



California Franchise Tax Developments—Fall 2005

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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.

(1) For water's edge taxpayers, a full dividends received deduction will be allowed under RTC § 24402 rather than a 75 percent deduction under RTC § 24411. Further, no foreign investment interest offset will be applied.

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

b. For years ending on or after December 1, 1999, no deduction will be allowed under RTC § 24402. The FTB will attempt to identify all taxpayers who have claimed a deduction under RTC § 24402 and will disallow that deduction.

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

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.

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.

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- b. For years ending on or after December 1, 1997, no deduction will be allowed for insurance company dividends. The FTB will attempt to identify all taxpayers who have claimed a deduction under RTC § 24410 and will disallow that deduction.

4. Assembly Bill No. 263

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

- (1) For years ending on or after December 1, 1997 and beginning before January 1, 2004, taxpayers were allowed to elect to claim an 80 percent dividends received deduction 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.

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

- (a) Deduction would be equal to 80 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.

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

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

- (1) Deductions disallowed to non-insurer for specified expenses paid or incurred to the insurer if the amount paid would constitute income to the insurer if the insurer were subject to California franchise tax.

- (2) Interest payable to third parties by an affiliated taxpayer is subject to disallowance if the borrowed funds are used to contribute capital to the insurer.

- (a) This disallowance does not apply to situations where the borrowed funds are loaned to the insurer.

- 5. Taxpayers not electing under AB 263 will be subject to the FTB's policy referred to above in **I.B.3.b.**

- a. The FTB's policy has not been sustained and may be subject to attack under various theories.

- b. *City of Modesto v. National Med, Inc.*, 2005 Cal. App. LEXIS 606, __ Cal. App. 4th __ (April 18, 2005)

- (1) 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. The FTB did not appeal.
- D. *Beneficial California, Inc.*, Case No. 203445 (SBE, September 1, 2005)
1. In a summary decision, the SBE unanimously concluded that none of the taxpayer's interest expense should be disallowed under RTC § 24425. The SBE found that under the facts and circumstances of the case, the requisite connection between the interest expense and the insurance company which paid the deductible dividends was absent.
- E. *Mercury General Corporation*, 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.
 3. Case awaits oral argument.
- 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. 4th 114 (2004).
 - (1) Court of Appeal concluded that gross receipts from treasury function activities are not to be included in the sales factor.
 - (2) 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.
 - (3) Petition for Review granted by the California Supreme Court. Case pending oral argument.
 - b. *Microsoft Corporation v. FTB*, San Francisco Superior Court No. CGC-01-400444 (September 9, 2003).
 - (1) Trial court held that gross proceeds from the sale of marketable securities must be included in the sales factor.
 - (2) 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.
 - (3) 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.
- (4) On April 25, 2005, the taxpayer filed a Petition for Review with the California Supreme Court which was granted. Case in the briefing process.
- c. *Limited Stores, Inc. v. FTB*, Alameda Superior Court No. C-837723 (April 11, 2003).
- (1) Trial court concluded that the return of principal must be excluded from the gross receipts generated by the taxpayer's sale of short-term financial investments and thus from the sales factor.
- (2) In *dicta*, court held that the inclusion of gross receipts would be distortive.
- (3) On July 28, 2005, Court of Appeal affirmed in an unpublished opinion (No. A102915).
- d. *Toys R Us, Inc. v. FTB*, Sacramento Superior Court No. 01 AS 04316 (August 21, 2003).
- (1) Trial court concluded that the term "gross receipts" in RTC §§ 25120 and 25134 does not include the return of capital from the taxpayer's investment in short-term paper and thus only the interest earned from those investments is includible in the sales factor.
- (2) In *dicta*, the court held that if the return of capital was included in the sales factor, RTC § 25137 would apply.
- (3) Case pending in the Court of Appeal.
- e. *Montgomery Ward and Co., Inc.*, Case No. 133828 (SBE, October 3, 2002)
- (1) In a summary decision, the SBE held that inclusion of the return of capital portion of the taxpayer's sales of various financial investments resulted in a distortion of the formula and thus those receipts were to be excluded.
- (2) Case pending in San Diego Superior Court (No. GIC 802767).
- f. *Colgate-Palmolive Co.*, Case No. 152028 (SBE, November 12, 2002)
- (1) In a summary decision, the SBE concluded that the taxpayer's gross receipts from its investment activity were not includible in the sales factor due to the fact the taxpayer failed to prove that it engaged in any income producing activities. The taxpayer employed independent contractors to perform the vast majority of the investment activities, while its own personnel performed *de minimis* investment activity. Under Regulation 25136(b), the work performed by independent contractors is not an income producing activity.
- (2) Case pending in Sacramento Superior Court (No. 03AS00707).
- g. *Polaroid Corporation*, Case No. 62415 (SBE, May 28, 2003)
- (1) 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.
- (2) 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 three-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 three-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.
 - (1) 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 have 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.
 - (1) Both activities are described in Division D of the SIC Manual.
 - c. The FTB argued that Save Mart was not a qualified taxpayer because “its primary activity” was retail (not manufacturing) and therefore should be assigned SIC Code 5411. As SIC Code 5411 is not in the manufacturing section of the SIC Manual, Save Mart did not meet the statutory requirement.

- d. Save Mart argued that it was a qualified taxpayer under the plain meaning of the statute and that the FTB's "qualified taxpayer" regulation (23649-3) was invalid because it imposed restrictions not contemplated by the MIC statute. Under that regulation, the FTB required that the taxpayer be classified or assigned a manufacturing SIC Code while the statute only requires that the taxpayer's activities be "described in" the manufacturing section of the SIC Manual.
 - e. Save Mart further argued that even if Regulation 23649-3 was somehow valid, Save Mart was a qualified taxpayer because it satisfied the three requirements under Regulation 23649-3(b)(1)(B), the "separate establishment" test.
 - f. The SBE agreed with Save Mart and overturned the FTB's qualified taxpayer regulation (23649-3).
 - g. The SBE specifically held that the MIC statute should be liberally construed in favor of taxpayers in order to effectuate the purposes of the legislation, *i.e.*, to encourage manufacturing in the State.
 - h. On September 3, 2003, the California Legislative Counsel issued an opinion that concluded that the SBE did not have the authority in *Save Mart* to declare an FTB regulation invalid. The opinion is not binding.
 - i. The FTB is refusing to follow *Save Mart*.
2. *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. *Sierra Pacific*, Case No. 268309 (SBE, September 1, 2005)

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

9. 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 has 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.
- b. Case awaits oral argument before the SBE.

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. 4th 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 three-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.
4. FTB Legal Ruling 2005-2.
 - a. On July 8, 2005, the FTB issued a ruling regarding the classification of income generated from repatriated funds pending their domestic reinvestment under IRC § 965.
 - b. The FTB indicated that the treatment of the dividends themselves will be controlled by California law. They may be eliminated or deducted under RTC §§ 25106, 24410 or 24411.
 - c. For dividends which are not eliminated or deducted, their classification as business or nonbusiness income will be governed by RTC § 25120.

C. *Square D Company v. FTB*, San Francisco Superior Court No. CGC 05442465.

1. Case involves issue whether income from leverage lease transactions constitute business income.
2. Case pending in the trial court.

V. Water's Edge Election

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

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

dividends under California law and thus subject to elimination under RTC § 25106.

3. The court also concluded that the elimination provisions of RTC § 25106 are to be applied prior to the 75 percent dividends received deduction provisions of RTC § 24411.
 4. In the only portion of the opinion in which the Court agreed with the FTB, the Court concluded that California's water's edge method of reporting does not facially discriminate against foreign commerce. The court distinguished the *Kraft v. Iowa* decision on the basis of the "footnote 23" argument which has been accepted by some other states.
 5. FTB's petition for review denied by the California Supreme Court.
- B. *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).

C. FTB Proposed Amendments to Regulation 24411.

1. On February 9, 2005, the FTB staff requested approval from the three-member FTB to proceed with amendments to Regulation 24411.
2. The amendments are designed to reverse the Court of Appeal decision in *Fujitsu* regarding the dividend ordering rules of RTC § 25106 and RTC § 24411.
3. In response to opposition voiced at the FTB meeting, the staff was ordered to hold a symposium for interested parties rather than proceed directly into the formal regulatory process.
4. The three-member FTB has not approved going forward into the formal regulatory process.

- D. *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.
- E. *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.
- F. *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.
- G. *Alpine Electronics of America, Inc.*, Case No. 281865
1. Case involves similar apportionment formula issues as were addressed in *Yamaha*.
 2. Case was argued on August 31, 2005.
 3. Due to a deadlocked 2-2 vote, case is still pending before the SBE.
- H. *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. On March 9, 2005, Court of Appeal affirmed the trial court in an unpublished opinion (No. A104602).
- I. FTB Notice 2004-8
1. On December 1, 2004, the FTB requested public comment on a discussion draft of proposed amendments to Regulation 25110(d)(2)(F)3.
 2. The proposed amendments address the manner in which deductions with respect to non-effectively connected income of a foreign corporation included in a water's edge combined report are to be determined.
 3. In FTB Notice 2005-2, FTB staff requested examples under the proposed amendments.
 4. FTB staff's request to move forward on the proposed regulations has not been approved by the three-member FTB.
- J. 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.
- VI. 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. Assembly Bill No. 911
1. On September 29, 2005, a minor amnesty clean-up bill was signed into law.
 2. Controversial issues relating to due and payable definition, among others, not covered.
- VII. Anti-Tax Shelter Legislation
- A. Senate Bill No. 614 and Assembly Bill No. 1601
1. Anti-tax shelter legislation was enacted in October 2003. It is 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.
4. *City National Corporation v. FTB*, Los Angeles Superior Court No. BC334772.
 - a. Taxpayer is challenging the FTB’s disallowance of REIT and RIC dividend deductions.

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*.

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. 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.

IX. Penalties

A. FTB Notice 2004-5

1. On August 6, 2004, the FTB announced that accuracy related penalties may be asserted against taxpayers who file California franchise tax original returns inconsistent with the standard allocation and apportionment provisions of RTC §§ 25120-25136 and who have not obtained prior approval from the FTB.
 - a. Applicable to returns with a due date, determined without extensions, after October 14, 2004.

- b. For returns with a due date before October 15, 2004, a statement attached to the return that adequately discloses that the taxpayer's return is inconsistent with the standard allocation and apportionment rules, or that the taxpayer has relied on RTC § 25137 will be considered adequate disclosure.

2. Existing FTB Regulation 19164 provides an exception to the accuracy related penalty for understatements of tax which are attributable to the taxpayer's good faith determination, whether based on the facts or unresolved legal issues, of either (i) the contours of the taxpayer's unitary business(es) or (ii) business vs. nonbusiness income items. Neither the amendments to the accuracy related penalty under SB 1100 (see VI.A) nor FTB Notice 2005-1 eliminates the exceptions provided under Regulation 19164.

X. Miscellaneous

A. Procedural Issues

1. *Ordlock v. Franchise Tax Board*, Cal. Ct. App. No. B169465 (2004).
 - a. 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.
 - b. 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.

B. Attorney Fees

1. In three recent decisions, courts have granted requests for attorneys fees for taxpayers in litigations against the FTB.
 - a. *Fujitsu Holdings, Inc. v. FTB*, 120 Cal. App. 4th 459 (2004)
 - b. *Milhous v. FTB*, California Court of Appeal No. D044362 (August 15, 2005)
 - c. *American General Realty v. FTB*, San Francisco Superior Court No. CGC 03425690 (2005)