OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of:

AMARR COMPANY AND
AMARR COMPANY (C SGNF)

OTA Case Nos. 20046125 & 20046127

OPINION

Representing the Parties:

For Appellants: Lesley S. Dunaway, CPA

For Franchise Tax Board: Brian L. Beck, Tax Counsel III

For Office of Tax Appeals: Grant S. Thompson, Tax Counsel IV

J. LAMBERT, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19324, Amarr Company (Amarr) and Amarr Company (C SGNF) (Amarr Shareholder Group) (collectively, appellants) appeal actions by respondent Franchise Tax Board (FTB) denying claims for refund of: (1) $69,823, plus interest, for Amarr for the short tax year ending November 24, 2013 (2013 short tax year); and (2) $228,626, plus interest, for Amarr Shareholder Group for the tax year ending December 31, 2013.[1]

Appellants waived their right to an oral hearing; therefore, the matter is being decided based on the written record.

ISSUES

1. Whether unreported installment sale gain should be accelerated for inclusion in Amarr's taxable income for the 2013 short tax year.
2. Whether the income from the deemed asset sale relating to intangibles such as goodwill constitutes business income.

[1] Amarr Company (C SGNF) refers to a nonresident shareholder group of Amarr, an S corporation. A group nonresident return for Amarr Shareholder Group was filed for the tax year ending December 31, 2013.

3. Whether gross receipts from the deemed asset sale should be excluded from Amarr's sales factor pursuant to California Code of Regulations, title 18, (Regulation) section 25137(c)(1)(A) as receipts arising from a substantial and occasional sale.

FACTUAL FINDINGS

1. Amarr is an S corporation headquartered in North Carolina. It manufactures garage doors in Kansas and North Carolina, and it sells garage doors throughout the United States, including in California. It sells its products through distribution centers, including several located in California.
2. To determine its California apportionment percentage for the 2010 through 2012 tax years, Amarr used a three-factor (double-weighted sales factor) apportionment formula, which was based on its property, payroll, and sales in California, as compared to property, payroll, and sales everywhere.[2]
3. Amarr's California apportionment percentage was: (1) approximately 5.7 percent in 2010; (2) approximately 5.8 percent in 2011; and (3) approximately 5.8 percent in 2012.
4. Amarr's percentage of its California total sales, as compared to total sales everywhere, was: (1) approximately 7.3 percent in 2010; (2) approximately 7.8 percent in 2011; and (3) approximately 8.0 percent in 2012.[3]
5. On November 6, 2013, appellants (both Amarr and the Amarr Shareholder Group), as sellers, entered into a stock sale transaction which closed on November 24, 2013. The purchase agreement for the sale transaction indicates that, in return for all the outstanding stock in Amarr, the third-party buyers paid an initial (fixed) purchase price and agreed to make deferred contingent earnout payments totaling up to $50 million if Amarr's earnings exceeded certain thresholds during the three years immediately following the transaction. The earnings thresholds were generally based on the amount of earnings

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[2] In Amarr's apportionment formula for tax years 2010 to 2012, the sales factor was weighted twice while the property and payroll factors were weighted once. Generally, for tax years beginning on or after January 1, 2013, California switched from a three-factor apportionment formula to a single-sales factor apportionment formula. (R&TC, § 25128.7.)

[3] In the 2010 to 2012 tax years, Amarr's California property and payroll factors (i.e., the percentage of its California property and payroll compared to its property and payroll everywhere) were between approximately 3 and 4 percent. Its California sales were: (1) approximately $18 million in 2010; (2) approximately $20 million in 2011; and (3) approximately $22 million in 2012.

before interest and taxes (EBIT), as defined by the purchase agreement. To achieve the $50 million maximum amount of earnout payments, Amarr's EBIT would need to increase at an average annual growth rate of approximately 38.4 percent over the three years immediately following the sale.

6. According to appellants, during the three years immediately preceding the stock sale, Amarr's EBIT increased from $1,018,000 in 2011, to $3,838,000 in 2012, and to $12,996,000 in 2013.
7. Appellants and the buyers jointly elected to treat the stock sale as an asset sale under Internal Revenue Code (IRC) section 338(h)(10).
8. The stock sale transaction ended Amarr's 2013 tax year.[4] Amarr's 2013 California tax return indicated that the return was Amarr's final California tax return and, consistent with the change in California law, it reported its California apportionment percentage based solely on its sales factor, rather than based on its property, payroll and double-weighted sales factors.
9. To determine its California apportionment percentage for the 2013 short tax year, Amarr reported 2013 total gross receipts of $386,963,308, with $285,761,485 of this amount attributable to its regular business sales of tangible personal property everywhere. It reported $23,625,307 in California sales of tangible personal property.
10. Amarr reported the $101,201,823 of gross receipts attributable to the fixed portion of the deemed asset sale as other gross receipts everywhere resulting in the inclusion of this amount in Amarr's sales factor denominator.[5] Of this amount, Amarr assigned $22,395 to California for inclusion in the numerator of its sales factor. Amarr did not report any taxable income or gross receipts from the earnout.
11. Amarr reported a California apportionment percentage of 6.1 percent for the 2013 short tax year.[6]

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[4] This is because the IRC section 338(h)(10) election caused Amarr to be treated as if it sold its assets and liquidated. (See Treas. Reg. § 1.338(h)(10)-1(d)(3)(i) & Treas. Reg. §1.338-1(a)(1).)

[5] According to FTB's Final Determination Letter issued during the audit, Amarr allocated the purchase price of intangible assets to brand, technology, and goodwill on its Form 8883, Asset Allocation Statement Under Section 338.

[6] If proceeds from Amarr's deemed asset sale were excluded from its single-sales factor, its California apportionment percentage would have been approximately 8.3 percent for the 2013 short tax year.

12. The buyers made earnout payments of $15 million in 2015, $5.792 million in 2016, and $12.3 million in 2017, resulting in total earnout payments of $33,092,000.[7]
13. FTB examined Amarr's 2013 California tax return. FTB determined that, because the 2013 return was Amarr's final California tax return, it should have accelerated the reporting of deferred installment gain (i.e., the earnout).
14. FTB also determined that, under Regulation section 25137(c)(1)(A), the sale was a substantial and occasional sale. As a result, FTB concluded that Amarr should have excluded the fixed portion of the sale amount from the sales factor. Based on these determinations, FTB proposed to add $31,364,828 of installment income[8] to Amarr's business income[9] and remove the fixed portion of the sale amount from the sales factor. FTB's proposed adjustments resulted in a California single-sales factor apportionment percentage of approximately 8.3 percent for the 2013 short tax year.
15. FTB issued a 2013 Notice of Proposed Assessment (NPA) for Amarr proposing to assess $69,823 in additional tax, plus interest, based on the 1.5 percent entity-level income tax on S corporations. The NPA for Amarr Shareholder Group proposed $228,626 in additional tax, plus interest, based on flow-through income from Amarr.
16. After the NPAs became final, appellants paid the additional tax reflected in the NPAs, plus accrued interest. Appellants then filed timely claims for refund, which FTB denied.
17. This timely appeal followed.

DISCUSSION

Issue 1: Whether unreported installment sale gain should be accelerated for inclusion in Amarr's taxable income for the 2013 short tax year.

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

[7] There is no evidence or argument that Amarr's Shareholder Group or Amarr paid any California income tax on the earnout payments.

[8] This amount is less than the $33,092,000 total earnout payments received due to the recovery of Amarr's basis in the assets sold.

[9] References to Amarr's business and its business income refer to its unitary business and unitary business income.

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*.)

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.)[10] 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.[11] (See *Appeal of West Valley Land Management Co.* (95-SBE-014-A) 1995 WL 793466 (*West Valley*).)

Appellants argue that, while Amarr was no longer an S corporation, it continued California business operations as a C corporation and continued to be subject to California tax after the sale. Therefore, appellants contend that R&TC section 24762(a) does not apply. However, when an IRC section 338(h)(10) election is made, the corporation is treated as if it sold its assets, liquidated, and ceased to exist. (Treas. Reg. § 1.338(h)(10)-1(d)(4)(i).) Amarr's shareholders agreed to treat the sale for income tax purposes as a sale of assets and liquidation of Amarr.[12] As a result, following the deemed asset sale, Amarr was generally treated for tax purposes as a different corporation.[13] (See Treas. Reg. §§ 1.338-1(a)(1) & (b), 1.338(h)(10)-

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[10] Except as otherwise provided, IRC section 453, 453A, and 453B apply to California. (See R&TC, §§ 17551, 17560 & 24667.)

[11] There is no federal counterpart to R&TC section 24672.

[12] Pursuant to R&TC section 23806(a) and (b), an election under IRC section 338 is a binding election for California income tax purposes. The S corporation's shareholders must consent to the IRC section 338(h)(10) election. (See Treas. Reg. § 1.338(h)(10)-1(c)(3).)

[13] There are exceptions to this general rule, not applicable here, as described in Treasury Regulation section 1.338-1(b)(2).)

1(d)(3)(i).)

While a taxpayer is free to organize its affairs as it chooses, nevertheless, once having done so, it must accept the tax consequences of its choice, whether contemplated or not, and may not enjoy the benefit of some other route it might have chosen to follow but did not. (*Commissioner v. National Alfalfa Dehydrating & Milling Co*. (1974) 417 U.S. 134, 149.) Therefore, under R&TC section 24672 and *West Valley*, *supra*, Amarr must recognize the unreported income from the installment obligation in its final tax year.[14]

As of the close of the 2013 short tax year, no earnout payments had been made, and the amount of the earnout payments depended on Amarr's future earnings. Accordingly, we must ascertain the amount of unreported earnout income to be included in Amarr's final tax year pursuant to R&TC section 24672. FTB based its proposed assessment on the actual amount of earnout payments that were ultimately paid. On the other hand, appellants argue that the fair market value (FMV) should be used as the amount of unreported income. Appellants argue that the payments should be treated as if Amarr elected out of the installment method and note that, for contingent payment obligations not reported under the installment method, such unreported income should be determined based on the FMV of the underlying property at the time the sale, pursuant to Temporary Treasury Regulation section 15a.453-1(d)(2)(iii).[15] Appellants assert that the FMV is "much less" than the actual payments or "zero since such payments were subject to meeting certain performance goals over the following three years, and these goals were based on aggressive growth assumptions such that it was in no way probable that they would be achieved." In support, appellants provide calculations showing that, to achieve the $50 million maximum amount of earnout payments, Amarr's EBIT would need to increase at an average annual growth rate of approximately 38.4 percent over the three years following the sale.

FTB contends that Temporary Treasury Regulation section 15a.453-1(c)(2)(i)(A) requires appellants to use the maximum sales price. Temporary Treasury Regulation section 15a.453-

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[14] R&TC section 24672 only applies to corporations (both S corporations and C corporations). Therefore, Amarr is subject to the 1.5 percent entity-level income tax imposed on S corporations pursuant to R&TC section 23802(b)(1) for the accelerated gain. In this case, the parties do not specifically dispute the calculation of the shareholders' pro rata share of Amarr's income, but rather argue that FTB's determinations of Amarr's apportionable business income and sales factor are erroneous. These arguments are addressed in the discussion of Issues 2 and 3 below.

[15] The temporary regulation remains in force because it was promulgated prior to the enactment of Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, section 6232(b), 102 Stat. 3734, 3734 (1988).

1(c)(2)(i)(A) applies to contingent payment sales under the installment method when the taxpayer has not elected out of the installment method. Temporary Treasury Regulation section 15a.453-1(c) provides methods for computing the gross profit ratio to apply to payments in order to calculate gain and recovery of basis. Temporary Treasury Regulation section 15a.453-1(c)(2)(i) provides that the contingent payment sale shall be treated as having the maximum selling price, when it can be determined under the terms of the agreement by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved.[16]

However, because the installment obligation is deemed to be distributed to the shareholders, the unreported income to be recognized under R&TC section 24672 is limited to the difference between the FMV of the obligation at the time of distribution and the basis in the obligation.[17] As a result of the election under IRC section 338(h)(10), the old corporation is treated as distributing in the deemed liquidation the installment obligation, and the shareholders are treated as receiving the installment obligation in the deemed liquidation. (See Treas. Reg. § 1.338(h)(10)-1(d)(8)(ii).) The Board of Equalization (BOE) has held that where a corporation distributes 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 FMV of the obligation at the time of distribution and the basis in the obligation. (*Appeal of Admiral Building Company* (71-SBE-006) 1971 WL 2687; *Appeal of Pioneer Development Co., Inc.* (61-SBE-002) 1961 WL 1393.)[18] The BOE placed the burden on the taxpayers to prove that the FMV of the obligation was less than its face amount. (*Appeal of Worldcombe Corporation* (66-SBE-053) 1966 WL

[16] Paragraph (c) of the regulation also provides for alternative methods for computing the gross profit ratio to apply to payments, including when the maximum selling price cannot be determined and the payment period is fixed, when the agreement neither specifies a maximum selling price nor limits payments to a fixed period, and a reasonable alternative method when the normal basis recovery rule will substantially and inappropriately defer recovery of basis and the taxpayer receives a ruling from the IRS before using the alternative method. (See Temp. Treas. Reg. § 15a.453-1(c)(3), (4) & (7).)

[17] In addition, we note that the maximum sales price may result in a conclusion that more tax is due, whereas we are only deciding whether appellants are entitled to a refund based on FTB's determination of accelerated gain of $31,364,828 based on the actual earnout payments received of $33,092,000.

[18] The BOE based its determination in these cases on former R&TC section 24670 which essentially adopted the provisions of IRC section 453B(a) through the use of substantially similar language. While former R&TC section 24670 has been repealed, the R&TC has now expressly conformed to IRC section 453B, through the addition of R&TC section 24667, unless otherwise provided. Given California's continued conformity to IRC section 453B(a) (either through its express adoption of IRC section 453B or the use of substantially similar language), the BOE's reasoning in these cases continues to be applicable to date.

1394.)

The BOE based this determination on former R&TC section 24670, which included substantially similar language as IRC section 453B(a).[19] An installment obligation can contain both a fixed amount component and a contingent component. (See Temp. Treas. Reg. § 15a.453-1(d)(2)(iii).) The gain on the fixed component was already recognized by Amarr in its 2013 short tax year. However, recognition of the contingent portion must be accelerated under R&TC section 24672, while being consistent with IRC section 453B(a). (*Appeal of Admiral Building Company*, *supra*; *Appeal of Pioneer Development Co., Inc.*, *supra*.) Therefore, the amount to be recognized by Amarr in its final tax year should be based on the FMV of the earnout at the time of distribution less Amarr's basis in the earnout, which appellants have the burden of proof to establish.[20]

In this case, the earnings history indicates that the earnout had substantial value as of the end of 2013. Amarr's EBIT increased from $1,018,000 in 2011, to $3,838,000 in 2012, and to $12,996,000 in 2013, which is an annual growth rate exceeding 200 percent. This earnings history suggests that, as of the end of 2013, it appeared that Amarr might well achieve an average annual EBIT growth rate that exceeded 38.4 percent over the next three years, resulting in the maximum possible earnout payments of $50 million. In addition, while appellants argue that the FMV should be much less than FTB's proposed value, we note that FTB's value already reflects a reduction from the maximum possible earnout due to future earnings not meeting certain thresholds to achieve the maximum payout. The evidence provided by appellants does not show that the FMV of the earnout was actually zero or any amount less than the value used by FTB.

Therefore, as appellants have not provided any evidence as to the FMV or that any adjustments should be made, and the actual earnout payments received are known, using the payments received to approximate FMV is reasonable. Accordingly, we find that appellants have not established error in FTB's determination of the amount of earnout income that must be included in their income for the 2013 short tax year.

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[19] As noted in the previous footnote, California now conforms to IRC section 453B by way of R&TC section 24667(a)(1), unless otherwise provided.

[20] There are no contentions as to adjustments to be made to account for any basis.

Issue 2: Whether the income from the deemed asset sale relating to intangibles such as goodwill constitutes business income.

Appellants contend that the income on the deemed asset sale is nonbusiness income under R&TC section 25120(d) and Regulation section 25120(c)(2) because the deemed asset sale income in question relates solely to intangibles such as goodwill and going concern value, which appellants contend were not used in the business prior to the sale.

Under the Uniform Division of Income for Tax Purposes Act (UDITPA) (R&TC sections 25120 through 25139), which was adopted by California and certain other states to establish uniform rules for the attribution of corporate income, a unitary enterprise's "business income" is apportioned among the taxing jurisdictions according to a formula. (See *Microsoft Corp. v. Franchise Tax Bd.* (2006) 39 Cal.4th 750, 755-756 (*Microsoft*).) Business income is income 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); Cal. Code Regs., tit. 18, § 25120(a).) Income of the taxpayer is business income unless clearly classifiable as nonbusiness income. (Cal. Code Regs., tit. 18, § 25120(a).) Nonbusiness income means all income other than business income. (R&TC, § 25120(d); Cal. Code Regs., tit. 18, § 25120(a).)

In addition, gain or loss from the sale, exchange, or other disposition of real or tangible or 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).) If such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income. (*Ibid*.)

In *Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508 (*Hoechst*), the California Supreme Court held that R&TC section 25120(a) establishes both a "transactional test" and a "functional test" for determining whether income constitutes business income. (*Id*. at pp. 520-526.) The satisfaction of either test leads to a determination that the income is apportionable business income. (*Id*. at p. 526.)

Under the transactional test, the controlling factor for identifying business income is the nature of the income-producing transaction. (*Hoechst*, *supra*, 25 Cal.4th 508 at p. 526.) To generate business income under the transactional test, the transactions and activity must occur in the regular course of the taxpayer's trade or business. (*Ibid*.) Relevant considerations include the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income. (*Ibid*.) Income arising from extraordinary events such as a complete liquidation and cessation of business cannot satisfy the transactional test. (*Id*. at p. 526-527.) There is no dispute that the sale does not meet the transactional test – the deemed asset sale was a once in a corporate lifetime occurrence that does not occur in the regular course of the trade or business.

The functional test, in contrast, focuses on the income-producing property. (*Hoechst*, *supra*, 25 Cal.4th at p. 527.) In applying the functional test, the critical inquiry is the relationship between the property and the taxpayer's business operations. (*Ibid*.) In *Jim Beam Brands Co. v. Franchise Tax Bd.* (2005) 133 Cal.App.4th 514, 526 (*Jim Beam*), the court explained that a taxpayer's gain from a sale of stock constituted business income under R&TC section 25120(a) and Regulation section 25120 because the stock contributed materially to the taxpayer's production of business income. The court further explained that property that generated unitary business income also generates business income when it is sold. (*Id*. at p. 527.)

Under both *Hoechst* and *Jim Beam*, the sale will result in business income if it meets the functional test. The *Jim Beam* court stated that the functional test of R&TC section 25120(a) requires that the taxpayer: (1) have interest and power over the income-producing property (i.e., acquisition, management, and disposition of the property); and (2) that the taxpayer's control and use of the property be integral to the taxpayer's regular trade or business operations. (*Jim Beam*, *supra*, 133 Cal.App.4th at p. 524.)

We note that "going concern value" has been referred to as "the increase in the value of assets due to their existence as an integral part of an ongoing business." (*Concord Control, Inc. v. Commissioner* (1982) 78 T.C. 742, 743, citations omitted.) And as stated in *Appeal of Borden, Inc*. (77-SBE-007) 1977 WL 3818 (*Borden*), goodwill may be described as:

> . . . the advantage or benefit which is acquired by an establishment beyond the mere value of its capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.

Whether acquired by purchase or built up over a period of time, the advantage or benefit of goodwill makes possible the profitable operation of a business. (*Borden*, *supra*.) Goodwill is so essential to the viable conduct of a business that it has been held to be inseparable from the business as a whole. (*Id*.; see also *Hoechst*, *supra*, 25 Cal.4th at p. 533, citing *Borden*, *supra*.) While appellants contend that Amarr's intangibles, such as goodwill and going concern value, were not used in its business, appellants provide no evidence in support of this assertion. In addition, appellants provide no evidence to show that the intangibles were not integral to its regular trade or business operations. Accordingly, we find that the income from Amarr's sale of intangibles, including goodwill and going concern value, constitutes apportionable business income.

<u>Issue 3: Whether gross receipts from the deemed asset sale should be excluded from Amarr's sales factor pursuant to Regulation section 25137(c)(1)(A) as receipts arising from a substantial and occasional sale</u>.

Since we conclude above that the income from the deemed asset sale is properly treated as apportionable business income, the next issue is how the gross receipts from that sale should be treated for sales factor purposes. For tax years beginning before January 1, 2013, California generally required a taxpayer's business income to be apportioned by a three-factor formula composed of a property factor, a payroll factor, and a double-weighted sales factor. (R&TC, § 25128(a).) For taxable years beginning on or after January 1, 2013, all business income of an apportioning trade or business, other than an apportioning trade or business described in R&TC section 25128(b), shall be apportioned to this state by multiplying the business income by the sales factor. (See R&TC, § 25128.7.)

"The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." (R&TC, § 25134.) The term "sales" is defined as "all gross receipts of the taxpayer not allocated [as nonbusiness income] under [R&TC] [s]ections 25123 to 25127, inclusive." (R&TC, § 25120(f)(1).)

"Gross receipts" is defined in part as "the gross amounts realized (the sum of money and the fair market value of other property or services received) on the sale or exchange of property . . . in a transaction that produces business income, in which the income, gain, or loss is recognized . . . under the [IRC], as applicable for purposes of this part. Amounts realized on the sale or exchange of property shall not be reduced by the cost of goods sold or the basis of property sold."[21] (R&TC, § 25120(f)(2).) Under the definition of gross receipts pursuant to R&TC section 25120(f)(2), gross receipts from the sale of Amarr stock, which appellants elected to have treated as a deemed asset sale under IRC section 338(h)(10), are generally included in the sales factor.

R&TC section 25137 also, however, provides that if the allocation and apportionment provisions of the UDITPA do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable: (a) separate accounting; (b) the exclusion of any one or more of the factors; (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

FTB has promulgated special apportionment regulations under R&TC section 25137. If a relevant special formula is specifically provided for in the R&TC section 25137 regulations and the conditions and circumstances delineated in such regulations are satisfied, the method of apportionment prescribed in those regulations shall be the standard by which the parties are to compute the taxpayer's apportionment formula. (*Appeal of Fluor Corporation* (95-SBE-016) 1995 WL 799363 (*Fluor*).) In other words, once found to be applicable to the particular situation, the R&TC section 25137 regulations will control. (*Ibid.*) Any party wishing to deviate from the method prescribed by the R&TC section 25137 regulations, when found to be applicable, must establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state. (*Ibid.*) Specifically, the party seeking to show distortion has the burden of showing by clear and convincing evidence that: (1) the approximation provided by the standard formula is not a fair representation; and (2) the proposed alternative is reasonable. (*Microsoft*, *supra*, 39 Cal.4th at p. 765.)

<u>Sales Factor Special Rule: Substantial and Occasional Sale</u>

Regulation section 25137(c) provides special rules with respect to the sales factor of the apportionment formula, including where a taxpayer receives substantial amounts of gross

[21] This definition of gross receipts is applicable for tax years beginning on or after January 1, 2011. (See R&TC, § 25120(f); see also *General Mills, Inc. v. Franchise Tax Bd.* (2012) 208 Cal.App.4th 1290, fn. 4.)

receipts from a substantial and occasional sale. Specifically, Regulation section 25137(c)(1)(A) provides:

> Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial.[22]

Here, FTB determined that, under Regulation section 25137(c)(1)(A), Amarr's deemed asset sale was a substantial and occasional sale. As a result, FTB required that Amarr exclude the fixed portion of the sale amount from the sales factor numerator and denominator. This increased Amarr's California sales factor apportionment percentage and, therefore, also increased its California taxable income and resulting tax liability.

On appeal, appellants agree that the deemed asset sale was substantial and occasional for purposes of Regulation section 25137(c)(1)(A). However, appellants argue that Regulation section 25137(c)(1)(A) should not be applied because the proceeds should be included in the denominator of the sales factor under Regulation section 25137(c)(1)(C). Regulation section 25137(c)(1)(C) provides:

> Where the income producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well.

Appellants assert that the proceeds at issue can be readily identified as related to intangible personal property. Therefore, appellants argue that the proceeds should be included in the denominator of the sales factor under Regulation section 25137(c)(1)(C). However, for tax years beginning on or after January 1, 2011, which includes the tax year at issue in this appeal,

[22] We note that in 2001, this regulation was amended to apply to intangibles, in addition to fixed assets. (Amendment of subsection (c)(1)(A) and new subsections (c)(1)(A)1.-2. filed 1-30-2001; operative 1-1-2001 (Register 2001, No. 5).) Prior to that, FTB issued Legal Ruling 1997-1, which stated that gross receipts from an incidental or occasional sale of intangible property held or used in the regular course of taxpayer's trade or business will be excluded from the sales factor, if substantial, because there is no logical basis for distinguishing between fixed assets and intangibles. We note that Regulation section 25137(c)(1)(A) states that, "[f]or example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial." Therefore, Regulation section 25137(c)(1)(A) makes clear that the substantial and occasional sale rule is applicable to sales of both tangible assets (i.e., a factory) and intangible assets (i.e., patents or an affiliates stock).

Regulation section 25137(c)(1)(C) is not applicable. (Cal. Code Regs., tit. 18, § 25136-2(h)(3)(B).) Accordingly, we find that appellants have not shown that FTB improperly applied Regulation section 25137(c)(1)(A) in excluding the gross receipts from the sales factor as a substantial and occasional sale.

Alternative Apportionment Method Under R&TC section 25137

R&TC section 25137 provides, in relevant part, that if the allocation and apportionment provisions of the UDITPA do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or FTB may require, in respect to all or any part of the taxpayer's business activity, if reasonable, the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Appellants contend that excluding the gross receipts from the sales factor while including the corresponding net gain in their apportionable tax base is distortive and does not fairly reflect the extent of Amarr's California business activity. As appellants are the party seeking a deviation from the standard apportionment formula, they have the burden to show that an alternative apportionment formula should be applied. (See *Microsoft*, *supra*, 39 Cal.4th at p. 765.) Accordingly, to prevent the application of the substantial and occasional sale provisions of Regulation section 25137(c)(1)(A), appellants must show by clear and convincing evidence that: (1) application of the regulation would not fairly represent Amarr's business activities in California; and (2) their proposed alternative apportionment methodology is reasonable. (*Ibid*.)

In *Microsoft*, the California Supreme Court examined the following two factors in deciding whether to apply an alternative method in place of the standard formula where treasury function receipts were included in the taxpayer's gross receipts: (1) whether the treasury functions were qualitatively different from the taxpayer's principal business; and (2) whether the quantitative distortion that arose from the inclusion of the treasury function receipts was substantial. (*Microsoft*, *supra*, 39 Cal.4th at p. 766.)[23] The qualitative and quantitative effects do not constitute two separate tests, but are examined together in "assessing whether the standard

[23] We note that other considerations have been examined when evaluating distortion under R&TC section 25137. (See, e.g., *Appeal of Crisa Corporation* (2002-SBE-004) 2002 WL 1400003 [providing five examples of fact situations that may result in using an alternative apportionment method].) In this case, we address the factors as applicable to appellants' arguments and the facts of this case.

formula fairly represents the company's business activity in California." (*General Mills, Inc. v. Franchise Tax Bd*. (2012) 208 Cal.App.4th 1290, 1301.)[24]

Qualitative Factor

Appellants argue that it is inherently distortive to both treat the net gain from the sale of goodwill as apportionable business income and exclude the gross receipts from its sale from the sales factor. Appellants argue that a substantial portion of the goodwill was generated in prior years when it was not doing business in California. On this basis, appellants argue that the exclusion of the gross receipts results in distortion because the goodwill income has no representation in the sales factor and is being apportioned based on Amarr's sales of tangible personal property (e.g., garage door inventory) for the tax year at issue, which consists of only a single year's activity. In other words, appellants argue that the apportionment factors of the year of sale should reflect the activities that gave rise to the goodwill income in prior years. (See *Tenneco West, Inc. v. Franchise Tax Bd*. (1991) 234 Cal.App.3d 1510, 1537-1538; *Appeal of Donald M. Drake* (77-SBE-012) 1977 WL 3823 ["income … although recognized and apportioned in the year of completion, was actually earned at least partially through business activity in a prior year or years"].)

In *Microsoft,* the burden was on FTB to establish it was distortive to *include* treasury function receipts in the sales factor and the court addressed whether the treasury functions were qualitatively different from the taxpayer's principal business. In this case, it is appellants who argue that it is distortive to *exclude* the gross receipts from the sales factor. Therefore, it is appellants who have the burden. In other words, in this case, appellants' arguments are the inverse of those by FTB in *Microsoft*; appellants are contending that the goodwill activities that gave rise to the gross receipts which have been *excluded* from representation in the sales factor pursuant to Regulation section 25137(c)(1)(A) are still qualitatively a part of Amarr's business that must be fairly reflected in the apportionment formula.

However, goodwill is represented in California's sales factor because the gross receipts from Amarr's regular sales of its inventory implicitly includes the added value of intangibles,

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[24] The qualitative and quantitative effects do not constitute two separate tests, but "are simply two factors…to apply to…factual findings." (*General Mills, Inc. v. Franchise Tax Bd*., *supra*, 208 Cal.App.4th at p. 1301 & fn. 9.) We apply these two factors to the facts before us because, even though this case does not involve treasury functions, the qualitative and quantitative effects may be examined in determining whether the standard formula fairly represents Amarr's business activity in California. (See *id*. at p. 1301.)

such as goodwill, that may contribute to sales. In addition, appellants have not provided evidence to support their argument that the exclusion of the gross receipts results in inherent distortion because, as they contend, the goodwill income has no representation in the sales factor.

Here, the value of Amarr's goodwill was built up over time, which is illustrated by costs incurred in creating and maintaining goodwill, including, for example, advertising expenses and other ordinary and necessary business expenses, which were deducted in prior years. However, the value of Amarr's goodwill was not recognized for tax purposes until the deemed asset sale. (See *Elliott v. United States* (1970) 431 F.2d 1149, 1154.) The value of the goodwill is an intangible asset that represents the ability of a company to generate earnings over and above the operating value of the company's other tangible and intangible assets, and often includes the company's name recognition, consumer brand loyalty, or special relationships with suppliers or customers. (*Sanders v. Jackson* (2000) 209 F.3d 998, 1001.) Therefore, the gross receipts from the sale of Amarr's intangibles, such as goodwill, are attributable to brand name, customer relationships, and other intangibles that increased in value over the years, but which were not recognized for tax purposes until the deemed asset sale.

In addition, the value of the intangibles is implicitly reflected in the sales factor, as those intangibles, such as goodwill, may contribute to the gross receipts from Amarr's regular sales of its inventory. Specifically, the activities related to creating, maintaining, and building Amarr's goodwill, such as those related to marketing and building its brand, contributed to sales as well as any increased prices due to the willingness of customers to pay for products bearing its brand name. We note that goodwill has been defined as "[t]he competitive advantage which… is represented by a number of property rights or interests, including tradenames, trademarks, some customer lists, customer routes and other distribution networks (citations omitted)…." (*Philip Morris v. Commissioner* (1991) 96 T.C. 606, 634.) Goodwill has also been defined as "the sum total of all the imponderable qualities that attract customers and bring patronage to the business without contractual compulsion." (*Richard S. Miller & Sons, Inc. v. U. S.* (1976) 537 F.2d 446, 451.) And as stated in *Borden*, *supra*, "the advantage or benefit of goodwill makes possible the profitable operation of a business."

There is an intrinsic relationship between Amarr's goodwill, including its brand name, and Amarr's gross receipts from its regular sales made to customers, including those customers within California's market.[25] As a result, the creation, maintenance, and build-up of goodwill in California may be regarded as having implicit representation in Amarr's gross receipts from the California sales of its inventory to its customers in the ordinary course of business.[26] Furthermore, appellants have not provided evidence to support their argument that the exclusion of the gross receipts results in the goodwill income having no representation in the sales factor. Therefore, we find that there is representation in the sales factor of the value of Amarr's goodwill.[27] Accordingly, appellants have not shown that there is inherent qualitative distortion or that the goodwill income has no representation in the apportionment factor due to the exclusion from the sales factor of the gross receipts from the sale of goodwill pursuant to Regulation section 25137(c)(1)(A).[28]

Quantitative Factor

As to the quantitative factor, appellants do not provide evidence to support their assertion that a substantial amount of goodwill arose in prior years in which Amarr was not doing business in California. Appellants provide no evidence as to the contribution to goodwill attributable to California or any other states. Furthermore, it is reasonable to infer that Amarr's California operations contributed to the creation of the goodwill, and appellants have not provided evidence to show that the apportionment factor for 2013 is assigning too much business income from the sale of goodwill to California.

In addressing the scope of Amarr's California business activities, as compared to business activities elsewhere, we use the information that has been provided, which is for the

[25] The sales factor is based on the idea that a state which provides a market for a product is entitled to some tax returns on the income which it has helped to produce. (*Microsoft Corp. v. Franchise Tax Bd*. (2012) 212 Cal.App.4th 78, 85.)

[26] We find persuasive the reasoning in *Pacific Coca-Cola Bottling Co. v. Department of Revenue* (1987) 10 Or. Tax 535, 541-542 [discussing that trademark activities are reflected in the sales factor].

[27] This is not to say that the amount of representation can be specifically calculated from the record. Rather, we are merely concluding that there is some representation, contrary to appellants' arguments otherwise, and as discussed below, appellants have not provided evidence to show that there is an unfair representation of Amarr's business activities in California.

[28] In addition, we note that including the deemed asset sale proceeds would combine regular business proceeds with proceeds not related to Amarr's principal business, as Amarr's principal business is not the sale of its entire business, including its goodwill. (See *Microsoft*, *supra*, 39 Cal.4th at p. 766 ["Microsoft's treasury functions are qualitatively different from its principal business"].)

2010 through 2013 tax years.[29] From 2010 to 2012, the percentage of Amarr's California sales, as compared to sales everywhere, grew from approximately 7.3 percent in 2010, to approximately 7.8 percent in 2011, and to approximately 8.0 percent in 2012. Due to a change in California law requiring most apportioning trades or businesses to use a single-sales factor, Amarr's apportionment percentage for 2013 was based solely on the extent of its California sales, as compared to its sales everywhere, rather than also reflecting its property and payroll, as was the case in 2010 through 2012. Therefore, rather than constituting an aberration or distortion that does not fairly reflect the extent of Amarr's California business activities, Amarr's California apportionment percentage of approximately 8.3 percent for the 2013 short tax year reflects this change in the law and the continued increase in its California sales, as compared to its sales everywhere.[30]

As discussed above, the value of Amarr's goodwill has inherent representation in the sales factor. California's contribution to goodwill is reflected in the prior years' sales factors when the goodwill was built up in California. The sales factor for the current year is consistent with prior years as it reflects a continued increase in both total gross receipts from sales everywhere and California gross receipts from sales. Therefore, it is reasonable to conclude that the sales factor in the current year is a fair reflection of California's contribution to the goodwill, as it is consistent with the sales factor in the prior years.[31] And as noted above, while appellants contend that the goodwill was primarily built up or created in prior tax years when Amarr had little or no California business activities or sales, they have not provided any evidence in support

[29] While other prior years may also be relevant, the record only includes information relating to Amarr's business activities and apportionment percentages in California for the 2010 through 2013 tax years.

[30] We note that inclusion of the gross receipts from the sale of the intangibles results in a 5.7 percent sales factor when the accelerated gain is added to the denominator as discussed in Issue 1, as compared to a 6.1 percent sales factor without the accelerated gain as reported on Amarr's 2013 tax return (we assume that the earnout payments would be included in the denominator of the sales factor only, as appellants do not contend otherwise). However, a 5.7 sales factor for 2013 (as well as the 6.1 percent as reported) is inconsistent with the sales factors of 7.8 and 8.0 percent in 2011 and 2012, respectively. This indicates that including the gross receipts from the sale of the intangibles in the sales factor in 2013 would misrepresent Amarr's business activity, whereas the current year sales factor (excluding the intangibles) of 8.3 percent and the prior year sales factors demonstrate that its business activities, as measured by the sales factor, did not significantly change.

[31] The standard formula is the single-sales factor. Appellants do not dispute the use of the single-sales factor or propose using another factor, such as the property and payroll factors as used in prior years, which is not part of the standard formula for the year at issue. Therefore, we address only the sales factor, which is the standard apportionment formula for the year at issue.

of this assertion. Accordingly, it is appropriate to utilize the sales factor from Amarr's normal business operations only, as it has not been shown to result in disproportionate income being assigned to California.[32] Therefore, appellants have not shown that exclusion of the gross receipts does not fairly represent Amarr's activities in California.

Reasonableness

Appellants have not provided evidence showing that their proposed remedy of including the deemed asset sale proceeds in the sales factor is reasonable.[33] Including the deemed asset sale proceeds would dilute the sales factor because it misrepresents the extent of Amarr's California business activities by combining regular business proceeds with the proceeds from the deemed sale of assets. Regulation section 25137(c)(1)(A) was promulgated to remedy distortion in the sales factor caused by a substantial and occasional sale. As stated in FTB Legal Ruling 1997-1 in discussing the application of Regulation section 25137(c)(1)(A) to both tangible and intangible property:

> The exclusion from the sales factor pursuant to 18 CCR § 25137(c)(1)(A) of substantial amounts of gross receipts from an incidental or occasional sale of a fixed asset is based on the rationale that such gross receipts do not fairly reflect the taxpayer's day-to-day business activity and therefore cause excessive income to be apportioned to the state where the occasional sale took place. This is especially so if the growth of built-in appreciation occurs over a substantial period of time, because taking the gross receipts into account in the year of a recognition event does not reflect the gradual effects of appreciation over several years.

As the deemed sale of assets was a substantial and occasional sale that was not conducted in the ordinary course of its business, it would be distortive to treat proceeds from this transaction the same as proceeds from Amarr's regular business operations in determining the apportionment percentage applicable to Amarr's regular business operations. Furthermore, including the gross receipts from the sale of goodwill in the apportionment factor for the current

[32] R&TC section 25137 must be analyzed on a case-by-case basis. (*Appeal of Crisa Corporation*, *supra*.) Therefore, while we do not rule out the possibility that it could be distortive to apportion net income from the sale of goodwill based solely on the California apportionment percentage in the year the sale occurred, appellants have not shown that it is distortive on the facts here.

[33] That is to say, even if appellants had shown that application of the regulation would not fairly represent Amarr's business activities in California, we find they have not shown that their proposed alternative apportionment method to include the deemed asset sale in the sales factor is reasonable.

year may not represent the gradual effects of the buildup of the goodwill's value over several years.

In addition, adding the deemed asset sale, including the fixed payments and accelerated earnout payments, to the sales factor would result in a large increase to the denominator of $132,566,651 (as would the $101,201,823 as reported by Amarr, which excludes the earnout payments), with only $22,395 assigned to the numerator.[34] This would create a substantially disproportionate addition to the sales factor denominator, which otherwise assigns $285,761,485 to the denominator and $23,625,307 to the numerator when the deemed asset sale is excluded. Appellants have not shown that it is reasonable for the sales factor to include this significant transaction, which is the result of a departure from Amarr's regular business activities that would cause an aberrational deviation in the sales factor denominator.

Accordingly, we find that appellants have not provided evidence that FTB's application of the standard apportionment rules, including Regulation section 25137(c)(1)(A), does not fairly reflect the extent of Amarr's California business activities for 2013 and that the proposed alternative apportionment methodology is reasonable.

[34] Considered alone, the deemed asset sale would result in a sales factor of approximately 0.02 percent as compared to 8.3 percent when considering Amarr's regular business operations alone (i.e., $22,395 / $132,566,651 = 0.00016893 [when including the accelerated earnout payments in the denominator of the sales factor, as appellants do not contend any of the earnout would be in the numerator]; we also note that the same computation when excluding the accelerated earnout payments from the denominator, as reported by Amarr, is $22,395 / $101,201,823 = 0.00022129).

HOLDINGS

1. The unreported installment gain should be accelerated for inclusion in Amarr's taxable income for the 2013 short tax year.
2. The income from the deemed asset sale relating to intangibles such as goodwill constitutes business income.
3. Gross receipts from the deemed asset sale should be excluded from Amarr's sales factor pursuant to Regulation section 25137(c)(1)(A) as receipts arising from a substantial and occasional sale.

DISPOSITION

FTB's actions are sustained.

DocuSigned by:
Josh Lambert
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Josh Lambert
Administrative Law Judge

We concur:

DocuSigned by:
Tommy Leung
0C90542BE88D4E7...
Tommy Leung
Administrative Law Judge

DocuSigned by:
Cheryl Akin
1A8C8E38740B4D5...
Cheryl L. Akin
Administrative Law Judge

Date Issued: 12/9/2021