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2022 – OTA – 375P
Precedential

OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

In the Matter of the Appeal of:	) OTA Case No. 18010200
B. HOUSMAN AND	)
B. PENA	)
	)
	)
	)

OPINION

Representing the Parties:

For Appellants:	B. Housman Jeffrey M. Vesely, Attorney Annie H. Huang, Attorney
For Respondent:	Bradley W. Kragel, Tax Counsel IV Ronald Hofsdal, Tax Counsel IV
For Office of Tax Appeals:	Andrew Jacobson, Tax Counsel III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, appellants B. Housman (appellant-husband) and B. Pena (appellant-wife) (together, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing an additional tax of $1,454,742.00, an interest-based penalty of $237,987.02, and a non-economic substance penalty of $581,897.00, plus interest, for the 2009 tax year.[1] In addition, pursuant to R&TC section 19324, appellants also appeal an action by FTB denying their claim for refund of tax paid on total capital gains of $4,715,796 for the 2009 tax year.

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Cheryl L. Akin, and Sara A. Hosey, held an oral hearing for this matter in Sacramento, California, on May 24, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

[1] On appeal, FTB agrees to waive both the interest-based penalty and the non-economic substance penalty. Therefore, this Opinion does not address the penalties.

ISSUES

1. Whether appellants were residents of California on August 29, 2009.
2. If appellants were residents of California on August 29, 2009, whether appellant-husband was entitled to a stepped-up basis as a result of a valid check-the-box election for federal and California income tax purposes.

FACTUAL FINDINGS

1. In 2000, appellant-husband, an Australian citizen, founded and became CEO and majority shareholder of Monkey Pty. Ltd. (Monkey), an Australian proprietary limited company.[2]
2. In 2004, Monkey co-founded a software venture called Business Catalyst Systems Pty Ltd. (BCS Ltd.), an Australian proprietary limited company, and appellant-husband became CEO and chief engineer of BCS Ltd. BCS Ltd. was a "software-as-a-service" company that helped small businesses create an online presence with sales and marketing tools. Monkey became a holding company for its shares in BCS Ltd., of which it owned a majority interest.[3]
3. On April 1, 2008, BCS Ltd. entered into a management agreement (Management Agreement) with Business Catalyst Systems LLC (BCS LLC), a Delaware limited liability company solely owned by appellant-husband. The Management Agreement provided for the expansion of BCS Ltd. in the U.S. market, and for BCS LLC to serve as consultant.
4. BCS LLC was to provide services through a representative, appellant-husband, that included setting up a satellite office for BCS Ltd. in San Francisco, California; hiring employees; sales and collection of payments from North American customers; negotiation, setup, and the ongoing management of a North American data center; and provisioning of after-sales support for North American customers.
5. On March 31, 2008, appellant-wife resigned from her job in Australia.
6. On April 19, 2008, appellant-husband moved to San Francisco. On April 30, 2008, appellant-wife moved to San Francisco.

[2] Appellant-husband owned a 70 percent interest in Monkey in August 2009.

[3] Monkey held a 66.48 percent interest in BCS Ltd. in August 2009.

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7. Appellant-husband resigned from BCS Ltd. and appellants both became employed by BCS LLC on June 1, 2008. Appellant-husband acted as BCS LLC's representative to provide consulting services to BCS Ltd., as provided in the Management Agreement between BCS LLC and BCS Ltd. Appellant-wife accepted employment with BCS LLC to assist with the setup of the satellite office.[4] BCS LLC rented an office in San Francisco and hired employees.
8. Appellants rented an apartment in San Francisco under a one-year lease. Appellants left behind a house they owned in Australia, which they rented to a tenant under a one-year lease.[5] After a year, they rented the house on a month-to-month basis and never moved back into the house they owned in Australia.
9. Appellant-husband opened a personal bank account in California soon after his arrival.
10. In November 2008, Adobe Systems Benelux, B.V. (Adobe), a Netherlands company, approached appellant-husband concerning a potential acquisition of BCS Ltd. and negotiations commenced.[6]
11. On August 29, 2009, Adobe acquired BCS Ltd. and purchased all its shares. Adobe paid appellant-husband for his shares in Monkey, which owned an interest in BCS Ltd., resulting in net sale proceeds to him of approximately $22.5 million. Appellant-husband used his California bank account to receive funds from the Adobe sale.
12. On August 17, 2009, appellants filed a joint 2008 California Resident Income Tax Return (Form 540), which listed their San Francisco address.
13. On October 5, 2009, Monkey filed a federal Form 8832, Entity Classification Election, in which it elected to be classified as a partnership for federal income tax purposes. The IRS approved the election and granted the requested retroactive effective date of April 1, 2008.[7]

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[4] Appellants each received E3 working visas from the U.S. An E3 visa is a work visa that is valid for two years and is renewable.

[5] Appellant-wife obtained a California driver's license in January 2010 and appellant-husband obtained a California driver's license in February 2010. Appellants did not own or lease a vehicle in California in 2008 or 2009. While in California, appellants continued to maintain their Australian driver's licenses and an Australian bank account and credit card.

[6] In addition, BCS Ltd. received an unsolicited offer from a venture capital company in September 2008.

[7] Monkey requested and was granted late-classification relief by the IRS pursuant to Revenue Procedure 2009-41, 2009-39 I.R.B. 439.

14. On October 13, 2009, appellants filed an amended 2008 California return, which states that appellants became California residents in April 2008, and attached the federal Form 8832.
15. On May 19, 2010, appellants purchased a house in San Francisco.
16. In December 2012, appellants purchased a house in Australia. In November 2014, appellants returned to Australia.
17. On July 6, 2010, appellants filed a 2009 California Resident Income Tax Return (Form 540), listing their San Francisco address.[8] Appellants reported total capital gains of $4,715,796, resulting from the Adobe sale: approximately $22.5 million sales proceeds, less a reported basis of $17,786,344. The reported basis of $17,786,344 consists of $13,789,029 in stepped-up basis in original shares, as well as additional invested capital and selling expenses.
18. Appellants' reported stepped-up basis in the Monkey stock is based on an independently prepared appraisal of the value of the Monkey stock as of April 1, 2008, the effective date of Monkey's check-the-box election. The appraisal was prepared by Burr Pilger Mayer, Inc. (BPM Appraisal) and is dated May 13, 2010. Appellants also obtained an independently prepared appraisal of the Monkey stock dated April 20, 2010, prepared by Lorenzo Heart (Heart Appraisal), which appellants did not use in determining the stepped-up stock basis.
19. FTB issued a Notice of Proposed Assessment (NPA) for 2009, which disallowed the stepped-up basis of $13,789,029 and increased appellants' taxable income by the same amount. The NPA proposed additional tax of $1,454,742, plus interest.[9]
20. Appellants protested the NPA and filed a claim for refund on the basis that appellants were California nonresidents on August 29, 2009. FTB affirmed the NPA in a Notice of Action and denied the claim for refund.
21. This timely appeal followed.

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[8] Appellants also filed California Resident Income Tax Returns (Forms 540) for 2010 through 2013 using their San Francisco address. On their original and amended 2014 California Nonresident or Part-Year Resident Income Tax Returns (Forms 540NR), appellants again indicated that they had been California residents since 2008.

[9] The proposed assessment of tax includes a mental health services tax of $176,957.00 computed on the revised taxable income. The NPA also proposed an interest-based penalty of $237,987.02 and a non-economic substance transaction penalty of $581,897.00, plus interest. As previously stated, FTB agrees to abate the penalties.

DISCUSSION

Appellants contend that they were nonresidents of California when Abode purchased appellant-husband's Monkey shares on August 29, 2009. Appellants assert that the gain from the sale is not subject to California tax, which is the basis for their claim for refund. It is not disputed that if appellants are determined to be California nonresidents, then the gain is not taxable in this state, and conversely, if they are determined to be California residents, then the gain is taxable here.[10] Appellants assert that if OTA determines they are California residents, then they are entitled to the claimed stepped-up basis, and FTB's disallowance of the stepped-up basis is erroneous.

Issue 1: Whether appellants were residents of California on August 29, 2009.

FTB's determinations of residency are presumptively correct, and the taxpayer bears the burden of showing error in those determinations. (*Appeal of Mazer*, 2020-OTA-263P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Ibid.*)

California residents are taxed upon their entire taxable income (regardless of source), while nonresidents are only taxed on income from California sources. (R&TC, §§ 17041(a), (b), & (i), 17951.) California defines a "resident" as including: (1) every individual who is in California for other than a temporary or transitory purpose; or (2) every individual domiciled in California who is outside California for a temporary or transitory purpose.[11] (R&TC, § 17014(a)(1)-(2); see also Cal. Code Regs., tit. 18, § 17014.) A "nonresident" is defined as "every individual other than a resident." (R&TC, § 17015.)

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[10] If appellants are found to be nonresidents of California, then the income from the sale of Monkey stock would not be California source income unless that stock had acquired a business situs in California or appellants bought or sold the stock so regularly, systematically, and continuously as to constitute doing business in this state, pursuant to R&TC section 17952 and California Code of Regulations, title 18, section 17952. FTB does not contend that the income from the sale of the stock would be California source income if appellants were found to be nonresidents of California at the time of the sale.

[11] An individual may have several residences simultaneously, but an individual can only have one domicile at any given time. (Cal. Code Regs., tit. 18, § 17014(c); *Whittell v. Franchise Tax Bd*. (1964) 231 Cal.App.2d 278, 284.) Domicile is defined as the one location where an individual has the most settled and permanent connection, and the place to which an individual intends to return when absent. (*Appeal of Bragg* (2003-SBE-002) 2003 WL 21403264; Cal. Code Regs., tit. 18, § 17014(c).) The burden of proof as to a change of domicile is on the party asserting such change. (*Appeal of Bragg*, *supra*.)

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In determining residency for an individual not domiciled in California, the inquiry is whether the individual is in California "for other than a temporary or transitory purpose." (R&TC, § 17014(a)(1); *Appeal of Mazer*, *supra*.) The determination cannot be based solely on the individual's subjective intent but instead must be based on objective facts. (*Appeal of Mazer*, *supra*.) Generally, if an individual is in California to complete a particular transaction, or perform a particular contract, or fulfill a particular engagement, which will require the individual's presence in California for but a short period, the individual is in California for temporary or transitory purposes. (Cal. Code Regs., tit. 18, § 17014(b).) If, however, an individual is in California for business purposes which will require a long or indefinite period to accomplish, or is employed in a position that may last permanently or indefinitely, the individual is in California for other than temporary or transitory purposes. (*Ibid*.)

In determining a taxpayer's residency, the contacts or connections a taxpayer maintains in California and other states are important factors to take into consideration. (*Appeal of Mazer*, *supra*.) In *Appeal of Bragg* (2003-SBE-002) 2003 WL 21403264, a list of nonexclusive objective factors was provided to assist in determining which state an individual had the closest connection with during the period in question. These factors serve merely as a guide, and the weight given to any particular factor depends upon the totality of the circumstances. (*Appeal of Bragg*, *supra*.) The focus of the examination of these factors is to determine whether an individual is present for other than a temporary or transitory purpose, and to this end, satisfaction of a majority or a significant number of the factors is not necessarily dispositive. (*Ibid*.)

The Bragg factors can be organized into three categories, which include evidence of: (1) registrations and filings (i.e., driver's license, address used, and state of residence claimed on tax returns); (2) personal and professional associations (i.e., employment, bank accounts, business interests, memberships in social, religious, and professional organizations, use of professional services); and (3) and physical presence and property (i.e., where taxpayer's spouse and children reside, location of residential real property, origination point of financial transactions, number/purpose of days in California versus other states.) (*Appeal of Bragg*, *supra*; see also *Appeal of Mazer*, *supra*.)

There is no dispute that appellants were domiciled in Australia prior to their move to California, and FTB does not assert that appellants changed their domicile to California. FTB contends that appellants were residents of California because they were in the state for other than

a temporary or transitory purpose, pursuant to R&TC section 17041(a)(1). Appellants contend that they were temporarily in California due to a particular engagement: to establish a satellite office in California for BCS Ltd. and to expand the global presence of BCS Ltd., which would be accomplished through appellant-husband's employment with BCS LLC and its contract to provide consulting services to BCS Ltd. Appellants assert that they always intended to return to Australia once the California office was opened, adequately staffed, and fully operational. During the hearing, appellant-husband provided testimony as to appellants' connections to California and Australia, his employment with BCS LLC, and the Adobe sale.

Personal and Professional Associations

Appellants had significant business interests in California relating to BCS LLC. In 2008, appellants resigned from their jobs in Australia and began working for BCS LLC in California. Specifically, appellant-husband resigned from BCS Ltd., an Australian entity. Appellant-husband provided testimony regarding his continued involvement with BCS Ltd. as chief engineer and CEO, and as cofounder, through his interest in Monkey.[12] As stated by appellants at the hearing:

> "[appellant] cofounded BCS [Ltd.] in Australia. They were still trying to grow that business globally. There was no way he was just going to wash his hands of it. He was the cofounder. He was the chief engineer. A business could not grow without its CEO. It could not grow without the chief engineer, not a business like theirs, a [software-as-a-service] business that was…up and coming."[13]

However, appellant-husband terminated his employment with BCS Ltd., an Australian entity, when he moved to California and began working for BCS LLC. While BCS LLC provided consulting services to BCS Ltd., BCS LLC had only a physical presence in California, not Australia. BCS LLC leased a San Francisco office and hired employees in California and had no operations itself in Australia. Furthermore, the Management Agreement contemplated that all of BCS LLC's and appellant-husband's services as representative of BCS LLC, would be provided to BCS Ltd. from California. While appellant-husband was committed to growing the

[12] The BPM Appraisal states that appellants' main functions in Monkey were related to "business strategy and management, business development and product development."

[13] With regard to Monkey, the BPM Appraisal states that "[t]he most significant potential impact would be that of [appellant-husband's] departure from his current role as CEO…. Under a sale of [Monkey] or change of CEO, it would be important for [appellant-husband] or [Monkey's other co-founder] to assist with the transitioning of these principal relationships."

business of BCS Ltd., a business which he had many connections to and had invested himself in over the years, his connections to, and objectives for that business became significantly tied to California during the relevant period. Accordingly, appellant-husband's consulting services were significantly tied to California because they were provided through appellant-husband's employment with BCS LLC and the Management Agreement between BCS Ltd and BCS LLC.

Appellants contend that they were only in California to complete temporary duties required by the Management Agreement. However, the Management Agreement did not provide for when the agreement would end but stated it could be terminated upon notice by either party and, therefore, was for an indefinite period. In addition, the underlying purpose of the Management Agreement was for BCS Ltd. to expand its market into the U.S., and appellant-husband's goal was to eventually sell BCS Ltd. to a U.S. Company. The Heart Appraisal states that appellant-husband's "strategy was to build up and eventually sell BCS [Ltd.], and the most likely candidate would be a United States-based company." The Heart Appraisal also states that his "overriding goal" was to "eventually sell BCS to a larger software company with greater financial and operational resources…." Therefore, the evidence indicates that appellant-husband had a wide-ranging purpose for being in California and that the timing for accomplishing his goals could not be determined with specificity.

Appellant-husband also states that the purchase offer from Adobe was a surprise because it was intended that BCS Ltd. would be sold when it was a larger business at some future point. Additionally, the Heart Appraisal states that in September 2008, BCS Ltd. "unexpectedly" received an unsolicited offer from a venture capital company, indicating that appellant-husband did not expect offers or a sale to occur so soon. This demonstrates that one, appellant-husband was prepared to potentially stay in California for a longer period to develop BCS Ltd. and two, that the timeline for receiving such a purchase offer was uncertain. Appellants also contend that they intended to return to Australia after the sale. However, after the sale, appellant-husband began employment with Adobe and appellants decided to stay in California for five more years, a decision which is indicative of appellant-husband's significant ties to California through BCS Ltd. and BCS LLC at the time of the sale on August 29, 2009.

Appellants state that in February 2009, appellant-husband planned to travel to London to open an office in May 2009. Appellants assert that appellant-husband appeared in a video at that time, where he publicly stated that he was planning to move to London to open an office. In a

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transcript of the video provided by appellants, appellant-husband states that a London office would open in May 2009. Appellants state in declarations dated June 2018, that appellant-wife visited London in April 2009 to explore areas they could live, and appellant-husband testified that appellants made a final trip to London in December 2009 to research both where they could live in London and how an office would operate there.

However, appellant-husband states in his declaration, that the plan to establish a London office was abandoned once discussions with Adobe became serious. In addition, the Heart appraisal states that "[i]n November 2008, [BCS Ltd.] entered into serious discussions with Adobe over the offering price and other terms and conditions of sale by March 2009, a term sheet was offered to [BCS Ltd.]…." While the video transcript states that a London office would be opened in May 2009, an office was never opened, which is consistent with the evidence stating that the plan to open a London office was abandoned once discussions with Adobe became serious. Appellants do not provide evidence establishing a definitive plan to move to London or that moving to London was being contemplated or considered by appellants as of August 29, 2009, the relevant date in this appeal.

Physical Presence and Property

Appellants were physically present in California for a substantial amount of time as compared to their time spent outside of California, which demonstrates a significant connection to the state, despite their assertion that they always intended to leave the state and the fact that they eventually left. (See *Appeal of Bracamonte*, 2021-OTA-156P.) Appellants continued to own their previous house in Australia, which they leased to a tenant. However, when appellants visited Australia, they stayed with their parents and never moved back into their previous house. Appellants searched for a new home in Australia in 2010 onwards and were outbid twice before purchasing a house there in 2012. However, in May 2010, at the time appellants contend they were searching for a new house in Australia, they purchased a house in San Francisco. In addition, appellants contend that difficulties in finding a family home in Australia led to the delay in leaving California. However, appellants did not move back to Australia until 2014, two years after purchasing the new house there in December 2012. Therefore, the evidence does not show an intention to return to their previous house in Australia or support their contention that leaving California depended on them finding a new home in Australia.

With regard to the location of spouses and children, appellant-wife resigned from her job in Australia to live in California and also worked at BCS LLC. This demonstrates appellants' significant connections to California through BCS LLC as appellant-wife moved with appellant-husband and also worked at BCS LLC. Appellants contend that they decided to stay in California once appellant-wife became pregnant in early 2010. However, the evidence demonstrates that appellants had established significant connections in California prior to the pregnancy, such that they decided to stay and began raising their child in California.[14]

Registrations and Filings

Appellants also filed 2008 and 2009 California resident returns, which listed a California address. On their amended 2008 California return, they stated that they became California residents in April 2008. Appellant-husband testified that he received advice that they should file as residents, but that nevertheless, he was still in California for temporary or transitory purposes. However, appellants never filed amended returns that changed their claimed residency status and continued to file as residents through 2014 when they returned to Australia. On their original and amended 2014 California part-year resident returns, they stated that they had been California residents since 2008. Appellants also did not dispute their residency status until filing their protest on December 5, 2014. Even after making this contention at protest, appellants continued to claim that their California residency began in April 2008 on both their original and amended 2014 California returns filed on October 8, 2015, and October 15, 2016, respectively. Appellants' statements on their returns that they were residents and use of their California address on their returns are consistent with the evidence showing that appellants were not in the state for a temporary or transitory purpose. (See *Appeal of Childs* (83-SBE-128) 1983 WL 15514 [admission of state of residency on a return may be evidence of residency]; *Appeal of Bragg*, *supra*.)

Conclusion on Residency

While appellants contend that they were in California only to complete a particular engagement (i.e., open a California office) and their presence in California was intended to be of a short duration and temporary and transitory in nature, OTA finds that they were not in California to complete a particular transaction, contract, or engagement that would require

[14] At the time appellants left California to return to Australia in November 2014, they had three children.

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presence for a short period, but rather were in California for a relatively long or indefinite period and had no definite intention of leaving shortly thereafter. (See Cal. Code Regs., tit. 18, § 17014(b).) Appellants were in California with the purpose of expanding BCS Ltd. into the U.S. market and eventually selling the company in the future with no definite timeline.

While appellants may have had an intention of returning to Australia eventually in the future at some indefinite time, that does not mean they were in California for a temporary and transitory purpose. (See *Appeal of Amado* (55-SBE-003) 1955 WL 795.) In *Appeal of Amado*, *supra,* the State Board of Equalization noted (as to the taxpayers in that appeal), "it appears that at all times the length of their stay in California was contingent upon the state of Mrs. Amado's health." Similarly, appellants' stay in California was contingent on the establishment of the San Francisco office, development of BCS Ltd. in the U.S. market, and finding a potential buyer for BCS Ltd.'s business, which would take an uncertain and indefinite amount of time. While those objectives may have only required appellants to be in California for a year or two, they also may have taken much longer to accomplish. The evidence demonstrates that appellants intended to stay in California until those objectives were met, and that they were uncertain of the time required for completion. OTA finds that appellants had significant connections in California and severed significant connections in Australia. OTA, therefore, concludes that appellants were not here for only a temporary or transitory purpose. Accordingly, appellants were California residents on August 29, 2009.

Due to the determination that appellants were California residents, the second issue will be addressed to determine whether appellants are entitled to a stepped-up basis and associated reduction in gain on the sale of Monkey.

Issue 2: If appellants were residents of California on August 29, 2009, whether appellant-husband was entitled to a stepped-up basis as a result of a valid check-the-box election for federal and California income tax purposes.

FTB's determination is presumed correct, and a taxpayer has the burden of proving error. (*Appeal of Head and Feliciano*, 2020-OTA-127P.) Unsupported assertions are insufficient to satisfy a taxpayer's burden of proof. (*Appeal of GEF Operating Inc.*, 2020-OTA-057P.) In the absence of credible, competent, and relevant evidence showing that FTB's determination is incorrect, it must be upheld. (*Appeal of Johnson*, 2022-OTA-166P.)

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Treasury Regulation 301.7701-3

The "check-the-box regulations" under Internal Revenue Code (IRC) section 7701 are generally effective January 1, 1997. The check-the-box regulations allow certain business entities to choose their classification for federal tax purposes.[15] Treasury Regulation section 301.7701-3(b) provides a default classification for an eligible entity that does not make an election. (Treas. Reg. § 301.7701-3(b)(2).) An entity whose classification is determined under the default classification retains that classification until the entity makes an election to change that classification.[16] (Treas. Reg. § 301.7701-3(a).)

Elections are necessary only when an eligible entity chooses to be classified initially as other than the default classification or when an eligible entity chooses to change its classification. (Treas. Reg. § 301.7701-3(a).) An eligible entity with at least two members can elect to be classified as either an association (and thus a corporation under Treasury Regulation section 301.7701-2(b)(2)) or a partnership, and an eligible entity with a single owner can elect to be classified as an association or to be disregarded as an entity separate from its owner. (*Ibid.*) An eligible entity may elect to change its classification by filing a federal Form 8832. (Treas. Reg. § 301.7701-3(c)(1)(i).) An election that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. (Treas. Reg. § 301.7701-3(g)(3)(i).)

R&TC section 23038(b)(2)(B)(ii) provides that the classification of an eligible business entity as a partnership or an association taxable as a corporation for purposes of both the California personal and corporation income tax laws shall be the same as the classification of the entity for federal tax purposes. In addition, the classification of an eligible business entity for California income and franchise tax purposes shall be the same as the classification of the eligible business entity for federal tax purposes under Treasury Regulation section 301.7701-3, except as otherwise provided. (Cal. Code Regs., tit. 18, § 23038(b)-3(c)(1).) The election of an

[15] "Per se" corporations are statutory corporations, as described in Treasury Regulation section 301.7701-2(b) and are not allowed to choose their classification. A business entity that is not classified as a "per se" corporation under Treasury Regulation section 301.7701-2(b) is an eligible entity that can elect its classification for federal tax purposes. (Treas. Reg. § 301.7701-3(a).)

[16] Unless the entity elects otherwise, a foreign eligible entity is: (1) a partnership if it has two or more members and at least one member does not have limited liability; (2) an association if all members have limited liability; or (3) disregarded as an entity separate from its owner if it has a single owner that does not have limited liability. (Treas. Reg. § 301.7701-3(b)(2)(i).)

eligible business entity to be classified as an association or a partnership for federal tax purposes shall be binding for California income and franchise tax purposes. (*Ibid*.)

Monkey filed a Form 8832 with the IRS, electing to change from its default classification as an association to a partnership, effective April 1, 2008, pursuant to Treasury Regulation section 301.7701-3(c)(1)(i). The IRS granted the change in entity classification.[17] There is no dispute that Monkey is a foreign eligible entity that made a valid election to be classified as a partnership that is binding for both federal and California tax purposes. However, the parties dispute the effect this change in entity classification had on appellant-husband's basis in Monkey.

Stepped-Up Basis

If an eligible entity classified as an association elects to be classified as a partnership, the association is deemed to have distributed all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders are deemed to have contributed all of the distributed assets and liabilities to a newly formed partnership. (Treas. Reg. § 301.7701-3(g)(1)(ii).) Any transactions that are deemed to occur as a result of a change in classification of an entity from an association to a partnership are treated as occurring immediately before the close of the day before the election is effective. (Treas. Reg. §301.7701-3(g)(3)(i).) For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions (including the liquidation of the association) are treated as occurring immediately before the close of December 31, and must be reported by the owners of the entity on December 31. (*Ibid*.) Thus, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1. (*Ibid*.)

[17] An election to change entity classification will be effective on the date specified by the entity on Form 8832. The effective date specified on Form 8832 cannot be more than 75 days prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. (Treas. Reg. § 301.7701-3(c)(1)(iii).) Revenue Procedure 2009-41, 2009-39 I.R.B. 439, provides that an eligible entity may request a late classification election from the IRS if there is reasonable cause for the failure to timely make the election and 3 years and 75 days from the requested effective date have not passed. Monkey was granted late-classification relief by the IRS pursuant to Revenue Procedure 2009-41.

IRC section 61(a)(3) defines gross income to include all income from whatever source derived including gains derived from dealings in property.[18] IRC section 1001 provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis of the property.[19] IRC section 1011 provides that the adjusted basis for determining the gain from the sale of property shall be the property's initial basis, determined under IRC section 1012 or other applicable statutes in that subchapter and subchapters C (corporation distributions and adjustments), K (partners and partnerships), and P (capital gains and losses), adjusted as provided for in IRC section 1016. IRC section 1012(a) provides that the basis of property generally shall be the cost of such property, except as otherwise provided.

Amounts received by a shareholder in a distribution in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock. (IRC, § 331(a).)[20] If property is received in a distribution in complete liquidation, and if gain or loss is recognized on receipt of such property, then the basis of the property in the hands of the distributee shall be the fair market value (FMV) of such property at the time of the distribution. (IRC, § 334(a).)

Appellants contend that Monkey was deemed to have distributed all of its assets to its shareholders in liquidation of the company on March 31, 2008, and the shareholders were deemed to have contributed all of the distributed assets to a newly formed partnership for U.S. tax purposes, pursuant to Treasury Regulation section 301.7701-3(g). Appellants contend that, as a result, the shareholders in Monkey were required to recognize gain or loss on the receipt of the assets measured by the FMV of the assets received pursuant to IRC section 331(a), and the basis of the assets in the hands of the shareholders therefore were stepped-up to such FMV at the time of distribution pursuant to IRC section 334(a).

FTB contends that Monkey was not relevant on March 31, 2008, for U.S. and California tax purposes. As a result, FTB contends that the deemed liquidation of Monkey pursuant to Treasury Regulation section 301.7701-3(g) had no effect for California or federal tax purposes. More specifically, FTB contends that the cited federal tax law (i.e., IRC sections 331 and 334) to

[18] Pursuant to R&TC section 17071, California conforms to IRC section 61, relating to gross income, except as otherwise provided.

[19] Pursuant to R&TC section 18031, California conforms to Subchapter O of Chapter 1 of Subtitle A of the IRC, relating to gain or loss on disposition of property, except as otherwise provided.

[20] Pursuant to R&TC section 17321, California conforms to Subchapter C of Chapter 1 of Subtitle A of the IRC, relating to corporate distributions and adjustments, except as otherwise provided.

which California conforms, which would permit Monkey's shareholders (including appellant-husband) to step-up their basis in the Monkey stock, is inapplicable.

Relevance of Entity Classification

A foreign eligible entity's classification is relevant when its classification affects the liability of any person for federal tax or information purposes. (Treas. Reg. § 301.7701-3(d)(1)(i).) The date that the classification of a foreign eligible entity is relevant is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined. (*Ibid.*) If the classification of a foreign eligible entity has never been relevant, then the entity's classification will initially be determined when the classification of the entity first becomes relevant. (Treas. Reg. § 301.7701-3(d)(2).)

In general, "the classification for [f]ederal tax purposes of a foreign eligible entity that files a Form 8832, 'Entity Classification Election,' shall be deemed to be relevant only on the date the entity classification election is effective." (Treas. Reg. § 301.7701-3(d)(1)(ii)(A).) However, "[i]f the classification of a foreign eligible entity is relevant within the meaning of paragraph (d)(1)(i) of this section, then the rule in paragraph (d)(1)(ii)(A) of this section shall not apply." (Treas. Reg. § 301.7701-3(d)(1)(ii)(B).)

FTB contends that, because Monkey did not operate in the U.S. and because appellant-husband and the other shareholders were not U.S. citizens on the date of the deemed liquidation of March 31, 2008, Monkey was not relevant for federal and California tax purposes on that date. FTB asserts that Monkey's tax classification did not become relevant until appellant-husband became a U.S. resident on April 19, 2008, which is when appellant-husband had an obligation to file a federal tax return. As a result, FTB asserts that Monkey did not exist for U.S. and California tax purposes at the time the deemed liquidation occurred, and appellant-husband was not entitled to increase his basis in Monkey's stock as a result of the deemed liquidation.[21]

Although FTB asserts that "Monkey was not relevant for U.S. tax purposes at the time of the deemed transaction," the regulation does not address whether the entity itself is relevant, but whether the classification of the entity is relevant. As stated in the preamble to the 2003 entity

[21] At the hearing, FTB also asserted that if Monkey had actually liquidated on March 31, 2008 (rather than being a deemed transaction), FTB still believed that U.S. law (i.e., IRC sections 331 and 334) would not apply since Monkey was an Australian entity and all of the shareholders were Australian, rather than U.S. taxpayers on that date.

classification regulations, "[o]ne commentator requested that the provisions be revised to clarify that it is the [f]ederal tax classification of the foreign eligible entity, and not the entity itself, that is deemed to be relevant. Treasury and the IRS have adopted this clarifying change in these final regulations." (2003-2 C.B. 1156, 68 FR 60296-02.) Therefore, relevance as discussed in the regulation is regarding the classification of the entity and not the entity itself.

IRS Chief Counsel Attorney Memorandum, IRS AM 2021-002

IRS guidance states that an entity has a classification for federal tax purposes during periods when its classification is not relevant, and that pre-relevancy classification is necessary to determine the entity's tax attributes, such as the tax basis in assets. IRS Chief Counsel Attorney Memorandum, IRS AM 2021-002 (AM 2021-002) addresses a situation where a nonresident, noncitizen owned stock in a foreign eligible entity and made a valid election to change the classification of the entity effective on the date the taxpayer became U.S. citizen. AM 2021-002 notes that the entity's classification became relevant on the day the noncitizen became a U.S. citizen because on that day, the classification affected the federal tax or information reporting liability of that person. AM 2021-002 states that, while the classification was never relevant before that day, Treasury Regulation section 301.7701-3(d)(2) applied to initially determine the default classification for the entity for the period before the nonresident, noncitizen became a U.S. citizen and the entity's classification became relevant. In addition, AM 2021-002 states that the transactions resulting from the deemed treatment under Treasury Regulation section 301.7701-3(g)(1) are deemed to occur immediately before the close of the day on which the noncitizen became a U.S. citizen, when the entity's classification is not relevant.[22]

AM 2021-002 concludes that "[a]n entity has a classification for federal tax purposes at all times, including during periods when its classification is not relevant and regardless of whether the classification has ever been relevant." Specifically, AM 2021-002 states that "[a] foreign eligible entity is classified pursuant to Treasury Regulation section 301.7701-3(b)(2) ('the default classification provision') during the period in which its classification is not relevant.

[22] While the example involves a non-citizen owning a foreign eligible entity with a default classification as a partnership, the principles are equally applicable where, as here, an entity has a default classification as a corporation.

This determination is made when the classification of the entity first becomes relevant, but the classification applies during the non-relevant period."

AM 2021-002 states that its conclusion is based on a plain reading of the default classification provision and statements in the preambles to the regulations. In addition, AM 2021-002 notes that the preamble to the entity classification regulations issued in 1997 provides that "[a]ny eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification." (See 1997-2 C.B. 649, 62 FR 55768-01.) AM 2021-002 also notes that the preamble to the entity classification regulations issued in 1999 states that "a foreign eligible entity that is not relevant has a [f]ederal tax classification." (See 1999-2 C.B. 670, 64 FR 66591-02.) AM 2021-002 states that the requirement in Treasury Regulation section 301.7701-3(d)(2) that an entity's classification must initially be determined when the entity becomes relevant is consistent with this conclusion.[23] AM 2021-002 states that the fact that the determination is first made when the classification becomes relevant addresses the time of determination but does not indicate that the entity has no classification prior to such time.

While an IRS Chief Counsel Memorandum is not binding authority, the IRS's interpretation of the federal statute and its own Treasury regulation that interprets the statute is persuasive. Additionally, the reasoning used is persuasive, given its analysis of the regulatory history and plain language of the regulation, and its consistency with other authorities with similar issues. The IRS and courts have applied U.S. tax principles to determine the U.S. tax consequences of events or transactions occurring outside the U.S., absent a clear expression that foreign concepts control, notwithstanding that the transaction may occur prior to any involvement by a U.S. taxpayer. (See, e.g., *U.S. v. Goodyear Tire and Rubber Co*. (1989) 493 U.S. 132; *Gutwirth v.Commissioner* (1963) 40 T.C. 666; see also *Appeal of Kuhn* (91-SBE-006) 1991 WL 280344; Preamble to Proposed Regulations under IRC section 362(e)(2), 2006-2 C.B. 1004, 71 FR 62067-01 ["under general principles of law, the [IRC] applies to all transactions

[23] In addition, relevance is defined in Treasury Regulation section 301.7701-3(d) as applicable to foreign eligible entities, and not "per se" corporations, which may result in inconsistent results under FTB's position, if it were determined that "per se" corporations may receive a stepped-up basis when not relevant, whereas foreign eligible entities that are classified as corporations under the default rules may not.

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without regard to whether such application has any current U.S. tax consequences"].)[24] Additionally, IRS Chief Counsel Attorney Memorandum, IRS AM 2007-006 concluded that a domestic or foreign corporation that acquires by purchase the requisite amount of the stock of a foreign target can make an IRC section 338 election for the foreign target and thereby obtain a step-up in the basis in the foreign target's assets even if no U.S. or foreign tax is incurred.

Conclusion on Application of Stepped-up Basis

Accordingly, because Monkey has never been relevant, its default classification will initially be determined on the date when the classification of the entity first becomes relevant, pursuant to Treasury Regulation section 301.7701-3(d)(2). Treasury Regulation section 301.770-3(d)(1)(ii)(A) provides that Monkey is deemed to be relevant on the date the entity classification election specified on the Form 8832 is effective. Therefore, Monkey's classification became relevant on the April 1, 2008 effective date of the election on the Form 8832. Monkey's "pre-relevance" classification is determined pursuant to the default classification rules set forth in Treasury Regulation section 301.7701-3(b)(2) (see AM 2021-002); under these default rules Monkey was classified as an association.

Pursuant to AM 2021-002, "[a]ny eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification." Thus, Monkey was permitted to elect to change its default classification from an association to a partnership, even if its classification was not relevant prior to the effective date of this election. Pursuant to AM 2021-002, the liquidation and stepped-up basis resulting from the change in classification is deemed to occur when Monkey was not relevant, which is the day before the effective date of April 1, 2008. (See also Treas. Reg. § 301.7701-3(g)(1)(ii).) The amounts received by Monkey's shareholder in the distribution in complete liquidation of Monkey are treated as full payment in exchange for the stock. (See IRC, § 331(a).) Because the property is received in a distribution in complete liquidation, and gain is recognized on receipt of the stock,

[24] In addition, R&TC section 17041(a)(1) states that "taxable income [is] computed for the taxable year as if the resident were a resident of this state for the entire taxable year and for all prior taxable years for any carryover items, deferred income, suspended losses, or suspended deductions." While the gain from the deemed liquidation of Monkey is not a carryover, suspended, or deferred item, this statute appears to support appellants' position, as the statute provides that California tax principles may apply to prior years when the taxpayer was a nonresident. If, consistent with this principle in R&TC section 17041(a)(1), appellant-husband were treated as a resident for all prior years, including on the April 1, 2008 effective date of change in entity classification election and the March 31, 2008 deemed liquidation date, then IRC sections 331(a) and 334(a) to which California conforms, would be applicable to the deemed distribution.

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the basis of the property in the hands of appellant-husband, as a shareholder of Monkey, is the FMV of the stock at the time of the distribution.[25] (See IRC, § 334(a).) Appellant-husband is then deemed to have contributed all the distributed stock to the newly formed partnership for U.S. tax purposes. (See Treas. Reg. § 301.7701-3(g)(1)(ii).) Therefore, the basis in appellant-husband's stock is "stepped-up" to the FMV at the time of distribution on March 31, 2008, and the gain on the subsequent sale of the stock to Adobe on August 29, 2009, is reduced due to the increased basis. (See IRC, §§ 1001, 1011, 1012.)

Next to be determined is the value of the stepped-up basis and the appraisal used to determine the basis will be examined.

Valuation of Monkey Stock

FMV is the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all relevant facts, and neither person being under a compulsion to buy or to sell. (*U.S. v. Cartwright* (1973) 411 U.S. 546, 551.) In the case of non-publicly traded stock the value of which cannot be determined by relevant arm's-length sales, FMV is generally determined by using three approaches: the income approach, the market approach, and the asset-based (cost) approach. (*Estate of Noble v. Commissioner*, T.C. Memo. 2005-2; see also *Morton v. Commissioner*, T.C. Memo. 1997-166.) The discounted cashflow method is one valuation method under the income approach and converts the anticipated economic benefits into a single present-valued amount. (*Estate of Noble v. Commissioner*, *supra*.) The market approach values the interest by comparing it to a comparable interest that was sold at arm's length in the same timeframe, accounting for differences between the companies by making adjustments to the sale price. (*Ibid*.) The asset-based approach values the interest by reference to the company's assets net of its liabilities. (*Ibid*.)

Revenue Ruling 59-60, 1959-1 C.B. 237, (Revenue Ruling 59-60) which has been widely accepted as setting forth the appropriate criteria to consider in determining FMV, provides factors to be considered when valuing stock in a closely held corporation, including: (1) the

[25] See also IRS Field Service Advice Memorandum, FSA 1995-5, noting that the term "recognized" in IRC section 334(a) likely means "recognizable" such that the shareholder's failure to report recognized gain or loss would not bar an application of the provision. Thus, the gain from the deemed distribution on March 31, 2008, would be considered "recognized" pursuant to IRC sections 334(a), such that appellant-husband is entitled to the stepped-up basis, even if he were considered to have only "recognizable" gain for federal or state income tax purposes that was not subject to federal or state tax, because he was not a U.S. or California resident at that time.

nature of the business and the history of the enterprise from its inception; (2) the economic outlook in general and the condition and outlook of the specific industry in particular; (3) the book value of the stock and the financial condition of the business; (4) the earning capacity of the company; (5) dividend paying capacity; (6) whether or not the enterprise has goodwill or other intangible value; (7) sales of the stock and the size of the block of stock to be valued; and (8) the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. (See also *Estate of Newhouse v. Commissioner*, (1990) 94 T.C. 193, 217.)

Appellants' reported stepped-up basis in the Monkey stock of $13,789,029, is based on the BPM Appraisal of the FMV of the Monkey stock as of April 1, 2008, the effective date of Monkey's check-the-box election.[26] The BPM Appraisal states that it was prepared in accordance with Revenue Ruling 59-60 and the American Institute of Certified Public Accountants' Statement on Standards for Valuation Services. The appraisal also specifies that it considered the eight factors listed in Revenue Ruling 59-60 in deriving its estimate of FMV. The BPM Appraisal assumed sales revenue growth of 150 percent to 200 percent through the fiscal year ended June 30, 2009, before projecting lower sales growth of 5 percent by 2018. The projected growth rates were based on prior growth rates preceding the valuation date as well as the BCS Ltd.'s stage of development and scalability of business model. The appraisal is based on BCS Ltd.'s financial statements for the years ended June 30, 2006, and 2007, and financial statements for the 9-month period ending March 31, 2008.

FTB argues that the BPM Appraisal is not reliable because it uses only a single valuation method, the income method, when all three typically used methods (income, market, and asset), were appropriate. However, there is no requirement than an appraisal must use all three methods or a prescribed formula, as it depends on the facts and circumstances. There is no fixed formula for applying the factors that are to be considered in determining the FMV of unlisted stock. (*Estate of Davis v. Commissioner* (1998) 110 T.C. 530, 536.) The weight to be given to the various factors in arriving at FMV depends upon the facts of each case. (*Id*. at 536-537.) And as

[26] Appellants assert that the Heart Appraisal used a higher value, and they used the lower value of the BPM Appraisal to be conservative. Also, it appears that the appraisals should have appraised the FMV of the stock as of the deemed distribution date of March 31, 2008, rather than the effective date of the election, April 1, 2008. However, OTA does not find the one-day difference to be material to the appraised FMV of the appellant-husband's stock in Monkey.

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stated in Revenue Ruling 59-60, "[d]epending upon the circumstances in each case, certain factors [e.g., earnings, cost, etc.] may carry more weight than others because of the nature of the company's business" and that "valuations cannot be made on the basis of a prescribed formula…."

In this case, the BPM Appraisal discussed the various methodologies and the reasons for either using or not using each approach. The appraisal used the income approach to value BCS Ltd., in which Monkey held a 66.48 interest.[27] Specifically, the BPM Appraisal used a discounted cash flow method weighted 35 percent, and a discounted cash flow method with a mergers and acquisitions exit weighted 65 percent, which is a method that uses market data and reflects that the company would eventually be sold. Revenue Ruling 59-60 states that "[e]arnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public…." Therefore, the approach used by the BPM Appraisal to value BCS Ltd. was reasonable. (See *Smith v. Commissioner*, T.C. Memo. 1999-368 ["an earnings-based method applies for corporations that are going concerns"].)

The BPM Appraisal used the adjusted net asset approach to value Monkey. Revenue Ruling 59-60 states that "in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued." Therefore, the approach used by the BPM Appraisal to value Monkey was reasonable. (See *Smith v. Commissioner*, *supra* ["an asset-based method of valuation applies in the case of corporations that are essentially holding corporations"].)

FTB argues that the appraisal is not reliable because it did not consider events in the future, such as the economic downturn in the second half of 2008. In addition, FTB asserts that the appraisal was prepared after the company was sold and the appraisers were informed of the sale before conducting their analysis. However, a valuation for income tax purposes is made as of the relevant date without regard to unforeseeable events occurring subsequently. (*Ithaca Trust Co. v. United States* (1929) 279 U.S. 151, 155; *Grill v. United States* (1962) 303 F.2d 922, 927.)

[27] The appraisal describes the lack of comparable companies for a market approach and that there was sufficient financial data from which a discounted cash flow could be determined.

Revenue Ruling 59-60 states that "[v]aluation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal."

As stated in the BPM Appraisal, the appraisal "reflects facts and conditions existing at the valuation date. Subsequent events have not been considered…." The BPM Appraisal considered the information and data available on April 1, 2008, relating to whether the economy would grow or decline in 2008 and beyond, including inflation rates and statements from the U.S. Federal Reserve. The appraisal also assumed that the Adobe sale was not known or knowable by Monkey on April 1, 2008.[28] Accordingly, the BPM Appraisal was appropriate in relying only upon facts and conditions existing as of April 1, 2008.

FTB also contends that the appraisal is not reliable because it did not use financial data from before 2006. As stated in Revenue Ruling 59-60, "[p]rior earnings records usually are the most reliable guide as to the future expectancy, but resort to arbitrary five-or-ten-year averages without regard to current trends or future prospects will not produce a realistic valuation." In this case, the appraisal discussed the high revenue growth in recent years due to the company ramping up, the company being newer and entering its second stage of development, the high level of estimated demand for the company's products, and the scalability of the business model. Revenue Ruling 59-60 states that if "a record of progressively increasing or decreasing net income is found, then greater weight may be accorded the most recent years' profits in estimating earning power." Likewise, the BPM Appraisal considered the facts and circumstances specific to this appraisal, including current trends and future prospects, as well as the progressively increasing income of the business in recent years. Accordingly, the appraisal's application of prior earnings is reasonable.[29]

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[28] The appraisal notes that it did consider the possibility of a sale of the company to a strategic buyer due to the nature of the company's product offering. As part of this analysis, BPM found that the implied rate of return (29.59%) between BPM's appraised value on April 1, 2008, and ultimate sales price to Adobe on August 29, 2009, to be consistent with their conclusions.

[29] FTB also contends that the appraisal did not account for lack of marketability or the failure rate. However, the appraisal addressed the issue of marketability by considering the liquidity of the business and that appellant-husband, as the owner with a controlling interest, had control over the decisions to sell, and the appraisal also implemented a higher rate of return based on the BCS Ltd.'s stage of development, signifying the risks facing the business.

Conclusion on Value of Stepped-up Basis

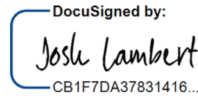
The BPM Appraisal, from which appellants determined the basis in Monkey, is reasonable and consistent with Revenue Ruling 59-60, and sufficiently supports appellant-husband's reported basis in his Monkey shares as of March 31, 2008.[30]

HOLDINGS

1. Appellants were residents of California on August 29, 2009.
2. Appellant-husband is entitled to a stepped-up basis as a result of a valid check-the-box election for federal and California income tax purposes.

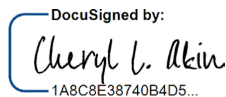
DISPOSITION

FTB's action in denying appellants' claim for refund is sustained. FTB's action in proposing additional tax is reversed.[31]

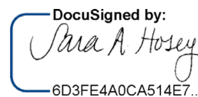


Josh Lambert
Administrative Law Judge

We concur:



Cheryl L. Akin
Administrative Law Judge



Sara A. Hosey
Administrative Law Judge

Date Issued: 8/31/2022

[30] FTB has not provided an alternative appraisal valuing Monkey as of March 31, 2008, or provided any other evidence to establish a different value for Monkey as of this date which it contends would be more "reasonable."

[31] As previously noted, FTB conceded the two penalties.