



Current California Franchise Tax Developments

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I. Deductibility of Dividends/Expense Attribution

A. *Farmer Bros. v. FTB*, 108 Cal. App. 4th 976 (2003), cert. denied, ___ U.S. ___, 124 S. Ct. 1411 (2004)

1. California Court of Appeal held California Revenue and Taxation Code (RTC) § 24402 unconstitutional under the Commerce Clause. RTC § 24402 allows a dividend 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.

i. 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.

i. For water's edge taxpayers, the 75 percent dividends received deduction will be allowed.

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

1. Court of Appeal held that RTC § 24410, which allowed a dividend 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.

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This bulletin contains the outlines of three presentations at the Orange County Chapter of the Tax Executive Institute at Irvine, California on May 5, 2004 by Jeffrey M. Vesely and Kerne H. O. Matsubara, tax partners, and Annie H. Huang, tax associate, all from the San Francisco office of Pillsbury Winthrop LLP. These outlines also can be found on the world wide web as part of the Pillsbury Winthrop LLP Tax Page at:

<http://www.pmstax.com/state/cadev0405.shtml>
<http://www.pmstax.com/state/caproc0405.shtml>
<http://www.pmstax.com/state/cashelter0405.shtml>

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. Proposed Legislation
 - a. Legislation has been proposed which would reverse FTB's policy statement. Numerous alternatives are being considered, one of which is the following:
 - i. For years beginning on or after December 1, 1997 and ending on or before December 31, 2002, a dividends received deduction (percentage not yet inserted) would be allowed and no expense attribution would be allowed.
 - ii. For years beginning on or after January 1, 2003, a dividends received deduction (percentage not yet inserted) would be allowed. No restriction on the use of expense attribution.
- C. *American General Realty Investment Corp., Inc.*, Case No. 156726 (SBE, June 25, 2003)**
1. In a summary decision, the State Board of Equalization (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. Case pending in San Francisco Superior Court (No. CGC 03425690).
- D. *Mercury General Corporation*, Case No. 145450 (SBE, 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 expenses under RTC § 24425 on the theory that the expenses were indirectly traceable to insurance company dividends which were deductible under *Ceridian*.
- E. *Beneficial California, Inc.*, Case No. 203445**
1. Case involves the issue whether any portion of the taxpayer's interest expense should be disallowed under RTC § 24425. The taxpayer contends that no interest expense should be disallowed since the FTB has not shown the requisite connection between the interest expense and the insurance company which paid the deductible dividends in question.
 2. Case awaits oral argument before the SBE.
- II. Anti-Tax Shelter Legislation**
- A. Senate Bill No. 614 and Assembly Bill No. 1601**
1. New anti-tax shelter legislation enacted in October 2003, generally effective January 1, 2004, but may apply to certain transactions entered into prior to that date.
 2. Generally conforms to existing federal law regarding tax shelter registration, list maintenance and disclosure of reportable transactions.
 3. Provides 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 provides for penalties aimed at tax shelter promoters, advisers and return preparers.
 5. Extends the statute of limitations to eight years for proposed deficiency assessments relating to abusive tax avoidance transactions.
 6. Directs 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. Provides for a "voluntary compliance initiative" (VCI) for the period January 1, 2004 through

April 15, 2004 during which eligible taxpayers voluntarily may 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. \$1.2 billion was collected by the FTB under VCI.

III. Apportionment Formula

A. Sales Factor

1. Gross receipts from treasury function activities. Numerous suits for refund pending. Three trial court decisions in favor of exclusion of gross receipts from the sales factor. One decision in favor of inclusion of gross receipts.
 - a. *Microsoft Corporation v. FTB*, San Francisco Superior Court No. CGC-01-400444 (September 9, 2003).
 - i. Trial court held that gross proceeds from the sale of marketable securities must be included in the sales factor.
 - ii. Trial court also held that the FTB did not prove that inclusion of the proceeds in the sales factor would be distortive under RTC § 25137.
 - iii. Case pending in the Court of Appeal.
 - b. *Toys R Us, Inc. v. FTB*, Sacramento Superior Court No. 01 AS 04316 (August 21, 2003).
 - i. 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.
 - ii. In dicta, the court held that if the return of capital was included in the sales factor, RTC § 25137 would apply.
 - iii. Case pending in the Court of Appeal.
 - c. *Limited Stores, Inc. v. FTB*, Alameda Superior Court No. C-837723 (April 11, 2003).
 - i. 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.
 - ii. In dicta, court held that the inclusion of gross receipts would be distortive.
 - iii. Case pending in the Court of Appeal.
 - d. *General Motors Corporation v. FTB*, Los Angeles Superior Court No. BC269404 (February 21, 2003).
 - i. Trial court concluded that gross receipts from treasury function activities are not to be included in the sales factor.
 - ii. Case also involves issues relating to use of research credits by a unitary group and the deductibility of withholding taxes.
 - iii. Case awaiting decision in the Court of Appeal. Oral argument held on March 25, 2004.
 - e. *Montgomery Ward and Co., Inc.*, Case No. 133828 (SBE, October 3, 2002)
 - i. 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.
 - ii. Case pending in San Diego Superior Court (No. GIC 802767).
 - f. *Colgate-Palmolive Co.*, Case No. 152028 (SBE, November 12, 2002)
 - i. 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.
 - ii. Case pending in Sacramento Superior Court (No. 03AS00707).
 - g. *Polaroid Corporation*, Case No. 62415 (SBE, May 28, 2003)
 - i. In a summary decision, the SBE concluded that the inclusion of gross proceeds from sales of securities prior to maturity was distortive and thus not includable.

- ii. Case also involved the question whether proceeds from the Kodak patent infringement litigation should be included in the sales factor. The SBE concluded that the entire proceeds were to be included in the denominator and a portion thereof, based on the taxpayer's California sales factor, was to be included in the numerator.
 - a. The SBE granted the taxpayer's petition for rehearing to reconsider this issue.

2. 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. May become quite relevant in post-*Ceridian* and post-*Farmer Bros.* years where the FTB is disallowing deductions for RTC § 24410 and RTC § 24402 dividends.

B. Property Factor

- 1. *Quick & Reilly, Inc.*, Case No. 202953 (SBE, March 9, 2004)
 - a. The SBE concluded that margin loans that were applied for at offices in California are includible in the numerator of the property factor of a financial corporation under Regulation 25137-4.1.

C. Distortion

- 1. *Weyerhaeuser Company*, 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. Other issues include the proper inclusion of gross receipts from the taxpayer's treasury function in the sales factor, the inclusion of a proper value for government-owned property in the property factor and various MIC issues.
 - c. Case being briefed. Oral argument scheduled for late 2004.

IV. Manufacturers Investment Tax Credit

A. *Save Mart Supermarkets*, 2002-SBE-002 (SBE, February 6, 2002)

- 1. On February 6, 2002, the SBE issued a rare formal opinion in the first manufacturers' investment tax credit (MIC) case to reach the Board. This was the first in a series of taxpayer victories in MIC cases in 2002 and 2003.
- 2. The case involved the issue of whether *Save Mart* was a qualified taxpayer with respect to its bakery and meat processing activities.
 - a. Both activities are described in Division D of the SIC Manual.
- 3. The Franchise Tax Board (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.
- 4. *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.
- 5. *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.
- 6. The SBE agreed with *Save Mart* and overturned the FTB's qualified taxpayer regulation (23649-3).
- 7. 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.

8. 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.
- B. *Jon and Rita Minnis and Milpitas Materials Company*, 2002-SBE-003 (SBE, June 20, 2002)**
1. In the second MIC case to reach the SBE, the SBE concluded in another 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.
 2. 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.
 3. The SBE refused to follow FTB Legal Ruling 2001-4.
- C. *Bronco Wine Company*, 2002-SBE-006 (SBE, September 12, 2002)**
1. The SBE again ruled against the FTB in the third MIC case to be heard.
 2. 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.
 3. 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).
- D. *California Steel Industries, Inc.*, 2003-SBE-001-A (SBE, July 9, 2003)**
1. In an Opinion on Petition for Rehearing by the new Board, the SBE once again rejected the FTB's position.
 2. 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.
- E. *Baxter Healthcare Corporation*, Case No. 140712 (SBE, May 28, 2003)**
1. In a summary decision, the SBE confirmed its decision in California Steel regarding the capitalized labor issue.
 2. 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.
 3. The SBE also concluded that certain facilities were special purpose buildings and foundations and thus qualified property.
 4. The SBE held that the heating, ventilating and air conditioning systems installed in clean rooms was not qualified property.
- F. *Lienau*, Case Nos. 156798, 156810, 156814 and 156808 (SBE, July 9, 2003)**
1. 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.
- G. *LSI Logic, Inc. and Cypress Semiconductor Corporation*, Case Nos. 142330 and 173287 (SBE, August 7, 2003)**
1. 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.
 2. 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.

3. 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.
4. 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.

H. MIC Repealed

1. The MIC was repealed by its own terms and ceased to be operative as of January 1, 2004.
2. Various bills have been introduced to revive the MIC.
 - a. Assembly Bill Nos. 1998, 2070, 2076 and Senate Bill No. 1295.
3. MIC credits for years prior to 2004 and which have not yet been used, may be carried forward until fully utilized.

V. Business v. Nonbusiness Income

A. *Jim Beam Brands Co.*, Case No. 89002468010 (SBE, March 29, 2001)

1. Gain from the sale of a unitary subsidiary held to be business income under the functional test.
2. The SBE declined to follow the partial liquidation exception noted in *Lenox, Inc. v. Offerman*, 538 S.E. 2d 203 (N.C. 2000), aff'd No. 17A01 (N.C. S.Ct. 2001).
3. Case pending in San Francisco Superior Court (No. CGC-02-408203).

VI. Water's Edge Election

A. *Yamaha Motor Corporation*, Case No. 89002467500 (SBE, November 28, 2001)

1. Taxpayer made intercompany sales of inventory during a year in which it filed on a worldwide

basis and eliminated the gains. Taxpayer then elected water's edge the next year. The inventory was sold to third parties outside of the group. On a petition for rehearing by the FTB, the SBE reversed its earlier decision. In a summary decision, the SBE concluded that the gains should be included in income at the taxpayer's apportionment percentage for the worldwide year which was lower than the taxpayer's apportionment percentage in the year of sale to the third parties. The SBE also concluded that the income should be prorated over a five-year period, beginning with the first water's edge year, consistent with FTB Notice 89-601.

B. *Alps Electric (USA), Inc. and Canon U.S.A., Inc.*, Case Nos. 55001 and 55446 (SBE, January 13, 2003)

1. In a summary decision by the new Board which is at odds with *Yamaha*, the SBE concluded that the taxpayer was required to use the elimination and carryover basis approach with respect to inventory sold in intercompany transactions in years prior to the making of a water's edge election. The later sale of the inventory to third parties occurred after the water's edge election. The gain was included in income at the taxpayer's apportionment percentage for the water's edge year. No proration of the gain was allowed.

C. *Mitsubishi Electric America, Inc.*, Case No. 207902 (SBE, February 18, 2004)

1. The SBE concluded that domestic subsidiaries of a Japanese parent should have used the elimination and basis transfer or carryover basis, method of accounting for inventory items they had acquired by intercompany purchases from their parent and its foreign affiliates in pre-water's edge years, in determining their basis in inventory.

D. *Pacific Telesis Group, Inc. v. FTB*, SFSC No. 319008 (2003)

1. While not a water's edge election case, the case involved deferral/elimination issues similar to those raised in *Yamaha* and *Alps*.
2. California trial court concluded that a parent corporation of a unitary group was not entitled

to a refund of corporation franchise taxes paid by one of its subsidiaries on gains realized by a sister subsidiary on equipment sales.

3. Case is pending in the Court of Appeal.

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

1. In a summary decision, the SBE concluded that Income Tax Regs. § 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 Income Tax Regs. § 1.954-2(b)(1).

F. *Amdahl Corporation v. FTB*, SFSC No. 321296 (2002)

1. California trial court concluded that the dividend elimination rules of RTC § 25106 should be applied to dividends from controlled foreign corporations that are partially included under the Subpart F rules pertaining to water's edge elections.
2. Case is pending in the Court of Appeal.

G. FTB Notice 2004-2 (May 3, 2004)

1. On May 3, 2004, FTB issued a notice regarding the implementation of new water's edge election statute.

VII. Unitary Business

A. *Conopco, Inc.*, Case No. 129732 (SBE, August 6, 2003)

1. In a letter decision, the SBE concluded that a unitary business existed between appellants and Unilever United States but not with any foreign Unilever affiliates.

VIII. Mark-To-Market

A. *The McGraw-Hill Companies, Inc. v. FTB*, San Francisco Superior Court No. CGC 03424737

1. Case involves the issue whether for 1993 and 1994 the taxpayer should be permitted, for California purposes, to use the mark-to-market

method of accounting for accounts receivable and customer paper where it was required to do so under IRC § 475. The applicability of FTB Legal Ruling 95-6 is in issue.

2. Trial scheduled for August 23, 2004.

IX. Legislation

A. Senate Bill No. 1061

1. Eliminates the requirement that corporations enter into a contract with the FTB when they elect water's edge. The water's edge election process will now be the same as it is for all other tax elections.
2. Applicable to elections made in taxable years beginning on or after January 1, 2003.

B. Senate Bill No. 103

1. Deduction for distributions by regulated investment companies (RIC) eliminated.
2. Aimed at RIC transactions which the FTB has identified as "listed transactions" in Chief Counsel Announcement 2003-1.
3. Applicable to taxable years beginning on or after January 1, 2003.

C. Senate Bill No. 640

1. Prohibits state agencies or departments from entering into contracts with publicly held corporations that have incorporated offshore to avoid taxes.

D. Proposed Legislation

1. Numerous bills are pending which address water's edge (Senate Bill Nos. 1571 and 1876), establishment of State Tax Court (Assembly Bill No. 2472 and Senate Bill No. 1424), consolidation of the FTB and SBE (Assembly Bill No. 2000), amnesty (Assembly Bill No. 2203), research and development credits (Senate Bill No. 1501), among others.
2. Treasurer Phil Angelides' call for repeal of "unjustified corporate loopholes."
 - a. Restrict S corporation use.
 - b. Eliminate various agricultural sales tax exemptions.

- c. Eliminate ability to have different IRC § 338 election treatment under California law.
 - 3. Angelides also calling for annual review of credits, deductions, etc., in budget process.
 - 4. Finally, Angelides would require FTB study of water's edge election and require FTB to report on whether law should be changed.
- X. Miscellaneous
- A. "Total Recall"
- 1. On October 7, 2003, California Governor Gray Davis (D) was recalled ("terminated") and replaced by Arnold Schwarzenegger (R). The impact on California tax policies still remains to be seen.
 - 2. The Director of the Department of Finance which is a governor appointed position changed. This in turn altered the make-up of the 3-member FTB.
 - a. Carole Migden, who is the Chairwoman of the SBE and thus also on the FTB, is running for State Senator. If elected in November, this will open up slots on both the FTB and SBE.
- B. *Franchise Tax Board v. Gilbert P. Hyatt*, 538 U.S. 488 (2003)
- 1. The U. S. Supreme Court affirmed a Nevada Supreme Court decision that Nevada courts had properly exercised jurisdiction over intentional tort claims brought against the FTB, for alleged abuses occurring during a personal income tax (residency) audit, by a former California resident, who was a Nevada resident at the time of the audit.
- C. *Geneva Towers Limited Partnership v. City and County of San Francisco*, 29 Cal. 4th 769 (2003)
- 1. In a case with potentially far reaching ramifications, the California Supreme Court reversed the Court of Appeal and concluded that where a taxing authority fails to act on a claim for refund within six months, the claimant may deem the claim denied and file a suit for refund at any time prior to the mailing of a notice of action on the claim.
 - 2. The Court of Appeal had held that there was a four-year statute of limitations to file the action which began to run six months after the claim was filed.
- D. *Magnetek, Inc.*, Case No. 198051 (SBE, January 27, 2004)
- 1. The SBE concluded that a federal waiver executed by a parent corporation on behalf of its federal consolidated return filing group did not serve to extend the California statute of limitations for foreign affiliates included in the parent's California combined report but not included in the consolidated return.

California Franchise Tax Administrative Procedures

Jeffrey M. Vesely • Kerne H. O. Matsubara • Annie H. Huang

- I. Notice of Proposed Assessment
- A. Statute of Limitations. The statute of limitations for issuing a notice of proposed assessment (NPA) is four years from the due date of the return. This period can be extended through a California or federal waiver of the statute of limitations.
- 1. Multiple NPAs are possible if issued within the statute of limitations.
 - 2. If a federal waiver has been granted for the same year, the FTB can issue an NPA six months after the expiration of the federal waiver. The NPA may be based on any grounds.
 - 3. Generally, the statute of limitations for filing a claim for refund is the same as that for issuing an NPA. There was a major exception for the return years 1992 and thereafter. In those years, while an NPA may be issued four years from the extended due date, a claim for refund is limited to four years from the original due date of the return. This disparity in treatment was corrected in 2001.

B. What must the NPA include?

1. Generally speaking, the NPA only includes the amount of proposed assessment with a brief description of the reasons for the issuance.

C. Workpapers. Detailed workpapers are prepared by the auditor. The taxpayer should obtain a copy of them automatically from the auditor.**D. Audit narrative.** The auditor also prepares a written audit narrative which describes the audit procedures used, the information reviewed, the facts relied upon and the legal conclusions reached. The taxpayer should specifically request a copy of the audit narrative and all audit files at the close of the audit.**II. Protest****A. Statute of Limitations**

1. Within 60 days after the date shown on the face of the NPA, a written protest must be filed. There are no extensions under California law for the filing of a protest.
2. Under California law, the mailing date is the filing date of the protest.

B. What must the protest include?

1. The protest must specify the grounds upon which it is based. These grounds do not need to be detailed.
 - a. Caution: If the taxpayer chooses to later pay the NPA during the protest proceedings, this will automatically convert the protest into a claim for refund. The grounds set forth in the protest will then frame the grounds upon which the taxpayer could bring a suit for refund. A taxpayer should make certain that the grounds in the protest are complete enough to avoid a later challenge that the taxpayer failed to exhaust administrative remedies.
2. The protest should include a request for an oral hearing before the FTB.
3. The taxpayer should consider filing a protective claim for refund in conjunction with the protest. This will allow the taxpayer to obtain refunds of amounts paid with the return.
 - a. Caution: There is a statute of limitations issue which should be carefully considered. If an NPA is

issued close to the end of the statute of limitations, the claim for refund may need to be filed almost immediately after the issuance of the NPA to avoid a statute of limitations bar.

4. The grounds contained in the protest may also include affirmative issues, *i.e.*, issues which may have arisen during or after the audit but which were not raised in the tax return.

5. The taxpayer should request a copy of the audit files.

C. No payment is required with a protest. Interest will continue to accrue.**D. The protest procedures are informal.**

1. The hearing officer may or may not be an attorney.
 - a. If the hearing officer is an attorney, that individual may end up wearing an "advocate" hat in later administrative steps or in court litigation.
2. Information requests are common.
 - a. Should you respond?
 - i. There is an issue of exhaustion of administrative remedies which should be considered. See *E. C. Barnes v. State Board of Equalization*, 118 Cal.App.3d 994 (1981). See also *U.S. Steel v. Franchise Tax Board*, 144 Cal.App.3d 473 (1983).
3. The hearing is informal.
 - a. There is no "record" which is created in the administrative process.
 - b. Generally, there is no court reporter at a protest hearing. However, there is nothing prohibiting the same. A taxpayer should consider showcasing key witnesses at the protest hearing and may wish to record the testimony.
 - c. Declarations of key witnesses should be considered.
 - d. There may be multiple protest hearings.
4. A taxpayer should consider preserving testimony through depositions of key witnesses. See California Code of Civil Procedure section 2035.
5. The protest hearing officer generally attempts to "resolve" issues as opposed to "settle" cases.

- a. While cases are generally “settled” administratively in the Settlement Bureau (discussed below), on occasion, the protest hearing officer may engage in settlement discussions with the taxpayer.
- 6. Hearing officer issues a written decision in the form of a letter at the conclusion of the protest.
- 7. A Notice of Action is issued on the protest by the FTB. The Notice may affirm, reverse or modify the NPA.

III. Claim for Refund

A. Alternative to protest. An alternative to filing a protest is to pay the tax and pursue the claim for refund procedure. Payment can be made at the time the NPA is issued or at any time during the administrative review process.

B. Statute of Limitations.

- 1. The general rule is that a refund claim must be filed four years after the last day prescribed for filing the return for a particular year or one year from the date of an overpayment, whichever period expires later.
- 2. Where a waiver has been executed for California purposes extending the running of the statute of limitations on deficiency assessments, the limitation date for refunds is the same as the date for mailing NPAs.
- 3. If a federal waiver has been granted, a claim for refund may be filed within six months after the expiration of the federal waiver. The grounds in the claim are not limited to federal issues.

C. Requirements for valid claim.

- 1. The claim must be in writing, signed by the taxpayer or its representative, and must state the specific grounds upon which it is based.
 - a. The grounds which are set forth in the claim for refund are critical since they frame the grounds upon which a later suit for refund can be brought.
 - b. If payment of the tax is made after the filing of a protest or an appeal to the SBE, this will convert the protest to a claim for refund on the grounds set forth in the original protest document. Taxpayers should consider filing a claim with the payment

incorporating all arguments and grounds which have been set forth not only in the original protest, but also those which may have been raised during the protest proceeding.

- 2. The entire amount of the tax, interest and penalties must be paid. See FTB Notice 2003-5.
- 3. An informal hearing may be requested by the taxpayer. The hearing would be similar to that which is provided in the protest proceeding.

D. The claim for refund procedure is informal.

- 1. The claim may be considered by the same hearing officer who would otherwise consider a protest.
- 2. Information requests are common.
- 3. Any hearing held at this stage would be informal, similar to that which is held in the protest proceeding.

E. Deemed denial of claim.

Unlike a protest, the claim may be deemed denied by a taxpayer six months after the filing thereof.

- 1. Following the deemed denial, the taxpayer may either appeal the denial of the claim to the SBE or file a suit for refund in the California Superior Court.

F. Formal action on claim.

The hearing officer will generally take action on the claim for refund. The action will be to grant or deny the claim. A formal notice of action will be issued.

IV. Appeal to SBE

A. Administrative appeal. If a taxpayer’s protest or claim for refund is denied, it has the option of filing an administrative appeal to the SBE.

B. Statute of Limitations. The statute of limitations for the appeal to the SBE is different depending upon whether a taxpayer is appealing the denial of a protest or the denial of a claim for refund.

- 1. If a protest is denied, the taxpayer needs to file a written appeal with the SBE within 30 days after the notice of action is mailed to the taxpayer.

The date on the notice of action is deemed to be the date of mailing. No payment is required by the taxpayer of the tax, interest or penalties.

2. If a taxpayer's claim for refund is denied, it must file an appeal with the SBE within 90 days after the mailing of the notice of action disallowing the claim. As with the notice of action denying the protest, the mailing date is deemed to be date shown on the face of the notice.

C. Requirements for appeal

1. The appeal is directed to the SBE, not the FTB.
2. The appeal must be in writing and state the name of the appellant, the amounts and years involved, the date of the notice of action, a summary of the facts of the case, a summary of the specific legal grounds upon which the appeal is made, points and authorities in support of the appellant's position and a signature of the appellant or its representative.
3. Two copies of the appeal and supporting documentation should be sent directly to the SBE. The SBE will then forward a copy to the FTB.
4. The appeal may be supplemented by the taxpayer by use of an opening brief. A specific request to do so should be noted in the appeal itself.

D. *De novo* proceeding. None of the information which has been presented at the FTB level will be automatically forwarded to the SBE. Thus, a taxpayer needs to present all facts and arguments directly to the SBE.

E. The appeal process is more formal than the protest or claim for refund process.

1. Formal briefing is allowed. Following the original appeal or supplementation by the taxpayer, the FTB will be provided the opportunity to file its brief in support of its position. The individual representing the FTB may be the same individual who acted as a hearing officer in the earlier protest or claim for refund.
 - a. The taxpayer will be provided the opportunity to file a reply brief to the FTB's brief. Additional supplementary briefs by both sides is common.

- b. The completion of the briefing process may last beyond a year from the original filing of the appeal.

2. The hearing before the SBE is more formal than the hearing held at the protest level.

- a. At least three of the five members of the SBE or their designees will be present.
 - b. A court reporter will be recording the testimony and arguments.
 - c. Witnesses are sworn in.
 - d. Rules of evidence are less stringent than court proceedings.
 - e. The duration of the hearing is limited—35 minutes is generally the maximum.
 - f. On occasion, additional briefing or evidence may be presented after the hearing.

3. A written decision is issued.

- a. The SBE may issue either a formal opinion or an informal summary decision. The formal opinion is precedential while the summary decision is not. Both an opinion and a decision are reported in the various tax services.
 - b. The briefs, exhibits and transcripts of cases which have been recently decided are available to the public for a copying charge.

F. Does a taxpayer have to go through the appeal process in order to exhaust its administrative remedies?

1. A taxpayer is not required to appeal a denial of a protest or a denial of a claim for refund in order to litigate a case in court. The taxpayer can bypass the SBE and go directly to court from the denial of a claim for refund.

- a. Caution: If you commence an appeal at the SBE, there is an issue whether you can dismiss and file a suit for refund. You should consider the statute of limitations for filing a suit for refund.

G. Advantages and disadvantages of going through the SBE.

1. Advantages

- a. No prepayment requirement.
 - b. Cost

- i. The administrative appeal is less expensive than a court litigation.
 - c. The administrative appeal may facilitate the resolving of factual disputes.
 - d. The FTB cannot appeal an adverse decision from the SBE.
 - e. Rules of evidence are lax.
 - f. No formal discovery rules exist at the SBE. While subpoenas may be issued, there is no formal process for interrogatories, *et al.*, from the FTB.
 - g. Additional bite at the apple.
 - h. Decision within twelve months.
 - i. Taxpayer has right of review in Superior Court.
 - j. Expertise on certain tax issues.
 - k. Certain cases may be better to bring to the SBE in view of the existing precedent.
 - l. Political.
2. Disadvantages
- a. Absence of independent review.
 - i. The FTB's winning percentage at the SBE is high. This may be due to a number of factors, including the makeup of the respective boards and the fact that the FTB cannot appeal an adverse decision.
 - b. Abbreviated hearing.
 - i. Due to the time constraints in the hearing, a taxpayer is not able to put on an elaborate presentation.
 - c. No written opinion required.
 - i. Three formal opinions issued in 2003.
 - d. Amounts in dispute may have impact.
 - e. Political.

V. Settlement Process

- A. **Administrative settlement powers.** In 1992, the FTB obtained administrative settlement powers. See Revenue and Taxation Code section 19442. The FTB set up a formal Settlement Bureau which is separate and apart from the normal administrative review process.

B. Settlement vs. resolution. What is the difference?

1. Prior to the enactment of section 19442, the FTB believed that it only had the ability to resolve issues and cases administratively, and not settle issues or cases. Resolution of issues is more of an all or nothing approach, while settlement may take into consideration the relative values and merits of each issue.
2. The powers which have been granted under section 19442 are similar to those which have been utilized in the course of actual court litigation settlements.

C. How does the settlement process work?

1. A taxpayer may request transfer to the settlement bureau during the pendency of a protest, claim for refund or an appeal.
2. A taxpayer may request a transfer of the case immediately to the Settlement Bureau once an NPA has been issued. The taxpayer must, however, file a protest in addition to such request.
 - a. A good faith settlement proposal must be included.
 - b. An analysis of the issues should be included.
3. Generally, settlement officer who is different from the protest hearing officer is assigned the case.
 - a. The conferee may be an attorney or a non-attorney.
4. The process is confidential. In order to promote open discussion, the settlement file is not available to auditors, hearing officers or other individuals within the FTB. The parties enter into a written agreement to keep the matter confidential. This agreement may be waived by the parties in the event the taxpayer wishes to allow an auditor or hearing officer for later years to review the recommendations of the settlement officer.
5. Generally, there is at least one face-to-face settlement conference.
6. Once a settlement is reached, a formal written settlement agreement is drafted and executed by the parties. If the settlement requires a payment

by the taxpayer, it is generally required to be made up front. If the settlement falls through during the review process, the taxpayer would obtain a refund of its payment plus interest.

7. The settlement officer's recommendation must be reviewed by the assistant chief counsel in charge of the Settlement Bureau and the chief counsel of the FTB. If it is approved by those individuals, it is then forwarded to the Attorney General's office for review. There may be discussions between the Attorney General's office and the FTB settlement officer regarding the terms of the settlement. The settlement can be rejected at that level. If it is in fact accepted, it is then forwarded on to the full Franchise Tax Board for review. Again, the settlement may be accepted or rejected at that level.
8. Once the settlement has been approved, there is a one-page description of the settlement that is open for public review. The statement does not get into the merits of the issues. It does mention the taxpayer's name and the amounts at issue, along with the amount which was settled upon.

D. Advantages to the settlement process.

1. Cases move quicker through the system. There is a nine-month rule. Settlement must be reached with the settlement officer within nine months of the date the request to transfer was filed.
2. A taxpayer can possibly avoid extensive information requests which would otherwise be generated during the protest proceeding.
3. Issues are settled administratively which in the past had to be litigated.

E. Disadvantages to the settlement process.

1. Public disclosure of settlement results.
 - a. From time to time, there has been media criticism of the FTB for various settlements.
2. The settlement process is somewhat cumbersome due to the approval required by the Attorney General and the FTB itself.

F. Should I Consider Going to Settlement? Why? When?

1. Timing.
 - a. Early vs. late in protest process.
 - i. Should you consider waiting until the hearing officer issues his/her decision?
2. Do you have issues you do not want to compromise?
3. Do you want to avoid inquiries by the hearing officer?
4. Do you have evidentiary problems?
5. Do you have difficult issues?
6. Will FTB settle refund claims?
7. If on appeal, when should you file the request?
 - a. Prior to final decision, settlement negotiations may occur (Regulation 5076.1).
8. Is it easier to settle deficiency cases rather than refund claims?
9. Should you narrow the issues or keep as many issues on the table as possible?
10. Should you keep as much tax in dispute as possible?
11. Should you settle tax disputes or entire taxable years.
12. What about Federal RARs?
 - a. Tie down your apportionment percentages.

G. Once a taxpayer is in the settlement process, can it get out?

1. If a taxpayer is unable to reach a settlement, the case will then go back into protest or appeal.
2. The details of the settlement discussion will remain unknown outside of the Settlement Bureau unless a waiver of the confidentiality occurs.

VI. Section 25137 Petition

A. **Additional administrative step.** In unitary tax matters, a taxpayer has an additional administrative step which it can choose to pursue. Under Revenue and Taxation Code section 25137 (UDITPA § 18), a taxpayer may petition the FTB for relief if it believes the allocation and apportionment provisions of the Bank and Corporation Tax Act do not fairly represent the extent of the taxpayer's business activity in California. The procedures under section 25137 are not well defined. Generally, the request for relief under section 25137 is considered jointly with the protest, claim for refund and appeal mentioned above.

B. **Not required for exhaustion of administrative remedies.** Contrary to the position sometimes asserted by the FTB, this is not a necessary step which needs to be exhausted prior to proceeding to a refund suit in a franchise tax matter.

C. **Separate hearing before FTB.** The request for a separate hearing before the FTB under section 25137 can be made at any time during the administrative process.

D. **Petitions for relief under section 25137 are rarely granted.**

California Tax Shelter Rules

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I. **Tax Shelter Disclosure Rules.** California generally has adopted the federal tax shelter disclosure rules under IRC § 6011 with modifications (RTC § 18407).

A. **Federal disclosure rules.** Income Tax Regs. § 1.6011-4 requires taxpayers that participate in a "reportable transaction" to disclose such participation to the IRS. The following rules generally reflect the final federal regulations under IRC § 6011, which were issued February 23, 2003.

1. **Reportable transactions.** The six types of reportable transactions are:

a. **Listed transactions.**

i. Transactions—or substantially similar transactions—that the IRS has identified by published guidance. Currently approximately 30 transactions (*e.g.*, IRS Notice 2003-76).

b. **Confidential transactions.**

i. A transaction is offered under conditions of confidentiality if the advisor (a) is paid a minimum fee (\$250,000 if the taxpayer is a corporation) and (b) places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor's tax strategies.

ii. Does not include transactions labeled as "proprietary" or "exclusive" if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.

iii. These rules on confidential transactions reflect T.D. 9108 (December 29, 2003), which scaled back the confidentiality "trigger" to carve out routine commercial transactions that normally include elements of privacy.

c. **Transactions with contractual protection.**

i. Transactions in which the taxpayer or related party has the right to a full or partial refund of fees if all or part of the intended tax consequences are not sustained.

ii. Also, transactions in which the fees are contingent on the taxpayer's realization of tax benefits from the transaction.

d. **Loss transactions.**

i. Transactions resulting in a corporate taxpayer claiming a loss under IRC § 165 of at least \$10 million in any single taxable year or \$20 million in any combination of tax years.

ii. Lesser threshold amounts for partnerships, S corporation, trusts and individuals.

- e. Transactions with a significant book-tax difference.
 - i. Transactions in which the amount for tax purposes of any item or items of income, gain, expense or loss differs by more than \$10 million (on a gross basis) from the amount of the item or items for book purposes.
 - ii. The book-tax category generally applies only to large business entities (*i.e.*, reporting companies under the SEC and business entities with \$250 million or more of gross assets).
 - f. Transactions involving a brief asset holding period.
 - i. Transactions resulting in the taxpayer claiming a tax credit exceeding \$250,000 if the underlying asset giving rise to the credit is held by the taxpayer for 45 days or less.
 - 2. Exceptions. Transactions that fall within one of the above categories must be disclosed irrespective of the taxpayer's motive or whether the transaction is "abusive." Limited exceptions have been provided in published guidance, *e.g.*, certain losses (Rev. Proc. 2003-24) and certain book-tax differences (Rev. Proc. 2003-25).
 - 3. Who is a participant? Income Tax Regs. § 1.6011-4(c)(3) defines participation with respect to each reportable transaction category. In general, a taxpayer has participated in the transaction if the taxpayer's tax return reflects tax consequences of the transaction (*e.g.*, listed transactions) or reflects a tax benefit from the transaction (*e.g.*, confidential transactions and transactions with contractual protection).
 - a. Participation also includes indirect participation as a partner in a partnership, a shareholder in an S corporation, or through a trust.
 - b. Certain exceptions apply with respect to pass-through entities (*e.g.*, where the partner, S shareholder or beneficiary is not individually subject to a confidentiality limitation or does not individually possess the right to a refund of fees).
 - 4. Disclosure procedures.
 - a. Form 8886. Disclosure is made by attaching Form 8886, *Reportable Transaction Disclosure Statement*, to the taxpayer's return for the affected tax year. In addition, Form 8886 should be attached to each amended return that reflects a taxpayer's participation in a reportable transaction.
 - b. OTSA. A copy of Form 8886 must be sent to the Office of Tax Shelter Analysis (IRS) at the same time that any Form 8886 is first filed by the taxpayer.
 - c. "Springing" listed transactions. If a transaction engaged in by a taxpayer becomes a listed transaction after the filing of the taxpayer's tax return (and before the end of the statute of limitations period for that return), then the taxpayer must file Form 8886 with its next filed tax return.
 - d. Rulings and protective disclosures. A taxpayer may submit a request to the IRS for a ruling as to whether a transaction is subject to the disclosure requirements. In addition, if a taxpayer is uncertain whether a transaction must be disclosed, the taxpayer may disclose the transaction and indicate that it was uncertain whether the transaction was required to be disclosed and that the disclosure is being filed on a protective basis.
 - e. Retention of documents. The taxpayer must retain a copy of all documents and other records related to a transaction subject to disclosure that are material to an understanding of the tax treatment or tax structure of the transaction.
 - i. Documents should be retained until the expiration of the statute of limitations.
 - ii. Documents include the following: marketing materials, written analyses, correspondence and agreements between the taxpayer and any advisor, documents related to the tax benefits and documents referring to the business purpose.
 - iii. Taxpayer is not required to retain earlier drafts of a document if the taxpayer retains a copy of the final document (or most recent draft, if no final document exists) and the final/most recent document contains all the information in the earlier drafts that is material to an understanding of the tax treatment or tax structure.
 - f. Effective date. The disclosure regulations under IRC § 6011 generally apply to federal income tax returns filed after February 28, 2000.
- B. California modifications.**
- 1. FTB authority. For California income and franchise tax purposes, "reportable

transactions” and “listed transactions” include transactions designated as such by the FTB.

- a. Chief Counsel Announcement 2003-1. Issued December 31, 2003 identifying as California “listed transactions” (i) all federal listed transactions, (ii) certain real estate investment trust (REIT) transactions and (iii) certain regulated investment company (RIC) transactions.
 - i. FTB’s position on the REIT structure is that California does not conform to consent dividends for purposes of the REIT dividends paid deduction.
 - ii. FTB attacks the RIC structure on the basis that certain wholly owned or controlled RICs are “shams.”
 - b. Office of Administrative Law. The normal rulemaking rules under Cal. Gov’t. Code § 11340, *et seq.* do not apply to FTB notices or rules.
2. Effective date. For California purposes, the disclosure rules (RTC § 18407) are generally effective for taxable years beginning on or after January 1, 2003.
- II. Tax Shelter Registration (Confidential Corporate Tax Shelters).** California generally follows the federal tax shelter registration rules under IRC § 6111, with certain modifications (RTC § 18628).
- A. **Federal registration rules.** In general, any tax shelter organizer must register the tax shelter with the IRS no later than the day on which the first offering for sale of an interest in such tax shelter occurs. For registration purposes, a “tax shelter” is an investment that has a greater than 2 to 1 “tax shelter ratio,” which is the ratio that the aggregate amount of deductions and 200% of the credits allowable to an investor bears to the investment base. In addition, “confidential corporate tax shelters”—the focus of this section—are treated as tax shelter subject to the registration requirement.
 1. Defining characteristics. Any transaction with the following three characteristics (“a,” “b” and “c”) is a confidential corporate tax shelter requiring registration (IRC § 6111(d)):
 - a. Avoidance or evasion of federal income tax. Transaction in which a significant purpose of the structure is the avoidance or evasion of federal income tax for a direct or indirect corporate participant.
 - i. In general: (a) listed (or substantially similar) transaction or (b) any other tax-structured transaction that has been structured to produce federal income tax benefits that constitute an important part of the transaction and the tax shelter promoter reasonably expects the transaction to be presented in the same or substantially similar form to more than one participant.
 - ii. Except: if (a) the potential participant is expected to participate in the ordinary course of its business in a form consistent with customary commercial practice and (b) there is a generally accepted understanding (*e.g.*, rulings) that the expected federal income tax benefits from the transaction are properly allowable under the IRC for substantially similar transactions.
 - iii. Other exceptions: if (a) the tax shelter promoter reasonably determines that there is no reasonable basis under federal tax law for denial of any significant portion of the expected federal income tax benefits from the transaction, (b) the IRS makes a determination by published guidance that the transaction is not subject to the registration requirement, or (c) the IRS makes a determination by individual ruling (*e.g.*, PLR) that the specific transaction is not subject to the registration requirements for the taxpayer requesting the ruling.
 - b. Offered under conditions of confidentiality. Transactions that are offered to any potential participant under conditions of confidentiality, with exceptions for (i) disclosures restricted by securities law and (ii) certain merger and acquisition situations.
 - c. Possible receipt of fees in excess of \$100,000. Transactions in which the tax shelter promoters may receive fees in excess of \$100,000 in the aggregate. (A “promoter” is any person or any related person who participates in the organization, management or sale of the tax shelter.)
 2. Registration procedures.
 - a. Time for registering. A tax shelter must be registered not later than the day on which the first offering for sale of interests in the shelter occurs.
 - b. Form 8264. Use Form 8264, *Application for Registration of a Tax Shelter*.
 - c. Person required to register. The principal tax shelter promoter is generally the party responsible

for registering the confidential corporate tax shelter. If, however, the principal tax shelter promoter does not register the confidential corporate tax shelter, other parties may become responsible for registering the shelter.

B. California rules.

1. California additions. RTC § 18628 modifies the federal rules by including the avoidance or evasion of “California income or franchise tax.” In addition, the federal definition of “tax shelter” under IRC § 6111(d) is modified to include any federal or California listed transaction.
2. Registration. In general, a tax shelter organizer must send a duplicate of the federal registration information, or the same information required for federal tax shelters in the case of California tax shelters, to the FTB no later than the day on which the sale of interests in the tax shelter is first offered.
 - a. FTB Notice 2004-1: The FTB also requires that the applicable California business entity number be provided.
3. What is a California shelter? The California registration requirements apply to tax shelters that satisfies any of the following:
 - a. Organized in this state,
 - b. Doing business in this state,
 - c. Deriving income from sources in this state,
 - d. At least one of its investors is a California taxpayer.
4. Nexus issues. FTB’s position is that the nexus of the promoter is irrelevant to the registration requirements on the basis that the nexus of the taxpayer and the transaction determines whether the promoter has an obligation to register the shelter. FTB also maintains that each member of a unitary group that reports to California an abusive tax shelter transaction impacting unitary business income subject to apportionment “participates” in that abusive tax shelter.
5. Effective date.
 - a. General. Effective January 1, 2004.

- b. Federal listed transactions. Any federal listed transaction entered into on or after February 28, 2000 that became a listed transaction at any time must be registered with the FTB by the later of:
 - i. 60 days after entering into the transaction,
 - ii. 60 days after the transaction becomes a listed transaction,
 - iii. April 30, 2004
- c. California listed transactions. Any California listed transaction entered into on or after September 2, 2003 that became a listed transaction at any time must be registered with the FTB by the later of:
 - i. 60 days after entering into the transaction,
 - ii. 60 days after the transaction becomes a listed transaction,
 - iii. April 30, 2004

III. List Maintenance. California generally follows the federal list maintenance rules under IRC § 6112, with certain modifications (RTC § 18648).

A. Federal list maintenance. In general, each organizer and seller of a transaction that is a potentially abusive tax shelter must prepare and maintain a list of persons (that possess certain characteristics—*e.g.*, persons that would be required to disclose their participation in the transaction) to whom the advisor provides a tax statement with respect to the transaction.

1. Defining characteristics. A potentially abusive tax shelter is any transaction that is an IRC § 6111 tax shelter (*e.g.*, confidential corporate tax shelters or certain shelters with a 2:1 tax shelter ratio) or a transaction that has potential for tax avoidance or evasion.
 - a. IRC § 6111 tax shelter. An IRC § 6111 tax shelter is any transaction that is required to be registered with the IRS under that section, regardless of whether that tax shelter is properly registered.
 - b. Avoidance or evasion of federal income tax. A transaction that has potential for tax avoidance or evasion includes any of the following:
 - i. Any listed transaction under the disclosure rules,
 - ii. Any transaction that a potential material advisor knows is or reasonably expects will

- become a reportable transaction under the five other categories of reportable transactions,
- iii. Certain stepped transactions (*i.e.*, subsequent transfer of an interest in a transaction) where the transferor knows or reasonably expects the transferee will sell or transfer an interest and the transferred interest of the transaction would be a listed or reportable transaction.
2. Organizer and seller. A person is an organizer of, or a seller of an interest in, a transaction that is a potentially abusive tax shelter if that person is a material advisor with respect to that transaction.
 - a. Material advisor. A person is a material advisor with respect to a transaction that is a potentially abusive tax shelter if the person is required to register the transaction under IRC § 6111, or the person receives or expects to receive at least a minimum fee—\$250,000 where all the advisees with respect to the transaction are corporations, or \$50,000 where all of the advisees are not—and the person makes a tax statement for the benefit of:
 - i. A taxpayer who is reasonably expected to disclose the transaction,
 - ii. A person who is required to register the transaction under IRC § 6111,
 - iii. A person who purchases or acquires an interest in an IRC § 6111 tax shelter, or
 - iv. A transferee of an interest whereby the transferred interest would be a listed or reportable transaction.
 - b. Tax statement. A tax statement means any statement, oral or written, that relates to a tax aspect of a transaction that causes the transaction to be a reportable transaction.
 - c. Designation agreements. If more than one material advisor is required to maintain a list of persons relating to a potentially abusive tax shelter, the material advisors may designate by written agreement a single material advisor to maintain the list or a portion of the list. Further, the designation of one material advisor to maintain the list does not relieve the other material advisors from their obligation to furnish the list if the designated material advisor fails to furnish the list to the IRS in a timely manner.
 3. List maintenance procedures.
 - a. Contents. Each list must contain the following information:
 - i. The name of each transaction that is a potentially abusive tax shelter and the registration number, if any, obtained under IRC § 6111,
 - ii. The taxpayer identification number (TIN), if any, of each transaction,
 - iii. The name, address and TIN of each person required to be on the list,
 - iv. The number of units acquired by each person required to be on the list, if known,
 - v. The amount invested in each transaction by each person required to be on the list, if known,
 - vi. A summary or schedule of the tax treatment that each person is intended or expected to derive from participation in each transaction, if known,
 - vii. Copies of any additional written materials (*e.g.*, opinions) relating to each transaction that are material to an understanding of the purported tax treatment or tax structure of the transaction that have been shown to any person (or agent of such person) who acquired or may acquire an interest in the transaction and
 - viii. For each person required to be on the list, the name of the person from whom the interest was acquired if the interest in the transaction was not acquired from the material advisor maintaining the list.
 - b. Retention and furnishing of lists. In general, each material advisor must maintain the list for seven years following the earlier of the date on which the material advisor last made a tax statement relating to the transaction, or the date the transaction was entered into. Further, each material advisor responsible for maintaining a list of persons, must upon written request by the IRS, furnish the list to the IRS within 20 days from the day on which the request is provided.
 - c. Limited claim of privilege. Under the IRC § 6112 regulations, material advisors are subject to the list maintenance rules despite claims of attorney-client privilege or the confidentiality privilege. Current cases on the extent of such privileges are pending.

- d. Ruling requests. A person may submit a request to the IRS for a ruling as to whether a transaction will be considered a potentially abusive tax shelter and whether that person is a material advisor with respect to that transaction.

B. California rules.

1. Application. The California list maintenance requirements apply to any organizer, seller or material advisor of a potentially abusive tax shelter (within the meaning of IRC § 6112) that additionally satisfies any of the following conditions:
 - a. Organized in this state,
 - b. Doing business in this state,
 - c. Deriving income from sources in this state,
 - d. At least one of its investors is a California taxpayer.
2. Additional requirements. The list shall be maintained in the form and manner prescribed by the FTB. In contrast to the federal rules which require lists to be furnished upon request by the IRS, California lists involving listed transactions must be provided to the FTB.
 - a. FTB's position is that RTC § 18648 requires the organizer or promoter to maintain a list of all investors regardless of the investor's physical address.
3. Effective date. In general, see registration rules above.

IV. California Penalties.

- A. **Penalty for failure to disclose.** California imposes a penalty (RTC § 19772) on any "large entity" or "high net worth individual" who fails to disclose a reportable transaction in accordance with the rules under IRC § 6011, as modified by RTC § 18407.
 1. Large entity. A large entity is a person (other than an individual) with gross receipts in excess of \$10,000,000 for either the taxable year in which the transaction occurs or in the preceding taxable year.
 2. Individuals. A high net worth individual is an individual whose net worth exceeds \$2,000,000 immediately before the transaction.

3. Penalty amount. The penalty is \$15,000 for each omission. For listed transactions, the penalty is \$30,000 for each omission. The penalty is in addition to any other penalty that may be imposed.
4. Waiver. The penalty may be rescinded at the sole discretion (*i.e.*, without administrative or judicial review) of the FTB Chief Counsel if the following conditions apply:
 - a. The transaction is not a listed transaction;
 - b. The taxpayer has a history of compliance with the tax shelter rules and the California franchise and income tax law;
 - c. The violation is due to an unintentional mistake of fact;
 - d. Imposing the penalty would be against equity and good conscience;
 - e. Rescinding the penalty would promote compliance with the tax shelter rules and the California franchise and income tax law and effective tax administration.
5. Effective date. The penalty generally applies to taxable years beginning on or after January 1, 2003. The penalty also applies to persons (otherwise subject to the penalty) who invested in a federal listed transaction after February 28, 2000 and before January 1, 2004, where the transaction becomes listed at any time. For California listed transactions, the FTB's position is that the penalty applies to transactions entered into on or after September 2, 2003.

B. Registration and list maintenance penalties.

1. Failure to register. The penalty for the failure to timely register a tax shelter or show the required information is generally \$15,000. In the case of a "listed transaction" the penalty is the greater of (a) \$100,000 or (b) 50% of the gross income that the organizer or material advisor derived from that activity (75% in the case of intentional disregard) (RTC § 19173(b)).
2. Failure to maintain or provide list. For reportable transactions, the penalty for the failure to furnish the list within 20 days of an FTB request or show the information required to be provided on such list is:

- a. \$10,000 per day for each day after the 20th day that the organizer or material advisor has failed to make the list available to the FTB upon written request;
 - b. In the case of a listed transaction, the greater of (i) \$100,000 or (ii) 50% of the gross income that the organizer or material advisor derived from that activity (75% in the case of intentional disregard).
3. Application and effective date. The registration and list maintenance penalties are in addition to any other penalty. In general, the penalties are effective January 1, 2004 on any return for which the statute of limitations has not expired.

C. Understatement penalties. The California understatement penalties include an accuracy-related penalty, a penalty for understatements relating to a reportable transaction and a penalty for understatements relating to a transaction that lacks economic substance. An understatement penalty generally will apply to the extent that another understatement penalty has not been applied.

1. Accuracy-related penalty. In general, California conforms to the federal accuracy-related penalty (IRC § 6662), with specified modifications (RTC § 19164).
 - a. Federal rules. Under federal rules, a 20% accuracy-related penalty is imposed on understatements of tax attributable to negligence, “substantial understatements” of tax or “substantial valuation misstatements” (40% in the case of “gross valuation misstatements”).
 - i. “Substantial understatement” is an understatement of tax for the taxable year which exceeds the greater of (a) 10% of the correct amount of tax or (b) \$5,000 (\$10,000 in the case of corporations).
 - ii. Substantial authority or adequate disclosure: An “understatement” does not include any portion attributable to the tax treatment of an item for which there is (a) substantial authority or (b) an adequate disclosure on the return by the taxpayer. In the case of a tax shelter, “(b)” does not apply and “(a)” only applies if the taxpayer reasonably believed that its tax treatment of the item was more likely than not the proper tax treatment.
 - iii. Reasonable cause exception: The reasonable cause and good faith exception may apply with

respect to all or any portion of an underpayment, including, for example, reliance on a tax opinion or advice (IRC § 6664). However, in the case of tax shelter items of a corporation, at a minimum, the substantial authority requirement and the belief requirement (greater than 50% likelihood of success on the merits) must be satisfied. Minimum requirements are not dispositive if, for example, the taxpayer’s participation in the tax shelter lacked significant business purpose, the claimed tax benefits are unreasonable in comparison to the taxpayer’s investment in the shelter or the taxpayer agreed to protect the confidentiality of the tax aspects of the shelter (Income Tax Regs. § 1.6664-4(f)).

- b. California modifications.
 - i. Lower threshold for certain corporations: Corporations (other than S corporations) that have been contacted by the FTB regarding the use of a “potentially abusive tax shelter” (see RTC § 19177) are subject to the accuracy-related penalty if the understatement exceeds the lesser of (a) 10% of the correct tax (or, if greater, \$2,500) or (b) \$5,000,000.
 - ii. “Listed transactions”: FTB is authorized to prescribe a list of positions for which there is not substantial authority or there is no reasonable belief that the tax treatment is more likely than not the proper tax treatment.
 - iii. Fraud penalty: A fraud penalty (75% of the underpayment) may apply to the portion of any underpayment of tax due to fraud (IRC § 6663 and RTC § 19164(c)).
 - iv. Effective date. All taxable years beginning on or after January 1, 1990 and any other taxable year for which an assessment is made after July 16, 1991.
2. Reportable transaction understatement penalty. In general, California imposes a 30% penalty on a “reportable transaction understatement,” which is reduced to 20% if there is adequate disclosure (RTC § 19773).
 - a. Application. The penalty applies to any listed transaction and any reportable transaction (other than a listed transaction) if a significant purpose of that transaction is the avoidance or evasion of California income or franchise tax.
 - b. Reportable transaction understatement—defined as the sum of the following:
 - i. (The increase, if any, in taxable income due to the difference between the proper treatment

- and the taxpayer's treatment) x (the highest marginal tax rate applicable to the taxpayer), and
- ii. The decrease, if any, in the aggregate amount of credits determined under the RTC that result from a difference between the taxpayer's treatment of an item and the proper treatment.
- c. Reasonable cause exception. The reasonable cause and good faith exception under IRC § 6664 generally applies if all of the following requirements are satisfied (RTC § 19164(d)(2)):
 - i. Adequate disclosure of the tax treatment of the item, including any tax shelter identification number, (or if the RTC § 19772 penalty is rescinded);
 - ii. Substantial authority for that treatment; and
 - iii. Reasonable belief by the taxpayer that the tax treatment was more likely than not the proper treatment, which requires that the belief be based on the facts and law that exist at the time the return is filed and not take into account the likelihood of FTB audit of the return or settlement outcomes. In addition, a taxpayer cannot rely on a tax opinion to establish reasonable belief if either
 - a. the tax advisor:
 - is a material advisor who participates in the organization, management, promotion or sale of the transaction, or is related to any person who so participates,
 - is compensated directly or indirectly by a material advisor with respect to the transaction,
 - has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax benefits from the transaction or
 - has a continuing financial interest with respect to the transaction as determined by Treasury or FTB regulations; or
 - b. the tax opinion:
 - is based on unreasonable factual or legal assumptions (including assumptions as to future events),
 - unreasonably relies on representations, statements, findings or agreements of the taxpayer or any other person,
- does not identify and consider all relevant facts or
 - fails to meet any other requirements as the IRS or FTB may prescribe.
- d. Adequate disclosure. For purposes of the reduction in the penalty from 30% to 20%, the disclosure rules under IRC § 6011, as modified by RTC § 18407, generally apply.
 - e. Chief Counsel discretion. If the penalty applies, only the FTB Chief Counsel, at his or her own sole discretion without delegation, may abate all or a portion of the penalty. The Chief Counsel's decision is not subject to administrative or judicial review.
 - f. Effective date. The penalty applies to taxable years beginning on or after January 1, 2003. For California listed transactions, the FTB's position is that the penalty applies to transactions entered into on or after September 2, 2003.
3. Noneconomic substance transaction understatement penalty. In general, California imposes a 40% penalty on a "noneconomic substance transaction understatement," which is reduced to 20% if there is adequate disclosure (RTC § 19774).
 - a. Application. The term "noneconomic substance transaction understatement" means any amount which would be a "reportable transaction understatement" taking into account items attributable to "noneconomic substance transactions" rather than reportable transactions.
 - b. Reportable transaction—includes a transaction or arrangement that lacks economic substance or in which an entity is disregarded as lacking economic substance. A transaction is treated as lacking economic substance if the taxpayer does not have a valid nontax California business purpose for entering into the transaction.
 - i. Common law: Federal case law, in particular, Ninth Circuit cases, *e.g.*, *Sacks v. Commissioner*, 69 F.3d 982, 991 (9th Cir. 1995) (rejecting the IRS's argument that a tax-subsidized transaction lacked economic substance because it resulted in a pre-tax loss, holding that the "investment did not become a sham just because its profitability was based on after-tax instead of pre-tax projections"); *Casebeer v. Commissioner*, 909 F.2d 1360, 1363 (9th Cir. 1990) (looking to both "objective economic substance" and "subjective business motivation" in determining whether a transaction has sufficient economic substance

and noting that a “sham transaction” has “no business purpose or economic effect other than the creation of tax deductions”).

- ii. Proposed federal codification: Under proposed new IRC § 7701(n) (S. 1637), a transaction would have “economic substance” under the common law doctrine only if:
 - a. the transaction changes in a meaningful way (apart from federal tax effects) the taxpayer’s economic position, and
 - b. the taxpayer has a substantial nontax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.

In addition, a transaction would not be treated as having economic substance by reason of having a potential for profit unless the present value of the expected pretax profit from the transaction must be substantial in relation to the present value of the expected tax benefits, and the pretax profit potential must exceed a risk-free rate of return.

- c. Chief Counsel discretion. If the penalty applies, only the FTB Chief Counsel, at his or her own sole discretion without delegation, may abate all or a portion of the penalty. The Chief Counsel’s decision is not subject to administrative or judicial review.
- d. Effective date. The penalty generally applies with respect to any penalty assessed on or after January 1, 2004, on any return for which the statute of limitations on assessment has not expired.

D. Other tax shelter penalties.

1. “100% interest” penalty. Taxpayers that have been contacted by the FTB regarding the use of a potentially abusive tax shelter and who have a deficiency are subject to a penalty in an amount equal to 100% of the interest payable for the period beginning on the due date for payment of tax (i.e., generally, the return filing date without regard to extensions) and ending on the date that the notice of proposed assessment (NPA) is mailed (RTC § 19777).
 - a. A “potentially abusive tax shelter” is defined as (i) any tax shelter for which registration is required under IRC § 6111 or (ii) any entity, investment plan or arrangement, or other plan or arrangement which is of a type that Treasury

or FTB determines by regulations as having a potential for tax avoidance or evasion.

- b. Application. The penalty is in addition to any other penalty that may be imposed. The statute is unclear whether the penalty only applies to the portion of interest attributable to the deficiency arising as a result of the potentially abusive tax shelter.
 - c. Effective date. Generally effective with respect to any penalty assessed on or after January 1, 2004, on any return for which the statute of limitations has not expired.
2. Higher interest in other situations. For an amended return for taxable years beginning after December 31, 1998 filed after April 15, 2004, and before the taxpayer is contacted by the IRS or FTB regarding a potentially abusive tax shelter, the taxpayer is subject to applicable interest but at a rate of 150% of the adjusted annual rate with respect to any understatement of tax relating to the use of a reportable transaction (RTC § 19778).

E. Frivolous return and submission penalties.

1. Frivolous return. California generally conforms to the federal penalty (IRC § 6702) for filing a frivolous return, except that in the case of any taxpayer that has been contacted by the FTB regarding the use of a potentially abusive tax shelter, the penalty has been increased from \$500 to \$5,000 (RTC § 19179(a), (b)). The penalty applies to:
 - a. Filings based on a position that is frivolous or is based on a position that the FTB has identified as frivolous, or
 - b. The filing reflects a desire to delay or impede the administration of the federal or California tax laws
2. Frivolous submission. Any person who submits a “specified frivolous submission” is subject to a \$5,000 penalty (RTC § 19179(d)). A specified frivolous submission is any protest, request for hearing or applications relating to installment payment of tax liability, compromises or actions of the Taxpayer Right’s Advocate, if the submission is based on a position that the FTB has identified as frivolous or reflects a desire to delay or impede administration of the tax laws.

F. Promoter and preparer penalties.

1. **Promoter penalty.** California generally conforms to the federal penalty (IRC § 6700) for promoting abusive tax shelters (RTC § 19177). In general, promoters of tax shelters are subject to a penalty if the person makes a “gross valuation overstatement” (generally 200% of the correct valuation) or makes a statement with respect to the allowability of any deduction or credit that the person knows or has reason to know is false. In the case of the making of a false statement, the California penalty is 50% of the gross income derived from the activity on which the penalty is imposed.
2. **Tax return preparer penalty.** California also conforms, with modifications, to the federal penalty (IRC § 6694) imposed on certain tax return preparers (RTC § 19166). The California penalty is imposed on return preparers who take a position for which there was no reasonable belief that the tax treatment was more likely than not the proper tax treatment (*cf.* federal standard of “no realistic possibility of success”), the preparer knew or reasonably should have known of such position and the position was not properly disclosed.

V. Other Tax Shelter-Related Rules.

- A. **Statute of limitations.** For California income and franchise tax purposes, the statute of limitations for proposed deficiency assessments relating to an “abusive tax avoidance transaction,” which includes, but is not limited to, listed transactions, is extended to eight years after the return was filed (RTC § 19755). This provision applies to returns filed on or after January 1, 2000.
- B. **Subpoena.** The FTB power to subpoena documents in tax shelter cases has been expanded. For taxpayers that have been contacted by the FTB regarding the use of a potentially abusive tax shelter, the subpoena may be signed any FTB board member, the FTB Executive Officer “or any designee” (RTC § 19504).
 1. On April 14, 2004, the FTB announced that it issued shelter-related subpoenas to two insurance companies demanding the names of all California persons who were issued insurance policies or who sought to buy policies

insuring against government enforcement actions related to the use of shelters.

VI. Voluntary Compliance Initiative (VCI).

- A. **Summary.** During the limited period from January 1, 2004 through April 15, 2004, taxpayers had the opportunity to file amended returns and pay tax liabilities and applicable interest relating to the use of abusive tax avoidance transactions (which include without limitation listed transactions) for open taxable years beginning before January 1, 2003 (RTC § 19751). Taxpayers were given two options under VCI: with appeal rights and without appeal rights. If the taxpayer opted for VCI without appeal rights, no claim for refund may be filed and all penalties are waived or abated. Under VCI with appeal rights, the taxpayer preserves its right to file a refund claim and all penalties, except the accuracy-related penalty, are waived or abated.
 1. As of April 28, 2004, VCI brought in approximately \$1.2 billion from corporations and individuals, more than \$800 million of which was paid with notices of appeal.

B. Refund of amounts paid with VCI.

1. If the taxpayer pays less than 100% of the tax liability and interest due to the use of a tax shelter (*e.g.*, due to non-shelter offsetting issues) and such offsetting amounts are later held to be invalid, the taxpayer will remain subject to penalties on the invalid amounts.
2. No portion of an amount paid in connection with VCI without appeal rights may be refunded to the taxpayer, even if the taxpayer has claims with respect to non-shelter items (RTC § 19752(a)(4)).
3. Amounts paid in connection with VCI with appeal rights may be refunded to the taxpayer, including with respect to claims for non-shelter items.

C. VCI with appeal rights—Now what?

1. **Accuracy-related penalty.** Though subject to the accuracy-related penalty under this option, the taxpayer does not pay the penalty with the VCI amended return. The penalty may be assessed (a) when the FTB takes action on

the claim or (b) when a federal determination becomes final for the same issue, in which case the penalty will be assessed if the penalty was assessed at the federal level. The penalty is due and payable upon notice and demand.

2. Claim for refund. Under this option, taxpayers could elect to either treat the amended return filed pursuant to VCI as a claim for refund or file a claim for refund at a later date. The normal procedures for refund claims apply (RTC § 19752(b)(4)).
3. Statute of limitations. If taxpayers elected to file a refund claim at a later date, the claim should be filed within the statute of limitations for refund claims—generally, the later of (a) one year after the VCI payment was made, (b) four years after the due date of the original return, (c) the expiration date under California waivers or (d) the expiration date under federal waivers, plus six months.
4. Appeal to SBE. Notwithstanding the “deemed denial” rule (*i.e.*, taxpayer may deem a claim denied if the FTB fails to act within 6 months

and appeal to SBE), the taxpayer may not file an SBE appeal until after either of the following:

- a. the date the FTB takes action on the claim for refund or
 - b. the later of the following: (i) 180 days after the date of a final IRS determination with respect to the shelter transaction or (ii) four years after the date the refund claim was filed or one year after full payment of all tax, including penalty and interest was made, whichever date is later.
5. Suit for refund in court.

VII. FTB and IRS Cooperation. Most states, including California, have entered into agreements with the IRS and with each other to cooperate and share information regarding taxpayers that may be engaged in tax shelters. These efforts are expected to result in a greater sharing of information, more structured and efficient channels of communication and earlier sharing at the front-end of taxpayer audits. In addition, a multiple-nation task force (U.S., Canada, Australia, U.K.) has been formed to increase collaboration and coordinate information about abusive tax transactions.

