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## ***California – Trial court finds unitary requirements not satisfied and termination fee was business income***

March 14, 2014

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### ***In brief***

On March 6, 2014, the Los Angeles County Superior Court found that a taxpayer and its subsidiary were not engaged in a unitary relationship for the 1998 and 1999 tax years at issue. Additionally, the receipt of a merger termination fee constituted business income. [*ComCon Production Services I, Inc. v. California Franchise Tax Bd.*, Los Angeles Superior Ct Case No. BC489779, (3/6/2014)]

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### ***In detail***

In 1995, Comcast acquired a majority interest in QVC. For the 1998 and 1999 tax years, Comcast and QVC did not file California corporate income tax returns as members of the same unitary group.

In 1999, Comcast contracted to acquire MediaOne by merger. The contract contained a liquidated damages provision pursuant to which MediaOne paid \$1.5 billion to Comcast when MediaOne terminated the contract and merged with another entity. Comcast used the proceeds from the fee for business-related activities, primarily debt repayment. On its 1999 California income tax return, Comcast did not report

the termination fee as taxable income because, for federal purposes, Comcast took the position that the fee resulted in a nontaxable recovery of basis.

On audit, the Franchise Tax Board (FTB) asserted that QVC and Comcast operated as a unitary business and that the termination fee was apportionable business income. On review, the Board of Equalization ruled in favor of the FTB on both matters and Comcast appealed to the Los Angeles County Superior Court.

The court's decision adopted Comcast's argument in its closing brief that it was not unitary with QVC. The court also adopted the Franchise Tax Board's argument in its closing

brief that Comcast's revenue from the termination fee was apportionable business income. The summaries below reflect the parties' arguments as detailed in their respective closing briefs.

### ***In detail – Activities did not satisfy the 'hallmarks' of a unitary relationship***

In its closing brief with the court, Comcast asserted that the three criteria of a unitary business are: (1) centralization of management, (2) functional integration, and (3) economies of scale. Comcast provided the following facts to support that a unitary relationship did not exist between Comcast and QVC.

*Centralization of management did not exist*

- QVC was a retailer of consumer products in an entirely different business from Comcast, a cable services business.
- QVC and Comcast maintained separate headquarters and there were no transfers of personnel between the two companies.
- QVC's president (who was the president both before and after the acquisition) had complete autonomy in managing QVC.
- QVC employees made all meaningful business decisions without direction or shared expertise from Comcast.
- QVC's management independence extended from day-to-day operations to major strategic decisions, including expanding internationally, investing major capital expenditures, and establishing call centers.
- QVC's non-Comcast officers held all meaningful officer-level positions, set QVC policy, and made meaningful decisions.

*Functional integration did not exist*

- QVC and Comcast maintained separate headquarters.
- QVC and Comcast maintained separate departments responsible for the operation of the companies' respective businesses, including QVC's critical operational functions (departments responsible for sourcing products, testing products, studio productions, warehousing and shipping products, and call centers).

- QVC and Comcast maintained separate back-office and administrative functions (e.g., accounting, tax, research and development, finance, advertising, marketing, legal, human resources, personnel, and purchasing).

*Economies of scale did not exist*

- There was no attempt to consolidate back-office or administrative departments to obtain cost savings from potential economies of scale.
- There was no opportunity for QVC and Comcast to engage in centralized purchasing of materials due to their different core businesses.
- There were no significant cost benefits recognized by QVC or Comcast by purchasing products in bulk.

***In detail – Merger termination fee revenue was apportionable business income***

In its closing brief, the FTB acknowledged that business income, for California purposes, is income arising from (1) transactions and activity in the regular course of the taxpayer's trade or business (the 'transactional' test) and (2) 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 (the 'functional' test).

*Termination fee satisfies the transactional test*

The FTB asserted that the transactional test requires a determination as to whether the income at issue was generated by a transaction occurring in the regular

course of the taxpayer's trade or business. This determination includes the frequency and regularity of similar transactions.

The FTB argued that the termination fee constituted business income under the transactional test because: (1) it arose from an acquisition agreement, which was a type of transaction and activity that was of the same basic nature as scores of other agreements Comcast regularly entered into in the course of its business; and (2) Comcast used the proceeds to pay down its business obligations.

The FTB provided that it was irrelevant that the termination fee was the only termination fee Comcast ever received because the transaction test looks to the 'nature' of the transaction involved and whether the taxpayer regularly engages in similar transactions. Because Comcast regularly engaged in acquiring cable systems, the execution of a termination fee provision in an acquisition contract qualified as a transaction regularly engaged in by Comcast.

*Termination fee satisfies the functional test*

The FTB asserted that the termination fee constituted business income under the functional test because the merger agreement represented intangible property rights that Comcast acquired, managed, and disposed of as an integral part of its regular business.

- Comcast acquired the contract rights in the course of its regular acquisition activity.
- Comcast managed those rights by transferring them to its unitary subsidiary.
- Comcast disposed of those rights when it accepted payment of the \$1.5 billion termination fee.

The FTB also argued that the \$1.5 billion fee represented lost profits that Comcast would have earned had the merger been completed. Because the fee for lost profits replaced profits Comcast would have earned in the regular course of its business, those profits constituted business income.

### ***The takeaway***

This case is remarkable because it is highly unusual for a taxpayer to prevail in a California Superior Court. However, this case was not conducted

in a manner typical of most tax cases. Testimony lasted 19 days and included high-level executives and notable expert witnesses. On the unitary issue, the court was not willing to ignore this testimony and found that this evidence rebutted the FTB's presumption of correctness.

The FTB did prevail on the termination fee issue. In its closing brief, the FTB significantly relied on *Citicorp*, *Pennzoil*, and *Atlantic Richfield* in its efforts to establish that

significant acquisitive activity can become part of the acquirer's regular trade or business. Further, it was irrelevant that Comcast considered the termination of the contract to be unforeseeable because the parties had contemplated such a scenario when drafting the agreement.

The parties' next court date is March 28, 2014, when the court should issue its judgment and statement of decision.

## ***Let's talk***

### ***State and Local Tax Services***

Jon Sperring  
Principal, *Sacramento*  
+1 (916) 930-8204  
[jon.a.sperring@us.pwc.com](mailto:jon.a.sperring@us.pwc.com)

Wendy Buchman  
Director, *Sacramento*  
+1 (415) 498-6021  
[wendy.l.buchman@us.pwc.com](mailto:wendy.l.buchman@us.pwc.com)

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