

FACTUAL FINDINGS

1. Peak Travel operated as a travel management company. It was founded in 1963 by J. Peak.
2. In 2007, Peak Travel purchased the assets of Journeys by Ambassador, a travel agency located in Oregon, for approximately \$2.5 million.
3. Effective November 1, 2009, Peak Travel elected S corporation status and converted from a C corporation to an S corporation.
4. On November 1, 2014, Peak Travel and its sole shareholder at the time (R. Peak, the son of J. Peak), entered into an agreement (Stock Purchase Agreement) for him to sell all outstanding shares of Peak Travel to a third-party purchaser, Direct Travel, Inc. (Direct Travel), for \$15 million, as adjusted for certain balance sheet items, plus a contingent earnout payment (Earn-Out) with a maximum stated payout of \$8 million.¹ The Stock Purchase Agreement listed an effective closing date of November 1, 2014, and an estimated closing purchase price of \$11.8 million. As noted below, the sale was treated as an asset sale pursuant to Internal Revenue Code (IRC) section 338(h)(10).
5. Because Peak Travel operated as a C corporation for a period of time before it elected S corporation status, Peak Travel was subject to the built-in gain tax provided for in IRC section 1374 on gain from the sale based on asset appreciation from the original C corporation basis to the fair market value of those assets on the effective date of the S corporation election.
6. To determine the fair market value as of the date of the S election, Peak Travel engaged the appraisal firm of Marshall & Stevens.
7. In an appraisal dated January 26, 2015, Marshall & Stevens determined that the “fair market value of total equity” of Peak Travel, as of the S election date of November 1, 2009, was \$710,000. The fair market value of total equity was based on an analysis of three valuation methods: (1) earnings before interest, taxes, depreciation, and amortization (EBITDA) times a multiple based on comparable sales; (2) an adjusted public multiple applied to EBITDA; and (3) a capitalization of projected net earnings. The average of those three methods was used and then adjusted for balance sheet items to arrive at the \$710,000 valuation.

¹ Ultimately, only \$3,537,500 (out of a maximum stated payout of \$8 million) was paid under the Earn-Out. The \$3,537,500 was paid in tax year 2016. In addition, FTB’s auditor found that a holdback payment of \$257,456 and tax reimbursement payment of \$370,479 were received in the 2015 tax year.

8. Peak Travel also relied on a letter report (appraisal) dated August 17, 2008, by Joselyn, Tepper & Associates, Inc. (Joselyn Tepper) to determine a value for Peak Travel. The Joselyn Tepper appraisal applied an industry-based multiple to pre-tax cash flow and adjusted for various balance sheet items. The Joselyn Tepper appraisal determined a value for Peak Travel of \$774,478.
9. On August 12, 2015, Peak Travel filed a California S Corporation tax return for the fiscal year ending October 31, 2014 (Form 100S). In a California Form 3805E (Installment Sale Income), Peak Travel reported the stock sale as an installment sale. Further, in an IRS Form 8883 (Asset Allocation Statement under IRC Section 338), Peak Travel reported the stock sale as a deemed sale of corporate assets under IRC section 338(h)(10). Peak Travel, however, reported no built-in gain.
10. During audit, the parties agreed that Peak Travel owed built-in gain tax on the difference between Peak Travel's adjusted basis and Peak Travel's valuation as of the S election date of November 1, 2009. Peak Travel used an adjusted basis for tangible assets of \$293,978 in its proposed built-in gain calculation, which FTB accepted. The parties, however, disagreed on the applicable value of Peak Travel as of the date of the S election. Peak Travel relied on the appraisals of Marshall & Stevens and Joselyn Tepper, as set forth above. FTB, in turn, retained a valuation consultant, Arxis Financial, Inc. (Arxis), to provide an expert opinion of the fair market value of Peak Travel as of the date of the S election and to review the appraisals provided by Marshall & Stevens and Joselyn Tepper.
11. The Arxis appraisal determined that the fair market value of 100 percent of the outstanding common shares of Peak Travel, as of the S election date of November 1, 2009, was \$9 million, which included tangible value of \$293,000 and intangible value of \$8,707,000.
12. The Arxis appraisal stated that Arxis did not use an asset-based (or cost) approach to value Peak Travel because the reported net book value of Peak Travel as of October 31, 2009 (i.e., the day before the S election) was \$293,978, which Arxis did not consider to be a reasonable measure of Peak Travel's fair market value, noting that Peak Travel's total assets were reported as \$3,691,326 and its long-term debt was reported as \$2,475,834.
13. Also, the Arxis appraisal stated that Arxis did not use an income approach (e.g., EBITDA, etc.) to value Peak Travel because: (1) detailed financial data was not available for Arxis' review; (2) appellants' responses to Arxis' questions regarding

Peak Travel’s finances were not satisfactory, making it impossible for Arxis to address Peak Travel’s non-operating expenses, non-recurring transactions, and related-party transactions; and (3) Arxis believed that Peak Travel’s profits had been managed and distributed through payroll and other expense items to avoid double taxation.

14. Instead of using an asset-based approach or an income approach to value Peak Travel, the Arxis appraisal used two different market approaches: (1) a market approach based on sales of comparable companies, and (2) a market approach based on prior transactions involving Peak Travel.
15. To implement a market approach based on sales of comparable companies, Arxis obtained sales data from a subscription database named DealStats.²
16. Arxis sorted the sales data to reflect the following criteria: (1) all sales must have occurred prior to Peak Travel’s S election date of November 1, 2009; (2) all sales must have been worth at least \$1 million; and (3) all sales must have involved private company transactions (not public transactions). Arxis found 12 sales that met all the afore-mentioned criteria.
17. The Arxis appraisal stated that of the 12 comparable companies, there was a mix of business entity types (e.g., C corporations, S corporations, partnerships, etc.), which made multiples of any measure other than sales unreliable (i.e., a multiple could not be applied, for example, to profits or EBITDA).
18. Using the above-listed data, Arxis calculated a multiple of 0.12³ times Peak Travel’s annual sales through October 31, 2009. Based on the foregoing, the Arxis appraisal stated that the implied value of Peak Travel as of the date of the S election was \$8,957,302, derived as follows:

Peak Travel’s annual sales through 10/31/09	\$95,276,141
Harmonic mean of MVIC ⁴ to Sales – DealStats	<u>0.12x</u>
Implied value of invested capital	\$11,433,136
Less: Peak Travel’s long-term debt 10/31/09	<u>\$ 2,475,834</u>
Value Equity	\$ 8,957,302

² <https://dealstats.bvresources.com>

³ The multiple was calculated from the DealStats data using a harmonic mean, as follows: $12 \text{ (i.e., the sample number of companies)} \div \text{the reciprocal of MVIC/Sales for each of the companies } [1/.04 + 1/.05 + 1/.06 + 1/.09 + 1/.12 + 1/.19 + 1/.22 + 1/.31 + 1/.38 + 1/.48 + 1/.57 + 1/.83] = 0.117 \text{ (appx. 0.12)}$. “Harmonic mean” is defined as “the reciprocal of the arithmetic mean of the reciprocals of a finite set of numbers.” (<https://www.merriam-webster.com/dictionary/harmonic%20mean.>) Arxis stated that “[t]he harmonic mean is the preferable method for averaging multiples (such as MVIC to Sales) where price/value is in the numerator.”

⁴ Market Value of Invested Capital (MVIC).

19. In considering a market approach based on transactions involving Peak Travel, the Arxis appraisal stated that there were no known transactions of Peak Travel's stock before the S election date of November 1, 2009. The Arxis appraisal noted, however, that Peak Travel had previously purchased Journeys by Ambassador for approximately \$2.5 million. The Arxis appraisal estimated that the purchase of Journeys by Ambassador added approximately \$29 million to Peak Travel's annual sales and would have produced a MVIC (market value of invested capital) to Sales ratio of 8.7 percent. If this percentage was applied to Peak Travel's annual sales through October 31, 2009, which was approximately \$95 million, it would result in a valuation for Peak Travel of approximately \$8,265,000.
20. The Arxis appraisal stated that in considering a market approach based on transactions involving Peak Travel, it did not consider the sale of Peak Travel to Direct Travel in 2014 because the terms of that transaction were not known or knowable as of the date of the S election of November 1, 2009.
21. Based on the above-listed market approaches, the Arxis appraisal stated that the fair market value of 100 percent of the outstanding common shares of Peak Travel, as of the S election date of November 1, 2009, was \$9 million.
22. The Arxis appraisal stated that the Marshall & Stevens appraisal was unreliable for the following reasons:
 - Marshall & Stevens' appraisal used historical financial statements without any effort to normalize reported net income to adjust for non-operating income and expenses, non-recurring income and expenses, related party transactions, and owner/officer compensation.
 - Marshall & Stevens' appraisal used incorrect interest-bearing debt amounts.

- Marshall & Stevens' appraisal considered 100 percent of Peak Travel's cash to be a non-operating asset and classified Peak Travel's "other assets" to be non-operating assets, without explanation or justification.
 - Marshall & Stevens' appraised value for Peak Travel (i.e., \$710,000) included tangible net assets of \$293,978 and net intangible assets of \$416,022; however, (i) the intangible asset value was substantially less than intangible assets acquired by Peak Travel via the prior acquisition of Journeys by Ambassador, and (ii) there was no indication that Marshall & Stevens was aware of, or considered, the prior acquisition of Journeys by Ambassador.
 - Without the aggressive adjustment for non-operating assets (\$835,000) and understating debt by \$951,000, the appraised value set forth by Marshall & Stevens would have been zero.
23. The Arxis appraisal stated that the Joselyn Tepper appraisal failed to set forth a particular standard of value (e.g., fair market value, etc.) and failed to set forth a specific valuation date. In addition, the Arxis appraisal stated that the Joselyn Tepper appraisal failed to include the assets of Journeys by Ambassador (worth approximately \$2.1 million) which Peak Travel had previously acquired.
24. At the conclusion of the audit, FTB determined that built-in gain on the sale of Peak Travel's assets should be adjusted to reflect a fair market value of \$9 million. In addition, FTB found that because Peak Travel reported an installment sale of its business assets, the recognition of Peak Travel's installment income upon dissolution of the business was required to be accelerated, which resulted in additional income of \$8,627,994 subject to the 1.5 percent tax rate.
25. On December 8, 2020, FTB issued a Notice of Proposed Assessment (NPA) to Peak Travel for the tax year ending October 31, 2014, which set forth an additional tax of \$642,596, plus applicable interest.
26. On December 8, 2020, FTB issued an NPA to R. Peak and L. Peak for the 2016 tax year, which set forth an additional tax of \$69,433, plus applicable interest. The NPA provided that R. Peak and L. Peak had capital gains in the 2016 tax year, resulting from flowthrough adjustments from Peak Travel for the 2014 tax year that impacted capital loss carryovers through the 2016 tax year.
27. Appellants filed timely protests. After reviewing the matter, FTB affirmed the NPAs in Notices of Action dated May 25, 2022.
28. Appellants then filed timely appeals, which were consolidated.

29. During the appeal proceedings, appellants provided a declaration dated May 11, 2023, from Mr. J. Coffman (Mr. Coffman). In his declaration and during his testimony at the hearing, Mr. Coffman states that: (1) he has been employed in the travel agency industry since 1998, and (2) he has served as Direct Travel's Chief Operating Officer since 2013.
30. In his declaration and during his testimony at the hearing, Mr. Coffman asserts that: (1) he has handled (or has been involved with) approximately 150 travel agency purchases; (2) an appraisal based on EBITDA is the most common valuation method used in the travel agency industry, with travel agencies typically being valued at 3 to 9 times EBITDA; and (3) the Arxis appraisal results in Peak Travel being valued at almost 40 times Peak Travel's EBITDA.
31. As to the maximum contingent payout of \$8 million that was set forth in the Stock Purchase Agreement, Mr. Coffman describes that payout as a "*speculative* contingent future payment based on actual growth in the year following the transaction." (Italics added.) Elaborating further on the alleged speculative nature of the \$8 million payout, Mr. Coffman states that Peak Travel "had just signed several new customers and wanted a mechanism to include the possible future EBITDA / cash flow from the new customers into the valuation."
32. During the appeal proceedings, appellants provided a letter dated May 11, 2023, from Mr. B. Sweeney (Mr. Sweeney). In his letter and during his testimony at the hearing, Mr. Sweeney states that his firm has helped facilitate sales of over 660 travel businesses. Mr. Sweeney states that travel agencies are typically sold for between 2.5 to 6 times EBITDA.

DISCUSSION

Issue 1: Whether appellants have demonstrated error in FTB's determination that the fair market value of Peak Travel's assets, as of the S election date, was \$9 million.

Applicable Law

Burden of Proof

FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc.*, 2020-OTA-057P.) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*) FTB's determinations cannot be

successfully rebutted when the taxpayer fails to provide credible, competent, and relevant evidence as to the issues in dispute. (*Ibid.*)

Built-in Gain Tax

IRC section 1374 imposes a tax on built-in gain, which is the gain accrued while an asset is held by a C corporation which later makes an S election. (IRC, § 1374(1)-(d); *The Ringgold Telephone Company v. Commissioner*, T.C. Memo. 2010-103 (*Ringgold*) at p. *3.)

An S corporation's gain upon disposition of an asset generally is treated as built-in gain to the extent that the fair market value of that asset on the first day of the first taxable year for which the S election is in effect exceeds that asset's adjusted basis on such date. (*Ringgold, supra*, at p. *3.) If an asset with built-in gain is sold during the 5-year period⁵ beginning on such date, the S corporation will be taxed on the built-in gain. (IRC, § 1374(a)-(d); *Ringgold, supra*, at p. *3.) Therefore, the proper valuation date to determine the amount of built-in gain is the effective date of the corporation's S election. (*Garwood Irrigation Company v. Commissioner*, T.C. Memo. 2004-195 at p. * 7 (*Garwood*).)

IRC 338(h)(10) Election

When an IRC section 338(h)(10) election is made, which recharacterizes a stock sale as an asset sale, the corporation is treated as if it sold its assets, liquidated, and ceased to exist (i.e., a deemed asset sale).⁶ (Treas. Reg. § 1.338(h)(10)-1(d)(4)(i).) Following a deemed asset sale, a company is generally treated for tax purposes as a different corporation. (See Treas. Reg. §§ 1.338-1(a)(1) & (b), 1.338(h)(10)-1(d)(3)(i).)

Fair Market Value

Fair market value is defined as the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all of the relevant facts and neither person being under a compulsion to buy or sell. (*United States v. Cartwright* (1973) 411 U.S. 546, 551-552 (*Cartwright*).)

In the case of non-publicly traded stock, the value of which cannot be determined by relevant arm's-length sales, fair market value is generally determined by using three approaches. (*Estate of Noble, et al. v. Commissioner*, T.C. Memo. 2005-2 at p. *7 (*Estate of*

⁵ For California purposes, a 10-year recognition period applied for the tax year ending October 31, 2014. (See R&TC, §§ 23051.5, 23809.)

⁶ IRC section 338 is generally incorporated into California law at R&TC section 24451.

Noble.) The first approach is the market approach; the second approach is the income approach; and the third approach is the asset-based approach. (*Ibid.*)

1. Market Approach

The market approach values a company's non-publicly traded stock by using one or more methods to compare that stock to the same or comparable stock that has sold in arm's-length transactions in the same timeframe. (*Estate of Noble, supra*, at p. *7.) The non-publicly traded stock subject to valuation is valued by adjusting the sales price of the sale or comparable stock to reflect any differences between that stock and the non-publicly traded stock. (*Ibid.*)

2. Income Approach

The income approach values a company's non-publicly traded stock by using one or more methods that convert anticipated economic benefits into a single present amount. (*Estate of Noble, supra*, at p. *7.) Valuation methods under this approach may directly capitalize earnings estimates or may forecast future benefits (earnings or cashflow) and discount those future benefits to the present. (*Ibid.*)

3. Asset-Based Approach

The asset-based (or cost) approach values a company's non-publicly traded stock by using one or more methods which look to the company's assets net of its liabilities. (*Estate of Noble, supra*, at p. *7.)

Analysis

As indicated above, Peak Travel converted from a C corporation to an S corporation, effective November 1, 2009. Within 10 years of the S election, Peak Travel and its sole shareholder at the time (R. Peak) entered into an agreement (i.e., the Stock Purchase Agreement dated November 1, 2014) for R. Peak to sell all of his outstanding shares of Peak Travel to a third-party purchaser, Direct Travel. On IRS Form 8883 (Asset Allocation Statement under IRC Section 338) for the tax year ending October 31, 2014, Peak Travel reported the stock sale as a deemed sale of corporate assets under IRC section 338(h)(10).

On appeal, the parties agree that Peak Travel owes built-in gain tax on the difference between Peak Travel's adjusted basis and Peak Travel's valuation as of the S election date of November 1, 2009. Peak Travel used an adjusted basis for tangible assets of \$293,978 in its

proposed built-in gain calculation, which FTB accepts. The parties, however, disagree on the applicable valuation of Peak Travel as of the date of the S election.⁷

Gross Sales v. Net Sales

Appellants contend that the fundamental difference between the valuations of appellants' experts and the valuation of FTB's expert (Arxis) is that Arxis misunderstood the sales figure that must be used to value Peak Travel. Appellants assert that to understand the correct sales figure to use, it must be understood how the business of a company such as Peak Travel works. Appellants state that a travel agency, such as Peak Travel, "acts as a service provider for customers that includes the customers' entire vacation package, including cost of airline tickets, hotels, car rentals, cruises, etc."

Appellants contend that Peak Travel "earns a fee for selling travel related services (airline tickets, hotel reservations, cruise packages, etc.);" and that the "vast majority of the funds for the travel related services are passed on directly to the providers of such services (the airlines, hotels, cruises, etc.)," such that Peak Travel's "income is the small percentage of such funds that it earns as commissions."

Appellants argue that it is extremely important when valuing Peak Travel to understand that the gross amount for an entire vacation package is not the legal property of Peak Travel, and that Peak Travel is only legally entitled to its commission percentage. More specifically, appellants argue that the Arxis appraisal "adopted a valuation model based on 'net sales' and then applied an MVIC factor to determine its valuation" but failed to use Peak Travel's net sales in the valuation, incorrectly using Peak Travel's "gross sales."

During audit, FTB requested that Arxis respond to appellants' argument that Arxis improperly used Peak Travel's "gross sales" in the Arxis appraisal.

In response, Arxis stated that what appellants call "net sales" is traditionally called "gross profits." Further, Arxis stated that Peak Travel's "income statement reporting (Sales minus Cost of Sales = Gross Profit) is consistent with financial reporting for all other travel agencies."

⁷ The parties' appraisals attempt to value Peak Travel's equity and by inference the value of Peak Travel's assets for purposes of the built-in gain tax of IRC section 1374.

Peak Travel's income statement for the fiscal year ending October 31, 2009 (as set forth on page 14 of the Marchall & Stevens appraisal) reported the following amounts:

Income Statement for Fiscal Year Ending October 31, 2009

Net Sales	\$95,276,141
Cost of Goods Sold	<u>\$86,211,555</u>
Gross Profit	\$9,064,586
Operating Expenses	<u>\$8,904,323</u>
Operating Income	\$160,263
Other Income (Expenses) Net	<u>\$(147,339)</u>
Profit Before Income Taxes	\$12,924
Income Tax Expense	<u>\$(7,770)</u>
Net Income	\$20,694

In the above-listed income statement, the \$95,276,141 is labeled "Net Sales" but represents the entire amount customers paid for vacation packages (including amounts received by airlines, hotels, Peak Travel, etc.) during the fiscal year ending October 31, 2009. Further, the \$9,064,586 is labeled "Gross Profit" in the above-listed income statement but represents the commissions that Peak Travel received during the fiscal year ending October 31, 2009.

To implement a market approach based on sales of comparable companies, Arxis obtained sales data from a subscription database named DealStats. The income statement data reported as part of DealStats database used the same income statement terminology as Peak Travel's income statement set forth above. Therefore, Arxis' appraisal did not fail to recognize that the \$95,276,141 represents the entire amount customers paid for vacation packages (including amounts received by airlines, hotels, Peak Travel, etc.) in the fiscal year ending October 31, 2009, and that the \$9,064,586 represents the commissions that Peak Travel received during the same fiscal year.

Appraisal Method

As indicated above, appellants provided appraisals from Marshall & Stevens and Joselyn Tepper, each of which used an income approach (e.g., EBITDA, etc.) to value Peak Travel. In response, FTB provided an appraisal from Arxis.

Appellants contend that the Arxis appraisal erroneously used a sales-based appraisal method, which appellants assert "no one in the industry uses" to value travel agencies.

Appellants argue that Arxis should have used an appraisal method based on EBITDA, which appellants contend is the industry standard. In support, appellants provided the testimony of Mr. Coffman and of Mr. Sweeney during the hearing, both of which state that an appraisal of a travel agency is usually based on a multiple of EBITDA.

FTB’s determination is presumed correct, and the taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc., supra.*) While appellants provided thorough testimony during the hearing as to the valuation, it was not sufficient to overcome the presumption. The Arxis appraisal persuasively explains that Arxis did not use an income approach (e.g., EBITDA, etc.) to value Peak Travel because: (1) detailed financial data was not available for Arxis’ review; (2) appellants’ responses to Arxis’ questions regarding Peak Travel’s finances were not satisfactory, making it impossible for Arxis to address Peak Travel’s non-operating expenses, non-recurring transactions, and related-party transactions; and (3) Arxis believed that Peak Travel’s profits had been managed and distributed through payroll and other expense items to avoid double taxation.

Here, given the limited financial information provided by appellants, OTA finds as follows: (1) Arxis acted reasonably in not providing an appraisal based on Peak Travel’s reported EBITDA, and (2) other than the modifications set forth below, the Arxis appraisal of Peak Travel based on a multiple applied to annual sales (more particularly, Net Sales, as that term is used in Peak Travel’s income statement for the tax year ending October 31, 2009) was reasonable.

Appraisal Calculation

After a review of the Arxis appraisal, OTA finds a modification of the value calculation is in order. As noted in the facts above, the Arxis appraisal calculated a multiple, using a harmonic mean, of 0.12 times annual sales (more particularly, Net Sales through October 31, 2009). Based on the foregoing, Arxis’ appraisal stated that the implied value of Peak Travel, as of the S election date of November 1, 2009, was \$8,957,302, derived as follows:

Peak Travel’s annual sales through 10/31/09	\$95,276,141
Harmonic mean of MVIC to Sales – DealStats	<u>0.12x</u>
Implied value of invested capital	\$11,433,136
Less: Peak Travel’s long-term debt 10/31/09	<u>\$ 2,475,834</u>
Value Equity	\$ 8,957,302

Ultimately, after considering all factors, the Arxis appraisal determined that the fair market value of 100 percent of the outstanding common shares of Peak Travel, as of the S election date of November 1, 2009, was \$9 million, which included tangible value of \$293,000 and intangible value of \$8,707,000.

OTA finds that the value should have been calculated using only 7 of the 12 sample companies, excluding: (i) two companies based in China (Guangdong Tianma International Travel Co., Ltd. and Foshan Overseas International Travel Service Co., Ltd.), and (ii) three companies that did not report cost of goods sold data (an unnamed partnership that reported a “Sale Date” of June 4, 2004; a company named Global Leisure Travel, Inc.; and a company named Northwestern Travel Service, LP). Without further information, OTA is reluctant to rely on: (1) valuations of companies based outside of the United States to value a company based in the United States, and (2) valuations of domestic companies that have not provided adequate financial data (e.g., cost of goods sold).

Based on the foregoing, OTA finds that the fair market value of Peak Travel’s assets, as of the S election date of November 1, 2009, was \$5,146,257, derived as follows:

Peak Travel’s annual sales through 10/31/09	\$95,276,141
Harmonic mean of MVIC to Sales – DealStats	<u>0.08x⁸</u>
Implied value of invested capital	\$ 7,622,091
Less: Peak Travel’s long-term debt 10/31/09	<u>\$ 2,475,834</u>
Asset Value as of 11/01/09	\$ 5,146,257

Open Transaction Doctrine

The United States Supreme Court established the open transaction doctrine in *Burnet v. Logan* (1936) 283 U.S. 404 (*Logan*). In *Logan*, stock in a company which had a leasehold interest in a mine was sold. The sales prices consisted of a stated price plus contingent future payments based on the tons of ore mined. (*Logan, supra*, at p. 410.) The Supreme Court applied the open transaction doctrine because the amount of proceeds could not be reasonably estimated during the taxable year of the sale. (*Id.* at pp. 412-414.) Accordingly, the taxpayer’s basis was applied entirely to the initial payments for the stock and gain was recognized only when the actual payments received exceeded the remaining basis amounts applied. (*Ibid.*)

⁸ OTA calculated this multiple as to the remaining seven companies using the same harmonic mean calculation method used by Arxis: 7 (i.e., the revised number of companies) ÷ [1/.04 + 1/.05 + 1/.06 + 1/.09 + 1/.12 + 1/.31 + 1/.38] = 0.08.)

However, the open transaction doctrine “is confined in its application to those situations that present elements of value so speculative in character as to prohibit any reasonably based projection of worth.” (*Campbell v. United States* (1981) 661.F.2d 209, 215 (*Campbell*)). Under those circumstances, the taxpayer first applies to his or her basis any payments received. Once the taxpayer has recovered his or her basis, the taxpayer reports any additional payments as income. (*Logan, supra*, at pp. 413-414.)

The doctrine, however, only applies in “rare and extraordinary cases” and is generally rejected “in favor of the best estimate of fair market value which the circumstances allow.” *Rosenberg v. United States* (1983) 3 Cl.Ct. 432, 438 (*Rosenberg*)). The burden of proof as to the insusceptibility of valuation rests upon the taxpayer. (*McCormac v. United States* (1970) 191 Ct.Cl. 483, 498 (*McCormac*)).

Peak Travel is deemed to have sold its assets pursuant to its election under IRC section 338(h)(10) and part of the purchase price was paid through an Earn-Out, which was paid in the 2016 tax year. Further, as noted above, FTB’s auditor found that a holdback payment of \$257,456 and tax reimbursement payment of \$370,479 were received in the 2015 tax year.

Appellants contend that the contingent payments from the deemed sale of Peak Travel’s assets should be recognized as income under the open transaction doctrine, citing *Logan, supra*. Appellants assert that the facts at hand are similar to the facts in *Logan* in that amounts received by Peak Travel pursuant to the contingent payment provisions in the Stock Purchase Agreement were based on unknowable future events (e.g., future earnings from specific new clients, as addressed in the declaration of Mr. Coffman).

As noted above, the open transaction doctrine only applies in “rare and extraordinary cases” and is generally rejected “in favor of the best estimate of fair market value which the circumstances allow.” (*Rosenberg, supra*, at p. 438.) The burden of proof as to the insusceptibility of valuation rests upon the taxpayer. (*McCormac, supra*, at p. 498.)

Here, appellants have not successfully discharged their burden of proof with respect to the insusceptibility of valuation. Appellants have not shown, for example, that the contingent payments (e.g., the Earn-Out, holdback, and tax reimbursement payments) were related to an inherently speculative undertaking, such as an oil or gas exploration venture, or that the contingent payments were related to a totally new and untested business. (See *Campbell, supra*, at p. 671.) In short, appellants have not demonstrated that this case is one of those rare and extraordinary cases where the open transaction doctrine should be applied.

Issue 2: Whether appellants have demonstrated error in FTB's determinations regarding the installment sale.

FTB's determination of tax is presumed to be correct, and a taxpayer has the burden of proving error. (*Appeal of GEF Operating, Inc., supra.*) Unsupported assertions are not sufficient to satisfy a taxpayer's burden of proof. (*Ibid.*)

Where property is sold and at least one payment will be received in a later tax year, the sale is taxed as an installment sale, unless the taxpayer elects out of installment sale treatment. (IRC, § 453.)⁹ Under the installment method, taxpayers generally recognize income in the year in which installment payments are received. (IRC, § 453(c).) However, California law provides an exception. Under R&TC section 24672(a), where a taxpayer subject to the California corporation franchise or income tax reports income from a sale, and the entire income from the sale has not been reported prior to the year that the taxpayer ceases to be subject to tax, then "the unreported income shall be included in the measure of tax for the last year in which the taxpayer is subject to the [California corporation franchise or income tax]." The primary purpose of R&TC section 24672(a) is to ensure that, in the event of the dissolution or cessation of a business, deferred income from an installment sale does not escape taxation at the corporation level in this state.¹⁰ (See *Appeal of West Valley Land Management Co.* (95-SBE-014-A) 1995 WL 793466.)

As indicated above, fair market value is defined as the price that a willing buyer would pay a willing seller, both persons having reasonable knowledge of all of the relevant facts and neither person being under a compulsion to buy or sell. (*Cartwright, supra*, at pp. 551-552.)

In *Estate of Obering v. Commissioner*, T.C. Memo. 1984-407, the U.S. Tax Court relied on subsequent offers to buy a corporation's assets as an indication of the fair market value of the stock. The U.S. Tax Court explained that valuation is a question of fact and, therefore, an approximation derived from all of the evidence. (*Ibid.*) It further stated that contemporaneous offers to buy stock are also valuable, provided that conditions between the time of the offer and the valuation date are not significantly unchanged. (*Ibid.*)

Similarly, in *First National Bank of Kenosha v. United States* (7th Cir. 1985) 763 F.2d 891, 893 (*First National Bank of Kenosha*), the court noted that as a general rule, subsequent events are not to be considered in a valuation except to the extent that such events were reasonably foreseeable as of the date of valuation. (*Id.* at p. 894.) However, the court further

⁹ IRC section 453 generally applies to California. (See R&TC, §§ 17551, 17560 & 24667.)

¹⁰ There is no federal counterpart to R&TC section 24672.

noted that courts have not been reluctant to admit evidence of actual sales prices received for property after the valuation date, so long as the sale occurred within a reasonable time after the valuation date and no intervening events drastically changed the value of the property. (*Ibid.*)

Additionally, in *Estate of Noble, supra*, the tax court determined the fair market value of 116 shares of stock, as of a September 2, 1996 valuation date, should be based on the price for which the taxpayer's estate subsequently sold the shares on October 24, 1997. (*Id.* at pp. *9-12.) The tax court found that there was no material change in circumstances between the valuation date and subsequent sale date to affect the fair market value. (*Id.* at p. *12.) The tax court identified circumstances for which adjustments are generally required but concluded that the only adjustment required was for price inflation. (*Ibid.*)

Furthermore, in *Garwood, supra*, which concerned the valuation of an asset (i.e., water rights) of an S corporation for purposes of the built-in gain tax, the IRS argued that events occurring after the valuation date, including the later sale of the taxpayer's irrigation assets for \$75 million, supported its valuation. In contrast, the taxpayer argued that later events were not foreseeable by a hypothetical willing buyer and seller. The tax court considered the testimony of the valuation experts and all the surrounding circumstances and concluded, in part, that while a later sale of the water rights was reasonably foreseeable, the valuation reflected in the \$75 million purchase was "not sufficiently predictable [as of the valuation date] to form the basis for valuation." (*Id.* at p. *43.) The tax court then determined its own estimate of value of approximately \$22.5 million, in part, by adjusting the assumptions made by the expert witnesses.

As indicated above, Peak Travel is deemed to have sold its assets pursuant to its election under IRC section 338(h)(10). Part of the purchase price was paid through an Earn-Out, which was paid in the 2016 tax year.

Appellants assert that FTB incorrectly determined gain for the tax year ending October 31, 2014, by including the Earn-Out as a contingent payment with a maximum stated payout of \$8 million. Appellants contend that: (1) under R&TC section 24672, the fair market value (instead of the maximum stated payout) of the Earn-Out should have been accelerated and included as part of the calculation of gain for Peak Travel's final tax year ending October 31, 2014; and (2) the fair market value of the Earn-Out as of October 31, 2014, should be found to be \$3,537,500 (as evidenced by the amount actually paid, which occurred in the 2016 tax year), not maximum stated payout of \$8 million.

In response, FTB contends that Temporary Treasury Regulation section 15a.453-1(i)(2) requires appellants to use the maximum stated payout (i.e., \$8 million) for the Earn-Out and that

all future payment amounts under the Stock Purchase Agreement (e.g., the Earn-Out, the holdback payment of \$257,456, and the tax reimbursement payment of \$370,479) must be accelerated under R&TC section 24672 to Peak Travel's final tax year ending October 31, 2014.

An installment obligation can contain both a fixed amount component and a contingent component. (See Temp. Treas. Reg. § 15a.453-1(d)(2)(iii).) Recognition of the contingent portion must be accelerated under R&TC section 24672. (*Appeal of Amarr Company*, 2022-OTA-041P.)

Where a corporation is deemed to have distributed an installment obligation in the taxable year to which R&TC section 24672 is being applied, the unreported income is limited to the difference between the fair market value of the obligation at the time of distribution and the basis in the obligation. (*Appeal of Amarr Company, supra.*) Therefore, the amount to be recognized by Peak Travel in its final tax year due to the Earn-Out should be based on the fair market value of the Earn-Out at the time of distribution less Peak Travel's basis in the Earn-Out at that time, which appellants have the burden of proof to establish. (See *Appeal of Amarr Company, supra.*)

As noted in the facts above, only \$3,537,500 (out of a maximum stated payout of \$8 million) was paid under the Earn-Out—and that \$3,537,500 was paid in the 2016 tax year. As the Earn-Out was paid relatively soon after the sale transaction at issue (i.e., within approximately two years of the Stock Purchase Agreement), and the record includes no more persuasive evidence of the value of such contingent payment, OTA finds that, based on the record before us, the amount actually paid (\$3,537,500) provides the best approximation of the fair market value of the Earn-Out at the time of the deemed asset sale. (See *First National Bank of Kenosha, supra*, at p. 894 [subsequent events can be an indication of value]; see also *Estate of Obering v. Commissioner, supra.*)

In addition, OTA finds that all future payments under the Stock Purchase Agreement (e.g., the fair market value of the Earn-Out, the holdback payment of \$257,456, and the tax reimbursement payment of \$370,479) must be accelerated to Peak Travel's final tax year ending October 31, 2014.¹¹

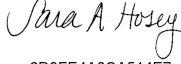
¹¹ Appellants make no contentions for adjustments to be made to account for allocation of basis in relation to the Earn-Out, the holdback, and the tax reimbursement payments. In addition, the record does not include a proposed discount rate to account for the time value of money, or a reliable basis to adjust the value of the subsequent payments for the possibility that payments might have been lower or higher. On this limited record, OTA finds that the amount of the payments actually received, without adjustment, provides the best approximation of fair market value.

HOLDINGS


1. The fair market value of Peak Travel’s assets, as of the S election date of November 1, 2009, was \$5,146,257.
2. The fair market value of the Earn-Out at the time of the deemed asset sale was \$3,537,500. All future payments under the Stock Purchase Agreement (i.e., the fair market value of the Earn-Out, the holdback payment of \$257,456, and the tax reimbursement payment of \$370,479) must be accelerated to Peak Travel’s final tax year ending October 31, 2014.

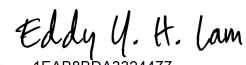
DISPOSITION

FTB’s actions are modified in accordance with the holdings above. Otherwise, FTB’s actions are sustained.

DocuSigned by:

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 Sara A. Hosey
 Administrative Law Judge

We concur:

DocuSigned by:

 7B47E668B7C44AC
 Amanda Vassigh
 Administrative Law Judge

DocuSigned by:

 1EAB8BDA3324477
 Eddy Y.H. Lam
 Administrative Law Judge

Date Issued: 2/13/2025