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7 **BOARD OF EQUALIZATION**

8 **STATE OF CALIFORNIA**

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10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **CORPORATION FRANCHISE TAX APPEAL**  
12 **MILLENNIUM DENTAL TECHNOLOGIES,** ) Case No. 747501<sup>1</sup>  
13 **INC.** )  
14

15 Tax Year Proposed  
Ending Assessment  
16 12/31/2008 \$116,445

17 Representing the Parties:

18 For Appellant: Blake E. Christian and Stacy Yamanishi  
Holthouse Carlin & Van Trigt, LLP

20 For Franchise Tax Board: Jaelyn N. Appleby, Tax Counsel

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22 **QUESTIONS:** (1) Whether appellant has shown error in respondent's determination that gross  
23 profits from certain sales are attributable to the 2008 tax year.  
24 (2) Whether appellant's claimed net operating loss (NOL) deductions should be  
25 allowed for 2008.  
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28 <sup>1</sup> This matter was originally scheduled for oral hearing at the Board's June 24-26, 2014 Culver City Board meeting, but was postponed at appellant's request and rescheduled for the Board's October 14-15, 2014 Culver City Board meeting. The matter was again postponed at appellant's request, to allow additional time to prepare, and rescheduled for the Board's February 24-26, 2015 Culver City Board meeting.

1 HEARING SUMMARY

2 Background

3 The transactions at issue in this appeal involve appellant's patented PerioLase© MVP-7  
4 Digital True Pulse™ Laser (PerioLase). Appellant was formed in 1994 (incorporated in 1996) to market  
5 the PerioLase for use in place of a scalpel and sutures in the treatment of gum disease, and currently  
6 manufactures and sells the PerioLase to dental professionals. As part of the sale of the PerioLase,  
7 appellant requires its customers to attend three initial days of mandatory "boot camp" training prior the  
8 delivery of the PerioLase. An additional day of training is provided six months after boot camp, and  
9 another training day is provided one year after boot camp. (Resp. Op. Br., p. 2.)<sup>2</sup> After the boot camp,  
10 the customers are granted a "limited, non-exclusive, non-sublicensable, non-transferrable personal  
11 license" allowing the customers to use the equipment solely in connection with their practice. The  
12 license does not allow customers to train other people in the use of the equipment, treat anyone other  
13 than patients, or use advertising material other than in their practice. The license also provides that the  
14 customers are responsible for their use of the PerioLase, and that they indemnify and hold appellant  
15 harmless against any losses as a result of the customers' use of the equipment. (*Id.* at exhibit A.)  
16 Appellant offers customers a six-month period during which customers can unilaterally rescind the  
17 contract and return the PerioLase if the product does not perform as represented by appellant. (*Id.* at  
18 exhibit B, "Satisfaction Guarantee.") This guaranty policy is only for purchases, not leases, and can be  
19 voided if the customer fails to complete the fourth day of training. (*Ibid.*)

20 Appellant filed a California corporation tax return (Form 100) for the 2008 tax year  
21 within the extended deadline. Appellant reported gross receipts of \$14,053,434 plus interest and other  
22 income of \$34,377, excluded cost of goods sold of \$2,906,688, and reported a total income of  
23 \$11,181,123. Appellant reported deductions of \$11,079,118, net income of \$287,026 after California

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28 <sup>2</sup> Additional information regarding the PerioLase and the training program can be found, generally, on appellant's website:  
<<http://www.lanap.com/periolase.php>>.

1 adjustments,<sup>3</sup> and applied NOL carryover deductions of \$287,026 for a zero taxable income amount.  
2 Appellant reported and paid the \$800 minimum franchise tax plus a \$50 self-assessed underpayment of  
3 estimated tax amount. (Resp. Op. Br., exhibit C.)

4 Respondent thereafter audited appellant's return, and determined that appellant had  
5 incorrectly deferred income from "sales not complete" that occurred in the last 60 days of the year.  
6 Respondent revised appellant's taxable income to include the \$1,039,270 in income from the "sales not  
7 complete" transactions. After this revision, appellant's income exceeded the \$500,000 threshold for  
8 claiming NOL deductions in 2008, and respondent accordingly disallowed the claimed NOL deduction  
9 of \$287,026. Based on the audit results, respondent issued a Notice of Proposed Assessment (NPA) on  
10 June 22, 2012, proposing an additional tax liability of \$116,445.

11 Appellant protested the NPA, arguing that the unique nature of the sales and return policy  
12 employed by appellant creates a situation where customers take "incremental" ownership while  
13 completing five days of training over the course of a year, and that the sale of the equipment, therefore,  
14 is a multiple-step process that does not end with the delivery of the equipment. (Resp. Op. Br.,  
15 exhibit H, pp. 2-4.) Appellant provides five different options for how it could recognize income during  
16 the course of the alleged incremental ownership period, and asserts that income should not be  
17 recognized for sales taking place 60 days from the end of the year, as it reported on its original returns.  
18 Appellant contended that it was not reasonable to require appellant to recognize all income from the sale  
19 at the time of the delivery because the customer could return the unit for a full refund and, therefore,  
20 does not bear the economic risk of loss at that time. (*Ibid.* at p. 4.)

21 Respondent replied to the protest, asserting that the arbitrary deferral of 60 days was a  
22 change in appellant's accounting method from previous years and is not acceptable as it does not  
23 accurately reflect income earned during 2008. (Resp. Op. Br., exhibit I, p. 6; citing Treas. Reg.,  
24 § 1.446-1(1)(ii)(C); Rev. & Tax. Code, § 24651.) Appellant replied, reiterating its assertions in the  
25 protest and referencing its shipping agreement as support that its customers did not have ownership of  
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28 <sup>3</sup> Appellant's deductions of \$11,079,118 applied to total income of \$11,181,123 leaves net income before deductions of \$102,005. This amount is increased by California adjustments of \$800 for amount deducted for foreign or domestic tax based on income or profits and \$184,221 in depreciation and amortization in excess of amounts allowed by state law, for the total net income amount of \$287,026.

1 the laser hardware while it was in transit. Appellant also contended that its multistate apportionment  
2 percentage should be decreased by 20.99 percent. (Resp. Op. Br., exhibit J.) Respondent thereafter  
3 issued a determination letter disagreeing with appellant’s interpretation of the shipping agreement, and  
4 indicating that it was going to affirm its NPA based on its findings that the sale of the PerioLase  
5 equipment was complete as of the time of the shipping, and that appellant was not entitled to change its  
6 method of accounting without prior approval. Respondent’s determination letter stated that appellant  
7 would need to file an amended return to report the claimed apportionment adjustment. (*Id.* at exhibit K.)  
8 Respondent issued a Notice of Action affirming the NPA, and this timely appeal followed.

### 9 Contentions

#### 10 Appellant’s Contentions

11 Appellant asserts that respondent’s position of recognizing all of the income from the sale  
12 up front is not reflective of the PerioLase’s sale cycle. Appellant contends its business is very unique,  
13 noting that it is governed by the United States Food and Drug Administration and requires extensive  
14 training administered by appellant to its customers over the course of 12 months. (App. Reply Br., p. 1.)  
15 Appellant asserts that it should therefore recognize income in a manner consistent with its particular  
16 circumstances and sales cycle, which produces incomplete sales. Appellant contends that the sale of its  
17 products are incomplete because only a *provisional* license to operate the machinery is provided when  
18 the machine is delivered to the customers and after the first three days of training are completed. (*Id.* at  
19 p. 2 [emphasis in original].) Appellant states that customers then have the unilateral right to rescind the  
20 sales contract and return the equipment if the product does not perform as represented by appellant for  
21 six months after delivery. Appellant asserts that the sales process continues during this first six months,  
22 including monthly follow-up calls by the clinical instructor and appellant’s sales representative to ensure  
23 satisfaction with the product and “maximize the probability of clinical and financial success for the  
24 practitioner, and minimize the probability of a ‘return’ of the unit . . . .” (*Id.* at p. 3.) Appellant asserts  
25 the return policy is a very liberal one, and is not a warranty. Appellant contends the completed sale and  
26 licensure culminates on the 12th month, after the fifth and last day of training.

#### 27 Respondent’s Contentions

28 Respondent asserts that appellant is an accrual basis taxpayer, and therefore is not

1 permitted to defer gross profits from equipment sales made during the last sixty days of the taxable year  
2 in accordance with R&TC section 24651 and Treasury Regulation section 1.446-1(c)(1)(II)(A). (Resp.  
3 Op. Br., p. 5.) Respondent asserts that the sales of the PerioLase equipment meets the two-prong test  
4 under the aforementioned Treasury Regulation for the income from the sales to be taxable in the year at  
5 issue because the right to the income was fixed and the income amount could be determined with  
6 reasonable accuracy. Respondent contends that courts have found that a sale is complete when the  
7 buyer assumes the benefits and burdens of ownership. (*Id.* at p. 6; citing *Hallmark Cards, Inc. v.*  
8 *Commissioner* (1988) 90 T.C. 26; *Major Realty Corp. v. Commissioner* (11th Cir.1985) 749 F.2d 1483.)  
9 Respondent asserts that the PerioLase equipment was shipped at the conclusion of the three-day training  
10 course and the shipping terms indicate that title to the equipment was conveyed to the buyer when the  
11 equipment was given to the common carrier for shipment. Respondent contends, therefore, that the “all  
12 events test” was satisfied when the equipment was shipped and the income is includible in appellant’s  
13 2008 gross income. (*Ibid.*)

14 Respondent notes that the Laser Periodontal Therapy License became effective upon  
15 completion of the three-day training, and states that the customer bore all the risks of owning and using  
16 the equipment from that point on. Respondent contends that the fact that the customer was not able to  
17 train other users on the equipment, treat non-patients with the equipment, or use advertising material  
18 outside of their practice has no bearing on the fact that the customers bore full responsibility for the  
19 equipment. Respondent asserts that the six-month warranty is a condition subsequent to the transaction,  
20 and does not impact the accrual of the income earned on the sales shipped in 2008. If there is actual  
21 receipt, respondent further asserts that under the “claim of right” doctrine any contingencies that would  
22 require return of amounts received must be ignored. (Resp. Op. Br., pp. 6-7; citing, e.g., *Western Oaks*  
23 *Building Corp. v. Commissioner* (1968) 49 T.C. 365 and *North American Oil Consol. v. Burnet* (1932)  
24 286 U.S. 417.)

25 Respondent notes that the appeal included the full amount of the proposed assessment,  
26 which includes a disallowed NOL deduction amount. Respondent asserts that R&TC section 24416.9  
27 suspended the allowance of NOLs in California for tax years beginning on or after January 1, 2008, and  
28 before January 1, 2010, for companies with taxable income of \$500,000 or more. Appellant’s original

1 return reported net income before NOLs of \$287,026, and, therefore, was not subject to the NOL  
2 suspension; however, appellant's taxable income under the proposed assessment is \$1,326,296, and,  
3 therefore, appellant is subject to the NOL suspension imposed by R&TC section 24416.9. Respondent  
4 asserts that if the Board finds in its favor on the main issue in this appeal, then it should also affirm the  
5 disallowance of the NOL.

#### 6 Applicable Law

##### 7 Burden of Proof

8 It is well-settled that a presumption of correctness attends respondent's determinations as  
9 to issues of fact and a taxpayer has the burden of proving error in such determinations. (*Appeal of*  
10 *Oscar D. and Agatha E. Seltzer*, 80-SBE-154, Nov. 18, 1980.) This presumption is a rebuttable one and  
11 will support a finding only in the absence of sufficient evidence to the contrary. (*Ibid.*) A taxpayer's  
12 unsupported assertions are not sufficient to satisfy his burden of proof. (*Appeal of James C. and*  
13 *Monablanché A. Walshe*, 75-SBE-073, Oct. 20, 1975.)

##### 14 Income from Sales

15 As described in Treasury Regulation section 1.446-1(c)(1), which interprets and  
16 implements IRC section 446, the two common methods of accounting are the cash and the accrual  
17 methods.<sup>4</sup> Under the accrual method, "income is to be included for the taxable year when all the events  
18 have occurred that fix the right to receive the income and the amount of the income can be determined  
19 with reasonable accuracy," i.e., the all events test. (26 C.F.R. § 1.446-1(c)(1)(ii).) For income tax  
20 reporting, income shall be computed under the method of accounting on the basis of which the taxpayer  
21 regularly computes its income in keeping its books, and a taxpayer who changes the method of  
22 accounting on the basis of which it regularly computes its income shall secure the consent of the FTB  
23 before computing its income under the new method. (Rev. & Tax. Code, § 24651, subs. (a) & (e).)

24 Determining the point in time that a sale takes place requires looking at the totality of the  
25 circumstances, with passage of title and transfer of possession being significant factors.  
26 (*Hallmark Cards, Inc.*, *supra*, at p. 32; *Commissioner v. Segall* (6th Cir. 1940) 114 F.2d 706, 709-710.)  
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<sup>4</sup> California incorporates Internal Revenue Code (IRC) section 446 under R&TC section 24651.

1 A factor also often considered is whether there has been such substantial performance of conditions  
2 precedent that imposes upon the purchaser a duty to pay. (*Commissioner v. Segall, supra*, at p. 710.)  
3 “The objective is to determine at what point in time the seller acquired an unconditional right to receive  
4 payment under the contract.” (*Hallmark Cards, Inc., supra*, at p. 32.) The all-events test is based on the  
5 existence or nonexistence of legal rights or obligations at the close of a particular accounting period, not  
6 based on the probability of a change in rights after the close of the accounting period. (*Id* at p. 34.)

#### 7 NOL Suspension

8 R&TC section 24416.9, as applicable to tax years ending December 31, 2008, states,  
9 generally, that no NOL deduction shall be allowed for any taxable year beginning on or after January 1,  
10 2008, and before January 1, 2010. Subdivision (d) of this section provides, generally, that this  
11 temporary suspension of NOLs shall not apply to a taxpayer with taxable income less than \$500,000 for  
12 the taxable year. The section also provides that the carryover period under IRC section 172 for any  
13 NOL for which a deduction is denied by this section shall be extended by one or two years, depending  
14 on when the loss was incurred.

#### 15 STAFF COMMENTS

##### 16 Income from Sales

17 Appellant is an accrual basis taxpayer, and generally recognizes gain when the  
18 two-pronged all events test is met, which is when the right to income is fixed and the income amount  
19 can be determined with reasonable accuracy. Here, appellant asserts that respondent errs when it  
20 attributes \$1,039,270 in income from certain sales of its PerioLase equipment shipped to customers in  
21 2008 to the 2008 tax year. (See Resp. Op. Br., exhibit F, p. 5.) Appellant contends that it has a unique  
22 sales cycle that involves extended training and limitations on use of the device. At protest, appellant  
23 asserted that sales made within the last 60 days of the year should be considered as “sales not compete,”  
24 and that the income should therefore be recognized in the following year. On appeal, appellant  
25 references the six-month “Satisfaction Guarantee” return policy on the equipment, the follow-up calls  
26 that are part of its customer relations process, and the training program that includes a fourth day of  
27 training at the end of a six-month period and an optional fifth day of training at the 12-month mark.  
28 Appellant does not, however, specify why it chose the 60-day period for its deferral of income from

1 sales. Appellant should be prepared at the hearing to specify the date upon which it believes income  
2 from the sale of the PerioLase equipment should be recognized, and to provide legal support for its  
3 position.

4           If appellant is asserting that its reporting method should be something other than the  
5 traditional accrual method, it appears appellant is changing its method of accounting under which it had  
6 been previously computing income on its tax returns. In that event, appellant should be prepared to  
7 discuss R&TC section 24651, subdivision (e), and whether it was required to obtain respondent's  
8 consent before changing its method of computing its income.

9           Respondent provides a copy of appellant's "Terms, Conditions and License Agreement."  
10 This document states that customers have to pay a deposit to secure their training date, and must pay the  
11 balance of the purchase price 30 days prior to the beginning of the three-day training. The agreement  
12 states that the PerioLase is delivered after the boot camp training is completed. The agreement also  
13 specifies that the customers "take title (ownership) of the merchandise at the time" appellant delivers it  
14 to the shipping company, and that the customers retain ownership in transit and at the destination. This  
15 ownership includes responsibility to file any claims against the carrier for damage or loss of product.  
16 According to the terms of the agreement, it appears as though the customers take ownership of the  
17 product when it ships, and appellant is entitled to payment prior to that time. At the hearing, the parties  
18 should be prepared to discuss, for purposes of determining whether the all events test is met, the effect  
19 of the restrictions of use, two subsequent training days, subsequently-provided accessories, follow-up  
20 customer relations calls, option to return the product for a full refund within six months, and any other  
21 events occurring after the shipment of the product on appellant's right to the income at the time the  
22 balance of the purchase price is due.

### 23           NOL Suspension

24           The issue of the disallowed NOL deduction is not argued directly by appellant, but is  
25 included in the proposed assessment that is appealed here. According to R&TC section 24416.9,  
26 NOL deductions are not allowed for the 2008 tax year for taxpayers with taxable income of \$500,000 or  
27 greater. Accordingly, appellant's NOL deduction claimed for 2008 should be disallowed if the Board  
28 sustains respondent's proposed assessment or otherwise reaches a decision resulting in appellant's

1 taxable income for 2008 to be \$500,000 or greater. Appellant's NOL deduction should not be  
2 disallowed if the Board grants appellant's appeal or otherwise reaches a decision resulting in appellant's  
3 taxable income to be less than \$500,000 for the 2008 tax year.

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