



## 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, 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.

(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.

5. Assembly Bill No. 666.

a. This bill would allow a 100 percent dividends received deduction, but only to the extent of the amount of the dividend that, within two years of its receipt, is invested in qualified property in California.

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.

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.

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### 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.
  - (i) 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 and 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.
  - (ii) 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 percent of the qualified dividends (increases to 85 percent 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.

- (iii) 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.

- (i) 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.

- (ii) 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.
- b. *City of Modesto v. National Med, Inc.*, 2005 Cal. App. LEXIS 606, \_\_\_ Cal. App. 4<sup>th</sup> \_\_\_ (April 18, 2005)
  - (i) 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."

### 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. On April 28, 2005, the SBE's decision was reversed in the San Francisco Superior Court (No. CGC 03425690). 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. *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 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.
- 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. Apportionment Formula
- A. Sales Factor
1. Gross receipts from treasury function activities. Numerous suits for refund pending. Two court of appeal and two trial court decisions in favor of exclusion of gross receipts from the sales factor. One trial court decision in favor of inclusion of gross receipts.
    - a. *General Motors Corporation v. FTB*, 120 Cal. App. 4<sup>th</sup> 114 (2004).
      - (i) Court of Appeal 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 on intercompany dividends, royalties and interest.
        - (a) The Court concluded that the credits can only be used by the member of the unitary group which generated the credit, not the entire group.
        - (b) With respect to the deductibility of withholding taxes, the Court concluded such taxes were on income and thus nondeductible.
      - (iii) Petition for Review granted by the California Supreme Court. Case still in the briefing process.
    - b. *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 gross proceeds in the sales factor would be distortive under RTC § 25137.
      - (iii) On February 28, 2005, in an unpublished opinion which is not precedential, the Court of Appeal reversed the trial court's decision.
        - (a) The Court only reached the distortion issue and concluded that the FTB had proven that the inclusion of the gross proceeds would create a distortion under RTC § 25137.

- (b) The Court concluded that under RTC § 25137(d), the FTB's remedy of curing the distortion by excluding the return of principal from the sales factor was proper.
  - (c) The Court declined to decide the issue whether the term "sales" includes return of capital under RTC § 25120(e).
  - (d) The Court invited the California Supreme Court in *General Motors* to provide a uniform treatment of the issue, rather than a case-by-case distortion analysis.
- (iv) On April 25, 2005, the taxpayer filed a Petition for Review with the California Supreme Court.
- c. *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.
- d. *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.
- 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. 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.

### 3. FTB Proposed Amendments to Regulation 25106.5-1

- a. On February 9, 2005, the FTB staff requested approval from the 3-member FTB to proceed with amendments to Regulation 25106.5-1.
- b. The proposed amendments are intended to clarify the 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.
- c. The 3-member FTB approved going forward with a symposium for interested parties.

### 4. 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.
  - (i) Separate income-producing activities in each state.
- c. Time-spread method applies only when capital is not a material income-producing factor.

### 5. Assembly Bill No. 1037

- a. Proposed legislation would include the "net gain" from treasury function activities in the sales factor, rather than gross receipts.
- b. Sponsored by Controller Steve Westly.

## B. Property Factor

### 1. *Quick & Reilly, Inc.*, Case No. 202953 (SBE, March 9, 2004)

- a. In a summary decision, 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.

### 2. Amendments to Regulations 25130 and 25137(b)(1)

- a. Amendments to the government-owned property factor regulation were approved by Office of Administrative Law.
- b. Amendments reflect to some extent FTB Legal Ruling 97-2.

## 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. 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*.

## III. Credits

### A. Manufacturers Investment Tax Credit

#### 1. *Save Mart Supermarkets*, 2002-SBE-002 (SBE, 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.
    - (i) 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 (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.
2. *Jon and Rita Minnis and Milpitas Materials Company*, 2002-SBE-003 (SBE, June 20, 2002)
    - a. 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.
      - 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.
  3. *Bronco Wine Company*, 2002-SBE-006 (SBE, September 12, 2002)
    - a. The SBE again ruled against the FTB in the third MIC case to be heard.
    - 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).
  4. *California Steel Industries, Inc.*, 2003-SBE-001-A (SBE, July 9, 2003)
    - a. In an Opinion on Petition for Rehearing by the new Board, 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.
  5. *Baxter Healthcare Corporation*, Case No. 140712 (SBE, 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 was not qualified property.
6. *Lienau*, Case Nos. 156798, 156810, 156814 and 156808 (SBE, 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.
  7. *LSI Logic, Inc. and Cypress Semiconductor Corporation*, Case Nos. 142330 and 173287 (SBE, 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.
  8. 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.
- B. Enterprise Zone Credits
1. *Deluxe Corporation*, Case No. 260869
    - a. Case involves challenge to FTB's position of looking behind vouchers obtained from local enterprise zones. 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.
  2. Proposed vouchering regulations being drafted by the Department of Housing and Community Development.
- C. Separate But Unitary
1. *General Motors Corporation v. FTB*, 120 Cal. App. 4<sup>th</sup> 114 (2004)
    - a. Court of Appeal 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.
    - c. Case pending in the California Supreme Court.
- IV. Business v. Nonbusiness Income
- A. *Jim Beam Brands Co. v. FTB*, San Francisco Superior Court No. CGC-02-408203 (June 28, 2004).
1. Trial court concluded that the gain from the sale of a unitary subsidiary was business income under the functional test.

2. The court declined to follow the cessation of line of business or partial liquidation exception theories.
  3. Case pending in the Court of Appeal.
- B. Taxation of Investment Income Earned on Foreign Earnings Repatriated Under the American Jobs Creation Act
1. On February 9, 2005, the 3-member FTB approved the staff's recommendation to issue a Notice providing guidance on how California will tax investment income earned on foreign earnings repatriated under the American Jobs Creation Act.
  2. The FTB staff indicated that it is their position that the income will be classified as business income.
  3. Significant issues exist regarding the deductibility and/or elimination of the dividends, sales factor treatment and factor representation.
- V. California Tax Amnesty ... Not?
- A. Senate Bill No. 1100
1. On August 16, 2004, two tax amnesty programs were signed into law: the personal and corporate income/franchise tax amnesty program and the sales/use tax amnesty program were administered by the FTB and the SBE, respectively.
  2. Both programs ran from February 1, 2005 through March 31, 2005.
  3. Both programs applied to tax liability due and payable for tax reporting periods (sales/use tax) and for taxable years (personal/corporate income/franchise tax) beginning before January 1, 2003.
  4. Both programs were in reality nothing more than tax payment acceleration programs to reduce the magnitude of California's budget deficits.
  5. Taxpayers under both amnesty programs are subject to a new 50 percent Interest Penalty; personal and corporate income taxpayers are also subject to a doubling of the Accuracy Related Penalty (ARP) from 20 percent to 40 percent and applicable sales/use tax penalties are doubled.
- a. The 50 percent Interest Penalty is equal to 50 percent of the applicable interest on any final amount for the period beginning on the original due date through March 31, 2005.
  - b. Increased ARP does not apply to any taxable years in audit, protest, appeal, settlement or litigation as of February 1, 2005. No similar exception exists for the 50 percent Interest Penalty.
6. Under the FTB Amnesty Program, all penalties are waived. However, no claims for refund are allowed for any amounts paid in connection with the FTB Amnesty Program. Claims for refund are allowed under the SBE Amnesty Program.
  7. Unless a taxpayer was a nonfiler, had outstanding final liabilities, or had criminal or significant penalty exposure, the FTB Amnesty Program was not an attractive option.
  8. Due to the 50 percent Interest Penalty and to a lesser extent the increased ARP, it was prudent for personal and corporate income taxpayers to undertake an analysis of each open taxable year prior to January 1, 2003 and determine the strengths and weaknesses of their California reporting positions issue by issue. A similar review should have been made of a taxpayer's federal reporting positions and audits, since federal RAR adjustments also are subject to the 50 percent Interest Penalty. Taxpayers could then determine whether it was beneficial to pay tax and interest outside amnesty prior to March 31, 2005 to avoid the 50 percent Interest Penalty (and if relevant, the increased ARP).
    - a. For amounts paid outside of amnesty, claims for refund were allowed.
  9. The FTB purportedly collected \$3.36 billion, \$777 million under amnesty and \$2.58 billion outside amnesty.
  10. For more information on the California Tax Amnesty Programs, see our [January 2005 State & Local Tax Bulletin](#), "California Tax Amnesty ... Not?"

## B. Post-Amnesty Procedural Issues

## 1. Claims for Refund

a. Taxpayers should consider filing a separate claim for refund even if an amended return accompanied the payment.

(i) This allows for the inclusion of additional grounds in support of the claim for refund.

(ii) Multiple claims for refund are permissible for a given taxable year.

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 an additional claim 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.

## c. Statute of Limitations

(i) 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.

(ii) 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 Notices of Proposed Assessments (NPA).

(iii) 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. This is to be contrasted with a claim for refund based on federal adjustments.

## d. Requirements for valid claim

(i) 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.

(ii) The entire amount of the tax, interest and penalties must be paid. See, FTB Notice 2003-5.

(iii) An informal hearing may be requested by the taxpayer. The hearing would be similar to that which is provided in the protest proceeding.

e. The claim for refund procedure is informal.

(i) 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.

(ii) Information requests are common.

(a) Should you respond? 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).

(iii) Any hearing held at this stage would be informal, similar to that which is held in the protest proceeding.

(a) There is no "record" which is created in the administrative process.

(b) Generally, there is no court reporter at a claim for refund hearing. However, there is nothing prohibiting the same. The taxpayer should consider showcasing key witnesses at the hearing and may wish to record the testimony.

(c) Declarations of key witnesses should be considered.

(d) There may be multiple hearings.

(iv) A taxpayer should consider preserving testimony through depositions of key witnesses. See California Code of Civil Procedure section 2035.

(v) The 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 hearing officer may engage in settlement discussions with the taxpayer.

(vi) The hearing officer issues a written decision in the form of a letter at the conclusion of the proceedings.

- f. Deemed denial of claim. Unlike a protest, the claim may be deemed denied by a taxpayer six months after the filing thereof.
    - (i) 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.
  - g. 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 in whole or in part. A formal notice of action will be issued.
  - h. *Ordlock v. Franchise Tax Board*, Cal. Ct. App. No. B169465 (2004). In an unexpected decision, the Court of Appeal held in *Ordlock* that the FTB was time-barred from issuing an assessment based on a federal change that occurred after the normal four-year statute of limitations had expired. The FTB filed a petition for review, which the California Supreme Court granted. If affirmed, the Court of Appeal decision in *Ordlock* could be interpreted to prevent taxpayers from filing California claims for refund of federal adjustments that occur after the expiration of the normal limitations period for filing refund claims.
2. 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.
    - (i) 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.
    - (ii) 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
    - (i) The appeal is directed to the SBE, not the FTB.
    - (ii) 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.
  - (iii) 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.
  - (iv) 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.
    - (i) Formal briefing is allowed. Following the original appeal and/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.
    - (ii) The hearing before the SBE is more formal than the hearing held at the protest or claim level.
    - (iii) A written decision is issued.
  - f. Does a taxpayer have to go through the appeal process in order to exhaust its administrative remedies?
    - (i) 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) If you commence an appeal from a denial of a claim at the SBE, you can proceed to court without completing the appeal process, provided the suit for refund is filed within 90 days of the dismissal of the appeal by the SBE.
  - g. Advantages and disadvantages of going through the SBE from a denial of a claim.

### 3. Settlement Process

- a. Settlement vs. resolution. What is the difference?
  - (i) Prior to the enactment of RTC § 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.
  - (ii) 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.
- b. How does the settlement process work?
- c. Advantages and disadvantages to the settlement process.
- d. Once a taxpayer is in the settlement process, can it get out?

### 4. Suit For Refund

- a. Statute of Limitations
  - (i) Four years from the last day prescribed for filing the return.
  - (ii) One year from the date of payment.
  - (iii) 90 days after notice of action by the FTB denying a claim for refund.
  - (iv) 90 days after determination by the SBE on an appeal from the action of the FTB on a claim for refund becomes final.
- b. Deemed denial of claim
  - (i) A claim for refund may be deemed denied by a taxpayer six months after the filing thereof.
    - (a) *Geneva Towers Limited Partnership v. San Francisco*, 29 Cal. 4<sup>th</sup> 769 (2003)
  - (ii) Following the deemed denial, the taxpayer may file a suit for refund.
- c. Venue
  - (i) Suit may be in the Superior Court in any city or county in which the Attorney General maintains an office.
    - (a) San Francisco, Los Angeles, Sacramento, San Diego, Oakland.

- d. Grounds of Refund Claim Frame Suit for Refund
  - (i) The suit for refund is limited to the grounds set forth in the claim for refund.
  - (ii) The grounds must be sufficient to put the FTB on notice.
- e. *De Novo* Proceedings
  - (i) The suit for refund is not an appellate review of the decision of the SBE or FTB.
- f. Non-jury Trial
  - (i) The FTB will assert that there is no right to a jury trial in a suit for refund.
- g. Burden of Proof
  - (i) The burden of proof is generally on the taxpayer to prove the right to a refund and the amount of overpayment.

## VI. 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 percent) and reportable transaction understatements (up to 30 percent).
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.

## B. Voluntary Compliance Initiative (VCI) and Beyond

1. 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.
2. FTB issued final report on VCI.
  - a. 1,202 taxpayers participated: 342 corporations, banks and pass-through entities, 804 individuals and 56 trusts.
  - b. \$1.4 billion collected: \$465 million from corporations.
  - c. 60 percent of VCI taxpayers opted to preserve their appeal rights.
3. Both VCI and non-VCI taxpayers should consider filing or perfecting claims for refund within the applicable statute of limitations.
  - a. VCI taxpayers who opted to preserve their appeal rights (Option 2 filers) should file refund claims before the expiration of the limitations period. Option 2 filers who opted to treat the VCI Participation Agreement (Form 621) as a refund claim also should perfect their claim (if not already done) by providing the FTB with specific grounds for the claim.
  - b. Non-VCI taxpayers who did not take a California tax benefit for REIT or RIC dividend deductions may wish to consider filing claims for refund before the expiration of the limitations period (see [V.B](#) regarding procedures).

## C. Recent FTB Anti-Tax Shelter Activity

1. The FTB has cooperated with the IRS regarding federal listed transactions, including audits and settlements (*e.g.*, Son of Boss transactions). FTB has indicated that it generally will follow federal audit determinations and settlements, but will pursue taxpayers involved in federal listed transactions that have a California impact, even if the statute has closed for federal purposes.
2. The FTB has increased its audit activity regarding the California listed transactions—certain REIT and RIC transactions.

3. Several “tax shelter” cases are currently pending before the State Board of Equalization. These cases do not involve REIT/RIC transactions, but generally involve basis shifting and partnership transactions.
4. In addition to the REIT/RIC transactions described in FTB Chief Counsel Announcement 2003-1, the FTB has identified other transactions that it considers to be abusive.
  - a. *Basis shifting*: Use of foreign corporations and instruments to artificially increase and shift the basis of foreign shareholder stock to stock owned by U.S. shareholders. U.S. taxpayers ultimately sell their stock and report an inflated loss, despite incurring no economic loss.
  - b. *Inflated basis*: Contingent debt transactions to inflate an owner’s basis in a pass-through entity investment. The taxpayer contributes cash or securities and “contingent” debt to the pass-through entity, and includes the amount of the contingent debt in the taxpayer’s basis in the investment.
  - c. *Commercial domicile*: Use of Nevada or Delaware corporations to avoid California income taxes.

## D. American Jobs Creation Act of 2004

1. The federal anti-tax shelter legislation enacted under the 2004 Jobs Act mirrors much of the California anti-tax shelter legislation enacted by California under SB 614 and AB 1601 in 2003.
2. The common law “economic substance doctrine” was not codified in the tax shelter provisions under the 2004 Jobs Act. The FTB has indicated that it will follow the more stringent Ninth Circuit federal cases in determining whether transactions have sufficient economic substance for tax purposes (*e.g.*, *Casebeer*, requiring business purpose and economic effect). Thus, the FTB will not follow the more taxpayer favorable cases such as *Black & Decker* and *Coltec*.

## VII. 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. Cross motions for summary judgment were filed. Trial court granted FTB's motion.
  3. On April 8, 2005, the taxpayer filed a notice of appeal.
- B. *Ventas Corporation v. FTB*, San Francisco Superior Court No. CGC 03423154
1. Case involved the issue whether the taxpayer should be allowed to use the mark-to-market method of accounting for its customer paper for the 1997 taxable year.
  2. California conformed to IRC § 475 beginning in 1997. (RTC § 24710).
  3. The FTB took the position that the taxpayer was not permitted to use mark-to-market because, according to the FTB, it did not make a proper election to do so.
  4. The trial court rejected the FTB's position. The court found that the taxpayer's federal election to use mark-to-market in 1994 was properly deemed to be a California election to do so, under RTC § 23051.5(e), effective upon the enactment of RTC § 24710 for 1997.
  5. The FTB did not appeal the trial court's decision.
- 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 V.A) nor FTB Notice 2005-1 eliminates the exceptions provided under Regulation 19164.

## State Income Tax Implications of Repatriation of Foreign Earnings

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- I. Section 422 of the American Jobs Creation Act of 2004 (P.L. 108-357, the "Act")
  - A. Temporary Dividends Received Deduction.
    1. Designed to stimulate economic growth.
    2. One-time 85 percent dividends received deduction for certain distributions from controlled foreign corporations (CFC).
      - a. 5.25 percent effective federal income tax rate for the dividend.
3. New Internal Revenue Code (IRC) section 965 provides that taxpayers may elect to deduct 85 percent of the dividends received from a CFC either in their last year beginning before the enactment of the Act on October 22, 2004 (for calendar year taxpayers, their 2004 year) or their first tax year beginning after October 21, 2004.
4. Deduction only applies to cash dividends.
  - a. Amounts treated as dividends under IRC sections 78, 367 or 1248 are not included.

5. Limitations on the deduction.
  - a. Dividends must be extraordinary.
    - (i) Applies only to repatriations in excess of the taxpayer's average repatriation level over three of the five most recent taxable years ending on or before June 30, 2003.
    - (ii) Base-period average is determined by disregarding highest-repatriation year and lowest-repatriation year.
    - (iii) United States shareholders that file a consolidated tax return are treated as one United States shareholder. All such shareholders are aggregated in determining the base-period average, as are all CFCs.
    - (iv) Deemed repatriations are included in the base-period average.
  - b. Amount of dividends eligible for the deduction is limited to the greater of the following:
    - (i) \$500 million.
    - (ii) Amount of earnings shown as permanently invested outside the United States on the taxpayer's most recent financial statement as defined.
    - (iii) If the applicable financial statement fails to show earnings permanently invested abroad, but does show a tax liability attributable to such earnings, the amount of the tax liability divided by 35 percent.
  - c. Dividends received must be invested in the United States under a domestic reinvestment plan previously approved by the taxpayer's senior management.
    - (i) Permitted uses include, but are not limited to the following:
      - (a) Funding of worker hiring.
      - (b) Funding of worker training.
      - (c) Infrastructure.
      - (d) Research and development.
      - (e) Capital investment.
      - (f) Job retention.
      - (g) Job creation.
    - (ii) Payment of executive compensation is not a permitted use.
6. Under the Act, expenses related to the portion of the dividend eligible for deduction are disallowed.

## II. State Income/Franchise Tax Issues

### A. Income Base Issues.

1. States which conform to IRC § 965.
  - a. 85 percent dividends received deduction.
  - b. Balance of dividends may be includible in income base.
    - (i) Business/nonbusiness income issues.
  - c. What is the effect of other dividends received deduction statutes in these states?
  - d. Expense attribution under IRC § 965 will be applied.
    - (i) What is the effect of other expense attribution statutes in these states?
2. Worldwide Combined Reporting States (California).
  - a. If the payor is unitary with the payee and the earnings were generated in the unitary business, the dividend should be fully eliminated under California Revenue and Taxation Code (RTC) section 25106.
    - (i) Dividends from nonunitary earnings generally should be includible as nonbusiness income allocated to the commercial domicile of the payee.
      - (a) In the past, the Franchise Tax Board (FTB) has taken the position that such dividends may be business income.
    - (ii) Can a dividends received deduction be taken under Farmer Brothers and RTC § 24402?
      - (a) FTB current policy would not allow a deduction.

- b. If the payor is not unitary with the payee, the dividends will not be eliminated.
    - (i) Will they be classified as business or nonbusiness income?
      - (a) Note the permitted uses of the dividends.
      - (b) Note the extraordinary distribution requirement under the Act.
3. Water's Edge Combined Reporting States (California).
- a. If the payor is unitary with the payee and included in the water's edge combined report, the dividend will be eliminated to the extent it is paid out of unitary earnings. (RTC § 25106)
  - b. If the payor is outside the water's edge group, a 75 percent dividends received deduction under RTC § 24411 should apply.
    - (i) Foreign investment interest offset under RTC § 24344 will be applied.
    - (ii) Whether the balance of the dividend will be includible in net income will depend on its classification as business or nonbusiness income.
4. Separate Company Filing States.
- a. Whether the dividend will be taxable depends on the following:
    - (i) Does the payee have nexus with the taxing state?
    - (ii) Are there other applicable dividends received deduction statutes?
    - (iii) Is the dividend apportionable or allocable income?
- B. Apportionment Formula Issues.
1. Sales Factor Treatment of Dividends.
- a. FTB Legal Ruling 2003-3.
    - (i) Business income dividends are includible in the sales factor if the payee participates in the management and operations of the payor.
    - (ii) Where are the payee individuals located who participate in the management and operations of the payor?
      - (a) The income-producing activity rules under Regulations 25137(c)(a)(C) and 25136 should be reviewed.
  - b. FTB Proposed Amendments to Regulation 25106.5-1.
    - (i) Deductible dividends includible in the sales factor while eliminated dividends are not to be included.
  - c. Since the dividend is required to be extraordinary under IRC § 965, what is the effect of Regulation 25137(c)(1)(A)?
2. Factor Representation
- a. If the dividend is included in business income and constitutes a major portion of the unitary group's business income, should a portion of the factors which generated the earnings from which the dividend was paid be included in the apportionment formula?
- III. Miscellaneous Issues
- A. Does the domestic reinvestment requirement under IRC § 965 raise Commerce Clause issues?
  - B. Has the state conformed to new IRC § 965? Or has it decoupled? Or has it selectively conformed?

