Comcast Loses California NBI and Non-Unitary Appeal: SBE Finds Comcast Unitary With QVC and MediaOne Termination Fee Business Income

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On February 2, the California State Board of Equalization voted 3-2 against Comcast, holding that (1) Comcast was unitary with majority-owned QVC and (2) the fee Comcast received for a failed merger with MediaOne was apportionable business income.[1] The appeal has been pending for a long time and the decision has been highly anticipated.[2] The Board declined to make its decision a formal opinion and, therefore, it will not be precedential.[3]

Unity with QVC

One issue before the Board was whether Comcast was unitary with QVC. Comcast is a cable television provider, while QVC's business is as a cable television channel that sells products. Through stock purchases, Comcast acquired 57.45 percent ownership of QVC. Various Comcast officers and board members then replaced various QVC officers and board members. However, the officers of QVC prior to Comcast's acquisition continued to manage QVC in the same manner as before the acquisition. Further, Comcast treated QVC as it did any other cable channel, not providing any preferential treatment to QVC.

The Board was presented with arguments applying the "three unities" test.[4] The three unities include the vaguely defined concepts of unity of use and unity of operation. The Board was also presented with arguments applying the contribution or dependency test.[5] After consulting with the Appeals Division during the hearing, the Board seemed to conclude that the two tests are alternative tests, and that a failure to establish the "three unities" was not dispositive. The Board generally acknowledged the lack of clarity on the law with regard to these tests. This led to substantial discussion and a general sense of unease toward finding a unitary relationship.

Ultimately, the Board voted 3-2 in favor of the Franchise Tax Board, holding that the relationship was unitary.

The two Board members who voted for Comcast emphasized that Comcast did not give preferential treatment to QVC. The three Board members who voted against Comcast, however, heavily emphasized certain flows of value between the two companies, such as the ability to pay executives with options and overlapping board members. Those members cited the "contribution or dependency test."

Although the result of this case was a taxpayer loss, discussions by the Board demonstrate that a unitary analysis is subjective. Board members and Board staff indicated that the decision was a close call and that plenty of facts were presented that could have led the Board to reach a decision in favor of either Comcast or the FTB on the unitary relationship issue.

Termination Fee

The other major issue decided by the Board was whether a termination fee from a broken merger was apportionable business income. Comcast had entered into an agreement with MediaOne to acquire the latter through a merger. Under the merger agreement, MediaOne was prohibited from soliciting competing merger offers, but could accept an unsolicited offer. However, if it accepted such an offer, it was required to pay a termination fee of $1.5 billion to Comcast. After accepting a competing offer from AT&T, MediaOne paid Comcast this termination fee.

Comcast sought to treat this income as nonbusiness income not subject to California tax.[6] To be treated as nonbusiness income, it must pass two separate tests: the transactional test and the functional test. The transactional test requires that the transaction or activity that gave rise to the income arise in the regular course of the taxpayer's business. Comcast's position was that the termination of the MediaOne merger was the relevant transaction, and that the termination fee was a "once-in-a-lifetime" transaction.

Comcast also argued that the termination fee did not meet the functional test, which requires the acquisition, management, and disposition of the property from which the income is earned to be integral parts of the taxpayer's regular trade or business. Its position was that the relevant property could not be integral to its business because the transaction was terminated before MediaOne could be acquired.

The FTB, on the other hand, sought to treat the termination fee as apportionable business income. With respect to the transactional test, the FTB argued that Comcast built its business through acquisitions, and the termination fee represented lost profits from its business. With respect to the functional test, the FTB argued that the merger agreement was the relevant property and that it was integral to Comcast's expansion efforts.

Without further discussion during voting, the Board members voted, 3-2, in favor of the FTB's position that the termination fee was apportionable business income.

Next Steps

The Board is the highest level of administrative review of tax matters in California. Thus, for Comcast to maintain its appeal, it would need to file an action in Superior Court.[7] However, the posture of this matter was as a proposed deficiency. California is a "pay-to-play" state, requiring the payment of outstanding taxes[8] before a matter can be heard in state court. Accordingly, Comcast must now pay the outstanding tax, file a refund claim for that payment, receive a denial of the refund claim[9] or wait six months for a "deemed denial,"[10] and file a refund action in Superior Court. If Comcast chooses to pursue this action further, final resolution may be years in the future.[11]

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1. -- Additionally, the Board held that Comcast was not entitled to a dividends-received deduction in light of the deduction being held unconstitutional in Farmers Bros. Co. v. Franchise Tax Board 108 Cal.App.4th 976 (2003), and the entire deduction statute, not just the unconstitutional portions, being held invalid in light of Abbott Laboratories v. Franchise Tax Board 175 Cal.App.4th 1346 (2009). The Board also held that an accuracy-related penalty was improper based on an exception to the penalty for reasonable cause and good faith.

2. -- Sollie and Toman, BNA Weekly State Tax Report, "Deal Break Up Fees and Joint Ventures: Comcast's California Appeal Presents Interesting Issues to Watch" (March 5, 2010).

3. -- Cal. Code Regs. § 5452.

4. -- The three unities test includes the unity of ownership (more than 50 percent of voting power), unity of operation (staff functions), and unity of use (central executive force and sharing of personnel and facilities). See Butler Bros. v. McColgan, 17 Cal.2d 664 (1941).

5. -- See A.M. Castle & Co. v. Franchise Tax Board, 36 Cal.App.4th 1794 (1995).

6. -- Comcast originally filed its federal and state returns treating the termination fee as a nontaxable recovery of basis. Later, it amended its federal return to treat it as taxable income and filed a refund claim. When that federal refund claim was denied, Comcast agreed to include it on its California return as income, but sought to treat it as nonbusiness income.

7. -- Comcast may also file a petition for a rehearing before the Board. Revenue and Taxation Code § 19048. However, such a rehearing would be granted only in limited circumstances, such as a surprise, irregularity in the Board's proceedings, the discovery of new facts, or if the decision was contrary to law. Cal. Code Regs. § 5461.

8. -- Revenue and Taxation Code § 19382. The FTB's position is that interest is also required to be paid for an action to be brought in court.

9. -- Revenue and Taxation Code § 19324.

10. -- Revenue and Taxation Code § 19331.

11. -- Revenue and Taxation Code § 19382. Alternatively, Comcast may attempt to appeal the matter before the Board once again on a refund posture. Although this is statutorily permitted, such procedural step is not required and, in fact, is discouraged unless new facts or legal theories come to light. Revenue and Taxation Code § 19324, et seq. While the Board has jurisdiction to hear the FTB's denial of the claim, this does

not usually occur unless new facts or legal theories come to light in the presentation of the claim for the tax years at issue.

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