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2023 – OTA – 150P
Precedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeal of: **R. NAG AND S. RUDD**	) OTA Case No. 18073501

OPINION

Representing the Parties:

For Appellants: R. Nag
Jonathan Golub, Attorney

For Respondent: David Hunter, Tax Counsel IV

For Office of Tax Appeals: Nguyen Dang, Tax Counsel III

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045, R. Nag (appellant-husband) and S. Rudd (appellant-wife) (collectively, appellants) appeal an action by respondent Franchise Tax Board (FTB) proposing additional tax of $839,757, plus applicable interest, for the 2010 tax year.[1]

Office of Tax Appeals (OTA) Administrative Law Judges Josh Lambert, Sara A. Hosey, and John O. Johnson held an oral hearing via videoconference for this matter on June 28, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for decision.

ISSUES

1. What is appellant-husband's adjusted basis in the stock of Cellmania Inc. (Cellmania)?
2. What is the qualified small business stock (QSBS) gain that appellant-husband may exclude from the disposition of the Cellmania stock, pursuant to R&TC section 18152.5?

[1] FTB agrees to abate interest from December 2015, through March 2017, and from August 2017, through December 2017.

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FACTUAL FINDINGS

1. Appellant-husband owned stock in Cellmania, a C corporation that built and licensed software for mobile infrastructure providers and mobile content owners.
2. On June 11, 2010, Research in Motion (RIM) sent a letter of intent (Letter of Intent) to Cellmania indicating its interest in acquiring Cellmania. The Letter of Intent states in part:

> Based on our preliminary discussions and our review of publicly available data and the information provided by [Cellmania] to date…we confirm [RIM's] preliminary indication of interest in the Transaction at a total value of $75.5 million to $79.5 million (the "Transaction Price"). The Transaction Price is calculated on a cash-free and debt-free basis.[2]

3. The Letter of Intent states that Cellmania must provide a balance sheet as of the closing date with a "good faith estimate of Net Working Capital as of the Closing Date." The letter states that future agreements will specify, based on Cellmania's operating history, a "threshold amount (the 'Peg') upon which to base any closing adjustment." The letter states that "[t]he Transaction Price payable by [RIM] shall be decreased by an amount equal to the amount by which the Net Working Capital, as of closing but as determined after closing, is less than the Peg."[3]
4. On July 29, 2010, in a document entitled "Action by Unanimous Written Consent of the Board of Directors of Cellmania, Inc." (Board Action), Cellmania's board of directors declared a distribution (Special Dividend) totaling $6,000,000, which would be paid to its shareholders on July 30, 2010.[4] The Board Action states in part:

> [T]he Board of Directors of [Cellmania] (the "Board") has reviewed the financial statements of [Cellmania] and deems it to be advisable and fair to, and in the best interests of, [Cellmania] and its stockholders for [Cellmania] to declare and pay a special dividend to the stockholders of [Cellmania]…

[2] The Letter of Intent also states: "[Cellmania] is responsible for retiring all outstanding debt as disclosed on the balance sheet, and furthermore [RIM] will assume no pre-transaction debts, debentures, or other forms of financial or accrued liability from [Cellmania] unless expressly noted otherwise."

[3] The Letter of Intent also states: "For greater certainty, [Cellmania] agrees that there will be no dividends declared or paid or debt for borrowed money paid off or incurred outside of the ordinary course of business and there will be no changes in policies, capital structure, capital expenditures, compensation, bonus or retention or severance arrangements, positions, or equity based compensation (including, without limitation, options or restricted share unit) grants without prior discussion with and agreement by [RIM] in writing."

[4] The Board Action includes director signatures on July 29, 2010, as well as July 30, 2010.

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5. The Board Action states in another section entitled "Merger with RIM", that the Board approved an Agreement and Plan of Merger (Agreement) with RIM. The Board Action states that the obligations of the Agreement will be performed, pending approval by the stockholders of Cellmania.
6. The Board Action provides for other actions "in connection with the Merger", such as accelerating the vesting of awards under the stock option plan and exercising stock warrants to purchase shares of Cellmania from certain stockholders.
7. On July 30, 2010, RIM entered into the Agreement with Cellmania to acquire all its stock in a cash merger. The Agreement indicated that the "Merger Consideration" was $72,850,000, subject to closing adjustments.
8. The Agreement provided that, no later than 30 days after the closing date, a closing balance sheet shall be provided with the "Net Working Capital" on the closing date (Closing Net Working Capital). The Agreement defines "Net Working Capital" as "the excess of current assets over total liabilities of [Cellmania], calculated on a consolidated basis in accordance with GAAP [Generally Accepted Accounting Principles]…."
9. The Agreement states in part:

> [I]f the Closing Net Working Capital is less than the Target Closing Net Working Capital, then the Merger Consideration payable by Parent shall be decreased by an amount equal to the amount by which the Closing Net Working Capital is less than the Target Closing Net Working Capital (the "Working Capital Deficit").[5]

10. The Agreement states that, if "the Closing Net Working Capital as set forth in the Final Closing Statement exceeded the Target Closing Net Working Capital (a 'Working Capital Excess')," then the surviving corporation would deposit into the "Escrow Fund" an amount equal to the lesser of the "Working Capital Excess" or certain initial collections of Cellmania's accounts receivable by the surviving corporation following closing.
11. The Agreement defines "Target Closing Net Working Capital" as "$0.00."
12. The Agreement states that the "aggregate of the amounts deposited in the Escrow Fund…shall be an adjustment to the Merger Consideration." The Agreement

[5] The Agreement provides other conditions of closing, as well as further closing adjustments that may be made.

states that a "Payment Agent" will receive the "Merger Consideration, less the Escrow Amount…" The Agreement states that the "Payment Agent" will provide the Merger Consideration to the shareholders entitled to a portion of the consideration.

10. The Agreement states that Cellmania could not, without consent:

> [P]ay any dividend or other distribution (whether in cash, securities or property or any combination thereof) in respect of any class or series of its capital stock, other than any dividend declared prior to the date hereof or any dividends or other distribution(s) reasonably required in order to distribute all or substantially all cash and cash equivalents to the Stockholders prior to the Effective Time (the "Special Dividend"), provided that in no case shall the amount of the Special Dividend cause the Closing Net Working Capital to be less than the Target Closing Net Working Capital[.]

11. The Agreement provides terms for dispute resolution, including disputes as to the calculation of Closing Net Working Capital. The terms provide that, if a resolution is not reached within a certain period of time, an independent auditor would be used to resolve any disagreements, and the auditor could determine if any adjustments should be made to Closing Net Working Capital.

12. In an August 20, 2010 Board Action, the board of directors of Cellmania authorized a second distribution (Special Dividend) totaling $4,648,978, payable to the holders of Cellmania's stock on that day. The Board Action states that the board "has reviewed the financial statements of [Cellmania] and deems it to be advisable and fair to, and in the best interests of, [Cellmania] and its stockholders for [Cellmania] to declare and pay a special dividend to the stockholders of [Cellmania]."

13. On August 20, 2010, the merger was completed.

14. Appellant-husband received sales proceeds totaling $25,456,070, which were reported to appellant-husband on Forms 1099-B, Proceeds from Broker and Barter Exchange Transactions, which are used to report the sale of stock for cash.

15. Appellant-husband received Special Dividends from Cellmania after each of the Board Actions on July 30, 2010, and August 20, 2010. The Special Dividends received by appellant-husband totaled $5,180,355 ($2,761,222 + $2,419,133) and were reported by

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Cellmania on Forms 1099-DIV, Dividends and Distributions, as non-dividend distributions to appellant-husband.[6]

16. On their joint 2010 California income tax return, appellants did not treat the Special Dividends as non-dividend distributions that reduced appellant-husband's stock basis in Cellmania, but as part of the consideration received in exchange for the Cellmania stock.[7] Specifically, on appellants' federal Form 1040, Schedule D, Capital Gains and Losses, appellants reported a sale price of $30,636,425 ($25,456,070 [sale proceeds] + $5,180,355 [Special Dividends]), a stock basis of $1,629,067, and a realized gain of $29,007,358 ($30,636,425 - $1,629,067).

17. Appellants also claimed a 50 percent California QSBS gain exclusion of $14,503,679. After applying the exclusion to the realized gain, appellants reported a taxable gain of $14,503,679 ($29,007,358 - $14,503,679).

18. 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. FTB determined that the capital gain in excess of basis from the Special Dividends was $3,551,288 ($5,180,355 - $1,629,067), which reduced appellant-husband's basis in the Cellmania stock to zero, and that the realized capital gain from the sale was $25,456,070 ($25,456,070 - $0).

19. FTB also determined that appellant-husband's California QSBS gain exclusion was limited to $5,000,000. After applying the $5,000,000 exclusion, FTB determined a taxable gain from the sale of $20,456,070. After adding the taxable Special Dividends in excess of basis of $3,551,288, FTB's determination of total gain is computed to be $24,007,358 ($20,456,070 + $3,551,288). FTB's total increase to appellants' taxable

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[6] A dividend is generally any distribution of property made by a corporation to its shareholders out of its current or accumulated earnings and profits (E&P). (See Internal Revenue Code (IRC), § 316.) A non-dividend distribution is generally a distribution of property that is not made from current or accumulated E&P that is first treated as a non-taxable return of capital which reduces the shareholder's basis in the stock and is then treated as capital gain to the extent it exceeds the basis. (See IRC, § 301(c)(2) & (c)(3)(A).)

[7] Cellmania filed a 2010 California Corporation Franchise or Income Tax Return (Form 100) for the fiscal year beginning January 1, 2010, and ending August 20, 2010, and reported that it was "merged/reorganized" on August 20, 2010. On the return, Cellmania reported the distributions as a non-liquidating distributions on federal Form 5452, Corporate Report of Non-dividend Distribution. Cellmania reported that the total dividends paid of $10,648,978 ($6,000,000 + $4,648,978) were made from other than E&P. Cellmania had no current or accumulated E&P at the time of the distributions.

gain is computed to be $9,503,679, which is the difference between FTB's determination of total gain of $24,007,358 and appellants' reported taxable gain of $14,503,679.

20. FTB issued a Notice of Proposed Assessment (NPA) to appellants reflecting the above determinations, which increased appellants' taxable income by $9,503,679 in capital gain and proposed an assessment of additional tax of $839,757, plus interest.[8] Appellants protested the NPA, and FTB issued a Notice of Action affirming its NPA.

21. This timely appeal followed.

DISCUSSION

Issue 1: What is appellant-husband's adjusted basis in the stock of Cellmania?

Burden of Proof

An FTB determination is generally presumed to be correct, and a taxpayer bears the burden of proving otherwise. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) Unsupported assertions are not sufficient 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.*)

Reduction of Basis for Non-Dividend Distributions

Internal Revenue Code (IRC) section 61(a)(3) defines gross income to include all income from whatever source derived including gains derived from dealings in property.[9] 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.[10] IRC section 1011(a) 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.

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[8] The proposed assessment of tax includes a mental health services tax of $245,032 computed on the revised taxable income.

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

[10] Pursuant to R&TC section 18031, California conforms to IRC sections 1001, 1011, 1012, and 1016, except as otherwise provided.

IRC section 316, incorporated by R&TC section 17321, 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.[11] (IRC, § 316(a).) IRC section 301(c)(1) states that the portion of the distribution which is a dividend shall be included in gross income. In general, 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).) The portion of a distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property. (IRC, § 301(c)(3)(A).)

In this case, appellant-husband received two Special Dividends from Cellmania totaling $5,180,355, in addition to proceeds of $25,456,070 paid to appellant-husband by RIM in exchange for his Cellmania stock. Appellants reported the $5,180,355 as part of the proceeds from the sale of the stock and did not reduce appellant-husband's basis in the stock, pursuant to IRC section 301(c)(2).[12]

Appellants contend that, in substance, the Special Dividends were part of the consideration received in the sale to RIM and that the Special Dividends were one step in a multi-step sales transaction. FTB argues that the form and substance of the transaction was that the Special Dividends were not part of the sale consideration and that, as a result, appellant-husband's stock basis should be reduced by those distributions.

Legal Authorities Relevant to Whether the Special Dividends were Merger Consideration

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.) Interrelated yet formally distinct steps in an integrated

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[11] Specifically, the E&P referred to here is: (1) E&P accumulated after February 28, 1913; or (2) E&P of the taxable year, as defined in IRC section 316(a). Cellmania did not have E&P from which the Special Dividends could be treated as dividends, pursuant to IRC section 316.

[12] It is necessary to compute the basis in the stock at the time of the sale to calculate the QSBS gain exclusion in issue 2. If, as appellants contend, the Special Dividends were in substance sale proceeds and should be treated as such, the Cellmania stock basis would not be reduced to zero and appellants would receive a higher QSBS exclusion calculated using the basis. (See e.g., R&TC, § 18152.5(b)(1) which limits the amount of gain which may be excluded under R&TC, § 18152.5(a) to the greater of $10 million or 10 times the aggregate adjusted basis in the stock.) This would result in a more beneficial tax treatment than what was adopted contemporaneously in the form of the transaction.

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transaction may not be considered independently of the overall transaction. (*Commissioner v. Clark* (1989) 489 U.S. 726, 738.) By thus linking together all interdependent steps with legal or business significance, rather than taking them in isolation, the tax liability may be based on a realistic view of the entire transaction. (*Ibid*.)

When examining whether a particular transaction may be disregarded, courts have examined two related factors: (1) whether, from a subjective standpoint, the transaction was motivated by a business purpose other than tax avoidance, that is sufficient to justify the form of the transaction; and (2) whether the transaction had economic substance beyond tax avoidance. (*Bail Bonds by Marvin Nelson, Inc. v. Commissioner* (9th Cir. 1987) 820 F.2d 1543, 1549; *Levy v. Commissioner* (1988) 91 T.C. 838, 853-856.) The economic substance factor includes an examination of whether the substance of the transaction reflects its form, and whether from an objective standpoint the transaction was likely to produce economic benefits aside from a tax benefit. (*Ibid*.)

While taxpayers are free to organize their affairs as they choose, nevertheless, once having done so, they must accept the tax consequences of their choice, whether contemplated or not, and may not enjoy the benefit of some other route they might have chosen to follow but did not. (*Commissioner v. National Alfalfa Dehydrating & Milling Co.* (1974) 417 U.S. 134, 149.) When taxpayers attempt to recharacterize the form of a transaction and show that the substance of the transaction should prevail, they are held to a higher burden than the tax agency. (See, e.g., *Glacier State Elec. Supply Co. v. Commissioner* (1983) 80 T.C. 1047, 1053.) Taxpayers have less freedom than the tax agency to ignore the transactional form that they adopted. (*Coleman v. Commissioner* (1986) 87 T.C. 178, 202; *W. E. Hall Co. v. Franchise Tax Bd*. (1968) 260 Cal.App.2d 179, 184.) This is particularly true where the form of the transaction was adopted in order to achieve a bona fide, permissible tax purpose. (*Coleman v. Commissioner*, *supra*, 87 T.C. at p. 202.)

Courts have examined whether a distribution of unwanted assets was, in substance, a dividend or part of the purchase price, and whether the dividend should be considered as a part of a multi-step transaction for the sale of stock. In *Waterman Steamship Corporation v. Commissi*oner (5th Cir. 1970) 430 F.2d 1185 (*Waterman*), the court held that a dividend by a subsidiary was payment for the purchase price to the seller for the subsidiary's stock. A dividend was declared immediately after a sale agreement was executed to purchase two

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subsidiaries. One subsidiary distributed a dividend in the form of a promissory note, and immediately after the sale, the buyer loaned the subsidiary the cash to pay off the note. (*Id*. at pp. 1188-1190.) The court held that the parties contemplated the purported dividend as inextricably tied to the purchase price, and the distribution of funds was supplied by the buyer of the stock, with the subsidiary acting as a mere conduit for passing the payment through to the seller. (*Id*. at pp. 1191-1192.)[13]

In *TSN Liquidating Corporation, Inc. v. U.S.* (5th Cir. 1980) 624 F.2d 1328 (*TSN*), the court held that a dividend was not part of the purchase price of a sale of a subsidiary. As required by the buyer of a subsidiary, the subsidiary distributed unwanted investment assets to its shareholders prior to the sale, and the assets were not included in the purchase price. (*Id.* at p. 1332.) After the sale, the purchaser made capital contributions to the subsidiary of assets which were different "in kind" from the unwanted assets that had been distributed to the shareholders prior to the sale but had the same value as the distributed assets. (*Id.* at p. 1335.) The court held that the distribution constituted a dividend to the shareholders because the purchaser did not negotiate or pay for the unwanted assets, and there was a valid business purpose for the presale distribution of the assets. (*Id.* at p. 1336.)

The court in *TSN* cited to *Coffey v. Commissioner* (1950) 14 T.C. 1410 (*Coffey*), where it was held that a pre-sale distribution of an unwanted asset, an interest in a contingent payment, was not part of the sale. The TSN court noted the following from *Coffey*:

> We do not agree with petitioners that they received the [unwanted asset] as part of the consideration for the sale of their stock. The purchasers did not agree to buy their stock and then turn over to them $190,000 and the [unwanted asset] in consideration therefor. From the testimony above set forth it is apparent that they were not interested in the [unwanted asset], did not want it included in the assets of the corporation at the time they acquired its stock, and negotiated with petitioners to acquire stock of a corporation whose assets did not include the unwanted [asset] . . . Under the contract of sale, they did not sell or part with their interest in the [unwanted asset].

(*TSN*, *supra*, 624 F.2d at p. 1332, citing *Coffey v. Commissioner*, *supra*, 14 T.C. at p. 1418.)

[13] In addition to the above cases, the parties discussed cases such as *Walker v. Commissioner* (1976) 544 F.2d 419, and *Casner v. Commissioner* (1971) 450 F.2d 379, which include the issue of whether the deemed recipient of a dividend was the seller or buyer and an examination of the beneficial owner of the stock when the dividend was declared; that issue is not present in this case. (See *Waterman*, *supra*, 430 F.2d at p. 1195.)

The court in *TSN* also cited to *Gilmore v. Commissioner* (1956) 25 T.C. 1321 (*Gilmore*), where the court ruled that the distribution was a taxable dividend rather than part of the stock sale price. In that case, the purchaser offered to buy the stock for a specified price and waived any claim to the company's cash and liquid assets, and the parties agreed to a presale dividend to exclude the assets from the sale. *TSN* quotes *Gilmore* as follows:

> The [purchasers] chose to make this offer, one that "waived" the quick assets after payment of indebtedness....... The [purchasers] did not agree to pay the stockholders $6.50 or any other sum from the surplus. They "waived any claim" to the surplus and consented that it "may be paid to the present stockholders." . . .

(*TSN*, *supra*, 624 F.2d at p. 1332, citing *Gilmore v. Commissioner*, *supra*, 25 T.C. at pp. 1323-1324.)

Analysis

Appellants assert that the Agreement contemplated that the Special Dividends would be made, and that RIM wanted Cellmania to be cash and debt free for purposes of the sale. Therefore, appellants contend that the Special Dividends were necessary to distribute cash from the business. Appellants argue that, as a result, the purchase price was lower to account for the distribution of the Special Dividends. Appellants also assert that the terms of the Agreement for closing adjustments provided for an increase to the sales price at closing if no Special Dividends were made, which demonstrates that the Special Dividends should be considered part of the purchase price.

RIM and Cellmania Did Not Intend for the Special Dividends to be Part of the Sale or Included in the Purchase Price

The evidence presented, including the Agreement, does not show that the Special Dividends were considered or intended by the parties to be part of the sale. Similar to *TSN*, *supra*, 624 F.2d 1328, RIM did not want, or negotiate, to purchase Cellmania with the cash at issue that was eventually distributed to the shareholders through the Special Dividends. In the Letter of Intent, RIM states that the transaction price is calculated on a cash-free, debt-free basis. Appellants also assert that "[b]oth buyer and seller desired to have as little cash and debt as possible on consummation…" There is no evidence that RIM lacked funds for the purchase of the excess cash or that its intent to exclude cash from the sale was for that reason. Appellant asserts that, at that time, RIM was valued at $40 billion and had over $6 billion in cash, and there

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was no issue of RIM having insufficient liquidity to consummate a $75 million transaction. Completing such a sale on a cash-free, debt-free basis is typical, and there are various possible business reasons for completing a sale on a cash-free, debt-free basis that are valid for tax purposes. As to a cash-free sale, one such reason includes that the buyer may not want to purchase cash for cash. As to a debt-free sale, one such possible reason may be that the buyer does not want to assume or be responsible for the debt of the seller.

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, consistent with the parties' intent for it to be excluded from the sale. This was completed via distributions, i.e., the Special Dividends, which is an expected occurrence in such cash-free, debt-free transactions. (See, e.g., *Transeo S.A.R.L. v. Bessemer Venture Partners VI L.P.* (2013) 936 F.Supp.2d 376 ["AVG offered to acquire NHI for $25 million on a 'cash free' basis, which meant that NHI's cash on hand would be distributed *pro rata* to shareholders"].) As stated by appellants, to complete the transaction on a cash-free, debt-free basis, "the practical way to accomplish this is via a distribution."

These circumstances are similar to those in the *TSN*, *Coffey*, and *Gilmore* line of cases, where the courts respected the pre-sale dividends. In those cases, the purchasers did not want the assets included in the sale and negotiated for the sale to exclude the assets. (See *TSN*, *supra*, 624 F.2d at p. 1336; *Coffey*, *supra*, 14 T.C. at p. 1418; *Gilmore*, *supra*, 25 T.C. at pp. 1323-1324.) On the other hand, in *Waterman, supra*, 430 F.2d 1185, where the court found the dividend was part of the purchase price, the purchase price for all the stock in the subsidiaries was negotiated to include the amount of the dividend, no specific assets owned by the subsidiaries were distributed prior to the sale, and the distribution was instead made in the form of a promissory note which was ultimately paid by the buyer. (See *TSN*, *supra*, 430 F.2d at p. 1334.)

Additionally, in this case, the Board Actions declaring the Special Dividends do not state the distributions are related to the Merger, but instead state that they are authorized because it is "advisable and fair to, and in the best interests of, [Cellmania] and its stockholders…." The parties did not negotiate the sale to include the cash which was paid out to the shareholders as the Special Dividends and the there is no allocation of the purchase price in the Agreement for the Special Dividends; instead, the purchase price was calculated as excluding consideration for the cash or Special Dividends.

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Appellants assert, however, that the Special Dividends should be considered part of the purchase price because, but for the merger, they would not have been made, and the Agreement also contemplated that the Special Dividends would be made. However, those facts demonstrate that the cash was not intended to be part of the sale, and the Special Dividends were needed to extract the cash pre-sale. This intent to exclude the cash from the sale is reflected in the Agreement, which provides that Special Dividends could be made "in order to distribute all or substantially all cash and cash equivalents to the Stockholders prior to the Effective Time [of the merger]." While Cellmania and RIM had a shared goal to consummate the sale, there was no intention for the cash or Special Dividends to be included in the consideration to be paid by RIM.

The Closing Adjustment Terms Do Not Show that the Special Dividends should be Included in the Purchase Price

Appellants also assert that the Agreement required that, if Cellmania had extra cash at closing, then RIM would need to increase to purchase price, which demonstrates that Cellmania's cash would be factored into the sales price, whether ultimately included or excluded from the sale. While an actual closing adjustment could adjust the purchase price, distributed cash that would hypothetically result in a closing adjustment if it was not distributed, does not alone mean such cash is consideration for the sale and part of the purchase price. In *TSN*, *supra,* 624 F.2d at p. 1329, adjustments were made to the purchase price prior to the sale to account for the unwanted assets being excluded from the sale, and the court held that the distributions were dividends and not part of the purchase price.

In addition, in this case, the Agreement terms providing for the closing adjustments do not establish that the Special Dividends were part of the consideration. Closing adjustments were to be made to adjust for any differences in the Target Closing Net Working Capital and the Closing Net Working Capital, which may arise due to changes in the balance sheet before the closing date. 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. The closing adjustments terms of the Agreement, which are commonplace, were not the result of negotiations for the acquisition of the excess cash as part of the purchase but were intended to serve a different purpose, including keeping the purchase price consistent with the financial circumstances of the company.

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Specifically, the closing adjustment terms were intended primarily to assure that Net Working Capital at closing would be at the "Peg" of zero, and to allow for any adjustments following closing for any excess or deficit in Net Working Capital at closing.[14] The Target Net Working Capital at closing reflects an intent by the parties for Cellmania to have no excess cash, so that RIM would not have to pay cash for cash (and cash equivalents) that were not part of the sale. This demonstrates that the excess cash was not intended to be part of the sales price.

Furthermore, closing adjustment terms can ensure that working capital does not drop to an insufficient level at closing, such that the business cannot operate after the sale. (See, e.g., *In re Joy Recovery Technology Corp*. (2002) 286 B.R. 54, 78 ["A low level of working capital means that the company will have difficulty funding its operations"].) RIM likely set the Target Closing Net Working Capital at zero, not only because it did not want to acquire Cellmania's cash (and cash equivalents) but also because it likely did not want to acquire Cellmania with a deficit in Net Working Capital. This is demonstrated by the Agreement, which provides that "in no case shall the amount of the Special Dividend cause the Closing Net Working Capital to be less than the Target Closing Net Working Capital…." The closing adjustments terms ensured that the Special Dividends did not result in the distribution of cash from Cellmania to the extent that RIM would be acquiring a company with significantly more total liabilities than current assets, which would create difficulties for RIM in operating Cellmania after the close of the sale.

Additionally, disputes may arise between a buyer and seller as to the calculation of closing adjustments. (See, e.g., *Severstal U.S. Holdings, LLC v. RG Steel, LLC* (2012) 865 F.Supp.2d 430; *In re Bachrach Clothing, Inc*. (2012) 480 B.R. 820.) In this case, the terms of the Agreement provide for dispute resolution as to closing adjustments and provide that an independent auditor could be used to resolve any disputes. This further illustrates that the closing adjustment terms had a distinct business purpose that accounted for any potential disputes that may arise as a result of the independent motivations of the parties in an arm's length transaction. The closing adjustment terms do not demonstrate, as appellants contend, a shared goal of Cellmania and RIM to treat the pre-sale Special Dividends as consideration for the sale. It is more likely that the parties would have preferred that no closing adjustments were

[14] The record does not include specifics of the funding necessary for Cellmania's operations prior to and following the acquisition by RIM. However, the relevant fact is that the parties agreed to a Net Working Capital of zero, which reflects that the sale would not include the excess cash distributed by the Special Dividends.

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made, requiring no dispute resolution. That would mean that the negotiated Target Net Working Capital at closing was reached, and that the purchase price corresponded to the financial circumstances of Cellmania at closing. In other words, RIM would receive only the assets it negotiated for, and not the excess cash or liabilities, and Cellmania would receive the cash expected and negotiated for at closing. Accordingly, the closing adjustments do not show that the Special Dividends were part of the sales price.

The Special Dividends had Economic Substance and a Business Purpose

Appellants argue that the Special Dividends should be disregarded as lacking independent economic substance apart from the sale.[15] However, 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.) As noted by appellants, it is commonplace to purchase a company on a cash-free, debt-free basis and to make closing adjustments for net working capital. Therefore, appellants' arguments could be made for any purchase of a company using these common transaction methods, which does not fall within the scope of the type of transaction that should be recharacterized after the fact as lacking independent economic substance.

While the Special Dividends and the sale may be related, that does not mean that the Special Dividends were part of the purchase price or a substitute for merger consideration. (See *Turner Broadcasting Sys., Inc. v. Commissioner* (1998) 111 T.C. 315, 327 [existence of an overall plan by itself does not justify combining steps].) Appellants note that the Special Dividends and the sale took place in a short space of time. However, that the Special Dividends were made near the time of the Agreement and closing of the sale illustrates the negotiations and intent of the parties to exclude the cash from the sale, and that the Special Dividends were needed for the sale to be completed as intended.

The second Special Dividend and the closing of the sale occurred on the same day but, as appellants note, fluctuations occur daily in a balance sheet, which, as described above, is a

[15] "While the doctrine may well also apply if the taxpayer's sole subjective motivation is tax avoidance even if the transaction has economic substance, a lack of economic substance is sufficient to disqualify the transaction without proof that the taxpayer's sole motive is tax avoidance." (*Coltec Industries, Inc. v. United States*, 454 F.3d 1340, 1355.)

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reason for including closing adjustments terms in such an agreement. The Agreement states that Cellmania is to provide a closing balance sheet and the Net Working Capital balance on the closing date, which would be used to determine any necessary closing adjustments. Therefore, a review of the balance sheet at closing would more accurately reveal the amount of cash that needed to be distributed at or prior to close in order to reach the Target Net Working Capital at closing, so that the related closing adjustments would not be required or could be minimized to the extent possible. In other words, it is logical that the Special Dividend would be made near the time of the closing of the sale. Therefore, the fact that the Special Dividends and the sale occurred within a short timeframe does not demonstrate that the Special Dividends were part of the purchase price.

In addition, the Special Dividends had independent legal significance from the sale. The parties chose to structure the transaction so that: (1) the Special Dividends were legally independent from the sale; and (2) the cash distributed by the Special Dividends was excluded from the sale and purchase price. The Agreement did not legally obligate Cellmania to pay the Special Dividends as a condition of the sale, the Special Dividends were not contingent on consummation of the sale, and RIM's approval was not required for the Special Dividends.[16] Cellmania's shareholders were not required to relinquish any of their Cellmania stock in exchange for receiving the Special Dividends. The Agreement also stated that RIM would be held harmless from any tax liability in connection with the Special Dividends. Had there been a change in circumstances causing the merger to fall through, Cellmania's shareholders would have been entitled to retain both their stock and the Special Dividends. Therefore, the Special Dividends were legally binding irrespective of the outcome of the sale.

In addition, RIM did not want to acquire Cellmania's cash and cash equivalents, and the Special Dividends were not intended or negotiated to be part of the purchase price; therefore, any requirement in the Agreement that Cellmania distribute its cash and cash equivalents to the shareholders prior to the close of the sale would only serve as evidence of such an intent. Accordingly, even if the Special Dividends were required to be made by the Agreement, they would still not be part of the purchase price.

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[16] Per section 6.1(c) of the Agreement, while prior written consent was required for certain distributions or dividends, any Special Dividend (defined as any dividend or distribution "reasonably required in order to distribute all or substantially all cash and cash equivalents to the [stockholders of Cellmania]") was expressly excluded from this requirement.

In *TSN*, the court's decision was partly based on a conclusion that the distribution had a business purpose; specifically, the court stated that, "[t]he facts…clearly demonstrate a business purpose for the presale dividend of the unwanted assets which fully explains that dividend."[17] (*TSN*, *supra*, 624 F.2d at p. 1336.) In this case, the Special Dividends did not add an extra meaningless step, for the sole purpose of generating a tax benefit. Instead, as described above, the Special Dividends had a significant business purpose and economic substance. (See *Esmark, Inc. v. Commissioner* (1988) 90 T.C. 171, 195 [examining whether there are meaningless or unnecessary steps to be ignored].)[18] Appellants state that they "do not believe the buyer's motivation for requiring the distribution of target company cash affects the proper tax treatment of such amounts." However, the court in *TSN*, *supra*, 624 F.2d at p. 1336, declined to focus on "the business purpose of one participant in a multi-party transaction" in "isolation from the over-all business purpose for the entire transaction." RIM wanted the sale to be completed on a cash-free, debt-free basis, and did not want the distributed cash, so the Special Dividends were necessary to distribute the cash prior to the sale.

As stated by the court in TSN, "[w]e view the sham aspect[,] the hollow sound of the transaction described in *Waterman*[,] as one of the critical aspects of that decision, and we decline to extend the *Waterman* rule to a case which admittedly does not involve a sham…." (*TSN*, *supra*, 624 F.2d at p. 1335.) In *Waterman*, *supra*, 430 F.2d 1185, there was a reinfusion of cash from the purchaser that was previously negotiated by the parties and was ultimately used to pay the promissory note that had been distributed to the parent in the pre-sale distribution. In this case, however, the source of the funds was not RIM, but Cellmania. Comparably, there was a reinfusion of assets in *TSN*, *supra*, 624 F.2d at p. 1333, following the sale and the court held the dividend should be respected because it was negotiated as separate from the purchase price and there was a valid business purpose for the dividend. In this case, there is no evidence of any circular cash flows or reinfusion of funds, or any steps taken so that RIM would be the indirect

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[17] In *TSN*, *supra*, 624 F.2d at p. 1336, the court stated that an incidental tax benefit to the taxpayer as to the form of the transaction, without more, does not necessitate the disallowance of treatment. In this case, there is no evidence showing the purpose of the Special Dividends was tax avoidance.

[18] Business purpose by itself does not preclude finding the individual steps of a multi-step transaction should be combined. (*True v. United States* (1999) 190 F.3d 1165, 1177.) Although the absence of economic effects or business purposes may be decisive, the presence of those factors is not dispositive. (*Id.*) In this case, there is a significant business purpose and no evidence of anything other than bona fide transactions.

or obscured source of the cash distributed by the Special Dividends. The transactions at issue are the type of business activity expected in a bona fide, arm's length business deal between unrelated parties.

Alternative Form Not Taken

Appellants assert that the same results could have been reached if RIM and Cellmania had gone through the circular and unnecessary steps of leaving cash in Cellmania, increasing the purchase price by net cash at close, and taking a tax-free distribution of cash post close. Appellants contend that had they taken these "unnecessary" steps, the result would have been exactly the same as if the sales proceeds included the distribution. However, it is unclear if the sale would have closed if the Special Dividends were not made, as the parties did not negotiate for the cash to be included in the sale, and RIM wanted Cellmania to make the Special Dividends so that it could acquire Cellmania on a cash free, debt free basis. As such, Cellmania was incentivized to remove the cash, as it was not part of the sale. Appellants also assert that RIM's preference was to have the Special Dividends distributed just prior to closing, instead of employing a closing adjustment. Appellants assert: "No acquirer would consummate a transaction if there was an unanticipated taking of the target company's cash assets prior to closing." As a result, it does not appear that, as appellants contend, there were necessarily two plausible and interchangeable alternatives: the Special Dividends or a closing adjustment.

Furthermore, a taxpayer's ability to identify an alternative path to a given end result that provides more favorable tax consequences than the path actually taken, is not enough to entitle the taxpayer to the desired tax treatment. (*Complex Media, Inc. v. Commissioner*, T.C. Memo. 2021-14.) And as stated in *Gilmore*:

> It may be true the parties could have reached much the same result and have avoided some tax consequences to the stockholders by casting the transaction in the form of a higher purchase offer that would have included all of the quick assets. But this just was not done.
>
> (*Gilmore*, *supra*, 25 T.C. at p. 1323.)

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Conclusion

The Special Dividends were in substance and form, separate from the consideration appellant-husband received in exchange for his Cellmania stock. Accordingly, appellants have not shown error in FTB's determination that the Special Dividends were a return of capital that reduced appellant-husband's stock basis to zero.[19]

Issue 2: What is the QSBS gain that appellant-husband may exclude from the disposition of the Cellmania stock, pursuant to R&TC section 18152.5?

R&TC section 18152.5(a) states that "[f]or purposes of this part, gross income shall not include 50 percent of any gain from the sale or exchange of [QSBS] held for more than five years."[20] R&TC section 18152.5(b)(1) provides:

> "[i]f the taxpayer has eligible gain for the taxable year from one or more dispositions of stock issued by any corporation, the aggregate amount of the gain from dispositions of stock issued by the corporation which may be taken into account under subdivision (a) for the taxable year shall not exceed the greater of either of the following:
>
> (A) Ten million dollars ($10,000,000) reduced by the aggregate amount of eligible gain taken into account by the taxpayer under subdivision (a) for prior taxable years and attributable to dispositions of stock issued by the corporation.
>
> (B) Ten times the aggregate adjusted bases of [QSBS] issued by the corporation and disposed of by the taxpayer during the taxable year. For purposes of subparagraph (B), the adjusted basis of any stock shall be determined without regard to any addition to basis after the date on which the stock was originally issued."[21]

FTB contends that appellant-husband's stock basis was reduced to zero because of the non-dividend distributions received. FTB asserts that R&TC section 18152.5(b) provides that the eligible gain, that may be excluded up to 50 percent, is limited to the greater of $10 million

[19] This conclusion is based on the facts and circumstances in this specific appeal; it does not mean that a corporation can never, under any circumstances, distribute cash prior to the sale and have such distribution treated as part of the subsequent sale.

[20] R&TC section 18152.5 was repealed effective January 1, 2016. All references to R&TC section 18152.5 in this Opinion are to the version in effect from January 1, 2000, to December 31, 2013.

[21] R&TC section 18152.5(b)(1)(B) provides that the adjusted basis is determined without regard to any additions to basis from when the stock was originally issued, which does not apply in this case, since there was no addition to basis but a reduction in basis due to a return of capital.

or 10 times the stock basis. FTB states that the stock basis is zero, 10 times zero is zero, and because $10 million is greater than zero, appellants' eligible gain is limited to $10 million. FTB contends that the eligible gain is multiplied by 50 percent, pursuant to R&TC section 18152.5(a), and appellants are therefore entitled to a QSBS gain exclusion of $5 million.

Appellants assert that the phrase "which may be taken into account under subsection (a)" in R&TC section 18152.5(b)(1) is ambiguous and means that the gain exclusion amount, after calculating the 50 percent exclusion, is limited to the greater of $10 million or 10 times their basis in Cellmania stock.[22] Because OTA finds that the Cellmania stock basis is zero, under appellants' interpretation, the limitation would be the greater of $10 million and the basis of zero times ten, which is zero. Because the gain on the sale of the Cellmania stock exceeds $20 million, 50 percent of that gain would exceed the $10 million limitation provided in R&TC section 18152.5(b)(1); as a result, the QSBS gain exclusion would be limited to $10 million under appellants' interpretation.

Appellants contend that policy goals of the statute are better served by their interpretation, which creates a higher "cap" for the exclusion and greater benefit to the taxpayer. Appellants argue that, when deciding between conflicting interpretations of a statute, the policy of the statute should be considered. Appellants assert that the statute is intended to help small businesses and encourage investment in small businesses. Appellants assert that the California Legislature re-authorized the exclusion for the period relevant to this appeal to help small businesses.[23] Appellants contend that the policy goals should be given more weight because the relevant period was during a recession. Appellants assert that the legislative history contains no support for FTB's position.

[22] Specifically, appellants contend that appellant-husband is entitled to a QSBS gain exclusion of $14,503,679. Under R&TC section 18152.5(b)(1)(B), appellants calculated the limitation or cap to equal 10 times appellant-husband's claimed basis, which is $16,290,670 (i.e., $1,629,067 x 10). Appellants contend that this amount is greater than $10 million and, therefore, is the cap for the exclusion. Under R&TC section 18152.5(a), appellants calculated $14,503,675, which is 50 percent of the gain (i.e., $29,007,350 x 50 percent). Appellants contend that, because $14,503,675 does not exceed the cap of $16,290,670, they are entitled to a QSBS gain exclusion of $14,503,675. However, because OTA found that the Cellmania stock basis is zero, these numbers will be revised in accordance with appellants' interpretation.

[23] R&TC section 18152.5 was ruled unconstitutional in *Cutler v. FTB* (2012) 208 Cal.App.4th 1247. FTB issued FTB Notice 2012-03, which stated R&TC section 18152.5 was invalid and unenforceable, and that it would issue NPAs denying claimed exclusions or deferrals of gain for tax years beginning on or after January 1, 2008. However, California Assembly Bill 1412 rejected FTB Notice 2012-03 and authorized the exclusion to taxpayers who sold QSBS from January 1, 2008, to January 1, 2013. (Stats. 2013, ch. 546, § 2, effective January 1, 2014.)

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R&TC section 18152.5(b)(1)(B)(2) states that, "[f]or purposes of this subdivision, the term '*eligible gain'* means *any gain from the sale or exchange of [QSBS] held for more than five years*." (Italics added.) This language is similar to that in R&TC section 18152.5(a), which states that "gross income shall not include 50 percent of *any gain from the sale or exchange of [QSBS] held for more than five years*." (Italics added.) In other words, R&TC section 18152.5(a) provides that gross income shall not include 50 percent of any "eligible gain."

R&TC section 18152.5(b)(1) states that the eligible gain that may be taken into account under R&TC section 18152.5(a) shall not exceed the greater of $10 million or 10 times the basis. Specifically, R&TC section 18152.5(b)(1) provides that "[i]f the taxpayer has eligible gain for the taxable year…the gain…which may be taken into account under subdivision (a) for the taxable year shall not exceed the greater of either of the following…." A plain reading of the phrase "taken into account" would interpret it to mean "considered" or "taken into consideration."[24]

The Legislative history of R&TC section 18152.5 indicates that the $10 million or 10-times-basis limitation is applied to the eligible gain. The Bill Analysis of Senate Bill 671, which implemented R&TC section 18152.5, summarizes the statute as providing that the "amount of *gain eligible* for the 50% exclusion is limited to the greater of…." (Italics added.) The Bill Analysis also refers to the "$10 million gain limitation on *eligible gain*" and the "10-times-basis limitation." (Italics added.) Additionally, the House Bill for the Omnibus Budget Reconciliation Act of 1993 (1993-3 C.B. 393, 8/4/93), which implemented the federal QSBS provisions in IRC section 1202 upon which R&TC section 18152.5 is based, states that "[t]he amount of *gain eligible* for the 50 percent exclusion is limited to the greater of…." (Italics added).[25] (See also *Voss v. Commissioner* (2015) 796 F.3d 1051, 1060 ["the $10 million limitation on eligible gain"].)

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[24] See https://www.merriam-webster.com/thesaurus/take%20into%20account; https://dictionary.cambridge.org/us/dictionary/english/take-into-account.

[25] The section at issue in R&TC section 18182.5 is similar to IRC section 1202(b). Federal law interpreting a federal statute may be considered highly persuasive when interpreting a California statute that is substantially similar to a federal statute. (See *Appeal of Calegari*, 2021-OTA-337P; see also FTB Notice 2003-6 ["With certain exceptions, California's provisions on small business stock found in Revenue and Taxation Code sections 18038.5 and 18152.5 mirror IRC sections 1045 and 1202, respectively. Due to their similarity and the express intent of the Legislature, any federal rules or procedures applicable to the federal QSBS provisions apply to California's QSBS provisions to the extent that they do not conflict with any California rules or procedures".]

These indicate that the "eligible gain" that may be "taken into account" or "considered" for the 50 percent exclusion is "limited" to the greater of $10 million or 10 times the basis.[26] The limitation applies to the eligible gain before the 50 percent exclusion has been taken. The gain first must be "eligible" for the exclusion, which means it must first satisfy certain conditions.[27] In other words, R&TC section 18152.5(b) provides for limitations to the eligible gain, similar to IRC section 1202(b), which is entitled "Per-Issue Limitation on Taxpayer's Eligible Gain." First, the eligible gain is determined, pursuant to R&TC section 18152.5(b), by calculating it so that it does not exceed the limitation, which is the greater of $10 million or 10 times the basis in the stock. Second, the gain that is determined to be eligible is then taken into consideration under R&TC section 18152.5(a) and is multiplied by 50 percent to calculate the exclusion amount.

<u>Conclusion</u>

OTA acknowledges that R&TC section 18152.5 was implemented to benefit small businesses through tax benefits, as appellants assert. However, as to the extent of the benefit provided by the exclusion, the plain language of the statute and Legislative history of the California statute and similar federal statute do not indicate that the exclusion should, or was intended to, be calculated as appellants contend. Statutes 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. (*Honeywell Information Systems, Inc. v. County of Sonoma* (1974) 44 Cal.App.3d 23, 27.) An 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. (*Hospital Service of California v. City of Oakland* (1972) 25 Cal.App.3d 402, 405.)

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[26] For instance, the House Bill, in describing the applicability of the exclusion to certain stock, illustrates that, for the 50 percent exclusion to be applied, gain must first be found eligible under such limitation rules: "…for purposes of calculating the *gain eligible for the 50 percent exclusion* for [QSBS] under new section 1202." (Italics added.)

[27] See https://www.merriam-webster.com/dictionary/eligible; https://dictionary.cambridge.org/us/dictionary/english/eligible.

Appellants provide no legal authorities, and OTA is not aware of any, that establish that a different conclusion is warranted.[28] Accordingly, the disputed amount specified in R&TC section 18152.5(b)(1) refers to the eligible gain which must be further reduced by 50 percent to compute the exclusion amount set forth in R&TC section 18152.5(a). As determined under the first issue, appellants must reduce their basis in Cellmania stock to zero. The $10 million limitation amount is greater than zero and is therefore the eligible gain. Therefore, the QSBS gain exclusion is $5 million, reflecting 50 percent of the eligible gain of $10 million ($10 million x 50 percent).

HOLDINGS

1. Appellant-husband's adjusted basis in the stock of Cellmania is zero.
2. The QSBS gain that appellant-husband may exclude from the disposition of the Cellmania stock is $5,000,000, pursuant to R&TC section 18152.5.

DISPOSITION

FTB's action is sustained.

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Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

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Sara A Hosey
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Sara A. Hosey
Administrative Law Judge

DocuSigned by:
John O Johnson
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John O. Johnson
Administrative Law Judge

Date Issued: 10/5/2022

[28] Appellants provide a law review article in support of their contention, which states that IRC section 1202(b) has "two very distinct interpretations…" and that the interpretation allowing for the highest benefit (appellants' interpretation) is consistent with the intent of the statute "to incentivize potential business owners to make the investment." (See Cantley, *The New Section 1202 Tax-Free Business Sale: Congress Rewards Small Businesses That Survived the Great Recession* (2012) 17 Fordham J. Corp. & Fin. L. 1127, 1150.) The article states that "neither Congress nor the IRS [has issued] an opinion regarding this clause" and that "taxpayers currently use both approaches." (*Ibid.*) The article provides no supporting legal authorities other than citing the intent of the statute, similar to appellants' arguments, and OTA does not find the article persuasive.