DocuSign Envelope ID: C923497E-7082-4B6F-AD06-C4C742D6596D

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of:

**R. NAG AND
S. RUDD**

OTA Case No. 18073501

OPINION ON PETITION FOR REHEARING

Representing the Parties:

For Appellants: R. Nag
Jonathan Golub, Attorney

For Respondent: David Hunter, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: On October 5, 2022, the Office of Tax Appeals (OTA) issued an Opinion which sustained respondent Franchise Tax Board's (FTB's) action proposing additional tax of $839,757, plus applicable interest, for the 2010 tax year. Appellants filed a timely petition for rehearing (PFR) pursuant to Revenue and Taxation Code (R&TC) section 19048.

A rehearing may be granted where one of the following six grounds exists, and the substantial rights of the filing party (here, appellants) are materially affected: (1) an irregularity in the appeal proceedings which occurred prior to issuance of the Opinion and prevented fair consideration of the appeal; (2) an accident or surprise which occurred during the appeal proceedings and prior to the issuance of the Opinion, which ordinary caution could not have prevented; (3) newly discovered, relevant evidence, which the filing party could not have reasonably discovered and provided prior to issuance of the Opinion; (4) insufficient evidence to justify the Opinion; (5) the Opinion is contrary to law; or (6) an error in law in the appeals hearing or proceeding. (Cal. Code Regs., tit. 18, § 30604(a)(1)-(6).)

As described in the Opinion, appellant-husband owned stock in Cellmania Inc. (Cellmania), which was acquired by Research in Motion (RIM) in a cash-free/debt-free stock sale, and Cellmania and RIM entered into an Agreement and Plan of Merger (Agreement). Prior to the closing of the sale, in documents entitled "Action by Unanimous Written Consent of the

DocuSign Envelope ID: C923497E-7082-4B6F-AD06-C4C742D6596D

Board of Directors of Cellmania, Inc." (Board Actions), Cellmania's Board of Directors declared that "Special Dividends" would be paid to the shareholders of Cellmania. The first Board Action also approved the acquisition of Cellmania by RIM. Appellant-husband received two Special Dividend payments from Cellmania prior to the closing of the sale, and subsequently received sale proceeds from RIM in exchange for his Cellmania stock.

On their 2010 California income tax return, appellants reported the Special Dividends as part of the proceeds from the sale of the stock, pursuant to Internal Revenue Code (IRC) section 1001, which provides that the gain on the sale of property shall be the excess of the amount realized over the adjusted basis of the property.[1] Appellants also claimed a 50 percent California qualified small business stock (QSBS) gain exclusion of $14,503,679, pursuant to R&TC section 18152.5. R&TC section 18152.5(a) provides that gross income shall not include 50 percent of any gain from the sale or exchange of QSBS held for more than five years. R&TC section 18152.5(b)(1) limits the amount of gain which may be excluded under R&TC section 18152.5(a) to the greater of $10 million or 10 times the aggregate adjusted basis in the QSBS disposed of by the taxpayer during the taxable year.

FTB audited appellants' return and determined that appellant-husband's receipt of the Special Dividends from Cellmania was not part of the gain from the sale, but a non-dividend distribution that should be treated as return of capital in excess of his basis in the Cellmania stock, pursuant to IRC section 301(c)(2).[2] A distribution of property made by a corporation to a shareholder with respect to its stock that is not a dividend shall be applied against and reduce the adjusted basis of the stock. (IRC, § 301(c)(2).) FTB determined that appellant-husband's stock basis was reduced to zero and that appellant-husband's California QSBS gain exclusion, which uses basis in its calculation, was $5,000,000, 50 percent of $10 million.

Appellants filed an appeal with OTA, contending that the Special Dividends were consideration for the merger with RIM, and that, as a result, the Special Dividends were not distributions that reduced appellant-husband's stock basis in Cellmania under IRC

---

[1] Pursuant to R&TC section 18031, California conforms to IRC section 1001,except as otherwise provided.

[2] IRC section 316(a) provides that a dividend means any distribution of property made by a corporation to its shareholders out of its current or accumulated earnings and profits. Cellmania did not have earnings and profits from which the Special Dividends could be treated as dividends, pursuant to IRC section 316. California conforms to IRC sections 301 and 316, pursuant to R&TC section 17321.

section 301(c)(2). In addition, appellants contend that the limitation contained in R&TC section 18152.5(b)(1) is ambiguous and propose an interpretation that would allow them a higher gain exclusion than was permitted by FTB.

In its Opinion, OTA determined that, in substance and form, the Special Dividends were separate from the consideration appellant-husband received in exchange for his Cellmania stock, and that the Special Dividends should be treated as non-dividend distributions that reduced appellant-husband's stock basis to zero.[3] OTA also determined that the plain language of R&TC section 18152.5 did not support appellants' interpretation of the statute, and that appellant-husband's gain exclusion was limited to $5,000,000, 50 percent of $10 million. Accordingly, OTA sustained FTB's action.

In their PFR, appellants assert that, in the same Board Actions, Cellmania's Board of Directors declared the Special Dividends and approved the merger with RIM. Therefore, appellants argue that the Special Dividends and the merger are tied together, such that the Special Dividends were part of the merger consideration. Appellants assert that the Special Dividends were made in preparation of the merger and prevented the deal from falling apart. Appellants also assert that cash-free/debt-free sales are commonplace to ensure negotiation and transaction simplicity. In support of this contention, appellants provide articles which they assert are new evidence. Appellants state that they do not think this argument is accounted for or understood in the Opinion.

Appellants' arguments appear to suggest that appellants believe a rehearing should be granted based on the grounds that there is insufficient evidence to justify the Opinion, the Opinion is contrary to law, and because of newly discovered, relevant evidence. To find that there is an insufficiency of evidence to justify the Opinion, OTA must find that, after weighing the evidence in the record, including reasonable inferences based on that evidence, OTA clearly should have reached a different opinion. (*Appeals of Swat-Fame, Inc.*, *et al.*, 2020-OTA-045P.)

The contrary to law standard of review shall involve a review of the Opinion for consistency with the law. (Cal. Code Regs., tit. 18, § 30604(b).) The question of whether the Opinion is contrary to law is not one which involves a weighing of the evidence, but instead,

[3] In general, the substance rather than the form of a transaction governs for tax purposes; thus, the form of a transaction may be discounted, and the tax consequences may be determined based on its substance. (See *Commissioner v. Court Holding Co*. (1945) 324 U.S. 331; *Gregory v. Helvering* (1935) 293 U.S. 465.)

DocuSign Envelope ID: C923497E-7082-4B6F-AD06-C4C742D6596D

requires a finding that the Opinion is "unsupported by any substantial evidence"; that is, the record would justify a directed verdict against the prevailing party. (*Sanchez-Corea v. Bank of America* (1985) 38 Cal.3d 892, 906.)[4] This requires a review of the Opinion in a manner most favorable to the prevailing party and indulging in all legitimate and reasonable inferences to uphold the Opinion if possible. (*Id*. at p. 907.) The question before OTA on a PFR does not involve examining the quality or nature of the reasoning behind OTA's Opinion, but whether that Opinion can be valid according to the law. (*Appeal of NASSCO Holdings, Inc*. (2010-SBE-001) 2010 WL 5626976.)

A party seeking a rehearing under the ground of newly discovered, relevant evidence must show that: (1) the evidence is newly discovered; (2) the party exercised reasonable diligence in discovering and producing it; and (3) the evidence is material to the party's case. (*Doe v. United Air Lines, Inc*. (2008) 160 Cal.App.4th 1500, 1506.) Newly discovered evidence must be material in the sense that it is likely to produce a different result. (*Hill v. San Jose Family Housing Partners, LLC* (2011) 198 Cal.App.4th 764, 779.)

In their PFR, appellants repeat the same arguments that were previously considered and addressed in the Opinion. Appellants' dissatisfaction with the Opinion, and their attempt to reargue the same issues a second time, do not constitute grounds for a rehearing. (*Appeal of Graham and Smith*, 2018-OTA-154P.) The Opinion considered the Board Actions and the other evidence, including the Agreement, and determined that the Special Dividends were not considered or intended by the parties to be part of the sale. OTA noted that the Board Actions declaring the Special Dividends do not state the distributions are part of the merger. OTA stated that, as a result of the sale being completed on a cash-free, debt-free basis, Cellmania extracted cash prior to the consummation of the sale via the Special Dividends. OTA stated that these circumstances are similar to the facts in court cases, such as *TSN Liquidating Corporation, Inc. v. U.S*. (5th Cir. 1980) 624 F.2d 1328, *Coffey v. Commissioner* (1950) 14 T.C. 1410, and *Gilmore v. Commissioner* (1956) 25 T.C. 1321. In those cases, the purchasers did not want the assets

---

[4] California Code of Regulations, title 18, (Regulation) section 30604 is based upon the provisions of California Civil Code of Procedure (CCP) section 657. (See *Appeal of Wilson Development, Inc.* (94-SBE-007) 1994 WL 580654 [Board of Equalization (BOE) utilizes CCP section 657 in determining grounds for rehearing]; *Appeal of Do*, 2018-OTA-002P [OTA adopts BOE's grounds for rehearing].) Therefore, the language of CCP section 657 and case law pertaining to the operation of the statute provide guidance in interpreting the provisions contained in Regulation section 30604.

DocuSign Envelope ID: C923497E-7082-4B6F-AD06-C4C742D6596D

included in the sale and negotiated for the exclusion of the assets, and, as a result, the courts determined the assets, distributed to the shareholders prior to the sale, were not part of the sale.

In addition, OTA considered and acknowledged that the sale was completed on a cash-free/debt-free basis, which is a commonplace method for purchasing a company, and stated that it demonstrates that the Special Dividends were not part of the sale consideration. OTA noted that the Agreement included terms for closing adjustments to ensure that net working capital, which is the excess of Cellmania's current assets over current liabilities, would be zero at closing.[5] OTA stated that, the fact that the sale was completed on a cash-free/debt-free basis and the Agreement included terms for closing adjustments, demonstrates that the excess cash distributed by the Special Dividends were not part of the merger consideration. In addition, OTA held that, because it is commonplace to purchase a company on a cash-free/debt-free basis and to make closing adjustments for legitimate business reasons, these common transaction methods do not fall within the scope of the type of transaction that should be recharacterized after the fact as lacking economic substance.[6] The articles provided by appellants add nothing to the analysis. OTA already addressed the concepts described in the articles and determined they demonstrate that FTB's action should be sustained.

As to the second issue of the gain exclusion limitation, appellants provide no new arguments. In their PFR, appellants argue that the language of R&TC section 18152.5 does not have a plain meaning but is "doubtful" because the word "doubtful" was used in a citation provided by OTA in its Opinion. The Opinion provided that "[a]n exemption will not be inferred from doubtful statutory language; the statute must be construed liberally in favor of the taxing authority, and strictly against the claimed exemption," citing *Hospital Service of California v. City of Oakland* (1972) 25 Cal.App.3d 402, 405.[7] Appellants misread the Opinion and misplace

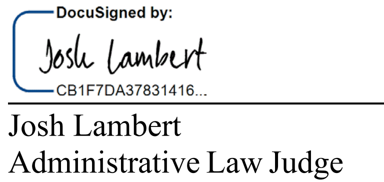
---

[5] Generally, if there is a deficit in net working capital, the seller provides more cash at closing and, conversely, if there is an excess in net working capital at closing, the buyer provides more cash at closing.

[6] Where there is a genuine multi-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the government should honor the allocation of rights and duties effectuated by the parties. (*Frank Lyon Co. v. U.S.* (1978) 435 U.S. 561, 583-584.)

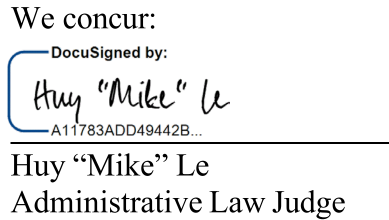
[7] The Opinion also provided that "[s]tatutes granting exemption from taxation are strictly construed to the end that such concession will not be enlarged nor extended beyond the plain meaning of the language employed," citing *Honeywell Information Systems, Inc. v. County of Sonoma* (1974) 44 Cal.App.3d 23, 27.

reliance on the word "doubtful." The Opinion already considered the language of the statute and held that its plain language, legislative history, and a similar federal statute, IRC section 1202, do not establish that the exclusion is calculated as appellants contend. Appellants' argument relating use of the word "doubtful" in a case citation does not address OTA's actual analysis of the statute. Accordingly, appellants have not shown that any ground exists such that a rehearing should be granted. Consequently, the petition for rehearing is denied.[8]



Josh Lambert
Administrative Law Judge

We concur:



Huy "Mike" Le
Administrative Law Judge

Kenneth Gast
Administrative Law Judge

Date Issued: 2/28/2023

[8] Appellants assert that they are willing to entertain a settlement position. However, OTA does not have jurisdiction over settlement matters. (See *Appeal of Eichler*, 2022-OTA-029P.)