,968. Appellant concedes that it is "undisputed that Herbalife, on its own, submitted to the IRS a value of $4,167,000 for the equipment."[11]
14. For the 2009 tax year, appellant filed an Asset Acquisition Statement with the IRS, reporting a total purchase price of $10,000,000. Appellant thereafter filed an amended Asset Acquisition Statement, reporting a purchase price of $12,363,358. The amended form states, in pertinent part, that the reason for the increased sales price includes "assumed liabilities which would not ordinarily be classified as class III assets."
15. Appellant did not report the sale of any fixed assets to CDTFA.
16. CDTFA informed appellant that its account was selected for an audit. On January 27, 2011, appellant informed CDTFA that the business was sold, and requested to meet with the auditor at CDTFA's Irvine office.
17. On March 25, 2011, appellant provided documentation to CDTFA about the sale of the business. Upon audit, CDTFA reviewed the appraiser's fair market value, and

[11] The form in the evidentiary record lists an amount of $4,343,764. We need not resolve this conflict because the actual number is not relevant or material to our analysis.

Herbalife's appraised value, and determined a fair market value of $3,321,153 for machinery and equipment, based on the appraiser's fair market value as reflected on Herbalife's asset listing (and excluding any in-place value amount).[12] Next, to determine the selling price of the machinery and equipment, CDTFA rounded Herbalife's reported purchase price to the IRS down to $12,500,000 and determined that 26.57 percent of the sales price was allocable to tangible personal property ($3,321,153.04 / $12,500,000). Thereafter, CDTFA multiplied 26.57 percent by an amount it determined to be the total gross receipts [from the sale of] the business ($12,500,000 + $4,314,384 in debt assumption)[13] and concluded that appellant sold the machinery and equipment for $4,467,451.

18. In addition, CDTFA calculated an additional liability for appellant's failure to report and pay tax on purchases of fixed assets based on an actual basis examination of appellant's records ($364,409) and consumable supplies based on a block test examination of appellant's records for 2008 ($138,993).
19. On July 16, 2012, CDTFA issued the NOD to appellant for the liability disclosed by audit, which appellant timely petitioned.
20. On August 15, 2016, appellant submitted a statement under penalty of perjury, requesting relief of interest from August 8, 2012, until the date CDTFA's decision was ultimately issued.
21. In a decision dated January 31, 2017, CDTFA reduced the selling price of machinery and equipment to $3,321,153, to account for the appraiser's fair market value of the equipment (in other words, CDTFA determined the selling price was the same as the fair market value). CDTFA also provided interest relief for the period July 13, 2015, through January 31, 2017, for a delay in issuing the decision, but otherwise denied the petition. In denying the petition, CDTFA explains:

> Where [CDTFA's] Audit Manual provides an interpretation of a [CDTFA]-promulgated regulation which results in a more accurate

[12] The $3,321,153 amount is the sum of the following: $25,400 for computer equipment, $191,290 for laboratory equipment, $3,078,803 for machinery and equipment, and $25,660 for office equipment. These figures are tallied in CDTFA Audit Schedule 1R-12C-1 (5/30/12), which summarizes Herbalife's list of assets as of August 20, 2009. This schedule appears to contain errors; the source document indicates that machinery and equipment is $3,078,003, and office equipment is $25,650.

[13] In a brief dated February 24, 2020, appellant conceded that the assumed liabilities are $4,314,384, for purposes of calculating appellant's liability.

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> determination of tax, we are bound to follow it........ Accordingly, we must reject [appellant's] contention that book value must be used per Regulation 1595, subdivision (b)(1).[14]

This timely appeal followed.

22. On March 5, 2018, appellant filed with the Office of Tax Appeals (OTA) a declaration under penalty of perjury, requesting additional relief of interest through March 5, 2018, including specifically the period December 2014, through March 5, 2018, on the basis that CDTFA's decision on appellant's petition should have been issued during December 2014.
23. On appeal, appellant also contends that CDTFA is required to follow its own regulations, and must accept book value, instead of fair market value, for the machinery and equipment. Appellant contends that the correct calculation is $1,426,378 (book value) divided by $13,114,384 ($10,000,000 sales price plus $4,314,384 debt assumption less the $1,200,000 capital adjustment amount) times the total gross receipts from the sale of the business of $13,114,384. In other words, appellant contends the taxable measure is simply the book value of tangible personal property: $1,426,378.
24. On April 16, 2018, CDTFA responded that it is unable to apply the method in Regulation 1595 to calculate the liability because appellant failed to provide required documentation on book value for all the assets of the business. CDTFA also indicated it would be willing to recompute the liability if appellant provided such records.
25. By order dated January 6, 2020, OTA requested additional briefing on whether the parties would like to postpone the appeal in order to recalculate the liability, and for appellant to provide or identify any records that CDTFA required in order to recalculate the liability.
26. Appellant responded that the necessary records were attached as exhibits to CDTFA's decision (including the pre-closing balance sheet discussed above). CDTFA responded that book value maintained for recording tax depreciation is unreliable.

[14] All further references to "Regulation" refer to title 18 of the California Code of Regulations.

DISCUSSION

Issue 1: Whether appellant established a basis for adjustment to the liability as determined by CDTFA.

California imposes sales tax on a retailer's retail sales in this state of tangible personal property, measured by the retailer's gross receipts, unless the sale is specifically exempt or excluded from taxation by statute. (R&TC, §§ 6012, 6051.) For the purpose of the proper administration of the Sales and Use Tax Law and to prevent the evasion of the sales tax, the law presumes that all gross receipts are subject to tax until the contrary is established. (R&TC, § 6091.) It is the retailer's responsibility to maintain complete and accurate records to support reported amounts and to make them available for examination. (R&TC, §§ 7053, 7054; Cal. Code Regs., tit. 18, § 1698(b)(1).)

When CDTFA is not satisfied with the amount of tax reported by the taxpayer, or in the case of a failure to file a return, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession. (R&TC, §§ 6481, 6511.) In the case of an appeal, CDTFA has a minimal, initial burden of showing that its determination was reasonable and rational. (See *Schuman Aviation Co. Ltd. v. U.S.* (D. Hawaii 2011) 816 F.Supp.2d 941, 950; *Todd v. McColgan* (1949) 89 Cal.App.2d 509, 514; *Appeal of Myers* (2001-SBE-001) 2001 WL 37126924.) Once CDTFA has met its initial burden, the burden of proof shifts to the taxpayer to establish that a result differing from CDTFA's determination is warranted. (*Riley B's, Inc. v. State Bd. of Equalization* (1976) 61 Cal.App.3d 610, 616.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (See *ibid.*; see also *Appeal of Magidow* (82-SBE-274) 1982 WL 11930.)

Here, it is undisputed that appellant sold its fixed assets to Herbalife, that appellant failed to report any of its sales of fixed assets to CDTFA, and that appellant's retail sale of fixed assets to Herbalife is taxable. In summary, the parties agree there was an underreporting. Under such circumstances, CDTFA may determine the amount required to be paid on the basis of any information which is in its possession or may come into its possession, and the burden to establish error will shift to the taxpayer, so long as the determination is both reasonable and rational.

Appellant’s sale of fixed assets to Herbalife

Every person engaging in or conducting business as a seller within this state is required to hold a seller’s permit. (R&TC, § 6066(a).) A seller includes every person engaged in the business of selling tangible personal property of a kind the gross receipts from the retail sale of which would be subject to sales tax when sold at retail, regardless of whether the seller makes retail sales of such property. (R&TC, § 6014.) Tax applies to the gross receipts from the retail sale of tangible personal property in this state by any seller holding or required to hold a seller’s permit. (See R&TC, §§ 6012(a), 6015(a), 6066.)

R&TC section 7051 grants CDTFA the authority to prescribe, adopt, and enforce rules and regulations relating to the administration and enforcement of the Sales and Use Tax Law.[15] CDTFA exercised its delegated lawmaking authority, and promulgated Regulation 1595, which provides, in pertinent part:

> In general, when a person sells a business which is required to hold a seller’s permit, tax applies to the gross receipts from the retail sale of tangible personal property held or used by that business in the course of its activities requiring the holding of the seller’s permit. The gross receipts from the sale of the business include all consideration received by the transferor, including cash, notes, and any other property as well as any indebtedness assumed by the transferee..........The measure of tax is the price agreed to by the parties. In the absence of an agreement as to the price of the tangible personal property, the gross receipts from that sale is allocated among the taxable portion and the nontaxable portion by dividing the selling price of the tangible personal property acquired by the purchaser for use rather than resale by the selling price of the entire business sold, and then multiplying that amount by the total gross receipts (i.e., all consideration) received for the business. Book value will be regarded as establishing the price of properties sold.

(Cal. Code Regs., tit. 18, § 1595(b)(1). Regulation 1595 does not further define book value for these purposes. Nevertheless, CDTFA’s Audit Manual provides:

> Listed below are the methods the auditor should use to determine the sales price of the property transferred:
>
> a) Determine the book value. In some instances, book value may not represent true value of tangible personal property or other assets transferred. Accelerated depreciation may have been used whereas the straight-line method would have

[15] The courts have concluded that the legislative delegation in R&TC section 7051 is proper even though it confers some degree of discretion on CDTFA. (*Henry’s Restaurants of Pomona, Inc. v. State Bd. of Equalization* (1973) 30 Cal.App.3d 1009, 1020.)

> reflected a more accurate value. Unless otherwise substantiated, it will be presumed that when a sale of a business is made for an amount in excess of the depreciated book value, the parties to the contract bargained to sell and purchase all assets at the pro rata increased value.
>
> b) Convert the county tax assessor's appraisal to actual value. As the percentage of appraisal varies in the several counties of the state, the auditor should, if possible, determine the percentage used by the local assessor.
>
> c) Independent appraisal.
>
> d) Taxpayer's estimate.
>
> The auditor should, if at all possible, use two or more of the above methods in order to check the results of one method against the other.

(CDTFA Audit Manual, § 1004.25 (May 2000).)

Here, the parties did not agree to a selling price for the tangible personal property sold at retail. In absence of such an agreement, Regulation 1595 states that the "book value will be regarded as establishing the selling price of properties sold." (Cal. Code Regs., tit. 18, § 1595(b)(1).)

Regulation 1595 requires the use of a relatively simple calculation to determine the taxable measure using book value. This calculation requires the use of only three numbers: (1) the book value of tangible personal property sold at retail; (2) the book value of all assets of the business included in the sale, tangible and intangible; and (3) the total consideration, including debt assumption, received for all of the assets of the business. (Cal. Code Regs., tit. 18, § 1595(b)(1).) To determine the measure of tax using book value, Regulation 1595 requires: dividing the first number (#1) by the second number (#2) and multiplying the result by the third number (#3). In other words, the calculation is as follows: [(#1 book value of tangible personal property) / (#2 book value of all assets)] x (#3 total consideration)]. The parties dispute whether there is enough documentation in the record to calculate the liability using the book value method set forth in Regulation 1595(b)(1). Therefore, we must address each number in turn.

<u>The first number (#1): the book value of tangible personal property sold at retail</u>

First, appellant provided a pre-closing balance sheet. As of August 20, 2009, the book value for fixed assets was $1,426,378.90. Appellant contends that this is its book value. In support, appellant also provided a Closing Balance Sheet dated August 21, 2009, reflecting the

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same book value for fixed assets ($1,426,378.90), and a statement of depreciation dated July 31, 2009, recording a book value of $1,425,678.90 for fixed assets (see footnote 6). Both balance sheets were prepared as required by the Purchase Agreement, and appellant maintained the statement of depreciation for tax purposes. We find these documents internally consistent, and as such we accept appellant's contention that the book value for fixed assets was $1,426,378.90.

Second, appellant contends that leasehold improvements are not tangible personal property. As indicated above, the book value included the depreciated value of leasehold improvements. As such, appellant contends that an adjustment is allowable for the book value in the amount of $282,904.80, to account for the depreciated book value of nontaxable leasehold improvements. The term "leasehold improvements" generally means beneficial changes to lease property made by or for the benefit of the lessee. (See Black's Law Dict. (8th ed. 2004) p. 910, col. 1.) In this case, appellant contends that the leasehold improvements consist of improvements such as walls, ventilation, wiring, and lighting fixtures. Consistent with appellant's contention, section 4.17 of the Purchase Agreement refers to the leasehold improvements as improvements to real property. The law imposes sales tax on the sale of tangible personal property. (R&TC, § 6051.) Transfers of interests in real property are not subject to sales tax. (*Ibid.*) We believe appellant established that the leasehold improvements were not tangible personal property sold at retail to Herbalife. Consistent with our finding, we note, for example, that in appeals involving the sale of a business by other taxpayers, CDTFA has historically treated leasehold improvements as non-taxable. (See, e.g., CDTFA Annotations 395.0160 (8/8/75) & 395.1530 (9/25/91).)[16]

Having concluded that leasehold improvements are deductible from the book value of tangible personal property, we must determine the amount of the deduction. Both balance sheets identify a book value of $1,793,918.40 for leasehold improvements, less depreciation. The balance sheets do not include a breakdown for depreciation; however, appellant's statement of depreciation reflects that amount of depreciation on the leasehold improvements was $1,511,013.60 as of July 31, 2009. The book value of fixed assets in this statement ($1,425,678.90) is substantially the same as the book value of fixed assets listed in the balance

[16] Annotations do not have the force or effect of law but may be entitled to some consideration by OTA. (*Appeal of Praxair, Inc.*, 2019-OTA-301P, citing *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 15.)

sheets ($1,426,378.90). As such, we find that appellant sufficiently established that it is entitled to a $282,904.80 reduction to the book value of fixed assets, to account for leasehold improvements. In summary, we conclude that the book value of tangible personal property sold for use by Herbalife was $1,143,474.10 (i.e., $1,426,378.90 - $282,904.80 for leasehold improvements).

Appellant contends that it is allowed an additional adjustment because some of the machinery and equipment sold under the Purchase Agreement was affixed to realty. In support of its position that machinery and equipment was affixed to realty, appellant submitted photographs of machinery and equipment bolted to the floor. Regulation 1596(c) provides that tax applies to the sale of machinery and equipment owned by a lessee of the real property to which those items are affixed when the lessee-seller has the right to remove the items as trade fixtures (i.e., without damage to the premises), or under the express terms of the lease (i.e., irrespective of the nature of the attachment to real property). Tax also applies if removal of the machinery and equipment is contemplated by the contract of sale. (Cal. Code Regs., tit. 18, § 1596(c).) Here, section 7.4 of the lease agreement between appellant and the landlord provides that "Lessee's Trade Fixtures shall remain the property of Lessee and shall be removed by Lessee subject to its obligation to repair and restore" any "damage caused by the removal of Lessee's Trade Fixtures." Section 7.3 defines Trade Fixtures, for purpose of the lease agreement, as "machinery and equipment that can be removed without doing material damage to the Premises." As such, we conclude that tax applies to appellant's sale of machinery and equipment because appellant had the right under the lease agreement to remove its machinery and equipment. Appellant provided no documentation to otherwise establish that any specific item of machinery and equipment sold to Herbalife did not qualify as a removable trade fixture for purposes of the lease agreement, and, if removal would cause material damage, the amount of the book value allocable to such property.[17] Therefore, we further find that appellant failed to establish that an adjustment is warranted on account of the machinery and equipment.

CDTFA also raises several contentions. First, in its decision, CDTFA contends that it is "bound to follow" its Audit Manual, and that the Audit Manual "results in a more accurate

[17] We also note that section 8 of Herbalife's August 21, 2009, lease agreement with the landlord specifies that Herbalife "may elect, in its sole and absolute discretion, to remove any [alternations, modifications, or improvements to the real property] at any time" during the lease term.

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determination of tax." On appeal to OTA, CDTFA further expands upon its original contention, and states:

> Regulation 1595(b)(1) only provides that book value should be used in the numerator and denominator when using the regulation formula, not that the tax measure cannot be determined by means other than using the regulation formula . . . . Legally, [CDTFA] has the statutory authority to compute and determine the measure of tax on the basis of any information within its possession or that may come into its possession (see e.g., Rev. & Tax Code, § 6481), and, thus, is not limited to one method. Practically, there may be situations when book value is not available, incomplete, or unreliable for various reasons.[18] For this reason, Audit Manual section 1004.25, Bulk Sales of Businesses (Sales Price of Tangible Personal Property Not Specified), provides . . . .
>
> > In some instances, book value may not represent true value of tangible personal property or other assets transferred. Accelerated depreciation may have been used whereas the straight-line method would have reflected a more accurate value. Unless otherwise substantiated, it will be presumed that when a sale of a business is made for an amount in excess of the depreciated book value, the parties to the contract bargained to sell and purchase all assets at the pro rata increased value.

CDTFA goes on to conclude that it "agrees with the [decision] on both [CDTFA's] authority to use other methods to establish the measure of tax and on the [decision's] ultimate determination of the measure of tax at the appraisal value." In summary, CDTFA believes that Audit Manual section 1004.25 is consistent with CDTFA's general statutory authority to determine tax based on any information and, as such, it may apply the valuation methods set forth in CDTFA's Audit Manual in lieu of Regulation 1595, which requires book value. (R&TC, § 6481; Cal. Code Regs., tit. 18, § 1595(b)(1).)

In promulgating Regulation 1595, CDTFA was exercising its substantive rulemaking power set forth in R&TC section 7051.[19] As such, it was "truly 'making law,' [and CDTFA's] quasi-legislative rules have the dignity of statutes." (*Yamaha Corp. of America v. State Bd. of*

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[18] CDTFA's decision had addressed the reliability aspect of the book value. On appeal CDTFA had addressed the impossibility aspect of book value. OTA sought additional briefing on the impossibility aspect and CDTFA was initially open to a recalculation using book value conditioned on appellant providing new documentation to support book value. Appellant was unwilling to provide additional documentation to support book value and, as a result CDTFA was ultimately not willing to recalculate the liability using book value. In any event, CDTFA continues to assert its authority to follow its Audit Manual under either scenario (i.e., impossibility or reliability).

[19] According to the California Code of Regulations and CDTFA's rulemaking file for Regulation 1595, the statutory authority cited for Regulation 1595 is R&TC section 7051.

Equalization (1998) 19 Cal.4th 1, 6.) A “regulation adopted by an administrative agency pursuant to its delegated rulemaking authority has the force and effect of law.” (*California Teachers Assn. v. California Com. on Teacher Credentialing* (2003) 111 Cal.App.4th 1001, 1008.) CDTFA is required by law to follow Regulation 1595 and “must be faithful to its own announced regulations.” (*Newco Leasing, Inc. v. State Bd. of Equalization* (1983) 143 Cal.App.3d 120, 124; *Appeal of Talavera*, 2020-OTA-022P.)

In absence of an allocation agreed to by the parties, Regulation 1595 states that book value “will be regarded as establishing the price of properties sold.” (Cal. Code Regs., tit. 18, § 1595(b)(1) [emphasis added].) On the other hand, CDTFA’s Audit Manual provides that the auditor may disregard book value in certain circumstances, such as where the taxpayer claimed accelerated depreciation for federal income tax purposes. (CDTFA Audit Manual, § 1004.25 (May 2000).) In such circumstances, CDTFA’s Audit Manual goes on to provide alternative valuations, including independent appraisals, to determine the taxable measure. (*Ibid*.) Relying entirely on its Audit Manual, CDTFA contends that appellant’s book value is “unreliable for this purpose because it clearly reflects use of an accelerated depreciation method (e.g., ‘db200’ or double declining balance method as stated in the ‘method’ column of that schedule), and thus, does not provide a reasonable indication of the true value of [appellant’s] fixed assets.” In support, CDTFA cites to a section in the Audit Manual which provides as follows: “book value may not represent true value of tangible personal property or other assets transferred” when accelerated depreciation is used. (CDTFA Audit Manual, § 1004.25 (May 2000).)

Nevertheless, the “true value” of the numerator (true value of the property sold at retail) is not a relevant consideration under Regulation 1595. The regulation provides for the use of the selling price if the parties agreed to a selling price, otherwise it requires the use of book value. (Cal. Code Regs., tit. 18, § 1595(b)(1).) It is undisputed that the parties did not agree to a selling price for the tangible personal property. The reason for use of the formula in the case of book value is to determine a taxable percentage, not the true value. The regulation applies book value for BOTH the numerator and the denominator, and the percentage is then multiplied by the selling price for the business, to determine the true value of tangible personal property sold at retail. If “true value” was used for the numerator, and “book value” was used for the denominator, that result would be an apples-to-oranges comparison, and it would artificially increase the taxable measure to the detriment of the taxpayer. So long as both the numerator and

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the denominator are book value, the true value is obtained by multiplying the ratio of tangible personal property sold at retail (i.e., #1 / #2) by the selling price for the business (i.e., #3). Otherwise, one would need to eliminate the formula set forth in Regulation 1595 and assess tax on the fair market value of tangible personal property sold at retail, in order to accurately determine the taxable measure.

We cannot, however, deviate from the formula set forth in Regulation 1595.[20] There is no provision in Regulation 1595 which permits CDTFA to rebut or reject this presumption. As such, we agree with appellant that under these facts, the law (as set forth in Regulation 1595) states that appellant's book value must be applied using the formula in Regulation 1595 to determine the selling price of property sold at retail. Appellant offered evidence of the book value. CDTFA does not contend that these documents do not reflect appellant's book value. Therefore, we find that the regulation applies and requires use of book value. The provision of the Audit Manual cited by CDTFA on appeal to OTA, which allows for alternative methods of valuation when "book value may not represent true value of tangible personal property," merely summarizes CDTFA's audit policies and procedures, and has no precedential value in an appeal before OTA. (CDTFA Audit Manual, § 1004.25 (May 2000).) We find that CDTFA cannot turn to other methods to value the property, such as fair market value, when book value is available. CDTFA was bound to follow its own regulation, and cannot cite to CDTFA's Audit Manual section 1004.25, as authority to disregard Regulation 1595(b)(1).[21] (See *Appeal of Finnish Line Motor Sports, Inc.*, 2019-OTA-138P.)

CDTFA further contends that "book values are not obtainable for both the numerator and denominator." Nevertheless, as indicated above, the exhibits attached to CDTFA's decision include book value for both fixed assets, and all assets. As such, we reject this contention.

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[20] Government Code section 11340.5 generally provides that: "No state agency shall issue, utilize, enforce, or attempt to enforce any guideline, criterion, bulletin, manual, instruction, order, standard of general application, or other rule, which is a regulation as defined in [Government Code section] 11342.600," unless it has been adopted pursuant to a formal rulemaking process. CDTFA's Audit Manual has not been adopted pursuant to a formal rulemaking process.

[21] It is important to note here that CDTFA may issue a determination on the basis of any information within its possession or that may come into its possession. (R&TC, § 6481, 6511.) There is nothing in the R&TC which specifies the method that CDTFA shall use when allocating the consideration from the sale of all or substantially all the assets of a business between taxable and nontaxable items. Our decision on this appeal is based on our finding that CDTFA is required to follow its own regulations. We offer no opinion on whether CDTFA may, by regulation, require application of an alternative formula, such as the ones set forth in its Audit Manual.

CDTFA separately contends that appellant's book value is unreliable because CDTFA obtained an alternative balance sheet titled "Archive Company – HLF" which was allegedly generated by appellant's accounting system and archived by Herbalife. CDTFA contends that this balance sheet shows a book value of $4,167,700 for appellant's fixed assets. Appellant disputes the accuracy of this balance sheet. Nevertheless, we have no basis upon which to recalculate the liability or otherwise make a finding based on CDTFA's allegations because, after a review of the written record, it appears that neither party submitted this document as evidence.[22] Therefore, we do not address this contention further.

The second number: the book value of all assets of the business

Second, appellant proffered the same documents, the balance sheets prepared before and after close of escrow, and the depreciation statement, to document the book value for all assets of the business. The pre-closing balance sheet reflects a book value for all assets of $6,646,583. This is consistent with the closing balance sheet, which reflects total assets of $4,914,962.18, after subtracting $1,731,621.22[23] for the working capital adjustment as provided in the Purchase Agreement (i.e., $4,914,962.18 + $1,731,621.22 = $6,646,583.40). Additionally, the statement of depreciation dated July 31, 2009, shows a book value of $7,189,281.29 for all assets. Considering that we already accepted appellant's argument that the balance sheet reflects book value, we accept that the book value for all assets of the business (current and fixed) sold to Herbalife was $6,646,583.40.

Appellant contends that we should use the total consideration received, instead of book value, for the denominator (#2). Nevertheless, Regulation 1595 makes clear that book value must be used to establish the price of properties sold (i.e., #1 and #2). We noted above that using fair market value for the numerator and book value for the denominator would unfairly overstate the measure of tax. For the same reason, using book value for the numerator and fair market value for the denominator would unfairly understate the measure of tax. The parties cannot choose to use book value when book value is more favorable, and true value when book value is less favorable. The purpose of determining the book value of the fixed assets and dividing it by

[22] By letter dated October 23, 2018, OTA requested CDTFA to provide a complete copy of the audit working papers. CDTFA's audit work papers identified Herbalife as "HLF."

[23] This amount represents the bad debt deduction and the inventory reserve, which were specifically included in the sale to Herbalife.

the book value of all assets sold is to determine what percentage of assets sold is taxable, not the true (fair market) value of the numerator (#2) and/or denominator (#3). This ratio would have no logical meaning if we mixed fair market value with book value. As such, we reject appellant's contention.

<u>The third number: the total selling price (consideration) for the business</u>

Third, the gross receipts from the sale of the business include all consideration received from Herbalife, including debt assumption. (Cal. Code Regs., tit. 18, § 1595(b)(1).) For these purposes, the parties agree that the consideration included the $10,000,000 in cash, plus the $4,314,384 debt assumption specified in the Purchase Agreement. The disagreement is whether to reduce the total consideration for the $1,200,000 working capital adjustment. CDTFA contends that, because the $1,200,000 was paid pursuant to the March 5, 2010 settlement agreement, which occurred after the sale of the business and was even identified as a "Settlement Agreement" by the parties, it cannot serve to retroactively reduce the purchase price. Appellant contends that CDTFA "should be embarrassed by this [argument]" because the post-closing adjustments were provided for in the Purchase Agreement. We find this to be a factual dispute, which we resolve in favor of appellant with respect to the $1,000,000 deposit, and in favor of CDTFA with respect to the $200,000 rent credit paid by the landlord.

As a general matter, amounts returned to a purchaser as a result of a legal settlement are not considered to retroactively alter the original purchase price, but are instead regarded as damages paid as compensation for the seller's actions. (*Southern California Edison Co. v. State Bd. of Equalization* (1972) 7 Cal.3d 652, 655.) If we were to apply this rule, as a general matter there would be no basis to adjust the taxable measure for a settlement agreement. Nevertheless, we cannot focus solely on the title of the document, and assess tax based on title alone, without regard to the actual provisions of the Purchase Agreement. The Purchase Agreement specifically provided that $1,000,000 in holdback would be paid by Herbalife into escrow, essentially as security in the event the financial health of the business was not as expected (whether overstated or understated). The Purchase Agreement required the parties to agree to the manner this amount was distributed by June 30, 2010, and that amounts returned to Herbalife reduced the purchase price (and increased the purchase price, if paid to appellant). Additionally, the Purchase Agreement provided for additional contingencies in the event the $1,000,000 was insufficient. Consistent with the Purchase Agreement, the parties timely agreed on March 5, 2010, that

Herbalife would receive the entire $1,000,000 from escrow, after applying the capital adjustment calculation set forth in the Purchase Agreement. Although the additional $200,000 was paid to Herbalife in the form of reduced rent to the landlord, appellant points out that the settlement agreement between the parties specified that this amount was "paid on behalf of Micelle."[24] Nevertheless, there is nothing in the agreement which requires appellant to reimburse the landlord for the $200,000. Furthermore, the settlement agreement specifies that it also resolves disputes between Herbalife and the landlord. As such, there is evidence that the rent credit between the landlord and its tenant, Herbalife, was paid, in whole or part, as satisfaction of disputes arising between those parties. As such, we find appellant failed to provide documentation to sufficiently establish that the $200,000 was an amount returned by appellant to Herbalife pursuant to the Purchase Agreement, as opposed to a settlement payment by the landlord to Herbalife. Therefore, we find that the total selling price must be reduced by $1,000,000, because this reduction was provided for in the Purchase Agreement originally agreed to by the parties, but that no adjustment is allowable for the $200,000 rent credit paid by the landlord. As such, we find that the total consideration received by appellant for the sale of the business was $13,314,384 (i.e., $10,000,000 cash + $4,314,384 debt assumption - $1,000,000 deposit = $13,314,384).

In summary, we find that the amount of CDTFA's determination was not reasonable or rational to the extent that CDTFA failed to follow its own regulation when calculating the deficiency. As required by Regulation 1595(b)(1), the taxable measure for the unreported sale of the business assets shall be further reduced from $3,321,153[25] to $2,290,598.39 (i.e., ($1,143,474.10 / $6,646,583.40) x $13,314,384 = $2,290,598.39).

Unreported purchases of fixed assets ($364,409) and consumable supplies ($138,993)

Appellant disputes the amount of consumable supplies that CDTFA determined appellant failed to report. The basis of appellant's disagreement is that CDTFA conducted a block test of 2008 and projected the error rate to the balance of the audit period. The law allows CDTFA to issue a determination based on any information in its possession. (R&TC, §§ 6481, 6511.) In the absence of records, CDTFA may estimate the liability. (*Ibid.*) There is no requirement under

[24] Appellant and the landlord are related entities.

[25] In its decision, CDTFA recommends reducing the measure for this item from $4,467,451 to $3,321,153.

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the law that CDTFA issue its determination on an actual basis review of documentation. To the contrary, this would be unduly burdensome to taxpayers and CDTFA. CDTFA has established audit methods to efficiently determine the liability without the need to review every single document maintained by a taxpayer, and those methods are set forth in its Audit Manual. Here, CDTFA's audit working papers indicate that it conducted a block test of 2008 to examine paid bills due to the availability of records for this period, and that appellant admitted to the auditor that "original source documents were not located" to show that it paid tax on its other purchases. As such, we conclude that it was rational and reasonable for CDTFA to estimate the liability for the audit period based on a review of 2008. Therefore, appellant has the burden to establish error. Appellant has not provided any evidence to support an adjustment, nor has appellant alleged or offered evidence that the block test of 2008 was not representative of the audit period. We conclude that appellant failed to establish a basis to reduce the liability as determined by CDTFA for unreported purchases of consumable supplies.

Appellant also contends that adjustments are warranted for unreported purchases of fixed assets. According to CDTFA's audit working papers, CDTFA examined these purchases on an actual basis, and appellant did not provide evidence to show tax was paid at the time of the audit. On appeal, appellant admits that all the records "have been either lost or destroyed, so we were unable to provide proof." Appellant has the burden of proof. In absence of proof, we have no basis upon which to order an adjustment.

In summary, we find that appellant failed to establish a basis for an adjustment to the liability as determined by CDTFA for its failure to report and pay tax on its purchases of fixed assets and consumable supplies.

Issue 2: Whether appellant established a basis for relief of interest.

There is no statutory right to interest relief. The law allows SBE,[26] in its discretion, to grant relief of all or any part of the interest imposed on a person under the Sales and Use Tax Law where the failure to pay the tax is due in whole or in part to an unreasonable error or delay by an employee of SBE acting in his or her official capacity. (R&TC, §§ 20, 6593.5(a)(1).) Such an error or delay shall be deemed to have occurred only if no significant aspect of the error

[26] R&TC section 6593.5 states "board"; however, on and after July 1, 2017, the term "board," generally means CDTFA. As an exception, on and after January 1, 2018, the term "board," with respect to an appeal, means OTA. (R&TC, § 20(a), (b).)

or delay is attributable to an act of, or failure to act by, the taxpayer. (R&TC, § 6593.5(b).) Any person requesting interest relief must include a statement under penalty of perjury setting forth the facts on which the request is based.[27] (R&TC, § 6593.5(c).)

Delay while the appeal was with OTA

As a preliminary matter, appellant requests interest relief for the period January 1, 2018, through March 5, 2018, a period during which the appeal was with OTA. In support, appellant declared, under penalty of perjury, that CDTFA admitted during settlement negotiations that the NOD was overstated and "should be reduced by approximately two-thirds [but was] unable, under [SBE] policy to make any reduction of more than 50%." Thereafter, settlement negotiations fell though. As such, appellant contends that CDTFA's actions maintaining this appeal constituted an unreasonable delay. Appellant contends that it should be granted interest relief because CDTFA continued to maintain this appeal with OTA, despite knowing the liability was overstated. Here, appellant is confusing an allegedly unsubstantiated position on appeal with an unreasonable delay by CDTFA.

R&TC section 6593.5 authorizes interest relief for certain unreasonable errors or delays that prevented the taxpayer from timely paying the tax. Such a delay means, for example, an unreasonable failure to work on an appeal. On the other hand, interest relief does not extend to an allegedly "unreasonable" position taken on appeal, that is otherwise being actively maintained. Working on an appeal is, by definition, not a "delay" for purposes of R&TC section 6593.5. Instead, the remedy for such a scenario as alleged by appellant is expressly contemplated by R&TC section 7091, which authorizes reimbursement of certain fees and expenses if the actions taken by CDTFA on appeal were unreasonable. (R&TC, § 7091.) Such a claim may be filed within one year after the date the decision on the appeal becomes final. (R&TC, § 7091(a)(1); Cal. Code Regs., tit. 18, § 30705.) The instant appeal is not yet final and such a reimbursement claim is not before OTA in this appeal. Furthermore, appellant does not contend that there was a delay by OTA.[28] In summary, we find that interest relief is inapplicable

[27] Regulation 1703 restates, without adding further clarification to, the requirements for interest relief within the meaning of R&TC section 6593.5. (See Cal. Code Regs., tit. 18, § 1703(b)(1)(E).)

[28] We need not, and do not, address the issue of whether R&TC section 6593.5 authorizes OTA to grant relief of interest for a delay by OTA.

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even if we were to accept as true appellant's contention that CDTFA was acting unreasonably in maintaining this appeal before OTA.

Delay by CDTFA

Here, appellant similarly requests interest relief for the period the appeal was being handled by CDTFA, on the basis that CDTFA acted unreasonably in maintaining this appeal. For the same reasons discussed above, interest relief is inapplicable on this basis.

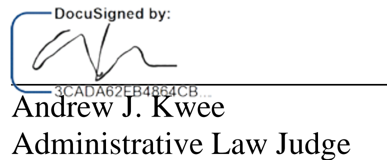
Appellant further contends that CDTFA delayed working on this appeal. For example, appellant contends that CDTFA's position that the normal timeframe of 9 to 18 months to process a petition for redetermination is unreasonable, and this matter should have gone to an oral hearing by Fall of 2013. In summary, appellant essentially contends that CDTFA's standard timeframes to respond to an appeal are unreasonably slow. CDTFA has already examined its response timeframes, considering its workload limitations, and granted interest relief for the period July 13, 2015, through January 31, 2017. All other periods fell within CDTFA's standard working timeframes. The law allows CDTFA to grant interest relief "in its discretion," provided certain elements are met. (R&TC, § 6593.5.) There is no statutory right to interest relief. (R&TC, § 6593.5.) As such, in these circumstances OTA will generally not second-guess the standard timeframes determined by CDTFA for purposes of granting discretionary interest relief, and will instead defer to CDTFA's decision absent evidence of an abuse of discretion. It does not appear, from the record, that CDTFA has abused its discretion in deciding what periods were eligible for interest relief. As such, we conclude that no additional interest relief is warranted.

HOLDINGS

1. Appellant established a basis to reduce the taxable measure for the unreported sale of business assets by $1,030,554.61 (from $3,321,153, to $2,290,598.39), as determined by OTA. Appellant failed to establish a basis for an adjustment to the measure of unreported purchases of fixed assets and consumable supplies.
2. Appellant failed to establish a basis for additional interest relief.

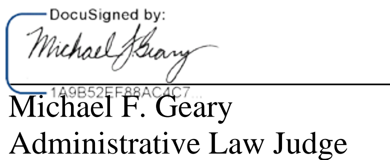
DISPOSITION

CDTFA's action as set forth in CDTFA's decision is sustained, with the exception that appellant shall be given an additional adjustment of $1,030,554.61, further reducing the taxable measure for the unreported sale of business assets from $3,321,153 to $2,290,598.39.

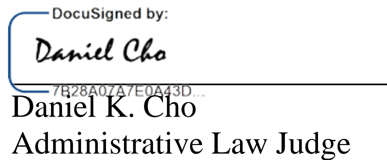


Andrew J. Kwee
Administrative Law Judge

We concur:



Michael F. Geary
Administrative Law Judge



Daniel K. Cho
Administrative Law Judge

Date Issued: 8/12/2020