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COST 2012 43rd Annual Meeting/Fall Audit Session
Orlando, Florida

October 24 - 26, 2012

CALIFORNIA

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I. Apportionment Formula

A. Sales Factor

1. Gross receipts from treasury function and hedging activities.

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 Revenue and Taxation Code (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 Section II.B.1. below.)

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 Franchise Tax Board (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 Section I.B.1. below)

c. *Limited Stores, Inc. v. FTB*, 152 Cal. App. 4th 1491 (2007)

(1) Trial court concluded that the return of principal must be excluded from the gross receipts generated by the taxpayer's sale of short-term financial investments and thus from the sales factor.

(2) In dicta, the court held that the inclusion of gross receipts would be distortive.

(3) On July 28, 2005, Court of Appeal affirmed in an unpublished opinion (No. A102915).

(4) On October 26, 2005, the California Supreme Court granted the taxpayer's petition for review. The matter is deferred pending *General Motors* and *Microsoft*.

(5) On November 15, 2006, the California Supreme Court returned the case to the Court of Appeal with instructions to that court to vacate its prior decision and reconsider the case in light of *General Motors* and *Microsoft*.

(6) Upon remand, the Court of Appeal held that the return of principal from short-term financial instruments was a "gross receipt" for sales factor purposes.

(7) The Court further held that inclusion of gross receipts in the sales factor was distortive under RTC § 25137 because the taxpayer's treasury function was qualitatively different from its principal, retail store business.

d. *General Mills, Inc. & Subsidiaries v. FTB*, 172 Cal. App. 4th 1535 (2009) (*General Mills I*)

(1) Trial court concluded that commodity hedging transactions did not generate gross receipts for sales factor purposes.

(2) Because of its holding above, the court did not consider the issue whether inclusion of such receipts would be distortive under RTC § 25137.

(3) On April 15, 2009, the Court of Appeal reversed the trial court's decision. The Court concluded that the gross receipts from the hedging transactions should be included in the sales factor. However, since the trial court did not reach the RTC § 25137 issue, the case was remanded to the trial court to address that issue.

(4) Petition for review was denied on July 29, 2009.

(5) The case was tried on remand on the RTC § 25137 issue. On January 10, 2011, the trial court ruled that the gross receipts from hedging transactions should be excluded from the sales factor under RTC § 25137. An appeal was filed on March 17, 2011.

(6) On August 29, 2012, the Court of Appeal affirmed the trial court judgment. The Court held that the taxpayer's hedging transactions were qualitatively different from its main business and that a change in the overall apportionment percentage of 8.2 percent was sufficient quantitative distortion to invoke RTC § 25137. *General Mills, Inc. & Subsidiaries v. FTB*, ___ Cal. App. 4th ____ (2012) (*General Mills II*)

e. *Square D Co. v. FTB*, San Francisco Superior Court No. CGC-05-442465 (Apr. 11, 2007)

(1) Trial court concluded that the taxpayer's gross receipts from Eurodollar time deposits were includible in the sales factor.

(2) However, the court also concluded that the FTB proved, by clear and convincing evidence, that the inclusion of such receipts was distortive under RTC § 25137.

(3) The case is now closed.

f. *Toys R Us, Inc. v. FTB*, 138 Cal. App. 4th 339 (2006), vacated on remand (2006)

(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.

(5) On July 26, 2006, the California Supreme Court granted the taxpayer's petition for review. The matter was deferred pending *General Motors* and *Microsoft*.

(6) On November 15, 2006, the California Supreme Court returned the case to the Court of Appeal with instructions to that court to vacate its prior decision and reconsider the case in light of *General Motors* and *Microsoft*.

(7) On April 30, 2009, following mediation the appeal was dismissed.

g. *Montgomery Ward and Co., Inc. v. FTB*, San Diego Superior Court No. GIC 802767 (Dec. 10, 2007)

(1) On October 3, 2002, in a summary decision, the State Board of Equalization (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) The San Diego Superior Court reversed the SBE's decision. In granting summary judgment for the taxpayer, the trial court concluded that the FTB failed to meet its two-part burden of showing distortion and that its proposed alternative to the standard apportionment formula was reasonable.

(3) The FTB did not appeal.

h. *Home Depot USA, Inc.,* SBE Case No. 298683 (Dec. 16, 2008)

(1) The SBE held that Home Depot could include its gross receipts from certain treasury functions in its sales factor.

(2) Both parties agreed that a qualitative difference between the treasury receipts and receipts generated in the ordinary course of business must exist for the FTB to depart from the standard formula, and such difference existed in this case. However, the parties disagreed on the significance of

the quantitative difference between the apportionment results with and without the inclusion of the gross receipts from treasury function.

(3) Taxpayer argued that quantitatively, the apportionment results varied by only 3.3 percent with and without the inclusion of the gross receipts, and that this variation was insufficient to satisfy the necessary quantitative difference.

(4) FTB argued that inclusion of gross receipts from a treasury function in the sales factor always results in failure of the standard apportionment formula where there is a qualitative difference between the treasury function and the taxpayer's ordinary business operations.

(5) The SBE administrative cases that were deferred pending the resolution of *Home Depot* were re-activated.

(6) In 2008, the FTB put forth a general proposal for settling pending treasury function cases. It is based on the percentage of gross receipts from treasury activities in the sales factor denominator (i.e., total gross receipts including treasury receipts).

(a) The tax amounts conceded by FTB are as follows:

Percentage	FTB Concession
Up to 6.6%	75%
More than 6.6%, up to 17.3%	60%
More than 17.3%, up to 27.9%	30%
More than 27.9%, up to 33.9%	15%
More than 33.9%, up to 50%	10%
More than 50%	5%

(b) Query: what types of gross receipts should be considered gross receipts from treasury activities?

(c) In June 2010, the FTB extended the above proposal (entitled Treasury Function Resolution Program) to taxpayers with pending audits, protests and refund claims. To participate in this program a taxpayer had to have filed a return or claim before January 1, 2010 which included treasury receipts in the sales factor. The taxpayer had to advise the FTB by August 16, 2010 that it wanted to participate in the program.

i. *In re Buffets Holdings, Inc.,* Case No. 08-10141, U.S. Bankruptcy Court (D. Delaware) (Aug. 15, 2011)

(1) Bankruptcy court concluded that the FTB's use of an alternative apportionment formula, which excluded treasury gross receipts from the sales factor denominator, was reasonable.

(2) The court also held that the debtors' "back of the house activities," including kitchen and food preparation, were properly classified as manufacturing activities for Manufacturers' Investment Credit (MIC) purposes. Citing *Save Mart Supermarkets*, 2002-SBE-002 (Feb. 6, 2002), the court concluded that the MIC statute does not require that the food manufacturing or processing be the only business of the taxpayer, only that some of its activities fit in Division D of the Standard Industrial Classification Manual.

2. Regulation 25137(c)(1)(D)

a. Effective for taxable years beginning on or after January 1, 2007, the FTB amended Regulation 25137(c)(1) by adding subsection (D) to exclude from the sales factor all interest, dividends and gains (gross and net) in connection with the taxpayer's treasury function.

b. "Treasury function" is defined as "the pooling, management, and investment of intangible assets for the purpose of satisfying the cash flow needs of the trade or business . . . ." It includes the use of futures and options contracts to hedge foreign currency fluctuations, but does not include futures and options transactions to hedge price risks of the products or commodities consumed, produced or sold by the taxpayer.

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

3. In 2009, the statutory definition of "gross receipts" under RTC § 25120 was amended to exclude, amount other items, amounts received from certain transactions in connection with the taxpayer's treasury function activities.

a. For taxable years beginning before January 1, 2011, "sales" for purposes of the sales factor includes all gross receipts not allocated

under RTC §§ 25123 through 25127. This was a "clarifying" non-substantive change. RTC § 25120(f)(1).

b. For taxable years beginning on or after January 1, 2011, "gross receipts" include the gross amount realized in a transaction producing business income and recognized under the Internal Revenue Code, without reduction for basis or costs of goods sold. RTC § 25120(f)(2). However, gross receipts, even if business income, do not include the following:

(1) Repayment, maturity, or redemption of the principal of a loan, bond, mutual fund, certificate of deposit, or similar marketable instrument;

(2) The principal amount received under a repurchase agreement or other transaction properly characterized as a loan;

(3) Proceeds from the issuance of a taxpayer's own stock or from sale of treasury stock;

(4) Damages and other amounts received as the result of litigation;

(5) Property acquired by an agent on behalf of another;

(6) Tax refunds and other tax benefit recoveries;

(7) Pension reversions;

(8) Contributions to capital (except for sales of security by securities dealers);

(9) Income from discharge of indebtedness;

(10) Amounts realized from exchanges of inventory that are not recognized under the Internal Revenue Code;

(11) Amounts received from transactions in intangible assets held in connection with a treasury function of the taxpayer's unitary business and the gross receipts and overall net gains from the maturity, redemption, sale, exchange, or other disposition of those intangible assets;

(a) "Treasury function" means the pooling, management, and investment of intangible assets for purposes of satisfying the cash flow needs of the taxpayer's trade or business, such as providing

liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, and business acquisitions, and also includes the use of futures contracts and options contracts to hedge foreign currency fluctuations.

(12) Amounts received from hedging transactions involving intangible assets.

4. Single sales factor election

a. Multistate taxpayers may make an irrevocable annual election on an original timely filed return to apportion its income using a single sales factor. This election is available for taxable years beginning on or after January 1, 2011. The election is not available to taxpayers listed in RTC § 25128(b), which derive more than 50 percent of their gross receipts from agricultural, extractive, savings and loan, or banking or financial activities. Those taxpayers must continue to use the standard, equally weighted three-factor apportionment formula. RTC § 25128.5.

b. Taxpayers that make the single sales factor election are required to use market-based sourcing for the assignment of sales other than sales of tangible personal property. Taxpayers that do not make such election source such sales to the state where the greater proportion of income producing activity is performed, based on the costs of performance.

c. A study released in June 2010 indicated that changing to the single sales factor formula will create 144,000 new jobs in California and increase state revenues by $411 million annually.

5. Regulation 25136-2—Sourcing of sales from intangibles/services

a. FTB adopted Regulation 25136-2 to provide guidance on assigning sales of other than tangible property where a taxpayer makes an election to use the single sales factor formula and its market based rules.

b. For taxable years beginning on or after January 1, 2011, if a taxpayer makes a single sales factor election, sales of other than tangible personal property are generally sourced for sales factor purposes as follows.

(1) Sales from services are sourced to the state where the purchaser receives the benefit of the services, to the extent the benefits are received.

(2) Sales of intangible property are sourced to the state where the intangible property is used. Special rules apply in the case of the sale of ownership interests in a corporation or pass-through entity (other than sales of marketable securities), the licensing of marketing intangibles and the licensing of manufacturing intangibles.

(3) Sales from the sale, lease, rental, or licensing of real or tangible property are sourced to the state where the property is located.

(4) The sales factor provisions in Regulations 25137 through 25137-14 are incorporated, with certain modifications to reflect market-based sourcing.

c. On March 29, 2012, the FTB held an interested parties meeting to discuss possible amendments to Regulation 25136-2 to address certain sales of services and intangible property which were not addressed previously.

6. *Finnigan* Returns (Again)

a. For taxable years beginning on or after January 1, 2011, all sales of tangible personal property of a combined reporting group properly assigned to this state must be included in the sales factor numerator regardless of whether the member of the combined reporting group making the sale is subject to tax in California. Sales not assigned to California are not included in the California sales factor numerator if a member of the combined reporting group is subject to tax in the state of the purchaser. RTC § 25135(b).

b. On May 26, 2011, the FTB held an interested parties meeting to discuss proposed amendments to Regulation 25106.5 (sales factor; sales of tangible personal property; throwback sales), to implement the return of *Finnigan*.

c. A second interested parties meeting was held on October 4, 2011 to discuss proposed amendments to Regulation 25106.5.

7. FTB Legal Ruling 2006-2 and Amendment to Regulation 25136

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.

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

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

d. The FTB proposed an amendment to Regulation 25136, regarding the assignment of sales of other than tangible personal property, to conform to recent changes by the Multistate Tax Commission relating to the "on behalf of" rule under MTC Regulation IV.17. Specifically, the amendment would include the activities of an independent contractor in the taxpayer's "income producing activity." The amendment, which became final on July 17, 2010, is applicable retroactively to taxable years beginning after 2007.

e. On August 23, 2011, the FTB issued Chief Counsel Ruling 2011-01 and concluded that a taxpayer may use its customers' billing addresses maintained in the ordinary course of business as a reasonable proxy for its customers' commercial domicile, for

purposes of assigning sales of other than tangible personal property under Regulation 25136(d)(3)(D), relating to income producing activity performed on behalf of a taxpayer by an agent or independent contractor.

8. Proposed Regulation 25128.5

   a. On March 29, 2011, the FTB held a hearing on the proposal to adopt FTB Regulation 25128.5 setting forth guidance on the single sales factor election. On July 7, 2011, the FTB approved the Regulation.

9. Equally-weighted apportionment formula under Multistate Tax Compact

   a. In January 2010, a number of companies filed complaints in San Francisco Superior Court claiming refunds based on the election to compute California apportionable income using an equally-weighted three-factor apportionment formula under the Multistate Tax Compact, in place of California's standard three-factor formula under RTC § 25128 which includes a double-weighted sales factor.

   b. Cases included: *The Gillette Company & Subsidiaries* (CGC-10-495911); *Kimberly-Clark World Wide, Inc. & Subsidiaries*; *The Procter & Gamble Manufacturing Co. & Affiliates*; *RB Holdings (USA) Inc.*; *Sigma-Aldrich Corp.*; and *Jones Apparel Group*.

   c. On November 2, 2010, the trial court sustained the FTB's demurrers in the above cases. An appeal was filed on December 2, 2010.

   d. On June 27, 2012, California repealed the Compact. See Section VIII.A.1 below.

   e. On October 2, 2012, the Court of Appeal issued its opinion on rehearing and reversed the trial court. The Court held that the Compact, which required states to offer the three-factor election, was binding on California and superseded subsequent conflicting state law. *The Gillette Company et al v. FTB*, __ Cal. App. 4th ____ (2012).

   f. FTB guidance issued on October 5, 2012

      (1) FTB issued Notice 2012-01 setting forth the procedures for filing a protective claim for refund if a taxpayer wants to raise the Compact election issue pending in *Gillette*. FTB

will only take action on the claim once *Gillette* has been fully resolved.

(2) FTB issued a News Flash indicating that a taxpayer making the election under the Compact on its 2011 return runs the risk of having the large corporate understatement penalty (LCUP) imposed if *Gillette* is ultimately reversed.

10. FTB Chief Counsel Ruling 2012-01

a. FTB ruled that the gross proceeds from principal trades of a registered broker-dealer should be included in the sales factor under the standard apportionment formula.

b. FTB also ruled that intrastate apportionment was not a proper subject for analysis under RTC § 25137, even though inclusion of the gross proceeds from principal trades may impact the intrastate apportionment between the broker-dealer and the financial corporation members of the broker-dealer'

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) RTC § 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 RTC § 25137 is not a prohibited separate accounting analysis.

(4) RTC § 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 RTC § 25137 may be inappropriate.

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

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

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

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

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

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

e. Technical Advice Memorandum 2007-3.

(1) In TAM 2007-3, the FTB set forth the types of treasury activity information that should be collected from taxpayers upon audit post-*Microsoft* and *General Motors*, including the taxpayer's main line of business, the number of treasury and total employees, the gross margin from treasury function compared to other activities and the percentage of

total income that would be assigned to the location of the treasury function.

(2) Purpose of the information is to enable the FTB to perform a quantitative distortion analysis.

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

a. Case involved 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 generated virtually all of its unitary income, yet the standard apportionment formula does not reflect this fact. The taxpayer contended that RTC § 25137 should be applied to correct the distortion.

c. Case also involved the proper inclusion of gross receipts for taxpayer's treasury function in the sales factor. The FTB argued that the gross receipts from the taxpayer's treasury function activity should be excluded from the sales factor under RTC § 25137. The taxpayer disagreed and argued that if the FTB has sustained its burden of proof under RTC § 25137 on this issue, then so had the taxpayer with respect to its Washington timber activities.

d. Oral argument held January 25, 2005.

e. 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*. It was further deferred pending *Home Depot* (see Section I.A.1.h. above). The case settled and the SBE appeal was dismissed.

3. *Microsoft Corporation v. FTB*, San Francisco Superior Court No. CGC-08-471260. Suit for refund filed on January 22, 2008.

a. Trial court entered judgment on March 21, 2011, ruling in favor of the FTB on the following issues for the 1995 and 1996 tax years:

(1) Royalties from computer software products were derived from the licensing of tangible personal property that was shipped or delivered to a location in California and, as such, should be assigned to the California numerator of the sales factor.

(2) Gross receipts from marketable securities should be excluded from the sales factor under RTC § 25137.

(3) The value of trademarks, copyrights, patents and other intangible assets should not be included in the property factor.

(4) The amnesty penalty under RTC § 19777.5 is not unconstitutional.

b. On appeal, case has been fully briefed and oral argument was heard on October 1, 2012.

4. Airline Industry

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. Effective April 18, 2010, the FTB adopted Regulation 25101.3 and amended Regulation 25137-7 to require that air transportation companies engaging in business within and outside California group aircraft by model, for purposes of determining payroll, sales and property factors used to apportion income. In addition, all members of a unitary group that are engaged in a unitary business of providing air transportation must apportion business income from air transportation as provided in Regulation 25137-7.

5. Franchisors

a. In Chief Counsel Ruling 2010-2, the FTB determined that the special apportionment and allocation of income rules applicable to franchisors under Regulation 25137-3 applies to a company's licensing activity which includes granting licenses for the use of the company's trademark to licensees who market products bearing the company's trademark. The FTB also concluded that royalty and franchise payments by the company's foreign subsidiaries are treated as payments by third-party licensees, where the company has made a water's edge election.

6. Motion Picture and Television Industry

a. The FTB held interested parties meetings in January 2008 and May 2009 to consider revising Regulation 25137-8, regarding apportionment for the motion picture and television industry. On June 16, 2009, the three-member FTB approved proceeding with

the formal rulemaking process to adopt proposed amendments to Regulation 25137-8. On September 13, 2011, the FTB held a hearing on proposed amendments to Regulation 25137-8 (renumbered as 25137-8.1) and the proposed adoption of Regulation 25137-8.2, which were approved. Regulation 25137-8.1 is applicable for taxable years beginning before January 1, 2011, while Regulation 25137-8.2 is applicable for taxable years beginning on or after January 1, 2011.

II. Credits

A. Enterprise Zone Hiring Credits

1. *Deluxe Corporation*, 2006-SBE-003 (December 15, 2006)

   a. Case involved challenge to FTB's position of looking behind vouchers obtained from local enterprise zones. The taxpayer is arguing "voucher reliance" and that RTC § 23622.7 only requires that a certificate (voucher) be obtained from the enterprise zone or other appropriate agency and provided to the FTB upon request.

   b. On January 31, 2006, the SBE held in a 4-1 vote that the FTB is permitted to look behind the vouchers. Post-hearing briefs were filed regarding whether the 51 remaining employees qualify for the credit.

   c. On December 15, 2006, the SBE issued a formal opinion confirming the decision in January that the FTB is permitted to look behind the vouchers. In a letter decision issued that same day, the SBE concluded that 15 of the 51 employees at issue qualified for the credit.

   d. On April 11, 2007, the taxpayer filed a suit for refund in the San Francisco Superior Court (No. CGC-07-462305).

   e. Trial was scheduled for July 14, 2008, but case settled and has been dismissed.

2. *Dicon Fiberoptics, Inc. v. FTB*, 53 Cal. 4th 1227 (2012), rev'g, 173 Cal. App. 4th 1082 (2009)

   a. On March 13, 2007, a suit for refund was filed challenging the FTB's authority to look behind the vouchers (Los Angeles Superior Court No. BC 367885).

b. On August 17, 2007, the trial court sustained the FTB's demurrer without leave to amend, and on October 3, 2007, an order of dismissal of plaintiff's action was filed. Plaintiff appealed.

c. On May 7, 2009, the Court of Appeal issued a published opinion in favor of the taxpayer. The Court of Appeal concluded that, while the FTB had the authority to look behind the vouchers, the FTB had the burden of proof to demonstrate the invalidity of the vouchers.

(1) The vouchers are de facto valid.

(2) The FTB cannot request additional information from the taxpayer.

d. The FTB filed a Petition for Rehearing, which was denied.

e. The FTB then filed a Petition for Review with the California Supreme Court, which was granted on August 19, 2009.

f. On April 26, 2012, the California Supreme Court reversed and held that the FTB may conduct an audit to determine whether a taxpayer is entitled to the credit and is not required to accept a voucher as conclusive or prima facie proof.

3. *Jessica McClintock* and *Jessica McClintock, Inc.*, SBE Case Nos. 304497 and 304512 (August 14, 2007)

a. Case involved the following issues: (1) whether subsection (c) of Section 1603 of the JTPA (the 10% exception) provides a separate eligibility category for purposes of the hiring credit; and if yes, then (2) whether the employees in question were eligible for services under subsection (c) of section 1603 of the JTPA.

b. The FTB argued that subsection (c) does not provide a separate eligibility category. The FTB further argued that individuals who could be enrolled in a JTPA program pursuant to subsection (c) were not "eligible" for JTPA services under RTC § 23622.7 and could only constitute qualified employees for purposes of the hiring credit if they were actually enrolled under the JTPA. The FTB also argued that "older worker" is not a barrier to employment because it is not enumerated in the statute.

c. The SBE voted 5-0 to grant the taxpayer's refund claims. The SBE held that for the 10% exception, an employee only needs to be eligible for JTPA services (and not required to be enrolled in JTPA) to be a qualified employee. The SBE further held that

"older worker" is a barrier to employment for purposes of the 10% exception because of the legislative history, EDD publications and the FTB's own audit manual. The SBE concluded that the "older worker" need not meet low-income guidelines.

d. On April 1, 2008, the FTB announced in its Tax News that based on purported "new information," it is taking the position in pending appeals at the SBE that an individual must be both 55 years or older and meet low-income guidelines.

4. On November 27, 2006, vouchering regulations were issued by the Department of Housing and Community Development.

5. *Taiheiyo Cement USA, Inc.*, 204 Cal. App. 4th 254 (2012)

a. In a letter decision, the SBE sustained the FTB's disallowance of the enterprise zone sales and use tax credit for property that the taxpayer currently expensed (SBE Case No. 332855, Feb. 4, 2008).

b. On July 11, 2008, the SBE granted the taxpayer's petition for rehearing, which was denied.

c. In July 2010, the Los Angeles Superior Court, Case No. BC422623, entered judgment in favor of the FTB. On March 13, 2012, the Court of Appeal affirmed the judgment.

6. *DeVry, Inc.*, SBE Case No. 357029 (August 19, 2008)

a. In a letter decision, the SBE reaffirmed its decision in *Jessica McClintock* and *Jessica McClintock, Inc.*, SBE Case Nos. 304497 and 304512 (August 14, 2007), and held that "older workers" need not meet low-income guidelines in order to be "qualified employees" for the enterprise zone hiring credit.

b. The SBE did not agree with the FTB's stringent requirement of third-party verification for disabled and dislocated worker categories.

7. *NASSCO Holdings, Inc.*, 2010-SBE-001 (Nov. 17, 2010)

a. In a letter decision, the SBE held that the taxpayer is entitled to apply its EZ and MIC tax credits to reduce its alternative minimum tax liabilities, which results in no tax owed.

b. The FTB filed a petition for rehearing, which the SBE denied on August 31, 2009.

c. On November 17, 2010, the SBE issued a formal opinion in favor of the taxpayer.

d. The FTB issued Notice 2011-02 (March 18, 2011) to provide guidance regarding the SBE's formal opinion.

B. 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.

3. Credit Assignment

a. AB 1452, enacted on September 30, 2008, added RTC § 23663, which provides that an "eligible credit" may be assigned by a taxpayer to an "eligible assignee." The election to assign is irrevocable and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

(1) "Eligible credit" means any credit earned by a taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned prior to July 1, 2008, that is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008.

(2) "Eligible assignee" means any "affiliated corporation" that is properly treated as a member of the same combined reporting group.

(3) "Affiliated corporation" means a corporation that is a member of a commonly controlled group.

b. The FTB released a set of Frequently Asked Questions (FAQs) and Form 3544 concerning the new credit assignment provisions. On April 3, 2009, FTB held an interested parties meeting (IPM) to discuss the FAQs, and released a summary of the IPM. FTB addressed the manner in which the credit assignment election must

be made, substantiation of the credit after assignment, and post-assignment credit utilization limitations. The FAQs were recently amended to address limitations on credits attributed to a disregarded business entity and assignment limitations relating to the low income housing tax credit and the California film and television tax credit.

c. On October 1, 2012, the FTB held an interested parties meeting to discuss issues relating to defective elections made under RTC § 23663, including identifying and defining defective elections and possible methods to correct a defective election.

C. Research and Development Credit

1. FTB Legal Division Guidance 2012-03-01

a. In June 2011, the FTB issued Legal Division Guidance 2011-06-01 in which it advised that a purely service company with no "gross receipts" within the meaning of RTC § 23609(h)(3) could not claim the California research and development (R&D) credit.

b. In July 2011, the FTB withdrew Legal Division Guidance 2011-06-01.

c. On March 16, 2012, the FTB issued Legal Division Guidance 2012-03-01 and confirmed that a taxpayer with no "gross receipts" under RTC § 23609(h)(3) can claim the R&D credit.

2. *Pacific Southwest Container, Inc.*, SBE Case No. 473587 (March 22, 2011)

a. The SBE ruled in favor of the taxpayer and concluded the taxpayer met its burden of proof demonstrating that its activities constituted "qualified research."

b. The SBE rejected the FTB's attempt to impeach the taxpayer's documentation and other evidence.

3. *Thomas A. Leonardini and Karen M. Leonardini*, SBE Case No. 449478 (November 10, 2010)

a. Case involved issues related to whether sufficient evidence was presented to demonstrate that the taxpayers' activities constituted "qualified research" under IRC § 41.

b. The SBE concluded that the taxpayers did not meet their burden of proof.

4. In testimony before the SBE on February 22, 2011, former FTB Chief Counsel, Geoffrey Way, noted that there is a significant increase in audit activity by the FTB in this area.

5. The FTB will hold an interested parties meeting on October 11, 2012 to discuss what legislative proposals should be considered in California and how the FTB can expedite the audit process while ensuring the documentation and substantiation for the credit is sufficient to determine the proper qualified activities and expenses.

D. Other Credits

1. Motion Picture Production Credit

a. For taxable years beginning on or after January 1, 2011, a credit is allowed for 20 percent of the qualified expenditures of qualified motion pictures, or 25 percent of such expenditures for independent films or a television series whose production was relocated to California primarily because of the credit.

b. The credit may be carried forward for 6 years, and is available for individuals and corporations.

2. Small Business Hiring Credit

a. For taxable years beginning on or after January 1, 2009, small businesses may claim a $3,000 tax credit for each qualified full-time employee hired during the taxable year which results in a net increase in full-time employees from the previous year.

b. Only employers having 20 or fewer employees may qualify for the credit as a small businesses.

III. 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 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* (see Section III.B below), 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. 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) *Abbott Laboratories, et al. v. FTB*, 175 Cal. App. 4th 1346 (2009)

(a) On July 21, 2009, in a published decision, the Second District Court of Appeal affirmed in favor of the FTB. The Court held that *Farmer Bros.* found RTC § 24402 to be unconstitutional in its entirety and could not be reformed. The Court declined to apply the severability provisions of RTC § 23057.

(3) *River Garden Retirement Home v. FTB*, 186 Cal. App. 4th 922 (2010)

(a) On July 15, 2010, the First District Court of Appeal largely followed the *Abbott Labs* decision. The Court concluded that RTC § 24402 cannot be saved by severance of the offending language and the remedy of disallowing the dividends received deduction did not violate the Due Process prohibition against retroactive tax increases.

(4) *C.V. Starr & Co.* and *MediaNews Group, Inc.* (May 25, 2011). Citing *Abbott Labs* and *River Garden*, the SBE

sustained the FTB's denial of dividend deductions under RTC § 24402 for the 1999 and subsequent tax years.

c. Corporations which repatriated foreign earnings in 2004 and 2005 and were able to claim an 85-percent deduction for dividends received from controlled foreign corporations under IRC § 965 do not have the same ability under California law, since California has not conformed to IRC § 965.

(1) If the corporation is a water's edge filer, a 75-percent dividends received deduction will be allowed and the foreign investment interest offset rules apply.

(2) In view of *Fujitsu* and *Apple* (see Sections III.F, IV.A and IV.C below), consideration should be given to filing claims for refund.

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.

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.

b. 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.

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

d. AB 263 also amended RTC § 24425, regarding the deductibility of expenses related to insurance companies, for taxable years beginning on or after January 1, 2004.

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

C. *American General Realty Investment Corp., Inc. v. FTB*, San Francisco Superior Court No. CGC-03-425690 (April 28, 2005)

1. On June 25, 2003, 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. The San Francisco Superior Court reversed the SBE's decision. 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 attorney's 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 v. FTB*, San Francisco Superior Court No. CGC-07-462688 (Aug. 4, 2008)

1. On June 25, 2003, in a letter decision similar to *American General*, the SBE affirmed the FTB's disallowance of the deduction of administrative expenses and interest expense under RTC § 24425 on the theory that the expenses were indirectly traceable to insurance company dividends which were deductible under *Ceridian*.

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

3. The taxpayer filed a suit for refund in the San Francisco Superior Court challenging the SBE's decision.

4. On August 4, 2008, the trial court entered judgment in favor of the plaintiff on the RTC § 24425 issue and concluded that all of the administrative expenses were deductible.

5. Plaintiff's motion for attorney's fees was denied on October 23, 2008.

6. The FTB did not appeal.

F. *Apple Inc. v. FTB*, 199 Cal. App. 4th 1 (2011)

1. On January 26, 2010, the trial court issued a final statement of decision in favor of the plaintiff and concluded that the FTB's disallowance of interest expense deductions under RTC § 24425 was erroneous (San Francisco Superior Court No. CGC-08-471129, Jan. 26, 2010).

2. The trial court concluded that the dominant purpose of plaintiff's borrowing which generated the interest expense was to fund domestic working capital needs and not to provide funds to the foreign dividend payors whose dividends were deductible under RTC § 24402.

3. The trial court held that none of the interest expense deductions should be disallowed.

4. On September 12, 2011, the Court of Appeal affirmed the trial court on the interest expense deduction issue. The FTB did not file a petition for review. See Section IV.C below.

IV. 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 Treasury Regulation 1.954-2(b) (1) excluded from Subpart F income for California water's edge purposes, the dividend paid by one foreign subsidiary to another foreign subsidiary.

2. The SBE agreed with the taxpayer that IRC § 959(b) was incorporated into California law through the operation of Treasury Regulation 1.954-2(b)(1).

C. *Apple Inc. v. FTB*, 199 Cal. App. 4th 1 (2011)

1. On November 20, 2006, the SBE issued a formal opinion and agreed with the FTB—contrary to *Fujitsu* (see Section IV.A 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 (LIFO proration approach).

2. On January 16, 2008, the taxpayer filed a suit for refund in San Francisco Superior Court (No. CGC-08-471129).

3. The taxpayer contended that the issue was decided by the Court of Appeal in Fujitsu. In that case, the Court rejected the FTB's LIFO proration approach and concluded that such dividends are to be paid first from unitary earnings and thus eliminated under RTC § 25106 (preferential ordering).

4. The FTB refused to follow *Fujitsu* and contended that it was not binding precedent. The FTB attempted to amend Regulations 24411 and 25106.5-1 to conform to the SBE decision in *Apple*, rather than *Fujitsu*.

5. Case also involved RTC §24425 and interest expense disallowance issues. (See Section III.F above)

6. Trial was held on February 25-26, 2009. On January 26, 2010, the trial court issued a final statement of decision in favor of the FTB on the distributions ordering issue and in favor of the taxpayer on the interest expense disallowance issue.

7. The taxpayer appealed the distributions ordering issue and the FTB cross-appealed on the interest expense disallowance issue. The taxpayer also appealed the trial court's denial of an award of attorney's fees.

8. On September 12, 2011, the Court of Appeal affirmed the trial court on all issues. On January 4, 2012, the California Supreme Court denied the taxpayer's petition for review.

D. FTB Technical Advice Memorandum 2011-02 (March 15, 2011)

1. In TAM 2011-02, the FTB concluded that it would continue to apply the last-in-first-out (LIFO) ordering approach to dividend distributions from subsidiaries that are partially included in a water's edge combined report.

2. The FTB's position is that, with each year's distribution, dividends are deemed first distributed from that year's unitary earnings, until those earnings are depleted, with the remaining dividends deemed distributed from non-unitary earnings.

V. Tax Shelters

A. On March 24, 2011, California enacted a second voluntary compliance initiative (VCI 2). (Senate Bill No. 86.)

1. The period to participate in VCI 2 is August 1, 2011 to October 31, 2011. RTC § 19761.

2. Applies to tax liabilities attributable to the use of abusive tax avoidance transactions (ATATs) and income from offshore financial arrangements for taxable years beginning before January 1, 2011.

a. An ATAT is defined as a tax shelter, a reportable transaction, a listed transaction or a gross misstatement, as those terms are defined in the Internal Revenue Code, as well as any transaction subject to California's noneconomic substance transaction penalty. RTC § 19777(b).

3. A taxpayer may participate by filing an amended return to report income from all sources including ATATs and offshore financial arrangements, without deduction of any transaction costs relating thereto, and paying in full all taxes and interest.

a. No refunds or credits are allowed with respect to amounts paid under VCI 2.

b. Participating taxpayers agree to cooperate with any inquiries by the FTB into the facts and circumstances related to the use of ATATs or offshore financial arrangements.

c. Other restrictions and eligibility requirements may apply.

4. Most penalties are waived under VCI 2, including the accuracy-related penalty (RTC § 19164), the noneconomic substance transaction penalty (RTC § 19774) and the interest-based penalty (RTC § 19777).

a. The 20-percent large corporate understatement penalty (RTC § 19138) and the amnesty penalty (RTC § 19777.5) are <u>not</u> subject to waiver under VCI 2.

5. Failure to participate in VCI 2 may result in a penalty equal to 100 percent of the interest payable from the due date of the return (without extension) through the date of the Notice of Proposed Assessment (NPA). A reduced

50-percent penalty may apply to nonparticipants that file an amended return prior to the issuance of the NPA.

6. Statute of limitations for assessments relating to ATATs is extended to 12 years from the due date or filing of the return.

7. On August 16, 2011, Nordstrom, Inc. filed suit in Los Angeles Superior Court challenging the validity of VCI 2 and, in particular, the inability of participating taxpayers to preserve refund or appeal rights with respect to amounts paid under VCI 2. *Nordstrom, Inc. v. FTB*, Los Angeles Superior Court (Case No. BS133291). On October 21, 2011, the court denied the taxpayer's application for a preliminary injunction to extend the closing date for participation in VCI 2. The Court of Appeal denied the taxpayer's request for a writ of mandate directing the superior court to issue the injunction.

B. Challenges to FTB's Disallowance of REIT and RIC Dividend Deductions

1. *City National Corporation v. FTB*, Los Angeles Superior Court No. BC334772

   a. The taxpayer challenged the FTB's disallowance of REIT and RIC dividend deductions.

   b. The FTB's demurrer on procedural grounds was sustained without leave to amend.

   c. On January 16, 2007, the Court of Appeal reversed the lower court and held that the taxpayer was not barred from proceeding with its suit for refund.

   d. On April 11, 2007, the California Supreme Court denied the FTB's petition for review.

   e. The case settled in May 2010.

2. *City National Corporation v. FTB*, Sacramento Superior Court No. 06AS02275

   a. In an action similar to the above case but for subsequent taxable years, the taxpayer claimed a refund with respect to REIT dividend deductions.

   b. The case settled in May 2010 (see above).

C. FTB Notice 2008-4. On June 6, 2008, the FTB issued Notice 2008-4 regarding resolution of Bogus Optional Basis (BOB) transactions and certain employee stock ownership plan (ESOP) transactions.

D. FTB Notice 2011-01. On January 6, 2011, the FTB issued Notice 2011-01 identifying as a California "listed transaction" certain transactions involving apportioning corporate taxpayers that use one or more partnerships to improperly inflate the denominator of the California sales factor, thereby reducing the amount of business income apportioned to California for franchise or income tax purposes.

E. FTB Notices 2011-03 and 2011-04. On April 22, 2011, the FTB issued Notice 2011-03 identifying as a California "listed transaction" certain circular flow of cash transactions involving parent corporations that artificially increase their basis in the stock of their subsidiaries without any outlay of cash or property, prior to the parent selling the stock of the subsidiary to an unrelated party. On August 4, 2011, the FTB issued Notice 2011-04 to withdraw 2011-03 and more "clearly identify" the abusive nature of the transactions that the FTB intended to identify as a listed transaction.

VI. Penalties

A. Large Corporate Understatement Penalty (LCUP)

1. In 2009, California imposed a new penalty on corporate taxpayers equal to 20 percent of the understatement of tax if the understatement exceeds $1 million. RTC § 19138.

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

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

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

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

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

   b. There is a change of law that causes the understatement, where the law change occurs after the date the taxpayer filed the return (or the extended due date for the return, whichever is earlier) for the taxable year for which the change is operative; or

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

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

7. The California Taxpayers' Association (Cal-Tax) filed a lawsuit against the FTB in February 2009 to enjoin the enforcement of the LCUP. On May 21, 2009, the trial court rejected the challenge to the LCUP. On December 13, 2010, the appellate court affirmed the trial court's decision. *California Taxpayers' Association v. FTB*, 190 Cal. App. 4th 1139 (2010). Cal-Tax's petition for review was denied on March 16, 2011.

8. For tax years beginning in 2010, the LCUP was amended such that the penalty may not be imposed unless the understatement of tax exceeds both $1 million and 20 percent of the tax shown on the original return. RTC § 19138(a)(1).

9. FTB issued Legal Division Guidance 2012-03-02 indicating that a taxpayer cannot, for the same taxable year, make a single sales factor (SSF) election and report tax based on income apportioned using the three-factor formula to avoid the LCUP in the event the taxpayer is later determined to be ineligible to use the SSF formula.

B. Amnesty Penalty under RTC § 19777.5

1. *General Electric Company v. FTB*, San Francisco Superior Court No. 449157

a. The taxpayer challenged the validity of the Amnesty Penalty under RTC § 19777.5 (SB 1100) in a declaratory relief action.

b. It was the taxpayer's position that the Amnesty Penalty is invalid for a number of reasons and sought a declaration from the Court to that effect.

(1) The taxpayer alleged that the Amnesty Penalty is unconstitutional under the Due Process Clause due to the absence of a plain, speedy and efficient remedy to challenge the merits of the penalty either in court or administratively.

(2) The taxpayer alleged that the Amnesty Penalty is unconstitutional under the Due Process Clause due to its retroactive nature.

(3) The taxpayer alleged that the FTB's interpretation of "due and payable" in RTC § 19777.5 is at odds with RTC § 19049. The taxpayer requested a declaration from the Court, consistent with RTC § 19049, that no Amnesty Penalty will arise if the taxpayer pays the amount of the assessment on or before it receives a notice and demand for payment or within 15 days thereafter.

c. The FTB filed a demurrer to the complaint on the ground that the action was not ripe. The Court sustained the demurrer with leave to amend. On May 10, 2006, the taxpayer filed an amended complaint, to which the FTB filed another demurrer on ripeness grounds. The Court sustained the FTB's demurrer.

d. On September 15, 2006, the taxpayer filed a notice of appeal.

e. On July 13, 2007, after briefs were filed and while the case was awaiting oral argument, the case settled and the appeal was dismissed.

2. *River Garden Retirement Home v. FTB* (see Section III.A.3.b.(3) above). On September 24, 2008, the trial court granted the FTB's motion for summary judgment on the Amnesty Penalty issue. The court held that even if the plaintiff's interpretation of "due and payable" was correct, payment was not made within 15 days of notice and demand. On July 15, 2010, the appellate court held that an amount becomes "due and payable" for purposes of the Amnesty Penalty upon a final determination of tax and thus affirmed the imposition of the penalty. The Court also concluded that RTC § 19777.5 did not operate retroactively and thus did not violate the substantive Due Process Clause. The taxpayer's petition for review was denied on November 12, 2010.

3. Other cases pending in California court challenging the validity of the amnesty penalty include *Microsoft Corporation v. FTB* (see Section I.B.3 above).

VII. **Miscellaneous**

A. Attorney's Fees

1. *Northwest Energetic Services, LLC v. FTB*, 159 Cal. App. 4th 841 (2008)

a. Attorney's fees were granted based on a "private attorney general" doctrine (California Code of Civil Procedure Section 1021.5).

b. On appeal, the Court of Appeal reversed and remanded the case to the trial court on the issue of attorney's fees.

c. Case was settled in July 2010.

2. *Hyatt v. FTB*, Nevada District Court Case No. A382999 (2008)

a. In August 2008, a Clark County, Nevada jury rendered a verdict in favor of plaintiff and awarded $388 million in damages, including $1.1 million for attorney's fees.

b. FTB filed an appeal with the Nevada Supreme Court.

c. Oral arguments in the Nevada Supreme Court were heard on May 7, 2012 and June 18, 2012.

3. Senate Bill No. 342 (SB 342) was introduced in 2011 and would have banned contingent fee tax cases. Although the bill was aimed at enterprise zone and research and development credit cases, the bill would have prohibited contingent fees for services rendered on any matter involving state tax law, including matters before the SBE, FTB and assessment appeals boards.

a. SB 342 also would have limited the recovery of attorney's fees for taxpayers in cases with the FTB to awards under RTC § 19717. It would have specifically excluded awards under the private attorney general doctrine in such cases.

b. The bill died in committee.

B. Limited Liability Company Issues

1. *Northwest Energetic Services, LLC v. FTB*, 159 Cal. App. 4th 841 (2008)

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 (San Francisco Superior Court No. CGC-05-437721, March 3, 2006).

b. The LLC in *Northwest Energetic* was a Washington state LLC that registered to do business in California, but never had any sales, property, payroll or other activity in California.

c. While the court's decision appears to conclude that the LLC fee is unconstitutional and cannot be imposed on any LLC, including those with California activities, it remains uncertain whether a California court would be as willing to conclude the fee is unconstitutional for an LLC that generated all, or most, of its income from California sources.

d. On appeal, the Court affirmed but reversed and remanded the case to the trial court on the issue of attorney's fees. The FTB did not seek review of the LLC fee issue by the California Supreme Court.

e. On April 14, 2008, the FTB issued Notice 2008-2 summarizing the information needed for taxpayers filing claims for refund based on the *Northwest Energetic* decision.

f. For taxable years beginning on or after January 1, 2007, legislation was enacted that provides that total income from all sources reportable to California means gross income, plus cost of goods sold, derived from or attributable to California within the meaning of specified provisions of the Corporation Tax Law relating to apportionment and allocation.

2. *Ventas Finance I, LLC v. FTB*, 165 Cal. App. 4th 1207 (2008)

a. Similar to *Northwest Energetic*, the trial court concluded the LLC fee under RTC § 17942 was an unfairly apportioned tax (San Francisco Superior Court No. CGC-05-440001, November 7, 2006).

b. The court concluded that RTC § 17942 could not be reformed to add an apportionment mechanism since that was contrary to the Legislature's intent.

c. The taxpayer had approximately 10 percent of its revenues from California sources.

d. On appeal, the Court of Appeal affirmed the unconstitutionality of the fee but reversed the trial court's determination that the company was due a refund for the entire amount of the fee it paid.

e. On September 19, 2008, the taxpayer filed a petition for review with the California Supreme Court.

f. Plaintiff's petition for review was denied on November 13, 2008.

g. On April 6, 2009, the U.S. Supreme Court denied plaintiff's petition for a writ of certiorari.

3. *Bakersfield Mall LLC v. FTB*, San Francisco Superior Court No. CGC-07-462728

a. A limited liability company that does business solely within California filed suit challenging the constitutionality of the LLC fee.

b. The court denied class status for LLCs that derive all income from within California.

c. Discovery has revealed that the taxpayer may have conducted business both within and outside California, and, as such, this case may be controlled by *Ventas*. See Senate Committee Bill Analysis of SB 342 (Apr. 25, 2011).

d. The court overruled the FTB's demurrer and the case is currently pending in trial court.

4. *CA-Centerside II, LLC v. FTB*, Fresno Superior Court No. 10CECG00434

a. Suit is substantially similar to that originally filed in *Bakersfield*.

b. The FTB challenged the attempted class-action certification. The trial court has not certified the case as a class-action, and the Court of Appeal declined the FTB's petition for a writ directing the trial court to throw out the class-action portion of the lawsuit.

c. The court overruled the FTB's demurrer and the case is currently pending in trial court.

5. *Bunzl Distribution v. FTB*, San Francisco Superior Court No. CGC-10-506344

a. Pending case involving issue whether a nonresident corporate member of a single-member LLC, which is a "disregarded entity" that conducts business in California, is a California taxpayer solely as a result of its membership interest in the LLC.

b. Suit also alleges that the policies and/or procedures of the FTB Settlement Bureau violate the statutory settlement rules and constitute improper underground regulations.

6. FTB Legal Ruling 2011-01 (Jan. 11, 2011)

a. FTB ruled that the sole owner of a disregarded entity "doing business" in California is "doing business" in California even if the owner has no activities in the State other than those of its disregarded entity.

b. Disregarded entities include single-member LLCs and qualified Subchapter S subsidiaries (QSubs).

C. Business/Nonbusiness Income

1. *ComCon Production Services I, Inc. v. FTB*, LA Superior Court No. BC489779

    a. On February 2, 2012, the SBE ruled that a break-up fee from a failed merger was business income and that the taxpayer was engaged in a single unitary business with a majority-owned corporation. *Comcast Cablevision Corp.*, SBE Case No. 424198.

    b. Taxpayer filed suit in Los Angeles Superior Court on August 6, 2012.

2. *Crane Co. & Subsidiaries*, SBE Case No. 357027 (June 30, 2009)

    a. In a summary decision, the SBE determined that a taxpayer's gain from the sale of stock in an affiliate in which the taxpayer owned a 49 percent interest is apportionable business income under the functional test.

    b. The SBE found that the stock was purchased pursuant to a strategic business relationship.

    c. Taxpayer conceded that the acquisition and disposition of the stock was an integral part of its business.

    d. Taxpayer argued that the element of management was lacking.

    e. Taxpayer also conceded that the sale of the assets of its wireless business sold as part of a package with the sale of stock in issue generated business income.

3. *Imperial, Inc.,* SBE Case Nos. 472648 and 477927 (July 13, 2010)

    a. In a summary decision, the SBE determined that the gain from goodwill on the sale of a corporation's assets is business income.

    b. The SBE also ruled that the gross proceeds from the sale should be excluded from the sales factor, because the sale resulted in substantial gross receipts from an infrequent, occasional sale of property that was used in the business. See FTB Regulation 25137(c)(1)(A).

4. *Levi Strauss & Co. and Levi Strauss Associates, Inc.,* SBE Case No. 547505

    a. Pending SBE appeal involving issue whether interest and other expenses incurred in connection with a leveraged buyout (LBO) of a California corporation's stock are nonbusiness expenses wholly allocable to California.

b. Issue is similar to that raised in *Esprit de Corp.*, SBE Case No. 48986 (Apr. 20, 2001), in which the SBE determined that LBO interest expense was a nonbusiness expense.

c. Prior to the SBE hearing, the case settled.

5. *Rheem Manufacturing Company*, SBE Case No. 485872 (2010)

a. The SBE ruled that the FTB properly classified a manufacturing company's sale of stock in a distribution company as business income because the ownership of the stock was integral to the taxpayer's strategic business relationship with the distribution company.

6. *Pacific Bell Telephone Company & Affiliates*, SBE Case No. 521312 (2011)

a. On September 20, 2011, the SBE ruled that the 2001 and 2002 income from Pacific Bell's investments in seven foreign phone companies was nonbusiness income.

7. *Mercedes-Benz USA Inc. v. FTB*, Sacramento Superior Court Nos. 34-2012-00116949 and 34-2012-00124506

a. Cases involve issues whether income generated by pension assets is nonbusiness income and whether taxpayer was engaged in a single unitary business with another entity.

8. FTB Legal Ruling 2012-01

a. The FTB ruled on the business/nonbusiness characterization on the taxpayer's sale of stock in a corporation under various scenarios. Referring to *Occidental Petroleum*, 83-SBE-119 (June 21, 1983), the FTB concluded that the frustration of the taxpayer's intended purpose for the acquisition of the stock was not a determining factor. Rather, the FTB considered the actual operational ties between the taxpayer and the corporation, and the significance of those ties, to be the most important.

D. Intercompany Transactions

1. The FTB held interested parties meetings on April 21, 2010, September 22, 2010 and August 16, 2011 regarding possible amendments to Regulation 25106.5-1 relating to intercompany transactions between members of a combined reporting group.

a. FTB has proposed amendments to specify that a taxpayer that makes an election under Regulation 25106.5-1(e) to currently

recognize intercompany income/loss on a separate basis shall not include the gross receipts related to such income in the sales factor in the year of the election.

b. FTB also has proposed amendments to address certain issues relating to the FTB's deferred intercompany stock account (DISA) provisions. Under the FTB's current DISA rules, gain from distributions in excess of basis is deferred until a triggering event occurs (e.g., member leaves the combined reporting group). FTB has proposed amendments to state that (1) a "brother-sister" merger between members of a combined reporting group will not trigger the recognition of a DISA, (2) a distribution through various tiers of subsidiaries should not trigger more than one DISA and (3) subsequent capital contribution may reduce DISA balances.

2. FTB Chief Counsel Ruling 2012-02

a. The FTB ruled that gain from the sale of a partnership interest by a member of a combined reporting group to a unitary partnership is not subject to the gain deferral rules under Regulation 25106.5-1. Instead, the gain should be currently recognized in the year of sale.

3. FTB Notice 2009-1 (Feb. 20, 2009)

a. The FTB announced that it is enforcing the requirement under Regulation 25106.5-1 that taxpayers annually disclose their DISA balances to the FTB (Form 3726). Failure to do so can result in the FTB, in its discretion, requiring that undisclosed DISA amounts be taken into account in any year of such failure.

E. Nexus

1. New "Economic" Nexus Standard

a. The definition of "doing business" under RTC § 23101 is amended.

b. For taxable years beginning on or after January 1, 2011, a taxpayer is doing business in this state if any of the following conditions has been satisfied:

(1) The taxpayer is organized or commercially domiciled in this state;

(2) Sales of the taxpayer in this state exceed the lesser of $500,000 or 25 percent of the taxpayer's total sales;

(3) The real property and tangible personal property of the taxpayer in this state exceed the lesser of $50,000 or 25 percent of the taxpayer's total real property and tangible personal property;

(4) The amount paid in this state by the taxpayer for compensation exceeds the lesser of $50,000 or 25 percent of the total compensation paid by the taxpayer.

c. However, in the Assembly Floor analysis for the bill (AB X3 15), it is stated that because of federal law, nexus "does not currently, and would not under this measure, extend to companies whose only connection is that they sell tangible property in the state."

2. FTB Chief Counsel Ruling 2012-03

a. The FTB ruled that foreign sales of tangible personal property (TPP) should not be thrown back to the California sales factor numerator where the taxpayer has more than $500,000 of TPP sales in the foreign jurisdiction, because it would be taxable in such foreign jurisdiction under RTC § 25122 and California's new doing business standard.

(1) The FTB concluded that for years beginning on or after January 1, 2011, the new doing business standard in RTC § 23101(b) will be applied to determine if the taxpayer is taxable in the destination jurisdiction.

(2) The FTB specifically noted that the ruling does not address the question whether a corporation is taxable in the destination jurisdiction prior to January 1, 2011, if one of the conditions under RTC § 23101(b) is met.

b. Similarly, the FTB also ruled that domestic sales of TPP to a state should not be thrown back to the California sales factor numerator where taxpayer's unitary affiliate has more than $500,000 of sales in that state.

3. *Harley-Davidson, Inc. v. FTB*, San Diego Superior Court No. 37-2011-00100846

a. Case involves issue whether certain corporate subsidiaries are not taxable in California due to the lack of nexus with the State.

4. In Legal Ruling 2011-01, the FTB ruled that mere ownership of a disregarded entity creates California franchise tax nexus. See Section VII.B.6 above.

F. Miscellaneous FTB Chief Counsel Rulings

1. IRC § 355 transactions

a. In Chief Counsel Rulings 2009-1 and 2009-2, the FTB analyzed various transactions to determine whether the subject entities were engaged in the active conduct of a trade or business within the meaning of IRC § 355(b), as in effect prior to its amendment under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA). The FTB concluded that, due to California's lack of conformity to TIPRA at the time of the ruling, the pre-TIPRA active trade or business requirement would need to be satisfied under pre-TIPRA IRC § 355(b) for California purposes.

2. Investment partnerships

a. In California, the taxable income of a nonresident or out-of-State corporation from sources within the State does not include dividends, interest or gains/losses from "qualifying investment securities" of an investment partnership if certain requirements are met. RTC §§ 17955, 23040.1.

b. "Qualifying investment securities" include, without limitation, common and preferred stock, bonds, debentures and other debt securities, foreign and domestic currency deposits or equivalents, stock and bond index securities, various forward/futures contracts, options and other securities.

c. In Chief Counsel Ruling 2010-1, the FTB concluded that commodity-linked derivatives are "qualifying investment securities."

d. Similarly, in Information Letter 2010-4, the FTB concluded that derivatives could be included in the definition of "qualifying investment securities," noting that the reference to "stock and bond index securities" encompasses derivatives.

G. Right to Jury Trial

1. On June 6, 2011, the California Supreme Court ruled in *FTB v. Superior Court (Gonzales),* 51 Cal. 4th 1006, that the taxpayer did not have the constitutional right to a jury trial in an action for refund of taxes. A petition for rehearing was denied and the jury trial issue is final.

H. Qualified Small Business Stock

1. On August 28, 2012, the Court of Appeal held in *Cutler v. FTB*, __ Cal. App. 4th __ (2012), that California's deferral of capital gain from the sale of qualified small business stock (RTC §§ 18038.5, 18152.5) violated the Commerce Clause because it was available only to taxpayers that invested in corporations that did a substantial portion of their business in California. The case was remanded to the trial court to determine whether other requirements for qualified small business stock were satisfied.

VIII. Legislative Updates and Ballot Measures

A. 2012 Legislation Enacted

1. SB 1015 (June 27, 2012)

   a. California repealed all provisions relating to the Multistate Tax Compact while *Gillette* was pending in the Court of Appeal. See Section I.A.9 above.

   b. The Legislature also declared, as a matter of existing law, that the "doctrine of election" provides that an election affecting the computation of tax must be made on an original timely filed return for the taxable period for which the election is to apply.

   c. The validity of SB 1015 is in question because of Proposition 26. See Section VIII.E.3 below.

2. AB 2026 (September 30, 2012)

   a. State's film tax credit is extended through July 1, 2017.

3. AB 2323 (September 29, 2012)

   a. State Board of Equalization is required, for cases with disputed amounts of at least $500,000, to publish written formal opinions, written memorandum opinions or written summary decisions within 120 days of the date the Board rendered its decision.

B. AB X3 15 (February 20, 2009)

1. New "Economic" Nexus Standard. See Section VII.E.1 above.

2. Apportionment Formula and Sales Factor Issues

   a. Single sales factor election. See Section I.A.4 above.

   b. Statutory amendment to definition of gross receipts. See Section I.A.3 above.

c. *Finnigan* returns (again). See Section I.A.6 above.

3. Motion Picture Production Credit. See Section II.D.1 above.

4. Small Business Hiring Credit. See Section II.D.2 above.

C. AB 1452 (September 30, 2008)

1. NOL Carryback

a. RTC § 24416 is amended to conform to the federal NOL carryback rules for NOLs attributable to taxable years beginning on or after January 1, 2011, with some modifications including the following:

(1) Allow an NOL to be carried back only 2 years;

(2) Limit the amount of NOL carryback attributable to taxable year 2011 to 50% of the NOL;

(3) Limit the amount of NOL carryback attributable to taxable year 2012 to 75% of the NOL;

(4) Disallow NOL carrybacks to any taxable year beginning before January 1, 2009.

2. NOL Suspension

a. NOL deductions suspended for taxable years 2008 and 2009 for a taxpayer with income subject to tax of $500,000 or more. RTC § 24416.9.

b. Senate Bill No. 858 (October 19, 2010) extended the suspension of NOL deductions to the 2010 and 2011 taxable years, except for taxpayers with preapportioned income of less than $300,000. RTC § 24416.21.

c. See FTB Legal Ruling 2011-04 regarding guidance on the NOL suspension and extension of carryover periods.

3. Credit Assignment

a. See Section II.B.3 above.

D. Proposed Legislation (2012 Legislative Session)

1. Mandatory single sales factor apportionment for most multistate corporate taxpayers for taxable years beginning on or after January 1, 2012 failed to pass (Assembly Bill No. 1500).

E. Election Results of Ballot Measures of Note (effective November 3, 2010)

1. Proposition 24: Voters defeated a measure to repeal recent legislation that would allow businesses to carry back losses, share tax credits among affiliated corporations and elect to use a single sales factor apportionment formula.

2. Proposition 25: Voters approved a measure to change the legislative vote requirement to pass a budget from two-thirds to a simple majority. The two-thirds vote requirement for taxes would be retained.

3. Proposition 26: Voters approved a measure to increase the legislative vote requirement to two-thirds for state levies and charges by expanding the definition of a "tax" subject to the two-thirds vote. In addition, any tax adopted after January 1, 2010, but prior to November 3, 2010, that was not adopted by two-thirds vote will be void unless reenacted by November 3, 2011.

   a. The FTB issued Legal Division Guidance 2011-01-01 on the impact of the adoption of Proposition 26 on the FTB's enforcement of Senate Bill No. 401 (SB 401).

      (1) SB 401, which was enacted on April 12, 2010 and generally applies to taxable years beginning on or after January 1, 2010, conforms to various provisions of the Internal Revenue Code that were added or amended after January 1, 2005.

      (2) The FTB will enforce SB 401 at least until November 3, 2011 or until an appellate court rules otherwise.

F. Measures of Note on Upcoming November 2012 Ballot

1. Proposition 30: Measure would increase the state sales and use tax by 0.25 percent. The increase would be in effect from January 1, 2013 through December 31, 2016. The measure also would increase the personal income tax rate for the 2012-2017 taxable years for taxpayers with taxable income exceeding $250,000.

2. Proposition 31: Measure would prohibit legislation, including the Governor's budget, that reduces taxes by $25 million or more, unless another tax is increased or funding for an existing program is reduced or eliminated.

3. Proposition 38: Measure would increase personal income taxes for most taxpayers by imposing a surcharge, ranging from rates of 0.4 percent to 2.2 percent, for the 2013-2024 taxable years.

4. Proposition 39: Measure would require use of a single sales factor apportionment formula to determine California business income.

IX. Sales and Use, Property and Other Taxes

A. Sales and Use Tax

1. Technology Transfer Agreements

a. On January 18, 2011, the California Court of Appeal held in *Nortel Networks Inc. v. SBE*, 191 Cal. App. 4th 1259, that software licensed by a taxpayer to operate switching equipment was exempt from California sales and use tax under statutes regarding technology transfer agreements (TTA). The Court held that the SBE's attempt to limit the scope of the TTA statutes by excluding prewritten computer programs was an invalid exercise of the SBE's regulatory powers. The SBE's petition for review was denied on April 27, 2011.

b. On June 22, 2011, the SBE amended Regulation 1507 concerning TTAs to make it consistent with the holding in *Nortel*.

c. In light of *Nortel*, the SBE's Business Taxes Committee on August 24, 2011 approved conducting a study to evaluate the feasibility of developing an optional percentage to reasonably estimate the fair market value of tangible personal property sold with a TTA.

d. On March 20, 2012, the SBE approved the commencement of an interested parties process to discuss whether it is necessary to amend Regulation 1507.

e. On June 29, 2012, a discussion paper was issued by SBE staff.

f. On August 21, 2012, the SBE Business Taxes Committee met and concluded that additional information was needed before proceeding with the regulatory process.

2. Online Retailers

a. On June 28, 2011, Assembly Bill X1 28 (ABX1 28) was signed into law to impose a use tax collection obligation on retailers "engaged in business" in California, including those without direct physical presence in this State, as follows (RTC § 6203):

(1) Any retailer that has "substantial nexus" with California or upon whom federal law permits California to impose a use tax collection obligation;

(2) Any retailer that is (1) a member of a commonly controlled group, (2) and is also a member of a unitary combined reporting group for California income/franchise tax purposes and (3) the combined reporting group includes another member of the retailer's commonly controlled group that performs services in California in connection with tangible personal property (TPP) to be sold by the retailer; or

(3) Any retailer that has entered into an agreement under which a person in California, for a commission, refers potential purchasers of TPP to the retailer, including by weblink, subject to certain minimum sales thresholds.

b. Amazon sought to place a referendum on the ballot to overturn ABX1 28. On September 23, 2011, Governor Brown signed into law Assembly Bill 155 (AB 155), a compromise bill that deferred use tax collection for one year. The purpose of the postponement was to allow federal legislation to be enacted authorizing states to require the collection of sales and use taxes on sales of goods to in-state purchasers without regard to the location of the seller.

c. Because the above federal legislation was not enacted by July 31, 2012, AB 155 became operative on September 15, 2012.

d. Regulation 1684 Amended

(1) Retailer is presumed to be engaged in business in California if it has "any physical presence in California." Presumption is rebuttable if retailer can substantiate that its physical presence is so slight that the U.S. Constitution would prohibit a use tax collection obligation.

(2) Services are "performed in connection" with TPP to be sold by the retailer if the services help the retailer establish or maintain a California market for sales of TPP.

(3) Retailer can demonstrate that an agreement did not amount to solicitation of potential California customers if (1) the agreement prohibits engaging in any solicitation activities in California that refer potential customers to the retailer and (2) the counterparty certifies that no solicitation activities were engaged in California.

3. The SBE adopted new California sales and use tax audit procedures under Regulation 1698.5, which became effective on August 18, 2010. Regulation 1698.5 sets forth the new audit procedures to establish the

responsibilities of taxpayers and SBE staff and to ensure the completion of audits in a timely and efficient manner, including the expectation that sales and use tax audits be completed within a two-year period.

B. Property Tax

1. *Elk Hills Power, LLC v. California State Board of Equalization*, San Diego Superior Court No. 37-2008-00097074-CU-MC-CTL

   a. Case involves issue whether the SBE properly included the assumed costs of emissions reductions credits when valuing the taxpayer's property under RTC § 110.

   b. Trial court ordered summary judgment in favor of SBE. On May 10, 2011, the Court of Appeal affirmed.

   c. On August 24, 2011, the California Supreme Court granted the taxpayer's petition for review.

2. *Western States Petroleum Association v. SBE*, LA Superior Court, Case No. BC403167

   a. On April 27, 2010, a California trial court held that Property Tax Rule 474 is invalid. Rule 474 provides that in the valuation of petroleum refining properties, the land, improvements, and fixtures and other machinery and equipment classified as improvements, are rebuttably presumed to constitute a single appraisal unit. The court concluded that Rule 474 is inconsistent with the California statutes and violates Proposition 13 in that it was enacted to increase revenues by changing the method of computation of the tax, without the necessary vote of the Legislature.

   b. On January 19, 2012, the Court of Appeal affirmed, declaring Rule 474 to be invalid.

   c. On May 16, 2012, the California Supreme Court granted the SBE's petition for review.

3. *Charter Communications Properties v. San Luis Obispo County*, 198 Cal. App. 4th 1089 (2011)

   a. On August 30, 2011, the California Court of Appeal held that the county assessor properly valued a company's unexpired cable franchises using a reasonably anticipated term of possession that exceeded the remaining number of years on the franchise agreement. Based on Property Tax Rule 21, the Court affirmed the trial court's conclusion that the assessor demonstrated by "clear

and convincing evidence" that the parties to the franchise agreement had a mutual understanding that the term of the unexpired franchises would be longer than the term stated in the agreement.

4. *Chevron USA Inc. and Chevron Corporation v. County of Contra Costa*, Case No. MSC10-01390

   a. On September 8, 2011, a California trial court granted the taxpayer's motion for a judgment on the pleadings. RTC § 1615 requires a governmental entity to bring an action for judicial review of an assessment appeals board's (AAB) final determination within 6 months following a final determination. In this case, the AAB's final decision was made on November 19, 2009, and the taxpayer's complaint was filed on May 10, 2010. The Court ruled that the County's cross-complaint filed on October 12, 2010 and the City of Richmond's complaint in intervention filed on November 4, 2010 challenging the AAB's decision were both time-barred.

5. Proposed legislation

   a. Assembly Bill No. 832 (AB 832) would raise the burden of proof required by taxpayers claiming an exemption for software that is embedded or bundled with machinery and equipment. Taxpayers would need to show by "clear and convincing evidence" that they are entitled to the exemption. AB 832 appears to be in response to *Cardinal Health 301, Inc. v. County of Orange*, 167 Cal. App. 4th 291 (2008), in which the Court held that not all bundled software is taxable. AB 832 was not enacted.

   b. Split roll legislation was introduced under Assembly Bill No. 448 (AB 448), which would trigger more frequent reassessments of property owned by legal entities. AB 448 was not enacted.

C. Local Taxes

1. *Chevron v. City of Richmond,* Contra Costa Superior Court, Case No. C09-00491 (Dec. 16, 2009)

   a. City's business tax was held to be facially invalid under the Commerce Clause and the Internal Consistency Test. City's appeal was dismissed; case is now final.

2. *The Roman Catholic Archbishop of San Francisco, A Corporation Sole v. City and County of San Francisco*, San Francisco Superior Court, Case No. CGC-10-498795

a. Case involved the issue whether documentary transfer tax applies to a transfer of parish and school real property within the San Francisco Archdiocese pursuant to an internal corporate restructuring.

b. On January 26, 2010, the San Francisco Transfer Tax Review Board issued a written decision upholding the Recorder's determination that transfer tax was due.

c. On January 24, 2012, the trial court reversed the Review Board's decision. The trial court's order was not appealed.

3. San Francisco Gross Receipts Tax

a. Measure included on the November 2012 ballot that would phase out San Francisco's current payroll tax and implement an apportioned gross receipts tax.

b. Tax rates and apportionment rules would be determined by industry.