



California Franchise Tax Developments—Spring 2007

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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.

(2) In a non-precedential summary decision, *River Garden Retirement Home*, SBE Case No. 297405 (September 12, 2006), the State Board of Equalization (SBE) agreed with the FTB and ruled that no deductions were allowable to the taxpayer under RTC § 24402 for the 1999 and 2000 taxable years.

(3) *City of Modesto v. National Med, Inc.*, 128 Cal. App. 4th 518 (2005)

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

(4) FTB's policy is being challenged. Query, is it consistent with RTC § 23057?

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

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

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2. Case also raises the retroactive versus prospective remedy issue. While *Ceridian* was allowed a full deduction and accordingly obtained its refund, the Court left open the remedy with respect to other taxpayers.
3. FTB Policy Regarding Post-*Ceridian*
 - a. For years ended prior to December 1, 1997, taxpayers will be allowed a full deduction for insurance company dividends. However, the expense attribution provisions of RTC § 24425 will be applied.
 - b. For years ending on or after December 1, 1997, no deduction will be allowed for insurance company dividends. The FTB will attempt to identify all taxpayers who have claimed a deduction under RTC § 24410 and will disallow that deduction.
4. Assembly Bill No. 263
 - a. On September 29, 2004, legislation was enacted which would reverse FTB's policy statement for taxable years ending on or after December 1, 1997.
 - (1) For years ending on or after December 1, 1997 and beginning before January 1, 2004, taxpayers were allowed to elect to claim an 80-percent dividends received deduction. No expense attribution would be allowed.
 - (a) Taxpayers were required to make a retroactive irrevocable election.
 - (b) At least 80 percent of each class of stock of the insurance company must be owned.
 - (c) Election applied only to taxable years during the election period for which the statute of limitations was open or if the statute had closed for any taxable year, to taxable years for which a final tax determination had not been made because of a dispute over the dividends received deduction or the expenses related to that deduction.
 - (d) Elections were required to be made by filing amended returns which had to be filed by March 28, 2005.
 - (2) For years beginning on or after January 1, 2004, a dividends received deduction would be allowed. No restriction on the use of expense attribution.
 - (a) Deduction would be equal to 80% of the qualified dividends (increases to 85% in 2008).
 - (b) Dividend deduction may be reduced if insurance company overcapitalized ("anti-stuffing").
 - (c) Certain transfers of property to insurers in an exchange described in various IRC provisions and which would otherwise result in non-recognition of gain will be deemed taxable events.
 - (3) FTB Notice 2004-6 was issued by the FTB to inform taxpayers how to make the election.
 - b. AB 263 also amended RTC § 24425 for taxable years beginning on or after January 1, 2004.
 - (1) Deductions disallowed to non-insurer for specified expenses paid or incurred to the insurer if the amount paid would constitute income to the insurer if the insurer were subject to California franchise tax.
 - (2) Interest payable to third parties by an affiliated taxpayer is subject to disallowance if the borrowed funds are used to contribute capital to the insurer.
 - (a) This disallowance does not apply to situations where the borrowed funds are loaned to the insurer.
5. Taxpayers not electing under AB 263 will be subject to the FTB's policy referred to above in **I.B.3.b.**
 - a. The FTB's policy has not been sustained and may be subject to attack under various theories.
6. *Argonaut Group, Inc.*, SBE Case No. 287738 (June 28, 2006)
 - a. In a letter decision, the SBE ruled that the taxpayer could not include its insurance company subsidiaries in its combined report "by proxy," under RTC § 25137, for purposes of determining its California franchise tax liability.
 - b. Petition for rehearing denied on November 20, 2006.
- C. *American General Realty Investment Corp., Inc.*, SBE Case No. 156726 (June 25, 2003)
 1. In a summary decision, the SBE concluded that the FTB properly disallowed under RTC § 24425, a portion of the interest expenses incurred by the taxpayer's unitary financial and real estate subsidiaries on the theory that the interest expenses were indirectly traceable

to insurance company dividends which were deductible under *Ceridian*.

2. On April 28, 2005, the SBE's decision was reversed in the San Francisco Superior Court (No. CGC 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. On September 14, 2005, the trial court granted the taxpayer's request for attorneys' fees based on market rates.
 - e. The FTB did not appeal.
- D. *Beneficial California, Inc.*, SBE Case No. 203445 (September 1, 2005)
1. In a summary decision, the SBE unanimously concluded that none of the taxpayer's interest expense should be disallowed under RTC § 24425. The SBE found that under the facts and circumstances of the case, the requisite connection between the interest expense and the insurance company which paid the deductible dividends was absent.
- E. *Mercury General Corporation*, SBE Case No. 145450 (June 25, 2003)
1. In a letter decision similar to *American General*, the SBE affirmed the FTB's disallowance of the deduction of administrative expenses and interest expense under RTC § 24425 on

the theory that the expenses were indirectly traceable to insurance company dividends which were deductible under *Ceridian*.

2. The taxpayer's petition for rehearing was granted with respect to the deduction of administrative expenses, not interest expense. On March 28, 2006, the SBE reaffirmed its decision disallowing the deduction of administrative expenses.

II. Apportionment Formula

A. Sales Factor

1. Gross receipts from treasury function activities. Numerous suits for refund pending.
 - a. *General Motors Corporation v. FTB*, 39 Cal. 4th 773 (2006)
 - (1) California Supreme Court concluded that, except with respect to repurchase agreements ("repos"), gross proceeds from the sale of marketable securities in the course of treasury function activities, including redemptions on maturity, are to be included in the sales factor. The Court remanded for further proceedings the issue whether inclusion of such proceeds in the sales factor is distortive under RTC § 25137. In the case of repos, only the interest received from repos should be included in the sales factor.
 - (2) The Court also concluded that research credits can only be used by the member of the unitary group which generated the credit, not the entire group. (See III.C below.)
 - (3) On January 29, 2007, the Court of Appeal remanded the case to the trial court to resolve the matter consistent with the Supreme Court's decisions in *General Motors* and *Microsoft*.
 - b. *Microsoft Corporation v. FTB*, 39 Cal. 4th 750 (2006)
 - (1) California Supreme Court held that gross proceeds from the sale of marketable securities, including redemptions on maturity, are includible in the sales factor.
 - (2) Based on the specific facts in the case, the Court concluded that the FTB sustained its burden of proving that the inclusion of gross receipts from treasury function activities in the denominator of the sales factor created a distortion under RTC § 25137. (See II.B.1 below)

- c. *Limited Stores, Inc. v. FTB*, 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, the court held that the inclusion of gross receipts would be distortive.
 - (3) On July 28, 2005, Court of Appeal affirmed in an unpublished opinion (No. A102915).
 - (4) On October 26, 2005, the California Supreme Court granted the taxpayer's petition for review. The matter is deferred pending *General Motors* and *Microsoft*.
 - (5) On November 15, 2006, the California Supreme Court returned the case to the Court of Appeal with instructions to that court to vacate its prior decision and reconsider the case in light of *General Motors* and *Microsoft*.
- 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) On April 5, 2006, the Court of Appeal affirmed the trial court's decision in a published opinion. The opinion was modified on May 4, 2006 (138 Cal. App. 4th 339).
 - (a) The Court of Appeal disagreed with the trial court regarding the meaning of the term "gross receipts." The Court concluded that return of capital is included within gross receipts under RTC §§ 25120 and 25134.
 - (b) The Court of Appeal concluded that under RTC § 25137, the inclusion of return of capital resulted in distortion and thus should be excluded.
 - (4) Both the FTB and the taxpayer filed petitions for rehearing. The Court of Appeal denied both petitions. The Court, however, modified the opinion to strike its original burden of proof discussion and to instead note that under RTC § 25137, the party seeking to deviate from the standard apportionment formula bears the burden of proof.
- e. *Montgomery Ward and Co., Inc.*, SBE Case No. 133828 (October 3, 2002)
- (1) In a summary decision, the SBE held that inclusion of the return of capital portion of the taxpayer's sales of various financial investments resulted in a distortion of the formula and thus those receipts were to be excluded.
 - (2) Case pending in San Diego Superior Court (No. GIC 802767).
- f. *Colgate-Palmolive Co.*, SBE Case No. 152028 (November 12, 2002)
- (1) In a summary decision, the SBE concluded that the taxpayer's gross receipts from its investment activity were not includible in the sales factor due to the fact the taxpayer failed to prove that it engaged in any income producing activities. The taxpayer employed independent contractors to perform the vast majority of the investment activities, while its own personnel performed *de minimis* investment activity. Under Regulation 25136(b), the work performed by independent contractors is not an income producing activity.
 - (2) Case pending in Sacramento Superior Court (No. 03AS00707).
- g. Numerous treasury function appeals are pending at the SBE. The SBE is moving forward on one case. *Home Depot USA, Inc.*, SBE Case No. 298683. All other cases are deferred until at least 30 days after a final decision is issued in *Home Depot*.
2. On April 4, 2007, the FTB authorized staff to proceed with a regulatory solution under RTC § 25137 to the treasury function issue. A legislative solution under RTC § 25120 will also be pursued. Both will be prospective.

3. FTB Legal Ruling 2006-1

- a. On April 28, 2006, the FTB issued a legal ruling to address the issue of how to reflect, for apportionment factor purposes, activities related to income that is excluded from the measure of tax, in whole or in part.
- b. The FTB concluded that deductible dividends are not to be included in the sales factor to the extent of the amount which is deducted. Thus, for a 75-percent dividends received deduction under RTC § 24411, only 25 percent of the dividend would be included.
 - (1) This is contrary to the FTB's proposed amendments to Regulation 25106.5-1. See II.A.7 below.

4. FTB Legal Ruling 2006-2

- a. On May 3, 2006, the FTB issued a legal ruling to address the application of the "on behalf of" rule of Regulation 25136(b). Under Regulation 25136(b), receipts from services or sales of intangible personal property are assigned to the state where the "income producing activity" was performed, based on where the greater costs of performance occurred. Income producing activity generally does not include activities performed on behalf of a taxpayer, such as those of an independent contractor.
- b. When a contractor and subcontractor are members of the same unitary combined reporting group, the activities of the subcontractor will be considered income producing activities directly engaged in by the contractor for purposes of the "on behalf of" rule.
 - (1) Payments made by the contractor to the subcontractor will be assigned to the location where the subcontractor actually performed the service.
 - (2) FTB's analysis assumes that members of a combined report must be treated as a single corporate enterprise. Query whether the FTB essentially has applied a *Finnigan* analysis and whether FTB's analysis is consistent with its position on credit "siloing" at issue in the pending *General Motors* case.
 - (3) FTB recognizes that, in the case of water's edge taxpayers, the "on behalf of" rule excludes activities performed by members outside the water's edge combined report.

5. FTB Legal Ruling 2006-3

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

6. FTB Legal Ruling 2003-3

- a. On December 4, 2003, the FTB issued a legal ruling to address the issue when income producing activity exists with respect to a business income dividend so that the dividend is includible in the sales factor.
- b. The FTB concluded that a dividend payee that participates in the management and operations of the dividend payor is engaged in income producing activity with respect to the dividend so that the dividend is includible in the payee's sales factor.
- c. Departure from the FTB's position set forth in its Multistate Audit Technique Manual Section 7562.
- d. This ruling becomes quite relevant in post-*Ceridian* and post-*Farmer Bros.* years where the FTB is disallowing deductions for RTC § 24410 and RTC § 24402 dividends. The FTB is applying it on audit.

7. FTB 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.
 - (1) See, however, FTB Legal Ruling 2006-1.
- c. The 3-member FTB approved going forward with a symposium for interested parties. See FTB Notice 2005-1.

8. 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.

9. Assembly Bill No. 1591

- a. Proposed legislation would hyperweight the sales factor and provide property and payroll factor relief for new investment in California.

10. *Galvantech, Inc.*, SBE Case No. 288289 (February 1, 2006)

- a. In a summary decision, the SBE ruled that the taxpayer’s sales to purchasers in foreign countries must be thrown back to California for sales factor purposes.
- b. The SBE determined that the taxpayer did not provide sufficient proof that it was taxable in the foreign jurisdictions, applying the jurisdictional standards applicable to a state of the United States. See *Dresser Industries*, 82-SBE-307 (June 29, 1982), Opinion on Rehearing 83-SBE-118 (October 26, 1983).

B. Distortion

1. *Microsoft Corporation v. FTB*, 39 Cal. 4th 750 (2006)

- a. The California Supreme Court concluded that the FTB sustained its burden of proving the inclusion of gross receipts from treasury function activities in the denominator of the sales factor created a distortion under RTC § 25137. The Court further concluded that the FTB’s “cure” for the distortion of including net receipts from the redemption transactions was reasonable. In reaching these conclusions, the Court emphasized the following:

- (1) Section 25137 is not confined to correcting unconstitutional distortions.

(2) The comparison of low margin sales (treasury function) with higher margin sales (software transactions) presents a problem for Uniform Division of Income for Tax Purposes Act (“UDITPA”). UDITPA’s sales factor contains an implicit assumption that a corporation’s margins will not vary inordinately from state to state.

(3) The comparison of margins in determining whether distortion exists under Section 25137 is not a prohibited separate accounting analysis.

(4) Section 25137 is not to be applied in only unique non-recurring situations.

(5) While the “cure” the FTB proposed in this case was reasonable, the Court cautioned that the FTB’s approach might fail the test of reasonableness in another case. For example, if, unlike the instant case, the treasury operations provide a substantial portion of a taxpayer’s income, the use of Section 25137 may be inappropriate.

(6) The party seeking to apply Section 25137 has the burden of proving by clear and convincing evidence that the standard formula does not fairly represent the extent of the taxpayer’s business activities in California.

b. The Court’s decision opens the door for challenges to the standard apportionment formula for both taxpayers and the government. The endorsement of a comparison of margins between functions of the unitary business is a significant development.

c. FTB Audit Practice. Currently, auditors are analyzing whether distortion exists in the treasury function setting under four different tests—*Microsoft*, *Merrill Lynch*, *Pacific Telephone* and *Toys-R-Us*. If the taxpayer fails any of the four tests, the auditors are instructed to remove the gross receipts from the sales factor.

d. FTB Notice 2006-3 (Sept. 28, 2006).

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

(2) The FTB based its position on *Microsoft* and *Pacific Telephone*.

2. *Weyerhaeuser Company*, SBE Case Nos. 104355 and 246164

- a. Case involves distortion issues pertaining to the taxpayer's timber activities in the State of Washington vis-à-vis its activities in California.
- b. The taxpayer's Washington timber activities generate virtually all of its unitary income, yet the standard apportionment formula does not reflect this fact. The taxpayer is contending that RTC § 25137 should be applied to correct the distortion.
- c. Case also involves the proper inclusion of gross receipts for taxpayer's treasury function in the sales factor. The FTB is arguing that the gross receipts from the taxpayer's treasury function activity should be excluded from the sales factor under RTC § 25137. The taxpayer disagrees and is arguing that if the FTB has sustained its burden of proof under RTC § 25137 on this issue, then so has the taxpayer with respect to its Washington timber activities.
- d. Other issues include the inclusion of a proper value for government-owned property in the property factor and various manufacturers' investment tax credit (MIC) issues.
- e. Oral argument held January 25, 2005.
- f. The SBE deferred its decision on the treasury function sales factor and the Washington timber distortion issues pending the California Supreme Court's decision in *General Motors*.

3. Proposed Regulation 25137-14

- a. The proposed regulation provides for an alternative apportionment methodology for mutual fund service providers that looks to the location of the underlying shareholders of the mutual funds, for purposes of assigning receipts to the numerator of the sales factor. See FTB Notice 2005-3.
- b. On April 4, 2007, the proposed regulation was approved by the FTB.

4. Airline Apportionment Formula

- a. *Alaska Airlines, Inc.*, SBE Case No. 342596 (March 1, 2007), CCH Calif. Tax Rptr. ¶ 404-226. In a letter decision, the SBE held that the FTB incorrectly applied Regulation 25137-7, California's special apportionment formula for airlines.
- b. On April 4, 2007, the FTB approved holding an interested parties meeting to discuss how Regulation 25137-7 should be interpreted and administered.

III. Credits

A. Manufacturers' Investment Tax Credit

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

- a. On February 6, 2002, the SBE issued a rare formal opinion in the first MIC case to reach the Board. This was the first in a series of taxpayer victories in MIC cases in 2002 and 2003.
- b. The case involved the issue of whether Save Mart was a qualified taxpayer with respect to its bakery and meat processing activities.

(1) Both activities are described in Division D of the SIC Manual.

- c. The FTB argued that Save Mart was not a qualified taxpayer because "its primary activity" was retail (not manufacturing) and therefore should be assigned SIC Code 5411. As SIC Code 5411 is not in the manufacturing section of the SIC Manual, Save Mart did not meet the statutory requirement.
- d. Save Mart argued that it was a qualified taxpayer under the plain meaning of the statute and that the FTB's "qualified taxpayer" regulation (23649-3) was invalid because it imposed restrictions not contemplated by the MIC statute. Under that regulation, the FTB required that the taxpayer be classified or assigned a manufacturing SIC Code while the statute only requires that the taxpayer's activities be "described in" the manufacturing section of the SIC Manual.
- e. Save Mart further argued that even if Regulation 23649-3 was somehow valid, Save Mart was a qualified taxpayer because it satisfied the three requirements under Regulation 23649-3(b)(1)(B), the "separate establishment" test.
- f. The SBE agreed with Save Mart and overturned the FTB's qualified taxpayer regulation (23649-3).
- g. The SBE specifically held that the MIC statute should be liberally construed in favor of taxpayers in order to effectuate the purposes of the legislation, *i.e.*, to encourage manufacturing in the State.
- h. On September 3, 2003, the California Legislative Counsel issued an opinion that concluded that the SBE did not have the authority in *Save Mart* to declare an FTB regulation invalid. The opinion is not binding.
- i. The FTB is refusing to follow *Save Mart*.

2. *Costco Wholesale Corporation*, SBE Case No. 266592 (October 25, 2005), CCH Calif. Tax Rptr. ¶ 403-908
 - a. In a 4-1 vote, the SBE reaffirmed its decision in *Save Mart*.
 - b. In a letter decision, the SBE held that Costco was a qualified taxpayer with respect to its bakery and meat processing activities.
3. *Safeway, Inc.*, SBE Case Nos. 268637, 283211 (December 13 2005)
 - a. In a summary decision, the SBE reaffirmed its decision in *Save Mart* and concluded that Safeway was a qualified taxpayer with respect to its bakery and meat processing activities. With the exception of a meat box, the SBE also concluded that the property used in these activities was qualified property.
4. *Jon and Rita Minnis and Milpitas Materials Company*, 2002-SBE-003 (June 20, 2002)
 - a. The SBE concluded in a formal opinion, that a cement mixer truck, comprised of a truck chassis and mixer barrel, constituted a single integrated piece of manufacturing equipment and thus the entire truck was qualified property for purposes of the MIC.
 - b. The SBE rejected the FTB's attempt to bifurcate the truck into two components—manufacturing (mixing drum) which qualified for the MIC and transportation (chassis) which did not.
 - c. The SBE refused to follow FTB Legal Ruling 2001-4.
5. *Bronco Wine Company*, 2002-SBE-006 (September 12, 2002)
 - a. Late in 2002, the SBE again ruled against the FTB in another formal opinion.
 - b. The SBE concluded that wine tanks which had a capacity of 215,000 gallons were qualified property for purposes of the MIC. The SBE relied on the fact that the tanks could be moved and placed in productive use without damaging the property during the move.
 - c. The FTB had taken the position that smaller wine tanks qualified as tangible personal property but that the larger wine tanks were “inherently permanent structures” under *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975).
6. *California Steel Industries, Inc.*, 2003-SBE-001-A (July 9, 2003)
 - a. In a formal Opinion on Petition for Rehearing in 2003, the SBE once again rejected the FTB's position.
 - b. The SBE held that payments made to third party contractors that are directly allocable to qualified property and are capitalized, constitute qualified property for purposes of the MIC.
7. *Baxter Healthcare Corporation*, SBE Case No. 140712 (May 28, 2003)
 - a. In a summary decision, the SBE confirmed its decision in *California Steel* regarding the capitalized labor issue.
 - b. The SBE also held that payments made to in-house engineers which are directly allocable to qualified property and are capitalized, constitute qualified property for purposes of the MIC.
 - c. The SBE also concluded that certain facilities were special purpose buildings and foundations and thus qualified property.
 - d. The SBE held that the heating, ventilating and air conditioning systems installed in clean rooms were not qualified property.
8. *Lienau*, SBE Case Nos. 156798, 156810, 156814 and 156808 (July 9, 2003)
 - a. In another taxpayer victory, the SBE held in a summary decision that the gain realized by a California S corporation, passed through to its shareholders, on the receipt of insurance proceeds for equipment losses and deferred under IRC § 1033 was chargeable to the capital account and thus constituted qualified costs for purposes of the MIC.
9. *LSI Logic, Inc. and Cypress Semiconductor Corporation*, SBE Case Nos. 142330 and 173287 (August 7, 2003)
 - a. In a controversial summary decision, the SBE voted 2-1 to grant refund claims under RTC § 6902.2. Under that statute, a taxpayer may claim a sales tax refund in lieu of the MIC. The in-lieu credit cannot be claimed any earlier than the MIC could have been claimed and the amount of the in-lieu credit cannot be in excess of the amount of the MIC that could have been claimed by the taxpayer.

- b. In these cases, the taxpayers used research and development credits to eliminate their franchise tax liability. They did not claim MIC credits, although they would have been entitled to do so. The taxpayers thus claimed the in-lieu credit under RTC § 6902.2 in the amount of the MIC they otherwise could have claimed.
 - c. The SBE rejected its staff's arguments that the Legislature did not intend to allow taxpayers to claim both the R&D credit and the MIC in-lieu refund because such could essentially make the MIC a refundable credit.
 - d. On September 29, 2003, Senate Bill No. 1064 was signed into law overturning on a prospective basis the *LSI* and *Cypress* decisions. SB 1064 permits any taxpayer that had filed a MIC in-lieu claim under RTC § 6902.2 on or before the date of the *LSI* and *Cypress* decisions (August 7, 2003) to obtain that refund.
 - e. On January 25, 2005, the SBE granted refund claims of a series of taxpayers who filed MIC in-lieu of claims on or before August 7, 2003.
10. *Sierra Pacific*, SBE Case No. 268309 (September 1, 2005), CCH Calif. Tax Rptr. ¶ 403-852
- a. In a letter decision, the SBE unanimously held that the taxpayer's steam generation assets which were primarily used to produce steam for use in its wood manufacturing process were qualified property for purposes of the MIC.
11. *Foster Poultry Farms*, SBE Case Nos. 268417, 268429, 268418, 268431 (May 17, 2006), CCH Calif. Tax Rptr. ¶ 404-013
- a. In a summary decision, the SBE ruled that the taxpayer's electrical substations were qualified property for purposes of the MIC. The SBE rejected the FTB's contention that the electrical equipment was not tangible personal property. See *Scott Paper Co. v. Commissioner*, 74 T.C. 137 (1980).
12. *Granite Construction Corporation*, SBE Case No. 301578 (November 21, 2006), CCH Calif. Tax Rptr. ¶ 404-094.
- a. In a letter decision, the SBE ruled that a taxpayer which manufactured aggregate for both external sales and for use in its manufacturing of asphalt and ready-made concrete was entitled to claim the MIC.
13. *Penny-Newman Grain Co., Inc.*, SBE Case No. 338714 (Feb. 8, 2007), Calif. Tax Rptr. ¶ 404-209
- a. In a letter decision, the SBE ruled that the taxpayer did not prove that its railroad tracks and scales was qualified property for MIC purposes.
14. MIC Repealed
- a. The MIC was repealed by its own terms and ceased to be operative as of January 1, 2004.
 - b. Various bills have been introduced to revive the MIC, but none 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 Hiring Credits
1. *Deluxe Corporation*, 2006-SBE-003 (December 15, 2006)
- a. Case involved challenge to FTB's position of looking behind vouchers obtained from local enterprise zones. The taxpayer is arguing "voucher reliance" and that RTC § 23622.7 only requires that a certificate (voucher) be obtained from the enterprise zone or other appropriate agency and provided to the FTB upon request.
 - b. On January 31, 2006, the SBE held in a 4-1 vote that the FTB is permitted to look behind the vouchers. Post-hearing briefs were filed regarding whether the 51 remaining employees qualify for the credit.
 - c. On December 15, 2006, the SBE issued a formal opinion confirming the decision in January that the FTB is permitted to look behind the vouchers. In a letter decision issued that same day, the SBE concluded that 15 of the 51 employees at issue qualified for the credit.
2. *Dicon Fiberoptics, Inc. v. Franchise Tax Board*, Los Angeles Superior Court No. BC 367885
- a. On March 13, 2007, a suit for refund was filed challenging the FTB's authority to look behind the vouchers.
3. On November 27, 2006, vouchering regulations were issued by the Department of Housing and Community Development.

C. Separate But Unitary

1. *General Motors Corporation v. FTB*, 39 Cal. 4th 773 (2006)
 - a. California Supreme Court rejected the taxpayer's argument that a research expense credit should be applied against the tax liability of the unitary group, or in the alternative, should be "intrastate-apportioned" against the tax liability of each of the taxpayer-members of the unitary group.
 - b. The Court accepted the FTB's argument that the credit should be limited to the taxpayer which incurred the research expenses.
2. Cases pending in the administrative process challenging the siloing of credits under RTC § 25137.

IV. Business v. Nonbusiness Income

A. *Jim Beam Brands Co. v. FTB*, 133 Cal. App. 4th 514 (2005)

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. On October 17, 2005, the Court of Appeal affirmed the trial court's decision in a published opinion.
4. On January 4, 2006, the taxpayer's petition for review with the California Supreme Court was denied.

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.

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

4. In the only portion of the opinion in which the Court agreed with the FTB, the Court concluded that California's water's edge method of reporting does not facially discriminate against foreign commerce. The court distinguished the *Kraft v. Iowa* decision on the basis of the "footnote 23" argument which has been accepted by some other states.
 5. The FTB's petition for review was denied by the California Supreme Court.
- B. *Baxter Healthcare Corporation*, SBE Case No. 150881 (August 1, 2002)
1. In a summary decision, the SBE concluded that Income Tax Regulations § 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 Regulations § 1.954-2(b)(1).
- C. *Apple Computer, Inc.*, 2006-SBE-02 (November 20, 2006)
1. On November 20, 2006, the SBE issued a formal opinion and agreed with the FTB—contrary to *Fujitsu* (see V.A.3 above)—that the dividends paid by a controlled foreign corporation that was partially included in a water's edge combined report is prorated among the RTC § 25106 dividend elimination provision and the RTC § 24402 dividend deduction provision.
- D. FTB Proposed Amendments to Regulation 24411
1. On February 9, 2005, the FTB staff requested approval from the 3-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. See FTB Notice 2005-1.
4. On April 4, 2007, the FTB approved going forward into the formal regulatory process.
- E. *Yamaha Motor Corporation*, SBE Case No. 89002467500 (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.
- F. *Alps Electric (USA), Inc. and Canon U.S.A., Inc.*, SBE Case Nos. 55001 and 55446 (January 13, 2003)
1. In a summary decision which is at odds with *Yamaha*, 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.
- G. *Mitsubishi Electric America, Inc.*, SBE Case No. 207902 (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.

H. *Alpine Electronics of America, Inc.*, SBE Case No. 281865 (November 20, 2006)

1. On November 20, 2006, the SBE issued a summary decision in a case similar to *Yamaha*.
2. The taxpayer purchased inventory from its foreign parent during years in which a worldwide combined report was filed. The inventory was ultimately sold to third parties during a year in which a water's edge election was in place.
3. The SBE rejected the taxpayer's argument that the gain should be apportioned using the worldwide apportionment percentages.
4. The SBE concluded the gain was to be reduced by certain costs.

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 ("NECI") of a foreign corporation included in a water's edge combined report are to be determined.
3. In FTB Notice 2005-2, FTB staff requested examples under the proposed amendments.
4. FTB staff's request to move forward on the proposed regulations has not been approved by the 3-member FTB.
5. During a 3-member FTB meeting on September 20, 2006, FTB Multistate Tax Counsel Benjamin Miller reported that FTB staff determined that the Legislature did not intend to include NECI in the water's edge combined report.
6. On January 23, 2007, the FTB filed with the Secretary of State a revised version of proposed Regulation 25110 which incorporates FTB staff's concession and provides that certain types of NECI is excluded from the definition of United States source income. The Regulation is effective February 23, 2007.

J. Senate Bill No. 663

1. On May 8, 2006, legislation was enacted to "clarify" that the water's edge combined report

includes the income and apportionment factors of a controlled foreign corporation ("CFC") to the extent of its subpart F inclusion ratio, even though the CFC is also a California taxpayer with U.S. source income.

2. Prior to SB 663, under a literal reading of California's water's edge statute, only the U.S. source income and U.S. factors of such a CFC should be included in the water's edge combined report.

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 Amnesty 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 Amnesty 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 Amnesty 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 Amnesty Penalty, many individual and corporate taxpayers made payments outside amnesty before March 31, 2005 and filed protective claims for refund.
 9. Under the FTB's interpretation of the Amnesty Penalty, no protest or appeal rights exist to challenge the merits of the penalty. No claims for refund are allowed except on the grounds that the Amnesty Penalty was computed incorrectly (see VI.B below). The term "due and payable" used in the legislation is interpreted by the FTB inconsistently with RTC § 19049.
 10. The FTB purportedly collected \$4.3 billion. \$661 million was collected under amnesty. \$3.63 billion was collected outside amnesty for which protective claims have been filed by nearly 900 taxpayers.
 11. For more information on the California Tax Amnesty Programs, see our January 2005 State and 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.
 - a. Legislation changed the law to allow for claims for refund of the Amnesty Penalty on limited grounds, *i.e.*, that it is computed incorrectly.
 - b. The legislation allowed for a limited offsetting of overpayments against underpayments to reduce the exposure to the Amnesty Penalty.
 2. Controversial issues relating to the due and payable definition, among others, not covered.
- C. Assembly Bill No. 561
1. Pending legislation sponsored by the FTB.
 2. Some of the provisions include the following:
 - a. Increases interest rate on overpayments for payments made between February 1, 2005 and March 31, 2005. The rate is equal to the underpayment rate.
 - b. Allows for a Chief Counsel review of whether the Amnesty Penalty should be abated.
 - (1) Taxpayer must show the underpayment of tax arose from an item for which substantial authority exists; or
 - (2) Underpayment is due to RAR adjustments. This is limited to situations where the taxpayer was first contacted by the IRS concerning an examination after March 31, 2005; or
 - (3) Taking into account all facts and circumstances, holding the taxpayer liable for the Amnesty Penalty is against equity and good conscience.
 - (4) Review of the Chief Counsel's decision is permitted only under an abuse of discretion standard.
 - c. Converts Amnesty Penalty to interest.
 - d. Allows for reduction in Amnesty Penalty to the extent it is due to change in interpretation of law.
- D. *General Electric Company v. Franchise Tax Board*, San Francisco Superior Court No. 449157
1. The taxpayer is challenging the validity of the Amnesty Penalty in a declaratory relief action.
 2. It is the taxpayer's position that the Amnesty Penalty is invalid for a number of reasons and is seeking a declaration from the Court to that effect.
 - a. The taxpayer has alleged that the Amnesty Penalty is unconstitutional under the Due Process Clause due to the absence of a plain, speedy and efficient remedy to challenge the merits of the penalty either in court or administratively.
 - b. The taxpayer has alleged that the Amnesty Penalty is unconstitutional under the Due Process Clause due to its retroactive nature.

- c. The taxpayer has alleged that the FTB's interpretation of "due and payable" in RTC § 19777.5 is at odds with RTC § 19049. The taxpayer has requested a declaration from the Court, consistent with RTC § 19049, that no Amnesty Penalty will arise if the taxpayer pays the amount of the assessment on or before it receives a notice and demand for payment or within 15 days thereafter.
- 3. The FTB filed a demurrer to the complaint on the basis that the action was not ripe. The Court sustained the demurrer with leave to amend. On May 10, 2006, the taxpayer filed an amended complaint, to which the FTB filed another demurrer on ripeness grounds. The Court sustained the FTB's demurrer.
- 4. On September 15, 2006, the taxpayer filed a notice of appeal. Briefs have been filed. The taxpayer has requested the Court reverse the lower court and reach the merits. Case is awaiting oral argument.
- E. *David A. and Cheryl D. Duffield v. Franchise Tax Board*, San Francisco Superior Court No. CGC07459331.
 - 1. Suit for refund of personal income taxes, interest and Amnesty Penalty. In addition to the merits of the dispute, the taxpayer is challenging the validity of the Amnesty Penalty.
- F. FTB Notice 2005-6
 - 1. On November 28, 2005, the FTB issued procedures relating to tax deposits pursuant to California's recent conformity (AB 115) to the "tax deposit" provisions of IRC § 6033.
 - 2. The tax deposit provisions (RTC § 19041.5) replace the "deposit in the nature of a cash bond" provisions.
 - 3. The FTB also will apply the tax deposit rules to amounts that were paid outside California's 2005 amnesty program (e.g., protective claim payments).
 - 4. Interest on tax deposit amounts that are returned to the taxpayer will be paid at the statutory overpayment rate.
 - 5. The FTB announced that it has developed new forms, Forms 3576-3579, Tax Deposit Voucher,

to designate a remittance as a tax deposit for a specific tax year. In addition, Form 3581, Tax Deposit Refund or Transfer Request, should be used to request a tax deposit refund, designate the application of a tax deposit to a different tax year, or apply a tax deposit to convert an administrative protest or appeal to an administrative refund action.

VII. Anti-Tax Shelter Legislation

- A. Senate Bill No. 614 and Assembly Bill No. 1601
 - 1. Anti-tax shelter legislation was enacted in October 2003. It was generally effective January 1, 2004, but may apply to certain transactions entered into prior to that date.
 - 2. Generally conformed to existing federal law regarding tax shelter registration, list maintenance and disclosure of reportable transactions.
 - 3. Provided for various penalties in connection with the use of tax shelters, including enhanced penalties for noneconomic substance transaction understatements (up to 40%) and reportable transaction understatements (up to 30%).
 - 4. Also provided for penalties aimed at tax shelter promoters, advisers and return preparers.
 - 5. Extended the statute of limitations to eight years for proposed deficiency assessments relating to abusive tax avoidance transactions.
 - 6. Directed the FTB to identify and publish California "listed transactions," pursuant to which the FTB issued Chief Counsel Announcement 2003-1 on December 31, 2003 identifying certain REIT and RIC transactions as listed transactions for California purposes.
- A. 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. The taxpayer is challenging the FTB's disallowance of REIT and RIC dividend deductions.
 - b. The FTB's demurrer on procedural grounds was sustained without leave to amend.
 - c. On January 16, 2007, the Court of Appeal reversed the lower court and held that the taxpayer was not barred from proceeding with its suit for refund.
 - d. On April 11, 2007, the California Supreme Court denied the FTB's petition for review.
 5. *City National Corporation v. FTB*, Sacramento Superior Court No. 06AS02275
 - a. In an action similar to the above case but for subsequent taxable years, the taxpayer is claiming a refund with respect to REIT dividend deductions.
- B. Recent FTB Anti-Tax Shelter Activity
1. California Tax Shelter Resolution Initiative. The FTB issued Notice 2006-1 on January 11, 2006, announcing that it will closely follow the IRS tax shelter settlement initiative as outlined in IRS Announcement 2005-80. Only those taxpayers eligible to participate in, and who fully complete the requirements of, the IRS initiative may participate in the California initiative, which ended on March 31, 2006.
 2. 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.
 3. The FTB has increased its audit activity regarding the California listed transactions—certain REIT and RIC transactions.
 4. Several “tax shelter” cases are currently pending before the SBE. These cases do not involve REIT/RIC transactions, but generally involve basis shifting and partnership transactions.
 5. 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.
- C. 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*.

3. In 2005 (AB 115), California generally conformed to the federal tax shelter provisions, including those under the 2004 Jobs Act.

VIII. Mark-To-Market

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

1. Case involved the issue whether for 1993 and 1994 the taxpayer should be treated as a dealer in securities and thus 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 was in issue.
2. California formally conformed to IRC § 475 in 1997 (RTC § 24710).
 - a. FTB has agreed that IRC § 475 and its broad definition of dealer in securities applies for California purposes for 1997-2001.
3. Cross motions for summary judgment were filed. Trial court granted FTB's motion and concluded that the taxpayer was not permitted to use mark-to-market for 1993 and 1994.
4. On March 30, 2006, the Court of Appeal affirmed the trial court in an unpublished opinion.
5. On July 12, 2006, the taxpayer's petition for review with the California Supreme Court was denied.

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 [VIA](#) above) nor FTB Notice 2005-1 eliminates the exceptions provided under Regulation 19164.

B. FTB Notice 2006-3

1. The FTB announced that, for purposes of applying FTB Notice 2004-5 (see **IX.A** above), a taxpayer that excludes from the sales factor the amount realized on the redemption of marketable securities as part of its treasury function, and includes only the interest income and net gains from such securities, will not be subject to the accuracy related penalty under RTC § 19164.
2. The FTB based its position on the California Supreme Court's August 17, 2006 decision in *Microsoft* (see **II.A.1.b** above) and *Pacific Telephone & Telegraph*, 78-SBE-028 (May 4, 1978).

X. Miscellaneous

A. Procedural Issues

1. *Ordlock v. Franchise Tax Board*, 38 Cal. 4th 897 (2006)
 - a. The California Supreme Court reversed the decision of the appellate court and held that the FTB was not time-barred from issuing an assessment based on a federal change that occurred after the normal four-year statute of limitations had expired.
2. FTB Protest Procedures Modified
 - a. The FTB issued two notices pertaining to the processing of docketed protests. See FTB Notices 2006-5 and 2006-6.
 - b. The intention is to attempt to achieve greater efficiency in the processing of protests.
 - c. Reduced timeframes for the processing of protests (12-18-24 months).
3. SBE Rules of Practice Modified
 - a. The SBE has issued new proposed Rules for Tax Appeals.

B. Attorneys Fees

1. In four recent decisions, courts have granted requests for attorney's fees for taxpayers in litigations against the FTB.
 - a. *Fujitsu Holdings, Inc. v. FTB*, 120 Cal. App. 4th 459 (2004)

(1) Time-Bar Issue

- (a) The taxpayer made payment of taxes for 1988 during the pendency of protest.
- (b) The FTB's position was that the suit for refund was untimely for 1988.
 - (i) RTC § 19335 converted protest into claim for refund.
 - (ii) After the SBE decision upholding the FTB's denial of the protest, Fujitsu's subsequent claim for refund was a nullity.
 - (iii) Fujitsu's suit for refund for 1988 was not filed within 90 days of the SBE's decision.
- (c) The FTB did not apply the payment to the protest until after the SBE decision.
- (d) Trial court held the FTB could not invoke RTC § 19335 to bar refund suit.
- (e) The time-bar issue was not appealed by the FTB.

(2) Attorneys Fees Awarded With Respect to Time-Bar Issue

- (a) RTC § 19717 provides that reasonable litigation costs, including attorneys fees may be recovered.
 - (i) FTB's position must not be substantially justified.
 - (ii) Taxpayer must substantially prevail.
 - (b) Court of Appeal held that the FTB's position was not "substantially justified."
 - (i) FTB's application of the payment after SBE decision was critical in the Court's view.
 - (c) The taxpayer did substantially prevail even though the time-bar issue was not the most significant issue in the litigation.
- b. *Milhous v. FTB*, California Court of Appeal No. D044362 (August 15, 2005)
 - c. *American General Realty v. FTB*, San Francisco Superior Court No. CGC 03425690 (2005)
 - (1) See **I.C** above.
 - (2) Trial court granted the taxpayer's request for attorneys fees based on market rates.
 - (3) The FTB did not appeal the trial court's decision.

- d. *Agnew v. SBE*, 134 Cal. App. 4th 899 (2005)
 - (1) In a sales and use tax case, the taxpayer's request for attorney fees was not granted under RTC 7156.
 - (2) However, costs, including expert witness fees, were awarded.
 - (a) See California Code of Civil Procedure Sections 998 and 1032.
- e. *Cardinal Health v. SBE*, San Francisco Superior Court No. CGC 04-437052 (May 2006)
 - (1) Case dealt with the issue whether the SBE's denial of a sales and use tax exemption was proper.
 - (2) Trial court ruled in favor of the taxpayer and granted its request for attorneys fees based on market rates.
- f. *Northwest Energetic Services, LLC v. FTB*, San Francisco Superior Court No. CGC-05-437721 (March 3, 2006)
 - (1) Attorneys fees were granted based on a "private attorney general" doctrine (California Code of Civil Procedure Section 1021.5).

C. Limited Liability Company Issues

- 1. *Northwest Energetic Services, LLC v. FTB*, San Francisco Superior Court No. CGC-05-437721 (March 3, 2006)
 - a. The trial court concluded that California's LLC fee under RTC § 17942 violates the Commerce and Due Process Clauses because it is based on worldwide gross income and not apportioned between gross income sourced within and without California.
 - b. The LLC in *Northwest Energetic* was a Washington state LLC that registered to do business in California, but never had any sales, property, payroll or other activity in California.
 - c. While the court's decision appears to conclude that the LLC fee is unconstitutional and cannot be imposed on any LLC, including those with California activities, it remains uncertain whether a California court would be as willing to conclude the fee is unconstitutional for an LLC that generated all, or most, of its income from California sources.

- d. Case is pending on appeal.
 - e. A bill (AB 1614) that would have revised the California LLC fee schedule from one based on the LLC's total income to one based on the LLC's income apportionable to California was vetoed by Governor Schwarzenegger.
- 2. *Ventas Finance I, LLC v. FTB*, San Francisco Superior Court No. CGC-05-440001 (November 7, 2006)
 - a. Similar to Northwest, the trial court concluded the LLC fee under RTC § 17942 was an unfairly apportioned tax.
 - b. The Court concluded that RTC § 17942 could not be reformed to add an apportionment mechanism since that was contrary to the Legislature's intent.
 - c. The taxpayer had approximately 10 percent of its revenues from California sources.
 - d. Case is pending on appeal.
 - 3. *Mockingbird Partners, LLC*, SBE Case No. 306061 (May 17, 2006)
 - a. The SBE ruled that an out-of-state LLC was subject to California's LLC minimum tax under RTC § 17941 based on the activities of the LLC's members who were California residents.
 - b. The LLC, which was formed to acquire and manage real estate, was organized in Montana, was not registered in California, held Montana real estate and was managed by a Montana real estate management company. The SBE determined that some activity relating to the purchase of the Montana property occurred in California based on the activities of the LLC's members who were the managers of the LLC under the LLC's operating agreement.

D. Miscellaneous Legislative Activity

- 1. Assembly Bill No. 675
 - a. Gov. Schwarzenegger vetoed AB 675 which would have required publicly traded corporations with assets of \$10 million or more that are subject to California corporation franchise or income tax (or included in a California combined report) to report their book-tax differences to the FTB.

2. Assembly Bill No. 970
 - a. Legislation was enacted authorizing the FTB to allow corporations to file a California group nonresident income tax return on behalf of electing nonresident directors who receive director fees from that corporation.
 - b. The rate of tax for electing directors is the highest marginal personal income tax rate, and no deductions or credits may be claimed on the group return.
3. Assembly Bill No. 2341
 - a. California law has been amended to eliminate the requirement of a terminating corporation, LLC or limited liability partnership to obtain a tax clearance certificate from the FTB, subject to certain filing requirements with the California Secretary of State.
- E. California Compliance Resolution Program (IRC § 409A)
 1. On February 23, 2007, the FTB issued Notice 2007-1. The purpose of the Notice was to advise employers participating, or intending to participate, in the IRS Compliance Resolution Program (Announcement 2007-18), that they may also participate in the corresponding California Compliance Resolution Program.
- F. Election Results
 1. Governor Schwarzenegger (R) was reelected.
 2. SBE Chairman John Chiang (D) was elected Controller replacing Steve Westly (D). He is on both the FTB and SBE.
 3. Claude Parrish (R) was replaced on the SBE by Michelle Steele (R).
 4. Judy Chu (D) was elected to the SBE, taking John Chiang's spot.