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MULTISTATE INCOME/FRANCHISE TAX

California OTA concludes gain from goodwill constitutes apportionable business income to nonresident S corporation shareholders

Tax Alert

Overview

On January 5, 2022, the California Office of Tax Appeals ("OTA") issued its opinion in *In the Matter of the Appeal of: T. Faries and Estate of D. Faries Jr. (Dec'd)* (*"Faries"*). The OTA concluded that (1) the gain derived from an S corporation's sale of goodwill constituted apportionable business income to its nonresident shareholders under California Code of Regulations, title 18, ("Regulation") section 17951-4(f), (2) the S corporation's sale of goodwill constituted an "occasional sale," and accordingly, its gross receipts therefrom were properly excluded from the sales factor under Regulation section 25137(c)(1)(A), and (3) the taxpayer failed to demonstrate by clear and convincing evidence that exclusion of such gross receipts pursuant to Regulation 25137(c)(1)(A) caused the S corporation's apportionment percentage to unfairly reflect the extent of its business activities in California.

This Tax Alert summarizes some of the highlights from the *Faries* decision and provides some taxpayer considerations.

Background

Corporation X was an S corporation incorporated in a state other than California. A nonresident individual ("Husband") was the 100 percent shareholder of Corporation X before Husband's death. Upon his death, Husband's ownership interest in Corporation X passed to his nonresident wife and his estate (collectively referred herein as "Taxpayer").

Corporation X manufactured, assembled, and/or sold medical supplies in multiple states, including California. On March 3, 2011, Corporation X sold substantially all its business assets to a third-party, consisting of tangible personal property used in the business, certain intellectual property, and goodwill. The primary issue in this case was whether the gain derived from the sale of goodwill should be sourced entirely outside California as income from intangible personal property pursuant to California Revenue and Taxation Code ("CRTC") section 17952 or apportioned to California as business income pursuant to Regulation section 17951-4(f).

Summary of OTA's analysis

Issue 1 – California source income to nonresident S corporation shareholder relating to gain derived from sale of goodwill:

The OTA stated that its precedential decision in *Appeals of The 2009 Metropoulos Family Trust; The Evan D. Metropoulos 2009 Trust,* 2019-OTA-385P ("*Metropoulous*"), controlled the outcome of the present case. In *Metropoulos,* the taxpayers were small business trusts that owned interests in a multistate Delaware S corporation. The S corporation sold its interest in a wholly owned subsidiary in a transaction that was treated as a sale of assets, including goodwill. The OTA concluded that the gain derived from the sale of the goodwill should be apportioned as business income under Regulation section 17951-4(f) and not entirely allocated outside of California under CRTC section 17952.

Regulation sections 17951-4(f) and 17952 are provisions found under California's personal income tax provisions ("PITL"), which apply to nonresident individuals. However, Regulation section 17951-4(f) and (d)(1) leverage California's corporate tax provisions (called the Corporation Tax Laws, or "CTL") to determine the California source income for a nonresident S corporation shareholder on his or her distributive share of S corporation business income.

Specifically, Regulation section 17951-4(f) and (d)(1) provide that, in the case of a nonresident shareholder of an S corporation that carries on a unitary business in California and elsewhere, total business income of an S corporation is apportioned at the S corporation level using the apportionment rules of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and the resulting apportioned amount is treated as California source income to the nonresident shareholder. However, CRTC section 17952 provides that income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from California sources, unless the property has acquired a business situs in California.

In *Faries,* Taxpayer argued that *Metropoulos* applied a regulation (Regulation section 17951-4(f)) in lieu of a statute (CRTC section 17952) without legal authority. Taxpayer further asserted that, contrary to the conclusion reached in *Metropoulos,* only the CTL required the characterization of an S corporation's income as business or nonbusiness income under UDITPA, while the PITL mandates characterization of a nonresident S corporation shareholder's pro rata share of such income as intangible income sourced under CRTC section 17952.

The OTA disagreed, reasoning, *inter alia,* that although California conforms to the federal subchapter S provisions under the PITL pursuant to CRTC section 17087.5, that statute applies those federal provisions except as otherwise provided under the PITL and CTL. Moreover, CRTC section 17951 authorizes the FTB to adopt regulations that provide nonresident income sourcing rules. Regulation section 17951-4(d)(1) and (f) collectively provide that, for S corporations that carry on a unitary business within and without California, the nonresident shareholder's pro rata share of the S corporation's income sourced to California must be determined in accordance with the apportionment rules of UDITPA.

Accordingly, the OTA concluded that Regulation section 17951-4(f) applied in the present case. Noting that Corporation X had reported the gain from the sale of the goodwill as business income on its California tax return, which the OTA found was proper, the OTA concluded that the Corporation X's gain from the sale of the subject goodwill constitutes apportionable business income, and Taxpayer's pro rata share of Corporation X's apportioned California business income constitutes California source income.

<u>Issues 2 and 3 – application of occasional sale rule under Regulation 25137(c)(1)(A) to gross receipts derived from sale of Corporation X's assets:</u>

Having determined that the income from the asset sale was apportionable business income, the OTA turned to the question whether the gross receipts from such sale should be excluded from the sales factor pursuant to the "occasional sale" rule found in Regulation section 25137(c)(1)(A). This section provides that "substantial amounts of gross receipts aris[ing] from an occasional sale of a fixed asset or other property held or used in the regular course of business . . . shall be excluded from the sales factor." However, a taxpayer can avoid the application of the occasional sale rule if it establishes by clear and convincing evidence that the exclusion of the subject receipts does not fairly represent the extent of the taxpayer's business activites in California.

Applying the above stated rule, the OTA concluded that there is no dispute that the gross receipts from the sale of Corporation X's assets were substantial. Further, the subject sale was an occasional sale, as it was a single sale of Corporation X's assets and fell outside of Corporation X's course of business. The OTA further concluded that Taxpayer had not demonstrated by clear and convincing evidence that the application of the occasional sale rule did not fairly reflect the extent of Taxpayer's business activities in California.

Taxpayer argued that the operation of the occasional sale rule effectively was distortive because it mixed "low margin" receipts with "high margin receipts" contrary to California Supreme Court case precedent, and that the FTB's adjusted sales factor violated the principles of external consistency, which requires that the factor or factors used in the apportionment formula actually reflect a reasonable sense of how income is generated. The OTA rejected these arguments, reasoning, *inter alia,* that the sales factor is designed to attribute a business's income to the jurisdictions in which its goods and services are consumed, regardless of whether the business later turns a profit or loss on those purchases. Moreover, Taxpayer had not shown that Corporation X's margins will vary from state to state, as the income at issue (the gain from the sale of goodwill) was accumulated over time as a result of Corporation X's operational business activities in numerous states.

Considerations

Both *Metropoulos* and *Faries* both considered how properly to source a nonresident shareholder's pro rata share of gain from the sale of goodwill that was reported on an S corporation's California tax return as business income. *Faries* is the second time that the OTA has concluded that the source of such income must be determined by reference to the apportionment rules of UDITPA, not by reference to the income sourcing rule applicable to intangible personal property found in CRTC 17952. Taxpayers should consult their tax advisors to evaluate whether and how the *Faries* decision may impact their California tax liabilities and/or prospective tax planning.

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