

CALIFORNIA STATE BOARD OF EQUALIZATION

SUMMARY DECISION UNDER REVENUE AND TAXATION CODE SECTION 40

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

For Appellants:	Robert H. Wood, Wood LLP Dashiell C. Shapiro, Wood LLP Henry K. Chen, Wood LLP
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For Franchise Tax Board:	Daniel Biedler, Tax Counsel III Roman Johnston, Tax Counsel IV
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Counsel for the Board of Equalization:	Grant S. Thompson, Tax Counsel IV
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LEGAL ISSUE

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

BACKGROUND AND CONTENTIONS

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

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

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

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

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

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

18 Appellant filed a 2005 California tax return by the extended due date, and subsequently, in
19 2007, filed an amended California tax return. Thereafter, the IRS conducted an audit and determined
20 that the Chief Executive Officers of PAMF and appellant orally agreed, in 2000, to withhold the
21 payment to appellant of \$10,179,648 of physician payments for services provided after the effective
22 date of the affiliation agreements (i.e., an amount equal to the pre-affiliation accounts receivable
23 amount collected by PAMF for appellant). By late 2005, appellant had deferred approximately
24 \$34 million in physician payments, including the \$10,179,648 from the oral agreement.
25 (In accordance with the briefing and documentation, this decision sometimes rounds this \$10,179,648
26 amount to \$10 million.) The issue in this appeal is whether this \$10,179,648 in deferred
27 compensation, which arose from services provided after the effective date of the affiliation
28 agreements, was constructively received by appellant in 2005.

1 The IRS determined that the payment of this \$10,179,648 amount was not subject to the
2 restrictions on payment set forth in the affiliation agreements. Pursuant to the affiliation agreements,
3 the other deferred amounts could not be paid except to the extent that payment was needed for
4 appellant to meet its operating expenses and would not be paid in 2005 if the planned integration
5 occurred. In light of these restrictions on payment, the IRS concluded that the other deferred amounts
6 were not constructively received. However, the IRS determined that the \$10,179,648 payment that
7 was deferred pursuant to the oral agreement was not subject to these restrictions and that appellant
8 elected not to receive it. The IRS therefore determined that this amount was constructively received in
9 2005, and the IRS included this amount in appellant's gross income as compensation for services
10 pursuant to Internal Revenue Code (IRC) section 61(a)(1) and Treasury Regulation section 1.451-2.

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

14 On February 4, 2011, on the basis of the final federal determination, respondent issued a
15 Notice of Proposed Action (NPA) for tax year 2005 finding \$10,179,648 in additional income, reduced
16 by an additional charitable contribution deduction of \$904,857 and an amortization deduction of
17 \$1,131,072.¹ During protest proceedings, respondent followed the IRS in arguing that the \$10,179,648
18 deferred amount was taxable because, unlike the \$24 million in other deferred compensation, the
19 \$10,179,648 amount was not subject to the restrictions on payment that are set forth in the affiliation
20 agreements. On May 29, 2012, respondent issued a Notice of Action (NOA) affirming the NPA.
21 After respondent issued the NOA, appellant paid the additional tax (\$702,260.94) and interest
22 (\$325,833.19) asserted in the NPA and filed a refund claim. Respondent denied appellant's refund
23 claim, and appellant then filed this timely appeal.

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26 ¹ The amortization deduction was the result of the determination of the IRS that appellant constructively received the
27 \$10,179,648 amount but, by deciding not to take the payment, effectively purchased a contract right. On this basis, the IRS
28 and respondent allowed appellant to amortize its cost to purchase that intangible contract right with deductions. At the
federal level, the income recognized in 2005 was offset by amortization amounts and the net result, due to net operating
loss (NOL) carrybacks from amortization deductions taken in subsequent years, was that appellant owed a minimal
additional amount (only \$2,176) of federal income tax in 2005. However, California law did not allow the carryback of
NOLs, so respondent's determination resulted in the additional California income tax at issue in this appeal.

1 During briefing in this appeal, respondent continued to follow the IRS in arguing that the
2 \$10,179,648 deferred amount was taxable because, unlike the \$24 million in other deferred
3 compensation, the \$10,179,648 amount was not subject to the restrictions on payment that are set forth
4 in the affiliation agreements. Appellant argued that all of the deferred income was subject to the same
5 substantial restrictions on payment in that it would not be paid unless it was required to fund current
6 operations or unless the planned integration did not occur. Appellant contended that the deferred
7 compensation effectively provided a safety net that would allow it to reestablish an independent
8 practice if its affiliation with PAMF was not deepened at the end of the testing period as contemplated
9 by the affiliation agreements.

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

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

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

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

3 In response, appellant contended that respondent’s new position was inconsistent with the
4 reasoning of the IRS and with respondent’s prior position that the \$10 million amount was not subject
5 to the same restrictions as the \$24 million amount. Appellant’s outside counsel, Mr. Tom Driscoll,
6 who was present during the negotiations with PAMF and during the IRS audit, stated that the
7 \$10 million amount was treated the same as the \$24 million deferred amount and that appellant only
8 agreed to the IRS resolution because the federal resolution did not increase its federal tax liability.
9 Appellant argued that in 2005 it made a business decision not to disrupt its practice and end its
10 affiliation with PAMF, so it never had the right to receive any of the deferred compensation because
11 the compensation was only payable if it left PAMF.

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

15 APPLICABLE LAW

16 Federal Assessment

17 Revenue & Taxation Code (R&TC) section 18622, subdivision (a) provides that taxpayers
18 shall either concede the accuracy of a federal determination or state wherein it is erroneous.
19 Moreover, “[i]t is well settled that a determination with respect to federal income tax liability will
20 generally be followed when determining California tax liability where the applicable federal and state
21 provisions are identical and where there is no compelling reason for departure from the federal
22 interpretation.” (*Appeal of Sierra Pacific Industries*, 94-SBE-002, Jan. 5, 1994.) Although
23 respondent’s determination based on a federal assessment is presumed correct, the presumption is
24 rebuttable, and neither respondent nor this Board is required to follow an IRS determination.
25 (See *Appeal of Sierra Pacific Industries, supra*; *Appeal of Der Wienerschnitzel International, Inc.*,
26 79-SBE-063, Apr. 10, 1979.)

27 Constructive Receipt

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

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

9 FINDINGS OF FACT, ANALYSIS, & DISPOSITION

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

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

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

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

3 ORDER

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

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7 Michelle Steel _____, Member

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9 Betty T. Yee _____, Member

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11 George Runner _____, Member

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