BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,	)	
	)	
T. FARIES and	)	
ESTATE OF D. FARIES JR. (DEC'D),	)	OTA NO. 18043049
	)	
APPELLANT.	)	
	)	
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TRANSCRIPT OF VIRTUAL PROCEEDINGS

State of California

Wednesday, September 29, 2021

Reported by:
ERNALYN M. ALONZO
HEARING REPORTER

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Transcript of Virtual Proceedings, taken in the State of California, commencing at 1:08 p.m. and concluding at 4:35 p.m. on Wednesday, September 29, 2021, reported by Ernalyn M. Alonzo, Hearing Reporter, in and for the State of California.

APPEARANCES:

Panel Lead:	ALJ TOMMY LEUNG
Panel Members:	ALJ JOSHUA LAMBERT ALJ CHERYL AKIN
For the Appellant:	CARLEY ROBERTS CHRIS PARKER
For the Respondent:	STATE OF CALIFORNIA FRANCHISE TAX BOARD MARIA BROSTERHOUS NATASHA PAGE RAFAEL ZAYCHENKO

I N D E X

E X H I B I T S

(Appellant's Exhibits 1-9 were received at page 6.)

(Department's Exhibits A-P were received at page 6.)

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California; Wednesday, September 29, 2021

1:08 p.m.

THE COURT: Then we are going on the record, Ms. Alonzo.

This is Appeal Number 18043049, the Appeal of Faries for the taxable year 2011. There are three issues to be decided, and I will paraphrase them because it's a lot to go through the entire text of these issues.

The first issue is whether Appellant's gain -- pro rata share of gain from the sale of Medical's goodwill as a California source, and Medical being the Appellant's wholly owned S corporation. Issue number two, whether the individuals were already subject to the personal income tax law must also use the uniform division income for Tax Purposes Act in UDIPTA under the corporation tax law to source their pro rata share of income, loss, deductions, and credit from the sale of Medical's assets. Issue number three, if the answer to number two is yes, how does -- how do we apply UDIPTA to an individual under the personal income tax law.

We have exhibits for this appeal, Exhibits A, as in Adam, through P, as in Peter, for Respondent Franchise Tax Board. It's submitted into evidence.

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(Department's Exhibits A-P were received in evidence by the Administrative Law Judge.)

Exhibits 1 through 9 from Appellant's are admitted into evidence.

(Appellant's Exhibits 1-9 were received in evidence by the Administrative Law Judge.)

We have outstanding exhibits, number 10 through 16. And I understand the Franchise Tax Board has some comments and probably objections to those exhibits.

So Ms. Brosterhous?

MS. BROSTERHOUS: Yes, we do. Would you like to hear them now?

THE COURT: In a minute. I forgot to ask the parties to state their appearances for the record. I do that right now, starting with you Ms. Roberts.

MS. ROBERTS: Yes. Carley Roberts with Pillsbury on behalf of Tarry Faries and Estate of Durward Faries.

THE COURT: Thank you.

Mr. Parker.

MR. PARKER: Chris Parker also on behalf of Tarry Faries and Estate of Durward Faries.

THE COURT: Thank you.

Ms. Brosterhous.

MS. BROSTERHOUS: Maria Brosterhous representing Respondent Franchise Tax Board.

THE COURT: Okay.

And Ms. Page.

MS. PAGE: Natasha Page, also representing Franchise Tax Board.

THE COURT: Okay. Mr. Zaychenko.

MR. ZAYCHENKO: Rafael Zaychenko, representing Franchise Tax Board.

THE COURT: Thank you.

Okay. Ms. Brosterhous, you can begin with your comments regarding Appellant's Exhibits 10 through 16.

MS. BROSTERHOUS: Respondent reasserts its objection to these recently filed exhibits based on the enormity of the production and relevance. These exhibits were provided on Friday, September 24th at nearly 6:00 p.m., and they were provided without any contextualization. Although Appellant has attempted to minimize the volume of these documents by indicating that the bulk of what has been provided is the Metropoulos transcript, that does not diminish the fact that that transcript is a 100-page document presented without any context and, therefore, requires a great deal of time to analyze.

At the prehearing conference on the 20th, Appellant indicated they expected to provide four to five exhibits, indicating we would be familiar with them, and downplaying the volume they intended to provide. We hereby object based on relevance because Appellant has not tied these exhibits to a specific argument. Further, the inclusion of the Metropoulos transcript is a plain attempt to insert argument as evidence.

Moreover, when the parties agreed to admission of additional exhibits by Friday the 24th, this agreement was based on Appellant's representation that these exhibits would be a few minor items, and not a substantial number of documents. We assert this is an irregularity in the proceedings.

Finally, we also object to yesterday's submission of an additional 12 pages to be added to Exhibit 12. This submission is outside the timeline decided upon in Judge Leung's order.

THE COURT: Thank you, Ms. Brosterhous.

Ms. Roberts, your response.

MS. ROBERTS: Yes. As Appellant's responded yesterday to Respondent's request, the documents that have been provided -- Appellants are not required to reveal to opposing counsel prior to the hearing its arguments or rebuttal statements that could be used to the extent that Respondent makes inconsistent statements during the hearing, much like deposition testimony.

And much of the documentation that was produced, including the Metropoulos transcript, at most, would be two to three pages out of the entire transcript. But Appellant's did not want to narrow it down to two or three pages, so that we we're not telling Respondent what our arguments were going to be in advance of today's hearing and argument.

So as set forth in yesterday's response, both the transcript for Metropoulos, as well as Respondent's briefing in Metropoulos, and Respondent's briefing in Michigan Cogeneration, all of those documents, which make up a substantial portion of the exhibits are there in the event they need to be used for inconsistent statements made by Respondent.

The additional documents are of the nature that Appellants described the additional legislative history documents. Again, we're not certain what Respondent is going to argue, but we felt it was important to have certain documents in the record, and as exhibits, in the event that it comes up on argument. The addition of the bill analysis that was added yesterday, that was a clerical omission from last week's filing, and we do not believe that it should be excluded on the basis that it was late.

MR. PARKER: Particularly, as it was produced by the Franchise Tax Board, along with a number of the documents that are included in Appellant's submission. The Franchise Tax Board is very familiar with these documents. So contrary to the assertion that they were surprised with the volume of those documents in some way burdens Respondent, Respondent's familiarity with those documents likely surpasses that of Appellant's.

THE COURT: Thank you, Ms. Roberts and Mr. Parker.

And I forgot to mention for the benefit of our stenographer and everybody else listening, that to please identify yourself before speaking because not everybody is familiar with your voices. So let's keep that in mind. It's one of those things we need to do for these hearings.

Ms. Brosterhous, let me ask you about yesterday's submission and the Franchise Tax Board's legislative analysis for the bill introducing Revenue & Tax Code Section 17955. Does that attachment that came in yesterday accurately represent FTB's legislative analysis?

MS. BROSTERHOUS: Yes. I'm simply objecting on timeliness issues.

THE COURT: I understand that. I understand that these ledger analyses are available on Franchise Tax Board's web page, at least publicly available either by web page or going to the Secretary of State's office; is that correct?

MS. BROSTERHOUS: That's correct.

THE COURT: Okay. Here's my ruling on the objection. It will be overruled with the exception of yesterday's submission. We will take and note Franchise Tax Board's objection regarding relevance. This panel will take relevance into account and giving weight to these exhibits.

As far as the attachment to yesterday's e-mail they were submitted late. But, you know, it's sort of that good news and bad news, Ms. Roberts. They are not being admitted into evidence, but they are publicly available and nothing prevents you from referring to them in your presentation today. So if need be, we have a wonderful staff here at OTA which, you know, we can dig up these documents.

And so that will -- we will exclude your exhibit from yesterday's e-mail from the exhibit list. So I will admit into the record Appellant's Exhibits 10 through 16, with the exception of the FTB ledger analysis that was submitted to OTA on September 28th by e-mail.

Okay. Without any further questions, we will begin with Appellant's presentation. We will be taking a break after that presentation and after Franchise Tax Board's presentation.

So Ms. Roberts, you may begin at your pleasure.

MS. ROBERTS: Thank you Judge Leung.

PRESENTATION

MS. ROBERTS: Good afternoon.

The parties to this appeal are Mrs. Tarry Faries and the Estate of Durward Faries, Jr. Tax year at issue is 2011. Mr. Faries was the sole shareholder and CEO of Medical Company, Inc, or Medical, or Virginia S corporation. Medical sold substantially all its assets, including goodwill, in 2011. The gain produced by the sale of goodwill was approximately $244 million. But for the gain on the sale, Medical was in a $13 million loss position.

This case involves two primary legal issues. The first issue is whether Appellants, California nonresidents, are subject to tax under California's personal income tax law on their distributive share of income from the sale of goodwill by a Virginia based S corporation. If the first issue is decided in favor of Appellants, there are no further issues.

If the first issue is decided against the Appellants, then the second issue is how much of the distributive share of income is subject to tax by California, and to what extent, if at all, are Appellants as individuals and not corporations required to apply

California's S corporation tax law rules, including the Uniform Division of Income for Tax Purposes Act or UDIPTA, U-D-I-T-P-A, to determine the amount of tax under the personal income tax law.

The issue of whether the Faries as nonresidents are subject to tax under California's PIT law on their distributive share of income from the sale of assets by Medical turns on the interpretation and application of a single federal income tax S corporation rule, IRC 1366(b), which is referred to as the conduit rule. The conduit rule informs the character and item of income, loss, deduction, or credit consistent with the IRC understanding of those items.

The code section states, "The character of any item included in a shareholder's pro rata share of income, loss, deduction, or credit shall be determined as if such item were realized directly from the sources, from which realized by the corporation." Cutting through all the noise, it comes down to this. If we pass through the federally determine character of income items at the entity level into the hands of the individuals, then there is one clear statute to apply to the income in Part 10. That's Section 17952. It is that simple, a tale of two statutes.

Now, the FTB will tell you this case is no different than Metropoulos. That is not true. This case is factually and legally distinguishable from other recent cases heard by the OTA in four separate ways. First, Mr. Faries was a party to the sale transaction, unlike the other cases. This is a critical distinguishing fact in the source and determination. The FTB has already conceded in its briefing in this matter and in briefing in oral argument and other matters that the income character determination is different when the individual of nonresident shareholder is a party to the transaction.

As the evidence will show, Mr. Faries was a direct party to the Asset Purchase Agreement as the sole shareholder of Medical and as the CEO of Medical. Second, the OTA has not considered California's separate federal conformity to the IRC's Subchapter S Rules for personal income tax law and corporation tax law purposes. PIT law conforms separately to Subchapter S Rules through a specific PIT law statute. The corporation tax law conforms to the Subchapter S Rules through a specific series of statutes.

While there are legislative modifications to the federal provisions in dispute, conduit rule under IRC 1366(b)in a corporation tax for purposes of determining California's S corporation tax for the S corporation, there are no legislative modifications to IRC 1336(b) for

PIT law purposes. In other words, California requires strict conformity under the PIT law to the Subchapter S Rules with regard to 1366(b).

Third, the OTA has not considered the legislative intent behind California's adoption of the nonresident sourcing statutes in Chapter 11 by the PIT law. The legislative history of California's adoption of the nonresident sourcing statutes in Chapter 11 establishes California legislature knowingly codified the mobilia doctrine in business situs exception as part of California's original enactment and recodification of the personal income tax law at the same time the California judiciary adopted the mobilia doctrine in business situs exception.

The legislature could have chosen to reject the judicially blessed mobilia doctrine but, instead, adopted the rule in the same form as it exists today in Chapter 11 of the PIT law. The legislative history also shows the independence of each statute and the lack of support for Respondent's argument that Section 17951 controls over other statutes in Chapter 11.

MR. PARKER: This is Chris Parker.

Fourth, the Office of Tax Appeals has not considered the secondary issues raised in this appeal regarding how much, if any, of the distributive share of income is subject to tax by California, and the unusual situation created by the application of UDITPA, rules that are normally for corporation subject to the corporate tax law, now being applied to individuals who are normally only subject to the personal income tax law.

How do individuals who are subject to the personal income tax law also apply the UDITPA provisions to their share of S corporation items of income, deductions, and credits. California's definition of taxable income comes from Internal Revenue Code Section 63. That's per California Revenue & Taxation Code 17073, which does not include any references to the business income non-business income distinction as used in the corporate tax law.

The California legislature has never added those concepts to the applicable provisions of the personal income tax law. Instead, we see the federal concepts of compensation, gains for dealing in property, interest, royalties, dividends, and rents. This is an inclusive provision, not a divisive one. The construct of business nonbusiness income does not align with K-1 reporting, which breaks out items along the lines we see in IRC Section 61 to 63, which California conforms to.

Put simply, how would an individual shareholder looking at their K-1 know the business income under the corporation tax law? If we have to work through this application of corporation tax law to individuals, then the question becomes how are the UDITPA rules apply to an individual. There are multiple differences between the corporate tax law concepts and the individual tax law concepts. For example, we talk about individual residency in domicile. In contrast for entities, we instead talk about corporate domicile and taxable nexus.

For individuals, there is no division of income based on fact or representation as there is in the corporate tax law. In fact, there's nothing similar to UDITPA in the applicable personal income tax law. There is no nonbusiness allocation of income in the hands of individuals either. Instead, many states use the same inclusive taxable income concept that we find in the Internal Revenue Code, which inherently beats to the possibility of multiple taxation of income by different states.

FTB's attempts to implement these corporate tax law treatments upon individuals frustrates the legislature's use of taxable income concept in the personal income tax law and the enactment of Chapter 11 because the business income umbrella in the corporate tax law does not separate out streams of income as found in the personal income tax law. If UDITPA rules are to be applied to individuals in this appeal, then we submit the Farieses have carried their burden to establish that Respondent has created 25137 distortion of the income received in their hands as individuals.

As Respondent points out when it works in their favor, the individuals are not the business. Thus, there are four independent ways for the Office of Tax Appeals to rule in Appellants' favor. First, find Mr. Faries was a party to the transaction as an individual. Second, follow the direct conformity of the Subchapter S Rules, including Section 1366(b), in the personal income tax law without modifications, which results in the character of the income flowing out as intangible to Appellants.

Third, follow the legislative intent regarding the correct application of Chapter 11 of the personal income tax law as applied to the intangible goodwill income at issue in this matter. And fourth, find the individuals, even when subjected to UDITPA on their distributive share of income from an S corporation still apply individual income tax principles to report all income on a cash basis without the divisions found in the corporate tax law.

MS. ROBERTS: If we can just pause for -- this is Carley Roberts. If we could pause for one moment. Appellants want to be able to share their screen. Give me just one moment. Can everyone see that okay?

MR. PARKER: Great. Thank you.

MS. ROBERTS: Before we dive into each of the legal issues in detail, we want to direct your attention to a series of five figures that walk through California's personal income tax law and corporation tax law as applied to the parties' respective positions in this case.

Directing your attention to Figure 1, Figure 1 has the basic structure of California's two income tax laws. The laws are housed separately under Division 2 of the California Revenue & Taxation Code. In the leg to the left, we have Part 10 with the personal income tax law. In the leg to the right, we have Part 11 with the corporation tax law. Corporations are taxable under Section 23501 with the character of income and sourcing determinations made under UDITPA for multistate corporate taxpayers like Medical.

Individuals are taxable under Section 17041 with the character of income and sourcing determinations made for nonresident S corporations under Section 17087.5 and the nonresident sourcing rules in Chapter 11. Nonresidents, like the Faries, are taxed under the PIT law on taxable income. This concept of taxable income is inconformity with the federal definitions of gross income and taxable income in IRC Section 61 and 63.

Corporate taxpayers like Medical are taxed under the corporation tax law on business income and nonbusiness income applicable to California. Business and nonbusiness income are California specific corporate income tax constructs that find no basis in federal income tax law.

Moving to Figure 2, this figure identifies the separateness of California's conformity to the IRC in the personal income tax law and corporation tax law. So you can see this follows the first figure with the Part 11 with the corporation tax law on the right, the personal income tax law in Part 10 on the left. The general premise, California generally conforms to IRC. Both the personal income tax and the corporation tax law have separate general conformity statutes.

Under Part 10, general conformity with the IRC is under 17024.5. Whereas, under the corporation tax law, general conformity with the IRC is under Section 23501.5. The PIT law in the corporation tax law also separately conform to the federal Subchapter S rules. For Part 10 that is through 17087.5, which you can see there on the bottom left. And for the corporation tax law, it is through Sections 23800 et seq, as you can see on the bottom right.

There are no legislative modifications to how 1366(b) is applied to personal income taxpayers. There are modifications to how 1333(b) applies to corporation tax law payers, including the application UDITPA to determine the application of income.

MR. PARKER: This is Chris Parker.

Turning to Figure 3, we look at the corporate tax treatment on the right of Part 11 and the income flowing down from Medical company through the corporation's tax code. Business income is defined under California Revenue & Taxation Code Section 25120 for purposes of determining the entity level tax, and does not have an equivalent in the Internal Revenue Code.

To better understand the breadth of business income's application, we look to Regulation 25120(a). The classification of income by the labels occasionally used, such as compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, nonoperating income, et cetera, is of no aid in determining whether income is business or nonbusiness income.

The income character determination as understood in IRC Section 1366(b) does not control in the state corporate tax law because of the application of the business income nonbusiness income construct. We see that towards the bottom with one bubble being business income and one bubble being nonbusiness income.

Theoretically, if all of the states adhered to this methodology of UDITPA, there would be no double taxation of income. Because where income is from within and outside the state, the UDITPA provisions of 25120 to 25139 require division of income between the states and an allocation of income between business income and nonbusiness income.

Turning to Figure 4 we see the contrasting treatment under the personal income tax law relating to the gain from the sale. Taxable income for individuals is the measure for determining tax rate and taxable amount of income for determining for nonresidents. Under 17041(b), we look to the entire taxable income of a nonresident to determine the rate. Under 17041(i), we still look to the taxable income -- just not entire taxable income -- to determine the amount subject to tax by California. Taxable income is computed under California Revenue & Taxation Code Section 17071 et seq.

California's conformity to IRC Section 1366(b) in the personal income tax code is under 17087.5, as Ms. Roberts mentioned. We see the federal character of income flowing through to the individuals, which is consistent with the application of the taxable income construct in California Revenue & Taxation Code 17073. Section 17087.5 is specifically included in the computation of taxable income.

Now, the parties have stipulated the primary asset in dispute is goodwill, which is an intangible. That's in Joint Stipulation Sections 13 and 22. It is required as to be characterized for federal purposes under 1366(b) as an intangible. The character of the income as an intangible asset then clearly passes through the individuals through Section 1366(b) to Section 17087.5. And then we look at the nonresident sourcing rules under Chapter 11.

When we get to Chapter 11, we see that only one section, Section 17952 speaks to income from intangibles where the income is sourced within and without the state. Then, and only then, do we look to the regulations to determine whether they might apply. The regulations to Section 17952 is whether we determine whether or not the business side of this section applies. These regulations related to the sourcing of income in the state versus out of the state are created under the exact same authority 17954 as the regulations under Sections 17951.

MS. ROBERTS: This is Carley Roberts.

So turning next to Figure 5, what we have here is the culmination of figures 1 through 4. Side by side you can see the proper treatment of the gain at the individual and entity levels under California's two independent tax laws. There is nothing inconsistent with a corporate taxpayer under the corporation tax law reporting the gain as business income for purposes of the S Corp tax and simultaneously having an individual taxpayer under the personal income tax law reporting the distributive share of the gain as intangible income source under Section 17952.

Now, sticking here with Figure 5, I think it's very helpful to understand Respondent's position in this case. Respondent's position -- and this comes right out of their reply brief at Page 3. Respondent's analysis places the shareholder in the shoes of the S corporation and requires the shareholders to conform to the S corporation's obligation to apportioned business income. So in the bottom right of Figure 5, FTB makes the UDITPA business income nonbusiness income determination for Medical, and then they're done.

They jump straight to FTB's apportionment rules in Regulation 17951-4. They don't complete any of the analysis required under Part 10. FTB cites no statutory authority or any other authority for this position. FTB's position also ignores the personal income tax laws separate federal conformity to S Corp rules and the lack of modification to 1366(b) and has several other legal conformities that we will discuss in more detail later.

But more, fundamentally, FTB's position fails on the facts. Mr. Faries was a party to the sale transaction. This was not the case in Metropoulos where the nonresident S corporation shareholders were not party to the sale transaction. In briefing and oral argument in the other recent matters, like Metropoulos and Michigan Cogeneration, the FTB repeatedly relies on the fact the individual shareholder is not a party to the sale transaction in its income character determination.

The FTB thought the same was true in this case. If I can direct your attention to Figure 6, these are quotations from FTB's reply briefs about the Farieses not being a party to the transaction. Respondent states, "Appellants may not ignore the structure of the transaction and omit the fact that the S corporation was the party involved in the asset sale and not Appellants. Appellants' interpretation ignores the fact that Medical, an S corporation, was involved in the transaction and treats the sale of goodwill as if were made by directly of Appellants."

But the FTB got it wrong. Unlike the nonresident taxpayers in those other cases, Mr. Faries was a party to the sale transaction. Looking back to Figure 5, this puts the character determination squarely within Part 10 of the code on the left side of the flow chart, and the sale of goodwill should be treated as if it were made directly by Mr. Faries.

MR. PARKER: This is Chris Parker.

The Asset Purchase Agreement in Respondent's Exhibit C substantiates Mr. Faries' role as a party to the sale of the assets. Under the agreement, Mr. Faries has collective rights and obligations of the seller and shareholder. The simultaneous roles as sole shareholder and CEO of the S corporation make him subject to material responsibilities in the transaction as described in these examples from the agreement.

Turning to Figure 7, example C, the Asset Purchase Agreement is by and among, Ecolab, O.R. Solutions, also known as Medical, and Durward Faries. Page 6, Recital C, the seller board and the shareholder have approved this agreement and determine that the transactions contemplated, hereby, are in the best interest of the seller and the shareholder as its sole shareholder. The sole shareholder was Mr. Faries.

The shareholder Recital E, the shareholder owns all the equity interest of seller, and the shareholder will receive substantial monetary and other benefits from the transactions contemplated, hereby, and in connection therewith, is undertaking certain obligations in order to induce buyer to enter into this agreement and complete the transactions contemplated by -- hereby.

Exhibit C on page 69 we see indemnification of the seller and buyer. The buyer will indemnify in full the shareholder, seller, and seller's officers, directors, employees, and agents. We also see indemnification of the buyer. The seller and shareholder will jointly and severally indemnify in full buyer and its affiliates, together with their respective officers, directors, employees, and agents.

We see it in the conditions to the buyer's obligations. Seller and shareholder will have performed in all material respects each of the obligations they are required to perform at or prior to the closing day. That's Exhibit C, page 65. On Exhibit C, Page 43 to 44, we see the reps and warranties of the shareholder. The shareholder, Mr. Faries, represents and warrants to buyer, shareholder has all necessary power and authority to execute and deliver this agreement and to complete the transaction contemplated by this agreement. The shareholder has taken all action required by law and otherwise to authorize shareholder's execution, deliver, and performance of this agreement.

These are only a handful of the applicable terms substantiating Mr. Faries' role as a party to the agreement. Having firmly established Mr. Faries was a party to the sale transaction, one of the Respondent's primary arguments unravels because the starting point for determining the character of income is not limited to the corporation.

The Respondent cannot automatically leap to a business income classification for income received into the hands of an individual. Moreover, with Mr. Faries as a party to the transaction, it makes the character and sourcing determination under IRC Section 1366(b) and its conformity under the personal income tax law of California even easier and more straight forward.

Turning to the Figure 8, we see the language of IRC Section 1366(c) with the critical -- 1366, excuse me -- with the critical language of subsection (b), character passed through. The character of any item included in 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. This rule, the conduit rule, at the federal level was designed to put the shareholder in the shoes of the S corporation for purposes of determining the character of an item of income, loss, deduction, or credit.

However, with Mr. Faries serving as a party to the agreement, there's no need to apply the conduit rule because Mr. Faries was as much a party to the transaction as Medical. Accordingly, in the hands of Mr. Faries, there's no business income in the corporate tax law since because we're firmly under the personal income tax law, not the corporation tax law or its UDITPA provisions.

Under the personal income tax law, we only take into consideration items of income, deductions, credit, et cetera as we see in Revenue & Taxation Code Sections 7071 et seq. Mr. Faries has income from the sale of goodwill and intangible.

MS. ROBERTS: This is Carley Roberts.

Even if Mr. Faries wasn't a party to the transaction, he was, OTA still must rule in the Faries' favor. If I can direct your attention back to Figure 2. Figure 2, again, is where you can see the relevant separate general and specific IRC conformity statutes in the personal income tax and the corporation tax law. I'm not going to repeat what's already been stated, but I do want to draw your attention to the corporation tax laws specific modifications to the S corporation rules or personal income tax law purposes.

For example, Section 23802(d)(4) modifies Section 17276 of the personal income tax law relating to the limitations for loss carry overs to S corporation

shareholders for IRC Section 1363 purposes.
Section 23803(a)(1)(F) modifies the personal income tax law starting at Section 17001 relating to go credit computations for IRC Section 1361 purposes.
Section 2306(a) modifies specific subsections of Section 17024.5 of the personal income tax law related to certain stock purchases treated as asset acquisitions for IRC 1371 purposes.

These examples of statutory modifications, and there are others. But these examples of statutory modifications by the legislature make clear the legislature knows how to modify the Internal Revenue Code provisions when necessary to produce a desired outcome. Notably absent from the statutory modifications in Sections 23800 et seq or elsewhere in the corporation tax law or the personal income tax law is any modification to 1366(b) for PIT law purposes.

FTB's silence on this issue speaks volumes. Respondent, after it received Appellants' reply brief, requested an extension of time of four months to respond to additional arguments made by Appellants. And, yet, there is nothing in Respondent's reply brief that responds to this federal conformity issue. And that is because there is no response. It cannot be refuted.

I'm going to stop screen sharing here for just a minute. Okay. Moving onto the next legal issue.

Respondent contends that because it has legislative rule-making authority that it can promulgate a legislative regulation that must be, quote, "Given the same weight as a statute and is, therefore, controlling." This is out of Respondent's reply brief at page 5.

The regulation that Respondent contends controls the statute is Regulation 17951-4, and it contends that regulation should be given the same weight as Section 17952, a statue adopted by the legislature. Respondent further contends that its regulation controls the application of 17952. We will turn to the legal infirmities of Respondent's position shortly. But first, we want to focus on the legislative history behind California's adoption of the nonresident sourcing rules in Chapter 11 and the inconsistency with the FTB's position with that history.

As the California legislative history cited in Appellants' reply and supplemental briefs makes clear there has never been any interdependence between the statutes in Chapter 11. From the first iteration of what came to be the Section 17951 language in the 1935 -- when the 1935 Income Tax Act was first adopted to the first iteration of what came to be the Section 17952 language in 1937 and continuing through recodification of the act in

1943 and consistently thereafter, the modern-day versions of 17951, 17952, 17953, and 17954 maintained their independence.

Each rule remains separate and applied with equal force to the others. Nowhere in the legislative history is there even a hint the legislature intended Section 17951 or 17954 to narrow or otherwise control the application of Section 17952 or any other statute in Chapter 11. In fact, the opposite is true. The legislature knowingly adopted the mobilia doctrine in determining the taxable situs of intangible assets, and with it the business situs as exception.

As explained by the California Supreme Court in 1941 -- in the 1941 Miller versus McColgan decision, in 1935 when the income tax act was enacted by the legislature, the courts of California and the federal courts had declared that the taxation of intangibles was subject to the mobilia rule. And the fact that the legislature had adopted a new nonresident -- new nonresident sourcing rules at the same time as the court decisions declaring the mobilia doctrine applies, has to be construed consistently.

The question before the court in Miller was whether a credit was allowable for a Philippine income tax on dividends and gains received by a California nonresident from his stock in a corporation located in the Philippine Islands. The court determined no credit was available on the basis the dividends dividend and gains had their source in the stock itself, and that the situs of the stock was a residence of the owner. In reaching this conclusion, the court applied the common law doctrine often followed in determining the taxable situs of intangible assets; mobilia sequutur personam, meaning, movables follow the person.

Four months later the court issued its decision in Holly Sugar. Holly Sugar involved a New York corporation, Holly Sugar, that acquired 70 percent of a California entity, Santa Ana Sugar. Holly Sugar liquidated Santa Ana Sugar and in the process had a million -- $1 million uncompensated loss. The Tax Commissioner, Respondent's predecessor, refused to consider this loss in computing the tax due arguing the investment in Santa Ana Sugar did not rise to conducting business in California. The court disagreed. In addressing the core issues in dispute, the court reiterated its holding in Miller. It is well settled that intangible property has a taxable situs at the domicile of the owner under the mobilia doctrine.

Now, turning back to the California legislature's adoption of the nonresident sourcing rules in the 1930s.

And as noted by the court in Miller, this was at the exact same time the courts had judicially adopted the mobilia rule, an intangible followed the domicile of the owner, and had also adopted the business situs exception to that rule.

The timing cannot be ignored. First, the mobile doctrine had been adopted outside California in federal decision law, including the U.S. Supreme Court. And then it was adopted by the California courts, and then it was adopted by the California legislature. The California legislature could have enacted legislation that abandoned the mobilia rule and treated intangible property no different than any other property subject to the general sourcing rule in modern day Section 17951, but it did not.

Instead, the California legislature enacted a specific statute codifying the mobilia rule and the business situs exception in modern day 17952. The FTB cannot refute this history of Sections 17951 and 17952. And, again, this is another issue that Respondent had four months to respond to and did not respond to in its reply brief, and its silence, again, speaks volumes.

MR. PARKER: This is Chris Parker.

As Ms. Roberts stated, Respondent claims that because it has legislative rule-making authority under 17954, it can promulgate a legislative regulation that must be, quote, unquote, "Given the same weight as a statute and is, therefore, controlling." Respondent has overstated its rule-making authority and the weight to be afforded to Regulation 17951-4.

The Supreme Court of California and appellate courts of California provide clear limits upon regulatory authority. The court has made it abundantly clear that only the legislature can create statutes. The Respondent as an administrative agency is not the legislature. Regulation cannot constrict, restrict -- excuse me -- or enlarge the scope of a statute. Even the Yamaha case that Respondent regularly cites, states, "The regulation must be found to be reasonably necessary to implement the purpose of the statute."

The California Government Code is abundantly clear. No regulation is valid or effective unless consistent and not in conflict with the statue. It's Government Code Section 11342.2. And all of these quotes are in our briefing as well. A ministerial officer may not under, the guise of a rule or regulation, enlarge the terms of a legislative enactment or compel that to be done, which lies without the scope of the statute. Statutes must be given a fear and reasonable interpretation with due regard to the language used and the purpose sought to be accomplished.

The court should avoid a construction of a statute that makes some words surplusage. It is well settled that a general provision is controlled by one that is special. The latter being treated as the exception to the former. It's worth noting that the Ordlock Court was speaking specifically to statutes here, not regulations. Respondent conveniently misquotes this by applying it to the regulations. But the California Supreme Court is clear in their guidance that it is the statutes that control by giving weight to statutory construction. Regardless of whether regulations are administrative or legislative, they continue to be instructive as to the interpretation of the statutes. They do not become statutes.

Further, regular regulations cannot deviate from statutory law as written. In that regard, the regulations cannot control the application of another statute. Respondent attempts to confuse this point by misreading the word dignity in the Yamaha Decision. In the hierarchy of laws, statutes control and regulations provide clarity to the application of the appropriate statute. Dignity is not a quality. In fact, the word "equal" does not appear in the Yamaha Decision in the primary text of that decision. It only appears once in a footnote stating all else being equal, not in reference to a regulation.

Similarly, the word equality does not appear in the Yamaha Decision. Let's compare the definitions of dignity and equality. Dignity is the state of quality or being worth of honor or respect. Equality is the state of being equal, especially, in status, rights, and opportunities. This is intentional. The California Supreme Court chooses its words very carefully.

A prime example of dignity versus equality is the LGBT marriage cases where we saw civil unions held out as having the legal dignity of marriage. The courts decided that was not equality because dignity and equality are not the same. Once it is clear a regulation is not equal to a statute, then Respondent's fundamental argument on the application of the regulation as primary falls apart. Respondent's primary arguments that Regulation Section 17951-4 control the application of a completely separate statute, Section 17952, is absurd. It violates the hierarchy of laws detailed by the California Supreme Court and multiple California Appellate Courts.

Yet, Respondent makes this argument in their opening brief on Page 6. Respondent's suggestion that a regulation can be amended to supersede an Appellate Court's determination is outright false, if not a material fraud. Yet, Respondent makes this argument in their opening brief on Page 4. Respondent is not the legislature. Respondent cites no authority for their proposition of such grandiose power. Respondent cites no statute that enables them to ignore or otherwise contravene an appellate court.

While we appreciate Respondent's self-aggrandizement of their authority, Respondent has no ability to contradict the California Supreme Court, California Appellate Court or California Government Code when it comes to determining the correct and quite limited application of their regulations.

But Respondent's representations regarding the regulations under Sections 17952 are equally curious and -- excuse me -- under Section 17952 are equally curious. Beginning in 1999 and continuing through 2002, there was an FTB regulation project for 17951-4. The amendment shows that with the economic impact statement that we provided in Exhibit, I think, 16, 171 -- excuse me -- 17951-4(d) was never intended to be the all-powerful phantasm Respondent is perpetuating it to be now. What we see in Appellant's Exhibit 16 is clear on this point from the regulations' promulgation. It was intended to have a minimal impact.

Then in 2014 we see a new regulation project launched. In this case there's an effort to amend 17951-4 and add a statement about 17951-4 controlling the application of 17952. This is in Appellants' Exhibit 6, 7, and 8. What we see is the Franchise Tax Board -- excuse me -- the Respondent attempting to mitigate their losses before the Board of Equalization where 17952 applies. Looking at cases like Ames and Bass, which we will detail more later, there were other cases as well where the Board of Equalization found the FTB's interpretation of 17952 to be incorrect.

But what's striking in these regulation projects beginning in 2014 and carrying on all the way into 2017 and 2018 is the Franchise Tax Board's disingenuous approach to Venture Communications. In Venture the Board of Equalization considered the sale of a partnership interest by a nonresident. The Board analyzed Holly Sugar, Valentino, and Ames.

There are two important points from the Venture Communications matter. First, they agree the two-step sourcing rule in Valentino is first character of the income and then an evaluation of the sourcing rule to apply to the intangible property at issue. And second, they point out the Board's wholesale rejection of Respondent's dictum argument regarding the language that applies to intangibles towards the end of Valentino. If Venture Communications was the uninformative matter that the Respondent alleges in their briefing, then why was a multiyear regulation project necessary to address the case? And, yet, the statement of reasons for that regulation project that started in 2014 is expressly stated as responding to Venture Communications.

In Figure 9 that we have up on your screen, you see an excerpt from the statement of reasons for the regulation project, include -- excuse me. You see the fiscal impact statement regarding the regulation project. And you see at the bottom there could be a minor increase or decrease in state tax revenue as of this regulation. This regulation affects very few taxpayers and, yet, both of our firms have multiple of these cases that are coming before the Office of Tax Appeals in different stages. It affects a lot of taxpayers.

So, clearly, this was -- the impact of this regulation was either not as it was intended when it was enacted in 2000, or it has morphed into the phantasm we describe it as now. The FTB's contradictory comments on this matter only further highlight the agency's disjointed position. During a review of the proposed regulation by the three-member Franchise Tax Board, the Board cited the lack of transparency behind Respondent's 17952 comments, and the fact that 17952 makes no references to business or nonbusiness income. That's in Appellants' Exhibit 8.

Respondent is equally confused on their

application with respect to the Regulations of 17951 and 17952. To be clear, as stated before, the same authority that created the regulations under Sections 17951 also created the regulations under 17952. Section 17954 enables the creation of regulations to address income within and without the state by enabling the creation of rules and regulations to assist in determining the source of income.

What we see in Regulation 17952 is an evaluation. Particularly, 17952(c) is an evaluation of whether the exception to the mobilia rule, which would pull the income out of state, may apply. Once it is clear that Section 17952 applies, then Regulation 17952 can be applied, and we can look to whether or not one of the exceptions to the intangible rule applies. To use Respondent's own argument regarding specificity, the regulations under 17952 are much more specific to the intangible income at issue in this matter, than the general regulations under 17951.

Notably, Respondent cannot square how the regulations under Sections 17951 and 17952 interact. Here too, we raise this issue in our supplemental briefing. Respondent took four months to respond and did not address this issue.

MS. ROBERTS: This is Carley Roberts.

I'd like to switch gears here and talk a little bit about the case law that's on point. But before addressing the relevant case law that further supports Appellants' arguments regarding the application of 17952, we want to make clear that Appellants are not asking the OTA to invalidate Regulation 17951-4. There is no need to invalidate the regulation, and that's not Appellant's request.

The regulation works when it clarifies the application of section -- of statute 17951 consistent with the hierarchy of laws as it is supposed to when ordinary business income is involved. What we're asking the OTA to do is interpret and apply the nonresident sourcing rules in Chapter 11, consistent with their statutory independence as evidenced by the legislative history and nearly a century case law interpreting and applying the mobilia rule, as embodied in Section 17952.

Turning now to the case law. The cases addressing California's interpretation and routine application of the mobilia doctrine and the related business situs exception are too numerous to discuss and are amply addressed in Appellants' briefing. However, a few are especially noteworthy. We've already discussed the California Supreme Court's 1941 decision in Miller and Holly Sugar. Both confirm California's judicial adoption of the mobilia rule when sourcing income from intangibles.

The court also goes on in each case to examine whether the intangible income, nonetheless, should be sourced to California and lays out the requirements of the business situs exception, which Mr. Parker will be addressing shortly.

Next, is the Court of Appeals' 2011 decision in Valentino. We know this esteemed panel is intimately familiar with the facts and analysis of Valentino. We do not mean to belabor either. But now that the OTA is aware of the legislative history behind California's adoption of nonresident sourcing rules in Chapter 11 and the fact that PIT law separately conforms to the subchapter S rules about any modification to Section 1366(b), a discussion of Valentino is critical.

The plaintiffs in Valentino were residents of Florida who owned stock in a Delaware corporation qualified to do business in California. The corporation, Cellular 2000, elected as court treatment. The income in dispute was derived from Cellular 2000's ordinary business activity conducted within California. The plaintiffs made the argument the corporation's income in their hands as individuals was derived from the stock of the corporation, rather than the conduit rule.

In making the argument the stock was the source of the income rather than the underlying ordinary business activity, the plaintiff's erroneously argued the mobilia doctrine controlled the taxation of the income in their hands as residents of Florida.

The court in Valentino applied the conduit rule, holding the character of a shareholder's pro rata share of S corporation income is determined as if the income are realized directly from the source from which is realized by the corporation. In this case, however, the income was realized by the corporation from its everyday regular business activity. As such, in the hands of the shareholder the income retained that same character. The income did not arise from the intangible stock.

To reach this conclusion, the court applied a two-step analysis. The court stated the source of a shareholder's pro rata share of S corporation income is first characterized by reference to corporate income-producing activities under IRC Section 1366(b), then as characterized, is sourced to locations according to rule -- to the rule that applies to that type of income. Rules, of course, are those that are found for nonresident -- nonresidence in Chapter 11. The court continued with a key analysis.

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, Section 17952 is not displaced by 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.

While FTB attempts to argue the last quote as dictum, we strongly disagree. Last quote is the court directly addressing the plaintiff's question as to the applicability of Section 17952. In contradiction to FTB's arguments, the court needed to answer the plaintiff's question. And this last quote about this applicability of Section 17952 is court's answer. Appellants also note administrative agencies are bound under the doctrine of stare decisis to follow Valentino under Auto Equity Sales, Inc. versus Superior Court of Santa Clara County. The cite on that is 57 Cal.2d 450 at 455.

Prior to Valentino, there is a whole string of California straight Board of Equalization cases on point. We will not go through all of them, but we do want to briefly discuss the Board's 1987 decision in Appeal of Amyas and Evlyn Ames, et al. In Ames, the nonresidents sold their interest in a limited partnership. The partnership's principal business activity concerned real property located in California. The general partners were located in California.

The FTB argued the Respondent's gain from the sale of the partnership interest were subject to tax as California source income under the business situs exception in Section 17952. Never did the FTB attempt to argue the mobilia doctrine did not apply to the income from the intangible business interest, nor did the Board of Equalization in its analysis, despite the fact that each limited partnership interest was an intangible interest that FTB argued. The limited partnerships in question had developed a business situs in California because of the partnership's principal activity concerned real property in California.

In its decision, the Board reviewed Holly Sugar, citing to the language that, quote, "Business situs arises from the act to the owner of the intangibles and employing the wealth represented thereby as an integral portion of the business activity. The Board continues, quote, "Rather than admitting that Appellant's actions do not meet the Holly Sugar test, however, Respondent attempts to salvage its assessments by redefining the term business situs."

The Board concludes, quote, "Appellants made no attempt to employee the wealth represented by their limited partnership interest as to integrate that interest into the business activities in California. Consequently, we find that the intangibles did not acquire business situs in California."

In sum, California's legislative history adopting the nonresident sourcing statutes in Chapter 11, the PIT law separate conformity without modification to the conduit rule and the foregoing case law overwhelmingly support the conclusion that Appellant's gain from the sale of goodwill must be characterized as an intangible and source under Section 17952.

MR. PARKER: This is Chris Parker.

Section 17952 directly applies and directly addresses the goodwill intangible income at issue. We submit there is no California business situs. How we reached that conclusion; Revenue & Taxation Code Section 17952 states, "Intangible personal property is not income from sources within the state unless the property has acquired a business situs in the state."

We look to the Regulation 17952(c), which explains the test for business situs. Test number one, if it is employed as capital in the state. The goodwill in issue in this matter was not employed as capital in this state. Has the possession and control of the property been localized in connection with the business, trade, or profession in this state so that its substantial use and value attach to and become an asset of the business, trade, or profession in this state?

There's a couple of examples. If a nonresident pledges stocks, bonds, or other intangible property in California as a security for the payment of indebtedness, taxes, et cetera, incurred in connection with a business in this state, the property has a business situs here.

There's a second example. If an nonresident maintains a branch office here and a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with activities in this state, the bank account has a business situs here. Notably absent, the branch office does not.

These tests focus on property in the state, control of property, capital, pledging property, all at the entity level. The dictionary definition of substantial is of considerable importance, size, or worth, or concerning the essentials of something. The property factor did not change during Respondent's audit of Medical. Medical's property in the state was 5.59 percent of their total property. Put another way, 94.4 percent of the value of the property was outside of California. This is not a substantial use in value within the meaning of regulation.

The Holly Sugar case informs the business situs rule and explains the standard. Business situs arises from the act of the owner of the intangibles in employing the wealth represented thereby as an integral portion of the business activity of the particular place so that it becomes identified with the economic structure of that place and most importantly, loses its identity with the domicile of the owner.

The court continues. There must be something like a general or more or less continuous course of business or series of transactions within the state where the property is physically located as distinguished from mere sporadic and isolated transactions. Similarly, if we look at the Ames matter before the Board of Equalization, we see there was a Los Angeles building that the Board of Equalization still did not find business situs on the sale of their intangible. If we look at the appeal of Bass, which predated the application of 17955. There was a substantial office and team in place in California of the investment partnership, but the Board of Equalization still did not find a business situs to their intangible income.

Put simply, just having property in this state is not enough to take the position there is business situs as Respondent attempts to do. Instead, the substantial use and value must be prominent. This aligns with the idea from Holly Sugar of the loss of identity with the other place. Take, for example, California Pizza Kitchen. It is unquestionably California, even if it's in New York because it's the California Pizza Kitchen.

If the case for substantial use and value is weak at the entity level, it is nonexistent at the individual level. Hereto, we raise this issue in our briefing. Hereto, the Franchise Tax Board asks for four months of time to address these issues. But they never responded to the business situs argument in the subsequent briefing. Respondent has agreed the Farieses were nonresidents in 2011. That's Joint Stipulation Number 1. In the hands of the Farieses as individuals there is no business situs to be found.

Here, again, FTB's silence speaks volume because without a finding of business situs consistent with the regulations, they have no authority to tax the income.

MS. ROBERTS: This is Carley Roberts.

That concludes our argument on the primary issue in this case, and we transition now to the secondary issues. If the OTA determines Appellant's income from the sale of goodwill as a California source, then there are two secondary issues to be addressed.

The OTA must first decide whether individuals who are subject to the persona income tax law must also apply to their income the apportionment and allocation provisions of UDITPA of the corporation tax law. If the OTA determines that personal income tax law taxpayers are required to also apply UDITPA, then the next issue is how are the UDITPA provisions apply to an individual under the personal income tax law.

Respondent does not bother to address either issue in its briefing. Instead, Respondent subjected the individual nonresidents to the corporation tax law rules as if the individuals were a corporation with no regard for either the complexity or protections necessary for individual income taxpayers. Mechanically, Respondent took the Appellant's gain reported on the Schedule K-1s and apportioned it to California using Medical's apportionment formula. And I say apportioned because that's a strange word in the individual income tax context. We're not used to talking about apportionment income or division of income when we're talking about an individual subject to the PIT law. So Respondent took Appellant's gain reported on the K-1s and apportioned it using Medical's apportionment formula.

On Medical's original return, Medical calculated its apportionment formula under UDITPA without application of any Respondent's special formula rules under Section 25137. Respondent subsequently audited Medical and adjusted Medical's apportionment formula. Respondent applied the occasional sale rule and excluded the entirety of the sale proceeds from Medical's sales factor. This is the apportionment formula that Respondent used to determine the amount of income subject to tax in California for Appellants. They used Medical's audited apportionment formula to apportion the nonresident individual's gain to California for personal income tax law purposes.

So turning back to what I said is the first issue in the secondary issue; are individuals who are subject to the personal income tax law also required to apply the provisions of UDITPA of the corporation tax law? We think the answer is no. And we believe we have amply addressed this issue. The personal income tax law and the corporation tax law are two independent laws within the Revenue & Taxation Code. Personal income taxpayers are not subject to the corporation tax law. There's no statutory authority for the FTB to apply UDITPA to personal income taxpayers.

MR. PARKER: This is Chris Parker.

And if the Office of Tax Appeals determines that individual taxpayers must apply the corporation tax laws UDITPA rules on top of the personal income tax law rules, then we are left with the issue of how the UDITPA rules apply to individuals. The problem is individuals are not businesses, and we cannot just add the blanket application of UDITPA on individuals as if we're dealing with a business.

In the hands of individuals, there is no excluded income. For the record, there is no tax-exempt income at issue in this that could potentially produce distortion. There is no potential nonbusiness exclusion of income. Individuals report all of their taxable income on a cash basis. In determining that individuals' income subject to tax, Section 17041(i) directs to Chapter 11 to determine the income from sources within and without California. Chapter 11 then helps individuals determine gross income from sources within the state that is subject to the rate determined under 17041(b).

Here there is no uniform application of division of income in the individual tax code. I draw your attention to example in Figure 10 where we see an individual having Virginia income of $1,999,000 and $1,000 of California income. But because of California's application of 17041(b) to the entire taxable income avenue an individual, that individual is subject to 13.3 percent tax on that$1,000. If they were paying under the ordinary rates, the tax rate would be 1 percent.

To be blunt, not even Respondent knows what to do with this. They tried to mechanically apply

Section 25137. Curiously, they leave out of their reply brief met that Respondent's Regulation 25137 committee met to decide this issue of apportionment in the hands of Appellants.

A little background. Appellants received an e-mail, Appellant's Exhibit 10, stating they would be subjected to review by the 25137 committee. Appellants were not told when the committee would meet. When Appellants called to inquire what authority was being relied on, they were told Regulation 17951-4 invokes the corporate tax law, and the corporate tax law gives the Regulation 25137 committee unfettered authority to do whatever they want. Specifically, they cited to Fluor.

Appellant's were not given any analysis before or after the committee met. When Appellants inquired as to the status of this exercise, they received a voicemail from Respondent's counsel, Mr. Zaychenko, saying the committee decided, Appellant's Exhibit 11. While we acknowledge Respondent's unbridled enthusiasm for their Regulatory Committee's authority, maybe this is sufficient evidence that the reins need to be gathered up.

If the Office of Tax Appeals is going to say UDITPA has to be applied to individuals, this history is a prime example of why those rules have to be administered through the lens of the personal income tax law, including additional protections for individuals who are not accustomed to Respondent's tactics. Most individuals are not prepared for the way those rules are commonly applied to corporations. Respondent's application of Section 25137 is only a single example of the complexities and disfavor to the individual taxpayers created by blindly applying the UDITPA rules to taxpayers subject to the personal income tax law.

Another example is the application of the occasional sale rule, which makes no sense in the individual income tax matter. The purpose of the occasional sale rule as applied to businesses is found in Respondent's legal ruling 97-1, which says it's designed to cure distortion based on the rationale that substantial amounts of gross receipts from occasional sales do not fairly reflect the taxpayer's day-to-day business activity and, therefore, cause excessive income to be apportioned to the state where the occasional sale took place.

Clearly, this is designed for businesses and not individuals. Because there's no comparable application to individuals -- because there's no ability to divide individuals' income in the manner that the occasional sale rule is meant to address. A hypothetical test determines this. Assume you have an individual income taxpayer whose regular income includes multiple sources of revenue, including wage income, investment income, and licensing income.

One year, however, the individual sells a building that is used to conduct their activities giving rise to regular income. The individual sale of the building would not change the calculation of the individual's taxable income. Again, a federal income concept in a distorted matter because there's no division of income, and there's no sales factor representation. The taxable income concept is inclusive, and it is adopted by many states. The individual would simply be subject to tax based on the source of the income. If the individual was a resident of one state and the building that was sold was located in another state, the individual could potentially be sacked -- excuse me -- potentially be subject to double taxation because of the federal taxable income standard.

For the same reasons the occasional sale rule, which is designed to prevent distortion of income for businesses that divide their income, should not apply to personal income taxpayers.

MS. ROBERTS: This is Carley Roberts.

In the event the OTA determines that the corporation tax laws UDITPA provisions, including the occasional sale rule apply to individuals subject to the

PIT law, then Appellants have met their burden to establish the standard apportionment rules do not fairly represent the extent of Medical's activity in California, and have met their requirements for equitable relief under Section 25137.

Section 25137 is the statutory authority for allowing for equitable relief if the allocation and apportionment provisions of UDITPA do not fairly represent the extent of the taxpayer's business activity in California. The taxpayer or the FTB may seek equitable relief. As the party invoked in Section 25137, Appellants have the burden of proving by clear and convincing evidence that one, the approximation provided by the standard formula is not a fair representation; and two, their proposed alternative is reasonable. Appellants have more than amply met this burden.

In this case, Medical's standard apportionment formula includes application of the occasional sale rule under Regulation 25137. This is because the occasional sale rule is a codified special formula rule. Respondent has promulgated many formula -- special formula rules under 25137. As the State of California Board of Equalization held in Appeal of Fluor, if the circumstances prescribed by a special formula regulation are satisfied, then the method of apportionment prescribed in the special formula becomes the standard apportionment formula.

As Mr. Parker explained, the occasional sale rule is ordinarily designed to preventively cure distortion, but its application has the exact opposite effect, as applied to the individuals in this case. FTB cites Appeal of Fluor it's unfettered ability to use its special apportionment rules, but the drafters of Fluor were smart and recognized there would be, in fact, situations where the FTB special apportionment rules go too far.

Quote, "It will be inevitable that some situation will arise where use of a special formula under Section 25137 Regulations will not be appropriate, and a party may wish to object to the use of the special formula." This is exactly one of those cases. To determine whether distortion exist for 25137 purposes, the California Supreme Court has fashioned a two-prong test in its 2006 Microsoft Decision.

The first prong looks to whether the activity in question is qualitatively different from the taxpayer's principal business. The second prong looks to whether the quantitative distortion is substantial. Microsoft involved the company's treasury receipts, and Microsoft is involved in its normal, you know, software business IT Solutions. But it also, like many large corporations, had its treasury function. And the question was whether or not all of the receipts generated by the treasury function should be included --

JUDGE AKIN: I'm so sorry to interrupt. Sorry, Ms. Roberts.

Judge Akin speaking. With the permission of our lead, Judge Leung, I would like to request a quick 15-minute break for us. We've been going an hour and a half, and I just want to make sure everybody has the chance to use facilities and what not, if needed.

THE COURT: Ms. Roberts, I apologize for the interruption.

We'll take a quick 15-minute break now. It's about 2:31. So we will reconvene at about 2:45 with your presentation on the Microsoft case and to finish with your presentation.

So we'll be back at 2:45. Please mute your devices and close your cameras. Thank you.

(There is a pause in the proceedings.)

THE COURT: We are back on the record.

And, again, I apologize. Ms. Roberts, please continue with your presentation.

MS. ROBERTS: No worries. We can pick back up right where we left off, and we don't have, actually, that much time left.

THE COURT: Okay.

MS. ROBERTS: Actually, I guess to clarify, Appellants -- we've been, you know, keeping track here of our time. We're showing we're right about 71, 72 minutes. Does that sound about right?

THE COURT: That sounds about right.

MS. ROBERTS: Okay. So we just were in the process of looking at the California Supreme Court's decision in Microsoft for determining whether or not distortion exist. And, again, the court fashioned a two-prong test to look at qualitative and quantitative distortion. And the facts in Microsoft, again, applied its -- were related to its treasury function and treasure activity. So it had a very high volume of receipts that were paired with not all that much income.

So on the qualitative test, the court held that Microsoft's treasury function was qualitatively different from its principal business of selling software and IT services. It was that simple. It didn't matter that it was all unitary -- from a unitary business. It didn't matter that it was all business income. What mattered was that the activity, in this case giving rise to the income and receipts in dispute, the treasury function that it was qualitatively different from Microsoft's, you know, normal regular principal business.

The same is true in this case. Appellants and

Medical sale, substantially, all the business assets was qualitatively different from Medical's regular surgical equipment business. It was, you know, not in the business of selling off assets or selling all of its -- substantially, all of its assets. You know, whether it all produced business income or not is not of relevance. It's, again, looking at the activity and looking for that qualitative difference that you have two activities that are very different from each other.

On the quantitative test, the court held that exclusion of Microsoft's gross receipts from the treasury operations was proper because the treasury operations -- because their inclusion created a distortion since these transactions generated minimal but enormous gross receipts. So, specifically, in Microsoft the gross receipts in disputes from the treasury function, they generated less than 2 percent of the income from Microsoft, but they generated 73 percent of the gross receipts.

In holding in favor of the FTB, FTB was the one seeking equitable relief in Microsoft. In holding in favor for Respondent, the court warned that the FTB -- warned the FTB that special apportionment under Section 25137 could go too far. The court stated, "If, unlike here, treasury operations provide a substantial portion of a taxpayer's income, special apportionment may result in an apportionment that does not fairly present California business activity."

That situation has presented itself in this case. The quantitative distortion caused by Respondent's application of Medical's as audited apportionment formula is staggering. The round peg, square hole approach of pushing individuals into UDITPA is exacerbated here because of the fact that Medical was in a $13 million loss position for the year under its regular business operations. FTB taxed all the income generated by the asset sale but did not give any factor representation to the loss position.

Using the test for quantitative distortion articulated by the court Microsoft, Respondent's application of the as audited apportionment formula that excluded the sales proceeds from the sales factor created roughly 4,880 percent as detailed in the briefing. Further, the asset sold by Medical for $249 million represent more than 100 percent of Medical's taxable income for 2011. Medical's taxable income was only $229 million. Receipts from the activity in dispute -- so the activity in dispute is the sale proceeds of $249 million. It represents 96 percent of Medical's total receipts. Total receipts were $259 million.

This is exactly the distortion in the opposite direction the Court in Microsoft and the Board in Fluor warned against. Respondent is taxing 100 percent of the income and not including any of the underlying receipts. Appellants contend inclusion of the sale proceeds and the sales factor denominator cures the distortion and fairly represents Medical's activity in California in 2011.

MR. PARKER: This is Chris Parker.

Appellants would like to reserve the balance of the time for rebuttal and closing. Thank you.

THE COURT: This is Judge Leung. Thank you, Mr. Parker.

And let's see. My guesstimate of your remaining time is about seven minutes, Mr. Parker. Is that correct, or am I a little bit off there?

MR. PARKER: ALJ Leung, we see about 3 minutes of our opening time of 80 minutes, and then we have the balance of the 30 minutes for rebuttal still available to us is our understanding. Is that correct?

THE COURT: Okay. I mean, I think that's about right. I mean, those allocations we did on the PHC were not strict divisions of time for you. You had a total of -- Appellants have a total of 110 minutes, I believe. Yes. And so you've got about -- yeah. You've got about 33 minutes left. That's about right. That will be fine.

MR. PARKER: Thank you ALJ.

THE COURT: You're welcome. I just want to make sure. 33 minutes left for the Appellants' for rebuttal.

Before we go to the Franchise Tax Board, Judge Akin, do you have any questions for the Appellants?

JUDGE AKIN: Thank you, Judge Leung. I'm sorry. I'm getting a lot of feedback. I don't have any questions. Thank you.

THE COURT: You're welcome. I'll take that as Judge Akin saying she has no questions for Appellants at this time.

Judge Lambert, any questions from you?

JUDGE LAMBERT: Hi. This is Judge Lambert. No questions yet. Thanks.

THE COURT: Okay. Thank you, Judge Lambert.

Ms. Brosterhous, when you are ready, please proceed.

MS. BROSTERHOUS: Thank you.

PRESENTATION

MS. BROSTERHOUS: Good afternoon. My name is Maria Brosterhous, and I'm representing Respondent Franchise Tax Board. With me are Natasha Page and Rafael Zaychenko, also of the Franchise Tax Board.

As this is a matter of stipulated facts and undisputed exhibits, Respondent's primary focus today will be on the legal issues. Our argument will cover why the FTB's assessment should be sustained. The issue I will address is whether Appellant's gain, including income from goodwill received as a shareholder in an S corp -- corporation -- excuse me -- is California source income taxable by California. You will see that the undisputed record demonstrates FTB properly determined the income Appellant received as a shareholder in an S corporation is properly sourced under Regulation 17951-4.

The second issue of whether Appellants have shown, by clear and convincing evidence, that receipts from the sale at issue are not excludable under the substantial and occasional rule will be handled by my co-counsel, Rafael Zaychenko.

I will begin with the basic facts which are undisputed. Here the S corporation, Medical Company Incorporated or Medical, agreed to sell its assets to a third-party company, and the sale was consummated in 2011. Even though Medical was a party to the agreement, Medical itself was the seller, and we cannot ignore the existence of the S corporation here. Because this was the sale of assets, Medical survived this transaction and was still in existence as of 2019 as seen in Exhibit B.

As the 100 percent shareholder in the

corporation, Appellant received flow-through gain passed through as a distributive share from the sale and did not report this income as California -- as income on -- as a California nonresident return. However, the S corporation reported it as business income on the Schedule K-1 issued to Appellant and on Medical's Schedule R. It was also reported as the sale of business assets on the S corporation's Schedule D-1.

Now that I've set forth the facts, it should be readily apparent that the case before you is extremely similar to the recent precedential decision in the consolidated Appeals of the Metropoulos Trust. In Metropoulos the OTA determined that an S corporation shareholder's flow-through gain from the sale of the S corporation's asset, specifically goodwill, is properly determined to be business income to be sourced under Regulation -- excuse me -- Revenue & Taxation Code Section 17951 and Regulation 17951-4.

As such, the income was found to be subject to apportionment under UDITPA to determine the portion of California source income. Metropoulos is the precedential authority on this issue and is definitively on point with the facts before us. As such, I would like to walk through this decision.

The basic facts are incredibly similar to those of Appellant. And aside from a hollow attempt to distinguish Appellant's facts from Metropoulos, Appellant avoids the issue of this precedential value. Just like the Faries, the Appellants in Metropoulos were California nonresidents who were the shareholders in an S corporation. Also, as occurred here, the S corporation sold all of its assets and reported distributive share of the gain to the shareholders.

Finally, just like in Metropoulos, the income here was reported as apportionable business income on Schedule R and on a Schedule K-1 of the S corporation return. As in Metropoulos, Appellant asserts that the income at issue should be sourced as an intangible under 17952. It's important to remember that what happened here is that Appellant received distributive share income as a shareholder in an S corporation. Appellant did not directly receive income from intangible property.

And a discussion of Metropoulos will explain why the income is properly sourced under Regulation 17951-4. The decision in Metropoulos begins with the discussion of the conduit rule. As noted in the decision, California largely conforms to federal treatment of S corporations under Revenue & Taxation Code 23800. Included in this treatment is Internal Revenue Code Section 1366(b), also known as the conduit rule.

The Metropoulos decision explains the rule was properly applied in Valentino v. Franchise Tax Board, and describes how the Valentino court found the income of a shareholder in an S corporation is properly characterized by reference to the corporate income producing activity, and once characterized is to be sourced according to the particular sourcing rule applicable to that type of income. In this way, Valentino held that S corporations are to be taxed in the same manner as partnerships.

The Metropoulos decision goes on to explain that the primary dispute before the OTA was over the interpretation of IRC Section 1366(b) and Valentino, indicating that Appellant's interpretation would ignore the existence of the S corporation and Respondents would put the shareholder in the shoes of the corporation, including the corporation's obligation to apportion income. In Metropoulos the OTA followed the Valentino holding that the source of the income in the hands of the shareholder looks through the S corporation to the income producing activities.

But, significantly, the OTA stated that its decision would go a step further. In examining the regulations that were enacted after Valentino, the OTA noted that Valentino is an incomplete guide for sourcing the income before it because Valentino dealt only with income that was wholly within California and not income from an apportioning multistate business. This distinction becomes especially significant in light of the amendments made to Regulation 17951-4 post-Valentino.

From there, OTA diverged from Valentino and stated that although Valentino is instructive, the more explicit rules for sourcing of such income are contained in Regulation 17951-4. Noting, specifically, that they were revised after the Valentino decision to include the treatment of S corporation. The OTA went on to explain that 17951-4(d)(1)provides the general rule that business income is to be apportioned at the S corporation level, not the shareholder level; and then explained that 17951-4(d)(3) provides further confirmation that this is the proper treatment of such income by specifically instructing that 17952 is only appropriate to apply as to nonbusiness income. The OTA, therefore, found that the taxpayer must apportion its income at the S corporation level.

In closing the decision, the OTA determined that in this way following 17951-4 comports with the holding in Valentino and that the focus on classification of income as originally being from the sale of intangibles and apply 17952 is to completely bypass the more explicit rules of 17951-4 and 17951. The precedent is clear. Here

Appellant did not receive income from intangibles. Appellant received distributive share income as a shareholder in an S corporation. As such, Metropoulos tells us the shareholder's income was properly determined to be business income to be sourced under Regulation 17951-4.

Next, I would like to look more closely at IRC Section 1366(b), which gives us the conduit rule discussed in Valentino and Metropoulos. But first, I would like to explain that we do not dispute that we conform to 1366(b) without modification. The problem here is that Appellant and Respondent disagree how to apply 1366(b) or the conduit rule. 1366(b) must be examined within the context of federal reporting. It is important to remember that what is being looked at in 1366(b) is characterization, not sourcing.

When the IRC instructs S corporations to pass through the character of any item in a shareholder's pro rata share, it only includes that character that has an impact on federal reporting. Examples of important federal level characterizations, include passive activity items and farm income and loss. These items are specific line-items on a return. There's no line item reporting of whether income is from tangible or intangible personal property for these purposes because this distinction is not important for federal level characterization.

Consider that an S corporation does not pay entity level tax at the federal level, the income -- excuse me -- the income tax to be paid is paid by the shareholders. Therefore, the character of the income or loss must be retained and accounted for at the shareholder level. That characterization is reported on the Schedule K-1 issued to the shareholder. Here, the characterization that is carried forward from the federal return is whether it is business or nonbusiness income.

As demonstrated by the K-1, Appellant received a distributive share of business income. There is no such line item for an item of intangible income. Here, had the Appellant not been the 100 percent shareholder, there would have been no way of knowing which portion of the gain was intangible. It is only after this characterization has been carried through that the California sourcing rules are applied to determine whether income to an S corporation shareholder that conducts business in California is sourced to California. Here, the character that is relevant for federal purposes is that of business income. And as such, the income is properly sourced using 17951-4. Thus, to summarize, character is not synonymous with source and should not treated as such here.

The next error Appellant makes is arguing that Regulation 17951 cannot supersede a statute, namely, 17952. In fact, the statute that provides the authority for the sourcing rules under 17951-4 is 17954. 17954 and 17951 are the rule-making authority here. Both code sections provide the rules defining what portion of a nonresident's income is sourced to California. By contrast, 17952 provides the rules for determining when a nonresident's income may not be sourced to California. Thus, the issue is not as simple as saying 17951-4 is being used to supersede a statute. It is more nuance.

As I've already explained, the statutes being implemented by Regulation 17951-4 are 17951 and 17954. And authority to apply these statutes and this regulation are well established in case law. A well-known state Supreme Court case that provides a great deal of guidance here is Yamaha versus Board of Equalization. Yamaha is clear that quasi legislative regulations, such as 17951-4, hold the power of a statute, defining them as the substantive product of a delegated legislative power conferred on the agency, here the Franchise Tax Board.

In Yamaha the State Supreme Court states, within its jurisdiction, the agency has delegated the legislature's lawmaking power. Because agencies granted such substantive rule-making power are truly making law, their quasi-legislative rules have the dignity of statutes. When a court assesses the validity of such rules, the scope of its review is narrow. If satisfied, that the rule in question lay within the lawmaking authority delegated by the legislature and that it is reasonably necessary to implement the purpose of the statute, judicial review is at an end.

As such, FTB's rule making power here derives from 17954, and Regulation 17951-4 status is a quasi-legislative regulation gives it the weight and authority of a statute. Moreover, it has long been held that the more specific guidance takes precedence over a general statute.

In the Appeal of Daks versus Franchise Tax Board, the California Appellate Court quoted Wilson versus Board of Retirement as follows: It is established the specific provision relating to a particular subject will govern in respect to that subject as against a general provision, although, the latter standing alone would be broad enough to include the subject to which the more particular provision relate.

Here as explained in the Metropoulos Decision, the more explicit instructions are contained in 17951-4, not 17952. Valentino is also instructive here in citing Chilson v. Jerome. The court notes, every statute should be construed with reference to the whole system of law, which it is a part, so that all may be harmonize and have effect. This specifically speaks to the need to view Chapter 11 as a whole and not each section as independent pieces.

Thus, although business income may include income from intangibles, 17954 is the more specific authority here because it provides explicit instructions on how to source business income. In fact, 17951-4 gets even more specific than that. It provides guidance on how to source business income received as a distributive share as a shareholder in an S corporation. To be clear, Appellant did not receive income from intangible property here. Appellant received a distributive share of income as a shareholder, which is evidenced by the reporting of the income on a Schedule K-1. Again, this is a schedule that does not distinguish between tangible and intangible income.

When contrasting 17952 against 17951, the language is clear. When a taxpayer receives income from intangibles, it may not be sourced to California, but that is not what happened her. Instead, Appellant as a shareholder received a distributive share of business income and as such, that income is subject to 17951-4.

Now, I would like to address the issue of whether the UDITPA standard apportionment may be applied to taxpayers subject to personal income tax law. To clarify, Respondent is not attempting to subject individual taxpayers to UDITPA or the corporate code. Rather, the personal income tax code incorporates the apportionment rules for how to source specific items of income pass through to an owner of a pass-through entity.

Regulation 17951-4(d)(1) specifically incorporates UDITPA apportionment rules by reference for purposes of sourcing the flow-through business income of an apportioning S corporation or partnership. It would be clear, the apportionment occurs at the partnership level. FTB is simply applying these rules as provided by the controlling legal authority.

Lastly, it is well established that the -- excuse me. It is well established U.S. Supreme Court precedent that the California method is constitutional as established by Great Atlantic and Pacific Company versus Grosjean and Maxwell versus Bugbee.

And now my co-counsel, Rafael Zaychenko, will discuss whether Appellants have shown by clear and convincing evidence that receipts from the sale at issue are not excludable under substantial -- under the substantial and occasional rule.

Thank you.

MR. ZAYCHENKO: Good afternoon. This is Rafael Zaychenko with the Franchise Tax Board.

So my discussion will focus on the application of UDITPA and the substantial and occasional rule. Appellants assert that should the requirements for requesting equitable relief under Section 25137 apply, Appellants have met those requirements. However, Appellants have not met those requirements. They concede the substantial and occasional rule is applicable, but they don't refute that the sale at issue in this appeal resulted in a drastic reduction in Medical's apportionment. And they don't show by clear and convincing evidence that the standards of substantial and occasional rule results in distortion. For these reasons, Appellant's requests to deviate from the standard substantial and occasional rule is properly rejected.

First, the substantial and occasional rule is the standard apportionment method taxpayers are required to utilize. According to Fluor, which also involve the application of the substantial and occasional rule, if the conditions of Regulation 25137(c)(1)(a) are satisfied, the regulation becomes the standard apportionment rule, which taxpayers must utilize. Appellants have not asserted the substantial and occasional rule is not a valid standard apportionment methodology.

In addition, Appellants have not shown the conditions described in the regulation are not met. Therefore, to deviate from the substantial and occasional method, Appellants must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of Medical's activities in this state.

This brings me to my second point. Appellants have not shown distortions, so their attempt to deviate from the substantial and occasional rule must be rejected. Pursuant to Revenue & Taxation Code Section 25137, if California's allocation and apportionment provisions do not fairly represent the extent of taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, if reasonable, the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The rationale for the substantial and occasional rule is that gross receipts from substantial and occasional sales fairly reflect the taxpayer's day-to-day business activities and, therefore, cause excessive income to apportioned to the state where the occasional sale took place. And according to FTB Legal Ruling 1997-1, which was the impetus for the FTB promulgating the regulation at issue here, this is especially so if the growth of built-in appreciation occurs over a substantial period of time, because taking the gross receipts into account in the year of recognition does not reflect the gradual effects of appreciation over several years.

The sales factor is intended to apportion income from the usual day-to-day activities of the taxpayer. However, when a substantial and occasional sale occurs, it is by definition outside of the taxpayer's day-to-say activities. Since the activities that give rise to income from an occasional sale differs from taxpayer's day-to-day activities, the method of assigning such sales must also differ.

The standard sales factor is, therefore, and improper metric to apportion gain from extraordinary events, like substantial and occasional sales. Thus, under the substantial and occasional rule, taxpayers are required to throw out substantial and occasional sales from the sales factor. Taxpayers here must utilize the substantial and occasional method because their situation is the very same situation contemplated by FTB which promulgated that rule.

In fact, the taxpayer's situation is the very same as contemplated by the regulation demonstrates that they did not show that the substantial and occasional method produces inequitable results. Taxpayers, therefore, are required to use that rule.

The gain in question was from the asset sale of Medical's business. The vast majority of Medical's gain arose from the sale of goodwill, the very type of asset that appreciates over a substantial period of time. Medical's gain from the asset sale is the type of gain that is properly excluded from the sales factor under the substantial and occasional method. The extreme change in apportionment for taxpayers post-methodology highlights the removal of Medical's asset sale amounts from the sales fact is proper.

In addition, taxpayers, in fact, appear to concede that the sale was outside Medical's normal day-to-day business. In taxpayer's proposal to include asset sales in the sales factor results in a drastic shift in its apportionment factor, from 6.5 percent in 2010, to the 1.7 percent in 2011, which taxpayers propose. Taxpayer's approach, in fact, results in distortion, which the substantial and occasional rule was intended to remedy.

By contrast, FTB's approach results in an apportionment factor of 6.5 percent, which is essentially identical to Medical's apportionment factor in the prior year. A consistent apportionment factor under FTB's approach demonstrates that the substantial and occasional rule works as intended by preventing excessive income from being apportioned to any state and drastically changing Medical's apportionment factor.

Taxpayers don't refute the significant change in apportionment. They, instead, state that FTB should let each year stand on its own. Though each year stands on its own, nothing prohibits FTB from looking at different years and comparing differing apportionment methodologies. This is particularly the case where the case of goodwill has been appreciating over several years. Taxpayers argue that the exclusion from the sales factor results in the minimization of the contribution of an out-of-state transaction.

However, the whole purpose of the substantial and occasional rule is to exclude gross receipts from extraordinary substantial and occasional sales. This is because measuring income from those sales by gross receipts is inherently distortive. Gross receipts are a proper method to assign sales from taxpayer's day-to-day activities, not substantial on occasional sales. And the purpose of the sales factor is reflecting the markets for a unitary business' goods and services. Including sales from the day-to-day activities of Medical reflects the markets from Medical's goods. By contrast, including sales from Medical's business does not reflect the market for Medical's good and must be rejected.

Moreover, taxpayers proposed apportionment method does not adequately reflect Medical's activity in California. Medical assigned the asset sales by utilizing the cost of performance methodology that was effective for the years at issue or the year at issue. The cost of performance methodology assigns sales based on where the greater costs of performance takes place. However, assigning income from the sale of Medical's assets to a single state in which the Medical sale was negotiated and completed, effectively under represents the effect of taxpayer's regular business activities in California.

Medical would source its goodwill to the location where the administrative costs incurred for selling where the business occurred. However, such costs don't adequately measure where the value of Medical's goodwill was created. The value inherent in Medical's goodwill was not created by those administrative costs. Instead, the value of Medical's goodwill was created by the long-term appreciation of the entire business wherever operated, including California.

Assigning the sale of goodwill to the location of the administrative costs of the sale does not fairly represent Medical's activities in California. Thus, the sales of Medical's goodwill and other assets must not be assigned to that location. Instead, those sales must be removed from Medical's sales factor.

Taxpayers also argue that absent the asset sale which generated the income at issue, Medical would have an ordinary loss of $13 million. But Medical was reportedly operating at a loss in 2011. It reported $229 million in net business income. The fact that Medical purportedly operated a loss for one year does not demonstrate that FTB's application of the substantial and occasional rule fairly reflects Medical's activities.

Its business assets were sold for a substantial gain of $244 million in characterized business income on its California return. Given the substantial amount of gain for Medical's sales -- excuse me -- FTB properly subjected that gain to the proper amount of tax. This is despite the fact that Medical happened to purportedly operate a loss for one year.

Lastly, taxpayer's referenced to the sheer magnitude of distortion is insufficient to prove that distortion exists. In BOE Crisa, it states that the central section -- rather the question under 25137 is not whether some quantitative comparison has produced a large enough distortive figure. Rather, the question is whether there is an unfair reflection of business activity under the standard apportionment formula. Taxpayer's simple comparison of the varying levels of taxation from differing apportionment methods, by itself, does not show that the standard apportionment formula is sufficiently distortive to invoke Section 25137.

Finally, FTB's application of the substantial and occasional rule is entirely externally consistent. External consistency refers to the requirement that the factors used in the apportionment formula must actually reflect the reasonable sense of how income is generated. The Medical reported $229 in net business income -- sorry -- $229 million. So Appellants assert that Medical operated at a loss in 2011. The asset sales resulted in $224 million in net capital gain.

This clearly indicates that overall, Medical was a valuable business when it was sold, and Medical's day-to-day activities are what made that business valuable. Appellants assert that Medical operated at a loss, but it's not surprising that -- given that during the year of the sale, Medical would not generate much income during its partial year of operation prior to that sale. Given the substantial amount of gain from Medical's asset sale, Respondent properly sourced that gain based on Medical's day-to-day sales, as well as property factors, pursuant to the applicable standard rules.

Even if Medical happen to generate losses during its partial year of operation prior to the sale, including the only the gross receipts, as well as property and payroll factors, Medical's normal business activities in order to apportion Medical's asset sale powerfully -- properly and fairly reflects Medical's activities within California.

Respondent's use of factors for Medical's day-to-day activities are properly utilized at apportion gain from the asset sale. Because of those day-to-day activities, they are responsible for substantial appreciation of Medical's goodwill over the years and not the administrative costs incurred in the sale of the business. Respondent's application of the standard substantial and occasional rule, therefore, it's externally consistent.

And now my co-counsel will make concluding remarks. Thank you.

CLOSING STATEMENT

MS. BROSTERHOUS: In closing, the facts before you are uncannily similar to those in Metropoulos. Appellant has not distinguished itself from that case, which is the precedential authority on the issue of how to source distributive share income from an S corporation. Here, as Appellant received distributive share income and not income from an intangible, it is the correct analysis and must be applied.

Lastly, since Appellants have not demonstrated by clear and convincing evidence that the application of the substantial and occasional rule unfairly represents Medical's business activity in California, their approach is properly rejected.

Thank you, and we're happy to take your questions.

THE COURT: Thank you, Ms. Brosterhous.

Before we go to another short break, Judge Akin, do you have any questions for the Franchise Tax Board?

JUDGE AKIN: Judge Akin speaking. I have no questions at this time.

THE COURT: Thank you, Judge Akin.

Judge Lambert, do you have any questions for the Franchise Tax Board at this time?

JUDGE LAMBERT: This is Judge Lamber. I don't have any questions at this time. Thanks.

THE COURT: Thank you, Judge Lambert.

And neither do I, so -- I know this is unusually short, but we'll take a brief 10-minute recess. We'll be back at about 3:37 for Appellant's rebuttal arguments. I'll see you back then. Please mute your mics and close your cameras. Thank you.

(There is a pause in the proceedings.)

THE COURT: And we are back on the record.

I hope everybody is back. And judges are here. Appellants are here and FTB is here.

Ms. Roberts, you may proceed with your rebuttal at your pleasure.

MS. ROBERTS: Thank you, Your Honor.

CLOSING STATEMENT

MS. ROBERTS: First, Respondent misstates the issues in this case. The subject of not one but two prehearing conferences was the framing of the issues, and Respondent continues to ignore the two secondary issues before the issue of distortion can be addressed.

The as issues framed by the OTA on the secondary arguments are, the OTA first must decide whether individuals who are subject to the personal income tax law must also apply the income and the income -- the apportionment allocation provisions of UDITPA of the corporation tax law. And then if the OTA determines that PIT law taxpayers are required to also apply UDITPA, then the next issue is how are the UDITPA provisions applied to an individual under the PIT law.

Respondent did in its argument address, and we'll come back to it in terms of whether or not UDITPA applies or doesn't apply to personal income taxpayers. But it never states how, and does not address the complexities created by trying to apply to individual income taxpayers the Uniform Division of Income for Tax Purposes Act, which is not something that can be remotely applied to individuals.

Second, in attempting to say that Metropoulos applies, Respondent shrugs off the fact that Mr. Faries was a party to the agreement when, in fact, this is critical factor in the character of income determination. FTB says you cannot ignore Medical as a party to the transaction. You, equally, cannot ignore that Mr. Faries, an individual, is a party to the transaction. You cannot have Mr. Faries, an individual, a party to the transaction and say that you have business income because business income does not exist for individuals.

FTB's position is also disingenuous given its arguments in Metropoulos and Michigan cogeneration. I'd like to direct your attention to a document. Just give me one moment here.

This hearing today started with a discussion of the additional exhibits that Appellants submitted on Friday, and the purpose of those exhibits were to address this exact issue by Respondent. Respondent shrugging off the fact that Mr. Faries was a party to the agreement, not only in the briefing that we showed in Figure 6 when we were going through our case in chief, did Respondent in setting forth their analysis of the character of income determination mistakenly state that Mr. Faries was not a party to the transaction, and he did not directly sell the goodwill, we have both of those misstatements from its briefing in this case.

But here we have first, this comes from Appellant's Exhibit 14. This is the reporter's transcript for Metropoulos. In Metropoulos -- as a reminder, the parties in Metropoulos, you had a nonresident trust. And the nonresident trust was not a party to the agreement. You had the sale of an S corporation, Pabst Holding Company, which was an S corporation that sold another S corporation, Pabst Brewing. In that case there's no question that individuals were not involved in the transaction.

And Ms. Page, who is here arguing today, very clearly made this a point throughout the oral argument in Metropoulos. In Metropoulos, the reporter -- again, Exhibit 14, Metropoulos transcript at Page 47, lines 20 through 22, "The trust themselves did not sell the assets of Pabst Brewing Company or PHI."

That will become more important later. And it becomes more important because it's critical to the FTB's position that when you're looking at the 1366-character determination, that you look at it through the California corporate income tax law as applied to the S corp, and it is forever tainted as business income.

Next, at Page 49, lines 21 to 23, again, Ms. Page states, "The shareholders did not sell Pabst Brewery. The entity PCHI sold its two subsidiaries."

Again, page 48, line 24, to page 49, line 2, "So what's happened is, they believe when PCHI sold the intangibles, they follow Valentino in their way, they pretend that the trust sold the goodwill."

Mr. Faries is a party to the transaction who sold the goodwill, and it makes all the difference in the world. This one fact and this one distinction alone requires OTA to rule in favor of the Farieses.

Next, we have FTB's brief -- opening brief in Metropoulos. The statement there on Page 5 -- this is Appellant's Exhibit 15. Appellants did not sell the S corporation assets. And then in Respondent's brief in the consolidated Appeals of Michigan Cogeneration Systems, this is at Exhibit 13, on Page 34. Here, Appellants themselves did not sell the S corporation's assets. The italicizing you see here is Respondent's original emphasizes. This is an important and critical fact to the income character determination.

And then we have, again, the two quotes that come from Respondent's reply brief here in the Appeal of Faries that the Appellants were not a party to the transaction and that the sale of the goodwill was not made directly by Appellants.

MR. PARKER: Which brings us to Respondent's contention that there is no federal distinction regarding goodwill, and this could not be more false.

The federal code is very specific in defining goodwill. We see that in IRC Section 197 to which California conforms both in the personal income tax code and the corporate tax code at 17279 and 24355.5. We see that in the Joint Stipulation Number 22 where we look at Class 6 and Class 7 assets of the corporation of which $243,983,750 is broken out specifically as goodwill.

We see in IRC Section 865(d) the unique treatment of goodwill in the hands of individuals and how to treat it for sale purposes. Equally important, if we look back to those cases that we started our conversation with, Holly Sugar and Miller v. McColgan, we see federal case law history identifying intangibles as a separate and distinct asset stream that deserves separate and distinct treatment.

We then see the court in Holly Sugar say, as well as the court in Miller say this is correct. For

California we see intangibles as a separate and unique stream of income warranting separate an unique treatment, including the mobilia rule. We may have misheard Respondent, but I thought I heard Respondent say that 17951 and 17954 as sections include references to business income. This too is false. 17954 and 17951 do not include references to business income. They include references to gross income.

Gross income is defined under 17071 in reference to IRC Section 61. This is the federal gross income construct that informs the way the K-1 is structured. The federal K-1 and the IRC 61 actually line up pretty darn well, if you look at them. So it's no surprise that when we get to adjusted gross income in IRC 62 and taxable income in IRC 63, which is adding in the deductions and working through the changes to get to taxable income, it's no surprise that we continue to see the same federal concepts. And we see those same federal concepts in California individual income tax law.

Now, here again -- maybe I misheard Respondents -- but I heard them say, "Business income is on the federal K-1." That could not be more false. Business income in the California corporate law concept is specific contained -- is specifically contained in California Revenue & Taxation Code Sections 25120 to

25139. In contrast, what we see appearing on the federal K-1 is ordinary business income. This is a completely separate concept that is in federal law.

And then low and behold, when we look at the California K-1, Respondent's Exhibit N, we see again ordinary business income. The ordinary business income for the taxpayer in 2011, Mr. Durward Faries, was at a loss of $10 million. The overall ordinary business income of Medical was a loss of almost $13 million. And sure, maybe in 2010 they had an ordinary year, and they had a good year, and they had a substantial operating profit. But we're here to look at the year at issue, which is 2011.

And in 2011, the ordinary business income of the company was in a loss position. That item is not in dispute. It's part of our joint stipulation of facts. Respondent cannot ignore that loss of income for the year. And Respondent cannot conflate the California corporate business law -- excuse me -- business income construct with the personal income law construct of taxable income. They are separate, distinct, and unique for a reason.

So when we go back to IRC Section 1366, you also heard another very interesting comment from Respondent. They only look to Section 23800, but 23800 is not the only conformity section that pulls in IRC Section 1366, in particular, IRC Section 1366(b). When we look at IRC Section 1366(b), and we see that there's unique and distinct conformity in the personal income tax law, under 17087.5, which is in the exact same section as 17071 et seq for the computation of taxable income, it is then no surprise that we see on the personal income tax K-1 items of income broken out consistent with that federal treatment.

And consistent with that federal treatment, we see on that K-1 Section 1231 gains, which is where those intangible gains are sourced -- or excuse me -- are characterized. The character of intangible income is indisputably determined at the federal level. It then flows out to the individuals. The Franchise Tax Board has represented that somewhere magically, an individual is supposed to see the business income of the entity.

Now, Mr. Faries was in a unique position as both the sole shareholder and a CEO, but that is not every individual. We have plenty individuals who are shareholders that have very little to do with the business. They're still shareholders of an S corporation. They still receive a K-1. And nowhere on that K-1 is there a California business income line. There's an ordinary business income line. There's losses. There's the other federal reporting items that we're all familiar with.

So it gets a little difficult to follow Respondent's argument from there, because then they point to the exact same language in the Ordlock California Supreme Court Case that Appellants pointed to, but they have a remarkably different interpretation. For us, the Ordlock Case is undeniably clear that you are supposed to look at the specific statute that applies to the unique income at issue.

In this case, in Chapter 11 there were four original statutes, 17951, 17952, 17953, and 17954. 17951 is identified as gross income from sources within California. Clearly, that initially does not apply because we don't just have income from within California. 17952 is income from intangibles. It is a very specific section that applies to the intangible goodwill income that is at issue in this case.

Remember as we clarified at the outset, but for the intangible goodwill income, the business was in a loss position for the year. So other than that intangible goodwill income, the Farieses as individuals would owe not income tax to California because the business was at a loss. I think they maybe had $800 of interest income. But generally speaking from the business perspective, the business was at a loss.

From there, we hear Respondent say that we have to look to Metropoulos, and that Metropoulos is defining. Metropoulos is not defining. Metropoulos is in appeal litigation right at the moment. The Franchise Tax Board's brief is actually due in December. So we don't know the status of Metropoulos. And neither Appellant nor Respondent can predict the status of Metropoulos at any time in the near future, because there's going to be briefing and additional briefing and hearing, and then they may go on to the California Supreme Court. And we will all watch with bated breath that they do.

But in the meantime, Metropoulos does not apply here. And it doesn't apply here because unlike the trust that owned -- that were part of -- excuse me -- an ESBT, but then owned a sub-entity as was detailed in the exhibits from the Metropoulos briefing and the Metropoulos transcript. Here we have a single shareholder who is also the CEO, who is taking on, as we identified in our presentation, unique responsibilities and obligations in order to induce the buyer to enter the transaction. That means the individual is selling their assets.

And they did so knowingly as part of the very complicated transaction structure that you see in Respondent's Exhibit C. In addition, Respondent's argument, fundamentally, comes down to, we think it is okay to subject an individual taxpayer to business law and corporate tax law concepts. And it's not. In order to get to Regulation 17951-4, you have to find that there's gross income from sources within this state.

But if we're dealing with a Virginia-based corporation selling a Virginia-based asset, the goodwill, we don't have gross income from sources within a state. Goodwill is specifically identified at the federal level as an intangible. California conforms to that because of 1366(b), so we see a pass out of the entity as an intangible. It should be treated as an intangible in the hands of an individual.

In contrast, if you were to try and follow Respondent's logic, there should then be a determination of California business income under 25120 to 25139, and that business income is what is then handed to Appellants. But that belies and frustrates the legislature's passing of 17087.5 and the legislature's passing of 17952. Nowhere in 17951, 52, 53, or 54 does it refer to nonbusiness income being in -- or being the only income that is treatable under 17952. Quite the opposite. 17952 is described as income from intangibles. It is the very specific section that addresses the income at issue in this matter.

And I'll turn it over to Ms. Roberts.

MS. ROBERTS: Just to follow up on that last point by Mr. Parker, you know, Respondent also likewise makes no attempt to address the legislative history behind California's adoption of 17952. It's the adoption of the entirety of the statutory structure that's in Chapter 11, and the lack of interdependence of those statutes. The legislative history in and of itself speaks volumes in terms of when it was adopted in the 30s, and when it was shaped between 1935 and 1943, and at the same time the judicial doctrine of the mobilia doctrine was being adopted by the California courts. As much as the FTB wants to ignore that history and the creation of 17952 as a coequal, as its own specific item that it covers here in tangibles, it cannot.

Moving on to Respondent's arguments on the secondary issues. Respondent mixes up the standards for 25137. The California Supreme Court has established what the standards are. What they may or may not have been at the Board of Equalization and working their way up until that time is one thing, but the Microsoft Court said it is a two-prong test, qualitative distortion and quantitative distortion.

Qualitatively, Respondent can't get around the fact that the activity in question, selling of the business assets, is different from the everyday normal business of Medical in terms of selling the surgical equipment. Done. We have qualitative distortion under Microsoft. Appellants have met their burden.

Second, quantitative distortion. As much as Respondent's counsel would like to be able to cite Fluor, and cite Fluor for that ability to be able to use the special apportionment -- the special formula rules without, sort of, with unfettered applicability, that's not what they were designed to do. They are still subject to the normal 25137 rules. And that is why the Board in Fluor put in the language that it will be inevitable, that there will be situations that arise where the special formula, the occasional sale rule in the case, causes its own distortion. And that is exactly what you have here. You have Microsoft where you have the receipts. The activity in question, they represent less than two percent of the income, and they represent 76 percent of the gross receipts -- the total gross receipts.

You have the opposite here. You have the income. Instead of representing two percent, the income is 100 percent of what the FTB is taxing. And the receipts are actually less. The receipts are actually 96 percent of the total gross receipts. So when you want to talk about the fair reflection of income, the fair reflection of income is to include the gross proceeds from the occasional sale in the sales factor so that there is appropriate reflection of the activity outside California.

And even if we want to focus on the goodwill and how you would normally source goodwill, what Respondent ignores is that a tiny percent, less than 90 percent, maybe even less than 95 percent of that goodwill and the appreciation over time is from activities in California. So if we are looking at where that was generated -- if we want to think, you know, more along those lines -- the activity is overwhelmingly 90 percent, 95 percent outside California. It only goes to underscore the distortion that's created by applying the occasional sale rule to the facts of this case.

Yeah, Appellants, you know, the reasonable methodology that we have proposed as part of our burden under 25137, is to simply apply the apportionment rules without the occasion sale rule. If Respondent would prefer a methodology where, you know, we look at the apportionment formula in the prior years and we put in the numerator, you know, 5 percent of the receipts into the numerator and the balance into the denominator, you know, that would be reasonable as well to reflect the activity of how and when the goodwill was generated.

But for these reasons, Appellant believes that it has more than amply demonstrated under a clear and convincing standard that both qualitative and quantitative distortion exists, and that it has proposed a reasonable methodology.

MR. PARKER: And it was notable that Respondent's commentary on the distortion issue was solely focused on the entity, but we're not focused on the entity. The entity is not even an Appellant in this issue. It is solely the individuals. And how do we look at applying these UDITPA rules in the hands of individuals that do not have the benefits and protections of the division of income incumbent in the uniform division of income for Tax Purposes Act.

We have to think about how, if at all, you can overlay these federal tax rules into the hands of an individual that is subject to tax on their taxable income, a federal construct instead of the California Revenue & Taxation Code Sections 25120 to 25139 that Respondent is trying to apply to individuals. As we shared, multiple instances of those rules do not fit very well in the hands of an individual.

So we presented to you four ways that the Office of Tax Appeals can find in favor of Respondents. Or excuse me. Sorry. Find in favor of Appellants. I was with Respondent for 11 years. It's still in there somewhere. Find in favor of Appellants.

First, find Mr. Faries was a party to the transaction as an individual. We have demonstrated conclusively Mr. Faries was directly involved and directly responsible and took on direct obligations as part of the transaction.

Follow the direct conformity to the Subchapter S Rules, including Section 1366(b), in the personal income tax law where we see it without modifications, which results in the character of the income flowing out from the federal to the individual as an intangible.

Third, follow the legislative intent regarding the correct application of Chapter 11 of the personal income tax law as applied to the intangible goodwill income at issue in this matter.

And fourth, find that the Appellants as individuals, even when subjected to UDITPA on their distributive share of income from an S corporation, still apply individual tax principles to report all income on a cash basis without the divisions found in a corporate tax law.

And with that, we look forward to your questions which we ask that you find in favor of Appellants.

Thank you.

THE COURT: Thank you, Ms. Roberts.

Thank you, Mr. Parker.

I will begin with Judge Akin. Judge Akin, questions for either party?

JUDGE AKIN: Yes. Thank you. I think I'd like to ask FTB if they can maybe address the significance of the inclusion of Mr. Faries in the Asset Purchase Agreement and whether, you know, that potentially makes him a party to the agreement, such that he individually should be treated as a seller of the assets, including the goodwill.

MS. BROSTERHOUS: Yes. I'm happy to answer that question. If you look at our Exhibit C, the Asset Purchase Agreement itself, the very first paragraph defines who the seller is. And the seller is OR Solutions, which is Medical. And it says that Durward Faries is the shareholder. And I think Appellant -- yeah. Appellants are conflating the fact that he was a party with the idea that he's the seller when he wasn't.

Here we can't ignore that the S corporation is in between the shareholder and the buyer. And I want to be clear. Mr. Faries couldn't be selling goodwill. As an individual it's not possible that he had goodwill. When you look at the definition of goodwill, it is the favor or advantage that a business has acquired, especially, through its brand and its good reputation.

MR. PARKER: There's a case on that, and I --

MS. BROSTERHOUS: Additionally, I want to remind you that in the Appeal Sierra Pacific Industries it says that you cannot disregard the form you have chosen to do your business in, that you're bound by the tax consequences of your business. Here we have an S corporation, and the Appellants were a shareholder.

I just want to read from this appeal. Appellant is placed in the unenviable position of claiming that the form of its own transaction is without substance and should be ignored. It is accepted that taxpayers are generally free to choose a manner by which to structure their affairs, even when motivated by tax reduction considerations. Once having done so, however, they are bound by the tax consequences of that choice, whether contemplated or not. And they may not enjoy the benefits of some other path that they might have chosen to follow but did not.

So here we can't ignore the existence of the S corporation, and the S corporation was the seller in this agreement.

JUDGE AKIN: Thank you. And if you don't mind, I'd like to turn to Appellants to see if they wanted to respond.

MS. ROBERTS: Thank you. Yes. A couple of quick points here. Mr. Faries had all the rights and obligations as the seller thought both his roles as the shareholder and the CEO of Medical. If you go through, particularly, Recital C and E. You can see there the rights and obligations that Mr. Faries had. You don't normally have a shareholder that's a party to these agreements where they're indemnifying the seller, and they're having the same -- indemnifying the buyer and having the same obligations as the seller.

You don't normally don't have the seller and shareholder together with making the reps and the warranties and the same obligations in the closing statements of the agreement. These are all provisions that put Mr. Faries squarely as a party to the transaction and also with the rights and obligations collectively of the seller in the transaction.

MR. PARKER: And I want to apologize. I thought we were on mute, so I didn't mean to interrupt Respondent's commentary. I was somewhat surprised though. Respondent made the assertion that you cannot have personal goodwill in a sale, and that is not unequivocally false. There's actually a Tax Court case, Bross Trucking and another case, the Estate of Idell. Not that we want to brief personal goodwill in this matter, and we're not asking to go there. But as a function of goodwill, it can either be to the business or to the individual or to both, depending on the complexity of the transaction.

And, you know, we can only wonder. I mean, unfortunately, Mr. Faries passed away shortly after this transaction; just a couple of months. So we can't really predict what would have happened if he had stayed around. But what we see, as Ms. Roberts pointed out, is his instrumental impact in making this business work. This was a reasonably small business by overall income standards.

Their -- as Respondent pointed out, if we look at their 2010 tax return, they had the gross revenues of, like, $26 million. This is not a huge enterprise and, yet, they were able to sell their business -- or sell the assets for their business. As Respondent pointed out, the business is still operating; sell most of the assets out of the business for almost a quarter of a billion dollars, which is phenomenal. Part of that is the relationships that they had built up over the time, likely, including the relationships that Mr. Faries had built.

And as far as Respondent's comments that Mr. Faries wasn't involved, that just directly contradicts Respondent's own Exhibit C. The agreement, specifically, on it's very first page includes Durward Faries as a party to the agreement, right after the line read by Respondent, is Mr. Faries' name as an individual. We -- both firms see a lot of these sale transactions, and you don't see the individual specifically mentioned on the first like that.

So this was a unique transaction of a small business that was extraordinarily successful. Congratulations to them. And they're now being penalized for that success by the Franchise Tax Board's somewhat aggressive tactics in trying to deny the treatment of their sale that they properly reflected on their return, based on the structure of the sale that they entered into.

JUDGE AKIN: Thank you. I think that's all the questions that I have for this time. Thank you.

THE COURT: Judge Akin, thank you.

Judge Lambert, questions from you?

JUDGE LAMBERT: Hi. This is Judge Lambert. Yeah, maybe I have a couple of questions for Appellants. You already discussed this a lot, but maybe if you can just clarify. You stated that, you know, we shouldn't obviously invalidate the regulation but, you know, we can interpret it. And at the same time, but it seems like maybe we're not following it exactly. So maybe you could kind of discuss that and how we assess the deference given to statute versus quasi legislative. I think you went into that as well. Like, what laws of statutory construction are we applying? Are we reading those two statutes -- to the statute and regs and somehow -- or what is the interpretation that we follow? If we can't invalidate it, but we still have to interpret it, what -- what is the guidance you're suggesting here?

MR. PARKER: Sure. We appreciate the question. What we're suggesting is that if you follow the character of the income as intangible goodwill income into the hands of the individual, you don't ever get to Regulation 17951 because you would never apply Statute Section 17951.

The limited application statute here is Section 17952, which is income from intangibles. So you would look directly at Section 17952, see the income from intangibles is at issue. That section speaks specifically to income from intangibles. Then you would waterfall to the regulations under Section 17952 to see whether the business situs rule applies, or it does not, as we have put forward in our case.

So to answer your question in a very succinct manner, you don't have to invalidate section -- excuse. Sorry. Not enough water.

You don't have to invalidate Regulation Section 17951 because you never have to get to Regulation Section 17951. If you apply Chapter 11 holistically, then you would look to Section 17952 because that is the applicable section. As far as looking at the other section, 17953 is about beneficiaries of out-of-state trusts, so that clearly doesn't apply.

And then Section 17954 talks about gross income from within and without the state and how you -- and the rules and regulations that would be created. So the rules and regulations under Section 17952 are how you would address that question of what to do with income that is within and without the state. And that's where that business situs rule comes in.

And we even see others in Regulation 17952(a), what to do if we have an intangible with situs in California or of sources derived from California. So it is -- it answers. The regulation speaks to the statute. The statute is the limited application statute that Ordlock directs us to apply to the income at issue.

I hope that answers your questions.

JUDGE LAMBER: Yes. Thanks. Thank you very much.

And I guess I'll ask FTB a question. It was stated that a regulation can supersede a statute. And maybe you could clarify that because, you know, what situation would that apply that pertains to OTA, or would the statute and regulation have to be read in harmony? Because I'm not sure for our purposes it would be superseded or if you have some legal authorities. Maybe explain more the basis for that statement.

MS. BROSTERHOUS: I think that was poor drafting on our part, frankly. I don't -- I don't think I wouldn't use the term supersede. I think that here, based on case law, what we have to look at is the more specific of this -- the more specific authority. And here, the most specific authority we have is 17951-4, which provides for how to source the distributive share of income from an S corporation. And I think that also, it's important to remember that it's a quasi-legislative regulation and, therefore, it does hold the dignity of a statute as mentioned in Yamaha.

So I don't think it supersedes anything. I think they actually are in harmony. I think that 17952 tells us what isn't sourced in California, and 17951 tells us what is. And 17951-4 speaks specifically to business -- income from trade, business, or profession, and speaks specifically to distributive share from an S corporation.

JUDGE LAMBERT: Okay. Thanks. And just one more question. You can let me know if it's relevant or whatever. It seems as though applying Section 17952 and then to a nonresident shareholders of S corporations versus, you know, the reg, what Valentino directs where it seems like they're treated differently. So in one situation you're taxed, and one situation you're not, basically.

So I wonder if this is any kind of, like, treatment that maybe it seems contrary in a way that, you know, we should exam because it just seems like it depends on whether or not you're multi state or you're just -- or you're not. So it seems like it's treated differently in that respect, and I wonder if that's relevant or what you have to comment on it.

MR. PARKER: I'm sorry. Judge --

MS. BROSTERHOUS: I'm sorry.

MR. PARKER: It's all right, Maria. I was going to ask probably the same question you are.

MS. BROSTERHOUS: Yeah.

MR. PARKER: Who are -- I'm sorry, Judge Lambert. Who are you directing that to?

JUDGE LAMBERT: Okay. Well, okay. FTB, maybe you could speak on that and then Appellants can ask -- respond after that.

MS. BROSTERHOUS: Okay. I need a little clarity on the question. I'm sorry. So is being treating unfairly. I'm a little confused what is in this scenario.

THE COURT: It just seems as though that when you have a nonresident shareholder of a non-multistate S corporation and they are conducting business only partially within the state, then you're applying Valentino in that situation. But then otherwise when you just have a shareholder -- a nonresident shareholder of an S corporation and it's just you go to the business situs. So it seems like it's treated differently perhaps.

MS. BROSTERHOUS: I'm sorry. Did we say in our briefing at any point that you looked to the business situs?

JUDGE LAMBERT: Well, I'm talking about when you're not applying the reg.

Well, may -- Appellants did you have something you want to state on that.

MR. PARKER: Yeah. Thank you for the question on that. I think what we see in Valentino is the ordinary operating income of the business. And the question then is how you've managed the ordinary operating income of the business. In the case of Valentino, the ordinary operating income of the business was from California sources. So you would say it's gross income from sources within the state. That would be 17951. You would then track the waterfall down to the regulations of 17951 and look at the distributive share income received in the hands of the shareholders.

In contrast, our situation there was a loss in the ordinary operating income. So we're not going to look at the ordinary operating income. We're solely looking at this intangible goodwill income. And that -- we also can look to Valentino because Valentino talks about -- at the end it says that if you have an intangible source at the entity level, then you apply 17952 in the hands of the shareholder, which is exactly what we're directing is the correct application of the law. So it's because of the different character of the income at the entity level that you reach those different rules that you're describing.

Does that address your question, or was there more to it that we can answer for you.

JUDGE LAMBERT: Yeah, no. That answers. Yeah. That makes sense. I see what you're saying that, you know, in your -- what you're saying is it just -- it worked out, and it could be read without any sort of contradictions, basically.

Yeah. Sorry for the confusion, FTB.

So that answers the question. Thanks.

MS. PAGE: Can I add to that, Mr. Lambert -- Judge Lambert? This is Natasha Page for the Franchise Tax Board.

JUDGE LAMBERT: Yes, of course. Yeah.

MS. PAGE: I just wanted to point out that one of the important notes that Mr. Parker just made was that distributive share is taxed under 17951-4. And in the case at hand, we are dealing with distributive share income. So it would also be taxed under 17951-4. And that is the distinction that we're making is that 17951-4 is the more specific statute because it deals with distributive share.

JUDGE LAMBERT: Okay. Thanks.

MR. PARKER: Judge Lambert, can we respond to that real quick, please?

JUDGE LAMBERT: Yeah.

MR. PARKER: Thank you, sir.

So I don't know that we disagree about the fact that it is distributive share. I think we disagree about the components of that distributive share. FTB is arguing that distributive share is a function of California business income as determined under 25120 to 25139. We are saying that distributive share is a function determined at the entity level under the federal rules. The federal wool -- sorry. Not even enough water. I'll take some after I answer your question.

The federal rule say you break out ordinary business income assets of a corporation's intangibles -- intangible assets -- and namely goodwill. And that's that Joint Stipulation Number 22 is the chart. And you can actually also see that in Respondent's Exhibit A, maybe it's the 8594, maybe. It's Respondent's Exhibit B. It's breaking out those different asset classes. And those asset classes define the shareholder is getting a share of each of those asset classes.

Because here we basically have two shareholders that were at the time married. So there was one, Mr. Faries. When Mr. Faries passed away, there was his estate, and there was Mrs. Faries. But they all -- they both get distributive shares of those asset classes. The only asset class that has taxable value to the State of California is that intangible income because the number is that $244 million.

So hopefully that's the distinction -- that creates a distinction between Respondent's position and Appellant's position in this matter.

JUDGE LAMBERT: Okay. Thanks.

Okay. Back to you, Judge Leung.

THE COURT: Thank you, Judge Lambert.

And while Mr. Parker gets a drink of water, I will pose my questions. And for the most part my questions will be for both parties. I'm intrigued by 17952, specifically, the mobilia rule or the intangible will follow the person. Now, reading the 17952 and the mobilia rule itself, it seems to be an all or nothing rule. In other words, no apportionment at all. Would you agree with that, Ms. Roberts?

MS. ROBERTS: Yes, Judge Leung.

THE COURT: Okay. And even if we were to find business situs situation as in Metropoulos, it's still an all or nothing rule?

MR. PARKER: This is Chris Parker. I don't -- so what we see and what we put together in our briefing was when you apply the regulations under Section 17952 to find business situs, then it would have to be that substantial use and value. So you would basically be saying that the substantial use and value, if you were to find business situs in California, is here in California. That -- that would, in our view, would directly contradict the facts and the application of the law the way Holly Sugar, Valentino, and the other cases define it.

But to our understanding, the way 17952 applies and the way mobilia is applied is generally all -- all to one. Now, I will say the California Supreme Court makes reference to Curry v. McCanless in the Holly Sugar and in Miller v. McColgan. And Curry v. McCanless talks about, essentially, double taxation of intangible income and how to address that with mechanisms like the other state tax credit, because you might have different types of tax applying to the same income.

If I recall correctly -- and I don't have Curry off of the top of my head -- there was an income tax and an estate tax from different states that were being applied to the same income. So it depends a little -- there's -- to use Respondent's word from earlier, there's a little more nuance to the question than just, you know, binary determination.

I hope that's helps.

THE COURT: I think it's helpful. Of course, the factor that you talk about, Mr. Parker, the state tax credit. And assuming both states involved, or all the states involved have similar credits available. And of course we know that that's really not the way it is in the 50 states of the United States, but that's an assumption we have to make to cure any type of multiple taxation.

To the Franchise Tax Board the same question. Is the mobilia rule or 17952 all or nothing?

MS. PAGE: Thank you, Judge Leung. This is Natasha Page.

THE COURT: Ms. Page, thank you.

MS. PAGE: As was determined in the concurring opinion in Metropoulos, the goodwill can be located in portions throughout its location because it is an intangible item. So we don't believe that a business situs has to be all or nothing, and that it can be read to be located under an apportionment factor.

THE COURT: So your legal authority would not be under 17952. I notice that in your opening brief that it was stated that if we were to find business situs, the Franchise Tax Board would use Medical's apportionment factor to source, I guess, the six-and-a-half percent to the State of California, but I couldn't find a legal authority for that conclusion. So you're saying that Metropoulos gives us that authority? Of course the only concurring opinion talk about the business situs.

MS. PAGE: No.

THE COURT: You have something else that you can give us if we were going in that direction?

MS. PAGE: It's our position that the assets of goodwill is owned by Medical. And it is assets to the corporation that is the -- as we said earlier, the advantage of the business has acquired, especially, through its brands, et cetera. So that goodwill is located everywhere that the business is located. So it's actually the fundamental definition of goodwill that gives us our authority to place it wherever the business is. And then it is UDITPA that is providing just the location of that business, which is the location of the goodwill.

So it's not that we are arguing that we're finding our authority in UDITPA. We're just approximating, if you will, where the goodwill would be located because it's the company that owns the goodwill. And the definition of goodwill is that idea of where that value is, is located where the business is.

THE COURT: Okay. I'll turn back to the, again, the basics of mobile. I heard two terms mentioned today with respect to mobilia, namely, domicile and residence of the owner of the intangible.

To the Appellants, is it both, either one, or how would you determine what principle would apply? Do we look at the domicile of the owner, or do we look at the residence of the owner?

MS. ROBERTS: Thank you, Judge Leung. We apologize if we may have used some of those terms interchangeably, especially, when talking about some of the case law and where particular individuals were residents. The test under the mobilia rule is the domicile of the -- the owner of the intangible.

THE COURT: Thank you, Ms. Roberts.

And Franchise Tax Board, is that your understanding too? You look at the domicile of the owner of the intangible?

MS. BROSTERHOUS: That's correct.

THE COURT: Okay.

MS. BROSTERHOUS: This is Maria Brosterhous. Sorry.

THE COURT: That's okay, Ms. Brosterhous.

My final question about the mobilia rule, my final question of the day would be given that the fact that both parties agree that there's an all or nothing rule under the mobilia, what would we do when there is a situation where community property comes to play, and one of the spouses lives in California and the owner of the intangible is out of state.

And in this situation where the taxpayer is you can argue whether the apportionment factor is 1.7 percent or 6 and 1/2 percent, clearly not 50 percent. And if you apply the all or nothing rule, you would have to apply -- what would you guys do? I shouldn't say you would have to apply.

What would you, do, Ms. Roberts, in that situation where the owner of the intangible moves out of state, the mobilia rule applies to give that owner 100 percent of the income from the sale of the goodwill, and that owner has got an ex-spouse in California, another community property state?

MR. PARKER: Judge Leung, this is Chris Parker. Those rules are separate and distinct. So the mobilia rule would control the sale; the income of the intangible being directed to the domicile of the out-of-state spouse. The community property rule would then come in and say that under community property reporting principles, it is the community's income, and the community would then have to report the income as a community respectively in their various states, whether that was California or another community property state.

So I -- I don't know that those rules contradict each other. They are separate parts of the code for a reason because multiple states don't have community rules, or they have marital property rules that would be a different treatment. So I think you can look at those rules in concert and say that they can coordinate to produce a tax event where then you would have to evaluate whether you're creating double taxation like we mentioned before, and that other state tax credit issue comes back.

But that's how, I think, it may be applied. But it looks like Respondent may have another idea.

THE COURT: Okay. Ms. Brosterhous or either Ms. Page or Zaychenko. Either one. One of you guys.

MS. BROSTERHOUS: This is Maria Brosterhous. I don't think we disagree that what determines whether community property rules are applied is based on the domicile of the acquiring spouse. And I think that's what Mr. Parker was saying.

THE COURT: Okay. As I promised, that's my last question, and I don't believe my fellow panel members have anything else.

Judge Akin?

JUDGE AKIN: Judge Akin speaking. I don't have any additional questions. Thank you.

THE COURT: Okay. Thank you, Judge Akin.

Judge Lambert, anything further?

JUDGE LAMBERT: This is Judge Lambert. No questions. Thanks.

THE COURT: Thank you, Judge Lambert.

On behalf of OTA, we would like to express our appreciation to both parties for putting on well, thought-out presentations.

We will endeavor to get a decision out in this case within 100 days. The record is closed, and the hearing has ended.

I wish you all a good day. Thank you very much.

(Proceedings adjourned at 4:35 p.m.)

<u>HEARING REPORTER'S CERTIFICATE</u>

I, Ernalyn M. Alonzo, Hearing Reporter in and for the State of California, do hereby certify:

That the foregoing transcript of proceedings was taken before me at the time and place set forth, that the testimony and proceedings were reported stenographically by me and later transcribed by computer-aided transcription under my direction and supervision, that the foregoing is a true record of the testimony and proceedings taken at that time.

I further certify that I am in no way interested in the outcome of said action.

I have hereunto subscribed my name this 28th day of October, 2021.

____
ERNALYN M. ALONZO
HEARING REPORTER