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BOARD OF EQUALIZATION

STATE OF CALIFORNIA

In the Matter of the Appeal of: **COMCAST CABLEVISION CORP. OF CA. &** **COMCON PRODUCTION SERVICES I, INC., ASSUMER**[1]	**HEARING SUMMARY**[2] **CORPORATION FRANCHISE TAX APPEAL** Case No. 424198

Year	Deficiency Amount	Accuracy-Related Penalty
1998	$930,962	$0
1999	$9,738,793	$1,544,728

Representing the Parties:

For Appellants:	Jeffrey A. Friedman, Sutherland, Asbill & Brennan LLP Pilar Mata, Sutherland, Asbill & Brennan LLP Jon A. Sperring, PricewaterhouseCoopers LLP
For Franchise Tax Board:	Jeffrey I. Margolis, Tax Counsel IV

[1] Appellant is headquartered in Philadelphia, Pennsylvania.

[2] Due to the complexity of the issues, the record is voluminous. Staff notes that the length of this hearing summary reflects the fact that there are four separate complex issues and the parties submitted 273 pages of briefing, including over 100 single-spaced pages in response to staff's additional briefing request, plus over 1,000 pages of exhibits. In an effort to assist the Board in evaluating the materials, staff has provided a "Brief Synopsis" of the party's contentions with regard to issues 1 and 2, and set forth the Applicable Law prior to setting forth the parties' contentions.

Staff also requested joint stipulations of fact from the parties in order to narrow the issues. However, despite the parties' efforts to agree on joint stipulations, they have not been able to do so, at least as of the writing of this hearing summary.

QUESTIONS: (1) Whether a payment of $1.5 billion received by appellant from MediaOne Group Inc. (MediaOne) as a termination fee in connection with an Agreement and Plan of Merger between the parties in 1999 constitutes apportionable business income of appellant.

(2) Whether appellant has shown that respondent Franchise Tax Board erroneously concluded that appellant was unitary with QVC, Inc. (QVC) in 1998 and 1999 and subject to combined reporting.

(3) Whether appellant has shown that respondent erroneously disallowed appellant's dividends received deduction for tax year 1999.

(4) Whether appellant has shown that the accuracy-related penalty for tax year 1999 was not properly imposed.

HEARING SUMMARY

Procedural Background

Respondent audited appellant for taxable years 1998 and 1999 and, on September 30, 2005, issued a Notice of Proposed Assessment (NPA) for each year. (Resp. Opening Br., Exh. T.) Appellant timely protested the NPAs and respondent issued a protest determination on February 16, 2007. With the exception of one adjustment in the amount of $2,095,315, which reversed the disallowance of an expense deduction for 1998, respondent affirmed the NPAs in Notices of Action (NOA) issued on July 16, 2007, and appellant filed this timely appeal. (Resp. Opening Br., Exh. U.)

Issue 1: Whether a payment of $1.5 billion received by appellant from MediaOne as a termination fee in connection with an Agreement and Plan of Merger (Agreement) between the parties in 1999 constitutes apportionable business income of appellant.

Factual Background

Appellant commenced business in 1963 as a three-system cable services business with 1,200 subscribers. By 1998 and 1999, appellant's business had grown to more than six million subscribers with revenues from cable services of nearly $3 billion. (App. Opening Br., p. 1.) As of 1998, MediaOne was the country's third largest cable television system operator, with cable systems throughout the United States, including California. (See Resp. Opening Br., exhibit K.) On March 22, 1999, it was announced that Comcast and MediaOne had entered into an agreement whereby Comcast would acquire MediaOne through a merger. (*Id*. at p. 4 & exhibit L.) The Agreement prohibited MediaOne from soliciting competing merger offers but MediaOne was permitted to evaluate and accept an unsolicited "superior proposal". However, if MediaOne accepted such a proposal, MediaOne was obligated to pay Comcast a "termination fee" in the amount of $1.5 billion. (*Ibid*; App. Opening Br., pp. 18-19.) MediaOne subsequently accepted a proposal from AT&T Corp. (AT&T) that MediaOne deemed superior to appellant's offer. As a result, MediaOne paid the $1.5 billion termination fee on May 6, 1999. (App. Opening Br., pp. 18-19.)

On or about April 10, 2000, Arthur Andersen LLP and its CPA Len Polodin advised that the termination fee "more likely than not" could be treated as liquidated damages resulting in a nontaxable recovery of basis for federal tax purposes.[3] (Resp. Opening Br., exhibits P & Q.) As discussed further, below, with respect to Issue 4 (the accuracy-related penalty), appellant initially reported the termination fee as taxable income on its federal tax return with the September 14, 2000 filing of its federal tax return, that reported the termination fee as a taxable gain. (*Id*. at exhibit N.) It appears that this position was taken because appellant perceived some risk that its return-of-capital position might be denied and it wished to avoid potential interest and/or penalty expenses. On October 11, 2000, appellant filed an amended federal tax return that took the position that the $1.5 billion termination fee was a nontaxable recovery of capital and claimed a refund. (*Id*. at exhibit O.) On October 16, 2000, appellant appellant filed its original (and only) state income tax return for 1999. The tax return did not report the termination fee as taxable income (whether as nonbusiness income or otherwise), but reflected the position that the termination fee represented a nontaxable return of capital. (*Id*. at exhibit I.) Although the tax return did not expressly reference the termination fee, line 7 of Schedule M-1 (appellant's reconciliation of its accounting income with its taxable income) listed

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[3] It appears as though Mr. Polodin was asked to provide a legal opinion regarding tax advice for the treatment of the termination fee. Mr. Polodin's letter, dated April 10, 2000, provides a two-page opinion and indicates that appellant sought outside assistance in reaching this opinion from Arthur Andersen. Mr. Polodin's letter states that appellant attached Arthur Andersen's opinion letter (Andersen opinion), as well as the lengthier memorandum (Andersen memo), in support of the findings. The two-page Andersen opinion was provided at the beginning of the appeal, but the twenty-six page Andersen memo was not provided to either respondent or to the Board until appellant's supplemental brief was filed on April 3, 2009.

$2,583,645,656 of income recorded on its books but not reported as taxable income, and this amount apparently included the $1.5 billion termination fee. (Resp. Opening Br., pp. 5-6.)

Respondent audited appellant's 1999 return and discovered that the termination fee had not been reported as taxable income. When asked to explain its position, appellant informed respondent that it had filed an amended federal return seeking a refund based on the re-characterization of the termination fee as a nontaxable return of basis and provided in support a letter from Arthur Andersen, LLP (Andersen opinion) and a letter from Leonard Podolin, CPA. On December 13, 2004, appellant informed respondent that the IRS denied its federal claim for refund and advised that, in the event that respondent agreed with the IRS's determination, the termination fee should be classified as nonbusiness income not subject to California tax. (Resp. Opening Br., pp. 6-7.)

Applicable Law

As an equitable and constitutional method for taxing corporations that do business in multiple states and countries, California, like many other states, has adopted the Uniform Division of Income for Tax Purposes Act (UDITPA).[4] (See Rev. & Tax. Code, §§ 25120 – 25141.) Under UDITPA, a corporation's income is divided into business or nonbusiness income. Business income is typically apportionable to each state by the use of a three-factor formula.[5] Nonbusiness income, however, is allocable only to the taxpayer's commercial domicile. (*Hoechst Celanese, supra*, at pp. 508, 513.)

R&TC section 25120, subdivision (a), defines that "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." R&TC section

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[4] The UDITPA has been adopted by over 20 states and attempts to address the fair assessment of corporate taxes by the various states based upon a taxpayer's economic activity. The UDITPA seeks to establish uniform rules for the attribution of corporate income, rules that in theory will result in an equitable taxation scheme—equitable to each jurisdiction which is seeking its own fair share and equitable to the taxpayer so that the taxpayer does not have the same income taxed multiple times.

[5] For taxable years beginning on or after January 1, 2011, R&TC section 25128.5 provides that any apportioning trade or business may make an irrevocable annual election on its return to use a single sales factor method of apportionment instead of the three-factor formula based on property, payroll, and sales factors, as provided by R&TC section 25128.

25120, subdivision (d), defines "nonbusiness income" as "all income other than business income."

Regulation, section 25120, title 18 of the California Code of Regulations (Regulation 25120), further provides in subdivision (a) that

> . . . the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of, a trade or business.

Regulation 25120, subdivision (c)(2), provides that "gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange or other disposition, the gain or loss will constitute nonbusiness income."

R&TC section 25120, subdivision (a), has been construed by the California Supreme Court to provide two alternative tests, the "transactional" test and the "functional" test, to determine whether income constitutes business income. (*Hoechst Celanese Corp. v. Franchise Tax Bd.* (2001) 25 Cal.4th 508, 520-256 (*Hoechst Celanese*).) Under the "transactional" test, the relevant inquiry is whether the transaction or activity that gave rise to the income arose in the regular course of the taxpayer's trade or business. (*Id*. at p. 526.) Under the "functional" test, income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (*Id*. at p. 527.) If either of those two tests is met, the income will constitute business income. Respondent's determination regarding the character of the income under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (*Appeal of Twentieth Century-Fox Film Corporation*, 89-SBE-007, Mar. 2, 1989.)

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*, the court stated that the "controlling factor" is the "nature of the particular transaction" generating the income. (*Hoechst Celanese*, *supra*, at p. 526 [internal citation omitted].) It 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 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 doing so, the court rejected the FTB's "attempt to define the relevant "transactions and activity" as the purchase and sale of securities by the fund managers appointed by Hoechst[,]" noting that those securities investments would not result in taxable income until and unless both (i) the investments generated more assets than necessary to fund the defined benefits and (ii) Hoechst acted to recapture the assets. (*Id.*) Thus, the court found that it was only the conversion itself that generated taxable income, rather than the underlying securities investments, which, but for the reversion, would not have generated taxable income.

The functional test focuses on the income-producing property and the "critical inquiry" is the "relationship between this property and the taxpayer's business operations." A taxpayer's control and use of the income-producing property must be part of the taxpayer's normal or typical business activities. In providing meaning to the term "integral" in the statute, a determination must then be made as to whether the property has a close enough relationship to the taxpayer to satisfy the functional test. Thus, "'integral' requires an organic unity between the taxpayer's property and business activities whereby the property contributes materially to the taxpayer's production of business income." In this regard, "[t]he property must be so interwoven into the fabric of the taxpayer's business operations that it becomes 'indivisible' or inseparable from the taxpayer's business activities with both 'giving value' to each other." (*Hoechst Celanese, supra*, at pp. 528-530, 532.) The court further held in *Hoechst Celanese* that this Board "has consistently refused to find business income under the functional test where the taxpayer's control and use of the property did not contribute materially to the production of business income and were separate from the taxpayer's business." (*Hoechst Celanese, supra*, at p. 534.)

In *Pennzoil Co. v. Department of Revenue* (2001) 33 P.3d 314, cert. den., (2002) 535 U.S. 927 (*Pennzoil*), the court applied the transactional test and found that Pennzoil had received business income. There, the taxpayer was in the business of acquiring and developing oil and gas reserves and it entered into a merger agreement with Getty Oil (Getty) for the purpose of gaining access to Getty's oil reserves. However, Texaco secretly merged with Getty prior to the consummation of the Pennzoil-Getty merger agreement and Pennzoil brought a lawsuit against Texaco for tortuous interference with the contract between Pennzoil and Getty. The jury awarded Pennzoil a judgment for tort damages of more than $11.1 billion, including $3 billion in punitive damages. Later, the parties negotiated a settlement agreement that required Texaco to pay Pennzoil $3 billion in satisfaction of the outstanding tort judgment. The Supreme Court of Oregon held that the settlement award was business income under the transactional test because the income arose from Pennzoil's continued expansion efforts to acquire established oil reserves in the ordinary course of Pennzoil's business, and not from an agreement for the purchase of Getty's stock as Pennzoil argued.

The transactional test was also applied in *Atlantic Richfield Co. v. State of Colorado* (1979) 601 P.2d 628 (*Atlantic Richfield*). The taxpayer in that case planned to merge with another oil company but was forced by court order to sell off substantially all of the acquired oil company's assets as a result of an antitrust lawsuit. The taxpayer argued that the income from the sale of the assets should be classified as nonbusiness income because the taxpayer was not in the business of buying and selling large blocks of assets pursuant to court order. The Colorado Supreme Court held that the income was business income under the transactional test for the following reasons: 1) the income resulted from a transaction in the regular course of the taxpayer's business; 2) the taxpayer regularly engaged in mergers, acquisitions, and dispositions; 3) the taxpayer was aware that the asset sales were the potential result of the transaction contemplated; and 4) the sales were part of the taxpayer's regular acquisition activity because they were not an unforeseeable consequence of the merger.

In *Polaroid Corp. v. Offerman,* 507 S.E.2d 284, the North Carolina Supreme Court applied the functional test. The taxpayer, a photographic equipment corporation, brought legal action against Kodak Eastman Corporation, another photographic equipment corporation, to enjoin Kodak Eastman's alleged infringement of the taxpayer's patent and recover damages from such infringement.

The taxpayer was awarded approximately $900 million in damages measured, in part, by the taxpayer's lost profits and, in part, by an estimate of reasonable royalties as well as prejudgment and post-judgment interest. The court noted that the taxpayer's patents were an "integral part of its regular trade or business operations" and thus characterized the patents as "integral income-producing assets." (*Id*. at pp. 295-296.) For purposes of the functional test, the court then held that "once a corporation's assets are found to constitute integral parts of the corporation's regular trade or business, income resulting from the acquisition, management, and/or disposition of those assets constitutes business income regardless of how that income is received." (*Id*. at 296.) The court found that both portions of the damages measured by lost profits and reasonable royalties and the prejudgment and post-judgment interest amounts constituted business income.

Contentions

Brief Synopsis

Appellant contends that the termination fee does not constitute business income under either the transactional test or the functional test. With regard to the transactional test, appellant contends that the termination of the merger agreement (rather than its acquisition activities) constitutes the relevant transaction or activity for analysis. Appellant contends that the proposed merger was an extraordinary transaction and the receipt of the termination fee was a once-in-a-lifetime transaction, like the pension reversion in *Hoechst Celanese*, *supra*, and therefore did not arise in the regular course of its business. With regard to the functional test, appellant contends that it never acquired any property from which business income could arise because the merger was terminated and, further, that it was impossible for any property to become interwoven into its business in the six-week period between its decision to merge and the termination of the agreement.

Respondent contends that the termination fee constitutes business income under both the transactional test and the functional test. With regard to the transactional test, respondent contends that the fee was received as a result of appellant's regular and recurring activity of building its business through acquisitions and that the fee represented compensation for lost profits. Respondent contends that, under *Hoechst Celanese*, *supra*, the relevant transaction for analysis is appellant's entry into the merger agreement, which was part of its regular business practice, rather than its receipt of the termination fee. With regard to the functional test, respondent contends that the merger agreement, which generated the fee, was an integral part of appellant's business expansion efforts.

Appellant's Opening Brief

Appellant contends that the termination fee received in connection with the Agreement was properly characterized as nonbusiness income as defined by Revenue and Taxation Code (R&TC) section 25120, subdivisions (a) and (d), and is not taxable by California because appellant's domicile is outside of California. (Appeal Letter, pp. 2-3.) Appellant states that, under the Agreement, MediaOne was permitted to receive and evaluate any unsolicited offers to merge and to accept a "superior proposal" and that, in fact, MediaOne received a superior proposal from AT&T Corporation (AT&T) and notified appellant of its intent to accept AT&T's offer and to terminate the Agreement. Appellant accepted MediaOne's termination which obligated MediaOne to pay a $1.5 billion termination fee to appellant pursuant to the Agreement. (App. Opening Br., pp. 18-19.) [6]

Appellant contends that the termination fee does not meet either the transactional test or the functional test for business income as set forth in R&TC section 25120, subdivision (a). Appellant asserts that the transactional test is not met because the income did not arise in the regular course of appellant's business. Specifically, appellant argues that it received no taxable income until and unless MediaOne terminated the Agreement as a result of a superior proposal and appellant accepted the termination. Citing *Hoechst Celanese Corp., supra*, appellant argues that the relevant transaction, for purposes of determining whether the income arose in the regular course of its business, is the transaction that directly and immediately generated the taxable income. Appellant argues that the termination of the Agreement and the receipt of the termination fee did not occur in the regular course of its business because it has not received a termination fee prior to or since this transaction. (App. Opening Br., pp. 20-21.)

Appellant contends that the functional test applies only when the income derives from property, including intangible property, but in this case the termination fee arose from the failure to acquire property, i.e., the MediaOne stock. Appellant further argues that even if the termination fee

[6] The first eighteen pages of appellant's opening brief focus on whether Comcast and QVC were unitary and are therefore summarized under Issue 2 below.

could be construed to derive from property, there was no "acquisition, management or disposition" of any property that constituted an integral part of appellant's regular business operations and it would have been impossible for such integration to occur in the six-week period between appellant's decision to merge with MediaOne and MediaOne's termination of the Agreement. (App. Opening Br., p. 22.)

Appellant further argues that the United States Constitution prohibits respondent from imposing a tax on the termination fee because it requires some definite link and some minimum connection between a state and the person, property, or transaction that it seeks to tax. Appellant asserts that there was no such minimum connection here as the income did not arise from a unitary business and the merger termination did not serve an operational function. Appellant further asserts that the United States Supreme Court held in *Allied Signal, Inc. v. Director, Division of Taxation* (1992) 504 U.S. 768 (*Allied Signal*) that an operational function cannot be established by a policy or pattern of a taxpayer's operations, but instead must be determined by reference to the actual operational connection between the specific transaction and asset, if any, and the taxpayer's unitary business. Appellant notes that in *Allied Signal* the taxpayer made an investment in a subsidiary which was deemed not to serve an operational function whereas appellant's investment attempt in MediaOne failed. (App. Opening Br., pp. 23-24.)

<u>Respondent's Opening Brief</u>

Respondent contends that appellant has failed to overcome the presumption that the termination fee was business income and that the evidence establishes that both the transactional test and the functional test were met. With respect to the transactional test, respondent contends that the termination fee arose from appellant's "regularly recurring activity of acquiring cable systems and their system subscribers by acquiring other cable companies." In this regard, respondent states that appellant's business grew from 1,200 subscribers in 1963 to 5.7 million subscribers in 1999 and just under 25 million currently. Respondent asserts that this "phenomenal growth" was accomplished primarily by acquiring other cable systems, which was the "primary engine of growth" for cable companies. For the 15-year period from 1985 through 1999, respondent determined that appellant engaged in over 30 such transactions and in four such transactions during 1999 alone. In addition, appellant's 1999 Summary Annual Report stated that acquisitions and service-area swaps will nearly double its subscribers from 4.5 million at year-end 1998 to 8.2 million at year-end 2000. (Resp.

Opening Br., pp. 8-9.)

Respondent contends that appellant offers no support for its position that the size of the transaction changes its essential nature for purposes of applying the transactional test. Citing *Pennzoil Co., et al. v. Dept. of Revenue* (2000) 15 OTR 101, aff'd 332 Or 542, 33 P3d 314 (2001), respondent further contends that courts have rejected such a position and that the test focuses only on the nature of the transaction and the activity in issue. Respondent also rejects appellant's argument that the transaction was unique because only one other merger agreement to which appellant was a party included a termination fee provision. Respondent contends that a termination fee provision is one type of "deal protection device" and other agreements may have included other types of such devices. However, respondent contends that even if the other agreements had no deal protection device, appellant would have the right to sue for breach and any recovery for a terminated or breached agreement would constitute income to appellant. In that event, respondent states that the amount received would be characterized in accordance with what the amount was intended to compensate appellant for. (Resp. Opening Br., pp. 9-10.)

Respondent describes this characterization as the "origin-of-the-claim" test for determining the taxable nature of the payment. Citing *Raytheon Production Corp. v. Commissioner* (1st Cir. 1944) 144 F.2d 110, 111 and the *Appeal of Feld* (77-SBE-042), decided on March 2, 1977, respondent argues that "recoveries which represent a reimbursement for lost profits are income." Respondent further states that the Internal Revenue Service (IRS) issued a private letter ruling (PLR) to appellant concerning this transaction that applied the origin-of-the-claim test to determining the tax consequences of the termination fee and found that the termination fee was a "bargained-for" provision that paid for the recovery of lost profits. Respondent concludes that appellant would have accrued the lost profits in the regular course of appellant's unitary business and, therefore, the lost profits constitute unitary business income. In support, respondent cites *Polaroid Corp. v. Offerman*, *supra*, arguing that the court there determined that a recovery of lost profits constituted business income and was cited with approval by the California Supreme Court in *Hoechst Celanese*. (Resp. Opening Br., p. 11.)

In reply to appellant's argument that the MediaOne merger transaction was unique because it was the only transaction that generated a termination fee, respondent asserts that the transaction was of the same basic nature as appellant's other transactions involving the acquisition of cable system assets and that one looks to the nature of the transaction in applying the transactional test. Respondent notes that the termination fee provision was reciprocal and, if appellant had backed out of the Agreement and paid the termination fee, appellant would now argue that the payment was a unitary business expense. Respondent argues that appellant treated and respondent allowed the $40 million in expenses relating to the merger as unitary business expenses claimed against appellant's unitary income. (Resp. Opening Br., pp. 11-12.)

Citing *Hoechst Celanese*, respondent argues that the controlling factor by which the transactional test identifies income is the nature of the particular transaction that generates the income and respondent concludes that the nature of the particular transaction at issue here was an agreement to acquire a cable television business – a type of transaction in which appellant had engaged in more than 30 times in 15 years. Respondent argues that its position is supported by the *Appeal of General Dynamics*, 75-SBE-037, decided June 3, 1975, in which the Board held that gain from the disposition of stock received from the sale of aircraft constituted business income because appellant regularly engaged in aircraft sales, even though the appellant in that appeal had never received stock in payment for aircraft before. (Resp. Opening Br., pp. 12-13.)

Respondent also contends that appellant "fails to recognize the factual differences between the situation in *Hoechst Celanese* and the one here." In that case, the court found that the income arose from a pension reversion which was a "once-in-a-lifetime" corporate transaction unrelated to the taxpayer's main business of manufacturing and selling chemicals. However, respondent states, appellant's acquisition of other cable companies was "a repeatedly engaged-in activity that was central to Comcast's business." (Resp. Opening Br., pp. 13-14.)

Respondent cites *Pennzoil Co., et al. v. Dept. of Revenue, supra*, in which the taxpayer won a damage award as a result of a failed merger. There, the court found that the merger agreement was an activity or transaction in the regular course of Pennzoil's business. Respondent maintains that Pennzoil's regular business of acquiring assets for use in its oil and gas business is comparable to appellant's "systematic and recurrent" activity of acquiring cable system assets. Respondent notes that the Tax Court rejected Pennzoil's argument, which it contends is similar to appellant's argument, that there were certain unique aspects of the income in issue (notably the size of the amount and that it resulted from a litigation settlement) as a basis for finding that the transaction was not in the ordinary course of Pennzoil's regular business. (Resp. Opening Br., pp. 14-15.)

Respondent disputes appellant's argument that the income resulted from a failed investment because the $1.5 billion termination fee was exactly what appellant bargained for under the Agreement. Respondent cites *Atlantic Richfield, supra*, in which the taxpayer, a large integrated oil company, sold oil properties pursuant to a court order to avoid anti-trust law violations. Respondent argues that, like appellant, Richfield contended that the proceeds from the sale were nonbusiness income by focusing on the unique aspects of the transaction from which the income arose. However, the court rejected the argument and held that the proceeds were business income under the transactional test, finding that Richfield regularly engaged in major acquisitions and dispositions of the same type which therefore constituted a systematic and recurrent business practice. Respondent contends that the same reasoning applies to the transaction in issue here and that appellant was even more active than the taxpayer in *Atlantic Richfield* in making acquisitions and dispositions. (Resp. Opening Br., pp. 15-16.)

With respect to the functional test, respondent contends that the property that generated the termination fee was the contractual right to receive the termination fee. Respondent further contends that the Agreement, and the rights arising therefrom, were an integral part of appellant's efforts to expand its cable television business. Respondent concludes that appellant exercised its right to demand and receive the termination fee under the Agreement as part of its business and, therefore, respondent contends, the functional test was also met. Respondent contends that its position is supported by *Pennzoil* and notes that the court held that "the Getty contract was intangible property" from which the income arose. Respondent rejects the argument that there was insufficient time for the property to become interwoven into appellant's business, contending that there is no aspect of the functional test that precludes treatment as business income based on the time period in which it was earned. Respondent also argues that appellant's position that the termination fee was not integrally related to its business operations is inconsistent with its reporting position on its amended federal return that MediaOne's failure to complete the merger damaged appellant's existing business in the amount of $1.5 billion. (Resp. Opening Br., pp. 17-19.)

Appellant's Reply and Supplemental Briefing

Appellant asserts that the premise of respondent's argument is that the termination fee payment should be treated as if it was income from a successful merger of appellant and MediaOne, i.e., the operating profits from a unitary affiliate. Appellant contends that there is no factual or legal basis for such treatment and, even if the merger had been consummated, the two companies would not have become unitary immediately after the transaction was completed. Appellant argues that respondent erroneously relies on the Oregon case of *Pennzoil* in which the court applied Oregon law when, in *Hoechst Celanese*, the California Supreme Court held that the relevant transaction for purposes of the test is the transaction that directly and immediately generated the taxable income. Appellant contends that the court in *Hoechst Celanese* looked to the pension reversion, rather than the "integral nature" of the pension plan to the taxpayer's business, as the relevant transaction. Appellant contends that the relevant transaction in this appeal is the termination of the Agreement. (App. Reply Br., pp. 15-17; App. Supp. Br., p. 12.)

Appellant argues that respondent ignores *Hoechst Celanese*, a California case which is directly on point, and erroneously relies on case law from different states to support its interpretation of the transactional test. In this regard, appellant argues that respondent's citation of *Polaroid Corp. v. Offerman*, *supra*, 507 S.E.2d 284, is inapposite because it was decided under the functional test and *Atlantic Richfield* is distinguishable because the court concluded that the taxpayer was regularly engaging in the business of acquiring and disposing of assets whereas in this appeal there is no evidence that appellant is regularly engaged in the business of terminating contracts or of disposing of assets. Moreover, appellant contends, and cites for support the *Appeal of General Dynamics*, *supra*, respondent "slips from focusing" on appellant's acquisition of cable systems to acquisitions and dispositions without justification because there is no evidence that appellant regularly engages in selling cable companies. (App. Reply Br., pp. 17-18.) In addition, appellant contends that respondent wrongly claims that appellant's numerous acquisitions of competitors' cable companies gave rise to business income when there is no evidence that these transactions generated any income. (App. Reply Br., p. 19.)

Appellant asserts that it is in the business of operating cable systems and those operations generate appellant's income. The acquisition of other cable systems alone generates no income. In contrast, appellant argues, the activities that generated the termination fee were the decision to execute the Agreement, MediaOne's decision to accept AT&T's bid, and appellant's decision to terminate the Agreement. Thus, analogous to the pension reversion in *Hoechst Celanese*, appellant argues the only transaction that generated the income was the termination of the Agreement. Appellant maintains that it has never received another termination fee from a failed merger. (App. Supp. Br., pp. 13-14.)

Appellant further contends that respondent's argument incorrectly assumes that appellant would have become instantly unitary with MediaOne if the merger had been completed. Finally, appellant argues that, contrary to respondent's assertion, appellant did not use the proceeds from the termination fee to acquire other cable systems but deposited those proceeds into regular working capital accounts. (App. Reply Br., pp. 19-20.)

Respondent's Reply Brief

Respondent takes issue with appellant's assertion that acquisitions of cable companies do not produce income and argues that appellant's acquisition activity "caused its business to increase ten-fold in size during the 1980's, and this growth continued throughout the years in question . . .", which increase "affected the amount of its unitary business income." By taking such a position, respondent argues, appellant fails to acknowledge that the transactional test considers whether the income resulted from an "activity" undertaken in the regular course of the taxpayer's trade or business. Respondent concludes that appellant regularly entered into contracts to acquire other cable companies and when those transactions closed, appellant's customer base and gross income would increase. When those transactions did not close, appellant could sue for and possibly recover damages for a breach of contract. In either event, according to respondent, the amount paid to appellant would be considered business income (or loss) to appellant. (Resp. Reply Br., pp. 5-6.) Respondent counters appellant's contention that there is no evidence that appellant engaged in dispositions of cable systems, by referencing minutes of board meetings, appellant's annual reports, and appellant's website. (Resp. Reply Br., p. 7, fn. 16.)

Request for Additional Briefing

In response to a request for additional briefing from staff, appellant confirms its position that the relevant transaction for purposes of the transactional test is the termination of the Agreement because the termination fee arose from this transaction. Appellant maintains that its position is supported by *Hoechst Celanese* because appellant received no taxable income until and unless the events triggering the payment of the termination fee occurred. Appellant further argues that the merger termination did not arise in the regular course of appellant's business and was inconsistent with appellant's business plan. Moreover, appellant states that the Andersen memo reflects that both the merger termination and the merger transaction itself were extraordinary transactions. In this regard, appellant states that the Andersen memo notes that the merger was "a unique opportunity for Comcast to become an industry leader" and there was no candidate for merger comparable to MediaOne for appellant to reach its long-term strategic goals in a single transaction. (App. Nov. 28, 2011 Add'l Br., pp. 20-23.)

Appellant also states that it appears that the termination fee was used to reduce appellant's corporate debt. Appellant contends that its use of that money is not relevant under either the transactional test, which focuses only on the transaction or activity that generated the income, or functional test, which focuses only on the property that generated the income. Appellant acknowledges that the court in *Hoechst Celanese* held that, under the transactional test, "relevant considerations include [. . .] the taxpayer's subsequent use of the income" but states that it is unaware of "any case in California that actually deemed the taxpayer's use of proceeds as relevant to the transactional test analysis." Appellant states that the *Hoechst Celanese* court found that the taxpayer used the funds for general corporate purposes but held that the funds were not business income under the transactional test. Appellant also notes that the United States Supreme Court held in *Allied Signal* that the subsequent use of proceeds is not a relevant consideration in determining whether income is apportionable. (App. Nov. 28, 2011 Add'l Br., pp. 23-24.)

Respondent confirms its position that the relevant transaction or activity is appellant's acquisition and merger activity as set forth in its opening brief. Furthermore, respondent states that the Andersen memo contains factual admissions by appellant, which are inconsistent with the facts appellant now advances for its position, that strongly support respondent's position that the termination fee constitutes business income under both tests. Respondent asserts the memo notes that appellant entered into the Agreement in the course of its regular and ongoing business of acquiring cable companies to expand its subscriber base. As support, respondent quotes several portions of the memo to the effect that appellant had been making acquisitions for several years in pursuit of its goal to become "an elite player in the cable industry" and the merger was "in large part" for MediaOne's cable subscriber base that would have benefited appellant's "whole" business. In addition, respondent quotes a portion that describes appellant's "nearly frenetic spate of acquisitions" with the rise of Brian Roberts in the management of the company. Respondent also refers to a recent summary decision in which the Board held that income was business income under the transactional test (*Appeal of Sonic Automotive, Inc.*, Case No. 505065, July 27, 2011).[7] Respondent acknowledges that the decision may not be cited as precedent, but notes that the Board, in that appeal, relied on the same case law authorities that respondent cites in this appeal. (Resp. Nov. 28, 2011 Add'l Br., pp. 33-35.)

With respect to the functional test, respondent notes that the memo states that "these acquisitions were more than passive portfolio investments in the stock of random corporations" in that the acquisitions "became part of the Comcast Group and were, and are now, woven into the Group's business strategy." In addition, the memo states that completing the merger "would have been an integral element" in achieving appellant's goals of geographical expansion and the enhancement of the value of appellant's existing cable franchises. Respondent also contends that other representations in the memo to the effect that the termination immediately and materially damaged appellant's infrastructure show that the Agreement "instantly had become an integral part of [appellant's] unitary business." In this regard, respondent quotes portions of the memo stating that the termination fee compensated appellant for damage to the value of its "aggregate intangible asset or infrastructure value" and that the termination fee as payment for such damage is "considered a restoration of capital to the extent of the basis in the property" because "the failed acquisition touches and impacts the value of every aspect of [appellant's] business." (Resp. Nov. 28, 2011 Add'l Br., pp. 35-37.)

Respondent further notes that the memo advises appellant to apply the termination fee to the basis of the goodwill and stock of all of its cable and cable-related companies. If one of those cable-related companies was QVC, such that appellant offset its basis in QVC goodwill and QVC stock, respondent contends that action would be inconsistent with appellant's position that appellant and QVC were not unitary. (This issue is discussed further in Issue 2.) (Resp. Nov. 28, 2011 Add'l Br., pp. 37.)

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[7] Rule 5451, subdivision (d), of the Board's Rules for Tax Appeals provides that summary decisions "may not be cited as precedent in any appeal or other proceeding before the Board."

STAFF COMMENTS

Preliminarily, staff notes that the functional test focuses on the asset generating the income, and asks whether the asset is an integral part of the unitary business. By contrast, the transactional test focuses on the transaction or activity generating the taxable income and asks whether it was undertaken in the regular course of business. Income constitutes business income if either test is satisfied. Respondent's determination regarding the character of the income under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (*Appeal of Twentieth Century-Fox Film Corporation, supra*.) For appellant to prevail, it must prove error in respondent's determinations under both the functional test and the transactional test.

With respect to the transactional test, appellant argues that, under *Hoechst Celanese,* the relevant transaction is the transaction that directly and immediately generated the taxable income which, according to appellant, is the termination of the Agreement. On the other hand, respondent argues that the transaction was part of appellant's "regularly recurring activity of acquiring cable systems and their system subscribers by acquiring other cable companies."

It appears to staff that the determination under the transactional test breaks down to two questions: first, what is the underlying transaction or activity that generated the taxable income, and, second, was that transaction or activity undertaken in the regular course of appellant's business? With regard to the first question (i.e., what transaction or activity generated the taxable income), the parties may wish to discuss the following questions. In *Hoechst Celanese,* what is the relevance, if any, of the court's analysis that the company's pension securities transactions should not be considered the relevant transaction or activity because those transactions did not generate taxable income in the absence of a reversion of pension assets? In this appeal, did appellant's acquisition activities typically generate taxable income and would the MediaOne merger have generated taxable income in the absence of the reversion? Put differently, are appellant's acquisition activities analogous to the pension securities transactions in *Hoechst Celanese* such that they are too indirect to constitute the relevant transaction or activity to be considered for purposes of the transactional test, or are they different because the pension transactions did not normally generate taxable income? More generally, is the termination of the merger agreement the underlying transaction or activity, as appellant contends, or is the underlying transaction or activity appellant's acquisitions of cable assets, as respondent contends? Once the Board determines the relevant transaction or activity that generated the taxable income, it should evaluate the second question, which is whether the transaction or activity, as so determined, is a part of the regular course of appellant's business.

Issue 2: Whether appellant has shown that respondent erroneously concluded that appellant was unitary with QVC, Inc. (QVC) in 1998 and 1999 and subject to combined reporting.

Factual Background

QVC was formed in 1986 as a cable television channel by Joseph Segal to "market consumer products and services through a televised home shopping program broadcast by satellite (the "Program")." On July 21, 1986, QVC and appellant entered into a "Program Agreement" which recites, *inter alia*, that QVC, appellant and Mr. Segal had entered into an agreement on July 1, 1986, "relative to the purchase by [appellant] of shares of Common Stock and shares of Class B Common Stock of QVC." It further recites that QVC and appellant were entering into the Program Agreement "to set forth certain terms relative to the distribution of the Program by [appellant]." (Resp. Opening Br., p. 29, Exh. OO, p. 1.)

Under the Program Agreement, appellant agreed to transmit the Program to at least 900,000 subscribers of its cable systems on an exclusive basis for a period of two years. In the event that appellant failed to comply with those terms, QVC had the right to reacquire shares of its stock as set forth in an equity participation agreement referenced therein. The Program Agreement further provides that "QVC shall consult with [appellant] as to the content and presentation of the Program and shall consider in good faith the recommendations of [appellant], if any." As the first cable operator to carry the Program, the Program Agreement provides that appellant shall receive "the highest rate of consideration paid to any operator carrying the Program but, in no event, less than a five percent (5%) commission for sale made by QVC" to addresses in appellant's service areas. (Resp. Opening Br., Exh. OO, pp. 1-3.)

QVC filed with the Securities and Exchange Commission a Form S-1 Registration Statement and Preliminary Prospectus dated July 21, 1986 which states that 60,000 shares of Common Stock and 3 million shares of Class B Common Stock were being offered by QVC to multiple cable system operators. The Prospectus states that QVC is making the offering "in connection with a commitment to transmit" the Program to at least 3 million subscribers. (Resp. Opening Br., Exh. PP, pp. 3, 9.) Appellant purchased 18,000 shares of common stock and 900,000 shares of Class B common stock, becoming QVC's second largest shareholder until 1995. (Resp. Opening Br., p.30 & Exh. PP, pp. 23.)

In August of 1994, appellant and Liberty Media Corporation (Liberty) made a tender offer for all the outstanding stock of QVC. The stock acquisition deal closed on February 9, 1995, with appellant owning a 57.45 percent share and Liberty owning a 42.55 percent share of QVC outstanding stock. (App. Opening Br., pp. 3-4.) After appellant acquired a majority interest in QVC, Douglas Briggs, a QVC employee, replaced Barry Diller as its CEO. Also, the following individuals were appointed as officers and/or directors of QVC:

Individual	Comcast Position[8]	QVC Position[9]
Ralph J. Roberts	Chairman of the Board of Directors	Vice Chairman
Brian L. Roberts	President and CEO, Board Member	Vice Chairman
Julian A. Brodsky	Vice Chairman of the Board of Directors	Vice Chairman, Assistant Treasurer and Assistant Secretary
John R. Alchin	Co-Chief Financial Officer, Senior Vice President	Senior Vice President and Assistant Treasurer
Lawrence S. Smith	Co-Chief Financial Officer And Executive Vice President	Senior Vice President
Stanley Wang	Senior Vice President and Secretary	Senior Vice President and Assistant Secretary
C. Stephen Blackstrom	Senior Vice President, Taxation	Vice President

[8] See FTB Dec. 5, 2011 Add'l Br., exhibits XXXXX and HHHHHH [Comcast SEC filing and Board Minutes].

[9] See FTB Opening Br., exhibit NNN [appellant's response to Information Document Request (IDR)].

Arthur R. Block	General Counsel and Secretary	Vice President, Assistant Treasurer And Assistant Secretary

However, according to appellant, with the exception of Barry Diller, QVC's existing officers prior to appellant's acquisition of a controlling interest in QVC continued in their roles and managed QVC in the same manner as they had prior to appellant's acquisition of a controlling interest.

As indicated below, the parties dispute the nature, extent, and significance of the intercompany transactions occurring between the companies as well as whether and/or to what degree appellant exercised control or influenced QVC.

Applicable Law

The issue here is whether QVC was unitary with appellant such that it should be included in a combined report with appellant. If QVC's business was unitary with appellant's unitary business, QVC's property, payroll, and sales would be included in the calculation of appellant's apportionment factors, and QVC's business income would be combined with appellant's other unitary business income in the calculation of California tax.[10]

The California Supreme Court has articulated two tests to determine whether unity exists:

1. The first test, the "three unities" test, finds a unitary relationship is "definitely established" if there is unity of ownership, unity of operation, and unity of use. (*Butler Bros. v. McColgan* (1941) 17 Cal.2d 664, 678.) R&TC section 25105 contains the test for determining unity of ownership. (*Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Board* (1991) 229 Cal.App.3d 784, 789.) R&TC section 25105 provides that, in order to file a combined report, corporations must be members of a commonly controlled group, which generally requires ownership of more than fifty percent of the voting power. (Rev. & Tax. Code § 25105.) If this requirement is met, the question becomes whether the other unities, unity of operation and unity of use, are present. Unity of operation generally refers to "staff functions such as purchasing, personnel, advertising, accounting, legal services and financing." (*A.M. Castle & Co. v. Franchise Tax Board* (1995) 36

[10] Thus, this issue is different from Issue 1, discussed above, which addresses whether a termination fee received by appellant constitutes business income.

Cal.App.4th 1794, pp. 1806 -1807; see also *Butler Bros.*, *supra*, 17 Cal.2d at p. 678;) Unity of use is found in a centralized executive force and the sharing of personnel or facilities. (*Butler Bros., supra*, 17 Cal.2d at p. 678; *Dental Insurance Consultants, supra*, 1 Cal.App.4th at p. 349.)

2. The second test is the "dependency or contribution" test, which is satisfied if the businesses are ". . . dependent upon or contribute to each other and the operations of the taxpayer as a whole." (*A.M. Castle & Co. v. Franchise Tax Board, supra*, at p. 1805 [quoting Cal. Code Regs., tit. 18, § 25120, subd. (b) and citing, among other authorities, *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481, *Dental Insurance Consultants, Inc., supra*, at p. 347]; see also *Tenneco West v. Franchise Tax Board* (1991) 234 Cal. App. 3d 1510, 1525.)

The United States Supreme Court has stressed the importance of an unquantifiable "flow of value" between segments of a unitary business. (*Container Corp. of America v. Franchise Tax Board* (1983) 463 U.S. 159, 178-179.) For constitutional purposes, a finding of unity requires "some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." (*Id.* at p. 166.)

A finding of unity may be made under either one of those two alternative tests. (*Dental Insurance Consultants, Inc., supra*, at p. 348; *A.M. Castle & Co., supra*, at p. 1805.) In *A.M. Castle & Co., supra*, at pp. 1802, 1805-1806, the court rejected the argument that the three unities must be found to establish unity, explaining that California's tax regulations setting forth the dependency or contribution test must be given deference and "there is no constitutional constraint which compels us to apply the three unities test in all cases." The court noted that "[a]s a practical matter, the dependency or contribution test overlaps with the three unities test 'in many areas and many of the same facts and factors are used in reaching a determination under either test.'" (*Id.* at p. 1807.)

The United States Supreme Court has evaluated "functional integration, centralized management, and economies of scale" in its unitary analysis. (See *Tenneco West*, *supra*, at p. 1525 and fn. 7 [noting the dependency or contribution test and three unities test and that in *Container Corp. of America*, *supra*, at p. 178, the Court considered functional integration, centralized management, and economies of scale].) In *Mobil Oil Corp. v. Commissioner of Taxes of Vermont* (1980) 445 U.S. 425, 438, the Court explained that "separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralized management, and economies of scale." (*Id.* [citing the United States Supreme Court decision in *Butler Bros. v. McColgan*, *supra*, at pp. 508-509, which affirmed the California Supreme Court's decision in the case].) The Court later explained, in discussing functional integration, centralized management, and economies of scale, that "if such 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of value that has no other connection with that State." (*F. W. Woolworth Co. v. Taxation & Revenue Dep't* (1982) 458 U.S. 354, 364 [quoting *Mobil Oil Corp., supra*, at p. 438]; see also *ASARCO Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, 317.) This principle was reiterated in *Container Corp. of America*, *supra*, at p. 166. Most recently, in *MeadWestvaco Corp. v. Ill. Dep't of Revenue* (2008) 553 U.S. 16, the Court, in considering the taxation of gain from the sale of a business, stated that ". . . a unitary relationship's 'hallmarks' are functional integration, centralized management, and economies of scale." (*Id.* at p. 30 [citing *Mobil Oil Corp.*, *supra*, *Allied Signal, Inc. v. Director, Division of Taxation* (1992) 504 U.S. 768, *Container Corp.*, *supra*, *F.W. Woolworth Co.*, *supra*].)

The criteria of "functional integration, centralized management, and economies of scale" are consistent with the factors considered by California courts under the three unities test and the dependency or contribution test. (*Mole-Richardson Co. v. Franchise Tax Board* (1990) 220 Cal.App.3d 889, 899 [stating "the determinative factors are the same"]; *Appeal of Sierra Production Service Inc.*, 90-SBE-010, Sept. 12, 1990.) In *Dental Insurance Consultants, Inc., supra*, at p. 348, the court rejected the argument that "the three-unities test should be abandoned in favor of the United States Supreme Court test of 'functional integration, centralization of management, and economies of scale' . . . ." Instead, the court found that no choice between the tests is compelled, "so long as the test used in this state infringes no constitutional rights of out-of-state businesses." (*Id.*) In the *Appeal of Sierra Production Service Inc.*, *supra*, the Board stated that ". . . 'functional integration' is not a new 'test' for the existence of a unitary business . . . , but is merely a descriptive term for what has long been regarded as an inherent characteristic of a unitary business." (*Id.* at fn. 2.) The Board further cautioned that "labels are not helpful" and that unitary cases are decided on the basis of specific evidence or based on the burden of proof where evidence is lacking. (*Id.* at p. 8.)

California Code of Regulations, title 18, section (Regulation) 25110, subdivision (b)(5), defines a "unitary business" as "those activities required to be included in a combined report pursuant to Revenue and Taxation Code section 25101 [which provides for the allocation and apportionment of multistate income] and the cases decided thereunder by the United States Supreme Court, the courts of this State, and the California Board of Equalization." The regulation further states that "[a]ctivities constitute a 'unitary business' if unity of ownership, unity of operation, and unity of use are present, or if the activities carried on within the state contribute to or are dependent upon the activities carried on without the state, or if there is a flow of value between the activities." Regulation 25120, subdivision (b), creates a "strong presumption" that a unitary business exists under one or more of the following three circumstances:

> (1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.
>
> (2) Steps in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps are operated substantially independently of each other with only general supervision of the taxpayer's executive offices.
>
> (3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing . . . .

Under Regulation 25120, subdivision (b), and the cases set forth above, a unitary determination depends on the facts of each case. As noted above, the three unities test and the dependency or contribution test overlap in many areas, and they consider many of the same facts and factors. (*A.M. Castle & Co.*, *supra*, 36 Cal.App.4th at p. 1807.) For example, a finding that two of the unities exist may constitute evidence of unity under the dependency or contribution test. (*Id.*) In evaluating whether unity exists, courts have considered, among other factors:

- executive management control;[11]
- unity of operation in functions such as purchasing, personnel, advertising, accounting, legal services, and financing;
- whether there are substantial intercompany flows of products, goods or raw materials (although a finding that substantial intercompany sales are lacking does not necessarily prevent a finding of unity);[12]
- whether there is a sharing of technology and expertise;
- whether there is intercompany financing in which there is an exchange of value beyond the mere flow of funds from a passive investment;[13] and
- whether the companies are in the same line of business.

The Franchise Tax Board's determination regarding the existence or non-existence of a unitary business is presumptively correct, and the taxpayer bears the burden of proving otherwise. (*Appeal of Kikkoman International, Inc.*, 82-SBE-098, June 29, 1982.)

The following California cases provide examples of how courts have weighed various factors in order to determine, on the facts of each case, whether businesses are unitary.

***Container Corporation of America v. FTB* (1981) 17 Cal.App.3d 988, cert. granted, opin. at 463 U.S. 159 (1983).**

In this case, the parent company produced and distributed paperboard packaging materials and all but one of the subsidiaries at issue were engaged in the paper-board packaging business. Evaluating the trial court record, the California Court of Appeal found that unity existed, and its determination was affirmed in a decision by the United States Supreme Court. Unity of ownership was present because the parent corporation owned the subsidiaries. In evaluating unity of operation and

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[11] Local autonomy in day-to-day management does not necessarily prevent a unitary finding where the businesses otherwise contribute to and depend upon one another. (See *Container Corp. v. Franchise Tax Board*, *supra*, at p. 172.) Courts frequently consider whether there is control over major policy decisions. (See *A.M. Castle Co.*, *supra*, at p. 1806.) There is not a unitary business if other factors are lacking and the central management's oversight is simply that which one would find in any parent-subsidiary relationship. (*Tenneco West v. Franchise Tax Board*, *supra*.)

[12] See *Container Corp. of America*, *supra*, at p. 178.

[13] See *Tenneco West, Inc. v. Franchise Tax Board*, *supra*, at p. 1526; *Container Corp. of America*, *supra*.

unity of use, the Court of Appeal first noted that the unitary determination "is guided by various factors; no one element controls the decision." (*Id.* at p. 995.)

The court noted, among other things, that:

- although the parent did not purchase materials from the subsidiaries, it sometimes sold small quantities of paperboard and raw materials to its subsidiaries;
- the parent sold some used equipment to the subsidiaries and assisted the subsidiaries in the acquisition of paper, personnel, and equipment;
- the parent loaned over $18 million to the subsidiaries during the period in question, and guaranteed approximately one-third of the subsidiaries' other debt; and
- although there was no common employee benefit plans, some employees remained on appellant's payroll. (*Id.* at pp. 995 – 997.)
- although there was not a steady flow of raw materials and goods between the parent and subsidiaries, this is "only one of several factors to be evaluated in determining whether a business is unitary[;]"
- the integration of "major executive functions is a factor of great importance" and, though everyday operations were handled by local employees, "major policy decisions were subject to review" by the parent;
- the parent provided substantial technical assistance to the subsidiaries; and
- the parent presented a public self-image of unity and, although there were areas where the subsidiaries acted independently, there were "other areas in which the parent and subsidiaries contributed to each other in unity of use and unity of operation." (*Id.* at pp. 997 – 999.)

In conclusion, the court found "[a]lthough in many respects the foreign subsidiaries acted independently, the financing, general direction and control of the subsidiaries were in the hand of [the parent,]" and the subsidiaries "were treated as overseas divisions of the parent corporation." Consequently, the application of the formula apportionment method was appropriate. (*Id.* at p. 1001.)

The United States Supreme Court affirmed the judgment of the Court of Appeal. In its decision, the court noted that the parent owned between 66.7 percent and 100 percent of the stock of the subsidiaries, and, where it did not own all the stock, the remainder of the stock was owned by local nationals. (463 U.S. 159, 171.) The court further noted that the subsidiaries were in essentially the same business as the parent. (*Id.*) The court acknowledged that sales from the parent to the subsidiaries accounted for only about 1 percent of the subsidiaries' total purchases and the subsidiaries were "relatively autonomous with respect to matters of personnel and day-to-day management." (*Id.* at p. 172.) However, the court found the relationship between the parent and subsidiaries to be "decidedly close" in some areas, noting that approximately half of the subsidiaries' long-term debt was held or guaranteed by the parent, that appellant provided technical advice and consultation, and that appellant occasionally assisted subsidiaries in the procurement of equipment. (*Id.* at p. 173.) Evaluating all of the facts, the court concluded that, for constitutional purposes, a flow of goods between the companies was not necessary, as long as there was a flow of value. (*Id.* at pp. 178-179.) The court further noted that there was "no indication" that any of the capital transactions with the subsidiaries were conducted at arms' length. (*Id.* at p. 180, fn. 19.)

The court also found noteworthy the managerial role played by the parent. (*Id.*) The court stated, on the one hand, that a unitary business finding cannot not be based on occasional financial oversight that any parent gives a subsidiary. On the other hand, the "mere decentralization of day-to-day management responsibility cannot defeat a unitary business finding." (*Id.*) The court explained that "the difference lies in whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy[,]" and found that the facts pointed to an operational role in management by the parent. (*Id.*) The court concluded that "[t]aken in combination, at least, [the relevant factors] clearly demonstrate that the state court reached a conclusion 'within the realm of permissible judgment.'" (*Id.* at p. 181 [internal citation omitted].)

***Mole-Richardson Co. v. FTB* (1990) 220 Cal.App.3d 889.**

In this case, the court found that a California lighting business and a Colorado farming business were unitary, citing the following evidence:

- "[s]trong centralized management in that all major business decisions" were made by one individual;
- "[a]ll accounting, payroll, insurance, pension plans, primary banking, major purchasing and advertising for [both businesses]" were conducted in California, resulting in cost savings and

economies of scale;

- real property in California was mortgaged to fund the improvement of ranch property in Colorado; and
- "[o]ne California attorney acted as general counsel for all businesses." (*Id.* at p. 899.)

In reaching its decision, the court cited both the dependency or contribution test and the three unities test. (*Id.* at pp. 895-896.) In response to the taxpayer's arguments regarding United States Supreme Court cases applying a "functional integration" standard, the court stated that a review of the analyses employed in those cases "makes it clear that the determinative factors are the same" as set forth in California regulation 25120, *Butler Brothers v. McColgan*, *supra*, and other authorities. (*Id.* at p. 899.)

***Tenneco West, Inc. v.FTB* (1991) 234 Cal.App.3d 1510.**

In this case, the Franchise Tax Board audited Tenneco and its subsidiaries and permitted Tenneco to treat its subsidiaries in its oil and oil-related businesses as being engaged in a unitary business with Tenneco, but determined that Tenneco's shipbuilding, packaging, automotive parts, and manufacturing subsidiaries were not functionally integrated with the unitary business and should be treated as separate businesses for tax purposes. The trial court and the appeals court agreed with the Franchise Tax Board's determination.

The Court of Appeal noted that the trial court found the relationship between Tenneco and the subsidiaries at issue was "such as would exist between any parent and its subsidiaries[,]" and that the existence of long-range planning demonstrated "nothing more than the potential to operate" the subsidiaries as a unitary business. (*Id.* at p. 1526.) Reviewing the evidence, the court found that, although there was evidence to the contrary in the record, "substantial other evidence" supported the trial court's determination that there was not strong centralized management, and further found that the evidence showed the subsidiaries had "a high degree of autonomy and Tenneco's policy control was neither strong nor uniform." (*Id.*) In support, the court noted public documents, policy manuals, and speeches that reflected a policy of operating autonomy for the subsidiaries, that Tenneco only became involved in subsidiary decisions when the decisions involved millions of dollars, and testimony from an expert in management and accounting. (*Id.* at pp. 1527 - 1528.)

The court further found that the record supported a finding that Tenneco did not have substantial centralized departments. Among other things, it noted: common advertising was "minimal," there was "little or no centralized research," "insubstantial amounts of intercompany sales" and purchasing transactions, and the subsidiaries "maintained autonomous legal activities," with their own in-house counsel. (*Id.* at pp. 1528 - 1529.)

The court distinguished *Mole-Richardson Co., supra*, on the basis that the executive in that case directly supervised the operations, all services were performed in one central office, and there were economies of scale. (*Id.* at p. 1530.) As a result, the court concluded that the trial court reasonably found that Tenneco did not demonstrate "the same contribution and dependency or economies of scale . . . ." (*Id.*)

Reviewing intercompany financing, the court found that it served an investment function, rather than operational function, and that the evidence supported the trial court's determination that the transactions "primarily served to diversify [Tenneco's] corporate portfolio and reduce business cycle risks instead of making better use of Tenneco's existing resources through economies of scale, operational integration or sharing of expertise." (*Id.* at pp. 1531 – 1533.) As support, the court cited statements from Tenneco's strategic plan, as well as a finance expert and an economics expert. (*Id.* at p. 1532.)

In summary, the court concluded that the balance of relevant factors warranted a conclusion that the subsidiaries were not in a unitary business with Tenneco. The court highlighted Tenneco's "weak central management," a lack of "substantial centralized departments," the fact that Tenneco and the subsidiaries had "a history of separateness and were of a diverse unrelated nature," and that the intercompany financing "served an investment function, not an operational function." (*Id.* at p. 1533.)

***Dental Insurance Consultants, Inc. v. FTB* (1991) 1 Cal.App.4th 343.**

In this case, the court found that dental insurance company was unitary with its wholly-owned subsidiary, which operated farms. At the outset, the court stated that, since unity of ownership was clearly present, "the decisive inquiry is whether these two diverse businesses were sufficiently interconnected in the shared performance of their operational functions and the executive decision making to be treated as a unitary business." (*Id.* at p.348.) The court further noted that "[n]o bright line exists to aid in this determination as each case must be decided on its unique business arrangements." (*Id.*) The court acknowledged that the categories between unity of operation and unity of use "are somewhat artificial, and precise distinctions are therefore impossible, as they often overlap[,]" and stated that "[t]hese descriptions are useful only to the extent they reflect the organizational and economic interrelation between the parent and subsidiary companies," which interrelation must be "significant" to find unity. (*Id.*)

The court found unity of operation because bookkeeping and other administrative functions were performed by the parent and, further, there were "substantial" intercompany loans and loan guarantees. (*Id.* at pp. 349 – 350.) With respect to unity of use, the court noted that there was "significant overlap" between directors and officers and "ultimate policy decisions" were the responsibility of the parent's board of directors. (*Id.* at p. 350.) The court further noted, among other things, that officers of the parent approved all checks of the subsidiary, as well as managers' decisions regarding operations such as deepening a well, regularly visited and contacted the farms, and negotiated and executed farm management and consulting agreements. (*Id.* at pp. 350 – 351.) For these reasons, the court determined that the management role of the parent was "much more than the occasional oversight any parent routinely gives to an investment in a subsidiary[,]" and "[t]he operational role played by [the parent] went far beyond that of a passive investor or absentee landlord." (*Id.* at p. 351.) The court also noted that most operational activities, such as purchasing and advertising, were conducted "entirely" at the parent's California headquarters. (*Id.*) In summary, the court concluded that "[t]he close control by the parent and the shared administrative functions, coupled with undisputed unity of ownership, establish the requisite economic, operational and managerial interdependence to establish the unitary nature of these businesses." (*Id. at 352.*)

***A.M. Castle & Co. v. FTB* (1995) 36 Cal.App.4th 1794.**

Here, the parent processed metals for resale, and its wholly-owned subsidiary distributed specialty metal products. The parent purchased the subsidiary in order to gain access to the specialty aircraft metals market. Reviewing the trial record, the court noted that the parent accounted for between 31 percent and 48 percent of the subsidiary's sales, and the parent's purchases from the subsidiary constituted from 2.05 percent to 5.44 percent of the parent's purchases. (*Id.* at pp. 1799 – 1800.) The court noted that the parent's annual report emphasized that the subsidiary had made "substantial contributions to the company," and that the parent loaned money to the subsidiary and sponsored an industrial revenue bond for the subsidiary that the subsidiary could not have obtained on its own. (*Id.* at p. 1800.) For these reasons, the court concluded that there was "considerable economic interdependence" between the two companies. (*Id.*) The court further noted that there was "considerable overlap" between directors and management. (*Id.*) However, the court noted that the companies maintained separate administrative operations, such as separate advertising, accounting, and legal functions. (*Id.*)

Based on the record, the court found unity of ownership and unity of use, noting that the parent was effectively able to control the subsidiary, at least with respect to "major policy decisions." In reaching its conclusion regarding unity of use, the court contrasted its finding with that of *Tenneco West*, *supra*, in which the court found that Tenneco did not exercise strong central management over its subsidiaries, as Tenneco had an express policy that its subsidiaries should be highly decentralized as each division was given an unusual degree of autonomy. (*Id.* at p. 1806.)

The court found that unity of operation presented a "closer question," due to separate administrative functions, but declined to decide this issue because of its conclusion that the two companies were "*unquestionably* unitary under the dependency or contribution test." (*Id.* at pp. 1806-1807 [emphasis in original].) The court explained that the companies were in the same line of business and it was "a classic case of a larger parent purchasing a smaller subsidiary to better utilize its existing resources, and to capitalize on the synergy between the two corporations." (*Id.* at p. 1808.) Noting that each business contributed to the other business's success, and the financing provided by the parent, the court found the two companies were unitary. (*Id.* at p. 1809.)

<u>Contentions</u>

<u>Brief Synopsis</u>

Appellant contends that QVC constituted a discrete retail business that was different from its technology-intensive cable business, not integrated with appellant's operations and independently managed and operated. As a result, appellant contends that QVC was not unitary under any test and that

FTB has relied on an overly broad interpretation of the “dependency and contribution” test which disregards the lack of control and integration. Appellant further contends that two of the “three unities” are lacking (unity of operation or staff functions and unity of use in executive control) and that respondent has disregarded the United States Supreme Court standard of “functional integration, centralized management, and economies of scale.” Appellant contends that its numerous affidavits, including affidavits from former employees with no stake in the litigation, demonstrate that its position is correct and, despite a thorough audit, respondent has not identified evidence to the contrary. Appellant states that, while its affidavits demonstrate the non-unitary nature of the businesses, it cannot prove a negative (i.e., that it did not control or become involved in QVC’s business) and that, if integration or control existed, it would be reflected in the documentary record. Appellant argues that the documentary evidence presented by the FTB is taken out of context, misrepresented, would be inadmissible in court and/or relates to periods outside of the years at issue. Appellant further argues that its intercompany transactions with QVC were minimal and that its carriage agreement with QVC was undertaken on arms-length terms that were obtained by other cable competitors. With regard to control, appellant argues: that it had only the potential to exercise control; that it left QVC’s existing management team in place when it acquired control; that Douglas Briggs (a QVC executive who became QVC’s CEO after Barry Diller) demanded and received independence; and that appellant’s officers only became “assistant” officers of QVC to perform ministerial functions and to provide occasional financial oversight over its investment.

Respondent contends that appellant and QVC were engaged in a vertically-integrated and complementary unitary business in which QVC provided programming content, which was then distributed by appellant. Respondent contends that appellant’s affidavits are unsupported by evidence, conclusory, irrelevant to the legal issues, and/or undermined by documentary evidence. The FTB argues that its position is supported by contemporaneous documents such as SEC filings, news articles, and company documents such as board minutes. With regard to control, respondent contends: that every member of QVC’s board of directors was a Comcast employee; that appellant appointed its employees as officers of QVC and not simply in ministerial roles; and that those Comcast employees provided valuable insight and assistance, as evidenced in part by the fact that they received millions of dollars in options to acquire QVC stock. Respondent states that it is not relying on the regulatory presumption that is established by strong centralized management and instead is relying on the presumption established by the existence of a vertically-integrated enterprise. Respondent argues that a flow of value is established by appellant's carriage agreement with QVC, joint marketing activities, the expertise provided by Comcast executives, and financing provided by appellant to QVC. Respondent contends that unity exists even if appellant's carriage agreement reflected arms-length terms (which respondent argues has not been established) because the carriage agreement ensured appellant's access to QVC's programming and ensured QVC's access to appellant's cable customers, generating profits and synergies for both companies, as evidenced by SEC filings and other documents. Respondent further argues that appellant's assertions on appeal are contradicted with the factual representations in the Andersen memo and appellant's decision to reduce its basis in QVC stock to reflect damage to the entire business, including QVC, from the termination of the MediaOne agreement.

Appellant's Appeal Letter and Opening Brief

Appellant contends that it properly treated QVC and its affiliates as a separate, non-unitary group. Appellant states that during the years in issue it managed its stock interest in QVC as an investment. Thus, appellant contends the relationship between appellant and QVC lacked unity of operation and unity of use. (Appeal Letter, pp. 2-3.) Appellant explains that it is a cable services business that purchases programming content, secures advertising, and enters into service agreements with customers. The business is technology and equipment-intensive and requires engineering expertise, construction labor and physical resources to build and maintain the cable services system. Appellant further explains that, by contrast, QVC sells consumer goods at retail which requires that it manufacture goods or purchase goods from other manufacturers, to warehouse goods and maintain inventory and to take and ship orders.

Appellant states that, in 1986, QVC sought to enter into "carriage agreements" with satellite and cable providers, including appellant, and QVC reasoned that the right to purchase QVC stock would "sweeten the deal" for those providers to enter into carriage agreements. At that time, appellant asserts, a number of other home shopping ventures, similar to QVC, were also entering into "equity and carriage contracts". Thus, appellant purchased approximately 14.3 percent of QVC's stock.

(App. Opening Br., pp. 1-2.)

Appellant contends that it had no management role in QVC as a result of this stock ownership nor did it further any operational relationship between the two companies. Appellant asserts that other cable companies invested in QVC under the same or similar terms and that QVC became commercially and financially successful.

Appellant states that, beginning in 1993, QVC used its "plentiful cash flow" in an attempt to acquire or merge with another media company. After QVC failed to acquire Paramount in 1993, appellant states that QVC sought a merger with Columbia Broadcasting System (CBS). Appellant explains that, in the event QVC and CBS had merged, Federal Communications Commission (FCC) regulations would have prohibited appellant from owning more than 5 percent of a combined QVC/CBS broadcast network. Because appellant did not want to divest from QVC, appellant first made efforts to persuade QVC to abandon its merger talks with CBS. When those efforts failed, in August of 1994, appellant and Liberty made a tender offer for all of the outstanding stock of QVC. The stock acquisition deal closed in 1995 with appellant owning a 57.45 percent share and Liberty owning a 42.55 percent share of QVC's outstanding stock. (App. Opening Br., pp. 3-4.)

Appellant contends that it never managed QVC's operations and that even though the 57.45 percent equity interest endowed appellant with "the potential to assert influence or control over QVC, the evidence demonstrates unequivocally" that appellant never exercised such control. Appellant asserts that "the same individuals ran QVC both before and after [appellant] acquired a majority interest in 1995" and appellant's officers held positions in QVC "only to complete ministerial and/or administrative tasks like signing documents." Appellant also states that Douglas Briggs, one of the founding members of QVC and the Executive Vice president of QVC, was named the Chief Executive Officer and President of QVC on February 22, 1995, under two conditions: (1) QVC would operate independently of appellant and (2) QVC would assume a new identity by building a new headquarters. Appellant further states that QVC's Board of Directors had a passive role without substantive review of or involvement in the business operations of QVC. According to appellant, appellant's representation on the Board only served as a means for appellant to monitor its investment in QVC. (App. Opening Br., pp. 4-5, exhibit 1, p. 3.)

Appellant also maintains that there were "significant barriers" to appellant becoming involved in QVC's operations as follows:

(1) Appellant takes a decentralized management approach for its cable operations. Thus, it is inconceivable that appellant would have exercised centralized management control over QVC.

(2) Appellant was unable to contribute meaningfully to QVC's operations due to substantial differences in the nature of appellant's and QVC's businesses. For example, appellant states that it sold services and its core business was "cutting-edge cable technology" whereas QVC sold tangible personal property because its business was traditional retail sales. Appellant had a continuing indefinite revenue stream derived from "ongoing subscriber contracts" while QVC made discreet sales to generate revenue.

(3) The "exceptional profitability" of QVC provided appellant with the "strongest incentive" not to get involved in QVC's business because appellant could not improve on QVC's financial success and any involvement by appellant could jeopardize that success.

(App. Opening Br., pp. 6-7.)

Appellant asserts that QVC's facilities were separate from appellant's facilities for all management and administrative services such as accounting, tax, research and development, and finance.

Appellant also contends that the carriage agreement and appellant's stock ownership were independent of each other. Appellant argues that its large share of the cable market made it inevitable that QVC would purchase time on appellant's system. Appellant further argues that it was not required to own QVC stock as a condition of entering into a carriage agreement. In addition, appellant contends the carriage agreement: was an arm's-length transaction; its terms did not change when appellant acquired its majority interest in QVC; and the carriage agreement had no significant effect in terms of appellant's revenue or QVC's total sales.

(App. Opening Br., pp. 8-9.)

Appellant contends that there is no unitary relationship under either of the established tests for determining unity – the three unities and the contribution and dependency tests – and the presumption of unity, pursuant to Regulation section 25120, subdivision (b), does not apply either because appellant and QVC were not horizontally integrated, i.e., engaged in the same line of business, and were not vertically integrated because appellant did not participate in the daily operations of QVC and QVC served only as a portfolio investment for appellant. Appellant also asserts that the "immateriality" of the intercompany payment amounts precludes a finding of vertical integration and that appellant's subscribers were only 6.5 percent and 7.3 percent of QVC's total worldwide subscriber base in 1998 and 1999 and QVC had carriage agreements with other cable and satellite companies. Appellant cites the *Appeal of Daniel Industries, Inc.* (80-SBE-069), decided on June 30, 1980, in support of its position that intercompany sales are only "a meaningful unitary characteristic if they are significant in the scope of the purchaser's and seller's businesses." In that appeal, appellant asserts that the Board held that the taxpayer's purchase of 50 percent of its "bolt and nut requirements" from its subsidiary, which represented approximately 2 percent of the taxpayer's total purchases of material and approximately 5 percent of the subsidiary's sales, was not a significant unitary factor because they were insubstantial amounts. Under that analysis, appellant argues that its transactions with QVC cannot be considered a significant unitary factor. Finally, appellant cites *ASARCO, Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307 in which the Supreme Court held that the taxpayer, a large mining, smelting and refining company, was not unitary with its subsidiary in Peru even though the subsidiary sold approximately 35 percent of its output of copper to the taxpayer. (App. Opening Br., pp. 9-11.)

In view of the diversity of their operations and the immateriality of the transactions between appellant and QVC, appellant states that the only possible element creating a presumption in favor of unity is strong centralized management but that the facts do not demonstrate that appellant and QVC had strong centralized management. According to appellant, there are only two published California cases (*Mole-Richardson Co. v. Franchise Tax Bd., supra*, and *Dental Ins. Consultants, Inc. v. Franchise Tax Bd., supra*, in which the courts have "upheld combination of diverse businesses". Appellant asserts that this dearth of published cases demonstrates "the tremendous obstacles to combining diverse businesses" and that the control "exhibited in those cases was possible only because the enterprises at issue were tiny and closely held." (App. Opening Br., pp. 11-13.)

Instead, appellant argues that *Tenneco West, Inc. v. Franchise Tax Bd.* (1991) 234 Cal.App.3d 1510, which involved "extremely large, diverse, and highly specialized businesses" is controlling in this appeal. In that case, according to appellant, despite the fact that the taxpayer held 100 percent of the stock of its affiliate, the court held that there was no centralized management based on the taxpayer's policy of operating autonomy for its subsidiaries due to the "large and diversified nature." Similarly, appellant argues that there were significant barriers to appellant's direction and control of QVC's operations, as outlined above, and no centralized administrative functions. (App. Opening Br., pp. 13-14.)

Appellant contends that, in the absence of a presumption of unity, the business operations of appellant and QVC may be combined only if they are shown to be characterized by substantial mutual interdependence and a flow of value. With respect to the three unities test, appellant contends that two of the three unities, unity of operation and unity of use, have not been met. Appellant asserts that unity of operation is evidenced by centralized departments, such as purchasing and personnel, which did not exist. Likewise, appellant asserts that unity of use which is characterized by a centralized executive force and general system of operations also did not exist, as shown above, by the absence of centralized management. (App. Opening Br., pp. 15-16.)

With respect to the contribution or dependency test, appellant argues that the evidence shows a "nearly complete absence of any connections that could promote contribution or dependency" and argues there is no integration of operations, no central management, no central administrative services and immaterial intercompany sales. Appellant further contends that respondent's claims of connections between appellant and QVC were "deals that never materialized" and would have occurred without appellant's equity ownership interest in QVC. In addition, QVC was not "dependent" on appellant because QVC had carriage agreements with other cable and satellite companies. (App. Opening Br., pp. 16-17.)

Finally, appellant contends that there is no evidence of any of the factors satisfying the constitutional requirements for combination of separate businesses into a unitary group – functional integration, centralization of management, and economies of scale. Appellant asserts that it had no expertise to exert centralized management over QVC and QVC insisted on independence. Appellant and QVC could not functionally integrate due to the vast differences in the businesses. Appellant and QVC were each self-sufficient in terms of headquarters and other facilities and management and administrative functions, such that the companies could not benefit from economies of scale. (App. Opening Br., pp. 17-18.)

Respondent's Opening Brief

Respondent contends that appellant was vertically integrated with QVC and that a "particularly strong presumption of unity arises" when entities have such a relationship. Respondent argues that appellant's 57.4 percent ownership interest in QVC satisfies the common ownership requirement for unity and the only remaining unitary issues relate to whether appellant's operations contributed to or depended on QVC's operations or vice versa. (Resp. Opening Br., pp. 28-29.)

Respondent notes that QVC invited appellant to become one of QVC's founding shareholders on the condition that appellant agree to carry QVC as its only home shopping channel through October 31, 1988 and to transmit QVC programming to a minimum of 900,000 subscribers. Appellant later replaced its two-year exclusive carriage agreement with a seven-year agreement. In return for exclusivity, appellant received QVC stock and at least a 5 percent commission on QVC sales. Under the carriage agreement, respondent further notes:

- QVC had the right to reacquire appellant's QVC shares if appellant failed to abide by the terms of the carriage agreement;
- QVC was obligated to consult with appellant as to QVC's content and presentation and to consider appellant's recommendations in good faith; and
- appellant had "most favored carrier" status, such that appellant was guaranteed the highest rate of consideration paid and the most favorable terms afforded to any other carrier.

(Resp. Opening Br., pp. 29-30.)

Respondent cites "one historian of the home shopping industry" as noting that QVC and HSN, the other large home shopping channel, would "hardly be able to exist" without appellant and TCI, another large cable television company, because without appellant and TCI "there would not be the large customer base and audience reach necessary to produce the sales volume required for profitability." During the years at issue, respondent states that appellant provided approximately 10 percent of QVC's cable audience and appellant provided over 20 percent of the audience for QVC's unitary affiliate, Q2, which was launched in 1994 but discontinued in 1998. In addition, respondent states that appellant provided additional financing to QVC in 1989 that allowed QVC to acquire one of its largest competitors, CVN, and, by that acquisition, QVC became the world's largest home shopping channel. After acquiring control of QVC in 1995, respondent states that appellant and Liberty Media, QVC's other shareholder, agreed to invest another $20 million in QVC to finance overseas expansion. (Resp. Opening Br., pp. 31-32.)

Respondent further cites a newspaper article in 1994 which reported that appellant's president and his father, appellant's chairman, "lured" Barry Diller, a former chief executive officer of two major media companies, to become head of QVC. When Mr. Diller proposed that QVC acquire CBS, a major television network, in 1994, respondent notes that appellant opposed and successfully blocked the acquisition which would have required appellant to divest most of its interest in QVC. In that action, appellant acquired a majority equity interest of 57.4 percent in QVC and wrested control from Mr. Diller. Respondent notes that the minutes of appellant's board of directors meeting states that the chairman opposed the merger of CBS and QVC, because it would have left appellant with a limited role as a passive investor in QVC.

Respondent states that in connection with the takeover of QVC, an Amended and Restated Stockholders Agreement was executed by appellant, Liberty Media, and QVC which provided that QVC would be managed on a day-to-day basis by appellant and appellant would have the right to appoint every member of the board of QVC and QVC's subsidiaries. Respondent quotes appellant's president who explained at the time that "a combination of Comcast and QVC makes excellent strategic sense." (Resp. Opening Br., pp. 32-33.)

Respondent states that after appellant became the majority shareholder in QVC, Mr. Diller resigned, and appellant replaced QVC's entire board of directors with appellant's executive staff members and that a number of appellant's executives became officers of QVC, and not simply in ministerial positions. Respondent notes that appellant caused QVC's board of directors to grant additional compensation, in the form of stock appreciation rights, to appellant's executives who held positions in QVC. By so doing, respondent contends that their compensation would be measured by their success in managing QVC. (Resp. Opening Br., p. 34.)

Respondent argues that after acquiring a majority interest, appellant and QVC engaged in numerous cross-promotional activities intended to benefit each company. For example, appellant opened stores that promoted appellant's family of companies which included QVC and customers were able to purchase products from QVC in the stores. QVC and appellant's sports channel produced a show that featured sports memorabilia related to the Philadelphia Flyers and Philadelphia Phillies, two teams in which appellant held interests. Respondent also states that appellant offered "to cause QVC to increase its purchases of Irish-sourced goods" in appellant's bid to obtain "a valuable mobile phone license in Ireland." Respondent cites the "contemporaneous statements" of appellant and industry analysts "attesting to the synergies and increased value arising from" the combination of appellant and QVC, including appellant's statement that appellant's "mix of properties 'let[s] it cross-promote its cellular, cable and QVC businesses.'" (Resp. Opening Br., pp. 34-36.)

Respondent contends that appellant aided QVC by declining to carry QVC's principal competitor, Home Shopping Network, and that QVC became one of appellant's "core" businesses in 1995 and contributed to appellant's overall financial success. Respondent states that, during the years in issue, QVC provided almost half the gross revenues reported on appellant's consolidated financial reports and almost a third of appellant's total operating cashflow. In addition, respondent contends there were substantial flows of customers and funds between appellant and QVC as QVC was the principal provider of appellant's home shopping entertainment and appellant provided a substantial part of QVC's cable audience. Finally, respondent argues that QVC generated net income to appellant of approximately $7.8 million in 1998 and $9.5 million in 1999. (Resp. Opening Br., pp. 36-37.)

Respondent further contends that a contribution and dependency relationship began when appellant helped found QVC in 1986 and that a unitary relationship was formed upon appellant's acquisition of a majority interest in QVC in 1995. Respondent notes the following as unitary factors:

- Appellant and QVC were engaged in a "complementary, vertically integrated, relationship" whereby appellant distributed television programming and QVC produced such programming, as evidenced by Federal Communications Commission (FCC) documents and confirmed by industry analysts. Respondent cites the *Appeal of Capitol Industries-EMI, Inc.* (89-SBE-029), decided on October 31, 1989, in which a record distribution agreement between two companies was found to provide a mutual benefit and evidence a vertically-integrated relationship.

Respondent also cites the *Appeal of Saga Corp.* (82-SBE-102), decided on June 29, 1982, in which the taxpayer provided food services to colleges and other institutions and owned a 50.51 percent interest in a corporation that developed and managed off-campus dormitories to which appellant provided food service. The Board found that the taxpayer was unitary with the corporation and with a partnership that operated a student complex to which the taxpayer provided food service, noting that "their complementary operations made them very similar to a vertically integrated business[,]" and provided the taxpayer with "a guaranteed market for its services, [enabling it] to keep additional income within the group."

- The relationship between appellant and QVC created economies of scale and efficiencies for both companies. Appellant was able to "simply flick a switch and earn money from QVC's use of [appellant's] excess channel capacity[,]" and QVC was able to reach a far broader audience without additional up-front costs.
- The overlap of officers and directors indicates a unitary flow of value in that appellant's officers and directors constituted 100 percent of QVC's board of directors. In the *Appeal of Coachmen Industries of California, Inc.* (85-SBE-147), decided on December 3, 1985, this Board held that common officers and directors would seem to lead inevitably to "a mutually beneficial exchange of information and know-how." Likewise, appellant's cable and internet expertise presumably would have been helpful to QVC in its marketing, in its dealing with other cable companies and in developing its internet-based business.
- The intercompany transactions are an indicator of unity. For example, in *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, the Supreme Court found unity even though sales from a parent to its subsidiaries accounted for only about 1 percent of the subsidiaries' total purchases and the subsidiaries were relatively autonomous and not fully integrated. In addition, the Board held in the *Appeal of Nippondenso of Los Angeles, Inc.* (84-SBE-134), decided on September 12, 1984, that intercompany sales at arms-length prices were no less significant as a unitary indicator. Furthermore, where vertical integration exists as it does here, "even de minimus intercompany sales are significant for unitary purposes."
- The numerous cross-promotional activities and other synergies are indicators of unity.

(Resp. Opening Br., pp. 38-43.)

Respondent also contends that appellant's arguments have no merit as follows:

- The carriage agreement and appellant's QVC stock ownership interest were not independent of each other. To the contrary, appellant was permitted to acquire the QVC founder's stock and the discounted stock only because appellant agreed to carry QVC on an exclusive basis.
- Appellant claims that it sold its QVC stock in 2003 because "QVC had no strategic value". If so, then one must conclude that appellant held stock in QVC for the years in issue because QVC had strategic value to appellant in those years. Appellant's ownership of QVC had "strategic value" for QVC because it helped ensure that QVC programming would be carried.
- Appellant claims that it could not have been unitary with QVC because they were each "self-sufficient". However, QVC entered into carriage agreements because QVC's content needed distribution and, on the other hand, the distribution networks needed content.
- Appellant claims that QVC was not appellant's programming or content based on the statement of Amy Banse, appellant's vice-president for content, in which she concluded that QVC was not under her direction and thus could not have been appellant's content. However, Ms. Banse's statement is inconsistent with sworn statements made in appellant's SEC filings, numerous contemporaneous statements made by appellant's officers and industry analysts and the FCC's determination.
- The merging of cable distribution (appellant) with cable content (QVC) is "a prototypical example of vertical integration from which a strong presumption of unity arises."
- Even if, as appellant claims, appellant ran QVC as "an independent company" with a "hands off approach", autonomous businesses may be unitary if there is contribution or dependency.
- Appellant replaced all of QVC's board of directors with appellant's officers in 1995, appointed its executives to positions of authority in QVC, and assumed the responsibility for managing QVC on a day-to-day basis.
- Appellant and QVC were engaged in different aspects of the cable television business which resulted in their vertical integration as confirmed by appellant's 1998 Summary Annual Report which states that appellant decided to build "strong franchises" in both content and distribution.

- Appellant alleges that QVC did not view appellant as a business partner but all of QVC's directors were appellant's executives and they had incentives to act for both companies' mutual benefit.
- Even if appellant did not receive preferential treatment from QVC, the flows of value between the two companies give rise to unity.
- Appellant's claim that it "did not disfavor QVC's competitors" is inconsistent with its decision to drop HSN, QVC's main competitor, from some of its cable systems.
- The fact that QVC had a minority shareholder to whom appellant claims it owed a fiduciary duty does not preclude unity so long as contribution or dependency or a flow of value exists.
- The carriage agreement between appellant and QVC was not "fungible"; QVC could not have reached appellant's four to six million subscribers without an agreement with appellant. This Board has rejected appellant's position that an agreement loses its unitary significance simply because a business enters into dozens or even hundreds of agreements with identical terms.
- Although appellant claims there was no strong central management and centralized departments, respondent is not relying on the presumption of unity arising from this indicator and this Board has rejected the premise that such a management structure must exist as a prerequisite to unity.
- Appellant's reliance on *Tenneco West, Inc. v. Franchise Tax Bd., supra*, does not support its position because this appeal does not involve "allegations of centralized departments or strong central management." Nonetheless, in this appeal, as in *Tenneco West*, respondent is relying on appellant's contemporaneous statement and documentation which are entitled to greater weight than an after-the-fact statement prepared solely for purposes of this appeal.
- A unitary determination is based on a flow of value, not a flow of funds or products, and there is no requirement that the contribution or benefit be quantified. Thus, there is no merit to appellant's argument that the intercompany payments were miniscule and the carriage agreement had no significant impact on either company's bottom line. Nevertheless, appellant reflected the position that the termination fee represented a nontaxable return of capital, the amount of QVC's sales and commission payment to appellant were not miniscule, and the carriage agreement was critical to QVC's success.

(Resp. Opening Br., pp. 43-48.)

Appellant's Reply Brief

Appellant contends that respondent bases its unitary determination on appellant's 57 percent ownership interest in QVC "by stringing together a series of statements divorced from their context." Appellant states that it has provided sworn statements of appellant's chief executive officer, Brian Roberts, and QVC's former chief executive officer, Douglas Briggs, who are "the two individuals most authoritative on the relationship" between appellant and QVC. Each of them has stated that appellant played no management role in QVC and that QVC was self-sufficient and independent of appellant. As a result of that testimony, appellant asserts, respondent instead relies solely on the presumption of vertical integration based on very weak evidence. (App. Reply Br., pp. 1-2.)

In his affidavit, Mr. Roberts states that appellant's QVC stock ownership was not intended to, and did not, confer any management role on appellant, nor did it establish or further any operational relationship between the two companies. Mr. Roberts describes that series of events that led to appellant's acquisition of a majority equity interest in QVC and he states that Mr. Segal recommended Douglas Briggs to lead QVC after the acquisition. He further states that QVC's original officers continued to hold all meaningful officer-level positions responsible for the management of QVC's operations and that QVC maintained fully independent administrative functions. (App. Reply Br., Exh. B.)

In his affidavit, Mr. Briggs states that, after appellant acquired its majority interest in QVC, he met with Mr. Roberts and conveyed his view that QVC should remain autonomous and free of appellant's control. He further states that all dealings between appellant and QVC were at arms-length before and after the acquisition "largely because of the fiduciary duty that [appellant] had to the other QVC shareholder, Liberty." Mr. Briggs cites several examples of what he considers to be an arms-length relationship, such as the fact that many of appellant's cable systems did not carry QVC and appellant's joint marketing with QVC's competitor, Home Shopping Network. Mr. Briggs also notes that the number of homes that could view QVC did not change after the acquisition or after appellant sold its majority interest in QVC. Furthermore, he states that QVC's Board of Directors "asserted its influence only in financial matters such as budgeting." In his view, appellant treated its majority interest in QVC as an investor and, other than financial oversight, appellant did not exercise oversight or control. (App. Reply Br., Exh. A.)

Appellant contends that the respondent's conclusions as to the five factors cited - vertical integration, economies of scale and efficiencies, overlap of officers and directors, intercompany transactions and cross-promotional activities – are incorrect and do not justify a finding of a unitary relationship as follows:

Vertical Integration

- Intercompany sales are meaningful for unitary combination and rise to the level of vertical integration only if the intercompany sales are significant in the scope of the purchaser's and seller's businesses. Respondent has ignored data that establishes the transactions between appellant and QVC were miniscule and insufficient to establish vertical integration. With respect to the *Appeal of Saga Corp.,* appellant argues that this Board found that the sales from the taxpayer to the subsidiary accounted for 13.98 percent and 7.98 percent of the subsidiary's expenses but the most important factor to establish vertical integration was that the taxpayer provided 100 percent of the food services for the facilities managed by the subsidiary. The other cases cited by respondent – *Appeal of Capitol Industries-EMI, Inc.* and *Appeal of Dr. Pepper Bottling Co.* (90-SBE-015), decided on December 5, 1990 - are equally distinguishable because the intercompany sales and purchases were much greater than those in issue here and, in the *Appeal of Dr. Pepper*, the taxpayer was the sole source of supply of an essential component of the purchaser's product. (App. Reply Br., pp. 3-4.)
- Appellant disputes respondent's assertion that it provided 10 percent of QVC's customers and states that it established that it supplied only 6.5 percent and 7.3 percent of QVC's cable customers during the two years in issue. Appellant contends that its figures were provided by QVC and are more accurate. Moreover, appellant contends that these percentages represent appellant's market share and bear no relationship to appellant's ownership interest in QVC as demonstrated by the fact that appellant owned a greater interest in QVC than Liberty, but the percentage of QVC's potential customers supplied by Liberty was higher than appellant's. (App. Reply Br., p.5.)

- With respect to the FCC statement, appellant contends that the FCC only stated that appellant was "vertically integrated", and not that appellant was vertically integrated with QVC. In addition, appellant contends that vertical integration is a term of art in California law, and there is no basis for assuming that the FCC's definition is the same. Finally, the industry analysts' views are less probative because they are not issued by the regulatory authority.

Economies of Scale or Efficiencies

- Contrary to respondent's assumption, appellant's analog system did not have excess capacity during the year in issue and thus respondent is incorrect by concluding that appellant incurred no additional cost for granting QVC access to one or more of its channels. In addition, respondent inappropriately focuses on the carriage agreement which would have existed without appellant's QVC ownership interest. The lack of common control and centralized departments is evidence that there were no economies of scale between appellant and QVC which lends support to the position that they were not unitary. (App. Reply Br., p. 7.)

Overlap of Officers or Directors

- There is no evidence that appellant's personnel named as officers and directors in QVC did anything more than oversee appellant's investment in a subsidiary. In *F.W. Woolworth Co. v. Franchise Tax Bd.* (1984) 160 Cal.App.3d 1154, the court of appeal held that "managerial links . . . are characteristic of a parent and its wholly owned subsidiary and without more are not relevant on the issue of unity." QVC's officers continued to hold "all meaningful officer-level positions responsible for the management of QVC's operations and, accordingly, to set QVC policy and to make business decisions." Appellant's personnel were named as officers and directors only to facilitate routine filings, such as those with the Office of the Secretary of State. The comments and media reports cited by respondent are not persuasive in that Mr. Segal's comments were made 10 years before the tax years in issue and the media report about Mr. Alchin's activities was simply wrong and contradicts Mr. Alchin's testimony given in this

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- appeal.[14] (App. Reply Br., pp. 8-9.)

Intercompany Transactions

- The only factor allegedly evidencing intercompany transactions as an indicator of unity, which is not discussed elsewhere in respondent's brief, is intercompany financing. Appellant assumes that respondent is referring to the initial capitalization of QVC and agreeing the carry QVC as the only home shopping channel, providing financing to acquire CVN, and the investment with Liberty Media of $20 million to finance overseas expansion. However, each of those transactions reflect appellant's investment in QVC and not an operational function. (App. Reply Br., pp. 10-11.)

Cross-Promotional Activities

- Despite the "sweeping statement" describing numerous cross-promotional activities and other synergies, respondent is able to point to only three examples. With respect to appellant's stores cross-promoting its family of companies, only two of the dozens of stores "experimented" with promoting appellant's cable services, sports teams, and QVC's retail business. QVC widely promoted and sold memorabilia related to many sports teams, and there was no effort to cross-promote appellant's sports teams. Finally, there is no evidence that appellant received the cellular license in Ireland or that QVC sourced any additional goods from Ireland. (App. Reply Br., pp. 11-12.)

Appellant disputes respondent's description of key events in its relationship with QVC. For example, while appellant was the first to contract with QVC, many other cable companies followed and the exclusivity provision with QVC was in effect for only two years and occurred several years before the tax years in issue. Appellant's carriage agreement was identical in all material respects with the agreements of the other cable companies and many of them had "most favored nation" provisions. Respondent's own evidence shows that John Malone of TCI, Liberty's parent company, and not appellant recruited Mr. Diller to become head of QVC. Finally, appellant did not run QVC's day-to-day

[14] Mr. Alchin states that he "never had any job responsibilities that involved QVC's operations in any way" and he "never participated in the daily operations of QVC." He states that his only QVC responsibilities involved "reviewing QVC's financial information on a quarterly basis." (App. Reply Br., Exh. D.)

operations and the statement in appellant's SEC filings regarding the management of QVC on a day-to-day basis was not evidence of an attempt to exert operational control but rather to make clear that appellant and not Liberty would have primary shareholder control because Liberty's right to exercise such control was legally restricted. (App. Reply Br., pp. 12-13.)

Respondent's Reply Brief

In its reply brief, respondent takes issue with the affidavits provided with appellant's reply brief made by John Alchin and Douglas Briggs, QVC's President and CEO from 1995 to 2006. With respect to Mr. Alchin's affidavit, respondent states that several months after respondent filed its opening brief, appellant disclosed that Mr. Alchin had executed an affidavit on this matter approximately eight months earlier. Respondent questions Mr. Alchin's statement that he never had "any job responsibilities that involved QVC's operations" except that he was involved in "reviewing QVC's financial operation on a quarterly basis" in view of the fact that he served as QVC's Senior Vice President and Assistant Treasurer commencing in 1995, he regularly reported to the investment community on QVC's financial status and he received stock appreciation rights from QVC. In addition, respondent argues that Mr. Alchin does not explain how a press report in 1999, purportedly based on his own statements, could have erroneously indicated he devoted a majority of his time to working on QVC-related matters. In his capacity as a senior level officer of appellant and QVC, respondent contends that Mr. Alchin had "high-level oversight, input and responsibility" regardless of whether he considered such involvement as a "job responsibility" concerning the "daily operations" of both companies. (Resp. Reply Br., pp. 7-8.)

Respondent further contends that Mr. Briggs' statement that appellant exerted no control over or involvement in QVC's operations is contrary to appellant's contemporaneous sworn statements to the SEC that appellant managed QVC's operations after acquiring majority control in 1995 and appointing QVC's board of directors and many of its officers. Additionally, respondent contends that Mr. Briggs' statements are contrary to contemporaneous evidence in the following respects:

- Appellant's expertise in and knowledge of the cable television business and later of the internet business was valuable to QVC as demonstrated by QVC inviting appellant to become a founding shareholder and offering appellant seats on QVC's board of directors. (Resp. Reply Br., p. 9.)

- At the time appellant's president was appointed to QVC's board of directors, QVC's president stated that he and another director brought a wealth of cable television experience to QVC's board which further strengthened QVC's ties to the cable industry which was the most effective medium for the transmission of QVC's programming. Thus, QVC's founding was contingent upon appellant's assistance and appellant was valued as a part of QVC's management team.
- Appellant also acknowledged that it played a significant role in QVC's success as evidenced by statements made by appellant's president and CEO in 2004 in which he touted appellant's "track record on the content side" which he described as "the most dramatic example of value creation has got to be QVC." (Resp. Reply Br., pp. 9-10.)
- Appellant appointed all of the officers and directors of QVC during the years in issue and, contrary to Mr. Briggs' statement that the board of directors only exercised influence in financial matters, appellant provided funds to QVC critical to its growth and acquisition of a competitor, appellant advised and represented QVC's business, appellant blocked QVC's acquisition of CBS, and appellant and QVC engaged in joint marketing promotions. QVC allowed appellant to use its studios for television programming production. Furthermore, appellant directed that QVC's earnings would be used for appellant's cable system upgrades. (Resp. Reply Br., pp. 10-11.)
- QVC was not entirely self-sufficient, as QVC provided content that needed a medium of distribution. In recognition of this fact, QVC offered appellant discounted stock and later convertible debentures on very favorable terms. These incentives contradict Mr. Briggs' assertion that all dealings between appellant and QVC were "strictly at arm's-length." (Resp. Reply Br., p. 11.)
- Mr. Briggs' comment that appellant owed a fiduciary duty to QVC's minority shareholder reflects a "fundamental misunderstanding" of the requirements for a unitary relationship. Specifically, the test is whether contribution and dependency or a flow of value exists and one need not find that "a majority shareholder took unfair advantage of other shareholders." If the latter was a requirement for unity, then only wholly-owned subsidiaries could be unitary which is clearly not the case. (Resp. Reply Br., p. 12.)

- Mr. Briggs did not support his assertions that QVC's marketing and advertising with appellant was comparable to such efforts with other cable companies and that QVC had a "most favored nation" provision in its agreements with other cable providers. He also failed to explain why some of appellant's systems did not carry QVC after 1995 and whether they did carry QVC at some point. In addition, his statement that appellant and HSN had a contract whereby appellant put HSN coupons in its billings is not evidence of a lack of unity between appellant and QVC. (Resp. Reply Br., pp. 12-13.)
- Mr. Briggs' statement that the number of QVC viewers was not influenced by appellant's ownership interest in QVC is inconsistent with QVC's initial issuance of its stock to appellant which was dependent on the carriage agreement and with appellant's own statement that QVC granted appellant the right to purchase its stock on favorable terms to "sweeten the deal for satellite and cable companies entering into carriage agreements." (Resp. Reply Br., p. 13.)

<u>Appellant's Initial Supplemental Briefing and Sur-reply</u>

In its supplemental brief (entitled "Appellant's Sur-reply"), appellant notes that its numerous affidavits all state that appellant and QVC were separately managed and operated and functioned as independent companies. Appellant asserts that respondent calls into question "the very integrity and honesty" of these individuals and makes baseless "allegations of deception and untruthfulness" regarding Mr. Alchin's statements. Appellant contends that Mr. Alchin's responsibility of receiving and reporting financial results of QVC did not require involvement in QVC's operations or business decisions and that Mr. Alchin held the position of assistant treasurer for "ministerial purposes" only. (App. Add'l Br., pp. 16-18.)

Appellant contends that respondent "blatantly misrepresents" an article about a media conference which stated that Mr. Alchin devoted most of his time at the conference discussing QVC's operations and not, as respondent stated, that Mr. Alchin devoted a majority of his time working on QVC-related matters. Appellant also contends that respondent mischaracterized an article that paraphrased Mr. Alchin when he described the role QVC's cash flow "helped pay for cable system rebuilds." Appellant argues that QVC paid dividends only in 1989 and 1990, prior to appellant acquiring a majority interest, that totaled less than $1 million whereas appellant made more than $7 billion in expenditures for its cable system between 1994 and 2002. Appellant concludes that QVC's cash flow did not fund appellant's cable system rebuilds. (App. Add'l Br., pp. 18-20.)

With respect to respondent's assertion that Mr. Briggs' affidavit was "at odds with [appellant's] contemporaneous sworn statements to the SEC", appellant states that those statements were forward-looking and although there was a potential to manage QVC's day-to-day operations, appellant never exerted this authority. After appellant acquired a majority interest in QVC, QVC retained its autonomy and appellant's relationship with QVC did not change in any significant way and the companies did not share operations or become functionally integrated. Appellant cites *Allied-Signal, supra*, in support of its position that the mere potential to exert control is not sufficient to create a unitary business. Appellant contends that it took only the actions of a passive investor to monitor and protect its investment, such as thwarting the proposed merger of QVC and CBS which appellant believed would compromise its investment. (App. Add'l Br., pp. 20-21.)

Appellant states that it is noteworthy that appellant and Liberty Media relied upon the advice of QVC's founder in identifying Mr. Briggs, who was a member of QVC's original management team, as the successor to Mr. Diller. Although appellant appointed all of the officers and directors of QVC, appellant states that Liberty Media retained veto rights over the QVC board and a had buy/sell clause, which Liberty Media exercised. In addition, after appellant's majority interest acquisition, all of the QVC officers (except Mr. Diller) retained their authority and appellant's officers were made "assistants" to the QVC officers for ministerial purposes only and did not participate in the day-to-day management or operations. Appellant's executives met with QVC on a quarterly basis to discuss QVC's financial performance and reviewed QVC's annual budget, but appellant did not assert actual control. (App. Add'l Br., pp. 21-23.)

Appellant contends that respondent overstates the significance of appellant's financing to QVC in that appellant provided financing to QVC on only two occasions. The first time occurred in 1989, prior to the acquisition of the majority interest, and the second involved joint funding between appellant and Liberty Media in 1996. Appellant further contends that respondent exaggerates the interdependence of appellant and QVC and that the coupling of distribution and content necessarily means that the companies must function as a unitary business. Finally, appellant argues that QVC was only one of many networks that appellant carried and neither company was dependent on the other. In this regard, there is no evidence of a level of contribution and dependency that enabled the companies to function as a unit or that the companies achieved a unitary flow of value. (App. Add'l Br., pp. 23-25.)

Responses to Additional Briefing Requested November 4, 2011

Unity of Operation/Centralized Staff Functions

Staff requested that the FTB clarify whether it contended there were centralized staff functions such as accounting and advertising (i.e., unity of operation). The FTB states that it has never contended that unity of operation existed, and instead is relying on the "contribution or dependency" and the "flows of value" tests for unity. (Resp. Nov. 28, 2011 Add'l Br., pp. 18-19.) Appellant argues that the FTB thus acknowledges that Comcast and QVC were not unitary businesses under either the test of functional integration, centralized management, and economies of scale as set forth in *Mobil Oil Corp., supra*, or the three unities test established by *Butler Bros., supra*. (App. Dec. 5, 2011 Add'l Br., pp. 3 – 4.)

Tests for Unity

Staff requested that each party stipulate that, as an alternative to the three unities test, unity may be found if, during the years at issue, the businesses were ". . . dependent upon or contribute[d] to each other and the operations of the taxpayer as a whole."[15] In its initial additional brief, the FTB states that the law clearly so provides, except that, in fact, unity "must" (rather than "may") be found if dependency or contribution exists, citing *Edison California Stores, Inc., supra*, at p. 481, and other authorities. (Resp. Nov. 28, 2011 Add'l Br., p. 19.)

In its initial additional brief, appellant confirms that "contribution and dependency" is one of several tests that may be used to determine whether unity existed. Appellant argues that the Board should also consider the three unities test, and the United States Supreme Court standard of "functional integration, centralization of management, and economies of scale," citing *Mobil Oil Corp., supra*, p. 438, *Exxon Corp. v. Wisconsin Department of Revenue* (1980) 447 U.S. 207, 224, *Container*

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[15] *A.M. Castle & Co. v. Franchise Tax Board (1995) 36 Cal.App.4th 1794*, at pp. 1803-1805 (citing, among other authorities, Cal. Code Regs., tit. 18 § 25120, subd. (b); *Edison California Stores, Inc. v. McColgan* (1947) 30 Cal.2d 472, 481; *Dental Insurance Consultants, Inc.*, (1991) 1 Cal.App.4th 343, 347; *Tenneco West, Inc. v. Franchise Tax Bd.* (1991) 234 Cal.App.3d 1510, 1525).

Corp., *supra*, p. 179, and *MeadWestvaco Corp. v. Ill. Dep't of Revenue* (2008) 553 U.S. 16. Appellant further argues that the FTB has expressly adopted the *Mobil* test as its primary test, quoting FTB Notice 89-713, which states that although the three unities and contribution or[16] dependency test remain valid standards, the *Mobil* statement will be the "primary standard" relied upon by the FTB. Appellant quotes section 3030 of the FTB Multistate Audit Technique Manual ("Audit Manual"), which states in part that courts have "consistently applied the three unities test and the contribution or dependency test" and that references to "contributions to income from functional integration, centralization of management and economies of scale" are "often viewed as variations of the contribution or dependency test." Appellant contends that it was not unitary with QVC under any test, and the best evidence that there was no contribution or dependency is that "the QVC business remained the same before, during, and after Comcast's ownership." (App. Nov. 28, 2011 Add'l Br., pp. 10 - 12.)

In response to appellant's initial additional brief, the FTB argues that Comcast incorrectly suggests that the contribution or dependency test "somehow became less valid than other tests" after the United States Supreme Court's decision in *Mobil Oil Corp.*, *supra*. Respondent contends there is no preferred or primary test and notes that in *Barclay's Bank PLC v. FTB* (1994) 512 U.S. 298, 304, fn. 1, a case decided many years after *Mobil Oil*, the United States Supreme Court has continued to list the dependency or contribution test as a valid test. With regard to appellant's references to FTB Notice 89-713, respondent states that this notice addressed proposed regulations that were never adopted. With regard to the quotation provided by appellant from the Audit Manual, respondent states that appellant fails to provide the very next paragraph, which states that in FTB Notice 1992-4 the FTB noted that each of the judicially-acceptable tests apply with "equal force and a finding of unity will result when any one of the tests has been met." (Resp. Dec. 5, 2011 Add'l Br., pp. 6 - 8.)

Citing *Container Corp.*, *supra*, *Appeals of Trails End*, 85-SBE-106, Sept. 10 1985, and *Appeals of Monsanto Co.* 70-SBE-038, Nov. 6, 1970, respondent argues that neither the "contribution or dependency" test nor the "flow of value" test depends upon whether a business was independent or autonomous. With regard to *Appeals of Monsanto*, respondent argues that unity was found even though

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[16] Appellant quotes the above document as referring to the contribution "and" dependency test, however the document refers to the contribution "or" dependency test.

the subsidiary "functioned as a separate and distinct entity" with its own staff services and management because of the substantial intercompany sales and the total dependence of the parent on the subsidiary for a principal raw material. Respondent argues that the facts in this appeal are analogous because QVC was during the appeal years dependent upon appellant to provide approximately 10 percent of its viewers and had no alternative but to deal with appellant in areas served by appellant. Respondent further argues that "[i]ntercompany product flow, even at market prices, is a strong indicator of unity," citing *Appeal of Coachmen Industries of California, Inc.*, 85-SBE-147, Dec. 3, 1985, *Appeal of Nippondenso of Los Angeles, Inc.*, 84-SBE-134, Sep. 12, 1984 and other decisions indicating that the fact that intercompany transactions are arms-length does not make them a less significant factor. (Resp. Nov. 28, 2011 Add'l Br., pp. 6 – 9; Resp. Dec. 5, 2011 Add'l Br., pp. 6 - 10.)

In response to the FTB's initial additional brief, appellant argues that the FTB has violated its mission of fair tax administration by mischaracterizing the applicable law. Appellant argues that the FTB's mischaracterization "reduces the unitary business test to a mere ownership plus intercompany sales test, and focuses exclusively on a misapplied contribution and dependency test while ignoring the test used by the United States Supreme Court for more than thirty years . . . ." Appellant contends that all three factors of the three unities test and the functional integration test must be met, and that respondent has acknowledged that two of the three factors of each test (functional integration and centralized management, and unity or operations and unity of use) have not been met. (App. Dec. 5, 2011 Add'l Br., pp. 1, 3 – 4.)

Appellant states that "the vertical integration regulation relied upon by the FTB only creates a *presumption* of unity, which may be rebutted." (Emphasis in original.) Appellant argues that the FTB seeks to apply the regulation too broadly, and, citing *ASARCO, Inc. v. Idaho State Tax Comm'n, supra*, 458 U.S. 307, 328 that the United States Supreme Court has rejected the view that a vertical relationship "with little more than common ownership suffices to establish unity." Appellant argues that the *Appeal of Monsanto*, *supra*, and the *Appeal of Trails End, supra*, are distinguishable because, among other things, those appeals involved more significant intercompany transactions, while Comcast's cable subscribers accounted for 10 percent of QVC's total viewers and QVC's payments to Comcast represented between 0.24 percent and 0.58 percent of Comcast's annual revenue. With regard to the FTB's argument that the arms-length nature of transactions does not decrease their significance, appellant argues that intercompany transactions by themselves are not sufficient for unity and that a lack of significant intercompany transactions impairs a finding of unity, citing the *Appeal of Quaker State Oil Refining Corporation*, 87-SBE-070 (Oct. 6, 1987) and the *Appeal of Daniel Industries, Inc.*, 80-SBE-069 (June. 30, 1980). Appellant further argues that the FTB "misrepresent[s] the true nature" of the decisions cited by it, such as the *Appeal of Coachmen Industries of California*, *supra*, because those appeals relied on an analysis of all of the relevant facts, rather than merely on intercompany transactions. Appellant further argues that overlapping management and the parent's participation in "major financial decisions" cannot constitute the "sole basis" for a unitary relationship, citing *Asarco*, *supra*, *F.W. Woolworth Co.*, *supra*, and *Tenneco West*, *supra*. (App. Dec. 5, 2011 Add'l Br., pp. 11 - 14.)

Evidentiary Record – Annual Reports filed on October 6, 2011

Staff requested that the parties discuss the exhibits, including the annual reports, filed by appellant on October 6, 2011, after the close of briefing. In its initial additional brief, appellant states that the annual reports provided demonstrate that QVC's business and brand were distinct from Comcast and only contain one reference to Comcast. (Resp. Nov. 28, 2011 Add'l Br., p. 1.) In the context of discussing Mr. Briggs' affidavit, respondent states that the annual reports prepared by QVC after it became a private company in 1995 were promotional documents, and that in QVC's 1994 annual report filed with the SEC it mentions Comcast 547 times, and, during the years at issue, Comcast's annual report filings with the SEC mentions QVC 126 times and 108 times, respectively, for 1998 and 1999. (Resp. Nov. 28, 2011 Add'l Br., p. 12.) In response, appellant states that the 1994 annual report only mentions Comcast 47 times (rather than 547 times) and does so predominately in the context of the Paramount tender offer and related litigation. By contrast, appellant states that, in the same annual report QVC mentions Liberty Media and its affiliates 62 times. (App. Dec. 5, 2011, p. 11.)

Evidentiary Record –Affidavits

Staff requested that appellant identify or supply evidence (such as, perhaps, interoffice memos or emails, job descriptions or employment contracts indicating duties with respect to appellant and/or QVC, or reviews of personnel indicating areas of responsibility) supporting the statements made in the affidavits. In its initial additional brief, appellant states that it has searched its files and "has not identified additional evidence, beyond the documents already in the record, that support the statements made in the affidavits." (App. Nov. 28, 2011 Add'l Br., p. 9.)

Staff also requested that the parties discuss the exhibits filed on October 6, 2011, which included new and supplemental affidavits. In its initial additional brief, appellant states that the newly-filed affidavits supplement and confirm testimony provided in the seven previously-filed affidavits. Appellant groups the affidavits into three categories: (1) affidavits of Comcast executives regarding its relationship with QVC, (2) affidavits of QVC executives regarding the relationship and (3) affidavits of executives responsible for Comcast's 1999 tax returns. (App. Nov. 28, 2011 Add'l Br., pp. 2 – 3.)

Appellant notes that it has provided affidavits from the following Comcast executives regarding the QVC relationship: Comcast's President and CEO, Brian Roberts; Comcast's former co-Chief Financial Officer, John Alchin; Comcast's former co-Chief Financial Officer, Lawrence Smith; Comcast's General Counsel and Secretary, Arthur Block; Comcast's former Vice President of Programming Investments (and Comcast Venture's current Managing Director & Head of Funds), Amy Banse; and Comcast Cable Communications, LLC's ("Comcast Cable") Senior Deputy General Counsel, Thomas Nathan. In summary, appellant argues that these executives confirm that QVC and Comcast "did not operate as an integrated enterprise and did not exchange flows of value." Appellant argues that the affidavits testified to the following facts, among others:

- that prior to Comcast and Liberty Media taking QVC private, QVC was an independent, publicly-traded, and profitable company;
- that Comcast acquired its majority stake in QVC to avoid being forced to liquidate its ownership due to a proposed QVC-CBS merger;
- that QVC's CEO, Douglas Briggs, "demanded autonomy" from Comcast;
- that Comcast "did not intervene in QVC's business operations" due to a "mandate" from Comcast's President and CEO, Brian Roberts;
- that Comcast and QVC's businesses were very different, not integrated, and its officers "did not oversee QVC's operations," "assert control" or participate in "day-to-day" management;

- that Comcast cable operations did not change following Comcast's acquisition of majority ownership;

- that Comcast did not use QVC's earnings to fund or support its business and did not receive dividends during the appeal years; and

- that Comcast did not favor QVC and a lawsuit alleging such favoritism was without merit. (App. Nov. 28, 2011 Add'l Br., pp. 3 – 5.)

Appellant notes that it also provided affidavits from the following former QVC officers: QVC's former President and Chief Executive Officer, Douglas Briggs; its former General Counsel, Neal Grabell; its former CEO and Chief Operating Officer, William Costello; and, its former Senior Vice President of Marketing, Fred Siegel. Appellant summarizes that these individuals confirm the testimony of Comcast's executives and testify that: QVC and Comcast did not share or transfer employees; Comcast expected QVC to protect the interests of Liberty Media; Comcast's interest in cross-marketing was rejected by QVC; and QVC and Comcast did not provide beneficial treatment to one another. (App. Nov. 28, 2011 Add'l Br., pp. 6 – 7.)

In its initial additional brief, respondent contends that the QVC-related affidavits are unsupported by documentation, contain allegations inconsistent with many established facts and fail to address many clear indications of unity. Respondent contends that the assertions and anecdotes, even if accepted as true, are not relevant to the unitary analysis. More specifically, respondent makes the following arguments, among others, with regard to the affidavits.

- Appellant's argument that "nothing changed" is irrelevant because there was contribution or dependency when Comcast helped found QVC, and the only change needed to become unitary was Comcast's acquisition of a majority ownership, citing the *Appeal of Dr. Pepper Bottling co. of Southern California et al., supra*, in which the taxpayer was in a vertically-integrated enterprise and became unitary with the addition of unity of ownership.

- Comcast and QVC's businesses were complementary and generated economies of scale because QVC needed the distribution of its content and Comcast needed content to distribute.

- Respondent is not relying on the presumption of unity arising from "strong central management with centralized departments" and the Board has rejected arguments that such strong central management is a requirement (citing the *Appeal of Trails End, supra*).

- Comcast employees comprised the entirety of QVC's Board of Directors and provided "critical insights," advice, and assistance. Contrary to the affidavits, Comcast repeatedly intervened in QVC's business by, among other things, providing financing in 1989 and 1996 and by preventing QVC from taking over CBS. With regard to the latter, contemporaneous documents show it was done to prevent Comcast's role from being "that of a passive investor" "with no management role."

- Comcast's agreement to withdraw its co-branding suggestion after QVC demonstrated it was a bad idea does not show a lack of unity, and Mr. Siegel's affidavit fails to account for the "numerous examples of joint promotional activities."

- The affidavits are mistaken in stating that QVC employees had no interaction with Comcast employees other than periodic financial reporting, as evidenced by the joint marketing activities, statements to the contrary in Mr. Briggs' supplemental affidavit, and Comcast's use of QVC's production facilities.

- QVC's discounts to Comcast employees and the provision of "better channel positions" to Comcast indicates a flow of value, even if one credits appellant's assertions that these benefits were also provided to other carriers (which may have been required under "most favored nations" clauses). (Resp. Nov. 28, 2011 Add'l Br., pp. 2 – 12.)

In response, appellant contends that the FTB "questions these witnesses' integrity, based only upon speculation and hearsay evidence, and unabashedly misrepresents the nature of [QVC and appellant's relationship]." Among other arguments, appellant contends as follows:

- the FTB fails to recognize that four of the 12 affiants are former QVC executives with no financial stake in the outcome of this litigation;

- the FTB ignores the fact that "documents generally do not show facts that do not exist and, thus, would not show Comcast's lack of involvement in QVC's business" and the FTB has not discovered any contrary documents in its thorough audit;

- the FTB erroneously relies upon events occurring outside of the audit period;

- the FTB "dramatically overstates" the interactions and cross-promotional activities between the companies, by, among other things, ignoring the fact that Comcast did not include QVC's promotional materials in bills but instead included HSN's promotional materials in its bills;

- QVC programming was carried on direct broadcast satellite ("DBS") providers, which "were formidable competitors to the cable industry";

- the FTB misrepresents SEC filings by equating QVC's dependence upon all cable providers with dependence on QVC and overstating by 10 times the number of times Comcast was referenced in QVC's annual report; and

- the FTB's "attempt to discredit Comcast's witnesses based on a lack of documents supporting their testimony is inconsistent with FTB policy," as evidenced by section 3510 of FTB's Audit Manual which states that "[u]nless the FTB can offer another side of the story that is supported by documentation, the taxpayer's 'story' will be controlling . . . ." (App. Dec. 5, 2011 Add'l Br., pp. 2, 5 – 10.)

Respondent states that, after the filing of its initial additional brief, it discovered that Comcast had offset the termination fee income against the tax basis of its stock in QVC, along with other subsidiaries. Respondent notes that, according to the Andersen memo, the reason Comcast offset the fee against its basis in QVC stock was that QVC, like other members of the Comcast group, benefited from the Group's goodwill and franchise network so that "the relevant goodwill and franchise value should be that of the entire group." Respondent contends that this acknowledged benefit is an "undeniable indicator of unity," and that Comcast should be bound by this position, which was taken in tax returns under penalty of perjury, citing *Penson et al. v. Comm'r*, T.C. Memo. 2000-208. (Resp. Dec. 5, 2011 Add'l Br., pp. 2 – 3.)

Respondent contends that flows of value are further demonstrated by substantial stock options issued by QVC to Comcast executives who also served as officers of QVC. Respondent argues that these stock options undermine Comcast's claims that those individuals only served a ministerial function that served to protect Comcast's investment. Respondent provides documentation indicating that, after Comcast obtained control of QVC, it caused QVC to issue stock options to the QVC executives every year such that, by the time Comcast sold its QVC stake, Comcast executives Ralph Roberts, Brian Roberts, Lawrence Smith, Julian Brodsky, and John Alchin had a remaining balance due from their QVC stock of almost $9 million, after having received over $11 million in stock payments in 2003. Respondent argues that Comcast, having caused QVC to pay tens of millions of dollars of deductible compensation to Comcast executives who served as QVC's officers and directors, cannot argue that those executives did not provide any value to QVC. (Resp. Dec. 5, 2011 Add'l Br., pp. 3 – 5.)

Respondent further contends that, in addition to being legally irrelevant, appellant's assertion that "nothing changed" is factually refuted by the stock option grants described above. Respondent states that appellant has not provided documentation showing that its carriage agreements with non-shareholder cable companies were on the same terms as the QVC agreement or that QVC and Comcast did not favor one another. (Resp. Dec. 5, 2011 Add'l Br., pp. 5 – 6.)

Evidentiary Record –Efforts to Obtain Internal Documentation

In its additional briefing request, staff requested that "to the extent any such supporting evidence is available and not already in the appeal record, . . . provide any such evidence (such as, perhaps, interoffice memos or emails, job descriptions or employment contracts indicating duties with respect to appellant and/or QVC, reviews of personnel indicating areas of responsibility) that bears on whether appellant exercised control over QVC or other relevant issues." Staff further stated that it appears ". . . much of the evidence consists of affidavits provided by appellant or external materials such as news articles and SEC filings." Consequently, staff requested that the parties "discuss efforts made to obtain internal documentation, such as interoffice memos or other examples listed above, bearing on the relevant issues and what materials were or could be provided."

Respondent states that it conducted a thorough audit and that it primarily relies on facts "supported by *contemporaneous documentation*, including *sworn filings* with the SEC, *admissions* by the taxpayers, and reasonable inferences that may be drawn therefrom." (Emphasis in original.) Respondent argues that "many (if not most) of those facts are undisputed" and Comcast primarily disputes their legal significance. (Resp. Nov. 28, 2011 Add'l Br., p. 14.)

Appellant states that he FTB has not discovered documents contradicting the affidavits despite its admittedly "thorough" audit generating an audit file exceeding 10,750 pages. Appellant further contends that: "as pointed out by BOE Staff – the primary evidence relied upon by the FTB in this case consists of news articles and other publications that will not be admissible as evidence in a

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court of law."[17] Appellant argues that: it cannot prove a negative (i.e., that it did not control or become involved in QVC's operations); documents are not created in the regular course of business that would show a lack of integration and control; and, further, if such integration or control existed, documents would show those facts. (App. Dec. 5, 2011 Add'l Br., pp. 5 – 6.)

<u>STAFF COMMENTS</u>

Staff cautions that no single factor should be considered in isolation in determining unity. The applicable cases and authorities indicate that all of the relevant facts should be considered in order to determine whether taxes are properly calculated by reference to the unitary income and activities of the enterprise as a whole, rather than through a separate accounting as discrete business enterprises. As the Board cautioned in the *Appeal of Sierra Production Service Inc.*, *supra*, there is a "tendency by all parties to rely on labels and conclusionary terms rather than on the evidence itself and what it fairly can be said to establish" when unitary cases are decided "on the basis of specific, concrete evidence, when it is available" or based on the burden of proof where evidence is lacking. In addition, when the Franchise Tax Board determines that a unitary relationship exists, a taxpayer must prove by a preponderance of the evidence that, in the aggregate, the unitary connections relied on by the Franchise Tax Board are so lacking in substance as to compel the conclusion that a single integrated economic enterprise did not exist. (*Appeal of Saga Corp., supra*.)

It appears that the FTB's core argument is that dependency or contribution exists because appellant and QVC were engaged in a vertical enterprise in which appellant obtained content and revenue for its cable operations, while QVC obtained additional viewers. (See Cal. Code Regs., tit. 18 § 25120, subd. (b)(2).) Appellant contends that intercompany transactions were relatively minimal and the benefits obtained were similar to those that QVC and appellant obtained from other companies. At the hearing, each party should be prepared to explain, with reference to evidence in the record, its view regarding the materiality of transactions and/or benefits flowing between QVC and appellant and

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[17] Staff's question did not address whether documents would be admissible in court or what inferences should be drawn from appellant's reliance on affidavits or the FTB's reliance on SEC filings and other external documentation. Section 5523.6 of this Board's Rules for Tax Appeals states that "any relevant evidence, *including* affidavits, declarations under penalty of perjury, and *hearsay evidence*, may be presented to the Board at a hearing. (Emphasis added.) In staff's view, it is up to the Board to determine the weight to be given and inferences to be drawn from the evidence in the record.

whether such transactions and/or benefits, in light of other relevant facts and factors, indicate the existence of a unitary business.

After Comcast obtained control over QVC, Comcast officers constituted all of the members of QVC's Board of Directors and served in executive positions at QVC; however, Comcast's management frequently served in "assistant" positions and QVC's existing management largely remained in place (with the exception of Barry Diller who was replaced as CEO by Douglas Briggs). The parties will want to discuss whether appellant's executive ties with QVC reflected only a passive role with occasional financial oversight that would be provided by any parent to a subsidiary, as appellant contends, or whether the Board of Director control and management ties provided benefits and value to each company through expertise, insight, or coordination. In this connection, appellant will want to address the contemporaneous documents cited by the FTB regarding the QVC relationship and whether the issuance of options to acquire QVC stock to Comcast executives indicates that such executives provided value to QVC and enabled Comcast to better compensate its executives without incurring additional expense. Respondent will want to address the multiple affidavits under penalty of perjury provided by appellant and appellant's argument that the two businesses were so dissimilar that there was no advantage in Comcast providing management expertise to QVC.

Issue 3: Whether appellant has shown that respondent erroneously disallowed appellant's dividends received deduction for tax year 1999.

Applicable Law

Discussion

The validity of R&TC section 24402. R&TC section 24402 allows for the deduction of:

> (a) A portion of the dividends received during the taxable year declared from income which has been included in the measure of the taxes imposed under Chapter 2 (commencing with Section 23101), Chapter 2.5 (commencing with Section 23400), or Chapter 3 (commencing with Section 23501) upon the taxpayer declaring the dividends.
>
> (b) The portion of dividends which may be deducted under this section shall be as follows:
>
> (1) In the case of any dividend described in subdivision (a), received from a "more than 50 percent owned corporation," 100 percent.
>
> (2) In the case of any dividend described in subdivision (a), received from a "20 percent owned corporation," 80 percent.

> (3) In the case of any dividend described in subdivision (a), received from a corporation that is less than 20 percent owned, 70 percent.

In *Farmers Bros. Co. v. Franchise Tax Board* (2003) 108 Cal.App.4th 976 (*Farmers Bros.*), the Court of Appeal considered the constitutionality of section 24402 and concluded that section 24402 discriminates "between transactions on the basis of an interstate element which is facially discriminatory under the commerce clause" because it favors dividend-paying corporations doing business and paying taxes in California over other dividend-paying corporations not doing business and paying taxes in California. (108 Cal.App.4th at pp. 986-987.)

R&TC section 23057 provides the general statutory authority for severing any provision contained in part 11 of the R&TC, wherein section 24402 is found:

> If any chapter, article, section, subsection, clause, sentence or phrase of this part which is reasonably separable from the remaining portions of this part, or the application thereof to any person, taxpayer or circumstance, is for any reason determined unconstitutional, such determination shall not affect the remainder of this part, nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby.

Abbott Laboratories Decision

In *Abbott Laboratories v. Franchise Tax Board* (2009) 175 Cal.App.4th 1346 (*Abbott Laboratories*), the Court of Appeal was called upon to decide the "effect" of *Farmer Bros.* in view of the plaintiffs' proposition that the court should rewrite R&TC section 24402, subdivision (a), to sever its invalid portion limiting the deduction to dividends received from corporations whose income was subject to California tax. (*Id.* at p. 1349-1350.) The court held that *Farmer Bros.*, by declaring R&TC section 24402, subdivision (a), unconstitutional, eliminated the statutory deduction in its entirety and, as a result, the allowed percentages of dividend deductions prescribed by subdivision (b) could not be applied. (*Id.* at p. 1356.)

The Court of Appeal also held that it would be inappropriate for the court to rewrite or reform the invalid portion of subdivision (a) as proposed by plaintiffs, so as to allow a deduction for dividends declared from the income of any corporation regardless of whether it was subject to California tax. The court found the invalid provision grammatically and functionally separable but not volitionally separable from the rest of the statute because the Legislature "intended to provide the dividends received deduction only to dividends declared from income subject to tax in California." (*Id.* at 1358.) Thus, the court concluded that, by rewriting subdivision (a) as proposed by the plaintiffs, the statute would cease to function in the manner intended by the Legislature. (*Id.* at pp. 1358-1361.)

River Garden Retirement Home Decision

In *River Garden Retirement Home v. Franchise Tax Board* (2010) 186 Cal.App.4th 922 (*River Garden*), the taxpayer attacked the validity of the Franchise Tax Board's remedy of disallowing the deduction for tax years ending on or after December 1, 1999, on the grounds that (1) R&TC section 19393 applies only to national banks, and not to general corporation taxpayers, and (2) respondent did not establish that the remedy cured the discrimination by treating favored and disfavored taxpayers equally. The court of appeal rejected the taxpayer's first argument and held that the plain language of R&TC section 19393 provides that it applies to the "broader range of taxpayers" than national banks. With respect to the taxpayer's second argument, the court noted that the taxpayer provided no authority for its position and that requiring such a showing would improperly burden respondent by "exponentially enlarg[ing] the action to encompass collateral trials on how, at any given point in time, implementation of a given remedy or program is progressing." (*Id*. at 940.) In this regard, the court cited the duty of the government articulated by the United States Supreme Court in *McKesson Corp. v. Florida Alcohol & Tobacco Div., supra*, to provide a "clear and certain remedy" to rectify discriminatory tax treatment which the Supreme Court held was satisfied by the government's good-faith effort to administer and enforce a remedy that included retroactive assessments constituted adequate relief. In *River Garden Retirement Home*, the Court of Appeal held that the taxpayer had not shown, or even alleged, that respondent failed to make a good-faith effort to administer and enforce the remedy. (*Id*.)

Contentions

Appellant's Appeal Letter and Opening Brief

Appellant contends that respondent erroneously disallowed the deduction claimed in 1999 for dividends received pursuant to R&TC section 24402. Although the Court of Appeal held in *Farmer Bros., Inc. v. Franchise Tax Bd.* (2003) 108 Cal.App.4th 976 that R&TC section 24402 was unconstitutional, appellant argues that only the offending language should be stricken from that section, "leaving the deduction intact without any reductions to reflect the payor's apportionment presence within California." As a result, appellant asserts that it is entitled to its full deduction under R&TC section 24402 without any disallowance of expenses deemed to be related to the deducted dividends. (Appeal Letter, p. 3; App. Opening Br., pp. 27-28.)

<u>Respondent's Opening Brief</u>

Respondent states that the Court of Appeal in *Farmer Bros.* held that R&TC section 24402 discriminated against interstate commerce in violation of the Commerce Clause. Respondent contends that the United States Supreme Court in *McKesson Corp. v. Florida Div. of Alcoholic Beverages and Tobacco* (1990) 496 U.S. 18 (*McKesson Corp.*) prescribed the methods whereby a state may remedy the unconstitutional discrimination and held that the state's tax authority has discretion over which method to implement. In this case, respondent states that it has been guided by the *Farmer Bros.* decision and R&TC section 19393 in choosing the appropriate course of action by denying the benefit of the deduction and recomputing the taxes of those taxpayers who had previously received the benefit. Respondent notes that it was not able to recompute the taxes for tax year 1998 due to the expiration of the statute of limitations but, for tax year ending December 31, 1999, the limitations period for issuing deficiency assessments was still open for all taxpayers. Finally, respondent argues that appellant provides no authority for its position that the Board has the authority to strike some language from R&TC section 24402 and render the rest of the statute operative. (Resp. Opening Br., pp. 49-50.)

Additional Briefing

<u>Additional Briefing</u>

In the additional briefing request, staff asked appellant whether it would concede this issue in light of the decisions in *Abbott Laboratories v. Franchise Tax Bd.*, *supra*, and *River Garden Retirement Home*, *supra*. Appellant states that it does not wish to concede this issue based on those decisions and states that the *Farmer Bros.* court "did not hold that the [dividends received deduction] itself was unconstitutional." Appellant asserts that courts in other jurisdictions have allowed a dividends received deduction even though statutory provisions governing the application of the deduction were held unconstitutional, citing *Hutchinson Technology Inc. v. Comm'r of Revenue* (2005) 698 N.W.2d 1, in which the Minnesota Supreme Court "preserved the deduction by remedying the offensive language." Appellant requests that this Board decide the issue in the same manner. (App. Nov. 28, 2011 Add'l Br.,

p. 13.)

Respondent requests that the Board follow California, and not Minnesota, law in this matter. Respondent asserts that the Minnesota case has no applicability to this matter as it fails to discuss United States Supreme Court precedent (i.e., *McKesson Corp.*) and does not address the effect of R&TC section 19393, which controls the resolution of this issue. (Resp. Dec. 5, 2011 Add'l Br., p. 25.)

STAFF COMMENTS

This Board is bound by the controlling decisions of California courts, and decisions of other states are persuasive only in the absence of controlling California case law authority (*Ahlborn v. Peters* (1940) 37 Cal. App. 2d 698, 705). As a result, it is the view of the Appeals Division that, in light of *River Garden Retirement Home* and *Abbott Laboratories* (which were decided after appellant filed its appeal), there is no legal basis for granting the relief sought by appellant.

Issue 4: Whether appellant has shown that the accuracy-related penalty for tax year 1999 was not properly imposed.

Background

Appellant reported the termination fee on Schedule D of its original consolidated 1999 federal corporation income tax return as a gain of $1.5 billion described as "Media-One Contract Rights". (Resp. Opening Br., Exh. N, pp. 1-3.) Appellant filed the original 1999 federal return on September 15, 2000. On October 11, 2000, appellant filed an amended 1999 federal return in which it made an adjustment of $1.5 billion to total income. (App. Add'l Br., Exh. 4.)

Appellant filed its 1999 California corporation income tax return on October 15, 2000. Appellant did not report the termination fee as income on the California return. However, appellant included the termination fee in the amount reported on line 7 of the California Schedule M-1, $2,582,645,656, which is described as "Income recorded on books this year not included in this return (itemize)". (Resp. Add'l Br., p. 1.)

Applicable Law

R&TC section 19164, which incorporates the provisions of Internal Revenue Code (IRC) section 6662, provides for an accuracy-related penalty of 20 percent of the applicable underpayment. The penalty applies to the portion of the underpayment attributable to negligence or to the disregard of rules and regulations or to any substantial understatement of income tax. (Int.Rev. Code, § 6662(b).) The Internal Revenue Code defines "negligence" to include "any failure to make a reasonable attempt to comply" with the provisions of the code. (Int.Rev. Code, § 6662(c).) The term "disregard" is defined to include any "careless, reckless, or intentional disregard." (Ibid.) There is a "substantial understatement of income tax" when the amount of the understatement for a taxable year exceeds the greater of ten percent of the tax required to be shown on the return, or $5,000. (Int.Rev. Code, § 6662(d)(1).)

There are three potential exceptions that may provide relief from the imposition of the penalty. First, IRC section 6662(d)(2)(B)(i) provides that the amount of the understatement of tax is reduced by the portion of the understatement that is attributable to the tax treatment of any item by the taxpayer if there is, or was, "substantial authority" for such treatment. Second, IRC section 6662(d)(2)(B)(ii) provides, in pertinent part, that the amount of the understatement of tax is also reduced by the portion of the understatement that is attributable to any item if (a) the relevant facts affecting the item's tax treatment are "adequately disclosed" in the return or in a statement attached to the return <u>and</u> (b) there is a "reasonable basis" for the tax treatment of such item by the taxpayer. Third, IRC section 6664(c)(1) provides, in pertinent part, that no penalty shall be imposed under IRC section 6662 with any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with regard to that portion.

With regard to the first exception, IRS regulations state, in part, that:

> The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard . . . , but more stringent than the reasonable basis standard as defined in Sec. 1.6662-3(b)(3). The possibility that a return will not be audited or . . . raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.
> (3) Determination of whether substantial authority is present—
> (i) Evaluation of authorities. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. . . . . There may be substantial authority for more than one position with respect to the same item. Because the substantial authority standard is an objective standard, the taxpayer's belief that there is substantial authority for the tax treatment of an item is not relevant in determining whether there is substantial authority for that treatment.
> (ii) Nature of analysis. The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. . . .
> (Treas. Reg. 1. § 1.6662-4(d)(2)-(3).)

The IRS regulation explains that, among other authorities, the Internal Revenue Code and other statutory provisions, regulations, revenue rulings and court cases may constitute substantial authority. (Treas. Reg. § 1.6662-4(d)(3)(iii).)

With regard to the second exception (i.e., where there is "adequate disclosure" and a "reasonable basis"), IRC section 6662(d)(2)(B)(ii) provides that the penalty shall be reduced to the extent attributable to an item if "(I) the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and (II) there is a reasonable basis for the tax treatment of such item by the taxpayer."

With regard to the meaning of "reasonable basis", IRS regulations provide, in part, as follows:

> Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities [permitted for the purpose of the "substantial authority" test], the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in Sec. 1.6662-4(d)(2). . . . In addition, the reasonable cause and good faith exception in Sec. 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard. . . . (Treas. Reg. § 1.6662-3(b)(3).)

With regard to the third exception, the reasonable cause and good faith exception, Treasury Regulation section 1.6664-4(b)(1) provides in relevant part:

> The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. . . . Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge and education of the taxpayer . . . .

Under California law, Regulation 19164, subdivision (a)(2), provides that an understatement determined pursuant to that regulation "shall not include any amounts which are attributable to the taxpayer's good faith determination, whether based on the facts or unresolved legal issues, of . . . amounts which are attributable to the classification of an item as business or nonbusiness income for purposes of Article 2 of Chapter 17 of this part [i.e. the UDITPA]."

Respondent's determinations of proposed assessments generally carry a presumption of correctness, and an appellant has the burden of proving error in those determinations.[18] (See *Appeal of Myron E. and Alice Z. Gire*, 69-SBE-0029, Sept. 10, 1969; *Appeal of Robert and Bonnie Abney*, 82-SBE-104, June 29, 1982.)

Contentions

Appellant's Opening Brief

Appellant argues that the accuracy-related penalty was not properly imposed because (1) there is substantial authority for characterizing the MediaOne termination fee as nonbusiness income and (2) California expressly prohibits penalizing taxpayers for their treatment of business/nonbusiness income. With respect to the first point, appellant asserts that Treasury Regulation section 1.6662-4(d)(2) provides that "substantial authority" is "an objective standard involving an analysis of the law and application of the law to relevant facts." Appellant interprets that provision as not requiring "any disclosure by the taxpayer of the reason for the treatment of an item" and not requiring "proof of the taxpayer's subjective state of mind at the time of filing the return." (App. Opening Br., p. 25.)

Appellant argues that there is substantial authority for a tax treatment position if the weight of authorities, i.e., statutes, regulations, case decisions and other rulings, in support of such treatment is "substantial in relation to" contrary authorities. Appellant contends that, in the absence of any authority directly on point, "a well-reasoned construction of the applicable statutory provision" is substantial authority. Furthermore, appellant interprets the federal regulatory provision that recognizes that "there may be substantial authority for more than one position with respect to the same item" as confirmation that "substantial authority requires less than a 50 percent likelihood that a particular tax treatment will be sustained." (App. Opening Br., pp. 25-26.)

According to appellant, in this appeal there exists substantial authority for excluding the MediaOne termination fee from California taxable income because, as discussed above, appellant relied on a well-reasoned construction of R&TC section 25120, subdivision (a), the interpretive regulation, and case law. Appellant also points out that, as of the time of the termination fee payment and the filing of

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[18] The Appeals Division notes that there are some deviations to this rule. For example, R&TC section 19180 specifically provides that the Franchise Tax Board bears the burden of proof in regard to three penalties not at issue in this appeal (i.e., promoting tax shelters, aiding and abetting an understatement of tax liability, and the filing of frivolous returns). No such statute switches the burden away from the taxpayer for the accuracy-related penalty.

the return, the Court of Appeal had held in *Hoechst Celanese*, *supra*, that the pension reversion income was nonbusiness income under both the transactional and functional tests and the California Supreme Court had not yet issued its decision. Appellant also contends that the Due Process Clause and the Commerce Clause of the United States Constitution provide substantial authority for the exclusion of the termination fee income based on the absence of a unitary relationship and the absence of a transaction serving an operational function. Finally, appellant contends that Regulation 19164 (Cal. Code Regs., tit.18, § 19164) expressly forbids the imposition of an accuracy-related penalty in controversies involving business/nonbusiness income issues. (App. Opening Br., p. 27.)

Respondent's Opening Brief

Respondent contends that the accuracy-related penalty was properly imposed due to appellant's substantial understatement of tax of more than $9 million. Respondent states that appellant has the burden of showing that (1) there is substantial authority for its tax treatment or (2) the relevant facts were adequately disclosed in the return and there is a reasonable basis for appellant's tax treatment. However, with respect to the latter condition, respondent contends that appellant failed to disclose on its California return that it received the termination fee income. Thus, respondent contends that condition is not applicable here. (Resp. Opening Br., pp. 19-20.)

Respondent further contends that there is no substantial authority for appellant's tax treatment because the weight of the authorities in support of appellant's treatment are not substantial in relation to the weight of the contrary authorities. In this regard, respondent cites Tax Court decisions in which the court held that the weight accorded an authority "depends on its relevance and persuasiveness and the type of document providing the authority. An authority which is materially distinguishable . . . is not particularly relevant and is not substantial authority." Respondent also cites Treasury Regulation section 1.6662-4(d)(3)(iii) which provides that conclusions of legal opinions rendered by tax professionals are not authority. (Resp. Opening Br., pp. 20-21.)

Respondent asserts that appellant's failure to report the $1.5 billion termination fee constituted no tax treatment of that amount. Thus, according to respondent, appellant claims that it had substantial authority for the tax position that the termination fee was nonbusiness income, but appellant failed to take such a position on its return by not reporting that amount. Stated differently, because appellant failed to disclose the existence of the income on the return but, according to respondent, deducted the $40 million in expenses attributable to that income, respondent concludes that appellant did not treat the income as nonbusiness income. Respondent further contends that appellant's only explanation to respondent's auditor, regarding the reporting of the termination fee, were two letters from tax professionals which respondent contends do not constitute substantial authority. In addition, respondent asserts that appellant has refused to provide a memorandum upon which the letters and appellant's amended return reporting were based and such refusal leads to the inference that the memorandum would undermine appellant's claim of good faith and reasonable reliance.[19] (Resp. Opening Br., pp. 21-22.)

Respondent further contends that, even if appellant had reported the termination fee as nonbusiness income, there was no substantial authority to support such treatment. Respondent asserts that appellant is required to overcome the presumption in favor of business income by affirmatively showing that the termination fee did not constitute business income under the functional and transactional tests. First, respondent contends that appellant's position that the functional test was not met because the income did not arise from property "lacks any identified legal support." Second, respondent disputes appellant's argument that the functional test was not met because, even if the contractual obligation constituted property, the Agreement was held too briefly to become an integral part of appellant's business. Respondent contends that appellant's position is inconsistent with appellant's sworn position in its federal claim for refund that the termination fee was for damages to appellant's existing business structure. Respondent adds that appellant's sole authority for its position that the transactional test is not met is *Hoechst Celanese*, which is readily distinguishable and therefore not substantial authority. (Resp. Opening Br., pp. 22-23.)

Respondent contends that appellant has not acted in good faith, as required by Regulation 19164, subdivision (a)(2). Respondent further contends that appellant cannot claim that it relied in good faith on the two letters referenced above because those letters lacked any legal analysis and expressly stated that they did not apply for purposes of state taxation. Furthermore, respondent states that

[19] Appellant later provided the Andersen memo as an exhibit to its final brief in this matter prior to staff's request for additional briefing. Staff's additional briefing letter requested that both parties discuss the memorandum.

appellant's admission during the audit and at protest that appellant did not seek or obtain advice from tax professionals regarding the state tax treatment of the termination fee is contradicted by a statement from appellant's in-house certified public accountant, Thomas Donnelly, who claims that "[w]e thoroughly analyzed the legal and factual support for characterizing the Media One termination fee as nonbusiness income" and concluded that "such treatment constituted a viable position." (Resp. Opening Br., pp. 23-24.)

In view of the fact that appellant has not presented any written analysis to support its position, respondent contends that there is no adequate evidentiary basis for determining whether appellant acted in good faith. Furthermore, respondent asserts that a contemporaneous memorandum written by Mr. Donnelly advising that appellant report the income on its California Schedule D consistent with its federal amended return shows that appellant did not act in good faith because it failed to follow his advice. Thus, according to respondent, appellant "hid the income altogether from California." Respondent further states that Mr. Donnelly, in his affidavit, claims it was his expectation that the termination fee would be reported as nonbusiness income but that appellant never followed his advice by so reporting the income. Finally, respondent states that Mr. Donnelly, in his affidavit, claims that he believed that appellant was required to exclude the termination fee from gross income consistent with the federal amended return based upon an "internal review and analysis, as well as input from outside tax advisors", but appellant has not identified any of the outside advisors and has not provided any documents substantiating that advice. Respondent concludes that the implication of Mr. Donnelly's statement is that appellant should be excused from the penalty because it believed it was required to file consistent with the federal amended return. Respondent contends that such a position is absurd and, regardless of that position, appellant did not file its California return consistently with its federal amended return. (Resp. Opening Br., pp. 24-25.)

Finally, respondent contends that the absence of good faith is evidenced by appellant's failure to properly implement "the return of basis position taken on its California return by allocating the fee to reduce the basis of its assets and reducing its amortization deductions." In this regard, respondent asserts that appellant completely excluded the termination fee income but deducted $40 million in expenses attributable to that income against its unitary business income. Moreover, respondent states that appellant failed to report the termination fee as income to Pennsylvania, the state to which its nonbusiness income was allocable, which respondent asserts also demonstrates a lack of good faith. Finally, respondent contends that the imposition of the accuracy-related penalty fulfills the purpose of the penalty which is to deter taxpayers from playing the audit lottery. (Resp. Opening Br., pp. 26-27.)

Appellant's Reply and Supplemental Briefing

Appellant contends that it did not fail to report the termination fee on its California return, but rather took the position that the fee was not income. Appellant states that it used "considerable due diligence" to justify that treatment and amended its federal return accordingly. Appellant asserts that it was not obligated to make any representation about its treatment of the fee as business or nonbusiness income. (App. Reply Br., p. 21.) If the nonbusiness income treatment had been its "primary position", appellant argues, it would have reported the termination fee as nonbusiness income on the Schedule R. However, appellant contends, the evidence shows that the treatment of the termination fee as nonbusiness income was appellant's alternative position to support its position that the fee was not taxable to California. Appellant argues that a taxpayer is not legally required to disclose an alternative position on a tax return and, as respondent acknowledges, disclosure is a voluntary means of penalty mitigation. Thus, according to appellant, it is entitled "to pursue an exception to the accuracy-related penalty based on substantial authority for its nonbusiness income position." (App. Reply Br., pp. 21-22.)

Appellant argues that it had substantial authority for its nonbusiness income position based on the plain language of the statute as the transactional test was not met because the termination fee was a once-in-a-lifetime corporate occurrence, and the functional test was not met, because there was no property that became integral to appellant's business during the period from the execution to the termination of the Agreement. In addition, appellant argues that Regulation 19164 precludes the imposition of the accuracy-related penalty in these circumstances as the circumstances reflect appellant's good faith belief that the amount in issue was attributable to the classification of the item as business or nonbusiness income. Appellant argues that its subjective good faith belief in its treatment is supported by Mr. Donnelly's affidavit. Finally, appellant contends that respondent's argument that appellant hid the income and did not act in good faith lacks factual support and common sense. Due to its size, appellant maintains that it expects tax return audits by state and federal governments and, in every state audit, the first item requested is a copy of appellant's federal return which for 1999 reported the termination fee. In addition, appellant maintains that as a matter of philosophy and ethics it has never intended to play the audit lottery. (App. Reply Br., pp. 22-23.)

Appellant contends that it reported the termination fee on the face of its return as it was disclosed on line 7 of appellant's California Schedule M-1 which "provides for the disclosure of income that a taxpayer has recorded for book purposes but does not recognize as income for California tax purposes." Appellant further contends that it did not deduct "the failed acquisition costs as an expense for California tax purposes" as it viewed "the termination fee as a nontaxable return of capital" and reported the expenses on line 5 of the California Schedule M-1 which, as stated above, identifies expenses a taxpayer has reported for book purposes. (App. Add'l Br., pp. 4-5.)

Appellant states that, contrary to respondent's claim that appellant did not properly depreciate certain business assets, appellant did adjust the tax basis in its assets and reduced its amortization expense by approximately $7.1 million in 1999 as reported on line 5 of the Schedule M-1. Appellant further states that the adjustments for its failed acquisition costs and amortization expenses are apparent when appellant's original federal return is compared with its California return. Appellant explains that the difference in the amount of "other deductions" reported on line 26 of the federal return and the amount of "other deductions" reported on line 26 of the California Schedule F exactly matches the adjustment reported on appellant's federal amended return. (App. Add'l Br., pp. 5-6.)

Appellant objects to respondent's assertion that appellant was playing the audit lottery. Appellant contends that it properly disclosed the termination fee on its California return and, as evidenced by Mr. Donnelly's affidavit, "carefully evaluated" the proper reporting of the termination fee for state income tax purposes. Appellant recounts that it originally reported the termination fee as income on the federal return but later filed an amended federal return and excluded the fee from income. Appellant states that it then determined that its California reporting should be consistent with its reporting of the termination fee as a return of capital on the amended federal return. Appellant disputes respondent's assertion that appellant ignored the advice of Mr. Donnelly to report the termination fee on its California return and contends that the termination fee was disclosed on the California return as

Mr. Donnelly has acknowledged in his declaration. (App. Add'l Br., pp. 7-8.)

Appellant also objects to respondent's assertion that appellant could escape reporting the adjustment to respondent even if the IRS rejected the position reported on appellant's amended federal return. In support of that assertion, appellant contends that respondent cites an outdated version of R&TC section 18622, subdivision (a), which prior to October 10, 1999, did not require a taxpayer to report federal changes unless they increased the taxpayer's liability. However, according to appellant, a 1999 amendment which was effective at the time appellant filed its return required corporate taxpayers to report all federal changes regardless of whether they increased or decreased the liability. For that reason, appellant contends that appellant would be required to report a federal adjustment resulting from the IRS's rejection of appellant's treatment of the fee. Appellant further describes the IRS's audit of the 1999 original and amended federal returns, the IRS's eventual determination that the termination fee was ordinary income, appellant's protest of five issues, including the termination fee treatment, in the revenue agent's report (RAR), and the resolution of the issues negotiated by appellant with the IRS in 2009. Appellant states that the matter is still pending and once the adjustment is processed appellant will have six months to report the changes to respondent. (App. Add'l Br., pp. 9-11.)

<u>Respondent's Reply and Supplemental Briefing</u>

Respondent contends that appellant's assertion that it does not play the audit lottery is not credible, does not amount to substantial authority, and does not establish appellant's good faith. First, respondent argues that, in its reply brief, appellant makes the incorrect assertion that "[appellant] did not fail to report the termination fee on the California return." Respondent contends that, even if the termination fee was not taxable, appellant should have accounted for the fee on its California return by adjusting the basis of its assets and should have not deducted the $40 million in expenses from its unitary business income. Respondent asserts that appellant ignored the fee completely rather than make the foregoing adjustments that might have put respondent on notice that appellant received the termination fee. Respondent concludes that the simplest explanation for these omissions is that appellant was attempting to hide the transaction from state taxing authorities. Respondent further argues that appellant's actions with respect to obtaining the legal advice letters, failing to disclose materials related to the Andersen memo and failing to make the necessary adjustments described above on the

California return are not consistent with a reporting position taken in good faith. Finally, respondent contends, if appellant had been acting in good faith, there would have been no reason for appellant's "last minute assignment of the fee from Comcast Corporation (domiciled in Pennsylvania) to a subsidiary domiciled in Delaware." (Resp. Reply Br., pp. 2-3.)

Respondent argues that appellant did not follow the advice of Mr. Donnelly, whom appellant describes as the individual directly responsible for appellant's 1999 franchise tax return, to report the receipt of the termination fee income on the California return and appellant has not provided any contemporaneous documentation to explain why or by whom that advice was overruled. Respondent further argues that appellant was not regularly audited by respondent prior to the years in issue contrary to appellant's statement that it was "widely audited" by state governments. Finally, respondent argues that appellant conceded at protest that it reported the termination fee income on the federal return and later filed an amended federal return for a refund because it sought to avoid potential liability for a federal penalty for a substantial understatement of tax liability. (Resp. Reply Br., p.4.)

Respondent contends that appellant did not properly disclose the termination fee. Respondent notes that appellant's Schedule M-1 does not mention either MediaOne or a termination fee. Respondent further notes that appellant disregarded the Schedule M-1 instructions requiring itemized descriptions for amounts reported on lines 4, 5, 7, and 8. Respondent also states that appellant disclosed on both the original and amended federal returns the receipt of the $1.5 billion termination fee but not on its California return. (Resp. Add'l Br., pp. 1-2.)

Respondent further states that appellant appears to contend that the termination fee could have been inferred from the amount entered on line 7 of the Schedule M-1 as a "book-tax difference" but respondent contends that such amounts are required to be reported and not inferred. In addition, respondent contends that the identification of a book-tax difference does not put the tax authorities on notice of a taxpayer's error because such differences can arise from a variety of reasons, other than unreported income by the taxpayer. Respondent further contends that the Schedule M-1 reporting does not protect appellant from a substantial understatement penalty, citing *McCoy Enterprises, Inc., et al. v.*

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Commissioner of Internal Revenue, T.C. Memo. 1992-693 (*McCoy Enterprises*),[20] in which the Tax Court held that the taxpayer was liable for the substantial understatement penalty because the taxpayer failed to satisfy the requirements of adequate disclosure of relevant facts. (Resp. Add'l Br., pp. 4-5.)

Respondent further argues that although appellant maintains that the termination fee is nonbusiness income, appellant did not report any nonbusiness income on its 1999 California Schedule R. Respondent maintains that appellant's argument that the termination fee was reported on the Schedule M-1 is simply evidence of appellant's position that the fee was not taxable income but appellant has not provided any substantial authority to support its position. Furthermore, respondent argues that appellant makes the "absurd" suggestion that it is insulated from the substantial understatement penalty because it was required to file its California return consistent with its federal income tax return in view of the fact that appellant's federal claim for refund was not allowed. (Resp. Add'l Br., pp. 5-6.)

With respect to appellant's contentions that respondent made "negligent and irresponsible" allegations that appellant deducted $40 million in expenses against its business income, respondent asserts that appellant's prior attorney, Amy Silverstein, conceded that point and stated that appellant would amend its return to correct the error. According to respondent, appellant reverses course in the additional brief and claims that the failed acquisition costs were treated as an offset to its return of capital and reported the expenses on line 5 of the Schedule M-1. Respondent states that, during the protest phase of this matter, appellant failed to comply with respondent's requests for schedules showing how the federal change in treatment affected the amortization and other items on appellant's federal return and to produce comparable schedules prepared for state tax reporting, if any. Respondent states that appellant provided some information reflecting a reduction in federal amortization but no indication that it made any comparable adjustments for California purposes or whether appellant deducted other expenses relative to the termination fee. On that basis, respondent acted reasonably in

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[20] The Tax Court decision was affirmed by the United States Court of Appeals for the Tenth Circuit at 58 F.3d 557. The Court of Appeals stated that McCoy did not file a separate disclosure statement and instead relied on a balance sheet attached to a subsidiary's return. The Court of Appeals found that the Tax Court "correctly observed" that any disclosures on the subsidiary's return "would have been inadequate in any event because [the subsidiary's] return is not a "pass through" entity for which surrogate disclosure is permitted." (*Id.* at p. 562.)

concluding that appellant deducted the $40 million in transaction costs in computing its business income for California tax purposes. (Resp. Add'l Br., pp. 7-8.)

Appellant's Supplemental Brief

Appellant replies as follows:

- Appellant has already explained why reporting the termination fee on the California Schedule R would have contradicted the position taken on its amended federal return, and respondent ignores the fact that appellant would have to report the termination fee to respondent a second time if appellant changed its federal tax position that the fee did not constitute taxable income. Appellant states that it eventually conceded to the IRS that the fee constituted federal taxable income and appellant reported that federal adjustment to respondent. (App. Supp. Br., pp. 1-2.)
- Appellant filed its California return consistent with its amended federal return and consistent with Mr. Donnelly's advice. On the amended federal return, appellant reduced its Total Income by the amount of the termination fee and the California return reflects the same treatment. With respect to Mr. Donnelly's advice, appellant already explained that appellant's tax department had extensive deliberations about the proper reporting of the termination fee and respondent has taken Mr. Donnelly's comments out of context. (App. Supp. Br., pp. 3-4.)
- Appellant understood that it had an obligation to follow its most recent federal filing position reflected on the amended federal return that the termination fee was not income. Even if the termination fee was income, it was nonbusiness income allocable outside of California. (App. Supp. Br., p. 4.)
- Appellant is not subject to the accuracy-related penalty because it has established reasonable cause for the underpayment and it acted in good faith. Respondent fails to note that the IRC section 6661 penalty for substantial understatement was repealed by the Omnibus Budget Reconciliation Act of 1989 and a modified substantial underpayment penalty is now included in IRC section 6662 and the reasonable cause exception of IRC section 6664(c) applies to all IRC section 6662 penalties. (App. Supp. Br., p. 5.)
- Appellant has shown reasonable cause and good faith as evidenced by appellant's

consultation with competent tax professionals who provided an opinion in support of appellant's position. Appellant also relied on its in-house tax professionals who reviewed the facts and law in deciding the proper tax treatment. (App. Supp. Br., pp. 6-7.)

- Contrary to respondent's contention, the law concerning the tax treatment of liquidated damages is not straightforward or well-established. Moreover, the tax professionals' advice was supported by appellant's in-house professionals and substantial authority as defined in Treasury Regulation section 1.6662-4(d)(3)(iii). Thus, appellant had a reasonable basis for treating the termination fee as a return of capital on the California return. (App. Supp. Br., p. 7.)
- Appellant acted in good faith as the proper treatment of the termination fee income was carefully evaluated by appellant's tax department which determined that California law required appellant to file the return consistent with its most recently-filed federal reporting position. After an extensive analysis, and based upon experience and professional judgment, appellant determined that it was most appropriate to report the fee on the Schedule M-1. (App. Supp. Br., pp. 7-8.)

Appellant argues that "reasonable cause and good faith is especially apparent" based on appellant's two separate grounds for excluding the termination fee from apportionable income. Appellant further argues that Regulation 19164 "recognizes that business or nonbusiness positions are inherently reasonable given their highly factual nature and the subjectivity of the analysis and ultimate determination." Appellant disputes respondent's position that Regulation 19164 is inapplicable because appellant reported the termination fee on the Schedule M-1 rather than the Schedule R. Appellant contends that a taxpayer is not required to report all alternative positions on its tax return. In this regard, appellant states that Mr. Donnelly's affidavit and supporting documents evidence that appellant intended to classify the termination fee as nonbusiness income if the fee was determined to be income rather than a return of capital. Finally, in reply to respondent's claim that appellant deducted the $40 million in expenses against California business income, appellant asserts that it viewed the failed acquisition costs as an offset to a return of capital (as it characterized the termination fee) and for that reason it reported those costs on line 5 of the Schedule M-1. (App. Supp. Br., pp. 8-9.)

Responses to Additional Briefing Request Dated November 4, 2011

Affidavits of Kevin O'Connor and Thomas Donnelly

With respect to the proper characterization of the termination fee, appellant refers to and summarizes the affidavits of Kevin O'Connor and Thomas Donnelly, its vice presidents of federal tax and state and local tax, respectively, as follows:

- Appellant's tax department analyzed the fee for federal tax purposes and considered whether it was income or a return of capital and, if it was income, whether it was ordinary income or capital gain.
- Appellant's tax department also analyzed the fee for state tax purposes and, if it was income, whether it should be treated as business or nonbusiness income. In the Fall of 1999, after consulting internally and with outside advisors, appellant's tax department determined it should be treated as nonbusiness income and never changed its determination.
- Appellant's tax advisor, Arthur Andersen, determined the fee was not income for federal tax purposes and concluded that there was "substantial authority" under IRC section 6662 to treat the fee as a return of capital.
- Appellant followed the Andersen advice when it filed its amended federal return and then filed its California return consistent with the reporting on the amended federal return after consulting with external advisors, including a California specialist.
- In its determination to report the termination fee on line 7 of Schedule M-1 of the California return, appellant's state tax group consulted within the group and with the federal tax group. Appellant also reported other adjustments related to the termination fee in a consistent manner on line 5 of Schedule M-1.
- The IRS subsequently disallowed appellant's reporting position on its amended federal return, which appellant protested and eventually resolved with the IRS. Appellant conceded its position on the termination fee characterization in exchange for a more favorable settlement of another issue. Appellant then reported the IRS adjustment to respondent and indicated that the fee should be treated as nonbusiness income.

(App. Nov. 28, 2011 Add'l Br., pp. 8-9.)

Respondent argues that Mr. O'Connor's affidavit and Mr. Donnelly's supplemental affidavit make allegations regarding negotiations between appellant and the IRS in which Mr. O'Connor states that he was "made aware" of, but was not directly involved in, the negotiations. Respondent argues that the email message attached to Mr. O'Connor's affidavit in support of those allegations only reflects that appellant intended to ask for a concession from the IRS in exchange for appellant's concession but does not reflect that the IRS ever agreed to that deal. Respondent asserts that Mr. Donnelly makes the same allegations based upon his personal knowledge and that neither affidavit provides evidence that such an exchange took place. Respondent also contends that both affidavits mention discussions in 1999 and 2000 concerning the proper state tax treatment but that the affidavits are "largely devoid" of contemporaneous documentary support. Respondent states that the one contemporaneous document appellant provided is an email message dated October 15, 2000, in which Mr. Donnelly tells a subordinate, Mr. Berenholz, that "it would be more appropriate to reflect the [termination fee] transaction showing receipt of the $1.5 billion and reporting the 'cost' as $1.5 billion consistent with the 1120-X theory of this being a capital transaction." However, respondent states that appellant has not provided any evidence as to why this advice was overruled the following day when appellant filed its California return. (Resp. Nov. 28, 2011 Add'l Br., pp. 12-13.)

Respondent also states that appellant has not explained why Mr. Donnelly's first affidavit did not identify any attorneys from appellant's federal tax group or any outside tax advisors from whom he sought advice but that the second affidavit identifies two such persons at Arthur Andersen without any corroborating documentation. In response to Mr. Donnelly's statement that the tax department never changed its characterization of the termination fee as nonbusiness income, respondent states that appellant did not report the fee as nonbusiness income. Respondent also contends that Mr. Donnelly did not allege or show that he considered any relevant authorities. Finally, respondent contends Mr. Donnelly's statement that appellant reported the termination fee as nonbusiness income on its original federal return to avoid any potential interest expense is "at least partly inconsistent" with a statement by Michael Bryan that the fee was reported in that manner to avoid any possible penalties. Respondent states that appellant has not explained the foregoing inconsistencies and contends that this Board should recognize that these inconsistencies affect the weight and veracity of this evidence. (Resp. Nov. 28, 2011, Add'l Br., pp. 13-14.)

Furthermore, respondent asserts that factual disputes concerning the accuracy-related penalty have arisen largely because appellant had changed its basis for penalty relief "multiple times" and due to appellant's withholding of documents related to its reporting position. As an example, respondent states that, five years ago, it requested that appellant produce the Andersen memo and all documents relating to advice appellant may have received regarding the reporting of the termination fee and all of appellant's internal documents which discuss the reporting of the termination fee for federal and state purposes. Respondent states that appellant refused to provide the Andersen memo because appellant had "decided not to rely on the substance" of the Andersen memo as support for the abatement argument. Appellant also stated that it was not aware of: any outside tax advice or that its own employees had prepared any analyses regarding the tax treatment, any documents discussing why appellant reported the termination fee on its original federal return but not on its California return and any internal documents regarding the treatment of the fee for federal or state purposes. Despite these statements, respondent states that appellant finally attached a copy of the Andersen memo to its most recent brief but has still not provided all relevant evidence related to its original filing position. (Resp. Nov. 28, 2011 Add'l Br., pp. 16-17.)

Respondent adds that appellant must bear responsibility for any factual deficiencies and respondent contends that the law provides that appellant must overcome the presumption that a receipt of funds is gross income, appellant has the burden of proving that amounts received are for capital replacement, appellant has the burden of proving its basis in the assets to offset the fee income, and appellant has the burden of proving it has satisfied one of the conditions for relief from the penalty. (Resp. Nov. 28, 2011 Add'l Br., pp. 17-18.)

<u>Relevance of IRS Actions</u>

Staff requested that each party address whether the actions of the IRS to resolve appellant's federal tax refund claim and in the issuance of the Technical Advice Memorandum (TAM) are relevant to this issue. Appellant states that the IRS only issues a TAM when the application of the law to the facts presented is unclear and, therefore, the issuance of the TAM indicates that the tax treatment of the termination fee was unclear. Moreover, the fact that the TAM was requested by the IRS auditor demonstrates that the tax treatment was unclear. Appellant also asserts that the depth of the TAM analysis indicates the complexity of the issue. Finally, appellant notes that the IRS did not suggest that appellant's treatment of the termination fee as a return of capital would subject appellant to the accuracy-related penalty. (App. Nov. 28, 2011 Add'l Br. pp. 14-15.)

Respondent states that appellant has conceded that "it is now relying exclusively on its alternative position to defend against application of the accuracy-related penalty." For that reason, respondent states that appellant has refused to provide relevant information concerning the legal advice given regarding its federal refund claim. Respondent contends that it would be prejudiced if appellant were allowed to "reverse course" and withdraw that concession. However, even if appellant is allowed to withdraw that concession, respondent asserts that the TAM does not provide support for appellant's position because it rejected that position. Respondent further asserts that the TAM described appellant's authorities as "factually distinguishable" and that appellant's reliance thereon was "misplaced." Thus, appellant has not demonstrated reliance on substantial authority. Respondent also quotes a portion of the TAM which states that those cases involved tortuous acts that resulted in damage to the taxpayer's goodwill or the virtual destruction of the taxpayer's business while the termination fee was a form of liquidated damages which are treated as ordinary income. (Resp. Nov. 28, 2011, Add'l Br., pp. 25-26.)

Respondent states that the TAM found that appellant misapplied the "origin-of-the-claim" doctrine, which requires a focus on the origin and character of the claim, i.e., the bargained-for termination fee, rather than the potential consequences on appellant's business operations. Moreover, the TAM found that appellant failed to provide any evidence that the termination fee was intended to compensate appellant for damages to goodwill. Respondent also points to the TAM finding that the purpose of the termination fee provision was to avoid litigation and respondent contends, at the time the Agreement was entered into, MediaOne would have had no reason to know or agree to pay for damages to appellant's existing infrastructure. Respondent contends that the only claim appellant would have against MediaOne was the failure to comply with the Agreement and not for damages to appellant's infrastructure. In that regard, respondent quotes a portion of the TAM stating that the Agreement "is silent as to the allocation of the recovery to either lost profits or damage to capital" and "the [IRS] has substantial support for the position that whenever the status of the payment is unclear or no allocation is made, the recovery will be treated as lost profits." Thus, respondent asserts the TAM concluded that the termination fee was to compensate appellant for lost profits. (Resp. Nov. 28, 2011 Add'l Br., pp. 26-27.)

Respondent further states that the TAM did not address other aspects of appellant's position for which appellant has "the burden to establish the existence of substantial authority" which include appellant's "apparent contention" that the fee was earned by all of appellant's affiliated entities and that appellant can offset the termination fee with its basis in the affiliated entities. Therefore, respondent contends that appellant may not claim the TAM as substantial authority with respect to those issues. Finally, respondent disagrees with appellant's contention that the issuance of the TAM suggests that the issue was a close call and so substantial authority exists for the rejected position. Respondent argues that either a taxpayer or the IRS can request a TAM which will be granted unless it raises a frivolous legal question. However, respondent argues that the standard for substantial authority is considerably higher than "not frivolous". (Resp. Nov. 28, 2011 Add'l Br., pp. 27-28.)

<u>Andersen Memo</u>

Staff also requested that each party address the analysis of the Andersen memo, which was first provided in appellant's final brief prior to staff's request for additional briefing, and whether it relates to the reasonable cause and good faith exception. Appellant contends that the Andersen memo is relevant to the determination of reasonable cause and good faith and also constitutes substantial authority for its position that the termination fee was properly treated as a return of capital. Specifically, appellant states that the memo was prepared at the request of its CPA and is about 30 pages of "carefully analyzed factual and legal conclusions." The fact that appellant requested this analysis demonstrates its desire to determine the proper federal tax treatment. In addition, Mr. Donnelly and his staff worked diligently to determine the proper state tax treatment. Appellant asserts that the IRS's disagreement with the Andersen memo has no bearing on the fact that appellant made significant efforts to determine the proper treatment. (App. Nov. 28, 2011 Add'l Br., pp. 15-16.)

Appellant states that Treasury Regulation Section 1.6664-4(b) and (c) provides that a taxpayer may rely on professional advice if the advice is reasonable and the taxpayer acted in good faith. Appellant asserts that both of those conditions have been met with respect to its reliance on the Andersen memo. Appellant also cites *United States v. Boyle* (1985) 469 U.S. 241, 251 for the proposition that a taxpayer is entitled to rely on the advice of a tax professional. As a result, appellant contends that such reliance should not result in an accuracy-related penalty. (App. Nov. 28, 2011 Add'l Br. p. 16.)

Respondent repeats its contention that appellant has conceded its exclusive reliance on its alternative position and allowing appellant to reverse its position would prejudice respondent. Respondent contends the Andersen memo "exhibits willful blindness to the facts" by stating that:

- Appellant entered into the Agreement on behalf of the consolidated group when in fact the Agreement was between only appellant and MediaOne.
- The market value for Appellant's stock rose when the merger was announced and declined when the merger was terminated when in fact the opposite was true.

Thus, respondent contends the opinion of the Andersen memo was based on the foregoing erroneous factual premises. In addition, respondent contends that in applying the origin-of-the-claim doctrine the memo ignores the well-established rule of considering the payor's intent rather than the recipient's intent. Furthermore, respondent argues that the memo errs by assuming that MediaOne intended to compensate each of appellant's affiliates for damages to their infrastructure and compounds that error by looking at the reasonableness of the fee rather than considering the payor's intent. (Resp. Nov. 28, 2011 Add'l Br., pp. 28-29.)

Respondent argues that the memo errs by assuming that the uniqueness of the Agreement was the reason MediaOne agreed to pay appellant for infrastructure damages and that termination fee provisions were "regularly included" in such agreements during the period in question. Respondent cites a 1998 law review article stating that "termination fee provisions have become an integral part of merger agreements." Respondent further argues that the credibility of the memo is "compromised by [the] sheer absurdity of some of its arguments." As an example, respondent notes that the memo posits that, if the termination fee was intended to act as a "poison pill" to deter other suitors of MediaOne, then it failed to fulfill its purpose. Respondent states that the memo ignores the obvious possibility that fee could well have been intended as a poison pill but that the dosage of the poison was too small. Finally, respondent questions other conclusions of the memo such as the apparent conclusion that appellant may offset the fee with basis in its subsidiaries and with basis in the goodwill of those subsidiaries which would result in a double deduction of “inside” and “outside” basis. Respondent also incorporates by reference the same arguments made in the TAM rejecting the legal authorities cited by the memo. (Resp. Nov. 28, 2011 Add’l Br., pp. 29-30.)

Request to Discuss Specific Cases and Authorities – Andersen Memo and IRS Actions

In support of its substantial authority position, appellant states that it relies on the cases discussed in the Andersen memo and provides a “brief overview” of the memo as follows:

In the cases cited, the IRS attempted to tax proceeds from various litigation settlements and in each case the court “looked at the allegations and evidence produced during the litigation to determine whether the settlement proceeds constituted lost profits or lost capital.” Appellant asserts that the line of cases articulated a test which is essentially the same “origin of the claim” test set forth in the TAM. Appellant further asserts that respondent does not dispute the applicability of this test but only its application to the facts presented. Appellant argues that the difficulty in applying the test is that the termination fee arose from a provision of the Agreement rather than from litigation and thus appellant had no opportunity to allege in litigation its right to the termination fee or to develop evidence to support its position. As a result, the TAM concluded that appellant did not satisfy its burden of proving the “origin of the claim”. (App. Nov. 28, 2011 Add’l Br., pp. 17-18.)

Appellant cites the affidavits provided by Kevin O’Connor and Thomas Donnelly, its vice presidents of federal tax and state and local tax, respectively, stating that appellant’s tax department consulted with appellant’s legal counsel and outside consultants as to the proper tax treatment and concluded that the termination fee constituted a return of capital. Appellant asserts that it should not be “punished” in the application of the test because it did not engage in litigation. Appellant also reasserts that the issuance of the TAM is evidence that the application of the law to the facts was unclear. Finally, appellant contends that the TAM “merely concluded” that appellant failed to sustain its burden of proving that the purpose of the termination fee was the replacement of lost capital but stated that “it was reasonable to conclude” that the treatment was proper and that appellant had “substantial support” for its position. Consequently, appellant contends that the TAM does not undermine appellant’s position that it had “substantial authority”, which requires less than a 50 percent likelihood of success, for its reporting and, thus, allows that appellant can recognize that another reporting position could exist. (App. Nov. 28, 2011 Add'l Br. pp. 17-18.)

Respondent repeats its contention that appellant has conceded its exclusive reliance on its alternative position and allowing appellant to reverse its position would prejudice respondent. Thus, respondent contends that appellant cannot now claim to have substantial authority or even a reasonable basis for its return of capital position or to have made adequate disclosure of that position on the return. Moreover, respondent states that, during the audit and at protest, appellant did not claim adequate disclosure or respond to respondent's request that appellant identify where the termination fee was reported on the California return. In a follow-up letter, appellant did not set forth adequate disclosure as one of the grounds for requested relief and appellant did not assert this ground in its opening and reply briefs. In view of the fact that appellant never asserted this ground until its new counsel raised it in later briefing, respondent questions whether appellant can now make the argument that it made a good-faith adequate disclosure. Respondent also incorporates by reference the arguments and legal authorities discussed in its response to appellant's "adequate disclosure argument". (Resp. Nov. 28, 2011 Add'l Br., pp. 30-31.)

Respondent further argues that appellant may not be relieved of the penalty on the basis that it followed its reporting position on the amended federal return and the federal return does not constitute substantial authority. Respondent also rejects appellant's claim that an Illinois private letter ruling supports its position and asserts that the PLR does not address penalties and does not make clear whether the amended federal return reported more income or was a claim for refund. As supporting case law authority, respondent cites *High v. Comm'r*, T.C. Summary Opinion 2011-35,[21] *Healthpoint, Ltd. v. Comm'r*, T.C. Memo 2011-241 and *Campbell v. Comm'r* (2010) 134 T.C. 20, aff'd (10th Cir. 2011) 2011 U.S. App. LEXIS 19745 in which the courts imposed accuracy-related penalties for the taxpayers' erroneous treatment of settlement recoveries. In the latter two cases, the penalty was imposed even though the taxpayers disclosed the amounts on the returns. Respondent also cites a string of cases in which, respondent states, the courts rejected the taxpayers' claims that they acted in good faith and with

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[21] Staff notes that this citation is to a summary opinion entitled *Parsley v. Comm'r*, and, though it deals with a settlement and accuracy related penalty, it may not be cited as precedent pursuant to IRC section 7463(b). It appears that FTB meant to cite to T.C. Summary Op. 2011-36, which is entitled *High v. Comm'r*, and which also may not be cited by precedent.

reasonable reliance on the opinions of tax professionals, including *Alpha 1, LP et al. v. U.S.* (Ct. Fed. Claims 2010) 2010 U.S. Claims LEXIS 265, *Fid. Int'l Currency Advisor A Fund, LLC v. U.S.* (D. Mass. 2010) 747 F.Supp.2d 49, and *Tigers Eye Trading, LLC et al. v. Commissioner*, T.C. Memo 2009-121 (*Tigers Eye Trading*). (Resp. Nov. 28, 2011 Add'l Br., p. 32.)

Substantial Authority for Alternative Position

The parties were also requested to provide any legal authority as to whether the existence of "substantial authority" or "reasonable basis" for an alternative position rather than the position taken on the return can constitute grounds for such a finding with regard to the actual reporting position taken on the return. Appellant maintains that the definition of "substantial authority" allows for "at least one other filing position to also exist" and that appellant had substantial authority for its 1999 amended federal return treatment and original California return treatment. Alternatively, appellant contends that it had a reasonable basis for its position as demonstrated by the very fact the IRS issued a TAM on this matter, since the IRS will not issue a TAM "regarding a frivolous position." Appellant further contends that it was not required to attach a separate disclosure statement to its 1999 original California return and that it disclosed the termination fee on Schedule M-1 consistent with its filing position. Finally, appellant states that it considered the termination fee to be nonbusiness income "in the absence of its federal return" and Regulation 19164 provides that an understatement does not include amounts related to whether income should be classified as nonbusiness income. (App. Nov. 28, 2011 Add'l Br., p. 18-19.)

Respondent incorporates by reference its assertions in the previous section regarding appellant's reliance on its alternative position and whether appellant can successfully claim to have substantial authority or a reasonable basis for its filing position. (Resp. Nov. 28, 2011 Add'l Br., p. 33.)

Parties' Replies to Responses

In its reply, appellant contends that respondent attempts to discredit Mr. Donnelly by implying his testimony has changed and is not supported by contemporaneous evidence. Appellant asserts that he has elaborated on, but has not changed, his original testimony. Appellant states that Mr. Donnelly addresses in both affidavits the issues of the proper characterization of the fee for California purposes and the proper reporting on the California return after the amended federal return reporting.

In addition, appellant argues that respondent has misrepresented Mr. Donnelly's testimony in that Mr. Donnelly did not testify that he had first-hand knowledge of the IRS negotiations or settlement terms. Respondent also ignores the email message attached to Mr. O'Connor's affidavit as contemporaneous documentation of the settlement discussion between appellant's tax department and the IRS. Appellant adds that the closing agreement between appellant and the IRS shows that the IRS agreed to the terms discussed in that email message and incorporated them into the final settlement. (App. Dec. 5, 2011 Add'l Br., pp. 15-17.)

Appellant contends that respondent incorrectly argues that Mr. Donnelly's advice as to the proper reporting of the fee was overruled and that appellant has presented evidence showing that Mr. Donnelly's advice was inconsistent with the amended federal return reporting which is the reason appellant did not follow that advice. Appellant further contends that the lack of documentation of the conversations relating to the proper reporting treatment does not mean it did not happen. Appellant also rejects respondent's assertion that appellant must have questioned the state tax characterization of the termination fee as nonbusiness income because it did not report the fee in that manner. Appellant states that respondent's assertion ignores the reporting position taken on the amended federal return and appellant's consistent litigation position that, if the termination fee were deemed to be income, it should be characterized as nonbusiness income. With respect to respondent's assertion of the inconsistency in the statements made by Mr. Donnelly and Mr. Bryan regarding the reason for reporting the fee as nonbusiness income on the original federal return, appellant argues that their statements are consistent because appellant may have been subject to both penalties and interest if it had taken the return of capital reporting position on that return. (App. Dec. 5, 2011 Add'l Br., pp. 17-18.)

Appellant argues that the reasonable cause and good faith exception would be frustrated if, as respondent asserts, the analysis for determining that exception were limited to the actual filing position rather than a consideration of all of the relevant facts and circumstances which included all other positions resulting in the nontaxable treatment considered by appellant. In support of its position, appellant cites *Candyce Martin 1999 Revocable Trust v. United States*, 2011 U.S. Dist. LEXIS 115616 (N.D. CA 2011) in which the court held that "penalties are inappropriate" when "'a taxpayer underpays as a result of an honest misunderstanding of fact that is reasonable in light of all the facts and circumstances.'" Appellant also argues that respondent's cited authorities do not support respondent's point that appellant's alternative position is not relevant to the reasonable cause and good faith exception analysis.

Appellant contends that respondent confuses the amount by which the underpayment may be reduced under IRC section 6662(d)(2)(B) based on return disclosure with the amount by which the underpayment may be reduced under IRC section 6664(c)(1) based on the reasonable cause and good faith exception. Appellant states that respondent "inexplicably asserts" that the tax treatment under 6662(d)(2)(B) precludes an analysis of the alternative position under IRC section 6664(c)(1), but the latter section requires an analysis of all relevant facts and circumstances. (App. Dec. 5, 2011 Add'l Br., pp. 19-20.)

Appellant states that the cases relied on by respondent as support for its position that the good faith requirement was not met, *Stobie Creek Investments LLC* v. U.S. (2010) 608 F.3d 1366 and *Candyce Martin, supra*, involved abusive tax shelter transactions that were promoted by tax advisors. The court in *Stobie Creek* found no good faith because the taxpayer should have known about the tax advisor's "inherent conflict of interest" and because the taxpayer should have known that the tax benefits from the transaction were "too good to be true". In *Candyce Martin*, the taxpayer should have known the tax result was too good to be true because the transaction was an IRS "listed transaction". Appellant contends that the transaction at issue here bears no resemblance to those types of transactions, so the analysis in those cases is inapplicable. Appellant cites *United States v. Boyle, supra*, for its position that a taxpayer may reasonably rely on a tax advisor for a complicated tax matter such as the proper reporting of a termination fee. Appellant also rejects respondent's position that appellant "somehow could not rely on the substantial authority position" set forth in the Andersen memo which appellant states reflects respondent's bias that a tax advisor's favorable opinion to the taxpayer is necessarily too good to be true or tax motivated and therefore suspect. Finally, appellant asserts that respondent makes the "absurd" suggestion that appellant should have taken a filing position on its California return different than on its amended federal return. As a result, respondent suggests that the federal treatment should conform to the California treatment, which is inconsistent with the manner in which California tax law conforms to the Internal Revenue Code. (App. Dec 5, 2011 Add'l Br., pp. 20-

21.)

Appellant also contends that it is not estopped, as respondent contends, from relying upon its California filing position even though appellant had previously based its reasonable cause and good faith position on the termination fee being nonbusiness income and respondent would not be prejudiced if appellant adopted this position. Respondent cannot bar appellant from asserting alternate positions for penalty relief; appellant previously (in its June 26, 2009 brief) asserted a reasonable basis position for treating the termination fee as a return of capital. (App. Dec 5, 2011 Add'l Br., pp. 21-22.)

To summarize and clarify, appellant asserts that it has four alternate defenses to the penalty, each of which independently serves to abate the penalty: (1) appellant had substantial authority for its California filing position; (2) appellant had a reasonable basis for its position, coupled with the disclosure on the Schedule M-1; (3) appellant had a reasonable cause to exclude the termination fee from taxable income and relied on the Andersen memo in good faith; and (4) under Regulation 19164, appellant's good faith determination, that the termination fee was nonbusiness income, provides it with relief from the penalty. (App. Dec 5, 2011 Add'l Br., p. 22.)

Regarding the issuance of the TAM, appellant asserts that the IRS, in rejecting appellant's position, merely stated that appellant had not sustained its burden of proof, without stating what level of proof was required. Notwithstanding the disagreement between the parties in the TAM, appellant contends that both parties can be treated as having substantial authority for their position because, by definition, the term "substantial authority" allows two competing positions each with a confidence level of less than 50 percent. In the TAM, appellant states that the IRS only disagreed with appellant's factual assertions (as the IRS stated that appellant had not adequately proven that the termination fee represented damages to appellant's capital) and did not dispute the validity of appellant's legal analysis. As the conclusion in the TAM was based upon a factual dispute, and based upon the legal authorities in the Andersen memo, appellant argues that there was substantial authority to support its position to treat the termination fee as a return of capital. (App. Dec 5, 2011 Add'l Br., pp. 22-24.)

Appellant next responds to respondent's unrelated comments to the question of whether or how the Andersen memo should factor into the reasonable cause and good faith exception. Appellant first addresses respondent's contention that the intent of the payor establishes the characterization of the funds. Appellant states that it does not know what MediaOne intended and asserts that a taxpayer is not assumed to know that a position may be subject to penalties merely because the income is treated as being nontaxable. Appellant argues that respondent's position, that every item of income is subject to tax and to treat items otherwise creates a strict liability for penalties, is not supportable by law. Appellant contends that the termination fee would have been excludable from its California tax base whether treated as a return of capital or as nonbusiness income. Appellant asserts that, as the IRS did not conclude that the Andersen memo misstated the law, appellant had reasonable cause for its position and relied upon the Andersen memo in good faith, entitling appellant to relief from the penalty. (App. Dec 5, 2011 Add'l Br., pp. 24-26.)

Respondent asserts that appellant does not have substantial authority for its tax treatment of the termination fee. Respondent argues that the cases which appellant relies upon for its "substantial authority" contention were held to be factually distinguishable for the IRS and not legally relevant. (Resp. Dec 5, 2011 Add'l Br., pp. 9-10.)

Respondent also argues that the Andersen memo does not constitute substantial authority as, pursuant to Treasury Regulation section 1.662-4(d)(3)(iii), conclusions reached in opinions rendered by tax professionals are not authority. Regarding the Andersen memo, respondent contends that the cases relied on in the memorandum, for its nontaxable return of basis conclusion, are distinguishable from appellant's situation in that: (1) the cases cited were tort cases and not breach of contract cases as involved here; and (2) the taxpayers in those cases provided contemporaneous evidence of the nature of their claims and of the negotiations leading up to the settlement payments. (Resp. Dec 5, 2011 Add'l Br., p. 10.)

Respondent questions the assumption used in the Andersen memo that the payment was to account for damages to appellant's goodwill and infrastructure. Respondent states that, upon its review of appellant's Board of Director's minutes, there is no indication that the termination fee was anything other than a run-of-the-mill break-up fee for lost profits and benefit-of-the-bargain damages. Moreover, respondent states that appellant has not produced any of the documentation that was submitted to its board of directors regarding the termination fee or any documentation regarding its negotiations with MediaOne. Respondent asserts that appellant's failure to produce such documentation as evidence, that the termination fee was intended to compensate appellant for damages to its goodwill and infrastructure, creates the obvious inference that such evidence, if it had been produced, would have been inconsistent with appellant's position in this matter. (Resp. Dec 5, 2011 Add'l Br., pp. 10-11.)

Respondent contends that the Andersen memo also fails to take into account the principle that the character of the payment is determined by looking at the intent of the payor in making the payment. In addition, respondent also contends that the Anderson memo fails to state the manner in which the return of basis position should be reported on appellant's tax returns. (Resp. Dec 5, 2011 Add'l Br., p. 12.)

Respondent next asserts that, pursuant to IRC section 6662(d)(2)(B)(ii), appellant did not adequately disclose the termination fee on its California return and lacked a reasonable basis for its position. Citing *Recovery Group, In., et al. v. Commissioner*, T.C. Memo 2010-76 (*Recovery Group*), respondent argues that an adequate disclosure must "provid[e] sufficient information on the return to enable the IRS to identify the potential controversy" and that simply reporting income or claiming a deduction without identifying the nature of the potential tax issue, relating to the income or deduction, does not constitute "adequate disclosure". Here, respondent states that appellant's sole basis for disclosing the $1.5 billion termination fee was through its inclusion in the Schedule M adjustment of $2,583,645,656. Respondent argues that the Tax Court in *McCoy Enterprises, supra*, held that identifying an item on Schedule M-1 did not constitute adequate disclosure for purposes of avoiding the substantial understatement penalty. Finally, respondent contends that appellant failed to have a reasonable basis, in fact and in law, for its position, as the Andersen memo only identified cases which were over fifty years old and which permitted a tort-like recovery to be treated as a return of basis. (Resp. Dec 5, 2011 Add'l Br., pp. 12-14.)

Respondent also argues that appellant did not exhibit reasonable cause and good faith with respect to its tax treatment of the termination fee, as appellant failed to supply evidence for this Board to even consider, much less actually determine, these standards. Under *Tigers Eye Trading, supra*, respondent asserts that the reliance on professional tax advice is reasonable if the advice is from a competent and independent advisor who is unburdened with a conflict of interest. Here, respondent argues that appellant has not shown what representations that it made to its outside advisors (Arthur

Andersen) whose advice appellant claims to have relied upon, what advice was received from those advisors, other than the Andersen memo, and whether Arthur Andersen had a conflict of interest because it may have received an unreasonably large fee for its advice or because it may have had a financial interest in whether the tax plan succeeded. Respondent states that Arthur Andersen's position (i.e., that the payment of the fee represented a nontaxable return of basis) would have saved appellant $319 million in federal tax and $150 million in state tax. Respondent contends that, because appellant did not fully disclose its communications with Arthur Andersen, appellant has not made the basic predicate showing that a taxpayer must make in order to contend that it acted with reasonable cause and good faith. (Resp. Dec 5, 2011 Add'l Br., pp. 14-16.)

Respondent states that appellant alleges that it has made significant efforts, research, and consultations regarding the tax positions that it has taken on its tax returns. However, respondent argues that appellant has not produced a single document which reflects such analysis except for the Andersen memo, the related cover letters, and an internal email relating to Illinois tax reporting. In addition, appellant has not provided any documentation to explain why it declined to follow the advice to treat the termination fee as a nontaxable return of capital when it filed its original federal return. As appellant has failed to produce documentation, respondent argues that this Board should assume that such documentation, if produced, would be adverse to appellant's reasonable cause and good faith claims. (Resp. Dec 5, 2011 Add'l Br., p. 16.)

Respondent next contests appellant's assertion that the existence of the TAM issued by the IRS supports appellant's penalty relief claims or that the issue considered in the TAM was unclear. Respondent asserts that a TAM may be issued if the application of the law to the facts is unclear, may be issued if a TAM was previously issued on the same matter, or may be issued for other situations as well and that, generally, if a TAM is requested, it will be issued. In addition, respondent states that a TAM may be requested by a taxpayer or by an Internal Revenue Service field office. Respondent also states that appellant has not provided any documentation to support how the TAM was requested by the IRS and has likewise not provided any documentation that it submitted to the IRS relating to the issuance of the TAM. (Resp. Dec 5, 2011 Add'l Br., pp. 17-18.)

Respondent also contests appellant's claim that the TAM did not suggest that appellant's treatment of the termination fee, as a return of capital, was without merit or would be subject to the accuracy-related penalty. Respondent argues, to the contrary, that nothing in the TAM suggests that appellant's arguments had any merit and the TAM dismisses appellant's authorities as being factually distinguishable, explains that appellant's origin-of-the-claim analysis was backwards, and states that appellant provided no support for its conclusion (i.e., that the bargained-for fee was intended to compensate appellant for damages to its goodwill). In fact, respondent asserts that the TAM found that the facts showed there was indirect support for the position that appellant's receipt of the termination fee was for the recovery of lost profits. (Resp. Dec 5, 2011 Add'l Br., p. 18.)

As to appellant's contention that the TAM did not discuss penalties, respondent argues that, since appellant reported the fee as income on its return and paid the tax on that income, there was no understatement of tax for federal purposes that could have been subject to a penalty. In addition, respondent contends that TAMs are not issued on penalty issues as, according to Revenue Procedure § 4.07, the IRS will not provide technical advice on matters involving the collection of tax, including interest and penalties. (Resp. Dec 5, 2011 Add'l Br., p. 18.)

Respondent next distinguishes appellant's reliance on *Recovery Group, supra*, in which the Tax Court found that a taxpayer's plausible-sounding argument (that a 23 percent interest in an entity was not a "substantial interest") was not supported by substantial authority. However, respondent states that the Tax Court did find that the taxpayer acted with reasonable cause and in good faith because: (1) due to the complicated nature of the issue involved, the taxpayer's accountants were competent professionals which justified the taxpayer's reliance, such that the taxpayer's reliance was based upon good faith; and (2) it was reasonable for the taxpayer to rely on the accountant's advice in light of the complexity of the issue involved. Respondent argues that here, however, there was nothing complicated about the legal principles involved as IRC section 61 provides that gross income means all income from whatever source derived. (Resp. Dec 5, 2011 Add'l Br., pp. 19-20.)

Respondent states that in *Neonatology Associates, P.A. et al. v. Commissione*r (2002) 299 F.3d 221, the court explained that the accuracy-related penalty was warranted because the taxpayers had taken a "head-in-the-sand" approach with respect to a tax position that they should have known to be true and that the penalty applied to a taxpayer who did receive outside tax advice. Respondent disputes appellant's claim that the substantial underpayment penalty should not be imposed when the underpayment results from a failure of proof. (Resp. Dec 5, 2011 Add'l Br., pp. 20-21.)

Respondent notes that appellant failed to address its "last-minute transfer" of the termination fee to a Delaware entity and asks whether this was to avoid paying $150 million of taxes on the income to Pennsylvania, consistent with appellant's position that the termination fee constituted nonbusiness income (and would be taxed by the state of appellant's domicile, Pennsylvania). In determining whether appellant acted with reasonable cause and in good faith, respondent contends (citing *Pinson et al. v. Commissioner*, T. C. Memo 2000-208) that it is fair for the Board to look at appellant's tax treatment of this matter in other jurisdictions to determine whether appellant acted consistent with its actions and reporting. Finally, respondent also notes that appellant has not produced any documentation to support or explain its decision to include the termination fee in its income for Florida tax purposes. (Resp. Dec 5, 2011 Add'l Br., pp. 21-22.)

Finally, respondent argues that appellant does not qualify for penalty relief for the treatment of the termination fee as nonbusiness income, as this treatment was neither taken, nor disclosed, on appellant's California return. Respondent states that appellant offers no authorities for its position that a taxpayer can qualify for relief from the substantial understatement penalty for a tax treatment that was neither claimed nor disclosed on a tax return. Because appellant did not make an adequate disclosure claim with respect to reporting nonbusiness income from the termination fee, and did not report the fee as such on its return, respondent argues that there is no need to discuss whether appellant would have had a reasonable basis for taking such a position. In addition, respondent states that appellant has produced no documentation which reflects its research as to the state tax treatment of the termination fee, such that appellant has not identified substantial authority for its position or for its reasonable cause and good faith arguments. In light of appellant's failure to produce documents relating to the advice given to it, respondent asserts that appellant bears the burden of producing such evidence and, its failure to do so, raises a clear inference that such evidence would be unfavorable to its position. (Resp. Dec 5, 2011 Add'l Br., pp. 24-25.)

STAFF COMMENTS

As noted above, the issue here is whether appellant has established that one of three exceptions to the imposition of the accuracy-related penalty: (a) the "substantial authority" exception; (b) the "reasonable basis" with "adequate disclosure" exception; and (c) the exception for understatements for which there is "reasonable cause" and with respect to which the taxpayer "acted in good faith." With this in mind, staff offers the following potential "roadmap" or outline for consideration. Although the following outline starts with the "substantial authority" and "reasonable basis" exceptions, the Board could alternatively first consider the reasonable cause and good faith exception (Item 4 below) in light of the fact that a determination that any one of the exceptions applies would result in an abatement of the penalty. Appellant bears the burden of establishing an exception exists, and respondent's determination is otherwise presumed correct.

(1) Do the applicable legal authorities provide "substantial authority" or a "reasonable basis" for appellant's treatment of the fee on its California tax return?

The first two exceptions (i.e., substantial authority, reasonable basis with adequate disclosure) require a consideration of the applicable legal authorities. The parties should discuss whether the following authorities (which are cited by the parties and/or in the Andersen memo or the IRS Technical Advice Memorandum) and/or other authorities constitute either "substantial authority" in relation to contrary authorities, or, alternatively, a "reasonable basis," for appellant's treatment of the termination fee. As noted in the Applicable Law section to this issue above, under IRS regulations, the weight accorded an authority depends on its relevance and persuasiveness, as well as the type of authority.

Authorities Cited in Support of Appellant's Return-of-Capital Position

- *Farmers and Merchant's Bank v. Comm'r* (6th Cir. 1932) 59 F.2d 912. In this case, the court determined that a lawsuit settlement received by a bank was paid for damages to goodwill, rather than lost profits, so the settlement income should not be characterized as income. Also, since the taxpayer could have recovered at trial only for the reduction in the value of its business, and not lost income, the settlement did not represent the replacement of lost income. The underlying lawsuit arose from the claim by the Farmers Bank that the Federal Reserve Bank interfered with its affairs, forcing it to store and lose the earning power of a great deal of money, damaging its business, and injuring its reputation and prosperity.

- *Durkee v. Comm'r* (6th Cir. 1947) 162 F.2d 184. In this case, a contractor received a settlement for lost goodwill and business income due to restraint of trade and price fixing. The court remanded the case for further hearings to determine the proper allocation between the taxable and nontaxable portions of the amount received and to determine the basis of the goodwill for which the settlement might have compensated the taxpayer to determine the amount of taxable gain.
- *Raytheon Production Corporation v. Comm'r* (1st Cir. 1944) 144 F.2d. 110. This case involved an antitrust suit alleging business damage and damage to goodwill and related patent claims. The court found that the damages represented a return of capital; however, since the taxpayer's tax basis in its goodwill could not be determined, the entire amount was taxable income.

Authorities Cited Against Appellant's Return-of-Capital Position[22]

- *Harold S. Smith v. Comm'r* (9th Cir. 1969) 418 F.2d 573, aff'g (1968) 50 T.C. 273. This case involved contractual liquidated damages deposited and paid as a result of the failure to complete a stock purchase transaction. Citing various cases, the court rejected the taxpayers' argument that the amount represented damages to the value of their stock interests. The court found that the payments were not paid for tortuous acts but arose from the contractual agreement "as payment for the restrictions they agreed to place upon their business operations during the sale period [such as not selling to other parties]." As a result, the court found the amount received was taxable as ordinary income.
- *Binns v. U.S.* (6th Cir. 1967) 385 F.2d 159, aff'g, (M.D. Tenn. 1966) 254 F.Supp. 889. This case involved a deposit that was forfeited in consideration for being released from further liability due to the buyer's inability to complete a stock purchase agreement. The court found that the forfeited deposit was taxable as ordinary income.
- *Martin Bros. Box Co. v. Comm'r* (1943) 1. T.C.M. 999, aff'd (6th Cir. 1944) 142 F.2d 457. This case involved the settlement of various items and claims, including claims for breach of a supply contract and antitrust damages, with no agreement as to the allocation of the funds paid. Reviewing

[22] The cases listed above are cited in the IRS Technical Advice Memorandum issued with regard to appellant's return-of-capital position. Respondent lists additional cases on page 32 of its November 28, 2011 additional brief. Those cases address the treatment of settlements and the accuracy related penalty in the context of the settlement of litigation and taxpayers' reliance on professional opinions as a basis for abatement.

all the evidence, the court concluded that the settlement was paid to replace the loss of anticipated profits, rather than damage to capital, goodwill or reputation, and that no part of the settlement could be allocated to replacement of capital.

(2) If the Board determines that there was "substantial authority" for appellant's tax treatment of the termination fee, then its inquiry is completed and the penalty will be removed. On the other hand, if the Board determines that there was not "substantial authority" for appellant's tax treatment, it should determine whether there was a "reasonable basis" (i.e., that the return position was reasonably based on one or more authorities) for appellant's tax treatment.

As noted in Applicable Law, IRS regulations provide that the "reasonable basis" standard is "a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper," and "is not satisfied by a return position that is merely arguable or that is merely a colorable claim." (Treas. Reg. § 1.6662-3(b)(3).)

(3) If the Board determines there was a "reasonable basis" for the return position, it should consider whether the position was "adequately disclosed." If there was a "reasonable basis" and "adequate disclosure," the penalty will be removed.

At the hearing, appellant will want to address the FTB's argument that the Schedule M-1 disclosure did not provide adequate notice to identify the potential controversy with regard to the termination fee because it does not expressly refer to the termination fee and was not itemized. The parties should also discuss whether appellant's capital recovery position should have been set forth on a Schedule D showing the $1.5 billion of income and the recovery of basis.

(4) Does the reasonable cause and good faith exception apply?

It appears to staff that, under IRC section 6664(c)(1) and the applicable IRS regulations summarized in Applicable Law, the Board is free to consider all the facts and circumstances in making the determination of whether there was reasonable cause for the understatement (if an understatement is found) and whether appellant acted in good faith with regard to the understatement. Thus, while the FTB seems to argue that appellant's alternative position (that the income was nonbusiness income) cannot be considered, it appears to staff that the Board is free to consider the existence of an alternative or "back-up" basis for the position that no tax was due, along with the other relevant facts, in determining whether appellant had reasonable cause and acted in good faith with regard to the understatement. However, the fundamental question is not whether the penalty can be avoided if there was reasonable cause and good faith with regard to appellant's alternative "nonbusiness-income" position (which, considered in isolation, would fail to take into account all the facts and circumstances); instead, it is the broader question of whether there was reasonable cause and good faith *with respect to the understatement*, considering *all* of the circumstances. In this connection, the parties will want to address whether appellant's manner of disclosing its filing position with regard to the $1.5 billion fee (i.e., as a non-itemized part of a $2,582,645,656 amount listed as a book/tax difference on appellant's Schedule M-1) reflects, as appellant contends, a good faith disclosure of reasonably determined legal position or, as FTB contends, an effort to obscure the item to minimize the risk of audit.

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