STATE BOARD OF EQUALIZATION
CORPORATION FRANCHISE TAX APPEAL

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

In the Matter of the Appeal of:	)	Case No. 719011
	)	
CAMINO MEDICAL GROUP, INC.	)	Oral hearing date: April 22, 2014
	)	
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	)	
	)	

Representing the Parties:

For Appellants: Robert H. Wood, Wood LLP
Dashiell C. Shapiro, Wood LLP
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For Franchise Tax Board: Daniel Biedler, Tax Counsel III
Roman Johnston, Tax Counsel IV

Counsel for the Board of Equalization: Grant S. Thompson, Tax Counsel IV

LEGAL ISSUE

Whether appellant has demonstrated error in respondent's determination that appellant had constructive receipt of $10,179,648 in deferred compensation during the 2005 tax year.

BACKGROUND AND CONTENTIONS

Appellant Camino Medical Group, Inc. is a California medical corporation. As discussed below, on the basis of a final federal determination from the Internal Revenue Service (IRS), the Franchise Tax Board (FTB or respondent) determined that appellant constructively received $10,179,648 of deferred income in 2005 from the Palo Alto Medical Foundation (PAMF), a California non-profit public benefit corporation.

Around May 2000, appellant entered into three agreements, effective June 1, 2000, with PAMF. The agreements consisted of an Agreement for Professional Services, an Affiliation Agreement, and a Deferred Compensation Agreement (DCA) (hereafter, collectively, the affiliation agreements). Under the affiliation agreements, appellant's physicians would act as the medical staff

for a division of PAMF named the Camino Health Care Division (Camino Division).

The DCA stated that the Camino Division would have insufficient receipts to pay appellant during the initial start-up period while appellant may have excess cash. It therefore provided that appellant would only currently be paid cash amounts necessary to meet current expenses. It further provided that "[a]ny difference between the amounts earned under the Agreement for Professional Services and the amount actually requested from and paid by [PAMF] shall be considered Deferred Compensation." It stated that the balance of the Deferred Compensation would become due and payable on the termination of the Agreement for Professional Services.

The Affiliation Agreement set forth a plan for the integration of the Camino Division with the Palo Alto Division of PAMF once certain criteria were met. One of the criteria for integration was that appellant must have forgiven PAMF's liability under the DCA.

In 2000, on behalf of appellant, PAMF collected $10,179,648 of appellant's outstanding patient accounts receivable and remitted the amounts collected to appellant. These accounts receivable arose from services provided by appellant's physicians prior to the effective date of the affiliation agreements, and PAMF received a fee for the collection of these pre-affiliation accounts receivable. Appellant recognized the receipt of taxable income from the collection of the pre-affiliation accounts receivable on its California tax return for 2000.

Appellant filed a 2005 California tax return by the extended due date, and subsequently, in 2007, filed an amended California tax return. Thereafter, the IRS conducted an audit and determined that the Chief Executive Officers of PAMF and appellant orally agreed, in 2000, to withhold the payment to appellant of $10,179,648 of physician payments for services provided after the effective date of the affiliation agreements (i.e., an amount equal to the pre-affiliation accounts receivable amount collected by PAMF for appellant). By late 2005, appellant had deferred approximately $34 million in physician payments, including the $10,179,648 from the oral agreement. (In accordance with the briefing and documentation, this decision sometimes rounds this $10,179,648 amount to $10 million.) The issue in this appeal is whether this $10,179,648 in deferred compensation, which arose from services provided after the effective date of the affiliation agreements, was constructively received by appellant in 2005.

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The IRS determined that the payment of this $10,179,648 amount was not subject to the restrictions on payment set forth in the affiliation agreements. Pursuant to the affiliation agreements, the other deferred amounts could not be paid except to the extent that payment was needed for appellant to meet its operating expenses and would not be paid in 2005 if the planned integration occurred. In light of these restrictions on payment, the IRS concluded that the other deferred amounts were not constructively received. However, the IRS determined that the $10,179,648 payment that was deferred pursuant to the oral agreement was not subject to these restrictions and that appellant elected not to receive it. The IRS therefore determined that this amount was constructively received in 2005, and the IRS included this amount in appellant's gross income as compensation for services pursuant to Internal Revenue Code (IRC) section 61(a)(1) and Treasury Regulation section 1.451-2.

The IRS Form 4549-A states that the IRS adjustments were "for federal income tax purposes only" and that "[n]othing in this report shall be deemed to limit [appellant's] ability to recharacterize the amount and nature of its income, expenses, and tax liability for state or local purposes . . . ."

On February 4, 2011, on the basis of the final federal determination, respondent issued a Notice of Proposed Action (NPA) for tax year 2005 finding $10,179,648 in additional income, reduced by an additional charitable contribution deduction of $904,857 and an amortization deduction of $1,131,072.[1] During protest proceedings, respondent followed the IRS in arguing that the $10,179,648 deferred amount was taxable because, unlike the $24 million in other deferred compensation, the $10,179,648 amount was not subject to the restrictions on payment that are set forth in the affiliation agreements. On May 29, 2012, respondent issued a Notice of Action (NOA) affirming the NPA. After respondent issued the NOA, appellant paid the additional tax ($702,260.94) and interest ($325,833.19) asserted in the NPA and filed a refund claim. Respondent denied appellant's refund claim, and appellant then filed this timely appeal.

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[1] The amortization deduction was the result of the determination of the IRS that appellant constructively received the $10,179,648 amount but, by deciding not to take the payment, effectively purchased a contract right. On this basis, the IRS and respondent allowed appellant to amortize its cost to purchase that intangible contract right with deductions. At the federal level, the income recognized in 2005 was offset by amortization amounts and the net result, due to net operating loss (NOL) carrybacks from amortization deductions taken in subsequent years, was that appellant owed a minimal additional amount (only $2,176) of federal income tax in 2005. However, California law did not allow the carryback of NOLs, so respondent's determination resulted in the additional California income tax at issue in this appeal.

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During briefing in this appeal, respondent continued to follow the IRS in arguing that the $10,179,648 deferred amount was taxable because, unlike the $24 million in other deferred compensation, the $10,179,648 amount was not subject to the restrictions on payment that are set forth in the affiliation agreements. Appellant argued that all of the deferred income was subject to the same substantial restrictions on payment in that it would not be paid unless it was required to fund current operations or unless the planned integration did not occur. Appellant contended that the deferred compensation effectively provided a safety net that would allow it to reestablish an independent practice if its affiliation with PAMF was not deepened at the end of the testing period as contemplated by the affiliation agreements.

Appellant provided a declaration under penalty of perjury, dated February 10, 2012 (after the IRS determination), from Dr. Richard Slavin, who was formerly the Chairman and CEO of appellant and is currently the CEO of PAMF. Dr. Slavin declared that the parties agreed that the $10,179,648 amount would be subject to the same restrictions on payment as the other deferred compensation amounts. Respondent did not directly address Dr. Slavin's testimony in briefing. Appellant argued that the testimony was supported by contemporaneous evidence and the conduct of the parties.

Appellant provided a December 8, 2005 memorandum from Sutter Health (a party to the Affiliation Agreement and the sole corporate member of PAMF). The memorandum stated in part that the $10 million amount at issue "has been held as a liability of [PAMF-Camino Division] per a stipulation that provided that if a certain level of integration had been achieved, [appellant] would forgive the obligation."

During oral argument, respondent changed its position and conceded that both the $10,179,648 deferred amount and the $24 million deferred amount were subject to the same restrictions. Respondent stated that its position now was that both amounts were subject to the restrictions in the affiliation agreements, but that those restrictions had expired in 2005, such that appellant had a choice to receive or forgive both deferred amounts in 2005. Respondent argued that, while the statute of limitations prevented it from assessing tax on the $24 million deferred amount, the $10 million deferred amount was constructively received and should be taxed. Respondent further argued that, while its assessment arose from the IRS determination, it did not believe that the IRS had "deeply

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considered" whether the $24 million should be subject to tax and that respondent was not bound by the reasoning of the IRS.

In response, appellant contended that respondent's new position was inconsistent with the reasoning of the IRS and with respondent's prior position that the $10 million amount was not subject to the same restrictions as the $24 million amount. Appellant's outside counsel, Mr. Tom Driscoll, who was present during the negotiations with PAMF and during the IRS audit, stated that the $10 million amount was treated the same as the $24 million deferred amount and that appellant only agreed to the IRS resolution because the federal resolution did not increase its federal tax liability. Appellant argued that in 2005 it made a business decision not to disrupt its practice and end its affiliation with PAMF, so it never had the right to receive any of the deferred compensation because the compensation was only payable if it left PAMF.

On April 22, 2014, following the oral argument, the Board reversed respondent's action denying appellant's refund claim. No petition for rehearing was filed, so the determination of the Board became final and rendered on May 22, 2014.

APPLICABLE LAW

Federal Assessment

Revenue & Taxation Code (R&TC) section 18622, subdivision (a) provides that taxpayers shall either concede the accuracy of a federal determination or state wherein it is erroneous. Moreover, "[i]t is well settled that a determination with respect to federal income tax liability will generally be followed when determining California tax liability where the applicable federal and state provisions are identical and where there is no compelling reason for departure from the federal interpretation." (*Appeal of Sierra Pacific Industries*, 94-SBE-002, Jan. 5, 1994.) Although respondent's determination based on a federal assessment is presumed correct, the presumption is rebuttable, and neither respondent nor this Board is required to follow an IRS determination. (See *Appeal of Sierra Pacific Industries*, *supra*; *Appeal of Der Wienerschnitzel International, Inc.*, 79-SBE-063, Apr. 10, 1979.)

Constructive Receipt

IRC section 451(a), to which California conforms, provides generally that the amount of any

item of gross income shall be included in gross income in the taxable year in which it was received by the taxpayer. Treasury Regulation section 1.451-1(a) provides, in pertinent part, that gains, profits, and income are to be included in gross income for the taxable year in which such amounts are actually or constructively received by the taxpayer. Treasury Regulation section 1.451-2(a) states, in pertinent part, that income not actually reduced to a taxpayer's possession is constructively received by him or her in the taxable year during which it is credited to his or her account, set apart for him or her, or otherwise made available so that he or she could draw upon it at any time, unless the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

FINDINGS OF FACT, ANALYSIS, & DISPOSITION

Under Treasury Regulation section 1.451-2(a), "income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions."

We find that when a deferred amount is subject to substantial limitations or restrictions on payment, such as those contemplated by the affiliation agreements, the amount is not constructively received. While the IRS, based on the limited record available to it, found that the $10,179,648 amount was not subject to such restrictions, we now have the undisputed affidavit of Dr. Slavin declaring under penalty of perjury that the $10,179,648 deferred amount was subject to such restrictions. Significantly, this declaration is corroborated by the contemporaneous Sutter Health memorandum, as well as the explanation provided by Mr. Driscoll, who was present during the PAMF negotiations and the IRS audit. In light of the present evidentiary record, it is not surprising that the parties now agree that the $10,179,648 deferred amount was subject to the same restrictions on payment as the $24 million deferred amount.

The intent of the affiliation agreements was to create an arrangement in which the affiliation between PAMF and appellant would deepen and continue. If payment of the deferred compensation was not required to meet appellant's operating expenses, payment would not occur unless appellant ended its affiliation with PAMF. Thus, as contended by appellant, the business purpose and effect of the entire arrangement was to provide a safety net to appellant in the event that the intended deepened affiliation did not occur. As the IRS determined in its consideration of the $24 million amount, the fact that appellant would have had to end the affiliation in order to be paid constitutes a substantial

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restriction on payment. Therefore, appellant did not have constructive receipt of the $10,179,648 amount at issue in this appeal.

ORDER

It is hereby ordered that appellant's claim for refund be granted. Adopted at Culver City, California, this 5th day of August, 2014.*

Michelle Steel, Member

Betty T. Yee, Member

George Runner, Member

*The State Controller's Deputy, Marcy Jo Mandel, did not participate in the matter.

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