

1 William J. Stafford
Tax Counsel III
2 Board of Equalization, Appeals Division
450 N Street, MIC: 85
3 P.O. Box 942879
Sacramento, CA 95814
4 Tel: (916) 206-0166
5 Fax: (916) 324-2618

6 Attorney for the Appeals Division

7 **BOARD OF EQUALIZATION**
8 **STATE OF CALIFORNIA**

9
10 In the Matter of the Appeal of:) **HEARING SUMMARY**
11) **PERSONAL INCOME TAX APPEAL**
12 **CATHERINE A. ZIKAKIS¹**) Case No. 767950
13)

14
15 Year Additional Tax
16 2006 \$115,213

17 Representing the Parties:

18 For Appellant: Donald Segretti, Esq.
19 For Franchise Tax Board: Judy F. Hirano, Tax Counsel III
20

21 QUESTION: Whether appellant has shown that the Franchise Tax Board (FTB) erred in its
22 determination that gain from the sale of real property should be included in appellant's
23 taxable income.

24 ///
25 ///
26 ///

27 _____
28 ¹ Appellant lists an address in Orange County, California.

1 HEARING SUMMARY

2 Background

3 Appellant held title to commercial real property located in Santa Ana, California. (App.
4 Reply Br., pp. 3-4.) On January 23, 2006, a purchase agreement was executed to sell the real property
5 for \$1,890,000. (*Id.*, p. 2.) Even though appellant held title to the real property as an individual, the
6 agreement listed the seller as “A to Z Wholesale Floral Supply by Catherine Zikakis, Owner.” (*Id.*)
7 A to Z Wholesale Floral Supply, Inc. (hereinafter the “corporation”) is appellant’s wholly-owned
8 corporation, under which appellant operated a wholesale floral supply business. (*Id.*)

9 Later, an amended agreement was executed in May of 2006, increasing the selling price
10 to \$1,900,000. (*Id.*, p. 3.) The amended agreement stated that (i) escrow was to close on October 2,
11 2006, (ii) the buyer was to deliver to the escrow holder a deposit check of \$100,000 that would be
12 applied toward the purchase price, and (iii) the escrow holder was to release the deposit amount to the
13 seller upon expiration of various contingencies. (*Id.*) The amended agreement also listed the seller as
14 “A to Z Wholesale Floral Supply, Inc. by Catherine A. Zikakis, Owner.” (*Id.*)

15 On June 8, 2006, the escrow holder issued a check for \$100,000 to appellant in her
16 individual name, Catherine Zikakis, as a release of the deposit. (*Id.*) Appellant deposited the check
17 into her personal bank account on June 12, 2006; thereafter, appellant immediately withdrew the
18 deposit funds and deposited them into the bank account of the corporation that same day. (App. Supp.
19 Br., p. 2.) On the day of closing, October 2, 2006, appellant transferred the property to the corporation.
20 The corporation immediately transferred the property to the named purchaser and received the balance
21 of the purchase price. (*Id.*, p. 2; FTB Reply Br., p. 4.) Appellant did not report the gross sales proceeds
22 on her individual income tax return. (FTB Reply Br., p. 5; FTB opening brief (FTB OB), Ex. S.)
23 Instead, the corporation reported the gross sales proceeds on its corporate income tax return and offset
24 those gross sales proceeds, in part, with a net operating loss carried over from prior tax years. (FTB
25 Reply Br., p. 6; FTB opening brief (FTB OB), Ex. N.)

26 During audit, the FTB determined that appellant transferred the property to the
27 corporation solely to utilize the corporation’s net operating loss carryover balance and, thus, the
28 transfer of the property to the corporation did not have a valid non-tax business purpose. (FTB OB,

1 Exs. W & Y.) Accordingly, the FTB determined that appellant (rather than the corporation) must
2 report the proceeds from the sale. (*Id.*) Based on the foregoing, the FTB issued a Notice of Proposed
3 Assessment (NPA) dated October 8, 2010. (FTB OB, Ex. AA.) The NPA proposed an additional tax
4 of \$115,213.00, plus interest of \$14,328.62. (*Id.*)

5 Subsequently, appellant filed a timely protest, asserting that her transfer of the property
6 to the corporation had valid non-tax business purposes. (FTB OB, Ex. BB.) However, after reviewing
7 the matter, the FTB affirmed the NPA in a Notice of Action (NOA) dated August 26, 2013. (*Id.*, Ex.
8 DD.) The NOA proposed additional tax of \$115,213.00, plus interest of \$27,530.95.² (*Id.*) In
9 response, appellant filed this timely appeal. (*Id.*, p. 9.)

10 Contentions

11 Appeal Letter

12 Appellant's Declaration

13 Appellant provides a declaration dated December 4, 2010, in which she sets forth the
14 following narrative chronology: She was born in 1942, is a high school graduate, and has no college,
15 tax, or formal business education. (*Id.*, p., 1.) For the past 25 years, she has owned and operated a
16 wholesale floral supply business named A to Z Wholesale Floral Supply, Inc., which was located on
17 Saint Gertrude Place in Santa Ana, California (which is the location of the real property at issue) until
18 October of 2006. (*Id.*) Her business is now located along McFadden Avenue in Santa Ana, California.
19 (*Id.*) For the past 25 years, her personal tax returns and those for her business always were prepared by
20 a certified public accountant (CPA) named John Gustavson. Her CPA was always very careful with the
21 preparation of her tax returns, and she never had a tax audit until the matter at hand. (Appeal Letter
22 (AL), Ex. B, pp. 1-2.)

23 She further states that the loan for the real property was in her name originally and in the
24 name of the corporation as a co-borrower. Over the years there were at least two refinancing
25 transactions, and in one of those transactions the corporation may have been dropped as a co-borrower.
26 She preferred to have the loan and the real property in the name of her corporation, but the loan on the
27

28 ² The NOA states that the FTB suspended interest pursuant to the time period reflected in Revenue and Taxation (R&TC) section 19116.

1 real property was in her name as no lender would make the loan to the corporation solely. (*Id.*, p. 2.)
2 She states that from approximately tax year 2000, she contemplated selling her business with the real
3 property for a number of personal and business reasons, namely (i) she was getting older and wanted to
4 retire, and (ii) her business was marginally profitable and had little working capital. (*Id.*, p. 3.)

5 She states that in March of 2004 she listed the corporation for sale with Sunbelt
6 Business Brokers and that she informed her broker that she would prefer to sell the business with the
7 real property. (*Id.*) Her broker received an offer in April of 2004 for the sale of the business and real
8 property. (*Id.*) Neither that offer nor other offers resulted in sales, because the corporation's financial
9 statements were not strong enough to support a price that appellant believed was equitable after paying
10 the debt. (*Id.*)

11 She states that around late 2005 she began thinking about how to improve her business
12 in order to sell it and that two of her primary goals were (i) to improve the financial statements of the
13 business, and (i) to bundle both the business and the real property for sale together. (*Id.*, pp. 3-4.)
14 However, the agreement with the lender placed several severe restrictions on any sale or transfer of the
15 property. (*Id.*, p. 4.) Among these restrictions, she had a "one-time transfer right" but only upon
16 payment of a transfer fee equal to two percent of the outstanding principal balance of the loan at the
17 time of transfer; and she asserts that the transfer fee in 2006 would have amounted to \$17,000. (*Id.*) In
18 addition, there was a problem with a "due on sale" provision and a prepayment penalty of five percent
19 of the principal prepaid. (*Id.*) In addition, for the initial 24 months of the loan term she was not
20 permitted to prepay the note due to a "lock-in" provision. (*Id.*) But for these severe loan restrictions,
21 she would have transferred the real property to the corporation prior to or during 2004. (*Id.*)

22 She asserts that her business continued to languish during 2005 and finally in late
23 December of 2005 or early January of 2006, she asked a real estate broker to sell both the real property
24 and her business. (*Id.*, p. 5.) She states that much sooner than expected, on January 23, 2006, she
25 received an offer for the real property but not the business. Although she requested that the \$100,000
26 deposit be issued in the corporation's name, it was made out in error to her as an individual. (*Id.*)
27 These circumstances occurred while appellant was out of the state for a period of time after the death of
28 her mother. (*Id.*) She contends that she made a "pass through" deposit of the \$100,000 deposit from

1 her account to the corporation's account. (*Id.*, pp. 5-6.)

2 She states that she discussed the sale with her CPA, Mr. Gustavson, and he repeated his
3 advice for her to transfer the real property to her corporation after the "lock out" date passed (which
4 appellant asserts was September 24, 2006) and to sell the real property through her corporation and to
5 sell her business as well. (*Id.*, p. 6.)

6 She states that she followed her CPA's advice and transferred the real property to the
7 corporation. (*Id.*) She understood that the real property was to be transferred to allow payment of
8 pressing debts of the corporation, including money owed to appellant by the corporation, as she had not
9 taken a salary for many months because the cash flow of the business was insufficient to manage its
10 debts and "invest in growth." (*Id.*, pp. 6-7.) She contends that she transferred the real property to the
11 corporation for the business reason of having a financially strong corporation that would attract a buyer.
12 (*Id.*, p. 7.)

13 She states that as a result of the sale, she was able to improve substantially the balance
14 sheet of the corporation in anticipation of selling the corporation and taking the corporation out of
15 insolvency. (*Id.*) She asserts that the business now has an operating profit. (*Id.*) She states that the
16 transaction at issue was never hidden and was fully disclosed on the corporation's tax return. (*Id.*, pp.
17 7-8.)

18 As supporting evidence, appellant provides the following documents: (1) a copy of a
19 letter dated March 8, 2004, from Steve Thomson, a broker at Sunbelt Business Brokers, located in
20 Irvine, California; (2) a letter dated April 12, 2004, titled "Letter of Offer for A to Z Wholesale Floral
21 Supply Inc."; (3) an undated agreement (that was not signed by the seller, but was signed by a potential
22 buyer on April 12, 2004, titled "Purchase Agreement for Business Assets"; (4) a deposit check dated
23 April 12, 2004, for \$10,000 that is addressed to "Sunbelt Business Broker Trust Account"; (5) a letter
24 dated April 23, 2006, from appellant's current representative, Donald Segretti, who discusses, in part,
25 the corporation's financials and lender restrictions on the sale of the real property; (6) a copy of the
26 amended purchase agreement dated May 17, 2006; (7) corporate board minutes dated September 29,
27 2006; (8) earning/deposit statements; and (9) a letter dated May 2, 2007, from appellant to the County
28 of Orange, Office of Assessor. (AL, Ex. B, and exhibits attached thereto.)

1 Valid business purposes

2 Appellant contends that so long as a transaction has a valid non-tax business purpose,
3 the transaction will be sustained without being a taxable event, citing *Bondy v. Commissioner*
4 (4th Cir. 1959) 269 F.2d 463, 465. In addition, appellant cites *Commissioner v. Neustadt's Trust* (2nd
5 Cir. 1942) 131 F.2d 528, and states that the court therein allowed as a valid business purpose the
6 strengthening of the financial condition or structure of a corporation. Appellant also cites *Estelle*
7 *Pardee Erdman v. Commissioner*, 1946 Tax. Ct. Memo. LEXIS 279; 5 T.C.M. (CCH) 63; T.C.M.
8 (RIA) 46038 for the same proposition. (AL, Ex. C, p. 1-2.) As for the current appeal, appellant asserts
9 that the applicable non-tax business purposes were (i) to bundle the real property and the business
10 together to sell as a unit, (ii) to strengthen the financial condition and structure of the corporation to
11 prepare it for sale, and (iii) to rehabilitate what was essentially an insolvent corporation by repayment
12 of some of its officer loans and other pressing debts. (*Id.*, p. 2.)

13 Appellant argues that since the tax year 2000 she contemplated having the real property
14 transferred to the corporation but loan restrictions prevented the transfer. (AL, Ex. C, pp. 2-3.) She
15 contends that on the advice of her long-standing CPA, she sought to transfer the real property as soon
16 as the “lock out” provisions on the loan expired. (*Id.*) She also contends that transferring the real
17 property earlier would not only have triggered a due-on-sale provision, but also would have triggered
18 large transaction costs which neither appellant nor the corporation could have paid without a sale. (*Id.*,
19 p. 3.)

20 Next, appellant asserts (i) the entire transaction must be considered in the context of her
21 intent to transfer the real property to the corporation several years earlier as part of her business plan,
22 (ii) the sale of the real property was negotiated with the corporation in mind as the seller, and (iii) the
23 initial down payment of \$100,000 was passed through to the corporation. (AL, Ex. C., p. 3.)

24 Also, appellant asserts that “the goal of shoring up the corporation to allow it to grow
25 with an operating profit has come about”—and appellant asserts that such circumstances will make the
26 business an attractive investment to future potential buyers. (AL, Ex. C, p. 4.)

27 Finally, appellant asserts, in a general manner, that the transfer of the real property to the
28 corporation was not a conduit to avoid taxes; and she contends that she did not realistically “cash out”

1 on the gain inherent in the property when it was transferred and, thus, no tax should be assessed, citing
2 *Smalley v. Commissioner*, T.C. Memo. 1973-85. (AL, Ex. D, p. 2.)

3 **The FTB's Opening Brief**

4 Substance-Over-Form Doctrine

5 The FTB asserts that when appellant signed the agreement and received the earnest
6 money deposit, she was the true seller of the property and her subsequent transfer of the property to her
7 wholly-owned corporation should be disregarded for tax purposes under the substance-over-form
8 doctrine, citing *Commissioner v. Court Holding Co.* (1945) 324 U.S. 331; *Palmer v. Commissioner*
9 (1965) 44 T.C. 92, aff'd, (1st Cir. 1965) 354 F.2d 974; *Appeal of Brookfield Manor, Inc.*, 89-SBE-002,
10 Jan. 11, 1989.³

11 The FTB cites *Commissioner v. Court Holding Co.*, *supra*, in which a corporation held
12 legal title to real property, entered into negotiations for the sale of the property, and reached an oral
13 agreement on terms and condition of the sale with the buyers. The corporation subsequently learned,
14 however, that it would incur a large amount of income tax on the sale and decided to liquidate its
15 assets, including the property, to the shareholders who then surrendered their stock. Thereafter, a sale
16 contract was executed with one of the buyers which named the shareholders as the sellers of the
17 property and included substantially the same terms and conditions agreed to by the corporation. A sum
18 previously paid to the corporation was also applied toward the purchase price and the property was sold
19 three days later.

20 The FTB states that upon reviewing the matter, the Supreme Court found that the
21 liquidation and transfer of legal title to the shareholders were "mere formalities" to avoid tax liability
22 and, thus, held that the gain was attributable to the corporation. The FTB also quotes a portion of the
23 holding in which the Court stated that "[t]he incidence of a taxation depends upon the substance of a
24 transaction [which] must be viewed as a whole, and each step, from the commencement of the
25 negotiations to the consummation of the sale, is relevant." Similarly, the FTB concludes that the
26 transfer of title by appellant to the corporation was "a mere formalism to avoid tax liability" because
27

28 ³ Board of Equalization cases are generally available for viewing on the Board's website (www.boe.ca.gov).

1 “the executed sale was, in substance, a sale by appellant. (FTB OB, pp. 9-10.)

2 The FTB also cites *Palmer v. Commissioner, supra*, in which a company was in debt and
3 losing money and when the creditor requested collateral, the shareholders mortgaged real property to
4 which they held title. They then decided to sell the property and use the proceeds to reduce the
5 company’s debt. The shareholders entered into a contract of sale and received an earnest money
6 deposit. They transferred the property to the company which sold the property to the buyer. The FTB
7 states that the court found that the sale of the property occurred before the transfer to the company so
8 the gain was attributable to the shareholders. The FTB asserts that the facts presented here similarly
9 indicate that appellant sold the property before she transferred it to the corporation. (FTB OB, pp.
10 10-11.)

11 Finally, the FTB cites *Appeal of Brookfield Manor, supra*, in which the FTB asserts the
12 Board has applied the substance-over-form doctrine to facts similar to those presented in this appeal. In
13 *Brookfield Manor*, a corporation owned mobile home park real property and entered into negotiations
14 for a like-kind exchange under IRC section 1031 with a third party and opened escrow. A few weeks
15 later the shareholders’ names were substituted for the corporation in the escrow instructions. Two
16 weeks later the corporation adopted a liquidation plan and then distributed the mobile home park to the
17 shareholders with each holding a proportionate interest in the property. The corporation was dissolved
18 and the exchange occurred about a week later. The FTB states that the Board found that the facts in
19 *Brookfield Manor* were similar to the facts in *Commissioner v. Court Holding Co., supra*, in that the
20 corporation negotiated the exchange with the third party and the exchange occurred under substantially
21 the same terms to which the corporation had agreed. The FTB also asserts that the Board found no
22 evidence the shareholders were involved in the negotiations and the exchange occurred a short time
23 after the negotiations. In the current appeal, the FTB argues that (i) appellant negotiated for the sale of
24 the subject property, (ii) there is no evidence appellant’s corporation was involved in the negotiations,
25 and (iii) the sales transaction was closed on substantially the same terms and conditions as originally
26 agreed upon. (FTB OB, p. 12.)

27 Sham Transaction Doctrine

28 The FTB asserts that appellant transferred the property to the corporation solely to take

1 advantage of the corporation's net operating loss carryover balance and, thus, the transfer of the
2 property to the corporation did not have a valid non-tax business purpose and, accordingly, should be
3 disregarded as lacking economic substance, citing *Coltec Industries, Inc. v. United States* (Fed. Cir.
4 2006) 454 F.3d 1340, 1356; *Higgins v. Smith* (1940) 308 U.S. 473, 477; *Gregory v. Helvering* (1935)
5 293 U.S. 464.) (FTB OB, pp. 12-20.)

6 In discussing the issue of economic substance, the FTB contends that if the form
7 employed for doing business or carrying out the challenged tax event is unreal or a sham, then the
8 government may disregard the effect of the fiction as best serves the purpose of the tax statute. (Citing
9 *Higgins v. Smith, supra*, at 477 and *Gregory v. Helvering, supra*, at 469-470.) (FTB OB, p. 13.)

10 In relation to appellant's argument that she relied upon the advice of her CPA, the FTB
11 asserts that given the CPA's extensive experience of having prepared returns for over 25 years, the
12 CPA undoubtedly knew that selling the appreciated property through the corporation would offset the
13 gross sales proceeds, appellant would avoid a substantial amount of individual tax on the gain and that
14 the CPA would have communicated that tax benefit to appellant. The FTB also asserts that the CPA
15 knew that the corporation had a net operating loss carryover balance which would substantially offset
16 the capital gain realized by the corporation. The FTB contends that the CPA knew or should have
17 known that this type of transaction has been determined by courts as lacking economic substance. (*Id.*,
18 pp. 13-14.)

19 Next, the FTB asserts that appellant's alleged non-tax business purposes—i.e.,
20 (i) reducing the corporation's debt and (ii) improving the corporation's financial statements by, among
21 other things, establishing a history of paying wages—could have been accomplished if appellant first
22 sold the property herself and then transferred the net proceeds to the corporation. (*Id.*, p. 14.) With
23 respect to appellant's argument that she had contemplated selling the real property and the business as
24 early as 2000, the FTB asserts that in January 2006 appellant entered into negotiations to sell only the
25 real property in September or October 2006 and, thus, at that point she had no valid and objective
26 business purpose to sell the business and real property when she transferred it to the corporation two
27 days before the sale. (*Id.*, p. 15.)

28 Next, in relation to appellant's assertion in her declaration that as a result of the sale her

1 business has been strengthened and is now showing an operating profit, the FTB asserts that the
2 evidence in the appeal record does not show that the corporation had an operating profit after the fiscal
3 year ending June 30, 2007. For that fiscal year, the FTB notes that the corporation incurred only the
4 minimum franchise tax of \$800 after application of the net operating loss carryover deduction and
5 enterprise zone tax credits. However, the FTB states that for fiscal years ending June 30, 2008 through
6 June 30, 2011, the corporation reported net losses before state adjustments. (*Id.*, pp. 15-16.)

7 Also, the FTB asserts that any alleged positive effect on the corporation's financial
8 condition as a result of the sale was merely transitory, as appellant reaped personal benefits from the
9 sale in the form of wages of \$200,000 and a bonus of \$180,000, citing *Hallowell v. Commissioner*
10 (1971) 56 T.C. 600. (FTB OB, pp. 16-17.) In *Hallowell*, the taxpayer transferred, over three years,
11 appreciated IBM stock to a family-controlled corporation, which sold the stock and reported the gain.
12 (*Id.*, 601-604.) During those three years, the corporation made distributions to the taxpayer and his
13 wife in approximately the same amounts as the capital gain from the stock sales. (*Id.*) In analyzing the
14 transaction, the Tax Court held that the stock sales, in substance, were made by the taxpayer and the
15 corporation was merely a conduit to that end. (*Id.*, at 607.) Citing *Hallowell*, the FTB asserts that
16 appellants failed to establish a valid business purpose because any alleged positive effect on the
17 corporation's financial condition as a result of the sale was merely transitory. (FTB OB, p. 17.) In
18 addition, the FTB asserts that, from a reading of appellant's declaration, it is clear that she had the
19 intent of benefiting personally from the transfer and sale, as she expressly indicated that part of the
20 proceeds would be used to pay corporate debts that were owed to her. (*Id.*)

21 Next, the FTB notes that appellant cites *Smalley v. Commissioner, supra*, in support of
22 her argument that her transfer of the property to her wholly-owned corporation served valid non-tax
23 business purposes—i.e., allegedly to (i) to reduce indebtedness of the corporation, and (ii) to improve
24 the corporation's financial statements. (FTB OB, p. 19.) The FTB first discusses the facts of *Smalley*
25 and then attempts to distinguish those facts from appellant's circumstances. The FTB notes that in
26 *Smalley* the Tax Court held that gain from the sale by a controlled corporation of securities transferred
27 to it in exchange for corporate stock properly was attributable to the corporation because the taxpayer
28 established two sufficient non-tax reasons for the transfer: a third-party creditor of the corporation

1 strongly advocated the transfer; and the taxpayer believed it was necessary to do so to strengthen the
2 corporation's balance sheet to facilitate ongoing negotiations for the sale of the business. (*Id.*) In
3 comparison to the facts in *Smalley*, the FTB asserts that appellant provided no evidence indicating that
4 any third-party lender advocated that the corporation reduce its indebtedness. The FTB also asserts
5 that, unlike the facts in *Smalley*, there is no evidence that appellant was actively negotiating for the sale
6 of her business in 2006 and appellant provided no evidence indicating that the corporation had any
7 potential buyers in 2006. Finally, the FTB asserts that there is no evidence that in 2006 any broker had
8 found a potential buyer or had told her to shore up the corporation's balance sheet to make it more
9 attractive to a potential buyer. (*Id.*, pp. 19-20.)

10 Assignment of Income Doctrine

11 The FTB contends that appellant's interest in her real property ripened into a fixed right
12 to receive income before she transferred the property to her corporation, such that she must report the
13 gross sales proceeds on her individual income tax return under the assignment of income doctrine,
14 citing *Ferguson v. Commissioner* (9th Cir. 1999) 174 F.3d 997, 1003; *Appeal of J.R. and*
15 *Claudia Hengelmann*, 86-SBE-132, July 29, 1986.) (*Id.*, pp. 20-22.)

16 The FTB asserts that the Board recognized and applied the anticipatory assignment of
17 income doctrine in *Appeal of J.R. and Claudia Hengelmann, supra*, in which the appellant had reported
18 only a portion of the wages reported on the Form W-2 because he purported to have sold his "personal
19 services property asset" to another entity. The Board held that "one who earns income cannot avoid
20 taxation by diverting it to another entity, since anticipatory assignment of income is ineffective as a
21 means of avoiding tax liability." (*Id.*, p. 20.)

22 The FTB also asserts that the anticipatory assignment of income doctrine was applied in
23 *Ferguson v. Commissioner* (9th Cir. 1999) 174 F.3d 997, 1003, wherein the court stated that "once a
24 right to receive income has 'ripened' for tax purposes," the taxpayer who earned or created the right,
25 will be taxed on it. As for the facts at hand, the FTB contends that the anticipatory assignment of
26 income doctrine is applicable because "[b]efore appellant transferred the real property to her
27 corporation, the surrounding circumstances indicated the receipt of income from the real property sale
28 was practically certain to occur." (*Id.*, p. 22.)

1 **Appellant’s Reply Brief**

2 Appellant reasserts many of the same contentions she made in her appeal letter (and in
3 her declaration thereto). First, appellant reiterates that since at least 2004 she considered selling the
4 real property and the business as a bundle. (App. Reply Br., p. 2.) Second, she reiterates that she
5 wanted to transfer the real property to the corporation in 2004 but was prevented from doing so by loan
6 agreement provisions and the “lock-out” provisions of the agreement did not expire until September 24,
7 2006. (*Id.*, p. 2-3.) Third, she reiterates that the transaction should be viewed as a whole, with the
8 understanding that the transaction allowed the corporation to become financially solvent. (*Id.*, pp. 3-4.)

9 Appellant cites *Helvering v. Gregory* (2d Cir. 1934) 69 F.2d 809, 810, aff’d, *Gregory v.*
10 *Helvering, supra*, in which the court stated “[a]ny one may so arrange his affairs that his taxes shall be
11 as low as possible; he is not bound to choose that pattern which will best pay the Treasury . . .”⁴ (*Id.*, p.
12 4.) She asserts that the court set forth the principle that if there is a valid non-tax business purpose for a
13 transaction, the transaction should be deemed a non-taxable event. (*Id.*)

14 She further asserts that the real property was not transferred to the corporation before
15 October 2, 2006 because of the loan agreement “lock-out” provisions and that she took “earlier steps”
16 to transfer the property to the corporation by completing the transfer deed on June 21, 2006. She states
17 that she listed the property and the corporation for sale but received an offer only to purchase the
18 property. However, she asserts that the property sale offer did not change “her intent to transfer the real
19 property to the corporation for sale – as that would accomplish making the business (which was not
20 purchased by the buyer) a much more attractive proposition.” (*Id.*, p. 5.)

21 She also asserts that the strengthening of the financial condition of the corporation was a
22 business purpose in itself and the timing of the transfer does not negate that there was a bona fide
23 business purpose. (*Id.*, pp. 5-6.) Finally, she contends that (i) her intent from the beginning was to
24 have the corporation sell the property and (ii) she had given instructions for the deposit check to be
25 issued to the corporation but when she was in New Jersey attending to her severely ill mother, the
26 deposit check mistakenly was issued to appellant in her individual name—Catherine Zikakis. (*Id.*, p.
27

28 ⁴ Although appellant’s reply brief attributes the quote to the United States Supreme Court, the stated language was made by
Judge Learned Hand of the Second Circuit Court of Appeals.

1 6.) Appellant acknowledges that she deposited the check into her personal bank account, but she notes
2 that she immediately withdrew the deposit funds and deposited them into the corporation's bank
3 account. (*Id.*)

4 In support of her assertions, appellant provides a declaration dated February 26, 2014,
5 wherein appellant makes the arguments set forth in her reply brief, as well as the arguments made in her
6 declaration dated December 4, 2010, that was provided with her appeal letter. Appellant also provides
7 (i) a copy of a Grant Deed, recorded on October 2, 2006, and (ii) a checking account statement dated
8 June 30, 2006, for A to Z Wholesale Floral Supply, Inc.

9 **The FTB's Reply Brief**

10 **Substance-Over-Form Doctrine**

11 The FTB notes that appellant was the legal owner of record at the time the purchase
12 agreement was signed and when the deposit was made—thus, the FTB asserts that appellant was the
13 true seller, citing *Commissioner v. Court Holding Co., supra*. (FTB Reply Br., pp. 6-9.) The FTB
14 asserts that the escrow company correctly issued the earnest money deposit check to appellant as an
15 individual because it knew that as of the dates the agreement was signed and the deposit was tendered,
16 appellant was the legal owner/seller of the property. (*Id.*, p. 7.) In addition, the FTB asserts that the
17 following facts further support the conclusion that appellant was the true seller: (i) after appellant
18 transferred the \$100,000 earnest money deposit to the corporation, she then withdrew \$90,000 from the
19 corporation's bank account a week-and-a-half later, and (ii) after appellant conveyed the property to the
20 corporation, the corporation immediately⁵ conveyed the property to the named purchaser. (*Id.*, pp. 7-
21 9.)

22 Next, in relation to appellant's arguments regarding transfer restrictions, the FTB asserts
23 that if appellant wanted to transfer the property to the corporation as soon as possible, then she could
24 have transferred the real property to the corporation some time after September 24, 2006 when the
25 restrictions allegedly expired and she did not have to wait until October 2, 2006. (*Id.*, p. 9.) The FTB
26 asserts that the fact appellant did not transfer the real property until October 2, 2006, indicates that
27

28

⁵ After the FTB submitted its opening brief, the parties clarified that appellant's wholly-owned corporation deeded the property to the named purchaser on the same day that appellant deeded the property to her wholly-owned corporation.

1 appellant did not plan to transfer the real property to the corporation unless the sale was certain to
2 occur. (*Id.*)

3 Sham Transaction Doctrine

4 The FTB reiterates that the transfer of the property to the corporation did not have a
5 valid non-tax business purpose and should be disregarded as lacking economic substance. (*Id.*,
6 pp. 10-12.) With regard to appellant's argument that she wanted to sell the business and real property
7 as a bundle in 2004, the FTB asserts that there are two problems with appellant's argument. First, a
8 letter dated March 8, 2004, from Sunbelt Business Brokers states that the broker would put forth its
9 best efforts to sell the "business" but says nothing about selling the business and the real property
10 together. Second, a draft agreement dated April 12, 2004, titled "Letter of Offer for A to Z Wholesale
11 Floral Supply Inc." does not mention the sale of real property. (*Id.*) The FTB reiterates that appellant's
12 transfer of the property to the corporation was an unnecessary step that was used to take advantage of
13 the corporation's net operating loss carryover balance. (*Id.*, pp. 11-12.)

14 Appellant's Supplemental Brief

15 Appellant reiterates that she wanted to sell the real property and the business as a
16 package deal. (App. Supp. Br., pp. 1-2.) Next, she reiterates that she had given instructions for the
17 deposit check to be issued to the corporation but contrary to her instructions the deposit check
18 mistakenly was issued to appellant in her individual name—Catherine Zikakis. (*Id.*, p. 2.) Appellant
19 acknowledges that she deposited the check into her personal bank account, but she notes that she
20 immediately withdrew the deposit funds and deposited them into the bank account of the corporation.
21 She asserts that the earnest money deposit was a "pass-through" deposit. (*Id.*)

22 She also reiterates that her transfer of the property to the corporation served valid
23 non-tax business purposes, in that the corporation used the net proceeds from the sale of the property
24 (i) to reduce indebtedness of the corporation, and (ii) to improve the corporation's financial statements
25 by, among other things, establishing a history of paying wages. Appellant asserts that each of those
26 purposes would make the corporation more appealing to any potential buyers of the corporation and,
27 thus, the transfer of the property to serve non-tax business purposes. (*Id.*, pp. 2-3.)

28 Next, in response to the FTB's argument that her transfer of the property to the

1 corporation was an unnecessary step, appellant asserts that if she first sold the property as an individual
2 and then contributed the cash to the corporation there would have been either an increase in officer
3 loans (debt) or a recent capital contribution, which appellant contends would have weakened the
4 financial reports of the corporation by reducing the “selling ratios” of the company. (*Id.*, p. 4.)

5 Next, she states that she executed the grant deed to the real property on June 21, 2006,
6 but it was not notarized until September 7, 2006. (*Id.*, p. 5.) She states that she believed the real
7 property was transferred on June 21, 2006. (*Id.*) She states that she is not sure why the grant deed was
8 not notarized until September 7, 2006. (*Id.*) She also states that she left it up to the Escrow Company
9 to do the recording (which was done on October 2, 2006). (*Id.*)

10 She contends that before closing, she provided the escrow company with “amended
11 escrow instructions” dated June 20, 2006, indicating that the seller would be the corporation not
12 appellant. (*Id.*, p. 6.) In support, appellant provides a document titled “Amendment to Escrow
13 Instructions and/or Purchase Contract.” (*Id.*, Ex. N.) The document is dated June 20, 2006, and it is
14 signed by appellant but not by the buyer and states, in part, “[w]hatever duties, obligations and/or
15 benefits imposed within this escrow upon Catherine Zikakis, as Seller are assigned to and assumed by
16 A to Z Wholesale Floral Supply, Inc., a California corporation.” (*Id.*)

17 Applicable Law

18 Substance-Over-Form

19 The substance-over-form doctrine provides that the form of an agreement or transaction
20 does not control its substance. (See *Court Holding Co., supra*; *Appeal of Brookfield Manor, Inc.,*
21 *supra.*) The substance-over-form doctrine was articulated by the U.S. Supreme Court in *Court Holding*
22 *Co., supra*, in which a corporation entered into oral negotiations to sell its real property. (*Id.* at 333.)
23 After the purchaser made a down payment, the controlling shareholders discovered that if the sale was
24 consummated as structured, the corporation would incur a large tax liability. Consequently, the
25 controlling shareholders dissolved the corporation, distributed the property to themselves and then sold
26 the property. The U.S. Supreme Court held that the sale was properly attributable to the corporation
27 observing that:

28 ///

1 ///

2 the transaction must be viewed as a whole, and each step, from the commencement of
3 negotiations to the consummation of the sale, is relevant . . . To permit the true nature of
4 the transaction to be disguised by mere formalisms, which exist solely to alter tax
5 liabilities, would seriously impair the . . . administration of the tax policies of Congress.
(*Court Holding Co.*, *supra*, at 334.)

6 Sham Transaction Doctrine

7 The “sham transaction” doctrine allows the taxing agency to disregard transactions that
8 lack economic substance beyond the creation of tax benefits. (*United States v. Consumer Life Ins. Co.*
9 (1977) 430 U.S. 725, 737; *Gregory v. Helvering*, *supra*; *Knetsch v. United States* (1960) 364 U.S. 361,
10 365.) A taxpayer must show that the transaction:

11 “. . . was not motivated or shaped solely by tax avoidance features that have meaningless
12 labels attached, [but instead] is compelled or encouraged by business or regulatory
13 realities, and has economic substance independent of the apparent tax shelter potential.”
(*Anagnostom v. Commissioner*, T.C. Memo 94-334, citing *Frank Lyon Co. v. United*
14 *States* (1978) 435 U.S. 561.)

15 In *Palmer v. Commissioner*, *supra*, the taxpayers negotiated and entered into a contract
16 to sell real property as individuals and they received an earnest money deposit of \$1,000. (*Palmer*,
17 *supra*, 44 T.C. 92, 93, aff’d, 354 F.2d 974.) Before the sale closed, they transferred the property to
18 their wholly-owned corporation and the corporation transferred the property to the purchasers and
19 received the balance of the purchase price. (*Id.*, p. 94.) The taxpayers argued that the corporation
20 should be treated as the seller and the transaction was not a sham because it served a business purpose.
21 (*Id.*, p. 95.) The Tax Court held that the taxpayers’ arguments regarding “business purpose” were
22 “without force” because the taxpayers signed the agreement and received a deposit, (*Id.*) The Tax Court
23 found that “the presence of the written contract to sell and also the payment of \$1,000 to [taxpayers] as
24 part payment of the purchase price before title was passed to the corporation, practically demands that
25 this be regarded as a sale by [taxpayers] . . .” (*Id.*)

26 In *Smalley v. Commissioner*, *supra*, the Tax Court held that gain from the sale of
27 securities by a controlled corporation (which had been transferred to the corporation in exchange for
28 corporate stock) was attributable to the corporation because the taxpayer established two sufficient

1 non-tax business purposes for the transfer: a third-party creditor of the corporation strongly advocated
2 the transfer and the taxpayer believed the sale was necessary to strengthen the corporation's balance
3 sheet to facilitate ongoing negotiations for the sale of the business. (*Smalley*, T.C. Memo. 1973-85.)

4 Assignment of Income

5 Internal Revenue Code (IRC) section 61 defines gross income as "all income from
6 whatever source derived" including compensation for services. The assignment of income doctrine
7 provides that income is ordinarily taxed to the person who earns it, and that the incidence of income
8 taxation may not be shifted by anticipatory assignments. (*Lucas v. Earl* (1930) 281 U.S. 111, 114-115.)

9 Burden of Proof

10 The FTB's assessment is presumed correct, and a taxpayer has the burden of proving it
11 to be wrong. (*Todd v. McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Ismael R. Manriquez*,
12 79-SBE-077, Nov. 17, 1982.) Unsupported assertions are not sufficient to carry a taxpayer's burden of
13 proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274, Nov. 17, 1982.)

14 STAFF COMMENTS

15 Appellant asserts that her non-tax business purposes for transferring the property to the
16 corporation arose from her intention to bundle the real property and the business together to sell as a
17 unit, to strengthen the financial condition and structure of the corporation to prepare it for sale, and to
18 rehabilitate what was essentially an insolvent corporation by repayment of some of its officer loans and
19 other pressing debts. At the hearing, appellant should be prepared to explain whether she still owns the
20 business and whether she attempted to sell the business after the sale of the property and to provide
21 supporting evidence. In addition, appellant should be prepared to explain whether there were other
22 means of accomplishing the stated purpose of making the corporation solvent, such as converting the
23 shareholder loan to a capital contribution or selling the property and contributing the proceeds to the
24 corporation.

25 In *Smalley v. Commissioner, supra*, the Tax Court held that the sales of securities
26 transferred to a corporation by shareholders was attributable to the corporation because a third-party
27 creditor of the corporation recommended the transfer and the taxpayer believed it was necessary for
28 financial reasons to facilitate ongoing negotiations for the sale of the business. At the hearing,

1 appellant should be prepared to discuss whether there were any other circumstances, such as those
2 found in *Smalley*, indicating a business purpose for the transfer of the property by appellant to the
3 corporation.

4 The FTB contends that the gain on the sale is attributable to appellant based on the
5 assignment of income doctrine because appellant’s right to receive the sale proceeds “ripened” before
6 she transferred the property to the corporation. At the hearing, the FTB should be prepared to cite any
7 legal authority to support the position that a right to receive income “ripens” by entering into a
8 purchase agreement.

9 Additional Evidence

10 If a party has any further evidence that the party wants the Board to consider, then
11 pursuant to California Code of Regulations, title 18, section 5523.6, that party should provide such
12 evidence to the Board Proceedings Division at least 14 days prior to the oral hearing.⁶

13 ///

14 ///

15 ///

16 Zikakis_wjs

17

18

19

20

21

22

23

24

25

26

27

28

⁶ Evidence exhibits should be sent to: Khaaliq A. Abd’Allah, Appeals Analyst, Board Proceedings Division, State Board of Equalization, P.O. Box 942879 MIC:80, Sacramento, California, 94279-0080.