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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of:	**SECOND REHEARING SUMMARY**[2]
	PERSONAL INCOME TAX APPEAL
BILLY WAYNE BLANKS AND	Case No. 268581
GAYLE H. BLANKS AND	Case No. 268579
BG STAR PRODUCTIONS, INC.[1]	

Appellants	Years	Proposed Assessments
BG Star Productions, Inc.	1998	$112,394[3]
	1999	62,250
Billy Wayne Blanks and Gayle H. Blanks	1998	$663,038
	1999	987,125

Representing the Parties:

For Appellants: Thomas W. Henning, Attorney

For Franchise Tax Board: William C. Hilson Jr., Tax Counsel IV

[1] Appellants appear to reside currently in West Hills in Los Angeles County.

[2] This second rehearing summary reflects additional briefing and information requested by the Board at the rehearing held on May 15, 2008. The original rehearing summary is hereby incorporated and attached to this second rehearing summary as exhibit A. This second rehearing summary has been revised to remove the issue with respect to the frivolous appeal penalty, which respondent indicates it withdrew at the May 15, 2008, oral hearing.

[3] Respondent should be prepared to provide the accrued interest amount at the time of the oral hearing.

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QUESTIONS: (1) Whether the installment sale of the exclusive rights to market and sell "Tae Bo" took place in 1998 or 1999.

(2) What is the appropriate method to value the deferred obligation and what is the value of the deferred obligation.

REHEARING SUMMARY

Background

On February 1, 2006, this Board adopted a summary decision sustaining respondent Franchise Tax Board's (respondent or FTB) deficiency assessments for 1998 and 1999 based on respondent's determination that appellant BG Star Productions, Inc. (BG Star) entered into an installment sales agreement in 1998 for the exclusive rights to market and sell "Tae Bo" pursuant to which respondent properly imputed interest pursuant to Revenue and Taxation Code (R&TC) section 24667, which incorporates the installment sale rules of Internal Revenue Code section 453A. In the summary decision, the Board found that appellants' 1999 state tax return and two sales agreements (the "Temporary Operative Deal Memorandum," dated July 21, 1999 (TODM), and the "Final Agreement" (dated August 31, 1999) presented as evidence by appellants established that an installment sales agreement commenced on August 31, 1998. The TODM provided that the term of the agreement shall be seven years with a retroactive effective date of August 1, 1998 and that "NCP was to pay $20,000,000 for year one which commenced August 1, 1998. $20,000,000 in advance for year two which commences August 1, 1999." The TODM was finalized in the Final Agreement dated August 31, 1999 (1999 Agreement), which provided that appellants would transfer to NCP Marketing Group, Inc. (NCP) the exclusive right and license to use the "Tae Bo" name and all related intellectual property rights and other rights.

Appellants filed a timely petition for rehearing accompanied by a copy of an agreement, titled "Deal Memorandum" between appellant Billy Blanks and Universal Management Services, Inc., dated May 9, 1997. The Board granted the petition and a rehearing summary, which is incorporated by reference and attached, was drafted by the Appeals Division. The Board held the rehearing on May 15, 2008, then continued the hearing and directed the parties to provide the following additional information:

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- Respondent was to provide a breakdown of the 1999 proposed assessments, specifically: (1) identifying the amount of the IRC section 453A interest proposed as additional tax as well as identifying the remaining amounts; and (2) allowing for the appropriate $10 million exclusion amount applicable to married taxpayers for imposition of IRC section 453A interest (as opposed to the previously applied $5 million exclusion amount).
- Both parties were instructed to brief the issue of the appropriate method for calculating the IRC section 453A interest and to provide an expert's valuation of the installment obligation owing at the end of 1999.

Contentions

Appellants' Contentions

Appellants disagree with respondent's calculation of the interest for the year 1999, which appellants contend is based on the full principal amount of the installment obligation. Appellants state that there are two reasonable methods for determining IRC section 453A interest: the fair market value method and the wait-and-see method. Appellants state that the Internal Revenue Service (IRS) has taken the position in a private letter ruling that the fair market value is reasonable because it results in equal treatment for taxpayers who report under the installment method and taxpayers who elect out of that method. Appellants also note that the IRS has adopted the wait-and-see method for valuing original issue discount contingent payments such that there is no taxable income or deduction until a payment is actually made and the taxpayer recognizes taxable gain. (App. Add. Br., pp. 6-7.)

Appellants contend that the application of either the fair market value or the wait-and-see method results in the imposition of no IRC section 453A interest to this contingent obligation. Appellants assert that the Marshall & Stevens appraisal report (M&S Report or Report), attached to their brief as Exhibit A, indicates that there was little realistic possibility on December 31, 1999, that NCP would pay any portion of the contingent obligation and that NCP elected under the agreement to terminate its obligation in 2000 by converting to a royalty arrangement. Appellants further assert that the M&S Report concludes that the contingent obligation had a value of $300,000 which is less than the $10 million threshold applicable to married taxpayers for imposition of IRC section 453A interest. Thus, appellants conclude that IRC 453A was not applicable under either the fair market value method based

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on the threshold amount or the wait-and-see method because no installment payments were ever received. (App. Add. Br., pp. 7-8.)

The M&S Report emphasizes that NCP had the ability, at its option, to convert the contingent installment obligation to a 5 percent royalty arrangement and states that the appraisal is only concerned with determining the fair market value of NCP's contingent obligation "given that NCP may convert to a straight royalty." (App. Add. Br., Exhibit A, p.3.) The Report assumes that the $20 million contingent installment payment obligation would be more advantageous to NCP only if annual sales exceeded $400 million (an average of $33 million per month) or if NCP anticipated that cumulative adjusted gross revenue would exceed $2 billion for the five-year term of the agreement. The M&S Report concludes that NCP would have great incentive to convert to the royalty arrangement if revenue did not or was not expected to reach those targets.

In evaluating the willingness of a potential investor to purchase appellants' right to the installment payments based on the risk that those payments may not be made, the M&S Report surmises that based on past performance it is unlikely that a potential investor as of December 31, 1999, would project average monthly sales of $33 million for 12 continuous months. The M&S Report then posits that such a potential investor would assume that any level of sales below $33 million per month would cause NCP to convert to the royalty arrangement at which time the installment obligation becomes worthless. The Report concludes that there was a very strong likelihood that NCP would opt out of the installment obligation because of the remote possibility that sales would reach $33 million per month. Based on the conclusion, the report states that the 1999 agreement "effectively put Blanks on a 5% royalty arrangement because the odds were overwhelming that sales would not double in 2000 over actual results in 1998 and 1999." (App. Add. Br., Exhibit A, pp. 6-8.)

Based on that conclusion, the M&S Report opines that the installment sale obligation had no fair market value and that any potential investment would be equivalent to purchasing a lottery ticket. The report speculates that there are individuals willing to pay between .5 percent and 2.5 percent of the $20 million potential payout essentially to gamble that the annual installment amount would be paid. For that reason, the Report makes a fair market value determination of $300,000, which amount is at the midpoint of that range. (App. Add. Br., pp. 20-21.)

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Appellants further contend that respondent's use of the "maximum theoretical amount" of the contingent obligation, which results in appellants paying interest on a large amount of gain that was never recognized, is not a reasonable method. Appellants maintain that a reasonable method for computing IRC section 453A interest should result in a taxpayer paying interest on gain that is either forecast (fair market value method) or actually received (wait-and-see method), which are consistent with the purpose of installment sale reporting to match the imposition of tax with the payment received. Instead, appellants contend that respondent's method would require the Board to ignore the fact that no installment payment was ever received and result in appellants paying interest to defer nonexistent gain on a contingent obligation with virtually no value. (App. Add. Br., pp. 8-9.)

Appellants also repeat their contention that the 1999 agreement was effective on August 31, 1999, but was made retroactive to August 1, 1998, in order to relieve NCP and its predecessor company of any obligation to pay royalties to appellants under the 1997 agreement. However, appellants contend that the retroactivity provision did not make the sale transaction effective as of August 1, 1998.

Respondent's Contentions

Pursuant to the Board's request at the May 15, 2008 oral hearing, respondent submitted a revised schedule on October 22, 2008, showing an IRC section 453A interest charge for 1999 as follows: BG Star Productions, Inc., $63,198[4] and Billy and Gayle Blanks, $358,603. (Attached as exhibits B-D.)[5] With respect to Billy and Gayle Blanks, respondent indicates in its revised schedule that the remaining proposed adjustment amounts contained in the proposed assessment are for:

- Reversed amended amounts for capital gain and interest ($6,438,951)
- Limitation on itemized deductions—difference $382,545

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[4] Respondent provided its revised schedule for 1999 for Billy and Gayle Blanks and did not provide a revised schedule for BG Star Productions, Inc. Staff notes that the BG Star Productions Inc.'s revised 1999 453A interest charge is set forth on the schedule respondent provided for Billy and Gayle Blanks, as $63,198. (See the attached exhibit B, note "d.")

[5] Respondent has also provided a schedule (attached to this hearing summary as exhibit C) showing the calculation of 453A interest for 1999 for Billy and Gayle Blanks based on a total selling price of $111,708,448. The schedule explains that appellants Billy and Gayle Blanks originally paid 453A interest in the amount of $470,615 for 1999, but were refunded this amount subject to an audit of the amended return. Finally, respondent provides a schedule of Billy and Gayle Blanks' revised tax liability without 453A interest charges (attached to this hearing summary as exhibit D.)

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In an additional brief dated February 6, 2009, respondent argues that the 1999 agreement was a valid installment sale agreement that commenced on August 1, 1998. Respondent contends that the terms of the 1999 agreement provide for a total amount of $140 million to be paid in seven installments and that appellants reported the transaction as an installment sale with a date sold of August 1, 1998, on their 1999 return. In addition, respondent points out that the 1999 agreement provides that NCP was required to place 20 percent of the annual profits exceeding $100 million into a trust fund, so as to provide a source of funds to make future installment payments. Respondent also contends that the NCP's option of converting the installment obligation to royalty payments does not alter the fact that the parties entered into an installment sales agreement as of August 1, 1998. (Resp. Add. Br., pp. 2-3.)

Respondent states that appellants asserted in the 1999 amended return that the 1999 agreement was amended due to the buyer's inability to pay the installment obligation but respondent contends that appellants have not produced any writing to support a modification. Respondent also disputes appellants' position that no installment sales agreement existed in 1998 because the 1999 agreement was executed a year later in 1999 in derogation of the statute of frauds. Respondent contends that the subject matter of the 1999 agreement did not require the agreement be reduced to writing at the time performance commenced. In addition, respondent contends that under California law an agreement not reduced to writing does not violate the statute of frauds if one party has fully performed his or her obligations under the agreement. Respondent asserts that the terms of the 1999 agreement clearly prove that the parties commenced the contractual relationship as of August 1, 1998, as demonstrated by the provision for payment of $8,333,333 for 1998 and appellants' acknowledgement that they received such payment. (Resp. Add. Br., pp. 4-5.)

Respondent asserts that all the evidence shows that the parties entered into an installment sales agreement in 1998 to which the installment sales reporting provisions of IRC section 453A are applicable. Respondent further asserts that the IRC or the temporary regulations do not permit or contemplate the use of a fair market value analysis to determine the computation of interest. Respondent contends that the installment method of reporting is the proper tax treatment in this case because appellants failed to opt out of the installment method which was required before the due date of the 1998

return. (Resp. Add. Br., pp. 6-7.)

Respondent discusses the relevant installment sale provisions of IRC sections 453 and 453A and the legislative purpose behind those provisions. Respondent notes that for taxpayers who elect out of installment reporting, Congress imposed a tax on the discounted fair market value of the taxable gain that the seller expected to receive whereas for taxpayers who report under the installment method, the interest assessment is intended to compensate the government for the time value of the tax payments that are deferred.

Respondent also discusses the provisions of IRC section 453B relating to installment sale obligations owed to sellers which are satisfied at an amount other than face value or disposed of in some manner by the buyer. Respondent states that the rules under this section provide that the sale or other disposition of an installment obligation results in the recognition of gain or loss to the seller. Under IRC section 453B, subdivision (a)(2), respondent states, the gain or loss is recognized as the difference between the seller's basis in the obligation and the fair market value of the obligation at the time of disposition. Respondent states that its discussion of the foregoing provisions is presented to point out that Congress implemented tax laws dealing with various installment sale transactions but conspicuously omitted the use of the fair market valuation method "in situations where the underlying business transaction is ongoing and the taxpayer is subject to the installment method." (Resp. Add. Br., pp. 8-9.)

Respondent asserts that appellants' M&S Report totally ignores the facts and documented conduct of appellants and NCP during 1998 and 1999. Respondent disputes the conclusion of the M&S Report that NCP's promise to pay the $100 million contingent obligation was illusory because NCP could terminate the agreement at any time and instead pay appellants under a 5 percent royalty arrangement. Specifically, respondent notes that

- Annual sales were $192 million for any twelve month period from August 1998 to December 1999 or an average of $16 million a month.
- The 1999 Agreement recites that it commenced in August 1998 with payments of $40 million for the two-year period from August 1998 through July 2000.

Respondent states that the M&S Report suggests that NCP was only required to make the $20 million annual payment when and if annual adjusted profits were $400 million but fails to explain

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why NCP made two annual payments of $20 million when annual gross sales were only $192 million. If NCP was free to change the payments to a 5 percent royalty at any time, respondent concludes that the two $20 million payments would not have been made because $20 million is more than double the 5 percent royalty payment of $9,600,000 ($192 million x 5%). Respondent further asserts that the 5 percent royalty arrangement appears to be contingent on, among other events, annual profits below $75 million and the depletion of funds held in a trust account. Based on those provisions, respondent believes that the parties intended that the $20 million payment would continue until profits dipped below $75 million and the trust account was depleted. Respondent states that the M&S Report fails to mention those facts. (Resp. Add. Br., pp. 10-12.)

Respondent's appraisal (appraisal) disagrees with the basic assumption of the M&S Report that NCP had an incentive to switch to a 5 percent royalty arrangement whenever annual revenue dropped below $400 million. The appraisal points out that section 5(b) of the 1999 Agreement provides that if in any year NCP earned profits in excess of $100 million, it would deposit 20 percent of the excess in an account but not in an amount to exceed $20 million. The funds in this account would be used to satisfy the annual installment payments under the 1999 agreement. Then, under section 5(d), if in any year NCP earned profits of less than $75 million, it could access the funds in the account with the limitation that NCP could withdraw a maximum of $20 million less 20 percent of that year's profits. The appraisal concludes that NCP could not opt for the royalty arrangement unless the amount in the account was below the maximum amount that could be withdrawn. (Resp. Add. Br., exhibit A, pp. 2-3.)

In order to determine the value of the installment sale in 1999, the appraisal estimates the profit margin, projected sales and a discount rate for present value calculations. With respect to the profit margin, the appraisal states that a range of 30 percent to 80 percent would be possible given that ownership of the intangible assets would entitle NCP to earn more profit than a mere distributor and that duplication and distribution of the tapes would not involve substantial operating expense to NCP. The appraisal states that the gross revenue was assumed to be $192 million for 1999. With respect to the discount rate, the appraisal assumes 15 percent which represents a risk far greater than the interest rate on the debt of a large corporation. Finally, the appraisal assumes that the amount of money in the account for 2000 would be $11,666,667 because NCP already paid that amount toward the 2000

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installment. The appraisal then applies varying revenue decay rates and profit margin percentages, weights each value by it corresponding probability and adds the results to determine an estimate of value of approximately $18 million of which $11,666,667 has already been paid. (Resp. Add. Br., exhibit A, pp.4-6.)

Applicable Law

California law has generally adopted the provisions under IRC sections 453 and 453A relating to the installment method and special rules for nondealers. (Rev. & Tax. Code, § 24667(a)(1).) IRC section 453, subdivision (a) provides generally that "income from an installment sale shall be taken into account for purposes of this title under the installment method." As relevant here, an installment sale is defined, for purposes of the section, as "a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs." (Int.Rev. Code § 453(b)(1).) The installment method is defined, for purposes of the section as "a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price." (Int.Rev. Code § 453(c).) A taxpayer may opt out of reporting an installment sale under the installment method by making a timely election. (Int.Rev. Code § 453(d).)

IRC section 453A provides that "[t]his section shall apply to any obligation which arises from the disposition of any property under the installment method, but only if the sales price of such property exceeds $150,000." (Int.Rev. Code, § 453A(b)(1).) With respect to an installment obligation to which section 453A applies "interest shall be paid on the deferred tax liability with respect to such obligation in the manner provided under subsection (c)." (Int.Rev. Code, § 453A(a)(1).) However, the interest provision is applicable only if the installment obligation is outstanding as of the close of such taxable year *and* the face amount of all such obligations held by the taxpayer which arose during, and are outstanding as of the close of, such taxable year exceeds $5,000,000. (Int.Rev. Code, § 453A(b)(2)(A) and (B).) An IRS private letter ruling, TAM 9853002, concluded that by imposing interest on the applicable percentage of a deferred tax liability, Congress required a taxpayer to forgo the time value of the money that would have been used to pay the deferred taxes, thereby placing the taxpayer in a position similar to a taxpayer who elected out of the installment method.

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The interest for any taxable year is computed by multiplying the applicable percentage of the deferred tax liability with respect to such obligation by the underpayment rate in effect under IRC section 6621(a)(2) for the month with or within which the taxable year ends. (Int.Rev. Code, § 453A(c)(2)(A) and (B).) For purposes of IRC section 453A, "deferred tax liability" means, with respect to any taxable year, "the amount of gain with respect to an obligation which has not been recognized as of the close of such taxable year, multiplied by the maximum rate of tax in effect under section 1 or 11, whichever is appropriate, for such taxable year." (Int. Rev. Code, § 453A(c)(3)(A) and (B).) The "applicable percentage" of the deferred tax liability is determined by dividing "the portion of the aggregate face amount of such obligations outstanding as of the close of such taxable year in excess of $5,000,000, by the aggregate face amount of such obligations outstanding as of the close of such taxable year." (Int. Rev. Code, § 453A(c)(4)(A) and (B).) IRC section 453A also provides that the Secretary of the Treasury "shall prescribe such regulations as may be necessary to carry out the provisions of this subsection including regulations providing for the application of this subsection in the case of contingent payments, short taxable years, and pass-thru entities." (Int.Rev. Code, § 453A(c)(6).)

Valuation of Contingent Installment Obligations

Although IRC section 453A(c)(6) provides that regulations shall be prescribed as necessary to carry out the provisions for contingent payments, no regulation has been promulgated that prescribes the method for valuing a contingent installment obligation for purposes of computing interest under IRC section 453A. In addition, the IRS has not provided any other guidance in this area.

With respect to regulations promulgated under IRC section 453, Treasury Regulations section 15a.453-1 generally provides that, unless a taxpayer elects otherwise, income from a sale of real property or a casual sale of personal property, where any payment is to be received in a taxable year after the year of sale, is to be reported on the installment method. (26 C.F.R. § 15a.453-1(a) (2008).) The regulation sets forth rules describing installment method reporting of a "contingent payment sale" which means "a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which such sale or other disposition occurs." (26 C.F.R. § 15a.453-1(c)(1) (2008).)

Subsection (c)(2)(i)(A) of section 15a.453-1 provides that "a contingent payment sale

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will be treated as having a stated maximum selling price if, under the terms of the agreement, the maximum amount of sale proceeds that may be received by the taxpayer can be determined as of the end of the taxable year in which the sale or other disposition occurs. The stated maximum selling price shall be determined by assuming that all of the contingencies contemplated by the agreement are met or otherwise resolved in a manner that will maximize the selling price and accelerate payments to the earliest date or dates permitted under the agreement." The maximum selling price is used to determine the gross profit ratio from the sale upon which the recovery of the taxpayer's basis in the property sold is computed. (26 C.F.R. § 15a.453-1(c)(2)(i)(A) (2008).)

If a taxpayer elects out of installment method reporting, Treasury Regulation section 15a.453-1 provides, in relevant part, that the fair market value of a contingent installment payment obligation "may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale)." (26 C.F.R. § 15a.453-1(d)(2)(iii) (2008).) Furthermore, only in "rare and extraordinary cases" when the fair market value of the obligation cannot be reasonably ascertained will the taxpayer be entitled to assert that the transaction is "open." (*Id*.)

Presumption of Correctness

It is well established that respondent's determination is presumed to be correct and that the burden is on the taxpayer to prove that it is erroneous. (*Appeal of Janice Rule*, 76-SBE-099, Oct. 6, 1976.) However, the presumption is a rebuttable one and will only support a finding in the absence of sufficient evidence to the contrary. (*Appeal of Janice Rule, supra*.) Respondent's determination is not evidence to be weighed against evidence produced by the taxpayer. (*Appeal of Janice Rule, supra*.) The presumption of correctness disappears once evidence that would support a contrary finding has been submitted. (*Appeal of Janice Rule, supra*.)

STAFF COMMENTS

At the hearing, respondent should be prepared to explain the schedules submitted October 22, 2008, which provide a breakdown of the 1999 proposed assessment for Billy and Gayle Blanks, and identify and discuss the amount of section 453A interest proposed as additional tax, as well as the remaining additional tax components of the proposed assessments, for both Billy and Gayle

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Blanks and BG Star Productions, Inc.

Appellants' M&S Report at page 8 concludes that the 1999 Agreement "effectively put Blanks on a 5% royalty arrangement" because "the odds are overwhelming that NCP is switch to the royalty arrangement and make moot any value of the prospective installment payments." However, under the 1999 Agreement NCP agreed to pay and did pay appellants a portion of the installment obligation for 2000 in the amount of $11,666,667. Appellants should be prepared to reconcile the Report's conclusion with the actual contingent installment payment made by NCP for 2000.

Respondent should be prepared to explain how the tax liability and interest charge, if any, for 1999 would be calculated if the Board accepts the fair market value of the contingent installment obligation as determined by respondent's appraisal.

Attachments: Exhibits A-D

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