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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**HEARING SUMMARY**
	PERSONAL INCOME TAX APPEAL
ARTURO LOPEZ AND	Case No. 740943
MARIA D. LOPEZ	

Years	Proposed Assessments
2006	$ 87,262
2007	$ 9,667

Representing the Parties:

For Appellants: Lynwood Ford, Enrolled Agent

For Franchise Tax Board: D. Todd Watkins, Tax Counsel III

QUESTION: Whether respondent correctly determined that appellants underreported their flow - through capital gains for the tax years at issue.

HEARING SUMMARY

Background

Introduction

As discussed below, appellants own and operate Arturo Lopez, M.D., Inc. (ALMD), an S corporation whose business activity is listed as "medical services." ALMD was a general partner in

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Caremore Medical Group (CMG), a partnership. In 2006, CMG held an interest in Caremore Medical Management Company (CMMC), a limited partnership. In addition, CMG owned stock in Caremore Medical Enterprises (CME), a C corporation. In 2006, CMG sold its partnership interest in CMMC and its stock in CME. Thereafter, CMG liquidated, filed its final return in 2007, and merged with Caremore Medical Group, Inc. (CMGI), a separate entity. In 2006, ALMD sold its partnership interest in CMG. The sale of the CMG's interest in CMMC and stock in CME and the sale of ALMD's interest in CMG resulted in the capital gain at issue in this appeal.

Arturo Lopez, M.D., Inc. (ALMD) and Caremore Medical Group (CMG)

ALMD was incorporated in California on July 11, 2003. Appellant-husband and appellant-wife owned respectively 90 percent and 10 percent of the stock in ALMD. ALMD was formed for the purpose of being a partner in CMG, which was formed in 1993 to engage in the provision of medical services. At the beginning of the 2006 tax year, CMG had 38 general partners, each of which was a professional medical corporation. In addition to the medical practice, CMG owned approximately 81 percent of the shares of stock of CME, a healthcare management company. The other owners of CME included the Caremore Employee Stock Ownership Trust (ESOP trust) and two individual doctors, Dr. Z and Dr. F. CMG also owned a 98 percent limited partnership interest in CMMC. Caremore LLC held the remaining 2 percent interest in CMMC.[1] (Resp. Op. Br., p. 1.)

Sale of Caremore Medical Group (CMG) in 2006

In 2006, the partners of CMG sold their interests in their CMG medical practices and the assets held by CMG. According to the Stock Purchase Agreement among CME, CMG, the ESOP trust, Dr. Z, and Dr. F (Sellers) and Caremore Holdings, Inc. (CHI) (Buyer) dated as of December 22, 2005, CHI purchased all of the shares of CME from the Sellers, including the CME stock owned by CMG. The closing of the sale occurred on February 28, 2006. The total purchase price paid by CHI for the CME stock was stated as $230 million. Of that amount, $15 million was consideration to CMG and Caremore LLC for contributing their respective 98 percent and 2 percent interests in CMMC to CME prior to the closing. According to the flow-of-funds memorandum, CMG's share of the amount paid

[1] It appears that CMG did not have an ownership interest in Caremore LLC.

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

for CMMC was $12.8 million. A fixed amount of $10.28 million was paid to the CME ESOP trust and $2.4 million was paid on behalf of the ESOP trust to pay off stock purchase liabilities to two shareholders. Other amounts were paid out for transaction expenses and to pay off various liabilities.[2] The portion of the purchase price payable to CMG and to Drs. Z and F was subject to a reduction of up to $10 million attributable to a holdback payment referred to as the "Blue Shield Holdback Amount," and up to an additional $2 million attributable to the "CMG Coverage Holdback Amount." In addition, the portion paid to these shareholders was subject to an increase of up to $10 million for a contingent earn-out payment based on the financial performance of CME for the 2006 calendar year. (Resp. Op. Br., p. 2, Exhs. A & B.)

In addition to the Stock Purchase Agreement, CMG also entered in the related Agreement and Plan of Merger dated "as of December 22, 2005," (Merger Agreement) with CMGI.[3] According to the Merger Agreement, the individual physicians who practiced medicine through the S corporations as partners of CMG were required to enter into employment agreements with CMGI. A condition of closing was that the Stock Purchase Agreement must have occurred. (Resp. Op. Br., pp. 2-3, Exh. C.)

According to the Certificate of Merger filed with the California Secretary of State, CMG merged into CMGI effective on February 28, 2006. According to the recitals to the Merger Agreement, $5 million of the "Net Purchase Price Proceeds" with respect of the CME shares sold to CHI pursuant to the Stock Purchase Agreement shall be allocated to, and constitute consideration for, the CMG partners' sale of their professional medical practices through the distribution of such funds in exchange for the partners' interests in the CMG partnership. The agreement provided that, within 2 days of the closing, CMGI would pay as an "Initial Partnership Distribution" to each CMG partner its pro rata share of the "CMG Purchase Price Proceeds." According to the recitals, "CMG Purchase Price Proceeds" was defined as the sum of CMG's allocation of the Net Purchase Price Proceeds from the sale of the CME stock and consideration paid for CMG's 98 percent interest in CMMC. The Merger

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[2] It is not clear what portion of these payments, if any, constituted consideration to the shareholders of CME, including CMG.

[3] It appears that CMGI was not a subsidiary corporation of CHI.

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Agreement further provided that CMGI would pay each "former partner of CMG" a "Final Partnership Distributions" which consisted of each former partner's respective percentage of the earn-out amount, the "Blue Shield Holdback Amount," and the "CMG Coverage Holdback Amount" when those amounts were determined in 2007. (Resp. Op. Br., p. 3, Exh. C.)

The following payments totaling $136,242,836 were made to the CMG partners:

- 2/28/06: $116,401,131, which consisted of cash proceeds paid with checks from CMGI.
- 12/31/06: $2,900,000, which consisted of $800,000 in insurance proceeds, $2,100,000 of "phantom" gain related to CMG's interest in Downey Community Hospital.
- 7/14/07: $11,819,163, which consisted of the release of the holdback accounts and the payment of earn-out. ($13,308,069 (Total for CME) - $744,453 (Dr. Z) - $744,453 (Dr. F).)
- 9/19/07: $5,122,542, which consisted of the release of holdback accounts and payment of earn-out. ($5,767,848 (Total for CME) - $322,653 (Dr. Z) - $322,653 (Dr. F).)

(Resp. Op. Br., p. 4.)

On February 28, 2006, pursuant to the Stock Purchase Agreement and the Merger Agreement, ALMD received a check of $3,426,680 as its share of the Initial Partnership Distribution. According to the flow of funds memorandum, the amount distributed to former partners of CMG was net of amounts necessary to satisfy outstanding capital account receivables and amounts to be retained to satisfy outstanding liabilities as of closing. According to documents provided by appellants at audit, ALMD had an outstanding capital account contribution liability of $70,093 to CMG. The $3,426,680 that ALMD received was the net amount due to ALMD after the satisfaction of its capital accounts payable to CMG. In addition, ALMD received a memorandum from CMG dated December 2006, which indicated that it was allocated $24,505.82 of "insurance proceeds" and $62,168.27 of "phantom income" related to the gain from CMG's interest in Downey Hospital as part of the sale of CME. In 2007, ALMD received at least two additional payments that comprised ALMD's percentage share of the earn-out amount, the "Blue Shield Holdback Amount," and the "CMG Coverage Holdback Amount." On July 11, 2007, ALMD received a check for $343,118. On September 16, 2007, ALMD received a second check of $148,711. (Resp. Op. Br., p. 5, Exhs. B, E, F, G & H.)

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

ALMD and Appellants' 2006 Tax Returns

In 2006, ALMD reported a capital gain from the sale of property described as "Medical Acq." on its Schedule D (Form 100S). ALMD reported the sales price of the property as $3,426,680, the basis in the property as $1,097,750, and a gain from the sale of $2,328,930. Rather than the gain being reported to ALMD as an item of ALMD's distributive share of CMG's items of income, it was treated as a partner level sale (i.e., the sale of the property was treated as a sale made by the partners of CMG). The distributive share items of CMG that ALMD reported on its 2006 tax return included ordinary business income of $103,900, capital gains of $63,018, "other income" of $21,784 attributable to the cancellation of indebtedness, interest of $4,109, and charitable contributions of $7,258. ALMD reported total capital gains on its 2006 tax return of $2,391,948 (i.e., $2,328,930 + $63,018). (Resp. Op. Br., pp. 5-6, Exhs. I & J.)

Appellants filed a timely 2006 California tax return (Form 540) in which they included the capital gains reported to them by ALMD on their Schedules K-1 (Form 100S). Appellants also included the distributive share items of CMG that flowed through to their pro rata shares of ALMD's income, except for the $21,784 in "other income" attributable to the cancellation of indebtedness income reported by CMG to ALMD. (Resp. Op. Br., p. 6, Exh. K.)

ALMD and Appellants' 2007 Tax Returns

In 2007, ALMD reported the capital gain from the sale of property described as "Caremore Sale" on its Schedule D (Form 100S). ALMD reported the sales price of the property as $451,828,[4] the basis in the property as $87,692, and a gain from the sale of $364,136. ALMD's distributive share of CMG's items of income, as reported on the 2007 Schedule K-1 (Form 565) issued to ALMD, included a capital gain of $58,061. However, ALMD's Schedule D (Form 100S) did not report the $58,061 distributive share of capital gain. ALMD reported all other items of its 2007 distributive share of CMG's income and deductions, which consisted of an ordinary business loss of $17,743 and interest of $2,119. CMG's 2007 Schedule K-1 (Form 565) for ALMD reported an end-of-year capital account balance of $87,691. CMG's 2007 Form 565 stated that this was its final

[4] Staff notes that there is a difference of $40,001 between this amount reported ($451,828) and the amount ALMD received from CMG ($491,829).

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

return. ALMD's 2007 Form 100S balance sheet reported zero for assets at the end of the year, but reported shareholder equity of $771,183. On ALMD's 2008 Form 100S, it reported no business or investment activity. The 2008 Accumulated Adjustments Account (Schedule M-1) subtracted $771,183 from the beginning balance and stated that the amount subtracted was attributable to "prior distributions." (Resp. Op. Br., p. 6, Exhs. L, M & O.)

Appellants filed a timely 2007 California tax return (Form 540) in which they included the capital gain of $364,136 reported to them by ALMD. Appellants also included all other amounts reported on their Schedule K-1s from ALMD. (Resp. Op. Br. p. 6, Exh. N.)

Audit

Respondent examined the capital gains reported by CMG and its partners in 2006 and 2007 related to the CMG asset sale and merger.

2006 Tax Year

Respondent determined that the amount realized by ALMD was underreported because ALMD did not include the $86,754 "insurance proceeds" and "DCH phantom income" on its Schedule D and this amount had not been included in ALMD's distributive share of CMG's income. As such, respondent determined that the correct amount realized by ALMD was $3,513,434 (i.e., $3,426,680 + $86,754). Respondent also disallowed ALMD any basis in its interest in CMG, which ALMD reported as $1,097,750 on its Schedule D. (Resp. Op. Br., p. 7, Exhs. P, Q & G.)

ALMD provided a statement listing three sources in support of the reported basis: (1) there was basis in the corporation of $500,516 which was used to offset the gain declared for 2006; (2) according to the CMG Schedule K-1, ALMD contributed $145,020[5] to the capital of CMG; and (3) ALMD had $452,000 in basis attributable to the contribution to CMG of appellant-husband's book of patients. Appellants' representative clarified in a subsequent letter dated March 9, 2011, that the claimed basis of $500,516 was based on the $500,516 reported as end-of-year retained earnings on the

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[5] Although appellants claimed contributions of $145,000 in their appeal letter instead of the amount listed above, it appears that the correct amount of the claimed contribution is $145,020 (i.e., $74,927 + $70,093). If the parties dispute this amount, they should be prepared to explain their position.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

balance sheet (Schedule L) of ALMD's 2006 tax return.[6] (Resp. Op. Br., p. 7, Exh. R.)

Respondent examined appellants' worksheet submitted with their letters that purportedly supported appellants' claim of $500,516 in basis and noted that there was no description of what the amounts were for. As such, respondent disallowed the claimed basis of $500,516. Respondent also reviewed letters from CME's controller which supported appellants' claimed basis of $145,020. According to a letter dated May 21, 2010, at the time of the sale of CMG on February 26, 2006, ALMD had paid a total of $74,927 to CMG as capital contributions. According to a letter dated March 2, 2011, $70,093 of the proceeds due to ALMD from the sale of CMG was applied towards ALMD's capital account. Respondent issued a letter dated March 21, 2011, in which it stated that, if the $70,093 was allowed for basis, that amount should also be included in the amount realized. Since respondent computed the gain using the amount of the check which reflected the net cash proceeds, taking the $70,093 into account as basis did not change the computation of the capital gain. With regard to the $74,927, although respondent initially allowed that amount, respondent disallowed this amount because appellants failed to provide additional documentation to verify the payment of this amount. With regard to the alleged $452,000 value of the patients contributed to CMG, appellants provided statistical information which respondent apparently did not accept as support for the $452,020 claimed basis. Respondent's net adjustment to ALMD's capital gain for 2006 attributable to the sale of the CMG assets and ALMD's interest in CMG was $1,184,504 (i.e., $3,513,434 (gain determined at audit) - $2,328,930 (gain reported on ALMD's return)). (Resp. Op. Br., p. 8, Exhs. S, F, T & U.)

Respondent accordingly adjusted appellants' taxable income to include a revised flow-through income of $1,184,504. Respondent also adjusted appellants' taxable income to include "other income" of $21,784 attributable to the cancellation of indebtedness income reported as a distributive share item of ALMD from CMG because appellants failed to report this amount on their return even though this item of income was included on ALMD's Schedule K and Schedule K-1s issued to appellants. (Resp. Op. Br., pp. 8-9, Exhs. Q & V.)

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[6] At audit, appellants did not provide a legal argument for why the retained earnings were relevant for purposes of ALMD's basis in CMG or to the amount of net capital gain reportable by ALMD for the 2006 tax year.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

2007 Tax Year

Respondent determined that ALMD and appellants understated their capital gain from the CMG merger and asset sale. Respondent determined that ALMD should have recognized a gain of $404,138 (i.e., $491,829 - $87,691). Respondent computed this amount as the total of the additional payments that ALMD received in 2007 of $491,829 (i.e., $343,118 + $148,711) less ALMD's basis in its partnership interest of $87,691. Respondent accepted ALMD's basis reported on its Schedule D for purposes of the sale, which was the same amount as ALMD's capital account balance at the end of 2007 as reported by CMG on the Schedule K-1 issued to ALMD. Respondent increased the gain from the sale of CMG by $40,002 (i.e., $404,138 (gain determined at audit) - $364,136 (gain reported on ALMD's return)). In addition, respondent adjusted ALMD's capital gains by an additional $58,061, which was reported as a distributive share item on the 2007 CMG Schedule K-1. An additional adjustment was made to appellants' itemized deductions on their individual return. (Resp. Op. Br., p. 9, Exhs. P & Q.)

Notices of Proposed Assessment

Respondent issued Notices of Proposed Assessment (NPA) dated February 28, 2012, to appellants for the 2006 and 2007 tax years.[7] The NPA for the 2006 tax year proposed to increase appellants' taxable income by $1,206,288, which was comprised of $1,184,504 flow-through capital gain from ALMD as a result of the CMG sale and $21,784 flow-through income from ALMD as a result of other income. The 2006 NPA proposed additional tax of $124,248, plus interest. (Resp. Op. Br., p. 9, Exh. V.)

The NPA for the 2007 tax year proposed to increase appellants' taxable income by $103,947, which was comprised of $40,002 flow-through capital gain from ALMD as a result of the CMG sale, $58,061 flow-through capital gain from ALMD through the CMG Schedule K-1, and $5,884 of disallowed itemized deductions. The 2007 NPA proposed additional tax of $9,667, plus interest. (Resp. Op. Br., p. 9, Exh. V.)

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[7] Respondent also issued NPAs dated March 7, 2012, to ALMD for the same years reflecting these adjustments.

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Protest

Appellants and ALMD protested the adjustments by letter dated April 22, 2012. Respondent reviewed the audit adjustments to capital gains by considering the taxability of four events: (1) CMG's sale of 100 percent of its shares of CME stock; (2) CMG's sale of its 98 percent interest in CMMC; (3) ALMD's sale of its interest in CMG; and (4) CMG's reported liquidation and filing of its final return in 2007. Respondent's hearing officer determined the tax effects from the payment of $3,426,680 to ALMD by treating the payment as a distribution entirely from CMG to ALMD. (Resp. Op. Br., pp. 9-10, Exhs. W & X.)

With regard to the sale of the CME stock, respondent determined that CMG should have reported $215 million attributable to the sale of the stock. Respondent calculated this amount by subtracting the $15 million stated in the Stock Purchase Agreement as attributable to the purchase of 100 percent of the interests in CMMC from the $230 million stated purchase price. Respondent indicated that, because it was unable to determine the breakdown of the ownership of the CME shares, all 100 percent would be allocated to CMG. In addition, since the 2006 balance sheet filed with CMG's return showed no basis in its interest to CME, respondent determined that CMG had a basis of zero in its CME stock. ALMD's distributive share of the $215 million in gain was determined to be $5,703,520 based on the end-of-year share of profits and losses of 2.6528 percent as reported on its Schedule K-1 from CMG (i.e., $215,000,000 x 0.026528). (Resp. Op. Br., p. 10, Exhs. X, J.)

With regard to CMG's sale of its interest in CMMC, respondent noted that CMG was paid $13,190,000 for its interest in CMMC pursuant to the Stock Purchase Agreement. Respondent could not determine conclusively CMG's basis in its interest in CMMC. According to the Schedule K-1 issued by CMMC to CMG, the capital account of CMG in its interest in CMMC was a negative $114,138, at the end of the 2006 tax year and CMG was not allocated any partnership liabilities. Based on that information, respondent determined that CMG's basis in its interest in CMMC was zero, and that CMG realized $13,190,000 in capital gain from the sale of its interest in CMMC. Pursuant to ALMD's 2.6528 percent distributive share of profits and losses of CMG, ALMD's share of the gain from the sale of CMMC was $394,904 (i.e., $13,190,000 x 0.026528). (Resp. Op. Br., p. 10, Exhs. X, Y & J.)

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

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With regard to ALMD's sale of its interest in CMG, respondent reviewed the issue of ALMD's basis in CMG. Respondent affirmed the denial of the $500,516 in retained earnings that ALMD argued should offset its gain from the sale of its interest in CMG in 2006. Respondent determined that the retained earnings on the balance sheet of ALMD did not reflect ALMD's investment in CMG, but rather, appellants' equity in ALMD, and that this equity was still reported in ALMD at the end of 2007. With regard to the $452,000 in basis claimed for the contribution of ALMD's patient roster, respondent affirmed the denial of that amount based on the determination that self-created assets do not have any cost basis for income tax purposes and appellants and ALMD had not provided any evidence that anything had been paid for the patient roster. Respondent allowed ALMD as basis the $145,020 in contributions that ALMD claimed to have made to CMG. Respondent then added the $145,020 amount to ALMD's ending 2006 capital account balance of $127,309, and increased ALMD's basis by the amount of the gains from the sale of its CME stock ($5,703,520) and CMMC limited partnership interest ($349,904) to arrive at a basis of $6,325,753.[8] Respondent treated the $3,426,680 payment as a distribution from CMG to ALMD that produced no gain because it was not in excess of ALMD's basis. The $3,426,680 distribution reduced ALMD's basis in CMG to $2,899,073. Respondent determined that ALMD's net capital gain for 2006 was $3,154,351 (i.e., $5,703,520 + $349,904 - $2,899,073). Respondent revised the capital gain adjustment for 2006 to $825,421 (i.e., $3,154,351 - $2,476,620). (Resp. Op. Br., p. 11, Exh. X.)

With regard to CMG's reported liquidation and filing of its final return in 2007, respondent determined that the additional payments totaling $491,829 (i.e., $343,118 + $148,711) received by ALMD were not items to be reported as part of ALMD's distributive share because these payments were part of the amount realized from the sale in 2006. Although respondent determined that ALMD sold its partnership interest in 2006, respondent treated the payments as distributions from CMG to be added to the distribution of $81,964 reported on the 2007 Schedule K-1 issued to ALMD. Respondent determined that ALMD's basis in its partnership interest was $2,119, attributable to the interest income reported on the Schedule K-1, and the distributions produced a gain of $571,674 from

[8] On appeal, respondent contends that the $145,020 should not have been added to the capital account balance of $127,309 in computing ALMD's basis in CMG.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

the sale of a partnership interest pursuant to Internal Revenue Code (IRC) section 731. Respondent determined that ALMD correctly excluded the $58,061 distributive share item of capital gain reported on the Schedule K-1 because all gains attributable to the sale had been included at the partnership level in 2006. Respondent determined that the proper amount of the adjustments was $207,538 (i.e., $571,674 - $364,136). As this amount was more than the $98,063 adjustment at audit, respondent determined that the adjustments on the 2007 NPA issued to ALMD should be affirmed.[9] Respondent also determined that the adjustments on the 2007 NPA to appellants should be affirmed. (Resp. Op. Br., 12. Exh. X .)

Notices of Action

Respondent issued Notices of Action (NOAs) to appellants dated May 31, 2013, for the 2006 and 2007 tax years. The 2006 NOA reflected appellants' taxable income increase by $847,205, which was comprised of an $825,421 flow-through capital gain from ALMD as a result of the CMG sale and $21,784 flow-through income from ALMD as a result of other income. The 2006 NOA reflected the revised additional tax of $87,262 assessed for the 2006 tax year. The 2007 NOA affirmed the additional tax of $9,667 assessed for the 2007 tax year. (Resp. Op. Br., 12., Exh. Z.)

This timely appeal then followed.

Contentions

Appellants' Contentions

Appellants contend that respondent erred in disallowing their basis in the sale of ALMD and CMG assets. Appellants contend that they have additional evidence to support their position that was not examined by respondent's protest officer. (Appeal Letter.)

Respondent's Contentions

Respondent contends that appellants underreported their capital gains in amounts that exceed the amounts determined at protest. As such, respondent requests that its action on protest be

[9] Respondent issued notices of tax due to ALMD. ALMD's right to protest was suspended pursuant to R&TC sections 23301 and 23301.5 on August 1, 2012, because ALMD failed to pay the corporate minimum franchise tax and file tax returns for the 2009 through 2012 tax years. ALMD was sent a letter dated April 9, 2013, notifying it that it had 30 days to revive by filing the necessary returns and by paying the taxes due or its protest would be dismissed. As ALMD did not revive, its protest was dismissed.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

sustained. Respondent contends that ALMD was required to include in its income its distributive share of items of income of the CMG partnership, including capital gains and losses recognized by CMG, citing IRC sections 61 and 702. Respondent contends that appellants, as S corporation shareholders of ALMD, were required to include in their income their pro rata shares of ALMD's items of income pursuant to IRC section 1366. Respondent contends that appellants were also required to recognize any gain or loss on the sale or exchange of their interests in ALMD. (Resp. Op. Br., p. 13.)

Respondent contends that, according to the merger transaction, all of CMG's interests were sold as of February 28, 2006, to CMGI and CMG's existence as a partnership terminated, citing IRC section 708(b)(1)(A). Respondent contends that, as the amount of consideration received by CMG for its CME stock was contingent and payments were received in 2006 and 2007, the sale of the CME stock was an installment sale. Respondent contends that the gain from the sale of the CME stock should have been reported on the installment method as required by IRC section 453 and Treasury Regulation section 15a.453-1(c)(2). (Resp. Op. Br., pp. 13-14.)

Respondent contends that it is not clear after reviewing the Stock Purchase Agreement and the flow of funds memorandum whether the total price included only the actual cash proceeds paid to CMG or included the deemed income from the payment of liabilities and expenses of CMG. Respondent contends that, as the amount realized from the sale of the CMG assets and CMG interests could not have been less than the amount of proceeds ALMD received, respondent used that amount to determine the amount of recognized gain. Respondent argues that ALMD received $3,496,773 in 2006 comprised of the check of $3,426,680 and $70,093 applied to its capital account payable to CMG.[10] Respondent further argues that ALMD received $491,829 in 2007 comprised of checks of $343,118 and $148,711. Respondent contends that the sum of these actual direct and indirect cash payments constitute the minimum total amount realized. (Resp. Op. Br., p. 14.)

Respondent contends that CMG's basis in the CME stock and its basis in the interest in CMMC were both zero as determined at audit and protest. Respondent contends that ALMD had a

[10] Respondent acknowledges that ALMD received a memorandum in 2006 stating that ALMD had additional income of $86,754, which ALMD did not include in the sales price reported on the Schedule D. Respondent acknowledges that this amount may have been included, as respondent's hearing officer concluded, in the distributive share of CMG's income reported to ALMD on its Schedule K-1.

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

distributive share of capital gain of $3,348,206 includible in its income pursuant to IRC section 61 and 702.[11] Respondent contends that this increased ALMD's basis in its interest in CMG pursuant to IRC section 705 in the same amount. Respondent notes that $3,348,206 was then distributed to ALMD immediately prior to the sale by ALMD pursuant to the merger of its interest in CMG. Respondent argues that the distribution was a non-liquidating distribution of cash accompanied by the distribution of ALMD's share of the right to receive contingent payments in 2007 (installment obligation). Respondent contends that the distribution did not exceed ALMD's basis in CMG pursuant to IRC section 731, and did not produce a taxable gain. Respondent contends that ALMD received the installment obligation with the same zero basis that CMG held in the obligations. Respondent contends that ALMD then sold its partnership interest for $148,567, recognizing a gain pursuant to IRC sections 741 and 1001 in the amount in excess of ALMD's adjusted basis in its interest in CMG. (Resp. Op. Br., pp. 14-15.)

Respondent notes that the only issue raised by appellant is ALMD's basis in its interest in CMG. Respondent contends that ALMD's basis in its interest in CMG can be determined by its capital account. Respondent contends that ALMD's basis in its interest in CMG should be derived from its capital account balance and, according to the 2006 Schedule K-1, was reported as $127,309 as of the end of CMG's 2006 taxable year. Respondent contends that the $127,309 already included the $74,927 of cash contributions by ALMD already made and should also have included the $70,093 amount applied from the cash proceeds of the sale.[12] Respondent argues that its auditor incorrectly added $145,020 to $127,309 to arrive at ALMD's basis in its interest in CMG. Respondent argues that the $145,020 already was reflected in the $127,309 reported on the Schedule K-1 which reflected distributions during the 2006 tax year and prior years. Respondent contends that the capital account balance approximates ALMD's basis as the Schedule K-1 did not report any partnership liabilities allocated to ALMD. Respondent further notes that the Schedule K-1 only reported $75 of

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[11] $148,567 of the $3,496,773 received in 2006 by ALMD was attributable to the sale of ALMD's interest in CMG. ($3,496,773 x ($5,000,000/($104,883,058 + $12,800,000))).

[12] In respondent's additional brief, respondent concedes that the basis should be increased by $70,093, for a total of $197,402.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

nondeductible expenses and no tax-exempt income, items which could cause the tax basis to vary from the capital account balance. (Resp. Op. Br., p. 15.)

As to appellants' claim that ALMD's basis should include $500,516 of retained earnings, as reflected on ALMD's balance sheet at the end of the 2006 tax year, to offset the gain of its sale in CMG, respondent argues that ALMD's retained earnings do not represent its investment in CMG. Respondent argues that the retained earnings represent appellants' equity in ALMD.[13] Respondent further contends that appellants have not offered any factual or legal argument to support a finding that appellants had a loss from their stock in ALMD. (Resp. Op. Br., pp. 15-16.)

As to appellants' claim that ALMD's basis should include $452,020 attributable to ALMD's contribution of its patient roster to CMG in 2003 when ALMD became a partner in CMG, respondent contends that this amount properly was disallowed. Respondent contends that the basis of a partners' interest in a partnership is increased by a contribution of property to the partnership by the amount of the adjusted basis of such property, not by the fair market value of the property contributed, citing IRC section 722. Respondent notes that the basis of property is determined pursuant to IRC sections 1011 through 1023, and the related regulations. Respondent argues that appellants have not provided any factual evidence to support that appellant-husband or ALMD incurred any capitalized costs in acquiring or creating the medical practice assets, such as the patient roster, contributed by ALMD to CMG. (Resp. Op. Br., p. 16.)

Respondent contends that ALMD's basis in its interest in CMG after the increase from the flow-through gains was $3,456,140 (i.e., $127,934 (basis per capital account balance) + $3,328,206 (increase attributable to the CMG flow-through gain/income)). Respondent further contends that the basis after the distribution was the same as the basis prior to the distribution. Respondent states that the basis after the distribution of cash and a zero-basis installment payment note was $127,934 (i.e., $3,456,140 (ALMD's basis in CMG after increase by gains from CMG's sale of CME stock and CMMC interest) – $3,328,206 (cash distributed by CMG to ALMD attributable to CMG's sale of assets) + $0 (basis of property distributed by CMG installment payment note for

[13] Respondent notes that ALMD's 2006 Schedule L did not reflect any investment in another entity which appears to conflict with the capital account balance reported to ALMD on its Schedule K-1 from CMG.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

CME)). Respondent further contends that ALMD's gain on the sale of its interest in CMG was $20,633 (i.e., $148,567 - $127,934). Respondent notes that ALMD received $148,567 on February 28, 2006, attributable to the sale of its interest in CMG and its basis after the distribution of cash and the zero basis installment payment note was $127,934. As such, respondent contends that ALMD's total capital gain in 2006 for ALMD from the sale and merger was $3,348,839 (i.e., $3,328,206 + $20,633). Respondent contends that the additional gain from the 2006 tax year, pursuant to respondent's computation on appeal, is greater than the amount of gain affirmed at protest.[14] Respondent also notes that appellants failed to report the $21,874[15] distributive of income from CMG which flowed through to appellants through their interests in ALMD. Respondent therefore contends that its proposed assessment for the 2006 tax year should be affirmed. (Resp. Op. Br., p. 17.)

For the 2007 tax year, respondent notes that ALMD received payments of $343,118 on July 11, 2007 and $148,711 on September 16, 2007, which constituted the full payment of the contingent amounts under the Stock Purchase Agreement. Respondent contends that CMG should not have filed a partnership return for the 2007 tax year as the partnership had terminated pursuant to IRC section 708(b)(1)(A) and Treasury Regulation section 1.708-1(b)(1). Respondent contends that the $17,743 reported as an ordinary loss on ALMD's Schedule K-1 from CMG and on appellant's Schedule K-1 from ALMD should not have been reported as a distributive share item. Respondent contends that this amount was attributable to the expenses reported on CMG's income statement. Respondent notes that CMG reported no business activity in 2007 other than expense deductions. Respondent acknowledges that the $17,743 in expenses could have been added to the basis of the installment obligations which would reduce the gain on the receipt of the contingent payment amount. Respondent contends that, in the absence of further evidence of the nature of the expenses, respondent contends that the $17,743 loss should be disallowed as a distributive share item and should also not be added to the basis in the installment obligation. (Resp. Op. Br., p. 18.)

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[14] $3,348,839 (total capital gain for 2006 per appeal) - $2,328,930 (capital gain as reported) = $1,019,909 additional capital gain per appeal. In contrast, respondent determined that the additional capital gain per protest was $825,421.

[15] Respondent referred to this amount as $21,874, but in other parts of its brief, respondent used the amount of $21,784. Respondent should clarify which amount is correct at the hearing.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

Respondent contends that an adjustment must be made to the investment interest income flow-through from CMG to ALMD on its Schedule K-1 in the amount of $2,119. Respondent contends that this amount presumably was included in the contingent sale proceeds. Respondent contends that ALMD and appellant-husband did not include the capital gain of $58,061 reported on CMG's Schedule K-1, and ALMD did not report any gain from the distributions totaling $81,964 reported on CMG's Schedule K-1 to ALMD. As such, respondent contends that adjustments to their returns are not necessary with respect to those items. Respondent contends that, like the $2,119 interest income, the $81,964 presumably was included in the net sale proceeds and there was no indication that a separate partnership distribution payment was made to ALMD.[16] As such, respondent contends that the additional gain from the sale of the CME stock recognized in 2007 was $491,829 (i.e., $343,118 + $148,711). Respondent contends that, although ALMD did not receive the maximum amount of the additional contingent consideration, ALMD had no unrecovered basis in the obligation, and therefore, was not entitled to any bad debt deduction. Respondent contends that the total adjustment to income for ALMD and appellants for the 2007 tax year should have been $143,317, which is greater than the adjustment of $98,063 reflected on the NPA and NOA for the 2007 tax year. As such, respondent contends that its action at protest should be sustained. (Resp. Op. Br., pp. 18-19.)

Respondent notes that an alternative characterization of the transaction is to treat it solely as a sale of the CMG partner's interests in CMG according to the "sale of a going business doctrine," citing *Hatch's Estate v. Comm'r* (9th Cir. 1952) 198 F.2d 26. Respondent contends that tax consequences that follow from taxpayers in a partnership incorporation transaction and partnership mergers appear to be contrary to the "sale of a going business" doctrine, citing Revenue Ruling 99-6, 1999-1 C.B. 432, and Treasury Regulation section 1.708-1(c)(3) and (4). (Resp. Op. Br., pp. 19.)

Respondent further notes that Treasury Regulation section 1.708-1(c)(4) also specifies that, in a merger taking the assets-over form, the terms of the merger agreement that describe any part of the merger as a transfer of partners' interests will be respected. Respondent further contends that,

[16] Respondent notes that, if the $81,964 represents an additional amount received, then it would be added to the contingent payment amounts.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

even if the transaction is viewed as a sale on the contingent installment method of the partners' interests in CMG, the adjustments at audit should still be confirmed. Respondent contends that, pursuant to treating the sale as wholly a sale of the interests in CMG, approximately $15,775 of ALMD's basis[17] in its interest in CMG would have been recovered in the 2007 year instead of the 2006 year, reducing the gain in 2007 of that amount, and increasing the gain in 2006 of that amount. Respondent contends that the reduction of the 2007 deficiency of $143,317 pursuant to respondent's position on appeal by $15,775 would still result in a deficiency greater than the deficiency determined at audit and affirmed at protest. Respondent further contends that this conclusion would still hold if appellants were allowed the loss of $17,743, reported as a 2007 CMG distributive share item. (Resp. Op. Br., pp. 19-20.)

Appellants' Additional Brief

In response to the Appeals Division staff's request for appellants to address respondent's opening brief, appellants maintain that they should be allowed $452,000 in outside basis. Appellants contend that they were unaware of CMG's failure to credit appellant-husband with this contribution when he became a partner in the medical group.[18] Appellants contend that they were only given credit for the cash payment of $145,020 upon entering the medical group.[19] Appellants contend that the medical group received the benefit of appellant-husband's patients as well as his cash contribution. Appellants contend that CMG's profits were enhanced by the patients appellant-husband converted into medical clients of CMG. (App. Addl. Br., p. 1.)

Appellants assert that, upon the sale of the medical group "per established law," appellant-husband should be entitled to both his inside and outside basis.[20] Appellants assert that their

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[17] This is calculated as follows: $127,934 x ($491,829/($3,496,773 + $491,829)).

[18] In support, appellants provided an explanation from their tax representative and appellant-husband's partner income statement from CMG for the year ending December 31, 2003. (App. Addl. Br., Atth.)

[19] Appellants provided documentation showing that ALMD was given credit for $74,927 in the capital account balance. Appellants also provided a letter from CMG indicating that $70,093 was deducted from the proceeds that ALMD received from the sale and merger, which was the balance of the initial capital contribution owed by ALMD to CMG for its partnership interest. (App. Addl. Br., Atths.)

[20] In support, appellants provided a document titled "Inside/Outside Tax Basis & Partnerships." (App. Addl. Br., Atth.)

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

gain should be the amount received upon the dissolution of the partnership less the amount of appellant-husband's partnership interest and his outside basis. Appellants contend that, since outside basis is calculated at the partnership level, appellant-husband still maintained that value as an asset and, unlike his book value, appellants should be entitled to claim that asset upon the dissolution of CMG. Appellants state that they are willing to settle this appeal based on the allowance of the additional basis of $452,000. (App. Addl. Br., pp. 1-2.)

Respondent's Additional Brief

Respondent notes that appellants have not contested respondent's calculations as to the amount realized from the sale of assets pursuant to the merger. Respondent notes that appellants' only argument appears to be that respondent improperly determined ALMD's basis in its interest in CMG. Respondent notes that, on Schedule D of its tax return, ALMD reported its basis in its share of the assets sold in the merger as $1,097,750. Respondent notes that appellants contend that ALMD should be allowed a basis of $145,020 attributable to the cash contributions made to CMG, $452,000 attributable to the value of ALMD's patient roster contributed to CMG in 2003, and $500,516 attributable to the retained earnings reported on ALMD's Schedule L balance sheet at year end 2007.[21] (Resp. Addl. Br., pp. 1-3.)

As to the $145,020 in claimed basis attributable to cash contributions made to CMG, respondent notes that its hearing officer incorrectly added the claimed $145,020 to the capital account balance of $127,309 reported on the year end capital account balance, allowing ALMD a total basis of $272,329 (i.e., $145,020 + $127,309). Respondent notes that, in its opening brief, it argued that the $145,020 already was reflected in the capital account balance of $127,309 and the correct basis amount was $127,309, and not $272,329. After further review, respondent contends that the correct basis attributable to cash contributions made to CMG should include the $70,093 amount that CMG held back from ALMD's share of the asset sale proceeds because ALMD still owed this amount for its partnership interest. As such, respondent now contends that the correct basis amount is $197,402 (i.e., $127,309 + $70,093). Respondent contends that this adjustment would not make a difference to the

[21] Appellants appear to concede the disallowed amount of $500,516 of claimed basis in their additional brief.

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

additional assessment for the 2006 tax year. Respondent contends that, as the adjustment reflected in the NOA of $825,421 (relating to the flow-through capital gain from ALMD) is less than the corrected adjustment on appeal of $ 949,816 (i.e., $1,019,909 - $70,093),[22] respondent's proposed assessment should be sustained. (Resp. Addl. Br., p. 3-4.)

As to the $452,000 in claimed basis attributable to the value of ALMD's patient roster contributed to CMG, respondent maintains that appellants have not shown that ALMD had a basis in this intangible asset for income tax purposes. Respondent further maintains that appellants have not provided any legal authority to support their assertion that ALMD has a basis in the intangible asset equal to its fair market value, or acquired basis in their CMG partnership interest as a result of contributing the intangible asset. Respondent contends that appellants have not shown that ALMD had any basis in the intangible property described as a patient roster at the time ALMD contributed such property, citing IRC sections 722, 1011, 1012, and 1016. Respondent contends that appellants have not shown that ALMD paid any amount to acquire the intangible property or that the property was self-created to which expenditures could be, and were, capitalized. (Resp. Addl. Br., pp. 4-5.)

Applicable Law

Burden of Proof

The FTB's determination is presumed correct and appellants have the burden of proving it to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.) In the absence of uncontradicted, credible, competent, and relevant evidence showing an error in the FTB's determinations, respondent's determinations will be upheld. (*Appeal of Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.)

Taxation of Partners in a Partnership

As incorporated by R&TC section 17851, IRC sections 701 to 761 (Subchapter K) govern the taxation of partners in partnerships in California. Generally, partners are required to include in their income, their distributive shares of items of income of the partnership, including capital gains and losses recognized by the partnership from the sale or exchange of capital assets. (Int.Rev. Code,

[22] $1,109,909 represents the additional capital gain calculated by respondent on appeal related to the sale of CMG (see footnote 14). $70,093 represents appellants' additional basis as recognized by respondent.

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STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

§ 702.)

As relevant to this appeal, in the case of a distribution by a partnership to a partner, gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution. (Int.Rev.Code, § 731(a)(1).) Any gain recognized under IRC section 731(a) shall be considered as a gain from the sale or exchange of the partnership interest of the distributee partner. (Int.Rev. Code, § 731(a).) In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. (Int.Rev.Code, § 741.) Generally, such gain or loss shall be characterized as a gain or loss from the sale or exchange of a capital asset. (*Id.*)

As relevant to this appeal, IRC section 705 provides that the adjusted basis of a partner's interest in a partnership is his original basis as determined under IRC section 722 increased by (1) the amount of money and the partner's basis in property subsequently contributed to the partnership and (2) the partner's distributable share of the income of the partnership and decreased (but not below zero) by (1) the amount of money and the partnership's adjusted basis in property distributed to the partner in a nonliquidating distribution to the partner and (2) his distributable share of partnership losses and expenditures. (Int.Rev. Code, §§ 705(a), 722, 732(a).) The outside basis of a partner who obtains an interest in a partnership by contributions to the partnership is equal to the amount of money contributed plus his adjusted basis in any property contributed, increased by the amount, if any, of the gain recognized at such time. (Int.Rev. Code, § 722; Treas. Reg. § 1.722-1.)

A partnership shall be considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. (Int.Rev. Code, § 708(b)(1)(A); Treas. Reg. § 1.708-1(b)(1).)

If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership the members of which own an interest of more than 50 percent in the capital and profits of the resulting partnership. (Treas. Reg. § 1.708-1(c)(1).) Under the "assets-over form," the merged or consolidated partnership considered terminated contributes all of its assets and liabilities to the resulting partnership in exchange for an interest in the resulting partnership. (Treas. Reg. § 1.708-1(c)(3).) Immediately thereafter, the

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

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terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminated partnership. (*Id*.) In this situation, a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership that occurs as part of a merger or consolidation will be respected as a sale of a partnership interest if: (1) the merger agreement (or another document) specifies that (a) the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and (b) the consideration that is transferred for each interest sold; and (2) the selling partner in the terminated partnership, either prior to or contemporaneous with the transaction, consents to treat the transaction as a sale of the partnership interest. (Treas. Reg. § 1.708-1(c)(4).)

"Sale of a Going Business" Doctrine

The "sale of a going business" doctrine provides that, for income tax purposes, the sale of a partnership interest in a going concern is treated as the sale of a capital asset and gives rise to a capital gain. (*Hatch's Estate v. Comm'r*, *supra*, 198 F.2d at 32.) In considering whether a taxpayer sold separate assets of the business (which would be subject to tax as ordinary income) versus the sale of a capital asset which would be subject to tax as capital gain, the Ninth Circuit Court of Appeals indicated that the form and steps used in their relation to the intended and accomplished entire transaction must be considered. (*Id*. at p. 28.)

Installment Sale

IRC section 453(a) provides that, generally income from an installment sale shall be taken into account for purposes of this title under the installment method. IRC section 453(b)(1) defines "installment sale" to mean "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs."

Taxation of Shareholders of an S Corporation

As incorporated by R&TC section 17087.5, IRC sections 1361 to 1379 (Subchapter S) govern the taxation of S corporations in California. IRC section 1366 generally provides that items of income, loss, deduction, or credit will be passed through on a pro rata basis from an S corporation to its shareholders and non-separately stated income or loss. S corporation shareholders are also required to recognize gain or loss on the sale or exchange of the corporation's capital assets.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

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Gain from Sale - Basis

IRC section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in IRC section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. Generally, the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. (Int.Rev. Code, § 1001(b).)

IRC section 1011 provides generally that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (as determined under IRC section 1012) and adjusted (as provided in IRC section 1016). IRC section 1012 generally provides that the basis of property shall be the cost of such property. IRC section 1016 generally provides that the proper adjustments of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made for taxes or other carrying charges or circulation expenditures for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years.

STAFF COMMENTS

Appellant-husband and appellant-wife own, respectively, 90 and 10 percent interests in ALMD, an S corporation. Appellants are required to include in their income their pro rata shares of ALMD's items of income and deductions, including any capital gains or losses recognized by ALMD as a result of the sale of ALMD's interests. (Int.Rev. Code, § 1366.) ALMD, a partner of CMG, is required to include its distributive share of items of income of the CMG partnership, including capital gains and losses recognized by CMG. (Int.Rev. Code, § 702.) ALMD is also required to recognize gain or loss on the sale of its partnership interest in CMG. (Int.Rev. Code, §§ 731(a), 741, & 1001.)

Respondent determined that appellants underreported the flow-through capital gain which resulted from CMG's sale of assets and merger and ALMD's sale of its interest in CMG. According to the 2006 NOA, respondent proposed to increase appellants' taxable income by $847,205, which was comprised of (1) $825,421 flow-through capital gain from the ALMD as a result of the

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

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CMG sale; and (2) $21,784 flow-through income from ALMD as a result of other income.[23] According to the 2007 NPA and affirmed by the 2007 NOA, respondent proposed to increase appellants' taxable income by $103,947, which was comprised of (1) an adjustment of $98,063 (i.e., $40,002 + $58,061) flow-through capital gain from the ALMD as a result of the CMG sale; and (2) an adjustment of $5,884 of disallowed itemized deductions.[24]

The parties do not appear to contest respondent's calculation of the amount that ALMD realized from the sale of assets pursuant to the merger. According to respondent's calculations, ALMD realized $3,496,773 (i.e., $3,426,680 + $70,093) in 2006[25] and $491,829 (i.e., $343,118 + 148,711) in 2007 from the CMG's sale of assets and ALMD's sale of its interest in CMG.

However, the parties dispute ALMD's adjusted basis in CMG. Appellants contend that ALMD's basis in CMG should be $1,097,536 based on the following: (1) $145,020 in cash contributions to CMG; (2) $452,000 in value based on ALMD's patient roster contributed to CMG; and (3) $500,516 in retained earnings as reported on ALMD's 2006 tax return.

Generally, the adjusted basis of a partner's interest in a partnership is the original contribution (net of liabilities) made to the partnership, increased by the sum of its distributive share of partnership income for the taxable year and prior taxable years, and decreased by distributions by the partnership. (Int.Rev. Code, § 705.) The basis of a partner's interest in a partnership is equal to the money and the adjusted basis of any property that the partner contributes to the partnership, increased by the amount, if any, of the gain recognized at such time. (Int.Rev. Code, § 722.)

With regard to the claimed additional basis of $145,020 attributable to ALMD's contribution to CMG's capital, at audit respondent initially allowed only $74,927 of the claimed $145,020, as reflected in the capital account balance shown on ALMD's 2006 Schedule K-1 from CMG. During protest, respondent allowed the entire $145,020 amount. It appears that respondent's

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[23] It appears that the adjustment for $21,784 of other income is not at issue in this appeal.

[24] It appears that the parties do not dispute the adjustment of $5,884 for the disallowed itemized deductions.

[25] It appears that $148,567 of the $3,496,773 received by ALMD in 2006 was attributable to the sale of ALMD's interest in CMG.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

protest officer incorrectly added this amount to the capital account balance of $127,309, for a total of $272,329, when the capital account balance of $127,309 already should have included the $74,927 contribution. On appeal, respondent originally contended that appellants were not entitled to the $70,093 additional basis, but now agrees that the remaining $70,093 should also be added to ALMD's basis because this amount was subtracted from CMG's payment to ALMD and this amount was not reflected in the capital account balance. As such, it appears that ALMD had a basis of $197,402 (i.e., $127,309 + $70,093) attributable to cash contributions.

With regard to the claimed additional basis of $452,000 attributable to ALMD's contribution of a patient roster to CMG, when ALMD became a partner in CMG in 2003, appellants should be prepared to provide evidence which demonstrates that ALMD incurred capitalized costs in acquiring or creating the patient roster pursuant to IRC sections 1012 and 1016. With regard to the claimed additional basis of $500,016 attributable to ALMD's retained earnings, appellants should be prepared to show how ALMD's retained earnings are related to its basis in CMG. It does not appear that ALMD contributed the retained earnings to CMG.

It appears that the adjustment to income for ALMD and appellants for the 2006 tax year as a result of the flow-through capital gain from ALMD due to the CMG sale should have been $949,816 (i.e., $1,019,909 (respondent's calculations in its opening brief) - $70,093 (additional basis)), which is greater than the adjustment of $825,421 reflected in the NOA for the 2006 tax year. It appears that appellants have benefited from $124,395 (i.e., $949,816 – $825,421) not being included in the proposed adjustment to the 2006 tax year.

It appears to staff that as ALMD's adjusted basis in CMG was fully used in 2006, ALMD had no additional basis to be used against the proceeds it received in 2007, pursuant to IRC sections 705 and 731. With regard to the 2007 tax year, ALMD received $491,829 from CMG for its share of the contingent payments. On its 2007 tax return, ALMD reported capital gains of $364,136. It appears to staff that the difference of $127,693 (i.e., $491,829 - $364,136) should be included as an adjustment to ALMD's income.

ALMD also reported a $17,743 loss as a distributive share item from CMG. It appears that, as CMG was terminated in 2006 pursuant to IRC section 708, CMG should not have filed a 2007

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

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partnership return. It appears that the $17,743 loss reported on ALMD's 2007 Schedule K-1 from CMG and on appellants' 2007 Schedule K-1 from ALMD should not have been reported as a distributive share item. However, appellants may want to provide evidence demonstrating that this $17,743 expense could be added to the basis of the installment obligations, which would reduce the gain on the receipt of the contingent payments.

In addition, respondent indicates that a reduction for the $2,119 related to investment interest from CMG is required because that amount already was included in the contingent sale proceeds. Appellants may want to address whether this amount was included in the contingent sale proceeds.

As such, it appears that the adjustment to income for the flow-through capital gain from ALMD for the 2007 tax year as a result of the CMG sale should have been $143,317 (i.e., $127,693 + $17,743 – $2,119), which is greater than the adjustment of $98,063 affirmed by the NOA for the 2007 tax year. It appears to staff that appellants received the benefit of $45,254 not being included in the proposed adjustment for the 2007 tax year.

The parties should also be prepared to discuss respondent's alternative characterization of the sale of assets and merger as the sale of CMG partner's interests in CMG according to the "sale of a going business" doctrine and whether it would have any impact on the proposed adjustments. According to respondent's calculations, if the sale is treated as wholly a sale of the interests in CMG, approximately $15,775 of ALMD's basis[26] in its interest in CMG would have been recovered in the 2007 year, instead of the 2006 year, reducing the gain in 2007 of that amount, and increasing the gain in 2006 of that amount. It appears that the reduction of the 2007 tax year adjustment of $143,317 by $15,775 would still result in a deficiency greater than the adjustment of $98,063 affirmed by the 2007 NOA. It appears that this result would still hold if appellants were allowed the loss of $17,743, reported as a 2007 CMG distributive share item. Respondent should be prepared to discuss and explain these calculations.

If either party has any additional evidence to present, they should provide their evidence

[26] $127,934 x ($491,829/($3,496,773 + $491,829)).

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL

to the Board Proceedings Division at least 14 days prior to the oral hearing pursuant to California Code of Regulations, title 18, section 5523.6.[27]

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[27] Evidence exhibits should be sent to: Khaaliq Abd'Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.

STATE BOARD OF EQUALIZATION
PERSONAL INCOME TAX APPEAL