

03-1509
Audit
Signed 05/10/2006

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2,)	FINDINGS OF FACT,
)	CONCLUSIONS OF LAW,
Petitioners,)	AND FINAL DECISION
)	
v.)	Appeal No. 03-1509
)	
AUDITING DIVISION OF)	Tax Period: 2001
THE UTAH STATE TAX)	Tax Type: Income Tax
COMMISSION,)	
)	Judge: Davis
Respondent.)	

Presiding:

Palmer DePaulis, Commissioner
Blaine Davis, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REPRESENTATIVE, Attorney at Law
For Respondent: RESPONDENT REPRESENTATIVE, Assistant Attorney General

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on January 13, 2005. The matter is before the Commission on an appeal of a Utah Individual Income Tax Audit deficiency issued for the tax year 2001. The parties stipulated to the admission of the exhibits contained in the exhibit binder with exhibits marked 1 through 15 representing the Petitioners' exhibits and exhibits 1 through 9 representing the Respondent's exhibits. The Commission admitted the exhibits into evidence.

Based upon the evidence and testimony presented at the hearing, the exhibits as stipulated by the parties, and incorporating the proposed finds submitted by the parties the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Petitioners are appealing audit deficiency of Utah individual income tax issued for the tax year 2001. The Division issued on October 23, 2005, a Statutory Notice of Estimated Income Tax to the PETITIONERS showing a deficiency in Utah state income tax for 2001 of \$\$\$\$\$, penalties of \$\$\$\$\$ and interest of \$\$\$\$\$ as of the date of the assessment. (See Respondent's Exhibit 1, "Statutory Notice".)

2. The PETITIONERS did not file a Utah state income tax return for the tax year 2001. They were not residents of the state of Utah for purposes of income tax for the year 2001.

3. The deficiency represented by the Statutory Notice related to a \$\$\$\$\$ payment made to the PETITIONERS as settlement of a lawsuit they had filed in the Second Judicial District Court of the State of STATE 1 against the estate of PARTNER 2. The lawsuit involved the actions of PARTNER 2 during the negotiations and completion of the sale of COMPANY A. ("COMPANY A") to COMPANY B ("COMPANY B"). (See Respondent's Exhibits 1, 3, 4 & 5.)

4. The sale of COMPANY A to COMPANY B occurred in 1998. (See Respondent's Exhibit 6.)

5. The PETITIONERS were residents of the state of Utah when the sale of COMPANY A to COMPANY B occurred.

6. While PETITIONER 1 was a shareholder of COMPANY A, COMPANY A was a Utah corporation doing business in Utah that filed as a subchapter S corporation for federal income tax purposes. (See Respondent's Exhibit 6, ¶ 3.13.2, "Stock Purchase Agreement.")

7. COMPANY A sold mobile homes in Utah under the brand "(X)." (See Respondent's Exhibit 5, p. 3, lines 18-20, "Motion for Summary Judgment".)

8. PETITIONER 1 managed COMPANY A from its date of incorporation and the PETITIONERS were residents of Utah from 1995 to March of 1999.

9. COMPANY A had three shareholders as follows: PETITIONER 1 owned 20% of the stock, PARTNER 1 owned 20% and PARTNER 2 (“PARTNER 2”) owned 60%. (See Respondent’s Exhibit 1, p. 57.)

10. PETITIONER 1 testified that his management services for COMPANY A were performed in anticipation of an increase of the value of his stock interest in COMPANY A.

11. PARTNER 2, in addition to his controlling interest in COMPANY A, controlled eight other corporations operating in states other than Utah, but in the same line of business as COMPANY A. These corporations consisted of COMPANY C, a STATE 1 corporation, COMPANY D, an STATE 2 corporation, COMPANY E, a STATE 1 corporation, COMPANY F, an STATE 3 corporation, COMPANY G, an STATE 4 corporation, COMPANY H, an STATE 5 corporation, COMPANY I, a STATE 6 corporation, COMPANY J, a STATE 1 corporation. (See Respondent’s Exhibit 6, “Stock Purchase Agreement,” p. 49.)

12. In 1998, COMPANY B entered into negotiations with PARTNER 2 for the purchase of COMPANY A and the other eight corporations.

13. PARTNER 2 and COMPANY B negotiated a total price for the nine corporations, including COMPANY A, of \$\$\$\$\$ dollars. (See Respondent’s Exhibit 5, “Motion for Summary Judgment,” p.5.)

14. As a condition of the purchase, COMPANY B required that all corporations be part of the acquisition. (See Respondent’s Exhibit 5, p.4, lns 22-23.)

15. The purchase price included \$\$\$\$\$ in cash, \$\$\$\$\$ in cash held back for eighteen months for unknown liabilities and \$\$\$\$\$ in contingent payments based upon the combined future earnings of the nine corporations. (See Respondent’s Exhibit 5, p.5, Exhibit 6, ¶ 2.1.3.)

16. The \$\$\$\$\$ in cash and \$\$\$\$\$ hold back was paid by COMPANY B, but the \$\$\$\$\$ dollar

contingent payment remained an unrealized contingency. (See Respondent's Exhibit 5, p.5.)

17. PARTNER 2 allocated this purchase price to the nine corporations.

18. PETITIONER 1 summarized PARTNER 2's allocation of the purchase price as follows:

PARTNER 2 never obtained an independent valuation of the nine corporations. The allocation of purchase price for the nine corporations was simply established by PARTNER 2 stating what he wanted to pay each minority shareholder The result of the PARTNER 2 allocations was that approximately 90% of the purchase price or 96% of the cash went to PARTNER 2. Corporations owned 100% by PARTNER 2 received 80% to 100% allocated purchase price in cash. [COMPANY A] received approximately 38% of the PARTNER 2 allocation of the purchase price in cash. Even though the 1997 audited financial statements, the basis of the COMPANY B transaction, established that the minority interests were valued at over 20% of the total net 1997 income for the nine corporations, PARTNER 2 received \$\$\$\$ (96.11%) of the \$\$\$\$ cash portion of the purchase price paid by COMPANY B Homes while the minority shareholders received a total of \$\$\$\$ (3.89%).

(See Respondent's Exhibit 5, p.5, ln 25, p. 6, lns. 1-3, 11-21.)

19. PARTNER 2 directed that \$\$\$\$ of the total \$\$\$\$ purchase price be allocated to COMPANY A. (See Respondent's Exhibit 5, p.6, lns. 4-10.)

20. PARTNER 2 directed that only 38% (or \$\$\$\$) of the \$\$\$\$ allocated to COMPANY A be comprised of the cash portion of the purchase price with 62% (or \$\$\$\$) pertaining to the deferred portion of the purchase price never realized. (See Respondent's Exhibit 6.)

21. PETITIONER 1's interest in the \$\$\$\$ purchase price was \$\$\$\$\$. (See Respondent's Exhibit 6.) However, the cash portion of the purchase price allocated to PETITIONER 1 was only \$\$\$\$.

22. PETITIONER 1 received the \$\$\$\$ cash portion of the purchase price of COMPANY A when he and the other shareholders consummated the sale to COMPANY B Homes based upon these terms on March 27, 1998, concurrently with the other PARTNER 2 corporations. . (See Respondent's Exhibit 6, "Purchase Agreement".) PETITIONER 1 did not receive any of the deferred portions

23. PETITIONER 1 and the other shareholders made an IRC § 338(h)(10) election which

caused the sale to be deemed an asset sale of the property of COMPANY A and subsequent liquidation of the sale proceeds to the shareholders. (See Respondent's Exhibit 6, ¶ 3.13.11.)

24. All of the shareholders in the other eight PARTNER 2 corporations whose sale was also included in the transactions executed a Section 338(h)(10) election. (Respondent's Exhibit 8.)

25. COMPANY A and the other corporations stepped up the basis of their assets as a result of the sale and IRC § 338(h)(10) election. (See Respondent's Exhibit 7.)

26. COMPANY A reported Utah as its "commercial domicile" on its 1998 Utah income tax return. (See Respondent's Exhibit 7, p.2, ln 3.)

27. COMPANY A reported on its Utah income tax return as business income the gain it received on its § 338(h)(10) deemed sale of assets to COMPANY B. (See Respondent's Exhibit 7, "COMPANY A 1998 TC-20S", Schedule A, ln. 5.b.)

28. COMPANY A reported a 100% business income apportionment fraction to Utah on its 1998 Utah income tax return. (See Respondent's Exhibit 7, "COMPANY A 1998 TC-20S", Schedule A, ln. 6.)

29. PARTNER 2 died in 1998. (See Respondent's Exhibit 4, p. 4, ¶ 22.)

30. The PETITIONERS changed their domicile and permanently moved to the state of STATE 1 in 1999. For the tax year in question, 2001, they were no longer Utah resident individuals for state income tax purposes.

31. After PARTNER 2's death, PETITIONER 1 learned that PARTNER 2 had not fairly allocated the purchase price from COMPANY B Homes and the cash portion of the purchase price to COMPANY A. In 2000, PETITIONER filed a Complaint in the Second Judicial District Court of the State of STATE 1, County COUNTY, against the Estate of PARTNER 2 et al (CV0002977). (See Respondent's Exhibit 4.)

32. The Complaint contained the following allegations.

“[PETITIONER 1] [has] discovered that the allocations of the purchase price affixed by PARTNER 2 for each corporation were not based upon the actual values of each corporation compared to the total purchase price offered by COMPANY B. Instead, PARTNER 2’s allocation inflated the values of those companies that he exclusively owned or where he had a large percentage of ownership. These allocations decreased the true value of [PETITIONER’S] ownership in [COMPANY A].

(See Respondent’s Exhibit 4, ¶ 19.)

33. The Complaint further alleged,

PARTNER 2 also allocated a substantially larger percentage of the cash proceeds of the purchase price to himself as compared to the cash paid to [PETITIONER]. [PETITIONER was] left relying upon achieving the uncertain performance criteria for the bulk of [his] allocated purchase price. On information and belief, PARTNER 2 has transferred and assigned to the PARTNER 2 Trust payments of money, effects and other value things, received by PARTNER 2 as a result of his disproportion allocation of purchase price and cash payments to the (X).

(See Respondent’s Exhibit 4, ¶¶ 20 and 21.)

34. The damages requested in the Complaint consisted of a constructive trust upon the proceeds received by PARTNER 2 which were disproportionate and which should have been paid to PETITIONER 1. (See Respondent’s Exhibit 4, p.9.)

35. PETITIONER 1 settled the Complaint in 2001 and reported a taxable gain from such settlement of \$\$\$\$\$. The confidential Settlement Agreement released and discharged any claim alleged in the Complaint. (See Respondent’s Exhibit 3.) As a result of the settlement of the complaint an additional payment of \$\$\$\$\$, this brought the total payment to PETITIONER 1 to approximately \$\$\$\$\$. The original allocation set forth in the purchase agreement had been \$\$\$\$\$. (See Respondent’s Exhibits 2 and 6.)

36. (X) prepared the PETITIONER’S 2001 federal income tax return, and he testified that regardless of the nature of the claim, the damages related to PETITIONER’S interest in COMPANY A should be reported as a capital gain, not as ordinary income.

40. PETITIONER 1 reported his share of the additional sale proceeds received under the settlement on his federal 2001 income tax return, Schedule D, Part II, as a long term capital gain on the sale of his “20% stock interest of COMPANY A, sold on 9/15/01.” (See Respondent’s Exhibit 2, p. 7.)

41. The Estate of PARTNER 2 took an IRC § 1341(a) claim of right credit on its 2001 1041 federal income tax return to offset the settlement proceeds it paid to PETITIONER in 2001 against the income previously recognized by PARTNER 2 in 1998 from the original sale. (See Respondent’s Exhibit 9.)

42. In 2001, the Estate of PARTNER 2 attempted to file an amended 1998 Utah State Income Tax Return reducing its Utah gain recognized from the sale of PARTNER 2’s stock by the amount of the settlement proceeds paid to PETITIONER in 2001. (See Respondent’s Exhibit 9, “Estate of PARTNER 2’s 2001 Amended Utah TC-40.”)

APPLICABLE LAW

Utah Code Ann. § 59-7-702 (2000)

Utah Code Ann. § 59-10-116 (2000)

Utah Code Ann. § 59-10-117(1) (2000)

Utah Code Ann. § 59-10-117(2)(a)(d) (2000)

Utah Code Ann. § 59-10-118 (2000)

Utah Code Ann. § 59-10-543 (2000)

CONCLUSION OF LAW

1. The threshold issue before this Commission is whether the net settlement proceeds received by PETITIONER in 2001 of \$\$\$\$ are subject to Utah State Income Tax. To make this determination, we must first determine the character and nature of the settlement proceeds. The Commission agrees with Respondent that for tax purposes the character and nature of settlement or

litigation proceeds are determined by asking the question, “In lieu of what were the damages awarded?” See Pennzoil Company v. Department of Revenue, 33 P.3d 314, 317 (Or. 2001) (citations omitted) and Hort v. Commission, 313 U.S. 28 (1941). The Commission concludes that the settlement proceeds essentially represent the amount PETITIONER 1 should have received for his COMPANY A stock in 1998.

2. As the amount of the litigation proceeds are in lieu of funds that PETITIONER 1 should have received at the time he was a Utah resident and had sold the stock in his Utah business, the funds are taxable as Utah Source income pursuant to Utah Code Secs. 59-10-116, 117 & 118.

3. The Commission has the authority to waive penalties upon a showing of reasonable cause and finds sufficient cause to do so in this matter. Utah Code Sec. 59-1-401(11). Respondent had issued against Petitioner both 10% failure to file penalties and 10% failure to pay penalties pursuant to Utah Code Sec. 59-1-401(1)&(2).

ANALYSIS

This question before the Commission is whether the settlement proceeds paid to PETITIONER 1 are subject to Utah tax considering PETITIONER 1 was no longer a Utah resident at the time the lawsuit was filed or settled. The income relates back to PETITIONER 1’s sale of stock of COMPANY A in 1998 when he was a Utah resident and the cause of action settled was to obtain a fair allocation of the purchase price for PETITIONER 1. In fact, upon receipt of the settlement funds in 2001, PETITIONER 1 included them on his federal tax return as a capital gain from the sale of the stock of COMPANY A.

On the other hand Petitioner argues the fraud action was against PARTNER 2 who was not a party to the stock agreement, but who had caused PETITIONER 1 to enter into the stock purchase agreement. As petitioner argues a “chose of action” is an intangible and the proceeds would be taxable to

the state of residence. In this case STATE 1. Petitioner points out that COMPANY B acquired 100% of the stock in COMPANY A in 1998.

Upon review of the information and arguments in this matter, the Commission concludes Respondent is correct in that the way to determine whether the settlement income at issue is taxable is determine the character and nature of the settlement proceeds. It is settled law that for tax purposes the character and nature of settlement or litigation proceeds are determined by asking the question, "In lieu of what were the damages awarded?" See Pennzoil, 33 P.3d 314, 317 (Or. 2001) (citations omitted) and Hort v. Commission, 313 U.S. 28 (1941).

The evidence before the Commission is PETITIONER'S Complaint filed against the Estate of PARTNER 2 that gave rise to the settlement. PETITIONER alleged in the complaint the following:

On information or belief, PARTNER 2 has transferred and assigned to the PARTNER 2 Trust payments and money, effects and other valuable things, received by PARTNER 2 as result of this disproportion allocation purchase price and cash payments to the (X) sale.

(See Respondent's Exhibit 6, ¶ 21.)

Considering the facts in this matter it is the position of the Commissioners that the damages sought in the PETITIONER'S complaint and the related motion for summary judgment were based upon the fact that PARTNER 2 had received money from COMPANY B that should have been paid to PETITIONER 1 arising from COMPANY B's purchase of the COMPANY A and the other eight entities stock. This conclusion is consistent with the testimony of PETITIONER'S accountant and PETITIONER'S 2001 federal income tax return that reported the settlement proceeds as a capital gain.

The fact that PETITIONER recovered the proceeds from COMPANY B through a lawsuit against PARTNER 2 does not alter our conclusion. In Pennzoil v. Department of Rev., 33 P.3d 314, (Or. 2001) and Pennzoil v. Dept. of Rev., 15 Or. Tax 101 (Or. Tax Regular Div. 2000), the Oregon

Supreme Court and Tax Court were faced with a similar issue. There, Pennzoil was seeking damages against Texaco resulting from Texaco's tortious interference of Pennzoil's contract with Getty Oil. The Oregon Courts were not concerned that Pennzoil received the litigation proceeds from Texaco, not Getty Oil. The Oregon tax court noted: "It is the same as if Pennzoil said to Texaco you stole our deal pay us what we would have benefited. In the court's view it does not matter whether the contract was stolen, condemned or interfered with or cancelled; the income realized from it by Pennzoil was income "arising from" that contract." Pennzoil, 15 Or.Tax 109. The Oregon Supreme Court similarly stated, "We conclude that Pennzoil received the settlement proceeds in lieu of its agreement with Getty and that agreement gave rise to the disputed income." Pennzoil, 33 P.3d at 317.

Having determined the nature and character of the settlement proceeds, we must determine whether such proceeds are subject to Utah income tax. The Division offers three independent basis for taxation: (i) the proceeds are Utah source income because they relate to a sale of Utah assets; (ii) the proceeds are Utah source income under Utah Code Ann. § 59-10-117(1)(b) since they represent the payment for services rendered in Utah; and (iii) the PETITIONER'S right to the proceeds were fixed when they were residents, and a subsequent change in domicile does not alter the taxability of the proceeds by Utah. We must only find a basis under one of the above three alternatives to sustain the Division's Statutory Notice of Deficiency and conclude that the proceeds are taxable to Utah as they pertain to the sale of Utah assets.

The original COMPANY A - COMPANY B transaction involved an IRC § 338(h)(10) election. The IRC § 338(h)(10) resulted in the sale being treated for tax purposes as if COMPANY A sold all of its assets to COMPANY B with a subsequent liquidation of the proceeds to the shareholders. As such, the gain on the sale of the assets is reorganized by COMPANY A.

Utah Code Ann. § 59-7-702(2)(b) requires that "a nonresident shareholder shall recognize

a portion of a S corporation's Utah taxable income derived from Utah sources. . . in accordance with Utah Code Ann. § 59-10-117 and Utah Code Ann. § 59-10-118." Utah Code Ann. § 59-10-117(d) provides that "A nonresident shareholder's distributive share of ordinary income, gain, loss and deduction from or connected with Utah sources shall be determined under Section 59-10-118." Section 59-10-118 provides that the "business income" shall be apportioned to Utah and "non-business" income from intangible sources allocated to the "commercial domicile."

COMPANY A reported the gain recognized in 1998 as business income and it was apportioned all to Utah. The allocated purchase price under the purchase agreement was \$\$\$\$\$. Because of PARTNER 2's actions, PETITIONER received only \$\$\$\$\$ of this amount in 1998. PETITIONER received an additional \$\$\$\$\$ from the settlement in 2001, for a total of \$\$\$\$\$.

The Commission is convinced that had PARTNER 2 received the settlement proceeds in 1998 under the purchase agreement, that such proceeds would clearly have been Utah source income under the statutes discussed above and finds that it makes no difference that the proceeds were paid in the form of settlement as opposed to the original transaction. The proceeds reflect the reallocation of the COMPANY B sale proceeds from PARTNER 2 and the other corporations controlled by PARTNER 2 to COMPANY A consistent with the value of the assets sold. The reallocation does not alter the nature or source of the purchase price.

Considering the issue of the failure to file and failure to pay penalties, although the Commission concludes that the law in this matter is clear and that Petitioner should have filed and paid Utah individual income taxes on the income at issue in 2001, this is a very complicated area of law and certainly difficult for Petitioners to understand that they would need to file Utah returns on the income when they were residents of STATE 1 at the time they had received the income. For this reason the Commission finds sufficient reasonable cause for waiver of the penalties.

CONCLUSION

Based on the foregoing the commission sustain the Division's Statutory Notice of Estimated Income Tax as it pertains to the tax and interest. However, the Commission waives the penalties. It is so ordered.

BY ORDER OF THE UTAH STATE TAX COMMISSION:

DATED this ____ day of _____, 2006.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Palmer DePaulis
Commissioner

Marc B. Johnson
Commissioner

Notice of Appeal Rights and Payment Requirement: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Sec. 63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Sec. 59-1-601 and 63-46b-13 et. seq. Failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.