OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Appeals of: **ALVACO TRADING COMPANY, INC.;** **ALVACO TRADING COMPANY, INC.** **(GROUP RETURN 540 NR);** **V. ALVAREZ** **C. ALVAREZ;** **A. ALVAREZ AND** **P. ALVAREZ (DEC'D)**	OTA Case Nos. 220410259, 220410261, 220410262, 220410263

OPINION

Representing the Parties:

For Appellants:	Christopher A. Karachale, Attorney Shannon Nessier, Attorney Daren Shaver, Attorney Wilson Feng, Attorney
For Respondent:	Brian L. Beck, Attorney Ellen Swain, Attorney DeLinda Tamagni, Ass't Chief Counsel
For Office of Tax Appeals:	Grant S. Thompson, Attorney

T. LEUNG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045,[1] Alvaco Trading Company, Inc. (Alvaco), Alvaco Trading Company, Inc. (Group Return 540 NR), V. Alvarez and C. Alvarez, and A. Alvarez and P. Alvarez (Dec'd) appeal actions by the Franchise tax Board (respondent) proposing the following assessments of additional tax, plus applicable interest, for the 2012 taxable year: for Alvaco, $41,676[2]; for

[1] Unless otherwise specified, all section references are to the 2012 R&TC.

[2] Respondent also imposed a late filing penalty of $9,792.94 on Alvaco. Appellants have not disputed this penalty.

Alvaco Trading Company, Inc. (Group Return 540 NR), $412,799; for V. Alvarez and C. Alvarez, $327,582; and for A. Alvarez and P. Alvarez (Dec'd), $2,790,787.[3]

Office of Tax Appeals Administrative Law Judges Amanda Vassigh, Ovsep Akopchikyan, and Tommy Leung held an oral hearing for this matter in Sacramento, California, on October 17, 2023. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

ISSUES

1. Whether Alvaco and ABB/Con-Cise Optical Group LLC (ABB) were engaged in a unitary business.
2. Whether Alvaco's gain on its sale of interest in ABB (Sale) is business income.
3. Whether California Code of Regulations, title 18, (Regulation) section 17951-4[4] should have the "dignity of law," trumping Revenue and Taxation Code section 17952.
4. Whether respondent's action violates the U.S. Constitution because it would tax appellants, who are nonresidents of California.

FACTUAL FINDINGS

1. Alvaco, an S corporation, was founded by appellant A. Alvarez and owned by him, the Alvarez Family 2005 Irrevocable Trust, B. Weinbrum, and appellant V. Alvarez.[5] Alvaco contributed substantially all of its operating assets to a joint venture, ABB. In October 2012, Alvaco disposed of substantially all of its interest in ABB, retaining a 13.46 percent stake at year's end.[6] The issue in this appeal is how gain from that 2012 Sale should be treated.

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[3] Appellants other than Alvaco will be referred to as the Shareholders.

[4] Unless otherwise specified, all Regulation references are to those sections operative for the 2012 taxable year.

[5] B. Weinbrum was a shareholder of Alvaco and a Group Return 540 NR for Alvaco was filed on his behalf. Respondent lists A. Alvarez's interest in Alvaco as being 78.74 percent, while appellants list A. Alvarez's interest as 56.71 percent and the trust's interest as 22.03 percent (totaling 78.74 percent). Presumably, A. Alvarez transferred a portion of his interest to the trust at some point.

[6] Respondent's Audit Issue Presentation Sheet Number 2 (AIPS2) dated January 10, 2019, states that Alvaco sold 41.54 percent of ABB, and later provides apportionment calculations that appear to indicate that Alvaco retained a 13.46 percent interest in ABB (i.e., 55 percent, less 41.54 percent). The record does not include a copy of the sale agreement.

2. A. Alvarez, B. Weinbrum, and C. Pelletier held the offices of, or served in the functions of, CEO, COO, and CFO, respectively, of Alvaco.[7] Appellant V. Alvarez "effectively served as in-house corporate counsel for Alvaco." For the 2012 taxable year, Alvaco reported that it paid A. Alvarez $8,440,945, B. Weinbrum $1,266,142, and V. Alvarez $1,208,624 and that each spent 100 percent of his time on Alvaco. Alvaco had a corporate office at 5360 N. W. 35th Avenue in Fort Lauderdale, Florida.
3. In 2007, Alvaco and Con-Cise LLC (Con-Cise) contributed substantially all of their operating assets to ABB in return for interests in ABB.[8] Alvaco and Con-Cise thus became the initial members of ABB. Alvaco received 55,000,000 units of ABB and an initial capital account of $49,500,000, and Con-Cise received 45,000,000 units and an initial capital account of $40,500,000.
4. At the time of the transaction, Alvaco and Con-Cise were, respectively, the largest and second-largest independent contact lens distribution companies in the United States. The transaction "was in furtherance of the business strategy to become the largest contact lens distributor in the United States."
5. ABB was a large business enterprise with approximately $479 million in annual revenue and over 20,000 eye care professional accounts. During 2012, ABB was doing business in California, and had a California apportionment factor of 29.21 percent at the time of the Sale.
6. ABB's Limited Liability Company Agreement (LLC Agreement) states that its principal place of business would be 5360 N.W. 35th Avenue, in Fort Lauderdale, Florida (i.e., the same address as Alvaco's business address), or such other place as is determined. The LLC Agreement provides that notices to ABB or Alvaco shall be delivered to appellant

[7] For simplicity, this Opinion will refer to them as officers of Alvaco, because, at a minimum, it appears they exercised functions normally associated with these offices. Appellants' opening brief states that A. Alvarez "has always been . . . the sole director and officer of Alvaco (i.e., President/[CEO], Treasurer and Secretary)" and that none of the other shareholders "has ever served as a director or officer of Alvaco, although they have been employed by Alvaco sporadically and at various times and capacities . . . ." However, appellants' opening brief also provides a chart that states the above-listed "pre-ABB title/function[s]" for A. Alvarez, B. Weinbrum, and C. Pelletier. During audit, Alvaco indicated that A. Alvarez and B. Weinbrum served as CEO and President, respectively, of ABB, and that, before and after 2012, they "served in much the same capacity for Alvaco as they did for [ABB] prior to and continuing after the transaction [referring to the 2012 transaction in which Alvaco sold its interest in ABB]."

[8] Con-Cise later changed its name to C-C Holding Group, LLC. Appellants describe the transaction as a merger, while respondent refers to it as a merger or joint venture.

A. Alvarez at this Fort Lauderdale address and that ABB's books and records will be kept at this address.

7. ABB was managed by a Board of Managers (Board) comprised of five individuals. Alvaco had the right to designate three managers to the Board so long as it held a majority of outstanding units. Alvaco designated appellant A. Alvarez and two other individuals, B. Weinbrum and a third individual, to the Board. Con-Cise designated two individuals to the Board.

8. The LLC Agreement required the prior written approval of either 80 percent of the managers or the holders of at least 75 percent of outstanding units to undertake certain significant actions such as adopting an annual budget, making distributions, issuing additional equity interests, selling material assets, incurring debt other than debt contemplated as of the closing date, or materially changing the business.[9]

9. The initial officers of ABB were appellant A. Alvarez, CEO; C. Moore, President;[10] B. Weinbrum, COO; C. Pelletier, CFO; and eight Vice Presidents (including one Executive Vice President).[11] Approval of 80 percent of the managers was required to determine the compensation of the CEO. The CEO, A. Alvarez, generally determined the compensation of other officers and employees in consultation with the managers (except for those employees with an approved employee contract). A. Alvarez and B. Weinbrum worked from ABB's and Alvaco's corporate office location in Fort Lauderdale, Florida.[12]

10. During audit, Alvaco stated to respondent that, prior to October 24, 2012, it did not provide services to ABB. Alvaco also stated that, on October 24, 2012 (the date the Sale was completed), it entered into a Management Agreement with ABB.[13]

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[9] The record does not include any such written approvals other than excerpts of a member resolution to approve a 2007 equity incentive plan that are quoted in AIPS2.

[10] B. Weinbrum later became President of ABB. It is not clear when he assumed this role.

[11] Appellants state that the members of the senior management team had employment agreements with ABB. The record does not include any employment agreements.

[12] According to appellants, C. Pelletier also worked from a Florida office, at least at some point. However, the record does not indicate whether it was the same Florida office. As noted above, C. Pelletier was CFO of Alvaco and ABB.

[13] The record does not include the management agreement. It is not clear what management services were provided by Alvaco.

11. The LLC Agreement imposes various restrictions and rights associated with the sale of units, including a co-sale right for other members to participate in any sale.

12. The LLC Agreement generally provides that the members will maintain confidentiality and not compete with one another. However, it provides that officers and other related parties of Con-Cise and Alvaco are not restricted by this provision unless they are employees of ABB. It also provides that members of ABB who are employees of ABB, or consultants to ABB, will be subject to such restrictions as are set forth in any employment, consulting, or similar agreement with ABB.[14] Without the non-compete clause, Alvaco and Con-Cise would not have (1) contributed their assets and liabilities to ABB and (2) been able to secure the considerable amount of highly leveraged financing, worth several hundred million dollars from a syndicate of banks, for the formation of ABB.

13. According to appellants, ABB was financed in part by a senior syndicated credit facility that had no recourse to Alvaco or its shareholders and imposed extensive restrictions on the operation of ABB's business.[15]

14. There is no evidence or contention of additional equity financing after the initial contribution of assets to ABB by Alvaco and Con-Cise.

15. ABB paid health insurance and meals and entertainment expenses for A. Alvarez and B. Weinbrum.

16. Alvaco was the Tax Matters Partner of ABB for federal and state income tax purposes. Both entities used the same tax preparer. ABB and Alvaco shared a common accounting department which provided information to their tax preparer for the preparation of their tax returns.

[14] The record does not include any employment agreements or consulting agreements other than the Advisory Services Agreement ABB and a California corporation entered into by which another entity would provide advice and assistance to ABB.

[15] The record does not include any documentation of the credit facility or any other ABB debt.

17. In 2007, Alvaco and Con-Cise adopted an equity incentive plan to provide employees and managers of ABB, and consultants to ABB, with options to purchase interests in ABB.[16]

18. In 2012, Alvaco paid officer compensation of $9,707,087 and salaries and wages of $1,208,624, for a total of $10,915,711.[17] In his Declaration, V. Alvarez testified that he provided services to Alvaco through 2012; he also stated that "[t]he compensation to the Shareholders reported by Alvaco, as well as all other material compensation received by the Shareholders from the date of the Merger through the date of the Sale, was not indicative of 'executive functions' performed for or on behalf of ABB or Alvaco, but rather paid by ABB to Alvaco entirely as a result of its equity interest in ABB." At the hearing, appellants asserted that Alvaco's officers were compensated for assisting Alvaco in the disposition of the ABB membership interest.

19. The record does not contain copies of board minutes or resolutions of ABB or Alvaco, other than excerpts of a Unanimous Written Consent in Lieu of a Meeting of the Members of ABB to approve a 2007 equity incentive plan.[18]

20. According to respondent, Alvaco reported that it was unitary with ABB on its tax returns for taxable years 2007 through 2012,[19] and that Alvaco apportioned its distributive share of income from ABB "over many years." For 2012, Alvaco reported gain from the Sale as nonbusiness income that it allocated pursuant to R&TC section 25125(d). But for its 55 percent interest in ABB, Alvaco had no sales, payroll, and property sourced to California.

21. Alvaco's 2012 tax return (Form 100S) reported that its principal business activity and product was "Holding Company." Specifically, on that return, Alvaco filed as if it was engaged in a unitary business with ABB, including 55 percent of ABB's sales, payroll,

[16] It is not clear which employees or officers received grants under this plan. The record does not include a copy of the plan or a complete copy of the resolutions authorizing it. However, AIPS2 provides excerpts from the plan that indicate its purpose was to incentivize key individuals so that they may benefit from ABB's growth. AIPS2 also indicates that Alvaco reported a stock option expense of $195,711.

[17] As noted previously, Alvaco reported paying A. Alvarez $8,440,945, paying B. Weinbrum $1,266,142, and paying V. Alvarez $1,208,624 and further reported that each of them spent 100 percent of their time on Alvaco.

[18] When respondent asked Alvaco for copies of board and officer minutes, Alvaco responded that appellant V. Alvarez, who it indicated was effectively ABB's corporate counsel, believed that ABB did not maintain a minute book for ABB. However, Alvaco indicated that the managers may issue authorizing resolutions.

[19] The record includes a copy of Alvaco's 2012 tax return only.

and property factors on Schedule R-1 to compute a California apportionment factor of 25.11 percent. Alvaco's Schedule F included over $4.2 million as a distributive share from ABB, over $1 million in advisory fees, and nearly $11 million in officer compensation and salaries paid to A. Alvarez, B. Weinbrum, and V. Alvarez, for a net loss of over $6.6 million; Alvaco also reported over $113.5 million in gain from the Sale.

22. Following an examination and protest proceedings, respondent issued a determination letter dated February 3, 2022. The letter reflects respondent's determination that Alvaco and ABB were part of the same unitary business and that the gain from Alvaco's sale of its interest in ABB was business income.

23. As a result of its determination, respondent issued Notices of Action proposing the additional tax set forth in the first paragraph of this Opinion.

DISCUSSION

If a taxpayer derives income from sources both within and without California, its tax liability is required to be measured by its net income derived from or attributable to sources within this state. (R&TC, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated entities, the income attributable to California sources must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated entities. (See *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472.) The apportionment of unitary business income takes into account activities of the entire unitary business, even if the business is conducted by separate entities. (See, e.g., *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* (1980) 445 U.S. 425, 441.)

Respondent's determination regarding the existence of a unitary business is presumptively correct, and appellants bear the burden of showing that it is incorrect. (*Appeal of United Mizrahi Bank* (95-SBE-011) 1995 WL672225; *Appeal of Kikkoman International, Inc.* (82-SBE-098) 1982 WL11776.) The California Supreme Court has held that the existence of a unitary business may be established by the presence of (1) unity of ownership, (2) unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions, and (3) unity of use in a centralized executive force and general system of operation (the three unities test). (*Butler Bros.v. McColgan* (1941) 17 Cal.2d 664, affd. (1942) 315 U.S. 501.) It has also stated that a business is unitary if the operation of the business done within California is dependent upon or contributes to the operation of the business outside California

(the contribution or dependency test). (*Edison California Stores, Inc. v. McColgan*, *supra*, 30 Cal.2d at p. 481.) If either test is satisfied, the businesses are unitary, and the application of either test should generally reach the same result. (*Dental Ins. Consultants, Inc. v. Franchise Tax Bd.* (1991) 1 Cal.App.4th 343, 348.) The tests are alternative tests, and unity exists if either one of them is satisfied. (*A.M. Castle & Co. v. Franchise Tax Bd.* (1995) 36 Cal.App.4th 1794, 1806 (*A.M. Castle*).)

More recently, the United States Supreme Court emphasized that a unitary business is a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. (*Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 178-179, rehg. den. (1983) 464 U.S. 909 (*Container Corp.*).) Later, the Court ruled that "the hallmarks of an acquisition that is part of the taxpayer's unitary business"--*i.e.*, functional integration, centralization of management, and economies of scale-- can respectively be shown by "transactions not undertaken at arm's length, a management role by the parent that is grounded in its own operational expertise and operational strategy, and the fact that the corporations are engaged in the same line of business." (*Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 789 (*Allied-Signal*); *Container Corp.*, at p. 180, fn. 19, and at p. 178; *Louis Dreyfus Petroleum Products Corp. v. Wisconsin Dept. of Rev.* (2008) 08CV494 (Wis. Cir. Ct.) (*Dreyfus*); see also *MeadWestvaco Corp.* ex rel. *Mead Corp. v. Illinois Dept. of Revenue* (2008) 553 U.S. 16, 30.) A unitary business can be found where, in combination with other indicia of unity, a holding company and its lower-tier operating company both derived their income from "a single underlying activity." (See *Appeal of Smith*, 2023-OTA-069P (*Appeal of Smith*); *Appeals of PBS Building Systems, Inc., et al.* (94-SBE-008) 1994 WL 719050 (*Appeals of PBS*); *Blue Bell Creameries, LP v. Roberts* (Tenn. 2011) 333 S.W.3d 59, 71.)

Where a business is conducted in more than one state, the income that is taxable by each state must be determined. Like many other states, California determines the taxable amount by dividing income into "business income" and "nonbusiness income." (See R&TC, § 25101; Cal. Code Regs., tit. 18, § 25101(a).)

The amount of business income that is taxable by California is generally determined based on an apportionment formula. (R&TC, § 25128.) In contrast, the amount of nonbusiness income that is taxable by California is determined pursuant to allocation rules that are set forth in R&TC sections 25124 through 25127. (R&TC, § 25123.)

> Generally, business income is apportioned through an apportionment formula that:
>
> rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that 'unitary business' between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction. (*Container Corp.*, at 165.)

Business income is defined as:

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

Nonbusiness income is defined as "all income other than business income." (R&TC, § 25120(d).) Income is business income unless clearly classifiable as nonbusiness income. (Cal. Code Regs., tit. 18, § 25120(a).) Activities that are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute business income. (*Ibid*.) Gain from the sale or disposition of intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. (Cal. Code Regs., tit. 18, § 25120(c)(2).)

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

With respect to intangibles, "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has

acquired a business situs in this state . . . ."[20] (R&TC, § 17952.) Intangible personal property acquires a business situs in California if (1) the intangible property is employed as capital in California or (2) the possession and control of the property have been localized in connection with a business, trade, or profession in California so that its substantial use and value attach to and become an asset of the business, trade, or profession in California. (Cal. Code Regs., tit. 18, § 17952(c).)

As to nonresident shareholders of S corporations, respondent's regulation provides a two-step analysis to determine what portion of income earned through an ownership interest in a multistate S corporation (i.e., an S corporation doing business both within and without California) is from California sources. (See Cal. Code Regs., tit. 18, § 17951-4(d), (f).) During 2012, Alvaco was "doing business" in California because it owned 55 percent of ABB and, thus, via attribution, 55 percent of ABB's sales, property, and compensation paid in this state for purposes of this determination.[21] (See R&TC, § 23101(b), (d).) Generally, the two-step analysis provides that the income of the multistate S corporation is first characterized at the S corporation level according to the S corporation's activities—i.e., the income is characterized as either "business income" or "nonbusiness income" under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA)—and second, such income is sourced to geographic locations according to the rules applicable to that type of income. (See Cal. Code Regs., tit. 18, § 17951-4(d), (f); *The J.P. Morgan Trust Company of Delaware v. Franchise Tax Bd.* (2022) 79 Cal.App.5th 245, 274-75 (*Metropoulos*); *Appeal of Smith*.) In this second step, business income is apportioned among the jurisdictions in which the S corporation does business in accordance with UDITPA and the regulations adopted thereunder, while nonbusiness income is sourced according to the sourcing rules of R&TC sections 17951 through 17955, and the regulations adopted thereunder, as if the income producing activity were undertaken by the S corporation shareholder in his/her individual capacity. Once the amount of the S corporation's California source income is determined, the S corporation's nonresident shareholder is subject to

[20] This is also commonly referred to as the "*mobilia* rule." It is noted that the pertinent language of R&TC section 17952 was originally enacted in 1937 as part of section 7(f) of the California Personal Income Tax Act. It is further noted that the relevant and pertinent language of former R&TC sections 7(f) is substantially similar in all material respects to the language in current R&TC section 17952.

[21] For example, ABB had over $10 million in California property, and even if only the 13.46 percent end-of-2012 ownership interest is applied, the result would exceed the doing business property threshold amount of $50,000. (See R&TC, § 23101(b)(3).)

California personal income tax on that shareholder's pro rata share of that California source income. (See Cal. Code Regs., tit. 18, § 17951-4(d), (f).)

Issue 1: Unity.

As a preliminary matter, a determination of whether an item of income is business or nonbusiness income is independent of whether the payor and payee are engaged in a unitary business. (See *Allied-Signal*, at p. 771; *Appeal of Smith*.) However, in this appeal, because Alvaco does not have California factors of its own and would have 55 percent of ABB's California sales, property, or payroll factors attributed to it only if it was unitary with ABB (see Reg. § 25137-1(f)),[22] the analysis must begin by first examining the relationship between these two entities. Absent a finding of a unitary relationship between Alvaco and ABB, the rest of the issues presented herein become moot as respondent's proposed adjustments would be zeroed out. (See Cal. Code Regs., tit. 18, § 17951-4(d) and (g).)[23]

Unlike the circumstances presented in *Metropoulos* and *Valentino*,[24] Alvaco did not simply dispose of its operating assets or earn operating income; instead, Alvaco contributed its operating assets to ABB in exchange for a 55 percent membership interest. Five years later, Alvaco disposed of substantially all of its ABB interest. Because this appeal involves an S corporation, a former operating company which later became an entity holding only one asset (i.e., the ABB membership interest), the law prescribes a more nuanced approach be taken to determine if Alvaco and ABB are unitary and can be included on a combined report. For example, because S corporations possess both corporate and partnership attributes, the Corporation Tax and Personal Income Tax Laws are implicated. (See, e.g., R&TC, §§ 23800, 17087.) Furthermore, the 50 percent ownership requirement for C corporations is replaced by a determination of unity, and combination of income/factors, that disregards minimum ownership requirements. (Cf. R&TC, §§ 25105, 23801(c), and Cal. Code Regs., tit. 18, § 25137-1(a); see also *Appeal of Smith*.) Here, both the stock ownership requirement for

[22] This regulation applies because, as an S corporation, Alvaco is subject to Part 11 of the R&TC (R&TC, §§ 23001, et seq.). Thus, Alvaco is a "taxpayer" for purposes of Regulation section 25137-1. (See R&TC, §§ 23037, 23802.)

[23] During this appeal, appellants argue that respondent improperly applied the 2019 version of Regulation section 17951-4(d)(2). However, as indicated above, only 2012 statutory and regulatory references are being applied. Therefore, this contention will be discussed no further.

[24] *Valentino v. Franchise Tax Bd.* (2001) 87 Cal.App.4th 1284 (*Valentino*); but see *Appeal of Smith*.

C corporations (because Alvaco owned 55 percent of ABB) and the traditional unitary tests disregarding ownership requirements (as prescribed in Regulation section 25137-1(a) and discussed next) were satisfied.

In *Appeals of PBS*, the State Board of Equalization (BOE) "explicitly dispel[led] the notion that a separate unitary test exists in the holding company context." (*Appeal of Smith*; *Appeals of PBS*.) It further concluded "there is no such separate standard or higher burden of proof which holding companies must meet in order to be held unitary with operating subsidiaries." (*Ibid*.) However, the BOE recognized that, with a holding company structure, some of the most significant unitary factors, such as intercompany product flow, often will not exist when there is no horizontal or vertical integration. (*Appeal of Smith*.) Factors that might be considered relatively insignificant in those situations take on added importance because they are the only factors to consider. (*Ibid*.) The typical level of unitary ties is augmented with other indicia which might otherwise be muted. (See *Appeal of Smith*; *Appeals of PBS*.)

From a high-level perspective, Alvaco and Con-Cise, the number one and number two U.S. contact lens distributors, respectively, created ABB, which rose from anonymity to become the number one U.S. contact lens distributor. Con-Cise was transformed from the number two U.S. contact lens distributor to become part of the number one contact lens distributor. Alvaco retained its prominence as the number one U.S. contact lens distributor through its majority ownership of ABB, reaping the financial benefits and shedding the risks and burdens of operating the enterprise, while absorbing its closest competitor.

From a more microscopic perspective, ABB was given the operational tools, Alvaco's operational assets and intellectual property (including business and financial contacts), to be the number one contact lens distributor. Alvaco's CEO and COO became ABB's CEO and COO, giving ABB the brains to run and maintain the business. In turn, ABB distributed its profits to Alvaco, and even paid Alvaco so Alvaco could compensate Alvaco's officers. Alvaco was able to continue profiting from its former business through ABB, with ABB presumably functioning as an extra layer of protection from the daily risks of running a business. Appellants have not presented any evidence that would rebut the obvious appearance of flow of value between Alvaco and ABB, such as explaining why they kept Alvaco as an active entity after the formation of ABB.

The fact that ABB paid Alvaco for the compensation/salary of Alvaco's officers, the covenant not to compete, and the installation of Alvaco's CEO and COO with ABB in those same roles take on greater importance in this context, while the claimed lower level of intercompany transactions and financing is less important. (See *Appeal of Smith* and *Appeals of PBS*; see also *Dreyfus*.) Furthermore, functional integration is satisfied because Alvaco was the number one independent U.S. contact lens distributor prior to joining with the number two U.S. distributor, Con-Cise, to form ABB, whose goal was to be the number one U.S. distributor; undoubtedly, owning Alvaco's operations and sharing the same CEO, A. Alvarez, and the same COO, B. Weinbrum, as well as retaining V. Alvarez as each entity's legal counsel helped ABB achieve this goal. This same sharing of senior executives also satisfies the centralized management requirement. While appellants stress that a super-majority was needed to make major decisions and that ABB was managed on a consensus basis (even though Alvaco owned 55 percent of ABB) and, hence, Alvaco did not control ABB, the reality is that this same super-majority requirement gave Alvaco veto power over policy proposals introduced by ABB's other member, Con-Cise, which is another form of control. Finally, economies of scale are demonstrated by Alvaco's contribution of startup and operating capital for ABB, a brand-new joint venture. (See *Allied-Signal*; *Container Corp.*; *Dreyfus*, citing *Chilstrom Erecting Corp. v. Wis. Dept. of Revenue*, 174 Wis. 2d at 529.)

In addition, mutual interdependence and flows of value existed as ABB was dependent on Alvaco's assets and executive know-how as much as Alvaco was dependent on ABB's revenue stream after contributing all of its operating assets to ABB; in the same vein, the flows of value were highlighted by Alvaco's assets and proprietary information going to ABB in exchange for membership distributions and executive compensation, as well as a non-compete clause which facilitated ABB's ability to obtain financing and maintain its status as the number one independent U.S. contact lens distributor. During 2012, ABB paid Alvaco nearly $11 million to compensate Alvaco's officers for working on the Sale, and Alvaco used that payroll expense to offset its distributive share of income from ABB; by including 55 percent of ABB's apportionment factors on Schedule R-1, Alvaco was able to reduce the proportion of ABB's income sourced to California from 29.21 percent to 25.11 percent.

If respondent's finding of unity is reasonable and rational (see *Todd v. McColgan* (1949) 89 Cal.App.2d 509), appellants then have the burden of establishing that Alvaco was not

engaged in a unitary business with ABB. (*Appeal of Saga Corp*. (82-SBE-102) 1982 WL 11779.) To meet this burden, appellants "must establish by a preponderance of the evidence that the unitary connections present in this case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist." (*Ibid.*) Appellants argue that Alvaco was not unitary with ABB because "Alvaco was simply an investment vehicle maintained by its shareholders." Based on the foregoing analysis and Findings of Fact, this panel concludes that respondent's determination of unity is reasonable and rational, and that appellants' arguments are not persuasive. (See *A.M. Castle*.) Because a unitary relationship exists, the next step is to determine if the gain from the Sale was business or nonbusiness income.

Issue 2: Business v. Nonbusiness income.

Appellants argue that, even if Alvaco was engaged in a unitary business with ABB, the "functional test" for business income is not met because (i) Alvaco did not have control over ABB and (ii) ABB could not have been integral to Alvaco's business operations because Alvaco became a passive investment vehicle and "effectively ceased to carry on any trade or business" when it contributed its operating assets to ABB.

California courts have established two tests to determine whether income constitutes business income under R&TC section 25120(a). (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 526-532 (*Hoechst*).) Under the transactional test, income constitutes business income if the relevant transactions and activity occurred in the regular course of the taxpayer's trade or business. (*Id.* at p. 526.) Thus, for example, a sale of inventory in the ordinary course of business generates business income under the transactional test. Under the functional test, income constitutes business income "if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income." (*Id.* at p. 526.) Thus, for example, a taxpayer's sale of stock generated business income when the stock generated unitary business income prior to its sale. (*Jim Beam Brands Co. v. Franchise Tax Bd.* (2005) 133 Cal.App.4th 514, 526 - 527 (*Jim Beam*).) If either test is satisfied, income constitutes business income. (*Id.* at p. 522.)

Here, the parties agree that the transactional test does not apply. However, they dispute whether Alvaco's sale of its interest in ABB generated business income under the functional test. Respondent properly argues that the functional test is met because ABB was integral to Alvaco's

regular business operations. Appellants acknowledge that Alvaco acquired its interests in ABB by contributing its business assets to ABB and that Alvaco disposed of its interest in ABB. In addition, ABB generated business income, which was passed-through to Alvaco as a result of Alvaco's ownership of ABB's membership interest, which suggests that Alvaco's disposition of its ABB interest should also generate business income. (See *Jim Beam*, at p. 527.)[25] However, appellants contend that it did not have sufficient control over ABB to satisfy the functional test. Appellants assert that Alvaco "did not have the potential or power to control ABB" and that it did not "exercise any control over ABB or its business or operations."

Appellants' argument is misplaced. For purposes of the functional test, the property for which control must be shown is the membership interest in ABB (which was Alvaco's only asset), not ABB. (See *Hoechst*, at 527; *Appeal of Centennial Equities Corp*. (84-SBE-086) 1984 WL 16165.) Moreover, in applying the functional test, the critical inquiry is the relationship between the property and the taxpayer's business operations. (*Hoechst*, at p. 527.)

The record leaves no doubt that Alvaco managed and controlled its interest in ABB. Alvaco was the sole owner of its ABB interest. The interest was a proxy for the business assets Alvaco formerly owned before their contribution to ABB; these same assets generated business income. Indeed, the ABB interest produced most, if not all, of Alvaco's income. Alvaco, through its CEO and COO, exercised powers associated with the interest, such as the appointment of managers and, ultimately, the power to dispose of most of the interest. (See *Hoechst*, at p. 536.)

In summary, Alvaco and ABB were engaged in the same unitary business of contact lens distribution. Alvaco held and managed that business through ABB, and Alvaco's control and use of its ABB interest contributed materially to its production of business income so that the interest was "interwoven into and inseparable" from its unitary contact lens business. (See *Hoechst*, at p. 529.) Consequently, Alvaco's gain on the sale of its ABB interest generated business income under the functional test. Because the shareholders of Alvaco are individuals, the provisions of

[25] Appellants contend that *Jim Beam* should be distinguished on the ground that the parent in *Jim Beam* conducted its own separate but related business while Alvaco, in appellants' view, conducted no business activities. However, the parent and subsidiary in *Jim Beam* were engaged in the same unitary business, as were Alvaco and ABB. As previously discussed, it appears that Alvaco participated in the unitary contact lens business by providing management services and equity financing to ABB and sharing administrative functions with ABB. A corporation's activities may contribute to the unitary business even if the corporation does not directly produce goods for sale. (See, e.g., *Appeals of PBS*.)

Regulation section 17951-4(f) are triggered to determine what portion of this business income is California-sourced.

Issue 3: Regulation section 17951-4 v. R&TC section 17952.

Appellants contend that Alvaco's sale of its interest in ABB was the sale of an intangible interest that generated nonbusiness income. Appellants further contend that the ABB membership interest did not have a business situs in California. On these grounds, appellants argue that the Shareholders' pass-through income from the Sale should be allocated as nonbusiness income and sourced under R&TC section 17952.

However, as concluded above, the sale of the ABB interest generated business income under the functional test. Consequently, the sourcing of the Shareholders' pro rata share of Alvaco's gain is determined using partnership rules. (See Cal. Code Regs., tit. 18, § 17951-4(f); *Metropoulos*, at p. 267.) This requires that the Shareholders apportion their share of Alvaco's gain from the sale of ABB as it was apportioned at Alvaco's level. (See Cal. Code Regs., tit. 18, § 17951-4(d); *Metropoulos*.) As a result, respondent correctly determined that the Shareholders are taxable by California on their pro rata share of Alvaco's unitary business income that is apportioned to California.[26]

Appellants also challenge the propriety of applying a regulation (Regulation section 17951-4) over a statute (R&TC section 17952). This question was asked and answered in *Metropoulos*. Because Regulation section 17951-4 was adopted by respondent pursuant to a grant of substantive rule-making authority from the Legislature, it is accorded the same "dignity" as a statute and need not be subordinated to R&TC section 17952. (*Metropoulos*, at p. 275.)

Issue 4: Constitutionality.

Under its Rules of Practice, OTA's jurisdiction over proposed tax deficiencies is limited to hearing and deciding appeals from respondent's notices of action. (Cal. Code Regs., tit. 18, § 30103(a).) An administrative agency's authority to act is of limited jurisdiction and it "has no powers except such as the law of its creation has given it." (See *Ferdig v. State Personnel Bd.* (1969) 71 Cal.2d 96, 105; *Appeal of Moy*, 2019-OTA-057P.) OTA has no jurisdiction over constitutional or substantive due process right claims. (See Cal. Code Regs., tit. 18,

[26] In light of this conclusion, we need not consider whether respondent's Legal Ruling 2022-02 also suggests this same result for all or a portion of Alvaco's gain on its sale of interests in ABB.

§ 30104(b), (d).) Nevertheless, this panel notes that the California Courts of Appeal have already ruled that respondent's use of the Regulation section 17951-4 regime to source income of pass-through entities to California and impose tax therefor on nonresident taxpayers satisfies constitutional standards because of the conduit rule set forth in Internal Revenue Code section 1366(b). (See *Metropoulos*, at p. 271; *Valentino*, at p. 1291, and *Appeal of Smith*.)

HOLDINGS

1. Alvaco and ABB were engaged in a unitary business.
2. Alvaco's gain on the Sale is business income.
3. Per *Metropoulos*, Regulation section 17951-4 has the "dignity of Law," and respondent properly applied that regulation over R&TC section 17952.
4. While OTA has no jurisdiction over constitutional claims, the California Courts of Appeal have ruled that respondent can properly subject the Shareholders to California tax on the gain from the Sale.

DISPOSITION

Respondent's action is sustained.

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Tommy Leung
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Tommy Leung
Administrative Law Judge

We concur:

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Ovsep Akopchikyan
Administrative Law Judge

DocuSigned by:
Amanda Vassigh
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Amanda Vassigh
Administrative Law Judge

Date Issued: 1/23/2024