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10 **BOARD OF EQUALIZATION**

11 **STATE OF CALIFORNIA**

12 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
 13 ) **CORPORATION FRANCHISE TAX APPEAL**  
 14 **KINGSTON TECHNOLOGY** ) Case No's. 480846, 480891, and 480894  
 15 **CORPORATION, JOHN TU AND** )  
 16 **MARY TU, AND DAVID SUN AND** )  
 17 **DIANA SUN.** )

	<u>Appellants</u>	<u>Years</u>	<u>Proposed Assessments</u> <sup>1</sup>
18	Kingston Technology	1999	\$34,873
19	David and Diana Sun	1999	\$551,221
20	John and Mary Tu	1999	\$497,799

21 Representing the Parties:

22 For Appellants: Christopher A. Whitney, Price Waterhouse Coopers  
 23 Peter J. H. Kim, Price Waterhouse Coopers

24 For Franchise Tax Board: Daniel V. Biedler, Tax Counsel III

25  
 26 **QUESTION:** (1) Whether appellants must recognize gain on the disposition of a contingent note  
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<sup>1</sup> Respondent will be prepared to state the amount of interest accrued as of the Board hearing date.

1 arising from an installment sale under Revenue and Taxation Code (R&TC)  
2 section 24667, which conforms to Internal Revenue Code (IRC) section 453B.

3 HEARING SUMMARY

4 Factual Background

5 Appellant Kingston Technology Corporation (KT Corp), a subchapter S corporation for  
6 federal and California tax purposes, was equally owned by its two shareholders, appellants John Tu and  
7 David Sun. Prior to September 1996, KT Corp was a General Partner in Kingston Technology  
8 Company (“KTC”), a general partnership owned 80 percent by KT Corp and 20 percent by other related  
9 entities. KTC operated a computer memory chip (DRAM) manufacturing business. (Appellant’s  
10 Opening Brief (AOB), pp. 1-2.)

11 During September 1996, Softbank Corporation (Softbank) purchased the 80 percent  
12 interest in KTC held by the KT Corp for approximately \$1.5 billion. Of this amount, \$875 million was  
13 received up front in cash and/or stock. The balance included a \$633 million installment note (“original  
14 note”), with payments due on specific future dates. By December 31, 1996, Softbank paid the first  
15 installment of \$300 million on the original note, such that appellants received proceeds totaling \$1.175  
16 billion in 1996 (i.e., \$875 million plus \$300 million). A balance of \$333 million remained on the  
17 original note at the end of 1996. (AOB, p. 3.)

18 The purchase agreement also allowed for an “earnings adjustment.” Respondent  
19 indicates that, in April 1997, appellants received a cash payment and an earnings adjustment of  
20 approximately \$31 million for 1996. (Respondent’s Opening Brief (ROB), p. 2.)

21 At the time of the purchase agreement and subsequent thereto, the market for DRAM  
22 chips manufactured by KTC was softening. In October 1997, appellants modified the agreement with  
23 Softbank by cancelling the original note (which had a then balance due of principal and accrued interest  
24 of approximately \$389 million) and replacing it with another note (“contingent note”) relating to the  
25 same transaction. The contingent note called for the payment of \$450 million, which was contingent  
26 upon the occurrence of either KTC achieving average annual earnings before interest and taxes of \$300  
27 million or an initial public offering of KTC with a pre-investment valuation of \$1.8 billion. As of 1999,  
28 the contingencies had not been met and appellants received no additional cash or stock from Softbank

1 for the purchase of the interest in KTC. On July 14, 1999, KT Corp reacquired the 80 percent interest in  
 2 KTC for \$450 million, which consisted of \$250 million in cash and a promissory note for \$200 million.  
 3 (AOB, pp. 4-5; ROB, pp. 3-4.) As part of that agreement, the \$450 million contingent note was  
 4 canceled and returned to Softbank.

#### 5 Procedural Background

6 The Board considered a prior appeal of appellants for 1997, and initially concluded that  
 7 appellants were liable for the interest charge on appellants' installment sale deferred tax liability  
 8 pursuant to R&TC section 24667, which incorporates IRC section 453A. Subsequently, the Board  
 9 granted appellants' Petition for Rehearing. On February 28, 2008, the Board reconsidered the appeal  
 10 and concluded that appellants' use of the "wait and see" method to calculate the interest charge pursuant  
 11 to IRC section 453A was appropriate. Thus, the Board ordered that the action of respondent be  
 12 reversed. (AOB, pp. 6-9.)

13 Respondent also audited appellants' 1998 tax returns and issued Notices of Proposed  
 14 Assessment (NPA's), asserting that IRC section 453A interest charge was due based on the fair market  
 15 value of the contingent note as of December 31, 1998. Following the February 2008 Board decision, the  
 16 FTB withdrew its 1998 assessments at the protest level. (AOB, p. 6.)

17 During the course of the audit and protest for these matters, appellants provided copies of  
 18 valuations they obtained regarding the contingent note for December 31, 1997 and December 31, 1998,  
 19 showing that the \$450 million contingent note had the following values on those dates:

20	December 31, 1997	\$38,500,000
21	December 31, 1998	\$22,420,000 (ROB, p. 5)

22 Regarding the 1999 tax year, respondent determined that a taxable event occurred with  
 23 the cancellation of the contingent note, pursuant to R&TC section 24667 which also incorporates IRC  
 24 section 453B, resulting in a gain to appellants. Respondent calculated a gain on the contingent note of  
 25 \$16,427,457, computed as follows (ROB, p. 7):

26	Fair market value based on appellants' Appraisal received from Kroll, Inc. completed on March 5, 2003	\$22,421,950
27		
28	Less: Appellants' Adjusted Basis	<u>\$ 5,994,493</u> <u>\$16,427,457</u>

1 As a result, respondent issued NPA's to appellants which, among other adjustments, reflected the  
2 assessment of this gain. Respondent issued Notices of Action to appellants during January 2009.  
3 Appellants filed timely appeals. (ROB, pp. 1 and 5.)

4 Contentions

5 Appellants' Opening Brief (AOB)

6 Appellants contend that they should not be subject to an IRC section 453B gain on the  
7 contingent note because no terms of the contingent note were voided in 1999. Appellants assert that  
8 when the contingent note was executed, neither appellants nor Softbank expected any payments to be  
9 made. Appellants also point to the Board's unpublished decision in 2008 where the Board held that no  
10 IRC section 453A interest was due on the contingent note because no payments were ever received on it.  
11 Appellants assert that respondent's position regarding the IRC section 453A interest charge and  
12 respondent's position in this matter are based on a theoretical gain that was never realized. (AOB, pp. 7-  
13 9.)

14 Appellants argue that they paid tax on the gain they recognized on the Softbank  
15 transaction, based upon proceeds received of \$1.175 billion in 1996. With appellants' reacquisition of  
16 80 percent of KTC in 1999, appellants contend they realized net proceeds of \$725 million (\$1.175  
17 billion less \$450 million). Appellants assert respondent's claim that additional gain should be  
18 recognized on the transaction between appellants and Softbank is inequitable and inappropriate. (AOB,  
19 pp. 9-10.)

20 Respondent's Opening Brief (ROB)

21 Respondent contends that based on IRC section 453B, appellants must recognize gain or  
22 loss on the disposition of the contingent note based upon the fair market value of the note, of which the  
23 best evidence is the valuation provided by appellants' expert. Respondent asserts that the only question  
24 to resolve is the fair market value of the contingent note when appellants cancelled it for purposes of  
25 calculating gain or loss pursuant to IRC section 453B. Respondent argues that the method for  
26 computing appellants' gain or loss required is to calculate the difference between appellants' basis in the

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1 contingent note and its fair market value.<sup>2</sup> (ROB, pp. 5-6.) Respondent contends that this matter  
2 involves no aspect of IRC section 453A. (ROB, p. 1.)

3 Respondent argues that appellants disposed of the contingent note by cancelling it, which  
4 triggered the recognition of gain or loss. Respondent asserts that the use of IRC section 453B does not  
5 force the recognition of “phantom gain”. Respondent contends that under IRC section 453B(f), when an  
6 obligation is cancelled, the obligation shall be treated as if it were disposed of in a means other than a  
7 sale or exchange. (ROB, p. 6.)

8 Respondent estimated the gain on the contingent note as \$16,427,457, computed as  
9 follows:

10	Fair market value based on appellants’ 11 Appraisal received from Kroll, Inc. 12 completed on March 5, 2003	\$22,421,950
13	Less: Adjusted Basis	<u>\$ 5,994,493</u> \$16,427,457

(ROB, p. 7.)

14 Respondent alleges that with an excess of five years remaining and a six month old  
15 valuation of more than \$22 million, the contingent note had a value above zero. Respondent states that  
16 appellants’ appraisal valuation appeared to account for the worst-case circumstantial scenario that would  
17 affect the value of the contingent note. Respondent points out that the contingent note was due to expire  
18 on December 31, 2004. Respondent asserts that although the contingent note’s trigger contingencies  
19 “may have been somewhat unlikely”, it is unreasonable to give a zero value with more than five years  
20 remaining on the contingent note. (ROB, p. 8.) Respondent asserts that available information  
21 concerning the Softbank transaction and the years subsequent to the sale and unwinding of the sale  
22 support a valuation of the contingent note above zero. (ROB, pp. 9-11.)

23 Appellants’ Reply Brief (ARB)

24 In their reply brief, appellants contend that no additional gain should be recognized  
25 because appellants’ net economic gain from the Softbank transactions was only \$725 million and  
26 appellants paid California income tax based on the receipt of \$1.175 billion. (ARB, pp. 3-5.)

27 \_\_\_\_\_  
28 <sup>2</sup> Respondent relies upon IRC section 453B(a).

1 Appellants assert that respondent's position regarding IRC section 453B is inconsistent with the Board's  
2 2008 decision on respondent's proposed IRC section 453A interest charge. Appellants argue that the  
3 Board's 2008 decision is relevant in this matter because respondent, similar to its position with respect  
4 to IRC section 453A, is also attempting to assess additional taxes on a phantom gain from the contingent  
5 note. Appellants contend that the Board's 2008 decision declined to base the IRC section 453A interest  
6 charge on the appraiser's estimated value of the contingent note but chose the "wait and see" approach.  
7 (ARB, pp. 5-7.)

8 Appellants assert respondent's indication that appellants received something of value for  
9 cancelling the contingent note is not supported by the facts. Appellants state that they paid \$450 million  
10 for Softbank's interest. Appellants claim that the contingent note was voided and does not show it had  
11 any value above zero. (ARB, pp. 7-9.) Appellants argue that there is sufficient evidence showing the  
12 contingent note had no value when the 1996 transaction was undone in 1999. Appellants state that the  
13 \$450 million contingent liability was not recorded on the balance sheet of Softbank because the  
14 company considered the possibility that any payment would be made to appellants extremely remote.  
15 Appellants argue that from the time the contingent note was executed, Softbank never expected to pay  
16 anything on that note. Appellants contend that the contingent note had no value in 1999 when it was  
17 about to be voided by the parties. Appellants assert that the information which became available after  
18 July 1999 is irrelevant to determine the value of the contingent note as of July 1999. (ARB, pp. 9-12.)

19 Appellants contend that the relevant legislative history and related regulations show the  
20 voiding of the contingent note was not the transaction type to which IRC section 453B(f) applies.  
21 Appellants point out that neither they nor Softbank entered into the transaction with the intent to evade  
22 or manipulate the installment obligation disposition rules. Appellants assert that it would be unfair to  
23 assess tax based on the avoidance of the contingent note, where unlike the examples provided in Treasury  
24 Regulation section 1.453-9(b)(3), appellants received nothing of value for terminating the contingent  
25 note. (ARB, pp. 13-15.)

#### 26 Respondent's Reply Brief (RRB)

27 Respondent replies by asserting that appellants treated the cancellation of the original  
28 note and replacement by the contingent note as a continuation of the 1996 sale. Thus, respondent

1 contends that appellants are now taking an inconsistent position and treating the cancellation of the  
2 original note as a disposition of that note, as appellants focus only on the payments received on the  
3 contingent note. Respondent further contends that appellants merge the net economic benefit to  
4 appellants of two separate transactions to an overpayment of tax on the 1996 transaction. Respondent  
5 argues that the net economic benefit of the 1996 transaction and the 1999 repurchase is not the measure  
6 of tax on the sales. Respondent asserts that the 1996 sale and 1999 repurchase were two separate  
7 taxable events producing gain or loss.

8 Respondent also argues that appellants' cancellation of the contingent note in 1999 was  
9 part of the consideration given to repurchase the 80 percent interest in KTC. According to respondent,  
10 "the cancellation had value to the seller [Softbank] and the buyer [appellants] received consideration for  
11 that value." Thus, the 1999 cancellation of the contingent note triggered IRC section 453B and  
12 recognition of gain or loss and the only remaining question is the measure of the gain or loss.  
13 Respondent points out that appellants have not shown what changed between December 31, 1998, the  
14 date of the appraisal, and the July 1999 repurchase that justifies their position that the contingent note  
15 had no value. (RRB, pp. 4-6.)

#### 16 Appellants' Supplemental Brief (ASB)

17 Appellants argue that the rationale behind respondent's IRC section 453B assessment is  
18 "fundamentally at odds" with the 2008 Board decision relating to respondent's 1997 IRC section 453A  
19 assessment. Because respondent asserts that the fair market value of the contingent note at the time of  
20 cancellation was equal to the appraiser's value as of December 31, 1998, appellants contend that  
21 respondent's position is inconsistent with the 1997 and 1998 assessments and the Board decision.  
22 Specifically, appellants first contend that respondent did not determine any gain under IRC section 453B  
23 even though respondent characterizes replacement of the original note with the contingent note as a  
24 cancellation of the former, presumably because respondent agreed with appellants' characterization of  
25 the original note cancellation as a "re-do" of the sale transaction. Appellants further assert that  
26 respondent withdrew the 1998 assessment under IRC section 453A because respondent acknowledged  
27 that the Board's decision on the 1997 assessment applied to subsequent years. Finally, appellants  
28 contend that the Board in its decision acknowledged that "the best measure of the deferred gain" was the

1 amount appellants ultimately received on the contingent note and not its fair market value. Thus, the  
2 Board concluded that the interest provisions of IRC section 453A were not applicable because the  
3 contingent note had no value, i.e., there was no deferred gain upon which interest could be assessed.

4 Appellants contend that no value was received for voiding the contingent note which  
5 supports their position that the contingent note had no value when it was voided; Softbank would have  
6 shown that in its next annual report. (ASB, pp. 6-9.)

7 Appellants assert there is adequate evidence indicating the contingent note had no value  
8 when the original transaction was undone in 1999. Appellants assert there is no indication that Softbank  
9 received any additional consideration from appellants other than the \$450 million for the 80 percent  
10 interest in KTC. Appellants argue that if the contingent note had any value when it was voided,  
11 Softbank would have stated that in describing the 1999 transaction in its annual report for 2000 but it did  
12 not. (ASB, pp. 9-11.)

13 Appellants assert that Article 1 of the Repurchase Agreement states the following:

14 PURCHASE AND SALE 1-1 Purchase of Partnership Interest . . . [Softbank] will sell to  
15 [Appellants] and [Appellants] will purchase from [Softbank], the Softbank interest . . .  
16 against payment of the total purchase price of \$450 million consisting of \$250 million in  
17 cash and a promissory note for \$200 million.

18 Appellants observe there is no evidence that Softbank received any additional benefit  
19 related to voiding the contingent note. (ASB, p. 12.)

20 Appellants contend that Softbank's 1998 annual report indicates that Softbank did not  
21 expect to pay anything on the contingent note when the parties replaced the original note with the  
22 contingent note. Also, appellants assert the fact that the terms of the contingent note were voided with  
23 appellants' reacquisition of the 80 percent interest in the KTC does not support a finding the contingent  
24 note had some value at that time. Appellants insist that no additional gain should be recognized because  
25 (1) appellants' overall net economic gain from the transaction with Softbank was only \$725 million and  
26 (2) no payments were received on the contingent note. (ASB, pp. 12-16.)

#### 27 Applicable Law

28 Respondent's determinations are generally presumed to be correct, and appellants  
generally bear the burden of proving error. (*Appeal of Sheldon I. and Helen E. Brockett*, 86-SBE-109,

1 June 18, 1986; *Todd v. McCogan* (1949) 89 Cal.App.2d 509, 514.) Unsupported assertions are not  
2 sufficient to satisfy appellants' burden of proof. (*Appeal of Aaron and Eloise Magidow*, 82-SBE-274,  
3 Nov. 17, 1982.) In the absence of uncontradicted, credible, competent and relevant evidence showing  
4 that respondent's determinations are incorrect, they must be upheld. (*Appeal of Oscar D. and Agatha E.*  
5 *Seltzer*, 80-SBE-154, Nov. 18, 1980.)

6 R&TC section 24667 adopts IRC section 453B. IRC section 453B provides in pertinent  
7 part:

8 Sec. 453B. Gain or loss on disposition of installment obligations.

9 (a) General Rule.

10 If an installment obligation is satisfied at other than its face value or  
distributed, transmitted, sold or otherwise disposed of, gain or loss shall result to  
the extent of the difference between the basis of the obligation and

11 (1) the amount realized, in the case of satisfaction at other than face value or a  
sale or exchange, or

12 (2) the fair market value of the obligation at the time of distribution,  
transmission, or disposition, in the case of the distribution, transmission,  
or disposition otherwise than by sale or exchange.

13 Any gain or loss so resulting shall be considered as resulting from the sale or  
exchange of the property in respect of which the installment obligation was  
14 received.

15 (b) Basis of obligation.

16 The basis of an installment obligation shall be the excess of the face value of  
the obligation over an amount equal to the income which would be returnable  
were the obligation satisfied in full.

17 \* \* \*

18 (f) Obligation becomes unenforceable.

19 For purposes of this section, if any installment obligation is cancelled or  
otherwise becomes unenforceable

20 (1) the obligation shall be treated as if it were disposed of in a transaction  
other than a sale or exchange, and

21 (2) if the obligor and obligee are related persons (within the meaning of  
section 453 (f)(1)), the fair market value of the obligation shall be treated as  
not less than its face amount.

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23 In *Miller v. Usry* (W.D. LA 1958) 160 F. Supp. 368, a parent transferred property to his  
24 son in exchange for an installment note payable in twenty annual installments. The parent later  
25 cancelled the note. The court held that the parent could only be taxed on the amount he realized from  
26 the sale. The unstated result of the *Miller* case was that the appreciation of the property could never be  
27 taxed, because the son's basis in the property was the face amount of the note, even though the son did  
28 not have to pay the note. Apparently, in response, Congress enacted IRC section 453B(f) which  
provides that when an installment loan between family members is cancelled the obligee recognizes as

1 income the difference between the basis in the obligation and the face amount of the note.

2           In *Frane v. Commissioner* (8th Cir. 1993) 998 F.2d 567, the issue was whether the  
3 parents were required to report income resulting from the cancellation of notes from their children upon  
4 the husband's death. Since the obligee and the obligor were related persons, the cancellation of the note  
5 caused the obligee to recognize income equal to the difference between the basis of the obligation and  
6 its face value, citing IRC section 453B(a) and (f).

7           In *Ballantyne v. Commissioner*, T.C. Memo 1996-456, the court indicated the substance  
8 of a transfer of real estate from the petitioner to Balmac was a sales transaction and that the purchase  
9 price for the real estate was \$7 million. At closing, Balmac paid \$2 million in cash and gave a \$5  
10 million installment note. Subsequently, security for the note was reconveyed to Balmac and there was  
11 no evidence of any further obligation to pay the note. The court ruled the reconveyance of the note  
12 amounted to a cancellation of the note and required recognition of the gain, citing IRC section 453B(a)  
13 and (f).

#### 14 STAFF COMMENTS

15           On February 28, 2008, the Board considered appellants' prior appeal for 1997 and  
16 concluded that appellants' use of the "wait and see" method to calculate the interest charge pursuant to  
17 IRC section 453A was appropriate. The parties should be prepared to explain to what extent the Board's  
18 prior decision is relevant to this appeal. In particular, appellants should be prepared to provide any legal  
19 authority to support their position that the manner in which IRC section 453A is applied has any bearing  
20 on the application of IRC section 453B(f).

21           Respondent contends that the cancellation of the contingent note was partial  
22 consideration for appellants' repurchase of the 80 percent interest in KTC. The parties should be  
23 prepared to discuss the terms of the Repurchase Agreement, including the terms of the agreement which  
24 call for the cancellation of the contingent note and the return of the note to SoftBank at closing. Staff  
25 notes that the record does not include a copy of the agreement.

26           Respondent relies on appellants' expert appraisal as the fair market value of the  
27 contingent note at the time of cancellation for purposes of determining the recognizable gain under IRC  
28 section 453B. However, appellants argue on page 15 of the ASB that "a note that is about to be voided

1 by the parties as part of undoing a transaction has no value.” Appellants should be prepared to provide  
2 any legal authority to support that assertion and appellants’ other assertions that the contingent note had  
3 no value.

4 Staff notes that the record reflects (AOB, Exhibit F) an appraisal from Kroll Consulting,  
5 dated March 5, 2003, which values the contingent promissory note as of December 31, 1997, with a  
6 value of \$38,500,000. The record does not include a copy of an appraisal which values the contingent  
7 note as of December 31, 1998, with a value of \$22,420,000. Nevertheless, such a value is not disputed  
8 by the parties. Kroll Consulting states that the December 31, 1997 appraisal was prepared for appellants  
9 for tax purposes. Consistent with this, we presume that the December 31, 1998 appraisal was also  
10 completed by Kroll Consulting in 2003 (i.e., after the 1999 repurchase of the partnership interest). The  
11 parties should be prepared to discuss when the December 31, 1998 appraisal was completed and whether  
12 it is reasonable to assert the December 31, 1998 appraised value to the 1999 transaction if the appraisal  
13 related to the contingent promissory note was completed up to four years after the date of the  
14 transaction.

15 If the Board determines that it is appropriate to recognize a gain on the contingent note,  
16 staff notes that appellants’ appraisals dropped the contingency note’s value from December 31, 1997  
17 (\$38,500,000) to December 31, 1998 (\$22,420,000). Is it reasonable to assume that the value of the note  
18 continued to drop during the ensuing six months, until the date the contingency note was voided in July  
19 1999? The parties are asked to discuss whether such an assumption should, or can, be made.

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23 Kingston et al\_cb

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