OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18043049
T. FARIES AND	)
ESTATE OF D. FARIES JR. (DEC'D)	)
	)
	)

OPINION

Representing the Parties:

For Appellants:	Carley Roberts, Esq. Chris Parker, Esq.
For Respondent:	Maria Brosterhaus, Tax Counsel IV Natasha Page, Tax Counsel IV Rafael Zaychenko, Tax Counsel III Mira V. Coutinho, Tax Counsel
For Office of Tax Appeals:	William J. Stafford, Tax Counsel III

T. LEUNG, Administrative Law Judge: Pursuant to section 19045 of the Revenue and Taxation Code (R&TC), T. Faries and Estate of D. Faries Jr. (Dec'd) (appellants)[1] appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $1,132,675, plus applicable interest, for the 2011 taxable year.

Administrative Law Judges Cheryl L. Akin, Josh Lambert, and Tommy Leung held a virtual hearing for this matter on September 29, 2021. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUES

1. Whether individuals who are subject to the California Personal Income Tax Law (Part 10 of the R&TC) must also apply the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC sections 25120 – 25139) of the Corporation Tax Law (Part 11 of the R&TC) with respect to their pro rata share of items of income, loss,

[1] Hereinafter, D. Faries, Jr. and/or his estate will be referred to as "appellant-husband" and T. Faries will be referred to as "appellant-wife"—and collectively they will be referred to as "appellants."

deduction, or credit from an S corporation's sale of its assets. If so, then how are the UDITPA provisions applied to individuals under the Personal Income Tax Law (PITL)?

2. Whether appellant-husband's pro rata share of gain from his S corporation's (Medical) sale of its goodwill in 2011 is California-source income.
3. Whether appellants have demonstrated by clear and convincing evidence that excluding gross receipts of $249,146,367 from the sales factor causes Medical's California apportionment percentage (as adjusted by FTB during audit) to unfairly reflect the extent of Medical's business activities in California for the 2011 taxable year.

FACTUAL FINDINGS

1. Appellant-husband was the 100 percent shareholder of Medical Company, Inc. (Medical), a Virginia corporation incorporated in 1991, with an S election in effect as of January 1, 1997. Medical manufactured, assembled, marketed, distributed, provided, and sold medical supplies used in surgical procedures, and it did business in multiple states, including California.
2. On March 3, 2011, Medical sold substantially all of its business assets to a third-party (Buyer) for $259,804,108, which consisted of (1) cash of $259,500,000, and (2) a post-closing adjustment of $304,108. Medical received the sale proceeds in 2011. The assets sold consisted of tangible personal property used in the medical supply business, certain intellectual property, and goodwill.[2] Medical's board and appellant-husband, as sole shareholder of Medical, approved the transaction.
3. Appellant-husband and appellant-wife were nonresidents of California during 2011. A few months after the sale closed, appellant-husband passed away. As a result of his death, the shares in Medical passed to appellant-wife and appellant-husband's estate.
4. Medical filed a 2011 Form 100S, California S Corporation Franchise and Income Tax Return. On line 4, Medical reported a net capital gain of $244,277,284. On Schedule D-1, Sale of Business Property, Medical reported $1,805,458 in gain from the sale of patents and tangible personal property, and $243,983,750 in gain from the sale of

[2] Medical allocated the total sales proceeds of $259,804,108 as follows: $5,593,593 to accounts receivable; $2,715,557 to inventory; $7,511,208 to patents and other assets; and $243,983,750 to goodwill.

goodwill.[3] Exclusive of the gains from the sale of its assets, Medical recognized an ordinary loss of $12,967,375 for the 2011 taxable year. On Schedule R, Apportionment and Allocation of Income, Medical reported business income of $229,458,019 on line 17, and an apportionment percentage of 1.7362 on line 18a. On Schedule R-1, Apportionment Formula, Medical reported gross receipts of $249,146,367 from the sale of its assets.

5. Medical filed a 2011 Form 1120S, U.S. Income Tax Return for an S Corporation for federal tax purposes. On line 9 of Schedule K, Shareholders' Pro Rata Share of Items, Medical reported a net Internal Revenue Code (IRC) section 1231 gain of $244,277,818.

6. FTB audited Medical's 2011 Form 100S.[4] The audit resulted in an adjustment to exclude gross receipts of $249,146,367 from the sales factor denominator.[5] FTB excluded the gross receipts of $249,146,367 from the sales factor denominator because Medical's sale of its assets was an "occasional" sale under California Code of Regulations, title 18, (Regulation) section 25137(c)(1)(A). That adjustment increased Medical's overall California apportionment percentage from 1.7362 percent (as reported by Medical) to 6.5033 percent (as determined by FTB), and in turn, resulted in Medical's net income for California purposes increasing from $3,983,850.00 to $14,922,343.35.[6]

7. FTB issued a Notice of Proposed Assessment (NPA) to Medical that imposed additional tax of $164,077. Medical did not protest the NPA and, therefore, the NPA became a final assessment.

8. In connection with the audit of Medical, FTB conducted an audit of appellants' joint 2011 California Nonresident Income Tax Return (Form 540NR). The audit resulted in

[3] In addition to the $1,805,458 gain from the sale of patents and tangible personal property, the Schedule D-1 reports a gain of $13,107 attributable to a sale of vehicles, which is a separate transaction from the asset sale at issue in this appeal. The Schedule D-1, Part I, shows a net gain of $243,983,189, which was calculated in a supporting schedule as a gain of $243,983,750 from the sale of goodwill, less losses totaling $561 from "other assets."

[4] In computing its California apportionment percentage, Medical used a three-factor formula, which was comprised of a property factor, a payroll factor, and a double weighted sales factor. The audit found no issues regarding the property factor and the payroll factor.

[5] As originally filed, Medical's 2011 Form 100S did not include this amount as a California gross receipt in the numerator of its sales factor.

[6] Medical had previously reported a California apportionment factor of 6.3915 percent for the 2010 taxable year.

FTB issuing an NPA to appellants proposing additional tax of $1,132,675, plus applicable interest. FTB stated that it was imposing the additional tax because Medical's apportioned California gain from the sale of its business assets is a flow-through item on which appellants are subject to California personal income tax. After receiving the NPA, appellants filed a timely protest. At the conclusion of the protest proceedings, FTB affirmed the NPA in a Notice of Action.

DISCUSSION

Issue 1: Whether individuals who are subject to the California PITL (Part 10 of the R&TC) must also apply the provisions of UDITPA (R&TC sections 25120 – 25139) of the Corporation Tax Law (Part 11 of the R&TC) with respect to their pro rata share of items of income, loss, deduction, or credit from an S corporation's sale of its assets. If so, then how are the UDITPA provisions applied to individuals under the PITL?

Subchapter S was added to the Internal Revenue Code (IRC) by the Technical Amendment Act of 1958. (Pub. L. No. 85-866 § 64, 72 Stat. 1606, 1650 (1958).) California's S corporation provisions were later enacted and added to the Corporation Tax Law (CTL) in 1987 (see Stats.1987, ch. 1139, § 55); specific conformity under the PITL was enacted in 1993 (see Stats.1993, ch. 873 (A.B.35), § 7). California imposes a 1.5 percent tax directly on the S corporation and then simultaneously taxes the S corporation's individual shareholders on their pro rata share[7] of the S corporation's items of income, loss, deduction, or credit pursuant to the PITL. (R&TC, §§ 23800, 23802(b)(1); *Heller v. Franchise Tax Board* (1994) 21 Cal.App.4th 1730, 1734.)

California generally incorporates the federal pass-through provisions of IRC section 1366(b), which provide that the character of any item included in a shareholder's pro rata share must be "determined as if such item were realized directly from the source from which it

[7] "An S corporation must report, and a shareholder is required to take into account in the shareholder's return, the shareholder's pro rata share, whether or not distributed, of the S corporation's items of income, loss, deduction, or credit . . . ." (Treas. Reg. § 1.1366-1(a)(1).)

was realized by the corporation, *or* incurred in the same manner as incurred by the corporation."[8] (IRC, § 1366(b), emphasis added; see also R&TC, §§ 17087.5, 23800, 23801.) Specifically, under the PITL, "[s]ubchapter S of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to tax treatment of "S corporations" and their shareholders, shall apply, *except as otherwise provided under this part or Part 11 (commencing with Section 23001).*" (R&TC, § 17087.5, emphasis added.)

California imposes its personal income tax on the taxable income of every nonresident to the extent the nonresident derives the taxable income from sources within California. (R&TC, §§ 17041(b), (i) and 17951(a).) For purposes of determining the taxable income of a nonresident or part-year resident, the amount of income from sources within and without California "shall be allocated and apportioned under rules and regulations prescribed by [FTB]." (R&TC, § 17954.)

With respect to intangibles, "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state . . . ."[9] (R&TC, § 17952.) Intangible personal property acquires a business situs in California if (1) the intangible property is employed as capital in California or (2) the possession and control of the property have been localized in connection with a business, trade, or profession in California so that its substantial use and value attach to and become an asset of the business, trade, or profession in California. (Cal. Code Regs., tit. 18, § 17952(c).)

As to nonresident shareholders of S corporations, FTB's regulation provides a two-step analysis to determine what portion of income earned through an ownership interest in a multistate S corporation (i.e., an S corporation doing business both within and without

[8] This provision contains two disjunctive approaches. In Approach 1, the term "source" addresses whether the character (see IRC, § 1221) of the item of income passing through from the S corporation to the shareholder retains the same character in the hands of the shareholder, for example, capital or non-capital gain, leading to capital gain or ordinary income, respectively (see Treas. Reg. § 1.1366-1(b)(1)). Approach 2 puts the shareholder in the shoes of the S corporation that, at the end of the day, has the corporation, not the individual shareholder, selling the assets, and not the other way around as appellants suggest.

[9] This is also commonly referred to as the "*mobilia* rule." We note that the pertinent language of R&TC section 17952 was originally enacted in 1937 as part of section 7(f) of the California Personal Income Tax Act (the Act) and was later codified as former R&TC section 17212 in 1943, effective as of June 5, 1945. This was well before California enacted UDITPA in 1966 and long before California enacted its S corporation rules in 1987, which included California's general incorporation of the federal pass-through provisions of IRC section 1366(b) that same year. We further note that the relevant and pertinent language of former R&TC sections 7(f) and 17212 is substantially similar in all material respects to the language in current R&TC section 17952.

California) is from California sources. (See Cal. Code Regs., tit. 18, § 17951-4(d), (f).) Generally, the two-step analysis provides that the income of the multistate S corporation is first characterized at the S corporation level according to the S corporation's activities—i.e., the income is characterized as either "business income" or "nonbusiness income" under the provisions of UDITPA—and second, such income is sourced to geographic locations according to the rules applicable to that type of income. In this second step, business income is apportioned among the jurisdictions in which the S corporation does business in accordance with UDITPA and the regulations adopted thereunder, while nonbusiness income is sourced according to the sourcing rules of R&TC sections 17951 through 17955 and the regulations adopted thereunder, as if the income producing activity were undertaken by the S corporation shareholder in his/her individual capacity. Once the amount of the S corporation's California source income is determined, the S corporation's nonresident shareholder is subject to California personal income tax on that shareholder's pro rata share of that California source income. (See Cal. Code Regs., tit. 18, § 17951-4(d), (f).)

Under UDITPA, business income is defined as:

> [I] ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (R&TC, § 25120(a).)

Nonbusiness income is defined under UDITPA as "all income other than business income." (R&TC, § 25120(d).)

<u>Analysis</u>

The two-step analysis, as applicable to S corporations and as provided for in the Regulation above, was promulgated after the California Court of Appeal set forth a similar two-step process in *Valentino v. Franchise Tax Board* (2001) 87 Cal.App.4th 1284 (*Valentino*). In *Valentino*, the court determined that because California generally conforms to IRC section 1366(b), (and because geographic sourcing is not a federal issue with respect to S corporations),[10] a two-step process is required to properly source a nonresident shareholder's

[10] Among other things, an S corporation must be a domestic corporation that has no "nonresident alien as a shareholder." (See IRC, §1361(b)(1).)

pro rata share of income from an S corporation. (*Id*., at pp. 1288, 1294 & 1296.) Specifically, the court concluded that the source of a shareholder's pro rata share of S corporation income is "first characterized by reference to corporate-income-producing activities . . ., and then as characterized is sourced to locations according to the rule that applies to that type of income." (*Id*., at p. 1296.)

The taxpayers in *Valentino* were Florida residents who owned stock in a Delaware S corporation that was qualified to do business in California. The S corporation did business solely within California. The taxpayers received their pro rata share of income from the S corporation's ongoing business operations, and the taxpayers argued that as nonresidents of California, they were not required to pay a California tax on income derived from their ownership of stock of a foreign S corporation doing business in California unless the intangible property (stock) acquired a business situs in California, citing R&TC section 17952. (*Valentino*, at pp. 1286-1287.)

The court examined the rules for sourcing of income for S corporations and found that S corporations are a "[c]ode-created hybrid combining traits of both corporations and partnerships." (*Valentino*, at p. 1289.) The court then analyzed California's general incorporation of the federal pass-through provisions of IRC section 1366(b) and reasoned that a two-step process, as set forth in the court's opinion, is required to properly source a nonresident shareholder's pro rata share of income from an S corporation. (*Id*., at pp. 1289-1294, 1296.) The court then applied its two-step process and affirmed the judgment of the lower trial court, which held that the taxpayers were required to report their pro rata share of the S corporation's income as gross income from sources within California. (*Id*., at p. 1297.)

While *Valentino* involved the sourcing of operating income earned by a non-apportioning S corporation, the decision nevertheless made statements regarding the sourcing of income from intangibles. Appellants rely heavily on such statements (which some, including FTB, refer to as *dicta*) from *Valentino*, wherein the court stated, in part, that California's general incorporation of the federal pass-through provisions of IRC section 1366(b) did not displace R&TC section 17952, which the court stated continues to apply in those situations it did before the enactment of the S corporation provisions:

> <u>In other words, section 17952 is not displaced by Internal Revenue Code section 1366(b), because it continues to apply in those situations it did before the enactment of the S corporation provisions—that is, to determine the source of</u>

> stock dividends and income from the sale of stock. (*Valentino*, at p. 1296, underscoring supplied.)

Appellants also note that the court in *Valentino* stated:

> Consequently, section 17952 never applies to a shareholder's share of S corporation income ***unless*** the corporate income itself is derived from intangibles. (*Valentino*, at p. 1292, emphasis added.)

Appellants argue that the *Valentino* court's use of the word "unless" in the above-listed statement indicates that the court recognized there can be instances when the characterization of income at the S corporation level results in the application of R&TC section 17952.

Relying on R&TC section 17952 and the "unless" language in *Valentino*, appellants assert that as nonresidents of California they are not required to pay a tax on any portion of the gain from the sale of goodwill by Medical unless the intangible property itself (i.e., the goodwill) acquired, in whole or in part, a business situs in California, which they assert did not happen.

In *Appeals of The 2009 Metropoulos Family Trust; The Evan D. Metropoulos 2009 Trust*, 2019-OTA-385P (*Metropoulos*), the Office of Tax Appeals (OTA) applied *Valentino* and Regulation section 17951-4 by first characterizing an S corporation's income as either "business income" or "nonbusiness income" under UDITPA, and second, sourcing such income according to the rules applicable to that type of income. As the income at issue was business income, OTA determined that the taxpayer-shareholders were subject to California income tax on their respective pro rata shares of the S corporation's business income that was apportioned to California.

The taxpayer-shareholders in *Metropoulos* were electing small business trusts that owned interests in a Delaware S corporation that did business in California and other states. The S corporation sold its interest in a wholly owned subsidiary in a transaction that was treated as a sale of assets for income tax purposes. The sale resulted in a capital gain of more than $600 million. The taxpayer-trusts argued that the gain from the sale of goodwill (i.e., an intangible) should not be apportioned under UDITPA but, rather, should be allocated to the taxpayer-trusts' respective commercial domiciles, which were states other than California. (*Metropoulos*, at pp. 2-3, 5.)

The majority opinion held that the gain from the sale of the goodwill was properly characterized at the S corporation level as business income and had to be apportioned among the jurisdictions in which the multistate S corporation did business. (*Metropoulos*, at pp. 7-8.) The general paradigm of characterizing income of a multistate business as either business income or nonbusiness income, as referred to in *Metropoulos*, is provided for in UDITPA, which California enacted in 1966, effective for taxable years beginning on or after January 1, 1967. (See Stats. 1966, Ch. 2.)

The *Metropoulos* concurrence reached the same conclusion as the majority; however, it used a different legal analysis. The concurrence determined that (1) the goodwill (intangible property) had partially acquired a business situs in California, and (2) the gain from the sale of goodwill should be sourced to California using the same apportionment percentage the S corporation used on its original return such that the resulting tax liability was the same as the majority's methodology. (*Metropoulos*, at pp. 10-13.)

While *Metropoulos* accurately reflects the mechanical outcome if UDITPA is to be applied to determine the amount of California-source income, appellants argue that the opinion applies Regulation section 17951-4(f) in lieu of R&TC section 17952 without legal authority; this is the main issue in today's appeal, which we endeavor to resolve below. Appellants further assert that California's PITL, located at R&TC sections 17001 et seq., and California's CTL, located at R&TC sections 23001 et seq., separately conform to the federal S corporation pass-through provisions of IRC section 1366(b), resulting in two different methods for characterizing income from the sale of Medical's goodwill, with (1) the CTL authorizing such income to be characterized at the S corporation level as business or nonbusiness income under UDITPA solely for purposes of computing the 1.5 percent tax that California imposes directly on S corporations, and (2) the PITL mandating that, as to appellants, FTB must characterize such income at the shareholder level as intangible income that is sourced according to the provisions of R&TC section 17952. FTB argues that Regulation section 17951-4(f) specifically addresses the issues in this appeal and should be applied over the more general *mobilia* rule in R&TC section 17952.

Preliminarily, we believe that OTA's precedential opinion in *Metropoulos* controls the outcome of this appeal. In addition, although the parties do not dispute that the *mobilia* rule, and the business situs exception, is literally an all or nothing rule (i.e., 100 percent of the income is sourced to either the nonresident's state of domicile or the state where the intangible has attained a business situs), FTB nevertheless asserts (without citing to legal authority) that if the business situs exception applied, it would apportion the Medical gain using Medical's 2011 apportionment factor.

Although the positions staked out by the parties have some merit, they suffer from some fatal flaws.[11] While we agree with appellants' observation that the PITL and CTL offer different methods for sourcing the S corporation's shareholders' pro rata shares of their respective items of income, loss, deduction, or credit, we disagree that the PITL mandates that R&TC section 17952 be used with respect to intangibles. FTB's approach and *Metropoulos* do not specifically address the issue of the appropriateness of applying a regulation instead of a statutory mandate (i.e., R&TC section 17952), as well as lacking legal authority to apportion Medical's gain if the goodwill was found to have a business situs in California.

As stated above, California's PITL conforms to the federal subchapter S provisions. (See R&TC, § 17087.5.) However, this conformity is not unconditional; in the conforming statute, the law subordinates the federal subchapter S provisions, including IRC section 1366, to the PITL and the CTL. (*Ibid*.) In so doing, California's statutory scheme bridges the gap between the PITL and the CTL; in this instance, R&TC section 17087.5 triggers the sourcing rules of the PITL for nonresidents, which reside in chapter 11 of part 10 of the R&TC (sections 17951

[11] The parties disagree about the extent of appellant-husband's involvement with Medical's sale of its assets. We disagree with the parties' emphasis on this point as the mission of this panel is to determine the geographic source of appellant-husband's pro rata share of Medical's income, which is derived from the sale of its assets. Put a different way, the record shows that Medical filed a Form 100S reporting gain from the sale of its assets, and Medical issued a Form K-1 to appellant-husband, reporting out his pro rata share of that gain. There is no documentary evidence indicating that appellant-husband sold assets that he owned in his own name. While it is true that appellant-husband was the sole shareholder of Medical, he chose to place his assets in corporate solution and now appellants are obliged to abide by the consequences of that decision, and we cannot ignore the existence of Medical. (See *Moline Properties, Inc. v. Commissioner* (1943) 319 U.S. 436.); *Appeal of Sierra Pacific Industries* (94-SBE-002) 1994 WL 14076.)

Regardless of the degree of appellant-husband's participation in the sale of Medical's assets, there is no dispute that Medical was the seller, and Medical issued a K-1 to appellant-husband reflecting his pro rata share of Medical's items of income, loss, deduction, or credit. The record also shows that appellants recognized income based on appellant-husband's pro rata share of Medical's items of income, loss, deduction, or credit, and not because appellants realized income from a direct disposition of assets by appellant-husband. Thus, we place little emphasis on the parties' disagreement on whether appellant-husband personally participated in the sale of Medical's assets or whether the outcome of this appeal and *Metropoulos* turns on only the S corporation being engaged in the transaction. Our ruling today is based on the fact that Medical's shareholder received a pro rata share of income from his S corporation, an income recognition event regardless of whether appellants actually received a distribution, which takes us back to R&TC section 17087.5.

through 17955, inclusive), and UDITPA, which reside within the CTL and codified as sections 25120 through 25139, inclusive.[12]

UDITPA applies in this case because Medical did business both within and without California. (See R&TC, § 25101.) Ultimately, we are confronted with two sourcing rules, UDITPA's and the PITL's nonresident sourcing provisions. FTB's regulations, adopted pursuant to a legislative grant of authority under R&TC sections 17954[13] and 19503, resolve this duality by telling us that, for S corporations that carry on a unitary business within and without California, the amount of the nonresident shareholder's pro rata share of income to be sourced to California is to be determined by using UDITPA. (See Cal. Code Regs., tit. 18, § 17951-4(f), (d).)

Procedurally, the parties posit, and we agree, that OTA lacks the authority to invalidate FTB's regulations. (See Gov. Code, § 11350; *Appeal of Talavera*, 2020-OTA-022P; *contra Appeal of Save Mart Supermarkets* (2002-SBE-002) 2002 WL 245682.) Moreover, read together, R&TC sections 17087.5 and 17954, along with Regulation section 17951-4(f), provide us with the proper statutory framework to integrate the UDITPA rules for determining the California source of a nonresident shareholder's pro rata share of an apportioning S corporation. This statutory scheme resolves appellants' concerns over FTB's use of its regulations instead of R&TC section 17952, and answers this very same question that was left open in *Metropoulos*. Thus, Regulation section 17951-4(f) shall be used to determine the California source of a nonresident shareholder's pro rata share of his/her apportioning S corporation's items of income, loss, deduction, or credit, regardless of whether the S corporation's items of income, loss, deduction, or credit are derived from the disposition of tangible or intangible assets, and regardless of whether the S corporation's intangible asset has attained a business situs in California. The shareholder's pro rata share of his/her apportioning S corporation's business

[12] Further, we note that R&TC section 23801(b) provides that an S corporation for federal income tax purposes shall be an S corporation for purposes of both the PITL and the CTL, which weighs against the statutory distinction appellants attempt to make between the PITL and the CTL. R&TC section 23801(b) provides:

> A corporation that is an "S corporation" for federal income tax purposes, shall be an "S corporation" for purposes of [the PITL] . . . and . . . [the CTL], and its shareholders shall be shareholders of an "S corporation" without regard to whether the corporation is qualified to do business or is incorporated in this state. (R&TC, § 23801(b).)

[13] Also known as "quasi-legislative rules," such regulations "have the dignity of statutes." See *Yamaha Corp. of Am. v. State Bd. of Equalization* (1998) 19 Cal. 4th 1, 3.

income shall be sourced using UDITPA, and nonbusiness income shall be sourced using the nonresident rules contained in R&TC sections 17951 through 17955, inclusive.

The superseding language in R&TC section 17087.5 renders moot appellants' reliance on IRC section 1366(b), based on language from *Valentino*, to source their pro rata share of Medical's income. Simply put, California's PITL and CTL contain methods to geographically source an apportioning S corporation's nonresident shareholder's pro rata share of income which are incompatible with IRC section 1366(b); therefore, California's sourcing rules will apply. (See R&TC, § 17087.5.)

In addition, because the pertinent language of R&TC section 17952 was first enacted (and subsequently codified as part of the R&TC) well before California enacted UDITPA in 1966 and long before California enacted its S corporation rules in 1987, the fact that the language of R&TC section 17952 does not specifically address the two-step process in relation to a nonresident who receives a pro rata share of income from an S corporation doing business both within and without California should not be interpreted as evidence the Legislature intended to assign income using solely an all or nothing approach (like the *mobilia* rule) to pass through income from an S corporation. Curiously, appellants point to the last sentence in *Valentino* to support their cause, but that sentence (*Valentino*, *supra*, at p. 1296, quoted and underscored above) suggests that the applicability of R&TC section 17952 post-S corporation conformity is limited to sourcing the income from the sale of the S corporation stock and dividends distributed with respect to that stock. Furthermore, applying the cardinal principle of legislative interpretation—i.e., ascertainment of the intent of the legislative body—we note that UDITPA itself commands that "[t]his act *shall* be so construed as to effectuate its general purpose to make uniform the law of those states which enact it." (R&TC, § 25138, emphasis supplied.) OTA's opinion in *Metropoulos* reaches that result. In comparison, the interpretation urged upon us by appellants would be contrary to the uniformity that is the objective of UDITPA. In addition, we note that many of the cases relied upon by appellants—e.g., *Holly Sugar Corp. v. Johnson* (1941)

18 Cal.2d 218; *Miller v. McColgan* (1941) 17 Cal.2d 432—were pre-UDITPA cases that focused on the principles of business situs or the *mobilia* rule.[14] While R&TC section 17952 continues to apply the *mobilia* rule, it does not override California's adoption of UDITPA, which generally requires the apportionment of unitary business income earned by multistate businesses.

Moreover, recent history informs us that taxing schemes which take an "all or nothing" approach are vulnerable to legal attack.

> The negative or dormant implication of the Commerce Clause prohibits state taxation [citation], or regulation [citation], that discriminates against or unduly burdens interstate commerce and thereby "imped[es] free private trade in the national marketplace." (*General Motors Corp. v. Tracy* (1997) 519 U.S. 278, 287, 117 S.Ct. 811, 136 L.Ed.2d 761.) State statutes imposing taxes on income earned outside the state, or imposing a tax on total income without apportionment to activities within the state, have long been held to violate the Commence [sic] Clause. (See, e.g., *Gwin, Etc., Inc. v. Henneford* (1939) 305 U.S. 434, 439–440, 59 S.Ct. 325, 83 L.Ed. 272 [state tax "measured by the entire volume of the interstate commerce" in which taxpayer participates and "not apportioned to its activities within the state" violates the Commerce Clause]; *Greyhound Lines v. Mealey* (1948) 334 U.S. 653, 662–664, 68 S.Ct. 1260, 92 L.Ed. 1633 [tax on gross receipts from transportation violates Commerce Clause to extent receipts were attributable to activities outside the state].)

(*Ventas Finance I, LLC v. Franchise Tax Bd.* (2008) 165 Cal.App.4th 1207, 1218 (*Ventas*).)

What *Ventas* teaches us is that taxing schemes that do not have some type of an apportionment feature tend to be distortive and reach extraterritorial income, thereby making them disfavored. Therefore, given: (1) that R&TC section 17087.5 resolves any conflict between California's adoption of the federal S corporation provisions and the PITL/CTL in favor of the PITL/CTL; (2) the existence of a lawfully adopted regulation (Regulation section 17951-4(f)), made applicable to chapter 11 of the PITL pursuant to R&TC section 17954, directing us to use UDITPA instead of the *mobilia* rule; and (3) the legal pitfalls potentially implicated by the application of the *mobilia* rule to the business income of an S corporation, we find that FTB

[14] In addition, appellants cite *Appeal of Bass* (89-SBE-004) 1989 WL 96906, a decision issued by the California State Board of Equalization (BOE) on January 25, 1989—but that decision does not address UDITPA. Appellants also cite *Appeals of Ames et al.* (87-SBE-042) 1987 WL 50165, a decision issued by the BOE on June 17, 1987—but that decision involved gains the taxpayers realized on sale of their limited partnership (LP) interests, not distributive share income from the LP's sale of its assets. In addition, appellants cite *Appeal of Venture Communications, Inc.*, a "Summary Decision" issued by the BOE on February 5, 2003; however, the *Venture* Summary Decision specifically states that it is "Not to be Cited as Precedent."

properly applied UDITPA to source appellants' pro rata share of Medical's income from the sale of its assets.

Issue 2: Whether appellants' pro rata share of gain from their S corporation's sale of its goodwill is California-source income.

Next, turning to the issue of whether FTB properly characterized the gain from sale of Medical's goodwill as business income under UDITPA (as opposed to characterizing the gain as nonbusiness income), we observe that in *Appeal of Borden, Inc*. (77-SBE-007) 1977 WL 3818 (*Borden*), the BOE specifically addressed whether gain from the sale of goodwill was properly included in the calculation of a taxpayer's "business income." The BOE first noted that R&TC section 25120(a) expressly provides that "business income" includes gain from the sale of tangible property, as well as gain from the sale of intangible property (such as goodwill). The BOE then found that the taxpayer's gain from the sale of goodwill was properly included in the calculation of the taxpayer's "business income," reasoning that "goodwill is so essential to the viable conduct of a business that it has been held to be inseparable from the business as a whole."

In a similar manner to the BOE's holding in *Borden*, we find that the goodwill in the current appeal was developed from, and essential to, the conduct of Medical's business and therefore the gain from the sale of Medical's goodwill constitutes business income under UDITPA. Moreover, appellants' contention that goodwill is an intangible does not give them a path to the *mobilia* rule. As noted above, UDITPA provides that gain from the sale of an intangible can produce business income, and geographic sourcing under Regulation section 17951-4(d) depends on whether the income in question is business or nonbusiness income, and not whether the property being disposed of is tangible or intangible property.

Furthermore, we note that Medical, in fact, reported the gain from the sale of its goodwill as business income on a Schedule D-1. In addition, in accordance with California's adoption of UDITPA, we find that Medical's business income from the gain on the sale of Medical's goodwill must be apportioned among the jurisdictions in which Medical did business. (See *Metropoulos*, at p. 8.)

Finally, appellants' concerns regarding the use of a nonresident taxpayer's entire taxable income to determine the rate of tax (R&TC section 17041(b)) is not novel. Nevertheless, this essential part of the so-called "California method" has been sustained by the courts. (See *Brady* *v. New York* (1992) 80 N.Y.2d 596, cert. den. (1993) 509 U.S. 905; see also *Appeal of Million*, (87-SBE-036) 1987 WL 59534.)

In summary, we find that:

- Pursuant to R&TC sections 17087.5 and 17954, nonresident shareholders of apportioning S corporations must apply UDITPA to determine the California source of their pro rata share of income, loss, deduction, or credit, even though they are also subject to the PITL.
- Regulation section 17951-4(f) and (d) provides guidance on how the CTL is to be applied to the nonresident shareholders of an apportioning S corporation.
- The gain from the sale of Medical's goodwill constitutes apportionable business income and appellants' pro rata share of Medical's apportioned California business income constitutes California source income.

<u>Issue 3: Whether appellants have demonstrated with clear and convincing evidence that excluding gross receipts of $249,146,367 from the sales factor causes the S corporation's California apportionment percentage (as adjusted by FTB during audit) to unfairly reflect the extent of the S corporation's business activities in California for the 2011 taxable year</u>.

In computing its California apportionment percentage, Medical used a three-factor formula, which was comprised of a property factor, a payroll factor, and a double weighted sales factor. FTB found no issue regarding the property and payroll factors. Thus, only the sales factor is at issue in this appeal.

Generally, under California's standard apportionment formula, sales of intangible property are included in the sales factor. In relevant part, "sales" means "all gross receipts" not specifically allocated. (R&TC, § 25120(f)(1); Cal. Code Regs., tit. 18, § 25134(a).) The term "gross receipts" is all-inclusive and thus includes all gross receipts of the taxpayer. (*Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 756-759 (*Microsoft*); see also *Appeal of Robert Half International Inc. and Subsidiaries*, 2019-OTA-330P.)

As part of its special apportionment regulations, California has adopted the "occasional sale" rule. (R&TC, § 25137; Cal. Code Regs., tit. 18, § 25137(c)(1)(A).) FTB's occasional sale regulation provides that "substantial amounts of gross receipts aris[ing] from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business . . . shall be excluded from the sales factor." (Cal. Code Regs., tit. 18, § 25137(c)(1)(A).) If the elements of the regulation are met, receipts from the occasional sale are not included in either the numerator or denominator of the taxpayer's sales factor. (*Ibid.*) Under the regulation, "a sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole." (Cal. Code Regs., tit. 18, § 25137(c)(1)(A)(1).) In addition, "a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently." (Cal. Code Regs., tit. 18, § 25137(c)(1)(A)(2).)

When a special apportionment rule is adopted by regulation, that regulation becomes the broadly applicable rule by which a taxpayer calculates its apportionment factor, and that rule replaces the general apportionment rules. (*Appeal of Fluor Corporation* (95-SBE-016) 1995 WL 799363 (*Fluor*).) Once it is determined that a special rule is applicable to a particular situation, the special apportionment rule becomes the standard rule that taxpayers must apply. (*Ibid.*) Any party wishing to deviate from the method prescribed by the special apportionment rule is then required to "establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's business activities in this state." (*Ibid.*; see also *McDonnell Douglas Corp. v. Franchise Tax Bd.* (1968) 69 Cal.2d 506.)

Later, the BOE indicated that R&TC section 25137 applies when the standard apportionment provisions "produce inequitable results when applied to unusual factual situations." (*Appeal of Crisa Corporation* (2002-SBE-004) 2002 WL 1400003 (*Crisa*).) Elaborating further, the BOE stated:

> The central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula. (*Crisa, supra*.)

The party invoking R&TC section 25137 must prove by clear and convincing evidence that (1) "the approximation provided by the standard formula is not a fair representation," and (2) the party's "proposed alternative is reasonable." (*Microsoft* at p. 765.) "What must be shown is sufficient distortion that appellant's business activity in the state is not fairly reflected." (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc*. (89-SBE-017) 1989 WL 95886 (*Merrill Lynch*).)

As noted above, FTB audited Medical's 2011 Form 100S. The audit resulted in an adjustment to exclude gross receipts of $249,146,367 from the sales factor denominator.[15] FTB excluded the gross receipts of $249,146,367 from the sales factor denominator because Medical's sale of its assets was an "occasional" sale under Regulation section 25137(c)(1)(A). That adjustment increased Medical's overall California apportionment percentage from 1.7362 percent (as reported by Medical) to 6.5033 percent (as determined by FTB), and in turn, resulted in Medical's net income for California purposes increasing from $3,983,850.00 to $14,922,343.35.

Here, there is no dispute that gross receipts from the sale of Medical's assets were substantial, and that the sale of Medical's assets was occasional, as it was a single sale of Medical's assets and fell outside of Medical's normal course of business. (See Cal. Code Regs., tit. 18, § 25137(c)(1)(A)(1) & (2).) Therefore, the occasional sale rule is the standard rule that appellants must apply unless they can show otherwise. (*Fluor*, *supra*.)

Appellants assert, however, that excluding gross receipts totaling $249,146,367 from the sales factor denominator causes distortion, such that the California apportionment percentage (as adjusted by FTB during audit) unfairly reflects the extent of Medical's business activities in California for the 2011 taxable year. Specifically, appellants assert that the sale of Medical's assets generated a large gain as Medical's assets were sold for a total amount of consideration well in excess of the total adjusted bases for those assets, with goodwill, in fact, being sold for a gain of $243,983,750. In comparison, appellants note that the income Medical earned from its ordinary business operations for the 2011 taxable year (i.e., income exclusive of the gain Medical realized from the sale of its business assets) generated a net loss of $12,967,375. Appellants argue that FTB's recalculation of the sales factor percentage is distortive because FTB uses only gross receipts from Medical's *unprofitable* ordinary business operations to compute the sales factor, and then uses that sales factor to apportion Medical's gain from the sale of its assets. In short, appellants assert that FTB is using a sales factor that is derived from "low margin" ordinary business operations to apportion income derived, to a large extent, from "high margin" sales (i.e., the gain Medical realized on the sale of its assets), resulting in distortion. Appellants further contend that FTB's use of the adjusted sales factor violates the principle of external consistency, which requires that "the factor or factors used in the apportionment formula

[15] None of these amounts was included in the sales factor numerator.

must actually reflect a reasonable sense of how income is generated." (*See Container Corp. of America v. Franchise Tax Bd.* (1983) 463 U.S. 159, 169 (*Container*).)[16]

Appellants contend that the problem of using their "low margin" daily business activities to apportion income from the "high margin" one-time business asset sale is discussed in the California Supreme Court's decision in *Microsoft*, *supra*, wherein the court held that exclusion from the taxpayer's sales factor of gross receipts attributable to short term investments was proper because the inclusion of such receipts in the taxpayer's sales factor created distortion, as the short term investments generated minimal income (less than 2 percent of income) but generated significant gross receipts (approximately 73 percent of gross receipts). (*Microsoft*, at pp. 771-772.)

We disagree. Formula apportionment is meant to measure a business's "activities within and without the jurisdiction." (*Container*, at p. 165.) The sales factor is designed to attribute a business's income to the jurisdictions in which its goods and services are consumed, "regardless of whether the business later turns a profit or loss on those purchases." (*Tesoro Corporation v. State Department of Revenue* (Alaska 2013) 312 P.3d 830, 849.)

The *Microsoft* decision is distinguishable. In that case, Microsoft operated in multiple states and had a treasury department that invested the company's excess cash in short-term securities. Microsoft's investment activity, however, occurred in only one state —the state in which the treasury department was located. Microsoft's investment activity generated minimal income (less than 2 percent of income) but generated significant gross receipts (approximately 73 percent of gross receipts). (*Microsoft*, at pp. 771-772.) Under such peculiar conditions, Microsoft's inclusion of total receipts from its short-term investment activity with receipts from its other business activities in the sales factor calculation distorted the measure of Microsoft's sales attributable to each state, and would have severely underestimated the amount of income attributable to every state *except* the state in which the treasury department was located. (*Id.*, at pp. 768-769.) The problem in *Microsoft* was due, in part, to "an implicit assumption [in the sale factor formula] that a corporation's margins will not vary inordinately from state to state." (*Id.*, at p. 768.) In short, it was both the quantitative and qualitative anomalies that drove the *Microsoft* decision.

[16] In contrast to the principle of external consistency, the principle of "internal consistency" requires that if the apportionment formula was applied to every jurisdiction, it would result in no more than 100 percent of the taxpayer's unitary business income being taxed. (*Container*, at p. 169.)

Here, unlike in *Microsoft*, the parties seeking alternative apportionment (appellants) have not shown that Medical's margins will vary from state to state, as the income at issue—largely gain realized on the sale of goodwill—was accumulated over time as a result of Medical's operational business activities in numerous states. In addition, appellants did not address the qualitative prong of *Microsoft's* distortion analysis – i.e., Medical's sale of nearly all of its assets was a unique event which dramatically affected its net income and apportionment factor. Put another way, but for Regulation section 25137(c)(1)(A), inclusion of the gross receipts from this asset sale would have distorted the apportionment factor in the opposite direction.

Further, although not essential to our determination, we note that appellants' proposal to include gross receipts of $249,146,367 in the sales factor denominator for the 2011 taxable year would result in a large change from the California apportionment percentage of 6.3915 percent that Medical reported for the 2010 taxable year, a prior taxable year not at issue, to a California apportionment percentage of 1.7362 percent that appellants are proposing for the taxable year at issue. By contrast, FTB's approach results in a California apportionment percentage for the 2011 taxable year of 6.5033 percent, which is approximately equal to the California apportionment percentage that Medical self-reported for the 2010 taxable year of 6.3915 percent. Even though this 6.5033 percent is greater than the 1.7362 apportionment percent originally reported by Medical on its 2011 Form 100S, it does roughly approximate Medical's prior year's California apportionment factor, which is a clearer reflection of the role goodwill played with respect to its business activities in California. Thus, since it took Medical several years to build up its goodwill, it would not be improper for FTB to analogize to a historical apportionment factor that more closely represents Medical's activities in California during those prior years. (*See Tenneco West, Inc. v. Franchise Tax Board* (1991) 234 Cal.App.3d 1510 [FTB's use of apportionment factor for year of sale to source an installment payment instead of apportionment factor for year of receipt of payment sustained].) Although this "temporal consistency" is not exactly the same as *Container's* external consistency test because the California factor comparison here stretches across two taxable years, the approach nevertheless is analogous to the spirit of that rule; this is so especially because the value of assets such as goodwill are impacted by the passage of time.

Appellants also argue that removing the gross receipts received by Medical as a result of the disposition of its assets from its sales factor would result in the taxation of the gain therefrom without factor representation. The record, and Medical's 2011 Form 100S, show otherwise.

Even after those gross receipts were removed pursuant to Regulation section 25137(c)(1)(A), Medical's apportionment formula still had a payroll, property, and sales factor. Indeed, Medical's payroll and property factors were unchanged, and only its double-weighted sales factor was impacted. Distortion exists when the entire apportionment formula is affected, not any single factor. (See *Merrill Lynch*, *supra*.)

In summary, appellants have failed to demonstrate by clear and convincing evidence that excluding gross receipts of $249,146,367 from the sales factor causes Medical's California apportionment percentage (as adjusted by FTB during audit) to unfairly reflect the extent of Medical's business activities in California for the 2011 taxable year.

HOLDINGS

1. Pursuant to R&TC sections 17087.5 and 17954, appellants are required to apply UDITPA to determine the California source of their pro rata share of Medical's items of income, loss, deduction, or credit, even though they are also subject to the PITL.
2. Regulation section 17951-4(f) and (d) provides guidance on how UDITPA is to be applied to the nonresident shareholders of an apportioning S corporation.
3. Appellants, as nonresidents, are required to report their pro rata share of Medical's apportioned California income that was earned on the sale of its assets (including goodwill) as income from a source within California.
4. Appellants failed to demonstrate by clear and convincing evidence that excluding gross receipts of $249,146,367 from the sales factor denominator caused Medical's California's apportionment percentage (as adjusted by FTB during audit) to unfairly reflect the extent of Medical's business activities in California for the 2011 taxable year.

DISPOSITION

FTB's action is sustained in full.

DocuSigned by:
Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

DocuSigned by:
Cheryl L. Akin
1A8C8E38740B4D5...
Cheryl L. Akin
Administrative Law Judge

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