

## California Franchise Tax Developments—Fall 2008

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### I. Deductibility of Dividends/Expense Attribution

A. *Farmer Bros. v. FTB*, 108 Cal. App. 4<sup>th</sup> 976 (2003), cert. denied, 540 U.S. 1178 (2004)

1. California Court of Appeal held California Revenue and Taxation Code (RTC) § 24402 unconstitutional under the Commerce Clause. RTC § 24402 allows a dividends received deduction for dividends from noninsurance companies. Similar to RTC § 24410, which was previously held to be unconstitutional in *Ceridian*, the deduction under RTC § 24402 is limited by the payor's presence in California as determined by its apportionment factors. The Court held that such a limitation violated the Commerce Clause.
2. A full dividends received deduction was allowed by the Court subject to the ownership limitations contained in RTC § 24402(b).
3. California Supreme Court denied review. The United States Supreme Court denied the Franchise Tax Board's (FTB) petition for a writ of certiorari on February 23, 2004.
4. FTB Policy Regarding Post-*Farmer Bros.*
  - a. For years ended prior to December 1, 1999, taxpayers will be allowed a full dividends received deduction subject to the ownership limitations contained in RTC § 24402(b). The expense attribution provisions of RTC § 24425 will be applied.
    - (1) For water's edge taxpayers, a full dividends received deduction will be allowed under RTC § 24402 rather than a 75 percent deduction under RTC § 24411. Further, no foreign

investment interest offset will be applied. Rather, the expense attribution provisions of RTC § 24425 will be applied.

- b. For years ending on or after December 1, 1999, no deduction will be allowed under RTC § 24402. The FTB will attempt to identify all taxpayers who have claimed a deduction under RTC § 24402 and will disallow that deduction.
  - (1) For water's edge taxpayers, the 75 percent dividends received deduction will be allowed.
  - (2) In a non-precedential summary decision, *River Garden Retirement Home*, SBE Case No. 297405 (September 12, 2006), the State Board of Equalization (SBE) agreed with the FTB and ruled that no deductions were allowable to the taxpayer under RTC § 24402 for the 1999 and 2000 taxable years.
    - (a) On October 2, 2007, the taxpayer filed suit for refund in the San Francisco Superior Court (No. CGC-07-467783).
    - (b) On February 8, 2008, the trial court sustained the FTB's demurrer without leave to amend on the ground that the plaintiff failed to state a cause of action.
  - (3) *Abbott Laboratories, et al. v. FTB*, Los Angeles Superior Court No. BC369808 (August 9, 2007)
    - (a) On April 20, 2007, the taxpayer filed a suit for refund challenging the FTB's policy of disallowing dividends received deduction under RTC § 24402 for the 1999 and 2000 tax years.
    - (b) On August 9, 2007, the trial court sustained the FTB's demurrer without leave to amend and dismissed the case.
      - (i) The trial court held that in light of *Farmer Brothers*, the plaintiffs could not state a cause of action under RTC § 24402. The court went on to hold that it would not reform RTC § 24402.
      - (ii) The trial court did not discuss the severability provisions of RTC § 23057: "If any chapter, article, section, subsection, clause, sentence or phrase of this part which is reasonably separable from the remaining portions of this part, or the application thereof to any person, taxpayer

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or circumstance, is for any reason determined unconstitutional, such determination shall not affect the remainder of this part, nor, will the application of any such provision to other persons, taxpayers or circumstances, be affected thereby.”

(c) On December 7, 2007, the taxpayer filed a notice of appeal.

(4) *City of Modesto v. National Med, Inc.*, 128 Cal. App. 4<sup>th</sup> 518 (2005)

(a) City tax case in which Court of Appeal, based on the Due Process Clause, declined to reform a prior unconstitutional ordinance to retroactively apply an apportionment provision since the period of retroactivity sought by the City was not “modest.”

B. *Ceridian Corporation v. FTB*, 85 Cal. App. 4<sup>th</sup> 875 (2000)

1. Court of Appeal held that RTC § 24410, which allowed a dividends received deduction for dividends received from an insurance company, was unconstitutional under the Commerce Clause of the U. S. Constitution. RTC § 24410 allowed a deduction only where the payee was commercially domiciled in California. Under RTC § 24410, the deduction was further limited by the payor’s presence in California as determined by its apportionment factors. The Court held both restrictions violated the Commerce Clause since they favored domestic (California) corporations over their foreign competitors.

2. Case also raises the retroactive versus prospective remedy issue. While Ceridian was allowed a full deduction and accordingly obtained its refund, the Court left open the remedy with respect to other taxpayers.

3. FTB Policy Regarding Post-*Ceridian*

- a. For years ended prior to December 1, 1997, taxpayers will be allowed a full deduction for insurance company dividends. However, the expense attribution provisions of RTC § 24425 will be applied.
- b. For years ending on or after December 1, 1997, no deduction will be allowed for insurance company dividends. The FTB will attempt to identify all taxpayers who have claimed a deduction under RTC § 24410 and will disallow that deduction.

4. Assembly Bill No. 263

a. On September 29, 2004, legislation was enacted which would reverse FTB’s policy statement for taxable years ending on or after December 1, 1997.

(1) For years ending on or after December 1, 1997 and beginning before January 1, 2004, taxpayers were allowed to elect to claim an 80-percent dividends received deduction. No expense attribution would be allowed.

(a) Taxpayers were required to make a retroactive irrevocable election.

(b) At least 80 percent of each class of stock of the insurance company must be owned.

(c) Election applied only to taxable years during the election period for which the statute of limitations was open or if the statute had closed for any taxable year, to taxable years for which a final tax determination had not been made because of a dispute over the dividends received deduction or the expenses related to that deduction.

(d) Elections were required to be made by filing amended returns which had to be filed by March 28, 2005.

(2) For years beginning on or after January 1, 2004, a dividends received deduction would be allowed. No restriction on the use of expense attribution.

(a) Deduction would be equal to 80% of the qualified dividends (increases to 85% in 2008).

(b) Dividend deduction may be reduced if insurance company overcapitalized (“anti-stuffing”).

(c) Certain transfers of property to insurers in an exchange described in various IRC provisions and which would otherwise result in non-recognition of gain will be deemed taxable events.

(3) FTB Notice 2004-6 was issued by the FTB to inform taxpayers how to make the election.

b. AB 263 also amended RTC § 24425 for taxable years beginning on or after January 1, 2004.

(1) Deductions disallowed to non-insurer for specified expenses paid or incurred to the insurer if the amount paid would constitute

- income to the insurer if the insurer were subject to California franchise tax.
- (2) Interest payable to third parties by an affiliated taxpayer is subject to disallowance if the borrowed funds are used to contribute capital to the insurer.
    - (a) This disallowance does not apply to situations where the borrowed funds are loaned to the insurer.
5. Taxpayers not electing under AB 263 will be subject to the FTB's policy referred to above in **I.B.3.b.**
    - a. The FTB's policy has not been sustained and may be subject to attack under various theories.
  6. *Argonaut Group, Inc.*, SBE Case No. 287738 (June 28, 2006)
    - a. In a letter decision, the SBE ruled that the taxpayer could not include its insurance company subsidiaries in its combined report "by proxy," under RTC § 25137, for purposes of determining its California franchise tax liability.
    - b. Petition for rehearing denied on November 20, 2006.
  7. *Electronic Data Systems Corp.*, SBE Case No. 361467 (August 8, 2008)
    - a. In a letter decision, the SBE ruled that the taxpayer's unitary and wholly owned Texas based insurance subsidiary should be included in its California combined report. The SBE rejected the FTB's contention that Legal Ruling 385 should apply to out of state insurance companies. Thus, taxpayer's sales factor properly included the premiums received by the insurance subsidiary during the course of the subsidiary's Texas insurance activities.
- C. *American General Realty Investment Corp., Inc.*, SBE Case No. 156726 (June 25, 2003)
1. In a summary decision, the SBE concluded that the FTB properly disallowed under RTC § 24425, a portion of the interest expenses incurred by the taxpayer's unitary financial and real estate subsidiaries on the theory that the interest expenses were indirectly traceable to insurance company dividends which were deductible under *Ceridian*.
2. On April 28, 2005, the SBE's decision was reversed in the San Francisco Superior Court (No. CGC-03-425690). The trial court concluded that no interest expense deductions should be disallowed.
    - a. The trial court concluded that RTC § 24344(b) should be applied before RTC § 24425 and thus since the taxpayer's business interest income exceeded the total amount of interest expense being deducted against business income, all of the interest expense could be deducted.
    - b. The trial court also concluded that even if RTC § 24425 was applicable, none of the taxpayer's interest expense was incurred to purchase or carry the insurance company stock, to contribute equity capital to the insurance company or to refinance any indebtedness directly or indirectly used for any such purpose.
    - c. The trial court concluded that under the facts presented, the debt was incurred solely for purpose of conducting the consumer finance and real estate businesses and the debt proceeds were used exclusively to generate taxable income in the ordinary course of their respective businesses.
    - d. On September 14, 2005, the trial court granted the taxpayer's request for attorneys' fees based on market rates.
    - e. The FTB did not appeal.
- D. *Beneficial California, Inc.*, SBE Case No. 203445 (September 1, 2005)
1. In a summary decision, the SBE unanimously concluded that none of the taxpayer's interest expense should be disallowed under RTC § 24425. The SBE found that under the facts and circumstances of the case, the requisite connection between the interest expense and the insurance company which paid the deductible dividends was absent.
- E. *Mercury General Corporation*, SBE Case No. 145450 (June 25, 2003)
1. In a letter decision similar to *American General*, the SBE affirmed the FTB's disallowance of the deduction of administrative expenses and interest expense under RTC § 24425 on the theory that the expenses were indirectly traceable to insurance company dividends which were deductible under *Ceridian*.

2. The taxpayer's petition for rehearing was granted with respect to the deduction of administrative expenses, not interest expense. On March 28, 2006, the SBE reaffirmed its decision disallowing the deduction of administrative expenses.
3. On April 24, 2007, the taxpayer filed a suit for refund in the San Francisco Superior Court challenging the SBE's decision (No. CGC-07-462688).
4. On August 4, 2008, the trial court entered judgment in favor of the plaintiff on the RTC § 24425 issue and concluded that all of the administrative expenses were deductible.

## II. Apportionment Formula

### A. Sales Factor

1. Gross receipts from treasury function activities. Numerous suits for refund pending.
  - a. *General Motors Corporation v. FTB*, 39 Cal. 4<sup>th</sup> 773 (2006)
    - (1) California Supreme Court concluded that, except with respect to repurchase agreements ("repos"), gross proceeds from the sale of marketable securities in the course of treasury function activities, including redemptions on maturity, are to be included in the sales factor. The Court remanded for further proceedings the issue whether inclusion of such proceeds in the sales factor is distortive under RTC § 25137. In the case of repos, only the interest received from repos should be included in the sales factor.
    - (2) The Court also concluded that research credits can only be used by the member of the unitary group which generated the credit, not the entire group. (See III.C below.)
    - (3) On January 29, 2007, the Court of Appeal remanded the case to the trial court to resolve the matter consistent with the Supreme Court's decisions in *General Motors* and *Microsoft*.
  - b. *Microsoft Corporation v. FTB*, 39 Cal. 4<sup>th</sup> 750 (2006)
    - (1) California Supreme Court held that gross proceeds from the sale of marketable securities, including redemptions on maturity, are includible in the sales factor.
    - (2) Based on the specific facts in the case, the Court concluded that the FTB sustained its burden of proving that the inclusion of gross receipts from treasury function activities in the denominator of the sales factor created a distortion under RTC § 25137. (See II.B.1 below)
  - c. *Limited Stores, Inc. v. FTB*, 152 Cal. App. 4<sup>th</sup> 1491 (2007)
    - (1) Trial court concluded that the return of principal must be excluded from the gross receipts generated by the taxpayer's sale of short-term financial investments and thus from the sales factor.
    - (2) In dicta, the court held that the inclusion of gross receipts would be distortive.
    - (3) On July 28, 2005, Court of Appeal affirmed in an unpublished opinion (No. A102915).
    - (4) On October 26, 2005, the California Supreme Court granted the taxpayer's petition for review. The matter is deferred pending *General Motors* and *Microsoft*.
    - (5) On November 15, 2006, the California Supreme Court returned the case to the Court of Appeal with instructions to that court to vacate its prior decision and reconsider the case in light of *General Motors* and *Microsoft*.
    - (6) Upon remand, the Court of Appeal held that the return of principal from short-term financial instruments was a "gross receipt" for sales factor purposes.
    - (7) The Court further held that inclusion of gross receipts in the sales factor was distortive under RTC § 25137 because the taxpayer's treasury functions were qualitatively different from its principal, retail store business.
  - d. *General Mills, Inc. & Subsidiaries v. FTB*, San Francisco Superior Court No. CGC-05-439929 (Aug. 9, 2007)
    - (1) Trial court concluded that commodity hedging transactions did not generate gross receipts for sales factor purposes.
    - (2) Because of its holding above, the court did not consider the issue whether inclusion of such receipts would be distortive under RTC § 25137.
    - (3) Case is pending on appeal.

- e. *Square D Co. v. FTB*, San Francisco Superior Court No. CGC 05-442465 (Apr. 11, 2007)
- (1) Trial court concluded that the taxpayer's gross receipts from Eurodollar time deposits were includible in the sales factor.
  - (2) However, the court also concluded that the FTB proved, by clear and convincing evidence, that the inclusion of such receipts was distortive under RTC § 25137.
  - (3) The case is now closed.
- f. *Toys R Us, Inc. v. FTB*, Sacramento Superior Court No. 01 AS 04316 (August 21, 2003)
- (1) Trial court concluded that the term "gross receipts" in RTC §§ 25120 and 25134 does not include the return of capital from the taxpayer's investment in short-term paper and thus only the interest earned from those investments is includible in the sales factor.
  - (2) In dicta, the court held that if the return of capital was included in the sales factor, RTC § 25137 would apply.
  - (3) On April 5, 2006, the Court of Appeal affirmed the trial court's decision in a published opinion. The opinion was modified on May 4, 2006 (138 Cal. App. 4<sup>th</sup> 339).
    - (a) The Court of Appeal disagreed with the trial court regarding the meaning of the term "gross receipts." The Court concluded that return of capital is included within gross receipts under RTC §§ 25120 and 25134.
    - (b) The Court of Appeal concluded that under RTC § 25137, the inclusion of return of capital resulted in distortion and thus should be excluded.
  - (4) Both the FTB and the taxpayer filed petitions for rehearing. The Court of Appeal denied both petitions. The Court, however, modified the opinion to strike its original burden of proof discussion and to instead note that under RTC § 25137, the party seeking to deviate from the standard apportionment formula bears the burden of proof.
  - (5) On July 26, 2006, the California Supreme Court granted the taxpayer's petition for review. The matter is deferred pending *General Motors* and *Microsoft*.
  - (6) On November 15, 2006, the California Supreme Court returned the case to the Court of Appeal with instructions to that court to vacate its prior decision and reconsider the case in light of *General Motors* and *Microsoft*.
- g. *Montgomery Ward and Co., Inc.*, SBE Case No. 133828 (October 3, 2002)
- (1) In a summary decision, the SBE held that inclusion of the return of capital portion of the taxpayer's sales of various financial investments resulted in a distortion of the formula and thus those receipts were to be excluded.
  - (2) On December 10, 2007, the SBE's decision was reversed in San Diego Superior Court (No. GIC 802767). In granting summary judgment for the taxpayer, the trial court concluded that the FTB failed to meet its two-part burden of showing distortion and that its proposed alternative to the standard apportionment formula is reasonable.
- h. *Colgate-Palmolive Co.*, SBE Case No. 152028 (November 12, 2002)
- (1) In a summary decision, the SBE concluded that the taxpayer's gross receipts from its investment activity were not includible in the sales factor due to the fact the taxpayer failed to prove that it engaged in any income producing activities. The taxpayer employed independent contractors to perform the vast majority of the investment activities, while its own personnel performed de minimis investment activity. Under Regulation 25136(b), the work performed by independent contractors is not an income producing activity.
  - (2) Case pending in Sacramento Superior Court (No. 03AS00707).
- i. Numerous treasury function appeals are pending at the SBE. The SBE is moving forward on one case. *Home Depot USA, Inc.*, SBE Case No. 298683. All other cases are deferred until at least 30 days after a final decision is issued in *Home Depot*.
2. FTB Regulation 25137(c)(1)(D)
- a. Effective for taxable years beginning on or after January 1, 2007, the FTB amended Regulation 25137(c)(1) by adding subparagraph (D) which would exclude from the sales factor all interest, dividends and gains (gross and net) in connection with the taxpayer's treasury function.
  - b. "Treasury function" is defined as "the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business . . ." It includes the use

of futures and options contracts to hedge foreign currency fluctuations, but does not include futures and options transactions to hedge price risks of the products or commodities consumed, produced or sold by the taxpayer.

- c. Registered broker-dealers and other taxpayers principally engaged in the business of purchasing and selling intangibles of the type typically held in a taxpayer's treasury function is not considered to be performing a treasury function.

### 3. FTB Legal Ruling 2006-1

- a. On April 28, 2006, the FTB issued a legal ruling to address the issue of how to reflect, for apportionment factor purposes, activities related to income that is excluded from the measure of tax, in whole or in part.
- b. The FTB concluded that deductible dividends are not to be included in the sales factor to the extent of the amount which is deducted. Thus, for a 75-percent dividends received deduction under RTC § 24411, only 25 percent of the dividend would be included.

- (1) This is contrary to the FTB's proposed amendments to Regulation 25106.5-1.
- (2) The proposed amendments to Regulation 25106.5-1 are intended to clarify the FTB staff's position that deductible dividends (RTC §§ 24402, 24410 and 24411) are includible in the sales factor while eliminated dividends (RTC § 25106) are not to be included. See **IV.D** below.

### 4. FTB Legal Ruling 2006-2

- a. On May 3, 2006, the FTB issued a legal ruling to address the application of the "on behalf of" rule of Regulation 25136(b). Under Regulation 25136(b), receipts from services or sales of intangible personal property are assigned to the state where the "income producing activity" was performed, based on where the greater costs of performance occurred. Income producing activity generally does not include activities performed on behalf of a taxpayer, such as those of an independent contractor.
- b. When a contractor and subcontractor are members of the same unitary combined reporting group, the activities of the subcontractor will be considered income producing activities directly engaged in by the contractor for purposes of the "on behalf of" rule.

- (1) Payments made by the contractor to the subcontractor will be assigned to the location

where the subcontractor actually performed the service.

- (2) FTB's analysis assumes that members of a combined report must be treated as a single corporate enterprise. Query whether the FTB essentially has applied a *Finnigan* analysis and whether FTB's analysis is consistent with its position on credit "siloeing" at issue in the pending *General Motors* case.
- (3) FTB recognizes that, in the case of water's edge taxpayers, the "on behalf of" rule excludes activities performed by members outside the water's edge combined report.

- c. On June 4, 2007, the FTB issued Chief Counsel Ruling 2007-2 which deals with the issue whether the investment activities of third party investors who manage investments on behalf of a taxpayer pursuant to an agreement, constitute income producing activity under RTC § 25136 and Regulation 25136.

- (1) The FTB distinguished Legal Ruling 2007-2 and concluded that the receipts were not generated by income producing activities and thus were excludible from the sales factor.

- d. The FTB held an interested parties meeting in January 2008 to consider amending Regulation 25136, regarding the assignment of sales of other than tangible personal property, to conform to recent changes by the Multistate Tax Commission relating to the "on behalf of" rule under MTC Regulation IV.17.

### 5. FTB Legal Ruling 2006-3

- a. On May 5, 2006, the FTB issued a legal ruling to address how gains resulting from an IRC § 338(h)(10) or IRC § 338(g) election are apportioned for California purposes.
- b. FTB analyzes three scenarios in which an IRC § 338(h)(10) or IRC § 338(g) election has been made. FTB describes which apportionment factors should be used to report the gain from the deemed sale of assets pursuant to the election.
- c. FTB does not directly address the issue whether the resulting gain is business or nonbusiness income, but instead assumes that, in each instance, the gain on the deemed asset sale is business income.

### 6. FTB Legal Ruling 2003-3

- a. On December 4, 2003, the FTB issued a legal ruling to address the issue when income producing activity exists with respect to a business income

dividend so that the dividend is includible in the sales factor.

- b. The FTB concluded that a dividend payee that participates in the management and operations of the dividend payor is engaged in income producing activity with respect to the dividend so that the dividend is includible in the payee's sales factor.
  - c. Departure from the FTB's position set forth in its Multistate Audit Technique Manual Section 7562.
  - d. This ruling becomes quite relevant in post-*Ceridian* and post-*Farmer Bros.* years where the FTB is disallowing deductions for RTC § 24410 and RTC § 24402 dividends. The FTB is applying it on audit.
7. FTB Legal Ruling 2005-1
- a. On March 21, 2005, the FTB issued a legal ruling to address the issue of what constitutes a "personal service" for purposes of attributing gross receipts to California using the so-called "time-spread method" provided by Regulation 25136(d)(2)(c).
  - b. Under the time-spread method, gross receipts for performing personal services are attributed to a state based on a ratio of time spent performing the services within and without the state.
    - (1) Separate income producing activities in each state.
  - c. Time-spread method applies only when capital is not a material income producing factor.
8. Amendments to Regulation 25128
- a. The FTB held interested parties meetings in January and September 2008 to discuss whether Regulation 25128, relating to double- vs. single-weighting of the sales factor, should be amended to provide greater clarity with respect to what constitutes "banking or financial business activity."
9. Assembly Bill No. 1591/Senate Bill No. 98
- a. Proposed legislation to hyperweight the sales factor, based on a taxpayer's new investment in California, did not pass.
  - b. Assembly Bill No. 2114 introduced on February 20, 2008.

## B. Distortion

1. *Microsoft Corporation v. FTB*, 39 Cal. 4<sup>th</sup> 750 (2006)
  - a. The California Supreme Court concluded that the FTB sustained its burden of proving the inclusion of gross receipts from treasury function activities in the denominator of the sales factor created a distortion under RTC § 25137. The Court further concluded that the FTB's "cure" for the distortion of including net receipts from the redemption transactions was reasonable. In reaching these conclusions, the Court emphasized the following:
    - (1) Section 25137 is not confined to correcting unconstitutional distortions.
    - (2) The comparison of low margin sales (treasury function) with higher margin sales (software transactions) presents a problem for Uniform Division of Income for Tax Purposes Act ("UDITPA"). UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state.
    - (3) The comparison of margins in determining whether distortion exists under Section 25137 is not a prohibited separate accounting analysis.
    - (4) Section 25137 is not to be applied in only unique non-recurring situations.
    - (5) While the "cure" the FTB proposed in this case was reasonable, the Court cautioned that the FTB's approach might fail the test of reasonableness in another case. For example, if, unlike the instant case, the treasury operations provide a substantial portion of a taxpayer's income, the use of Section 25137 may be inappropriate.
    - (6) The party seeking to apply Section 25137 has the burden of proving by clear and convincing evidence that the standard formula does not fairly represent the extent of the taxpayer's business activities in California.
  - b. The Court's decision opens the door for challenges to the standard apportionment formula for both taxpayers and the government. The endorsement of a comparison of margins between functions of the unitary business is a significant development.

- c. FTB Audit Practice. Currently, auditors are analyzing whether distortion exists in the treasury function setting under four different tests—*Microsoft*, *Merrill Lynch*, *Pacific Telephone* and *Toys-R-Us*. If the taxpayer fails any of the four tests, the auditors are instructed to remove the gross receipts from the sales factor.
- d. FTB Notice 2006-3 (Sept. 28, 2006).
- (1) The FTB announced that, for purposes of applying FTB Notice 2004-5, a taxpayer that excludes from the sales factor the amount realized on the redemption of marketable securities as part of its treasury function, and includes only the interest income and net gains from such securities, will not be subject to the accuracy related penalty under RTC § 19164.
  - (2) The FTB based its position on *Microsoft* and *Pacific Telephone*.
- e. Technical Advice Memorandum 2007-3.
- (1) In TAM 2007-3, the FTB set forth the types of treasury activity information that should be collected from taxpayers upon audit post-*Microsoft* and *General Motors*, including the taxpayer's main line of business, the number of treasury and total employees, the gross margin from treasury function compared to other activities and the percentage of total income that would be assigned to the location of the treasury function.
  - (2) Purpose of the information is to enable the FTB to perform a quantitative distortion analysis.
2. *Weyerhaeuser Company*, SBE Case Nos. 104355 and 246164
- a. Case involves distortion issues pertaining to the taxpayer's timber activities in the State of Washington vis-à-vis its activities in California.
  - b. The taxpayer's Washington timber activities generate virtually all of its unitary income, yet the standard apportionment formula does not reflect this fact. The taxpayer is contending that RTC § 25137 should be applied to correct the distortion.
  - c. Case also involves the proper inclusion of gross receipts for taxpayer's treasury function in the sales factor. The FTB is arguing that the gross receipts from the taxpayer's treasury function activity should be excluded from the sales factor under RTC § 25137. The taxpayer disagrees and is arguing that if the FTB has sustained its burden of proof under RTC § 25137 on this issue, then so has the taxpayer with respect to its Washington timber activities.
  - d. Other issues include the inclusion of a proper value for government-owned property in the property factor and various manufacturers' investment tax credit (MIC) issues.
  - e. Oral argument held January 25, 2005.
  - f. The SBE deferred its decision on the treasury function sales factor and the Washington timber distortion issues pending the California Supreme Court's decision in *General Motors*. Further briefs on the distortion issues will be filed following the SBE's decision in *Home Depot* (see II.A.1.i above).
3. *Microsoft Corporation v. FTB*, San Francisco Superior Court No. CGC-08-471260. Suit for refund filed on January 22, 2008, raising the following issues for the 1995 and 1996 tax years:
- a. Whether royalty income from computer software products should be sourced outside California based upon costs of performance for sales factor purposes.
  - b. Whether gross receipts from marketable securities should be included in the sales factor.
  - c. Whether the value of trademarks, copyrights, patents and other intangible assets should be included in the property factor.
  - d. Whether a deduction under RTC § 24402 should be allowed for dividends received for the years at issue.
4. Proposed Regulation 25137-14
- a. The proposed regulation provides for an alternative apportionment methodology for mutual fund service providers that looks to the location of the underlying shareholders of the mutual funds, for purposes of assigning receipts to the numerator of the sales factor. See FTB Notice 2005-3.
  - b. On April 4, 2007, the proposed regulation was approved by the FTB.
5. Airline Apportionment Formula
- a. *Alaska Airlines, Inc.*, SBE Case No. 342596 (March 1, 2007), CCH Calif. Tax Rptr. ¶ 404-226. In a letter decision, the SBE held that the FTB incorrectly applied Regulation 25137-7, California's special apportionment formula for airlines.

- b. FTB held an interested parties meeting on March 27, 2008 to discuss how Regulation 25137-7 should be interpreted and administered.
6. Trucking Apportionment Formula
- a. *Swift Transportation Co., Inc.*, SBE Case No. 266318 (February 4, 2008), CCH Calif. Tax Rptr. ¶ 404-616. In a letter decision, the SBE upheld the FTB's position that the special apportionment formula for trucking companies set forth in Regulation 25137-11 applied to all members of the taxpayer's combined reporting group and not just the trucking company.
  - b. FTB has scheduled an interested parties meeting on July 10, 2008 to discuss updating Regulation 25137-11.
7. Special Industry and Other Proposed Regulations
- a. The FTB held an interested parties meeting in January 2008 to consider revising Regulation 25137-8, regarding apportionment for the motion picture and television industry.
  - b. The FTB held an interested parties meeting in January 2008 to consider revising Regulation 25137-12, regarding apportionment for print media businesses.
- d. On April 11, 2007, the taxpayer filed a suit for refund in the San Francisco Superior Court (No. CGC-07-462305).
  - e. Trial was scheduled for July 14, 2008, but case settled and has been dismissed.
2. *Dicon Fiberoptics, Inc. v. Franchise Tax Board*, Los Angeles Superior Court No. BC 367885
- a. On March 13, 2007, a suit for refund was filed challenging the FTB's authority to look behind the vouchers.
  - b. On August 17, 2007, the trial court sustained the FTB's demurrer without leave to amend.
  - c. On October 3, 2007, an order of dismissal of plaintiff's action was filed.
  - d. Case is pending on appeal.
3. *Jessica McClintock and Jessica McClintock, Inc.*, Nos. 304497 and 304512 (August 14, 2007)
- a. Case involved the following issues: (1) whether subsection (c) of Section 1603 of the JTPA ("the 10% exception") provides a separate eligibility category for purposes of the hiring credit; and if yes, then (2) whether the employees in question were eligible for services under subsection (c) of section 1603 of the JTPA.
  - b. The FTB argued that subsection (c) does not provide a separate eligibility category. The FTB further argued that individuals who could be enrolled in a JTPA program pursuant to subsection (c) were not "eligible" for JTPA services under RTC § 23622.7 and could only constitute qualified employees for purposes of the hiring credit if they were actually enrolled under the JTPA. The FTB also argued that "older worker" is not a barrier to employment because it is not enumerated in the statute.
  - c. The SBE voted 5-0 to grant the taxpayer's refund claims. The SBE held that for the 10% exception, an employee only needs to be eligible for JTPA services (and not required to be enrolled in JTPA) to be a qualified employee. The SBE further held that "older worker" is a barrier to employment for purposes of the 10% exception because of the legislative history, EDD publications and the FTB's own audit manual. The SBE concluded that the "older worker" need not meet low-income guidelines.
  - d. On April 1, 2008, the FTB announced in its *Tax News* that based on purported "new information," it is taking the position in pending appeals at the

### III. Credits

#### A. Enterprise Zone Hiring Credits

1. *Deluxe Corporation*, 2006-SBE-003 (December 15, 2006)
- a. Case involved challenge to FTB's position of looking behind vouchers obtained from local enterprise zones. The taxpayer is arguing "voucher reliance" and that RTC § 23622.7 only requires that a certificate (voucher) be obtained from the enterprise zone or other appropriate agency and provided to the FTB upon request.
  - b. On January 31, 2006, the SBE held in a 4-1 vote that the FTB is permitted to look behind the vouchers. Post-hearing briefs were filed regarding whether the 51 remaining employees qualify for the credit.
  - c. On December 15, 2006, the SBE issued a formal opinion confirming the decision in January that the FTB is permitted to look behind the vouchers. In a letter decision issued that same day, the SBE concluded that 15 of the 51 employees at issue qualified for the credit.

SBE that an individual must be both 55 years or older and meet low-income guidelines.

4. On November 27, 2006, vouchering regulations were issued by the Department of Housing and Community Development.
5. *Taiheiyo Cement USA, Inc.*, SBE Case No. 332855 (February 4, 2008).
  - a. In a letter decision, the SBE sustained the FTB's disallowance of the enterprise zone sales and use tax credit for property that the taxpayer currently expensed.
  - b. On July 11, 2008, the SBE granted the taxpayer's petition for rehearing.
6. *DeVry, Inc.*, SBE Case No. 357029 (August 19, 2008)
  - a. In a letter decision, the SBE reaffirmed its decision in *Jessica McClintock* and *Jessica McClintock, Inc.*, SBE Case Nos. 304497 and 304512 (August 14, 2007), and held that "older workers" need not meet low-income guidelines in order to be "qualified employees" for the enterprise zone hiring credit.
  - b. The SBE did not agree with the FTB's stringent requirement of third-party verification for disabled and dislocated worker categories.

#### B. Manufacturers' Investment Tax Credit

1. *Save Mart Supermarkets*, 2002-SBE-002 (February 6, 2002)
  - a. On February 6, 2002, the SBE issued a rare formal opinion in the first MIC case to reach the Board. This was the first in a series of taxpayer victories in MIC cases in 2002 and 2003.
  - b. The case involved the issue of whether Save Mart was a qualified taxpayer with respect to its bakery and meat processing activities.
    - (1) Both activities are described in Division D of the SIC Manual.
  - c. The FTB argued that Save Mart was not a qualified taxpayer because "its primary activity" was retail (not manufacturing) and therefore should be assigned SIC Code 5411. As SIC Code 5411 is not in the manufacturing section of the SIC Manual, Save Mart did not meet the statutory requirement.
  - d. Save Mart argued that it was a qualified taxpayer under the plain meaning of the statute and that the FTB's "qualified taxpayer" regulation (23649-3)

was invalid because it imposed restrictions not contemplated by the MIC statute. Under that regulation, the FTB required that the taxpayer be classified or assigned a manufacturing SIC Code while the statute only requires that the taxpayer's activities be "described in" the manufacturing section of the SIC Manual.

- e. Save Mart further argued that even if Regulation 23649-3 was somehow valid, Save Mart was a qualified taxpayer because it satisfied the three requirements under Regulation 23649-3(b)(1)(B), the "separate establishment" test.
  - f. The SBE agreed with Save Mart and overturned the FTB's qualified taxpayer regulation (Regulation 23649-3).
  - g. The SBE specifically held that the MIC statute should be liberally construed in favor of taxpayers in order to effectuate the purposes of the legislation, *i.e.*, to encourage manufacturing in the State.
  - h. On September 3, 2003, the California Legislative Counsel issued an opinion that concluded that the SBE did not have the authority in *Save Mart* to declare an FTB regulation invalid. The opinion is not binding.
  - i. The FTB is refusing to follow *Save Mart*.
2. *Costco Wholesale Corporation*, SBE Case No. 266592 (October 25, 2005), CCH Calif. Tax Rptr. ¶ 403-908
    - a. In a 4-1 vote, the SBE reaffirmed its decision in *Save Mart*.
    - b. In a letter decision, the SBE held that Costco was a qualified taxpayer with respect to its bakery and meat processing activities.
  3. *Safeway, Inc.*, SBE Case Nos. 268637, 283211 (December 13, 2005)
    - a. In a summary decision, the SBE reaffirmed its decision in *Save Mart* and concluded that Safeway was a qualified taxpayer with respect to its bakery and meat processing activities. With the exception of a meat box, the SBE also concluded that the property used in these activities was qualified property.
  4. *Jon and Rita Minnis and Milpitas Materials Company*, 2002-SBE-003 (June 20, 2002)
    - a. The SBE concluded in a formal opinion, that a cement mixer truck, comprised of a truck chassis and mixer barrel, constituted a single integrated

- piece of manufacturing equipment and thus the entire truck was qualified property for purposes of the MIC.
- b. The SBE rejected the FTB's attempt to bifurcate the truck into two components—manufacturing (mixing drum) which qualified for the MIC and transportation (chassis) which did not.
  - c. The SBE refused to follow FTB Legal Ruling 2001-4.
5. *Bronco Wine Company*, 2002-SBE-006 (September 12, 2002)
- a. Late in 2002, the SBE again ruled against the FTB in another formal opinion.
  - b. The SBE concluded that wine tanks which had a capacity of 215,000 gallons were qualified property for purposes of the MIC. The SBE relied on the fact that the tanks could be moved and placed in productive use without damaging the property during the move.
  - c. The FTB had taken the position that smaller wine tanks qualified as tangible personal property but that the larger wine tanks were “inherently permanent structures” under *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975).
6. *California Steel Industries, Inc.*, 2003-SBE-001-A (July 9, 2003)
- a. In a formal Opinion on Petition for Rehearing in 2003, the SBE once again rejected the FTB's position.
  - b. The SBE held that payments made to third party contractors that are directly allocable to qualified property and are capitalized, constitute qualified property for purposes of the MIC.
7. *Baxter Healthcare Corporation*, SBE Case No. 140712 (May 28, 2003)
- a. In a summary decision, the SBE confirmed its decision in *California Steel* regarding the capitalized labor issue.
  - b. The SBE also held that payments made to in-house engineers which are directly allocable to qualified property and are capitalized, constitute qualified property for purposes of the MIC.
  - c. The SBE also concluded that certain facilities were special purpose buildings and foundations and thus qualified property.
  - d. The SBE held that the heating, ventilating and air conditioning systems installed in clean rooms were not qualified property.
8. *Lienau*, SBE Case Nos. 156798, 156810, 156814 and 156808 (July 9, 2003)
- a. In another taxpayer victory, the SBE held in a summary decision that the gain realized by a California S corporation, passed through to its shareholders, on the receipt of insurance proceeds for equipment losses and deferred under IRC § 1033 was chargeable to the capital account and thus constituted qualified costs for purposes of the MIC.
9. *LSI Logic, Inc. and Cypress Semiconductor Corporation*, SBE Case Nos. 142330 and 173287 (August 7, 2003)
- a. In a controversial summary decision, the SBE voted 2-1 to grant refund claims under RTC § 6902.2. Under that statute, a taxpayer may claim a sales tax refund in lieu of the MIC. The in-lieu credit cannot be claimed any earlier than the MIC could have been claimed and the amount of the in-lieu credit cannot be in excess of the amount of the MIC that could have been claimed by the taxpayer.
  - b. In these cases, the taxpayers used research and development credits to eliminate their franchise tax liability. They did not claim MIC credits, although they would have been entitled to do so. The taxpayers thus claimed the in-lieu credit under RTC § 6902.2 in the amount of the MIC they otherwise could have claimed.
  - c. The SBE rejected its staff's arguments that the Legislature did not intend to allow taxpayers to claim both the R&D credit and the MIC in-lieu refund because such could essentially make the MIC a refundable credit.
  - d. On September 29, 2003, Senate Bill No. 1064 was signed into law overturning on a prospective basis the *LSI* and *Cypress* decisions. SB 1064 permits any taxpayer that had filed a MIC in-lieu claim under RTC § 6902.2 on or before the date of the *LSI* and *Cypress* decisions (August 7, 2003) to obtain that refund.
  - e. On January 25, 2005, the SBE granted refund claims of a series of taxpayers who filed MIC in-lieu of claims on or before August 7, 2003.

10. *Sierra Pacific*, SBE Case No. 268309 (September 1, 2005), CCH Calif. Tax Rptr. ¶ 403-852

- a. In a letter decision, the SBE unanimously held that the taxpayer's steam generation assets which were primarily used to produce steam for use in its wood manufacturing process were qualified property for purposes of the MIC.

11. *Foster Poultry Farms*, SBE Case Nos. 268417, 268429, 268418, 268431 (May 17, 2006), CCH Calif. Tax Rptr. ¶ 404-013

- a. In a summary decision, the SBE ruled that the taxpayer's electrical substations were qualified property for purposes of the MIC. The SBE rejected the FTB's contention that the electrical equipment was not tangible personal property. See *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980).

12. *Granite Construction Corporation*, SBE Case No. 301578 (November 21, 2006), CCH Calif. Tax Rptr. ¶ 404-094.

- a. In a letter decision, the SBE ruled that a taxpayer which manufactured aggregate for both external sales and for use in its manufacturing of asphalt and ready-made concrete was entitled to claim the MIC.

13. *Penny-Newman Grain Co., Inc.*, SBE Case No. 338714 (Feb. 8, 2007), Calif. Tax Rptr. ¶ 404-209

- a. In a letter decision, the SBE ruled that the taxpayer did not prove that its railroad tracks and scales was qualified property for MIC purposes.

14. MIC Repealed

- a. The MIC was repealed by its own terms and ceased to be operative as of January 1, 2004.
- b. Various bills have been introduced to revive the MIC, but none have passed.
- c. MIC credits for years prior to 2004 and which have not yet been used, may be carried forward until fully utilized.

#### C. Separate But Unitary

1. *General Motors Corporation v. FTB*, 39 Cal. 4<sup>th</sup> 773 (2006)

- a. California Supreme Court rejected the taxpayer's argument that a research expense credit should be applied against the tax liability of the

unitary group, or in the alternative, should be "intrastate-apportioned" against the tax liability of each of the taxpayer-members of the unitary group.

- b. The Court accepted the FTB's argument that the credit should be limited to the taxpayer which incurred the research expenses.

2. Cases pending in the administrative process challenging the siloing of credits under RTC § 25137.

#### IV. Water's Edge Election

A. *Fujitsu Holdings, Inc. v. FTB*, 120 Cal. App. 4<sup>th</sup> 459 (2004)

1. California Court of Appeal concluded that for purposes of calculating the Subpart F inclusion ratio under the water's edge combined report, dividends from lower-tier controlled foreign corporations should be excluded and not taken into account under RTC § 25106. In addition, the Court concluded that California has adopted the previously taxed income provisions of IRC § 959.

2. The Court also concluded that refunds of UK Advance Corporation Tax payments are dividends under California law and thus subject to elimination under RTC § 25106.

3. On the preferential ordering v. pro rata dividend deduction issue, the Court also concluded that the elimination provisions of RTC § 25106 are to be applied prior to the 75-percent dividends received deduction provisions of RTC § 24411.

4. In the only portion of the opinion in which the Court agreed with the FTB, the Court concluded that California's water's edge method of reporting does not facially discriminate against foreign commerce. The court distinguished the *Kraft v. Iowa* decision on the basis of the "footnote 23" argument which has been accepted by some other states.

5. The FTB's petition for review was denied by the California Supreme Court.

B. *Baxter Healthcare Corporation*, SBE Case No. 150881 (August 1, 2002)

1. In a summary decision, the SBE concluded that Treasury Regulation 1.954-2(b) (1) excluded

- from Subpart F income for California water's edge purposes, the dividend paid by one foreign subsidiary to another foreign subsidiary.
2. The SBE agreed with the taxpayer that IRC § 959(b) was incorporated into California law through the operation of Treasury Regulation 1.954-2(b)(1).
- C. *Apple Computer, Inc.*, 2006-SBE-02 (November 20, 2006)
1. On November 20, 2006, the SBE issued a formal opinion and agreed with the FTB—contrary to *Fujitsu* (see IV.A.3 above)—that the dividends paid by a controlled foreign corporation that was partially included in a water's edge combined report is prorated among the RTC § 25106 dividend elimination provision and the RTC § 24402 dividend deduction provision.
  2. On January 16, 2008, the taxpayer filed a suit for refund in San Francisco Superior Court (No. CGC-08-471129).
  3. The plaintiff contends that the issue has already been decided by the Court of Appeal in *Fujitsu*.
  4. The FTB has refused to follow *Fujitsu* and contends that it is not binding precedent.
  5. The FTB has attempted to amend Regulations 24411 and 25106.5-1 to conform to the SBE decision in *Appeal of Apple*, rather than *Fujitsu*. (See IV.D below)
  6. Case is scheduled to go to trial January 26, 2009.
- D. FTB Proposed Amendments to Regulations 24411 and 25106.5-1
1. On February 9, 2005, the FTB staff requested approval from the 3-member FTB to proceed with amendments to Regulations 24411 and 25106.5-1.
  2. The amendments are designed to reverse the Court of Appeal decision in *Fujitsu* regarding the dividend ordering rules of RTC § 25106 and RTC § 24411.
  3. In response to opposition voiced at the FTB meeting, the staff was ordered to hold a symposium for interested parties rather than proceed directly into the formal regulatory process. See FTB Notice 2005-1.
  4. On April 4, 2007, the FTB approved going forward into the formal regulatory process. A public hearing was held on January 16, 2008. FTB staff issued a report dated March 6, 2008 in response to public comments.
  5. On March 6, 2008, the FTB staff pulled the regulation from the Board agenda and decided not to move forward on the regulation.
- E. FTB Notice 2004-8
1. On December 1, 2004, the FTB requested public comment on a discussion draft of proposed amendments to Regulation 25110(d)(2)(F)3.
  2. The proposed amendments address the manner in which deductions with respect to non-effectively connected income ("NECI") of a foreign corporation included in a water's edge combined report are to be determined.
  3. In FTB Notice 2005-2, FTB staff requested examples under the proposed amendments.
  4. FTB staff's request to move forward on the proposed regulations has not been approved by the 3-member FTB.
  5. During a 3-member FTB meeting on September 20, 2006, FTB Multistate Tax Counsel Benjamin Miller reported that FTB staff determined that the Legislature did not intend to include NECI in the water's edge combined report.
  6. On January 23, 2007, the FTB filed with the Secretary of State a revised version of proposed Regulation 25110 which incorporates FTB staff's concession and provides that certain types of NECI is excluded from the definition of United States source income. The Regulation is effective February 23, 2007.
- F. Proposed Legislative and Regulatory Amendments
1. In Legislative Proposal 08-03 the FTB proposed to revise the way in which the income from a controlled foreign corporation (CFC) is included in the water's edge combined report. Currently, Subpart F income from a CFC is not included in the combined report. Rather,

the ratio of a CFC's Subpart F income to its earnings and profits (the "inclusion ratio") is used to determine the extent to which the CFC's income and apportionment factors are included in the combined report. In LP 08-03, the inclusion ratio method would be replaced by the inclusion in the combined report of 100 percent of the Subpart F income from a CFC, subject to a 27 percent deduction.

2. The FTB scheduled an interested parties meeting on March 25, 2008 to discuss updating existing Regulation 25111 and proposed Regulation 25113. The purpose of the meeting is to address changes to the existing regulation providing for the contract method of making a water's edge election and discuss the content of a new regulation incorporating making a statutory water's edge election.
3. The FTB scheduled an interested parties meeting on March 25, 2008 to discuss updating existing Regulation 25114 regarding presumptions arising from federal audit for water's edge taxpayers.

#### V. Business/Nonbusiness Income

##### A. *Vidco Express, Inc.*, SBE Case No. 378528 (November 16, 2007)

1. In a letter decision, the SBE determined that the gain on the sale of the taxpayer's Michigan commercially domiciled business was business income.
2. The SBE rejected the taxpayer's argument that the business essentially consisted of goodwill and that the gain from the sale therefrom should be treated as nonbusiness income allocated to Michigan as gain from the sale of intangible property.
3. The SBE also rejected the taxpayer's alternative argument that apportionment of the gain under the standard apportionment formula was distortive.

#### VI. California Tax Amnesty ... Not?

##### A. *General Electric Company v. Franchise Tax Board*, San Francisco Superior Court No. 449157

1. The taxpayer challenged the validity of the Amnesty Penalty under RTC § 19777.5 (SB 1100) in a declaratory relief action.
2. It was the taxpayer's position that the Amnesty Penalty is invalid for a number of reasons and sought a declaration from the Court to that effect.
  - a. The taxpayer alleged that the Amnesty Penalty is unconstitutional under the Due Process Clause due to the absence of a plain, speedy and efficient remedy to challenge the merits of the penalty either in court or administratively.
  - b. The taxpayer alleged that the Amnesty Penalty is unconstitutional under the Due Process Clause due to its retroactive nature.
  - c. The taxpayer alleged that the FTB's interpretation of "due and payable" in RTC § 19777.5 is at odds with RTC § 19049. The taxpayer requested a declaration from the Court, consistent with RTC § 19049, that no Amnesty Penalty will arise if the taxpayer pays the amount of the assessment on or before it receives a notice and demand for payment or within 15 days thereafter.
3. The FTB filed a demurrer to the complaint on the ground that the action was not ripe. The Court sustained the demurrer with leave to amend. On May 10, 2006, the taxpayer filed an amended complaint, to which the FTB filed another demurrer on ripeness grounds. The Court sustained the FTB's demurrer.
4. On September 15, 2006, the taxpayer filed a notice of appeal.
5. On July 13, 2007, after briefs were filed and while the case was awaiting oral argument, the case settled and the appeal was dismissed.

B. *David A. and Cheryl D. Duffield v. Franchise Tax Board*, San Francisco Superior Court No. CGC-07-459331.

1. Suit for refund of personal income taxes, interest and Amnesty Penalty. In addition to the merits of the dispute, the taxpayer is challenging the validity of the Amnesty Penalty. There are no ripeness issues in this case.
2. Case was scheduled to go to trial in April 2008, but the parties have settled.

C. Other cases involving the amnesty penalty

1. *River Garden Retirement Home v. FTB* (see I.A.4.b(2) above). On September 24, 2008, the trial court granted the FTB's motion for summary judgment on the Amnesty Penalty issue. The court held that even if the plaintiff's interpretation of "due and payable" was correct, payment was not made within 15 days of notice and demand.
2. *Mercury General Corporation v. FTB* (see I.E above). Plaintiff raised the issue whether the Amnesty Penalty violates the Due Process Clause and statutory interpretation principles regarding the term "due and payable." Since the trial court entered judgment in favor of the plaintiff on the underlying substantive tax issue, the court did not reach the Amnesty Penalty issue.

D. Assembly Bill No. 561

1. Pending legislation sponsored by the FTB. The bill has been amended a number of times and is presently in the suspense file.
2. Some of the provisions include the following:
  - a. Allows for a Chief Counsel review of whether the Amnesty Penalty should be abated.
    - (1) Taxpayer must show the underpayment of tax arose from an item for which substantial authority exists; or
    - (2) Underpayment is due to RAR adjustments. This is limited to situations where the taxpayer was first contacted by the IRS concerning an examination after March 31, 2005; or
    - (3) Taking into account all facts and circumstances, holding the taxpayer liable for the Amnesty Penalty is against equity and good conscience.

(4) Review of the Chief Counsel's decision is permitted only under an abuse of discretion standard.

- b. Converts the Amnesty Penalty to interest.
- c. Allows for reduction in the Amnesty Penalty to the extent it is due to change in interpretation of law.
- d. Authorizes payment of a refund or credit for one year after the operative date of the bill, even if the one year statute of limitations under RTC § 19306 has expired, if the overpayment resulted from the provisions of the bill.

E. FTB Notice 2005-6

1. On November 28, 2005, the FTB issued procedures relating to tax deposits pursuant to California's conformity (AB 115) to the "tax deposit" provisions of IRC § 6033.
2. The tax deposit provisions (RTC § 19041.5) replace the "deposit in the nature of a cash bond" provisions.
3. The FTB also will apply the tax deposit rules to amounts that were paid outside California's 2005 amnesty program (e.g., protective claim payments).
4. Interest on tax deposit amounts that are returned to the taxpayer will be paid at the statutory overpayment rate.
5. The FTB announced that it has developed new forms, Forms 3576-3579, Tax Deposit Voucher, to designate a remittance as a tax deposit for a specific tax year. In addition, Form 3581, Tax Deposit Refund or Transfer Request, should be used to request a tax deposit refund, designate the application of a tax deposit to a different tax year, or apply a tax deposit to convert an administrative protest or appeal to an administrative refund action.

## VII. Anti-Tax Shelter Legislation

A. Senate Bill No. 614 and Assembly Bill No. 1601

1. Anti-tax shelter legislation was enacted in October 2003. It was generally effective January 1, 2004, but may apply to certain transactions entered into prior to that date.
2. Generally conformed to existing federal law regarding tax shelter registration, list

- maintenance and disclosure of reportable transactions.
3. Provided for various penalties in connection with the use of tax shelters, including enhanced penalties for noneconomic substance transaction understatements (up to 40%) and reportable transaction understatements (up to 30%).
  4. Also provided for penalties aimed at tax shelter promoters, advisers and return preparers.
  5. Extended the statute of limitations to eight years for proposed deficiency assessments relating to abusive tax avoidance transactions.
  6. Directed the FTB to identify and publish California "listed transactions," pursuant to which the FTB issued Chief Counsel Announcement 2003-1 on December 31, 2003 identifying certain REIT and RIC transactions as listed transactions for California purposes.
  7. SB 614 and AB 1601 also provided for a "voluntary compliance initiative" (VCI) for the period January 1, 2004 through April 15, 2004 during which eligible taxpayers voluntarily could pay all tax and interest due as a result of their use of tax shelter for taxable years beginning before 2003 to avoid tax shelter penalties.
  8. Legislation (Assembly Bill No. 115) was enacted on October 7, 2005 to conform to certain federal rules relating to reportable transactions.
- B. Challenges to FTB's Disallowance of REIT and RIC Dividend Deductions
1. *City National Corporation v. FTB*, Los Angeles Superior Court No. BC334772
    - a. The taxpayer is challenging the FTB's disallowance of REIT and RIC dividend deductions.
    - b. The FTB's demurrer on procedural grounds was sustained without leave to amend.
    - c. On January 16, 2007, the Court of Appeal reversed the lower court and held that the taxpayer was not barred from proceeding with its suit for refund.
    - d. On April 11, 2007, the California Supreme Court denied the FTB's petition for review.
    - e. The case is currently pending in the trial court.
  2. *City National Corporation v. FTB*, Sacramento Superior Court No. 06AS02275
    - a. In an action similar to the above case but for subsequent taxable years, the taxpayer is claiming a refund with respect to REIT dividend deductions.
    - b. Action stayed pending related case in Los Angeles superior court (see above).
- C. FTB Notice 2007-3
1. On July 31, 2007, the FTB issued Notice 2007-3 announcing that taxpayers who either failed to file or filed an incomplete IRS Form 8886, Reportable Transaction Disclosure Statement, with the FTB, have 60 days to file them before the FTB will assess penalties. Taxpayers filing a disclosure statement in accordance with Notice 2007-3 should file the statement with the FTB's Abusive Tax Shelter Unit.
- VIII. Penalties**
- A. FTB Notice 2004-5
1. On August 6, 2004, the FTB announced that accuracy related penalties may be asserted against taxpayers who file California franchise tax original returns inconsistent with the standard allocation and apportionment provisions of RTC §§ 25120-25136 and who have not obtained prior approval from the FTB.
    - a. Applicable to returns with a due date, determined without extensions, after October 14, 2004.
    - b. For returns with a due date before October 15, 2004, a statement attached to the return that adequately discloses that the taxpayer's return is inconsistent with the standard allocation and apportionment rules, or that the taxpayer has relied on RTC § 25137 will be considered adequate disclosure.
  2. Existing FTB Regulation 19164 provides an exception to the accuracy related penalty for understatements of tax which are attributable to the taxpayer's good faith determination, whether based on the facts or unresolved legal issues, of either (i) the contours of the taxpayer's unitary business(es) or (ii) business vs. nonbusiness income items. Neither the amendments to the accuracy related penalty under SB 1100 (See VI.A.1 above) nor FTB Notice 2005-1 eliminates

the exceptions provided under Regulation 19164.

B. FTB Notice 2006-3

1. The FTB announced that, for purposes of applying FTB Notice 2004-5 (see above), a taxpayer that excludes from the sales factor the amount realized on the redemption of marketable securities as part of its treasury function, and includes only the interest income and net gains from such securities, will not be subject to the accuracy related penalty under RTC § 19164.

2. The FTB based its position on the California Supreme Court's August 17, 2006 decision in *Microsoft* (see II.A.1.b above) and *Pacific Telephone & Telegraph*, 78-SBE-028 (May 4, 1978).

C. New 20-Percent Understatement Penalty under RTC § 19138

1. California has imposed a new penalty on corporate taxpayers equal to 20 percent of the understatement of tax if the understatement exceeds \$1 million.

2. In the case of taxpayers filing a combined report, the \$1 million threshold applies to the aggregate amount of the understatement for all entities in the combined report.

3. The penalty applies to understatements made on an original or amended return filed on or before the original or extended due date of the return for the taxable year.

4. The penalty is in addition to any other penalties and applies to taxable years beginning on or after January 1, 2003 for which the statute of limitations on assessment has not expired.

5. The penalty will not apply to understatements in the following situations:

a. The taxpayer files an amended return on or before May 31, 2009 and pays the amount of tax shown on that return by May 31, 2009; or

b. There is a change of law that causes the understatement, where the law change occurs after the date the taxpayer filed the return (or the extended due date for the return, whichever is

earlier) for the taxable year for which the change is operative; or

c. The understatement is attributable to the taxpayer's reasonable reliance on a legal ruling by the FTB Chief Counsel.

6. RTC § 19138 does not expressly provide for any "reasonable cause" exception and limits the grounds for refund or credit of any penalty paid to computational errors.

## IX. Miscellaneous

### A. Procedural Issues

1. *Ordlock v. Franchise Tax Board*, 38 Cal. 4<sup>th</sup> 897 (2006)

a. The California Supreme Court reversed the decision of the appellate court and held that the FTB was not time-barred from issuing an assessment based on a federal change that occurred after the normal four-year statute of limitations had expired.

2. FTB Protest Procedures Modified

a. The FTB issued two notices pertaining to the processing of docketed protests. See FTB Notices 2006-5 and 2006-6.

b. The intention is to attempt to achieve greater efficiency in the processing of protests.

c. Reduced timeframes for the processing of protests (12-18-24 months).

3. SBE Rules of Practice Modified

a. The SBE has issued revised Rules for Tax Appeals.

### B. Attorneys Fees

1. In recent decisions, courts have granted requests for attorney's fees for taxpayers in litigations against the FTB.

a. *Fujitsu Holdings, Inc. v. FTB*, 120 Cal. App. 4<sup>th</sup> 459 (2004)

(1) Time-Bar Issue

(a) The taxpayer made payment of taxes for 1988 during the pendency of protest.

(b) The FTB's position was that the suit for refund was untimely for 1988.

(i) RTC § 19335 converted protest into claim for refund.

- (ii) After the SBE decision upholding the FTB's denial of the protest, Fujitsu's subsequent claim for refund was a nullity.
    - (iii) Fujitsu's suit for refund for 1988 was not filed within 90 days of the SBE's decision.
  - (c) The FTB did not apply the payment to the protest until after the SBE decision.
  - (d) Trial court held the FTB could not invoke RTC § 19335 to bar refund suit.
  - (e) The time-bar issue was not appealed by the FTB.
- (2) Attorneys Fees Awarded With Respect to Time-Bar Issue
- (a) RTC § 19717 provides that reasonable litigation costs, including attorneys fees may be recovered.
    - (i) FTB's position must not be substantially justified.
    - (ii) Taxpayer must substantially prevail.
  - (b) Court of Appeal held that the FTB's position was not "substantially justified."
    - (i) FTB's application of the payment after SBE decision was critical in the Court's view.
  - (c) The taxpayer did substantially prevail even though the time-bar issue was not the most significant issue in the litigation.
- b. *Milhous v. FTB*, California Court of Appeal No. D044362 (August 15, 2005)
- c. *American General Realty v. FTB*, San Francisco Superior Court No. CGC-03-425690 (2005)
- (1) See **LC** above.
  - (2) Trial court granted the taxpayer's request for attorneys fees based on market rates.
  - (3) The FTB did not appeal the trial court's decision.
- d. *Agnew v. SBE*, 134 Cal. App. 4<sup>th</sup> 899 (2005)
- (1) In a sales and use tax case, the taxpayer's request for attorney fees was not granted under RTC § 7156.
  - (2) However, costs, including expert witness fees, were awarded.
    - (a) See California Code of Civil Procedure Sections 998 and 1032.
- e. *Cardinal Health v. SBE*, San Francisco Superior Court No. CGC 04-437052 (May 2006)
    - (1) Case dealt with the issue whether the SBE's denial of a sales and use tax exemption was proper.
    - (2) Trial court ruled in favor of the taxpayer and granted its request for attorneys fees based on market rates.
    - (3) On appeal, in an unpublished decision, the Court of Appeal reversed the granting of attorneys fees.
- f. *Northwest Energetic Services, LLC v. FTB*, San Francisco Superior Court No. CGC-05-437721 (March 3, 2006)
- (1) Attorneys fees were granted based on a "private attorney general" doctrine (California Code of Civil Procedure Section 1021.5).
  - (2) On appeal, the Court of Appeal reversed and remanded the case to the trial court on the issue of attorney fees. 159 Cal App. 4<sup>th</sup> 841 (2008).
2. On August 23, 2007, the FTB issued Information Letter 2007-2, which states that in order for a taxpayer to prevail on a request for attorneys fees under RTC § 19717, the taxpayer must exhaust all administrative remedies, including an appeal to the SBE.
- C. Limited Liability Company Issues
1. *Northwest Energetic Services, LLC v. FTB*, San Francisco Superior Court No. CGC-05-437721 (March 3, 2006)
- a. The trial court concluded that California's LLC fee under RTC § 17942 violates the Commerce and Due Process Clauses because it is based on worldwide gross income and not apportioned between gross income sourced within and without California.
  - b. The LLC in *Northwest Energetic* was a Washington state LLC that registered to do business in California, but never had any sales, property, payroll or other activity in California.
  - c. While the court's decision appears to conclude that the LLC fee is unconstitutional and cannot be imposed on any LLC, including those with California activities, it remains uncertain whether a California court would be as willing to conclude the fee is unconstitutional for an LLC that generated all, or most, of its income from California sources.

- d. On appeal, the Court affirmed but reversed and remanded the case to the trial court on the issue of attorney fees. 159 Cal App. 4<sup>th</sup> 841 (2008). The FTB did not seek review of the LLC fee issue by the California Supreme Court.
  - e. On April 14, 2008, the FTB issued Notice 2008-2 summarizing the information needed for taxpayers filing claims for refund based on the Northwest Energetic decision.
  - f. For taxable years beginning on or after January 1, 2007, legislation was enacted that provides that total income from all sources reportable to California means gross income, plus cost of goods sold, derived from or attributable to California within the meaning of specified provisions of the Corporation Tax Law relating to apportionment and allocation.
2. *Ventas Finance I, LLC v. FTB*, San Francisco Superior Court No. CGC-05-440001 (November 7, 2006)
    - a. Similar to Northwest, the trial court concluded the LLC fee under RTC § 17942 was an unfairly apportioned tax.
    - b. The Court concluded that RTC § 17942 could not be reformed to add an apportionment mechanism since that was contrary to the Legislature's intent.
    - c. The taxpayer had approximately 10 percent of its revenues from California sources.
    - d. On appeal, the Court of Appeal affirmed the unconstitutionality of the fee but reversed the trial court's determination that the company was due a refund for the entire amount of the fee it paid.
    - e. On September 19, 2008, the taxpayer filed a petition for review with the California Supreme Court.
  3. *Bakersfield Mall LLC v. FTB*, San Francisco Superior Court No. CGC 07-462728 (pending)
    - a. A limited liability company that does business solely within California filed suit challenging the constitutionality of the LLC fee. The suit seeks class status for LLCs that derive all income from within California.
    - b. The FTB's demurrer was overruled and the case is currently pending in trial court.
- D. Financial Corporation Classification
1. On March 12, 2007, the FTB issued Chief Counsel Ruling 2007-1 dealing with how to determine whether a corporation is a financial corporation under California law.
2. The precise issue addressed was whether a corporation's income from non-financial activities can give rise to financial income for purposes of the gross income test in determining financial corporation status.
  3. The FTB concluded that the focus should be on whether the activity generating the income was the "business of national banks," not on the character of the income.
- E. Federal Conformity
1. FTB Chief Counsel Ruling 2007-3
    - a. On July 17, 2007, the FTB issued a ruling confirming that a transaction was tax-free for California purposes under IRC § 355(b), as in effect prior to amendment by the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA").
    - b. The IRS issued a private letter ruling that the transaction was tax-free under IRC § 355(b), as amended by TIPRA, which permits a corporation to satisfy the "active trade or business" requirement if the affiliated group to which the corporation belongs is engaged in the active conduct of a trade or business.
    - c. Because California has not yet conformed to the TIPRA amendments to IRC § 355(b), the FTB analyzed the transaction under the pre-TIPRA rules. The FTB ruled that the transaction, as described in the IRS ruling, did not satisfy the tax-free requirements under pre-TIPRA IRC § 355(b). However, the taxpayer undertook additional steps in the transaction, which the FTB determined satisfied the active trade or business requirement under pre-TIPRA IRC § 355(b) and did not constitute a noneconomic substance transaction subject to penalties.
- F. California Compliance Resolution Program (IRC § 409A)
1. On February 23, 2007, the FTB issued Notice 2007-1. The purpose of the Notice was to advise employers participating, or intending to participate, in the IRS Compliance Resolution Program (Announcement 2007-18), that they may also participate in the corresponding California Compliance Resolution Program.