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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of: **EMMIS COMMUNICATIONS CORPORATION**[1]	**HEARING SUMMARY**[2] **CORPORATION FRANCHISE TAX APPEAL** Case No. 547964

Year	Deficiency Amount
February 28, 2006	$76,544

Representing the Parties:

For Appellant: Ryan Hornaday, SVP, Finance
Emmis Communications Corporation

Geoffrey J. Christian
James S. Helms
DowLohnesPrice

For Franchise Tax Board: Ted Tourian, Tax Counsel

QUESTIONS: (1) Whether respondent properly excluded $931,119,059 from the sales factor

[1] Appellant is headquartered in Indianapolis, Indiana.

[2] This appeal was originally scheduled for an oral hearing at the June 2012 Board meeting but prior to the oral hearing was accepted into respondent's settlement program and appeals proceedings were deferred until April 30, 2013. The appeal was reactivated because the parties were unable to negotiate a settlement agreement.

denominator pursuant to California Code of Regulations, title 18, section 25137(c)(1)(A) (Regulation 25137(c)(1)(A)) as substantial amounts of gross receipts arising from an occasional sale of a fixed asset or other property held or used in the regular course of appellant's trade or business.

(2) If respondent did properly exclude the gross receipts at issue, whether appellant has shown by clear and convincing evidence that the exclusion of gross receipts pursuant to Regulation 25137(c)(1)(A) results in an unfair representation of its business activities in California.

HEARING SUMMARY

Factual Background

Appellant is headquartered in Indianapolis, Indiana. During the year at issue, appellant was a diversified media company, principally focused on radio broadcasting, but also including magazines, television stations and other properties and activities. It was in the process of discontinuing its television operations and had also entered into an agreement to sell a Phoenix radio station. (Emmis Annual Report on Form 10-K for the Fiscal Year Ended February, 2006, p. 1 [available, together with other SEC filings, at http://www.emmis.com/investors]; Emmis Annual Report on Form 10-K for the Fiscal Year Ended February, 2012, p. 1.)

According to appellant, it completed "41 acquisitions/ exchanges and 28 dispositions/exchanges" of broadcasting locations from 1998 to 2008. (App. Reply Br., p. 5; see also App. Op. Br., p. 2.) Its company website provides a timeline showing the acquisition of a television station in 2002, six radio stations in 2003 and another radio station in 2005. As further discussed below, in 2005, the company began disposing of its television properties. (Company Timeline, http://www.emmis.com/who-we-are.)

Appellant began acquiring television properties in 1998. According to respondent, appellant purchased six television stations in two separate transactions during 1998. Appellant's Annual Report for the year ending February 28, 1999, appellant stated that it viewed the "entry into television as a logical outgrowth" of its radio broadcasting business and "as a platform for diversification." In the operation of the television stations, the Annual Report also stated that appellant would employ the same programming and marketing strategies that had proven successful with its radio properties. (Resp. Op. Br., p.2.)

According to appellant's Annual Report dated May 14, 2002, appellant purchased eight network-affiliated and seven satellite television stations from Lee Enterprises effective October 1, 2000. Its 2002 annual report states that during the preceding three-year period, it had acquired and retained 10 radio stations, nine television stations and three magazine publications, and that it sold or entered into agreements to sell assets of three radio stations in 2001 and 2002 (KALC-FM, KXPK-FM and WTLC-AM and FM) (Resp. Op. Br., exh. C, pp. 15-16.)

In its Quarterly Report for the quarter ending November 30, 2005, appellant stated that it was "in the process of divesting all of its television stations" as a result of "[appellant's] desire to lower its debt, coupled with [appellant's] view that its television stations needed to be aligned with a company that was larger and more singularly focused on the challenges of American television . . ." The Quarterly Report also stated that appellant expected to close on the sale of 13 of its 16 television stations by January 31, 2006, and to receive gross proceeds of approximately $927 million. (Resp. Op. Br., exh. D, p.38.) By the end of fiscal year February 28, 2006, appellant had sold 13 of its 16 television stations, resulting in a $342 million gain and $931 million in gross receipts. (Resp. Op. Br., p. 3.) Appellant states that the 13 sales were closed on four separate dates with four separate unrelated parties. (App. Op. Br., p. 14.) The remaining three television stations were sold on August 31, 2006, June 4, 2007, and July 18, 2008. (App. Op. Br., p.2.)

On its original California return for tax year ending February 28, 2006, appellant reported the gross receipts in the amount of $931,119,059 from the sales of its 13 television stations in the denominator of the sales factor. Appellant states that it did not report any of these gross receipts in the numerator of the sales factor because none of the television stations sold was located in California. At audit, respondent adjusted the sales factor denominator by excluding all the gross receipts from the sale of the television stations citing California Code of Regulations, title 18, section (Regulation) 25137(c)(1)(A) as authority for making the adjustment. (App. Op. Br., pp.2-3.)

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Contentions

Appellant's Contentions

Appellant asserts that the Federal Communications Commission (FCC) licenses issued to the sold television stations were those stations' most valuable asset and that more than 90 percent of gain on the transactions was attributable to the sale of those licenses. For that reason, appellant contends that the effect of excluding the gross receipts from the sales factor denominator "is to not attribute the majority of [appellant's] receipts to the jurisdiction in which the intangible property (FCC license) was utilized and to where the income was earned." (App. Op. Br., pp.2-3.) Appellant further contends that 100 percent of its apportionable income is attributable to the sale of the television stations and the failure to include the gross receipts in the denominator does not clearly reflect appellant's activities conducted within California and results in the apportionment of excessive income to "the non-sale states." (App. Op. Br., pp.3-4.)

Appellant states that respondent's position at audit was that appellant's day-to-day business activity is advertising and that the sale of the television stations reflects a shift in business strategy. Appellant asserts that this position does not consider that the acquisition and disposal of media properties are significant components of a media conglomerate like appellant. Appellant also states that respondent's auditor characterized the sales as "incidental sales" which the auditor improperly concluded did not fairly reflect appellant's day-to-day business activity. Appellant contends that respondent fails to recognize the gross receipts in question were a majority of appellant's gross receipts for the tax year in issue and were 100 percent of appellant's income. Appellant also summarizes its responses to respondent's correspondence dated June 2, 2009, in which appellant states its position concerning the exclusion of gross receipts from the sales factor. Appellant maintains that acquisition and disposition of media properties was part of its operations and respondent's characterization of the sale of the television stations as a "one time transaction" indicates that respondent is ignoring appellant's overall unitary business which involved the sale of media properties before and after the sales of the television stations. Respondent's own conclusion that the sales of the television stations "appear to be infrequent" indicates respondent's uncertainty as to the proper interpretation of what constitutes an occasional sale and such ambiguity in regulatory language should be construed in favor of appellant.

Appellant further argues that respondent states that gain from an occasional sale can be either business or nonbusiness income but fails to reconcile how an occasional sale "in the normal course of business" under Regulation 25137(c)(1)(A) differs from a transaction "in the regular course of the taxpayer's business" under the definition of business income set forth in R&TC section 25120 and as interpreted by case law. Finally, appellant contends that respondent fails to address the cases in which courts have applied a quantitative and qualitative analysis to determine the existence of distortion and fails to address appellant's quantitative and qualitative distortion analysis. (App. Op. Br., pp. 5-6.)

With respect to the distortion analysis, appellant contends that the *Appeal of Fluor*, 95-SBE-016, decided December 12, 1995, on which respondent partially relies for its position that the gross receipts in question should be excluded, held that the "special rule" for excluding gross receipts provided by Regulation 25137(c) should not be applied if the existence of distortion is proven. In addition, appellant asserts that respondent's conclusion that material distortion exists based on its comparison of apportionment percentages for tax years 2003 to 2006 is inconsistent with *Appeal of Vidco Express*, SBE Case No. 378528, decided on October 6, 2009,[3] in which the Board concluded that computations that merely show a different apportionment factor is not a showing of distortion. (App. Op. Br., pp. 6-7.)

Appellant contends that it fully complied with California law, and specifically R&TC section 25120 and *Microsoft Corp. v. FTB* (2006) 39 Cal.4th 750 (*Microsoft*), by including the gross proceeds from the sale of the television stations in the sales factor. Furthermore, appellant contends that its sale of the television stations did not result in substantial receipts arising from an occasional sale of property used in its business and that inclusion of those receipts did not result in an unfair reflection of appellant's business activities in California. With respect to the first point, appellant asserts that the application of Regulation 25137(c)(1)(A) requires that both conditions must be met: the gross receipts must be substantial and must arise from an occasional sale. Appellant concedes that the gross receipt amounts from each sale constituted substantial amounts but disagrees that the sales were occasional. (App. Op. Br., pp. 9-10.)

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[3] This is a Decision on Petition for Rehearing that was not adopted as a Formal Opinion and is therefore not citable as precedent. (Rules for Tax Appeals, Cal. Code Regs., tit. 18, section 5463(d).)

Appellant asserts that an "occasional sale" must meet two requirements under the regulation, it must be outside the taxpayer's normal course of business and it must occur infrequently. Appellant argues that a transaction that meets the transactional test for business income would not meet the definition of an occasional sale under Regulation 25137(c)(1)(A). For support, appellant cites an Alabama administrative law case[4] in which an administrative law judge (ALJ) of the Alabama Department of Revenue concluded that a sale cannot be outside the normal course of a taxpayer's business under an Alabama regulatory provision which is almost identical to Regulation 25137(c)(1)(A) and, at the same time, be part of the normal business of the taxpayer meeting the transactional test. Appellant notes that Regulation 25137(c)(1)(A)2 references a taxpayer's "normal course of business" and based on the language conclude that "occasional" within the meaning of this provision must mean an extraordinary event which occurs outside appellant's normal course of business. (App. Op. Br., pp. 11-12)

Appellant contends that the facts presented do not indicate that the sales were extraordinary events as appellant, during the regular course of its business, "utilized a corporate strategy of acquiring and disposing of operating locations in order to maximize its business." Appellant points to the 41 acquisitions/exchanges and 28 dispositions/exchanges of broadcasting locations from 1998 to 2008 as evidence that the frequency and nature of these transactions meets the standards of the transactional test and therefore would occur in appellant's normal course of business. Appellant further argues that respondent does not define the word "infrequent", which is subject to a "broad range of interpretations" and uncertainty of application, as exemplified by respondent's conclusion in correspondence dated June 2, 2009, that "[i]t *appears* that the sale of the 13 TV stations is neither normal course of business nor frequently." In this regard, appellant maintains that respondent has not articulated a standard for "infrequent" sales but rather respondent applies both the test of whether they

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[4] *Kimberly-Clark Corp. & Kimberly-Clark Worldwide, Inc. v. Alabama Department of Revenue*, Admin. L. Div. Dkt. No. CORP 01-983, CORP 01-995 (Mar. 11, 2003). The ALJ ruled that the gross receipts in question were properly characterized as business income and that the occasional sale regulation did not apply. The Department of Revenue appealed to the circuit court which reversed the ALJ's determination and held that that the gross receipts should be treated as nonbusiness income allocable solely to Alabama. The matter was further appealed and ultimately decided by the Supreme Court of Alabama which found that the subject sale transactions resulted in nonbusiness income. (*Ex parte Alabama Dept. of Revenue* (Ala. 2010) 69 So.3d 144.)

occurred in the normal course of business and whether they were "infrequent". Appellant contends that the statute requires that they must meet both tests to be considered "occasional", and thus a reasonable interpretation compels the conclusion that the tests are not the same. In view of the foregoing, appellant contends that ambiguity exists in the meaning of "infrequent" which requires an examination of "extrinsic sources" and that any doubt should be resolved in favor of appellant. (App. Op. Br., pp. 12-13.)

Appellant cites two Board formal opinions, *Appeal of New York Football Giants, Inc.*, 77-SBE-014, , decided February 3, 1977 and 77-SBE-015, decided June 28, 1979 and *Appeal of The Learner Company, et al.*, 80-SBE-103, decided September 30, 1980, to support its position that the subject sales transactions were not occasional. In the *Appeal of New York Football Giants, Inc.*, this Board held that a professional sports team that played one game in California in a tax year was considered "occasional". In *Appeal of the Learner Company, et al.*, this Board held that trips made by the appellant's officers once or twice a year were infrequent and occasional. Appellant also cites Regulation 1595(a)(1), a sales tax regulation which defines an "occasional sale" for purposes of determining whether the seller must obtain a seller's permit and provides in part that "[g]enerally, a person who makes three or more sales for substantial amounts in a period of 12 months is required to hold a seller's permit . . ." Appellant concludes that three or more sales is considered "not occasional" and notes that it had 13 sales of television stations during the tax year in issue, 14 such sales from November 30, 2005 to August 31, 2006 and two additional sales after August 31, 2006. (App. Op. Br., pp. 13-14.)

Appellant further argues that respondent erroneously aggregates as "a large one time disposal" the 13 sales that occurred during the audit period which were closed on four separate dates with four separate unrelated parties. Appellant asserts that under Regulation 25137(c)(1) the aggregation of sales is only required when combining sales to the same purchaser in order to determine whether a sale is substantial. Thus, appellant contends that respondent's misapplies that provision and each television station sale should be evaluated separately. Appellant states that it continued to operate television stations until July 18, 2008 so respondent's characterization of a one-time disposal is unfounded. In addition, appellant contends that respondent ignores the unitary concepts on which its jurisdiction to tax nondomiciliary gains is based by analyzing the sales as one transaction without considering disposition of other media properties to determine whether transactions are within appellant's normal course of business or are infrequent. Appellant further contends that respondent's segregation of activities for this analysis is contrary to the unitary concept of taxing activities as a single business. Specifically, appellant argues that if the exclusion of gains to accomplish fair apportionment is based on segregation of unitary activities while the disposal of other unitary activities within the same business are not considered "then arguably such segregated activities should not be apportioned as part of the unitary business (i.e., they should be treated as a separate unitary business)." (App. Op. Br., pp. 15-16.)

Because appellant's sales do not meet the requirements of Regulation 25137(c)(1)(A), appellant argues that the gross receipts are properly included in the sales factor under R&TC section 25134 and, consistent with the Board's holding in *Appeal of Fluor*, *supra*, it is respondent's burden to prove that distortion results from application of the standard apportionment formula. Furthermore, appellant argues that inclusion of the gross receipts from the sale of the television stations does not result in an unfair reflection of appellant's business activity in California. Appellant cites Legal Ruling 97-1 issued by respondent which opines that the purpose of Regulation 25137(c)(1)(A) is "to exclude gross receipts from the sales factor when they do not fairly reflect the taxpayer's day-to-day business activity." Based on the Legal Ruling, appellant asserts that even if one were to assume that the regulation is applicable, the exclusion of the gross receipts is distortive but respondent "appears to disagree with the necessity to consider distortion" under that provision "in stark contrast to the *Fluor* decision." Appellant further argues that respondent fails to recognize that this Board held in the *Appeal of Fluor*, *supra* that "any party wishing to deviate from the method prescribed by regulation, when found to be applicable, must first establish by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in this state." (App. Op. Br., pp. 17-18.)

Appellant contends that it has provided clear and convincing evidence that the exclusion of the gross receipts from the sales of the television stations results in distortion. By contrast, appellant argues that respondent "simply compared the apportionment percentages by including or excluding the gross proceeds in question" but did not consider the extent of the activities conducted inside and outside of California. Appellant notes that this Board in *Appeal of Vidco, supra* held that "simply labeling as 'grossly distortive" a percentage difference between a factor as computed by the taxpayer and a factor as computed by respondent" did not show an overstatement or understatement of a taxpayer's business activities in California. (App. Op. Br., pp. 18-19.)

Appellant asserts that it has provided a qualitative and quantitative analysis which meets its burden of proof of showing that the gross receipts from the television station sales are properly included in the sales factor. In support of its analysis, appellant cites a superior court case, *Square D Co. v. FTB*, Case No, CGC 05-442465 (San Francisco Superior Court, April 11, 2007)[5] which held that *Microsoft* examined four factors to determine whether R&TC section 25137 should apply. Appellant argues that the application of those four factors to the facts presented results in distortion when the gross receipts from the television station sales are excluded from the sales factor. With respect to its business, appellant argues that its decision to dispose of television stations was integral to its business and enabled it to focus on other media properties as "a continuation of its ingrained corporate strategy." In addition, the 13 sales constituted a material portion of appellant's business for that tax year, any tax due in California is completely attributable to those sales and as a qualitative matter represents appellant's business for the tax year ending February 2006. (App. Op. Br., pp. 20-21.)

Appellant maintains that even if one assumes that the sales were qualitatively different than appellant's principal business, the following quantitative analysis proves distortion exists if the gross receipts are removed from the sales factor:

(1) Gross receipts from the television station sales were more than the receipts from appellant's principal business (i.e. 59.28 percent of total receipts) and represented 100 percent of appellant's taxable income. Thus, to exclude that amount is distortive.

(2) All of appellant's income resulted from the gains generated by the sales of television stations located outside of California while operations that generated losses occurred within and outside California. Due to the significant difference between the in-state margins and out-of-state margins, the exclusion of the sales representing a significant portion of appellant's business from

[5] A superior court decision has no precedential value. (*Santa Ana Hospital Medical Center v. Belshe* (1997) 56 Cal.App.4th 819, 831.)

the sales factor results in out-of-state income being taxed in California at an apportionment factor that doesn't take into account the out-of-state proceeds that generated the income.

(3) If the gross receipts are included in the sales factor, taxable income is $18,227,394 before net operating losses (NOLs) and if they are excluded taxable income is $30,286,130 before NOLs. This results in an increase of 66 percent in taxable income even though none of the sales occurred in California and therefore gains would be taxed in California without proper representation in the apportionment formula.

Appellant asserts that respondent addressed only the third factor and concluded that the only relevant determination was the correct amount of tax computed under the appropriate tax laws. Appellant contends that respondent's conclusion ignores the *Fluor* decision and the requirement that even the special rules of the regulations are subject to fair apportionment standards. Appellant further contends that respondent's failure to address all aspects of the qualitative and quantitative analysis and sole reliance on a percentage change in the apportionment factors is contrary to court and Board decisions. (App. Op. Br., pp. 22-23.)

Because the gains from the sale of the television stations make up 100 percent of appellant's taxable income apportioned to California, appellant argues that it is reasonable to include the gross receipts as a better reflection of appellant's activities in California and excluding them would be distortive. Appellant asserts that the *Microsoft* court cautioned against failing to include in the sales factor the gross receipts from out-of-state transactions that provide a substantial portion of a taxpayer's income as that failure "exaggerates the income for California tax purposes and results in an unfair representation of a taxpayer's California business activities." According to appellant, such distortion occurs by excluding appellant's gross receipts from the television station sales because the contribution of the out-of-state transactions is minimized. Secondly, appellant argues that excluding the gross receipts results in 12 percent of the gains being taxed by California even though none of the assets was located in or produced income in this state. Consequently, none of the gains resulting from the appreciation of those assets "was influenced by California." (App. Op. Br., pp. 24-25.)

Appellant contends that the principles of fair apportionment require the apportionment of the underlying income, in an economic sense, to be represented by the factors of apportionment. In this appeal, more than 90 percent of the gain is attributable to intangible FCC licenses and the appreciation in the value of these licenses is economically attributable to the location of the income-producing activities, i.e., the television stations. However, appellant contends that these intangibles are not represented within the apportionment factors even though taxable income for taxable year ending February 28, 2006 was entirely related to disposal of the television stations and most of the gain was from intangibles, FCC licenses are generally 80 percent to 90 percent of a station's value, intangibles are not considered in the property or payroll factors and respondent excluded them from the sales factor, all of appellant's net taxable income represents gain from the sale of the television stations, and respondent's position applies apportionment factors to gains which are not economically represented in the factors based on appellant's business operations. (App. Op. Br., pp. 25-26.)

Appellant asserts that "the more income a certain activity contributes to the income of a unitary group, the greater the probability that distortion exists when that activity is not represented in the apportionment factors." Appellant cites an unidentified publication as commenting that UDITPA section 18, which is intended to fairly represent a taxpayer's business in the state by excluding extraordinary items that might skew the apportionment factor, can actually lead to unfairness when the vast majority of a taxpayer's income is from an occasional sale of a substantial portion of its business assets and such income is excluded from the factor. Appellant also cites respondent's Legal Ruling 2006-03 which states that it is appropriate to deviate from Regulation 25137(c)(1)(A) when exclusion of a taxpayer's gross receipts from the sales factor would not fairly represent the taxpayer's activities in each state. Appellant adds that apportioning gains from FCC licenses that were generated in certain states by the historical cost of fixed assets, payroll, and operational sales of media properties in all states fails to reflect economically how income is earned by apportioning more gain to states in which no stations were sold and less gain to the states in which the income was earned. (App. Op. Br., pp. 26-27.)

Finally, appellant contends that including the gross receipts in the sales factor does not eliminate taxable income apportioned to California as California is still able to tax a portion of the gain from the sales. Appellant further contends that respondent's apportionment approach is distortive because respondent attempts to tax the activities generating 100 percent of the taxable income by only considering other activities that did not generate that income. Appellant asserts that those other activities considered by respondent to be appellant's "normal operations" generated losses and if those activities were apportioned separately there would be no income taxable by California. (App. Op. Br., p.28.)

Respondent's Contentions

Respondent reviews the standard statutory apportionment formula and notes that under certain circumstances the standard formula does not provide a fair reflection of a taxpayer's business activities in California. To reflect business activities fairly, respondent states that the R&TC authorizes the use of alternative formulas and Regulation 25137 provides special rules for these other apportionment methods. Here, respondent contends that Regulation 25137(c)(1)(A) applies directly to the facts of this appeal and requires use of an alternative apportionment formula. Respondent cites *Appeal of Fluor, supra* as reflecting this Board's position that the special rules of Regulation 25137 must be applied "whenever the facts and circumstances of a particular appeal match those set forth in the regulation, as is the case herein." (Resp. Op. Br., pp. 2-3.)

Respondent first addresses the requirements of Regulation 25137(c)(1)(A) and argues that the gross receipts were substantial and that "divesting the television stations was occasional". Respondent contends that the substantial nature of the gross receipts is evidenced by the 59.2966 percent difference in the sales factor denominator when the gain from "the liquidation of the business" is included in the denominator. Respondent also contends that the "divestiture of appellant's television division" was occasional because appellant primarily generates revenue from selling advertising and is not in the business of "divesting whole segments of its operations." Therefore, respondent contends that the transactions were "infrequent" and "outside appellant's normal course of business" as required by Regulation 25137(c)(1)(A)2. (Resp. Op. Br., p.5.)

Respondent states that it agrees with appellant's position that the standards for determining whether a transaction is in the "regular course of business" under the transactional test are the same ones that should be used to determine whether a sale is "occasional" and outside the "normal course of business" standard under Regulation 25137(c)(1)(A)2. Respondent contends that, if the transactional test for business income is met, then a sale is "most likely" not "occasional" under Regulation 25137(c)(1)(A)2. However, contrary to appellant's position, respondent argues that the gain generated from the television station sales is business income under the functional test, not the transactional test, and therefore is an occasional sale. Respondent notes that the transactional test focuses on the nature of the income-producing transaction which must occur in the regular course of business. Respondent asserts that appellant's regular course of business was broadcasting so as to generate revenue from advertisers and appellant characterized the divestiture of its television division as "Discontinued Operations", which respondent contends was an extraordinary event. Respondent cites *Jim Beam Brands Co. v. Franchise Tax Bd.* (2005) 133 Cal.App.4th 514, 522, arguing that the controlling factor for identifying whether a transaction results in business income is the nature of the income-producing transaction. In support of its position, respondent states that the court in that case held that "[i]ncome arising from extraordinary events such as a complete liquidation [or] cessation of business cannot satisfy the transactional test." (Resp. Op. Br., pp. 6-7.)

Respondent cites *Appeal of Triangle Publications Inc.*, 84-SBE-096, decided August 1, 1984, as an appeal involving similar facts to those presented here in which the taxpayer operated the following divisions: radio, television, magazine, television publications and trade publications. The taxpayer sold its newspaper, radio, and television divisions and real property used by the trade publications division and this Board held that those sales generated business income under the functional test. This Board further held that the former version of Regulation 25137(c)(1)(A) appeared to apply, as respondent had argued, but the Board ruled against respondent because it failed to show that the standard apportionment formula did not fairly represent the extent of the taxpayer's business activity in California. Respondent contends that this Board subsequently changed its position with respect to application of Regulation 25137 in *Appeal of Fluor Corporation*, wherein the Board held that the "special formulas" prescribed by that regulation "must be applied whenever the facts and circumstances of a particular case match those set forth in the regulation." Respondent concludes that while the Board's position with respect to the application of Regulation 25137 has changed, the Board's observation in *Appeal of Triangle Publications Inc.* that divestiture of media divisions comes under the purview of Regulation 25137(c)(1)(A) still stands. (Resp. Op. Br., pp. 7-8.)

Respondent contends that appellant "overstates its position" by relying on the Alabama administrative decision in *Kimberly-Clark* because that decision has been overruled by the Alabama

Supreme Court. Respondent explains that in *Kimberly-Clark* the taxpayers were part of a large, widely diversified manufacturer and seller of paper and paper-related consumer products and one of the taxpayers had owned and operated a pulp and paper mill and large parcel of timberland for use in the mill for 34 years. In the 1990s, Kimberly-Clark decided to change its corporate strategy to one focused on consumer-products business lines and started divesting some of the businesses that did not fit that strategy and acquiring businesses that would further its goals. As part of its changed strategy, Kimberly-Clark sold the mill and parcel of timberland, which were among its largest timber holdings, although during the years audited Kimberly-Clark had bought and sold other timber properties. (Resp. Op. Br., pp. 9-10.)

Respondent states that the issues under appeal were whether the sale of the mill and timberland parcel generated business income in Alabama and whether the gross receipts from the sales should be included in the denominator of the sales factor. With respect to the business income issue, respondent states that Alabama does not recognize the "functional test" as a basis for business income so the Alabama Supreme Court held that the disposition of those properties resulted in nonbusiness income because it did not meet the transactional test. Respondent quotes a portion of the court's transaction test analysis and highlights the court's reasoning that "[t]here was a major shift in corporate strategy followed by a major transaction – different quantitatively and qualitatively from its other business transactions – to help achieve this goal." Based on appellant's assertion that *Kimberly-Clark* is applicable to the facts of this appeal, respondent contends that this Board would be able to classify the divestiture as part of appellant's day-to-day operations only by looking past the undisputed facts that the divestiture was the largest transaction in comparison to any of its other media broadcasting purchases or sales, except for appellant's initial decision to enter the television broadcasting business. Finally, respondent states that the court in *Kimberly-Clark* noted that the divestiture of a business line was an extraordinary event, thus was "occasional", and so would not meet the transactional test. (Resp. Op. Br., pp. 9-11.)

Because the divestiture satisfies the conditions of Regulation 25137(c)(1)(A), respondent contends that no further showing of distortion is required to exclude the gross receipts from the sales factor denominator. Respondent further contends that because appellant objects to the exclusion of the gross receipts appellant has the burden of showing by clear and convincing evidence that application of Regulation 25137(c)(1)(A) does not fairly represent the extent of its business activities in California. Respondent maintains that appellant has not met this burden and further asserts that excluding the gross receipts from the sales factor for taxable year ending February 28, 2006 accurately represents appellant's activities in California. Respondent provides a table showing the reported sales factor percentages for taxable years ending February 28, 2003, February 28, 2004, and February 28, 2005, as 13.8374 percent, 15.5829 percent and 15.0291 percent, respectively, and notes that the California sale factor percentages trended upward. Respondent then compares the sales factor percentage for tax year ending February 28, 2006, including the gross receipts from the television station sales and excluding the gross receipts. When the gross receipts are included the sales factor percentage is 6.9217 percent and when they are excluded the sales factor percentage is 17.0053 percent. Respondent contends that the latter percentage is more in line with the upward trending sales factor percentages for the prior three years. (Resp. Op. Br., pp. 12-13.)

Respondent contends that appellant overstates its position that the sales of the television stations was in the normal course of its business and thus met the transactional test. Contrary to appellant's position, respondent cites *Jim Beam Brands* in which the court held that income arising from "extraordinary" events such as a "complete liquidation [or] cessation of business" does not satisfy the transactional test. Respondent further contends that appellant's reasoning is similar to the reasoning of Limited Stores, Inc. in *Limited Stores, Inc. v. FTB* (2007) 152 Cal.App.4th 1491 (*Limited Stores*) in which the taxpayer argued that its treasury function was an integral and fundamental segment of its retail operations. The court of appeal held that just because an activity, such as a treasury function, is considered to be integral to a business does not mean that activity is part of the main line of a taxpayer's business. The court concluded that adoption of the taxpayer's position would completely obviate the qualitative test in *Microsoft* in which the court held that the treasury function activity was not part of Microsoft's primary business even though the revenue from that activity was used to complement the company's primary business. Similarly, respondent contends that appellant's primary business is media broadcasting and that, even though buying media properties may be an integral part of its business, it is not part of appellant's main line business of operating media properties. (Resp. Op. Br., pp. 13-14.)

Respondent also points to *Kimberly-Clark* in which the Alabama Supreme Court held that a one-time disposition of assets by a company that regularly buys and sells assets resulting from a shift in corporate strategy to liquidate a business segment "was most extraordinary" and did not occur in the company's regular course of business. Likewise, respondent argues that appellant made a strategic decision to divest its entire television division and discontinue television operations so those sales were outside appellant's "ordinary broadcasting operations." (Resp. Op. Br., p. 15.)

Respondent contends that the facts cited by appellant in its quantitative analysis describe the situation that FTB Legal Ruling 97-1 contemplates as "a justification" to exclude gross receipts from occasional sales of fixed and intangible assets from the denominator of the sales factor. Respondent states that the purpose of excluding such income is to ensure that the occasional sale does not cause the sales factor to be skewed by a one-time transaction because the assets may have appreciated over a number of years and allowed that accumulated appreciation to be reflected in a single year's sales factor might result in an inordinate amount of income being sourced to the state where the assets were located. Respondent maintains that appellant's "reliance" on the local operation of its television stations and increase in value of each station occurred where the economic activity took place, "obfuscates the true nature of appellant's business." Respondent cites appellant's exhibit G as evidence that appellant "engaged in a strategy of integration by adoption of a method of economies of scope" and cites appellant's 1998 Annual Report which states that its entry into television is a logical outgrowth of its radio business and appellant will employ the same strategies that have proven successful with its radio stations. From the foregoing statements, respondent concludes that appellant's media properties, although operated locally, all benefitted from "a centralized, experienced management team, to develop local innovative, and research-based programming." (Resp. Op. Br., pp.16-17.)

Respondent addresses *Appeal of Vidco, supra* which appellant cites for the proposition that "merely providing computations showing a different apportionment factor is not a showing of distortion." Respondent asserts that appellant's own quantitative analysis is premised on the effects of Regulation 25137(c)(1)(A)1 whereby excluding a substantial amount will result in the exclusion of 59.28 percent of appellant's gross receipts from the sales factor which would cause a 66 percent increase in taxable income in California. Respondent contends that showing the effects of Regulation

25137(c)(1)(A) is not clear and convincing evidence that the regulation does not fairly represent the extent of appellant's activities in California.

Respondent also addresses appellant's citation of FTB Legal Ruling 2006-3 which involved apportionment of gain from a deemed asset sale where a target corporation is purchased and the purchaser makes an Internal Revenue Code (IRC) section 338(g) election which results in the target corporation reporting the gain on the sale of the assets on a one-day return. Respondent states that the relevant portions cited by appellant refer to the apportionment of gain from the IRC section 338(g) election by the target corporation and in this case, because the target corporation would file a one-day return, it would not incur any payroll expenses in its apportionment. Thus, respondent asserts that if Regulation 25137(c)(1)(A) applied in these circumstances, the only method of apportionment would be based on the property factor which is based on the historical cost of such properties. Respondent argues that the Legal Ruling is distinguishable from this appeal because appellant did not divest its television stations as part of an IRC 338(g) election. Moreover, respondent states that FTB's Chief Counsel Ruling 2008-3 explains that Regulation 25137(c)(1)(A) does not apply in the IRC section 338(g) context because in an IRC section 338(g) transaction the sale of the assets is the only transaction in the reporting period, hence it is not an occasional sale. However, respondent asserts that the divestiture was an occasional sale so the regulation would apply under the facts of this appeal. (Resp. Op. Br., pp. 18-19.)

Appellant's Reply Brief

Appellant contends that respondent incorrectly equates the sale of television stations to a divestiture of a segment of business. Appellant asserts that it was a media broadcaster and the radio and television assets were an operation to deliver the same product, i.e. advertising, in the broadcasting segment of its business. Appellant states that the broadcasting assets were operated under the same business philosophy and model as the radio stations and were not different business segments. Appellant asserts that it engaged in distinct operations through its publishing and broadcasting businesses, but not through its radio and television broadcasting assets. (App. Reply Br., pp. 2-3.)

Furthermore, appellant contends that respondent overreaches by aggregating distinct and separate dispositions of broadcasting assets in order to apply Regulation 25137(c)(1)(A) because the "clear language" of that regulation requires each sale to be analyzed independently and does not allow for aggregation when determining whether a sale is occasional. Therefore, appellant contends that the disposition of the television stations was not a one-time extraordinary event but 13 separate transactions. (App. Reply Br., pp. 3-4.)

Appellant contends that respondent's analysis of whether the sales were "occasional" under Regulation 25137(c)(1)(A)2 and its conclusion that the sales were infrequent "relies solely on the premise that appellant is not in the business of divesting whole segments of its operations." By making such an assumption, appellant contends that respondent ignores the two independent tests of that provision (i.e., (1) an infrequent sale and (2) the sale is outside the normal course of business) and the intent of Regulation 25137(c)(1)(A) to apply to "an occasional sale" based on an analysis of each disposition transaction. According to appellant, respondent focuses on the decision by appellant to restructure its broadcast properties to determine the nature of the transaction and makes a "combined determination" that appellant fails both of the occasional tests. By failing to apply these tests separately, appellant contends that respondent fails to follow the clear language of its own regulation. (App. Reply Br., pp. 4-5.)

Appellant contends that respondent ignore the factual record demonstrating an industry-wide practice of growing advertising revenue through dispositions and acquisitions, as evidenced by appellant's 41 acquisitions and exchanges and 28 dispositions/exchanges of radio and television broadcasting properties from 1998 to 2008. Although respondent equates the disposition of television properties with an extraordinary event, i.e. complete liquidation or cessation of business, as described in *Jim Beam Brands*, appellant contends that even respondent agrees that appellant is in the broadcasting business so the disposition of television stations was not a complete liquidation or cessation of appellant's broadcasting business because appellant continued to own and operate radio and television broadcasting properties after the disposition. With respect to the *Appeal of Triangle Publications, Inc.*, appellant contends that this Board never analyzed the dispositions at issue there under the transactional test, because they met the functional test and the gain was therefore considered business income. Additionally, appellant maintains that respondent "overstates its position" by relying on "a speculative statement" made by this Board in *Appeal of Triangle Publications, Inc.* that "it does appear" that the taxpayer's sales would come within Regulation 25137(c)(1)(A). Contrary to respondent's characterization of the holding, appellant maintains that this Board provided no definitive analysis as to whether the regulation applied nor was such a determination required because the Board found that respondent had not shown a reason for deviating from the standard apportionment formula. (App. Reply Br., pp.6-7.)

Appellant cites *Citicorp North America v. FTB* (2000) 83 Cal.App.4th 1403 in which the taxpayer, a major banking concern, argued that gains from the disposition of real properties were nonbusiness income under the transactional test because those sales were not part of its regular business. According to the stipulated facts of the case, appellant states that Corporate Realty Services, a department of the taxpayer, was responsible for managing and leasing space in four real properties sold during the tax year and portions of those properties housed the taxpayer's corporate personnel. In addition, the sales were part of the restructuring of the taxpayer's real estate holdings. Appellant quotes a portion of the decision in which the court concludes that "sales of four corporate properties in one year" is not "the same situation as the example of a manufacturer that makes a one-time sale of a warehouse." By not focusing on a single restructuring transaction but rather on four independent sales, appellant contends that the court concluded that the dispositions met the transactional test and thus the gains were business income. Consistent with the holding in *Citicorp*, appellant contends that the dispositions in this appeal meet the transactional test and, as a result, are part of appellant's normal course of business thereby precluding application of Regulation 25137(c)(1)(A). (App. Reply Br., pp. 8.)

Appellant reiterates its position that inclusion of the gross receipts in the sales factor denominator is essential to reflect appellant's activities in California fairly. While appellant agrees that respondent properly noted that *Appeal of Fluor* overturned portions of *Appeal of Triangle Publications, Inc.* with respect to the application of special formulas, appellant contends that respondent ignores "its ultimate responsibility" of using the special formulas to fairly reflect the taxpayer's activities. Additionally, appellant notes that *Appeal of Fluor* recognized that applying a special formula may not fairly assign a taxpayer's activities to a particular state and appellant criticizes respondent's reliance on a change in the sales factor rather than a quantitative analysis as set forth in *Microsoft*. Furthermore, appellant takes issue with respondent's citation of Legal Ruling 97-1 and *Limited Stores, Inc.* because respondent fails to acknowledge that while "income can be shifted away from California due to improper representation of activities in the apportionment factor, the opposite can also be true." Appellant contends that when large portions of activities, such as the 13 dispositions in this case, are included in taxable income without factor representation, then excessive income is apportioned to those states where no activity occurred such as California. (App. Reply Br., pp. 10-11.)

Appellant maintains that other cases in which the court held that "a reduction in the sales factor was determined to be appropriate" involved facts distinguishable from the facts presented here. Specifically, appellant contends that in cases in which the court held that an alternative apportionment methodology was appropriate, "the facts of the cases determined that some activity represented a very low portion of taxable income (i.e., 1 percent – 2 percent) yet was a major contributor to the sales factor (i.e., 19 percent – 73 percent)." Appellant contends that this appeal is factually different in that the exclusion of a large portion of gross receipts representing all taxable income improperly inflates the income attributable to California. Appellant asserts that California courts have determined that any out-of-state activity with little or no contribution to taxable income should not be afforded substantial representation in the apportionment factors because it would cause an "unreasonable shift of income away from California." However, if the converse is true, such that the out-of-state activity contributes significantly to taxable income, as presented by this appeal, then appellant concludes that the apportionment factor should properly reflect that activity to avoid excessive income being shifted to California. Appellant contends that *Microsoft* supports its position that the failure to include gross receipts from out-of-state transactions that provide a substantial portion of a taxpayer's income overstates the income for California tax purposes and results in a distortion of the taxpayer's business activities in California. (App. Reply Br., pp. 12-13.)

Appellant further contends that respondent is incorrect in its argument that "if the recognition of appreciation were to incrementally occur in each year, then its impact would be substantially diluted by the activities in other states." Appellant argues that in fact the opposite would occur because including incremental appreciation in both income and the apportionment factors would increase the California denominator while the numerator would remain unchanged. Thus, less taxable income would be apportioned to California in each year the incremental income was recognized.

Furthermore, appellant argues that the California factors have not been diluted because incremental appreciation has not been recognized over the years. Rather, appellant contends, by applying the statutory method California was "attributed excess income throughout the years appreciation had occurred" and exclusion of "any recognition of the appreciation from the apportionment factors in the year of the sale ignores a natural true-up which occurs from the previous failure of standard apportionment methods to recognize appreciation incrementally." On the basis, appellant concludes that respondent's contention is incorrect. (App. Reply Br., pp.14-15.)

Finally, appellant takes issue with respondent's contention that appellant's business activities and value are not "locally driven" but benefit from a centralized experienced management team. Appellant maintains that such benefit is not a basis for apportioning a large part of the gains to California because these activities are derived from either local station management or from appellant's headquarters in Indiana. Appellant further contends that respondent is attempting to apportion excess gain to California when none of the disposed properties was located in California and when the management team resides outside of California. Thus, appellant concludes that respondent's method does not apportion a reasonable amount of income from the property dispositions that approximates the benefits that California provides appellant when the activities from which the value of those properties is determined occurred outside California. (App. Reply Br., pp. 15-16.)

Respondent's Reply Brief

Respondent contends that appellant argues for the first time in its reply brief that aggregation is not permitted under Regulation 25137(c)(1)(A) and the sale of the 13 television properties should be analyzed separately and that the sale of the television properties was part of appellant's day-to-day business activities which met the requirements of the transactional test for business income as decided in *Citicorp* and, for that reason, the sales were not "occasional" within the meaning of the regulation. (Resp. Reply Br., p. 2.)

With respect to aggregation, respondent asserts that appellant contends that each sale should be analyzed separately to determine whether it was occasional and the regulation does not permit aggregation of sales for this purpose. Respondent contends that appellant erroneously reasons that a determination of whether a sale is occasional is based on the number of assets involved in a particular transaction rather than the frequency and magnitude of a particular transaction. Respondent argues that appellant's interpretation is contrary to R&TC section 13 which provides that in the interpretation of R&TC sections, the singular number includes the plural and the plural includes the singular. Thus, respondent asserts that the provision of Regulation 25137(c)(1)(A) excluding substantial amounts from gross receipts that "arise from an occasional sale of a fixed asset or other property", should be read to include the plural as well as the singular. (Resp. Reply Br., p. 3.)

Respondent further argues that appellant's interpretation violates the principle of statutory construction requiring that every word and clause of a statute or regulation must be given effect and none of its language rendered surplusage. In this regard, respondent asserts that appellant's interpretation of an "occasional sale" would be based "upon the total number of assets included in a particular sale . . . rather than analyzing the total number of transactions and the cumulative total of the receipts realized from such transactions." Respondent contends that such an interpretation would "obliterate" Regulation (c)(1)(A)2 which defines an occasional sale by the frequency of such transactions and whether it occurs in the taxpayer's normal course of business rather than by the number of assets disposed of in a single transaction. Respondent further contends that appellant's interpretation would also "have the parallel effect of eroding the requirement that a sale be 'substantial' to be excluded from the sales factor", contrary to the last sentence of subsection (c) which provides that "sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial." Respondent quotes a portion of the rulemaking file for the regulation which includes a staff comment explaining that this sentence is intended "to address transactions which are completed in several steps rather than in one transaction." Respondent contends that appellant would disaggregate a single transaction on an asset-by-asset basis to make an occasional sale "frequent". Finally, respondent notes that the sentence refers to "sales of assets" whereas the first sentence of Regulation 25137(c)(1)(A) refers to "a fixed asset" which also indicates that the last sentence was intended to aggregate multiple assets between a buyer and seller where the sales would fall below the 5 percent threshold of Regulation 25137(c)(1)(A)1. (Resp. Reply Br., pp. 3-5.)

Finally, respondent argues that this Board has historically applied this provision on a transaction-by-transaction basis rather than an asset-by-asset basis. Respondent cites *Appeal of Fluor,* *supra* in which the appellant and two of its subsidiaries sold multiple properties inside and outside of California in three separate transactions and the appellant excluded the gross receipts from the sale of the California properties from the numerator and the gross receipts from all the sales from the denominator of the sales factor. This Board held that the sales met the requirements of Regulation 25137(c)(1)(A) and were properly excluded as occasional and substantial, that respondent had the burden of proving that application of the regulation resulted in distortion and that respondent failed to meet that burden. Respondent asserts that, in this appeal, the facts are substantially similar to the facts in *Appeal of Fluor* and respondent has followed the Board's reasoning in *Appeal of Fluor* in making its determination that the regulation applies. Respondent concludes that appellant's position conflicts with the Board's holding in *Appeal of Fluor* that where the requirements of a special regulation are met, any party that proposes to deviate from that method must show by clear and convincing evidence that the apportionment method does not represent the extent of the taxpayer's activities in California. (Resp. Reply Br., pp. 6-7.)

Respondent contends appellant overstates the applicability of *Citicorp* by arguing that the divestiture occurred in the normal course of appellant's business and, thus, satisfied the transactional test articulated by the *Citicorp* court. Respondent states that Citicorp and its affiliates provided traditional financial and banking services and the issue in that case (for purposes of discussion in this appeal) was the characterization of Citicorp's gain on the sales of four corporate properties as business or nonbusiness income. The properties were buildings and land that were used for corporate business or housing personnel of Citicorp or its wholly-owned subsidiary. Citicorp argued that the sale did not meet either the transactional test - the sales were not made in the normal course of its banking business – or the functional test – the acquisition, management and disposition of the properties was not an integral part of its business. The court of appeal held that the sales satisfied both tests and the gain was therefore business income.

With respect to the transactional test, the court found that Citicorp failed to show that the sales were not made in the normal course of its business by failing to present any evidence of the frequency, nature or extent of the real estate management activities of its realty services department. Additionally, the court found that the evidence in the record indicated that Citicorp considered the income from the properties to be business income prior to the sale and concluded that the sale of such corporate properties by the realty services department likewise produced business income. (Resp. Reply Br., pp. 7-10.)

Respondent challenges appellant's representation that appellant "continued to operate radio and television stations after the dispositions at issue" by positing that appellant made a prudent business decision, after the transaction in issue, to continue to operate its remaining three television stations while it maintained its intention to divest its entire television division. Respondent also contends that *Citicorp* is distinguishable from this appeal in that the *Citicorp* court was not presented with any evidence of the frequency, nature or extent of the real estate management activities of Corporate Realty Services whereas appellant stated that it made the decision to divest its television division as part of a corporate strategy to reduce debt and in recognition of the fact that its size and business model was not well-suited to the television industry. Respondent concludes that in *Citicorp*, Corporate Realty Services continued to manage property occupied by Citicorp affiliates but appellant did not liquidate its television division as a regular transaction of its trade or business. (Resp. Reply Br., pp. 10-11.)

Respondent also contends that appellant has not met its burden of proof by showing by clear and convincing evidence that exclusion of gross receipts from the denominator of the sales factor unfairly represents appellant's activities in California. Respondent asserts that appellant improperly cites two Board letter decisions to support its position that the proper evidentiary standard is a preponderance of the evidence to overcome the presumption of Regulation 25137(c)(1)(A). Respondent states that Rule for Tax Appeals (RTA) section 5551 provides that unpublished decisions are not citable as precedent and that this Board has so held in *Appeal of Charles W. Fowlks* (88-SBE-023-A), decided October 31, 1989. Respondent further cites *Microsoft Corp. v. Franchise Tax Board* (2006) 39 Cal.4th 750, 765, in which the California Supreme Court held that the party invoking section 25137 has the burden of proving by clear and convincing evidence that the approximation provided by the standard formula is not a fair representation and that party's proposed alternative is reasonable. Respondent contends that appellant has not met its burden. (Resp. Reply Br., pp. 12-13.)

Respondent also takes issue with appellant's case law interpretation as a basis for appellant's "comparison of qualitative and quantitative metrics" to support its position that exclusion of the gross proceeds from the divestiture of its television division would result in distortion because appellant contends that 100 percent of its income in that tax year resulted from its divestiture. Respondent states that such a comparison is misleading because those cases primarily deal with the dilution of the sales factor by the gross receipts of each taxpayer's ancillary treasury functions. Respondent further asserts that the courts in each of those cases analyzed the profit margins between the main line of business and the ancillary treasury function to demonstrate how the treasury functions were qualitatively different than the taxpayer's main line of business. Respondent contends that these cases did not link the taxpayer's business activity within California to the income earned from a certain activity but rather compared the nature of the activities giving rise to the gross receipts to the nature of the taxpayer's business. (Resp. Reply Br., p. 13.)

Respondent summarizes the facts of the cases cited by appellant and concludes that this Board and the courts upheld respondent's alternative apportionment formula because the standard UDITPA provisions resulted in an unreasonable apportionment of income. Respondent states that appellant provides two new exhibits and quotes a portion of the holding in *Microsoft* "for the proposition that it would result in distortion if Appellant's gross receipts were not linked to the income generated from the divestiture." However, respondent contends that appellant omits a footnote from that case which puts the quoted language in proper context by describing "the quandary of measuring the in-state presence of a company by comparing ratios of operational margins between various business activities." Respondent asserts that the *Microsoft* court included the footnote to ensure that the holding would not be interpreted as a precedent for "limiting the inclusion of gross receipts based on operational margins, where *Microsoft* dealt with treasury receipts." Additionally, respondent asserts that the footnote acknowledges that the location of where income is earned is not easily ascertainable, thus the need for an apportionment formula to source income from multistate businesses. Finally, respondent distinguishes the facts of *Microsoft* because appellant's television division divestiture resulted from a determination to liquidate part of its business and was not an ancillary part of appellant's normal day-to-day business similar to the treasury activities in *Microsoft*. Thus, appellant's comparison of the operational margins based on the divestiture and appellant's main line of business obfuscates appellant's actual business activity in California. (Resp. Reply Br., pp. 13-17.)

Respondent quotes a public comment made during the rulemaking process amending Regulation 25137(c)(1)(A) in which a tax practitioner recommended a definition of “substantial” in terms of the income resulting from a particular transaction and, as an example, proposes that a transaction that produced 90 percent of the income for the year and produced 90 percent of the gross receipts for that year should not be eliminated. Respondent’s staff recommended rejection of this proposal on the ground that such a definition is inconsistent with the basic premise that the sales factor is based upon gross receipts and not net income. Respondent further explains that “the sales factor is used to apportion income, not directly assign income from a particular activity to a particular location.” Respondent asserts that appellant’s argument confuses apportionment case law with separate accounting geographical income assignment and that a similar argument was rejected in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* (1980) 445 U.S. 425, 438 in which the Court held that profitability factors arise from the operation of a multi-state business as a whole so “it becomes misleading to characterize the income of the business as having a single identifiable ‘source’” and for state taxation purposes separate geographical accounting is not constitutionally required. Respondent asserts that the taxable income generated by the divestiture is included in the calculation of appellant’s unitary businesses’ tax base and California’s percentage of that tax base is determined by appellant’s business activities in this state as previously discussed. (Resp. Reply Br., pp. 17-18.)

Finally, respondent contends appellant has failed to provide a reasonable alternative apportionment formula as required by any party wishing to invoke R&TC section 25137. Rather, appellant merely proposes that the gross receipts from the divestiture be included in the sales factor denominator even though appellant admits in its reply brief at page 9 that that method results in distortion. (Resp. Reply Br., p. 18.)

Appellant’s Supplemental Brief

Appellant contends that respondent misreads Regulation 25137(c)(1)(A) by arguing that it requires aggregation of dispositions to determine whether a sale is occasional. Appellant asserts that the aggregation requirement of the regulation is only applied to determine whether a sale of assets is substantial, which is a point appellant has not argued, rather than whether a sale is occasional. Appellant contends that respondent confuses this issue by misconstruing appellant's analysis of the frequency and magnitude of the transactions by asserting that appellant is arguing that the sale of each asset of each television station must be considered as a separate transaction. Appellant states that it has argued that the aggregation of assets sold to a common purchaser is only required for the purpose determining whether a sale is substantial and not whether a sale is occasional. Thus, according to appellant, it has clearly stated that the sale of each television station as a distinct asset constitutes a transaction rather than each asset within a television station. (App. Supp. Br., p. 2.)

Appellant also contends that respondent overstates the Board's holding in *Fluor* by stating that the Board reasoned that the taxpayer in that appeal established "the existence of elements required for the application of the special sales factor computation . . ." Appellant maintains that the Board did not set forth an analysis of how it determined the existence of the elements to meet the occasional requirement nor did the Board discuss the reasoning used to arrive at that conclusion. Appellant asserts that such an analysis was unnecessary because respondent conceded that the taxpayer had satisfied the conditions of Regulation 25137. Because the Board in *Fluor* did not provide any reasoning to support the determination that the sales at issue were substantial or occasional, appellant concludes that respondent cannot claim to follow the Board's reasoning in that appeal. (App. Supp. Br., p.3.)

Appellant contends that the restructuring of its broadcasting operations was a part of its regular transactions of managing broadcast operations and thus meets the transactional test under the *Citicorp* court's analysis. In addition, appellant contends that in two recent appeals before this Board respondent has made arguments similar to appellant's argument in this appeal. In *Appeal of Sonic Automotive, Inc.*, Case ID No. 505065, decided July 27, 2011[6], respondent argued that an assignment fee was business income to the taxpayer under the transactional test because a "fundamental part of [the taxpayer's] business plan is the acquisition, operation and disposition of dealerships" and the controlling factor is that the nature of each dealership transaction "is the attempted expansion through acquisition or disposition of dealerships." In *Appeal of Comcast Cablevision Corp.*, Case ID No. 424198, decided

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[6] Summary decisions may not be cited as precedent in any appeal or other proceeding before this Board. (Rule for Tax Appeals, Cal. Code Regs., tit. 18, §5451(d).)

February 2, 2012[7], respondent argued that a termination fee was business income to the taxpayer under the transactional test because it arose from the taxpayer's "regularly recurring activity of acquiring cable systems and their system subscribers by acquiring other cable companies . . ." and over a 15 year period appellant engaged in over 30 transactions and 4 such transactions in 1999 alone. Similarly, appellant contends that its business plan achieves growth through acquisition and disposition of broadcast properties and thus generates business income under the transactional test. (App. Supp. Br., pp. 4-5.)

Finally, appellant contends that contrary to respondent's characterization of appellant's position, appellant has never admitted that the apportionment method it utilized on its original return results in distortion. Instead, appellant contends that it has always asserted that application of Regulation 25137(c)(1)(A) is distortive. (App. Supp. Br., p.6.)

<u>Applicable Law</u>

Appellant is engaged in a unitary business and, as a result, appellant's business income must be apportioned according to the Uniform Division of Income for Tax Purposes Act (UDITPA) which is codified in California law in R&TC sections 25120 through 25141. As in effect for the taxable year in issue, California's version of UDITPA generally requires that a taxpayer's business income be apportioned by a formula composed of a property factor, a payroll factor and a double-weighted sales factor. (Rev. & Tax. Code, § 25128.)[8] The numerators of these respective factors represent the taxpayer's property, payroll and sales in California, while the denominators represent the taxpayer's property, payroll and sales everywhere. (Rev. & Tax. Code, §§ 25129, 25132, & 25134.)

R&TC section 25134 provides that the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in California during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year. R&TC section 25120, subdivision (e), defines the term "sales" as "all gross receipts of the taxpayer not allocated under Sections 25123 to 25127, inclusive." For purposes of the sales factor, the term "sales" means all gross receipts derived by

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[7] Letter decisions may not be cited as precedent in any appeal or other proceeding before this Board. (Rule for Tax Appeals, Cal. Code Regs., tit. 18, §5450(d).)

[8] All statutory references are to the versions of those Revenue and Taxation Code sections in effect during the tax year in issue.

the taxpayer from transactions and activity in the regular course of the taxpayer's trades or businesses. (Cal. Code Regs., tit. 18, § 25134, subd. (a)(1).) The California numerator corresponds to the taxpayer's California in-state gross receipts, so as the amount of those receipts increases, so does the California sales factor. Conversely, as the amount of the taxpayer's out-of-state gross receipts increases, the denominator increases in relation to the California numerator, hence, the California sales factor decreases.

R&TC section 25137 provides that, if the allocation and apportionment provisions of the UDITPA do not fairly represent the extent of a taxpayer's business activity in California, the taxpayer may petition for, or respondent may require the following, if reasonable, with respect to all or any part of the taxpayer's business activity:

(a) a separate accounting;

(b) the exclusion of one or more of the apportionment factors;

(c) the inclusion of one or more additional factors that will fairly represent the taxpayer's business activity in California; or

(d) the employment of any other method to effect an equitable allocation and apportionment of the taxpayer's income.

It is well settled that the party invoking R&TC section 25137 bears the burden of proof. (*Appeal of Crisa Corporation*, *supra*.) The California Supreme Court has stated that the party invoking that section has the burden of proving by clear and convincing evidence that (1) the approximation provided by the standard formula is not a fair representation of the taxpayer's business activity in California and (2) its proposed alternative is reasonable. (*Microsoft* at p. 765.)

The interpretive regulation, Regulation 25137(c)(1), provides special sales factor rules as follows:

> (A) Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory, patent, or affiliate's stock will be excluded if substantial. For purposes of this subsection, sales of assets to the same purchaser in a single year will be aggregated to determine if the combined gross receipts are substantial.
>
> 1. For purposes of this subsection, a sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer or, if the

taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole.

2. For purposes of this subsection, a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently.

(B) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless such exclusion would materially affect the amount of income apportioned to this state. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as the sale of office furniture, business automobiles, etc.

Definition of Occasional Sale

In *Appeal of New York Football Giants, Inc., supra*, this Board upheld respondent's application of R&TC section 25137 by adjusting the payroll factor of the taxpayer professional sports team's apportionment formula. This Board found that the team occasionally played in California, i.e., one game a year, so the standard formula did not fairly reflect the extent of the taxpayer's business activity in California. In *Appeal of The Learner Company, et al., supra*, this Board described visits by the taxpayer's officers to Japan once or twice a year as "infrequent" and "occasional."

Sales and Use Tax Regulation 1595(a)(1) provides in part that, for purposes of determining whether the seller must obtain a seller's permit, "[g]enerally, a person who makes three or more sales for substantial amounts in a period of 12 months is required to hold a seller's permit . . ." The regulation further provides the following as an example of the application of the principles therein: In any 12 month period, if the operator of certain specified service enterprises "makes more than two sales in substantial amounts of tangible personal property used in the service enterprise, the first two sales are exempt occasional sales, but the operator is required to hold a permit for the third and subsequent sales during any 12-month period." (Cal.Code Regs., tit. 18, §1595(a)(5)(A)(2.).)

FTB Legal Ruling 97-1 addressed the issue of whether substantial gross receipts that arise from an incidental or occasional sale of intangible property held or used in the regular course of a taxpayer's trade or business should be excluded from the sales factor. Under the hypothetical facts presented, the taxpayer engaged in income-producing activity and sold an intangible asset held or used in the regular course of the taxpayer's trade or business, such as a patent used in the business or the stock of an affiliate, which generated substantial gross receipts and was properly characterized as business income. The legal ruling concluded that the gross receipts from an incidental or occasional sale of such intangible property should be excluded from the sales factor.

FTB Legal Ruling 2006-3 addressed the issue of how gains resulting from an election made under either IRC section 338(h)(10) or IRC section 338(g) should be apportioned for California purposes. In general, IRC section 338 allows taxpayers to elect to treat certain stock sales as sales of the underlying assets of the corporation whose stock was sold and the ruling states the deemed sale of assets is treated as an actual sale of assets for apportionment purposes. Thus, if the gain from the sale constitutes apportionable business income pursuant to R&TC section 25120, the gain must be apportioned to the states where the target corporation did business prior to the sale. However, under section 25137, subsection (c)(1)(A), if the deemed sale of the assets generates substantial amounts of gross receipts, then the gross receipts should be excluded from the target corporation's sales factor numerator and denominator, except where the target corporation reports the gain on a single-day return pursuant to an IRC section 338(g) election. FTB Chief Counsel Ruling 2008-3 explains that Regulation 25137(c)(1)(A) does not apply when the taxpayer makes an IRC section 338(g) election because the sale of the assets is the only transaction in the reporting period, hence it is not an occasional sale.

Application of Regulation 25137

In *Appeal of Triangle Publications Inc.*, *supra*, the relevant issue was whether respondent properly excluded gain from the sale of certain assets from the sales factor of the taxpayer's apportionment formula. The taxpayer operated radio, television, magazine, television publications and trade publication divisions and sold its newspaper, radio, and television divisions and real property used by the trade publications division. This Board held that those sales generated business income under the functional test. Although this Board found that the sales transactions appeared to satisfy the conditions for application of the special apportionment formula under the former version of Regulation 25137(c)(1)(A), the Board held that any party seeking to deviate from the standard formula bears the burden of proving exceptional circumstances. In this regard, the Board held that respondent could not rely on the regulation to meet its burden of proving that the statutory formula did not fairly represent the extent of the taxpayer's business activity in California. Because respondent failed to show that the standard formula did not fairly represent the extent of the taxpayer's business activity in California, the Board held that the special formula could not be applied and the standard formula must be used.

In *Appeal of Fluor Corporation, supra*, the issues before this Board were whether respondent correctly recalculated appellant's sales factor which included gross receipts from the sales of assets located within and without California and whether the party arguing for application of Regulation 25137 must make a preliminary showing of distortion. The taxpayer, a multinational corporation, and its subsidiaries made significant sales of their business properties in 1984 and 1985 resulting in total gross proceeds of approximately $528 million. The taxpayer included the net income from these sales in its apportionable business income on its California return but did not include the gross proceeds in its sales factor. Respondent revised the taxpayer's sales factor by including the entire amount of the gross proceeds in the denominator and approximately $334 million (from the sale of the taxpayer's California property) in the numerator.

The taxpayer took the position that the standard apportionment formula did not fairly represent the extent of its business activities in California and that an alternative method was required. In support of its position, the taxpayer cited Regulation 25137(c) and contended that its method of reporting asset sales conformed to this provision by excluding from the sales factor substantial amounts of gross receipts that arose from an occasional sale of fixed assets held or used in the regular course of the taxpayer's business.

The Board held that, where the regulations do not provide for a special formula or method, the standard UDITPA formula must be applied unless the party seeking to depart from it can prove distortion. However, the Board departed from its prior analysis in the *Appeal of Triangle Publications, Inc.* and held that, if a relevant special formula is provided in the section 25137 regulations and the conditions and circumstances for application of such a special formula are satisfied, the prescribed formula shall be applied. Furthermore, in the event that a party seeks to depart from the special formula, this Board held that party must prove by clear and convincing evidence that the regulation does not fairly represent the extent of the taxpayer's activities in the state.

<u>Business Income Tests</u>

California has two tests for business income, the functional test and the transactional test. As noted above, the parties appear to agree that the test for determining whether a transaction is "occasional" is similar to the test for determining whether a transaction occurs in the regular course of business such that it satisfies the transactional test for business income.

Under the transactional test, corporate income is business income if it arises "from transactions and activity in the regular course of the taxpayer's trade or business." (Rev. & Tax. Code § 25120, subd. (a).) In *Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, the court held that the "controlling factor" is the "nature of the particular transaction" generating the income. (*Hoechst Celanese*, *supra*, at p. 526 [internal citation omitted].) The court explained that "[r]elevant considerations include the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income." (*Id.* [internal citation omitted].) The court concluded that "the reversion [at issue in that case] and activities necessary to execute the reversion were extraordinary circumstances[,]" rather than "normal trade or business activities of Hoechst, which manufactured and sold a diversified line of chemicals, fibers and specialty products." (*Id.* at p. 527.) It further stated that "[b]ecause the reversion was a 'once-in-a-lifetime corporate occurrence,' it cannot meet the transactional test." (*Id.* [internal citation omitted].)

In *Citicorp North America, supra*, the taxpayer, a banking corporation, argued that gains from the disposition of real properties were nonbusiness income under the transactional test because the sales were not part of the taxpayer's regular business of banking. The court of appeal found that the taxpayer managed its corporate headquarters, other office buildings and property in Japan as an integral part of its business. The court acknowledged that the parties had stipulated that the sales of the properties were part of a restructuring of the taxpayer's real estate holdings and that the taxpayer had a department devoted to management and leasing of real property. The court also stated that "[t]here can be little argument that Citicorp managed its corporate headquarters, other office buildings and the property in Japan as an integral part of its business."

The court further stated that the evidence supported a finding that the taxpayer considered the income from the real estate properties to be business income prior to the sale. However, the court found no evidence as to how often, or for what purpose, the taxpayer was restructuring its real estate holdings other than the fact that the restructuring resulted in sales of four corporate properties in one year. In addition, the court found that the taxpayer did not present any evidence of the frequency, nature or extent of its in-house real estate management activities. Based on the foregoing, the court concluded that the taxpayer generated business income under either the transactional test or the functional test when its real estate department, which acquired, managed, leased and sold corporate real property, engaged in these transactions. (*Id.* at 1430-31.)

Distortion

In *Microsoft*, the Court held that redemption of marketable securities at maturity generates "gross receipts" that are includible in the apportionment formula under R&TC section 25128. (*Microsoft* at p. 755.) However, the Court further held that the inclusion of such "gross receipts" was distortive for purposes of R&TC section 25137, under the particular facts of *Microsoft*, and that an apportionment formula that included only "net receipts" was a reasonable alternative there. (*Microsoft* at pp. 755, 764-772.) The *Microsoft* court initially noted that the party invoking R&TC section 25137 has the burden of proving by clear and convincing evidence (1) that the approximation provided by the standard formula is not a fair representation and (2) that the party's proposed alternative is reasonable. (*Microsoft* at p. 765.) The Court then went on to explain that the issue relating to short-term security investments was one of scale and not the inclusion of the full sales or redemption price of the security in gross receipts. The Court noted that short-term securities involve margins (i.e., the difference between the cost and the sales price of the security) that are quite small in absolute terms and, as a result, make these securities quite different than the sale of other types of commodities. To illustrate this, the Court noted that Microsoft's 1991 redemptions totaled $5.7 billion, while the income from these investments totaled only $10.7 million, a margin of less than 0.2 percent. In contrast, Microsoft's nontreasury activities produced gross receipts of $2.1 billion and income of $659 million, a margin of more than 31 percent (170 times greater than the margin from its securities). (*Microsoft* at p. 767.)

The Court stated that this situation, a mix of low-margin sales with a mix of higher margin sales, presented a problem for the UDITPA because the "UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state." (*Microsoft* at p. 768.) The Court observed that "modern corporate treasury departments whose operations are qualitatively different from the rest of a corporation's business and whose typical margins may be quantitatively several orders of magnitude different from the rest of a corporation's business pose a problem." In that regard, the Court explained that under the UDITPA, the operations and gross receipts of a treasury department are properly attributed to the state where the department operates and the nature of these operations means that the corporation's true margin for its operations in that state will be much lower than the worldwide average, and its margin for every other state will be much higher than the worldwide average. The Court held that the application of the worldwide average margin to each state's gross receipts results in severely underestimating the amount of income attributable to every state *except* the state hosting the treasury department. On that basis, the Court concluded that rote application of the standard formula does not fairly represent the extent of a taxpayer's activity in each state, except in the rare instance when corresponding imprecision in the payroll and property factors may happen to balance out this distortion. (*Microsoft* at pp. 768-769.)

In *The Limited Stores*, *supra*, the Court of Appeals, consistent with the *Microsoft* decision, held that the entire amount received in the redemption of securities should be treated as gross receipts. The court determined that the taxpayer's treasury department functions were qualitatively different from the taxpayer's principal business (i.e., a retailer of men's and women's clothing and bath products) and that the quantitative distortion from the inclusion of its investment receipts in the sales factor was substantial, such that it was appropriate for respondent to correct these distortions by applying R&TC section 25137. The Court of Appeals then concluded that respondent's alternative of only including the net receipts from the taxpayer's redemptions in the sales factor denominator was appropriate.

In *Limited Stores*, for 1993, the taxpayer's short-term investments produced less than 1 percent of the company's business income, but over 62 percent of the company's gross receipts. For 1994, the taxpayer's short-term investments again produced less than 1 percent of the company's business income, but over 52 percent of the company's gross receipts. Looking at distortion on the basis of the taxpayer's margins, for 1993 and 1994, the company's redemptions totaled approximately $20 billion while its income from these transactions was approximately $16 million, a margin of less than 0.1 percent. From the sale of tangible property in 1993 and 1994, the company had $14.5 billion in gross receipts and income from these transactions of $6.7 billion, a margin of over 46 percent—roughly 460 times greater than its margin from the redemptions from the company's treasury department. (*The Limited Stores*, at p. 1500.)

In the *Appeal of Pacific Telephone and Telegraph Company,* 78-SBE-028, decided May 4, 1978, the taxpayer was a member of an integrated nationwide group of telephone companies and the issue was whether to exclude the return of capital element of the taxpayer's investment receipts. This Board found that distortion existed due to the inclusion of such receipts in the sales factor and that it was appropriate to utilize an alternative formula, pursuant to R&TC section 25137, as proposed by respondent. Specifically, the income from these investments constituted less than 2 percent of the company's business income, but when the receipts from these investments were combined with the gross receipts from the taxpayer's other business activities, such receipts would constitute approximately 36 percent of the company's total receipts in each appeal year. In other words, this one activity alone would treat approximately one-third of the nationwide group's total "sales" as having taken place in New York and the apportionment formula would assign about 11 percent of the nationwide group's entire business activities to New York. This Board concluded that distortion existed based on the fact that more than 11 percent of nationwide group's entire unitary business activities would be attributed to a single state even though the working capital investment activities were only an incidental part of one of the nation's largest and most widespread businesses.

STAFF COMMENTS

Question 1: Occasional Sale Regulation

Appellant points to "41 acquisitions/exchanges and 28 dispositions/exchanges" of broadcasting locations from 1998 to 2008 (App. Reply Br., p. 5) as evidence that the subject sales occurred in appellant's normal course of business. Respondent contends that the sales of appellant's television stations constituted a "divestiture" of an entire division of appellant's business operation which is properly characterized as "infrequent" and "occasional" because appellant primarily generates revenue from selling advertising. At the hearing, respondent should be prepared to explain and articulate a standard or basis for determining when a series of sales should be treated as an occasional transaction or transactions, and when such sales should be viewed as a normal part of a taxpayer's business activities. Each party should state its view of the circumstances in which appellant's sales or acquisitions of media properties, including radio stations, would be considered to be transactions in appellant's ordinary course of business.

At the hearing, each party should be prepared to discuss further its view of the interaction between Regulation 25137(c)(1)(A)2 and the transactional test. As noted above, appellant contends that its sales of media properties were in the ordinary course of business and, therefore, the subject sales of the television stations met the transactional test for business income. Respondent asserts that the transactional test and the occasional sale test apply similar standards, and, if the transactional test for business income is met, then a sale is "most likely" not "occasional" under Regulation 25137(c)(1)(A)2. However, respondent contends that the divestiture of the television division would not satisfy the transactional test for business income because it was an extraordinary event that did not occur in the regular course of appellant's business.

Question 2: Fair Representation

If the Board finds that both conditions of Regulation 25137(c)(1)(A) have been met, i.e., a substantial amount of gross receipts arose from an occasional sale, then the Board must determine whether appellant has shown, by clear and convincing evidence, that the exclusion of the gross receipts from the sales factor would not fairly represent the extent of appellant's business activities in California. The Board does not need to reach this issue unless it determines that the gross receipts arose from occasional sales that were conducted outside of appellant's normal business. With this in mind, appellant should be prepared to explain further how, if the sales were found to be outside of appellant's normal business, the exclusion of the sales would be distortive.

Formal Opinion

Staff recommends that the Board consider issuing a Formal Opinion in this matter. Rule for Tax Appeals section 5452, subdivision (e), provides a nonexclusive list of factors for determining whether a Formal Opinion might be appropriate. Staff believes that, under clause (3) of subdivision (e), the publication of such an opinion would involve "a legal issue of continuing public interest" by clarifying how the occasional sale test should be analyzed and how it relates to or compares with the transactional test for business income.

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