INTRODUCTION

The purpose of these materials is to provide an overview of California's interpretation and application of the Uniform Division of Income for Tax Purposes Act (UDITPA), the unitary method and the combined report methodology, as well as a brief discussion of common administrative/procedural issues. They are prepared for training purposes only, and under no circumstances should the contents be used or cited as authority for setting or advocating a technical position. The materials are dated and the views expressed herein are subject to change at any time. The views expressed herein do not necessarily reflect those of the faculty members, the Center for State and Local Taxation, the Franchise Tax Board, or the State or California.

The division of income between jurisdictions and the ability of a state to consider income, which in some sense arises in part from activities outside of its boundaries, is subject to constraints imposed by the United States Constitution. From a hierarchical perspective, the interpretation and the ultimate validity of an assessment is first determined by reference to the Constitution of the United States, then, in descending order, by reference to the California Constitution, the California statutes, the California regulations, and then the practices and policies of the California tax agencies.

Depending upon the nature of the issues involved in any dispute involving California taxes, the levels of review and authority, in descending order, are: the United States Supreme Court, the California Supreme Court, the California appellate courts (published decisions), the State Board of Equalization (published decisions), and Legal Rulings issued by the Franchise Tax Board. The California appellate courts and the State Board of Equalization issue "unpublished decisions" which are of no precedential significance. The State Board of Equalization has been issuing almost exclusively "unpublished decisions" since 1990. This practice makes it very difficult for taxpayers and tax administrators to research for precedents and determine the exact status of the law. The Legislature responded to this in 2012 by enacting Section 40 of the Revenue and Taxation Code requiring the publication of decisions in cases where the amount in controversy is \$500,000 or more. However, not all of these decisions will be precedential.

As a general rule, the California courts have not viewed the decisions of the State Board of Equalization, published or unpublished, as precedential. Citations to those decisions in judicial proceedings have generally been unpersuasive. However, the California Supreme Court in <u>Hoechst Celanese Corporation v. Franchise Tax Board</u> (2001) 25 Cal.4th 508 gave the following commentary and directions with respect to administrative decision.

"Although we are not bound by administrative decisions construing a controlling statute, we accord 'great weight and respect to the administrative construction.' <u>Yamaha Corp. of America v. State Board of Equalization</u> (1998) 19 Cal.4th 1, quoting <u>International Business Machines v. State Board of Equalization</u> (1980) 26 Cal.3rd 923. The amount of deference given to the administrative construction depends 'upon the thoroughness evident in its construction, the validity of its reasoning, its consistency with earlier and later pronouncements, and all of those

factors which give it the power to persuade, if lacking power to control.'" <u>Yamaha</u> at pp. 14-15, italics added by *Yamaha*, quoting <u>Skidmore v. Swift & Co.</u>, 323 U.S. 134, 140 (1944).

Another case where the courts have accorded significance to Board of Equalization decisions is <u>Citicorp North America, Inc. v. Franchise Tax Board</u> (2000) 83 Cal.App.4th 1403. In this case the court accepted the Board of Equalization's position and rationale on the Joyce/Finnigan/Huffy issue, see infra.

Similarly, the State Board of Equalization has expressed the position in an opinion that was subsequently withdrawn that it does not view the decisions of an individual lower California appellate court as binding upon its decisions. <u>Appeal of Rockwell International Corp.</u>, Cal. St. Bd. of Equal., Nov. 27, 1990. The Board of Equalization refused to follow an appellate decision, <u>Fujitsu IT Holdings v. Franchise Tax Board</u> (2004) 120 Cal.App.4th 459, in <u>Appeal of Apple Computer, Inc.</u>, Cal. St. Bd. of Equal., Nov. 20, 2006. The Franchise Tax Board endeavors to give deference to both lines of authority.

In several specific circumstances, e.g., sections 23101.5 and 25137, the Franchise Tax Board may rule directly upon a matter. Decisions of the Franchise Tax Board are nonprecedential in nature. The deference which the Board of Equalization or the California courts will give to decisions of the Franchise Tax Board has not been determined. Taxpayers should expect that it will be argued that decisions made by the Franchise Tax Board itself should be accepted unless it can be demonstrated that they were "arbitrary or capricious."

A useful source for information and decisions is found at the Franchise Tax Board's website <u>http://ftbnet/</u>. Click on "The Organization" then "Legal Branch" to access various resources.

Questions, comments or suggestions regarding these materials should be directed to the instructor:

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Unless otherwise indicated, all statutory references are to the California Revenue and Taxation Code. Unless otherwise indicated, all references to regulations are to Title 18 of the California Code of Regulations. These materials are dated March 31, 2014.

DEFINITIONS

The following definitions are relevant to the multistate taxation of income under the allocation and apportionment provisions of the California Corporation Tax Law.

Allocation

"Allocation" refers to the assignment of nonbusiness income to a particular state. (Regula25121(a)(3).)

Apportionment

"Apportionment" refers to the division of business income among states by the use of a formula containing apportionment factors. (Regulation 25121(a)(2).)

Apportionment Formula

An apportionment formula is a formula composed of factors reflecting various elements of business activity that is used to determine the portion of the business income derived from or attributable to sources within a state. California's apportionment formula (section 25128) for income years beginning on or after January 1, 1994, for most businesses consisted of the sum of the property factor plus the payroll factor plus twice the sales factor divided by four. For income years beginning prior to January 1, 1994, and for a taxpayer which has more than 50 percent of its gross business receipts from agricultural business activities, extractive business activities, or financial activities, an equally weighted three-factor formula of property, payroll and sales is used.

For taxable years beginning on or after January 1, 2011, taxpayers required to double-weight the sales factor may annually elect on an original return for a year to apportion their income to California on the basis of a sales factor only.

For taxable years beginning on or after January 31, 2013 all taxpayers other than those that have more than 50 percent of their gross business receipts from agricultural business activities, extractive business activities, or financial activities shall apportion income by a sales factor only.

Bank

"Bank" includes national banking associations, and any bank operated by any receiver, liquidator, referee, trustee or other officers or agents appointed by any court, or any assignee for the benefit of creditors. (Section 23039.)

Board of Equalization

See "State Board of Equalization."

Business Activity

"Business activity" refers to transactions and activity occurring in the regular course of a particular trade or business of a taxpayer. (Regulation 25121(a)(4).)

Business Income

"Business income" is income arising from transactions and activity in the regular course of the taxpayer's trade or business and 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. (Section 25120(a).)

California has construed this language as setting forth two separate tests, a transactional and a functional test. The Multistate Tax Commission the word "business" with "apportionable" and separate the two clauses om the definition to clarify that there are two separate tests for determining whether income is apportionable.

Combined Report

A combined report is a report of the combined business income and apportionment factors of a unitary group where the unitary activities are carried on within and without California. (See Chapter 9.)

Commercial Domicile

"Commercial domicile" is the principal place from which the trade or business of the taxpayer is directed or managed. (Section 25120(b).)

Compensation

"Compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. (Section 25120(c).)

Corporation

Generally, "corporation" means every corporation except corporations expressly exempted from tax by the Corporation Tax Law or the California Constitution. The principal exempt companies are insurance companies, which are exempt by Article XIII, Sec. 28 of the California Constitution. "Corporation" includes financial corporations, associations, Massachusetts's trusts, and business trusts. (Section 23038.) For special rules regarding "investment trusts," see Regulation section 23038(a).

Corporation Franchise Tax (formerly Bank and Corporation Franchise Tax)

Generally, under Chapter 2 of the Corporation Tax Law, every corporation (including financial corporations) and bank doing business within California and not expressly exempted from taxation shall annually pay to the state, for the privilege of exercising its corporate franchises within California, a tax according to or measured by its net income, to be computed as a percentage rate upon the basis of its net income for the next preceding income year or, if greater, the minimum tax. (Section 23151 et seq.)

Corporation Income Tax

Generally, the corporation income tax is imposed upon corporations under Chapter 3 of the Corporation Tax Law upon net income derived from sources in this state. (Section 23501 et seq.) The Corporation Income Tax is not applicable to banks.

Corporation Tax Law (formerly Bank and Corporation Tax Law)

The Corporation Tax Law consists of sections 23001 through 25141 of the Revenue and Taxation Code. The administrative provisions which apply to the Corporation Tax Law appear at sections 18000 to 21002 of the Revenue and Taxation Code.

Doing Business

"Doing business" means actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. (Section 23101(a).)

For income years beginning on or after January 1, 2011 a taxpayer is doing business in this state if it is commercially domiciled in this state or it exceeds any of the following levels:

- 1) Sales in this state exceed the lesser of \$500,000 or 25 percent of its total sales
- 2) Real and tangible personal property in this state exceed the lesser of \$50,000 or 25 percent of the taxpayer's total such property
- 3) The amount paid as compensation in this state exceeds the lesser of \$50,000 or 25 percent of the taxpayer's total compensation paid.

(Section 23101(b))

The taxpayer's property, payroll and sales include its pro-rata distributive share of pass-through entities. (Section 23101(d). The Franchise Tax Board shall annually revised the amounts. (Section 23101(c)).

Economic Nexus

The ability to assert a tax based on something other than a physical presence. For example, the licensing of intangibles for use in a state.

Financial Corporation

"Financial corporation" means a corporation, except as provided in subdivision (b) of section 23183, which predominantly deals in money or moneyed capital in substantial competition with the business of national banks. (Regulation 23183.)

Fiscal Year

"Fiscal year" means an accounting period of 12 months or less ending on the last day of any month other than December. (Section 23032.)

Franchise Tax Board

The Franchise Tax Board (FTB) is a three-member board, comprised of the Controller, the Director of Finance, and the Chair of the California State Board of Equalization. The FTB is also an agency of the State of California, organized and existing under and by virtue of California Government Code sections 15700 et seq. FTB is charged with the administration and enforcement of the California Corporation Tax Law and the Personal Income Tax Law. (Sections 23031, 26422, 17003, 19251-19253.) FTB has an agency staff, headed by an Executive Officer.

Income Derived From Sources Within This State

Income derived from or attributable to sources within this state includes income from tangible or intangible property located or having a situs in this state and income from any activities carried on in this state, regardless of whether carried on in intrastate, interstate or foreign commerce. (Section 23040.)

Legal Domicile

The legal domicile of a corporation is the state in which the corporation is incorporated.

Multistate Tax Compact, Multistate Tax Commission

The Multistate Tax Compact is a compact among states to facilitate the proper determination of state and local tax liability of multistate taxpayers. The Multistate Tax Compact created the Multistate Tax Commission (MTC). States join the MTC (currently 16 states as full members) by enacting the Compact, which incorporates the Uniform Division of Income For Tax Purposes Act (UDITPA) as Article IV. In 2014 the member states voted to revise Article IV in several areas including the adoption of market-based sourcing for all types of sales, limiting items included in the sales factor, and accepting a state's determination as to the elements and weighting of the apportionment formula.

The Commission has several other classes of members, including 7 "sovereignty members" and associate members. The main purposes of the MTC as stated in the Compact are: to facilitate proper determination of state and local tax liability of multistate taxpayers; to promote uniformity or compatibility of tax systems; to facilitate taxpayer convenience and compliance; and to avoid duplicative taxation. The MTC acts as a resource to those ends through research and publication, seminars, litigation (principally as an *amicus*), conducting a joint audit program, and representing member state interests in Washington, D.C. (See

section 38001 et seq.; see also <u>U.S. Steel Corp. v. Multistate Tax Comm'n</u> (1978) 434 U.S. 453.)

California adopted the Multistate Compact in 1974. It withdrew from the Compact on July 1, 2012. One of the provisions of the Compact, Article III.1., provides that taxpayers have an election to have their income apportioned pursuant to state law or Article IV of the Compact, UDITPA. A number of states have either adopted the Compact without this election provision or have attempted to disable the election. Taxpayers have brought legal challenges arguing that the election provision cannot be eliminated or disregarded. This issue is being litigated in at least five states: California, Michigan, Minnesota, Oregon and Texas.

The California Supreme Court in *The Gillette Company et al. v. Franchise Tax Board,* held that the Compact did not constitute a contract between the member states and California's disabling the election by use of the phrase "Notwithstanding" was effective. <u>The United States Supreme Court denied a</u> petition for certiorari Petitions for Certiorari have been denied in the Minnesota case where the state had amended the Compact to eliminate the election.

The Oregon Tax Court has reached a similar conclusion similar to the California Supreme Court's analysis. The Texas courts have held that the Texas tax was not an income tax and therefore the election provision was not involved. The Michigan courts initially held that the election could not be voided by implication but subsequently accepted the Michigan legislature's retroactive repeal of the election provision. Petitions for Certiorari are pending before the United States Supreme Court in six separate cases involving the Michigan action. If certiorari is accepted it may be limited to the question of retroactivity. For more information regarding the MTC and its activities, see its website www.mtc.gov.

Nexus

Nexus is the connection that a business has with a state that gives the state jurisdiction to impose a tax. See Economic Nexus, <u>supra</u>.

Nonbusiness Income

"Nonbusiness income" means all income other than business income. (Section 25120(d).) The Multistate Tax Commission has proposed amendments Article IV of the Compact to substitute the word "allocable" for "nonbusiness."

Payroll Factor

The payroll factor of the apportionment formula is a fraction, the numerator of which is the total amount paid in California during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year. (Section 25132.)

Property Factor

The property factor of the apportionment formula is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in California during the income year, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year. (Section 25129.) For banks and financial corporations, the property factor includes intangible property as well. (Reg. § 25137-4.2.)

Public Law 86-272

Public Law 86-272 (15 U.S.C.A. § 381) was enacted in 1959. It generally provides that a state cannot impose a net income tax on a business if its only business activities within the state are limited to the solicitation of sales of tangible personal property.

Sales

"Sales" defined in the original version of UDITPA to means all gross receipts of the taxpayer not allocated under sections 25123 through 25127. (Section 25120(e).) In California, effective for taxable years beginning on or after January 1, 2011, the following items are excluded from sales: A) repayment. maturity or redemption of loan or similar item; B) returns on repurchase agreements; C) issuance of securities; D) litigation damages; E) property acquired by an agent; F) tax refunds; G) pension reversions; H) contributions to capital; I) discharge of indebtness; J) exchanges of inventory not recognized under IRC; K) treasury activities; and L) hedging. (Section 25120(f)(2)).

The definition of "gross receipts" for purposes of the sales factor in prior California law was defined broadly by the California Supreme Court in the case of <u>Microsoft Corporation v. Franchise Tax Board</u> (2006) 39 Cal.4th 750. In *General Motors Corporation v. Franchise Tax Board* (2006) 39 Cal.4th 773, the California Supreme Court held that the repayment of the principal on a loan was not a gross receipt and therefore was not a sale for purposes of section 25120(e). In *General Motors* the instrument that was treated as a loan was a repurchase ("repo") agreement.

The Multistate Tax Commission in 2014 amended Article IV of the Compact to more narrowly define sales limiting it <u>to transactions in the normal course</u> of business, receipts that would satisfy the transactional test for classifying income as apportionable, nee business, income.

Sales Factor

The sales factor of the apportionment formula is a fraction, the numerator of which is the total sales of the taxpayer in California during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year. (Section 25134.)

Separate Accounting

Generally, separate accounting for purposes of state income taxation means carving out of the overall business of a taxpayer the activities taking place, the property employed, and the income derived from sources within a single state, and thereby treats the business within a state as if it were separate and distinct from the business carried on outside of that state. (J. Hellerstein, 1 State Taxation (1983) § 8.3. p. 323.)

<u>State</u>

"State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof. (Section 25120(f).)

State Board of Equalization

The California State Board of Equalization (SBE) is an elective body, created by the California Constitution, which administers numerous tax laws, including the sales and use tax law. The SBE is also an administrative appellate agency with respect to certain final actions of FTB, including those under the Corporation Tax Law and the Personal Income Tax Law. The SBE consists of five members, four of whom are elected from areas of the state known as Equalization Districts, and the fifth being the State Controller, who is elected at large.

Taxable In Another State

For purposes of UDITPA, a taxpayer is taxable in another state if (a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not. (Section 25122.)

A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in such other state pertaining to the production of nonbusiness income or business activities relating to a separate trade or business. (Regulation 25122.)

Taxpayer

A taxpayer is any person or bank subject to the tax imposed under Chapter 2 ("The Corporation Franchise Tax"), Chapter 2.5 ("Alternative Minimum Tax")

or Chapter 3 ("The Corporation Income Tax") of the Corporation Tax Law. (Section 23037.) For purposes of computing the apportionment formula, "taxpayer" generally means a unitary business.

Unitary Method of Taxation

The "unitary method of taxation" is not a tax. It is a method by which the business income of a unitary business is divided, for tax purposes, among taxing jurisdictions in which the unitary business is subject to tax.

UDITPA

"UDITPA" is the Uniform Division of Income for Tax Purposes Act. California's version is found at sections 25120 through 25139, inclusive of the Revenue and Taxation Code. UDITPA is contained as part of the Multistate Tax Compact as Article IV. The original version of UDITPA appeared at sections 38000 et seq. of the California Revenue and Taxation Code. California repealed the Multistate Tax Compact effective July 1, 2012.

In 2006 the Uniform Law Commissioners, formerly the National Conference of Commissioners on Uniform State Laws began a review of UDITPA. That project has now been abandoned. The Multistate Tax Commission reviewed Article IV and approved several changes in 2014 including the adoption of market based sourcing, narrowing the definition of sales, and deferring to the individual states the elements and the weighting of the apportionment formula. These changes may be referred to the Uniform Law Commissioners.

<u>CHAPTER 1</u> <u>CONSTITUTIONAL LIMITS ON THE STATES' POWERS</u> <u>TO TAX -- AN OVERVIEW</u>

1. **INTRODUCTION**

The general subject of the constitutional limits on the states' powers to tax will be addressed in a separate segment of this course. Nevertheless, it is helpful to outline some of the major constitutional decisions and the propositions for which they are frequently cited as they relate to income and franchise taxes. The three main federal constitutional limitations on State corporate taxation are the (1) Due Process Clause of the Fourteenth Amendment (Amendment XIV, Section 1); (2) Commerce Clause (Article I, Section 8, clause 3); and (3) Equal Protection Clause of the Fourteenth Amendment (Amendment XIV, Section 1).

2. <u>SIGNIFICANT DECISIONS – UNITED STATES SUPREME COURT</u>

Underwood Typewriter Co. v. Chamberlain, (1920) 254 U.S. 113

The first state income tax case that sanctioned the use of formula apportionment.

Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n. (1924) 266 U.S. 271.

The first case to use the term unitary business. The case also sanctioned the use of formula apportionment for a foreign country based business.

Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell (1931) 283 U.S. 123

The Court struck down as violating the Due Process Clause a single-factor apportionment formula based on owned tangible personal property where the difference between taxable income under the taxpayer's separate accounting analysis and the state's methodology was approximately 250 percent.

Northwest Portland Cement Co. v. Minnesota (1959) 358 U.S. 450

A pre-P.L. 86-272 case, which held that Minnesota's imposition of a net income tax did not violate the Due Process or Commerce Clauses where the taxpayer's Minnesota activities consisted of a regular and systematic course of solicitation of orders for the sale of its products, each order being subject to acceptance, filling and delivery by it from its Iowa plant. (The taxpayer also had an office in the state.)

Scripto v. Carson (1960) 362 U.S. 207

The Court held that Florida could constitutionally impose a use tax without violating Due Process or the Commerce Clauses where the only contact of the corporation with Florida was that orders for its products were solicited by brokers or wholesalers or jobbers who were residents of Florida.

"True, the 'salesmen' are not regular employees of appellant devoting full time to its service, but we conclude that such a fine distinction is without constitutional significance. The formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida."

National Bellas Hess v. Illinois (1967) 386 U.S. 753 (see Quill, infra)

A use tax case holding no nexus under Commerce Clause analysis if the only connection with the state is by common carrier.

"... [the] Court has never held that a State may impose the duty of <u>use</u> tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States mail."

Boston Stock Exchange v. State Tax Comm'n. (1977) 429 U.S. 318

The Court held that a New York stock transfer tax that imposed a higher tax on in-state transfers of securities resulting from out-of-state sales than those resulting from in-state sales violated the Commerce Clause.

The Court found the prohibition against discriminatory treatment of interstate commerce follows inexorably from the basic purpose of the Commerce Clause.

"Permitting the individual States to enact laws that favor local enterprises at the expense of out-of-state businesses 'would invite a multiplication of preferential trade areas destructive' of the free trade which the Clause protects.

"There has been no prior occasion expressly to address the question whether a State may tax in a manner that discriminates between two types of interstate transactions in order to favor local commercial interests over out-of-state businesses, but the clear import of our Commerce Clause cases is that such discrimination is constitutionally impermissible.

"Our decision today does not prevent the States from structuring their tax systems to encourage the growth and development of intrastate commerce and industry. Nor do we hold that a State may not compete with other States for a share of interstate commerce; such competition lies at the heart of a free trade policy. We hold only that in the process of competition, no State may discriminatorily tax the products manufactured or the business operations performed in any other State."

Complete Auto Transit, Inc. v. Brady (1977) 430 U.S. 274

Establishes a four-part test for state taxes under the Commerce Clause (where foreign commerce is not involved). Under <u>Complete Auto</u>, a state tax does not violate the Commerce Clause where the tax (1) is applied to an activity with a substantial nexus with

the taxing State; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the State.

National Geographic Society v. Cal. Bd. of Equalization (1977) 430 U.S. 551

A case involving California's imposition of a use tax measured by mail order sales to California residents by a nonprofit scientific and educational corporation of the District of Columbia. The out-of-state seller maintained two offices in California, but those offices performed no activities related to the seller's operation of its mail order business. The Court held the activities of the two California offices provided a sufficient nexus under the Due Process and Commerce Clauses for imposition of the use tax, even though the offices performed no activities related to the mail order sales being taxed.

"[T]he relevant constitutional test to establish the requisite nexus for requiring an out-of-state seller to collect and pay use tax is not whether the duty to collect the use tax relates to the seller's activities carried on within the State, but simply whether the facts demonstrate 'some definite link, some minimum connection, between [the State and] the person it seeks to tax'"

Japan Line, Ltd. v. County of Los Angeles (1979) 441 U.S. 434

A property tax case. When a state seeks to tax the "instrumentalities of foreign commerce," two additional considerations beyond those articulated in <u>Complete Auto</u> come into play under the Commerce Clause. The first is the enhanced risk of multiple taxation. The second is the possibility that a state tax will "impair federal uniformity in an area where federal uniformity is essential."

Mobil Oil Corp. v. Commissioner of Taxes of Vermont (1980) 445 U.S. 425

The Supreme Court held that Vermont's taxation, by means of an apportionment formula, of income received by a New York parent corporation as dividends from its foreign subsidiaries did not violate the Due Process Clause or the Commerce Clause.

"We do not mean to suggest that all dividend income received by corporations operating in interstate commerce is necessarily taxable in each State where that corporation does business. Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing State, due process considerations might well preclude apportionability, because there would be no underlying unitary business."

"[S]eparate [geographical] accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." (Citations omitted.)

The Due Process Clause imposes two requirements on state taxation: a "minimal connection" or "nexus" between the interstate activities and the taxing State, and "a rational relationship between the income attributed to the State and the intrastate values of the enterprise."

The "linchpin of apportionability" for state income taxation of an interstate business is the "unitary business principle."

Exxon Corp. v. Wisconsin Dept. of Revenue (1980) 447 U.S. 207

Held that Wisconsin's taxation under an apportionment formula of the income of a vertically integrated petroleum corporation carrying on only marketing activities within the state did not violate due process or the Commerce Clause. The fact that Exxon relied on its own "separate functional accounting" rather than separate geographic accounting "does not make the principles expressed in *Mobil* any less applicable."

ASARCO Inc. v. Idaho State Tax Comm'n (1982) 458 U.S. 307

As framed by the Court, "[t]he question is whether the State of Idaho constitutionally may include within the taxable income of a nondomiciliary parent corporation doing business in Idaho a portion of intangible income - such as dividend and interest payments, as well as capital gains from the sale of stock - that the parent receives from subsidiary corporations having no other connection with the State." The Court rejected Idaho's contention that intangible income should be considered a part of a unitary business if the intangible property (the shares of stock) is acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business, because this definition of unitary business "would destroy the concept." The Court concluded that Idaho's business income classification of the dividends violated due process because the business activities of the dividend payor had nothing to do with the activities of the recipient in the taxing state.

The parties had stipulated that capital gains realized with respect to the stock holdings in the various entities and interest paid by those entities on loans should be treated in the same manner as the dividends and as a consequence such amounts were also not apportionable. This was commented on by the Court in the decision but was not analyzed.

F.W. Woolworth Co. v. Taxation & Rev. Dept. (1982) 458 U.S. 354

Case argued in tandem with *ASARCO*. The Court held that New Mexico's taxation of a portion of dividends the taxpayer received from foreign subsidiaries that did not do business in the state violated due process.

"In *Mobil* we emphasized, as relevant to the right of a State to tax dividends from foreign subsidiaries, the question whether 'contributions to income [of the subsidiaries] result[ed] from functional integration, centralization of management, and economies of scale.' If such 'factors of profitability' arising 'from the operation of the business as a whole' exist and evidence the operation of a unitary business, a State can gain a justification for its tax consideration of **value** that has no other connection with that State. "

The Court found that the state had not shown that the taxpayer and its foreign subsidiaries operated as a unitary business. This is not normally the manner in which a burden of proof is applied. See the comment in *Container, infra*.

Container Corporation of America v. Franchise Tax Board (1983) 463 U.S. 159

Container is the leading case discussing the constitutional limitations placed upon the states' use of the unitary method. The decision upheld the constitutionality of California's worldwide unitary (combined report) method of accounting (involving a domestic parent), and establishes numerous propositions, including:

"The central purpose behind an apportionment formula is to ensure that each state taxes only its fair share of interstate transactions, but the Constitution does not impose any single apportionment formula on the states. Instead, the determination of whether a tax is fairly apportioned under Due Process and Commerce Clause analyses is made by examining whether the tax is 'internally' and 'externally' consistent. To be internally consistent, a tax must be structured so that if every state were to impose an identical tax, no multiple taxation would result. The external consistency test asks whether the state has taxed only the portion of the revenues from the interstate activity, which reasonably reflects the in-state component of the activity being taxed.

"California's three-factor apportionment formula is 'something of a benchmark against which other apportionment formulas are judged.' The three-factor formula used by California has gained widespread approval because payroll, property and sales appear in combination to reflect a very large share of the activities by which value is generated. No formula is 'perfect,' but 'we have seen no evidence demonstrating the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant."[A percentage increase in taxable income attributable to California of 14 percent between the methodology employed by the taxpayer and the methodology employed by the Franchise Tax Board was found to be permissible.]

"The out-of-state activities of a unitary business must be related 'in some concrete way' to the in-state activities. 'The functional meaning of this requirement is that there be some sharing or exchange of value not capable of precise identification or measurement - beyond the mere flow of funds arising out of a passive investment or a distinct business operation - which renders formula apportionment a reasonable method of taxation.""

"The taxpayer always has the distinct burden of showing by 'clear and cogent evidence' that the state tax results in extraterritorial values being taxed. One necessary corollary of that principle is that the Supreme Court will, if reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a unitary business. The task of the Supreme Court is to determine whether the state court applied the correct standard to the case and, if it did, whether its judgment 'was within the realm of permissible judgment.'

"While potential control is not 'dispositive' of the unitary business issue, it is 'relevant.""

The Court rejected a "bright line" rule which would require as a prerequisite to a finding that a business is unitary that it be characterized by a substantial flow of goods. "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods."

The Court rejected a "distortion" argument that taxpayer's foreign subsidiaries were significantly more profitable than were its domestic operations, and that the three-factor formula, by ignoring that fact and relying instead on indirect measures of income such as payroll, property, and sales, systematically distorted the true allocation of income between taxpayer and its foreign subsidiaries. The Court concluded the problem with this argument is "obvious," for the profit figures relied on by the taxpayer were "based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place."

The Court rejected a "distortion" argument that taxpayer's costs of production, especially wages of workers, in foreign countries were lower than in the United States, and that use of the formula unfairly inflated the amount of income apportioned to United States operations where wages are higher. The taxpayer and its foreign subsidiaries had been determined to be a unitary business. "It therefore may well be that in addition to the foreign payroll going into the production of any given corrugated container, there is also California payroll, as well as other California factors, contributing--albeit indirectly--to the same production."

The Court also introduced, as a test of fair apportionment, whether the apportionment formula satisfied "internal consistency" and "external consistency." Internal consistency was satisfied it it was assumed if every state applied the same formula no more than 100% of the income would be taxed. External consistency was satisfied if the formula reflected how income was earned.

Armco Inc. v. Hardesty (1984) 467 U.S. 638, 81 L.Ed.2d 540

Held that a West Virginia wholesale gross receipts tax, from which local manufacturers were exempt because they were subject to a manufacturing tax assessed at a higher rate, violated the Commerce Clause.

"It long has been established that the Commerce Clause of its own force protects free trade among the States.

"... One aspect of this protection is that a State 'may not discriminate between transactions on the basis of some interstate element.' That is, a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the state."

The Court also extended the "internal consistency" element of the fair apportionment prong of *Complete Auto Transit* dormant Commerce Clause test to discrimination. "A tax that unfairly apportions income from other states is a form of discrimination against interstate commerce." As a result an "internal consistency" analysis has become a common analytical tool in discrimination arguments.

Shell Oil Co. v. Iowa Dept. of Revenue (1988) 488 U.S. 19, 102 L.Ed.2d 186

The Court held the Outer Continental Shelf Lands Act did not prevent Iowa from including in the unitary tax base of its apportionment formula income earned from the sale of Outer Continental Shelf oil and gas, where the taxpayer was engaged in a unitary business.

The opinion pointed out that the function of an apportionment formula is to determine the portion of a unitary business's income that can be fairly attributed to in-state activities. Inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation in violation of the Commerce Clause.

Goldberg v. Sweet (1989) 488 U.S. 252, 102 L.Ed. 607

Held that Illinois statute that imposed <u>a transaction tax</u> on the gross charge of interstate telecommunications originating or terminating in Illinois did not violate the Commerce Clause. In order to prevent multiple taxation, the statute provided a credit to any taxpayer upon proof that the taxpayer had paid a tax in another State on the same telephone call that triggered the Illinois tax.

In an interesting discussion of the difficulties of taxing an industry undergoing "massive technological and legal changes."

"We doubt that States through which the telephone call's electronic signals merely pass have a sufficient nexus to tax that call. ... We also doubt that termination of an interstate telephone call, by itself, provides a substantial nexus for a State to tax a call. ... We believe that only two States have a nexus substantial enough to tax a consumer's purchase of an interstate telephone call. The first is a State like Illinois which taxes the origination or termination of an interstate telephone call <u>charged to a service address</u> within that State. The second is a State which taxes the origination or termination of an interstate telephone call <u>billed or paid</u> within that State. (Emphasis added.)

The Court also observed that "It is not a purpose of the Commerce Clause to protect state residents from their own state taxes."

<u>Amerada Hess Corp. v. Director, Div. of Taxation</u> (1989) 490 U.S. 66, 104 L.Ed.2d 58

The Court held that the "add-back" provision of the New Jersey tax, which denied the taxpayer a deduction for federal windfall profit tax paid, did not violate the Commerce Clause or Due Process Clause because New Jersey had substantial nexus with the activities that generated the taxpayer's entire net income.

The opinion stated that:

"The costs/expenses of a unitary business cannot be confined to the locality in which they are incurred. When a state denies a deduction for a cost of a 'unitary business,' the resulting net figure is still a unitary one, which a State may legitimately decide to apportion according to the standard three-factor apportionment formula.

"Even if a tax is fairly apportioned, it is possible for it to discriminate against interstate or foreign commerce. A tax may violate the Commerce Clause if it is facially discriminatory, has a discriminatory intent, or has the effect of unduly burdening interstate commerce.

"Some forms of discriminatory taxes might violate the equal protection clause even when they pose no Commerce Clause problem.

"The *Complete Auto* Commerce Clause test encompasses due process standards, and that a tax which satisfies all four prongs of the *Complete Auto* test also does not violate due process." (However, see *Quill, infra.*)

<u>Trinova Corp. v. Michigan Dept. of Treasury</u> (1991) 498 U.S. 358, 112 L.Ed.2d 884

Held that the Michigan single business tax (SBT) does not violate the Due Process Clause or the Commerce Clause, and rejected the argument that particular assignable costs of a business should be excluded from the tax base. (SBT apportionment formula multiplies a business's total added value (based on adjusted taxable income) by the portion of its business activity attributable to Michigan consisting of the average of three ratios: Michigan payroll to total payroll, Michigan property to total property, and Michigan sales to total sales.)

"The reasoning of *Amerada Hess Corp.* applies with equal force to the case here. The same factors that prevent determination of the geographic location where income is generated, factors such as functional integration, centralization of management, and economies of scale, make it impossible to determine the location of value added with exact precision."

Quill Corp. v. North Dakota (1992) 504 U.S. 298, 119 L.Ed.2d 91

The Court differentiated the nexus elements of Due Process and Commerce Clause analysis. Due Process nexus is based upon a sense of fairness or notice. An entity must meet a minimum contact level to be subject to tax. In contrast, the Commerce Clause nexus involves a means for limiting state burdens on commerce. Therefore, under the Due Process Clause, nexus is a question of fairness or notice and under the Commerce Clause, it is one of burdens or effects upon commerce, a balancing analysis.

The Court held, in a case involving imposition of the use tax collection duty on an out-ofstate mail-order house, and challenging <u>Bellas Hess</u>, that (1) if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum State, it may subject itself to the State's in personam jurisdiction, <u>even if</u> it has no physical presence in the state. "Thus, to the extent that our decisions have indicated that the Due Process Clause requires physical presence in a State for the imposition of duty to collect a use tax, we overrule those holdings as superseded by developments in the law of due process." But it also held, (2) the "substantial-nexus" Commerce Clause requirement of the <u>Complete Auto</u> analysis requires physical presence in a taxing state **at least** for sales and use tax purposes.

There have been a number of cases where states have refused to extend the *Quill* holding to taxes other than sales and use. The United States Supreme Court has denied certiorari in all of these cases.

<u>Allied-Signal, Inc. v. Director, Division of Taxation</u> (1992) 504 U.S. 768, 119 L.Ed.2d 533

In case involving state's constitutional power to include in taxpayer's apportionable tax base income from gain on sale of stock, the Court, in a 5 to 4 decision, held that apportionment of all income is not permitted by the mere fact of corporate presence within the state. A unitary relationship between the payor and the payee is one means to constitutionally permit apportionment, but not the only one. Even when payee and payor are not engaged in a unitary relationship, income may be constitutionally apportioned if the capital transaction serves an "operational" rather than an "investment" function. All 9 Justices reaffirmed that the unitary business principle was the appropriate standard to apply in determining a state's ability to consider all of a businesses income for purposes of taxation.

Kraft v. Iowa (1992) 505 U.S. 71, 120 L.Ed.2d 59

State statute which treats dividends received from foreign subsidiaries less favorably than those received from domestic subsidiaries by including the former, but not the latter, in taxable income, facially discriminates against foreign commerce in violation of the Commerce Clause. Conformity to the Internal Revenue Code is no defense. (Note: combined report states <u>may</u> avoid this problem.)

Wisconsin v. Wrigley (1992) 505 U.S. 214, 120 L.Ed.2d 174

For purposes of Public Law 86-272 (15 U.S.C. Sec. 381) immunity, "solicitation of orders" includes not only any speech or conduct that explicitly or implicitly proposes a sale, but also covers those activities that are "entirely ancillary" to requests for purchases. Activities are "entirely ancillary" if they serve no independent business function apart from their connection to the soliciting of orders. There is also a de minimis exception to

the activities that forfeits Section 381 immunity. Whether a particular activity is sufficiently de minimis depends upon whether that activity (or activities taken together) establishes a nontrivial additional connection with the taxing State.

West Lynn Creamery, Inc. v. Healy (1994) 512 U.S. 186, 129 L.Ed.2d. 157

The constitutionality of a tax measure is to be judged by its overall effect, not by a separate analysis of its component parts. In this case Massachusetts enacted a statute which assessed an identical tax on in-state and out-of-state dairies and use the proceeds to fund a credit that could only be received by in-state dairies. The Court found that the tax portion of the statute did not discriminate because it was applied equally to the two types of taxpayers and the credit was permissible to encourage activity within the state. However, the pairing of the two measures resulted in favoritism for in-state activities and therefore discriminated unconstitutional in favor of Massachusetts based companies.

<u>Barclays Bank PLC v. FTB</u> and <u>Colgate-Palmolive Co v. FTB</u> (1994) 512 U.S. 298, 129 L.Ed.2d. 244 (Colgate, 510 U. 806)

Barclays addresses the unanswered issues from *Container Corporation of America, supra*. The Court upheld the right of the States to apply worldwide combined reporting to a unitary business headquartered in a foreign country and reaffirmed its decision in *Container* that the worldwide combined report method was constitutionally permissible to a United Statesbased unitary business. With the movement to water's-edge combined reporting, either elective or required, the *Barclays* decision may be more of a historical footnote than a watershed decision.

Whether the taxpayers, and their related entities, constituted unitary businesses was not a question presented to the Court. In dicta, however, the Court addressed two significant unitary questions. First, in footnote 1 of the decision, the Court endorsed three separate judicial formulations of tests for unity. These are the *Mobil* test of "functional integration, centralization of management and economies of scale;" the *Edison Stores* test of "dependency or contribution;" and the *Butler Bros*. three unities test. Second, in footnote 10, the Court found that the unitary business principle provides sufficient nexus to allow the taxing state to consider the results and activities of members of the unitary business which themselves had no direct connection with the taxing state in determining the amount of tax owed by members of the unitary business which were directly present in the state.

Oklahoma v. Jefferson Lines, Inc. (1995) 514 U.S. 175, 131 L.Ed.2d 261

Oklahoma sales tax on the full value of a ticket purchased in Oklahoma for travel into other states was upheld. The tax was examined under the four-part *Complete Auto Transit* test and was found to be permissible. The nature of the tax, a transaction tax, was controlling. The fact that a method of apportionment could be easily applied did not negate the appropriateness of the state where the transaction took place assessing the full

amount of the transaction. The tax passed "internal consistency" because only one state could assert a tax based upon the situs of the transaction.

Fulton Corporation v. Faulkner (1996) 516 U.S. 325, 133 L.Ed.2d 796

The decision strikes down that portion of a North Carolina tax on intangibles which allowed a deduction to the extent the issuer of the intangible had been subject to the North Carolina income tax because it was found to discriminate against interstate commerce. North Carolina imposes a tax on intangibles measured by their value. A deduction was allowed to the extent the corporate issuer of the intangible had paid a tax on its income to North Carolina. The amount of income taxed by North Carolina was determined by application of the three-factor apportionment formula. North Carolina attempted to defend the deduction solely on the basis of the "compensatory tax" doctrine. (See <u>Henneford v. Silas Mason Co.</u>, (1937) 300 U.S. 577, 81 L Ed 814 and <u>Associated Industries of Missouri v. Lohman</u>, (1994) 511 U.S. 641, 128 L. Ed2nd 639) North Carolina's attempt to identify the intrastate tax for which it was compensating was unsuccessful. The Court held that it was virtually impossible to defend a specific tax on the basis of general forms of taxation.

Hunt-Wesson, Inc. v. Franchise Tax Board (2000) 528 U.S. 458, 145 L.Ed.2d 974

The decision strikes down California's interest offset rule, Section 24344(b) of the California Revenue and Taxation Code. That section provided rules for the allocation of interest expense between apportionable and nonapportionable income based upon a dollar-for-dollar relationship to particular types of income. The Supreme Court rejected California's method of allocating on a dollar-for-dollar basis as not bearing a rational relationship to the underlying income. The statement of decision indicates that the California statute violates both the Commerce and Due Process Clauses. The analysis appears to be basically Due Process oriented.

Meadwestvaco Corp. v. Illinois Department of Revenue (2008), 170 L.Ed. 2d. 404.

The taxpayer was principally a paper company based in Ohio that had acquired Lexis a number of years before. It sold Lexis and Illinois attempted to treat the gain on the sale as apportionable income. The lower court in Illinois has held that Lexis as not part of the unitary paper unitary business. The Illinois Supreme Court without addressing the unitary determination with respect to Lexis held that the gain was apportionable income.

<u>The Supreme Court decision was a A non-decision on the merits</u>, in the sense that the case was remanded to the Illinois' courts for further consideration. Upon remand the case was apparently resolved by the parties without further judicial consideration.

The decision holds that the Illinois courts had misapprehended the principles the Court has developed for determining whether a multistate business is unitary. Reaffirmed the holding in *Allied-Signal* that apportionment is constitutional even though the payor and payee were not engaged in the same unitary business.

Clarified that "operational function" is not a new ground justifying apportionment. An asset can be part of a unitary business even if we may term a "unitary relationship" does not exist between the "payor and payee."

Direct Marketing Association v. Brohl (2015) 135 S. Ct. 1124, ____ U.S. ____

An appeal from a Tenth Circuit decision that a challenge to a Colorado statute requiring notice and reporting duties on retailers not otherwise collecting Colorado sales and use taxes was barred from consideration by the federal courts under the Tax Injunction act, 28 USC Sec 1341. The Supreme Court held that because the Colorado act did not impose collection requirements on the retailers the Tax Injunction did not bar federal court consideration. The case was remanded to the Tenth Circuit. In a concurring opinion Justice Kennedy questioned the current vitality of the *Quill* decision that physical presence was required to assess sales and use taxes and appeared to invite a new challenge.

Direct Marketing Association v. Brohl, Tenth Circuit, February 22, 2016, U.S. Docket 16-458, cert. denied Dec 12, 2016.

The Tenth Circuit on remand from the United States Supreme Court, limited *Quill* to the liability for actual collection and remittance of, sales and use taxes. It sustained the Colorado statute requiring retailers to notify their customers of their duty to pay such taxes and requiring them to provide the state with information on their customers' purchases.

3. <u>SIGNIFICANT DECISIONS - CALIFORNIA</u>

Hoechst Celanese v. Franchise Tax Board (2001) 25 Cal.4th 508

Hoechst realized gain on the liquidation of an employee retirement plan. The California Supreme Court held that this gain was business income subject to apportionment. The court found that the business income definition in UDITPA consisted of both a "transactional" and "functional" test and that the liquidation of the retirement plan gave rise to business income under the functional test. For further discussion see pp. 91-101, *infra*.

Farmer Bros. Co. v. Franchise Tax Board (2003) 108 Cal.App.4th 976

Section 24402 of the California Revenue and Taxation Code allowed a dividends received deduction to the extent the dividends were paid from earnings and profits that had been included in the measure of California tax. The Court of Appeal held that the deduction discriminated against interstate commerce because no deduction was allowed if the dividends were received from earnings and profit that had not been included in the income that California had taxed.

Fujitsu IT Holdings, Inc. v. Franchise Tax Board (2004) 120 Cal.App.4th 459

The Court of Appeal held that 1) the United Kingdom's Advance Corporate Tax refund was a dividend for California purposes; 2) that in calculating the inclusion ratio for Subpart F income under a water's-edge election, the previously taxed income provisions of the Internal

Revenue Code are applicable. and such income should not be taken into account in the inclusion ratio; 3) that dividends should be first treated as being eliminated under section 25106 without regard to when the earnings and profits from which they are paid arose; and 4) the treatment of dividends under section 24411 was not discriminatory.

Jim Beam Brands Co. v. Franchise Tax Board (2005) 133 Cal.App.4th 514

Jim Beam sold unitary subsidiaries engaged in a particular line of business, terminating its participation in that line of business. The Court of Appeal held that the gain realized on disposition was business income subject to apportionment even though the disposition resulted in cessation of that particular line of business. For further discussion see pp. 93-94, *infra*.

Microsoft Corporation v. Franchise Tax Board (2006) 39 Cal.4th 750

Microsoft filed claims for refund to include the total proceeds it realized from making shortterm investments of idle cash in a variety of securities ("Treasury activity") in the denominator of its sales factor. The denominator of the sales factor without such receipts was \$2.1 billion; with such receipts, the denominator would be \$7.8 billion. The California Supreme Court first found the definition of gross receipts was broad and unambiguous and included the total proceeds realized on redemption. It did not discuss the nature of the various securities. Second, it held that in the circumstances of the *Microsoft* case, including such receipts in the sales factor would result in an unfair reflection of the taxpayer's activity in California. For a more complete discussion of this case see p. 140, *infra*.

General Motors Corporation v. Franchise Tax Board (2006) 39 Cal.4th 773

Delco, a subsidiary of General Motors included in the combined report filed in California, had research and development expenses in California that qualified for a tax credit. The credit attributable to Delco was in excess of the income assigned to it under the combined report. General Motors claimed that the credit should be allowed to the unitary business, rather than limited to Delco. The California Supreme Court held that the research and development credit is computed and allowed on an entity basis. In 2008 Legislation was enacted which allows for the one-time transfer between members of a unitary business of credits that existed as of July 1, 2008 for use in a taxable year beginning on or after January 1, 2010. Sec. 23662 Revenue and Taxation Code, Chap. 763, Laws 2008.

General Motors also involved the question of the proper apportionment factor treatment of Treasury Activity. This case was decided the same day as *Microsoft*. In this case, however, in contrast to the decision in *Microsoft*, the California Supreme Court considered the nature of the various transactions entered into as part of the Treasury Activity. It held, that for loan transactions only the interest income and net gains should be included in the receipts factor and that the investment in "repos" constituted a loan and the repayment of the principal of the loan did not constitute a receipt for purposes of the sales factor. The Court did not discuss the nature of the other securities and remanded the case to the lower courts for further consideration in light of the *Microsoft* and *General Motors* decisions.

Macy's Department Stores, Inc. v. City and County of San Francisco (2006) 143 Cal.App.4th 1444 (cert denied (2007) 168 Led2nd 727)

Macy's successfully brought an action against San Francisco alleging that a city tax assessed on the greater of an amount measured by payroll or gross receipts was unconstitutional because if violated the "internal consistency" standard of fairly apportioned/discrimination. The decision discusses the remedy to which Macy's was entitled. The decision holds that Macy's was only entitled to a refund equal to the difference between the tax it paid and what it would have been assessed on a nondiscriminatory basis.

Ordlock v. Franchise Tax Board (2006) 38 Cal 4th 897

The California Supreme Court, held that the general four-year statute of limitations provided for in section 19057 remains open as a result of sections 19059 and 19060, which provide special limitation periods when the Internal Revenue Service makes changes to the taxpayers federal tax liability. It found that the provision of section 18622, which does not require the taxpayer to report a federal change if there is no California consequence, did not provide an exception to the rules of sections 19059 and 19060. The lower appellate court had held that section 18622 provide such an exception because under the normal four-year statute, no assessment could be made for federal changes after that period, and therefore, there would be no California consequence. The Supreme Court found that the phrase "except as otherwise expressly provided in this part" included sections 19059 and 19060 in section 19057. The California Supreme Court's decision is consistent with long-standing FTB practice and numerous decisions of the California State Board of Equalization.

City National Corporation v. Franchise Tax Board (2007) 146 Cal.App.4th 1040

City National filed a suit for refund while Notices of Proposed Assessment were pending which the taxpayer was contesting at the administrative level. Under the authority of *Pope Estate v. Johnson* (1941) 43 Cal.App.2d 170, a suit for refund requires that all tax liabilities for a time period must be litigated in a single action. The Franchise Tax Board filed a demurrer on the grounds that a suit for refund can only be brought after all amounts due are paid. The trial court sustained the demurrer. The Court of Appeal overruled the demurrer, holding that only that tax which is final must be paid in order to bring a suit for refund and because Notices of Proposed Assessment are not final their existence is not a bar to a suit for refund. The decision does not address the interaction of the rule in *Pope Estate* with its determination other than to say *Pope Estate* does not make a proposed assessment final.

The Franchise Tax Board petitioned the California Supreme Court for review. Review was denied. Until the interaction with the *Pope Estate* decision is clarified taxpayers may have the option of bringing a suit for refund before an audit has even been commenced for a year and attempt to have a final adjudication of their tax liability for that year.

The case was settled without further proceedings.

The Limited Stores, Inc. v. Franchise Tax Board (2007) 152 Cal.App.4th 1491

The Limited is another case involving the question of the proper apportionment factor treatment of Treasury Activity. The case was decided on remand from the California Supreme Court after the decisions in *Microsoft* and *General Motors*. The Limited Stores argued that its circumstances were different than those involved in *Microsoft* because its Treasury Activity was a *fundamental* rather than an *incidental* activity of the business. The appellate court rejected this distinction holding that whether or not the revenue is used only to complement the company's primary business is not the test. For a more complete discussion of this case see pp. 146, *infra*

Northwest Energetic Services LLC v. Franchise Tax Board (2008) 159 Cal.App.4th 841

In 1996 California adopted legislation providing for the assessment of fees on Limited Liability Companies doing business in this state, section 17941(a), or registered with the Secretary of State, section 17941(b). A minimum tax of \$800 is assessed which is identical to the minimum tax assessed on most corporations. Section 17941.

In addition section 17942 imposes a fee based upon "the total income from all sources reportable to this state for the taxable year." The fee has five graduated steps. Those graduated steps are currently: zero if the total income is less than \$250,000, \$900 if the total income is between \$250,000 and \$500,000, subsection (a)(1); \$2,500 if the total income is between \$500,000 and \$1,000,000, subsection (a)(2); \$6,000 if the total income is between \$1,000,000 and \$5,000,000, subsection (a)(3); and \$11,790 if the total income is in excess of \$5,000,000, subsection (a)(4). Total income is defined as gross income plus the cost of goods sold. Section 17942.

Northwest did no business in California and was subject to the fee because it had qualified with the California Secretary of State. The court held that the fee was a tax imposed upon an unapportioned base of income unrelated to California and was therefore unconstitutional as applied.

<u>Ventas Finance I, LLC v. Franchise Tax Board</u>,(2008) 165 Cal. App. 4th 1207. (cert denied 77 USLW 3558)

Ventas is another LLC Fee case. Ventas did business within and without California with approximately eight percent of its business done in California as determined by the standard three-factor apportionment formula. The trial court, similar to the decision in *Northwest*, determined that fee was unconstitutional as applied to Ventas because it was an unapportioned tax. The trial court also determined that the fee was not susceptible to reformation by the court. In 2007 the California Legislature passed, and the Governor signed, AB-198, which limits the remedy in the LLC Fee cases to the difference between the fee due on apportioned base and an unapportioned base. The appellate court also held that the unapportioned fee was unconstitutional and rejected judicial reformation of the

statute. The appellate court held, however, under the authority of *Macy's Department Stores, Inc. v. City and County of San Francisco* (2006) 143 Cal.App.4th 1444, (cert. Denied 168 Led2nd 727) that Ventas' remedy was limited to the difference between the amount paid and the amount that would have been paid if the fee had been assessed on an apportioned basis. The appellate court did not rely on the 2007 California legislation.

Abbott Laboratories v. Franchise Tax Board, 175 Cal. App. 4th 1346 (2009).

This case involves the question of the remedy to be applied as a result of the decision in *Farmer Bros Co. v. Franchise Tax Board* (2003) 108 Cal App 4th 976, that the dividends received deduction limited to dividends paid from earnings and profits that had previously been subject to California tax discriminated against interstate commerce and was therefore unconstitutional. In an unpublished decision the appellate court held that the taxpayer was not entitled to a deduction with respect to any dividends. The appellate court held that the statute could not be reformed and allowing any deduction would be inconsistent with the apparent legislative intent.

The decision does not discuss section 19393 of the Revenue and Taxation Code. This section provides that if the allowance of a deduction is found to discriminate the remedy is to deny the deduction. The taxpayers argued that section 19393 only applies to national banks and that the statute can be reformed to allow a deduction for all dividends.

General Mills, Inc. v. Franchise Tax Board, (2009) 172 Cal App 4th 1535

General Mills engaged in hedging transactions with respect to its grain inventories and sought to include the full nominal consideration received upon the sale of an option contract regardless of whether the goods were delivered. The trial court concluded that there was no sale because no goods were delivered under the contracts and excluded amounts related to the contracts from the sales factor. In addition, the trial court held that if the amounts involved were determined to meet the definition of sales, including them in the sales factor would not fairly reflect the taxpayer's activities in the state.

On appeal the Court of Appeal held that the hedging transactions gave rise to sales for purposes of the apportionment formula equal to the total amount of the contract (the number of bushels sold multiplied by the price per bushel in the contract). The court found that the contract established a legally binding obligation to deliver a specified amount of the commodity at a specified price at a specified time. Offsetting the contract by another contract did not extinguish the contract but instead constituted receipt of consideration which should be included in the sales factor.

The Franchise Tax Board sought review with the California Supreme Court which was denied on a split vote. The appellate court remanded the case to the trial court for consideration of whether including these sales in the receipts factors would result in an unfair reflection of income. See subsequent *General Mills* case p. 28.

Apple, Inc. v. Franchise Tax Board, (2011)199 Cal App. 4th 1.

Apple received dividends from various foreign subsidiaries. Some portions of the dividends were eligible for deduction under various provisions of the Revenue and Taxation Code. Dividends classified as being paid from income previously included in the combined report are eliminated under section 25106 and no expenses can be attributed to such dividends. Expenses related to dividends deductible under other sections of the Revenue and Taxation Code can be disallowed under section 24425. The Franchise Tax Board took the position, sustained by the Board of Equalization, that for purposes of determining what section dividends were eliminated or deducted under, the dividends should be considered year by year on a last-in-first-out basis and should be treated as paid proportionally from the earnings and profits of the year. This is contrary to the holding in *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459.

Apple filed a suit for refund challenging the Board of Equalization's holding, San Francisco Superior Court CGC08471129. The trial court determined that the Franchise Tax Board was correct that dividends should be considered year-by-year on a last-in-first-out basis but held that the Franchise Tax Board's allocation of expenses to such dividends was incorrect which resulted in the refund being allowed in full. In spite of the fact that Apple was granted a refund of all amounts at issue it filed an appeal. The Franchise Tax Board sought to have the appeal dismissed as there was no issue of the amount due. The appellate court denied the request and stated it would consider that question along with the question of the treatment of dividend payments.

The appellate decision determined that dividends should be considered on a last-in-first-out basis. The court sustained the decision of the trial court that a full refund was appropriate and did not rule on the appropriateness of an appeal when the relief requested had been granted. Apple petitioned the California Supreme Court for review which was denied.

Gonzales v. Franchise Tax Board, (2011) 51 Cal 4th 1006

The issue presented to the California Supreme Court on a petition for review by the Franchise Tax Board is whether a taxpayer has a right to a jury trial in a tax refund lawsuit. On June 6, 2011 the California Supreme Court reversed and held that a taxpayer was not entitled to a jury trial in a suit for refund.

Dicon Fiberoptics Inc. v. Franchise Tax Board, (2012) 53 Cal 4th 1227, 274 Pac 3rd 446

The taxpayer claimed Enterprise Zone Credits supported by vouchers issued by a local agency. The Franchise Tax Board in auditing the claimed credits requested supporting documentation that the employees qualified. The taxpayer was unable to supply the documentation and the Franchise Tax Board denied the credits. A suit for refund was filed challenging the Franchise Tax Board's right to audit the vouchers and the Franchise Tax Board filed a demurrer alleging that no grounds were set forth in the claims. The demurrer was sustained without leave to amend. The Court of Appeal reversed and remanded holding that all that was required in a complaint for refund of taxes was allegations the taxes were paid, a claim filed and the claim was denied. Alternatively the

court of appeal held that the complaint could be amended to allege the reasons the claim should be allowed. The court of appeal held that the Franchise Tax Board had the right to audit the claimed credits, but the existence of the vouchers were *prima facie* evidence that the requirements for the credit were met and the Franchise Tax Board had the burden of proof of showing the employees did not qualify for the credit.

The California Supreme Court held that

As a textual matter, we find nothing in section 23622.7 that displaces or qualifies either the FTB's statutory authority to conduct an audit or the general principle in our case law that the taxpayer has the burden of proof in a suit for a refund. By its terms, section 23622.7 does not abrogate the general rule that the FTB is not "bound by the determination of any other officer or administrative agency of the state." (§19801.) Nor does the text of section 23622.7 otherwise limit the FTB's authority or expressly designate the certifying agencies as the exclusive arbiters of who is a qualified employee.

Cutler v. Franchise Tax Board, (2012) 208 Cal.App.4th 1247

This is a personal income tax case involving discrimination against interstate commerce. California allowed personal income taxpayers to defer the reporting of gain in qualified small business corporations. The deferral was available, however, only if the stock sold and purchased was issued by corporations that used 80 percent of their assets in the conduct of business in California and that maintained 80 percent of their payrolls in California. (Rev. & Tax. Code, §18152.5, subds. (c)(2)(A), (e)(1)(A) & (e)(9).)

The Court of Appeal found its decision controlled by the United States Supreme Court's decision in *Fulton Corp. v. Faulkner* (1996) 516 U.S. 325. The court said

The fact remains that the purpose and effect of the statute is, as *Fulton* forbids, to "favor investment in corporations doing business within the State" (*Fulton, supra*, 516 U.S. at p. 343), and the statute operates as a "disincentive … to buying stock in corporations doing business out of state." (*Id.* at p. 341.) As in *Fulton*, the statute "favors domestic corporations over their foreign competitors in raising capital among [California] residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce." (*Id.* at p. 333.)

In 2013 the Legislature passed, and the Governor signed, AB 1412 (Stats. 2013, Ch. 546) that retroactively amended Rev. & Tax. Code, §18152.5 to remove the requirements regarding the location of property and payroll. As a result taxpayers can file amended returns for years open under the statute to claim the deferral.

General Mills, Inc. v. Franchise Tax Board, (2012) 208 Cal.App.4th 1290

The Court of Appeal revisited this case after its 2009 decision that receipts from hedging activities were definitionally includible in the sales factor. On remand the trial court determined that such receipts should be excluded under Section 25137 of the California Revenue and Taxation Code, Section 18 of UDITPA.

The Court of Appeal held that

We conclude that General Mills's hedging activity—while integral to General Mills's main consumer food business is both qualitatively different from General Mills's other sales that are made for profit and substantially distorts the percentage of General Mills's income that is apportioned to California. The Franchise Tax Board's alternate formula, including only the net gains from General Mills' futures sales, is reasonable and may be imposed consistent with UDITPA.

As to the tests the Court of Appeal said, "The trial court found: 'While the parties in their proposed Statements of Decision have discussed two separate tests as requirements, the qualitative and quantitative, these decisions don't discuss separate qualitative and quantitative tests but rather the discussion concerns both effects.' We agree."

For a more detailed discussion of the decision in pp. 137, 153-157 *supra*.

Microsoft Corp. v. Franchise Tax Board, (2012) 212 Cal.App.4th 78

At trial there were three significant apportionment issues involved in this case. First, is the question of whether licensing fees received by Microsoft from original equipment manufacturers for installing Microsoft software on computers sold by the manufacturers are from the licensing of tangible or intangible property. Second, whether the exclusion of receipts from treasury activity from the sales factor was necessary to fairly reflect Microsoft's activity in California. And third, if the exclusion of receipts from treasury activity from the sales factor was necessary whether it was reasonable for the Franchise Tax Board not to adjust the apportionment formula to a) take into account Microsoft's intangible property in the apportionment formula and b) to equally weight the sales factor with the other factors of the apportionment formula. The trial court ruled in favor of the Franchise Tax Board on all three issues.

At issue before the Court of Appeal was only the question of the numerator assignment of receipts from the licensing of software products to original equipment manufacturers who installed the software on computers that sold purchasers of their computers. The trial court had held that the license agreements constituted the sale of tangible personal property and should be assigned to the state in which delivery occurred to the manufacturer. Microsoft contended that the sales were from the licensing of intangible property and should be assigned to the state with the predominate location of the income producing activity. The Court of Appeal relied on two sales and use tax cases in concluding that the transactions involved the licensing of intangible property and therefore receipts should be assigned based on the income producing activity that gave rise to the intangibles. *Preston v. State Bd. of Equalization (2001) 25 Cal.4th 197*"... the separate and distinct *transfer of a copyright—an intangible right distinct from 'any material object in which the work is embodied.*' In so holding, the court also found intangible property includes a license to use information protected under a copyright or patent. Thus, *Preston* supports plaintiff's position that the OEM licenses— granting the right to replicate and install—are best understood as involving an intangible property right. The amendment of Section 25136 to provide assignment based on where the benefits are received would reach a different result.

In *Nortel Networks, Inc. v. State Board of Equalization (2011) 191 Cal.App.4th 1259* the Court held the software was exempt from sales tax because it was protected intellectual property, copied by the licensee onto its computers for the purposes of making and selling products (telephone calls) embodying the copyright. (*Id.* at p. 1264.) The court noted the TTA statutes cover "any" transfer of an interest subject to a patent or copyright, which included the canned software.

<u>The Gillette Co. v. Franchise Tax Board</u>, California Supreme Court, No. S206587, December 31, 2015

Article III.1 of the Multistate Tax Compact allows a taxpayer to elect to apportion its income pursuant to the state's law or Article IV of the Compact which is UDITPA. In adopting a double-weighted sales factor in 1994 the California Legislature included language that stated "Notwithstanding" California's adoption of the Compact double-weighted sales would be used. Gillette and a number of other taxpayers so filed claims for refund to elect to use UDITPA's equally-weighted three factor formula. The Trial Court granted the FTB's demurrer but the Court of Appeal held that the "Notwithstanding" language impaired a contract in violation of the federal and California Constitutions and that such language also violated other California Constitutions regarding legislative actions.

The California Supreme Court held that the Compact did not constitute a contract between the states and that the "Notwithstanding" language was effective to disable the election provided by the Compact. This issue is being pursued in a number of other states. A Petition for Writ of Certiorari was filed with the United States Supreme Court and was denied on October 11, 2016 (Docket 15-1442)

Harley-Davidson v. Franchise Tax Board, 237 Cal App 4th 193 (2015),

The taxpayer had two special purpose entities (SPEs) that facilitated making loans to customers and securitizing the loans so they could be marketed. The separate entities had no direct presence or business activity in California, but various other related entities were agents for the SPEs. It was found that agents' activities in California conferred

taxable nexus over the two SPEs. The appellate court rejected the taxpayer's Due Process and Commerce Clause concerns. On the due process question, the court concluded that the SPEs, through their agent, had minimum contacts with California such that the state's taxation of the SPEs did not offend "traditional notions of fair play and substantial justice." Finally, in response to the taxpayer's argument that the substantial nexus required by the commerce clause is lacking because the SPEs lacked a physical presence in California, the court found that the SPEs' agent's participation in 17 auctions in California during the years at issue established a substantial nexus for commerce clause purposes.

An additional issue before the court was whether allowing wholly in-state unitary business to file on a combined report discriminated against interstate taxpayers. The trial court had sustained a demurrer on this question and the appellate court remanded it back to the trial court including a statement that the treatment was discriminatory but could survive if it past strict scrutiny. See further discussion in pending cases.

Hyatt v. Franchise Tax Board, Nevada United States Supreme Court

Plaintiff filed a lawsuit alleging various torts arising from a residency audit conducted by the Franchise Tax Board that resulted in the issuance of Notices of Proposed Assessment for two years primarily on the grounds that the plaintiff was a resident of California rather than Nevada for the period in question. After a 17 week trial a Nevada Jury awarded the plaintiff over \$490 million in damages, which included punitive damages of \$250 million. The case was argued before the Nevada Supreme Court in June of 2012. The Nevada Supreme Court issued a decision in September of 2014 sustaining a fraud penalty against the Franchise Tax Board in the amount of slightly more than \$1 million, remanding the case for a retrial on damages for the infliction of emotional distress because of errors in jury instructions and reversing and dismissing all other awards. A new trial date has not been set.

The Franchise Tax Board filed a petition for certiorari with the United States Supreme Court and in an unusual action certiorari was granted in spite of the earlier decision by the Court that the case could proceed in Nevada. Oral argument was held in early December of 2015. Forty-five states filed amicus briefs urging the Court to hold that a suit could not be brought against one state in another state's courts. In the course of the oral argument it appeared that at least 4 Justices were receptive to that view. Among those Justices was Antonia Scalia.

The Court divided 4-4 on whether to overrule *Nevada v. Hall.* Over-ruling *Nevada v. Hall* would have resulted in the dismissal of the Nevada Supreme Court judgment and vacated any judgement against the Franchise Tax Board. The Court ruled 6-2 that Hyatt's damages were limited to the amount that could have been awarded to a Nevada agency, \$50,000 per count.

4. <u>PENDING CASES</u>

<u>Bakersfield Mall, LLC v. Franchise Tax Board</u>, San Francisco Superior Court CGC0746278 <u>CA-Centerside I,I LLC v Franchise Tax Board</u>, Fresno Superior Court 10CEGC00434

LLC Fee cases where it has been alleged the companies did business only in California. These cases have now been consolidated and are known as *Judicial Council Coordianation Proceeding 4742.* An effort to make this into a class case was denied and an appeal has been taken from that denial. Briefing is complete.

Bunzl Distribution v. Franchise Tax Board, First Appellate District A137887

The plaintiff conducted a unitary business with a number of limited liability companies. Each of the limited liability companies were single-member LLC's owned by corporations that were members in the plaintiff's unitary business. Only the LLC's conducted business in California. At issue in the case is whether the single-member LLC's should have their income and apportionment factors included in the combined report of plaintiff. The trial court ruled in favor of the Franchise Tax Board. <u>An appeal</u> was filed, briefing is complete.

Hyatt v. Yee et al, 2:14 CV-008490 GEB DAD

Hyatt filed an action in federal court alleging that the length of time his tax case was pending before the Franchise Tax Board and the State Board of Equalization, in excess of 20 years, denied him Due Process of law. The Federal District Court dismissed the lawsuit with prejudice as barred by the Tax Injunction Act. Hyatt filed an appeal with the Ninth Circuit, 15-15296. Oral argument occurred in February.

Harley-Davidson v. Franchise Tax Board, Fourth Appellate District D064241, *Abercrombie & Fitch v. Franchise Tax Board,* Fresno 12 CECG03408

The primary issue in these cases is whether Section <u>2325101</u>.15 which allows wholly intrastate unitary businesses to elect to file on a separate or combined report basis discriminates against interstate commerce because multi-jurisdictional unitary businesses cannot elect to file on a separate basis. In *Harley-Davidson* the trial court sustained a demurrer that this treatment does not unconstitutionally discriminate against interstate commerce.

The appellate court in *Harley-Davidson* held that the demurrer should not have been granted and remanded the case back to the trial court. It offered the opinion that there was facial discrimination that could only be justified under "strict scrutiny" In *Harley-Davidson* the trial court concluded that the appellate court's comments on discrimination were only *dicta* because it was limited to deciding whether the demurrer had been

improvidently granted. The trial judge ruled there was not discrimination and that even if there was the legislation passed strict scrutiny.

In *Abercrombie* the trial court granted a motion for judgment in favor of the Franchise Tax Board after the plaintiff had presented its evidence.

Both cases are not on appeal.

. . . .

CHAPTER 2

ATTRIBUTIONAL/AGENCY NEXUS

1. <u>UNITED STATES SUPREME COURT DECISIONS</u>

Activities performed in California on behalf of a taxpayer may, in many cases, establish nexus to tax.

a. <u>Scripto v. Carson</u>

The Supreme Court's decision in <u>Scripto Inc. v. Carson</u> (1960) 362 U.S. 207, established two important agency principles. First, it established there is no constitutional significance to the label placed upon the agent, because it is the local <u>function</u> of the agent, not his title, which is controlling. The Court expressly found that "[t]he formal shift in the contractual tagging of the salesman as 'independent' neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into Florida." (362 U.S. at 211.) Second, *Scripto* held that from a constitutional standpoint, it is unimportant whether the agent worked for several principals. (*Ibid*.)

b. <u>Tyler Pipe Industries, Inc. v. Washington Dept. of Revenue</u>

The Supreme Court's decision in <u>Tyler Pipe Industries, Inc. v. Washington Dept. of</u> <u>Revenue</u> (1987) 483 U.S. 232, affirmed the principles established over 25 years earlier in <u>Scripto</u> that nexus cannot be defeated by labeling a taxpayer's representative as an independent contractor instead of as an agent. The Court looked with approval to the analysis of the Washington Supreme Court that "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." (483 U.S. at 250.)

c. Non-tax decisions

In <u>J. McIntyre Machinery, Ltd v. Nicastro</u>, 131 S. Ct. 2780 (2011), a product liability case the Court held that there was no Due Process nexus over a company that had machinery in the state and casting doubt upon prior decisions that held placing goods in the "stream of commerce" was sufficient to establish jurisdiction to tax. It is not clear whether this reasoning will be extended to the tax area. See also <u>Walden v. Fiore</u> 134 S.Ct. 1115 (2014), a question of personal liability involving the issuance of a seizure of money.

2. <u>SIGNIFICANT CALIFORNIA DECISIONS</u>

a. Illinois Commercial Men's Association v. State Board of Equalization

The first of the leading California decisions on the agency issue is <u>Illinois Commercial</u> <u>Men's Association v. State Board of Equalization</u> (1983) 34 Cal.3d 839. The facts of the case were that two foreign insurance companies brought actions against SBE for refunds of gross premium taxes paid. The companies solicited business in California by mail from outside the state and utilized independent contractors in California to perform functions incident to the acceptance of applications and the administration of claims. The issue was whether the contacts between the insurers and the state justified imposition of the tax under the Due Process Clause. (34 Cal.2d at 843.)

The California Supreme Court found no due process violation. The court undertook a lengthy discussion of the ties which established nexus in California under agency principles:

"Plaintiffs claim that, like the retailer in National Bellas, they have no employees or property in California, and their activities in this state amount substantially to communication with customers by mail. They assert that the application, verification, and claims procedures described above were minimal and sporadic, and were insufficient to justify imposition of the tax. We disagree.

"We observe, first, the fact that a foreign corporation performs acts in the taxing state through persons it designates as independent contractors is not determinative of whether the nexus required for taxation is present ..., [discussion of *Scripto*]

"In the present case likewise, the circumstance that investigation and/or settlement services on behalf of plaintiffs in California were performed by independent contractors is of little constitutional significance. The undeniable fact is that they were acting as agents of plaintiffs. Although plaintiffs assert a distinction between the present case and <u>Scripto</u> because the salesmen in <u>Scripto</u> solicited business for the foreign corporation, whereas here plaintiffs' agents did not perform that function, we are unimpressed by such distinction. What is significant in the present context is that the investigation and settlement of claims is an integral and crucial aspect of the business of insurance. Either or both of these functions were performed with respect to California policyholders by agents of plaintiffs residing in this state.

"That plaintiffs' agents, whose officers were in California, received the protection of this state's laws can hardly be doubted. In <u>Scripto</u>, the 'benefit' aspect of the constitutional test was not discussed, apparently on the assumption that a foreign corporation which has agents in the taxing state also receives the protection of that state's laws. ... [I]n the present case, the agents employed by plaintiffs performed for them a function crucial to the administration of the insurance policies covering California residents. The benefits afforded to these agents also benefited plaintiffs." (34 Cal.3d at 849-850, citations omitted, emphasis added.)

b. Scholastic Book Clubs, Inc. v. State Board of Equalization

The second leading California case on the agency issue is <u>Scholastic Book Clubs, Inc. v.</u> <u>State Board of Equalization</u> (1989) 207 Cal.App.3d 734, where the SBE assessed a use tax deficiency. The taxpayer was a New Jersey corporation which had no physical facility, bank account, or regular employees in California. It conducted its business by distributing catalogs through the mail to teachers and librarians in elementary and high schools throughout the United States. It mailed its catalogs to teachers and librarians who had previously placed orders or specifically requested catalogs. It also purchased mailing lists from third parties and maintained address lists of schools. If it did not know the name of a teacher, it sent the catalog to the grade or classroom, for instance, "Third Grade Teacher." (207 Cal.App.3d at 736.)

The taxpayer had a "premium" program to encourage teachers and librarians to place orders. They were given "bonus points" based on the size of their orders, which they could use to obtain merchandise from a gift catalog. The items in the gift catalog could be used either for classroom or personal use. Among the items available from the gift catalog were pocket calculators, books, audiocassettes, cameras, coffee makers, television sets, videocassette recorders, and microwave ovens. (*Ibid.*)

The court of appeal in <u>Scholastic Book Clubs</u> concluded the taxpayer had sufficient nexus with California to be subject to use tax. With respect to the agency issue, the court stated:

"The instant case is more analogous to <u>Scripto</u> than to <u>National Bellas</u>. Although the teachers herein do not have written agency agreements with appellant, they serve the same function as did the Florida jobbers in <u>Scripto</u> obtaining sales within California from local customers for a foreign corporation. In fact, they do more. Unlike the Florida jobbers, the California teachers collect payment from the purchasers, and receive and distribute the merchandise. <u>Appellant not only relies</u>, but, in fact, depends on the teachers to act as its conduit to the students.

"However, neither the form of the remuneration, the amount thereof, nor the fact that the teachers and librarians were not formally employed by, or dependent upon appellant for their primary income has any legal significance in determining whether they acted as appellant's representatives in soliciting orders for appellant's products in California." (207 Cal.App.3d at 739-740, emphasis added.)

Note this issue has been litigated in a number of other jurisdictions with mixed results. Cases finding nexus, *Appeal of Scholastic Book Clubs, Inc.* 260 Kan 528, 920 Pac 2nd 947 (1996); *Scholastic Book Clubs Inc. v. Commissioner of Revenue Services* _____ Conn ____ (March, 2012). Cases not finding nexus, *Pledger v, Troll Book Club,* 316 Ark 195, 871 SW 2nd 389 (1994); *Scholastic Book Club v. State of Michigan,* 567 NW 2nd 692 (1997); *Troll Book Club v. Tracey,* Ohio Board of Tax Appeals 92-Z-590 (1994); and *Scholastic Book Clubs v. Roberts,* U.S. Supreme Court Docket 12-374, November 26, 2012.
c. <u>Appeal of Dresser Industries</u>

The third leading California decision on the nexus-through-agency issue is the opinion by the Board of Equalization on petition for rehearing in <u>Appeal of Dresser Industries</u>, Cal. St. Bd. of Equal., Oct. 26, 1983. The question presented was whether in computing the sales factor of the taxpayer's apportionment formula, FTB properly applied the "throw back" rule to sales of pumps that were manufactured in California by the taxpayer and sold and shipped to customers located in various foreign countries in which the taxpayer itself did not do business or file income tax returns. In each of these countries, one of the taxpayer's wholly owned, unitary sales subsidiaries solicited sales of the taxpayer's pumps on a commission basis, and in some of these countries the sales subsidiary's local activities and presence extended substantially beyond the mere solicitation of sales. In the countries where the activities of the sales subsidiaries were confined essentially to solicitation, one or more of the taxpayer's unitary non-sales subsidiaries had substantial local activities and connections.

With respect to the issue of whether the taxpayer was "doing business" in the foreign countries, the Board in *Dresser* stated as follows:

"The facts of the present case stand in sharp contrast [to the facts in *National Bellas Hess*]. Here the record reveals a regular and systematic pattern of local sales solicitation on appellant's behalf in the foreign countries in question. While it is certainly true that this activity was conducted by employees of appellant's sales subsidiaries, rather than by appellant's own corporate employees, the Supreme Court's decision in *Scripto* ... leaves little doubt that such a distinction is without constitutional significance for nexus purposes.

"... [I]t makes no difference that appellant chose to conduct its selling activities through unitary sales subsidiaries, even if those subsidiaries may properly be regarded in this context as true 'independent contractors.""

d. <u>Borders Online v. State Board of Equalization</u>

Borders Online v. State Board of Equalization (2005) 129 Cal.App.4th 1179, involves the question of whether an internet seller of books, magazines, compact discs, videotapes and similar tangible goods is required to collect a use tax on these sales. Online had no employees in California during the period in question and did not own or lease property in California. Online is a wholly owned subsidiary of Borders, which in turn owned Borders book stores that operated in California. For a portion of the period Online posted on its website a return policy informing customers that they could return merchandise to a Borders bookstore for a refund, store credit or exchange. This was a more favorable return policy than that provided for merchandise purchased from other retailers.

The Court of Appeal found that Borders acted as Online's agent, and under *Scripto* this was sufficient to establish nexus. Online's argument that California has a four-part test for determining an agency relationship was rejected. The court accepted the broad definition of selling posited by the Board of Equalization, which included a return policy. In addition to

the return policy, the receipts issued by Borders included the phrase "Visit us Online at <u>www.Borders.com</u>." Borders' employees were encouraged to refer bookstore customers to Online, and the Online website included a link to <u>www.bordersstores.com</u>, the website for the bookstores.

e. Appeal of Barnes & Noble.com

In the *Appeal of Barnes & Noble.com*, Cal. St. Bd. of Equal., Sep. 26, 2001, Petition for Redetermination, Sep. 12, 2002, the Board of Equalization held that the online retailer Barnes & Noble.com had an obligation to collect use tax on sales to California customers over the internet when they arranged for a related entity, Barnes & Noble Booksellers, Inc., to insert discount coupons for purchases on the internet in shopping bags of customers at Booksellers stores for a limited period of time. The Internet seller paid for the printing of the coupons which were placed in promotional bags which were printed with the address of their website. The Board of Equalization held that the distribution of the coupons constituted selling and did not constitute advertising.

In 2007, a California Superior Court held in *Barnesandnoble.com LLC v. State Board of Equalization* (Superior Court, San Francisco, No. CGC-06-456465 (2007) reached a different conclusion. The state argued that Stores' use of the shopping bags with the coupons from Online made Stores (1) an "agent" or "representative" of Online (2) engaged in "selling" on Online's behalf. The court disagreed and held that Stores did not act as Online's agent or representative. In reaching its decision, the court distinguished this case from *Borders Online* ¶3.05[F][3][c]. The stores acted as representatives for the online retailer in *Borders Online* because there were substantially overlapping boards of directors and corporate officers, the stores accepted returns of items purchased from Online, and the employees in the stores solicited sales for Online. These factors were not present in *Barnesandnoble.com*. The court found that Online's placement of its coupons in the shopping bags constituted "selling," but there was no nexus because Stores was not Online's agent.

f. *Harley-Davidson, Inc.v. Franchise Tax Board,*

In *Harley-Davidson v. Franchise Tax Board*, 237 Cal App 4th 193 (2015), *t*he taxpayer had two special purpose entities (SPEs) that facilitated making loans to customers and securitizing the loans so they could be marketed. Many purchasers of Harley-Davidson motorcycles choose to purchase with credit. They are not obligated to obtain credit through Harley-Davidson. From January 2000 through July 2002, independently owned Harley-Davidson dealers extended credit directly to some customers via a finance contract. Beginning in August 2002, a Harley-Davidson-affiliated bank extended loans directly to some purchasers. In 2002, this bank and its 49 employees were located exclusively in Nevada; it had no offices, agents, employees, or property in California. Generally, neither the dealers nor the bank held the finance contracts or loans they

originated. Instead, they sold the loans to another wholly owned subsidiary, Harley-Davidson Credit Corporation (HDCC).

HDCC's offices were located in Nevada, Illinois, and Texas; it had no property in California and none of its 300-plus employees were based here. As servicer of the loans, if payments on a loan were not made timely or fully, HDCC employees based in Nevada performed collection activities. If collection efforts were not successful, HDCC hired third-parties to repossess the motorcycles securing the loans. Some repossessed motorcycles ended up at auction houses. An HDCC employee visited an auction house in California on 17 days total to assist in setting prices for motorcycles or to observe some part of the auction process. HDCC also made wholesale loans to Harley-Davidson dealers for their purchases of inventory and for upgrades to their showrooms.

To generate liquidity, HDCC securitized a portion of the consumer loans it purchased. Approximately two to three times per year, HDCC identified and sold a pool of loans to either of the SPEs, which were wholly owned subsidiaries of HDCC.. The pools included loans that had been originated in California, but the SPEs did not specifically target California or any state— to them,

Pursuant to written agreements, the SPEs established trusts capable of issuing securities. After purchasing loan pools from HDCC at fair value, the SPEs sold the pools (with security interests) to the trusts. The trusts then issued securities backed by the loan pools. Third-party underwriters purchased the securities from the trusts, marketed the securities, and resold them in the open market. As owners of the loans (through the trusts), the SPEs were responsible for servicing them. They did this by entering into servicing contracts with HDCC, which HDCC performed, primarily from Nevada, for a fee.

The SPEs are legally separate entities from HDCC. The SPEs had no offices, agents, employees, or property in California. In fact, they had no employees at all. The SPEs did not advertise or solicit business in California, and nearly all of their functions were completed entirely in Illinois and Nevada.

The court found that substantial evidence supports the finding of an agency relationship between the SPEs and HDCC. To begin with, the SPEs were only formed so that HDCC could obtain more favorable pricing from securitization investors than HDCC could obtain by directly securitizing the loans itself. The SPEs were governed by directors and officers who were also directors and officers of HDCC. The SPEs had no employees of their own but, rather, acted entirely through HDCC employees. The SPEs were only permitted to securitize HDCC loans. HDCC selected the pools of loans to securitize, administered the sale of the SPEs' securities to underwriters, and indemnified the underwriters. HDCC undertook collection activities on the SPEs' loans, and it was an HDCC employee who visited an auction house in California on 17 days total to assist in the auction process—a process designed to ensure the value of the collateral securing the loans held by the SPEs. This evidence, and the reasonable inferences derived from it, supports the trial court's finding that HDCC was the SPEs' agent.

g. <u>Swart Enterprises, Inc. v. Franchise Tax Board</u>

A corporation that held a .2% interest in a manager-managed LLC was not doing business in California. The LLC had investments in California property and the investor received distributions from the LLC which had elected to be taxed as a partnership. The investor by terms of the agreement had no ability to cause the manager of the LLC to take any action.

3. NEXUS ESTABLISHED VIA INDEPENDENT CONTRACTORS

It has traditionally been the position of the states that except as specifically enumerated in Public Law 86-272 the same activities performed by employees or independent contractors created a taxable presence. Therefore, if conducting repair activities by employees established a taxable presence, conducting the same activities through an independent contractor would also create nexus. The Multistate Tax Commission issued Nexus Bulletin 95-1 setting forth a list of activities which would establish taxability for both sales/use tax and income tax purposes for mail-order sellers of computers. The issuance of this Nexus Bulletin and the adoption of the Bulletin by the California tax agencies generated limited but highly vocal public comment objecting to this action. The commentators drew into question whether or not the use of independent contractors in a state to perform warranty work would give rise to a taxable presence. The staffs of the tax agencies continue to believe that the use of independent contractors to perform warranty work establishes nexus. Both Boards, however, have withdrawn their adoption of Nexus Bulletin 95-1.

In February of 1998, the Fourth Appellate District in California issued an unpublished decision in <u>Olen Management Corp. v. Magazine Publishing Company</u>, which held that the activities of a third party acting as an agent are sufficient to constitute doing business in the state. The Franchise Tax Board filed an amicus brief in this case which involved the question of whether a company which had not filed returns in the state would be permitted to defend a lawsuit brought by the agent.

In <u>Reader's Digest Association, Inc. v. Franchise Tax Board</u> (2001) 94 Cal.App.4th 1240, it was held that a wholly owned subsidiary, Reader's Digest Sales and Services, Inc., the exclusive United States sales agent for its parent company and other publishers of Reader's Digest, was not an independent contractor for purposes of Public Law 86-272. The parent company provided all administrative services for the subsidiary, and the sales of the subsidiary were eliminated for consolidated financial reporting purposes because, in the words of a corporate officer, "you can't generate income by selling between yourself." The fact that the subsidiary made sales for unrelated parties that published Reader's Digest in foreign countries did not make it an independent contractor in the eyes of the court because

the use of the subsidiary as the United States sales agent for the foreign publishers was a requirement of the licensing agreement with the parent.

In <u>Overstock.com, LLC v. New York State Department of Taxation and Finance Taxation and</u> <u>Finance</u>, Court of Appeals of the State of New York, Nos. 33 and 34, March 28, 2013, it was held that for sales and use tax purpose an internet seller that used "Affiliates" or "Associates," unrelated third-parties, to provide click through access to the sellers website had a physical presence in the state. The United States Supreme Court denied certiorari, Docket # 13-252, Dec 2, 2013.

4. <u>NEXUS ESTABLISHED VIA THE UNITARY BUSINESS</u>

For purposes of the Bank & Corporation Tax, California has not taken the position that nexus over one member of a unitary business establishes nexus over any other member of the unitary business. This difference may be largely semantic. See the discussion of <u>Joyce-Finnigan</u> beginning on page 38. Other states, see <u>Airborne Navigation Corporation v</u>. <u>Arizona Depart. of Revenue</u>, Ariz. Bd. of Tax Appeals (1987), have held otherwise.

For several years, California's sales and use tax statutes, former section 6203(g) of the Revenue & Taxation Code, provided that a retailer owned or controlled by the same interests which own or control any retailer engaged in the same or similar line of business in this state was required to collect sales or use tax. It appears that this statutory imposition of a duty to collect tax was grounded in a unitary relationship: ownership and similarity of business lines. This provision has been repealed.

In <u>Current, Inc. v. State Board of Equalization</u> (1994) 24 Cal.App.4th 382, it was held that a parent and subsidiary engaged in different aspects of the printing business were not in the same or similar lines of business. It was stipulated that the two corporations "did not have integrated operations or management," "were organized and operated as separate and distinct corporate entities," and "neither was the alter ego or agent of the other." Query: Would the result have been different if the corporations were "unitary"? This particular subsection of the California Sales and Use Tax Law has been repealed.

California has enacted a new statute in 2011, Section 6203(c) Revenue and Taxation Code, asserting nexus where there are enumerated relationships greater than ownership.

In <u>Reader's Digest Association, Inc. v. Franchise Tax Board</u> (2001) 94 Cal.App.4th 1240, the California appellate court held that a wholly owned subsidiary acting as a sales representative for its parent company was not an "independent contractor" on the basis of relationships between the parent and subsidiary, which would normally be expected to exist in a unitary business.

See *Harley-Davidson supra*. The decision does not specifically hold that the unitary relationship established nexus but the fact that all of the entities, except the independent dealers were related appears to have been a significant factor for the courts.

5. <u>FACTOR PRESENCE NEXUS</u>

In January of 2009, as part of the budget reconciliation process, the California Legislature enacted, and the Governor signed, legislation which established a factor presence test in California for years beginning after January 1, 2011. Section 23101 California Revenue and Taxation Code which defines "doing business" was amended by adding subsection (b) to provided that a taxpayer that has 1) sales that exceed the lesser of \$500,000 or 25 percent of the taxpayer's total sales; 2) real and tangible personal property in this state that exceed the lesser of \$50,000 or 25% of the taxpayers total such property; or 3) or compensation paid in this state that exceeds the lesser of \$50,000 or 25% of the taxpayer's total payroll is doing business in this state. Section 23101(b) California Revenue and Taxation Code. These amounts are to be adjusted annually. Section 23101(c) Revenue and Taxation Code. Property, payroll and sales include the taxpayer's pro-rata or distributive share of the property, payroll and sales of pass-through entities. Section 23101(d) California Revenue and Taxation Code.

The statute is phrased in terms of a floor not a ceiling. In other words, exceeding the limits establishes taxability. If an entity is under the limits, however, they may nonetheless still be doing business and therefore taxable.

The California section is patterned after model legislation proposed by the Multistate Tax Commission.

Note this section cannot supplant Public Law 86-272's limitation on state income taxation, but the Public Law only applies to sales of tangible property.

6. <u>ECONOMIC NEXUS</u>

A number of states have argued that "economic nexus" is sufficient to meet the requirements of the Commerce Clause jurisprudence of the United States Supreme Court. The question of economic nexus was argued in *Quill Corp. v. North Dakota* (1992) 504 U.S. 298. The Supreme Court in that case held that economic presence, in the sense of purposeful availment of a market in a state satisfied Due Process nexus. The Court differentiated Commerce Clause nexus and held that for sales and use tax <u>collection</u> purposes nexus required a physical presence in a state.

States have generally been successful in arguing that for purposes of other taxes Commerce Clause nexus does not require physical presence. These cases have typically arisen in "separate entity" states and in their efforts to assert a tax on intangible holding companies. The first case in this area was *Geoffrey, Inc. v. South Carolina*, (1993) 437 SE 2nd 13, cert. Denied 510 US 992. Geoffrey is the name of the intangible holding company formed by Toy's "R" Us to hold the image of its giraffe and to receive royalties on each purchase made at a Toys "R" Us story. For separate entity states, assuming they haven't adopted "addback" statutes, this gives rise to a deductible expense for the stores and income for the intangible holding company which only has a "presence" in Delaware its state of incorporation. South Carolina took the position that the intangibles held by Geoffrey were used on a regular, on-going basis in South Carolina and therefore they should be able to tax

a portion of the income as being attributed to South Carolina. They were sustained and the United States Supreme Court denied certiorari. Because taxability was established without the entity having a physical presence in the state the term "economic nexus" was coined.

Subsequently a number of other states have asserted nexus over similar operations. These states include among others Iowa (a franchisor) New Mexico, Maryland, Massachusetts and West Virginia (credit cardholders). The United States Supreme Court has refused certiorari in all of these cases in spite of many commentators arguing that this is an area ripe for the Court's consideration.

In *Griffith, West Virginia State Tax Commissioner v. Conagra*, (2012) 728 S.E.2d 74 a foreign licensor's contacts with West Virginia were not sufficient to establish nexus since the licensor had no physical presence in West Virginia and did not sell or distribute food-related products or provide services in West Virginia. Further, (1) all products bearing the trademarks and trade names were manufactured solely by unrelated or affiliated licensees of the foreign licensor outside of West Virginia; (2) the foreign licensor did not direct or dictate how its licensee distributed the products; and (3) the licensee, operating no retail stores in West Virginia.

In the Court's 2010 term it decided a product liability case, *J. McIntyre Machinery Ltd. v. Nicastro,* where it may have retreated from some of its holdings under the "stream of commerce" in holding that even though a company knew its products were sold into the state it would violate the Due Process Clause to impose products liability on it for isolated sales of industrial equipment.

CHAPTER 3

OVERVIEW OF THE TAX AND FEE FRAMEWORK

1. <u>CORPORATION FRANCHISE TAX</u>

a. Nature of the Tax

The franchise tax is found in Chapter 2 of the Corporation Tax Law. A <u>minimum franchise</u> <u>tax</u> is imposed upon all banks and corporations (including financial corporations) which are incorporated or qualified to do business in California, and which are not expressly exempted under the Corporation Tax Law or the California Constitution. (Insurance companies are the most significant exemption. The exemption is contained in Article XIII, section 28 of the California Constitution.) The minimum tax is imposed whether the corporation is active, inactive, operates at a loss, or files a return for a short period. There is no minimum tax for credit unions or for corporations that are subject only to the income tax and are not incorporated or qualified under the laws of California. (See section 23153.) The minimum tax is also imposed upon limited partnerships doing business in California. (Section 23081.)

The franchise tax is imposed upon all banks and corporations (including financial corporations) which are "doing business" in California. The franchise tax on general corporations is imposed under section 23151. The franchise tax on banks is imposed under section 23181. The franchise tax on financial corporations is imposed under section 23183. For a discussion by the Franchise Tax Board staff on what constitutes a "financial corporation," see FTB Legal Ruling 94-2 (Mar. 23, 1994). The statutory tax rate established for banks and financial corporations is the sum of the tax rate on general corporations plus 2 percent. (AB 1451, Stats. 1991, ch. 1087.)

The franchise tax is prepaid for the privilege of doing business. It is measured by the income of the preceding year (the "income year") for the privilege of doing business in the following year (the "taxable year").

Form 100 (California Franchise or Income Tax Return) is used for filing under the corporation franchise tax law.

b. "Doing Business" Defined - Section 23101

"Doing business" for years beginning prior to January 1, 2011 is defined in section 23101 to mean "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit." That standard has been explained as follows:

"The doing of business, however, does not necessarily mean a regular course of business ..., for by its plain terms a corporation is doing business if it actively engages in any transaction for pecuniary gain or profit. Defendant would identify 'doing business' with 'carrying on a trade or business.' A series of transactions regularly engaged in may be necessary to establish the 'carrying on of a trade or business' but the Legislature made it clear that it had no such concept in mind when it referred to transaction in the singular as 'any transaction.' The word 'actively' must therefore be interpreted as the opposite of passively or inactively" (*Golden State T. & R. Corp. v. Johnson* (1943) 21 Cal.2d 493, 496.)

Whether or not profit is made is not the controlling factor in the definition of doing business, "rather the criterion is whether or not the goal or aim is financial or pecuniary gain." It is sufficient "[i]f the aim was pecuniary gain." (*Hise* v. *McColgan* (1944) 24 Cal.2d 147, 150-151.)

A liaison office maintained to conduct market research and fielding inquiries for the foreign parent and a California subsidiary is sufficient to constitute doing business. <u>Appeal of</u> <u>Hyundai Precision & Industries Co., Led. and Hyundai Steel Industries, Inc.</u>, Apr. 19, 2001, unpublished.

In an unpublished decision, <u>Appeal of Personal Selling Power, Inc.</u>, March 16, 2009, the State Board of Equalization held that the presence of a single employee engaged in the sale of magazine and internet advertisements within California or behalf of the taxpayer was sufficient to create nexus.

For years beginning subsequent to January 1, 2011, a corporation that exceeds certain minimum levels of property, payroll and sales in California will also be treated as doing business and therefore subject to the Franchise Tax. The levels are 1) the lesser of \$50,000 or 25% of an entities real and tangible property; 2) the lesser of \$50,000 or 25% of an entities compensation; and 3) the lesser of \$500,000 or 25% of the entities sales. Section 25101(b) California Revenue and Taxation Code. A taxpayer's property, payroll and sales also include its share of any owned pass-through entity's property, payroll and sales. Under the statute failure to meet any of these levels does not, however, give rise to an inference that a corporation is not doing business in California.

c. Illustrative California Decisions on "Doing Business"

The "doing business" concept is an elusive one in application, as illustrated by the following decisions:

"A corporation was doing business when it made a purchase of bonds in one year, a sale of bonds in the following year, twelve purchases and sales of stock in the year thereafter and two such transactions in the last year which was considered. From the standpoint of 'actively' engaging in a transaction, the act of buying or selling is in marked contrast with merely receiving proceeds." (*Carson Estate Co.* v. *McColgan* (1943) 21 Cal.2d 516.)

"A corporation was doing business in California when, in the process of liquidation, it perfected title to properties in order to sell them and collected interest on notes." (*Appeal of Sugar Creek Pine Company*, Cal. St. Bd. of Equal., March 30, 1955.)

"The receipt of interest on the buyer's note and casualty insurance proceeds did not constitute doing business where the taxpayer had sold its assets and ceased conducting its department store business." (*Appeal of the Blanc Corporation, Assumer for Sponberg's, Inc.*, Cal. St. Bd. of Equal., Feb. 18, 1964.)

"A corporation commenced doing business when the incorporator, on behalf of his corporation, leased the business premises and paid rent in advance, purchased furniture and other assets, contracted for the design and printing of graphics and other advertisements, opened bank accounts, and actively solicited clients." (*Appeal of Craft International Travel, Inc.*, Cal. St. Bd. of Equal., June 22, 1976.)

"Maintenance of booths at multiple-day trade shows in California from which sales which were subject to California sales tax were made constitutes doing business" (*Appeal of Stack's Sales, Inc.*, Cal. St. Bd. of Equal., Dec. 4, 1996 (unpublished).)

In 1996, the Legislature added section 23104 to the Revenue & Taxation Code to provide that (1) the appearance at conventions or trade shows for seven or fewer calendar days within a year, and (2) a gross income of less than \$10,000, would not constitute "doing business" in the state. Gross income is determined by reference to the gross income of each member of the "commonly controlled group" of which the corporation is a member. Corporations which are not "doing business" in the state are not subject to the Franchise Tax, and therefore the minimum tax, but are subject to corporate income tax on income from California sources.

d. Partners and "Doing Business"

With respect to corporate partners, there is authority for the proposition that a corporate partner is "doing business" in California for purposes of section 23101 if the partnership is engaged in business in California. (*Appeal of H.F. Ahmanson & Company*, Cal. St. Bd. of Equal., April 5, 1965.) There is also authority for the proposition that a passive investment partnership, even one with property and employees in California, may not be doing business in California. (See <u>Appeal of Robert M. and Ann T. Bass, et al.</u>, Cal. St. Bd. of Equal., Jan. 25, 1989. See also Coffill, "Determining Source of Partnership Income for Nonresident Partners Under the Personal Income Tax Law," Journal of California Taxation, Spring 1990, p. 6.)

In 1996, the State Board of Equalization held that out-of-state corporations that were limited partners in a limited partnership that was doing business in California were not themselves doing business in California for purposes of the Franchise Tax. The decision states that the limited partnership and the general partner were doing business in California but that the limited partners were not doing business because the general partner does not have agency rights over the obligations or the property of the limited partners. (*Appeal of Amman & Schmid Finanz AG, et al.*, Cal. St. Bd. of Equal., April 11, 1996.) The decision in *Appeal of*

<u>*H.F. Ahmanson & Company, supra,*</u> was overruled as being overly expansive to the extent it addressed the status of limited partners. It should be kept in mind that the limited partners may still have income from California sources that would be subject to the corporate income tax.

The California Legislature adopted language that provides, for income years beginning on or after January 1, 2011, a company will be doing business if its pro-rata or distributive share of the property, payroll and sales of pass-through entities exceed the limits provided for in Section 25101(b). Section 23101(d) California Revenue and Taxation Code.

In *Swart Enterprises, Inc. v. Franchise Tax Board,* Fifth Apellate District F07092) the court held that a corporation that held a .2% interest in a manager-managed LLC was not doing business in California because under the terms of its investment it had no power to influence any actions on the manager of the LLC.

e. General Observations on the "Doing Business" Standard

Several general observations can be made on the "doing business" issue. First, section 23101 by its terms is extremely broad and requires but a single ("any") transaction. A continuous course of conduct or a series of transactions is not required under the statute. Second, pre-incorporation activities, without more, generally will not constitute "doing business." Third, section 23101 in all likelihood, will be interpreted by FTB as being commensurate with the minimum constitutional nexus required for California to assert its jurisdiction to tax. This means that as a practical matter, the issue in controversy will not be whether the section 23101 statutory definition of "doing business" has been satisfied, but whether California has the constitutional ability to tax.

Finally, P.L. 86-272, discussed below, acts as a federal, preemptive, limitation on the "doing business" standard <u>for purposes of taxing income</u>, but that limitation is applicable only to sales of tangible personal property. <u>Public Law 86-272 does not prevent the assessment of the minimum franchise tax.</u>

2. <u>CORPORATION INCOME TAX</u>

The corporation income tax is found in Chapter 3 of the Corporation Tax Law. An income tax is imposed upon corporations (including financial corporations) which, although not "doing business" in California within the meaning of section 23101, still "derive income from sources within the state" (Section 23501.) Section 23040 provides: "Income derived from or attributable to sources within this State includes income from tangible or intangible property located or having a situs in this State and income from any activities carried on in this State, regardless of whether carried on in intrastate, interstate, or foreign commerce."

Because of the extremely expansive scope of the "doing business" standard under section 23101, if a taxpayer has activities in California sufficient to provide California with the

constitutional nexus to tax, it is, in practically all cases, the franchise tax, and not the income tax, which will apply.

A taxpayer may be subject to the minimum tax (because of qualification) and the income tax (because of deriving income from California sources, although not "doing business"). In this situation, the minimum tax is allowed as an offset against the income tax. (Section 23503.)

There is no minimum tax for corporations that are subject only to the corporation income tax and that are not incorporated or qualified under the laws of California.

Form 100 (California Corporation Franchise or Income Tax Return) is used for filing under the corporation income tax law.

3. <u>LIMITED LIABILITY COMPANY FEE</u>

Limited Liability Companies doing business in California, organized in California or have registered with the Secretary of State, are subject to the minimum tax provided for in section 23151m, currently \$800. Section 17941. Through December 31, 2006, Limited Liability Companies are also subject to a fee, section 17942(a), which varies dependent upon the total income reportable to California. There are five steps to the fee:

- 1) Zero if the total income is less than \$250,000;
- 2) \$900 if the total income is more than \$250,000 and less than \$500,000;
- 3) \$2,500 if the total income is more than \$500,000 and less than \$1,000,000;
- 4) \$6,000 if the total income is more than \$1,000,000 and less than \$5,000,000;
- 5) \$11,790 if the total income is more than \$5,000,000.

Total income reportable to California is gross income as defined in the tax code plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer. One can think of the base as being gross receipts. Section 17942(b). Income that flows through from another LLC is not taken into account. Total income is total income of the LLC and is not limited to that attributable to California.

In 2007, AB-198 was passed by the Legislature and signed by the Governor. For years beginning on or after January 1, 2007, the fee is determined by reference to the amount of income that is apportioned to California on the basis of a sales factor. In addition, if the fee is determined to be unconstitutional with respect to a taxpayer for years ending prior to January 1, 2007, the remedy is limited to the difference between the fee determined on an apportioned basis and the amount paid with the return.

The fee has been challenged as unconstitutional under the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution because regardless of its label, it is a tax and it is unapportioned. A number of cases have been filed challenging the statute. The three leading cases are <u>Northwest Energetic</u> <u>Services, LLC v. Franchise Tax Board, Ventas Finance I, LLC v. Franchise Tax Board, and Bakersfield Mall, LLC v. Franchise Tax Board</u>. In Northwest the taxpayer did no business in California but had registered with the Secretary of State. Ventas did business in California as measured by the three-factor apportionment formula. In *Bakersfield Mall, LLC*, the LLC allegedly operated only in California.

In <u>Northwest Energetic Services, LLC v. Franchise Tax Board</u> (2008) 159 Cal.App.4th 841, the Court of Appeal determined that the fee as applied to an LLC with no income or activities in California was unconstitutional.

In *Ventas* the appellate court also held the fee was unconstitutional because it was not apportioned. The appellate court, after holding that the statute could not be reformed, limited the taxpayer's remedy to the difference between the fee assessed under the statute and a fee calculated on an apportioned basis. The appellate court did not rely on the remedy section of AB-198. Instead it followed the decision in *Macy's Department Stores, Inc. v. City and County of San Francisco* (2006) 143 Cal.App.4th 1444, (cert. Denied 168 Led2nd 727).

Bakersfield Mall, LLC has been consolidated with <u>CA-Centerside I,I LLC v Franchise Tax</u> <u>Board, Fresno Superior Court 10CEGC00434</u> and are now referred to as Judicial Counsel Consolidated case No, 4742. Plaintiffs counsel has attempted to have the cases tried as class actions. That effort was rejected and is now on appeal.

4. "<u>S" CORPORATIONS</u>

An entity that has elected to be an "S" Corporation for federal purposes will be an "S" Corporation for California purposes as well. "S" Corporations are subject to the minimum tax imposed by section 23153, currently \$800. Section 23800.5(a)(1)(B). In addition, an "S" Corporation is subject to a tax at the rate of one and one-half percent (1.5%) of its income. Section 23802(b)(1). An "S" Corporation is not eligible to be included in a combined report unless the Franchise Tax Board determines that it is necessary to include the "S" Corporation in order to clearly reflect income. Section 23801(c) and (d).

5. <u>COMMON STATE/FEDERAL DIFFERENCES IN COMPUTING INCOME</u>

Corporations having a federal reporting requirement usually calculate net income for California tax purposes by performing a federal reconciliation. The taxpayer generally begins with line 28 of its federal Form 1120, and then enters California adjustments to the federal net income figure to reach California net income, and eventually, net income for

California tax purposes. (See FTB 1061, see also Form 100, California Corporation Franchise or Income Tax Return, and Instructions.) The items listed below relate solely to the calculation of net income. They do not include any differences arising from the Due Process Clause limitations preventing a state from considering income that has no rational relationship to the activities carried on in the state. Some of the more significant California adjustments are as follows:

a. California Income/Franchise Taxes

California does not permit a deduction for California corporation franchise or income taxes paid or taxes measured by income paid to any other government. (Section 24345.)

b. Other Taxes On/Measured by Income/Profits

Under section 24345, California does not allow a deduction for any taxes on or according to or measured by income or profits paid or accrued within the income year. Regulation 24345-7 provides additional rules in the especially complex area of determining deductibility of "taxes" paid to foreign countries. (See also, Coffill, The Treatment of Foreign Income Taxes Under the California Bank and Corporation Tax Law (1985) 17 Pacific L.J. 77.) Several cases have discussed the deductibility of the Michigan Single Business Tax. In the Appeal of Dayton Hudson Corporation, Cal. St. Bd. of Equal., Feb. 3, 1994, the Board of Equalization held that the Michigan State Business Tax (MSBT) is not a tax "on income" and thus it is deductible. The SBE also rejected an alternative argument that the MSBT could be bifurcated between deductible (amounts not on income) and nondeductible (amounts on income) amounts. In reaching its conclusion, the SBE relied on earlier authorities which held that any tax imposed on a base which included a return of capital was not an income tax. In Appeal of Kelly Services, Inc., Cal. St. Bd. of Equal., May 8, 1997, the SBE held that the fact that in certain circumstances the tax base for purposes of the MSBT does not contain an element representing a return of capital does not mean that in those cases it is an income tax.

The State Board of Equalization has rejected an argument that withholding taxes asserted by foreign governments on royalties, interest and dividends paid to the United States parent were not taxes on or measured by income because such payments are "eliminated" when made between members of a combined report group. *Appeal of CTI Holdings, Inc.*, Cal. St. Bd. of Equal., Feb. 22, 1996. The Franchise Tax Board was successful in obtaining a motion for summary judgment on this question in *General Motors Corp. v. Franchise Tax Board, supra*. The determination of the trial court was upheld by the appellate court in a published opinion. General Motors had its petition for review of other grounds accepted by the California Supreme Court, which resulted in a vacating of the appellate decision.

c. Interest on Government Obligations

Corporations subject to the <u>franchise</u> tax must report all interest received on government obligations, such as federal, state or municipal bonds, even though exempt from state or federal income tax.

However, interest received on government obligations (federal, State of California and its political subdivisions) is exempt from the corporation <u>income</u> tax. This difference arises because the franchise tax is *measured by income* while the income tax is *on income*.

d. Net Capital Gain

The amount of net capital gain for federal and California purposes may not be the same for a number of reasons, primarily basis adjustments.

e. Depreciation and Amortization

California's law with respect to depreciation and amortization for corporations is substantially different from federal law. California adopted provisions of the federal Class Life Asset Depreciation Range System (ADR), which provides a range of useful lives. However, California law requires use of the mid-range class life. California law does not allow corporations to claim depreciation deductions under the current federal Modified Accelerated Cost Recovery System (MACRS), or its predecessor, ACRS. (See Form 3885, Corporation Depreciation and Amortization, and Instructions.) For individuals, however, MACRS is allowed. In addition, partnerships may claim MACRS because their income is determined under the Personal Income Tax Law, and therefore a corporate partner may use MACRS with respect to activities that it conducts through a partnership. FTB Legal Ruling 89-528. An LLC that elects to be treated as a partnership may also use MACRS.

f. Dividends

For federal purposes, corporations can generally deduct 70 percent of dividends received from taxable domestic corporations, or 80 percent if the recipient owns at least 20 percent of the distributing corporation. Affiliated corporations that file consolidated returns are allowed a 100 percent dividends received deduction for federal purposes for qualifying dividends received from members of the affiliated group. No deduction is allowed for dividends received from foreign corporations. Taxpayers may elect, however, to gross the foreign dividends up and claim a foreign tax credit with respect to the grossed-up amount.

For California purposes, an elimination is allowed for intercompany dividends paid from unitary income (section 25106). California does not follow the federal treatment regarding the grossing-up of foreign dividends. California has a number of other provisions relating to dividends.

i. Dividends Previously Included in Measure of Tax - Section 24402

Section 24402 provided a deduction for dividends received during the year declared from income that has been included in the measure of tax imposed under Chapter 2 (corporation franchise tax) or Chapter 3 (corporation income tax). The intent of this provision was to avoid double taxation by California of income at the corporate level. This section was declared to be unconstitutional by a California appellate court because it discriminated between dividend paying corporations on the basis of the amount of their business conducted in California by the dividend-paying corporation. *Farmer Bros. Co. v. Franchise*

<u>*Tax Board*</u> (2003) 108 Cal.App.4th 976. The California and United States Supreme Courts declined review of this determination.

In general, when a statute is found to be unconstitutional, it is treated as being void *ab initio*. Section 19393 of the Revenue and Taxation Code further provides that the appropriate remedy when a deduction is found to discriminate is to deny the deduction to all that benefited. The Franchise Tax Board has implemented the decision in *Farmer Bros*. by denying a deduction with respect to all dividends for years beginning on or after December 1, 1999. In striking down a similar section, section 24410, a California court of appeal held that the statute was not capable of reformation. <u>Ceridian Corp. v. Franchise Tax Board</u> (2000) 85 Cal.App.4th 875.

In <u>Abbott Laboratories v. Franchise Tax Board</u>, 175 Cal. App. 4th 1346 the Court of Appeal held that section 24402 could not be reformed and that the plaintiff was not entitled to a deduction of any amount with respect to dividends received. The taxpayer was seeking a judicial reformation of the statute and alleged that assessment of tax for years prior to *Farmer Bros.* violates the Due Process and Equal Protection Clauses of the United States Constitution. The appellate court rejected these arguments.

In addition, the taxpayers in *Abbott Laboratories* was also arguing that section 19393 is only applicable to National Banks. The appellate court did not address the construction of section 19393 and did not mention it in its analysis. In a subsequent case River Garden Retirement Home v. Franchise Tax Board, 186 Cal.App.4th 922, a different Court of Appeal did discuss Section 19393 and found that it was applicable. The court agreed that the statute has to be implemented in a manner that meets constitutional Due Process requirements. See McKesson Corporation v. Division of Alcohol Beverages and Tobacco (1990) 496 US 18. Because additional taxes cannot be assessed for years where the statute of limitations is closed, the only remedy that can be implemented is to allow refunds with respect to the years which are more than four years old, provided that a taxpayer is open under waivers of the statute of limitations or has already filed a claim for refund asserting the unconstitutionality of section 24402. Additionally, adjustments to allow full deductibility of dividends can be used as an offset to additional assessments made pursuant to other grounds. If those assessments were paid, the taxpayer would have a new open statute for one year from the date of payment of the assessments. Any such claim would be limited to the additional amount paid which opened the statute of limitations. The court in *River Garden* found that applying the denial to taxpayers open under the normal 4-year statute of limitations did not violate Due Process.

A corollary to allowing a deduction is the assignment of expenses to those deductions and the disallowance of such expenses, see *infra* "l". Conversely, if no deduction is allowed, then a taxpayer would be entitled to a deduction with respect to expenses it may not have claimed because they were assigned to that income.

ii. Dividends from Insurance Companies - Section 24410

Section 24410 allowed corporations commercially domiciled in California owning at least 80 percent of the stock of an insurance company a deduction for dividends received from the insurance company taxable in California, to the extent the insurance company was taxable on its gross premiums in California.

In <u>Ceridian Corp. v. Franchise Tax Board</u> (2000) 85 Cal.App.4th 875, section 24410 was found to unconstitutionally discriminate in several particulars. The decision holds that the statute discriminates against non-California domiciliaries by denying them a deduction that is allowed to California domiciliaries. The court also found that the statute discriminates with respect to the amount of the deduction allowed because the amount is determine based upon the relative amount of property and payroll that the dividend-paying entity has in California. This was found to discriminate in favor of insurance companies with a greater comparative presence in California in reliance on <u>Fulton</u> <u>Corporation v. Faulkner</u> (1996) 516 U.S. 325, 133 L.ed. 2d 796.

In *Ceridian* the court also had the occasion to address the question of what relief should be granted in the circumstances where a statute is found to unconstitutionally discriminate. Section 19393 of the Revenue and Taxation Code provides that in the event of a determination of unconstitutionality, "the tax of the favored taxpayer shall be recomputed ... by disallowing the deduction." Application of this statute would appear to deny a refund to Ceridian and require the Franchise Tax Board to assess additional taxes against every entity that had claimed a deduction. The court considered the years involved in the lawsuit, 1978 through 1982, and found that it was unlikely that the Franchise Tax Board would be able to deny deductions to Ceridian's competitors because the normal period for assessing additional taxes in California is four years from the due date of the return. In those circumstances, the court found the Due Process Clause of the Fourteenth Amendment of the United States Constitution required that a refund be allowed to Ceridian in order that it be provided meaningful relief.

The court also considered whether a reformation of the statute was possible and found that it was not. The court found no basis to determine that the legislature would have chosen to allow a deduction for dividends that had not been taxed by California.

The FTB staff has implemented the decision by allowing refunds for the years which are closed under the normal statute of limitations with respect to dividends received from 80%-or-more owned entities that are subject to the California gross premiums tax, and by denying all deductions claimed under section 24410 with respect to years that were open under the normal statute of limitations.

In 2004, section 24410, was amended to allow a corporation holding an eighty (80) percent or more interest in an insurance company a deduction of eighty (80) percent of the dividends regardless of where the insurance company does business for years beginning on or after January 1, 2005. The deduction increases to eighty-five (85) percent for taxable years beginning on or after January 1, 2008. Taxpayers were also given the

right to make an election on or before March 29, 2005, for earlier years for the same treatment.

The amendments contain various provisions that limit the ability to take or the amount of the deduction if the insurance subsidiary is overcapitalized. The capitalization ration is calculated by dividing the five-year average of premiums earned by the five-year average of total income earned. The lower the percentage, i.e. the greater the investment income in relation to dividends, the greater the overcapitalization. If the capitalization percentage is greater than sixty (60%) percent, (seventy (70%) beginning in 2008), a full dividendsreceived deduction is allowed. If it is less than ten (10%) percent, no deduction is allowed. Between sixty (60) percent and ten (10) percent, the deduction is ratably reduced. Another provision of the bill, section 24465, prevents the tax-free transfer of appreciated property to an insurance company. A deferral is allowed if the insurance company uses the property in its business. Finally, the bill also includes a "deemed dividend" provisions, section 24900. This deemed dividend provision only operates when the capitalization percentage is equal to or less than ten (10) percent and a substantial purpose of the accumulation of the earnings and profits of the insurance company is to avoid state income tax. The purpose of these limitations is to prevent the sheltering of income from the Corporation tax by "stuffing" assets in an insurance subsidiary beyond those needed for insurance purposes.

A corollary to allowing a deduction is the assignment of expenses to those deductions and the disallowance of such expenses, see *infra* "l". Conversely, if no deduction is allowed, then a taxpayer would be entitled to a deduction with respect to expenses it may not have

iii. Foreign Dividends in the Case of a Water's-Edge Election–Section 24411

For taxpayers that make a water's-edge election (§§ 25110 et seq.), a deduction is allowed with respect to dividends that are received from entities with less than 20% of their activity in the United States that are more than 50% owned. Constitutional concerns are probably avoided because the taxpayer must elect water's-edge treatment to receive this treatment.

The ruling that section 24402 is unconstitutional allowed taxpayers to claim a deduction for all dividends that would otherwise be dealt with by section 24411 for those years where a full deduction was allowed because of section 24402's unconstitutionality. Section 24411 provides a deduction for certain dividends "to the extent not otherwise allowed as a deduction" This language has been interpreted to mean that section 24402 applies prior to section 24411. Therefore, a deduction pursuant to section 24402 would be allowed before section 24411 applies. This will be for remedial purposes only.

iv. United Kingdom Advance Corporate Tax

As part of the United States-United Kingdom Tax Treaty, United States corporate shareholders of corporations subject to the United Kingdom's Advance Corporate Tax (ACT) were allowed a refund of that portion of the United Kingdom tax that would have been credited to their account if they had been subject to tax in the United Kingdom. In *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459, the Court of Appeal held that the ACT refund should be treated as a dividend. The court noted that the United Kingdom allowed the subsidiary to make a direct distribution of the amount of the tax to the shareholder rather than requiring that payment of the tax which would subsequently be refunded to the shareholder. The court held that treating the payment as a dividend for California purposes would effectuate the intent of the Treaty and would be consistent with the federal treatment. The court disregarded the argument advanced by the Franchise Tax Board that tax treaties by their terms do not apply state taxes except for purposes of non-discrimination. It found that treating the payment as a dividend income that tracked the federal definition.

v. Ordering of Dividend Distributions

In *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459, the court of appeals was presented with the question of determining from what earnings and profits dividends were paid. The dividend-paying subsidiary was an entity that was partially included in the dividend recipient's combined report. Section 25106 allows dividends to be "eliminated" to the extent they are paid from income that was included in a combined report in which both companies were members. The dividend-paying subsidiary had a portion of its income included in the combined report. The court of appeal held, pp. 479-80, that the dividends should be paid first from the earnings and profits included in the combined report and thereafter from other earnings and profits. For further discussion of this question, see pp. 143-144.

In <u>Appeal of Apple Computer, Inc.</u> Cal. St Bd. of Equal., Nov. 20, 2006, the State Board of Equalization found that the Court of Appeal's decision on this issue was erroneous. The Board found that the source of dividends should be determined under the "Last-In-First-Out" method under both section 24411 of the Revenue and Taxation Code and section 316 of the Internal Revenue Code. This means that dividends are considered to be paid first from the current year's earnings and profits, and if those are exhausted, from the next preceding year's earnings and profits. It further held that dividends are paid proportionately for the earnings of profits of each year; for example, if the earnings and profits for a year are \$100 of which \$50 are from one class of income and \$50 from another class of income. A dividend of \$50 is considered to be paid, one-half from each class of income. The Board of Equalization found the reasoning of the Court of Appeal in *Fujitsu* as puzzling and inconsistent with the Franchise Tax Board's regulations, federal practice and the decision of the California Supreme Court in <u>Safeway Stores v. Franchise Tax Board</u> (1970) 3 Cal.3d 745.

Apple filed a suit for refund in the appellate district that decided *Fujitsu* and argued that the trial court must follow the appellate decision. The trial court sustained the decision_of the Board of_Equalization as to ordering within a year_but held that the Franchise Tax Board's allocation of expenses to such dividends was erroneous. As a consequence the Franchise

Tax Board's denial of the taxpayer's claim for refund was erroneous. Apple filed an appeal from the trial court's decision even though it received the full refund requested. The Franchise Tax Board was unsuccessful in attempting to have the appeal dismissed. The Court of Appeal sustained the action of the trial court on the ordering of the dividends. 199 Cal App. 4th 1 (2011) It did not rule on the question of whether Apple could appeal. A petition for review to the California Supreme Court was denied.

g. Contributions

California law limits the contribution deduction to 5 percent of California net income, without regard to charitable contributions and special deductions (e.g., NOLs, dividends). Federal law limits the contribution deduction to 10 percent of federal tax income. Accordingly, not only are the allowable percentages different, but the definition of California net income differs from federal taxable income for computing the deduction.

h. Enterprise Zone Interest

A deduction may be claimed in California for net interest on loans made to an individual or company doing business inside an enterprise zone or program area. (See Form 3805Z, Enterprise Zone/Program Area Deduction and Credit Summary, and Instructions.)

i. Section 78 Gross-Up

For federal purposes, dividends received from foreign affiliates are "grossed up" under IRC §78 to include income taxes paid to foreign countries on the dividends. (The taxpayer is then allowed to take a federal foreign tax credit for the gross-up amount.) California has no such provision, and the gross-up amount/income should be eliminated.

j. Subpart F Income

For federal purposes, a U.S. shareholder must include in income its pro rata share of the Subpart F Income of a controlled foreign corporation as a deemed dividend. California has no such provision, and this deemed dividend income should not be included. (Note: The income and activities of a corporation with Subpart F income would be partially included in a worldwide combined report if it is part of the unitary business. If a water's-edge election has been made, the income and factors are proportionately included in the water's-edge return based upon the ratio of Subpart F income to the total earnings and profits of the corporation. For a discussion of the inclusion ration see *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459 and pp. 143-144, *infra*.)

k. Section 1248 Gain on Foreign Stock

For federal purposes, gain from certain sales or exchanges of stock in certain foreign corporations is included in income as a dividend under IRC section 1248. For California purposes, the provisions of IRC section1248 do not apply to transactions occurring after August 20, 1990, in income years beginning on or after January 1, 1990. (Section 24990.7; added by SB 2252, Stats. 1990, ch. 1348; SB 1925, Stats. 1990, ch. 1349.)

I. Expenses Relating to Tax Exempt Income

Section 24425 provides that deductions relating to income not included in the measure of tax are disallowed. Application of this section was discussed in <u>Great Western Financial</u> <u>Corp. v. Franchise Tax Board</u> (1971) 4 Cal.3d 1, and in the <u>Appeal of Sierra Pacific</u> <u>Industries</u>, Cal. St. Bd. of Equal., Jan. 5, 1994.

Two issues can arise with respect to the application of section 24425. The first is how to determine what expenses relate to income that has not been included in the measure of tax. The second is the interaction of this section with other provisions of the code that speaks to the allowance or disallowance of expenses. The first issue was addressed by the State Board of Equalization in the <u>Appeal of Zenith National Insurance Corp.</u>, Cal. St. Bd. of Equal., Jan. 8, 1998. The Board held that the taxpayer had the burden of showing the purpose for which expenses were incurred. In the circumstances of Zenith, the Board found that for three and one-half of the four years, the taxpayer could directly trace an interest expense to taxable insurance dividends in spite of the general fungibility of interest expense. For the last half of the fourth year, the taxpayer was unable to establish the direct tracing it could for the earlier years because it had disposed of the investments originally made with the borrowed funds, and a general apportionment of the expense was allowed.

AB-263 (Oropeza) was enacted in 2004 and deals with the allocation of expenses under section 24425 with respect to dividends received from insurance subsidiaries. As part of allowing an eighty (80) percent deduction for insurance dividends for income years beginning prior to January 1, 2004, section 24425 will not be applied. For income years beginning on or after January 1, 2004, special rules are regarding the deductibility of interest expense and some other expenses. Interest expense will be disallowed if it 1) relates to a contribution to the capital of an insurance company from a non-insurer member of the group, 2) it is paid in connection with the acquisition of an insurance company within the last five years, 3) if it paid where there are disqualified dividends, and 4) where an affiliate is paying premiums to the insurance company. Other expenses are disallowed if they involve the acquisition of property by insurance companies.

6. <u>SECTION 23101.5 EXCLUSION OF CERTAIN ACTIVITIES</u>

Section 23101.5 provides a statutory exclusion from paying California taxes if the taxpayer petitions the Franchise Tax Board and limits its presence in California to those activities described in the section. That section provides that if a corporation's operations in California are limited to certain specified procurement and student activities, the FTB may determine that the corporation is not doing business in California for purposes of the franchise tax or deriving income from sources within California for purposes of the corporation income tax. Specifically, the activities within California must be limited under section 23101.5 to either or both of the following:

(1) The purchase of personal property or services solely for its own use or use by its affiliate outside California

(A) if the corporation does not have more than 100 employees in California, whose duties are limited to solicitation, negotiation, liaison, monitoring, auditing, and inspecting the property or services acquired, or providing technical advice with respect to its requirements, and

(B) the corporation does not have more than 200 employees in this state whose duties are limited to solicitation, negotiation, liaison, monitoring, auditing, and inspecting the property or services acquired, or providing technical advice with respect to its requirements, and the personal property or services purchased by the corporation or its affiliate are used for the construction or modification of a physical plant or facility located outside the state. The total number of employees in these two activities cannot exceed 200.

(2) The presence of employees in California only for the purpose of attending a public or private school, college or university. There is no numerical limitation on this presence, and employees here as students do not count against the 200 limitation with respect to the first two activities.

A corporation does not automatically qualify for this exemption; it must petition the Franchise Tax Board. The procedure for filing the petition, and the requirements for its contents, are set forth in Regulation 23101.5. The filing of the petition shall be deemed a waiver of the confidentiality provisions of section 19542 with respect to the facts alleged in the petition and any additional evidence produced with respect to those facts. If such a determination is made, it shall remain in force for five years as long as the corporation continues to meet the criteria set forth in section 23101.5.

7. <u>PUBLIC LAW 86-272 EXCLUSION OF CERTAIN ACTIVITIES</u>

a. In General

In 1959, Congress enacted Public Law 86-272 (P.L. 86-272, 15 U.S.C.A. § 381), which limited the states' ability to impose taxes on or measured by income on persons engaged in interstate commerce. The legislation was enacted primarily in response to the United States Supreme Court decisions in February 1959 in *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings, Inc.* (1959) 358 U.S. 450. P.L. 86-272 provides that a state has no power to impose a net income tax on the income derived from the state by a corporation if the only business activities within the state by or on behalf of the corporation is solicitation of orders for the sale of tangible personal property and (1) the orders are sent outside the state for approval or rejection and (2) if approved, are filled by shipment or delivery from a point outside the state.

The United States Supreme Court in <u>Wrigley v. Wisconsin</u> (1992) 505 U.S. 214, 120 L.Ed.2d 174, provided additional guidance regarding the scope of immunity afforded under

P.L. 86-272. *Wrigley* held that for purposes of P.L. 86-272 immunity, "solicitation of orders," in addition to any speech or conduct that explicitly or implicitly proposes a sale, also covers those activities that are "entirely ancillary" to requests for purchases - those that serve no independent business function apart from their connection to the soliciting of orders.

The court in *Wrigley* also recognized a de minimis exception to the activities that forfeit immunity. Whether a particular activity is sufficiently de minimis depends upon whether that activity (or activities taken together) establishes a nontrivial additional connection with the taxing State.

b. FTB/MTC Position Statement

California is a signatory to a resolution adopting a document entitled "Information Concerning Practices of Multistate Tax Commission States Under Public Law 86-272." That document reflects the signatory states' current practices with regard to (1) whether a particular factual circumstance is considered immune or not immune from taxation by reason of P.L. 86-272; and (2) the jurisdictional standards which will apply to sales made in another signatory state for purposes of applying a throwback rule (if applicable) with respect to such sales.

The Franchise Tax Board has issued "Application and Interpretation of Public Law 86-272" (FTB 1050) which incorporates the substance of the Multistate Tax Commission document. The most recent release of FTB 1050, Attachment 1, should be consulted in detail in resolving P.L. 86-272 issues in California. Highlights of FTB 1050 are:

(1) <u>Nature of Property Being Sold</u>: Only the sale of tangible personal property is afforded immunity under P.L. 86-272. Therefore, the selling or providing of services, and the selling, leasing, renting, licensing or other disposition of real estate, personal property, intangibles or any other type of property are not immune from taxation by reason of P.L. 86-272.

(2) <u>Solicitation of Orders</u>: For the in-state activity to be immune, it must be limited solely to <u>solicitation</u> (except for certain activity conducted by independent contractors as explained in FTB 1050). If there is any other activity unrelated to solicitation, the immunity is lost. FTB 1050 sets forth examples of activities presently treated by California and the other signatory states (unless otherwise stated as an exception or addition) as either non-immune or immune.

(3) <u>Independent Contractors</u>: P.L. 86-272 provides immunity to certain in-state activities if conducted by an independent contractor that would not be afforded if performed by the taxpayer directly. Independent contractors may engage in the following limited activities in California without the taxpayer's loss of immunity: (a) soliciting sales; (b) making sales; (c) maintaining a sales office. Sales representatives who represent a single principal are not considered to be independent contractors and are subject to the same limitations as employees. Maintenance of a stock of goods in California by the independent contractor under

consignment or any other type of arrangement with the principal removes the immunity.

The statement provides a listing of certain additional activities that an independent contractor can carry on without losing immunity. Inherent in this statement is the premise that unless an additional activity is listed as being permitted, engaging in other activity that would cause a loss of immunity if performed by an employee would also cause a loss of immunity if carried out by an independent contractor.

The question of what is an "independent contractor" was considered and answered with respect to a wholly owned subsidiary in <u>Reader's Digest Association, Inc. v. Franchise Tax</u> <u>Board</u> (2001) 94 Cal.App.4th 1240. In that case the subsidiary was denied independent contractor status when it served as the exclusive United States advertising representative for all additions of Reader's Digest, including those published and distributed by unrelated foreign corporations. The foreign distributors were required to utilize the subsidiary was not prohibited from making ad sales for other entities but, in fact, did not do so. In addition, the parent company performed most administrative functions for the subsidiary, and an announcement by the parent of an office move for the subsidiary referred to the subsidiary's employees as "our employees." Finally, for financial accounting purposes, all of the subsidiaries' sales and income were eliminated as intercompany sales because "you can't generate income by selling between yourself."

(4) <u>Delivery of Goods in Own Vehicles</u>: It was originally the position of the Multistate Tax Commission that the delivery of goods into the state by the seller's own vehicles is an activity which exceeds that permitted by Public Law 86-272. In January of 1997, the Supreme Court of Virginia interpreted the language of Public Law 86-272 as describing a single transaction consisting of three parts: first, the solicitation of the order; second, the approval of the order; and third, the shipping or delivery of the goods. Under this interpretation, Public Law 86-272 provides a shield for income tax purposes for companies which deliver goods into a state in their own vehicles. *Virginia Department of Taxation v. National Private Truck Council*, 253 Va. 74 (1997). The Franchise Tax Board and the Multistate Tax Commission modified their statements to indicate they will follow the Virginia decision.

In 1996, the Illinois Supreme Court held that the delivery of goods into a state by an out-of-state seller's own vehicles created sufficient nexus for Due Process purposes to allow Illinois to require the seller to collect Illinois use tax. <u>Brown's Furniture, Inc. v. Wagner</u>, 171 Ill.2d 410 (1996).

The two cases are not, however, inconsistent. <u>Brown's Furniture</u> is a sales and use tax case determined under the Due Process Clause. <u>National Private Truck Council</u> is an income tax case decided under the federal statute. The delivery of goods by a seller's own vehicles is sufficient to establish Due Process nexus for income tax

purposes but it is insufficient to overcome the Commerce Clause created shield of the federal statute.

(5) <u>Miscellaneous Practices</u>: In order for there to be immunity under P.L. 86-272, the only activity in California must be in interstate commerce. If there is any other activity other than solicitation or that is incidental to solicitation, then immunity is lost. See *National Geographic Society v. Cal. Board of Equal.* (1977) 430 U.S. 551. Approval of the sales must be made outside California, except for sales by independent contractors. Deliveries must be made from a point outside California. In addition, the immunity afforded by P.L. 86-272 does not apply to any corporation incorporated within California. Finally, if a sale consists of a mixture of tangible personal property and services (e.g., photographic development), the immunity is lost.

c. Significant California Decisions

While FTB 1050 provides general rules for the application of P.L. 86-272, it is not intended to cover all possible situations. "Each case must be judged on its own facts, with particular emphasis placed on the totality of the taxpayer's activities within the state." (*Appeal of Aqua Aerobic Systems, Inc.*, Cal. St. Bd. of Equal., Nov. 6, 1985.)

i. Board of Equalization Decisions

The following decisions by the Board of Equalization illustrate the application of P.L. 86-272 in California:

I. <u>Appeal of Riblet Tramway Company</u> Cal. St. Bd. of Equal., Dec. 12, 1967

The taxpayer, a Washington-based corporation, manufactured and sold a ski lift through a salesman to Dodge Ridge Ski resort in California, which was then erected by the purchaser or an independent contractor hired by the taxpayer. No immunity, because inspection activities performed by the taxpayer after installing of the ski lift in California went beyond the protected activities under P.L. 86-272.

II. <u>Appeal of Nardis of Dallas, Inc.</u> Cal. St. Bd. of Equal., Apr. 22, 1975

The taxpayer, a Texas-based corporation, solicited orders by way of a person in California who also operated a showroom in California. No immunity, because the person was an employee of the taxpayer, as opposed to being an independent contractor. The finding of an employer-employee relationship was based primarily upon the taxpayer's right to discharge the person at will, without cause.

III. <u>Appeal of Aqua Aerobic Systems, Inc.</u> Cal. St. Bd. of Equal., Nov. 6, 1985

The taxpayer, an Illinois based corporation, marketed water and wastewater equipment in California through independent dealer representatives. No immunity, because warranty repairs and/or inspection activities were performed in California following the sales.

IV. <u>Appeal of Schwinn Sales West, Inc.</u> Cal. St. Bd. of Equal., May 3, 1988

No immunity, where the California activities of the taxpayer's (nonresident) sales manager included conducting training; investigating an accident case involving a Schwinn bicycle; conducting a dealership survey; making store location searches; a meeting to do cyclic write-ups; participating in an investigation and court trial relating to a bicycle accident; investigating a consumer complaint; conducting a service school; meeting with dealership applicants and prospects; assisting in a change of ownership of a dealership; and reimbursing a customer due to a complaint, since these activities of the manager went far beyond permitted solicitation activities. Even independent of the activities of the manager, service schools conducted in California by Schwinn personnel who resided out-of-state but traveled into California went beyond the scope of allowable solicitation and were outside the scope of P.L. 86-272.

V. <u>Appeal of Hauserman, Inc.</u> Cal. St. Bd. of Equal., Sept. 30, 1993

No immunity, where the taxpayer (a non-U.S. corporation) maintained a showroom/sales office in Los Angeles.

VI. Appeal of Stack's Sales, Inc.,

Cal. St. Bd. of Equal., Dec. 4, 1996 (Unpublished)

No immunity given by Public Law 86-272 where the taxpayer made sales directly to the public at trade shows conducted within the state. Such activities were not de minimis as defined by the U.S. Supreme Court in *Wrigley*.

VII. <u>Appeal of Personal Selling Power, Inc.</u>

Cal St. Bd. of Equal., Mar 9, 2009 (Unpublished)

The sale of magazine and internet advertising was not subject to Public Law 86-272.

ii. Court Cases

I. Brown Group Retail, Inc. v. Franchise Tax Board (1996) 44 Cal.App.4th 823

The activities of a separate division established by the taxpayer to assist retailers in establishing stores in which the taxpayer's products were sold were not protected by

Public Law 86-272. The employees of the division were not authorized to solicit sales and were forbidden from doing so. The employees' activities were independent of solicitation. The fact that such activities ultimately gave rise to increased sales does not make the activities ones of solicitation. The services offered by the division were of a nature that a small retailer would have to pay a marketing or management service to duplicate. The fact that the services were provided without charge was of no significance. The court's analysis relied on the decision of the United States Supreme Court in *Wrigley*.

II. <u>Reader's Digest Association, Inc. v. Franchise Tax Board</u> (2001) 94 Cal.App.4th 1240

The activities of a wholly owned subsidiary that sold advertising space for the parent's magazine and the foreign versions of the magazine were attributed to the parent company. The subsidiary did not qualify as an "independent contractor" because it only represented the parent company, affiliates and independent third parties who were required pursuant to their licensing agreement to use the subsidiary as their agent for the sale of advertising space to customers in the United States. In addition, the parent company provided many of the subsidiaries administrative services and treated the subsidiary as part of the parent company.

d. P.L. 86-272 and Foreign Commerce

In Appeal of Dresser Industries, Cal. St. Bd. of Equal., June 29, 1982, the SBE held that the provisions of P.L. 86-272 do not apply to foreign commerce. Export sales of pumps, whether made directly by the taxpayer or through its sales subsidiaries, were consummated by the direct shipment of pumps from California to foreign customers. FTB applied the "throwback rule" to pump shipments to foreign countries on the theory that if P.L. 86-272 were applicable to foreign commerce, these countries would not have jurisdiction to tax the taxpayer's income. The Board of Equalization held that FTB erred in concluding the jurisdictional limitations of P.L. 86-272 must be considered in determining whether the foreign countries in question had jurisdiction to tax the taxpayer under United States jurisdiction principles. Accordingly, the question in the area of foreign commerce is not whether 82-272 applies, but whether the foreign country lacks United States constitutional nexus to tax under the Due Process Clause which imposes two requirements: (1) a minimal connection or nexus between the interstate activities and the taxing (foreign) state, and (2) a rational relationship between the income attributed to the (foreign) state and the intrastate values of the enterprise. (See also, Jaques, Sales Throwbacks From Foreign-Nation Jurisdictions: California's Dresser Industries Decision, 3 Journal of State Taxation 179 (1984).)

The Franchise Tax Board issued Legal Rule 99-1 (Jan. 1999) opining that commerce with Puerto Rico constituted interstate commerce, and therefore the limitations of Public Law 86-272 were applicable in determining whether a taxpayer had a taxable presence in Puerto Rico. This determination does not apply to other territories and possessions of the United States.

e. P.L. 86-272 and *Finnigan*

i. The *Joyce/Finnigan/Huffy* Issue

For taxable years beginning on or after January 1, 2011, California will follow the *Finnigan* approach. Section 25135(b). The statute states that "all sales of the combined reporting group properly assigned to this state under this section shall be included in the sales factor numerator for this state regardless of whether the member of the combined group reporting group making the sale is subject to the taxes imposed [by California]." The section also includes a sentence stating that the *Finnigan* rule will be applied with respect to sales occurring outside of California.

The issue takes its name from three Board of Equalization decisions that have reached inconsistent results with respect to the question of whether "taxability with a state" is decided upon the presence and activities of each individual entity within a unitary business or upon the presence and activities of the unitary business itself. The answer to this question is significant for purposes of the "throwback" rule of the sales factor. If "taxability" is decided on an entity basis, a "throwback" rule could be applied to a member of the unitary business even though other members had a taxable presence in the state. If "taxability" were decided on a unitary basis, then the "throwback" rule would not be applicable to any entity as long as the unitary business has a "taxable" presence in the state.

In <u>Appeal of Joyce Inc.</u>, Cal. St. Bd. of Equal., Nov. 23, 1966, the SBE held that sales to California customers by an out-of-state seller which was part of a unitary business could not be included in the California sales factor of the combined report for members of the unitary business which were subject to California taxation, because the <u>seller itself</u> was immune from taxation in California under P.L. 86-272. Under <u>Joyce</u>, taxability is determined on an entity basis.

In <u>Appeal of Finnigan Corporation</u> ("Finnigan I"), Cal. St. Bd. of Equal., Aug. 25, 1988, the Board of Equalization concluded the sales made by an entity that was not taxable in the state where the sales were made should <u>not</u> be thrown back to California because <u>another</u> member of the unitary group, Finnigan Corporation, was taxable in that state. FTB filed a petition for rehearing from the decision in *Finnigan I*, and the Board of Equalization then issued its Opinion On Petition for Rehearing, "*Finnigan II*," on January 24, 1990. The *Finnigan II* opinion stated that it was "analytically and philosophically incompatible with *Joyce*," and the SBE expressly announced that it was overruling the apportionment rule of *Joyce*. Under *Finnigan*, taxability is determined on a unitary basis.

In <u>Appeal of The NutraSweet Company</u>, Cal. St. Bd. of Equal., Oct. 29, 1992, sales made by the parent's wholly owned unitary subsidiary operating in Puerto Rico were attributable to California for purposes of computing the sales factor of the apportionment formula for the parent's unitary group. The Board of Equalization, without reaching the question of whether

the subsidiary was taxable in California, concluded "[t]he case before us presents the same issue and fact pattern that appeared in *Joyce*. ... Since *Joyce* was overruled in *Finnigan*, it is obvious that appellant's position in this appeal must be rejected." Under *NutraSweet*, taxability is determined on a unitary basis.

On April 22, 1999, the State Board of Equalization issued the decision in <u>Appeal of Huffy</u> <u>Corporation</u>. Huffy conducted its business through itself and five wholly owned subsidiaries. The Franchise Tax Board and the taxpayer agreed that a unitary business existed and that two of the subsidiaries were subject to California tax on the basis of property and employees within the state. The parent corporation asserted, and the Franchise Tax Board did not contest, that it was not subject to tax in California.

The Franchise Tax Board, under the authority of *Appeal of Finnigan*, asserted that the sales made by the parent corporation into California should be assigned to the numerator of the sales factor of the unitary business to determine the amount of business income attributable to California. After the California income of the unitary business had been determined, that income should then be assigned to the members of the unitary business which was taxable in California. The taxpayer argued that the Joyce rule was the correct one.

The Board of Equalization agreed with the taxpayer and held that:

"While there were theoretically good reasons for the initial implementation of the *Finnigan/NutraSweet* rule, the actual practice has resulted in the taxation of income which would not otherwise be taxed by the State of California. In order to promote uniformity of the UDITPA law, and to more fairly reflect the fundamental principles of combined reporting, this Board believes that its pre*Finnigan* decision in *Joyce* is better law."

The taxpayer won the war but lost the battle. The Board of Equalization determined that taxpayers had conducted their business affairs in reliance upon *Finnigan*, and therefore re-application of the *Joyce* rule should be made on a prospective basis only. The *Huffy* decision "is limited to income years beginning on or after the date [April 23, 1999] of [the] opinion."

In the <u>Appeal of Wynn's International, Inc.</u>, Cal. St. Bd. of Equal., Sept. 1, 1999, the Board of Equalization affirmed its decision with respect to retroactivity in a case involving years that were prior to *Finnigan* and held that the *Finnigan* rule applied.

The California appellate courts have issued two decisions, <u>Citicorp North America, Inc. v.</u> <u>Franchise Tax Board</u> (2000) 83 Cal.App.4th 1403, and <u>Deluxe Corporation v. Franchise</u> <u>Tax Board</u>, unpublished, that relied upon the <u>Citicorp</u> decision, upholding the Board of Equalization's decision in <u>Appeal of Huffy</u> to apply the Joyce rule after April 23, 1999. Effective for income years beginning on or after January 1, 2011, the Legislature added Section 25135(b) to require the use of the *Finnigan* approach.

ii. Regulation 25106.5

The Franchise Tax Board has adopted a comprehensive package of regulations for preparing combined reports. One of the regulations adopted under section 25106.5, originally sanctioned the *Joyce*, or entity, rule for determining taxability. That regulation was amended for taxable years beginning on or after January 1, 2011 to reflect the *Finnigan* rule. Regulation 25106.5(c)(7).

iii. Other States

The *Finnigan/Joyce* issue has been raised in other states. The States of Kansas and Utah have adopted a regulation based upon the *Finnigan* approach. The Multistate Tax Commission has remained above the fray while noting the existence of the issue. In both Illinois, *Dover Corp. v. Dept. of Revenue*, 648 N.E.2d 1089 (1995), and Maine, *Great Northern Nekoosa Corp. v. State Tax Assessor*, 675 A.2d 963 (1996), the courts have come down on the *Joyce* side of the debate. Arguably, Arizona may be on the *Finnigan* side as the result of its decision in *Airborne Navigation Corporation v. Arizona Dept. of Revenue*, Ariz. Bd. of Tax Appeals (1987).

Most recently, the New York Board of Tax Appeals in the <u>Matter of the Petition of Disney</u> <u>Enterprises Inc. & Combined Subsidiaries</u>, 2005 N.Y. tax Lexis 239, held that the sales of non-nexus members of a unitary group could be taken into account in determining the corporate income tax liability of nexus members. This decision has been affirmed. Massachusetts in adopting combined reporting accepted the *Finnigan* approach in its sales factor rules. It appears that *Finnigan* may have new life.

iv. Citicorp North America, Inc. and Deluxe Corporation

Citicorp North America, Inc. v. Franchise Tax Board (2000) 83 Cal.App.4th 1403, cert. denied, June 29, 2001, 533 U.S. 963, involves a unitary financial service business that had a substantial presence in California. The subsidiary whose sales and property were at issue was incorporated in South Dakota and was the credit card processing arm for the business. It realized several hundreds of millions of dollars of interest and card fees from California residents and had receivables in the billons of dollars with respect to California cardholders. The South Dakota subsidiary had no tangible property or employees in California and was stipulated as not being taxable in California. The court's decision points out that the Finnigan rule is based upon interpretation of the word "taxpayer" for purposes of UDITPA. The court found that the consideration of the income of Citibank (South Dakota) did not mean the FTB was taxing but instead was only apportioning income attributable to California. It cited to the California Supreme Court opinion in Edison California Stores v. McColgan (1947) 30 Cal.2d 472, that "The ascertainment of income by the apportionment method is not necessarily a disregard of the corporate entity nor an extension of the provisions of the statute by implication. Formula allocation is merely a method of ascertaining the income attributable to the plaintiff's business."

The court reviewed the Board of Equalization's analysis and found it to be well thought out and thorough. It recognized that the Board of Equalization had attempted to establish a new rule with *Finnigan* but recognized that its leadership had not been accepted and therefore was authorized to return to the *Joyce* rule on a prospective basis.

The <u>Deluxe Corporation v. Franchise Tax Board of California</u> (unpublished) 122 S. Ct. 809, *cert. denied*, Jan. 7, 2002, case involves the sale of tangible property and therefore presented some different issues than the *Citicorp* case. These differences were not commented on, however.

f. Proposed Federal Legislation – Business Activity Tax (BAT)

For the last several years legislation has been introduced into Congress to replace Public Law 86-272 with a comprehensive federal limitation on state tax powers that would apply not only to taxes on or measured by income but would apply to all business activity taxes (BATs). The proposed legislation would

Apply to all business taxes – not be limited to income taxes and to the solicitation of sales;

Establish a physical presence requirement before a state could assert a BAT;

Would provide a requirement in most cases that the physical presence exist for 21 days or more;

Disregard the presence of property for purposes of contract manufacturing, for testing, and for leases to a service provider;

Disregard employee presence for purposes of purchasing and warranty work;

Agency or attributional nexus could not be relied upon absent a formal agency agreement.

The use of the *Finnigan* rule would not be allowed.

<u>CHAPTER 4</u> THE UNITARY METHOD OF TAXATION

1. HISTORY AND OVERVIEW

When a taxpayer derives income from sources both within and outside California, that taxpayer is required to measure its franchise tax liability by its income "derived from or attributable to sources" within California. (Section 25101.) California's reliance upon a "source" basis for taxation, as opposed to a residence basis (which taxes residents upon all income earned regardless of the source) is consistent with both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause of the United States Constitution in that a state may not, when imposing an income tax, "tax value earned outside its borders." (*ASARCO, Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, 315.) Difficulties may arise, however, in properly allocating the income of an integrated business enterprise operating in more than one state or in foreign countries. The approach utilized by California is the unitary business principle, a familiar concept in income tax cases for almost 100 years. (See, e.g., *United States Steel Corp. v. Multistate Tax Comm'n* (1978) 434 U.S. 452, 473, n. 25, 474 n. 26; *ASARCO v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, 320, n. 14; see also, Miller, *Worldwide Unitary Combination: The California Practice*, in The State Corporation Income Tax (C.E. McLure, Jr., ed. 1984) 132.)

The theory underlying the unitary business principle has its roots in real property tax law, where the issue of apportionment arose in the context of the property taxation of railroads . In <u>Union Pacific Railway Co. v. Ryan</u> (1884) 113 U.S. 516, the United States Supreme Court recognized that the value of a railroad line could not be measured merely by looking to the value of the property located within a specific geographic area. The Supreme Court found that a "separate mile or two of its length is almost valueless by itself," and approved the method enacted by the city of Cheyenne which taxed the value of the track within its city limits as a percentage of the value of the entire railroad line. The value attributed to Cheyenne was calculated by determining the value of the entire line and dividing this value by the total number of miles of line to generate a valuation per mile of track. In 1897, the court expanded this concept of "unit" valuation in <u>Adams Express Co. v. Ohio State Auditor</u> (1897) 165 U.S. 194, 222-24, by recognizing that unity of use and management of a business which is scattered through several states may be considered when a state attempts to impose a tax on an apportionment basis.

The first application of the unitary theory to income taxes was the 1920 Supreme Court decision in <u>Underwood Typewriter v. Chamberlain</u> (1920) 254 U.S. 113. The Court in <u>Underwood</u> approved a formula used by Connecticut to determine the amount of income from a multistate business that was attributable to Connecticut for state tax purposes. In approving for the first time the use of an apportionment formula for income tax purposes, the Court commented, "The profits of the corporation were largely earned by a series of

transactions beginning with manufacture in Connecticut, and ending with the sale in other states." *Id.* at 120.

The term "unitary business" itself can best be traced to the court's 1924 decision in <u>Bass</u> <u>Ratcliff & Gretton v. State Tax Commission</u> (1924) 266 U.S. 271 (1924). There, the Court held that the State of New York was justified in using formula apportionment to attribute a "just proportion of the profits earned by the company from such unitary business" which included the brewing of ale in England and its sale in New York. (*Id.* at 282.)

2. <u>TESTS OF UNITY</u>

a. Three Unities Test

Decisions subsequent to *Underwood* and *Bass Ratcliff* have set forth multiple tests for determining the existence of a unitary business. In <u>Butler Brothers v. McColgan</u> (1941) 17 Cal.2d 664, 678, 111 P.2d 334, 341, aff'd, 315 U.S. 501 (1942), the California Supreme Court announced the "three unities" test whereby a unitary business is established by the presence of the unities of ownership, operation and use. Specifically, the court stated:

"In accordance with the foregoing analysis it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operations." (17 Cal.2d at 678.)

b. Contribution or Dependency Test

In <u>Edison California Stores v. McColgan</u> (1947) 30 Cal.2d 472, 183 P.2d 16, the California Supreme Court announced the "contribution or dependency" test, under which a business is unitary if the operations in California are dependent on or contribute to the operation of the business outside the state. Specifically, the court stated:

"If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate." (30 Cal.2d at 481.)

c. Interrelationship of Three Unities and Contribution or Dependency Tests

The California cases have not always been clear as to whether there are two separate alternative tests of unity under the California cases or whether the tests represent different phrasings of the same test. Both tests were promulgated by the California Supreme Court. One court has concluded that the tests should be construed as alternative based upon the fact that the application of the three unities test led to a conclusion that unity was definitely established and the fact that the California regulations do not reference the three unities test at all. <u>A.M. Castle & Co. v. Franchise Tax Board</u> (1995) 36 Cal.App.4th 1794.

The <u>Castle</u> court concluded that a unitary business existed in the circumstances of that case under the contribution or dependency test and found that "the fact that two of the three unities clearly exist ... is evidence they are unitary under the dependency or contribution test." <u>A.M. Castle & Co. v. Franchise Tax Board</u> (1995) 36 Cal.App.4th 1794 at 1807.

d. "Constitutional" Tests

The Three Unities Test and the Contribution or Dependency Test have been applied consistently by the California courts in a variety of cases. (See, e.g., <u>Superior Oil Co. v.</u> <u>Franchise Tax Board</u> (1963) 60 Cal.2d 406, 411-412; <u>Honolulu Oil Corp. v. Franchise Tax</u> <u>Board</u> (1963) 60 Cal.2d 417, 423-424; John Deere Plow Co. v. Franchise Tax Board (1951) 38 Cal.2d 214, 221-222; <u>Anaconda Co. v. Franchise Tax Board</u> (1982) 130 Cal.App.3d 15, 25-28; <u>Container Corporation of America v. Franchise Tax Board</u> (1981) 117 Cal.App.3d 988, 994-1001, cert. granted, opn. at 463 U.S. 159, 77 L.Ed.2d 545 (1983); <u>Chase Brass & Copper Co. v. Franchise Tax Board</u> (1970) 10 Cal.App.3d 496, 501-502.)

However, the United States Supreme Court has alluded to another test(s) of unity, which, in reality, may be no more than a variation on these two standard tests. Specifically, the United States Supreme Court has referred to a unitary business as one which exhibits "contributions to income resulting from functional integration, centralization of management and economies of scale." (*Mobil Oil Corp.* v. *Comm'r of Taxes of Vt.* (1980) 445 U.S. 425, 438; *F. W. Woolworth Co.* v. *Taxation and Revenue Dep't of the State of N.M.* (1982) 458 U.S. 354, 366; *Allied-Signal, Inc.* v. *Director, Division of Taxation* (1992) 504 U.S. 768, 119 L.Ed.2d 533. In addition, the United States Supreme Court suggested another indicium of a unitary business is a flow of value, not a flow of goods." (*Container Corp. of America* v. *Franchise Tax Bd.* (1983) 463 U.S. 159, 178.) In an alternative approach, the Supreme Court has stated that for commonly controlled activities to be *non*unitary, they must be part of "unrelated business activity, which constitutes a 'discrete business enterprise.'" (*Mobil Oil Corp.*, *supra*, 445 U.S. at 439-440; *ASARCO Inc.* v. *Idaho State Tax Comm'n* (1982) 455 U.S. 307, 317.)

In footnote 1 in <u>Barclays Bank PLC v. Franchise Tax Board</u>, <u>Colgate-Palmolive Company</u> <u>v. Franchise Tax Board</u> (1994) 512 U.S. 298, 129 L.Ed.2d. 244, the United States Supreme Court in dicta endorsed the "functional integration, centralization of management and economies of scale" test along with California's "dependency or contribution" and "three unities" tests as the benchmarks of a unitary business.

e. Board of Equalization "Boilerplate" Tests of Unity

Before proceeding with an analysis of the specific facts and circumstances of a unitary case, it is common for the Board of Equalization to recite two standard paragraphs setting forth its view of the basic legal principles of the unitary method. (See, e.g., *Appeal of Doric Foods Corporation*, Cal. St. Bd. of Equal., Dec. 5, 1990; *Appeal of Dr. Pepper Bottling Company*

of Southern California, et al., Cal. St. Bd. of Equal., Dec. 5, 1990; <u>Appeal of Power-Line</u> <u>Sales, Inc.</u>, Cal. St. Bd. of Equal., Dec. 5, 1990; <u>Appeal of Sierra Production Service, Inc.</u>, <u>et al.</u>, Cal. St. Bd. of Equal., Sept. 12, 1990.) The language used in <u>Power-Line</u> is typical:

"If a taxpayer derives income from sources both within and without California, its franchise tax liability is required to be measured by its net income derived from or attributable to sources within this state. (Rev. & Tax Code, § 25101.) If the taxpayer is engaged in a single unitary business with affiliated corporations, the income attributable to California must be determined by applying an apportionment formula to the total income derived from the combined unitary operations of the affiliated companies. (*Edison California Stores, Inc. v. McColgan*, 30 Cal.2d 472 [183 P.2d 16] (1947).)

"The California Supreme Court has held that the existence of a unitary business may be established by the presence of unity of ownership; unity of operation as evidenced by central accounting, purchasing, advertising, and management divisions; and unity of use in a centralized executive force and general system of operation. (*Butler Bros. v. McColgan*, 17 Cal.2d 664 [111 P.2d 334] (1941), aff'd, 315 U.S. 501 [86 L.Ed. 991] (1942).) It has also stated that a business is unitary if the operation of the business done within California is dependent upon or contributes to the operation of the business outside California. (*Edison California Stores, Inc. v. McColgan, supra,* 30 Cal.2d at 481.) More recently, the United States Supreme Court has emphasized that a unitary business is a functionally integrated enterprise whose parts are characterized by substantial mutual interdependence and a flow of value. (*Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 178-179 (77 L.Ed.2d 545), reh'g den., 464 U.S. 909 [78 L.Ed.2d 248] (1983).)"

In the late 70's, the State Board of Equalization coined the term "quantitative substantiality" to describe the nature of the relationships which it believed were necessary to establish a unitary business. Subsequently, in <u>Appeal of Saga Corporation</u>, Cal. St. Bd. of Equal., June 29, 1982, it abandoned that catch phrase. The Board of Equalization affirmed its abandonment of "quantitative substantiality" in <u>Appeal of Bank of Tokyo, Limited and Union Bank (formerly California First Bank)</u>, Cal. St. Bd. of Equal., Aug. 2, 1995, stating "the taxpayer's burden of proof requires appellants to 'establish by a preponderance of the evidence that the unitary connections present in this case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist." (Emphasis in original.)

In so-called "diverse business" cases the Board often included the following paragraph:

"More is required to demonstrate the existence of a functionally integrated enterprise than the recitation of a number of so-called 'unitary factors.' One must be able to differentiate a unitary business from a group of commonly owned businesses or activities, the operations of which really have no effect upon one another. (*Appeal of Sierra Production Service, Inc., et al.*, 90 SBE- 010, Sept. 12. 1990.) As we said in the <u>Appeal of Saga Corporation</u>, decided by this Board on June 29, 1982, we must distinguish between those cases in which unitary labels are applied to transactions and circumstances which, upon examination, have no real substance, and those in which the factors involved show such a significant interrelationship among the related entities that they all must be considered to be parts of a single economic enterprise."

f. Regulation 25120

i. In General

Regulation 25120 provides additional guidance and rules regarding what constitutes a unitary business. Most significantly, the regulation (1) recognizes that a single taxpayer may have more than one "trade or business"; and (2) sets forth three factors, the presence of any one of which creates a "strong presumption" that the activities of the taxpayer constitute a single trade or business.

Regulation 25120 provides in pertinent part:

"(b) Two or More Businesses of a Single Taxpayer. A taxpayer may have more than one 'trade or business.' In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business is then apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

* * *

"The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

"(1) Same type of business: A taxpayer is almost always engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

"(2) Steps in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer
products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

"(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing."

ii. <u>Appeal of Sierra Production</u>

The application of the Regulation 25120 presumption was discussed in depth by the SBE in *Appeal of Sierra Production Service, Inc., et al.*, Cal. St. Bd. of Equal., Sept. 12, 1990. There, the SBE made the following observations on the regulation and the centralized management presumption:

(1) FTB, for some time, has not been applying this presumption to taxpayers engaged in diverse lines of business. "By our decision in this case today ... we intend to leave no doubt in anyone's mind that we strongly disapprove of ... [FTB's] ... failure to apply its own regulation. We believe that, fairly read in its entirety, the regulation is consistent with the applicable constitutional principles"

(2) "If, for example, a taxpayer is seeking the benefit of that presumption, the presumption will apply if the taxpayer establishes, by specific, concrete evidence that it had <u>both</u> 'strong central management' and 'centralized departments for such functions as financing, advertising, research or purchasing.' Once those are proven, the presumption of unity applies and the burden of going forward with the evidence shifts to ... [FTB] ..., who will then be obliged to offer concrete evidence sufficient to support a finding that a single integrated economic unit did not exist. If ... [FTB] ..., satisfies this burden, then the presumption disappears, and the taxpayer will, as in the usual tax case, bear the ultimate burden of persuading us, by a preponderance of the evidence, that the taxpayer's position is correct." (Emphasis in original, footnotes and citations omitted.)

(3) "What constitutes 'strong central management' will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the mere existence of 'common officers or

directors' or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular <u>operational</u> role in the business activities of the various divisions or affiliates. The significance of such a managerial role, in the constitutional context, was underscored by the Supreme Court in *Container*." (Citation omitted, emphasis added.)

(4) "There is no question that the regulation does not contain an allinclusive list of the services which might be centralized, and which might provide evidence of unitary integration. Similarly, it should be clear that proof of a 'centralized department' requires something weightier than merely alleging, for example, that there was a 'common accountant' who kept the books for each affiliate. Other trivialities like a 'common insurance agent' will likewise be insufficient."

In <u>Appeal of Doric Foods Corporation</u>, Cal. St. Bd. of Equal., Dec. 5, 1990, it was noted that while the taxpayer alleged there was centralized management and the taxpayer was engaged in the same line of business as the subsidiary, the taxpayer "had made no claim" that it was entitled to the presumptions of unity contained in the regulation. Under these facts, the Board of Equalization stated that, "[a]ccordingly, we do not rely on the provision of the regulation to decide this matter." See also <u>Dental Insurance Consultants, Inc. v.</u> <u>Franchise Tax Board</u> (1991) 1 Cal.App.4th 343, for a judicial application of Regulation 25120(b)(3). See also <u>Appeal of Faberge, Incorporated, et al.</u>, Cal. St. Bd. of Equal., Oct. 29, 1992, for an example of where the SBE concluded the taxpayer presented sufficient evidence to invoke the presumption. See also, <u>Appeal of F.W. Woolworth Co., et al.</u>, Cal. St. Bd. of Equal., June 24, 1993, where the SBE refused to decide whether the taxpayers were in the same line of business for purposes of invoking the section 25120(b)(1) presumption.

See also, <u>Appeal of Business Exchange, Inc.</u>, Cal. St. Bd. of Equal., Dec. 13, 1994, where the SBE found the Regulation 25120(b)(3) presumption of strong central management "clearly contemplates that the central managers will, among other things, play a regular operational role, in the business activities of the various divisions or affiliates." The SBE also apparently found in <u>Business Exchange</u> that holding real estate for investment purposes, and the active development of real property for resale, were "diverse lines of business" under the regulation.

iii. Judicial Use of Presumptions

In <u>Mole-Richardson Co. v. Franchise Tax Board</u> (1990) 220 Cal.App.3d 889, the court discussed Regulation section 25120(b) and analyzed United States Supreme Court decisions to determine whether they had precluded unitary treatment in that case. The court found that those decisions did not preclude unitary treatment, found that there was strong centralized management in the circumstances of that case but did not specifically hold that the regulation compelled a finding of unity.

In <u>Dental Insurance Consultants, Inc. v. Franchise Tax Board</u> (1991) 1 Cal.App.4th 343, the court found a unitary business and pointed out that strong central management satisfied the criteria set forth in the regulations adopted by the department. The court, however, did not rest its holding on the fact that the regulation was satisfied. It conducted a standard unitary analysis in concluding that a unitary business existed.

In <u>A.M. Castle & Co. v. Franchise Tax Board</u> (1995) 36 Cal.App.4th 1794, the court found that the taxpayer and its subsidiary were in the same line of business and therefore satisfied one of the principles set forth in the regulations. This fact by itself was not determinative for the court. The court looked to the reason behind the regulation, the ability to make better use of its resources, and concluded that reason was present in this case. It went on to analyze the case under both the three-unities test and contribution or dependency test and concluded that the requirements of the contribution or dependency test were satisfied.

iv. MTC Proposed Regulation

In January of 2004, the Multistate Tax Commission amended its regulation IV.1.(b). As amended, the regulation sets forth MTC's view of the principles for determining the existence of a unitary business. The regulation adopts the three-part test set forth by the United States Supreme Court in <u>Mobil Oil Corp. v. Vermont</u> (1980) 445 U.S. 425. It provides definitions and examples of functional integration, centralization of management and economies of scale. It continues the indicia of a unitary business, same type of business, steps in a vertical process and strong centralized management from the prior regulation, but does not refer to them as presumptions. A significant portion of the regulation deals with the question of ownership or control. California has taken no action to adopt the Commission's amendments to their regulation.

3. <u>ADMINISTRATIVE/JUDICIAL DICHOTOMY</u>

The State Board of Equalization provides the first independent review of a determination by the Franchise Tax Board. Furthermore, this review can be obtained without having to pay the tax. As a consequence, there are substantially more reported Board of Equalization decisions involving the question of what constitutes a unitary business than there are reported California judicial opinions. In recent years, the Board of Equalization has issued very few opinions. As a consequence, the decisions of the Board of Equalization as to what constitutes a unitary business are now two decades or more old and may not necessarily reflect current views.

In the years when the Board of Equalization was issuing published decisions, taxpayers which lost decisions before the State Board of Equalization pursued their rights in the courts with a significant degree of success. Sometimes the case proceeds under a different name, and other times the case is resolved in the judicial setting without a reported decision because of the introduction of new evidence or based on the hazards of litigation. In any circumstance, the result may be quite different than that reported by the Board of Equalization. Therefore, great care should be taken in making a unitary determination solely

on reliance on Board of Equalization decisions both because of the age of the decisions and the fact that they may not have been ultimately followed by the courts.

4. <u>SPECIFIC ISSUES</u>

a. Unity of Ownership

i. In General

Generally speaking, unity of ownership means common ownership of more than 50 percent of a corporation's voting stock. The general rule becomes more complex in the context of partnerships, joint ventures, and family businesses, and where attributional situations are present involving "indirect control."

ii. Amendment of Section 25105

Section 25105 was amended in 1994, effective for income years beginning on or after January 1, 1995, to provide a bright line test of unity of ownership. Unity of ownership exists when corporations are members of a commonly controlled group as defined in the statute.

A commonly controlled group exists when:

1) there is ownership of more than 50 percent of the combined voting power of the stock;

2) there is constructive ownership of more than 50 percent of the voting power of the stock by the same person;

3) the entities are "stapled entities;" and

4) more than 50 percent of the voting power is owned by members of the same family.

iii. Former Practice

Prior to the amendment of Section 25105, the Franchise Tax Board had issued Legal Ruling 91-1, which covered a variety of topics under unity of ownership. From a historical perspective, or if dealing with older years, it would be appropriate to review a number of authorities including *Hugo Neu-Proler International Sales Corp. v. Franchise Tax Board* (1987) 195 Cal.App.3d 326; *Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Board* (1991) 229 Cal.App.3d 784; *Appeal of Revere Copper and Brass Incorporated*, Cal. St. Bd. of Equal., July 26, 1997; and *Appeal of Douglas Furniture of California, Inc.*, Cal. St. Bd. of Equal., Jan. 31, 1984.

iv. Decisions

I. <u>Appeal of Casio, Inc.</u>

The Board of Equalization, in an unpublished decision, <u>Appeal of Casio, Inc.</u>, Jan. 8, 1998, concluded that a 40-percent owner of a corporation could not establish unity of

ownership when the remaining shares were held by another corporation. The SBE stated, "From these authorities [*Hugo Neu-Proler*, *Rain Bird*, and *Appeal of AMP, Inc.*] we conclude that a company may be found unitary with another company even though it does not own more than half of the voting stock, so long as it is a 'related' member of a group which does." The SBE went on to limit this holding to circumstances in which minority shareholders are acting in concert. The fact that the other entity was in a majority ownership position made these authorities inapplicable.

II. <u>Appeal of CDA Cable, Inc.</u>

The Board of Equalization, in an unpublished decision, <u>Appeal of CDA Cable, Inc.</u>, Cal. St. Bd. Of Equal., May 31, 2001, held that voting trusts created by a group of shareholders with different trustees nonetheless satisfied unity of ownership for several of the years involved in the appeal. The taxpayer submitted testimony that the voting trusts were only formalities, and that the group of corporations had been operated cooperatively. The Board of Equalization provided no discussion of the rationale supporting its conclusion. The years involved pre-dated Legal Ruling 91-1.

For other years, the Board held that section 23801 prevented the corporations, all of which had elected S corporation status for federal purposes, to file a combined report where all of corporations that had no California filing requirement were deemed to have elected S corporation status for California purposes.

b. "Instant Unity"

i. In General

Occasionally, the issue is not whether entities are unitary, but precisely <u>when</u> they became unitary. From a theoretical perspective there is good justification for not including an acquired entity immediately upon acquisition. The application of the unitary business principle is premised upon contribution and/or dependency. Contributions generally take some time to be manifested in changes in the amount of income. In special circumstances it may be appropriate to combined acquired entities immediately. The considerations would appear to be different in the case of an expansion of a business through internal means. This issue is illustrated by several decisions.

ii. Significant Decisions

I. <u>Appeal of Atlas Hotels, Inc., et al.</u>

In <u>Appeal of Atlas Hotels, Inc., et al.</u>, Cal. St. Bd. of Equal., Jan. 8, 1985, the Board of Equalization found that a subsidiary became "instantly unitary" with the parent's unitary business from the date of its (100 percent) acquisition where there was evidence that many of the managerial and operational changes which demonstrated the subsidiary's integration with its parent not only were implemented immediately upon acquisition, but were planned or commenced well before the actual acquisition date.

II. <u>Appeal of the Signal Companies, Inc.</u>

The <u>Appeal of The Signal Companies, Inc</u>., Cal. St. Bd. of Equal., Jan. 24, 1990. The SBE concluded the gradual exploration and institution of integrating ties between companies, which did not begin until acquisition, did not make the subsidiary unitary with its parent corporation upon the date of acquisition. As stated in *Signal*, "unity is almost never demonstrated by some single event, but is a conclusion drawn from the aggregation of connecting factors between entities."

Accordingly, except where there is "instant unity," the precise date upon which a subsidiary subsequently becomes unitary must be determined on a case-by-case basis. The determining factor in choosing the time for a combined report is the date when sufficient unitary ties existed to support a finding of unity. (See also <u>Appeal of Dr. Pepper Bottling Company of</u> <u>Southern California, et al.</u>, Cal. St. Bd. of Equal., Dec. 5, 1990.)

III. <u>Appeal of Paradise Systems, Inc.</u>

In the <u>Appeal of Paradise Systems, Inc.</u>, Cal. St. Bd. of Equal., March 19, 1997 (unpublished), the Board of Equalization found in favor of a taxpayer's claim of instant unity based upon an integrated executive force, the same line of business and the existence of intercompany product flow.

IV. Appeal of ARA Services, Inc.

The Board of Equalization in an unpublished decision, the <u>Appeal of ARA Services, Inc.</u>, Cal. St. Bd. of Equal., May 8, 1997, held that over a period of time newly acquired diverse business operations became unitary. "Much as a stream becomes a river, we do find that appellant's operations gradually became unitary."

V. Appeal of Hyundai Motor America

The Board of Equalization in an unpublished decision, the <u>Appeal of Hyundai Motor</u> <u>America</u>, Cal. St. Bd. of Equal., June 25, 1998, held that a corporation created to expand the parent's business operations into a new market was part of the unitary business operated by the parent corporation from the date of the new corporation's creation.

c. The "<u>Monsanto</u>" Issue

California may consider the activities and results carried on without its borders even though there is no direct relationship to the activities carried on within its borders as long as the out-of-state and in-state activities are part of the same overall unitary business. In <u>Appeal of</u> <u>Monsanto Company</u>, Cal. St. Bd. of Equal., Nov. 6, 1970, the taxpayer argued that its subsidiary, Chemstrand Corporation, was not a part of the parent's unitary business because it did not contribute to, or depend upon, the California operation and because it had no direct dealings with the California operation. The Board of Equalization rejected this argument and concluded:

"This argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separate from either Chemstrand or the California operations."

<u>Monsanto</u> has been consistently followed by the Board of Equalization. (See, e.g., <u>Appeal of</u> <u>Aimor Corporation</u>, Cal. St. Bd. of Equal., Oct. 26, 1983, "[I]t is not necessary for each part of a unitary business to be directly related to each other part"; <u>Appeal of Hyundai Precision</u> <u>& Industries Co., Led. and Hyundai Steel Industries, Inc.</u>, Apr. 19, 2001, unpublished, "all that need be shown is that during the critical period, the other business formed an inseparable part of the taxpayer's unitary business wherever conducted.") For a judicial authority for this principle see Albany International Corporation v., Halperin, (1978) 388 A. 2d 902.

Indirect recognition of the "Monsanto" principle was provided by the United States Supreme Court in footnote 10 in the *Barclays* decision. In that footnote, the court rejected a nexus argument made by Amici United Kingdom that it was necessary for the taxing state to have nexus over each member of the unitary business included by the state in the combined report used to determine the income attributable to the state.

d. Partnership Interests

If a partnership and a corporation are engaged in a unitary business, California treats the corporation's share of the partnership's business income as apportionable business income and apportions that income at the corporation level by combining the corporation's share of the partnership's apportionment factors with the corporation's own factors to determine the corporation's apportionment percentage. If the partnership and the corporation are not engaged in a unitary business, then the corporation's share of the partnership's business income is treated as a separate trade or business of the corporation, i.e., the corporation's share of the partnership factors. (Regulation 25137-1; See also Chapter 6 for business/nonbusiness income issues involving partnerships.)

Except for ignoring the unity of ownership element, the issue of whether a corporation and a partnership are engaged in a unitary business is examined under the standard unitary analysis. No clear distinction is made on the basis of whether the partner is a general or limited partner.

e. Insurance Companies

Insurance companies present unique issues under the Corporation Tax Law. Article XIII, section 28 of the California Constitution generally provides that insurance companies doing business in California (other than companies issuing title and ocean marine insurance) must pay to the state a tax based on gross premiums. Subdivision (f) of section 28 provides that with the exception of taxes on real estate and motor vehicles, the gross premiums tax is "in lieu of all other taxes and licenses, state, county, and municipal, upon such insurers and their

property" (See also, <u>Mutual Life Ins. Co. v. City of Los Angeles</u> (1990) 50 Cal.3d 402, 406.) FTB Legal Ruling No. 385 (Apr. 1, 1975) states that because of the constitutional limitation set forth in article XIII, section 28, a corporate insurer engaged in a unitary business is excluded from a California combined report.

In <u>Appeals of Dial Finance Company of California, etc.</u>, Cal. St. Bd. of Equal., Feb. 10, 1993, the SBE held that dividends received by the taxpayer from an insurance company subsidiary were business income. The SBE in <u>Dial</u> rejected arguments that such taxation of the dividends violated Article XIII, section 28, by unconstitutionally subjecting the insurance company to the franchise tax, and rejected arguments that dividends from insurance companies cannot be taxed because FTB excludes insurance companies from combined reports. The SBE also declined to rule on various other constitutional challenges.

Another issue which has arisen with respect to insurance companies is whether "captive" insurance companies should be treated as insurance companies and therefore excluded from a combined report or their insurance "status" ignored and therefore included in a combined report. The status of "captive" insurance companies has been the subject of litigation for federal income tax purposes. The Service has had some success, but plentiful opportunities exist to avoid "captive" status. In discussions with the California Insurance Commissioner's office, it has been determined that the "captive" nature of a company has nothing to do with the Commissioner's classification of a company as being in the insurance business and therefore subject to the gross premiums tax. As a consequence, the Franchise Tax Board has determined that it will not pursue this issue.

Whether insurance companies could be included in a combined report as part of a unitary business became significant when no deduction was being allowed for dividends from insurance subsidiaries. In many cases insurance companies are headed by a holding company that has limited factors and derives most of its income from the insurance subsidiaries. To the extent the insurance subsidiaries paid dividends that were deductible, it was of no consequence to the holding company that all of its factors might be in California because it had no taxable income. If the dividends are no longer deductible, the location of the subsidiary's factors are of great significance. If the insurance companies' activities can be included in the combined report, a dividend elimination can be achieved through section 25106, and, in addition, if the insurance subsidiaries are part of the combined report, their factors will be included in the apportionment process, and most of the income will be assigned to the insurance company's activities and therefore would be shielded from taxation because of the California constitutional provision providing that the gross premiums tax is in lieu of all other taxes.

The Franchise Tax Board has a long-standing Legal Ruling, LR-385, which holds that insurance companies cannot be combined. In the past the Board of Equalization has endorsed this ruling. The amendments to section 24410 allowing a dividends-received deduction for 80% of the dividends lessen its significance. Most companies that were prepared to litigate the issue decided to accept the assured treatment offered by the amendment of section 24410.

The State Board of Equalization, in the Appeal of Argonaut Cal St. Bd. of Equal., June 28, 2006 (unpublished), sustained the Franchise Tax Board's position that insurance companies could not be combined. The taxpayer filed a petition for rehearing arguing that the question of fair apportionment under section 25137 had not been addressed. The Board of Equalization granted a rehearing. An initial question to be addressed was whether the taxpayers who in their returns represented that all of their factors were within California were even entitled for relief under section 25137. The Franchise Tax Board argued that under the statutory framework in California only a taxpayer, or a combined report group, that had income from sources within and without California was entitled to petition for relief under section 25137. There is a California provision, section 25101.15 California Revenue and Taxation Code, that allows wholly intrastate companies conducting a unitary business to file a combined report under section 25101 and through that section to the uniform act. It was this section that the two taxpayers filed under. The taxpayer responded by arguing that the unitary business included the insurance companies even though they could not be combined. The taxpayer's suggested relief under section 25137 was phrased in the alternative. Initially it argued that relief should be accomplished by allowing a result equivalent to combined reporting. Subsequently it requested that the income of the holding companies should be assigned solely by reference to the premiums of the insurance companies or the expenses of the insurance companies. Under either of these alternatives the taxpayers were taking the position that their activities should be disregarded and their income should be apportioned solely by reference to the activities of the insurance companies. The Board of Equalization in a 2-1 decision directed the Franchise Tax Board to allow the taxpayers' refund claims. Appeal of Argonaut Group, Inc, Cal, St. Bd. of Equal., January 23, 2009 (unpublished). There was no published decision and no direction as to how the refund was to be computed.

In another case *Appeal of Electronic Data Systems*, Cal, St. Bd. of Equal., Sept. 22, 2008, (unpublished) the Board of Equalization was presented with a case where a subsidiary was qualified as an insurance company in Texas and also did business in California but was not subject to the California gross premiums tax. In an unpublished decision the Board of Equalization found that Legal Ruling 385 had no application because it only addressed circumstances where an entity conducted only an insurance business. As a consequence the Board of Equalization allowed the subsidiary to be combined and to include the gross payments received by the subsidiary in Texas in the sales factor of the combined report.

f. Holding Companies

i. In General

A holding company often performs no function other than to hold ownership of the stock of another corporation. In some instances, the holding company also engages in some management or oversight functions. However, holding companies typically do not engage in activities that are generally thought of as "operational" in nature. This limited role poses difficult questions in the unitary business context. Two cases illustrate the issue.

ii. Legal Rulings

I. 95-7

A passive parent, or top-tier, holding company is unitary with corporations in which it owns the majority of their stock if the corporations are conducting a single unitary business. The Legal Ruling reasons that the holding company serves a unitary function as a conduit between the shareholders and the operating companies and as the focal point for relationships with third-party regulatory agencies. These functions are an integral part of the unitary business and therefore are unitary. To disregard this function would elevate substance over form and would disregard economic reality.

II. 95-8

An intermediate passive holding company, a corporate entity whose function is to hold the stock of an operating company for its operating parent company, is part of the unitary business carried on by the parent operating company and the subsidiary operating company. The intermediate holding company performs a function for the unitary business and therefore is part of the unitary business.

iii. Unanswered Questions Re: Holding Companies

An area where no direction has been provided is where a holding company owns the stock of several subsidiaries involved in separate unitary businesses. Is the holding company unitary with only one of the businesses? Is it unitary with respect to all or several of them? If it is unitary with respect to several, does that result in there being a single unitary business? If it does not, how do you divide the activities of the holding company between the various unitary businesses?

5. <u>SIGNIFICANT CALIFORNIA JUDICIAL UNITARY DECISIONS</u>

a. Overview

In chronological order, the following is a list of some of the most significant California published appellate court decisions on the issue of what constitutes a unitary business:

b. Significant Decisions

Butler Brothers v. McColgan (1941) 17 Cal.2d 664

Established the "three unities test."

Edison California Stores, Inc. v. McColgan (1947) 30 Cal.2d 472

First case sustaining combined reporting for multi-entity businesses. Established the "contribution or dependency test." Also stands for the proposition that a unitary business relationship may exist even though the members of the unitary group are separately incorporated.

John Deere Plow Co. v. Franchise Tax Board (1951) 33 Cal.2d 214

Good discussion of issue that although a corporate taxpayer engaged in a unitary business may show that, according to a separate accounting analysis, the activities in California were less profitable than those outside California (or even resulted in a loss), the unitary business/formula apportionment method should still be used.

<u>Superior Oil Company v. Franchise Tax Board</u> (1963) 60 Cal.2d 406 and <u>Honolulu Oil Corp. v. Franchise Tax Board</u> (1963) 60 Cal.2d 417

Held that unitary method <u>must</u> be used where the requisite relationship exists between the portions of a taxpayer's business within and without California. Rejected FTB's contention that the unitary method "should be resorted to only where it is impossible to make a separate accounting, or where a separate account cannot be reasonably computed." (*Honolulu* at p. 425.)

<u>Chase Brass & Copper Co. v. Franchise Tax Board</u> (1970) 10 Cal.App.3d 496

Good, but slightly dated (pre-U.S. *Container*) discussion of unity under *Butler Brothers* and *Edison*. Still commonly cited for proposition that integration of executive forces is "an element of exceeding importance," and that "major policy matters are what count," as opposed to decisions involving day-to-day operations.

<u>Container Corporation of America v. Franchise Tax Board</u> (1981) 117 Cal.App.3d 988, cert. granted, opin. at 463 U.S. 159 (1983)

This is the opinion of the California Court of Appeals in the *Container* case, which was subsequently heard and decided in 1983 in the United States Supreme Court. The decision of the court of appeals contains a good discussion of the unitary analysis under *Butler Brothers* and *Edison* and *Chase Brass*. Also discussed, and rejected, numerous constitutional challenges to the unitary method which were subsequently discussed and rejected by the United States Supreme Court in its *Container* opinion.

F.W. Woolworth Co. v. Franchise Tax Board (1984) 160 Cal.App.3d 1154

Unitary issue decided without reference to *Butler Brothers* or *Edison* tests. Held, based upon citations to United States Supreme Court decisions in *F.W. Woolworth Co., Container, Mobil* and *Exxon*, that the California tax "fails to meet established United States constitutional due process standards." As characterized by the court of appeal: "*In the F.W. Woolworth Co.* case, the Supreme Court was faced with virtually the identical question before us. The

only difference between that case and this is the identity of the state taxing authority seeking to assert its right to tax Woolworth Canada and Woolworth U.S. as part of the same 'unitary' enterprise."

<u>Mole-Richardson Co. v. Franchise Tax Board</u> (1990) 220 Cal.App.3d 889, mod. at 221 Cal.App.3d 425a

First major published court of appeal decision on the unitary issue involving what is commonly referred to as the "diverse business" situation. As stated by the court, "the question presented is whether under the factual circumstances of this case the activities of a corporation with diverse business enterprises carried on both within and without the state constitute one unitary business for income apportionment purposes." Cites to both *Butler Brothers* and *Edison* standards. Cites to California and U.S. *Woolworth* decisions for standard of evaluating whether "functional integration" exists between members of the alleged unitary business, but points out this is not "a new and different concept" for analyzing the unitary issue. Emphasis on strong centralized management.

Tenneco West, Inc. v. Franchise Tax Bd. (1991) 234 Cal.App.3d 1510

"Diverse" business case holding Tenneco Unitary Group (subsidiaries in oil and oil related businesses, including land, gas, pipeline, agricultural and chemical activities) were not engaged in unitary business with Tenneco subsidiaries engaged in shipbuilding, packaging, automotive parts manufacturing, and manufacturing and selling construction and farm equipment. Trial court found, and appellate court agreed, that the enterprise lacked substantial centralized departments, the enterprise and its subsidiaries had a history of separateness and were of a diverse, unrelated nature, and the enterprise's intercompany financing served an investment function, not an operational one.

<u>Dental Insurance Consultants, Inc. v. Franchise Tax Bd.</u> (1991) 1 Cal.App.4th 343

Dental Insurance Consultants, a corporation that provided review and advice regarding dental insurance claims for insurance companies, found to be unitary with its wholly owned subsidiary, D.I.C. Farms, which operated a small number of farms in California. Court found unity of operation based upon significant intercompany loans and common administrative functions. Court found unity of use based upon strong centralized management (which satisfied Regulation 25120(b)(3)).

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

The taxpayer sold a wide range of specialty steel products and acquired a subsidiary, Hy-Alloy, which also distributed specialty steel products. There was a substantial level of intercompany sales and considerable overlap between the two companies' directors and management. The two companies maintained separate administrative departments. The court found that the three unities and dependency or contribution test were alternative tests. A finding of unity was sustained under the contribution and dependency test. In part, this test was found to be satisfied by the presence of unity of ownership and unity of use. The court cited, but did not specifically rely upon, the same-line-of-business presumption and found that in the circumstances of this case, the presumption reflected reality in that the parent was able to capitalize on the synergy between the two corporations. Of interest in the case was the fact that the taxpayer had contested and lost unity in the Kansas court system.

<u>Common Production Services I., Inc. v. Franchise Tax Board</u> (2016) Second District B259619

The parent company is Comcast and the unitary issue was whether a majority owned subsidiary QVC, Inc. was part of Comcast's unitary business. Comcast owns approximately 200 subsidiaries that operate cable television networks. QVC operates a home shopping network. QVC pays cable networks a fee, typically 5% of sales to carry its shows. Comcast gradually increased its stake in QVC until it owned 57 percent of QVC with Liberty Networks owning the other 47%.

Comcast had a majority of the Board of Directors and there was conflicting testimony as to the amount of control it exercised. The Franchise Tax Board argued that there was the requisite contribution and dependency between Comcast and QVC to establish that they were unitary. Comcast argued the neither the three unities test nor the *Mobil* test of functional integration, centralized management or economies of scale were met. The trial court opined that there was enough evidence to support a finding of contribution and dependency but hold that the other tests were not met and therefore QVC was not part of Comcast's unitary business. The appellate court sustained the trial court holding on the basis that it was supported by substantial evidence.

6. <u>SIGNIFICANT CALIFORNIA BOARD OF EQUALIZATION</u> <u>UNITARY DECISIONS</u>

The Board of Equalization is presented with the unitary business issue much less frequently now than it was through the 1980's. However, its philosophy with respect to unitary business cases has remained fairly consistent. Cases which can be reviewed

include: <u>Appeal of Meadows Realty Company</u>, Cal. St. Bd. of Equal., Order Denying Petition for Rehearing and Substituting Opinion, June 6, 1991; <u>Appeal of Hearst</u> <u>Corporation</u>, Cal. St. Bd. of Equal., June 8, 1992; <u>Appeal of Lakeside Village</u> <u>Apartments</u>, Cal. St. Bd. of Equal., July 30, 1992; <u>Appeal of Merry Mary Fabrics, Inc.</u>, Cal. St. Bd. of Equal., April 22, 1993; and <u>Appeal of Joel/Cal-Made</u>, Cal. St. Bd. of Equal., Oct. 10, 1996.

More recently, the Board of Equalization has been issuing "Memo" decisions that are considered by the Board to be non-precedential. Several of those decisions are quite lengthy and provide clues as to the Board's views on a unitary business.

a. <u>Appeal of The Singer Company and Singer Housing Company</u>, 90N-0829, decided June 25, 1998

Singer is a large diverse business with five major segments that reported as a single unitary business. Singer Housing Corporation was established in the first year on appeal and was engaged in the development, construction and sale of single-family housing, multi-family housing, and shopping centers. The corporation was established for purposes of merging a number of acquired companies involved in this type of activity. Appellant argued that the activities of Housing were part of the same overall business conducted by Singer and that there were various common administrative functions and strong central management. The common business was asserted to be "homes, and products for the home." The Board of Equalization found there was insufficient evidence to show that the acquisition of Housing was undertaken for any purpose other than diversification of the corporate portfolio and that the list of unitary factors had not been shown to arise from or result in any integration between Housing and Singer's other activities. The Board of Equalization relied upon internal memos and annual reports to support a finding of substantial autonomy. The action of the Franchise Tax Board in finding that Housing was not unitary with the other Singer activities was sustained.

b. <u>Appeal of Cossette Investment Company</u>, 97A-0305, decided May 14, 1998

Cossette is a family owned business with real estate assets in Hawaii, cable television franchises in Texas and truck dealerships in California. The Franchise Tax Board treated all of the activities as a single unitary business. The Board of Equalization did a separate analysis of the Cable TV operations and the Hawaiian real estate assets. With respect to the Texas Cable TV operations, the taxpayer offered the testimony of the general manager of the properties that he operated on an autonomous basis. This testimony was supported by declarations from other employees. The Board concluded that Mr. Cossette's only significant involvement in the Texas operations was in making a decision to sell them. The Board of Equalization distinguished *Mole-Richardson* on the lack of sharing of common administrative and managerial functions; *Dental Insurance Consultants* on the absolute necessity of the parent company's assets for the subsidiary's

operation; and the <u>Appeal of Sierra Production Service, Inc</u>. on the basis of the parent's use of the subsidiaries' assets. The Board of Equalization concluded that the Texas Cable TV operations were a separate business.

With respect to the Hawaiian real estate activities, which consisted of installment notes received on the sale of the properties and an underlying ground lease, the Board of Equalization found that Mr. Cossette was the sole individual responsible for those properties and therefore his activities were more than those of a passive investor. The Hawaiian real estate activities were found to be part of the unitary business conducted in California.

c. <u>Appeal of Itoham U.S.A., Inc. & Subsidiaries,</u> Cal. St. Bd. of Equal., Feb. 1, 2000 (unpublished)

The taxpayer is the United States holding company/subsidiary of a Japanese company. The Japanese company was not included in the unitary business by the taxpayer, but was included at audit by the Franchise Tax Board. The taxpayer did not contest this determination in its appeal, but did contend that two subsidiaries, Ito Cariani Sausage, a producer and marketer of Italian-style meats, and American Peptide, a company conducting biotech research and manufacturing peptides used in scientific research.

The Board of Equalization found that the two subsidiaries were unitary, with the Japanese parent and its subsidiaries relying on the existence of interlocking boards of directors and common officers, intercompany sales, systematic personnel transfers, financing and same-line-of-business and vertical integration.

The taxpayer made no effort to address the nature of the roles played by the shared officers and directors, which the Board of Equalization treated as acceptance of the Franchise Tax Board's argument that there was a benefit arising from this fact. The intercompany sales, which did not appear to be particularly significant in amount, were discussed in terms of amounts, but not in terms of percentages. Different presumptions were applied to different subsidiaries. The same-line-of-business presumption was applied to Ito Cariani Sausage, and the vertical integration presumption was applied to American Peptide.

d. <u>Appeal of Allied-Signal Inc., As Successor-In-Interest to Allied</u> <u>Corporation</u>, Cal. St. Bd. of Equal., Feb. 24, 2000 (unpublished)

Allied Corporation was described as a multidivisional conglomerate involved in five basic businesses: Chemicals, Automotive, Aerospace, Industry and Technological, and Oil and Gas. At issue was the unity of UTP, a global oil and gas business originally acquired in 1962 as a source for ethylene feedstock for the chemical business.

The Board of Equalization found for the taxpayer, noting that in only one instance had it found an oil and gas operation unitary with a company engaged in a different line of business. The taxpayer submitted the declarations of 13 officers and directors of the company describing the oil and gas operation as autonomous. The Board of Equalization

dismissed the intercompany product flow that existed as insignificant on the basis of comparing it to the amounts bought and sold by the various companies. The Board of Equalization also found there was no evidence to support a finding of shared expertise because of the diverse nature of the businesses. The Board of Equalization dismissed the financial flow stating that the fact that one entity is a cash cow and the other a cash drain is of limited significance. It also found that there were limited circumstances of common activities and a number of instances of stand-alone departments within UTP. The evidence indicated a policy of a "strong hands-off approach."

e. <u>Appeal of Hyundai Precision & Industries Co., Led. and Hyundai Steel</u> <u>Industries, Inc.</u>, Apr. 19, 2001 (unpublished)

HSII is a wholly owned subsidiary of its parent HPI, which is incorporated and headquartered in Korea. HPI manufactures large steel shipping containers, steel trailer chassis, and various other steel items. Its primary facility was located in Ulsan, Korea. HPI formed HSII in order to increase its penetration of the United States. HPI shipped trailer chassis components to HPII for assembly and sale. Late in the period HPI acquired a railway rolling stock facility in Changwon, Korea. Upon acquisition HPI transferred some of its manufacturing operations to Changwon.

The Board of Equalization found there was the transfer of high-level administrative personnel, vertical integration, and substantial product flow. It rejected arguments that the various entities were involved in different businesses. The Board also rejected a claim that the Changwon operations could not be combined because they had no relationship as to the business activities carried on in California.

f. <u>Appeal of Yoshinoya West, Inc.</u>, Aug. 30, 2000 (unpublished)

In a letter denying the taxpayer's appeal, the Board of Equalization sustained a finding of unity between a Japanese parent corporation and its United States subsidiary. Both companies were engaged in the restaurant business. The menus were similar though the style of service varied. The taxpayer filed a suit for refund and the trial court sustained the position of the Franchise Tax Board. The decision of the trial court was upheld by the appellate court in an unpublished decision.

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<u>CHAPTER 5</u> UDITPA IN CALIFORNIA

1. <u>THE STATUTORY FRAMEWORK</u>

a. UDITPA in General

The Uniform Division of Income for Tax Purposes Act, commonly known as "UDITPA," was drafted by the National Conference of Commissioners on Uniform State Laws (NCCUSL) and approved by NCCUSL and the House of Delegates of the American Bar Association in July 1957. UDITPA deals with the allocation and apportionment of income of multistate businesses and was designed for enactment in those states that have either net income taxes or taxes measured by net income. It defines "business income" and "nonbusiness income," defines the three-factor apportionment formula used to apportion business income, and provides specific rules for the allocation of nonbusiness income.

UDITPA makes two basic assumptions: (1) that the state has jurisdiction to tax, and (2) that the state has defined the base of the tax, and that the only remaining question is the amount of the base that should be assigned to the particular taxing jurisdiction. Section 2 of UDITPA exempts from its operation three major classes of taxpayers: (1) individuals, to the extent of their income for personal services; (2) financial organizations; and (3) public utilities. (See Pierce, "*The Uniform Division of Income for State Tax Purposes*," Taxes, Oct. 1957, p. 747.)

b. Enactment by California of UDITPA

UDITPA was enacted in 1966 by the California Legislature (AB 11, Stats. 1966, ch. 2) for taxable years beginning after December 31, 1966, and is found in sections 25120 through 25139 of the Revenue and Taxation Code. California <u>deviates</u> from the model UDITPA in that:

(1) California did not adopt Section 1(d) of the model UDITPA that included a definition of "financial organizations," and did not adopt the part of Section 2 that excluded financial organizations. By this action, California chose to tax banks and financial corporations under UDITPA (as modified by the code and regulations).

(2) California did not adopt Section 1(f) of the model UDITPA that included a definition of public utility, and did not adopt that part of Section 2 that excluded public utilities. By this action, California chose to tax public utilities under UDITPA.

(3) California did not adopt the language of Section 2 of the model UDITPA that excluded the rendering of purely personal services by an individual, since that exclusion was accomplished by enacting UDITPA

into the California Corporation Tax Law as opposed to the Personal Income Tax Law.

(4) In 1988, California modified previously adopted Section 6 of UDITPA which addressed the allocation of capital gains and losses. Specifically, Revenue and Taxation Code section 25125 was amended to provide special rules for allocation of gain or loss on the sale of a partnership interest. This amendment was in response to the Board of Equalization decision in <u>Appeal</u> of Holidays Inns, Inc., Cal. St. Bd. of Equal., Apr. 9, 1986. (See Chapter 6.)

(5) In 1993, the California apportionment formula was modified to double weight the sales factor for all businesses other than those involved in agriculture or extractive activities. In 1994, the exclusion from double weighting was extended to the financial industry.

(6) In 2009 California's UDITPA provisions were further changed, for taxable years beginning on or after January 1, 2011 to:

a) limit the definition of gross receipts for purposes of the sales factor;

b) adopt a market oriented assignment rules for the numerator assignment of sales of other than tangible personal property;

c) allow taxpayers required to double-weight sales to elect to apportion income solely on the basis of sales; and

d) apply the *Finnigan* rule for assigning sales.

(7) A ballot initiative was adopted in November 0f 2012 provides for taxable years beginning after January 1, 2012 most taxpayers will apportion income on the basis of the sales factor alone.

The following cross reference table shows the section numbers of the NCCUSL model version of UDITPA and the comparable Revenue and Taxation Code sections of the California version of UDITPA:

		Cross Reference	ce Table
	UDITPA		CALIFORNIA
Sec.	1(a)	Sec.	25120(a)
	(b)		25120(b)
	(c)		25120(c)
	(d)		Eliminated
	(e)		25120(d)
	(f)		Eliminated
	(g)		25120(e) as modified in 2011
	(h)		25120(f)
	2		25121

3	25122
4	25123
5	25124
6	25125, as modified in 1988
7	25126
8	25127
9	25128, as modified in 1993
10	25129
11	25130
12	25131
13	25132
14	25133
15	25134
16	25135, as modified for 2011
17	25136, as modified for 2011
18	25137
19	25138
20	25139

c. The Multistate Tax Compact

California enacted the Multistate Tax Compact in 1974. The Compact includes within its provisions the Uniform Division of Income for Tax Purposes Act, Section 38006, Article IV. Article III of the Compact allows a taxpayer to elect between allocating and apportioning its income pursuant to the laws of the State or Article IV of the Compact. Certain provisions of California's version of UDIPTA are now inconsistent with the Compact. When California modified the apportionment formula to double-weight the sales factor it disabled the Article III election provided by the Compact by inserting the word "Notwithstanding" the Compact sales would be double weighted. Taxpayers challenged this effort approximately 10 years later. While the litigation pending, and prior to the appellate court decision, California repealed the Multistate Tax Compact effective July 1, 2012.

On December 31, 2015 the California Supreme Court in *Gillette Co. et al.*. *v. Franchise Tax Board,* _____Cal 4th _____, held that the election contained in Article III of the Compact allowing taxpayers to choose between a state's allocation and apportionment rules and UDITPA contained in Article IV of the Compact was not effective in California. A In adopting a double-weighted sales factor in 1994 the California legislation disabled the Compact election by indicating double-weighted sales applied "Notwithstanding" the Compact. The Court held that the Compact was not a contract between the states and therefore the state could change the terms of the Compact. It also found that the "Notwithstanding" language was effective. The United States Supreme Court denied a Petition for Writ of Certiorari in October of 2016 so that determination is final with respect to California.

The question of whether a state could disable the election_is being litigated in several other states including Michigan, Minnesota, Oregon and Texas. The Minnesota Supreme Court determined that states Legislature had the power to enact the Compact without the election and the United States Supreme Court denied the Petition for Certiorari filed with respect to that case. The other States have been prevailing in every cases though the facts are different in each state and the reasoning may be different.

Possible Revision of UDITPA

In 2008 the National Conference of Commissioners on Uniform State Laws (NCCUSL), now the Uniform Law Commission, at the request of the Multistate Tax Commission appointed a drafting committee and reporters (Professor Richard Pomp and Prentiss Willson) to undertake a review and redraft of UDITPA. After several meetings the Committee determined that the project should not proceed. Testimony was presented by various state legislative leaders that this issue should <u>not</u> be undertaken by the Commission.

When the project was shelved by the Commissioners, the Multistate Tax Commission announced it was undertaking a review of Article IV of the Compact, UDITPA. There were five areas the Commission specifically designated for review: 1) The assignment of sales from other than tangible property with a view to making the rules more market oriented; 2) the definition of sales; 3) clarification of the business\nonbusiness income rules; 4) factor weighting; and 5) the use of Section 18. The consideration of these changes will will proceeded through the Commission's normal processes including receiving public input and the holding of hearings on the possible changes. The changes were approved by the Commission in 2014. It is possible that the changes will be re-referred to the Uniform Law Commission.

The <u>changes are to</u> 1) to revise Section 17 move to a market approach for all sales; 2) to narrow the definition of sales to what are classified as transactional for business income purposes; 3) to make it clear the business income includes both transactional and functional situations and that the intent is to include as much income in the apportionable base as is permitted by the Due Process Clause; 4) to accept a state's apportionment formula; and 5) specifically provide for adoption of special industry formulas and special situations by regulation.

The Commission has drafted proposed regulations to implement the various changes and they were adopted early in 2017.

2. <u>"TAXPAYER TAXABLE IN ANOTHER STATE" - DEFINED</u>

a. In General

For purposes of allocation and apportionment under UDITPA, a taxpayer is taxable in another state if (a) in that state it is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or

(b) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not tax. (Section 25122.) A state does not have jurisdiction to tax if it is prohibited from imposing a net income tax by virtue of P.L. 86-272. (Regulation 25122.)

b. <u>Appeal of the Olga Company</u>

This issue is illustrated by <u>Appeal of the Olga Company</u>, Cal. St. Bd. of Equal., June 27, 1984. The taxpayer was a California corporation which filed its corporate tax returns as a unitary business. In computing its sales factor, it included in the numerator only its sales to purchasers in California. On audit, FTB determined that the taxpayer's activities in approximately 33 states and the District of Columbia were immune from taxation by those jurisdictions by virtue of P.L. 86-272. Therefore, FTB "threw back" those sales into the California sales factor, pursuant to section 25135. With respect to the issue of proving taxability in those jurisdictions, the SBE commented:

"Appellant was asked to prove that it filed a return required by any of the foreign states and paid any tax imposed. In response, appellant admitted that it filed no returns in any of the taxing states and presented no reasonable explanation as to why it did not file any returns. Therefore, we must conclude that appellant is representing to those states that its activities within those states are merely solicitation and that it is immune from taxation by reason of Public Law 86-272."

c. 8/16/88 FTB Chief Counsel Letter

By Chief Counsel Letter dated August 16, 1988, FTB stated its policy regarding taxability in another state for purposes of section 25122. Generally, the position is that if a taxpayer asserts it is subject to one of the taxes specified in section 25122 in another state, the burden of proof is on the taxpayer to establish that it is subject to tax in the state of destination. The law of the <u>destination</u> state, including judicial and administrative interpretation of P.L. 86-272, will be applied in determining whether or not the taxpayer is subject to tax in that state. To satisfy its burden of proof, the taxpayer must show: (1) that in the state of destination it filed returns and paid taxes due; or (2) the destination state has chosen not to assert a tax despite the existence of sufficient jurisdictional ties; or (3) it must provide incontrovertible evidence that its activities in the state of destination exceed those protected by Public Law 86-272.

FTB has prepared Form 4505, "Declaration to Support Claim of Taxability in Other States of the United States" for use by taxpayers in substantiating assertions they are not taxable in another state, See Attachment 2.

3. <u>MTC AND THE UDITPA REGULATIONS</u>

a. The 1971 Regulations

Two major sets of regulations have been enacted by both the Multistate Tax Commission (MTC) and FTB to interpret the provisions of UDITPA. In order to understand the development of the regulations, it is first necessary to understand the development of the Multistate Tax Compact and the MTC.

In 1959, the United States Supreme Court in *Northwest Portland Cement* v. *Minnesota* (1959) 358 U.S. 450, suggested that a state could impose an income tax on a corporation's activities which were wholly in interstate commerce. In response to that decision and other actions of the Court in similar cases, and under pressure from the business community, Congress in 1959 enacted P.L. 86-272, which generally precluded the states from imposing a tax if the only activity of a corporation within the state consisted of soliciting sales of tangible personal property. Congress also commissioned at that time a study and report on the general subject of state taxation of multistate income. The report and recommendations of the study committee, common known as the "Willis" Committee, were published in 1964 and 1965.

In response to the formation of the Willis Committee and the proposed federal legislation it spawned, state tax officials commenced work on an alternative. In 1966, the National Association of Tax Administrators, the National Association of Attorneys General and the National Legislative Counsel drafted the Multistate Tax Compact (Compact). The Compact is an agreement among consenting states to facilitate the proper determination of state and local liability of multistate taxpayers. The Compact created the Multistate Tax Commission (MTC). The Compact also incorporates the Uniform Division of Income for Tax Purposes Act (UDITPA). States join the MTC (as full members) by enacting the Compact.

Regulations for UDITPA were drafted by a Regulations Committee of the National Association of Tax Administrators. In 1971, the Committee's regulations were adopted by FTB. The Committee's regulations were also proposed for adoption by the MTC. In 1971, the MTC adopted the Committee's regulations, but with numerous revisions. The 1971 MTC regulations were not adopted by FTB.

b. The 1973 Regulations

In response to comments and criticism of its 1971 model regulations for UDITPA, the MTC commenced a study to make revisions. In 1973, the MTC issued its revised regulations for UDITPA. Except for the treatment of dividend income, the 1973 MTC regulations were adopted by FTB in 1973.

The dispute between FTB and the MTC over the 1973 regulations centered on the issue of when dividend income should be treated as business income. The 1973 version of MTC Regulation IV.1 contained text and examples which provided that dividends would be classified as business income in a wide range of circumstances. When FTB amended its regulations in 1973, it failed to conform to the language in MTC Regulation IV.1. Instead,

FTB retained its existing Regulation 25120, subdivision (c)(4), which reflected pre-UDITPA California law and provided that in most instances intercorporate dividends were nonbusiness income even though the declarant and recipient corporations may engage in extensive intercorporate business activities.

The 1973 regulations also put greater emphasis on Section 25137 (Section 18 of UDITPA). Under the 1971 regulations, variances from the standard rules were placed in the regulations for a particular factor. In the 1973 version, all of the special variations were collected in a single place in recognition of the fact that they did in fact encompass differences from the standard rules. In addition, the 1973 regulations recognized the need for generally applicable special rules for particular industries and circumstances.

c. Developments After 1973

In <u>Appeal of Standard Oil of California</u>, Cal. St. Bd. of Equal., March 2, 1983, the SBE rejected FTB Regulation 25120, subdivision (c)(4) as invalid and inconsistent with the statutory definition of business income found in section 25120, subdivision (a). (See Chapter 6 for discussion of *Standard Oil*.) Consequently, in 1987, the FTB adopted the dividend provisions of MTC Regulation IV.a(c)(4).

Since 1973, numerous other changes have been made to the FTB and MTC regulations for UDITPA. However, those changes generally have not disturbed the fundamental rules for allocation and apportionment of income under UDITPA. Instead, the changes have been mainly in the area of promulgating regulations for special industries.

California adopted market-based sourcing for sales of other than tangible property in 2013 and had adopted regulations to implement that change. The Multistate Tax Commission as a result of changes to Article IV of the Compact is adopted regulations to implement those changes. It is unlikely given that California is no longer a member of the Commission and the fact California's market-based sourcing regulations in keyed to benefits received and the Multistate Tax Commissions regulations are based upon delivery.

The MTC has amended its regulations regarding the definition of business income, the determination of a unitary business, and the circumstances for application of Section 18 of UDITPA which have not been adopted by the Franchise Tax Board. However the practices of the FTB are consistent with the amendments to those regulations.

FTB's regulations are found in Title 18 of the California Code of Regulations. The section numbers of the regulations pertaining to UDITPA conform to the section numbers of sections 25120 through 25139 of the Revenue and Taxation Code, where UDITPA was enacted.

CHAPTER 6

BUSINESS AND NONBUSINESS INCOME

1. OVERVIEW OF BUSINESS AND NONBUSINESS INCOME

Income under UDITPA is divided into two categories: business income and nonbusiness income. Business income is apportioned to a state by the use of a three-factor formula consisting of the equally weighted factors of payroll, property and sales. Nonbusiness income is allocated to a particular state under a series of statutory rules based upon multiple rationales: the state of the taxpayer's commercial domicile; the asset from which the income is derived is located in the state; or the asset from which the income is derived has acquired a business situs in the state.

2. <u>BUSINESS INCOME</u>

a. In General

Business income is defined by statute as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and 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." (Section 25120, subd. (a).)

The language of section 25120's definition of business income was patterned after the definition of "unitary income" under Board of Equalization decisions predating UDITPA. *Hoechst Celanese Corporation v. Franchise Tax Board* (2001) 25 Cal.4th 508.

For an extended discussion of the development of the business income concept see Peters and Miller "Apportionability in State Income Taxation: The Uniform Division of Income for Tax Purposes Act and *Allied-Signal*," 60 <u>The Tax Lawyer (Fall 2006)</u> 58.

As was explained in <u>Appeal of W.J. Voit Rubber Corp.</u>, Cal. St. Bd. of Equal., May 12, 1964:

"The underlying principle in these [pre-UDITPA] cases is that any income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property which is developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole. And, with particular reference to assets which have been depreciated or amortized in reduction of unitary income, it is appropriate that gains upon the sale of those assets should be added to the unitary income."

All business income is apportioned to California by multiplying that income by a fraction commonly referred to as the apportionment factor. Effective for income years beginning on or after January 1, 1994, the apportionment factor for most businesses is calculated by

adding the property factor, the payroll factor and twice the sales factor and dividing the result by four. For the extractive, agriculture and financial industries, the apportionment factor is an equally weighted three-factor formula of property, payroll and sales. (Section 25128.)

For taxable years beginning on or after January 1, 2011 and before January 1, 2013, California taxpayers required to use the double-weighted sales factor may make an election annually to apportion their income by the sales factor only. For income years beginning on or after January 1, 2013 most taxpayer will apportion income solely by reference to a sales factor.

FTB's regulations, and the MTC's regulations provide the income of a taxpayer is business income "unless clearly classifiable as nonbusiness income." (Reg. § 25120, subd. (a).)

The Board of Equalization has repeatedly found that section 25120 provides two alternative tests to determine whether income constitutes business income. The first is the "transactional test." Under this test, the relevant inquiry is whether the transaction or activity which gave rise to the income arose in the regular course of the taxpaver's trade or business. (An example of the application of the transactional test is Appeal of General Dynamics Corporation, Cal. St. Bd. of Equal., June 3, 1975, Opinion on Petition for Rehearing, Sept. 17, 1975.) Under the second, or "functional test," income from property is considered business income if the acquisition, management, and disposition of the property were "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (An example of the application of the functional test is Appeal of Borden, Cal. St. Bd. of Equal., Feb. 3, 1977.) If either of these two tests is met, the income will constitute business income. The Board of Equalization has repeatedly stated that FTB's determination as to the character of income to a business under either test is presumed correct, and the taxpayer has the burden of proving error in that determination. (See Appeal of Twentieth Century-Fox Film Corporation, Cal. St. Bd. of Equal., Mar. 2, 1989, and decisions cited therein.)

The authorities in other states are split on the issue of whether there is a single "transactional" test or two tests. States that have found a single test include Kansas, Iowa and Tennessee. See <u>In the Matter of the Appeal of Chief Industries, Inc.</u> (1994) 255 Kan. 640, 875 P.2d 278; <u>Phillips Petroleum v. Iowa Dept. of Revenue</u> (1993) 511 N.W.2d 608 and <u>Union Carbide Corp. v. Huddleston</u> (1993) 854 S.W.2d 87. In several of these states, the judicial decision has been at least partially overruled by legislative action. Illinois, North Carolina and Oregon have all found there are two tests. <u>Dover Corp. v. Dept. of Revenue</u> (1995) 271 Ill. App.3d 700, 648 N.E.2d 1089. <u>Texaco Cities Service Pipeline Co.</u> <u>v. McGaw</u> (1998) 182 Ill.2d 262, 695 N.E.2d 481. <u>Kroger Co. v. Department of Revenue</u> (1996) 284 Ill. App.3d 473,673 N.E.2d 710. <u>Polaroid v. Offerman</u> (N.C. 1998) 349 N.C. 290. <u>Pennzoil Company v. Department of Revenue</u> (2001) 332 Ore. 542, 33 P.3d 314.

The states that have formally indicated that they recognize both a transactional and functional test are: Alabama, Alaska, Arkansas California, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa,

Kansas, Kentucky, Mississippi, Missouri, Montana New Jersey, New Mexico, North Dakota, Oregon, Tennessee, Utah, Vermont and West Virginia.

b. <u>Hoechst Celanese Corporation v. Franchise Tax Board</u>

In <u>Hoechst Celanese Corporation v. Franchise Tax Board</u> (2001) 25 Cal.4th 508, cert. denied Nov 26, 2001, the California Supreme Court confirmed that there were two tests for business income in California. *Hoechst* is the first decision of the California Supreme Court to address the question of whether income should be classified as business income or nonbusiness income. The decision is thorough and discusses a number of significant issues. It has the potential to be a landmark decision similar to <u>Container Corporation of America</u> <u>v. Franchise Tax Board</u> (1983) 463 U.S. 159.

i. Statutory construction

The court's analysis begins by establishing the requirements for resorting to extrinsic aides to construe the statute. It analyzes the statute grammatically and finds that it supports a two-part test because it contains two predicate clauses which contain different verbs, objects, and prepositional phrases and therefore constitutes a compound predicate that states two independent definitions. The court found that such an interpretation was in accord with the different language used in the two clauses and is bolstered by the fact that a broader definition, the second clause, can hardly exemplify a narrower definition, the first clause. (*Hoechst, supra,* at 519-520)

On the other hand the court notes that the use of the word "includes" after the conjunction suggests that the second clause is a subset of the first. The court found some support for such an interpretation in the language in the second clause. In addition, the breadth of the second clause supports the rejection of the functional test. (*Id.* at 521)

The court found that these conflicting interpretations supported a conclusion that there was ambiguity therefore justifying its resorting to extrinsic aides.

ii. History of UDITPA and its relationship to California authorities

The court referenced back to adoption of the uniform act and California's role in that adoption. Of particular significance were the California Board of Equalization's pre-UDITPA decisions and their emphasis on a functional relationship to justify the apportionment of income. The court also referred to the comments to UDITPA prepared by the drafters. Finally the court found that the existence of a functional test fulfills one of the primary objectives behind UDITPA to promote uniformity among the states. Of particular significance to the court was the fact that those states where courts had found a single test of business income almost immediately amended their statutes. (*Id.* at 522-526.)

iii. Application of the transaction test

The court found that the gain realized on the reversion on the pension surplus fails to meet the transactional test. The relevant considerations are the frequency and regularity of similar transactions, the former practices of the business and the taxpayer's subsequent use of the income. Unprecedented, once-in-a-corporate-lifetime transactions do not meet the requirements of the transactional test. (*Id.* at 526-27)

iv. The functional test

The court found that the functional test focuses on the relationship between the taxpayer's business and the property. The court found that providing compensation to employees was integral to the operation of the business. It pointed to the effect of the investment results on the contribution required from the business and the deductibility of such contributions. The court also looked to the use that was made of the income. (*Id.* at 527-5386)

I. Conjunctivity

The first phrase—"acquisition, management, and disposition of the property"—gives rise to the question of whether "and" should be construed conjunctively or disjunctively. The court accepted the taxpayer's position that "and" was used conjunctively, but held that it was used to describe conditions of ownership of the property by the taxpayer rather than activities that had to be undertaken with respect to the property. The court found that the conjunctive condition meant that the taxpayer had to 1) obtain some interest in and control over the property; 2) control or have direct use of the property; and 3) transfer, or have the power to transfer, control of that property in some manner. (*Id.* at 528-529.)

II. Legal Ownership

The court rejected the argument that legal ownership was necessary and found that the "acquisition, management and disposition" described collectively the interest the taxpayer must have. Use is sufficient and was consistent with the understanding of the drafters. (*Id.* at 529.)

III. Regular

Both the transactional test and the functional test contain the word "regular." In the context of the transactional test, regular refers to the normal or typical business activities of the taxpayer. It modifies the course of the taxpayer's trade of business. In the functional test, regular modifies trade or business, and therefore it does not refer to the extraordinary nature of the transaction or infrequency. It means that the property must be part of the taxpayer's normal business activities. (*Id.* at 529-530.)

IV. Integral

The court defined integral as used in the functional test to mean "an organic unity between the taxpayer's property and business activity whereby the property contributes materially to the taxpayer's production of business income." (*Id.* at 530.) Integral does not mean

necessary, but it means more than contributes. Integral means "the property must be so interwoven into the fabric of the taxpayer's business operations that it becomes 'indivisible' or inseparable for the taxpayer's business activities with both 'giving value' to each other." (*Id.* at 530-531.)

V. <u>Robert Half</u>

The court took the opportunity to characterize the court of appeals analysis in <u>Robert Half v.</u> <u>Franchise Tax Board</u>, 66 Cal.App.4th 1020, as "mistaken" for focusing on the extraordinary nature of the transaction, though it reached the right result. (*Id.* at 533.)

VI. Board of Equalization decisions

The court referenced Board of Equalization decisions and found them authoritative based upon the thoroughness of their reasoning, consistency of application, and period of application. (*Id.* at 533-534.)

VII. Other states' decisions

The court found its decisions were consistent with the actions of other states, either their decisions or the actions of their legislatives in responding to decisions rejecting a functional test. (*Id.* at 534.)

v. Constitutional considerations

The court found that "the income-producing asset—the pension plan and trust—undoubtedly served an operational function for Hoechst." (*Id.* at 539.)

c. Liquidation of a Business or Line of Business

i. Jim Beam Brands Co. v. Franchise Tax Board (2005) 133 Cal.App.4th 574

In *Jim Beam Brands Co. v. Franchise Tax Board*, a California appellate court held that gain realized on the liquidation of a line of business constituted business income. Jim Beam Brands had Clear Springs, a wholly owned subsidiary, sell the stock of its wholly owned subsidiary, Taylor Food. Taylor Food and Clear Springs both had been included as part of the unitary business conducted by Jim Beam Brands. Taylor Food was in the business of manufacturing mixers used with various alcoholic beverages. Jim Beam Brands stipulated that Taylor Foods was part of its unitary business and that it had contributed materially to the production of business income of the unitary group. The taxpayer attempted to argue that the disposition of the funds realized from the sale, a dividend paid to Jim Beam Brands' parent, American Brands, that was not part of its unitary business, established that the gain realized was nonbusiness income. In the alternative, it argued that to the extent there were undistributed earnings in the subsidiaries, that amount should be allowed as an offset to the gain.

The appellate court found that the gain realized was business income under the functional test. It also held that the use of the proceeds of the sale did not implicate the determination

of whether the income was business or nonbusiness income. The court rejected the reasoning of a number of out-of-state cases that the partial, or complete, liquidation of a line of business resulted in nonbusiness income. The out-of-state cases listed were: <u>American States Ins. Co. v. Hamer</u> (Ill. 2004) 816 N.E.2d 659; <u>Blessing/White, Inc. v. Zehnder</u> (Ill. 2002) 768 N.E.2d 332; <u>May Dept. Stores v. Dept. of State Rev</u>. (Ind. 2001) 749 N.E.2d 651; <u>McVean & Barlow, Inc. v. New Mexico Bureau of Rev</u>. (NM 1975) 543 Pac.2d 489; <u>Lenox, Inc. v. Tolson</u> (NC, 2001) 548 S.E.2d 513; <u>Kemppel v. Zaino</u> (Ohio 2001) 746 N.E.2d 1073; and <u>Laurel Pipe Line Co. v. Commissioner</u> (PA 1994) 642 A.2d 472. It rejected the reasoning of these cases because the focus was on the transaction, which gave rise to the income rather than the use of the property disposed of by the business.

The undistributed earnings residing in the subsidiaries would have been eligible for either a dividend deduction (section 24402) or dividend elimination (section 25106) if a dividend had been declared. Because of the absence of specific statutory authorization, a basis adjustment for undistributed earnings and profits, the court found no authority to allow the adjustment requested.

ii. <u>Meadwestvaco v. Illinois Department of Revenue</u>, (2008) 170 Led2nd 404

In January of 2008 the United States Supreme Court heard argument in *Meadwestvaco v. Illinois Department of Revenue*, 170 Led2nd 404. The issue presented to the Court was whether the sale by the taxpayer of a division that operated the Lexis/Nexis business gave rise to income apportionable by Illinois, a nondomiciliary state. The taxpayer alleged that it operated two lines of business as separate divisions. The line that was the original line, and the one that remained, operated a paper business, the disposed of line was Lexis/Nexis. The taxpayer had operated Lexis/Nexis as both a division and subsidiary over the course of the years and had filed as a single unitary business with the State of Illinois for a number of years. It is not clear from the record whether this was at the insistence of Illinois or by choice. It is clear that operating as a division was chosen at least in part to realize state tax savings.

The Illinois trial court found that the paper business and the Lexis/Nexis business were not unitary, but that the \$1 billion gain realized was apportionable income because Lexis/Nexis was functionally integrated with the paper business. The Illinois appellate court did not address the unitary issue because it found it could sustain the assessment based upon the functional integration standard of <u>Allied-Signal, Inc. v. Director, Division</u> <u>of Taxation</u> (1992) 504 U.S. 768, 119 L.Ed.2d 533.

The argument before the United States Supreme Court seemed to be confused. Illinois argued that 1) Mead paper and Lexis/Nexis were in fact unitary in spite of the fact that the Illinois courts had not so concluded; 2) that the operational functional test was met in any event; and 3) the tax could be sustained under an old line of United States Supreme Court cases upholding a state requiring withholding of tax on individual nonresident shareholders by corporations doing a portion of their business in the state. *State of Wisconsin v. J.C. Penney Company* (1940) 311 U.S. 435. The taxpayer argued that

Lexis/Nexis was separate from the paper business and the gain should be allocated to its commercial domicile. The record did not disclose whether the taxpayer had in fact allocated the income to the state of commercial domicile or attributed all of the gain there. Coincidentally the record did show that Lexis/Nexis and the paper company individually had approximately 4% of their activity in Illinois. The Justices appeared to have a difficult time trying to fit the facts into the existing case law.

The decision was issued on April 15, 2008. The Court vacated the decision of the Illinois appellate court and remanded if for re-consideration. The Court held that the Illinois courts had misapprehended the principles of the Court's decisions for determining whether a multistate business is unitary. It held that there was not a separate "operational purpose" test, but that such test was part of the unitary business principle.

The Court's statement of facts should be compared with the facts in *Container*. The facts are remarkably similar to those in *Container* except for the fact that Lexis and Mead were not engaged in the same line of business. It should be noted that the United States Supreme Court did not attached great significance to the same line of business fact in *Container*.

The case may be more noteworthy for what it did not decide. The Court did not consider whether Lexis/Nexis and Mead paper were unitary. The Court did not decide whether a tax could be asserted based upon the fact that the capital asset had a tie with the state separate from that of the taxpayer. The Court did suggest that it might be proper to assert a tax on that basis but speculated that the apportionment in that case would be on the basis of the apportionment factors of the owner of the capital asset. Depending upon one's perspective the decision could presage a victory at the state level for either side. Based upon a review of the transcript of oral argument it would appear that Meadwestvaco achieved the best result possible for it. On remand the parties were able to reach a resolution of the case without further published consideration.

The case, however, is noteworthy in two other aspects. First, the opinion does not cite to <u>*Complete Auto Transit, Inc. v. Brady*</u> (1977) 430 U.S. 274. This opinion has been the touchstone for United States Supreme Court analysis of state tax cases since it was issued. Second, the concurring opinion of Justice Thomas who opined that state taxes should not be subject to review by the Court under the Due Process Clause as long as there was some connection of the taxpayer or the asset to the state. This is similar to the position of Justices Thomas and Scalia with respect to dormant commerce clause analysis.

For a further discussion of the case see Miller, "Meadwestvaco: Fitting a Round Peg Into a Square Hole" 47 <u>State Tax Notes</u> 391 Feb, 2008, and other commentators.

d. Proposed Multistate Tax Commission Regulations

The Multistate Tax Commission has amended the definition of business income to apportionable income as follows":

(i) All income that is apportionable under the Constitution of the United States and is not allocated under the laws of this state including:

(A) income arising from transactions and activity in the regular course of the taxpayer's trade or business and,

(B) income arising from tangible and intangible property if the acquisition, management, employment, development, or disposition of the property is or was related to the operation of the taxpayer's trade or business; and

(ii) any income that would be allocable to this state under the Constitution of the United States, but that is apportioned rather than allocated pursuant to the laws of this state.

3. <u>NONBUSINESS INCOME</u>

a. In General

Nonbusiness income is defined by statute as "all income other than business income." (Section 25120, subd. (d).) Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent they constitute nonbusiness income, are allocated as provided in sections 25124 through 25137. (Section 25123.) Generally speaking:

<u>Rents and Royalties</u>: Rents and royalties from real property in California are allocable to California. Rents and royalties from tangible personal property are allocable to California (1) if and to the extent that the property is "utilized" in California, or (2) in their entirety, if the taxpayer's commercial domicile is California and the taxpayer is not organized under the laws of or taxable in the state in which the property is "utilized." (Section 25124.)

<u>Capital Gains and Losses</u>: Capital gains and losses from sales of real property located in California are allocable to California. Capital gains and losses from sales of tangible personal property are allocable to California if (1) the property had a situs in California at the time of the sale, or (2) the taxpayer's commercial domicile is in California and the taxpayer is not taxable in the state in which the property had a situs. Except in the case of the sale of a partnership interest, capital gains and losses from sales of intangible personal property are allocable to California if the taxpayer's commercial domicile is California.

<u>Capital Gains and Losses on the Sale of a Partnership Interest</u>: California varies from the model UDITPA in its treatment of this item. For income years beginning on or after January 1, 1988, gain or loss on the sale of a partnership interest is allocable to California in the ratio of the original cost of partnership tangible property in California to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than fifty percent (50%) of the value of the

partnership's assets consist of intangibles, gain or loss from the sale of the partnership interest is allocated to California in accordance with the sales factor of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold. (Section 25125, subd. (d).)

Interest and Dividends: Interest and dividends are allocable to California if the taxpayer's commercial domicile is California. (Section 25126.)

Patent and Copyright Royalties: Patent and copyright royalties are allocable to California (1) if and to the extent that the patent or copyright is "utilized" by the payor in California, or (2) if and to the extent that the patent or copyright is "utilized" by the payor in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in California. (Section 25127.)

A patent is used in the state to the extent it is employed in the production, fabrication, manufacturing, or other processing in the state or to the extent that a patent product is produced in this state. (Section 25127(b))

A copyright is used in the state to the extent that printing or other publication originates in the state. (Section 25127(c))

b. Labels

A mistake commonly made by those new to the State and Local area is that the title applied to an item income determines whether it is business income and that the allocation rules for UDITPA automatically apply to the enumerated items. It is not uncommon for practitioners to assume that because various types of income are specifically assigned to a location by the statutes that all such income of that type is assigned accordingly. The allocation rules set forth in UDITPA (section 25124-25127) only are applicable if the income is nonbusiness income. (Section 25123.)

4. <u>REGULATIONS</u>

California has adopted the regulations promulgated by the Multistate Tax Commission in 1973. Reg. sec. 25120(a) sets forth the definition of business and nonbusiness income. Reg. sec. 25120(c) sets forth examples applying the definitions to specific types of income.

The Multistate Tax Commission promulgated an amended Business/Nonbusiness Income regulation in August of 2003, Reg. IV.1.(a).

An item is nonbusiness income "only if it does not meet the definitional requirements for being classified as business income." Reg. IV.(a).(1). The existence of two separate tests for the determination of the business or nonbusiness character of income is clearly established by the regulations. Reg.IV.1.(a)(2). The new regulations provide definitions for the terms "trade or business" and "[t]o contribute materially." Reg. IV.1.(a)(3). It defines the Transactional Test and the Functional Test and sets forth the intended relationship between

these tests and United States Constitutional analysis. Reg. IV.1.(a)(4), (5) and (6). Examples of the application of the definitions to specific types of income are provided. Reg. IV.1.(c). The examples are identical to those in the 1973 regulations and are to be included at a state's option.

There are several differences in the language of the 1973 regulations and the 2003 regulations. With respect to rents, Reg. IV.1.(c).1., the new regulations expand the application to property that "was used" in the trade or business and drops "or incidental thereto" language of the 1973 version. In the rest of the examples, the 2003 regulations have replaced "incidental thereto" with "is an integral, functional or operative component ... or otherwise materially contributes" standard.

California has not yet acted to propose the amendment of its regulations to conform to the MTC's 2003 version.

5. <u>SIGNIFICANT ISSUES AND DECISIONS</u>

a. In General

The question of whether income constitutes business or nonbusiness income frequently must be answered on a case-by-case basis because of the intensely factual nature of the inquiry. While the label attached to items of income is not determinative of whether the income is business or nonbusiness, they nonetheless provide a convenient means of classification for analytical purposes.

b. Sale of Goodwill

i. <u>Appeal of Borden</u>

The issue of whether income from the sale of goodwill is business income was addressed in *Appeal of Borden*, Cal. St. Bd. of Equal., Feb. 3, 1977. The taxpayer sold all the tangible and intangible assets of its Western District milk processing operations to Knudsen Corporation. The contract of sale specifically allocated a portion of the purchase price to the Western District's goodwill. The sale of goodwill resulted in a loss, which qualified as a long-term capital loss for federal income tax purposes. The issue was whether the loss was "business income." The SBE concluded that Western District's goodwill was undeniably an important asset of the taxpayer's business and contributed materially to the production of business income. Therefore, under the functional test of section 25120, the loss on the sale of that goodwill was properly includable in Borden's business income.

The underlying transaction involved in *Meadwestvaco v. Illinois Department of Revenue*, (2008) 170 Led2nd 404, was whether gain realized on the sale of a business, goodwill, is apportionable income.

c. Dividend Income

Many of the United States Supreme Court decisions in the state tax area have involved the question of whether dividends are apportionable income. See <u>Mobil Oil</u>

<u>Corp. v. Commissioner of Taxes of Vermont</u> (1980) 445 U.S. 425; <u>ASARCO Inc. v.</u> <u>Idaho State Tax Comm'n</u> (1982) 458 U.S. 307; and <u>F.W. Woolworth Co. v. Taxation</u> <u>& Rev. Dept.</u> (1982) 458 U.S. 354. But the analysis in these cases leaves something to be desired since the issues were not clearly articulated and the decisions were based upon facts not contested by one or the other of the parties.

Two California Board of Equalization decisions better illustrate the analysis that arguably should be used to determine when dividend income is business income. *Standard Oil*, a landmark decision, held that the provisions of UDITPA are the exclusive means by which income is allocated and apportioned to California. It also held that it is not necessary for dividends to be paid by a part of a unitary business, as defined for combined report purposes, in order for the dividends to be business income under section 25120. *Twentieth Century-Fox* is a more recent decision which interprets and applies FTB's current (post-*Standard Oil*) 25120 regulation.

i. <u>Appeal of Standard Oil Company of California</u>

In <u>Appeal of Standard Oil Company of California</u>, Cal. St. Bd. of Equal., March 2, 1983, the SBE held that dividends received by the taxpayer and its subsidiaries from noncontrolled affiliated joint venture corporations were business income. The taxpayer is a fully integrated oil company engaged in all aspects of the petroleum business throughout the world. It owned 30 percent of the stock of Aramco, which held and operated major producing fields in Saudi Arabia, and 50 percent of the stock of CPI, which held and operated major producing fields in Indonesia. For the year in issue, and because of its equity interests, the taxpayer's entitlements to Aramco and CPI production amounted to 52 percent of its worldwide supply of crude oil and natural gas liquids. The taxpayer received dividends from both Aramco and CPI, which it treated as business income. FTB argued the dividends were nonbusiness income.

The SBE concluded that the dividend income was business income under the functional test. The SBE found the taxpayer's interests in Aramco and CPI had been acquired and maintained in furtherance of and as an integral part of its unitary business. The purpose in creating and maintaining Aramco and CPI as affiliated joint venture supply companies was to insure an available supply of crude oil and natural gas liquids for the taxpayer's worldwide petroleum operations. Under the shareholder agreements, which effectively precluded the joint venture supply companies from selling crude oil to unrelated third parties other than the host governments, the taxpayer was assured of a guaranteed supply of crude oil for its unitary business operations. The crude oil supply rights embodied in its Aramco and CPI stockholdings were an essential element of the taxpayer's worldwide operations.

The SBE explained why its conclusion was "in harmony" with the pronouncements of the Supreme Court in *Mobil*, *ASARCO* and *Woolworth*:

"The existence of the same sort of integration [required by the Supreme Court in *Mobil*, *ASARCO* and *Woolworth*] is what led us to conclude that

appellant's dividends from Aramco and CPI constituted apportionable business income within the terms of UDITPA's functional test. In this appeal the fundamental inquiry concerned the relationship between the interests represented by the stockholdings and the shareholder's unitary business. For this reason there is no inconsistency between the test applied by the Supreme Court and our application of UDITPA's functional test in this appeal.

"From the standpoint of general unitary theory, it is unfortunate that the three cases failed to distinguish between a 'unitary business' and 'business income,' two related but analytically distinct concepts. Defining the parameters of the 'unitary business' involves ascertaining the circumstances under which all corporations engaged in a single integrated economic enterprise may be permitted or required to file a combined report. The concept of 'business income,' on the other hand, generally concerns the differentiation between truly passive investment income and income which is integrally related to the taxpayer's unitary business activities. Merely because the operations and management of a corporation in which the taxpayer is a stockholder are not so closely connected with the taxpayer's business activities as to be part of the taxpaver's 'unitary business' for combined reporting purposes should not mean that dividends received from the stock cannot be 'income arising from transactions and activities in the regular course of the taxpayer's trade or business' or that the 'acquisition, management, and disposition' of the stock do not 'constitute integral parts of the taxpayer's regular trade or business operations.' The criteria for combined reporting purposes and the definition of business income serve different purposes, ask different questions and apply different standards. The resolution of one does not compel the same resolution of the other."

ii. <u>Appeals of Control Data Corp. and Commercial Credit Corp.</u>

In the <u>Appeals of Control Data Corp. and Commercial Credit Corp.</u>, Cal. St. Bd. of Equal., Feb. 22, 1996, the State Board of Equalization held that dividends received from insurance subsidiaries of the taxpayers constituted business income where the taxpayers conceded that they were engaged in a unitary business with such subsidiaries.

iii. Appeal of PQ Corporation

In an unpublished decision, <u>Appeal of PQ Corporation</u>, Cal. St. Bd. of Equal., Oct. 9, 1997, the Board of Equalization held that dividends received from two minority-owned subsidiaries were not business income. The SBE found that the purchase of the stock of the subsidiaries was at most prefatory to integrating their operations with those of the parent; therefore, under the authority of the <u>Appeal of Occidental Petroleum</u> and the *Appeal of Mark Controls*, the income should be treated as nonbusiness income.

d. Sale of Stock

The United States Supreme Court decisions assume that the treatment of dividend income and gain on the sale of stock should be the same. This assumption would probably be correct in most circumstances but it may not always be so. The issue of when gain or loss from the sale of stock constitutes business income is illustrated by several California decisions.

General Dynamics, supra, is a seminal case that discusses the development of the law on the issue. *Times-Mirror* is significant in that it was the only citable California judicial opinion dealing with business income classification prior to *Hoechst Celanese. Occidental Petroleum* provides a good summary of the Board of Equalization's position on the issue, and discusses the "potentiality" aspect of whether the stock and the operations of the stockholder are sufficiently integrated to give rise to business income. *Louisiana-Pacific* and *American Biltrite* are examples of the factual analysis which must be undertaken as part of the classification inquiry.

i. <u>Appeal of General Dynamics Corporation</u>

In <u>Appeal of General Dynamics Corporation</u>, Cal. St. Bd. of Equal., June 3, 1975, Opinion on Petition for Rehearing, Sept. 17, 1975, the taxpayer had sold jet aircraft in 1959 to Swiss Air Transport Co., Ltd. (SWISSAIR) and Scandinavian Airlines Systems (SAS). In 1960, the aircraft were resold to Airlift International, Inc. (Airlift). Airlift then defaulted on its payments and, with the object of protecting its position, the taxpayer entered into various refinancing arrangements with Airlift. In 1963, the taxpayer received 1,000,000 shares of Airlift stock in full settlement of Airlift's obligation, but (it appeared) those shares could only be sold with the approval of Airlift proposed a public offering, and permitted the taxpayer to sell its Airlift stock as part of the offering. The taxpayer and SWISSAIR and SAS, under which the gain from the sale of the stock was treated as cash from the resale of the aircraft by agreement. The gain on the sale of the stock was included in the price paid by the taxpayer to SWISSAIR and SAS. The taxpayer treated the gain realized from the sale of the stock as nonbusiness income.

The SBE found that under the transactional test, the gain on the sale of the Airlift stock was business income. It pointed out that the sale of the seven aircraft was an integral part of the taxpayer's unitary business, and that all the income from that sale, including the gain ultimately realized on the sale of the stock, arose in the ordinary course of that sale.

ii. <u>Times-Mirror Co. v. Franchise Tax Board</u>

In <u>*Times-Mirror Co. v. Franchise Tax Bd.*</u> (1980) 102 Cal.App.3d 872, the taxpayer acquired the stock of The Sun Company to further the regular business operations of the unitary group of businesses headed by the taxpayer. The parties stipulated that Sun Company was conducted as a unitary business with the taxpayer and was managed as an integral part of the regular business operations of the taxpayer. The taxpayer treated the gain
on the sale of the stock as business income. The FTB argued the gain was nonbusiness income. The court of appeals concluded the pre-UDITPA law relied upon by the FTB which classified income, including dividends and capital gains, was of no assistance after UDITPA.

iii. Appeal of Occidental Petroleum

In <u>Appeal of Occidental Petroleum</u>, Cal. St. Bd. of Equal., June 21, 1983, the taxpayer sold stock in five different corporations. First, it realized gain from the sale of 20 percent of the outstanding stock in Kern County Land Company (KCL), which it had obtained in connection with its unsuccessful effort to acquire KCL. Second, it realized gain on the sale of a relatively small amount of stock of Island Creek Coal Co., which it had acquired for the purpose of impressing Island Creek's management with the sincerity of the taxpayer's interest in acquiring the company. The stock was sold in order to complete the merger of Island Creek and the taxpayer as a tax-free reorganization. Third, it sold its stock for a loss in Cofesa, a wholly owned British subsidiary that sold fertilizer directly to farmers. The stock was sold to liquidate Cofesa in order to avoid continuing operating losses. Fourth, it sold all the stock of Waiawa Realty, which operated in Hawaii, and which it believed would not prove profitable. Fifth, it organized a subsidiary, Oxytrol, to market a nitrogencontrolled system for fruits and produce during shipment. It eventually sold all the stock, apparently based on the perception that Oxytrol's operations were at variance with its other operations and its desire to redeploy financial resources.

All these gains and losses were treated by the taxpayer as business income. The FTB argued that since the taxpayer and its affiliates were not dealers in securities, any dividends they might have received on their stockholdings would have constituted nonbusiness income under (former) Regulation 25120. Consequently, since the stock, while owned by the taxpayers, was used to produce nonbusiness income, any gain or loss from the sale of the stock would be nonbusiness.

The SBE found that with respect to the sales of the Cofesa, Waiawa Realty and Oxytrol stock, the transactions gave rise to business income under the functional test because the stock had been acquired (or created) and managed in furtherance of the actual operation of the unitary business, and the assets and activities represented by the stock were fully integrated and functioning parts of the existing unitary business.

With respect to the Tenneco and Island Creek stock, the SBE found the gains were nonbusiness income because neither the stockholdings nor the assets and activities they represented constituted integral parts of the taxpayer's existing unitary operations at the time the taxpayer decided to sell them. The SBE went on to add:

"In fact, at no time did they possess more than the potential for actual integration into appellant's ongoing business, and we believe that mere potential is insufficient to support a finding that the gains on these sales were business income under the functional test." (Emphasis added.)

If the Board of Equalization were to follow the decision of the Oregon Supreme Court in <u>Pennzoil v. Department of Revenue</u>, it might well reach a different result in circumstances similar to those presented in <u>Appeal of Occidental</u>.

iv. <u>Appeal of Louisiana Pacific Corp.</u>

<u>In Appeal of Louisiana Pacific Corp.</u>, Cal. St. Bd. of Equal., Jan. 6, 1987, the taxpayer owned 50 percent of the stock of Ketchikan International Sales Corporation (KISC) and Ketchikan Pulp Company (KPC). The other 50 percent of the stock of both corporations was owned by FMC Corporation, an unrelated company. The issue before the SBE was whether the taxpayer's gain on the sale of its 50 percent interest in KISC to FMC was business income. The SBE concluded the gain was business income under the functional test.

v. <u>Appeal of Atlantic Richfield Company</u>

In October of 2003, the Board of Equalization issued a decision in the <u>Appeal of Atlantic</u> <u>Richfield Company</u>, Cal. St. Bd. of Equal., Oct. 3, 2002 (unpublished). This decision was subsequently withdrawn on May 28, 2003.

In December of 1988 Atlantic Richfield Company (ARCO) acquired approximately a 25% interest in Britoil. At the same time, British Petroleum began an acquisition of Britoil. Both investments were ostensibly made to acquire the petroleum reserves of Britoil. In January of 1989, less than two months after the decision to attempt to make an acquisition, it became apparent that ARCO would be unsuccessful in its attempt to obtain a more significant interest in Britoil, and it sold its interest in Britoil to British Petroleum at a profit of in excess of \$200 million. ARCO took the position that the gain was business income. The Franchise Tax Board, in reliance on <u>Appeal of Occidental Petroleum</u>, supra, argued that the gain was nonbusiness income because it did not meet the requirements of the functional test. ARCO, while it may have had the potential to integrate Britoil into its business, was unable to acquire a controlling interest, and therefore the property was never part of the unitary business. The Board of Equalization sustained the Franchise Tax Board's determination.

In its petition for rehearing ARCO argued in the alternative that the Britoil investment should be viewed as business income under the transactional test. At the first hearing on the matter, the Board did not accept ARCO's position that ARCO was in the business of buying and selling assets of this nature, and therefore the income did not meet the transactional test. ARCO presented evidence with respect to its history of capital transactions, its projection of cash flow and use, and the fact it treated the gain as business income in every other state to support its position, The Board of Equalization ruled in ARCO's favor. See e. Income from Short-Term Investments - Working Capital, *infra*.

vi. <u>Appeal of Oryx Energy Co. & Sun Company, Inc. (R&M)</u>

Sun incorporated in the 19th century as an energy company. In 1976 it diversified its operations by acquiring some trucking operations. In 1986 it decided to divest itself of its trucking operations, consisting of five different companies, and formed an intermediate

holding company for that purpose. The taxpayer attempted to classify the gain realized on the partial disposition of the trucking companies as nonbusiness income. In <u>Appeal of Oryx</u> <u>Energy Co. & Sun Company, Inc. (R&M)</u>, Cal. St. Bd. of Equal., July 9, 2003 (unpublished), the Board of Equalization stated that "California does not recognize a cessation of business or liquidation exception to the functional test classification of the gain as business income."

vii. Jim Beam Brands Co. v. Franchise Tax Board

See m *infra*.

viii. <u>Appeal of Crane Co. and Subsidiaries</u>

The Board of Equalization in a summary decision, June 30, 2009, held that a taxpayer's acquisition, management and disposition of the shares of stock in an affiliate were integral parts of the taxpayer's business and the gain on disposition was business income.

e. Income from Short-Term Investments – Working Capital

The law is relatively well settled on the issue of whether income from short-term investments is business or nonbusiness income. Four decisions illustrate this issue. *Appeal of Beck Industries*, Cal. St. Bd. of Equal., November 17, 1982, discusses what is meant by the taxpayer's "business" for purposes of the functional and transactional tests. *Appeal of American Medical*, Cal. St. Bd. of Equal., June 10, 1986, and *Appeal of Inco*, Cal. St. Bd. of Equal., March 3, 1987, point out characterization problems involving temporary investments of funds, and note that it is not what is ultimately purchased with the funds, but the relationship of the funds to the unitary business, that controls the classification issue. Finally, *Appeal of Macy*, Cal. St. Bd. of Equal., July 26, 1988, illustrates it is irrelevant whether the short-term investments are made by choice as a matter of investment philosophy, or because of business necessity.

The dissent in the California Supreme Court's decision in *Hoechst Celanese* is remarkable in its naiveté in that it raises the specter that the state will treat this type of income as nonbusiness income. This is probably the one type of income that is generally accepted as business income. Disputes may arise as to whether some portion of such income might be of an investment nature, but it appears to be unremarkable that some portion is always considered to be business income.

In the <u>Appeal of Atlantic Richfield</u>, supra, the taxpayer in its petition for rehearing took the position that its purchase of the shares of Britoil were made from its working capital and therefore the gain it realized should be treated as business income. In response to this claim, the Franchise Tax Board analyzed the taxpayer's source and use of funds statement contained in its annual report in an effort to show that the funds invested in Britoil came from funds in excess of current working capital needs and argued that a projected long-term investment of this nature was inconsistent with the use of working capital. The Board of Equalization granted Atlantic Richfield's appeal by letter dated May 28, 2003, without providing any rationale for its decision. It can only be assumed that the Board of

Equalization found the taxpayer's claim that the gain arose from the investment of working capital persuasive.

f. "Earmarking"

For businesses other than financials, the question of whether income realized from holding liquid assets is business or nonbusiness income must be made under the functional test. Examples of cases where the Board of Equalization has applied this approach include *Appeal of American Medical*, Cal. St. Bd. of Equal., June 10, 1986; *Appeal of Inco Express, Inc.*, Cal. St. Bd. of Equal., March 3, 1987; and *Appeal of Cullinet Software, Inc., et al.*, Cal. St. Bd. of Equal., May 4, 1995.

In *Cullinet*, the taxpayer made stock offerings "to provide additional capital for the acquisition of companies and products in the systems and applications software markets or in markets complimentary to the Company's business." The funds were placed in separate subsidiaries and invested in United States government obligations. The Franchise Tax Board argued that the income generated from these funds generated business income unless they had been segregated in a manner which clearly establishes that they were not being held for use in the unitary business. The Board of Equalization agreed with the Franchise Tax Board and rejected the taxpayer's argument that the income generated should be nonbusiness income unless there was a specific intent to use the funds in the business. The Board of Equalization found that the taxpayer's position would effectively create a presumption in favor of nonbusiness income, a presumption directly contrary to the regulations. The Board of Equalization held that the income arising from such funds would be business income because the funds "were, in fact, at all times held readily available for any use in its unitary business which might have arisen during the appeal years."

In <u>Appeal of Consolidated Freightways, Inc.</u>, Cal. St. Bd. of Equal., Sept. 4, 2000, the Board of Equalization further refined its analysis identifying "a two-prong approach for applying the functional test to liquid asset accounts." The first prong is the working capital test. "The term 'working capital' is not a term of art but generally refers to a pool of liquid funds which is part of appellant's total assets held to meet the reasonable needs of the business." In <u>Appeal of American Medical Buildings, Inc.</u>, supra, the funds were used to make loans to customers of the taxpayer to allow the customers to use the taxpayer's services. In <u>Appeal of Inco Express, Inc.</u>, supra, the funds were retained to ensure that the taxpayer would not have to borrow to fund its business needs.

If the funds cannot be characterized as working capital, then the second analytical prong, earmarking, is applied. "If the funds are earmarked for a unitary business use, business income may be generated." <u>Appeal of Consolidated Freightways, Inc., supra</u>. The basis of the earmarking test is Example (F) of Regulation 25120(c)(3) Cal. Code of Regulations tit. 18. In <u>Consolidated Freightways</u>, the taxpayer had sold part of its unitary business with the intention of reinvesting the proceeds in a company that would enable to expand its presence in the transportation industry. In furtherance of this intent, the taxpayer engaged an investment banker to search out appropriate candidates. It was almost seven years before the taxpayer was ultimately able to use the funds to acquire additional assets for the business.

Throughout the period, the investment banker continually searched for and presented possible candidates. The funds were invested in liquid securities pending the finding of an appropriate acquisition candidate. The Board of Equalization stated,

"[t]hat availability and liquidity have never been the primary determining factors for the Board's determination regarding business income, however, the fact that the proceeds were managed to make them readily accessible, liquid, and available for immediate use with no prepayment penalty, while appellant was engaged in an active, ongoing effort to acquire a compatible business, is strong evidence that these funds were earmarked for an acquisition target in the transportation industry."

The Franchise Tax Board will be issuing a Legal Ruling stating that dividends repatriated under section 965 of the Internal Revenue Code will be considered "earmarked" by the investment plan required to qualify for the reduction in federal tax.

g. "Conversion" Issues

An issue occasionally arises regarding whether an item of income may, over time or based upon changed circumstances, change its character between business and nonbusiness. *Ethyl, Thor Power Tool, Nicholas Turkey* and *Masonite* all illustrate aspects of this issue involving the relationship between the nature of the asset and the nature of the income it generates.

i. <u>Appeal of Ethyl Corporation</u>

In <u>Appeal of Ethyl Corporation</u>, Cal. St. Bd. of Equal., March 18, 1975, the issue was whether the loss from the sale of equipment in 1965 from a tetraethyl lead plant was includable in business income. The plant first closed in 1963, but remained operable until the plant was dismantled in 1965. The SBE concluded the loss was includable in business income because although the plant was not being used by the taxpayer in 1965, it remained capable of being used. Since the plant was not "permanently withdrawn" from business use until 1965 when the plant was dismantled and the equipment was sold, the loss on the sale in 1965 was includable in business income.

ii. <u>Appeal of Thor Power Tool Company</u>

In <u>Appeal of Thor Power Tool Company</u>, Cal. St. Bd. of Equal., April 8, 1980, the issue was whether gain from a 1973 sale of land was business income. The taxpayer owned and operated, since its initial purchase in 1954, a manufacturing plant that it used in its unitary business. A decision was made in 1970 to close the plant. When no purchaser could be found, the building was razed in 1972 in order to facilitate a sale. The land was sold in 1973, and the taxpayer reported the gain on the sale of the land as business income. The SBE agreed, and pointed out the land/building had been consistently used in the taxpayer's business from the time of its acquisition, and the land was never converted to the production of nonbusiness income. The SBE noted: "While we do not consider the example of identifiable events sufficient to cause property to be permanently withdrawn from the property factor contained in respondent's regulations to be all inclusive, in this appeal we

are unable to conclude that such an <u>identifiable event</u> occurred with respect to the land prior to its sale." (Emphasis added.)

iii. <u>Appeal of Nicholas Turkey Breeding Farms</u>

In <u>Appeal of Nicholas Turkey Breeding Farms, Inc, Taxpayer, and Arbor Acres Farm, Inc.,</u> <u>Assumer and/or Transferee</u>, Cal. St. Bd. of Equal., May 7, 1987, the issue was whether income received from the rental and sale of four farms was business income. The taxpayer, a large breeder of large white turkeys, bought four farms in South Carolina, which it operated for egg and meat production until 1972, when the South Carolina operations were terminated. A "major factor" for the termination was because "ineradicable" diseases affected the operations, which made the farms unusable for producing turkey eggs, "appellant's principal product." The farms were then leased to third parties who used them to raise turkeys for meat. The leases contained options to buy, and those options were exercised during the appeal period. The taxpayer treated the rental income and gain on the sale of the farms as nonbusiness income on the theory the execution of the leases converted the farms into nonbusiness assets which then produced nonbusiness income.

The SBE agreed with the taxpayer, and pointed out that Regulation 25120, subdivision ((c)(1)), provides that rental income is business income if the property which generates the rent is used in the taxpayer's trade or business and the property, while rented, was includable in the property factor. Regulation 25129, subdivision (b) provides that property shall be included in the property factor if actually used or available for or capable of being used in the taxpayer's business. Regulation 25120, subdivision (c)(2) provides that gain on the sale of property is nonbusiness income if it was utilized for the production of nonbusiness income or otherwise removed from the property factor before the sale. The SBE concluded the farms were not so usable, both because of the disease infestation and because the farms were under extended term leases to unrelated parties.

iv. Appeal of Masonite Corporation

In <u>Appeal of Masonite Corporation</u>, Cal. St. Bd. of Equal, March 3, 1987, Opinion and Order Denying Petition for Rehearing, November 15, 1988, the issue was whether income received by the taxpayer from production of oil on its timberlands constituted business income. The taxpayer was engaged in the unitary business of manufacturing and selling building materials and other wood-based products, and was the world's largest producer of hardboard. It owned large tracts of land for the purpose of having a secure source of raw wood materials sufficient to satisfy at least part of the needs of its manufacturing plants. Oil was discovered on some of those lands after the taxpayer acquired them. For the most part, the taxpayer had only a royalty interest in the 76 operating wells on the land, but it had a working interest in seven of them and owned one of them totally. The taxpayer argued the income derived from the oil was nonbusiness income because it was unrelated to its unitary hardboard business.

The SBE agreed that the income was nonbusiness income, which arose from activities "completely unrelated" to the actual operation of the taxpayer's hardwood business. The

SBE pointed out that although the oil royalty income had its source in the timberlands originally purchased for future use in the taxpayer's unitary business, the "crucial factor" is that this income was generated through operations conducted entirely independently of the hardwood business.

v. Regulatory Examples

Various examples in the regulations promulgated by the Multistate Tax Commission and adopted by California to illustrate application of the business/nonbusiness rules suggest that the passage of time may give rise to change in classification from business income to nonbusiness income. See Reg. 25120(c)(1) Examples (F) and (G); 25120(c)(2) Examples (C), (D), and (E).

h. Partnership Interests

The decisions in *Centennial* and *Holiday Inns* and section 25125 illustrate the classification issues regarding gain or loss on the sale of a partnership interest. Regulation 25137-1 and *Peel Construction* concern the classification of income received from a partnership.

i. <u>Appeal of Centennial Equities Corporation</u>

In <u>Appeal of Centennial Equities Corporation</u>, Cal. St. Bd. of Equal., June 27, 1984, the issue was whether the gain on the sale of partnership interests was business income. The taxpayer and its unitary subsidiaries, which were all engaged in the business of real estate development and ownership, owned partnership interests in 39 partnerships, all of which involved real estate properties. The taxpayer argued the gain on the sale of partnership interests was nonbusiness income because it did not continuously acquire and dispose of partnership interests in the regular course of its business.

The SBE concluded the gain was business income. Citing to <u>Appeal of Fairchild Industries</u> (involving the sale of an exclusive license), the SBE pointed out that when income is realized from assets that are integral parts of a unitary business, it is considered business income even if it arises from an extraordinary disposition of the property.

ii. <u>Appeal of Holiday Inns, Inc.</u>

In <u>Appeal of Holiday Inns, Inc.</u>, Cal. St. Bd. of Equal., April 9, 1986, the issue was whether the gain from the sale of the taxpayer's interest in a California real property partnership was allocable to California. The parties had agreed that the gain on the sale of the partnership interest was nonbusiness income, but disagreed as to where the nonbusiness income should be allocated. The taxpayer argued that since the capital gain was nonbusiness income from the sale of an intangible (its partnership interest) it should be allocated under section 25125 to the state of its commercial domicile, Tennessee, rather than to California. FTB argued the gain should be allocated to California since if the gain were from the sale of California real property, it would be allocable to California under section 25125.

The SBE rejected FTB's argument and pointed out that the UDITPA provisions are the exclusive method to be used for apportioning and allocating business and nonbusiness

income. The SBE concluded that the item under consideration was the sale of a partner's interest, not the sale of partnership property, and gain on the sale of that interest, an intangible, was allocable under section 25125 to the taxpayer's commercial domicile.

iii. Section 25125

In response to *Holiday Inns*, section 25125 was amended in 1988 to provide a special rule for the allocation of nonbusiness gains and losses from the sale of a partnership interest. Specifically, for income years beginning on or after January 1, 1988, section 25125, subdivision (d), provides that gain or loss on the sale of a partnership interest is allocable to California in the ratio of the original cost of partnership tangible property in California to the original cost of partnership tangible property everywhere, determined at the time of the sale. In the event that more than fifty percent (50%)of the value of the partnership's assets consist of intangibles, gain or loss from the sale of the partnership for its first full tax period immediately preceding the tax period of the partnership during which the partnership interest was sold.

iv. Regulation 25137-1

With respect to the classification of income received from a partnership, Regulation 25137-1 provides that when a taxpayer has an interest in a partnership, the first step is to determine which portion of the taxpayer's income and its distributive share of the partnership items constitute business and nonbusiness income under section 25120. It is presumed under the regulation that income arising from transactions and activity in the regular course of the partnership's trade or business constitutes business income. (Regulation 25137-1, subd. (a).) Thus, a corporate partner's distributive share of partnership business income constitutes business income to the corporate partner, but the determination of whether the partnership's activities and the activities of the corporate partner constitutes a single trade or business or more than one trade or business turns on the facts in each case. (Regulation 25137-1.)

If the partnership's activities and the corporate taxpayer's activities constitute a unitary business, the taxpayer's share of the partnership's trade or business is combined with the taxpayer's trade or business as constituting a single trade or business. Thus, business income is apportioned at the taxpayer's level by combining the taxpayer's share of the partnership's apportionment factors with the taxpayer's own factors to determine the taxpayer's apportionment percentage. If the partnership and the corporate taxpayer are not engaged in a unitary business, then the taxpayer's share of the partnership's trade or business is treated as a separate trade or business of the corporation, i.e., the corporate taxpayer's share of the partnership income would be apportioned by using only the corporation's share of the partnership factors. (Regulation 25137-1.)

With respect to the treatment of nonbusiness income, regulation 25137-1, subdivision (b) provides that the taxpayer's distributive share of such nonbusiness income shall be reported in the same manner as other nonbusiness income derived from other activity of the taxpayer. However, it is not completely clear which commercial domicile is to be used in cases in

which the commercial domiciles of the partnership and the corporate partner are different. The regulation suggests the commercial domicile of the partner should be used, but *Peel Construction*, below, suggests the commercial domicile of the partnership should be used. Unanswered questions also remain if the nonbusiness activities of the partnership took place in more than one state.

v. <u>Appeal of Peel Construction, Inc.</u>

The approach taken in Regulation 25137-1 is somewhat at odds with the approach taken in *Appeal of Peel Construction, Inc.*, Cal. St. Bd. of Equal., Jan. 6, 1987. There, the taxpayer, a California corporation engaged in the construction business in California, entered into a joint venture to grow lettuce in Arizona. The joint venture reported losses, which the taxpayer treated as includable in business income (and partially apportionable to California). FTB argued the losses were nonbusiness losses wholly allocable to Arizona. The SBE concluded that before it was necessary to classify the losses as business or nonbusiness, it was necessary to determine whether the taxpayer and its joint venture operations were unitary. The SBE concluded the operations were not unitary, and (under pre-UDITPA law) allocated the losses to Arizona because the activities giving rise to the losses were carried on in Arizona.

Thus, *Peel Construction* concluded the income from the joint venture could not be business income to the taxpayer because the taxpayer and the joint venture were not unitary. This is a different approach than the one taken in regulation 25137-1 where the business/nonbusiness determination is made at the partnership level, and before the unitary determination is made.

i. Sale of Leasehold Interest

Appeal of PQ Corporation

In an unpublished decision, <u>Appeal of PQ Corporation</u>, Cal. St. Bd. of Equal., Oct. 9, 1997, the Board of Equalization held that the sale of a leasehold interest in mineral assets which was tied to obtaining a source of supply of a mineral which was used in the unitary business was a business transaction and gave rise to business income under the transactional test. The SBE relied on its decision in the <u>Appeal of General Dynamics</u>, supra. The SBE indicated that had it not been for the fact the agreement also contained provisions that the seller could obtain a guaranteed amount of minerals, the transaction would not have given rise to business income. The SBE dismissed as irrelevant the fact the property sold had been included in the property factor for a number of previous filings.

j. Lawsuit Recoveries

i. <u>Appeal of Gam Rad West, Inc.</u>

The proceeds from the settlement of a lawsuit brought for the loss of business revenues that resulted from the acceleration of a business loan was held to be business income in the <u>Appeal of Gam Rad West, Inc.</u>, Cal. St. Bd. of Equal., Sept. 11, 1996 (unpublished). A

question to consider is whether the proceeds should be included in the sales factor and, if they were, how they would be assigned to the numerator.

ii. <u>Appeal of Polaroid Company</u>

Polaroid brought a patent infringement action against East Kodak. It recovered damages for lost profits, royalties for the use of patents in foreign countries, and interest on the judgment. The Board of Equalization, in <u>Appeal of Polaroid Corporation</u>, Cal. St. Bd. of Equal., May 28, 2003, held that all of these items constituted business income. The award for lost profits was intended to compensate Polaroid for income it would have earned, business income, but for Kodak's use of its processes. The royalty income related to Kodak's use of the processes in foreign countries where Polaroid did not carry on its own activities.

Patent and licensing income is frequently classified as business income, particularly where the patent involved was a core element of the business. The interest income related to the period of time between when the tort occurred and when the judgment was paid.

A similar result was reached in North Carolina, <u>*Polaroid* v. Offerman</u> (N.C. 1998) 349 N.C. 290.

A petition for rehearing was granted in *Polaroid* to consider the question of whether and how the proceeds from the lawsuit should be included in the sales factor. Prior to the matter being briefed, Polaroid's tax liability was established pursuant to its bankruptcy proceedings.

iii. <u>Pennzoil Company v. Department of Revenue</u> (2001) 332 Ore. 542 33 P.3d 314

This case involves the settlement of the damage suit Pennzoil brought against Texaco for interfering with Pennzoil's attempt to acquire Getty Oil. Pennzoil won a verdict in Texas to compensate it for its potential loss profits to be realized from the exploitation of Getty's assets and, in addition, was awarded punitive damages. Pennzoil settled the case for only a portion of the amount awarded to it in its lawsuit. The Oregon courts analyzed the classification of the settlement from the perspective that Pennzoil was attempting to acquire a business asset that would have given rise to business income. The settlement was a substitute for the income that would have been received if Pennzoil had acquired the asset, and therefore the settlement was business income. The Oregon Supreme Court concluded that the settlement was business income under a transactional analysis.

Compare the result in the Oregon *Pennzoil* case with the California State Board of Equalization case, <u>Appeal of Occidental Petroleum</u>, supra. Should the fact that income was realized from the sale of stock in Occidental, as compared to damages awarded as a result of a lawsuit, *Pennzoil*, give rise to a different classification?

iv. Common Production Service I, Inc. v. Franchise Tax Board, Second District B259619 (California)

Comcast had entered into a merger agreement with MediaOne. As part of the agreement MediaOne agreed to pay Comcast \$1.5 billion dollars if it unilaterally elected not to

complete the transaction. The arrangement was similar to a number of other merger agreements Comcast had entered into over the years. While the payment did not arise from a lawsuit it in essence was liquidated damages. The trial court held, and the appellate court sustained treating the damages as apportionable income.

k. Pension Reversions

Hoescht Celanese Corporation v. Franchise Tax Board 25 Cal.4th 508; 106 Cal.Rptr.2d 568, *cert. denied* Nov. 26, 2001

The taxpayer exercised its rights to terminate a pensions plan and realized approximately \$500 million in gain. The Board of Equalization and the trial court held that the gain realized was business income. The Third Appellate District reversed, holding that the reversion gave rise to nonbusiness income. The California Supreme Court reversed the holding and result of the appellate court while holding that there was both a transaction and functional test in the business income definition.

It should also be noted that this issue was also addressed by the North Carolina courts. In <u>Union Carbide v. Offerman</u> (N.C. 2000) 351 N.C. 310, the North Carolina courts held that the gain realized on a pension reversion was nonbusiness income because of its extraordinary nature and the fact that the taxpayer did not own the property. The California Supreme Court criticized the holding of the North Carolina courts in *Hoechst*.

I. Loss on the Purchase of Stock Warrants

<u>Robert Half International, Inc. v. Franchise Tax Board,</u> 66 Cal.App.4th 1020

In this case the taxpayer realized a loss on the purchase and retirement of stock warrants issued for its common stock. During the years at issue, this loss was treated as an ordinary income item. Federal and state laws have subsequently been amended so transactions of this type are not immediately included in income. The Franchise Tax Board argued that the expense was a business loss subject to apportionment and not wholly allocable to California as a nonbusiness item. The parties stipulated that UDIPTA contained both transactional and functional tests and that losses are treated in the same manner as income. The court concluded that the loss was not part of the taxpaver's regular business and accepted the taxpayer's characterization of the event as "extraordinary and non-recurring" in nature and therefore a nonbusiness item. The court of appeal modified its decision at the request of the Franchise Tax Board to insert a footnote that stated it was expressing no opinion on whether the sale of property used in the regular trade or business should be characterized as business or nonbusiness income or on the corollary rule that the infrequency or extraordinary nature of the transaction is irrelevant. The California Supreme Court in Hoechst Celanese characterized the reasoning of the Half decision as "mistaken," even though the result was acceptable.

m. Termination of a Line of Business

An area that continues to be litigated is whether the gain or loss realized on disposition of assets arising from a full or partial termination of a line of business is business or nonbusiness income. In support of treating such gain or loss as nonbusiness income is the fact that there no longer is any "business." An argument in support of business income treatment includes the fact that expenses taking in computing business income were taken to acquire the assets now being disposed of by the termination.

Most state courts have found that the gain or loss should be treated as nonbusiness income. <u>Western Natural Gas Co v. McDonald</u> (Kan. 1968) 446 Pac.2d 781: <u>McVean & Barlow, Inc. v. New Mexico Bureau of Revenue</u> (N.M. 1975) 543 Pac.2d 489; <u>Laurel Pipe Line Co. v. Commonwealth of Pennsylvania</u> (Pa. 2004) 642 Atl.2d 472; <u>May Dep't Stores v. Indiana Department of Revenue</u> (Ind. 2001) 749 NE.2d 651; <u>Lenox v. Tolson</u> (N.C. 2001) 548 SE.2d 513; and <u>Kemppel v. Zaino</u> (Ohio 2001) 746 NE.2d 1073.

In <u>Jim Beam Brands Co. v. Franchise Tax Board</u> (2005) 133 Cal.App.4th 514, this question, and the significance of out-of-state authorities, was considered for California purposes. The court rejected the out-of-state authorities because they could not be reconciled with California Board of Equalization decisions, and the reasoning of those out-of-state cases was in conflict with the reasoning of the Board of Equalization. It found that all of the out-of-state cases focused on the disposition of the property rather than the use to which the property had been put prior to disposition. To follow the out-of-state authorities would have, in the court's opinion, required it to apply the functional test in a manner inconsistent with *Hoechst Celanese* and the Board of Equalization decisions on which that case relied. The decision also notes that most of the out-of-state decisions were superceded by subsequent legislative action in the specific states.

Meadwestvaco also involves the disposition of a line of business though the question was phrased as to whether the realization of gain inherent in goodwill gave rise to business income. See the discussion *infra.* at b.

6. <u>CONSEQUENCES OF BUSINESS/NONBUSINESS DETERMINATION</u>

Many consequences result from the classification of income as business or nonbusiness income. The most fundamental consequence is that business income/loss is apportioned, while nonbusiness income/loss is allocable to a state. This may become particularly significant with respect to dividend income as a consequence of the determination that section 24402 is unconstitutional and the Franchise Tax Board's implementation of that decision by denying a deduction with respect to all dividends. A taxpayer based in a jurisdiction other than California can avoid consideration of the dividends in the California tax base if the dividends are classified as nonbusiness income.

Another fundamental consequence is that classification of income as business or nonbusiness income may require a compensating adjustment to the factors of the apportionment formula to include or exclude the asset giving rise to the income. Regulation 25132, subdivision (a)(2), provides that employee compensation associated with

nonbusiness income is excluded from the payroll factor. Regulation 25134 defines the sales factor to include only sales from transactions and activity in the regular course of the taxpayer's trade or business. Regulation 25129, subdivision, (a) provides that property used in connection with the production of nonbusiness income shall be excluded from the property factor. For example, in <u>Appeal of Masonite Corporation</u>, supra, the SBE pointed out that because the income from land was nonbusiness income, the land must be removed from the property factor where it had apparently been included by the taxpayer.

Classification of an item as business or nonbusiness can also have an impact on the assignment of expenses. If an item is business income, the allocation of expenses has no impact because the expenses relate to all income and are in the apportioned net amount. In the case of a nonbusiness item, the allocation of expenses can have a significant impact because the expense is either fully deductible if the nonbusiness item is assigned to the taxing state, or is, effectively, nondeductible if it is assigned outside the taxing state. Formerly, California's interest offset provision frequently made the classification of interest and dividends as business or nonbusiness unimportant because there would be no revenue effect. With the decision in *Hunt-Wesson*, this may become a more significant issue.

<u>CHAPTER 7</u> <u>THE APPORTIONMENT FORMULA</u>

1. <u>OVERVIEW</u>

a. Factor Weighting

i. Over the last several decades states have been moving away from the equally-weighted three factor apportionment formula to a formula that gives greater weight to the sales factor. A number of states now apportion income solely on the basis of sales. California adopted a sales only apportionment formula for most corporations for income years beginning on or after January 1, 2013, Section 25128.7 Revenue and Taxation Code, The excluded entities are extractive industries, agriculture and banks and financials which will still use the equally-weighted three factor formula.

<u>ii.</u> California

Prior to January 1, 1993, and consistent with UDITPA, California used an equally weighted, three-factor formula of payroll, property and sales to apportion business income of all corporations (absent a special formula). (Section 25128.) In general, "payroll" includes all forms of compensation paid to employees. (Sections 25132-25133.) "Property" generally includes all real and tangible personal property owned (valued at original cost) or rented (valued at eight times the net annual rental rate) by the taxpayer. (Section 25129-25131.) "Sales" generally includes all gross receipts of the taxpayer from the sale of tangible and intangible property. (Sections 25134-25136.) The property and payroll factors were intended to emphasize the activity of the manufacturing state, while the sales factor was intended to recognize the contribution of the consumer state toward the production of the income of the business. (Pierce, "The Uniform Division of Income for State Tax Purposes," Taxes, Oct. 1957, 747, 780.) The three-factor formula has been evolving into a formula placing greater emphasis on the sales factor. From a theoretical perspective, the "double weighting" is justified on the grounds that the production states and the market states contribute equally to the earning of income. Currently approximately twenty percent of the states still use an equally-weighted three factor formula, one-half attributed greater weight to the sales factor, and one third using a sales factor only.

For income years beginning on or after January 1, 1993, California requires most corporate taxpayers (taxpayers engaged in agricultural or extractive business activity were originally exempted--in 1994 the exemption from double weighting was extended to financials) to use a "double-weighted" sales factor. Under the double-weighted sales factor approach, the amount of business income attributable to California is determined through the use of a formula consisting of a fraction, the numerator of which is the sum of the payroll factor, the property factor, and <u>twice</u> the sales factor, and the denominator of which is <u>four</u>. Accordingly:

<u>Calif. Prop.</u> + Total Property	<u>Calif. Payroll</u> Total Payroll	+	2 x <u>Calif. Sales</u> Total Sales	
	-			= CA factor
	4			

The significance of the double weighting the sales factor can best be illustrated by use of an example. Assume a corporation doing business within and without California has the following factors:

	IN CALIF	EVERYWHERE	CALIF PORTION
Payroll	\$ 100,000	400,000	25%
Property	300,000	3,000,000	10%
Sales	1,000,000	2,000,000	50%

The "double-weighted" apportionment formula utilizing payroll, property and sales attributable to California gives a factor of 33.75 percent (25 + 10 + 50 + 50 / 4). [In comparison, an equally weighted formula would result in a 28.33-percent factor.] Thus, if the corporation's total business income is \$500,000, the business income apportionable to California under the double-weighted sales factor approach is \$168,750 (500,000 x 33.75 percent).

A "taxpayer" is considered to be conducting an agricultural or extractive business activity if more than 50 percent of its gross business receipts is derived from such activities as defined in Revenue and Taxation Code section 25128, subdivision (c). In FTB Legal Ruling 94-1 (Mar. 8, 1994), the FTB concluded that when a combined unitary group of corporations consists of members engaged in both extractive and nonextractive business activity, and more than 50 percent of its gross business receipts of the combined unitary group is from extractive activities, all of such members must apportion their income using a single-weighted sales factor. Regulations were adopted in 1999 to aid in the determination of what receipts are to be treated as arising from extractive and agricultural activities.

For income years beginning on or after January 1, 2011 California will allow taxpayers that are otherwise required to double-weight sales to make an annual election on their original return for a year to use a sales factor only to apportion income.

To further complicate matters the Legislature in 2010 amended the sales factor so that taxpayers electing to apportion on the basis of the sales factor alone will use the market sourcing rules for sales of other than tangible property. For taxpayers that continue under the standard apportionment formula or double-weighted sales factor they will use the traditional assignment rules for sales of other than tangible property based upon the state with the predominance of income producing activity.

Beginning in 2011 there will be three separate apportionment formulas for California taxpayers. Taxpayers engaged in agriculture, extractive activities, and financial activities

will use an equally-weighted three factor formula. Other taxpayers will have a choice of a double-weighted sales factor with sales of other than tangible property assigned to a state based upon the predominate income producing activity or a sales factor only formula with sales of other than tangible property assigned on a market basis.

For income years beginning on or after January 1, 2013, most taxpayers in California will apportion income solely be reference to the sales factor.

iii. Multistate Tax Commission Proposed Change

The proposal being considered by the Multistate Tax Commission is to change Article IV to provide that business income, or in the MTC's proposal apportionable income, will be apportioned by the formula adopted by the state. This proposal recognizes that many states have moved to a sales factor only apportionment formula.

b. Variations from the Standard Formula

UDITPA expressly recognizes this standard apportionment formula may not be appropriate in all circumstances. For this reason, and as discussed in Chapter 8, section 25137 (identical to §18 of UDITPA) provides that in specified circumstances, a taxpayer may petition for, or the tax administrator may require, the use of apportionment methods other than the standard formula if the provisions of the standard formula "do not fairly represent the extent of the taxpayer's business activity" in the state.

c. Partnership Factors

In general if a corporation owns an interest in a partnership it includes its proportionate share of the income and the factors. In the <u>Appeal of Eli Lily, Inc.</u>, Cal. St. Bd. of Equal., Feb. 1, 2007, (unpublished) the Board of Equalization held that when a partnership terminate its taxable year closed as of the termination and its income and factors were included in the combined report taxable year of the partner in which the termination occurred.

2. <u>THE PAYROLL FACTOR</u>

a. In General

The payroll factor is a fraction, the numerator of which is the total amount paid in California during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year. (Section 25132.) Under section 25133, compensation is paid in California if:

(1) The individual's service is performed entirely in California;

(2) The individual's service is performed both within and without California, but the service performed outside California is incidental to the individual's service in California; or

(3) Some of the service is performed in California and (a) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in California, or (b) the base of operations or the place from

which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in California.

Regulations 25132-25133 provide additional rules for calculation of the payroll factor. The more significant rules are as follows:

(1) Employee compensation associated with nonbusiness income is excluded from the payroll factor. (Regulation 25132, subd. (a)(2).)

(2) Payments made to independent contractors, or any other person not properly classifiable as an employee, are excluded. (Regulation 25132, subd. (a)(3).)

(3) Compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation, for example, by virtue of P.L. 86-272, is included in the denominator of the payroll factor. (Regulation 24132, subd. (b).)

(4) The taxpayer may determine the amount of compensation "paid" under either the cash or accrual methods. If the cash method is used, Forms 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return), 941 (Employer's Quarterly Federal Tax Return), and DE-3 (California Unemployment Insurance quarterly returns) are often used for calculating the numerator and denominator. (Regulation 25132, subds. (a)(2), and (c).)

(5) Benefits and services furnished to employees by the taxpayer in return for personal services are "compensation" provided that such amounts are taxable income to the recipient under the Internal Revenue Code. (Regulation 25132, subd. (a)(3).) Thus, deferred compensation, health benefits, etc., are generally not included in the payroll factor.

(6) Compensation paid to employees for the construction of a fixed asset (e.g., a building), is includable in the payroll factor, even though it is also capitalized into the cost of the asset in the property factor. (Regulation 25132, Example (A).)

(7) The term "base of operations" is the place of more or less permanent nature from which the employee starts his work and to which he customarily returns in order to receive instructions from the taxpayer or communications from his customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of his trade or profession at some other point or points. The term "place from which the service is directed or controlled" refers to the place from which the powers to direct or control is exercised by the taxpayer. (Regulation 25133, subd. (3)(C).)

b. Significant Decisions

The calculation of the payroll factor is a relatively well-settled area of the law with few controversial issues. An issue that has not yet surfaced in published decisions is the use of

"leased" employees. That is a taxpayer using a third party to supply its employees so it has no payroll.

Two decisions, *Lipps* and *Photo-Marker*, illustrate two major issues: the meaning of "employee," and the location of a taxpayer's "base of operations."

i. <u>Appeal of Lipps, Inc</u>.

In <u>Appeal of Lipps, Inc.</u>, Cal. St. Bd. of Equal., March 3, 1967, the issue was whether certain workers in Mexico were employees of the taxpayer for purposes of the payroll factor. The taxpayer, which manufactured magnetic tape heads in California, contracted with Cal-Pacifico, an unrelated corporation, for the purpose of Cal-Pacifico providing labor and facilities for the taxpayer in Mexico. Under the contract, the taxpayer sent unfinished products to Mexico for assembly by the workers engaged by Cal-Pacifico. The taxpayer included wages paid to Cal-Pacifico on behalf of the Mexican workers as part of its own payroll factor.

The SBE held the wages paid to Cal-Pacifico for the Mexican workers must be eliminated from the payroll factor because they were not employees of the taxpayer. The SBE pointed out that under Regulation 25132, only amounts paid "directly to employees" are included in the property factor. Here, the taxpayer paid Cal-Pacifico and Cal-Pacifico, in turn, paid the Mexican workers. In addition, the SBE concluded that under the common law definitions of "employee" and "independent contractor," the Mexico workers were not the taxpayer's employees. The SBE declared the most important factor with respect to employee/independent contractor status is the right to control the manner and means of accomplishing the results desired. Here, Cal-Pacifico, not the taxpayer, controlled the workers.

ii. Appeal of Photo-Marker Corporation of California

In <u>Appeal of Photo-Marker Corporation of California</u>, Cal. St. Bd. of Equal., Nov. 19, 1986, the issue was whether compensation was paid in California. The two individuals in issue were officers and/or directors of the New York parent corporation of the taxpayer, a California corporation. The taxpayer argued the individuals' executive duties in New York were more important and permanent than their jobs in California, and that the base of operations for the individuals was New York at the parent's corporate headquarters. The SBE disagreed, and cited to section and Regulation 25133 which provide that if the employee's services are performed both within and without California, the compensation will be attributed to California if the employee's "base of operations" is in California. The SBE found the evidence demonstrated the base of operations was in California, based upon the long-term presence of the individuals in California and their business related duties in California.

3. <u>THE PROPERTY FACTOR</u>

a. In General

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in California during the income year, and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the income year. (Section 25129.)

This definition is significant in several respects. First, the property factor includes only real property and tangible personal property. <u>Intangible</u> property is excluded. Partly for this reason, special apportionment formulas have been created by FTB and the MTC for certain industries which include intangibles in the property factor. (See Chapter 8.) Second, the property factor includes owned <u>and</u> rented property. Third, the property must be "used" in the unitary business to be included in the property factor. Finally, property is assigned for numerator purposes to the place where it is used.

b. Tangible vs. Intangible Property

The issue of what constitutes "tangible" personal property was addressed in <u>Appeal of Retail</u> <u>Marketing Services, Inc.</u>, Aug. 1, 1991, Cal. St. Bd. of Equal., where the taxpayer argued that its coupon inventory should be included in the property factor. The FTB argued the coupons were intangible property, and only real and tangible personal property could be included in the property factor as defined in section 25129. The SBE declared that "property is intangible if its intrinsic value is attributable to its intangible elements rather than to any of its specific tangible embodiments." Applying this "intrinsic value" test, the SBE concluded the intrinsic value of the coupons was attributable to their intangible elements rather than to their tangible embodiments, and thus they were intangible rather than tangible property. As intangible property, they could not be included in the standard property factor. (The SBE also concluded the taxpayer was not entitled to modify the standard property factor under section 25137 so as to include the coupon inventory--see discussion in Ch. 8.)

A suit for refund was filed by Microsoft, <u>*Microsoft v. Franchise Tax Board*</u>, San Francisco Superior Court CGC08471260, where the taxpayer is contending that its intangible property should be reflected in some manner in the apportionment formula pursuant to section 25137 Revenue and Taxation Code. The trial court ruled against Microsoft. Microsoft abandoned this issue on appeal.

c. Valuation of Owned Property

Sections 25130-25131 and Regulations 25130-25131 set forth rules for determining the valuation of owned property. The more significant rules are as follows:

(1) Property owned by the taxpayer is valued at its original cost. (Section 25130.) As a general rule, "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or

improvements thereto and partial disposition thereof, by reason of sale, exchange, abandonment, etc. (Regulation 25130, subd. (a).)

(2) If the original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer. (Regulation 25130, subd. (a).)

(3) Inventory of stock of goods is included in the factor in accordance with the valuation method used for federal tax purposes. (Regulation 25130, subd. (a).)

(4) As a general rule, the average value of property owned by the taxpayer is determined by averaging the values at the beginning and ending of the income year. However, FTB may require or allow averaging by monthly values if such method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period. Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the income year or where property is acquired after the beginning of the income year or disposed of before the end of the income year. (Regulation 25131, section 25131.)

d. Valuation of Rented Property

Section 25130 and Regulation 25130 also set forth rules for the valuation of rental property. The more significant rules and decisions are as follows:

(1) Property rented by the taxpayer is valued at eight times its net annual rent. Net annual rental rate for any item is the annual rental rate paid by the taxpayer for such property, less the aggregate annual sub rental rates paid by subtenants of the taxpayer. However, sub rents are not deducted when they constitute business income. (Section 25130; Regulation 25130, subd. (b).)

(2) "Annual rent" includes amounts payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs of any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. (Regulation 25130, subd. (b).)

(3) Leasehold improvements are treated as property owned by the taxpayer. The original cost of leasehold improvements is included in the factor (regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease). (Regulation 25130, subd. (b).)

In addition, Regulation 25137 sets forth special rules for the property factor involving rentals. Specifically:

(1) If the sub rents taken into account in determining the net annual rental rate under subdivision (b) of Regulation 25130 produce a negative or clearly

inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by FTB or requested by the taxpayer. In no case, however, shall such value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for such property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property. (Regulation 25137, subd. (b)(1)(A).)

(2) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for such property shall be determined on the basis of a reasonable market rental rate for such property. (Regulation 25137, subd. (b)(1)(B).)

i. <u>Appeal of Castle & Cooke, Inc., et al.</u>

In <u>Appeal of Castle & Cooke, Inc., et al.</u>, Cal. St. Bd. of Equal., June 17, 1987, the issue was whether amounts paid for time charters and contracts of affreightment should be included as capitalized rents in the property factor. The taxpayer, through some of its subsidiaries, buys, ships and sells tropical fruit, which is shipped from Latin American in refrigerated vessels under either time charters or contracts of affreightment. In a time charter, a contract is made with a vessel owner to supply a vessel, crew, and supplies for a specific period of time. A contract of affreightment is basically the same as a time charter, except the contract is for a specified amount of space on a vessel. Under both arrangements, the charges to the taxpayer were payable regardless of whether the space on the vessel was actually used. The taxpayer argued the amounts it paid under both arrangements were actually "rents" and should be capitalized for purposes of the property factor.

The SBE held the costs were transportation expenses and not the rental of assets to be used by the taxpayer in its unitary business. The SBE reasoned: "What appellant was really contracting for was an integrated package providing adequate space and conditions for its produce while being transported, with payment being for the end result - delivery at the port of destination. The fact that tangible personal property was used in achieving this end result does not change a transportation contract into a lease."

ii. <u>Legal Ruling 97-2</u>

In Legal Ruling 97-2, the Franchise Tax Board, in reliance on the Board of Equalization opinion in the *Appeal of Proctor & Gamble Manufacturing Company*, Cal. St. Bd. of Equal., Sept. 26, 1989, ruled that royalties paid with respect to a property interest in the nature of a *profit a prendre*, to the extent actually used by the taxpayer, as a substantial equivalent to a rental, should be capitalized at eight times for purpose of valuing the interest for the property factor. This ruling applies to interests in land for timber and mineral leases.

In the <u>Appeal of Proctor & Gamble Manufacturing Company</u>, supra, the Board of Equalization held that under Regulation 25137(b)(1)(B), the taxpayer was entitled to include timberland for which it had a right to harvest in the property factor at a "reasonable market rental value." The Board of Equalization rejected the Franchise Tax Board's argument that

the amounts paid for the annual "holding charge" and "forest protection charge" of \$15.80 a square mile were anything other than nominal rent, and also rejected the argument of the Franchise Tax Board that the reasonable market rental value only applied to the amount of the property actually used in the year. The Board of Equalization made no finding as to what a reasonable market rental value might be.

In Legal Ruling 97-2, the Franchise Tax Board held that the payment of royalties between unrelated parties, neither of which is compelled to enter into the contract, will be assumed to be arm's-length and therefore represent fair value for use of the land. In the Legal Ruling, the Franchise Tax Board also held that by its terms, Regulation 25137(b)(1)(B) restricts the property to be considered to that actually used, not what is available for use.

Subsequently, the Board of Equalization issued an unpublished opinion in the <u>Appeal of Kimberly-Clark Corporation</u>, which overruled the <u>Appeal of Procter & Gamble</u>, supra, FTB Legal Ruling 97-2. This opinion was later withdrawn. This unpublished opinion was supportive of the notion that various charges made to the taxpayer were something other than nominal, but the opinion indicates that the Board of Equalization was troubled by using charges characterized as "royalties" as rent because of the exclusionary language regarding royalties in Regulation section 25130(b)(4)(B). This is an area, therefore, where the vitality of the <u>Appeal of Proctor & Gamble</u> and Legal Ruling 97-2 is uncertain. There are no published decisions overruling Proctor & Gamble or withdrawing Legal Ruling 97-2. However, it is clear that both have been criticized by the Board of Equalization. It should be expected that the Franchise Tax Board will continue to follow them until they are withdrawn or overruled, or until regulations are adopted providing for other methods.

e. "Use" of Property

Regulation 25129 provides rules for when property is "used" by the taxpayer. The more significant rules and decisions are as follows:

(1) Property used in connection with the production of nonbusiness income is excluded from the property factor. Property used for both the production of business and nonbusiness income is included only to the extent the property was used in the regular course of the taxpayer's trade or business. The method of determining the portion to be included in the factor will depend upon the facts of each case. (Regulation 25129, subd. (a).)

(2) Property is included in the factor if it is actually used or is available for or capable of being used during the income year in the regular course of business of the taxpayer. Property held as reserved or standby facilities or property held as a reserve source of materials is included. (Regulation 25129, subd. (b).)

(3) Property or equipment under construction during the income year is excluded from the factor until such property is actually used in the regular course of the trade or business of the taxpayer, but is partially included if partially used while under construction. (Regulation 25129, subd. (b).) (4) Property used in the regular course of the trade or business of the taxpayer remains in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale. (Section 25129, subd. (b).)

i. <u>Appeal of Tosco Corporation</u>

In <u>Appeal of Tosco Corporation</u>, Cal. St. Bd. of Equal., Nov. 18, 1980, the issue was whether the taxpayer properly included its interest in oil share reserves in the property factor. Concurrent with its development of technology to extract petroleum products from oil shale, the taxpayer gradually acquired interests in oil shale properties. By the appeal years, the taxpayer had acquired an interest in approximately 26,000 acres. The oil shale reserves were not used, and the issue before the SBE was whether they were "available for or capable of being used" within the meaning of Regulation 25129, subd. (b).

The SBE concluded the reserves were includable in the property factor. It reasoned that the taxpayer's capital was periodically invested in oil shale reserves throughout the 20-year development process on the good-faith belief that ultimately a suitable return on its investment would be achieved. Accordingly, since the reserves "clearly were available for use," they are includable in the factor. In addition, the reserves qualified as "reserves … or property held as a reserve source of materials" which are includable in the property factor under Regulation 25129, subd. (b).

ii. <u>Communications Satellite Corp. v. Franchise Tax Board</u>

In Communications Satellite Corp. v. Franchise Tax Board (1984) 156 Cal.App.3d 726, one issue addressed by the court was how to calculate the property factor of the taxpayer (Comsat), an operator and part owner of a global commercial communications satellite system. The satellites were in "synchronous" orbit so that they appeared to remain stationary over a fixed point on earth. The satellites were positioned over the Atlantic, Pacific and Indian Oceans, and never passed over California, even during launch. The taxpayer held a 50-percent ownership interest in seven earth stations in the satellite system, one of which was located at Jamesburg, California. In addition, the taxpayer maintained a small engineering office in California. The taxpayer included in the numerator of the property factor its interest in real and tangible personal property in California (i.e., the earth station and engineering office), but excluded from the numerator any value representing its interest in the satellites. The taxpayer included in the denominator its interest in all real and tangible personal property everywhere, including its undivided interest in the satellites. On audit, FTB included in the taxpayer's numerator a portion of the value of the taxpayer's interest in the satellites, based on the ratio of the value of the taxpayer's interest in real and tangible personal property on the ground in California divided by the value of its interest in real and tangible personal property on the ground everywhere (i.e., excluding the value of Comsat's interest in the satellites).

The court of appeals agreed with the FTB, and concluded there is "an invisible, but apparently continuous and very real, connection between the earth station and the satellites. The earth station has a value only because this connection exists, and it is otherwise of no value. Without the connection, the satellites function in outer space to no purpose involving this state. ... Because Comsat owns an interest in the satellites, and because they function in California at and through the Jamesburg earth station, we conclude that they are 'tangible personal property owned ... and used in this state,' by Comsat, within the meaning of section 25129."

iii. <u>Appeal of Kimberly-Clark Corporation</u>

In an unpublished opinion in the <u>Appeal of Kimberly-Clark Corporation</u>, Cal. St. Bd. of Equal., the State Board of Equalization held that the full value of a tract of timberland should be included in the property factor in spite of the fact that the taxpayer's right to harvest was limited to a certain amount of timber and in spite of the fact that the taxpayer never harvested the full amount allowed under the lease. This conclusion was based upon the fact that the taxpayer was unrestricted as to where on the tract it chose to harvest. This opinion was subsequently withdrawn. How this issue might be handled in other cases is unclear.

f. Property in Transit/Mobile Property

Regulation 25129 also provides rules regarding the inclusion in the property factor of property in transit and mobile or moveable property. The more significant rules and decisions are as follows:

(1) Property in transit between locations of the taxpayer to which it belongs is considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices is included in the numerator according to the state of destination. (Regulation 25129, subd. (d).)

(2) The value of mobile or moveable property such as construction equipment, trucks or leased electronic equipment which is located within and without California during the income year is included in the numerator of the factor on the basis of the total time within California during the year. (Regulation 25129, subd. (d).)

i. <u>Appeal of Craig Corporation</u>

In <u>Appeal of Craig Corporation</u>, Cal. St. Bd. of Equal., March 3, 1987, two inventory issues were presented: (1) whether in-transit inventory was properly included in the numerator of the property factor; and (2) whether FTB properly required the taxpayer to compute the inventory component of its property factor on a quarterly, rather than an annual, basis.

With respect to the first issue, the parties agreed that under Regulation 25129, property in transit between locations of the taxpayer to which it belongs is included in the numerator of

the state of its destination. The disagreement was over the state of "destination." The SBE concluded that "destination" in the regulation does not mean "ultimate destination" as argued by the taxpayer, but allows for several destinations for the same goods. Accordingly, the taxpayer was required to include all the goods in transit to California in its California denominator. The SBE added that when the goods leave California for the taxpayer's out-of-state customers, they are includable in the numerator of the property factor at their new destination by either the taxpayer or its customer, depending on which party would normally include the goods in its property factor denominator on the relevant inventory date.

With respect to the second issue, the FTB argued it could require the taxpayer to determine its average inventory value based on quarterly, rather than yearly, figures since the quarterly figures fluctuated widely throughout the year and were at a low point when the annual year-end figures were compiled. The SBE concluded that section 25131 gives FTB discretion to depart from the use of annual figures if "reasonably required to reflect properly the average value of the taxpayer's property," and the taxpayer had not established that FTB acted unreasonably in exercising that discretion.

ii. Montgomery Ward & Co. v. FTB (1970) 6 Cal.App.3rd 149

A pre-UDITPA case holding that property in transit for use in California is properly included in the California numerator of the property factor. The court pointed out that the question is not the ad valorem taxation of the property, but whether the apportionment formula constructed to assign income to the state has been properly constructed. A formula which "includes property which has been unconditionally appropriated for utilization in California, and which … has neither been taxed elsewhere, nor used as a measure of income derived for or attributable to another taxing jurisdiction" is proper.

g. Intercompany Items

Property sold between members of the combined report group is reflected in the property factor at the original cost of the seller. Regulation 25106.5-1(a)(5)(B)1. Rents between members of the combined report group are disregarded and the property is reflected in the property factor at the original cost of the owner. Regulation 25106.5-1(a)(5)(B)2.

h. Intangible Property

The UDITPA property factor only encompasses tangible property. The reasons behind this are the location of tangible property can be readily determined and historic federal cost provides a common basis for valuation.

In order to include intangible property in the property factor a taxpayer must make an argument under Section 18 of UDITPA. In some respects the assignment of the location of the property can be determined by reference to the sales factor. The UDITPA siting rule is based on where property is used. Intangible property is used where it produces income, that is the sales factor.

The inclusion of intangible property was attempted by Microsoft in litigation with California. It was pled as an offset to the exclusion of receipts from treasury activity

from the sales factor. The California had previously ruled in a case involving Microsoft that treasury receipts should be excluded from the sales factor except for net gains. The lower courts were unlikely to deviate from a ruling of the California Supreme Court. However, if the issue is presented unencumbered by another issue the logic for its inclusion might be compelling but the best defense might be where the intangible property would be assigned, that is by where it is used, the sales factor.

4. <u>THE SALES FACTOR</u>

a. In General

The sales factor is defined as a fraction, the numerator of which is the total sales of the taxpayer in California during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year. (Section 25134.)

The sales factor was originally included in UDITPA to provide reflection of the value which a market provided to the earning of income. It was intended to balance the property and payroll factor which generally reflect the contributions to the earning of income provide by capital and labor.

The sales factor is probably the most difficult of the three apportionment factors to calculate and administer. Many issues commonly associated with calculation of the sales factor, including P.L. 86-272, constitutional limits on a state's power to tax, the meaning of "taxable in another state," and *Finnigan*, are treated elsewhere in these materials. What follows is a discussion of the significant remaining sales factor issues.

Under UDITPA the sales factor is one of the equally weighted factors which are generally accepted as the income producing activities of a business. Assigning one-third weight to the sales factor was arbitrary and reflected the fact that introducing a sales factor was a break from traditionally views that income was produce only by capital and labor. As time past there was a recognition that the sales factor was intended to balance the contribution of capital and labor and that it should therefore be accorded equal weight. The result was a gradual transition to states adopting apportionment formulae with a double-weighted sales factor.

After the decision in *Moorman Manufacturing v. Bair* where the United States Supreme Court upheld Iowa's use of sales factor apportionment only the trend to double-weighting the sales factor accelerated and eventually gave rise to sales only apportionment.

Another issue that arises with respect to the sales factor is the assignment of a growing percentage of sales involving other than the sales of tangible personal property by reliance on the income producing activities of the taxpayer, that is its property and payroll. If the sales factor was intended to reflect the market why should a significant amount of sales be assigned based on the location of property and payroll. This has given rise to market-based sourcing of sales involving other than tangible personal property.

b. Sales

Under UDITPA "Sales" is defined to mean "all gross receipts of the taxpayer not allocated under sections 25123 through 25127" (Section 25120, subd. (e).) This broad definition includes more than simply sales of tangible personal property. It also includes receipts arising from the leasing of real property, licensing of intangible property, and the performance of services. This broad definition of sales has given rise to significant litigation involving the exclusion of various receipts either definitional, by regulation, or pursuant to Section 18 of UDITPA, Section 25137 Cal. Rev. and Tax Code.

i. Legislation A. California

For taxable years beginning on or after January 1, 2011, the California Legislature adopted legislation, Section 25120(f)(2), modeled on a Multistate Tax Commission regulation excluding certain items from the sales factor to the California statutes.

The list of items specifically defined as excluded are

- (A) Repayment of loan or redemption of a security. (Consistent with *General Motors* decision.)
- (B) Principal amounts on repurchase agreements. (Consistent with *General Motors* decision.)
- (C) Issuing stock or selling treasury stock.
- (D) Damages arising from litigation (presumably would included settlements)
- (E) Property acquired as an agent for another
- (F) Tax refunds and other tax benefits
- (G) Pension reversions (Consistent with *Hoescht Celanese*)
- (H) Contributions to capital
- (I) Discharge of Indebtness
- (J) Exchange of inventory not recognized as income
- (K) Treasury function proceeds (not in Multistate Tax Commission regulation)
- (L) Hedging transactions (not in Multistate Tax Commission regulation but see the decision in *General Mills Corp v. Franchise Tax Board,* (2009) 172 Cal App 4th 1535 which held that hedging transactions constituted sales under the current statute.)
- (M)

B. Multistate Tax Commission

The Multistate Tax Commission in 2014 amended Article IV of the Compact to replace the word "sales" with "receipts" and define them as

Receipts" means all gross receipts of the taxpayer that are not allocated under paragraphs of this article, and that are received from transactions and activity in the regular course of the taxpayer's trade or business; except that receipts of a taxpayer from hedging transactions and from the maturity, redemption, sale, exchange, loan or other disposition of cash or securities, shall be excluded.

This equates receipts to those arising from transactions that satisfy the transactional test for determining if income is apportionable.

ii. Regulations

California Regulation 25134 provided additional rules defining the sales factor. The more significant rules are as follows:

(1) "Sales" means all gross receipts derived by the taxpayer from transactions and activities in the regular course of such trade or business. (Regulation 25134, subd. (a)(1).)

(2) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, "sales" includes all gross receipts from the sale of such goods or products held for sale in the ordinary course of the business. "Gross receipts" means gross sales, less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. Federal and state excise taxes (including sales taxes) are included as part of such receipts if the taxes are passed on to the buyer or included in the selling price of the product. (Regulation 25134, subd. (a)(1)(A).) For example,

Excise taxes are included in the sales factor if such taxes are passed on to the buyer or included as part of the selling price of the product. (Regulation 25134, subd. (a)(1)(A).) Value Added Taxes (VAT) is an excise tax that falls within this provision. In the <u>Appeal of Colgate-Palmolive</u>, Cal. St. Bd. of Equal., Nov 12, 2002 (unpublished) the Franchise Tax Board agreed to this treatment, but the Board of Equalization refused to allow the adjustment requested by the taxpayer in full for a failure to present evidence in support of their assertion as to the relative percentage of the VAT that would have been collected.

(3) In the case of cost plus fixed fee contracts, "sales" includes the entire reimbursed cost, plus the fee. (Regulation 25134, subd. (a)(1)(B).) For example,

In some circumstances, a contractor may purchase goods as a customer's agent or the customer may issue its own purchase order for materials which are used by the contractor. In those cases, the contractor does not spend its money which is subsequently reimbursed. Rather, the principal is spending its money directly. In <u>Appeals of Bechtel Power Corp., et al.</u>, Cal. St. Bd. of Equal., March 19, 1997, it was held that such "client furnished materials" should be included in the sales factor of a contractor which was operating under a cost plus fixed fee contractor because they involved the same income producing activity as was involved when the contractor purchased the materials and was reimbursed by the client. The Board of Equalization emphasized that this case does not involve the computation of appellants' total income to be taxed, but rather the composition of the formula which determines how that income will be apportioned to California. This distinction is critical because we must determine which computation of the sales factor leads to a better measure of economic activity in California. Mechanical, precise application of black-letter law is quite important in determining the amount of income to be taxed.

(4) In the case of a taxpayer engaged in providing services, "sales" includes gross receipts from the performance of services, including fees, commissions, and similar items. (Regulation 25134, subd (a)(1)(C).)

(5) In the case of a taxpayer engaged in renting real or tangible property, "sales" includes the gross receipts from the rental, lease or licensing. (Regulation 25134, subd. (a)(1)(D).)

(6) If a taxpayer derives receipts from the sale of equipment used in its business, such receipts are "sales." (Regulation 25134, subd. (a)(1)(F).)

(7) In some cases, certain gross receipts must be disregarded in determining the sales factor, pursuant to the special rules in Regulation 25137, subd. (c). (Regulation 25134, subd. (a)(2).)

Regulation 25137(c) provides two special rules regarding the calculation of gross receipts. Specifically:

(A) Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset or other property held or used in the regular course of the taxpayer's trade or business, such gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded. (Regulation 25137, subd. (c)(1)(A).)

(2) Insubstantial amounts of gross receipts arising from incidental or occasional transactions or activities may be excluded from the sales factor unless such exclusion would materially affect the amount of income apportioned to California. For example, the taxpayer ordinarily may include or exclude from the sales factor gross receipts from such transactions as the sale of office furniture, business automobiles, etc. (Regulation 25137, subd. (c)(1)(B).)

For purposes of subsection (A), a "sale is substantial if its exclusion results in a five percent or greater decrease in the sales factor denominator of the taxpayer, or if the taxpayer is part of a combined reporting group, a five percent or greater decrease in the sales factor denominator of the group as a whole." (Regulation 25137, subd. (c)(1)(A)1.)

Also for purposes of subsection (A), "a sale is occasional if the transaction is outside of the taxpayer's normal course of business and occurs infrequently." (Regulation 25137, subd. (c)(1)(A)2.)

For years prior to beginning before January 1, 2001, the substantial sales exception applied only to the incidental occasional sale of fixed assets. A taxpayer may be able to request the benefit of this regulation with respect to other than fixed assets for years beginning prior to January 1, 2001, or, in some circumstances, the Franchise Tax Board may attempt to apply the regulation, but in those circumstances it will be necessary to seek relief or require different treatment under Section 25137 on an individual case basis. Cases involving application of this regulation include

I.Appeal of Merrill, Lynch, Pierce, Fenner & Smith,Inc.

In <u>Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.</u>, Cal. St. Bd. of Equal., June 2, 1989, one of the issues was whether FTB had properly exercised its authority under Section 25137 to require the taxpayer to use gross profits, rather than gross receipts, to reflect its principal and brokerage sales. The taxpayer conducted a worldwide unitary financial services business. In some of its securities transactions, it acted as a broker, buying and selling securities in the open market for customers. It earned commission income, but did not include the cost of the underlying securities from this activity. The taxpayer also traded in securities as a principal or underwriter. In these situations, it purchased the securities for its own account and attempted to remarket them. The taxpayer used its gross receipts, which included the underlying cost of the security, from all of these principal transactions in computing its sales factor. FTB determined this treatment resulted in overweighting the taxpayer's sales as principal and underweighting brokerage sales. Accordingly, FTB adjusted the sales factor under section 25137 by using gross profits to reflect the principal and underwriting transactions, rather than gross receipts.

The SBE ruled for the taxpayer and noted that the sales factor requires the use of gross "receipts" unless gross profits can be substituted under section 25137. The SBE added that it is the fairness of the reflection of business activity by the formula "as a whole" which is determinative for purposes of section 25137, regardless of whether the adjustment sought is separate accounting, adjustment of a single factor, or any other of the acceptable alternatives under that section. Whether distortion must be shown in all or just one of the factors will depend upon the ultimate distortive effect that occurs when all three factors are considered in combination. The

SBE rejected FTB's argument that the taxpayer's sales factor was distortive in comparison to FTB's alternative calculations of the sales factor, and concluded FTB had not met its burden of proving the statutory apportionment provisions did not fairly represent the extent of the taxpayer's activities in California.

II. Appeal of Fluor Corporation

In the <u>Appeal of Fluor Corporation</u>, Cal. St. Bd. of Equal., Dec. 12, 1995, the State Board of Equalization found that the regulations adopted by the Franchise Tax Board provided for the exclusion of receipts generated from the occasional sale of an asset and that the regulations should be viewed as controlling.

In 2008 the Franchise Tax Board adopted regulation section 25137(c)(1)(D), effective for income years beginning on or after January 1, 2007, which provides that the receipts factor shall exclude all receipts from the numerator and denominator of the factor that arising in connection with a treasury function. A treasury function is defined in subdivision 1. of this regulation to cover the cash management function of corporation and excludes entities such as broker-dealers and financial organizations.

ii Cases

I. Return of Principal

Businesses that have liquid assets normally make short-term investments of those assets in financial instruments to generate a return on those assets. In the 1970's, American Telephone and Telegraph maintained actions in a number of states, arguing that the trading of such instruments or holding them to maturity gave rise to a receipt that should be included in the sales factor. This effort was defeated by tax administrators on the basis that the inclusion of such items in the sales factor would not result in a fair reflection of the taxpayer's activities. See, for example, Ch. 8, 5.ii, *infra*.

A. <u>Merrill, Lynch</u>

In 1989 the California Board of Equalization in <u>Appeal of Merrill, Lynch, Pierce, Fenner</u> <u>& Smith, Inc.</u>, supra, held that a stockbroker could include such items in its sales factor. As a result, a number of taxpayers have advanced claims that they should be entitled to include such items in their receipts factor. In opposition to such claims, the Franchise Tax Board engaged in a further analysis of the circumstances of these transactions and determined that in many of these cases, the transactions involved government securities that were held to maturity or were securitized instruments commonly referred to as "repos," where a financial intermediary bundled together a number of such securities with the proceeds being dispersed on maturation of the securities. The Franchise Tax Board has analogized these transactions to those engaged in by banks and other financials that make loans. In those circumstances, the repayment of the loans represents a return of principal and is not included in the sales factor. The cases presented to the Board of Equalization in have been analyzed by that Board under the unfair reflection of business activities approach, and the return of principal argument has not been addressed. In an unpublished decision in <u>Appeal of Montgomery Ward</u>, Cal. St. Bd. of Equal., Oct. 3, 2002, the Board of Equalization accepted the Franchise Tax Board's argument regarding whether these transactions gave rise to a receipt for sales factor purposes. This acceptance, however, was done by reference to the Board of Equalization's decision in <u>Appeal of Pacific Telephone and Telegraph Co.</u>, supra, a case decided under an unfair reflection of activities analysis.

B. <u>Microsoft</u>

In <u>Microsoft Corporation v. Franchise Tax Board</u> (2006) 39 Cal.4th 750, the California Supreme Court held that the term gross receipts "includes the entire redemption price of marketable securities." *Id.* at 759. The Court did find that the term gross receipts could be ambiguous but found that the treatment of sales prior to maturity, which the Franchise Tax Board had agreed should be included as a receipt, support a conclusion that redeeming a security should also be treated as a receipt for factor purposes.

In *Microsoft* the California Supreme Court did not consider the nature of the various securities, treating all of them as "marketable securities." The securities included "commercial paper, corporate bonds, United States Treasury bills and notes, discount notes, United States money market preferred securities, floating rate notes, loan participations, municipal bonds and loan repurchase agreements." *Id* at 757, fn 6. The Franchise Tax Board lost the definitional argument in this case but was successful on the question of whether including such receipts in the apportionment formula resulted in an unfair reflection of activities in the state, see *infra*. at pp 136.

C. <u>General Motors</u>

In <u>General Motors Corporation v. Franchise Tax Board</u> (2006) 39 Cal.4th 773, a companion case to *Microsoft*, the California Supreme Court had occasion to consider the nature of two types of securities. It made the statement that "the repayment of a loan is never considered a receipt." *Id* at 784. In *General Motors* the principal security involved were repurchase agreements or "repos." In its argument the Franchise Tax Board has analogized repos to loans based upon a United States Supreme Court decision, <u>Nebraska Department of Revenue v. Lowenstein</u> (1994) 513 U.S. 123, and a California Supreme Court decision, <u>Bewley v. Franchise Tax Board</u> (1995) 9 Cal.4th 526. The Court adopted its analysis from *Bewley* and concluded that repos were loans, and therefore the return of principal should not be included in the sales factor.

The Court contrasted repos with debt instruments such as bonds and Treasury bills which it did not characterize as loans. The Court said that for purposes of bonds and Treasury bills the value of the commodity is independent of the price paid to the seller. What the holder receives is not money that it lent, but the value of the security held. It contrasted it with a secured loan where it said the amount received is dependent on the amount originally paid and is independent of the value of the particular value of the securities held a collateral, whose value may rise or fall during the term of the loan without effecting the amount received.

It should be noted that footnote 6 in *Microsoft* listed loan repurchase agreements as one of the securities involved. Though handed down the same day, it is apparent from the decisions that the California Supreme Court viewed *Microsoft* as preceding *General Motors* and that *General Motors* discussed an issue not addressed in *Microsoft*. Unfortunately, the two decisions leave many questions unanswered. The delineation between a "loan" and other transactions is less than clear. A repo is a loan and a Treasury Bill is not. What other securities or transactions may be called is unclear. In addition, the decisions do not deal with the question of how certificates of deposits and other similar instruments might be treated. Additionally clarification may have to await decisions in other cases or administrative action.

This issue has arisen in the courts of several states other than California. The leading litigant is Sherwin-Williams. See, e.g., *Sherwin-Williams Co. v. Department of Revenue* (1998) 14 Or. Tax 384. New variants on the issue are continuing to arise, including the treatment of foreign currency hedging and conversion transactions and transactions involving the temporary transfer of title for purposes of having certain activities performed with respect to product. This issue can arise, for example, when goods are transferred to an overseas (not part of the water's-edge combined report group or not a member of the federal consolidated return group) affiliate as part of the manufacturing process.

For additional discussion of the issues and cases raised by the *Microsoft* court's broad definition of sales see the material discussing section 25137.

II. Awards Arising from Lawsuits

There have been several instances where corporations have recovered substantial amounts as the result of lawsuits; for example, Polaroid recovered several billion dollars from Eastman Kodak from patent infringement in a South Carolina case, and Pennzoil recovered several billion dollars as the result of settling a lawsuit it brought against Texaco arising from the efforts to purchase Getty Oil in an Oregon case. Questions arise as to whether such recoveries should be included in the sales factor and, if they are included, how the recoveries should be allocated to the numerator of the sales factor. Each case may turn on its unique circumstances.

Taxpayers have typically argued that the recoveries represent something other than sales of tangible property, and therefore should be assigned pursuant to the rules applicable to those types of sales. Typically, taxpayers endeavor to characterize the sales as arising from personal services and seek to have the sales assigned to the state in which the lawsuit was maintained. States, on the other hand, view the proceeds as typically arising from the operation of the business as a whole so that the proceeds should be assigned ratably amongst the states. These results can easily be achieved by a "throw-out" approach where

the proceeds are left out of the sales factor, resulting in the sales effectively being assigned by all other activity.

The Pennzoil circumstance where the proceeds arose from the failure to acquire an asset, and therefore, presence in a particular state or states, illustrate one set of difficulties. The Polaroid circumstance where the award, in part, related to lost profits that would have been earned by the company where it is presently located, and partly to locations where it is not located, might have illustrated another variation on the problem. Polaroid also included an interest element that may have no particular identifiable situs.

The Board of Equalization granted a hearing on a petition for rehearing in Polaroid on this question. The matter was settled pursuant to Polaroid's bankruptcy proceeding before it could be briefed, let alone argued.

III. Hedging Transactions

General Mills engaged in hedging transactions with respect to its grain inventories and sought to include the full nominal consideration received upon the sale of an option contract regardless of whether the goods were delivered. The appellate court concluded that there was a sale because consideration was received even when the contract was satisfied by offset. *General Mills, Inc. v. Franchise Tax Board*, (2009) 172 Cal App 4th 1535.

The case was remanded to the trial court for a determination of whether including the receipts from hedging activities resulted in an unfair reflection of activity in California. The trial court has entered a decision holding that including receipts from hedging in the sales factor results in an unfair reflection and accepting the modification proposed by the Franchise Tax Board. The appellate court agreed with the trial court.

This would not be an issue for 2011 and subsequent years because of the statutory change in the definition of receipts for purposes of the sales factor.

IV. Multistate Tax Commission Model Regulation

The Multistate Tax Commission has adopted a model regulation to further explicate the meaning of the term "gross receipts." The primary emphasis of the definition is to exclude items which represent a return of capital such as the repayment of a loan and abnormal receipts such as income from the forgiveness of indebtedness, recoveries as the result of litigation, contributions to capital and pension reversions. California enacted a statute in 2009 based on the MTC regulation with several additions, see a. *supra*. The statute is effective for taxable years beginning on or January 1, 2011.

c. Rules for Sales of Tangible Personal Property

Section 25135 provides that sales of tangible personal property are in California if:

(1) The property is derived or shipped to a purchaser, other than the United States government, within California regardless of the f.o.b. point or other conditions of sale; or

(2) The property is shipped from an office, store, warehouse, factory, or other place of storage in California and either the purchaser is the United States government, or the taxpayer is not taxable in the state of the purchaser.

Regulation 25135 provides additional rules regarding sales of tangible personal property. The more significant rules are as follows:

(1) Property shall be deemed to be delivered or shipped to a purchaser within California if the recipient is in California, even though the property is ordered from outside California. (Regulation 25135, subd. (a).)

(2) Property is delivered or shipped to a purchaser in California if the shipment terminates in California, even though the property is subsequently transferred by the purchaser to another state. (Regulation 25135, subd. (a).)

(3) "Purchaser within this state" includes the ultimate recipient of the property if the taxpayer in California, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within California. (Regulation 25135, subd. (a).)

(4) When property being shipped by a seller from the state of origin to a consignee in another state is diverted while en route to a purchaser in California, the sales are in California. (Regulation 25135, subd. (a).)

(5) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to California if the property is shipped from an office, store, warehouse, factory or other place of storage in California. (Regulation 25135, subd. (a).)

(6) If a taxpayer whose salesman operates from an office located in California makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, then,

(a) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in such state;

(b) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in California. (Regulation 25135, subd. (a).)

(7) Gross receipts from sales of tangible personal property to the United States government are in California if the property is shipped from an office, store, warehouse, factory or other place of storage in California. For purposes of this regulatory rule, only sales for which the United States government makes direct payment to the seller pursuant to the terms of a contract constitute sales to the United States government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States government. (Regulation 25135, subd. (b).)

i. "Dock Sale" Decisions

I. <u>McDonnell Douglas</u>

In <u>McDonnell Douglas Corp. v. Franchise Tax Board</u> (1994) 26 Cal.App.4th 1789, the court of appeal, in interpreting Section 25135, held the phrase "within this state" modifies the word "purchasers," not the words "delivered or shipped." Thus, commercial aircraft delivered in California, but destined for ultimate purchasers outside California, were excluded from the (California) numerator of the taxpayer's sales factor.

II <u>Mazda Motors</u>

In <u>Appeal of Mazda Motors of America (Central), Inc.</u>, Cal. St. Bd. of Equal., Nov. 29, 1994, the SBE held the taxpayer must include in its sales factor denominator sales of certain vehicles to a Texas-based distributor. The taxpayer's business was the importation of Mazda vehicles and parts from Japan for sale in the United States to its regional distributors. The SBE found that vehicles transferred directly to Texas, via common carrier, after being offloaded from the ships in California, should be excluded from the numerator. However, receipts from sales of vehicles which were stored in California while accessories were being installed, repairs were being made, or other services were being performed by the taxpayer, and which the taxpayer subsequently shipped to the Texas distributor, must be included in the sales factor numerator.

ii. Burden of Proof

In <u>Appeal of Oryx Energy Co. & Sun Company, Inc. (R&M)</u>, Cal. St. Bd. of Equal., July 9, 2003 (unpublished), the Board of Equalization held that assertions of the taxpayer in an appeal were insufficient to establish that it was not taxable in the state, and therefore the Franchise Tax Board's assignment of sales to California customers to the numerator of the sales factor would be accepted. It was allowed for two of the years based on the sales of a prior year when the taxpayer submitted no information during audit or in response to subsequent requests.

iii. "Throwback" Issue

The "throwback rule" applies to sales of tangible personal property, and provides that if a taxpayer is not taxable in the state of the purchaser, the sale is attributed to California if the property is shipped from an office, store, warehouse, factory or other place of storage in California. (Regulation 25135, subd. (a)(6); section 25135, subd. (b).) The issue commonly arises when the taxpayer is not taxable in the state of the purchaser because of immunity under P.L. 86-272 (although this issue may arise less frequently in the future because of *Finnigan's* broad interpretation of "taxpayer").

The term "state" under UDITPA includes any foreign country. (Section 25120, subd. (f).) Accordingly, the throwback issue often arises in the context of sales of tangible personal property to foreign countries. In <u>Appeal of Dresser Industries, Inc.</u>, Cal. St. Bd. of Equal., June 29, 1982, Opinion on Denial of Petition for Rehearing, October 26, 1983, the SBE held
that P.L. 86-272 does not apply to foreign commerce. (See Chapter 3.) However, foreign country throwback issues may still be present, as illustrated by *Christie Electric*.

I. <u>Appeal of Christie Electric Corp.</u>

In <u>Appeal of Christie Electric Corp.</u>, Cal. St. Bd. of Equal., Aug. 18, 1987, the issue was whether FTB properly applied the throwback rule to the taxpayer's sales in foreign countries.

The SBE noted that under section 25120, the taxpayer was "taxable" in the foreign countries if those countries "had jurisdiction" to subject it to a net income tax regardless of whether, in fact, the foreign countries did or did not tax. The SBE noted that under *Dresser*, United States jurisdictional standards, rather than the actual standards of the foreign countries, should be used to determine taxability. The SBE stated that it is incumbent upon the taxpayer to provide sufficient evidence of its activities to establish taxable nexus in the foreign countries, and that (with one exception) the taxpayer's evidence fell short of establishing such nexus.

II. <u>Hoffman-LaRoche, Inc. v. FTB</u> (1980) 101 Cal.App.3d 691

Taxpayer challenged the constitutionality of the throwback provision contending that it resulted in the taxation of extra-territorial values. The court disagreed with the taxpayer's contentions. It found that income was generated from the whole of the taxpayer's operations, not just at the point where merchandise is delivered. The income from sales made in states where there is no nexus to tax are in part generated from other activities in other jurisdictions, and it is, therefore, appropriate to throw sales back to the state of next closest connection because it is the state most entitled to levy the tax.

d. Numerator Assignment of "Other" Sales Pursuant to Income Producing Activity

i. Statute

Under UDITPA, sales, other than sales of tangible property, are in a state if:

(a) The income-producing activity is performed in the state; or

(b) The income-producing activity is performed both in and outside the state, and a greater proportion of the income-producing activity is performed in the state than in any other state, based on costs of performance.

It should be noted that subsection (b) sets forth an all or nothing assignment rule, that is, the sales are all assigned to the one state that has the greatest portion of the income-producing activity. If one state has 2.1% of the income producing activity and all of the other states have 2% of the income producing activity, the sale is assigned to the state with 2.1% of the income-producing activity. The rule set forth in section 25136 is subject to criticism on this basis and also because the income-producing activity arguably duplicates the assignments made by the property and payroll factors.

Former Regulation 25136 provides additional rules for the inclusion in the sales factor of gross receipts from transactions other than sales of tangible personal property. The more significant rules are as follows:

(1) The term "income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profits. Such activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Also, the mere holding of intangible personal property is not, of itself, an income-producing activity. (Regulation 25136, subd. (b).)

(2) The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer. (Regulation 25136, subd. (c).)

(3) Gross receipts from the sale, lease, rental or licensing of real property are in California if the real property is located in California. (Regulation 25136, subd. (d)(2)(A).)

(4) Gross receipts from the sale, lease, rental or licensing of tangible personal property are in California if the property is in California. The rental, lease, licensing or other use of tangible personal property in California is a separate income-producing activity from the rental, lease, licensing or other use of the same property while located in another state. Consequently, if property is within and without California during the rental, lease or licensing period, gross receipts attributable to California are measured by the ratio which the time the property was physically present or was used in California bears to the total time or use of the property everywhere during such period. (Regulation 25136, subd. (d)(2)(B).)

(5) Gross receipts for the performance of personal services are attributable to California to the extent such services are performed in California. If services relating to a single item of income are performed partly within and partly without California, the gross receipts for the performance of such services is attributable to California only if a greater portion of the services were performed in California, based on costs of performance. Usually where services are performed partly within and partly without California the services performed in each state will constitute a separate income producing activity; in such case the gross receipts for the performing such services in California bears to the total time spent in performing such services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal services not directly connected with the performance of the contract or other

obligation, as for example, time expended in negotiating the contract, are excluded from the computations. (Regulation 25137, subd. (d)(2)(C).)

ii. Regulation

In addition, Regulation 25137 provides special rules for the sales factor where there is business income from intangible property. Specifically:

(1) Where the income-producing activity in respect to business income from intangible personal property can be readily identified, such income is included in the denominator of the sales factor and, if the income-producing activity occurs in California, in the numerator of the sales factor as well. For example, usually the income-producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property and income from the sale, licensing or other use of intangible personal property. (Regulation 25137, subd. (c)(1)(C).)

(2) Where business income from intangible property cannot readily be attributed to any particular income-producing activity of the taxpayer, such income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where business income in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, such dividends and interest shall be excluded from the denominator of the sales factor. (Regulation 25137, subd. (c)(1)(C).)

iii. Income Producing Activities

There are a number of issues raised by attempting to determine the income producing activities that are to be used in determining the assignment of sales to a particular state. The reference to direct costs joined with the language of the regulation directing that each item of income be examined strongly suggests that an argument can be made that only marginal costs need be considered and that fixed costs should be disregarded.

These issues have been brought into focus by two cases involving AT&T, one in Massachusetts (AT&T Corp. v. Commissioner of Revenue, Massachusetts Appellate Tax Board No, C293831 (2011). An appeal has been filed.) and the other in Oregon (AT&T Corp. v. Department of Revenue, Oregon Tax Court TC 4814 (2012)), with different results reached in the two cases based upon a different analysis applied to similar terms in the regulations adopted by the two states. A comparison of the analysis and conclusions reached in the two cases illustrates the complexities involved. It is possible that the different outcomes may have been the result of the extent and quality of the expert testimony offered by the state in support of its position.

(A) Object of cost of performance

The taxpayer and the states disagreed as to what activity or object should be the subject of the cost of performance analysis. The states, Massachusetts and Oregon, argue that the activity is each individual telephone call. AT&T argues that the activity was the operation of the long distance system.

In the Oregon case the state was successful in having the court treat each call as a separate transaction. The Oregon court, while acknowledging some merit in the taxpayer's reading, focused on the language in the regulation which required determination of the receipts arising from a transaction. The Oregon court rejected the taxpayer's contention that the focus should be on entire groups or classes of transactions.

In Massachusetts the court acknowledged that the Massachusetts's regulation offered a choice between a transaction, and a procedure or operation but that the choice was dictated by an analysis of the facts. The court found that the income producing activity was not the connection of an individual transmission over a specifically designated wire but the providing of a complete comprehensive long-distance system.

Given the language of the regulations and the billing practices of the taxpayer it appears that the transaction interpretation is the better approach.

(B) Direct Costs

Once a decision has been made as to the object of the cost of performance it is necessary to determine what costs are "direct costs." Again the states and the taxpayer did not agree as what constituted direct costs. The states argued that direct costs are only those that are incurred because of the call. The taxpayer argued that direct costs include all costs that must be incurred to engage in the activity of providing long distance service.

The states' regulations give an example of billing and accounting costs that are not direct costs. AT&T argued that the example was the sole exclusion while the states argued that it was only a non-inclusive example.

The Oregon court accepted the state's interpretation because to accept the taxpayer's interpretation would make direct costs virtually synonymous with all costs and because the state's interpretation was more closely aligned with each call being a transaction as the object of the cost of performance. The Oregon court characterized the state's position as a "but for" approach. The costs would not have been incurred unless a call was made. The cost of having the system available to make a call is not a "but for" cost.

The Massachusetts court, however, accepted the taxpayer's interpretation of direct costs because it was consistent with its view that object of the cost of performance was the operation of the system and it was consistent with the cost accounting method used by the taxpayer for internal management purposes.

Which approach is best turns in part on the determination of the object of the cost of performance. On balance, however, the "but for" approach appears to be the better approach and more consistent with the isolation of activities to a state which should inform the answer to the question of sales factor assignment.

(C) Generally Accepted Accounting Principles

The regulations described direct costs as being determined under "generally accepted accounting principles and accepted conditions or practices in the trade or business of the taxpayer."

Not surprisingly the Oregon court treated the statement in the regulation as merely illustrative of one standard but not the only standard. It dismissed the taxpayer's method, Activity Based Accounting, as one used for internal management purposes and the setting of prices, but not as being externally focused or a method of financial accounting.

The Massachusetts court accepted the internal accounting system as being the industry norm and as the accepted conditions or practice in the trade or business of the taxpayer.

(D) Independent Contractor Costs

A potential significant issue in determining direct costs in this case were "access fees" paid to the local telecommunication companies for connecting the local user to the long distance network provided by the taxpayer. The regulation that existed for the years in issue excluded from direct costs amounts paid to independent contractors.

The states argued that the access fees were direct costs of providing services to the taxpayer not services on behalf of the taxpayer. The difference being that services provided on behalf of the taxpayer would be the actual costs of the third party provider while if the services were provided to the taxpayer they would be the amount charged and would not just be a transfer of the provider's costs to the taxpayer.

Not surprisingly the two courts reached opposite conclusions with respect to this issue with Oregon holding that the access fees were direct costs and were not performed on behalf of the taxpayer and the Massachusetts court concluding that were performed on behalf of the taxpayer and even if they were not they would result in making the greater cost of performance being in Massachusetts because the Massachusetts court was taking into account system wide costs.

iv. Cases

I.

Appeal of the Babcock and Wilcox Co.

In <u>Appeal of the Babcock and Wilcox Co.</u>, Cal. St. Bd. of Equal., Jan. 11, 1978, the issue was whether the sale of large steam generating systems, assembled in California by the taxpayer from subunits fabricated by it outside of California, should be included in the numerator of the taxpayer's sales factor. FTB argued the sales were of tangible personal property assignable to California under section 25135. The taxpayer contended they were sales of "other" than tangible personal property under section 25136, and none were

assignable to California because a greater proportion of the costs resulted from activities performed outside California.

The SBE ruled the sales were assignable to California under section 25135, and stated that a resolution of the issue begins with the "classification" of the property in issue. It noted the California Civil Code divides property into real property, which consists of land and that which is affixed or appurtenant thereto, and personal property, which consists of all property which is not real property. Personal property may be either tangible or intangible. Thus, "it would appear from the statutes that the property in question must be either tangible personal property or fixtures and, therefore, realty, since we do not understand that appellant is arguing that a structure as large as a city block is intangible personal property." The SBE then concluded the sales were of tangible personal property.

II. <u>Appeal of Mark IV Metal Products, Inc.</u>

In <u>Appeal of Mark IV Metal Products, Inc.</u>, Cal. St. Bd. of Equal., August 17, 1982, the issue was whether the taxpayer's sales to a Texas company were assignable to California. The taxpayer was a California manufacturing corporation that made tables and chairs from metal. A principal customer was a Texas company, which shipped unfinished steel to the taxpayer that fabricated the metal into seat parts at its facilities in California. The finished parts were then shipped by common carrier back to the Texas company, which incorporated them into metal seats for sale to its own customers. The taxpayer never held title to the metal or the metal products.

The SBE concluded the sales were sales of services, not sales of tangible personal property. Under section 25136, sales of services are assigned to California for purposes of the property factor if the income-producing activity was performed in California. Since that activity took place in California, the SBE concluded the sales were includable in the numerator of the sales factor.

III. <u>Appeal of Pacificorp.</u>

In <u>Appeal of Pacificorp</u>, Cal. St. Bd. of Equal., Dec 19, 2002, the Board of Equalization ruled that the sale of electricity was a sale of other than tangible property. Pacificorp is headquartered in Oregon and generates power throughout the Pacific Northwest. It sells power to PG&E, Southern California Edison, San Diego Gas and Electric and a number of municipal utilities in California. The Franchise Tax Board took the position that electricity is tangible property and that the sales to California customers should be treated as California sales. The Board of Equalization concluded that the sales of electricity are "other than sales of tangible personal property" and, therefore, should be assigned pursuant to section 25136. The Board of Equalization found that electricity is an intangible and that selling it constituted a sale of a service. As such, the sale was assigned based upon costs of performance, the predominant amount of which was outside of California.

e. Market-Based Sourcing.

i. California

I. Statute

Section 25136 was amended for income years beginning on or after January 1, 2011 to reflect a market orientation and to abandon the all-or-nothing assignment. The amended statute provides:

- 1) Sales from services are in this state to the extent the purchaser of the service received the benefit of the service in this state
- 2) Sales from intangible property are in this state to the extent the property is used in this state, in the case of marketable securities, sales are in this state if the customer is in this state.
- 3) Sales from the sale, lease, rental, of licensing of real property are in this state if the real property is located in this state.
- 4) Sales from the rental, lease, or licensing of tangible property are in this state if the property is located in this state.

II. Regulations

The Franchise Tax Board has adopted a regulation to implement the statutory change. Reg. 25136-2 CCR title 18.

A) Services

Services are assigned to where the taxpayer's customer has either directly or indirectly received the benefit of the service. Different rules are provided for the assignment of sales from services depending upon whether the customer is an individual or a corporation or other business entity.

In the case of an individual the first choice for assignment is the billing address of the individual. This assignment will be accepted by the Franchise Tax Board unless the taxpayer chooses to rebut it. To rebut the assignment to the billing address the taxpayer must submit the contract or its records showing where the other assignment should be. The Franchise Tax Board is authorized to audit this alternative assignment. If for some reason this information does not allow for assignment then the location where the benefit of the services are received may be approximated.

In the case of sale to a corporation of other business entity the place of assignment shall be determined from the contract or the business records of the taxpayer. This assignment can be overcome by either the Franchise Tax Board or the taxpayer and the assignment will be made on that basis. If an assignment cannot be made based upon that evidence that it may be approximated. If the place of assignment cannot be reasonable approximated then it will be assigned to the location of the office of the customer that placed the order and failing that to the billing address of the customer.

Approximation are to be made in a manner consistent with the activities of the taxpayer's customer and are limited to the jurisdictions or geographic areas where the customer or purchaser is active at the time of the purchase. If population is used as a means of approximation it is limited to the United States unless the taxpayer can show that the benefit is being substantially being used outside of the United States.

B) Income from intangibles

There are different rules for different types of receipts.

In the case of an actual sale, as opposed to a license, the receipts shall be assigned based upon the contract or the taxpayer's books and records showing where the purchaser will use the intangible. If a determination cannot be made from the contract or the books and records then the use to be made by the purchaser will be approximated based upon where the purchaser does business. If an approximation cannot be made then it will be assigned to the billing address of the purchaser. An exception is made for sales where the price is contingent on future use in which case it is treated lack a license.

Specific rules are provided for the sale of stock or a pass-through entity. If 50 percent or more of the value of the intangible is attributable to real or tangible property the average of the property and payroll factors of the entity is used. If more than 50% of the value relates to intangibles then assignment will be made by the sales factor.

In the case of licensing the sales are broken down between marketing intangibles and other intangibles. In the case of marketing intangibles the assignment is to be made based upon where the goods to which the license applies are sold. This determination is to be made based upon the contract or the taxpayer's books and records then they shall be reasonably approximated. If the license relates to a customer who is a wholesaler assignment may be made based upon state population where the licensee does business.

In the case of non-marketing intangibles the sales shall be assigned to where the licensee uses the intangible as determined under the contract of the taxpayer's books and records. If the place of use cannot be determined that it may be approximated and if this is not possible then it will be assigned to the billing address of the licensee.

If a intangible involves both marketing and non-marketing elements it will be treated as a marketing intangible unless it is possible to determine a breakdown between the two types of licensing.

C) Fees from real and tangible property

The rules in the prior regime continue. Assignment is based upon location and use.

ii. Multistate Tax Commission Rules for Sales of Other Than Tangible Property.

The changes made by the Commission adopted a market-state approach and assign sales on the basis of where they are delivered. This is different from California where assigns on where the benefit is received. As part of the Commission's approach they have added a throwout rule if the place of delivery would be a jurisdiction where the taxpayer is not taxable.

The Multistate Tax Commission assignment of sales, or receipts, is also strongly influenced by its more limited definition of receipts or sales that are included in the factor. As a consequence almost all complete sales of intangibles are excluded from the factor.

f. Other Sales Factor Issues

i. Intercompany Sales

Intercompany sales, sales within the combined report group, are disregarded. Regulation 25106.5-1(a)(5)(A). This issue was ruled on in <u>Chase Brass & Copper Co. v. Franchise Tax</u> <u>Board</u> (1977) 70 Cal.App.3d 457, at 473, where the court held:

The Board [Franchise Tax Board)] excluded sales from one member of the unitary group to another, as no net income is realized as a result of the internal sales. Thus, the sales factor only included sales to outside purchasers. Chase argues that the sales factor as so computed erroneously distorts Kennecott's sales outside of California. The contentions ignore the fact that while *gross sales* are used to compute the sales factors, only *net income* is subject to the franchise tax. Since no net income is produced by the internal sales, it was not required that they be included in the computation. We think the above described methods used by the Board were fairly calculated to assign to California only that portion of the net income reasonably attributable to the business done in this state and concluded that the Board properly computed the ... sales factors.

ii. Double Counting Sales

In <u>Union Pacific Corporation v. State Tax Commission</u> (2004 Idaho) 83 P.3d 116, the taxpayer attempted to include in the sales factor the amount received with respect to the sales of its account receivables to a third party. The trial court initially allowed these sales to be included even though the taxpayer had already included the sales from the transactions that gave rise to the receivables. The Tax Commission was ultimately successful in excluding the receipts arising from the sales of the accounts receivables under section 18 of UDITPA on the grounds that including the sales twice would not result in a fair reflection of the taxpayer's activities in Idaho.

This issue could also arise in the context of a taxpayer selling parts to a third party for assembly, buying the assembled product back, and then selling it to third party customers. The taxpayer could claim that it had two separate sales and that each should be reflected in the sales factor. Taxpayers are only likely to attempt this strategy when one of the sales would not be reflected in the numerator of the sales factor of the state to which they are reporting.

Another variant on the theme is taxpayers that create a financial subsidiary to which receivables are transferred. The subsidiary then securitizes the receivables and sells them as

a package to investors. Arguments have been made to the Franchise Tax Board that selling the securitized receivables constitutes a sale that should be reflected in the sales factor.

iii. Dividends from "unitary" investments

Taxpayers frequently may hold stock investments in other companies that contribute to the operation of the unitary business as a source of supply or as a market but in which they do not have a sufficient ownership interest to include the entities in a combined report. In addition, taxpayers that make a water's-edge election can receive dividends from subsidiaries with which they are in a unitary relationship but that have not been included in a combined report because of the election. Because the subsidiaries have not been included in the combined report, the dividends received from the subsidiaries will not be eliminated under the authority of section 25106 but will still constitute business income. The Franchise Tax Board has issued Legal Ruling 2003-03, holding that if the shareholder is actively engaged in the management and oversight of the dividends received from a subsidiary not included in a combined report pursuant to a water's-edge election will normally be included in the sales factor and be assigned to the numerator of the state where the headquarters of the shareholder is located.

The Franchise Tax Board has issued Legal Ruling 2006-01, which provides that factor elements related to income that is not included in the measure of tax either because the income is exempt, is deductible, or is eliminated should not be included in the apportionment factor. A frequently occurring example where the Legal Ruling would have application is the receipt of dividends that are partially or wholly deductible. Pursuant to Legal Ruling 2003-03 such dividends would be included in the sales factor. Application of Legal Ruling 2006-01 would exclude any amount allowed as a deduction. The Legal Ruling analogizes such income to the treatment of factors related to nonbusiness income that are excluded because they are included in business income.

iv. "On behalf of" sales

Regulation 25136(b) provides for the assignment of sales based upon the income producing transactions and activities entered into with respect to those sales.

The regulation further provided that the transactions and activities to be considered are those entered into directly by the taxpayer, and it specifically states that transactions or activities performed on behalf of the taxpayer by an independent contractor are to be considered. In 2007 the Multistate Tax Commission amended Regulation IV.17 to provide that the activities of independent contractors would be considered in determining a taxpayer's cost of performance. The Franchise Tax Board made this change in April of 2010 to conform its regulation to that adopted by the Multistate Tax Commission. The change was prospective and applies to taxable years beginning on of after January 1, 2010.

Prior to that the Franchise Tax Board has issued Legal Ruling 2006-02, which provides that activities carried on by other entities within the unitary business will normally be considered as being carried on by the taxpayer. The Legal Ruling relies upon principles of agency and the fact that within a combined report intercompany transactions are normally not reflected in the apportionment factors, do not produce income for the unitary business and are effectively eliminated because income for one member of the group is offset by and expense of the other member of the group. The Legal Ruling holds that transactions or activities performed on behalf of one member of a combined report group by another member of the group are to be considered in determining in which state the greater cost of performance was located for the purpose of assigning the receipt received from the third-party.

Under the Legal Ruling a transaction or activity performed by one a member of the unitary business that is not included in the combined report, e.g., a unitary entity excluded because of a water's-edge election, will not be considered in making the sales factor numerator assignment.

CHAPTER 8

OTHER APPORTIONMENT METHODS UNDER SECTION 25137

1. <u>SECTION 25137 IN GENERAL</u>

The drafters of UDITPA, and the California Legislature in enacting UDITPA into California law, recognized that the allocation and apportionment provisions of the standard three-factor formula would not be appropriate in all circumstances. Accordingly, Section 18 of UDITPA, enacted without change in California as Revenue and Taxation Code section 25137, provides for departures from the standard formula in specified circumstances. Section 25137 provides in full:

"If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the Franchise Tax Board may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) Separate accounting;
- (b) The exclusion of one or more additional factors;
- (c) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

One of the drafters of UDITPA explained the purpose of this provision as follows:

"Section 18 is a general section which permits the tax administrator to require, or the taxpayer to petition, for some other method of allocating and apportioning the income where unreasonable results ensue from the operation of the other provisions of the act. This section necessarily must be used when the statute reaches arbitrary or unreasonable results so that its application could be attacked successfully on constitutional grounds. Furthermore, it gives both the tax collection agency and the taxpayer some latitude for showing that for the particular business activity, some more equitable method of allocation and apportionment could be achieved. Of course, departures from the basic formula should be avoided except where reasonableness requires. Nonetheless, some alternative must be available to handle the constitutional problem as well as the unusual cases, because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics." (Pierce, "The Uniform Division of Income for State Tax Purposes," Taxes, Oct. 1957, 747, 781.)

A request for relief under section 25137 must overcome two hurdles in order to prevail: (1) that the standard allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in California, and (2) that the alternative method proposed is "reasonable." (Section 25137.)

a. The Burden of Proof for Invoking

It is generally accepted that the party seeking to invoke section 25137 has the burden of showing that it is necessary. The Board of Equalization has held that the party seeking relief bears the burden of proving that exceptional circumstances are present. (*Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., Feb. 3, 1977.) The California Supreme Court in *Microsoft Corporation v. Franchise Tax Board* (2006) 39 Cal.4th 750, stated "As the party invoking section 25137, the Board has the burden of proving . . . the approximation provided by the standard formula is not a fair representation" At 765.

b. The Standard of Proof

In *Microsoft* the California Supreme Court held that the standard was clear and convincing proof. *Id.* at 765. The Court found that the Board had met the "clear and convincing evidence" standard when it was shown that 1) the substantial activity involved was not related to the taxpayer's main line of business; 2) that the activity in question was qualitatively different from its main business; and 3) the quantitative distortion from inclusion of the activity is substantial. *Id* at 765.

Other states have not imposed a clear-and-convincing standard on their tax authorities. *Union Pacific Corporation v. Idaho State Tax Commission* (2004) 83 P.3d 116, 119-120; *Kmart Properties, Inc. v. Taxation and Revenue Department* (2001) 131 P.3d 27, 41; *R.H.Macy & Co. v. Lindley* (1986) 495 N.E.2d 948, 950; and *American Telephone and Telegraph Company v. Tennessee* (1994) 880 S.W.2d 682, 691-92. In addition, at least one state has phrased the burden or proof differently for the taxpayer and the tax administrator. For example, in Tennessee the courts have held that "a taxpayer seeking to deviate from the standard apportionment formula bears the burden by clear and cogent evidence." *Petersen Mfg. Co. v. State* (1989) 779 S.W.2d 784, 787, but that the question to be answered when the Commissioner invokes the relief provision is whether it "amounts to an abuse of discretion." *Sherwin-Williams Co. v. Johnson* (1998) 989 S.W.2d 710, 715. The justification for such a distinction lies in the fact that, generally, the taxpayer is in possession of the facts necessary to establish the need for a variance.

Application of section 25137 is not justified simply because a proponent contends that its method is "better" than the standard formula, for what must be shown is sufficient distortion that the taxpayer's business activity in California is not clearly reflected. (*Appeal of Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, Cal. St. Bd. of Equal., June 2, 1989.) Nor do mere allegations that the standard formula is not precise justify the use of Section 25137. (*Appeal of Kikkoman International, Inc.*, Cal. St. Bd. of Equal., June 29, 1982.) In sum, section 25137 relief is rarely granted petitioning taxpayers, and is rarely invoked by FTB (except as it relates to the promulgation of the special industry regulations discussed below).

i. Main Line of Business

The question of whether the activity relates to the taxpayer's main line of business should be distinguished from the question of whether the activity gives rise to business or nonbusiness income so that it is subject to apportionment. The income must be business income to be subject to apportionment. In the case of the treasury function it is clear that such income is business income but for most businesses it such activity is "ancillary " to the main line of business. In *Appeal of Pacific Telephone, supra*. the taxpayers' main line of business was operating a telephone system and the investment of working capital that arose from the business was not part of the main line of business. The same was true in *Microsoft*. In *Appeal of Merrill, Lynch, Fenner, Pierce and Smith* the taxpayers main line of business was selling securities so sales on its account as well as sales to, or on behalf of customers, were found to be in the same line of business.

In *General Mills*, the activity involved was hedging and testimony was offered that General Mills would not be able to continue in business because of the volatility of the price of grains if it was unable to hedge. Consequently it was argued that hedging was part of the main line of the taxpayer's business. This appears to be an argument addressed to whether the activity gave rise to business income rather than whether it is a sale. The Court of Appeal responded "General Mills's futures sales are qualitatively different from its sales of consumer food products, flour and grain for profit. Hedging futures sales serve a risk management function and are not sales for profit. They rarely result in actual delivery of and payment for goods. They serve an important and even a critical supportive function to General Mills's ultimate sales of profit because they protect against the risk of price fluctuations in basic commodities that are needed to produce the end products. However, they play *only* a supportive function and would be economically meaningless if separated from ultimate sales of grain, flour and consumer food products for profit."

ii. Qualitatively Different

The question of whether the activity represented by the factor is qualitatively different than other items represented in the factors appears to be the primary question. The treasury cases, *Pacific Telephone, Microsoft*, and *The Limited* are illustrative of an activity that is qualitatively different than the main line of business of the taxpayer. Arguably the facts presented in the Idaho *Union Pacific* case are another circumstance that demonstrates a qualitative difference.

The <u>Appeal of Merrill, Lynch, Fenner, Pierce and Smith</u> is a case where the Board of Equalization found that a stockbrokers trading on its own account was not qualitatively different than providing brokerage services to its customers on a commission basis in spite of the fact that there is a substantial difference in the level of the receipts involved. In both circumstances the taxpayer was trading securities.

The Franchise Tax Board also argues that the nature of the activity involved and its relationship to the purpose of the individual factor needs to be considered along with consideration of whether the activity is otherwise represented in the apportionment formula.

In *General Mills* the Court of Appeal held that hedging transactions that were supportive in nature were qualitatively different that the outright sales of grain or products made from grain.

iii. Quantitatively Different

The California Supreme Court in *Microsoft* stated that the treasury function was both qualitatively and quantitatively different than Microsoft's software business. In *The Limited* the Court of Appeal interpreted the California Supreme Court as creating two separate tests that needed to be met to show an unfair reflection. The California Board of Equalization suggested in the *Appeal of Crisa* that the qualitative differences are shown by various quantitative measures and that therefore there are not two separate tests.

In the *Appeal of Pacific Telephone* the Board of Equalization found quantitative differences in the number of employees involved in the activity, few compared to many (a million or more), the amount of income assigned by the apportionment formula to the activity, and the relative profit margins. In *Appeal of Pacific Telephone* the Board of Equalization noted that including the treasury receipts in the sales factor would mean they constituted roughly 34% of the total sales factor which would result in more than 11% of the income of the unitary business, the formula was an equally-weighted one, being assigned to the treasury function which was carried on New York.

In *Microsoft*, on the evidence presented, the Court found that the difference in margins between the treasury function and the software business of several magnitudes, .2 percent compared to 31 percent, was probative of a quantitative difference. Consistent with *Appeal of Pacific Telephone*, the Court considered not only the formula representation that would result in California, the state seeking to invoke the section, but also the distortion that would arise in all states including the home state. In *Microsoft*, the treasury function would have resulted in an even greater portion of the income of the business being assigned to the treasury function and the State of Washington.

In *The Limited*, the amount of income assigned to the treasury function was assumed by the court to be 9.25% which was the average of the two years involved.

In *General Mills* the Court of Appeal engaged in an extended discussion of quantitative differences.

Attribution of sales to a single state - "On average, including futures gross receipts in the sales factor denominator results in assigning close to 9% [8.722%] of [General Mills's] entire business activities to Minnesota. We agree with the trial court that this factor weighs in favor of a finding of substantial distortion.

Percentage of Income vs. Percentage of Gross Receipts - hedging activities produced at most 2 percent of the company's income (and in two of six years operated at a loss) while it generated between 8 and 30 percent of the company's gross receipts. <u>13</u> We agree this metric weighs heavily in favor of a finding of substantial distortion, especially because the minimal profit realized in General Mills's hedging activity is essentially serendipitous, as the ideal outcome of hedging is zero profit or loss.

Profit Margin - For tax years in which General Mills's futures trading showed a profit, the non futures profit margin exceeded the futures profit margin by 153 times in TYE 1993, 9 times in TYE 1994, 36 times in TYE 1995, and 126 times in TYE 1997. It could be argued that the ratio of 81 times is misleadingly high because the profit margin figures under comparison are relatively small. However, one could also argue the factor is misleading low because futures sales are as likely to result in losses or come out even as to generate a profit. Nevertheless, there is no question this factor weighs heavily in favor of a finding of substantial quantitative distortion.

Percentage Change in the Standard Apportionment Formula - inclusion of General Mills's hedging gross receipts changed the apportionment formulas from about 10.9 percent to 10.5 percent for TYE 1992, from 11.2 percent to 10.8 percent for TYE 1993, from 11 percent to 10.3 percent for TYE 1994, from 10.4 percent to 9.5 percent for TYE 1995, from 10.8 percent to 9.3 percent for TYE 1996, and from 10.2 percent to 8.9 percent for TYE 1997. The percentage reductions in the standard apportionment figure thus ranged from 3.6 percent (TYE 1993) to 13.9 percent (TYE 1996), or an average of 8.2 percent. Clearly, the ultimate impact on the standard formula here is less severe than in the treasury cases. However, the case law does not indicate that this quantitative metric, or any one metric, alone is dispositive.

In sum, while some of the quantitative distortions in this case may not be as great as those cited in the treasury cases, they are nevertheless substantial. In the area of profit margin, which the Supreme Court identified as critical in *Microsoft*, the distortion arguably is greater here. And the treasury sales were made for the purpose of profit. Hedging for General Mills is not intended to be a profit center at all, although it is intended to facilitate the business of the company. If all works perfectly in such transactions, the profit will be zero.

c. Determination of the Relief to be Granted

With respect to the second issue, the statute appears to contemplate that the tax commissioner will make the determination as to the nature of the relief to be granted because it gives the taxpayer the right to petition or the commissioner the right to require thereby vesting the determination of relief in the commissioner's hands. However, the

California Supreme Court's decision in *Microsoft* is not clear on this question. First, in talking about the burden of proof, the Court applied the clear and convincing standard to whether the proposed alternative was reasonable. *Id.* at 771. It then went on to hold that "If the Board's proposal is reasonable, we are not empowered to substitute our own formula. (See § 25137; *McDonnell Douglas Corp. v. Franchise Tax Board* (1968) 69 Cal.2d 506.)" *Id.* at 771. This statement appears to be inconsistent with having to meet a clear-and-convincing standard.

In *General Mills* the Court of Appeal endorsed the proposition that the determination of the Franchise Tax Board will be upheld if it is reasonable.

d. Manner of Raising Request for Application of section 25137

FTB Notice 2004-5 provides that for returns due on or after October 15, 2004 a taxpayer must request permission of the Franchise Tax Board to file a return based upon section 25137 or it may be subject to the accuracy-related penalty of section 19164. Exceptions to the requirement of prior permission exist if 1) the filing treatment is one provided for in an Franchise Tax Board Audit Manual operative for the filing year and the taxpayer's facts are the same; 2) is a variant permitted in a published State Board of Equalization opinion; 3) has been approved for a prior year and the approval is applicable to the filing year; or 4) the taxpayer and the Franchise Tax Board have entered into a Closing Agreement which is applicable to the year approving the method.

A taxpayer may also request a variation under section 25137 in a protest or claim for refund. Because section 25137 states that the request must be made to the Franchise Tax Board an attempt to make such a request in an appeal to the State Board of Equalization or in a suit for refund will likely be challenged on the basis that the taxpayer has failed to exhaust administrative remedies.

2. <u>THE REGULATIONS</u>

FTB has promulgated a series of regulatory provisions under section 25137 that fall into three categories. First, regulation 25137 provides general rules regarding how and when the relief provisions may be used. Second, regulation 25137 provides special rules for the property and sales factors (discussed in Chapter 7). Third, regulations 25137-1 through 25137-14 provide special allocation and apportionment rules for designated special industries and circumstances.

a. General Rules

i. Regulations

Regulation 25137 sets forth general rules for invoking section 25137. Specifically, the regulation provides in part:

(1) Section 25137 permits a departure from the standard allocation and apportionment provisions "only in limited and specific cases." (Regulation 25137, subd. (a).)

(2) Section 25137 may be invoked "only in specific cases where unusual fact situations (which ordinarily will be unique and nonrecurring) produce incongruous results" under the standard apportionment and allocation provisions. (Regulation 25137, subd. (a).)

(3) In cases deemed appropriate by the FTB, it may elect to hear and decide petitions filed pursuant to section 25137 instead of having this function performed by staff. As a condition to having such a petition considered by FTB, the petitioning taxpayer must waive in writing the confidentiality provisions of section 26451 ["Returns confidential"] with respect to the petition and to any other facts that may be deemed relevant in making a determination. Consideration of the petition by the FTB shall be in open session at a regularly scheduled meeting. (Section 25137, subd. (d).)

ii. Interpretation of subdivision (a)(2)

Taxpayers have frequently pointed to the language of subsection (2) that relief should only be granted if the situation presents "unique and non-reoccurring situations" to defeat variances proposed by the Franchise Tax Board. For example, most corporations engage in Treasury activities, the short-term investment of idle cash. This activity is therefore neither unique not non-reoccurring. The Court in *Microsoft* rejected this argument. "Systematic oversights and undersights are equally a matter of legislative concern." *Id.* at 770. The Court went on to note that failure to address this particular issue could give rise to a significant loophole that could be exploited by subtle changes in investment strategy." *Id.* at 751. Furthermore, the regulation should not be read as limiting the statute because the phrase "unique and nonrecurring" is modified by the word "ordinarily." Ordinarily means there are other circumstances, which are not unique and nonrecurring that can give rise to a need for modification of the standard formula.

In 2010 the MTC modified its regulations to eliminate the phrase "unique and non-reoccurring situations." California has not yet conformed to this change but given the holding of the California Supreme Court in *Microsoft* this failure to conform probably has no significance.

iii. Evidence of Unfair Assignment

One of the issues that frequently arises in petitions under section 25137 is what evidence can be used to establish that the standard result is unfair. Reference is made to case law for the proposition that separate accounting cannot be used to impeach formulary results. E.g. *Butler Brothers* v. *McColgan* (1941) 17 Cal.2d 664, 678, 111 P.2d 334, 341, aff'd, 315 U.S. 501 (1942), *Container Corporation of America* v. *Franchise Tax Board* (1983) 463 U.S. 159.

The decision in *Microsoft* does not directly answer this question. It did, however, discuss evidence which it found to be clear and convincing in the circumstances presented. First, an activity not central to the taxpayer's main line of business that nonetheless would constitute a substantial activity in the apportionment formula. *Id.* at 765-766. Second, an application

that would give rise to uniformity. *Id.* at 766. Third, the comparative profit margins. *Id.* at 756. (It should be noted that the comparison made in *Microsoft* was between gross income and net income. It can be argued that a more appropriate comparison would be gross-to-gross or net-to-net.) Third, the Court also chose to determine the unfairness of the result by isolating the effect of the single formula involved. Fourth, the Court considered not only the effect of the assignment in California, but in all states, including the principal state.

b. Special Industry Rules

Regulation 25137 also provides that in the case of certain industries such as air transportation, rail transportation, ship transportation, trucking, television, radio, motion pictures, various types of professional athletics, and so forth, the standard allocation and apportionment regulations do not set forth appropriate procedures for determining the apportionment factors. The regulation then provides: "Nothing in Section 25137 or in this Regulation shall preclude the Franchise Tax Board from establishing appropriate procedures under Sections 25129 to 25136 inclusive, for determining the apportionment factors for each such industry, but such procedures shall be applied uniformly." (Regulation 25137, subd. (a)(4).)

FTB has established the following special formulas through the regulation process, many of which are similar to or identical to MTC regulations:

Regulation 25137-1: Allocation and Apportionment of Partnership Income

Regulation 25137.2: Construction Contractors, Apportionment of Income, Long-Term Contracts

Regulation 25137-3: Franchisors—Allocation and Apportionment of Income

Regulation 25137-4.2: Banks and Financial Corporations - Allocation and Apportionment of Income (Note the Multistate Tax Commission is currently considering revisions to its model regulation. The California regulation is based on the Multistate Tax Commission's model regulation.)

Regulation 25137-5: Commercial Fishing - Allocation and Apportionment of Income

Regulation 25137-7: Air Transportation Companies - Allocation and Apportionment of Income (Amendments to the regulation to clarify certain terms were adopted in 2010.)

Regulation 25137-8: Motion Picture and Television Film Producers and Television Networks - Apportionment of Income

Regulation 25137-9: Railroads - Allocation and Apportionment of Income

Regulation 25137-10: Combination of General (Non-Financial) and Financial Corporations

Regulation 25137-11: Allocation and Apportionment of Income of Trucking Companies (The Franchise Tax Board is currently holding interested party meetings to considered possible amendments.)

Regulation 25137-12: Print Media (The Franchise Tax Board is currently holding interested party meetings to considered possible amendments.)

Regulation 25137-14: Mutual Funds

c. Effect of Regulations

In the <u>Appeal of Fluor Corporation</u>, Cal. St. Bd. of Equal., Dec. 12, 1995, the State Board of Equalization held that regulations adopted by the Franchise Tax Board pursuant to section 25137, in effect, become the standard rules of allocation and apportionment and that a party seeking to vary from the rules has the burden of establishing that the rules provided by the regulations do not fairly reflect its activities within the state in the circumstances of that case.

3. <u>APPLICATION OF SECTION 25137</u>

As noted above, the staff of the Franchise Tax Board takes the position that invocation of Section 25137 is a two-step process. The first step is to establish that the standard formula does not fairly reflect the extent of the business activity in the state. Under the statute, the question is whether the business activity is fairly reflected. The question is not whether the income is fairly reflected. Therefore a request for relief or variation based upon the amount of income that is assigned to a particular jurisdiction does not address the standard applied by the statute.

The second step, once the first step has been met, is to determine the nature of the relief to be given. It is the staff's position that it is the Franchise Tax Board that is given this power by the statute. Under California law prior to the adoption of UDITPA, the Franchise Tax Board was given the authority to determine what factors should be used in the apportionment process. "Discretion as to the factors to be used was placed in the commissioner and his successor, the Franchise Tax Board." <u>Chase Brass & Copper Co. v.</u> Franchise Tax Board (1977) 70 Cal.App.3d 457, at 468, citing <u>Montgomery Ward & Co. v.</u> Franchise Tax Board 6 Cal.App.3d 149, at 155. <u>RKO Teleradio Pictures, Inc. v. Franchise Tax Board</u> 246 Cal.App.2d 812. Under these authorities, a taxpayer can only challenge the relief granted on the basis that it is unreasonable. The staff's position has not been ruled upon by the State Board of Equalization. The California Supreme Court appears to have given conflicting statements in *Microsoft, supra, w*here it first held that what was reasonable was subject to clear and convincing evidence (at 765) but later stated, "If the Board's proposal is reasonable, we are not empowered to substitute our own formula" (at 771).

4. HEARINGS ON SECTION 25137 PETITIONS

The Franchise Tax Board has adopted a resolution that on all 25137 petitions, where the staff is not prepared to recommend that a taxpayer's petition be allowed, or where the taxpayer does not agree with the staff's determination that a variance is required, the taxpayer shall be given a hearing before the three-member Board. Hearings are still subject to the requirement of the waiver of confidentiality as the regulations still provide that they will only be heard in open session.

5. <u>SIGNIFICANT DECISIONS</u>

a. Court decisions

i. <u>Microsoft Corporation v. Franchise Tax Board</u>

The decision by the California Supreme Court in *Microsoft Corporation v. Franchise Tax Board* (2006) 39 Cal.4th 750 is the most significant decision by virtue of the fact that it is a decision by the highest court in the state. As discussed above, it addresses a number of significant issues including:

- A) Who has the Burden of proof for invoking the section;
- B) The nature of that burden;
- C) Once the original burden has been met, who determines the relief;
- D) Whether there is a requirement that the circumstances be unique and nonrecurring;
- E) Various types of evidence that can be offered to meet the burden; and
- F) The promotion of uniformity.

The Court's answers to these issues were discussed in the preceding sections.

ii. <u>The Limited Stores v. Franchise Tax Board</u>

In *The Limited v. Franchise Tax Board,* (2007) 152 Cal App 4th 1491 on remand back to the Court of Appeal it was determined that a 9.25% difference in the apportionment factor was sufficient to allow the Franchise Tax Board to invoke section 25137 and exclude the receipts. The taxpayer argued to the Court of Appeal that because of the nature of its business, retail sales, the investment of working capital was an integral part of its business as distinguished from the facts in *Microsoft*. The Court of Appeal accepted the taxpayer's argument but found that that fact did not change the analysis.

iii. <u>General Motors Corporation v. Franchise Tax Board</u>, and <u>Toys "R" Us v. Franchise Tax Board</u>

Both of these cases involved treasury activity similar to that involved in *Microsoft*. In *General Motors* and *Toys* "*R*" *Us* there were Court of Appeal decisions that eliminated the return of principal from the receipts factor all of which were vacated when the petitions for review to the California Supreme Court were accepted. There was a California Supreme Court decision in *General Motors* which eliminated from receipts the return principal received on the redemption of "repos." This case was remanded back to the trial court to determine if there was "distortion" by including the remaining receipts. Both *General Motors* and *Toys* "*R*" *Us* were settled on remand.

iv. Montgomery Ward. LLC v. Franchise Tax Board

In another case involving whether including receipts from treasury activity could be excluded from the sales factor under section 25137 a trial court held that they should not be excluded under the facts of that case. During the years involved Montgomery Ward was teetering on the edge of bankruptcy and had little or no net income from all of its activities. The treasury activity did produce net income while the retail activity did not. Under the circumstances of that case the trial court concluded that because the treasury activity was a primary source of net income (14+%) including all of the receipts from such activity in the sales factor did not result in an unfair reflection of income even though the qualitative and quantitative tests were met with respect to that year. The Franchise Tax Board did not appeal the trial court decision. This case has no precedential value.

v. Square D v. Franchise Tax Board

In another trial court decision involving treasury receipts the trial court held that such receipts should be excluded as unfairly reflecting the taxpayer's activities in California. The statement of decision finds that both the qualitative and quantitative standards were met and that the fact that the taxpayer's California tax would be reduced significantly less than the almost 50% percent that existed in *Microsoft* did not mean that there was fair reflection. The taxpayer did not appeal the decision. This case has no precedential value.

vi. Microsoft Corporation v. Franchise Tax Board

Microsoft II is a trial court decision (San Francisco Superior Court CGC08-471260, judgment entered March 15, 2011) that dealt with two issues under Section 25137. The first was a revisitation of the treasury issue ruled upon by the California Supreme Court in *Microsoft I*. Not surprisingly the trial court reached the same conclusion that the California Supreme Court did. Microsoft attempted to established that its treasury department was more actively involved in the general business operations than had been shown in the *Microsoft I*. The second issue was whether Microsoft's intangible property needed to be reflected in the apportionment formula. This was presented as an alternative that should be considered in determining the relief to be granted if including the treasury activity resulted in an unfair reflection, Microsoft's expert suggested that the apportionment formula should be modified by creating an intangible property factor and by equally-weighting the four factors (tangible property, intangible property, payroll and sales).

The trial judge, consistent with Microsoft I, held that the determination of the Franchise Tax Board should be upheld if it was reasonable. In addition, the trial judge held that the intangible property was otherwise represented in both the payroll factor and the sales factor, that even under the proposed assignment by Microsoft there was an insufficient variance to warrant including intangible property and that the assignment method offered by Microsoft's expert was inappropriate. Microsoft did not file an appeal with respect to the trial court's rejection of its Section 25137 arguments.

vii. <u>General Mills v. Franchise Tax Board</u>

In *General Mills v. Franchise Tax Board* 208 Cal App. 4th 1290, the Court of Appeal engaged in an extended discussion of the nature of qualitative and quantitative differences and the discretion of the tax agency in determining the relief to be granted,

b. Board of Equalization decisions

i. Appeal of New York Football Giants, Inc.

In <u>Appeal of New York Football Giants, Inc.</u>, Cal. St. Bd. of Equal., Feb. 3, 1977, the issue was whether FTB under section 25137 could require the taxpayer to deviate from the statutory sales factor. The SBE held for the taxpayer, and found that discretionary adjustments to the statutory allocation and apportionment provisions are authorized only under exceptional circumstances, that is, only where those procedures do not fairly represent the extent of the taxpayer's business activity in California. The SBE stated that in order to insure that the standard UDITPA provisions are applied as uniformly as possible, the party who seeks to deviate from the statutory formula, whether the taxpayer or the taxing agency, bears the burden of proving that such exceptional circumstances are present.

ii. Appeals of Pacific Telephone and Telegraph Company

In <u>Appeals of Pacific Telephone and Telegraph Company</u>, Cal. St. Bd. of Equal., May 4, 1978, the issue was whether the taxpayer's sales factor should include the taxpayer's share of the gross receipts from the sale or redemption of pooled interest bearing and discount securities.

The SBE ruled for the FTB and excluded the gross receipts. It reasoned that in analyzing under section 25137 a problem concerning the composition of one of the factors, it is appropriate to begin by focusing upon the role that said factor plays in the formula. Here,

including the gross receipts in the sales factor would not accomplish the sales factor's function, which is to reflect the market for the taxpayer's goods. The SBE concluded the inclusion of this "enormous volume of investment receipts substantially overloads the sales factor in favor of New York, and thereby inadequately reflects the contributions made by all the other states, including California, which supply the markets for the communications services provided by Pacific and its affiliates."

iii. <u>Appeal of Kikkoman International, Inc.</u>

In <u>Appeal of Kikkoman International, Inc.</u>, Cal. St. Bd. of Equal., June 29, 1982, the issue was whether the taxpayer could use separate accounting under section 25137 for its unitary business because of alleged differences between California and Japan in property costs and wages. The SBE rejected the taxpayer's argument and discussed at length the question whether distortion could be shown, and section 25137 could thus be invoked, based upon separate accounting principles:

"In simply comparing Japanese property costs and wages with those in California, appellant totally overlooks the effect of the property and payroll of the rest of the worldwide unitary business. Isolated comparisons, which take into account less than the whole of the unitary business, do nothing to show that formula apportionment does not fairly reflect the California portion of the activities of the <u>entire</u> unitary business. In any event, variations in profitability among different jurisdictions have been held not to preclude apportionment of the income of a unitary business by an appropriate formula.

"Appellant contends that separate accounting would be more accurate and a better approach to the determination of its California income. Revenue and Taxation Code section 25137, however, does not authorize deviation from UDITPA's normal provisions simply because one purports to have found a better approach. Allegations that the standard formula is not precise also do not justify the deviations proposed by appellant." (Emphasis original.)

iv. <u>Appeal of American Telephone and Telegraph Co</u>.

In <u>Appeal of American Telephone and Telegraph Co.</u>, Cal. St. Bd. of Equal., June 29, 1982, one of the issues was whether the taxpayer was required to include two long distance telephone cables located in the Pacific Ocean between California and Hawaii in the numerator of its California property factor. The cables were jointly owned and maintained by the taxpayer and a third party, with the taxpayer owning a majority interest in each cable. The taxpayer included in the denominator of its California land operations and the portion of the cables out to the "three-mile limit." FTB increased the numerator by one-half of the taxpayer's investment in the portion of the cables lying in the deep ocean, i.e., beyond both the three-mile limit and the Outer Continental Shelf. The SBE sustained FTB's position, and

commented upon the purpose and use of section 25137 to prevent income from escaping taxation:

"The underlying basis for respondent's position is the notion that UDITPA's fundamental purpose is to assure that 100 percent, and no more and no less, of a multistate taxpayer's business income is taxed by the states having jurisdiction to tax it. ... [W]e believe that section 25137 authorizes respondent to deviate from UDITPA's standard provisions in this case in order to prevent some of appellant's business income from escaping state taxation entirely. To hold otherwise would contravene UDITPA's fundamental purpose [to] avoid both overtaxation and undertaxation of a multistate taxpayer's business income, and would unduly circumscribe respondent's powers to effectuate an equitable apportionment of a taxpayer's income. ... [W]hen the possibility of duplicative taxation exists, as it often will when the various taxing states apply different apportionment formulas to the same taxpayer, it seems entirely appropriate to strictly limit the use of section 25137. But duplicative taxation is not a possibility in this case, and it therefore seems equally appropriate to allow respondent somewhat greater latitude under section 25137, in order to ensure that the basic purposes of UDITPA are carried out."

v. Appeal of Oscar Enterprises, L.T.D.

In <u>Appeal of Oscar Enterprises, L.T.D.</u>, Cal. St. Bd. of Equal., Oct. 6, 1987, the issue was whether FTB properly applied a two-factor apportionment formula to the taxpayer. The taxpayer was a United Kingdom corporation that engaged in a unitary business in California and elsewhere. It filed its California franchise tax return on the basis of the standard three-factor formula using a sales factor of 83 percent, a payroll factor of 100 percent, and a property factor of 0 percent. Upon inquiry by FTB, the taxpayer reported that it did not own or rent any real or tangible personal property anywhere, either within or without California. Consequently, FTB under section 25137 excluded the property factor entirely from the apportionment formula and required the taxpayer to apportion its income on the basis of the average of its sales and payroll factors.

The SBE ruled for the FTB, and concluded that FTB had met its burden under section 25137 of proving the normal apportionment provisions did not fairly reflect the taxpayer's activities in California. The SBE then commented upon the ability to exclude a factor under section 25137:

"Using a zero property factor in the formula has the effect of reducing the amount of income apportioned to California, based upon the assumption that the taxpayer uses all of its property outside of California to help generate income from its out-of-state business activities. That assumption is manifestly false in this case. Here, the taxpayer has no tangible property anywhere which is used in the production of its income. Under such circumstances, the property factor cannot possibly aid in the determination of how much of the taxpayer's income is earned in California and in each of the other taxing jurisdictions in which it conducts its business."

vi. <u>Appeal of Fluor Corporation</u>

In the <u>Appeal of Fluor Corporation</u>, Cal. St. Bd. of Equal., Dec. 12, 1995, the State Board of Equalization held that the regulations adopted by the Franchise Tax Board pursuant to Section 25137 become the standard rules of allocation and apportionment. Under this decision, the regulation will apply unless the party seeking to avoid the regulation comes forward with proof that establishes that the rules of the regulation do not fairly reflect the taxpayer's activities in the state. This decision has attached new and significant importance to the regulations adopted pursuant to Section 25137. The effect of the decision is to put the taxpayer and the tax agency on the same footing with respect to the regulations. It also probably increased the significance which should be attached to the adoption of regulations pursuant to Section 25137.

vii. <u>Appeal of Hyundai Motor America</u>

In a memo decision, <u>Appeal of Hyundai Motor America</u>, Cal. St. Bd. of Equal., June 25, 1998, the State Board of Equalization held that the taxpayer had met the burden of showing "distortion" under the standard formula by presentation of its separate accounting results in a start-up situation where there had been no income generating activities performed in the initial start-up period. The Board of Equalization found that separate accounting reached a reasonable result in the circumstances presented and granted the taxpayer's request for relief. This occurred in spite of the fact that there was no indication in the decision that a petition had been filed with the Franchise Tax Board seeking the relief granted.

viii. <u>Appeal of Crisa Corporation</u>

In the <u>Appeal of Crisa Corporation</u>, Cal. St. Bd. of Equal., June 20, 2002, the Board of Equalization rejected the taxpayer's argument that section 25137 could be used to adjust its income computed in the currency of the parent company, the Mexican peso, to properly reflect its activities in California. The Board stated:

"At the outset, we note that section 25137 is a part of UDITPA, which deals only with the allocation and apportionment of income, and not the determination of income itself. ... Accordingly, this Board has held that relief under section 25137 is not available to correct alleged distortion in the amount of income to be apportioned."

The Board of Equalization also commented on a request for a property factor adjustment supported by a quantitative analysis and comparisons of various percentages. The Board rejected the argument and offered the following observations on the offer of proof on distortion:

"We acknowledge that, in some cases ..., quantitative comparisons based upon separate geographical accounting were discussed in the context of attempting to impeach the standard apportionment formula. Unfortunately, a discussion of percentage comparisons in distortion cases is often wrongly interpreted as having a greater significance than it actually had and acts as a distraction from the primary task of determining whether the standard apportionment formula fairly represents the extent of the taxpayer's business activity in California.

"The central question under section 25137 is not whether some quantitative comparison has produced a large-enough "distortive" figure. Rather, the question is whether there is an unusual fact situation that leads to an unfair reflection of business activity under the standard apportionment formula. [Citation omitted.] The answer to this question lies in an analysis of the relationship between the structure and function of the standard apportionment formula and the circumstances of a particular taxpayer. If the analysis reveals some manner in which the standard formula does not adequately deal with the taxpayer's circumstances, then section 25137 may apply. Section 25137 must be analyzed on a case-by-case basis; there is no bright line rule that determines when the standard formula does not adequately deal with a particular situation."

The Board went on to provide five examples of situations that trigger the use of section 25137:

- (1) A corporation does substantial business in California, but the standard formula does not apportion any income to California. (See <u>Appeal of New York</u> Football Giants; Appeal of Milwaukee Professional Sports and Services, Inc.)
- (2) The factors in the standard formula are mismatched to the time during which the income is generated. (See *Appeal of Donald M. Drake Company*.)
- (3) The standard formula creates "nowhere income" that does not fall under the taxing authority of any jurisdiction. (See <u>Appeal of American Telephone and</u> <u>Telegraph Company</u>.)
- (4) One or more of the standard factors is biased by a substantial activity that is not related to the taxpayer's main line of business. (See <u>Appeal of Pacific</u> <u>Telephone and Telegraph</u>.)
- (5) A particular factor does not have material representation in either the numerator or denominator, rendering that factor useless as a means of reflecting business activity. (See <u>Appeal of Oscar Enterprises, LTD</u>.)

Crisa filed a suit for refund that was settled. The California State Board of Equalization decision in *Crisa* was, however, cited by the California Supreme Court in *Microsoft* with approval. 39 Cal 4^{th} at 770.

ix. <u>Appeal of Quick & Reilly, Inc.</u>

In the <u>Appeal of Quick & Reilly, Inc.</u>, Cal. St. Bd. of Equal., March 9, 2004 (unpublished), the Board of Equalization refused to exclude from the numerator of the property factor margin loans made to California customers. There was no apparent dispute that the loans had been applied for at the California offices of the taxpayer, but the taxpayer argued that they were administered out of its New York offices and, apparently, that New York would assign the loans to New York. The taxpayer cited to regulation 25137-4.1(c)(1)(B)(ii) which provides that loans applied for at an office in the state may be assigned to another state if a "banking regulatory authority" would recognize it as assignable to that other state. Franchise Tax Board argued that there was no "banking regulatory authority" which controls security broker-dealers, and therefore the exception had no application. (The application of the bank and financial regulation was not at issue because the subsidiary involved in margin lending was agreed to be a financial.)

The Board of Equalization viewed the taxpayer's argument as an attempt to invoke section 25137 to obtain a treatment that was not authorized by the standard rules. Its analysis of whether the taxpayer had met its burden focused on the other two factors. It noted that the payroll factor had virtually no values in California relating to the margin loans and therefore, to the extent the property factor treatment overstated the activity in California, it was balanced by the payroll factor. It also made the same kind of finding with respect to the sales factor though the evidence was less clear as to whether the margin interest had been assigned to the California, it would "exaggerate potential distortion in the property factor."

x. <u>Appeal of Swift Transportation</u>

Recently the Board of Equalization in an unpublished decision, Cal. St. Bd. of Equal., February 14, 2008, considered the question of whether a special formula should be applied entity by entity or to a unitary business. Swift Transportation, a trucking business, reorganized itself along functional lines. The parent company entered into the contracts with the customers, one subsidiary operated the trucks, and another owned the trucks and leased them to the entity operating the trucks. The parent company claimed it was a freight forwarded, not a trucking company, and its receipts should be allocated on a cost of performance basis. The entity operating the trucks had no factors to speak of because all of its receipts were intercompany item. The entity that own the trucks leased them out and attempted to assign the trucks to its commercial domicile on the theory that it entered into the contracts at its commercial domicile. The Board of Equalization sustained the Franchise Tax Board's position that the commonly owned corporations functioned as a unitary trucking business and its income should be apportioned accordingly with both the receipts for the shipment of goods and the value of the trucks being assigned on a mileage basis.

xi. *Appeal of Home Depot. Inc.*

In a December 18, 2008 letter decision the Board of Equalization allowed the taxpayer's claim for refund to include the receipts from its treasury activity in the sales factor. Including these receipts only resulted in a 3% change in the sales factor though the tax involved was over \$1 million. This case has no precedential value.

xii. Appeal of Argonaut Group Inc.

On a petition for rehearing the Board of Equalization, Cal. St. Bd. of Equal., on a 2-1 vote, directed the Franchise Tax Board to allow the taxpayer's claim for refund with no holding as to how the refund was to be calculated, what the distortion was, or what relief would be reasonable. This case has no precedential value.

Argonaut Group is a holding company for several insurance subsidiaries. In addition, it owned a subsidiary which held title to various properties but was not engaged in the insurance business. Both Argonaut Group and its subsidiary filed a combined return under section 25101.15 on the basis that both of them conducted business only in California. On the initial appeal Argonaut Group sought to included the insurance subsidiaries in the combined report. The Board of Equalization held that this was not permissible. On the petition for rehearing the taxpayer claimed that the Board of Equalization had not considered its arguments based on section 25137. When the rehearing was granted the taxpayer advanced several alternatives for relief. First, it asked that it be allowed to compute its tax on a pro forma combined report including the insurance subsidiaries. Subsequently it modified its request, acknowledging that the Board of Equalization had already ruled that such an approach was not permissible, by requesting that either the taxpayer's income be apportioned solely by reference to the premiums of the insurance companies or by the insurance companies expenses. Particularly noteworthy is that under neither one of these alternatives are there any factors of the two taxpayers included in the apportionment process.

The Franchise Tax Board argued that section 25137 could not be invoked because the two taxpayers were solely California taxpayers so under the standard apportionment formula there could be unfair reflection of activities as between states because the taxpayers conducted activities only in a single state.

The action by the Board of Equalization leaves open many unanswered questions and appears to indicate that section 25137 can be used to accomplish virtually any result.

<u>CHAPTER 9</u> <u>THE COMBINED REPORT</u>

1. <u>THE CONCEPT OF THE COMBINED REPORT</u>

a. In General

Where a single corporation does business within and without California, the process of allocating and apportioning its income between California and other states is usually a relatively simple task under UDITPA. However, a far greater level of complexity is encountered when the corporation's activities in California are part of a unitary business conducted by the corporation and related corporations. California's methodology for addressing this situation is the "combined report" concept. When a group of corporations conducts a unitary business within and without California, California law requires the members of the group to compute their individual tax under the combined report method. This chapter discusses the basic principles of the combined report where no water's-edge election has been made. It should be kept in mind that some of these principles may not be applicable, or may have been modified by statute or regulation, where a water's-edge election has been made. (See section 25110 et seq.)

The father of the combined report explained the concept as follows:

"Simply stated, the purpose of the combined report is to insure that the income of a business conducted partly within and partly without the taxing state shall be determined and apportioned in the same manner regardless of whether the business is conducted by one corporation or by two or more affiliated corporations. In cases where one corporation conducts the business, the income is computed as a unit and apportioned by means of an appropriate formula. ... The income so attributed to the state is combined with any nonbusiness income that the taxpayer may have from sources within the taxing state ... to arrive at taxable income. When the combined report is employed, exactly the same procedure is followed, and the same results obtained, in cases where more than one corporation conducts the business. The income is still computed as a unit just as it would be if the business had been conducted by one corporation only." (Keesling, "A Current Look at the Combined Report and Uniformity in Allocation Practices," Journal of Taxation, Feb. 1975, p. 106.)

A "combined report" is not a tax return. It is a method by which the income and activities of commonly owned corporations operating as a unitary business are combined into a single report for purposes of calculating income, and then apportioning that income to the various entities involved and to the jurisdictions in which the business is taxable. Instructions for this process are found in FTB 1061, a new version is issued annually and in the regulations adopted under Section 25106.5.

The combined report procedure is derived from the general power and duty of the FTB to determine the amount of income attributable to sources within California for tax purposes. Section 25101 provides that if a taxpayer has income "derived from or attributable to sources both within and without the state, the tax shall be measured by the income derived from or attributable to sources within this state in accordance with the provisions of" UDITPA as found in section 25120 et seq. The Board of Equalization has noted that: "[i]t is well settled that the authority for requiring a combined report rests in section 25101." (*Appeals of Foothill Publishing Co. and The Record Ledger, Inc.*, Cal. St. Bd. of Equal., Feb. 4, 1986.) The combined report was first judicially approved as a reasonable allocation method in *Edison California Stores* v. *McColgan* (1947) 30 Cal.2d 472, and was approved by the United States Supreme Court in *Container Corporation of America* v. *Franchise Tax Board* (1983) 463 U.S. 159.

2. <u>ELEMENTS OF THE COMBINED REPORT</u>

As described in greater detail in FTB 1061 and regulation 25106.5, a combined report should contain the following schedules:

(1) A Combined Profit and Loss Statement showing the profit and loss of each corporation. (Regulation 25106.5(c)(1).)

(2) A Schedule Converting Net Income to Unitary Business Income Subject to Apportionment. This schedule includes adjustments necessary to account for differences between federal and California law, and to account for items of nonbusiness income for each corporation. Typical major adjustments might include differences between federal and California depreciation deductions; the add-back for California Corporation Tax and other state taxes measured by income; deductions for dividends under sections 25106, 24402, 24410 or 24411; and adjustments between federal capital loss carryovers and California capital loss carryovers. (Regulation 25106.5(c)(3) & (4).)

(3) A Schedule Showing the Combined Apportionment Formula. This schedule shows for each corporation the total amount of payroll, property and sales, and the California amount of payroll, property and sales. Certain intercompany transactions are eliminated in this process. (Regulation 25106.5(c)(7).)

(4) A Schedule Computing California Net Income and Tax. This schedule calculates the amount of net income for California purposes, and applies the tax rate to the amount to determine the amount of tax owed. The schedule first calculates the amount of unitary business income apportioned to California for each corporation by multiplying the combined unitary business income subject to apportionment (from (2) above) by each corporation's California apportionment percentage (from (3) above). To that result is added the amount of nonbusiness income attributable to California for each corporation. Other minor adjustments

are then made, including any deduction for contributions (from (6) below), to reach net income. (Regulation 25106.5(d).)

(5) A schedule showing the Computation of the Interest Offset on a combined basis; now applicable only for California-based businesses at their election.

(6) A schedule showing the Computation of the Amount of the Deduction for Contributions.

A series of regulations has been adopted under Section 25106.5 of the Revenue and Taxation Code to set forth the rules for preparing combined reports. Regulations 25106.5 (Definitions), Regulation 25106.5-1 (Intercompany Transactions) 25106.5-2 (Capital Gains and Losses), 25106.5-3 (Accounting Methods and Elections), 25106.5-4 (Fiscalization), 25106.5-5 (Interest Offset), 25106.5-9 (Partial-Period Combination), 25106.5-10 (Foreign Combination), and 25106.5-11 (Group Returns) have been adopted. Additional areas to be covered in the regulations are 25106.5-6 (California Source Carryover Items), 25106.5-7 (Charitable Contributions), and 25106.5-8 (Alternative Minimum Tax).

3. <u>COMMON ISSUES</u>

a. Corporations Operating Wholly Within California

At one time, a unitary business operating wholly within California was not permitted to use the combined report method. (See, e.g., <u>Appeals of O.S.C. Corporation, et al.</u>, Cal. St. Bd. of Equal., Dec. 3, 1985.) However, for income years beginning on or after January 1, 1980, section 25101.5 allows two or more corporations that are engaged in a unitary business solely within California to elect to file a combined report.

Harley-Davidson and Abercrombie and Fitch,, multistate unitary businesses, have filed a lawsuits alleging that the election provided to wholly California unitary businesses to file either on a separate entity or combined basis discriminates against multistate unitary business who can not file on a separate entity basis. The trial court-in Harley-Davidson sustained the FTB's demurrer to this cause of action. The appellate court reversed and commented that the treatment was discriminatory. Subsequently the trial court in Harley-Davidson rejected the appellate court's determination because it was only entitled to rule on whether the demurrer was proper and held that there was no discrimination and if there was it passed strict scrutiny. The trial court in Abercrombie ruled in favor of the Franchise Tax Board's motion for judgement after the plaintiff rested their case. Appeals have been filed.

b. Part-Year Members

A California reporting corporation may become a member of the unitary group after the beginning of the income year, or may cease to be a member of the unitary group during the income year. If the corporation does not have a short period filing requirement beginning on the date they become unitary, the corporation must use the combined report method to calculate its net income for California purposes for the portion of the year it is a member of the unitary business, and must use separate reporting to calculate its net income for

California purposes for the portion of the year it is not a member of the unitary business. (See FTB 1061 for example.) In addition, the part-year member may not be included in the election to file a single return. (See below.) (Regulation 25106.5-9.)

c. Corporations Having Different Accounting Periods

In filing a combined report, it is required that the income of all corporations be determined on the basis of the same accounting period. Where there is a parent-subsidiary relationship, the income of all corporations should be determined generally on the basis of the parent's income year. Where there is no common parent corporation, the income of the related corporations should be determined on the basis of the income year of the corporation required to file a California return. If more than one member is required to file a California return, the income should be determined on the basis of the income year of the California reporting corporation expected to have, on a recurring basis, the largest amount of California income. In addition to determining the combined unitary income on the basis of a common income year, the factors of the combined formula must also be computed on the basis of the same common income year. (See FTB 1061 for examples and regulation 25106.5(c)(8).)

d. Alternative Minimum Tax

When alternative minimum taxable income (AMTI) is derived from or attributable to sources both within and without California, the income attributable to California must be determined by use of the apportionment formula used in determining income subject to the regular tax. Where the AMTI is attributable to unitary operations of a combined group wholly in California, the income is assignable to each member by use of the average relative ratio of each member's payroll, property and sales of all members times the total AMTI items. (See FTB 1061 for examples; see also Schedule P (100), Alternative Minimum Tax and Credit Limitations-Corporation, and Instructions.)

A taxpayer may use Enterprise Zone Credits to offset an AMT Liability. *Appeal of NASSCO Holdings, Inc.*, Cal. St. Bd. Of Equal., Feb 26, 2009 (Unpublished decision.)

e. Net Operating Loss Carryover

California incorporates, with specific modifications, the provisions of IRC section 172 concerning carryovers of net operating losses (NOLs). Generally, California allows 50 percent of the NOL incurred in the income year to be carried forward and deducted in later years. A net operating loss shall not be carried forward to any income year beginning before January 1, 1987. (Section 24416.) California has no provision for carrybacks. (Section 24416.) Corporations that are members of a unitary group filing a single return must separately compute the loss carryover and application of the loss carryover based on their apportioned and allocated share of the California income or loss. (Section 25108.) Unlike the treatment on a federal consolidated return, a loss carryover of one member of a combined report may not be applied to the intrastate apportioned income of another member included in the combined report. NOL deductions for California purposes are limited to five years carry forward and were not permitted at all for income years 1991 and 1992. For those

years, the carry forward period was extended by one year for losses sustained in 1991 (deduction denied in 1992) and by two years for losses sustained prior to 1991 (deduction denied in 1991 and 1992). (Section 22416.3.) (Regulation 25106.5(e).)

f. Tax Credits

The Corporation Tax Law provides for a variety of credits. Credits are allowed to corporations, not to unitary businesses or combined reports. Taxpayers frequently argue that if their income is determined by reference to a combined report, then credits should be similarly computed. In the *Appeal of AeroVironment, Inc.*, Cal. St. Bd. of Equal., Jan. 10, 1997, the Board of Equalization sustained the Franchise Tax Board's assessments based upon limiting a solar credit on an entity basis. The decision, however, was based upon the legislative history surrounding this particular credit and not previous case authority that generally limited credits on an entity basis.

In <u>General Motors Corporation v. Franchise Tax Board</u> (2006) 39 Cal.4th 773, the California Supreme Court held that the research and development credit was allowed on an entity basis. The Court gave three reasons for its decision. First, the research and development credit was based on the federal credit limiting the credit to members of a controlled group that increased their research and development expenses in the year. The California legislature, in enacting the credit, made a number of variations from the federal provisions, but did not address this issue demonstrating it was following the federal approach. Second, the Legislature has allowed a credit to be used on a group basis in other circumstances. Third, the Court points out that if the credit were to be allowed on a group basis, it would necessarily be allowed to entities that had no California tax liability.

In 2008 legislation, section 23662 Revenue and Taxation Code, Chap 763, Laws 2008, was enacted which allows members of a unitary group to make a one-time assignment of a credit that existed as a carry-forward as of, or arises after, July 1, 2008, to another member of the unitary group. The assigned credit can only be used for the computation of tax for taxable years beginning on or after January 1, 2010. The assignment is to be made on the original return for the taxable year in which the assignment is made and is irrevocable. The entity making the assignment must reduce the amount of its unused credit and regardless of whether there is consideration for the assignment of the credit neither the assignment. The assignee will recognize income or incur an expense resulting from the assignment. The assignee cannot subsequently assign the credit. On March 30, 2009, the Franchise Tax Board issued an initial Frequently Asked Questions regarding the election. In addition, the Franchise Tax Board has held an interested parties meeting to discuss proposed regulations.

g. Bankruptcy Discharge

In the <u>Appeal of Ticor, et al.</u>, Cal. St. Bd. of Equal., June 27, 1996 (unpublished), it was held that the discharge of a parent corporation's tax liabilities in a bankruptcy proceeding did not result in the discharge of the tax liabilities of unitary subsidiaries that were allowed to file a combined report as a single unitary business. This issue has not been ruled upon in a bankruptcy proceeding.

h. Partnerships

A corporation which owns an interest in a partnership includes its proportionate share of the income and factors of a unitary partnership in its combined report, Regulation 25137-1. In the *Appeal of Eli Lilly and Co.* Cal. St. Bd. of Equal., February 1, 2007 (unpublished) it was held that a partnerships years ended on the date it was liquidated and that its apportionment factors for that year were to be included in the combined report filed for the year in which the partnership year ended.

i. Limited Liability Companies

There is a case pending, *Bunzl Distribution v. Franchise Tax Board*, First District Court of Appeal, A137887 where the question of whether a single-member LLC should be included in a combined report. The trial court ruled in favor of the Franchise Tax Board and an appeal has been filed.

4. <u>INTERCOMPANY TRANSACTIONS</u>

FTB adopted a regulation, 25106.5-1, in the year 2000 effective for income years beginning after January 1, 2001. In general, the rules adopted conform to Treasury Regulation section 1.1502-13. Exceptions arise due to the differences between the composition of the federal consolidated return group and the combined reporting group, the requirements of the California allocation and apportionment provisions, jurisdictional limitations, and the treatment of members of a combined reporting group as separate entities for purposes of the Revenue and Taxation Code (Reg. § 25106.5(a)(2)).

The general rule is one of deferring gains or losses from intercompany transactions in order to produce the effect of transactions between divisions of a single corporation. (Reg. $\S 25106.5-1(a)(1)$.) Intercompany transactions means transactions between corporations that are members of the same combined reporting group immediately after such transactions. (Reg. $\S 25106.5-1(b)(1)(A)$). It does not include transactions which produce nonbusiness income or loss to the selling member or income attributable to a separate business activity of the selling member. (Reg. $\S 25106.5-1(b)(10(B).)$ Simplifying rules are allowed so that accounting can be coordinated with federal treatment and elections with respect to the recognition or non-recognition of items. (Reg. $\S 25106.5-1(e).$)

Simplifying rules are allowed so that accounting can be coordinated with federal treatment and elections with respect to the recognition or non-recognition of items. (Reg. § 25106.5-1(e).)

a. Inventories

In computing the cost of goods sold, intercompany profits are eliminated from beginning and ending inventories. The reduction for intercompany profits shall also be applied for property factor purposes.

The question of how to treat the intercompany transfer of inventories arises in the context of the water's-edge election. No specific rules had been provided for handling inventory

transfers when entities are no longer part of the same combined report group prior to the adoption of Regulation 25106.5-1. In the <u>Appeal of Yamaha Motor Corp., USA</u>, Nov 2, 2000, Cal. St. Bd. of Equal., the State Board of Equalization ruled that a taxpayer was allowed to used its cost basis in a water's-edge year to determine its income with respect to inventory purchased from the parent company in the year a combined report was filed. The Board of Equalization held that the failure of the Franchise Tax Board to adopt regulations directing how such transactions were to be handled resulted in the taxpayer being able to claim the accounting treatment most advantageous to it. The Board of Equalization did not question the authority of the Franchise Tax Board to adopt rules and regulations but held that in the absence of such rules all doubts are to be resolved in favor of the taxpayer.

The Franchise Tax Board filed a petition for rehearing in the <u>Appeal of Yamaha</u> and a companion case, <u>Appeal of Pental of America, Ltd</u>. On December 3, 2001, the Board of Equalization issued a letter ruling on the petition for rehearing and adopted Franchise Tax Board Notice 89-601. The notice provides that previously unrecognized gains within a unitary group should, on the exercise of a water's-edge election, be apportioned using the apportioned factors of the year immediately prior to the year of the water's-edge election, and that the income be included over a five-year period beginning with the year of the water's-edge election. Notice 89-601, by its terms applies only to fixed assets and has no application to inventory. Nonetheless, the Board of Equalization held that it should be noted that the intercompany transactions to be reported are not limited to transactions between the water's-edge group and the collective excluded entities, but also include transactions between the excluded entities.

On January 8, 2003, in a letter ruling in <u>Appeal of Alps Electric (USA), Inc.</u> and <u>Appeal of</u> <u>Canon U.S.A., Inc.</u>, the Board of Equalization held that "under the facts of these cases, the appellants were required to utilize the carryover basis method (or 'elimination and basis transfer' approach) with respect to transferred inventory items received in the intercompany sale and purchase transactions."

In the <u>Appeal of Mitsubishi Electric America, Inc. & Subsidiaries</u>, Cal. St. Bd. of Equal. (unpublished), Nov. 2, 2000, the Board of Equalization provided a more thorough analysis of the issue. The Board held that the appellants were required to use the carry-over basis of the inventory and should not have stepped up the value of the inventory to their actual purchase price. Primary reliance was placed upon section 24913 (§ 1013, IRC), which states, "If the property should have been included in the last inventory, the basis shall be the last inventory value thereof." In addition, section 23051.5(d), which follows Internal Revenue Code section 471, requires taxpayers to be consistent in their treatment of inventory values from year to year. Finally, on a statutory basis, the Board of Equalization construed the taxpayer's treatment to constitute a change of accounting that required the permission of the Franchise Tax Board.
Subsequently, Alpine Electronics, in similar circumstances, sought to use section 25137 to justify using a stepped-up basis of its inventory. The three-member Franchise Tax Board denied their petition.

b. Fixed Assets and Capitalized Items

It is the general rule of FTB that the gain or loss on intercompany sales of business fixed assets or capitalized intercompany charges and expenditures between members of a combined group shall be deferred. (Reg. § 25106.5-1(c).) If an affiliated group that files a consolidated federal return elects not to defer gain or loss on intercompany transfers, the FTB will allow the federal election for a state return. (Reg. § 25106.5-1(e).) In the absence of an election not to defer the intercompany gain or loss, the general rule will apply. In practice, if a domestic entity currently reported intercompany sales to a foreign affiliate, the FTB does not disturb that method even though there was no federal election. Consequently, the gain or loss remains deferred as long as both the seller and the purchaser remain in the combined group and the asset is not sold to outsiders.

When either the seller or purchaser is eliminated from the combined group, or the group for any reason terminates combined reporting, the gain or loss is reportable by the seller at a time immediately preceding the date either corporation ceases to be a member of the group. If the asset is sold to third parties and combined reporting has not been terminated, the deferred gain or loss is reportable by the combined group in the year of sale. The amount of gain is generally the same amount as would be reportable for federal purposes under similar circumstances in a consolidated return. When gain or loss is deferred, the basis for property factor purposes shall be the seller's cost. (Reg. § 25106.5-1.)

This issue was decided this year by the appellate court in <u>Pacific Telesis Group, Inc. v.</u> <u>Franchise Tax Board</u>, Court of Appeal, First District, March 9, 2005 (unpublished). This case has no precedential value.

Pacific Telesis was part of the AT&T Bell Telephone unitary business prior to the divesture ordered by the United States Department of Justice. Another member of the group was Western Electric. That company manufactured the telephone switching equipment used by all members of the Bell system. In the combined report filed prior to the break-up, all of this equipment was reported on the basis of its cost of manufacture, rather than the price of the intercompany transfer, for purposes of computing income and for factor purposes. The Bell system entered into an agreement with the Internal Revenue Service, which allowed it to avoid reporting all the intercompany income on divesture. Instead, the income was reported ratably year by year by recognizing gain in the hands of the purchasers that offset the amount of increased depreciation taken on the basis of the actual purchase price of the equipment. No agreement was entered into with the Franchise Tax Board, but the taxpayer computed its California depreciation on a basis consistent with its federal treatment. After the year of divesture had closed, the year the income from the inter-company transactions would have been reported but for the agreement with the federal government, the taxpayer filed claims for refund claiming depreciation on the stepped-up basis of the equipment.

The trial court denied the taxpayer's claims for refund on a number of grounds. Factually if the gain involved for the whole Bell Group had been reported in the year of divesture, Pacific Telesis' tax would have been approximately equivalent to the additional tax it paid over the years by not depreciating the property on a stepped-up basis. The appellate court found that Pacific Telesis had not shown any statutory basis that would entitle it to a refund and also found that it was not entitled to a refund as a matter of "equity and good conscience." A copy of the opinion is at attachment 9.

c. Factor Adjustments

For factor purposes, intercompany sales and other intercompany revenue items are eliminated in computing the numerator and denominator of the sales factor. (Reg. § 25106.5-1(a)(5)(A).) Property sold intercompany is included in the property factor at the original cost of the selling member. (Reg. § 25106.5-1(a)(5))B)1.) Intercompany rent charges are also eliminated from the property factor computation. (Reg. § 25106.5-1(a)(5)(B).)

d. Dividends

To the extent intercompany dividends are paid out of apportionable business income, they are excluded in computing the California measure of tax (§ 25106). Distributions paid out of nonbusiness income not included in the California measure of tax or distributions from earnings and profits accumulated prior to the time the payor corporation became a member of the combined group, are not eliminated from the income of the recipient corporation. For the issues involved in determining which earnings and profits a dividend is paid from see the discussion in subsection 5(e) below.

e. Eliminations as Income

In the <u>Appeal of CTI Holdings</u>, Cal. St. Bd. of Equal., Feb. 22, 1996, the Board of Equalization rejected an argument that items "eliminated" by the use of a combined report were no longer income. The issue was presented by the taxpayer arguing that foreign withholding taxes on interest, royalties and dividends were not taxes upon income because such amounts were "eliminated" in a combined report. The Board of Equalization held that regardless of their treatment for combined report purposes, payments would be classified as income or not based upon their general treatment for tax purposes.

The same arguments were asserted and rejected in the <u>Appeal of Caterpillar Inc. and Solar</u> <u>Turbines</u>, Cal St. Bd. of Equal., April 7, 1998 (unpublished).

f. Deferred Intercompany Stock Account (DISA)

The Deferred Intercompany Stock Account (DISA) is an accounting mechanism that a distributee corporation, which is a member of the combined report group, uses to report and track non-dividend distributions in excess of its adjusted basis in the stock of the distributing subsidiary corporation. Such amounts are not required to be taken into account until there is a disaffiliation event. (Reg. § 25106.5-1(b)(8).) Taxpayers are required to disclose the amount of DISA annually on FTB Form 3726. Failure to file this form may result in the

loss of deferral. Taxpayers could fulfill the disclosure requirement for years 2001-2007 without penalty by filing the form by October 1, 2009. See FTB Notice 2009-01 and FTB Notice 2009-05.

g. Acceleration Events

Intercompany items are normally accounted for when the item is disposed of outside of the combined group to third parties. Acceleration can also occur when there is a change in the unitary relationship. Intercompany items are taken into account to the extent they cannot be taken into account to produce the effect of treating the selling entity and buying entity as if they were divisions of a single corporation. (Reg. § 25106.5-1(d).) Accelerating events include conversion of an asset to a nonbusiness use, or the termination of a unitary relationship, either by disaffiliation through the sale of an ownership interest so that less than a 50 percent ownership exists, or by election, such as a water's-edge election. Gain or loss is taken into account immediately prior to the acceleration event, and apportionment will occur by use of the factors in the year of acceleration.

An accelerating event does not occur if both the seller and buyer in an intercompany transaction leave the combined reporting group at the same time. (Reg. § 25106.5-1(j)(1).)

5. <u>DIVIDEND ELIMINATIONS/DEDUCTION ISSUES</u>

a. Intercompany Dividends - Section 25106

Section 25106 provides that where the tax of a corporation has been determined with reference to the income and apportionment factors of another corporation engaged in a unitary business, and the dividends were paid out of the income of the unitary business, the dividends are eliminated from the income of the recipient corporation. Dividends received from nonunitary income may not be eliminated under section 25106. See the dividend ordering discussion, *infra*.

i. <u>Appeal of Louisiana-Pacific Corporation</u>

In <u>Appeal of Louisiana-Pacific Corporation</u>, Cal. St. Bd. of Equal., Jan. 6, 1987, the issue was whether dividends paid to the taxpayer at a time the payor was not a <u>member</u> of the taxpayer's unitary group could be excluded under section 25106 from the measure of the taxpayer's California franchise tax. The SBE quoted the portion of section 25106 which provides the elimination is permitted only "to the extent such dividends are paid out of such income of such unitary business" The SBE concluded that dividends paid prior to the payor becoming a member of the unitary group cannot be eliminated under section 25106 because those dividends could not possibly have been paid out of the income of the unitary business.

ii. <u>Appeal of Willamette Industries, Inc.</u>

In <u>Appeal of Willamette Industries, Inc</u>., Cal. St. Bd. of Equal., March 2, 1989, the issue was whether dividends paid to the taxpayer at a time the payor was a member of the taxpayer's unitary group, but paid from income <u>not</u> generated in the course of the unitary business (i.e.,

not from E & P of the unitary business) could be eliminated under section 25106. The SBE concluded that section 25106, on its face, provides for elimination of dividends which are paid out of the unitary business income of the corporations engaged in the unitary business. Therefore, the SBE reasoned that only those dividends which were paid out of business income "generated in the course of the unitary business" can be eliminated under section 25106. Accordingly, the SBE held that dividends paid from earnings and profits a corporation earned before it became a part of the unitary business cannot be eliminated under section 25106 (even if the dividends are paid at a time the payor is part of the unitary business).

The taxpayer filed a suit for refund following its loss before the SBE. In <u>Willamette</u> <u>Industries, Inc. v. Franchise Tax Board</u> (1995) 33 Cal.App.4th 1242, the court of appeals held that dividends paid by a subsidiary to the parent corporation are excludable from income under Section 25106 only to the extent they are "unitary" intercompany dividends.

b. Earnings & Profits and "Dividends"

i. <u>Appeal of Young's Market Company</u>

In <u>Appeal of Young's Market Company</u>, Cal. St. Bd. of Equal., Nov. 19, 1986, the SBE addressed the issue of whether members of a unitary group must compute their earnings and profits on the basis of separate accounting or whether the earnings and profits of each member should be computed by reference to the amount of unitary business income attributed to each member of the group by formula apportionment. The SBE concluded the unitary concept and formula apportionment ascertains the amount of income subject to taxation with the state and does not act to consolidate the business group. Nor does it affect the earnings and profits of the separate entities, but simply determines how much of the unitary business income should be taxed to each corporate entity in California. Accordingly, a distribution to the taxpayer by its wholly owned subsidiary could not be treated as a dividend because during the years at issue the subsidiary had no earnings and profits from which to declare a dividend. The SBE concluded, "The income attributed to it because of the utilization of combined reporting cannot form the basis of earnings and profits from which a dividend can be declared."

ii. Willamette Industries, Inc. v. Franchise Tax Board

In <u>*Willamette Industries, Inc. v. Franchise Tax Board* (1995) 33 Cal.App.4th 1242, the appellate court rejected the taxpayer's argument that the pre-acquisition earnings and profits of a corporation ceased to exist once an acquisition was made and the acquired corporation became part of the acquirer's unitary business.</u>

c. Dividends from earnings previously taxed - Section 24402

Section 24402 of the Revenue and Taxation Code has been found to discriminate against interstate commerce, a violation of the Commerce Clause. *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal.App.4th 976. That decision is final and review was denied by both the California Supreme Court and the United States Supreme Court. The Franchise Tax

Board will be implementing the decision by allowing 100 percent for years beginning prior to December 1, 1999, and denying any deduction for years beginning on or after December 1, 1999. The Franchise Tax Board's implementation of the *Farmer Bros.* decision has been upheld. *River Garden Retirement Home v. Franchise Tax Board*, 186 Cal.App.4th 922 and *Abbott Laboratories v. Franchise Tax Board*, 175 Cal. App. 4th 1346 (2009)

d. Dividends from insurance subsidiaries – Section 24410

In <u>Ceridian Corp. v. Franchise Tax Board</u> (2000) 85 Cal.App.4th 875, section 24410 of the Revenue and Taxation Code was held to be unconstitutional because the deduction was allowed only to California domiciliaries, and it was limited in amount by the dividend-paying corporations' presence in California. The FTB staff will implement *Ceridian* by 1) allowing refunds with respect to the years that are closed under the normal statute of limitations with respect to dividends received from 80-percent-or-more-owned entities that are subject to the California gross premiums tax; and 2) denying all deductions claimed under section 24410 with respect to years that are open under the normal statute of limitations. Business interests argue that a deduction should be allowed with respect to all dividends received from the 80-percent-or more-owned entities without regard to the years. The Legislative Counsel's Office has issued an opinion that the staff's views are appropriate. Efforts are being made to deal with this question in legislation. The question of whether any insurance dividends can be deducted for years beginning after December 1, 1998, is currently before the State Board of Equalization.

e. Dividend Ordering

When a dividend-paying corporation has several types of income that has different tax attributes there is a need to determine from which income the dividend is paid. For example, in years in which section 24402 could be applied it was necessary to determine the source of a dividend to determine whether it was paid from income previously taxed by California so it would be entitled to a deduction. The Franchise Tax Board treated dividends as being paid proportionately from all of the income of the year from which it was paid. The <u>Safeway</u> yearly assignment principal was based upon section 316 of the Internal Revenue Code. A similar question can also arise under section 25106 when the dividend-paying corporation has income part of which is included in a combined report and part of which is not. In <u>Safeway Stores v. Franchise Tax Board</u> (1970) 3 Cal.3d 745, the California Supreme Court accepted the proportionate approach.

In *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459, the court of appeals held that dividends should be considered first paid from dividends that would be eliminated under section 25106. The dividend-paying subsidiary was an entity that was partially included in the dividend recipient's combined report. Section 25106 allows dividends to be "eliminated" to the extent they are paid from income that was included in a combined report in which both companies were members. The dividend-paying subsidiary had a portion of its income included in the combined report. The court of appeals held, pp. 479-80, that the dividends should be paid first from the earnings and profits included in the combined report and thereafter from other earnings and profits.

The court of appeals' conclusion was premised on what it believed was an inconsistency in two Franchise Tax Board regulations. The first, subdivision (a) of Regulation section 24411 specifically provided that dividends were to be treated as paid proportionally from all earnings and profits. The second, subdivision (f)(2) of Regulation section 25106.5-1 contains examples of how to account for intercompany dividends. The court of appeals misinterpreted the example in Regulation section 25106.5-1(F)(2) as treating dividends paid from section 25106 earnings and profits first. In reality that example reflects the substance of section 316 of the Internal Revenue Code that provides that earnings are paid from the most recently accumulated income. In the example, all of the earnings from other years were not eligible for a section 25106 elimination, and all of the Last In – First Out principal of IRC section 316 coincidentally resulted in all of the dividends eligible for 25106 elimination being eliminated.

The State Board of Equalization was presented with the question of dividend ordering in an appeal filed by Apple Computer. Consideration of this case had been deferred pending the Court of Appeal's consideration of *Fujitsu*. In an unusual circumstance, the Franchise Tax Board requested that the Board of Equalization consider the correctness of the decision in *Fujitsu*. In the <u>Appeal of Apple Computer, Inc.</u>, Cal. St. Bd. of Equal. Nov. 20, 2006, the Board of Equalization declined to follow the Court of Appeal decision. It held that dividends are paid from earnings and profits on a last-in, first-out basis and that the dividends for any year are paid proportionally from every class of income that made up the earnings and profits for the year. It based its opinion on "the weight of authority, a respect for long-standing administrative practice and a sound basis in policy and theory."

First, it determined that federal authorities adopted at last-in, first-out, treatment for dividends under section 316 IRC and the California had adopted section 316.

The weight of authority consisted of two Franchise Tax Board regulations, 24402 and 24411, that unambiguously require prorating. It expressed puzzlement over the Court of Appeal's reading regulations adopted under 24411 and 25106.5 as being inconsistent. In addition, it found the California Supreme Court (see *Safeway Stores*), a higher court than the Court of Appeal, had endorsed the pro-ration of dividends between pools of earnings and profits.

The long-standing administrative practice was evidenced by the Franchise Tax Board's consistent application of LIFO and prorating for decades.

Finally, it held that dividends are not directly traceable to any one source of earnings. It noted that the preferential ordering that the taxpayer was requesting would allow a taxpayer to "have its cake and eat it, too."

Apple filed a suit for refund, San Francisco Superior Court CGC08471129, challenging the holding of the State Board of Equalization. The trial court upheld the position of the Franchise Tax Board and Board of Equalization that dividends were ordered annually on a last-in first-out basis. The refund at issue in the case, however, turned on the question of the allocation of

expenses to those dividends. If expenses could be allocated to the non-taxable dividends, such expenses would be non-deductible. The trial court determined that none of the expenses, principally interest, should be allocated to the dividends, resulting in a full refund to the taxpayer. The taxpayer filed an appeal in spite of receiving the full relief requested. The Court of Appeal sustained the trial court determination that dividends should be considered on a last-in first-out basis. (*Apple, Inc. v. Franchise Tax Board*, (2011)199 Cal App. 1) A petition for review by the California Supreme Court was denied.

6. BASIS ADJUSTMENTS

Under the consolidated return provisions of the Internal Revenue Code, the basis of stock in a subsidiary is adjusted for accumulated earnings and profits and distributions. Under combined reporting, the only adjustments recognized are for capital contributions and for distributions in excess of earnings and profits. This position results from the absence of specific statutory authority requiring other adjustments. In the <u>Appeal of Safeway Stores</u>, <u>Inc</u>., Cal. St. Bd. of Equal., March, 2, 1962, it was held under pre-UDITPA law that the parent's basis in the stock of a unitary subsidiary should not be adjusted for prior results.

a. <u>Appeal of Resource Marketing, Inc.</u>

In the <u>Appeal of Resource Marketing, Inc.</u>, Cal. St. Bd. of Equal., July 25, 1996 (unpublished), it was the position of the Franchise Tax Board that no adjustment to the basis of a foreign subsidiary could be made as the result of either the deemed reinvestment of undistributed foreign personal holding company income as required by the Internal Revenue Code or the alleged payment of the subsidiary's expenses by the parent company.

b. <u>Appeal of Rapid-American Corporation</u>

In the <u>Appeal of Rapid-American Corporation</u>, Cal. St. Bd. of Equal., Oct. 10, 1996, it was held, in what the Board of Equalization termed a case of first impression, that the basis in the stock of a subsidiary could not be increased by the amount of the retained earnings of the subsidiaries which had been included in previously filed combined reports. The Board of Equalization's conclusion was based upon the absence of the consolidated return statutes from the California Corporation Tax Law and the elimination of several basis adjustment subsections contained in Section 1016 of the Internal Revenue Code when it was adopted by California.

c. Jim Beam Brands Co. v. Franchise Tax Board

In this appellate court decision, *Jim Beam Brands Co. v. Franchise Tax Board* (2005) 133 Cal.App.4th 514, the court followed the Board of Equalization's decision in *Appeal of Rapid-American Corporation*, Cal. St. Bd. of Equal., Oct. 10, 1996, without any significant discussion. It rejected arguments by the taxpayer that basis adjustment was necessary to prevent double taxation of corporate earnings, a policy reflected in section 24402. Section 24402, of course, has been held to be unconstitutional so did not represent a compelling analogy.

7. <u>INTEREST OFFSET</u>

For decades, California has a special rule for the allocation of interest expense between certain income assigned by formula, "business income," and certain income allocable to a single state, "nonbusiness income." Under the interest offset rule, Section 24344(b), Revenue and Taxation Code, interest expense was first assigned on a dollar-for-dollar matching basis to business interest income and allowed as a deduction in computing net business income. Next it was assigned on a dollar-for-dollar basis to nonbusiness interest and dividend income. Any remaining interest was allowed as a deduction in computing net business income. The interest expense assigned to nonbusiness interest and dividends was allowed as a deduction in computing the income allocable to California if the nonbusiness items were allocable to California.

The United States Supreme Court held that the interest offset provision was unconstitutional in *Hunt-Wesson, Inc. v. Franchise Tax Board* (2000) 528 U.S. 458, 145 L.Ed.2nd 974. The court's analysis held that the assignment of interest expense to nonbusiness income on a dollar-for-dollar basis resulted in the taxation of extraterritorial income in violation of the Due Process Clause of the Fourteenth Amendment. As a result, section 24344(b) is no longer enforceable. The interest offset provision dealt with the assignment, or division, of a specific expense between items of business and nonbusiness income. Arguments were made to the court that the operation of the interest offset gave rise to discrimination. The court's analysis did not address these arguments though it did hold that the interest offset violated the Commerce Clause.

UDITPA, and the regulations adopted pursuant thereto, have a general rule for the assignment of expenses between business and nonbusiness income, Regulation section 25120(d) in California, section I.v.1(d) in the Multistate Tax Commission regulations. This regulation provides authority for the division of interest expense, along with all other expenses, between business and nonbusiness income. The regulation appears to provide for direct tracing to the extent possible with authorization for proration to the extent the expense is not directly traceable. The interest offset, because it dealt with a specific expense item, was considered to be controlling over the general regulation. With the invalidation of the interest offset, staff took the position that the general regulation would control the allocation of interest deductions.

The three-member Franchise Tax Board determined that the Supreme Court's decision only considered the assignment of interest expense with respect to nondomiciliary corporations. Since the court's decision did not consider the consequences of the assignment of interest expense for domiciliary corporations, the Franchise Tax Board determined that the section should still be applied to those corporations. Under the Franchise Tax Board's notice, the interest offset continues to operate unless a taxpayer asserts a claim that it is unconstitutional.

The trial court in the case of <u>American General Realty Investment Corp., Inc. v.</u> <u>Franchise Tax Board</u>, San Francisco Superior Court, 0620643, held that section 24344(b) applied prior to section 24425 in spite of the fact that section 24344(b) was found to be unconstitutional by the United States Supreme Court in <u>Hunt-Wesson, Inc. v. Franchise</u> <u>Tax Board</u> (2000) 528 U.S. 458, 145 L.Ed.2nd 974. Decisions of trial courts are not precedential in California and the Franchise Tax Board did not appeal the trial court decision.

8. <u>ELECTION TO FILE A SINGLE RETURN</u>

A group of corporations subject to combined report procedures may elect to file a single return. Effective for returns to be filed on or after January 8, 2005, the Franchise Tax Board adopted regulation 25106.5-11. This regulation describes the manner of making the election, who can make the election and the effects of making an election. Prior to that date, the ability to elect to file a single return was described in FTB Form 1061.

The election to file a single return is made by the key corporation by filing the California Form 100, Schedule R-7. This schedule should identify the name, California corporate number, federal employer identification number and total self-assessed liability of the taxpayer members of a combined group that are intended to be included in the election. (Reg. 25106.5-11(c).)

The election is an annual election. (Reg. § 25106.5-11(a).)

Pursuant to the regulation, the "key corporation" must be either the parent corporation of the combined group (see Reg. § 25106.5(b)(12)(A)(1)), or the taxpayer member with the largest California property factor numerator. The key corporation must be in good standing with the California Secretary of State and must not have a petition pending with the United States Bankruptcy court on the last day of the taxable year. (Reg. § 25106.5-11(b)(1).)

To be included in a single combined report taxpayer member, corporations must be a member of the combined report group, including the key corporation, and have the same taxable year as the key corporation or have a taxable year wholly within the key corporation's taxable year. (Reg. § 25106.5-11(b)(2).) Unless the election is terminated, payment will be made only by the parent or key corporation designated on Schedule R-7, and any subsequent adjustments will be billed or paid to that corporation. The key corporation is the agent for all taxpayer members and can execute waivers and extensions on behalf of all members. (Reg. § 25106.5-11(d).) If it is subsequently determined that an entity included as a taxpayer member should not have been included, the key corporation and the other members are deemed to have agreed that any adjustments may be billed to them. (Reg. § 25106.5-11(d)(7).)

An election to file a single return stays in effect until 30 days after the receipt by the Franchise Tax Board of a written notice of termination filed by any taxpayer member. A terminating member must notify the key corporation, and if the terminating member is the key corporation, it must notify all taxpayer members. (Reg. § 25106.5-11(e).)

However, if the key corporation does not make payment on behalf of a member or its unable to fulfill its obligations, each member may be separately billed. (Reg. § 25106.5-11(f).)

The question has arisen when an election has been made to file a single return as to who has the right to any refund. The question normally occurs when there has been some act of disaffiliation between the entities included in the single return in subsequent years. It can also arise if it is determined that the entities which filed as a unitary business are determined not to be a unitary business. In <u>Appeal of First Pacific Bank, et al.</u>, Cal. St. Bd. of Equal., Nov. 9, 1995, the Board of Equalization sustained the position of the Franchise Tax Board that an intrastate apportionment should be performed to assign the tax to the members of the unitary business. The rationale in support of this approach and the means of accomplishing it are set forth in Legal Ruling 95-2.

The Federal Deposit Insurance Corporation brought an action in federal court for a determination as to its right to the refund involved. The Federal District Court accepted the approach of the Franchise Tax Board and the State Board of Equalization.

9. <u>COMBINED REPORTS INCLUDING FOREIGN ACTIVITIES</u>

California Administrative Code Regulation section 25106.5-10 sets forth the rules for the preparation of a combined report, which includes foreign activities. This regulation was originally denominated section 25137(m) and later renumbered section 25137-6. It is significant for those combined report groups that do not make a water's-edge election. In general, it provides for the preparation of a combined report in the currency of the parent company with the final amount of income apportioned to California translated into dollars. It adopts the profit and loss method of determining income so that unrealized exchange rate gains or losses will not be taken into account. The regulation allows for the use of alternative data and estimates when the cost of obtaining the data normally used for California purposes is excessive. It requires that foreign accounting methods be adjusted to a United States GAAP method only when the adjustments are material and failure to make the adjustment will result in a reflection of income, which is not clear.

10. WATER'S-EDGE COMBINATION

a. General

Effective for income years beginning on or after January 1, 1998, California allows taxpayers to elect out of worldwide combined reporting and report on a water's-edge basis. Section 25110 et seq., Revenue and Taxation Code. This change was occasioned by the United States Supreme Court decision in <u>Container Corporation of America v. Franchise</u> <u>Tax Board</u> (1983) 463 U.S. 159, and pressures brought by the federal government in response to complaints by foreign governments. The water's-edge provisions are the product of a number of political compromises and are continuing to evolve over the years. In form, the election is made by a contract. There is a requirement that all members of the unitary business with a filing requirement make the election on their original return. This requirement and the contract form have given rise to a number of problems regarding whether an election has been made. Taxpayers and the Franchise Tax Board are still wrestling with these problems. (See § 25111, Rev. and Tax. Code, and the various regulations adopted pursuant thereto.)

The election itself requires a taxpayer to include a number of specific entities. It generally includes all entities includable in a federal consolidated return, foreign-incorporated entities doing more than 20 percent of their activities, as measured by the apportionment factors, tax advantage corporations such as Foreign Sales Corporations and entities with Subpart F income. One of the conditions of the election is the agreement that the dividends received from entities that have been excluded as a result of the election are business income. (Rev. and Tax. Code, § 25110(b)(2)(B).)

The election once made is binding for a number of years. The exact number has varied over the years. It is possible for a taxpayer to terminate an election early under certain circumstances, and it has always been possible to change an election at the end of the period. For most years, this decision to terminate should be made immediately after the election because the election rolls forward for the maximum period for each year.

Dividends received from foreign entities are entitled to a seventy-five percent deduction pursuant to Section 24411, Revenue and Taxation Code. This section may be susceptible to an attack that it discriminates against foreign dividends as compared to domestic dividends. The dividend deduction has the flavor of combination/factor relief to it that might support a defense to a claim of discrimination. An alternative, and perhaps more viable ground of defense, is the fact that the water's-edge treatment is elected by the taxpayer, and therefore the taxpayer may not be able to complain of "unconstitutional" consequences.

As originally enacted, the election also included an election "fee" (former § 25115, Rev. and Tax. Code). The fee was an additional tax or fee that was part of the cost of making a water'-edge election. The fee was based upon the taxpayer's California property, payroll and sales. The fee provisions have been repealed, and a water's-edge election can now be made without having to pay an annual fee.

For income years beginning on or after January 1, 2003, the water's-edge "contracts" have been transmogrified into an election. The change was made because "elections" are more commonly encountered in taxes than are contracts, and therefore there is a body of law dealing generally with elections that can be applied. The election is made for a seven-year period and continues thereafter on a year-by-year basis unless the taxpayer specifically elects out or elects out by conduct. If the election is changed, the taxpayer is prevented from electing water's-edge again for seven years. With permission of the Franchise Tax Board, and in the case of various types of acquisitions, elections can be changed prior to the expiration of seven years. The Franchise Tax Board adopted a regulation effective May 6, 2009 which defines some of the terms and gives examples of how the regulation operates.

b. Fujitsu

In *Fujitsu IT Holdings v. Franchise Tax Board* (2004) 120 Cal.App.4th 459, the court of appeals held that provisions of the Internal Revenue Code not incorporated into the Revenue and Taxation should nonetheless by used in computing the inclusion ratio for determining

what portion of a Controlled Foreign Corporation's income and factors should be included in the combined report. The income at issue was the dividends paid, or deemed to be paid, between Controlled Foreign Corporations. Those dividends qualify as Subpart F income under the Internal Revenue Code. California does not conform to Subpart F, so there are no such things as deemed dividends for California purposes. Specifically it stated:

"Dividends paid out of unitary income of lower-tier subsidiaries should be excluded from all the factors used in the computation of the amount included under RTC section 25110(a)(6): that is such dividends should be excluded from the numerator (Subpart F income), the denominator (earnings and profits) and the amount to which the inclusion ratio is applied (the income of the controlled foreign corporation)."

This decision is perplexing, at least in one particular aspect. The elimination of the dividends from earnings and profits is inconsistent with the determination of earnings and profits, which includes all income whether taxable or not. It also works as a disadvantage for taxpayers in that by decreasing the denominator of a fraction, one increases the percentage involved.

CHAPTER 10

COMMON ADMINISTRATIVE/PROCEDURAL ISSUES

1. **INTRODUCTION**

A comprehensive discussion of administrative and procedural matters involving FTB and the Corporation Tax Law is beyond the scope of these materials and this course. However, a general discussion follows of some of the most basic and common administrative and procedural issues. Different procedural rules may apply for taxpayer's electing to file under the water's-edge method, especially in the area of penalties. (See § 25110 et seq.)

2. ESTIMATED TAXES

Generally speaking, every bank and corporation subject to the franchise or income tax, unless exempt by law, must pay estimated tax. Estimated tax is generally due and payable in three installments due 30 percent on the 15th day of the 4th, 40% on the 15th day of the 6th month, and 30% on the fifteenth day of the 12th month of the income year. If the amount of estimated tax does not exceed the minimum tax, the entire minimum tax must be paid on the first installment (§ 19025). For commencing corporations, the prepayment of tax made to the Secretary of State under section 23221 at the time of incorporation or qualification is for the privilege of doing business during the corporation's first income year. It may not be claimed as an estimated tax payment, and may not be claimed as a credit against the tax liability shown on the return for the first year. (See FTB 1060, Guide for Corporations Starting Business in California, Attachment 3; see also Form 100-ES, Corporation Estimated Tax, and Instructions.)

3. <u>RETURN FILING REQUIREMENTS</u>

Generally speaking, the corporation franchise/income tax return (Form 100) is due by the 15th day of the third month after the close of the income year (§ 18601). For 1992 and subsequent years, corporate taxpayers may receive an automatic paperless extension to file a corporate return. The extension is granted seven months from the original due date of the return (§ 18604, FTB Notice 92-11, Oct. 23, 1992). Thus, for calendar year taxpayers, the return is due on March 15th, or October 15th under the automatic extension. The paperless extension does not extend the time for payment of tax, and the full amount of tax due must be paid by the original due date for the return using FTB Form 3539, Payment Voucher for Automatic Extension.

4. <u>INTEREST</u>

In general terms, some of the most common issues involving interest are as follows:

a. On Tax

Interest is charged on unpaid tax from the original due date of the return until the date of payment. An extension of time to file the return does not stop interest from accruing. (§ 19101 et seq.)

b. On Penalties

Interest is charged on the penalty for late payment of tax and the penalty for late filing of the return from the due date (including any extensions) until the date of payment. Interest is not charged on the monthly addition to the penalty for late payment. Interest on all other penalties is charged from the date of the notice until the date of payment (§ 19106).

c. Compounding

Interest is compounded daily beginning July 1, 1983, for all purposes except the computation of additions to tax arising from the underpayment of estimated tax (estimate penalty) (§§ 19101, 19142, 19521). Beginning July 1, 1989, the interest rate is determined semiannually (§ 19521). With one exception, the same interest rate is applied to deficiencies and refunds. Effective January 1, 1992, California law conforms to Internal Revenue Code section 6621(c), which provides for the additional 2 percent interest on underpayments by C Corporations when cumulative unpaid tax for any income year exceeds \$100,000. Underpayment amounts are subject to the additional 2 percent once the cumulative unpaid tax for any single income year exceeds \$100,000, and any notice of additional tax was not paid within 30 days. A notice sent prior to January 1, 1992, (§§ 19104 and 19521).

d. 10-Day Provision

If the amount owed is paid within 10 days after the date of the notice, no interest will be charged beyond the date on the notice (§ 19111).

e. Interest Suspension

Section 19116 generally provides for the suspension of interest in the case of individuals if they are notified of an adjustment to their return within 18 months of the due date of a return if they file on or before the due date. For taxpayers who participated in the Voluntary Compliance Initiative and attempted to take advantage of the interest suspension, the Board of Equalization ruled that participation in the Voluntary Compliance Initiative and exercise of the option not to contest the assessment constituted a contractual relationship that does not allow the taxpayer to take advantage of the waiver. This issue has been raised in several suits for refund.

The Board of Equalization held in the *Appeal of Du*, Cal. St. Bd. of Equal., decision on rehearing Feb. 26, 2008, that the 18 month interest suspension period did not apply to payments made under the Voluntary Compliance Initiative because the terms of agreement required the assessment of interest.

5. <u>PENALTIES</u>

There are a multitude of technical provisions dealing with penalties and exceptions. In general terms, some of the most common penalties are as follows.

a. Failure to File Timely Return

A corporation that fails to file a required return on or before the original or extended due date is assessed a penalty of 5 percent of the tax due for each month or fraction elapsing between the due date and the date the return is filed. However, the total penalty may not exceed 25 percent of the tax. If the failure to file is fraudulent, 15 percent and 75 percent are substituted for 5 percent and 25 percent, respectively. The penalty is imposed on the net amount due after any timely credits and payments. The penalty may be waived if it is shown that the failure to file the return is due to reasonable cause and not due to willful neglect (§ 19131).

b. Failure to Pay Total Tax By Due Date

A corporation that fails to pay the total tax shown on the return by the original due date, or fails to pay any amount in respect of any tax required to be shown on a return which is not so shown within 10 days of the date of notice and demand therefore, is assessed a penalty of 5 percent of the unpaid tax, plus 0.5 percent for each month or fraction thereof (not to exceed 40 months) the tax remains unpaid. The penalty may not exceed 25 percent of the total unpaid tax. The penalty may be waived if it is shown that such failure is due to reasonable cause and not due to willful neglect. If a corporation is subject to both the penalty for failure to file a timely return and the penalty for failure to pay total tax due by due date, a combination of the two penalties may be assessed, but the total may not exceed 25 percent of the unpaid tax (§19132).

c. Underpayment of Estimated Tax

A corporation that fails to pay, pays late, or underpays an installment of estimated tax is assessed a penalty, based upon a percentage of the underpayment for the underpayment period. Generally, an underpayment of estimated tax is the difference between the amount that would be due for each installment of estimated tax if the estimated tax were equal to 90 percent of the tax shown on the return, prorated to each installment, and the amount actually paid or credited on or before the due date of that installment. There are a number of exceptions to the penalty (see § 19142 et seq).

d. Failure to Furnish Information Upon Request

A corporation that fails to furnish any information requested in writing by FTB or fails or refuses to file a return after notice and demand by FTB, may be assessed a 25 percent penalty of the tax due as estimated by FTB or 25 percent of the deficiency assessed concerning the assessment for which the information was required. The penalty may be waived if it is shown that such failure is due to reasonable cause and not due to willful neglect (§ 19133).

The State Board of Equalization has evidenced a lack of patience with taxpayers who appear to be unwilling to supply information. In the <u>Appeal of BSR USA, Ltd., et al.</u>, Cal. St. Bd. of Equal., April 11, 1996, it stated:

"[A]ppellants' behavior betrays their true intentions. Their conduct during the audit indicates a pattern of delay and misdirection that we cannot condone. If the requested records and data were not available or were too costly to obtain, a reasonable person under similar circumstances would have so informed respondent; it was not reasonable for appellants to tell respondent that they had the requested material and that it would be delivered, and then to not only fail to deliver such material, but fail to even return respondent's telephone calls."

A similar comment was made in <u>Appeal of Pan American Foods, Inc.</u>, Cal. St. Bd. of Equal., Jan. 10, 1997 (unpublished).

e. Accuracy Related (Substantial Underpayment) Penalty

In 1990, Internal Revenue Code section 6662, relating to the accuracy-related penalty, which includes the penalty applied to the portion of any underpayment attributable to any substantial underpayment of tax, was added to the Revenue and Taxation Code (§ 19164). The Franchise Tax Board, by administrative announcement, has adopted procedures comparable to the federal procedures that allow waiver of all or part of the penalty when the taxpayer shows additional tax or makes an adequate disclosure on a qualified amended return. (See FTB Notice 92-9 (Sept. 18, 1992); see also FTB Notice 92-12 (Dec. 28, 1992).)

FTB Notice 2004-5 provides that for returns with a due date on or after October 15, 2004, this penalty may be assessed if a taxpayer files a return in a manner inconsistent with the standard allocation and apportionment rules without obtaining prior permission of the Franchise Tax Board. Prior approval will be deemed to exist if 1) the filing is consistent with a section 25137 variation permitted in an audit manual; 2) is the same variant permitted under the authority of section 25137 in a published State Board of Equalization decision; 3) has been approved in writing in a prior year petition that also specifically applies to the filing year; or 4) has been approved in a Closing Agreement for an earlier year that by its terms is applicable to the filing year. For years where the due date was prior to October 15, 2004, a statement on the return disclosing the filing method, or that the filing is made pursuant to 25137, will be adequate disclosure to avoid the penalty.

f. Large Corporation Income Tax Underpayment Penalty

Legislation enacted in 2008 imposes a penalty on corporations with an understatement of tax in excess of \$1,000,000 for taxable years beginning on or after January 1, 2003 for which the statute of limitations has not expired as of December 19, 2008. The penalty is equal to 20% of the understatement and is addition to any other penalties. The penalty does not arise if the understatement is the result of a change in the law that is enacted, promulgated, issued or becomes final after the earlier of the date the taxpayer files the return of the extended due date of the return. Taxpayers were given until May 31, 2009 to file

amended returns for earlier years to avoid the penalty. The California Taxpayer's Association has filed a lawsuit challenging the penalty. The trial court has held that the plaintiff did not have standing to bring the suit. An appeal has been filed with the Third District, case No. C062791.

g. Penalty for Failure to Maintain Records

In 1993, effective for income years beginning on or after January 1, 1994, Section 19141.6 was added to the Revenue and Taxation Code. It provides penalties for failure to maintain records which are relevant to the determination of the unitary business of which the taxpayer may be a part, the apportionment formula for the unitary business, the classification of any items of income as business or nonbusiness, and for the attribution of income between United States and non-United States sources. "Maintain" is generally used in the sense of preserving that which is already created and not in the sense of requiring the creation of records which are not otherwise compiled by the taxpayer or related entities.

The penalty is in the amount of \$10,000 for a violation. If the violation is not corrected, additional penalties in the amount of \$10,000 a month begin accruing after the passage of 90 days of the taxpayer being notified of its failure to maintain records. In addition, in certain circumstances the FTB is authorized to re-determine any item included in the four subject areas in its discretion.

The penalty is based upon Internal Revenue Code section 6038A. It differs from the federal penalty in that it addresses more issues, applies to all apportioning taxpayers not just those owned by foreign interests, and has no specific information-filing requirement.

An element of the statute which is not always recognized is that the Franchise Tax Board is authorized in its sole discretion to re-determine various items if the taxpayer is unable to produce records. This can be a draconian penalty.

Regulations implementing the statute were adopted in March of 1996.

h. Electronic Funds Transfers

Corporate taxpayers who are required to make an estimate payment of more than \$50,000 or whose total tax liability exceeds \$200,000 in any income year are required to make payment by means of electronic funds transfers. Failure to do so gives rise to a penalty of 10 percent of the amount paid, subject to a reasonable cause exception (§ 19011(c)).

i. Information About Foreign-Owned Corporations

Section 19141.2 of the Revenue and Taxation Code requires taxpayers to file copies of the information required to be filed with the Internal Revenue Service by Section 6038A of the Internal Revenue Code. If the information is not filed, the taxpayer is subject to penalties at lesser amounts than provided for in the Internal Revenue Code (\$1,000 rather than \$10,000 and \$24,000 rather than \$50,000 as provided for in section 6038(b)(2) of the Internal Revenue Code). No penalty is to be assessed if the taxpayer corrects a failure to file the

information with their original return on their own initiative or within 90 days of notification by the Board of the requirements of filing (\S 19141.2(c)(2)(A)).

j. Redetermination of Income

When taxpayers do not provide sufficient information so that a return can be prepared, the tax agency is authorized to determine income on the basis of the best available information. The State Board of Equalization, in one case, sustained an assessment made on the basis of a rival company's published financial data. The Board of Equalization stated:

"In presenting its case on appeal, appellant must produce some credible and competent evidence in support of its contentions. [Citations omitted.] Further, the failure to produce evidence within the taxpayer's control gives rise to a presumption that such evidence is unfavorable to the taxpayer. [Citations omitted.] Legal arguments without factual support will not be sufficient to overcome the presumed correctness of respondent's determination on appeal ...

"[a]ppellant has stated that respondent's estimate was incorrect and implied that its data and methodology were imperfect, but [it] has not sustained [its] burden of proof by demonstrating that the amount of the estimate was incorrect and that some other amount was correct."

<u>Appeal of Pan American Foods, Inc</u>., Cal. St. Bd. of Equal., Jan. 10, 1997 (unpublished).

k. Amnesty Related Penalty

California enacted an amnesty period that ended March 31, 2005. As part of the enactment, the Legislature provided that any amounts unpaid for tax years ending on or before December 31, 2002, would be subject to a penalty equal to fifty percent (50%) of the amount of interest on the unpaid tax and penalties as of March 31, 2005. (Section 19177.5.) The penalty applies even to amounts which are not proposed to be assessed as of March 31, 2005. There are no exceptions to this penalty and no rights of appeal. The penalty is billed as if it were a mathematical error once the tax for the period is finally determined. The penalty applies whether a proposed assessment had been made or not and regardless of whether an audit was underway.

Many corporate taxpayers made payments to be held in suspense for issues that were being contested and for audit adjustments that might be made either as a result of a state audit or a federal audit. Taxpayers can ask for the amounts to be returned at any time. But once returned they then become subject to the penalty if it is subsequently determined that they owe additional tax for any of the years before 2003.

There were several cases raising questions about the amnesty penalty but they have been resolved without reaching the amnesty penalty issues.

I. Non-economic Substance Penalty

California enacted a non-economic substance penalty equal to forty percent (40%) of the amount of the understatement arising from a filing position that was not based upon economic substance, generally transactions listed as abusive tax shelters. The penalty may be waived, all or in part, by the Chief Counsel of the Franchise Tax Board. The taxpayer can defend against the penalty by showing that the transaction had economic substance. Taxpayers who took advantage of a Voluntary Compliance Initiative offered by the Franchise Tax Board, and paying the amount of additional tax while forsaking the right to contest the additional assessment, had the penalty waived.

m. Abusive Shelter Promoter Penalty

Section 19177 assesses a penalty equal to fifty percent (50%) of the gross income derived from the activity of the promoter of abusive tax shelters. The penalty can be contested through a suit for refund after payment of at least fifteen percent (15%) of the penalty. In *Franchise Tax Board v. Superior Court of San Francisco County (Quellos Group LLC)* a California appellate court held that the fifty percent penalty could not be applied retroactively. The penalty on the promoter was limited to two thousand dollars (\$2,000).

n. DISA Penalty

Failure to file FTB Form 3726 which discloses the amount of DISA may result in the immediate acceleration of all of the deferred amounts. See FTB Notice 2009-01 and 2009-05.

o. Suspension of Professional Licenses

Every six months the Franchise Tax Board and the Board of Equalization are required to published a list of the 500 taxpayers that have the greatest unpaid final tax liabilities in excess of \$100,000. Business and Professions Code Section 494.5 requires licensing agencies to suspend professional and driver's licenses of individuals whose names appear on these lists. Actions have been filed challenging such suspensions. A California trial court sustained the state's demurrer to a complaint. (*Berjikian v. Franchise Tax Board*, Los Angeles Superior Court BC 514589). The second appellate district in an unpublished opinion reversed (B 252427) finding that the lawsuit was not barred by Article 32 of the California Constitution which only allows a challenge to a state tax after payment of the tax, that the plaintiffs had been denied procedural Due Process because of an inadequate right to a hearing but upholding the trial court's dismissal of substantive Due Process and Equal Protection claims. Federal court actions have been filed (*Berjikian v. Franchise Tax Board*, U.S. District Court Central District of California 2:13-CV-06301-DDP; *Franceschi v. Chiang*, United States District Court 2:14-CV-01960-CAS (SHX), Ninth Circuit 14-56493) and *Deorio v. Yee*, U.S. District Court 2:15-CV-4793-RGK9RAO).

6. <u>STATUTES OF LIMITATIONS</u>

There are a multitude of technical provisions concerning statutes of limitations for tax deficiencies and claims for refund. In general, some of the most common statutes of limitation are as follows:

a. General Statute for Deficiencies

Except in the case of a fraudulent return, a notice of tax deficiency is timely if mailed to the taxpayer within four years after the return was filed, or four years after the last day for filing (including extensions), whichever is later. (§ 19057.)

b. General Statute for Claims for Refund

Prior to Legislation in 1992, a claim for refund could be filed within four years of the due date for filing the return (including extensions), or within one year from the date of overpayment, whichever occurs later. (Former section 26073.) This section was amended in 1992 (Stats. 1992, ch. 1295) to provide, <u>effective January 1, 1993</u>, that claims for refund must be filed within four years from the due date of the return <u>without</u> regard to extensions, or one year from the date of overpayment, whichever occurs later. (Section 19306.) (See FTB Notice 93-1 (Feb. 1, 1993); FTB Notice 93-2 (Feb. 23, 1993); FTB Notice 93-3 (Mar. 10, 1993).

c. Extension for Deficiency by Federal Waiver

Where a federal waiver is in effect, a deficiency is timely if mailed within six months after the date of the expiration of the federal waiver. (§ 19065.)

d. Extension for Claim for Refund by Federal Waiver

Where a federal waiver is in effect, a claim for refund is timely if filed within the time FTB may issue a deficiency, i.e., six months after the date of the expiration of the federal waiver. (§ 19308.)

e. Extension for Deficiency Where Federal Change Reported

For federal determinations prior to 1/1/93, where a taxpayer reports (by notice or amended return) to FTB a federal adjustment within 90 days after the final federal determination of adjustment, a deficiency notice "resulting from such adjustment" is timely if mailed to the taxpayer within six months from the date the adjustment is reported to FTB. (§ 19059.)

For federal determinations on or after 1/1/93, the 90-day notification period is increased to six months and the assessment period is extended from six months to two years.

f. Extension for Claim for Refund Where Federal Change Reported

For federal determinations prior to 1/1/93, where a taxpayer is required to report to FTB a federal adjustment and does timely report such adjustment, a claim for refund "resulting from the adjustment" may be filed within six months from the date the adjustment is reported to FTB (§ 19311).

For federal determinations on or after 1/1/93, there is no reporting requirement, and a claim may be filed within two years of the final federal determination.

g. Extension for Deficiency Where Federal Change Not Reported

For federal determinations prior to 1/1/93, where a taxpayer is required to report to FTB a federal adjustment and does not timely (i.e., 90 days) report such adjustment or file an amended return, a notice of deficiency "resulting from such adjustment" is timely if mailed to the taxpayer within four years after the adjustment is reported to or filed with the federal government. (§ 19060.) For final federal determinations after 1/1/93, if taxpayer properly reports the federal changes, the deficiency must be assessed within two years. If the taxpayer reports the changes after the six-month notification period, FTB has four years from the date reported. If taxpayer fails to report, FTB has an unlimited time.

h. <u>Ordlock v. Franchise Tax Board</u> (2006)

The California Supreme Court, in <u>Ordlock v. Franchise Tax Board</u> (2006) 38Cal.4th 897, held that the general four-year statute of limitations provided for in section 19057 remains open as a result of sections 19059 and 19060, which provide special limitation periods when the Internal Revenue Service makes changes to the taxpayers federal tax liability. It found that the provision of section 18622, which does not require the taxpayer to report a federal change if there is no California consequence, did not provide an exception to the rules of sections 19059 and 19060. The lower appellate court had held that section 18622 provide such an exception because under the normal four-year statute, no assessment could be made for federal changes after that period, and therefore, there would be no California consequence. The Supreme Court found that the phrase "except as otherwise expressly provided in this part" included sections 19059 and 19060 in section 19057. The California Supreme Court's decision is consistent with long-standing FTB practice and numerous decisions of the California State Board of Equalization.

i. Time for Deficiency Where Fraud or No Return Filed

Where a taxpayer fails or neglects to file a return, or files a false or fraudulent return with the intent to evade tax, FTB may require a return at any time (§ 19087).

7. <u>AUDIT REGULATION</u>

Regulation 19032 was adopted in 2002 and provides rules regarding the conduct of Franchise Tax Board audits. In general audits are to be completed within two years. Taxpayers should be aware that the audit staff is more likely to assert penalties for failure to provide information to assist in the timely completion of audits.

8. <u>PROTESTS TO FTB</u>

Within 60 days after the mailing by FTB of a notice of proposed additional tax, a taxpayer may file with FTB a written protest against the proposed additional tax, "specifying in the protest the grounds upon which it is based" (§ 19041). If a protest is filed, FTB will reconsider the proposed assessment, and <u>if</u> the taxpayer has so requested in the protest, will

grant the taxpayer or its authorized representative an oral hearing. FTB may act on the protest in whole or in part (§ 19044). FTB's action upon the protest is final, whether in whole or in part, 30 days from the date it mails notice of its action to the taxpayer, unless within 30 days the taxpayer appeals in writing to the Board of Equalization (§ 19045).

Any protest hearing shall be held at a reasonable time at a FTB office that is convenient to the taxpayer, when possible. The hearing may be recorded only if prior notice is given to the taxpayer, and the taxpayer is entitled to receive a copy of the recording. The taxpayer must be informed prior to any hearing that he or she has a right to have present at the hearing his or her attorney, accountant, or other designated agent (§ 21011).

If no protest is filed, the amount of additional tax specified in FTB's notice becomes final 60 days after mailing by FTB (§ 19042).

If with or after filing a protest with FTB or an appeal with the Board of Equalization, a taxpayer pays the tax protested before FTB acts upon the protest or before the Board of Equalization acts on the appeal, the protest or appeal is converted as a matter of law to a claim for refund or to an appeal from the denial of a claim for refund (§ 19335).

The Franchise Tax Board is continuing to try to accelerate the resolution of protests assigned to its Legal Department. FTB Notice 2006-6 proposes that protests assigned to Legal will be categorized upon receipt as either 12-month, 18-month or 24-month protests, with a goal of completing them in that time frame. The Notice continues and describes processing goals and reasons for deferral. It is too early to tell what impact these procedures will have on resolving protests.

9. <u>APPEALS TO THE BOARD OF EQUALIZATION</u>

a. General

A taxpayer may appeal to the Board of Equalization the denial by FTB of its protest within 30 days of the date FTB mails its notice of action. The appeal must be in writing. (§ 19045.) Two copies of the appeal and two copies of any supporting documents shall be addressed and mailed to the Board of Equalization in Sacramento (§ 19046).

A taxpayer may also appeal to the Board of Equalization the denial by FTB of its claim for refund within 90 days of the date FTB mails its notice disallowing the claim. (Section 19324.) If FTB fails to mail notice of action on a refund claim within six months after the claim is filed, the taxpayer may, prior to mailing of notice of action on the refund claim, consider the claim disallowed and appeal to the Board of Equalization (§ 19331). The appeal must be in writing (§ 19324).

b. Finality of Decision

The decision of the Board of Equalization on an appeal of FTB's denial of either a protest or a claim for refund becomes final upon the expiration of 30 days from the time of the decision, unless the taxpayer or the FTB files a petition for rehearing. If a petition for

rehearing has been filed, the decision shall not become final until 30 days from the date the Board of Equalization issues its opinion on the petition for rehearing (§§ 19048, 19334).

c. Regulations regarding appeals

The Board of Equalization has issued regulations (18 Cal. Code Regs., § 5021 et seq.) that set forth rules governing appeals from actions of the FTB. The rules address the manner of filing the appeal, timeliness, form, supplementation of the appeal, memoranda to be filed, supplemental memoranda, stipulation of facts, voluntary dismissal, deferrals, oral hearing and waiver, notice of hearing, time and place of hearing, hearing procedure, evidence, burden of proof and decisions and rehearings.

d. Types of Decisions

The SBE in recent years has been issuing significant numbers of summary decisions and virtually no precedential published decisions. While a summary decision resolves the issue in dispute as between the taxpayer and the FTB, the SBE has declared that such summary decisions are not citable authority and may not be relied upon or given any consideration as precedent. (*Appeal of Charles W. Fowlks*, Cal. St. Bd. of Equal., Opinion on Petition for Rehearing, Oct. 31, 1989.)

In 2012 the Legislature adopted Section 40 Revenue and Taxation Code which requires that in matters where the amount in controversy is \$500,000 the decisions must be published. The decisions are to include 1) findings of fact; 2) legal issues presented; 3) applicable law; 4) analysis; 5) disposition; and 6) names of adopting Board members. The statute applies to written formal opinions, written memorandum opinions, and written summary decisions. Consent items do not require published decisions. Formal opinions and memorandum opinions are precedential. Dissenting or concurring opinions may be submitted by any Board member. Interested Party Meetings are been held prior to adopting regulations to implement the statute.

e. Exhaustion of Administrative Remedies

The State Board of Equalization has been attempting to accelerate the consideration of appeals, and this influence is being felt in attempts to accelerate the consideration of protests. As a consequence of this effort, cases are being presented to the Board of Equalization that, from the perspective of the Franchise Tax Board, have not been fully developed because of lack of cooperation on the part of the taxpayer. This has given rise to a greater contentiousness with respect to the taxpayer's duty to supply information in response to questions. In the *Appeal of Allied Signal, Inc. as Successor-in-Interest to Allied Corporation*, Cal. St. Bd. of Equal., decided Feb. 24, 2000 (unpublished), the following comments were offered:

"Before discussing the merits of the instant appeal, we must comment on the procedural background for this case. During the audit phase, appellant allowed respondent to review its business records, but did not allow respondent to make copies of those records. Thereafter, appellant protested respondent's audit

determination and appealed that determination to this Board. Just prior to the appeal, respondent formally asked appellant to produce substantial documentary evidence. Appellant refused to comply with that request, and as a result, left respondent in a very tenuous position with regard to representing the interests of the State before this Board. Appellant relented in its position only after we asked for the same or similar evidence.

"Both parties are cautioned to avoid this situation in the future. First, it appears that respondent could have more fully utilized the procedural devices at its disposal to obtain the necessary evidence at the earliest possible date. The matter is now more than fifteen years old, and no doubt the best evidence could have been secured at an earlier time. Further, it appears very clear from the record that appellant deliberately thwarted respondent's efforts to obtain evidence necessary to properly resolve this appeal. While respondent's inaction may favorably be attributed to its efforts to accommodate appellant, appellant's position is much more puzzling as it has everything to lose by failing to provide evidence for consideration by this Board. Respondent's determination is presumed correct, and appellant carries the burden of proof. (Appeal of John Deere Plow Company of Moline, Cal. St. Bd. of Equal., Dec. 13, 1961.) The failure to provide evidence within appellant's control gives rise to a presumption that such evidence is unfavorable to the taxpayer. (Appeal of Don A. Cookston, Cal. St. Bd. of Equal., Jan. 3, 1983.) In extreme cases, the failure to cooperate with respondent may give rise to a jurisdictional question due to appellant's failure to exhaust administrative remedies." (United States Steel Corp. v. Franchise Tax Board (1983) 144 Cal.App.3d 473; Barnes v. State Board of *Equalization* (1981) 118 Cal.App.3d 994.)

The Board of Equalization has not had an occasion to consider a similar situation, however, taxpayers might be well advised to consider this warning in responding to the Franchise Tax Board and should not be surprised to see the Franchise Tax Board become more aggressive in the assessment of penalties or the use of subpoenas.

f. Ability to Maintain an Appeal

A qualified corporation has the right to maintain an appeal. A corporation that has been suspended, section 23301 et seq., cannot maintain an appeal. <u>Appeal of Al Tirpa & Associates, Inc.</u> Cal. St. Bd. of Equal., Feb. 26, 1997. A corporation that has never qualified in California may appeal a determination that it was doing business in California. However, if it is determined that the corporation was doing intrastate business, the appeal will be dismissed. <u>Appeal of Reitman Atlantic Corporation</u>, Cal. St. Bd. of Equal., 2001.

10. <u>SUITS FOR REFUND</u>

After payment of the tax and denial by FTB of a claim for refund, or after an appeal to the Board of Equalization and denial of the appeal by the Board of Equalization, a taxpayer may file suit for refund against FTB "upon the grounds set forth in its claim for refund." (Section 19382.) Filing such a claim is a jurisdictional prerequisite to bringing a suit for refund. See

Shiseido Cosmetics (America) Ltd. v. *Franchise Tax Bd.* (1991) 235 Cal.App.3d 478. For a discussion of the degree of specificity required in setting forth the grounds in the claim, see *Barclays Bank International, Ltd.* v. *Franchise Tax Board* (1992) 10 Cal.App.4th 1742, 1750.

The California Supreme Court, in <u>Agnew v. California State Board of Equalization</u> (1999) 55 Cal.App.4th 1479, decided that the right to bring a suit for refund only required the payment of the tax assessed and did not require that the interest associated with the assessment be paid. The decision does not directly address the question of whether a penalty also needs to be paid, though it suggests that the penalty need not be paid to challenge the validity of the tax. If the taxpayer wishes to challenge the validity of the penalty, a different result might be reached.

Subsequent to the decision in *Agnew*, section 19101(c) of the Revenue and Taxation Code was amended to include interest within the definition of tax. Part of the analysis in *Agnew* pointed out that interest had been defined separately from tax by the Legislature, and that if the Legislature wanted to include it in the definition, they could have done so. The Legislature has not done so and it is questionable whether *Agnew* continues to have any vitality for purposes of the Corporation Tax Law or the Personal Income Tax Law. The Franchise Tax Board's attempt to raise this full payment defense was rejected in *Milhous v*. *Franchise Tax Board* (2005) 131 Cal App.4th 1260, where it was raised for the first time on appeal. The Court of Appeal viewed the full payment rule as a jurisdictional defense that was waived when it was not asserted in a timely manner.

This question was raised by demurrer by the Franchise Tax Board in *Rohr, Inc. v. Franchise Tax Board*. The trial court refused to sustain the Franchise Tax Board's demurrer. The Franchise Tax Board filed an extraordinary writ which was denied without an opinion. The issues in the case, business income and unity, were then tried with a decision for the taxpayer. The Franchise Tax Board has filed an appeal, Fourth Appellate District No. D052309, and has raised the full-payment issue because there has been no consideration by the appellate courts. The case was dismissed by agreement of the parties on appeal.

The *Agnew* decision also gives rise to several interesting questions regarding partial payments of tax pursuant to installment agreements in that several statute of limitation provisions are related to the payment of the tax and the dates of payment. The Franchise Tax Board issued FTB Notice 2003-5, which explains how section 19322.1 will be applied and provides some guidance in this area.

If FTB fails to act on a taxpayer's claim for refund within six months after the claim was filed, the taxpayer may treat the claim as disallowed and bring an action against FTB on the grounds set forth in the claim for refund. (Section 19385.)

The taxpayer may file a suit for refund within any of the following time periods:

- (1) Four years from the last date prescribed for filing the return;
- (2) One year from the date the tax was paid; or

(3) Ninety days after a notice of action by FTB upon a claim for refund, or after notice of action by SBE on an appeal. (Section 19384.)

The suit may be filed in any county of California in which the Attorney General maintains an office. (Section 19388.) The Attorney General or counsel for the FTB will defend the action. (Section 19389.)

In <u>Geneva Towers v. City and County of San Francisco</u> (2003) 29 Cal.4th 769, the California Supreme Court held that the deemed denial sections do not require that the taxpayer take action with respect to filing a lawsuit. In this case, the City of San Francisco had successfully argued before the appellate court that the 6-month deemed-denial option given the taxpayer gives rise to a cause of action. Under the general statute of limitations found in the Code of Civil Procedure, an action must be brought within 4 years of the date of its accrual if another period is not provided. The California Supreme Court reversed the finding that the deemed denial section was permissive with the taxpayer and that until the taxing body acted, the taxpayer was not required to file a suit for refund to avoid a statute of limitations problem.

Historically taxpayers have not been able to obtain a jury trial in tax matters in California. In <u>Gonzales v. Franchise Tax Board</u>, Cal. Sup. Ct. S176943, the California Supreme Court reversed the trial court and appellate court determination that a jury trial could be had. The issue turned on whether a jury trial in tax refund matters was allowed at the time the California Constitution was adopted.

11. <u>TAXPAYER'S BILL OF RIGHTS</u>

In 1988, the Katz-Harris Taxpayers' Bill of Rights was enacted, commencing at section 21001 of the Code. Some of its major provisions are:

(1) If a taxpayer's failure to make a timely return or payment is due to the taxpayer's reasonable reliance on written advice from FTB, the taxpayer may be relieved of the taxes assessed or any interest, additions to tax, and penalties added thereto, as provided in a series of detailed provisions in Section 21012.

(2) A taxpayer may be entitled to reimbursement for any reasonable fees and expenses related to a hearing before the Board of Equalization if the conditions set forth in section 21013 are satisfied.

12. <u>RECOVERY OF LITIGATION COSTS</u>

In addition to the recovery of costs for proceedings before the State Board of Equalization, a taxpayer can also recover litigation costs in any civil proceeding brought in the judicial system. Section 19717 Rev. & Tax. Code. In order to be eligible to recover costs under this section, a taxpayer must have exhausted all administrative remedies available to it including an appeal to the Board of Equalization. Section 19717(b). To be awarded costs, the party must have been the prevailing party either with respect to the amount at issue or with respect to the most significant issue. Section 19717(c)(2)(A). In addition, the court must

determine that the department has not established that its position is substantially justified. Section 19717(c)(2)(B).

Traditionally, taxpayers had not sought litigation costs in suits for refund. However, beginning in 2004 litigation costs, in some cases in excess of \$1 million, have been awarded in a number of cases. The statute provides that the attorney's fees shall not be in excess of \$125 per hour, adjusted for inflation, unless there is a finding that there is a limited availability of counsel with appropriate expertise. Section 19717(c)(1)(B)(iii). In most of the cases, the courts allowed recovery of fees greatly in excess of the statutory rate.

California's tax agencies were of the belief that the Revenue and Taxation Code sections were the exclusive remedies available by which taxpayers could recover litigation costs. In the case of <u>Agnew v. State Board of Equalization</u> (2005) 55 Cal.App.4th 1479, the court of appeal held that litigation costs could be recovered under the general Civil Code provisions, sections 1032(b) and 998.

There have been two trial court cases where attorneys' fees and costs have been awarded under section 1021.5 of the Civil Code, otherwise known as the "private attorney general doctrine. The section allows the awarding of attorneys' fees and costs in cases where a private litigant functions in a capacity similar to what an Attorney General might do in challenging a statute where it might not be economical for an individual litigant to bring an action, but where a large number of individuals will benefit so that the collective benefit is great.

In *Northwest Energetic Services, LLC v. Franchise Tax Board* (2008) 159 Cal.App.4th 841, the taxpayer, who had no activity in California, challenged the LLC fee. For six years the total fees involved were \$31,867. The attorney for the fee payer estimated its normal fees for prosecuting the case as being in excess of \$200,000. The outcome of the case may affect the payment of fees that currently total over \$300 million a year and may involve over \$1.2 billion with respect to prior years. The attorneys requested fees of \$5 million and were awarded \$3.5 million. The Court of Appeal rejected the argument of the Franchise Tax Board that section 19717 Revenue and Taxation Code was the exclusive remedy for attorneys' fees and costs for matters involving the Personal Income Tax and Corporation Tax. The Court of Appeal did find that the trial court's award was not properly justified and remanded the case for a determination of the proper fee based on a multiple of the "lodestar" (normal billings). The Court of Appeal also strongly suggested that only a minimal multiplier should be applied.

The same attorneys also brought suit in <u>Ventas Finance I, LLC v. Franchise Tax Board</u>, Court of Appeal, First District, No. A116277, also involving the question of the constitutionality of the LLC fee in a slightly different circumstance. They obtained a trial court judgment on the merits and filed a request for attorneys' fees and costs of \$30 million even though they spent less time on that case than *Northwest*. The trial judge awarded attorneys' fees equal to 1.5 times the lodestar amount or approximately \$225,000. On appeal the costs were increased to over \$400,000.

The Legislature is currently considering legislation which would provide specific limits on attorney's fees in tax litigation.

13. <u>SETTLEMENTS PURSUANT TO AB 887</u>

In August of 1992, legislation was passed authorizing the Franchise Tax Board to settle matters in controversy at the administrative level. Previously, the Franchise Tax Board was only authorized to settle cases in litigation through the auspices of the Attorney General's Office. The Settlement Bureau is staffed by experienced attorney and audit personnel. All settlements must be approved by the Chief Counsel, the Attorney General's Office, and, finally, not disapproved by the Franchise Tax Board within a specified time period. Particulars of the settlement are made a matter of public record. The records may be reviewed in the office of the Executive Officer of the Board.

The Franchise Tax Board has interpreted the phrase "civil tax matter disputes" as meaning disagreements represented by the issuance of Notices of Proposed Assessment and extending through protests, appeals to the State Board of Equalization and claims for refund that have not been acted upon.

As originally enacted, this settlement authority only applied to matters in dispute as of July 1, 1992. The authority to settle has subsequently been extended to matters in controversy as of January 1, 1994. The settlement must be submitted to the Attorney General's Office for their review no later than June 30, 1994. Legislation is pending which would make the authority to settle permanent.

It is recommended that serious consideration be given to the use of the settlement authority in all matters. There is no downside to attempting to settle and the Board is authorized to compromise matters based on risks of litigation.

14. <u>ALTERNATIVE DISPUTE RESOLUTION</u>

The Multistate Tax Commission has instituted an alternative dispute resolution process that allows a taxpayer, with the consent of the affected states, to arbitrate or mediate a situation where there is inconsistent treatment of an item by several states. The states are not required to participate in this process but many states have evidenced a willingness to participate. If the underlying statutes of the states differ, it may not be possible to resolve matters. However, if the statutes were generally similar, it would appear that a mediation or arbitration would be successful. It does not appear that there have been many actual proceedings under the MTC procedures. This may be because the states, once their attention is drawn to the conflict, have been able to resolve the issues between themselves to the satisfaction of the taxpayer without having to take recourse to a third party.

There is much to be said in favor of using this procedure. First, it provides the only forum where a taxpayer can bring more than one state to the table. Lawsuits are state specific and involve only a single state at a time. Second, the cost is minimal and is shared equally by the taxpayer and the states. Third, it has been effective in having issues addressed and resolved even if not directly under the auspices of the program.

One caveat is appropriate. A taxpayer needs to be careful to preserve its ability to proceed in each of the states involved. If the statute of limitations is closed with respect to one of the states involved, it is very unlikely that it will be able to participate in the process and provide the taxpayer any relief.

15. <u>SECTION 25137 PETITIONS</u>

When a taxpayer believes that the standard allocation and apportionment provisions do not fairly represent its activities within California, it may seek a variance from the standard methods. The petition is to be filed with the Franchise Tax Board. The power to grant variances lies with the Franchise Tax Board and the determination with respect to the relief to be granted lies in the discretion of the Franchise Tax Board. The Franchise Tax Board has indicated a willingness to assert a failure to exhaust administrative remedies defense if a taxpayer does not petition for relief if it attempts to assert an unfair apportionment argument.

It is the position of the staff of the Franchise Tax Board that the review of its actions under the authority of section 25137 is subject to the "arbitrary or capricious" standard. Neither the Board of Equalization nor the courts have indicated whether they agree with the position of the Franchise Tax Board on this issue.

The staff of the Franchise Tax Board takes the position that invocation of section 25137 is a two-step process. The first step is to establish that the standard formula does not fairly reflect the extent of the business activity in the state. The California Supreme Court in *Microsoft Corporation v. Franchise Tax Boar* (2006) 39 Cal.4th 750, held that the burden of proof by clear and convincing evidence was on the party seeking to invoke section 25137. The second step, once the first step has been met, is to determine the nature of the relief to be given. While the California Supreme Court in *Microsoft* held that the reasonableness of the alternative must also be shown by clear and convincing evidence by the party seeking variance, it subsequently held that it must defer to the judgment of the Franchise Tax Board.

In a Superior Court decision in *Montgomery Ward LLC v. Franchise Tax Board*, San Diego Superior Court GIC802767, the trial judge, in a case involving treasury activity, found that the relief proposed by the Franchise Tax Board of including only income and net gains was unreasonable when the treasury activity produced 14% of the company's income and including all proceeds would have only accounted for 28% of the company's activities. This decision is not precedential and the Franchise Tax Board did not file an appeal.

Procedurally, a petition under section 25137 can be filed at any time the taxpayer and the year remain under the jurisdiction of the Franchise Tax Board. Whether a Section 25137 Petition can be raised for the first time before the Board of Equalization or in the courts has not been ruled upon in either forum. The language of the statute requiring a petition to the Franchise Tax Board provides the basis for arguing that this is a jurisdictional prerequisite, and the failure to do so appears to provide the basis for an argument that the taxpayer has not exhausted administrative remedies.

The three-member Franchise Tax Board will hold hearings on petitions filed pursuant to section 25137. The current regulation allows a taxpayer to request a hearing, Regulation section 25137(d). The Franchise Tax Board has adopted a resolution to grant a hearing whenever the taxpayer and the staff do not agree on the action to be taken with respect to a petition. The granting of a hearing is conditioned upon the execution of a waiver of confidentiality with the hearing held in open session. Materials submitted to the three-member Franchise Tax Board for open session consideration can be obtained upon request. The decisions of the three-member Franchise Tax Board are not reported and are not precedential, but they may provide guidance as to how a petition might be received by the Board. It should be kept in mind, however, that the membership of the Board of Equalization.
