

BEFORE THE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF:	)	
	)	
ALVACO TRADING COMPANY, INC.,	)	OTA NO. 220410259
ALVACO TRADING COMPANY, INC.,	)	220410261
GROUP RETURN,	)	220410262
V. ALVAREZ and C. ALVAREZ,	)	220410263
A. ALVAREZ and P. ALVAREZ,	)	
	)	
APPELLANT.	)	
_____	)	

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TRANSCRIPT OF ELECTRONIC PROCEEDINGS

Tuesday, October 17, 2023

Reported by:

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Hearing Reporter

Job No.:  
44378 OTA(B)



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STATE OF CALIFORNIA  
FRANCHISE TAX BOARD

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1 I N D E X

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3 E X H I B I T S

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6 (Department's Exhibits A-G were received at page 7)

7 (Appellant's Exhibits 1-11 were received at page 7)

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1 Sacramento, California, Tuesday, October 17, 2023

2 1:04 p.m.

3  
4  
5 JUDGE LEUNG: Today is October 17th, 2023.  
6 It's approximately 1:05 p.m. in the afternoon.

7 This is the Appeals of Alvaco Trading Company,  
8 Inc., and Al. Docket Numbers 220410259, 261, 262, and  
9 263.

10 The taxable year issue is 2012, and this  
11 concerns the Alvaco Trading Company, an S-Corporation  
12 which was or still is a member of the AB Liability  
13 Company in 2012. Alvaco sold or disposed of all -- or,  
14 substantially, all of its AB membership interest and a  
15 gain.

16 The issues for today's hearing and for the  
17 appeal, and I'll paraphrase with only agenda, are:

18 Number one, whether Alvaco Trading is unitary  
19 with AB; number two, whether the gain is business or  
20 nonbusiness income; number three, whether Revenue  
21 Taxation Code 17952 or Regulations, section 17951-4,  
22 applies; and number four, whether the FTB actions are  
23 bound of the constitution and it would tax nonresidents  
24 for California.

25 I would like to begin with introductions.

1           Begin with the Appellants, please.

2           MR. KARACHALE: Thank you, your Honor. This  
3 is Christopher Karachale on behalf of Appellants.

4           MS. NESSIER: Good afternoon, your Honors.  
5 Shannon Nessier also on behalf of the Appellants.

6           MR. SHAVER: Good afternoon, your Honors.  
7 Daren Shaver also with Appellants.

8           MR. LEUNG: Thank you. Thank you Mr.  
9 Karachale for correcting my mispronunciation of your  
10 name

11           MR. KARACHALE: That's a hard -- it's a hard  
12 one.

13           JUDGE LEUNG: There's a lot of hard ones  
14 today.

15           Mr. Beck for the Franchise Tax Board.

16           MR. BECK: I am Brian Beck. I am with the  
17 Franchise Tax Board.

18           MS. SWAIN: Good afternoon Judge Leung and  
19 Panel. My name is Ellen Swain for the Franchise Tax  
20 Board.

21           MS. TAMAGNI: And I'm Delinda Tamagni.  
22 Franchise Tax Board.

23           JUDGE LEUNG: Thank you.

24           To my left is Judge Akopchikyan, and to my  
25 right is Judge Vassigh.



1 Alvaco sold units of ABB Concise Optical Group; a  
2 Delaware LLC, in which it was a passive investor.  
3 Alvaco and ABB were not unitary.

4 Under the general conduit rule for multi-state  
5 s-corporations operating in California, the nonresident  
6 shareholders of Alvaco treated the gain as nonbusiness  
7 income under Revenue of Taxation Code, section 952.

8 My colleague, Ms. Nessier, is going to provide  
9 you with a lengthy discussion of why Alvaco and ABB were  
10 not unitary. I want to emphasize at the start, the  
11 story is simple.

12 Alvaco sold units of an LLC, in which there  
13 was no unitary relationship. Therefore, Revenue  
14 Taxation Code Section 17952 applies, and the nonresident  
15 Alvaco shareholders do not have California source  
16 business income.

17 Once my colleague, Ms. Nessier, finishes her  
18 discussion, my colleague, Mr. Shaver, will briefly  
19 address more technical issue that would plead is  
20 important for the Court to consider. In it's attempt to  
21 re-characterized, Alvaco's gain from the ABB units as  
22 business income, the FTB misapplied its own regulation.

23 Mr. Shaver will explain that the FTB  
24 improperly applied Regulation 7951-4 retroactively to  
25 Alvaco and it's shareholders for tax year 2012.

1           Finally, I will discuss how the FTB's recent  
2 guidance increasingly obscures the clearly demarcated  
3 federal guardrails that prevent California from taxing  
4 nonresidents like Alvaco and it's shareholders.

5           It is important for the Court to fully  
6 appreciate the increasingly unattainable decision  
7 adopted by the FTB, and the multi-state taxation of  
8 pass-through entities.

9           But before Ms. Nessier presents, I want to  
10 provide a brief background on Alvaco shareholders --

11           MR. AKOPCHIKYAN: Sorry to interrupt.

12           Can you please speak closer to the microphone.

13           MR. KARACHALE: Sure. Can you hear me a  
14 little better now?

15           MR. AKOPCHIKYAN: Yeah.

16           MR. KARACHALE: Sorry about that.

17           Did you get all of that before? Want me to  
18 start over? Thank you. I can go back.

19           Before Ms. Nessier presents, I want to provide  
20 a brief background on Alvaco, its shareholders, and ABB.

21           Alvaco was formed in 1989 and grew through the  
22 acquisition of various contact lens distribution  
23 businesses; including a joint venture with a leading  
24 European manufacturer and distributor of ophthalmic  
25 lenses and frames.

1           In 2007, Alvaco and its national competitor,  
2 Concise LLC, which we're going to refer to as CCHG,  
3 recognized that through a partnership, they can build  
4 the largest independent contact lens distribution  
5 company in the United States. They formed ABB as a  
6 marriage of two equals for the goal of an ultimate sale  
7 to a private equity investor.

8           The demonstrative here shows the relationship  
9 between Alvaco, Concise, and ABB -- and Judge Leung, I  
10 think we're having an OCR provided for you, if not now,  
11 after the hearing.

12           JUDGE LEUNG: It's been received. Thank you.

13           MR. KARACHALE: Thank you.

14           By 2012, ABB had over 530 employees and  
15 offices across the country; including warehouses and  
16 distribution centers in New York, Massachusetts,  
17 Florida, and Georgia.

18           ABB was a massive enterprise making up -- made  
19 up of a number of lines of businesses, merge and  
20 acquired entities, and a diverse leadership and  
21 executives.

22           Finding the right buyer in 2012, Alvaco and  
23 CCHG elected to sell ABB to New Mountain Capital, a \$15  
24 billion dollar private equity firm. Between 2007 and  
25 2012, Alvaco engaged in no business other than holding

1 its investment interest in ABB. It had no business  
2 assets or liabilities.

3 It was prohibited and that -- from and had no  
4 regular authority to engage in the contact lens  
5 business. And it had terminated all of its business  
6 contracts after effectively merging itself out of  
7 operation in 2007 as part of the joint venture with  
8 CCHG.

9 In the face of these facts, the FTB wants this  
10 Court to find that when the nonresident and  
11 nonoperational holding company, Alvaco, sold its units  
12 of ABB, the sale magically transformed the proceeds into  
13 business income; ultimately putting the Florida resident  
14 shareholders of Alvaco into the California tax regime.

15 Unfortunately, for the FTB in their case --  
16 unfortunately for the FTB, their case, like all magic,  
17 the smoking mirrors.

18 Ms. Nessier will speak first.

19 MS. NESSIER: Alvaco and ABB are not part of  
20 the same unitary business, and it doesn't matter how  
21 many times the FTB makes this conclusory claim.

22 The required indicia are missing. Because of  
23 many of the same facts that are fatal to the FTB's  
24 unitary claims, the FTB also cannot satisfy the  
25 functional test under HESH. We're just not talking

1 about business income here.

2 In light of these two over-reaches by the FTB,  
3 it has to concede that its efforts to tax the intangible  
4 personal property of the Florida resident shareholders  
5 is improper. The holdings never gained business situs  
6 in California, and they have to fall under the ambit of  
7 the Mobilia Doctrine. Such as the FTB needs to leave  
8 taxation to their home states.

9 And usually -- I'm going to start with the law  
10 -- but I think from the briefing, it's at least clear to  
11 me that the FTB is going to try and take the facts that  
12 we have here and shoehorn them into wholly different  
13 situations like Omar, and Smith, and Metropoulos.

14 So I've got to start with a quick hit on the  
15 most significant facts in the record. Because I think  
16 they're going to be pivotal to understand on how the  
17 FTB's application of the various tests, and there's a  
18 lot of them and they are long, that we have to talk  
19 about here today has been arbitrary.

20 It's a fact that with the formation of ABB in  
21 2007, by means of the merger of Alvaco and CCHG, Alvaco  
22 transferred all of its assets and liabilities to ABB  
23 and seized to carry on any trade or business operations;  
24 that's in Exhibit 8 and Exhibit 9.

25 It's a fact that as of 2007, Alvaco did not

1 engage in its own contact lens manufacturing business,  
2 nor in any partner distribution with ABB; that's in  
3 Exhibits 8 and 9.

4 It's a fact that control of ABB was vested  
5 exclusively in a five number management board. The make  
6 up of which had to be approved by both Alvaco and CCHG.

7 Only two of the managers of that board were  
8 from Alvaco. Two of them were from CCHG, and one was an  
9 independent manager who was not only not employed by  
10 Alvaco, but he came from the board of CCHG; that's in  
11 Exhibit 8, Exhibit 6, and Exhibit 9.

12 It's a fact that all material decisions of ABB  
13 required the consent of both members, Alvaco and CCHG;  
14 that's Exhibit 5, 7, 9, and 6. It's a fact that ABB  
15 retained and paid Riordan, Lewis, and Haden -- I'm going  
16 to talk about them and say RLH just to save words here  
17 -- to provide, quote: "advisory and management  
18 services".

19 The exact same kind of services the FTB is  
20 trying to suggest Alvaco was providing. That was a  
21 separate agreement in 2007, and it was between only ABB  
22 and RLH.

23 It's a fact that Alvaco and its shareholders  
24 never use ABB interest as capital or security in this  
25 state. That ABB's financiers for its debt had zero

1 recourse to Alvaco or CCHG. And that there weren't any  
2 loans, or loan guarantees, or debt refinancing, or debt  
3 rejection between Alvaco and ABB.

4 And finally, it's a fact that by 2012, nine  
5 plus executives who were hired by ABB dealt with the  
6 daily operations of ABB. Angel Alvarez and Brad  
7 Weinbrum were not appointed unilaterally by Alvaco, and  
8 their attention was entirely out of the hands of Alvaco.

9 With these facts, FTB is asking this Court to  
10 find that under one of the two longstanding tests, ABB  
11 and Alvaco were sufficiently unitary to justify its  
12 arbitrary tax treatment of investment income flowing up  
13 to the Alvaco shareholders from Alvaco's separate sale  
14 of ABB units; and that just isn't the case.

15 Before I go through the two tests, it just  
16 can't go unsaid that when the FTB wants two companies to  
17 be unitary, the smallest of things seem to get it done.  
18 But when the FTB doesn't want to find them unitary to  
19 avoid loss falling to the State of California like  
20 Lakeside Village, piles of unitary facts are magically  
21 not enough.

22 This outcome shopping by the FTB is manifest  
23 here in this case. And it reflects the arbitrariness of  
24 the tests here, and it should be rejected.

25 I'm going to take the two tests and turn --

1 and I know everyone in this room is familiar with them  
2 most. I'll cover the basics.

3 First, we've got our three unities test from  
4 Butler Brothers, which requires the showing of all three  
5 -- right, it's a conjunctive test -- must exist from  
6 these elements among the entities: Unity of ownership,  
7 unity of operation, and unity of use.

8 This test isn't met here. There was no unity  
9 of ownership and control at a potential or actual. On  
10 the potential to control, yes, Alvaco had 55% percent  
11 share of the ABB units. But that ownership did not and  
12 was never intended to provide Alvaco with control of  
13 ABB.

14 As Mr. Karachale said, this was a marriage of  
15 two equals. And to reflect that control of ABB by the  
16 express terms of the operating agreement, which is in  
17 the record, was entirely concentrated in and exercised  
18 by its board of managers. Which neither member of ABB  
19 had the power to control.

20 The Board of Managers made all major decisions  
21 for ABB, and those major decisions required a super  
22 majority.

23 Twenty-one decisions are listed in section 6.8  
24 of the Operating Agreement at Exhibit 6. Things like:  
25 the budget, distributions, issuance of sale of units,

1 modifying the capital structure, selling any material  
2 assets. Really all material changes in ABB's business.

3 And, again, you'll hear this quite a bit, but  
4 only two managers of the five are from Alvaco, right.  
5 Two were from CCHG, and one was an independently  
6 appointed manager; and that's James Callahan. And he  
7 was actually from CCHG's Board.

8 That couldn't be changed by Alvaco under the  
9 operating agreement alone. CCHG would have had to agree  
10 to moving that independent manager.

11 Rob Zielinski, who was one of the CCHG  
12 designated managers and Chairman of the Board of  
13 Managers in 2012 -- the tax year at issue, he confirmed  
14 that neither Alvaco nor CCHG could unilaterally bind  
15 ABB.

16 They couldn't direct its operations, and they  
17 couldn't engage in any significant business transactions  
18 without the approval of the other managing member.

19 And that's Exhibit 5 in Mr. Zielinski's  
20 letter.

21 It's worth noting that the Chairman,  
22 Mr. Zielinski, who after buying a share of CCHG with his  
23 own private equity firm, also then turned around and  
24 found and managed the sale in 2012 to another very large  
25 private equity firm.

1           Being of potential to control existed under  
2 the operating agreement, but we don't think it did.  
3 Certain actual control didn't based on those facts.

4           It was minority of The Board.

5           There was a super majority require for all  
6 major decisions. And, Mr. Zielinski, the Chairman of  
7 the Managers and, again, not represented out of Alvaco  
8 but of CCHG, confirmed in his letter, Exhibit 5, that  
9 neither Alvaco nor CCHG ever breach any portion of the  
10 supermajority cause, the 6.8 cause in the agreement, and  
11 never tried to exercise unilateral control over ABB.

12           The managers, Angel and Victor Alvarez, have  
13 confirmed in their declarations that the decisions of  
14 the Board of Managers were reached after full agreement  
15 of the five members.

16           And, I've go to add, because I know the FTB is  
17 going to talk about why there weren't recorded votes,  
18 this was an incredibly successful investment and  
19 business venture. And when things are going as well as  
20 it did in this case, the parties were all rowing in the  
21 same direction.

22           The two CCHG managers, the two Alvaco  
23 managers, and the independent manager, they were able to  
24 discuss the issues and come with the best outcomes for  
25 the success of this investment and the best return for

1 the parties.

2 The idea that Angel Alvarez could run  
3 roughshod over two CCHG managers, one of whom was a  
4 private equity guy spending other peoples' money that he  
5 had to back if it failed. One independent manager --  
6 it's absurd. And it's a claim the FTB has never  
7 provided support for. Because of these facts, there's  
8 no unity of ownership in control.

9 And to conjunctive test so we can be done.

10 There's also no unity of operations here. The  
11 test is whether they were shared and centralized:  
12 Purchasing. Advertising. Accounting and management  
13 enterprises.

14 The FTB is going to have to stop pretending  
15 that "shared" and "centralized" have no meaning.

16 First, Alvaco wasn't operating. So it had  
17 nothing to share and centralize with ABB. It had no  
18 goods to purchase. No wears to sell. No accounting to  
19 manage. The FTB makes a sizeable amount or some admin's  
20 at ABB doing some legacy paperwork after the merger.  
21 That kind of ministerial stuff doesn't rise to the level  
22 and scale the Case Law describes for this issue, right.

23 We see in Butler. We're talking about shared  
24 divisions for buying and accounting for two operating  
25 businesses. Or we're looking at Edison. We're talking

1 about centralized shared managers, purchasing,  
2 operations, advertising -- I'm going to slow down a  
3 little bit -- and administration.

4 This level of scaling just didn't exist here.

5 ABB and Alvaco maintained their own books.  
6 They had separate legal and accounting services. Victor  
7 Alvarez was the lawyer for Alvaco and was sent packing  
8 after the merger, right. Angel Alvarez's brother, one  
9 of the initial shareholders here.

10 While both used the same tax preparers -- and  
11 I know this is an issue for the FTB -- they managed  
12 their engagements separately, and they paid them  
13 separately.

14 I can't imagine the FTB is going to suggest  
15 that every entity with affiliates is going to be unitary  
16 because they don't want to use Pricewaterhouse -- that  
17 can't possibly be the outcome we're reaching here today.

18 Finally, there was no shared centralized  
19 management. But there was overlap. But the only  
20 overlap, which is not the same as shared and  
21 centralized, Angel Alvarez was the CEO, and Brad  
22 Weinbrum was the COO. And while they were at times the  
23 manager and employee of Alvaco, when it came to ABB,  
24 they were but two of a much larger executive force.

25 They were two members of a five-member board,

1 in which they were the minority; and they were two of  
2 more than 500 employees of ABB. None of whom had  
3 anything to do with Alvaco.

4 This simply cannot be what shared and  
5 centralized means. Because honestly, who isn't shared  
6 and centralized under these definitions the FTB is  
7 using. With some overlap, at best, and certainly no  
8 shared and centralized forces, there's no unity of  
9 operations that were over to.

10 Finally, there's no unity of use here. Alvaco  
11 and ABB did not share the required centralize executive  
12 force and general system of operations. On the executor  
13 force, Alvaco didn't have control over ABB's daily  
14 operations. They had a nine-plus executive team  
15 handling that, and that team wasn't shared.

16 To the extent, the FTB wants to suggest that  
17 mirror overlap is sufficient here; that's just flatly  
18 wrong.

19 It wasn't good enough in Lakeside Village when  
20 the Taxpayer wanted to be unitary. And Lakeside  
21 Village, referencing Sierra Production, makes it clear  
22 that a finding of a centralized executor force requires  
23 more than the mirror existence of, quote: "common  
24 officers and directors".

25 So even some day-to-day decision overlap by

1 Angel Alvarez and Brad Weinbrum, is just not enough.  
2 And even if the FTB wants to turn to The Board of  
3 Managers, that doesn't provide them any cover. The ABB  
4 agreement require the consent of both members, Alvaco  
5 and CCHG, for all material decisions about ABB.

6 And Alvaco was but a minority number without  
7 control. There also was not and could not be a shared  
8 central system of operations. Alvaco didn't have a  
9 system of operations. It wasn't operating. It wasn't  
10 engaged in the contact lens business, and it wasn't  
11 engaged in any business besides holding investments  
12 units.

13 Any general system of operations -- which  
14 certainly ABB had a system of operations, that's how it  
15 got so big and successful -- it would've had no place in  
16 -- no use to the investment company, Alvaco. Because  
17 none let alone all of the requirements of this  
18 conjunctive test were met, Alvaco and ABB just can't be  
19 found unitary under these tests.

20 After failing to satisfy the three unity's  
21 test, the FTB's other option is the contribution and  
22 independency's test. This requires both common  
23 ownership, and the showing of ABB's business contributed  
24 to the operation of Alvaco's business outside the state;  
25 or was dependent upon the business operations of Alvaco.

1           That's not the case here.

2           First -- sure you're tired of hearing me say  
3 this. I wish the FTB would get tired of making me say  
4 it -- Alvaco wasn't operating. So there was no  
5 contribution or dependents because as an investment  
6 company, Alvaco needed nothing from ABB just to hold  
7 units. And ABB didn't get any contribution from parking  
8 its units in Alvaco.

9           Further, the other elements of the testaments  
10 are just not satisfied. There was no intercompany sale  
11 or transfer of personal property or flow of products.  
12 There was no integrated executive force.

13           The law is clear. Chase Brass explains that  
14 contribution or dependency can't be found from the mere  
15 presence of common officers and directors.

16           The Edison facts just aren't met.

17           In PBS, the BOE identified some further  
18 indicia that might be present specific to the cases of  
19 holding companies -- and I think that it's real  
20 important that we talk about that.

21           The BOE identified in PBS a complete overlap  
22 of officers and directors, intercompany financing, and  
23 benefit flowing noncompetes.

24           Even with this help from the BOE to find other  
25 touch points to show flow of value, the FTB position as

1 to Alvaco fails. There was not complete overlap. Not  
2 even close. There were no intercompany financing  
3 arrangements between Alvaco and ABB.

4 Alvaco never used its ABB interest as capital  
5 or security in California. ABB's debt financiers had no  
6 recourse to Alvaco or CCHG. There were never any loans,  
7 loan guarantees, debt refinancing or debt reduction  
8 between Alvaco and ABB.

9 Even the noncompete that the FTB for sure is  
10 going to want to talk about to try and meet just one of  
11 the three factors from PBS. It doesn't help the FTB's  
12 theory in the case.

13 In PBS, Pica H. paid \$2 million dollars to  
14 PepsiCo for a noncompete; thus, expending its funds in  
15 contribution to PBS against it's prior owner.

16 Here, the noncompete was simply to assure the  
17 value of the assets that were already transferred to ABB  
18 at zero cost to Alvaco -- 'cause it wasn't operating.  
19 Alvaco contributed nothing with the noncompete as its  
20 assets had already gone to ABB.

21 It's important to note that the outcome here  
22 isn't changed by Smith. Yes, the Smith Taxpayers lost  
23 -- I hate studying those cases. But the reason the  
24 outcome isn't changed is that the integration and flow  
25 of value here, the facts just don't rise to the level of

1 Smith. Yes, both of them are investment companies.

2 They had a overlapping CEO and it was a  
3 noncompete. But in Smith, Holdco owned 90% percent of  
4 Shellco without the same intervening and balance board  
5 of managers that ABB had. Ginsberg and Smith was the  
6 sole manager of Holdco, and Holdco the sole manager of  
7 Shellco; so he had the powers to appoint executives.  
8 Jumping kind of -- jumping over into Shellco.

9 Alvaco wasn't the sole manager of ABB, had  
10 only two seats of five on the managing member board, and  
11 was definitely not in control of ABB. Alvaco couldn't,  
12 by virtue of its ownership units, fire or appoint  
13 executives of ABB.

14 Holdco, in the Smith case, created written  
15 resolutions for loans with Shellco as the guarantor.  
16 None of that intercompany financing exist here.  
17 Ginsberg from Smith actually had a 50% percent direct  
18 ownership of Shellco at one point. That was never the  
19 case for any of the Alvaco shareholders as to ABB.

20 Holdco even listed its principle business with  
21 the same as its -- as Shellco. And here, not the case.  
22 ABB is the contact lens distribution business, and  
23 Alvaco is listed in their disclosures as an investment  
24 company.

25 Alvaco just simply isn't Smith, and the FTB

1 can't make a showing for contribution independency  
2 relying on that case's outcome.

3 The outcome of contribution and dependence is  
4 further supported by -- I'm going to say these numbers  
5 slowly -- Legal Ruling 95-7, the Express Text of Legal  
6 Ruling 2021-01, and the existing BOE Guidance.

7 My colleagues will speak a little bit later to  
8 the overreach we think is hinted at in these documents.

9 But when applied facially to this matter, they  
10 still speak in favor of an outcome of the taxpayers.  
11 Lakeside Village was clear that a holding company is not  
12 automatically unitary. That the traditional indicia  
13 still have to be evaluated, and that a unitary business  
14 exist when the subsidiary is in a unitary relationship  
15 with other subsidiaries of apparent.

16 Alvaco held no interests in any other  
17 subsidiaries or entities. Alvaco wasn't in a control  
18 position with respect to ABB, so it's not really the  
19 typical holding company that 95-7 is about. It wasn't  
20 the glue holding multiple subs together like Pabst; or  
21 Jim Beam; or Taylor Foods.

22 Further, the relationship between Alvaco and  
23 ABB, it doesn't satisfy the factors that were identified  
24 in 2021-01, relating to holding companies with limited  
25 operations. As we have already talked about, there's no

1 intercompany financing. There's no control of ABB with  
2 the minority share of the board.

3 Beyond that, Alvaco never acted as a  
4 touchstone for ABB to third parties like lenders or  
5 government agencies. It had seized operations five  
6 years prior. It had no practical way to do that. And  
7 finally, Legal Ruling 2021-01 actually maps out why  
8 Alvaco is different than the rest of the cases the FTB  
9 wants to use in application here.

10 It notes that, quote: "where the structure of  
11 ownership through a holding company, evidences and  
12 investment purpose". End quote.

13 The holding company, quote: "will not be  
14 treated as unitary". End quote.

15 This is precisely the relationship that  
16 existed between ABB and Alvaco. They are, therefore,  
17 not unitary. Even under this kind of holding company  
18 end run around the traditional indicia the FTB is trying  
19 to employ here.

20 Without a unitary business, the only way these  
21 nonresidents can be taxed in California is if the income  
22 can be deemed business income under RTC 25125(D).

23 Unfortunately for the FTB, the test for this  
24 designation also cannot be satisfied.

25 It's settled law that business income is

1 portionable to California if a corporation does business  
2 here, or a unitary business group does business here;  
3 and that's Jim Bean.

4 Well, Alvaco didn't do any business here. We  
5 know that one. And as we've already talked about, it  
6 wasn't unitary with ABB. As such, the sale of ABB's  
7 interest could never be deemed business income under a  
8 unitary theory.

9 But even if Alvaco and ABB were found to be a  
10 unitary business, which they should not, the law  
11 requires for the income to be a portionable to  
12 California, there has to be a showing of one of the two  
13 tests satisfied under HESH.

14 Now, there's no universe in which the FTB can  
15 show -- and I don't think it's -- I think they may  
16 conceded or it's not going to talk about -- the  
17 applicability of the transactional test under HESH. So  
18 I want to address it any further to say there was no  
19 frequency, and there was no regularity for this income  
20 producing transaction. And that's why it doesn't apply.

21 Instead, what we're really talking about is  
22 HESH's functional test. Under that test, there must be  
23 two findings for the functional test to result in a  
24 characterization of the gains as business income.  
25 First, there's got to be a showing that the Taxpayer's

1 interest in and power over the income producing property  
2 exists.

3 Acquisition management disposition is the  
4 shorthand we all use, right. There also has to be a  
5 showing that the properties an integral part of the  
6 Taxpayer's regular trade or business operations. Alvaco  
7 concedes it had an interest in ABB and it transferred  
8 it, of course.

9 But it didn't have the power over those ABB  
10 units. And even more so, it didn't exercise any  
11 purported power to use the property in any way, let  
12 alone in an integral way for its trade or business  
13 operations because it had none. The facts here matter.

14 Alvaco transferred all of it's business assets  
15 and liabilities to ABB. Alvaco seized to carry on a  
16 trade or business. It did not engage in the contact  
17 lens business. It didn't engage in a distribution  
18 business with ABB. It never used the ABB units to carry  
19 on it's own trade or business.

20 There just wasn't an interdependency between  
21 ABB's contact lens business, and the singular investment  
22 objective of Alvaco. And HESH confirms only income from  
23 assets that -- quote:

24 "serve in operational rather than an  
25 investment function". End quote.

1           -- are a portionable to the state for tax  
2 purposes. The mere fact that a transaction has a  
3 business purpose is not enough; and that's HESH at 539,  
4 quoting Allied Signal. As much, Alvaco just doesn't  
5 meet HESH's functional test for business income.

6           The FTB pretends that this case is the same as  
7 some of the prior decisions that have been reached in  
8 its favor. But in honest review of the facts in those  
9 cases shows that none of them save the FTB's arbitrary  
10 application to these facts.

11           First of all, this just isn't Jim Beam. They  
12 are the parties that conceded that they were unitary.  
13 That Jim Beam had control over Taylor Foods, and that  
14 Taylor Foods sales and business were integral to Jim  
15 Beam's parallel business. One was selling mixers, the  
16 other selling the booze. It's pretty integral.

17           Here, not only did Alvaco not have control  
18 over ABB even if it did since it conducted no business  
19 or trade after the merger, any control would have been,  
20 I mean, basically, useless and unimportant to Alvaco and  
21 certainly not integral.

22           In Appeal of Omar, Omar and operating S-Corp,  
23 it wasn't even about investment income but about actual  
24 business assets. It was really a fight about tangible  
25 versus intangible, but all still business assets.

1           Here, the sale was only the sale of an  
2 interest of a legal entity.

3           Now to be clear, the Taxpayers are not saying  
4 -- even if the FTB says that we are -- that no holding  
5 company could ever be unitary. But what we also think  
6 is the FTB's position that almost every holding company  
7 is unitary is incredibly problematic as well.

8           And more importantly, the facts here make  
9 clear that a true investment company, the kind talked  
10 about in Legal Ruling 2021-01. Definitely, that  
11 position cannot apply.

12           And lastly, Metropoulos also doesn't help the  
13 FTB. And its not the Conduit Rule there that's the  
14 issue, right? In Metropoulos, the shareholders, Pabst,  
15 conceded the two key issues that are required for  
16 something to be designated business income.

17           Pabst conceded it was unitary with it's  
18 subsidiaries -- its multiple subsidiaries -- and agreed  
19 that the sale of good will was business income. The  
20 only possible outcome in that case with those facts was  
21 the determination that the gains were business income.

22           That's just not the situation here. Alvaco  
23 wasn't in a unitary relationship with ABB. It didn't  
24 hold the requisite control over ABB. It was a passive  
25 investment company. Not an operating one.

1           There were no business activities between the  
2 two to establish that kind of interdependence that's  
3 required in these tests. Metropoulos simply does not  
4 apply and doesn't save the FTB's analysis here.

5           The sale of the ABB units by Alvaco did not  
6 generate business income, nor were Alvaco and ABB  
7 unitary. The income was, as confirmed in Valentino, the  
8 result of the sale of intangible personal property, and  
9 under the longstanding mobilia doctrine, it's got to  
10 follow the persons who own it.

11           As such, RTC, section 17952, governs the tax  
12 treatment of the income from the sale as to the Florida  
13 resident shareholders of Alvaco. Section 17952 provides  
14 that for income of nonresidents to be taxable from  
15 personal proper -- intangible personal property, like  
16 LLC units, it's got to have gained business situs in the  
17 state.

18           And the Regulation for 17952-1 goes on to say  
19 it gains business situs if it's employed as capital in  
20 this state, or if possession in control of it is so  
21 localized that it becomes of substantially use in value  
22 to the enterprise in this state. None of that is true  
23 here.

24           Neither Alvaco nor its Florida resident  
25 shareholders employed ABB units as capital in this

1 state.

2 The units were never pledged as security for  
3 the payment of indebtedness, taxes, or any other  
4 expenses in connection with business in this state. And  
5 after the merger, neither the Florida resident  
6 shareholders nor Alvaco engaged in the trade or business  
7 of California.

8 Control of these investment units could not be  
9 more localized in the state of Florida. Absented  
10 business situs in the state gain on the sale of the ABB  
11 investment units, as to the Florida shareholders, just  
12 can't be sourced in California.

13 Allocating the capital gains to the Florida  
14 shareholders, residence, state; is the only outcome.  
15 Alvaco and ABB aren't unitary, and the sale of the ABB  
16 units isn't business income. The situation just isn't  
17 covered, but the cases FTB's been relying on.

18 Because the FTB can't get to Alvaco, it can't  
19 get to the Florida resident shareholders. Their units  
20 never had business situs here in California, so their  
21 tax treatment has to be left to their home states. The  
22 danger of working backwards from outcome is it obscures  
23 the facts, and it makes one's judgement arbitrary and  
24 unreliable.

25 That's what happened here, and we ask you to

1 correct it.

2 MR. SHAVER: Thank you, Ms. Nessler.

3 I'll be switching gears here to talk about the  
4 regulation at issue here.

5 As detailed in our supplemental briefing, we  
6 believe that the FTB's propagation and subsequent  
7 amendment of Regulation 17951-4, and I'll call it the  
8 Dash-Four Reg, attempts to create law relating to  
9 California's treatment of unitary business income, which  
10 conflicts with the existing statutory and regulatory  
11 framework of RTC, 17952.

12 Although the FTB may have been granted rule  
13 making authority with respect to RTC, section 17951, we  
14 do not believe such authority carried with it the  
15 ability to override the existing statutes such as RTC,  
16 section 17952, or the long established Mobilia Doctrine.

17 The FTB's application of the Dash-Four Reg. as  
18 it existed in 2012 to the facts would result in that  
19 very outcome.

20 The FTB's application of the Dash-Four Reg. as  
21 amended in 2018 to a 2012 sale would be even more  
22 egregious. With the sale of Alvaco's interest in ABB  
23 had occurred in 2019, the FTB would likely point  
24 directly to Regulation, section 17951-4(d)(ii), I'll  
25 call that D2.

1           Instead, the FTB makes more general references  
2 to the Dash-Four Reg. as the appropriate taxing  
3 provision considered of RTC, 17952. However, if the  
4 2012 version of the Dash-Four Reg. was clear on this  
5 matter, it would not have been necessary for the  
6 regulation to be revised in 2018 to provide, and I  
7 quote:

8           "That California Revenue and Taxation Code,  
9 section 17952, does not apply with respect to an  
10 interest in a partnership that conducts business within  
11 and without California."

12           That language is from the FTB's very own  
13 initial statement of reasons for the Amendment Code of  
14 Regulations, issued six years after the date of the sale  
15 in question. We could not have made the point more  
16 clearly ourselves. The amendment in 2018 was designed  
17 to allow the FTB to override RTC, section 17952.

18           Putting aside the question of whether the  
19 Dash-Four Reg. should be given the same dignity or  
20 perhaps more accurately equal force as a statute, the  
21 FTB has already told us that D2 cannot be applied to a  
22 2012 sale.

23           In 2008, D2 was added to the regulation to  
24 read as follows:

25           If the partnership and the business activity

1 of the partner are part of one unitary business, then  
2 the Rules of Regulations, section 25137-1(f), apply.  
3 And the apportionment business income is done at the  
4 partner level for the unitary partner or partners.

5 Each partner's distributive share of the  
6 partnership business income, a portion to this state, is  
7 income derived from sources within this state.

8 Subsection (j) goes on to instruct us as to  
9 which amendments should be applied retroactively, and  
10 that subsection states that amendments to (d)(4),  
11 (d)(5), and (d)(6) should apply for taxable year 2001  
12 onward, and that the remaining amendments to subsection  
13 (d), including (d)(2), are applicable only as of January  
14 1, 2019; the effective date of the amendment.

15 With notable exception of (d)(2), from the  
16 other sections of the dashboard regulation, demonstrates  
17 that (d)(2) should not be applied retroactively to a  
18 2012 transaction.

19 Put a different way, if the authors of (d)(2)  
20 intended to address deficiencies in the Dash-Four Reg.  
21 that existed in 2012, that is and as was the stated goal  
22 to provide that RTC, section 17952, does not apply in  
23 certain circumstances.

24 And two, the amended regulation by its terms  
25 only applied as perspective.

1           The only logical conclusion is that RTC,  
2 section 17952, is the superior tax supervision to apply  
3 to the facts of this dispute. The FTB suggest in its  
4 supplemental briefing that we do not believe Metropoulos  
5 or Smith provide precedential guidance.

6           To be clear, we do not believe this case is  
7 support of retroactive application of (d)(2). A  
8 keystone feature of the FTB's position.

9           MR. KARACHALE: Thank you, Mr. Shaver.

10          All right. We're getting to the end of our  
11 presentation. And I know you're tired. I'm tired.

12          So it's a good time to review United States  
13 Supreme Court Jurisprudence regarding the taxation of  
14 multistate passthrough entities.

15          And I want to be clear, my goal here is not to  
16 sound like a "con-law" professor, it is to show that  
17 California's approach to multistate taxation is  
18 increasingly at odds with the constitutional protections  
19 of Florida taxpayers. Like Angel Alvarez, who've  
20 elected to reside outside of California, but owned  
21 direct interest in multistate passthroughs.

22          The United States Supreme Court has ruled that  
23 the linchpin of apportion ability in the field of state  
24 taxation is the unitary business principle.

25          But as Respondents have pointed out in their

1 briefing, the Supreme Court has conceded that situations  
2 could occur in which apportionment might be  
3 constitutional even though the payee and the payor are  
4 not engaged in the same unitary business.

5 In that context, the Court stated that an  
6 asset could form part of a taxpayer's unitary business  
7 if it's served an operational rather than an investment  
8 function in the business.

9 But as the Court observed in MeadWestvaco,  
10 that operational function reference was not intended to  
11 modify the unitary business principle by adding a new  
12 apportionment ground. The operational function concept  
13 simply recognizes that an asset can be part of  
14 taxpayer's unitary business even without a unitary  
15 relationship.

16 Here's our concern, not just for Alvaco and  
17 it's nonresident shareholders, but every potential  
18 business person who has indirect connections with  
19 California.

20 The FTB's recent guidance on the treatment of  
21 multistate passthroughs no longer adheres to the  
22 constitutional perimeters for taxation; the unitary  
23 business principle or the operational function of  
24 business assets in a unitary business.

25 The FTB's position now appears perilously

1 close to a per se unitary assessment for every holding  
2 company. The positions contrary to the guidance in PBS  
3 Building Systems; and The State of Smith; and more  
4 importantly, it appears to run a foul of the Supreme  
5 Court's ruling in Meadwestvaco.

6 In the Legal Ruling 2021-01, the FTB attempted  
7 to synthesize existing California unitary apportionment  
8 rules for passthrough entities.

9 The FTB acknowledged the Federal restrictions  
10 on taxation of multistate passthroughs, but then  
11 proceeds to outline a regime for holding companies where  
12 -- where, quote -- where I quote:

13 One, "Unity can be found between a passive  
14 holding company and a single operating business."

15 And two, "The very structure involving a  
16 holding company used as a means to control an operating  
17 business strongly supports a finding of unity."

18 In other words, whether passive or active, the  
19 FTB's position is at a holding company is automatically  
20 unitary with its subsidiaries.

21 Now, in Legal Ruling 2021-01, the FTB does  
22 concede that where a nonresident owns an S-Corp that  
23 holds a 20% percent interest in a multistate LLC; where  
24 the S-Corp has only one of five votes on matters  
25 requiring manager approval and does not engage in any

1 activities either directly or indirectly with the LLC.

2 That is not a unitary relationship. But  
3 absent is effectively de minimis ownership and control  
4 the FTB's default position is that a holding company is  
5 unitary with its operating subsidiary.

6 Clearly, this cannot be the appropriate  
7 interpretation of the Supreme Court's, quote:  
8 "operational rather than investment function". End  
9 quote. For unity.

10 The whole point of the US Supreme Court's  
11 guidance and, for that matter, this Court's guidance is  
12 that the individual relationship between the holding  
13 company and the operating company need to be examined.

14 Legal Ruling 2021-01, by paying lip service to  
15 this idea, simply doesn't do that.

16 In Legal Ruling 2022-02, the FTB went farther,  
17 completely detaching state taxation of partnerships from  
18 the unitary requirements. Under this new guidance,  
19 nonresident partners must buy for gain from the sale of  
20 their interest in a partnership holding hot assets under  
21 IRC, section 751.

22 Where a partnership holds hot assets, the  
23 nonresident partner must source the gain from the deem  
24 sale of those assets as receipts from a trade or  
25 business under the Dash-Four Reg.

1           In other words, even if the partner is a 20%  
2     percent S-Corp with no material voting power and is not  
3     unitary with a multistate partnership, the FTB will  
4     still reach through and tax that nonresident on what it  
5     deems to be California assets of the partnership.

6           Interestingly, Legal Ruling 2022-02 appears to  
7     modify the all or nothing Mobilia principle by implying  
8     that while a partnership interest may be intangible as  
9     to the partner, some portion of the value is California  
10    source, and should be taxed accordingly.

11          The framework suggest it flies in the face of  
12    the unitary business idea, even if the underlying  
13    rational for California taxation, a partnership's hot  
14    assets is sound.

15          To be clear, we are not asking the OTA to  
16    affirmatively disagree with the FTB's legal rulings.  
17    But we are asking the OTA to recognize that there are  
18    both State and Federal limitations on the application of  
19    the Unitary Business Rules to holding companies.

20          The FTB's position make almost every single  
21    holding company unitary with it's subsidiaries. We  
22    believe this Court has a far more understanding of the  
23    rules that is consistent with Federal and California's  
24    state protections afforded nonresident taxpayers.

25          As the Court recognized in the State of Smith

1 or any of the other long line of cases on unitary  
2 treatment that Ms. Nessier discussed, under either  
3 Federal or California state law, the FTB simply cannot  
4 show that Alvaco's relationship with ABB was operational  
5 in nature. It was solely an investment function.

6 Thank you.

7 JUDGE LEUNG: Thank you, Mr. Karachale.

8 Judge Vassigh, any questions for the Appellant  
9 at this point?

10 JUDGE VASSIGH: Not at this time. Thank you.

11 JUDGE LEUNG: Thank you.

12 Judge Akopchikyan?

13 JUDGE AKOPCHIKYAN: Not at this time. Thank  
14 you.

15 JUDGE LEUNG: Thank you.

16 Franchise Tax Board. Please begin your  
17 presentation. Thank you.

18 MR. BECK: Thank you, Judge Leung.

19 Good afternoon. I'm Brian Beck.

20 As you know, I'm representing the Franchise  
21 Tax Board, and I have Delinda Tamagni and Ellen Swain  
22 with me.

23 And we are here for the consolidating appeal  
24 of Alvaco Trading Company, Inc., an S-Corporation --  
25 I'll call it Alvaco -- and it's shareholders Angel

1 Alvarez, Victor Alvarez, and Brad Weinbrum.

2 In October 2012, Alvaco sold substantially all  
3 of its interest in an operating company, ABB. And my  
4 presentation will discuss two issues: Whether Alvaco is  
5 unitary with ABB, and whether the sale was in business  
6 income for Alvaco. And my colleague, Ms. Swain, will  
7 handle the remaining issues.

8 And the facts of this case mirror the  
9 presidential Appeal of Smith, and the Metropoulos Court  
10 of Appeal decision. OTA should follow this precedent  
11 and find that Alvaco and ABB were unitary. The sale  
12 generated business income, and the business income  
13 should be apportioned.

14 I'm going to start with some background.  
15 Alvaco was originally an operating company engaging  
16 contact lens distribution since at least the 1990's. In  
17 2007, Alvaco entered into a joint venture with a  
18 third-party, CCHG . This joint venture formed ABB.  
19 From this point on, Alvaco's entire existence was  
20 focused on ABB.

21 In a IDR response, which we have saved as  
22 Exhibit B, Appellants stated that the merger was in  
23 furtherance of the business strategy to become the  
24 largest contact lens distributor in the United States.  
25 And Alvaco had a 85% percent membership interest in ABB.

1           Mr. Angel Alvarez was the CEO and founder of  
2 both Alvaco and ABB. Mr. Brad Weinbrum was the CEO of  
3 both and later he was also the president of ABB. And in  
4 the same IDR response, Appellants stated Mr. Alvarez and  
5 Mr. Weinbrum served in much same capacity for Alvaco as  
6 it did for ABB Optical prior to and continuing after the  
7 transaction.

8           ABB's own website describes Mr. Alvarez as the  
9 and Founder and Chief Executive of ABB; and Mr. Alvarez  
10 and Mr. Weinbrum worked out of a shared corporate office  
11 for Alvaco and ABB. There was a shared human resources,  
12 accounting, and tax resources.

13           And I'm just going to take a look at Alvaco's  
14 2012 Return, which we have set out as Exhibit F. If you  
15 look at -- so it's the -- it's the 2012 Form 100S  
16 Corporation Return for Alvaco Trading Company, Inc. And  
17 on page 3 is Schedule F -- excuse me, computation of  
18 trade or business income.

19           And here we've heard multiple times that  
20 Appellants claim that Alvaco had no trade or business,  
21 but as you can see from their Schedule F, they've got  
22 significant trade or business income.

23           And Appellants have also claimed that the  
24 officers of Alvaco were doing nothing, but you can see  
25 on the line 7 of their Schedule F, there's a line there

1 of compensation of officers which was 9.7 million; and  
2 this went to Mr. Alvarez and Mr. Weinbrum.

3 And then there was a line 8, salaries and  
4 wages, and that was 1.2 million which went to Mr. Victor  
5 Alvarez. And this is a deduction taken against income.

6 If you go forward -- if you go forward a  
7 little bit, on this -- the Schedule D-1 listed "gain  
8 from disposition of a business asset"; and that was sale  
9 the listed sale of ABB Concise Optical Group. And that  
10 would be on side two of Schedule D-1, which was page 8  
11 of the Return.

12 And lastly on the Return, the Schedule R-1 for  
13 apportionment. If you look at parenthesis B, which list  
14 the total within California, there is a 10.4 million of  
15 property within California; 4.7 million in payroll; and  
16 55.9 million of sales.

17 Okay. I'm going to move on to the first issue  
18 which was unity. Under principles of California Law,  
19 Alvaco and its interest in ABB constituted a single  
20 unitary business. This is important because the Court  
21 of Appeals in Jim Beam requires that the sale of that  
22 55% percent interest generates business income.

23 Under California Law, there are two  
24 alternative test for unity, and Alvaco and its interest  
25 in ABB passed both of them, and this is even before

1 looking at Alvaco as a holding company. The two tests  
2 are the three unities test, which requires unity of  
3 ownership; unity of use, which is major policy matters  
4 of the highest levels; unity of operations, which is  
5 common staff functions.

6 And the other tests is called the Dependency  
7 of Contribution, and is also known as the Flow of Value  
8 test. A business is unitary if the business done within  
9 California is dependent upon or contributes to the  
10 operation of business outside California. And the flow  
11 of value can be seen, for example, when there isn't an  
12 efficiency.

13 I'm going to say a few words about control as  
14 it relates to unity. Ultimately, because ABB is a  
15 passthrough, the issue is not relevant. Nevertheless,  
16 keep in mind that Alvaco owned 55% percent of the  
17 membership interest, appointed three out of five  
18 managers, and Mr. Alvarez was CEO; and Mr. Weinbrum was  
19 COO.

20 The OTA relying on Regulation in 25137-1,  
21 Subdivision (a), held in Smith that control is  
22 irrelevant in this context. Smith had a section on  
23 pages 15 to 16, under the heading "majority of ownership  
24 and control," are not required to establish unity.

25 And the OTA drew on that regulation which

1 stated that -- excuse me -- the regulation stated that  
2 you use established standards, you disregard ownership,  
3 and you only look at the taxpayers shares.

4 So when we say that AB -- that Alvaco and ABB  
5 are unitary, we are saying that Alvaco and its 55%  
6 percent membership interest are unitary. And there is  
7 no question that Alvaco controls that 55% percent  
8 interest.

9 So moving on to the three unities. We are not  
10 looking at unity of control because we are in the past  
11 through context. Unity of use is a major policy  
12 matters. You have a common CEO and COO with Mr. Alvarez  
13 and Mr. Weinbrum. They had -- there was -- Alvaco had  
14 \$10 million dollars as a business expense for them.

15 These executives were talented and knew the  
16 industry. Mr. Alvarez was described as the founder of  
17 ABB on the website. Mr. Weinbrum built teams through  
18 training, coaching, and development. Near the  
19 operation, Mr. Alvarez and Mr. Weinbrum worked out of  
20 the same office for both Alvaco and ABB -- it was a  
21 shared office.

22 And prior to 2007, Alvaco was the operating  
23 company. It contributed its assets to ABB. There is a  
24 direct line between Alvaco's own historic operations,  
25 and ABB's current activity. And again, Mr. Alvarez was

1 called the founder of ABB.

2 Alvaco and ABB shared a common human  
3 resource's department. Jeannette Delgado was vice  
4 president of Human Resources. She managed the health  
5 insurance plan for Alvaco's officers, as well as  
6 Alvaco's stock equity plan.

7 Alvaco and ABB shared a common accounting  
8 department. Kelly Lawrence was vice president and  
9 controller. She managed payments with Alvaco's health  
10 insurance plan; and meals; and entertainment expenses.

11 The same tax preparers, Ahearn Jasco and  
12 Company, maintained the work papers for and prepared  
13 Alvaco's and ABB's Returns for the 2012 Tax Year.  
14 Alvaco was a tax matters partner of ABB.

15 Thus, under the three unities, Alvaco and ABB  
16 were unity -- were unitary without looking at the  
17 holding company's status. And for contribution or  
18 dependency, the same facts apply and in short,  
19 Appellants wanted to become the leading US contact lens  
20 distributor. The executives provided leadership; and  
21 consequently, ABB achieved that executive.

22 And, thus, unity also exist under the  
23 contribution of dependency test. Again, before we've  
24 applied holding company status.

25 Now I'm go to discuss Alvaco's status as a

1 holding company, and this status strongly supports the  
2 finding of unity. The holding company refers to how  
3 Alvaco did not have significant operations. And its  
4 primary, if not sole asset, was its interest in the  
5 operating company, ABB.

6 Holding company is not defined in the statute.  
7 The concept is part of the unitary business principle.

8 The United States Supreme Court in Mobil Oil  
9 Corp. rejected Mobil's attempt to identify a separate  
10 business in its holding company function. The existence  
11 of a holding company does not require a separate  
12 accounting.

13 And the Smith's opinion summarized the effect  
14 of the holding company. Typical characteristics of  
15 unity may not exist. And factors, which are otherwise  
16 insignificant, take on at an importance because they are  
17 the only factors to consider.

18 So, for the three unities test, Alvaco  
19 provides a vehicle for executives for unity of use, and  
20 the holding company itself as administrative value and  
21 efficiency for unity of operation. And for contribution  
22 or dependency in addition to the above, Appellant's have  
23 also effectively conceded that the holding company  
24 provides unity.

25 And Appellant's original demonstrative

1 Exhibit's included statements that the limited use of  
2 these facilities/personnel as well as the retention of  
3 accounting firm were simply and efficiency that  
4 reflected the fact that Alvaco did not retain any other  
5 personnel business operations or administrative capacity  
6 after the merger.

7           And that efficiency is the flow of value. It  
8 takes on at an importance because it is the only factor  
9 to consider. Holding company's status emphasizes the  
10 economy of sale because it's cheaper to have one human  
11 resources department rather than two. From the general  
12 rule -- from the General Rule, of emphasizing certain  
13 doctrines, the Smith decision focused on three:

14           Integration of executive forces; substantial  
15 intercompany financing; and noncompete provisions.

16           And all of these strongly favor the  
17 conclusion that Alvaco, the holding company, was unitary  
18 with its interest in ABB; the operating company.

19           In recreation of executive forces, Alvaco had  
20 a greater integration of executive forces than the  
21 holding company in Smith. Smith focused on one  
22 individual, Mr. Ginsberg, who held the most important  
23 influential positions in the two entities.

24           Here, we not only have the CEO, Mr. Alvarez,  
25 but we also have the COO, Mr. Weinbrum.

1           And we have a -- from the company website,  
2           which we saved as an Exhibit, Mr. Alvarez is responsible  
3           for strategic direction and vision of the company, and  
4           his focus is on leveraging 15,000 independent eye care  
5           practitioner businesses. And Mr. Weinbrum holds his  
6           team accountable and critics them for training,  
7           coaching, and development.

8           And they were both managers of ABB appointed  
9           by Alvaco. And the effect of integration of executive  
10          forces between Alvaco and ABB is just like that in  
11          Smith. Alvaco, through it's managers, devoted all of  
12          its activity; however, small to ABB.

13                    Substantial Intercompany Financing.

14          Again, more so than for the holding company in  
15          Smith, substantial intercompany financing suggest Alvaco  
16          had unity with ABB. Smith emphasized that approval was  
17          needed for financing. Without Alvaco's approval, ABB  
18          could not have obtained financing.

19          Mr. Alvarez and Mr. Weinbrum were the CEO and  
20          COO. And the declaration of Victor Alvarez several  
21          times stated that the lenders would not have made the  
22          loan without the noncompete language and without Mr.  
23          Alvarez and Mr. Weinbrum working from ABB .

24          And, the fact is, finance does not happen  
25          without any influence from Alvaco.

1           The noncompetition agreement.

2           Finally, the noncompetition agreement supports  
3 unity. The fact is, Appellants could not use their  
4 extensive experience in the field of contact lens  
5 distribution to find investment and business  
6 opportunities separately from ABB. They were paid \$10  
7 million in compensation which was deducted against gross  
8 income.

9           The ABB LLC Agreement also contained a  
10 noncompetition clause for the protection of ABB, as well  
11 as nondisclosure confidential information and trade  
12 secrets. And again, we've seen the lenders required it.

13           So Alvaco has a stronger case for being  
14 considered a holding company than was the equivalent  
15 Holdco and Smith. And Alvaco directed all of its  
16 activity and served as a conduit portal to the  
17 shareholders. And thus, OTA should find unity.

18           I'm going to discuss presumptions, and  
19 particularly, in the area of unity, the OTA should give  
20 some weight to a presumption of unity.

21           In Appeal of Saga, The State Board of  
22 Equalization stated that FTB -- that after FTB finds  
23 unity, the Taxpayer must show that the unitary  
24 connections relied on by Franchise Tax Board are so  
25 lacking in substance as to compel the conclusion that a

1 single integrated economic enterprise did not exist.

2 And Smith also has a presumption for holding  
3 companies. And, in Smith, has stated when a group of  
4 corporations conduct only one business, it is expected  
5 that the requisite contribution or dependency would  
6 exist between the holding company and operating company.

7 And there's a Tennessee Supreme Court  
8 decision, Blue Bell Creameries, where a single business  
9 that was the source of all income between two entities  
10 created a presumption of unity.

11 So, here, we have only a contact lens  
12 business. Alvaco dedicated all of its efforts to this  
13 business. Franchise Tax Board has provided substantial  
14 evidence of unitary connections. Appellants need to  
15 show, and have not, that there's more than a single  
16 integrated economic enterprise between Alvaco and it's  
17 interest in ABB.

18 I'm going to turn to the second issue;  
19 business income. And this is simple. Since Alvaco sold  
20 a business asset, the sale was business income. So even  
21 if Appellants claim -- even if as Appellants claim  
22 against the weight of evidence, Alvaco and its interest  
23 in ABB were not a unitary enterprise, the sale resulted  
24 in business income. And the reason is that the interest  
25 in ABB was integral to Alvaco's California business.

1           The definition of "business income" is in  
2 Revenue Taxation Code, section 25120, subdivision (a),  
3 and it's a long definition, and there are two tests.  
4 And of which the functional test is important. And the  
5 functional test was explained in detail in hopes selling  
6 these corps thus California Supreme Court decision.

7           In -- the property was the residual  
8 value of an employee trust. The relationship between  
9 the corporate taxpayer and the property satisfied the  
10 functional test. Income from the property was business  
11 income. The functional test simply requires that the  
12 relationship between taxpayer and the property be  
13 integral.

14           In -- integral means that it cannot  
15 reasonably be characterized as an extraneous investment  
16 separate and apart from the California business of the  
17 taxpayer. And that's exactly the situation we have  
18 here.

19           If Alvaco and ABB were unitary, Jim Beam would  
20 require that unitary status per se establishes this  
21 relationship. And even if Alvaco and ABB were not  
22 unitary, Alvaco's interest in ABB cannot be  
23 characterized as an independent investment separate and  
24 apart from its California business.

25           Alvaco's business as an independent

1 distributor became its membership interest in ABB.  
2 Alvaco controlled and used the LLC interest by providing  
3 it's executive and management experience to ABB's  
4 operations. And by participating in the management of  
5 ABB in the capacity provided under the ABB LLC  
6 Agreement.

7 And Appellant is attempting to confuse what  
8 the property is and what the requisite relationship with  
9 the property is. Again, the property is just Alvaco's  
10 LLC interest in ABB, and that property was integral.

11 And finally, based on Alvaco's history of  
12 treating the distributive share from ABB as business  
13 income, it should be required to treat the sale of that  
14 asset as business income.

15 And Jim Beam, ask the question why the  
16 property that admittedly generated unitary business  
17 income for years prior to its disposition should not  
18 also generate business income when it is sold. And the  
19 Smith decision referenced the Holdco -- the holding  
20 company -- it used the unitary combination method into  
21 apportion its distributive share of income.

22 Conceptually, Appellant does not explain why  
23 the unitary method is proper to apportion its  
24 distributive share of income, yet it is improper to use  
25 that method to portion the gain from the sale of its

1 interest in the operating company. And, if you recall,  
2 we looked at the return and we saw that there was \$10.4  
3 million dollars of property factor in California.

4 4.7 million of payroll and 55.9 of sales in  
5 2012.

6 And I completed my section, and Ms. Swain?

7 MS. SWAIN: Thank you. Thank you. Ellen  
8 Swain for the Franchise Tax Board.

9 I think it was telling that the Appellants  
10 started by saying the story is simple, because theirs is  
11 a story. And what we're saying on our side when we're  
12 talking about the sourcing arguments, the specific hits  
13 sourcing argument, is that the law is settled.

14 And part of the confusion that I have heard is  
15 it's -- it's an apparent conflating of the concept of  
16 when 17952 applies and when 17951-4 applies, and then  
17 lets mix in some discussion about situs and talk about  
18 how there's no situs in California. That's not the  
19 analysis, and that's not California's position here.

20 California's position on pit sourcing rises  
21 and falls with your finding that this was a unitary  
22 relationship. If there's no unitary relationship, FTB  
23 walks away on the sourcing arguments. It's as simple as  
24 that. So we don't go to a traditional sale when you're  
25 talking about one individual singularly selling an

1 intangible, which takes you right to 17952.

2 Our position is it is not this case, and the  
3 reason it's not this case is because of the finding in  
4 by the Office of Tax Appeals in the Appeal of Smith.  
5 And my Co-Counsel, Mr. Beck, has gone through all of  
6 those factors.

7 So I would start from the position that it is  
8 -- the gain is business income, and because it's  
9 business income when Alvaco receives it, this decision  
10 of the appeal of Smith makes it clear that the income  
11 retains that character of business when it flows up to  
12 the taxpayer, and it is sourced through Regulation  
13 17951-4. That is a one-way street.

14 And the reason it's a one-way street is  
15 because of the explicitness with which this panel, this  
16 body, wrote the appeal of Smith. But what it also does  
17 is it reaches through and it brings in Metropoulos.

18 It brings in the determination of Metropoulos  
19 by the Court of Appeal -- which just for ease of  
20 argument, I'm going to refer to as JP Morgan -- because  
21 there are some arguments that they're also making based  
22 on OTA's decision in Metropoulos; which I'm going to  
23 distinguish those two. So the decision of JP Morgan  
24 trust that language is also explicit.

25 That language is also explicit. There leaves

1 no room to go back to 17952, because those were the  
2 argues that were hashed out over and over again. None  
3 less, it's being raised again here. So with the conduit  
4 rule, it's not just found in those two.

5 The conduit rule from the Internal Revenue  
6 Code, section 1361, is not just addressed in these  
7 recent cases which we -- some people think of as a  
8 change in the landscape of tax law for sourcing. But it  
9 predates that. It goes back to the case of Valentino  
10 where the Court of Appeal also applied the conduit rule.

11 We first see that really lengthy opinion  
12 discussing it. And talking about these, sort of,  
13 unequivocal nature that when there's income, that's  
14 business income. It's going to be sourced.

15 And I'm not suggesting that Valentino is on  
16 point to this case today, but the analysis of how it  
17 uses the conduit rule is that case just involved a  
18 typical distributor share rather than -- rather than  
19 what we're talking about here.

20 And, so, when they found that, they found that  
21 the reason that the S-Corporation items are tax with the  
22 shareholder level is that when they are taxed at that  
23 level, this character is determined at the corporate  
24 level, and each item passes through -- passes up, if you  
25 prefer.

1           And it was a way to treat -- it was a way to  
2 kind of look at S-Corporations in the same manner as  
3 partnerships as we know S-Corporations are these hybrid  
4 corporations. They're not exactly a -- they're not --  
5 they're not a C-Corp, but they're also not a  
6 partnership. They were slightly characteristics of both  
7 of them.

8           But as the Court said in Valentino, and I'll  
9 directly quote:

10           "Each item of corporate income and expense is  
11 passed through to the shareholder in exactly the same  
12 form as received by the corporation."

13           And the regulation at the time that Valentino  
14 was decided, the regulation did not -- Dash-Four  
15 Regulation did not have provision to source  
16 S-Corporations. The regulation was amended after that.  
17 Nonetheless -- nevertheless and it treats partnerships  
18 and S-Corporations exact same way. They reference back  
19 to one another.

20           But nevertheless, even without F in the  
21 Regulation, the Valentino Court was comfortable saying,  
22 "We're going to source this income through Dash-Four."  
23 Even though the closest provision involved partnerships.

24           The conduit rule was subsequently adopted by  
25 OTA in the appeal of Metropoulos in 2019. That case was

1 then upheld by the Superior -- by both the Superior  
2 Court as well as The Court of Appeals; and then certiori  
3 was denied and it was also deemed punishable. So it has  
4 gone to the highest levels.

5 And what's -- what's different about the JP  
6 Morgan case from the OTA case, the initial case -- well,  
7 obviously we see so much of this reasoning. We see so  
8 much of that case incorporated in the Court of Appeals.  
9 But we don't have a concurring opinion. There's no --  
10 that concurrence is -- is not the same way that The  
11 Court of Appeals structure their decision.

12 Nevertheless, the Appellants are resting in  
13 their briefing on this concurring opinion, which has  
14 effectively under -- under Rules of Supremacy and rules  
15 of -- subject of hierarchy authorities has been  
16 superceded by The Court of Appeal decision. And The  
17 Court of Appeal is the law of the land on this one.

18 And that law says -- goes straight to 17951-4.  
19 And that law says, specifically, it has dignity of  
20 statute.

21 So, nevertheless, the Appellants are  
22 disregarding this well settled precedent at this point,  
23 and they seek to undermine this authority on multiple  
24 fronts. They lack -- they argue -- again, 17951-4 lacks  
25 dignity of statute. And therefore, 17952 is the

1 preferred path of sourcing.

2 This argument has been previously raised and  
3 dismissed both by J.P. Morgan Trust and more recently in  
4 the Appeal of Smith. And it found that, I believe, the  
5 exact -- the precise language in Smith was it's accorded  
6 the same dignity as statute such that it does not  
7 subordinate RTC, section 17952, and in making this  
8 finding they applied the determination -- the Smith  
9 panel applies such a determination of J.P. Morgan trust.

10 And this is, of course, in accord with the  
11 fact that the legislature had granted FTB substantial  
12 rule making authority in Statute 17954, such that FTB  
13 promulgates the regulations that set up the sourcing --  
14 the sourcing provisions. And this was the exact word  
15 that OTA used was "critically".

16 The Court found Regulation, section 17951-4,  
17 is accordance in dignity as the statute such that it  
18 does not subordinate to RTC, section 17952. Next,  
19 Appellants tried to make a collateral attack on the  
20 business income by incorrectly -- by the sourcing of the  
21 business income by incorrectly asserting them.

22 Legal Ruling, 2202, somehow stops the FTB from  
23 arguing that in any case involving in the intangible.  
24 We must argue that it's sourced under 17952. But that's  
25 -- that's not actually an accurate reading of that legal

1 ruling.

2 That legal ruling is in harmony with exactly  
3 what we're saying here today. And what we're saying  
4 here today is that it's the sale -- it's the sale of  
5 business income that's changing this character. It's  
6 changing the character. It's not simply intangible.  
7 That good -- that law is still good law when an  
8 individual is selling -- is selling intangible, and it's  
9 still good law.

10 That is sourced under 17952, and that's  
11 precisely the analysis that's walked through in the  
12 legal ruling. And the legal ruling looks at what --  
13 looks at the gain that was received by the taxpayer, and  
14 it says, actually in some instances, there are  
15 unrealized intangibles; also known as hot assets.

16 Under Internal Revenue Code, section 741 and  
17 751, are the ones that come into play, and they say part  
18 of that money is actually from all of these unrealized  
19 intangibles that you received from the partnership --  
20 income from the partnership. What remains reflects your  
21 intangible.

22 Again, we're parsing through what is the  
23 character of what's in front of you, which is always the  
24 question we're trying to ask in sourcing cases. And,  
25 so, that case does not undercut FTB's position here.

1           Again, calling back to how I started the  
2 presentation. This was simply a case of an individual  
3 if you don't find unity, and you're looking simply at an  
4 individual selling an intangible. That's not the  
5 argument we're making today. That is a 17952 issue.

6           And they're also arguing -- they appear to be  
7 arguing a new retroactivity argument which is that OTA  
8 lacks jurisdiction to rule on the 2012 Tax Year;  
9 effectively, is what they're arguing. They're arguing  
10 that the FTB is making retroactive application. But  
11 that would -- that would mean that there's been a change  
12 in law.

13           There has been no change in law. There is no  
14 change in position. This is actually what the law has  
15 stood for and was articulated in *Metropoulos* -- was  
16 first articulated in *Metropoulos Trust Case* when we  
17 started to look at that.

18           And what is interesting about that is it  
19 almost -- if you follow the logical conclusion of their  
20 argument, they almost are saying that, well, the Smith  
21 panel didn't have any power in 2022 to make a decision  
22 in the 2012 tax year.

23           Likewise, *Metropoulos* didn't have any power in  
24 17 -- in 2019 to decide on the 2014 tax year. Which is  
25 obviously an absurd conclusion, but they're trying to

1 then raise that conclusion now which is not -- which is  
2 not appropriate.

3 And, you know, finally, they're -- they're  
4 also raising constitutional issues.

5 And as -- as clear, OTA lacks jurisdiction to  
6 address these constitutional issues because it's with  
7 their -- the question that's before the panel is whether  
8 or not FTB's actions violated the constitution and both  
9 the California constitution, as well as OTA's own  
10 determinations show that that is not something OTA has  
11 the jurisdiction for.

12 The case is similar to Acosta and Castro where  
13 the issue is not sort of an attack on constitutionality  
14 and regulation, but it fundamentally looked underneath.  
15 And, they said, "Actually, the issue here is whether or  
16 not it's preemption, and whether or not California has  
17 the authority to tax it on residence." And that's  
18 essentially the question they're asking you here.

19 And your own precedent says that you don't  
20 have jurisdiction to answer this question. And the  
21 proper remedy for the Appellants is to pay the Notice of  
22 Action and file a Refund Claim in Superior Court.  
23 That's a competent jurisdiction to hear those precise  
24 issues.

25 And for the foregoing reasons in conclusion,

1 FTB maintains that our assessment should be upheld.

2 Thank you so much for your time.

3 JUDGE LEUNG: Thank you, Ms. Swain.

4 Judge Vassigh, do you have any questions for  
5 Franchise Tax Board?

6 JUDGE VASSIGH: I do not. Thank you.

7 JUDGE LEUNG: Thank you, Judge.

8 Judge Akopchikyan?

9 JUDGE AKOPCHIKYAN: I don't either. Thank  
10 you.

11 JUDGE LEUNG: Okay.

12 Mr. Karachale, your closing.

13 MR. KARACHALE: Thank you, Judge Leung.

14 (Reporter Interruption)

15 JUDGE LEUNG: Thank you, Ms. Rodriguez.

16 Mr. Karachale.

17

18 CLOSING STATEMENT

19 MR. KARACHALE: Thank you, Judge Leung.

20 As we've described in my new detail, we are  
21 here because the FTB has contorted itself every way  
22 possible to avoid the very precise guidance from the OTA  
23 on holding companies and the memorabilia doctrine.

24 Going back to cases like Valentino and Ames,  
25 which the Respondents subsided. California Courts, as

1 well the BOE and now the OTA, these courts have  
2 established coherent doc. If you are a passing  
3 investment company, you are not unitary. Therefore,  
4 gains from the sale of the investments are not business  
5 income.

6 For the F -- for the FTB's arguments here  
7 survive, they have to demonstrate in the face of this  
8 doctrine that Alvaco's status is a passive investment  
9 company. Is meaningless because, allegedly, through  
10 Angel Alvarez, Alvaco controlled and operated ABB. The  
11 FTB simply has not done that here today.

12 The FTB has made series of factual and  
13 analytical mistakes. This conflated the pre and post  
14 merger periods in the long operating history of Alvaco,  
15 CCHG, and ABB. It has misconstrued the different  
16 positions of Mr. Alvarez and Alvaco in relation to the  
17 business of ABB during the pre and post merger periods.

18 And it has distorted and ignored the corporate  
19 formalities that existed to prevent or reduce entirely  
20 any function of Alvaco or its shareholders in the post  
21 merger business for operations of ABB. AB -- Alvaco --  
22 I'll get closer, sorry -- Alvaco was a passive  
23 investment company only.

24 As relationship to ABB was clearly  
25 distinguishable from the cases the FTB claims provide

1 instruction here.

2 This is simply not a case of the sale of  
3 business assets or good will. Like Veriaz, Omar, or  
4 Metropoulos. And the FTB's shoehorning of the facts of  
5 this case into those very different scenarios disregards  
6 fundamental concepts of California Taxation that cannot  
7 be overlooked.

8 It is no coincidence that just as this case  
9 would resolve in favor of the Appellants, if the FTB  
10 treated Alvaco as a passive holding company that it is,  
11 the same outcome must result even if this Court follows  
12 the FTB down it's winding path where it asserts its  
13 Alvaco sale of ABB units create California business  
14 income to the nonresident Alvaco S-Corp shareholders.

15 Under the general conduit rules for taxation  
16 of multistate S-Corporation, there is simply no way that  
17 Angel Alvarez and the other Alvaco shareholders had  
18 California business income under Revenue and Taxation  
19 Code, section 17951, or under the Regulation Dash-Four.

20 To review, these are the facts: Alvaco had no  
21 business operations of its own. The only business of  
22 Alvaco was to hold equity interests in ABB and in no  
23 other business or company. Neither Angel Alvarez, as a  
24 shareholder of Alvaco nor Alvaco itself, had the power  
25 to control ABB. Nor did Alvaco or Mr. Alvarez endeavor

1 to exercise any much power or control.

2           Instead, ABB was controlled under its  
3 operating agreement by a five-person board of managers.  
4 Alvaco selected a minority of the managers of ABB, and  
5 one of the managers from CCHG represented a billion  
6 dollar private equity firm that had a fiduciary  
7 obligation to run ABB for the benefit of it's limited  
8 partners.

9           Now, it is true that Angel Alvarez served as  
10 the CEO of Alvaco, but that woe was not attributable to  
11 Alvaco's ownership of ABB. And for his entire ten-year,  
12 Mr. Alvarez was subject to control of managers. Whether  
13 you look to the guidance under the traditional unities  
14 test, the recent case law from this Court were merely  
15 applied common sense.

16           All pass lead to the same simple conclusion.  
17 Alvaco was not unit -- not in a unitary business with  
18 ABB. The sale of the ABB units was not business income,  
19 and the gain for the Alvaco shareholders was controlled  
20 by Revenue Taxation Code, section 17952.

21           The ABB units did not acquire situs of  
22 California, so Angel Alvarez and the other Alvaco  
23 nonresident taxpayers could not be subject to tax in  
24 California on the gain and sale of those units.

25           Thank you for your time, and we're happy to

1 answer questions.

2 JUDGE LEUNG: Thank you, Mr. Karachale.

3 Judge Vassigh, any questions?

4 JUDGE VASSIGH: I would just like to ask  
5 Appellants a clarifying question.

6 You just mentioned that you believe that FTB  
7 has made some errors in -- factual errors between the  
8 post merger period and the pre merger period; can you  
9 repeat that statement and just explain a little bit more  
10 for me, please.

11 MR. KARACHALE: Yeah. I think our point here  
12 is that we can see that during the pre merger period,  
13 the shareholders Angel and Victor and Brad controlled  
14 Alvaco. But after the merger, and the -- this  
15 demonstrative is intended to help show control. They  
16 gave up control in exchange for investment, right? In  
17 this larger undertaker, ABB.

18 So the FTB -- anyhow I don't want to speak for  
19 Mr. Beck -- but my -- they seem to intimate that Angel  
20 Alvarez maintained the same control before the merger  
21 over Alvaco, and it just somehow switched to control in  
22 ABB. And this is the principle factual difference that  
23 we're trying to point out.

24 And again, we've talked a lot about these  
25 facts, but Angel Alvarez gave up control, and they did

1 this whether it's about the 55% percent. But the board,  
2 with the controlling separate group, their goal was to  
3 step back become investors in this larger entity and  
4 then have that company grow within intent to sale. They  
5 stepped back from being operators to being investors.

6 JUDGE VASSIGH: Thank you for extending on  
7 that.

8 I have no further questions.

9 JUDGE LEUNG: Thank you.

10 Judge Akopchikyan?

11 JUDGE AKOPCHIKYAN: Yes. I have a Court  
12 question for Appellants.

13 FTB, during your presentation, you referenced  
14 the 2012 Tax Return. Can you provide some additional  
15 insight into some of these items that appear on the  
16 Return. Specifically, I think FTB mentioned there were  
17 asset -- there were a change of assets in 2012, for  
18 instance.

19 Is there any additional insight regarding 2012  
20 in this Return?

21 MR. KARACHALE: Yeah. I'm happy to address  
22 them, but Mr. Shaver may have some comments as well.

23 So I believe that FTB is referencing the  
24 Schedule F and the confrontation of business income. If  
25 you see there, it refers to statement five in the -- at

1 least for the Net Gain; and loss; and other income.

2 This is -- if you go back to the statements in  
3 Return, this is income rolling up from ABB, right. I  
4 mean, ABB was a operating company.

5 What I believe this income represents, and,  
6 again, I can confirm this. This is -- until the sale of  
7 the ABB units income was rolling up through the LLC and  
8 flowing up through the S-Corp. Right, that's why they  
9 have business income there until that point.

10 Does that answer your question on at least the  
11 business income?

12 JUDGE AKOPCHIKYAN: Not the business income,  
13 but also the assets reflected on statement nine shows a  
14 beginning value and the end of tax year value. And  
15 there is a increase there and all of the description  
16 says it's due from the rate of entity.

17 I think FTB also referenced assets in  
18 California.

19 So just -- do you have any additional insight  
20 about that.

21 MR. KARACHALE: I don't.

22 MR. SHAVER: I would echo Mr. Karachale's  
23 assessment.

24 I believe the return reflects fundamental  
25 partnership taxation concepts. If you own the business,

1 the character of the income flows up sort of like the  
2 conduit rule. I don't think the inference should be  
3 that Alvaco itself is generating business income merely  
4 because it was allocated income from ABB. That's just  
5 something that had to happen under the tax law.

6 It would be a stretch to infer that that's  
7 business income within the meaning we've been talking  
8 about at the Alvaco level. And I think there's a little  
9 bit of a theme there with Metropoulos where we actually  
10 had a sale of a business asset in a disregarded entity.  
11 A CUE sub, that was the character that hit the S-Corp  
12 and had to be allocated consistently.

13 So we're not -- I don't think there's any  
14 disagreement about the conduit rule or flow through  
15 taxation on our point. It's just that a function of how  
16 the Return had to be completed.

17 JUDGE AKOPCHIKYAN: Okay. Thank you.

18 I don't have any additional questions.

19 MR. KARACHALE: I'm sorry. Maybe I can add --

20 MR. AKOPCHIKYAN: Sure. Go ahead.

21 MR. KARACHALE: -- they have to be referred to  
22 the compensation paid to Mr. Alvarez and Brad. This --  
23 I'm almost certain, but I can confirm this, you know, is  
24 the reasonable compensate that Alvaco would lose it's  
25 status as an S-Corporation if didn't pay reasonable

1 compensation to the -- to the people performing in their  
2 CEO hats, right.

3 So I believe that those salaries are to  
4 maintain the S-Corporation status.

5 JUDGE AKOPCHIKYAN: Thank you.

6 JUDGE LEUNG: Thank you, Judge Akopchikyan.

7 I've got many questions. I'm not sure where  
8 to start. I want to continue on Judge Akopchikyan's  
9 line of questioning and that's about the 2012  
10 S-Corporation Return. Or maybe go a little before that.

11 After 2007 when ABB was formed, this is for  
12 the Appellants, it's my understanding that, basically,  
13 Alvaco became the shell and the only asset it had was  
14 the ABB membership; would that be correct?

15 MR. KARACHALE: That's correct.

16 JUDGE LEUNG: Okay. So that then changed  
17 from, I guess, '07 through 2012; correct?

18 MR. KARACHALE: Correct.

19 JUDGE LEUNG: Okay. So in 2012, we're looking  
20 at the S-Corporation 100 Form, 100S. It's got a -- an  
21 auto one Schedule; with sales, property, payroll  
22 factors, and at the bottom line its got a 25% percent --  
23 California percentage; the question of factor.

24 Is that all from its 55% percent ownership of  
25 ABB?

1 MR. KARACHALE: Yes.

2 JUDGE LEUNG: Okay. So how did we get to the  
3 numbers on the -- on the all one if Alvaco and ABB are  
4 not unitary.

5 MR. KARACHALE: I believe that these -- so  
6 this is -- and this is reflective in the notices. So  
7 Alvaco was subject to the 1.5% percent S-Corporation tax  
8 in California, right. Those numbers are how Alvaco got  
9 to that 1.5% percent, right.

10 I don't think that merely showing those  
11 factors collapses this distinction between whether it  
12 was business income or not. But this is how they got to  
13 the 1.5% percent. Those numbers.

14 JUDGE LEUNG: I understand that, but I'm  
15 trying to figure out if you're saying that they're not  
16 unitary. You would not include 55% percent of the  
17 apportion of ABB's apportion, in fact, on your return.

18 So why did you include it? There would be a  
19 zero.

20 MR. KARACHALE: Right.

21 JUDGE LEUNG: You paid them the tax.

22 MR. KARACHALE: Yeah, I'm not sure.

23 JUDGE LEUNG: Okay. I'm trying to recall the  
24 testimony whether the presentation about what happened  
25 after the merger.

1           Mr. Angel Alvarez moved on. He was CEO. And  
2 Mr. Weinbrum also became CEO then they show Victor the  
3 door, yet you see compensation for Victor on the  
4 S-Corporation Return.

5           What's he being paid for?

6           MR. KARACHALE: I thought that the wages were  
7 to grab one time --

8           JUDGE LEUNG: There's like a \$1 million dollar  
9 plus figure for Victor Alvaco.

10          MS. NESSIER: They're shareholders  
11 distribution on part of the refinance that occurred.

12          JUDGE LEUNG: Shareholder distribution on  
13 refinancing characterize as payroll of salary.

14          I'm not putting two and two together. Help  
15 me.

16          MR. KARACHALE: Right. No.

17          As I say, I believe those -- and I don't think  
18 it was for Victor. I'm sorry, I got to find the right  
19 page of the Return.

20          These recall, Judge Leung, that Angel and Brad  
21 remain on the board of Alvaco. And I'm almost certain  
22 that what happened was those -- that those -- those  
23 payroll getting paid out to those S-Corporations,  
24 S-Corporation shareholders, was done because they had to  
25 -- they had a reason to comp in their roll as managers

1 as opposed to shareholders, right.

2 It was an S-corporation. A Federal  
3 S-Corporation decision, right. Because absent  
4 reasonable conflict, they're going to lose their --  
5 sorry -- absent reasonable conflict, they're going to  
6 lose their S-Corp status.

7 JUDGE LEUNG: I'll come back to you folks.  
8 For Appellants.

9 For the Franchise Tax Board -- I'm just afraid  
10 I'm going to forget what I'm going to ask.

11 The Appellants mentioned three Legal Rulings:  
12 95-7, 2021-01, 2022-02. Please distinct all three.

13 MR. BECK: I'm sorry. To distinguish --

14 JUDGE LEUNG: 95-7 is the -- I guess it's the  
15 original holding company --

16 MR. BECK: Mm-hm.

17 JUDGE LEUNG: -- the two most recent ones,  
18 2021-01 and 2022-02.

19 MR. BECK: Well, first of all the Dash-Two --  
20 and Ms. Swain will explain after I finish -- and that is  
21 just simply about treatment of high assets. 2021-01 and  
22 95-7, there are -- 2021-01 can be seen as an extension  
23 of 95-7. It's 95-7 referred to Corporations, and  
24 2021-01 was for passthroughs.

25 And it tried to state department policy

1 updating with respect to a loss or passthroughs. And  
2 95-7 tried to state department policy in determining the  
3 -- I believe three State Board of Equalization opinions  
4 regarding holding companies and it basically expressed  
5 how the Department would attempt to apply those.

6 And one thing I would notice in 2021-01 that I  
7 believe Appellants have missed in their presentation is  
8 that the -- that ruling distinguishes, for example, the  
9 holding company that has multiple different investments  
10 and not one if there's multiple investments. If it's  
11 got, like, three different businesses that it's  
12 investing in.

13 It's harder for the FTB to say that there's  
14 unity. And as apposed to where it's one -- not only  
15 one single -- one single business, but it was the same  
16 business that the holding company has as an operating  
17 company and it contributed those assets. So -- and I  
18 think that's my summary.

19 MS. SWAIN: Thank you, Mr. Beck.

20 Thank you, Judge Leung.

21 So I'm going to talk about 2022-02, which is  
22 the hot assets ruling, as I mentioned a little bit  
23 earlier, where it's dealing specifically with PIT  
24 sourcing.

25 So it's specifically -- that's a hard word --

1 when an individual is selling their interest in a  
2 partnerships and a intangible interest. And in that  
3 case that -- it actually restates the law of this very  
4 simple transaction.

5 Which is a simple 17952 transaction that  
6 follows the sourcing rules that we also see in Ames, and  
7 it kicks in the rule, and it takes the sourcing of the  
8 intangible entirely outside of California back to the  
9 place of residence. That is good law. That is bedrock  
10 law in California.

11 Nonetheless, that does have its own safe  
12 harbor for situs if the intangible is used in such a way  
13 that creates situs. And, again, outside of our case  
14 today. But what is -- what is -- so it's really not  
15 applicable to this case.

16 But the point that -- that Appellants have  
17 been making about that decision is simply this concept  
18 of overreaching by FTB or arbitrariness and, in fact,  
19 the portion of the sale proceeds that Appellants call  
20 "gain" -- "intangible gain".

21 They're trying to characterize it as  
22 "intangible gain" in their argument, essentially. And  
23 saying this is overreaching is characterized in 2022-02  
24 as income that is reflective from the partnership has  
25 formed unrealized intangibles and the partner is being

1 paid, essentially, that income.

2           And that is coming from the partnership level  
3 so it's -- it's effectively business income. It's  
4 separate distinct. It is not intangible. It is not  
5 income from the intangible. And that's where -- that's  
6 the distinction in that, and that's the -- what that  
7 stands for.

8           Again, it's not applicable to this case.  
9 There's no -- FTB has not made any argument in this  
10 case. It has not rest it's NPA on an idea that there  
11 are unrealized intangibles in this case.

12           In fact, it's closest to the Legal Ruling in  
13 2021-01 which is also mere in Smith. I think Smith --  
14 because Smith is the governing authority, we're talking  
15 about Smith. And as you know -- and there's this,  
16 like -- this, like, distinction between the two.

17           But, as you know, most of the analysis in  
18 those decisions goes to whether or not there's unitary  
19 relationship within the Legal Ruling and in the Smith  
20 decision.

21           As is the case here. We mere that, as well.  
22 And any sourcing that comes out of that has gone right  
23 to Dash-Four, which is following analysis laid out by  
24 Valentino; followed up by J.P. Morgan Trust seen here in  
25 OTA; and Metropoulos before that was superseded.

1 Thank you judge.

2 JUDGE LEUNG: Thank you, Ms. Swain.

3 So in what -- your presentation and Mr.  
4 Becks' presentation earlier, I seem to have heard that  
5 one of you said that there's no need to find unitary  
6 relationship to find a business income; and the other  
7 said you were required to find a unitary relationship.

8 So did I mishear that -- that presentation?  
9 That part. Or.

10 MS. SWAIN: To the extent that I have  
11 misspoken and contradicted my co-counsel and anything  
12 relating to unity in business formations, please,  
13 retract that and accept my apologies.

14 JUDGE LEUNG: So is it FTB's position that you  
15 do not need find unitary relationship before you make a  
16 finding of business income?

17 MS. SWAIN: I'm going to pass that to  
18 Mr. Beck. That's his --

19 MR. BECK: FTB's position is that the  
20 controlling authorities are bringing in Taxation Code  
21 25120, Subdivision (a), and Hoechst Celanese.

22 Both of these authorities allow finding of  
23 business income based on the role that an asset plays  
24 within a business if it has, like, an operational  
25 function, for example.

1 MS. TAMAGNI: And this is Delinda.

2 I'd like to also add that in Allied Signal, it  
3 is very clear that the United States Supreme Court  
4 stated that Payor or Payee do not have to be unitary  
5 relationship in order for it to be business income. So  
6 unity and concept of business income are two separate  
7 things.

8 When you are unitary and looking at whether  
9 companies are -- have unitary relationship with each  
10 other, you're looking at what do we put on the Return.  
11 When you're looking at business income and nonbusiness  
12 income, we're looking at what items are considered  
13 income.

14 So they are two separate concepts. However,  
15 they are very commonly discussed together like we are  
16 here today because both unitary income and business  
17 income have an operational purpose, and there tends to  
18 be a flow of value between the two.

19 Thank you.

20 JUDGE LEUNG: So you're basically saying that  
21 it's easier to find business income when there's no  
22 unitary relationship, but not required.

23 MS. TAMAGNI: That is correct. Thank you.

24 JUDGE LEUNG: Mr. Karachale, I imagine you  
25 disagree.

1 MR. KARACHALE: I -- no, I agree with the  
2 FTB's position.

3 Do you -- do you -- I'll let -- maybe  
4 Ms. Nessier will address.

5 MS. NESSIER: I think, technically, that's a  
6 true statement. The only problem is that it's really  
7 difficult given the factors that lay out first in the  
8 unitary analysis and then under HESH, because of the  
9 flow of value and or the three unities; and then the way  
10 HESH lays out the functional test.

11 The same factors matter and, so, that's why  
12 they don't in a practical sense, they'll never exist  
13 really without each other.

14 But I think one of the lines we had is  
15 regardless of the unitary status, it can only -- the FTB  
16 can only keep going if they can show that the business  
17 outside is integral. That the ownership units and their  
18 control and power over them -- which, again, control and  
19 power isn't quite the same as unitary, but control and  
20 power is integral to the operations of.

21 And, so, I think the technical split, they are  
22 correct. I think there is no practical world in which  
23 the two don't overlap in this Court's assessment of the  
24 facts.

25 JUDGE LEUNG: Thank you, Ms. Nessier.

1           While I have you up here. The -- the -- of  
2 the -- I really forgot what I was asking. The -- so --  
3 I really forgot what I was asking.

4           MS. NESSIER: It'll come back.

5           JUDGE LEUNG: Yeah. Too late.

6           MS. NESSIER: You can E-mail me.

7           JUDGE LEUNG: No. No. I'm still on the --  
8 now, I remember.

9           So, basically, during 2012, since Alvaco had  
10 zero factors in California, they were not doing business  
11 in California; is that correct?

12           MR. KARACHALE: That's correct. Yes, that's  
13 correct.

14           JUDGE LEUNG: Okay. The only entity here that  
15 was doing business in California was ABB; is that  
16 correct?

17           MR. KARACHALE: That's correct.

18           JUDGE LEUNG: Okay. I think that's all I need  
19 to ask. I'll go one more time for my colleagues.

20           Judge Vassigh, anything?

21           JUDGE VASSIGH: I have no further questions.  
22 Thank you.

23           JUDGE LEUNG: Thank you.

24           Judge Akopchikyan, any follow up questions?

25           JUDGE AKOPCHIKYAN: I just have one question

1 for FTB.

2 I think I heard Mr. Beck say the Appeal of  
3 Smith created some kind of presumption. Did I hear that  
4 correctly? Or.

5 MR. BECK: That's a good question. Let me  
6 find --

7 MR. AKOPCHIKYAN: Good ahead. Take your time.

8 MR. BECK: So it was -- so as regards -- in  
9 the area of unity -- so, specifically, Appeal of Saga,  
10 has established one presumption. And we believe the  
11 Supreme Court of Tennessee has a very good presumption;  
12 that a single business that was a source of income  
13 between two entities created presumption of unity.

14 And Smith, page 17, the direct quote is:

15 "When a group of corporations conduct only one  
16 business, it is expected that the requisite contribution  
17 or dependency would exist between the holding and  
18 operating companies."

19 And I believe they're referring to a state  
20 board of Equalization or perhaps it's an indirect quote  
21 from the State Board of Equalization. But I take that  
22 to be an endorsement of that position.

23 JUDGE AKOPCHIKYAN: Thanks for the  
24 clarification.

25 I don't have any more questions.

1 JUDGE LEUNG: Thank you, Judge Akopchikyan.

2 MR. KARACHALE: Judge, can I address just one  
3 more question that I think we left off outstanding?

4 JUDGE LEUNG: Yes.

5 MR. KARACHALE: This is regarding your  
6 question about the wages.

7 JUDGE LEUNG: Yes.

8 MR. KARACHALE: So if you look at Schedule D  
9 -- excuse me, Schedule F, there are wages paid to Angel  
10 Alvarez and Brad Weinbrum in their capacity as officers  
11 of Alvaco. And those wages were paid to the officers  
12 for their work in helping to sell ABB in 2012. This is  
13 -- I can confirm.

14 JUDGE LEUNG: Helping to sell its investment  
15 in ABB to whoever the purchasing was?

16 MR. KARACHALE: That's correct.

17 JUDGE LEUNG: Okay. Okay. Thank you.

18 That brings to the conclusion of this hearing.

19 The record is now close.

20 As I said, we will endeavor to have our  
21 decision to the parties within 100 days. Thank you for  
22 presenting your cases very well on both sides. Very  
23 interesting. And we'll get back to you as soon as we  
24 can.

25 (Proceedings concluded at 2:59 p.m.)

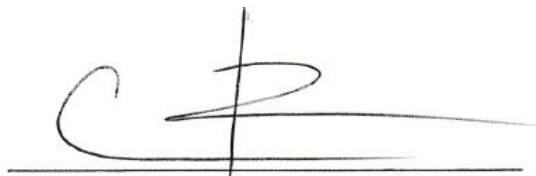
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12 I further certify that I am in no way  
13 interested in the outcome of said action.

14 I have hereunto subscribed my name this 2nd  
15 day November, 2023.

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21 Hearing Reporter  
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